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House of Representatives

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October 22, 2007

Mr. Erik Prince
Chairman
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1650 Tysons Boulevard, Suite 800
McLean, VA 22102

Dear Mr. Prince:

I have received documents which suggest that Blackwater may have engaged in significant tax evasion. According to an IRS ruling in March 2007, Blackwater violated federal tax laws by treating an armed guard as an "independent contractor." The implication of this ruling is that Blackwater may have avoided paying millions of dollars in Social Security, Medicare, unemployment, and related taxes for which it is legally responsible.

Unlike DynCorp and Triple Canopy, the two other major private military contractors providing security services to the State Department in Iraq, Blackwater classifies its armed guards as independent contractors rather than as employees. Under federal tax laws, this classification has important ramifications. Businesses must pay Social Security, Medicare, and unemployment taxes for their employees. They must also withhold federal income taxes on their salaries. By classifying its armed guards and other personnel as independent contractors instead of employees, Blackwater has apparently evaded withholding and paying these taxes.

When you testified before our Committee on October 2, 2007, Congresswoman Norton asked you why Blackwater treats its security personnel as independent contractors, while your competitors treat their guards as employees. You responded that Blackwater treats its guards as contractors because you found "it is a model that works" and because your guards prefer the "flexibility" of an independent contractor relationship.

Since the hearing, I have learned that the IRS determined in March — six months prior to your testimony — that your classification of a security guard working in Afghanistan as an independent contractor was "without merit." The IRS advised that "[y]ou are responsible for satisfying the employment tax reporting, filing, and payment obligations that result from this determination." By its terms, the IRS ruling applied only to the individual security guard who protested his classification, but the IRS warned that its ruling "may be applicable to any other

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individuals engaged by the firm.” The logic of the ruling would appear to apply to your entire workforce in Iraq and Afghanistan.

There is also evidence that Blackwater has tried to conceal the IRS ruling and the evasion of taxes from Congress and law enforcement officials. The IRS determination was issued in response to an inquiry by an individual security guard who questioned his classification as an independent contractor. In June, Blackwater required this employee to sign a nondisclosure agreement before it agreed to pay the back pay and other compensation that he was owed. The terms of this agreement explicitly prohibited the guard from disclosing any information about Blackwater to “any politician” or “public official.” The agreement further provided: “THE UTMOST PROTECTION AND NONDISCLOSURE OF CONFIDENTIAL INFORMATION IS OF CRITICAL IMPORTANCE AND IS THE ESSENCE OF THIS AGREEMENT.”

It is difficult to read the IRS ruling and the nondisclosure agreement and not question Blackwater’s intent and actions. When the IRS issued an alert in 2004 warning employers not to “incorrectly treat employees as independent contractors,” the IRS Commissioner described the “[f]ailure to pay employment taxes” as “stealing from the employees of the business” and said that “those who embrace these schemes face civil or criminal sanctions.” Yet it now appears that Blackwater used this illegal scheme to avoid millions of dollars in taxes and then prevented the security guard who discovered the tax evasion from contacting members of Congress or law enforcement officials.

I hope you will cooperate with the Committee in its investigation into this serious matter.

Background

The tax code draws a distinction between “employees” and “independent contractors.” As the IRS has explained:

An employer must generally withhold federal income taxes, withhold and pay social security and Medicare taxes, and pay unemployment tax on wages paid to an employee. An employer does not generally have to withhold or pay any taxes on payments to independent contractors.¹

In order to determine whether a worker is an employee or an independent contractor, federal regulations require the IRS to examine whether an employer exercises sufficient control over the worker. Companies generally exert more control over the activities of employees, but have less control over independent contractors. The regulations define the employer-employee relationship as follows:

¹ Internal Revenue Service, *Publication 15-A: Employer’s Supplemental Tax Guide* (Jan. 2007).

Generally such relationship exists when the person for whom services are performed has the right to control and direct the individual 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 that 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.²

The regulations identify characteristics of the employer-employee relationship. These include “the furnishing of tools” and “the furnishing of a place to work” to the individual performing the services.³ IRS guidelines state that other factors considered by the IRS include “[i]nstructions that the business gives to the worker,” “[t]raining that the business gives to the worker,” “[t]he extent of the worker’s investment,” and “[t]he extent to which the worker can realize a profit or loss.”⁴

The regulations make clear that a superficial label for a worker’s relationship to the company has no bearing on this determination. They direct the IRS to examine the true nature of the work. As the regulations state:

[T]he designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such a relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.⁵

Blackwater’s “Independent Contractor” Designations

The largest U.S. government contract for private military companies is the State Department’s “Worldwide Personal Protective Services II” contract. Under this contract, three

² 26 C.F.R. §31.3121(d)-1(c)(2); §31.3306(i)-1(b); and §31.3401(c)-1(b) (relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding on wages, respectively).

