VIA MESSENGER

November 30, 2007

The Honorable Henry Waxman, Chairman
House Committee on Oversight and Government Reform
2157 Rayburn House Office Building
Washington, DC 20515-6143

Dear Chairman Waxman:

As part of its response to your request issued on October 22, 2007, Blackwater has prepared the enclosed fourteen-page explanation regarding Blackwater’s treatment of its security personnel as independent contractors. This document addresses and responds to the allegations made in your October 22, 2007 letter.

As Blackwater continues to cooperate with the Committee’s review, it respectfully requests that the Committee afford the attached document the same level of public attention and consideration that the Committee afforded the letter you released on October 22, 2007.

Thank you for your attention to this matter.

Sincerely,

[Signature]

Stephen M. Ryan

cc: The Honorable Thomas M. Davis, III
Attn: Jennifer Safavian, Esq.
Mr. David Hammond, Esq.
BLACKWATER’S MODEL OF USING INDEPENDENT CONTRACTORS IS CONSISTENT WITH LAW AND GOOD PRACTICE.

Executive Summary

In an October 22, 2007, letter, Congressman Henry Waxman, the Chairman of the House Committee on Oversight and Government Reform, accused Blackwater Security Consulting, LLC ("Blackwater") of "significant tax evasion," claiming that Blackwater "violated federal tax laws" by treating its security personnel as independent contractors, rather than employees. Chairman Waxman fails to cite a single decision by a federal court or a precedential ruling from the Internal Revenue Service ("IRS") in support of his position. Instead, the Chairman's entire argument rests on a non-precedential form determination letter – a letter issued by a low-level IRS technician in response to an inquiry from a single disgruntled contractor. This is hardly the kind of foundation upon which to build such serious allegations. As further explained below, the Chairman's allegations are incorrect. Blackwater has fully complied with federal law.

Blackwater has more than 500 workers in the United States that it classifies as "employees" for tax purposes. These workers perform the kinds of jobs performed by workers throughout America. They include secretaries, IT professionals, paralegals, landscapers, and accountants. Along with the more than 500 employees, however, Blackwater also hires highly-specialized military veterans to serve as security for American officials throughout the world. These men and women only work several months at a time. They are deployed thousands of miles from home, often to war zones, where they are subject to the control, supervision, standards, and protocols of the United States government. It is these workers Blackwater classifies as independent contractors. One result of this classification is that the applicable income, unemployment, Medicare, Medicaid, and other taxes are paid to the U.S. Government via the tax returns of the contractors rather than Blackwater.
Contrary to the Chairman’s allegation, this classification is in complete compliance with federal law. Section 530 of the Revenue Act of 1978 - a provision not discussed in the Chairman’s letter - provides a Congressionally approved “safe haven” for a business that considers its personnel “independent contractors” as long as the business has a “reasonable basis” for doing so. A taxpayer has a “reasonable basis” if, among other things, it acts in reliance on the advice of an accountant.

Blackwater’s decision to treat its security personnel as independent contractors falls within the scope of Section 530’s “safe haven” and is not, therefore, “tax evasion.” First, when it decided to classify its security personnel, Blackwater obtained the advice of a large, nationally-recognized accounting firm on this issue. Over the years, it has relied upon that advice to develop and extend its policy on the treatment of its security personnel. Second, since that time, it has received further legal analysis from a law firm confirming that it is entitled to the protections of Section 530. Though the Chairman’s letter does not address Section 530, that provision proves that Blackwater has complied with the law.

So, too, Blackwater’s decision to treat its security personnel as independent contractors is good practice. For both Blackwater and its personnel, the independent contractor model provides the kind of flexibility that the employer/employee relationship does not. Most contractors being sent into a war zone do not wish to sign on for years on end. Instead, they prefer to have the flexibility to schedule their work in a way that is convenient for them and their families. Under Blackwater’s system, they can do just that. Such a system also benefits the government. Without having to force personnel to serve for years in a war zone, Blackwater can greatly reduce burnout, thereby providing more effective service to its government partners. For
all involved, therefore, the model works. Just as with thousands of other businesses, Blackwater's use of independent contractors is a reasonable, effective, and legal business model.

Blackwater takes its obligations under the Internal Revenue Code very seriously. Over the years, it has satisfied its required federal tax filing obligations and paid the government the taxes that it owes. When Blackwater classified its security personnel as independent contractors, it acted in compliance with the law and in a manner that made sense for its business and its workers. Any allegations to the contrary are incorrect.
I. Blackwater Is Entitled to Section 530's "Safe Haven" For Those Employers With a "Reasonable Basis" For Treating Their Personnel As Independent Contractors.

