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When we last wrote about independent contractor misclassification two years ago, we headlined the article "Feds on the lookout for misclassification." The U.S. Department of Labor and IRS continue to aggressively enforce laws against misclassifying employees as independent contractors.

But a major shift has taken hold in the past two years, with state legislatures and regulators actively taking a greater role in cracking down on companies that classify workers as contractors without properly documenting or structuring their relationships with those individuals.

Indeed, companies that use freelancers, consultants, long-term temps and other contingent workers may now be in greater danger of violating state laws than federal statutes.

In the past two years alone, 11 states passed laws curtailing the use of independent contractors or increasing penalties for misclassification: California, Connecticut, Florida, Kansas, Maine, Nebraska, New York, Pennsylvania, Utah, Vermont and Wisconsin.

Ten states passed similar laws before 2010, bringing the number of states targeting misclassification to 21. In addition, at least 18 more state legislatures have proposed bills intended to make misclassification more costly.

Recent legislative action

One type of legislation getting a great deal of attention in the past two years is aimed at industries in which misclassification is regarded as prevalent.

Pennsylvania's Construction Workplace Misclassification Act, for example, went into effect in 2011. Like similar laws passed in New York and New Jersey, it's aimed at the construction industry. The Pennsylvania law significantly narrows the definition of an independent contractor, limits some construction contracting opportunities and imposes much stiffer penalties for violators.

California's Independent Contractor Misclassification Law has generated a great deal of notoriety. Enacted Jan. 1, 2012, it applies to all industries, imposing harsh financial penalties for companies that engage in "willful misclassification" of employees as independent contractors. How harsh? The minimum penalty for willful misclassification is $5,000 *for each violation of the law*—and the maximum is $15,000. Plus, there's a $25,000 penalty *for each violation* if the business has engaged in a "pattern or practice" of willful misclassification.

State regulatory initiatives

In many states, employers are subject to regulatory agency challenges to their classification of contractors, through audits by workforce and tax agencies.

For example, Pennsylvania's Office of Unemployment Compensation Benefits conducts several thousand random audits of businesses each year, in addition to audits of companies in industries known to be prone to contractor misclassification.

Regulatory offices in some states are drastically ratcheting up their audits. New York's Joint Enforcement Task Force on Employee Misclassification has conducted enforcement sweeps prompted by calls to a state misclassification hotline.

New York is just one of more than a dozen states with misclassification task forces. Others include Connecticut, Iowa, Maryland, Massachusetts, Michigan, Minnesota, New Hampshire, Oregon, Rhode Island, Tennessee, Utah and Washington.

Unemployment, WC claims

Another way in which regulatory agencies are cracking down on contractor misclassification is through the unemployment and workers' compensation claims process.

For example, local offices are more often than ever making initial determinations of "employee" status in benefit claims filed by individuals who have signed contractor agreements or are receiving compensation on a 1099 basis.

As the sluggish economy continues to lead to staffing reductions, more workers who have traditionally regarded themselves as contractors are nonetheless applying for unemployment benefits. And unemployment officials are granting benefits to many of them, after claims examiners find that those

workers were actually misclassified. As terminated employees, it turns out they are entitled to unemployment benefits.

That can be a devastating determination for employers.

If a business has not paid unemployment contributions to a state fund on behalf of such workers, that initial determination can have the same effect of a comprehensive audit if an administrative law judge or referee upholds the determination that the worker had been misclassified as a contractor. Typically, once one worker is found to have been misclassified, the business is then charged for unpaid contributions for "all similarly situated" workers, along with costly penalties and fines.

Takeaway for employers

In almost every state, bona fide use of contractors is legal, and a valuable and affordable way to supplement a company's workforce.

But all too often, the business's independent contractor structure is imperfect and the very contracting agreements that companies assume will protect them from misclassification liability are being used by state agencies as evidence of employee status.

For companies that have business models that make legitimate use of contractors, there are steps that can be taken to avoid or minimize misclassification liability: (1) undertaking a legal review of contractor classification compliance, and (2) taking steps to enhance compliance by properly structuring, documenting and implementing proper worker classifications.