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COMMENTARY

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UNEMPLOYMENT INSURANCE COSTS AND AUDITS: WHAT TO DO

By Marcus Torrano and Melissa McIntosh

The Employment Development Department ("EDD") administers several programs that significantly impact California employers. This employment law commentary focuses on two of these programs: (1) the Unemployment Insurance Program and (2) the payroll tax audit program. It will focus on the procedural aspects of both programs and provide advice for reducing unemployment insurance costs, and preparing for an EDD tax audit.

Unemployment Insurance

The United States Department of Labor establishes guidelines for the administration of Unemployment Insurance ("UI") by the states, administers the UI fund, and provides oversight and guidance to the states. Each state administers a separate UI program within the federal guidelines. Each state's unemployment insurance law establishes UI benefits eligibility, and the amount and duration of benefits. See, e.g., Cal. Unemp. Insur. Code § 101. In most states, UI benefits are funded by employer taxes. See <http://ows.doleta.gov/unemploy/uifactsheet.asp>.

California's unemployment insurance program is administered by the EDD. Cal. Unemp. Insur. Code § 301. Most California employers pay a wage-based UI tax. Understanding EDD's policies and procedures regarding UI benefits can help an employer reduce UI taxes.

EDD Policies and Procedures Regarding UI Benefits

When a former employee files a UI claim, the EDD mails the claimant's last employer a *Notice of Unemployment Insurance Claim Filed, DE 1101CZ*. The employer has ten calendar days from the date this Notice is *mailed* to respond if it has reason to believe that the individual is *not* eligible for UI benefits. Any employer response must be in writing, and provide specific facts as to why the former employee is not entitled to UI benefits.

If an employer submits such a response, an EDD investigator will telephone the employer to determine the reason for the employee's discharge. Once the EDD has made its determination as to the claimant's eligibility for UI benefits, it mails the employer a written notice.

If an employer disagrees with the EDD's decision to grant benefits, it has the right to appeal, by submitting an *EDD Appeal Form, DE 1000M* or a letter of appeal within 20 calendar days of the date the *Notice of Determination and/or Ruling, DE 1080CT*, was mailed.

Eligibility for UI Benefits

It is important for the employer to understand the eligibility requirements for UI benefits so that it can adequately challenge a former employee's UI claim, if it chooses to do so.

Eligible for UI Benefits. A claimant is generally eligible for UI benefits if:

- Unemployed through no fault of his or her own (i.e. was laid off or voluntarily quit for good cause) and/or terminated for other than misconduct;¹
- Registered for work with the EDD;
- Physically able to work in his or her usual occupation, or an occupation for which he or she is reasonably qualified;
- Actively seeking work;
- He or she received wages during the base period; and
- He or she has complied with regulations in regard to filing a UI claim.

Not Eligible for UI Benefits. A claimant is generally not eligible for UI benefits if:

- He or she voluntarily quit without good cause;
- Was discharged for "misconduct;"²
- Is still receiving compensation from the employer; or
- Is reemployed.

Reducing Unemployment Insurance Costs

The UI tax rate for an employer depends, in part, on the employer's UI benefit "charges," which is the amount of UI benefits paid to former employees. There are other factors that contribute to a determination of the employer's tax rate, but an employer's benefit charges are one of the few factors over which the employer may be able to exercise some control.

By adhering to the following practices, an employer may reduce its unemployment insurance costs:

- Carefully screen applicants for employment.

- Document all incidents in which employees violate company policies and/or rules, including the dates the incidents occurred, and the dates of any resulting reprimand(s).
- Follow the company's policies to dismiss employees who engage in misconduct, and give all departing employees an exit interview.
- Mail a timely response to the EDD contesting a claimant's eligibility for UI benefits, when appropriate.
- Give detailed responses to an EDD interviewer's questions regarding a former employee's eligibility.
- Keep records of former employees receiving UI benefits and, when possible, offer reemployment to former employees who were good performers.
- Submit written information to the EDD about a claimant's refusal to accept appropriate, available work, if applicable.
- Audit EDD statements of charges to the employer's account for accuracy, and protest any mistakes.
- Make payment contributions in a timely manner.

It is our view that being aware of the foregoing procedures and guidelines regarding UI benefits, as well as following the above-described practices, should be of help to employers in regard to reducing UI taxes.

The Payroll Tax Audit

Administration of the Payroll Tax Audit

The EDD is authorized to conduct payroll tax audits of California businesses. The EDD's mandate is to educate employers regarding their tax obligations, and ensure sufficient funds to pay UI benefits. A payroll tax audit follows the process described below.

