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Internal Revenue Service  
**Memorandum**

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subject: Federal Agency Audit Program: Classification of Workers Performing Services  
Pursuant to Personal Services Contracts

Federal State and Local Governments ("FSLG") has asked this office for legal advice concerning the employment tax treatment of individuals who perform services for federal agencies pursuant to personal service contracts. The classification of these workers is a recurring issue in the federal agency audit program and FSLG wants to ensure consistent handling of this issue in all cases.

ISSUE

How does the Internal Revenue Service (Service) determine whether a personal service contractor working for a federal agency is classified as an independent contractor or an employee for federal employment tax purposes?

CONCLUSION

A federal agency may hire workers through the use of personal service contracts if the agency is allowed such hiring by a specific federal authorizing statute. The authorizing statute must be analyzed to determine whether it addresses the workers' tax treatment or otherwise specifies how workers hired under the authorized personal service

contracts are to be classified for federal tax purposes. The legislative history to the authorizing statute should also be consulted to ascertain whether it addresses the tax treatment in any way. Where the authorizing statute or another federal statute does not specify the tax treatment of the worker, the Internal Revenue Code (Code) applies, and classification of the worker will be determined by application of the Code's common law test to the specific facts and circumstances.

## BACKGROUND

We understand that FSLG has had disputes with more than one agency over the classification of workers hired pursuant to personal service contracts (PSCs). In such cases, the dispute tends to arise because the hiring agency will treat the workers as independent contractors for all purposes, regardless of the specific relationship between the parties to the contract. The Service will analyze the specifics of the relationship and conclude that the workers are employees under the Code and applicable regulations.

As explained herein it is Counsel's view that the Internal Revenue Code governs a worker's status for tax purposes where the statute authorizing the PSC is silent or vague as to how the worker should be classified and there is no other federal statute specific to the PSCs in question that directs how the workers are to be classified for federal employment tax purposes. We provide a discussion of the applicable federal law concerning an agency's authority to employ workers using a PSC, followed by a discussion of case law concerning the tax treatment of workers hired via a PSC.

## LAW AND ANALYSIS

### Federal Contracting Law

The Secretary of Defense, the Administrator of the General Services, and the Administrator, National Aeronautics and Space Administration are authorized to prescribe regulations necessary to carry out provisions of the Office of Federal Procurement Policy Act of 1974 (Pub. L. 93-400), as amended by Pub. L. 96-83 (currently codified at 41 U.S.C. §§ 401, et seq.). The authority includes authority for the creation of the Federal Acquisition Regulations System, (FAR), 48 C.F.R. §§ 1.000, et seq. (2008). In turn, the FAR provides guidance to federal agencies in establishing uniform procurement policies and procedures for all acquisitions by all executive agencies. FAR 1.101. This includes acquisitions of services contracts through PSCs. See, 48 C.F.R. § 37.104.

As defined in the FAR, a "service contract" means a contract that "directly engages the time and effort of a contractor whose primary purpose is to perform an identifiable task rather than to furnish an end item of supply." FAR § 37.101. A service contract may either be a nonpersonal or personal services contract. See, id. Most service contracts acquired by an agency will be nonpersonal in nature. A nonpersonal services contract means a "contract under which the personnel rendering the services are not subject,

either by the contract's terms or by the manner of its administration, to the supervision and control usually prevailing in relationships between the Government and its employees." Id.

Although the Government is "required to obtain its employees by direct hire under competitive appointment or the other procedures required by the civil service laws," the FAR recognizes that executive agencies may award personal services contracts if specifically authorized by statute. FAR §§ 37.104(a) and (b). A personal services contract is defined as being "characterized by the employer-employee relationship it creates between the Government and the contractor's personnel." FAR § 37.104(c)(1) provides that "An employer-employee relationship under a service contract occurs when, as a result of the contract's terms or the manner of its administration during performance, contractor personnel are subject to the relatively continuous supervision and control of a Government officer or employee."

In determining whether a services contract is personal or nonpersonal, FAR § 37.104(c)(2) provides that, "each contract arrangement must be judged in the light of its own facts and circumstances, the key question always being: Will the Government exercise relatively continuous supervision and control over the contractor personnel performing the contract."

