

TITLE: CIB 95-27 - Proper Characterization of Individual Contractors as "Employee" or "Independent Contractors"

December 11, 1995

MEMORANDUM FOR ALL CONTRACTING OFFICES AND NEGOTIATORS

TO: DISTRIBUTION LIST FAC

FROM: DAA/M, Michael D. Sherwin, Procurement Executive

SUBJECT: Proper Characterization of Individual Contractors
as "Employee" or "Independent Contractors"

CONTRACT INFORMATION BULLETIN 95-27

Given the very different tax treatment by the Internal Revenue Code of USAID's "employees" and "independent contractors" and the fact that USAID and the IRS have had some disagreements over the proper characterization of some individuals, this CIB will furnish Contracting Officers and Negotiators with information as to the factors which are to be used in distinguishing between an employee and an independent contractor. Since USAID may be held liable for failure to make required withholdings of FICA and Federal income tax, it is important for Contracting Officers to be aware of the factors considered relevant by the IRS in distinguishing employees from independent contractors and to use their best efforts to apply those factors appropriately.

Personal services contractors (PSCs) are considered Government employees for most purposes, including Federal tax purposes. As Government employees, U. S. PSCs are subject to social security (FICA) and Federal income tax withholding and are ineligible for the "foreign earned income" exclusion provided to certain individuals under the Internal Revenue Code. These salient tax consequences are noted both in USAID's regulation concerning PSC contracting, AIDAR Appendix D, and in the form of PSC contract included in Appendix D.

Non-personal services contractors, on the other hand, are generally independent contractors rather than employees, and thus are not subject to FICA or Federal income tax withholding and, subject to compliance with specified requirements, may be eligible for the "foreign earned income" exclusion.

FAR 37.104 (d) contains brief guidance on the factors to be used in determining whether a contract is for personal services, thus making the contractor "appear, in effect, [a] Government employee[]" under the FAR 37.101 definition of a "personal services contract." See Attachment 1. It should be understood, however, that while the FAR factors will, in the large majority of cases, lead to the same "employee" versus "independent contractor" determination as the IRS factors noted below, the IRS will apply its own factors, not the FAR factors, in making its determination on this issue. The FAR sets forth these factors not to assist Contracting Officers in determining whether tax withholding is required, but because the FAR forbids agencies to award personal service contracts unless specifically authorized by statute. It is therefore important for Contracting Officers to be aware of, and apply, the IRS's factors in determining whether tax withholding is required.

For tax purposes, the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The IRS generally applies 20 factors, derived from common law, in making this determination. The 20 common law factors are set forth in Attachment 2.

Given the complexity and ambiguity of the IRS's 20-factor test, the IRS has requested, and USAID has agreed, that if an individual, proposed to work for USAID under a contract, meets all of the following four factors, he or she will be treated as an employee for tax purposes (i.e., USAID will effect FICA and income tax withholding):

1. The individual is retained directly by, and performs services directly for, USAID, with no intermediary employer;
2. The individual performs services primarily on U.S. Government premises using primarily Government-furnished equipment;
3. The individual is not authorized to assign to others the responsibility for performing the contract services; and
4. The individual does not have an outside business or practice where similar services are advertised and/or offered to the public.

If these four tests are not met, the individual may still be an employee under the more complex 20-factor test.

When negotiating any contract with an individual, the Contracting Officer will thus first use this simplified four-factor test, and, if each of the four factors is met, the individual is to be classified as a PSC (employee), with the requisite tax withholding. If the worker does not fit within all four of the factors, the Contracting Officer must then consult and apply the 20 factors to determine whether the individual is an employee or an independent contractor. Given that both tests turn on the particular facts of the individual's circumstances in working for USAID, the Contracting Officer, in making the determination, should consult with the appropriate Project Officer to ascertain the circumstances of the intended working relationship. If the individual is an employee, the standard PSC contract form set forth in Appendix D may be used. If the individual is not an employee, the PSC contract form will not be appropriate.

A brief overview here of the 20 factors will help put the factors into some perspective. A worker is an employee under the usual common law rules if the relationship between him/her and the person for whom he/she performs services is the legal relationship of employer and employee. Generally such relationship exists when the person for whom services are performed has the right to direct and control the person who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he or she is an independent contractor.

When determining the existence of a common law employer-employee relationship under the 20-factor test, the crucial test is the right-to-control test: does USAID have the right of control over the manner in which the service is to be performed, the means to be employed in its accomplishment and the result to be obtained? The right to control is sufficient to establish the employer-employee relationship; it is not necessary that any control actually be exercised. Moreover, the absence of the need to control should not be confused with the absence of the right to control. Given the importance of the control factor in the tax issue and the fact that a "technical directions" clause suggests that USAID has a right to control the contractor's performance, Contracting Officers should generally not include a "technical directions" clause in a non-PSC contract with an individual.

It should also be emphasized that if the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial.

Apart from ensuring, in accordance with the PSC contract checklist in Handbook 14, Appendix D, that a PSC understands that he/she is an employee of the United States and thus subject to FICA and Federal income tax withholding and precluded from using the "foreign earned income" tax exclusion, no USAID employee is to provide guidance or advice to a USAID PSC or other worker regarding his/her tax liability. For tax advice, such workers should be referred to the IRS, a professional tax preparation service, a certified public accountant, or a tax attorney.

Attachments: (not attached)
FAR 37.104(d)
The IRS 20 Common Law Factors