Although Chairman Waxman's letter spans 13 pages, he never once cites the guiding legal provision: Section 530 of the Revenue Act of 1978, Pub. L. No. 95-600. That provision came into existence in response to what Congress perceived as overly aggressive efforts by the IRS to reclassify independent contractors as employees. Section 530 established a moratorium on the reclassification of workers as employees for federal employment tax purposes if the taxpayer had a "reasonable basis" for treating the workers as independent contractors. Originally intended as an "interim" relief measure while Congress studied the issue, Section 530 was soon extended indefinitely by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248.

In simple terms, Section 530 provides a "safe haven" for a business that classifies its personnel as "independent contractors" for tax purposes as long as the business has a "reasonable basis" for doing so. A taxpayer has a "reasonable basis" if its treatment of the worker as an independent contractor was in reasonable reliance on (A) judicial precedent, published rulings, technical advice or a letter ruling to the taxpayer, (B) a past Internal Revenue Service audit in

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1 See Tax Administration Problems Involving Independent Contractors, H.R. No 101-979, 101st Cong., 2d Sess. (November 9, 1990). This report cites to a GAO report which concluded that the 20-factor common law test developed by the IRS in Rev. Rul. 87-41, 1987-1 C.B. 296 to make classification decisions is extremely subjective and is often inconsistently applied by the IRS. See also testimony by Commissioner Richardson and Assistant Treasury Secretary Lubick before the Ways and Means Oversight Subcommittee on June 20, 1996. In announcing the hearing, Subcommittee Chairman Nancy L. Johnson said that the subcommittee would examine current problems with regard to classification of workers for tax purposes, including the IRS's handling of employment tax audit issues and reasons for its failure to liberally construe and administer the safe harbor rules created by Section 530. The subcommittee considered whether the IRS's recent worker classification initiatives (i.e. the settlement program, revised training materials, and appeals policy changes) adequately addressed perceived problems in this area. At the hearing, Commissioner Richardson testified that the IRS in recent months has adopted the posture that selecting the independent contractor status is "a valid business choice." Toward that end, she implemented a new approach to classification cases, including the retraining of IRS examiners, and making the retraining materials available for public comment; adoption of a classification settlement program, with a more lenient penalty procedure for qualifying cases; and the involvement of the national office in all large worker classification projects.
which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual\(^2\); or (C) long-standing recognized practice of a significant segment of the industry in which such individual was engaged.\(^3\) A taxpayer who does not meet any of the three "safe havens" may nevertheless still obtain legal protection if it can demonstrate, in some other manner, a reasonable basis for treating the individual as an independent contractor. As Congress has explained, a "reasonable basis" should be construed liberally in favor of the taxpayer. H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. 5 (1978), 1978-3 (Vol. 1) C.B. 629, 633.

Without question, Blackwater meets the requirements of Section 530, and is, therefore, entitled to treat its security personnel as independent contractors. Blackwater has consistently filed all required Forms 1099 MISC for its security personnel and has not treated these individuals as employees. In addition, several years ago, it consulted a large nationally-recognized accounting firm regarding the treatment of its personnel. It relied upon the advice of this accounting firm to develop and extend its policy on the treatment of its security personnel as independent contractors. Shortly after receiving the October 22, 2007, letter from Chairman Waxman, Blackwater again consulted with this accounting firm and received consistent advice.

This accounting firm is not the only tax professional that agrees that Blackwater is entitled to the protections provided by Congress under Section 530. In May of this year, Blackwater retained the services of a law firm to represent it in a matter before the IRS. In a filing with the IRS, that law firm concluded that Blackwater had reasonably and correctly

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\(^2\) For audits commenced after December 31, 1996, a taxpayer may not rely on an audit unless the audit included an examination for employment tax purposes of whether the individual involved (or any individual holding a position substantially similar to the position held by the individual involved) should be treated as an employee of the taxpayer.

\(^3\) In no event shall the significant segment requirement be construed to require a reasonable showing of the practice of more than 25 percent of the industry (determined by not taking into account the taxpayer). Section 1122 of the Small Business Administration Job Protection Act, Pub. L. No. 104-108.
classified its workers as independent contractors and, therefore, was entitled to the protections of Section 530’s “safe haven.” (Exhibit A).

Finally, the Small Business Administration ("SBA"), as part of a routine size determination, considered whether certain Blackwater security workers should be classified as independent contractors. The SBA applied its own standards, including the criteria used by the IRS in making its determination. It found that the workers in question were properly classified as independent contractors. Although the SBA size determination is for government procurement purposes, this determination further validates Blackwater’s prior classification of its deployed professionals as independent contractors for tax purposes.