Payroll Tax Audit Process and Coverage

Entrance Interview. An EDD auditor typically telephones the employer to schedule an audit. The auditor will describe the audit process. The auditor will also gather basic information about the operation and organization of the business and the employer's accounting records.

Examination of Records. Audits are conducted on-site, and begin with an examination of the employer's records for a "test year," which generally is the last full year. If a review of the test year reveals discrepancies, or violations of law, the auditor will likely expand the review period to include records from prior years, generally up to a maximum of three years.

Scope of the Audit. An EDD auditor reviews employers' books and records to verify that all individuals paid for services have been properly classified as either employees or independent contractors. See "Are Your Independent Contractors Really Independent Contractors?" Morrison & Foerster LLP, *Employment Law Commentary*, Oct. 1998. The auditor makes this assessment by discussing with the employer the nature of the working relationship between the employer and each employee. In addition, the auditor will review facts he or she obtains from the employer's records, such as contracts, employee fringe benefits, and invoices. The auditor may also verify that each employee's gross wages and taxable wages have been properly reported, and that the employer has correctly withheld and reported personal income taxes for each employee.

Exit Interview. At the conclusion of the auditor's investigative work, the auditor reviews his or her findings with the employer, identifies any additional information to be provided, and attempts to resolve any disputed issues. To the extent the employer disagrees with the auditor's findings, it may request a "pre-assessment" conference with the auditor's supervisor.

Outcome of Audit. An audit will result in either a "no-change

audit"; or an overpayment, where a credit or refund will be issued; or an underpayment, where the taxes due will be assessed.

Appeal. An employer against whom an assessment has been issued will receive information about its appeal rights. The employer may petition for reassessment with the California Unemployment Insurance Appeals Board, or for a hearing before an Administrative Law Judge.

Employer's Ability to Expedite the Audit Process

It is typically in the employer's best interest to streamline the audit process as much as possible. To do so, the employer should ensure that the following records are made available to the auditor:

- company bank statements
- general ledger and general journal entries regarding paid wages
- annual financial statements
- cash payment records
- company ownership verification
- federal/state income tax filings
- form 1099 issuances to independent contributors

The EDD auditor sometimes also requires the employer to supply the following additional documents:

- payroll records, such as payroll journal, individual earnings records, payroll summaries, etc.
- federal employment tax reports
- state employment tax reports

Avoiding Assessments

An employer may face substantial liability if an audit reveals that the employer failed to pay the required taxes or misclas-

sified one or more employees as independent contractors. If the employer did not have good cause for its failure to pay, it must pay the contributions due and a penalty of 10 percent of the contributions. See Cal. Unemp. Insur. Code § 1112³. In addition, an employer who failed to make required contributions must pay interest on the delinquent contributions at the adjusted annual rate, which currently is 6 percent. See Cal. Unemp. Insur. Code § 1113.

With regard to the payment of taxes, an employer may avoid assessments simply by paying the required taxes in a timely manner, and keeping clean records to prove it. With regard to employee classification, if it is unclear whether an individual is an employee or an independent contractor, the employer should refer to the Employee Determination Guide DE 38, and its "Worksheet on Employment Status," which are available at the EDD website, <http://www.edd.ca.gov>. The employer may also wish to consult legal counsel. If an employer remains uncertain as to an individual's employment status, it may request a written determination of employment status from the EDD. To request a written determination, an employer may download the form Determination of Employment Work Status DE 1870 from the EDD website.

Conclusion

It is our hope that the foregoing will be useful to California employers who wish to reduce their UI tax costs and/or who face the prospect of an EDD tax audit. ■

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¹ Simple poor performance does not constitute misconduct for purposes of UI eligibility. For example, an employee who was discharged because of his or her mere inefficiency; unsatisfactory conduct; failure to perform as a result of inability, incapacity, inadvertence, or an isolated act of negligence; good faith error in judgment or discretion; or participation in illegal or criminal actions

while away from work may still be eligible to receive UI benefits. See Cal. Code Regs. tit. 22, § 1256-30(d).

² Examples of employee "misconduct" include: committing an act of dishonesty, such as lying, theft, or making false entries on records; intoxication or use of intoxicants; intentionally, knowingly, or deliberately failing to perform, or for performing in a grossly negligent manner; fighting on the job with co-workers or using offensive language in relations with co-workers. See Cal. Code Regs. tit. 22, § 1256-30, *et seq.*

³ "Good cause" exists where "the circumstances causing the delay are clearly beyond the control of the employer or where the delay was not reasonably foreseeable by the employer." For example, "catastrophic occurrences" such as fires or floods that destroyed an employer's records would give the employer good cause for failure to make the required contributions. See Cal. Code Regs. tit. 22, § 1114-1(2)(c).

This newsletter addresses recent employment law developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.


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