FAR § 37.104(d) provides a list of "descriptive elements" that should be used in assessing whether a contract is personal in nature:

- (1) Performance on site.
- (2) Principal tools and equipment used.
- (3) Services are applied directly to the integral effort of the agencies or an organizational subpart in furtherance of assigned function or mission.
- (4) Comparable services, meeting comparable needs, are performed in the same or similar agencies using civil service personnel.
- (5) The need for the type of service provided can reasonably be expected to last beyond one year.
- (6) The inherent nature of the service, or in the manner in which it is provided reasonably requires directly or indirectly, Government direction or supervision of contractor employees in order to-
  - i. Adequately protect the Government interest;
  - ii. Retain control of the function involved; or
  - iii. Retain full personal responsibility for the function supported in a duly authorized Federal officer or employee.

While there are substantial similarities between the criteria used to determine whether a worker is providing personal services rather than nonpersonal services under federal government contract law and the common law factors used by the IRS to determine whether a worker is an employee or an independent contractor, the factors are not identical. For example, the FAR does not consider whether: 1) the worker had a

potential for profit or loss, 2) the worker received benefits, or 3) the parties to the contract believed they created an employer-employee relationship.

The FAR is silent as to whether or not workers under personal services contracts with an agency are employees for federal tax purposes. Moreover, both the Armed Services Board of Contract Appeals and the Comptroller General have opined that the employment tax treatment of personal services contracts is a tax issue rather than a contract issue. The Armed Services Board of Contract Appeals has stated that an agency's decision as to whether it can contract for personal services is not necessarily dispositive on the issue of whether the worker is an employee for federal tax purposes. See, e.g., Appeal of Robert K. Adams, 92-3 BCA (CCH) P25,165 (ASBCA 1992) (where the Armed Services Board of Contract Appeals recognized that personal services contractors authorized by statute may be subject to certain tax laws.) Likewise, the Comptroller General has recognized that the employment tax treatment of such contractors is a tax issue, rather than a contract issue. See, Part Time and Intermittent Physicians and Dentists of the Public Health Service, Comptroller Decision No. B-75089 (July 26, 1948). The Comptroller General specifically stated:

Generally, withholding tax requirements are not for application where there does not exist the relationship of employer and employee, as in the case of part time and intermittent physicians and dentists serving under nonpersonal services contracts with the Public Health Service, especially where such contractors also furnish their own office space, equipment, and supplies; however, a final determination of such matters is properly within the jurisdiction of the Treasury Department, Bureau of Internal Revenue.

In sum, neither the FAR, nor any other general procurement laws or regulations, provide federal agencies with explicit direction on how to classify PSC workers for federal employment tax purposes. We have not found any other statutes or regulations that address the classification of PSCs for federal tax purposes.

### Applicable Tax Law

The Service has not previously litigated a case against a federal employer, concerning whether workers hired pursuant to a PSC are employees or independent contractors for employment tax purposes. However, the Service has litigated many cases in the last 20 years in which an individual performing services for a federal employer under a PSC has sought an income tax exemption based upon the worker's employment status. In addition, the issue of whether a non-tax statute can govern a worker's status for tax purposes was considered by the District of Columbia Circuit Court of Appeals in Matthews v. Commissioner, 907 F.2d 1173 (D.C. Cir. 1990), aff'd, 92 T.C. 351 (1989).<sup>1</sup>

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<sup>1</sup> The Service later published an Action on Decision, whereby it acquiesced in the Tax Court's decision to the extent it addressed the accuracy-related penalty. See, Matthews v. Commissioner, AOD CC-1990-05 (February 20, 1990). The Action on Decision does not affect issues relevant to worker classification.

The court's reasoning in Matthews is generally instructive since it provides a framework for the Service to analyze federal agencies' positions; as federal agencies similarly rely upon non tax provisions to support their worker status position.

In Matthews, the court held that the taxpayers, who worked for nonappropriated fund instrumentalities ("NAFIs"), did not qualify for 26 U.S.C. ("I.R.C.") § 911(a)'s exclusion from gross income. 907 F.2d at 1179. The court determined that the taxpayers qualified as United States "employees" under I.R.C. § 911(b)(1)(B)(ii), and thus, any amounts paid to them did not qualify as "foreign earned income" subject to the gross income exclusion. See, id. at 1174. The taxpayers challenged whether the common law definition of "employee" should be used in determining whether they qualify for I.R.C. § 911(a)(1)'s gross income exclusion. See, id. at 1175. The taxpayers conceded they qualified as United States employees under the common law standard, but asserted that under a definition of "employee", from outside the Internal Revenue Code, the taxpayers did not qualify as federal employees. See, id.