For these reasons, Blackwater’s decision to classify its security workers as independent contractors was a reasonable one, entitled to protection under Section 530’s safe haven. Based on this provision alone, Blackwater has no underpaid employment taxes and it may continue to classify its security workers as independent contractors.

II. In His Letter, The Chairman Incorrectly Relies On An Unreliable SS-8 Determination Letter.

Rather than apply Section 530, Chairman Waxman’s letter relies, instead, on a form letter written by an IRS technician from a field office. There are significant problems, however, with the Chairman’s reliance on such a document.

A. The SS-8 Determination Is Unreliable.

First, the SS-8 determination letter relied on by the Chairman has little, if any, legal effect. As the letter itself states, it “may not be used or cited as precedent.” (Exhibit B, at 5). Unlike letter rulings issued by the IRS National Office involving common law issues, these SS-8 determinations are not published. They are not considered an examination, and therefore no assessment of employment taxes can be made based upon a conclusion reached in one of these
letters. Compared to Section 530, a well-established, reliable, and Congressionally-imposed “safe haven” designed for cases like this one, an SS-8 determination letter is of significantly less legal weight.

B. The IRS Field Office Did Not Have a Full and Open Adversarial Process Before Issuing Its Determination.

Second, the SS-8 determination letter was not the result of a full and open adversarial process. The IRS determination was not the result of a lawsuit or even a formal administrative proceeding. Instead, it was the result of a request from a contractor who, in an effort to obtain a determination of his status for tax purposes, completed a Form SS-8 and filed it with the tiny IRS SS-8 office in the small town of Newport, Vermont. Nothing more.

Unfortunately, these SS-8 determinations are frequently one-sided. In this case, for instance, the IRS field office made its decision based only upon information provided by the worker. Occasionally, individuals classified as independent contractors become disgruntled and file SS-8 Forms with the hope that the IRS will grant them a tax refund. Many are motivated to provide one-sided or, in some cases, completely fabricated factual assertions in order to obtain a ruling that they are employees. There is little to stop them from doing so since, unlike other requests, there is no fee for obtaining an SS-8 determination.

In the present case, the IRS provided Blackwater with little meaningful opportunity to participate in the process. At the time of the determination, Blackwater had not seen the facts provided by the independent contractor and had no way to evaluate whether the contractor's answers were accurate and complete. At no time during the process was Blackwater afforded the opportunity to explain or explore any bias or motivation on the part of the contractor making the request. To make matters worse, the IRS did not even acknowledge Blackwater's own position on the matter when it issued its determination on March 30, 2007. Blackwater's responses to the
questions on the Form SS-8 were provided to the IRS on March 29, 2007. (Exhibit C). The IRS letter at issue, however, was dated March 30, 2007 and did not reference any of Blackwater’s facts or analysis. (Exhibit B).

At that point, Blackwater had only one option: to request that the IRS reconsider its findings. With the assistance of tax counsel, Blackwater submitted a request for reconsideration to the Internal Revenue Service Office in Newport, Vermont, on May 15, 2007. (Exhibit A). Consistent with the advice that Blackwater received from its tax advisors, this legal submission concluded that Blackwater’s decision to classify its workers as independent contractors both fell within Section 530’s “safe haven” and was correct under the “20-factor test” established by the IRS and frequently used by the federal courts. (Exhibit A). To date, the IRS field office has neither responded to Blackwater’s submission nor altered its one-sided March 30, 2007, determination letter.

C. The IRS Technician Made Several Significant Errors In the SS-8 Letter.

The SS-8 determination letter relied on by the Chairman is riddled with legal and factual errors. Some of these errors are obvious. The IRS technician reached a conclusion without reviewing or considering Blackwater’s own filings in the case; and, when faced with a legal opinion that Blackwater’s decision was correct, the technician remained mute. Standing alone, these errors are sufficient to undermine the reliability of the SS-8 determination. Nonetheless, the IRS technician made several other significant missteps that cast doubt on the Chairman’s sole reliance on the SS-8 determination letter.

First, the technician failed to properly apply the IRS’s own training materials on two of the three testing elements that the IRS now employs when deciding whether a worker is an

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4 In fact, a company does not even have a right to appeal an SS-8 determination letter. The company in Blackwater’s position is limited to requesting that the IRS reconsider its conclusion.
independent contractor. *See Independent Contractor or Employee? Training Materials* ("IRS Training Materials") Training 332-102 (10-96) TPDS 84238I. The IRS Training Materials mandate that the IRS’s approach to worker classification focuses on three elements: (1) Behavioral Control, (2) Financial Control, and (3) Intent of the Parties. *Id.* at 2-7. On the issues of “behavioral control” and “intent of the parties” the technician misapplied IRS guidance.

