Afghanistan Initiates Plans To Tax US Government Contractors

As recently as April 2011, Afghanistan indicated that it plans to require certain US prime contractors and subcontractors performing work in Afghanistan under US government contracts to pay Afghan income tax.[1] This requirement could force affected US corporations to either pay significant sums to the Afghan government or risk additional monetary penalty and disruption in business operations, including the loss of a contractor's Afghan business license. Further complicating this issue is that the US government has signaled its position that both US prime contractors and subcontractors operating in Afghanistan are exempt from Afghan taxes pursuant to bilateral agreements known as Status of Forces Agreements (SOFAs). The US government's position could mean that US corporations that pay the Afghan tax to avoid stiffer Afghan penalties may be unable to recover these payments under their US government contracts. Although this uncertainty poses significant risk, there may be steps that US corporations can take to reduce their potential exposure and protect their bottom line.

Generally, SOFAs establish the legal framework under which military personnel operate in a foreign country, including the imposition of income taxes. Additionally, SOFAs may cover government contractors as well.[2] Two different agreements implicate the imposition of Afghan income taxes on US corporations doing business in Afghanistan under US government contracts. One is through a 2002/2003

1 Maria Abi-Habib, "Security Firms Threaten to Leave Afghanistan," *Wall Street Journal*, April 5, 2011; Karen DeYoung and Joshua Partlow, "Afghanistan's push to tax U.S. contractors could renew tensions," *Washington Post*, January 17, 2011; Rod Nordland, "Conflict on Afghan Efforts to Tax Foreign Contractors," *New York Times*, January 17, 2011.

2 Statistically, less than 10 percent of SOFAs address government contractors. G. Ballard and W. Bradley, Beyond Tax Treaties: Status of Forces and *USAID Agreements*, 17 J. Int'l Tax'n 52, 54 (April 2006).

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exchange of Diplomatic Notes related to Operation Enduring Freedom[3] and the other is through a Military Technical Agreement (MTA) related to the International Security Assistance Force (ISAF), led by the North Atlantic Treaty Organization.[4] Although both the Diplomatic Notes and MTA contain language that can be read to exempt certain covered personnel, including US "contractors and contractor personnel," from Afghan taxes, these agreements do not define the term "contractor" to explain whether it includes subcontractors.

The US government argues that both agreements prohibit the Afghan government from taxing US prime contractors *and* subcontractors operating thereunder. The US Department of Defense (DOD) Office of General Counsel recently issued guidance stating that the tax exemption contained in the agreement established through the exchange of Diplomatic Notes covers DOD contractors, subcontractors and their US or non-Afghan employees, as well as contractors and contractor personnel.[5] Indeed, since execution of the agreements, the Afghan government had interpreted the tax exemption to apply to subcontractors as well as prime contractors.

Subcontractors have reported receiving tax bills from the Afghan Ministry of Finance (MOF) demanding payment for income tax on profit earned in Afghanistan.[6] In addition, prime contractors are concerned that the Afghan MOF will demand compliance with Article 72 of the 2009 Afghanistan Income Tax Code, which requires prime contractors with an Afghan business license to withhold two percent and prime contractors without an Afghan business license to withhold seven percent from payments to subcontractors.[7] Reports indicate that nonpayment could result in a contractor's loss of its business licenses, as well as restrictions on the contractor's ability to fly in and out of the country or to bring goods into the country.[8]

The conundrum presented above is a set of unclear bilateral agreements regarding the application of Afghan taxes to contractors and subcontractors performing work under a US government contract in Afghanistan, and the competing interpretations of the US government and the Afghan government regarding the same. The Federal Acquisition Regulation (FAR) provides limited guidance on how to address the issues presented here, however, it is important to note that these provisions may not be applicable in all situations.[9]

For example, although FAR 52.229-6 specifically contemplates recovery for "after-imposed" taxes on a Foreign Fixed-Price Contract, where a foreign government changes its position regarding the applicability or exemption of a tax, the Armed Services Board of Contract Appeals has denied recovery where it finds that the tax in question is, in fact, not an "after-imposed" tax.[10] Moreover, contractors should be wary of contract terms and direction from the contracting officer regarding (a) the necessity to challenge the applicability of the tax

3 Agreement regarding the Status of United States Military and Civilian Personnel of the U.S. Department of Defense Present in Afghanistan in connection with Cooperative Efforts in Response to Terrorism, Humanitarian and Civic Assistance, Military Training and Exercises, and Other Activities, State Dept. No. 03-67, 2003 WL 21754316 (Treaty) (Diplomatic Notes) ("The Government of the United States of America, its military and civilian personnel, contractors and contractor personnel shall not be liable to pay any tax or similar charge assessed within Afghanistan.").

4 Military Technical Agreement between the ISAF and the Interim Administration of Afghanistan, January 2002.

5 Department of Defense, Office of General Counsel, *Memorandum For Director of Defense Procurement and Acquisition Policy*, March 29, 2011.

6 Abi-Habib, *supra.*

7 Article 72 of the Afghanistan Income Tax law of 2009. Article 72 of the Afghanistan Income Tax law of 2009 states that for contractors with a business license this tax is "in lieu of income tax." Conversely, contractors without a business license will treat the withholding as a final tax.

8 DeYoung & Partlow, *supra* note 7.

9 See FAR 52.229-6 Taxes—Foreign Fixed-Price Contracts. *See also* FAR 31.205-41 (taxes cost principle).

10 *See* e.g., *Wisser Disentleistungs GmbH*, ASBCA No. 41290, 93-2 BCA ¶ 25682 (denying contractor an increase in contract price where Board held that the German tax in question was tantamount to an employment tax and as such was excluded from the definition of after-imposed tax).

and (b) the recovery of the costs associated with such a challenge to the MOF.[11]

In light of these circumstances, contractors should take the following steps to protect their bottom line:

- Determine whether the contract activities in question are being performed pursuant to US government contracts in association with Diplomatic Notes and MTA.
- Review all contract provisions that may affect the inclusion of taxes in the contract cost or price.
- Communicate with their contracting officer.
- Consider executing special provisions to address these concerns in existing and future contracts.
- Prepare documentation and consider filing a claim under the Disputes clause of the contract.

11 *See Morrison-Knudsen Co., Inc.*, ASBCA No. 16483, 72-2 BCA ¶ 9733 (contractor not entitled to recover the costs of challenging the tax assessment, because it did so on its own accord).

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