Specifically, the taxpayers relied on 5 U.S.C. § 2105(c). 5 U.S.C. § 2105 generally provides the definition of "employee" for purposes of Title 5, the Title that addresses Federal Government organizations and employees. See, 5 U.S.C. § 2105. Under subsection (c), NAFI personnel, such as the taxpayers, were not considered federal employees for purposes of the civil service laws and regulations. See, 5 U.S.C. § 2105(c); Matthews, 907 F.2d at 1177. Therefore based on this provision, the taxpayers reasoned that they qualified for I.R.C. § 911(a)(1)'s gross income exclusion. See, id. In response, the court determined that "[i]t would be manifestly inappropriate to rely on statutes, regulations, and cases having limited purpose and applicability to interpret, in derogation of a plain meaning, another having an unrelated purpose." Matthews, 907 F.2d at 1178. Thus, the court upheld the use of the common law standard for determining whether taxpayers qualified as employees for federal tax purposes. See, id. at 1176-78.

In Matthews, the court rejected an attempt to find an "implicit exemption from taxation in statutory language that read plainly does not exempt them." 907 F.2d at 1178. The taxpayers had argued that notwithstanding the language of I.R.C. § 911, the legislative history intended to extend the § 911 exclusion to federal employees, but the court was not persuaded. The court addressed the standards for when a taxpayer is entitled to a tax exemption stating that "a claim for exemption must rest upon language in regard to which there can be no doubt as to its meaning, and that the exemption must be granted in terms too plain to be a mistake." Id. (quoting Bank of Commerce v. Tennessee, 163 U.S. 416, 423 (1896)). Thus, the court's view on tax exemptions is consistent with the traditional view that "tax exemptions are given a strict interpretation against the taxpayer and in favor of the taxing power." 6 Norman J.Singer, Sutherland Statutes and Statutory Construction § 66:9 (6th ed. 2005).

When tested against this strict standard, the court held that the taxpayers' status as NAFI employees, i.e., federal common law employees not subject to the civil service

requirements, in no way provided them with an exemption from I.R.C. § 911(b)(1)(B)(ii)'s limiting effects. See, Matthews, 907 F.2d at 1179. The court reasoned that there was nothing “specific in the statute or its history to indicate that they [taxpayers] were to benefit from the exclusion under section 911.” Id. The court further stated:

They [taxpayers] have picked from among the many statutory, regulatory, and case-law provisions defining “employee” a few that for nontax purposes define “employee of the United States” to exclude NAFI personnel and then argue that we should adopt such a definition for section 911 purposes. Obviously the rule requiring specific language to support an exemption from taxation prohibits us from adopting this interpretation.

Id.

There are a number of other cases in which the courts have applied the Code's common law test to determine whether an individual performing services for the government pursuant to a PSC is an employee or independent contractor for federal income tax purposes. See, Eren v. Commissioner, 180 F.3d 594 (4th Cir. 1999), aff'g, T.C. Memo. 1995-555 (held a PSC worker, who rendered architectural services for the Foreign Building Operation, to be a federal employee under I.R.C. § 911(b)(1)(B)(ii), and therefore not entitled to the exclusion of gross income under I.R.C. § 911(a)); Chin v. United States, 57 F.3d 722 (9th Cir. 1995), aff'g, 72 A.F.T.R.2d 93-6637 (N.D.Cal. 1999) (held a PSC worker, a medical doctor working for AID, to be an independent contractor, and thus, entitled to the gross income exclusion under I.R.C. § 911(a)); Levine v. Commissioner, T.C. Memo. 2005-86 (held a PSC worker, who worked for the State Department as an industrial hygienist, to be an independent contractor, and thus, entitled to a deduction for her contribution to a simplified employee pension); DeTorres v. Commissioner, T.C. Memo. 1993-161 (held a PSC worker, who consulted on engineering projects for USAID, to be an independent contractor, and thus, entitled to the gross income exclusion under I.R.C. § 911(a)); Marckwardt v. Commissioner, T.C. Memo. 1991-347 (held a PSC worker, who provided services to the Peruvian Ministry of Health on behalf of USAID, to be a federal employee under I.R.C. § 911(b)(1)(B)(ii), and therefore not entitled to the gross income exclusion under I.R.C. § 911(a)); Juliard v. Commissioner, T.C. Memo. 1991-230 (held a PSC worker, who worked as a consultant for USAID, to be a federal employee under I.R.C. § 911(b)(1)(B)(ii), and therefore not entitled to the gross income exclusion under I.R.C. § 911(a)); Matt v. Commissioner, T.C. Memo. 1990-209 (held a PSC worker, who worked to conduct a comparative study for USAID, to be a federal employee under I.R.C. § 911(b)(1)(B)(ii), and therefore, not entitled to the gross income exclusion under I.R.C. § 911(a)). Even though some of

these cases concluded the taxpayer was an independent contractor, such determinations were based on the common law test. See, id.<sup>2</sup>