Although Blackwater retains some degree of control over its independent contractors, most if not all of the operational controls over Blackwater’s contractors are either carried out or imposed by the United States government. In fact, under the contract with the Department of State at issue in the IRS determination letter, the government required Blackwater to impose significant conditions and controls on its contractors.\(^5\) Under that contract, the United States government established or controlled: the selection, qualifications, and performance of security professionals; their work assignments; the rules, regulations, and manner in which they can operate in a war zone; where they live; and even their off-duty conduct. (*Exhibit D,\(^6\) at ¶ C.3 – C.4). Blackwater’s contract with the Department of State provides that a “[federal Agent-in-Charge ("AIC")]] will have on-site authority over the operational units.” (*Exhibit D, at ¶ C.7.1*).

Likewise, Blackwater’s subsequent WPPS contract with the Department of State provides that “[t]he Contractor shall ensure that all work performed under this contract is accomplished with the applicable standards/standard operating procedures, general orders and specific orders issued by [the Department of State] . . . .” WPPS Contract (No. S-AQMPD-05-D-1098) ("WPPS II Contract"), SOW at ¶ C.4.1.1. Under the established contract terms and protocols, therefore, the government imposed the vast majority of the operative controls.

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\(^5\) When it executed these contracts and imposed these controls, the Government knew that Blackwater treated the contractors as independent contractors.

\(^6\) Exhibit D contains the relevant portions of the Worldwide Personal Protective Services ("WPPS") Contract (No. S-AQMPD-04-D-0061) ("WPPS I Contract) Statement of Work ("SOW").
In making his determination, the IRS technician failed to consult the IRS’s own internal position on controls imposed by governmental agencies. In discussing the Behavioral Control element, the IRS has specifically addressed the relevance of controls imposed or otherwise mandated by governmental agencies such as the State Department. If a business requires its workers to comply with rules established by a governmental agency, “the fact that such rules are imposed by the business should be given little weight in determining the worker’s status.” IRS Training Materials at 2-11. For this reason, the technician misapplied the IRS training materials on the issue of “behavioral control.”

The technician also misapplied IRS training materials on the issue of “intent of the parties.” In this case, the parties voluntarily signed a contract expressly classifying the worker as an independent contractor, not an employee. Under the IRS training materials, the contract is evidence of the parties’ intent that an independent contractor relationship was formed. In close cases, in fact, the contractual designation not only has merit, but is “very significant.” IRS Training Materials at 2-22; see Ill. Tri-Seal Products, Inc. v. United States, 353 F.2d 216, 218 (Ct. Cl. 1965).

Unfortunately, the technician ignored this clear guidance as well. Instead, the technician stated that “any contractual designation of the employee as a partner, coadventurer, agent or independent contractor must be disregarded.” (Exhibit B, at 2). It is true that the parties cannot create an independent contractor relationship merely by saying so, if all other evidence compels the conclusion that the worker is an employee. But, that is not the case here. An accounting firm

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In fact, the contracts are entitled “Independent Contractor Service Agreement.” The recitals section of the contract reads, “Whereas, Blackwater desires to engage Contractor . . . and Contractor desires to provide those services to Blackwater as an independent contractor.” The contract explicitly defines this relationship in a section entitled Independent Contractor Relationship, “[c]ontractor acknowledges that it is solely an independent contractor . . . Contractor may practice his or her profession for others . . . during those periods when Contractor is not providing services.”
and a law firm have concluded that Blackwater had a reasonable basis for its determination that its worker was an independent contractor (Exhibit A), the 20-factor test shows that Blackwater’s designation was correct (Exhibit A), and the contracts between Blackwater and its personnel clearly state that the workers are independent contractors. In such a case, the intent of the parties not only matters, but is “very significant.” Ill. Tri-Seal, 353 F.2d at 218.

Finally, the technician did not consider the many cases relied upon by Blackwater in its common law analysis. In assessing whether a business has properly classified a worker as an independent contractor, the IRS typically applies its “20-factor test.” In fact, in its letter request for reconsideration, Blackwater’s outside tax counsel exhaustively analyzed this test and the case law that applies it, concluding that Blackwater’s security workers are independent contractors, not employees. (Exhibit A, at 7-15). Instead of applying this case law, however, the technician inappropriately relied on three very old IRS revenue rulings relating to driving instructors, car rental agencies and used car dealers. All predate Section 530. In fact, the most of recent of these rulings is almost 40 years old.