³ *Id.*

⁴ Internal Revenue Service, *Publication 15-A: Employer’s Supplemental Tax Guide* (Jan. 2007) (describing as additional factors for the IRS to consider: instructions that the business gives to the worker, including when and where to do the work, what tools or equipment to use, what workers to hire or assist the work, where to purchase supplies and services, what work must be performed by a specified individual, what order sequence to follow; training that the business gives to the worker; the extent to which the worker has unreimbursed business expenses; the extent of the worker’s investment; the extent to which the worker makes his or her services available to the relevant market; how the business pays the worker; and the extent to which the worker can realize a profit or loss).

⁵ 26 C.F.R. §31.3121(d)-1(a)(3); §31.3306(i)-1(d); and §31.3401(c)-1(e).

different companies provide protective security services to the Department of State in Iraq: Blackwater, DynCorp, and Triple Canopy. Blackwater has been assigned task orders to operate in Baghdad and Al-Hillah; DynCorp has been assigned task orders to operate in Kirkuk and Erbil; and Triple Canopy has been assigned task orders to operate in Basrah and Tallil. Each contractor is authorized to receive task orders worth up to \$1.2 billion.⁶

The State Department has informed the Committee that under this contract, it has authorized Iraq staffing levels of 920 for Blackwater, 260 for Triple Canopy, and 151 for DynCorp. Within these authorized staffing levels, the number of staff specifically authorized to conduct security operations are 604 for Blackwater, 73 for Triple Canopy, and 77 for DynCorp.⁷

Both DynCorp and Triple Canopy designate their security guards as employees. Blackwater, however, classified its 604 security guards as independent contractors.⁸ Blackwater also classified other Blackwater personnel working in Iraq under the State Department contract as independent contractors. For example, the Blackwater personnel who shot the Iraqi Vice President's bodyguard on December 24, 2006, was working as an "armor" repairing and maintaining weapons for Blackwater's security guards. This individual was also classified by Blackwater as an independent contractor.⁹

The State Department contract specifies that Blackwater must maintain a high degree of control over the training, equipping, and conduct of its security guards. The State Department contract provides that Blackwater must establish training facilities, submit detailed training plans, and ensure that all security personnel have "successfully completed" at least 155 hours of specialized training before they are sent abroad to protect diplomats.¹⁰ Blackwater is also responsible for "maintaining that level of training throughout the performance of work."¹¹ The State Department contract does not allow any security guards to waive this requirement by using their own individual training methods.¹²

⁶ U.S. Department of State, *Fact Sheet: WPPSII Contracts Awarded to Blackwater, Triple Canopy, and DynCorp* (undated).

⁷ *Id.*

⁸ *Id.*

⁹ *Letter of Termination of Independent Contractor*, Blackwater USA (Dec. 25, 2006) (HOC008383).

¹⁰ Worldwide Personal Protective Services II Contract, at sec. C.4.3.2 (Aug. 25, 2004); *Id.* at attachment 5 to app. G, sec. C.

¹¹ *Id.* at sec. C.4.3.2.

¹² *Id.*

Once the security guards are in Iraq, the State Department contract requires Blackwater to provide its personnel with “all logistical support,” including equipment and supplies.¹³ In fact, contractor personnel are expressly prohibited from carrying or using their own weapons while serving in Iraq.¹⁴ Blackwater is also required by the contract to provide food, shelter, and even “laundry services” and “housekeeping” for its guards.¹⁵

The contract requires Blackwater to ensure that its security guards follow precise directions. According to the terms of the contract, Blackwater “shall ensure that all work performed under this contract is accomplished in accordance with the applicable standards/standard operating procedures, general orders and specific orders” issued by the Bureau of Diplomatic Security within the State Department.¹⁶

During your testimony before the Committee on October 2, 2007, you made many statements that emphasized the demanding training and extensive screening of Blackwater security personnel. For example, you highlighted the training Blackwater requires of its entire workforce. You testified that this training includes “embedding at Blackwater, tactics, techniques, procedures, driving, firearms, defensive tactics” as well as “a full psychological evaluation, medical/dental exam, physical tests, shooting tests.”¹⁷ You described this regimen as “very, very rigorous” and a significant expense for Blackwater.¹⁸

You also testified to the tight discipline Blackwater exercises over its workforce. You said that Blackwater provides its workers with “uniforms, equipment, body armor, boots, everything you wear from head to toe.”¹⁹ You testified that Blackwater provides its personnel with a handbook with “all the dos and don’ts of what they are expected to do and not do.”²⁰ According to your testimony, if your personnel do not follow these instructions, “we fire them,”

¹³ *Id.* at sec. C.4.3.8.1.1.