In Eren, the Court of Appeals for the Fourth Circuit upheld the Tax Court's prior determination that the taxpayer-husband failed to qualify for the gross income exclusion under I.R.C. § 911(a)(1). See, 180 F.3d at 598; see also, I.R.C. § 911(b)(1)(B)(ii). The taxpayer-husband was an architect, who worked exclusively for the Office of Foreign Buildings ("FBO") within the State Department. In 1984, the taxpayer-husband entered into his first PSC with FBO. Between 1984 and 1988, the taxpayer-husband worked under modified versions of the PSC. In 1988, upon his move to Bogota, Colombia, the taxpayer-husband's PSC was modified once again. See, id.

After an IRS review of FBO's employment tax practices, it was determined that over 350 of FBO's PSC workers had been improperly characterized as independent contractors. See, id. In response to the Service's review, FBO issued two directives in 1987 requiring that all PSC workers be treated as employees. In 1989, FBO notified the taxpayer-husband that he should designate himself as an employee on his 1989 federal income tax return. See, id. While these directives were somewhat influential in the Tax Court's decision, its determination that the taxpayer-husband was a federal employee was based primarily on the substantial control that FBO exerted on the taxpayer-husband in carrying out his job. See, Eren v. Commissioner, T.C. Memo. 1995-555. The Tax Court stated:

We are satisfied that petitioner was subject to substantial control by FBO. Although petitioner [taxpayer-husband] worked for FBO in a professional capacity, which would limit the amount of control FBO had over petitioner's day-to-day activities, FBO dictated the contract documents and drawings, budget, hours, and monthly reports with which petitioner was required to comply. We therefore conclude that FBO had the right to control over petitioner and in fact exerted a substantial amount of control over him.

Id.

Thus, the Tax Court's decision was rooted in the idea that worker status issues for federal tax purposes are determined by using the common law test for which the right to control is the most prominent factor "in determining the nature of a working relationship." Id. (citing Matthews, 92 T.C. at 361).

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<sup>2</sup> In addition to the federal tax cases, the Service has consistently used the traditional common law test to determine PSC workers' worker status for federal employment tax purposes. See, LTR 199917076 (April 30, 1999); LTR 9843012 (October 23, 1998); LTR 9804011 (January 23, 1998); LTR 9422043 (June 3, 1994); 1993 WL 1468173 (IRS FSA); LTR 9253020 (January 1, 1993); LTR 9135038 (August 30, 1991); see also, Revenue Ruling 75-343, 1975-2 C.B. 402.

In contrast to the decision in Eren, the Ninth Circuit upheld the District Court for the Northern District of California's decision to treat a PSC worker as an independent contractor for federal tax purposes. See, Chin, 57 F.3d at 726. In Chin, the taxpayer-husband was a renowned malariologist, and the Ninth Circuit applied the common law test and concluded that he was an independent contractor for federal tax purposes. See, id. at 726. Therefore, he qualified for the exclusion offered in section 911. Hence, the Circuit Court opinions in Eren and Chin illustrate that regardless of the outcome (favorable or unfavorable to the Service) the common law test is to be used in determining whether a taxpayer is an employee for federal tax purposes.

In an examination, it will be critical for the federal agency in question to supply the statute authorizing the hiring of the PSCs in question as well as any other federal statutes or regulations that the agency believes bear on the classification of the specific workers in question for federal tax purposes. A more specific federal statute could control over the generally applicable principles of the Code. Therefore, in developing these cases, it is important to ask the agency for this legal information in addition to asking for the factual information necessary to determine whether the personal service contractors are employees or independent contractors under the Code's common law test. If the agency points to any statute not already referenced in this memorandum, we recommend that you seek further legal advice with respect to the particular case.

### Conclusion

Where the language of the statute that authorizes a federal agency to hire its PSC workers does not directly address how such workers are to be classified for federal employment tax purposes, and where no other federal statute or regulation provides specific direction on this question, a PSC worker's status is determined by application of the Code's common law test.

If you need further assistance or have any questions concerning this Memorandum, please call me at (202) 622-6010 or Ligeia Donis of my office at (202) 622-0047.