When ruling on the SS-8 determination in this case, the IRS technician did not apply Section 530, did not mention an exhaustive 15-page analysis of the issue by Blackwater’s tax counsel, misapplied the IRS training guidance, and overlooked relevant case law. A decision fraught with such legal, factual, and procedural errors is not entitled to any deference. Perhaps that is why the IRS itself has indicated that such a determination is not precedential. For the same reasons, Chairman Waxman was wrong to use that decision as his sole basis for a public allegation of “tax evasion.”
III. Blackwater’s Treatment of Its Workers As Independent Contactors Did Not Result In An Underpayment of Taxes.

In his letter, Chairman Waxman stated that Blackwater’s classification of its workers as independent contractors somehow resulted in a massive underpayment of federal taxes. Once again, the Chairman’s claim is incorrect.

Treatment of the workers as independent contractors does not result in employment taxes being underpaid to the Department of Treasury. Whether Blackwater’s workers are employees or independent contractors, all employment taxes are still owed and are paid to the Department of the Treasury. If the workers are employees, Blackwater merely acts as the intermediary or conduit temporarily holding trust fund taxes on behalf of the workers and the United States. If the workers are independent contractors, however, then the contractors themselves must pay these taxes to the United States directly.\(^8\) The issue, therefore, is not whether taxes are paid to the Treasury. It is whether Blackwater withholds those taxes and transmits them to the Treasury or whether the workers bear that responsibility. Even if we were to assume that Blackwater mistakenly classified its workers as independent contractors for purposes of argument, it would not alter the total taxes owed or the amount of revenue flowing into the United States Treasury.\(^9\)

What would alter the flow of revenue, however, is Chairman Waxman’s incorrect position that the IRS technician’s SS-8 determination should control. Right now, Blackwater owes no employment taxes to the United States Government because it falls squarely within Section 530’s “safe haven” for those businesses that have a “reasonable basis” for classifying their workers as independent contractors. (Exhibit A). The SS-8 letter does not change

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\(^8\) During the IRS hearing referenced in Footnote 1, Chairman Johnson confronted Commissioner Richardson and Assistant Secretary Lubick repeatedly asking “What does it matter to the IRS if these workers are independent contractors or employees? Who cares?” She said that estimates of the overall amount of revenue collected by the IRS would not vary on the basis of the classification. Chairman Johnson was absolutely correct.

\(^9\) In actuality, if Blackwater were the employer of the contractors, then their remuneration would be reduced in recognition that Blackwater rather than the contractors was now liable for one-half of the FICA taxes.
Blackwater’s protection under Section 530’s “safe haven.” If, however, Chairman Waxman had his way and the SS-8 letter applied to all Blackwater personnel, it would have a significant effect on the amount of taxes flowing into the Treasury by Blackwater’s independent contractors. As for taxes paid in the past, the field determination letter would erase the contractors’ obligation to pay Self-Employment Contribution Act (“SECA”) taxes and would cut in half their obligation to pay FICA taxes. In other words, Blackwater would owe no employment taxes, but the U.S. Treasury would owe those contractors a substantial refund. As for taxes due in the years to come, under the SS-8 determination letter, the contractors will only owe one-half of future FICA taxes, but will still be entitled to full social security benefits. In short, if the technician’s informal and non-precedential decision is given the weight that the Chairman accords to it, this could result in a significant underpayment of federal employment taxes.

IV. Conclusion

Fortunately, the U.S. Treasury need not suffer such adverse consequences. The IRS technician’s SS-8 letter is not precedential, and it has no reach beyond the specific facts at issue in that letter. (Exhibit B, at 5). Any claim that the SS-8 letter is entitled to significant weight is simply incorrect.

What is entitled to weight in this case are the precautions taken by Blackwater to ensure that its classification of its security personnel was correct. Over the past several years, Blackwater has engaged an accounting firm and a law firm to assess its classification of its security workers as independent contractors. Both reached the same conclusion: Blackwater’s classification was reasonable and correct. Under Section 530 – a provision never analyzed by the IRS technician or even mentioned by Chairman Waxman – Blackwater’s decision is legally protected. Reliance on the advice of outside advisors on complex worker classification issues
that have remained unresolved by Congress, the courts, and the IRS for more than 50 years cannot constitute tax evasion. For these reasons, and the ones set forth above, the Chairman’s allegations to the contrary are simply incorrect.