¹⁴ U.S. Embassy, Baghdad, Iraq, *Mission Firearms Policy* (Aug. 2006).

¹⁵ Worldwide Personal Protective Services II Contract, at sec. C.4.3.8.1.1 (Aug. 25, 2004).

¹⁶ *Id.* at sec. C.4.1.1.

¹⁷ House Committee on Oversight and Government Reform, Testimony of Erik Prince, *Hearing on Blackwater USA: Private Military Contractor Activity in Iraq and Afghanistan*, 110th Cong. (Oct. 2, 2007).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

even when the infraction is as minor as a “bad attitude” or “riding someone’s bike that is not his.”²¹

Repeatedly, you referred to Blackwater personnel as “our guys.”²²

The terms of the State Department contract and your own statements would appear to make your security personnel employees, not independent contractors. When Congresswoman Norton asked you about their status, however, you insisted that Blackwater guards are independent contractors.

At one point, Congresswoman Norton asked why your company treats its workforce differently than do the other two companies working for the State Department under the same contract:

REP. NORTON: DynCorp and Triple Canopy and other security firms that support the State Department treat their personnel as employees entitled to these benefits. Why do you treat your personnel differently from these two companies?

MR. PRINCE: I don’t know the differences in how they compensate their people. I will tell you we have the highest retention in the industry. We have guys that sign up for us at a very, very high rate. So we don’t get losses. Men and women seem to feel very well treated by us.

REP. NORTON: Well, of course, one of the differences is in the employee benefit package I have just named. Does Blackwater hire personnel as independent contractors in order to avoid legal responsibility for the company?

MR. PRINCE: No, it is actually really what the men that deploy for us prefer. We find it is a model that works.²³

Later, you emphasized that the reason Blackwater uses independent contractor arrangements is because your workforce prefers it:

MR. PRINCE: They like the flexibility of signing on for a certain period of time and being able to schedule their off time around an anniversary, a child’s birthday, being home for Christmas, et cetera. So it gives them flexibility as to when they are going to

²¹ *Id.*

²² *Id.*

²³ House Committee on Oversight and Government Reform, *Hearing on Blackwater USA: Private Military Contractor Activity in Iraq and Afghanistan*, 110th Cong. (Oct. 2, 2007).

deploy, when they are going to go to work. Just like--

REP. NORTON: Does it really give them more flexibility than the other two companies who have them as employees? Those people don't have the same kind of flexibility? Or what kind of flexibility can you have if you need your employees at a time of engagement, for example?

MR. PRINCE: I don't know, ma'am.

REP. NORTON: Well, I think the fact is, when you need them, you need them. You don't say, you can go home for Christmas, sir.²⁴

When Congresswoman Norton asked you explicitly about whether Blackwater "can avoid making Social Security contributions or withholding taxes" as a result of its independent contractor designation, you responded: "I am not sure on that."²⁵

The March 2007 IRS Determination

On March 30, 2007, the IRS issued a letter to Blackwater ruling that the company had improperly classified a Blackwater security guard as an independent contractor rather than an employee. This letter was written in response to a complaint filed by a former "Personal Security Specialist" for Blackwater in Afghanistan who provided to the IRS his "independent contractor" agreement with the company, as well as additional information about the terms of his work for the company.

In its ruling, the IRS informed Blackwater that its designation of the security guard as an independent contractor was "without merit," concluding:

We hold the worker to have been an employee of the firm. ... [Y]our statement that the worker was an independent contractor pursuant to a written agreement is without merit.²⁶

In its ruling, the IRS methodically applied the provisions of the tax code and the Treasury regulations to make its determination. The IRS made the following findings regarding Blackwater's relationship with the guard:

²⁴ *Id.*

²⁵ *Id.*

²⁶ Letter from Internal Revenue Service to Blackwater Security Consulting LLC (Mar. 30, 2007).