

If the Afghan Tax Man Cometh, the U.S. Contractor Shall Not Pay: Implications of the SIGAR Audit Report on Contractors Supporting the U.S. Government in Afghanistan

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The Special Inspector General for Afghan Reconstruction (SIGAR) recently released an audit report highlighting concerns about Afghan taxes paid by contractors supporting the U.S. Government. See SIGAR Audit 13-8, *Taxes: Afghan Government Has Levied Nearly a Billion Dollars in Business Taxes on Contractors Supporting U.S. Government Efforts in Afghanistan* (May 2013). The primary finding of the SIGAR report is that, despite the existence of bilateral agreements exempting U.S. contractors from taxation, the Afghan Ministry of Finance (MOF) has levied \$921 million in business taxes and penalties on such contractors. This report is important for contractors operating in Afghanistan as it foreshadows potential developments related to the allowability of taxes paid to the Afghan government, and it emphasizes the importance of obtaining both a business registration and a tax-exemption certificate.

The U.S. and Afghan governments have not executed a comprehensive agreement governing the payment of taxes by U.S. contractors. Instead, agencies operating in Afghanistan, such as the Department of Defense and the Department of State have separately executed bilateral agreements with the Afghan MOF that generally exempt contractors supporting their agency-funded programs from taxation. The bilateral agreements do not, standing alone, provide exemption from Afghan taxation; rather, the Afghan MOF requires contractors to be registered with the host nation and to obtain a tax-exemption certificate in order to claim exemption from taxation pursuant to the bilateral agreements. Afghan business registration and tax exemption can be difficult to achieve, and typically take much longer to accomplish than similar actions in a U.S. state. Registration, moreover, is important in limiting tax liability in that the withholding rate for unregistered business is 7%, as compared to 2% for registered business.

Despite the existence of the bilateral agreements, the SIGAR audit discovered that the Afghan MOF levied \$921 million in business taxes and penalties against U.S. contractors since 2008, including assessments on contractors that possessed tax-exemption certificates from the Afghan MOF. One of the primary disputes relates to the application of the bilateral agreements to subcontractors, as the MOF has taken the position that the exemptions apply only to prime contractors. In contrast, the U.S. Government's position is that the

bilateral agreements were intended to apply to all non-Afghan contractors, both prime and subcontractors.

Ominously, the SIGAR report faults agencies that “erroneously” reimbursed contractors for taxes paid to the Afghan MOF. With this audit finding, agencies can be expected to increase their scrutiny of invoices seeking payment of Afghan taxes, and affirmative Government claims to recover taxes paid and reimbursed could ensue. The SIGAR has essentially taken the position that contractors and subcontractors should not pay taxes to the Afghan MOF (because they will not be reimbursed) if the relevant agency has executed a bilateral agreement with the Afghan government. This audit finding will place contractors and subcontractors in the difficult position of having to choose between paying taxes to the Afghan MOF—and risk having the agency not reimburse the costs—or not paying the taxes—and risk having assets frozen or personnel arrested.

Contractors can attempt to minimize their risk by ensuring that they are registered and have a tax-exemption certificate from the Afghan MOF because agencies are unlikely to reimburse any taxes paid to the Afghan MOF if the agency has a bilateral agreement in effect with the MOF. See FAR 31.205-41(b)(3) (providing that taxes are unallowable if “exemptions are available to the contractor directly, or available to the contractor based on an exemption afforded the Government . . .”). If a contractor fails to obtain the necessary tax-exemption certificate, it is less likely, in the wake of the SIGAR report, that the agency will reimburse any taxes paid to the MOF.

If the MOF insists on assessing taxes against a contractor that has a tax-exemption certificate, the contractor should inform the contracting officer and request guidance as to whether it should pay the taxes (and document the agency's response). Contractors should communicate to their contracting officers the potential risks associated with not paying the taxes, and the impact that failure to pay could have on operations. In this regard, there is an exception to the standard rule that taxes are unallowable costs if an exemption is available to the contractor. Specifically, the contracting officer has discretion to reimburse taxes if obtaining an exemption will impose an “administrative burden” that outweighs the “corresponding benefits accruing to the Government.” FAR 31.205-41(b)(3). This exception may be particularly relevant to subcontractors if the Afghan MOF continues to assert that subcontractors are not eligible for tax-exempt status. Presumably, if contractors and subcontractors are faced with the prospect of having assets frozen and personnel arrested, Government contracting officers might reasonably conclude that the burden associated with claiming the exemption outweighs any benefits. In our experience, contracting officers often try to evade their obligation to give guidance in regard to sensitive issues such as this one. However, this should not deter contractors from (repeated, if necessary) **documented** efforts to seek such guidance. By doing so, contractors create a record that may increase the company's freedom of maneuver in the event that a host-nation tax dispute arises.

The SIGAR report concludes that resolution of this problem is unlikely until the U.S. and Afghan governments can agree on this issue. Unfortunately, a new bilateral security agreement is not expected to take effect until the end of 2014; thus contractors can expect issues surrounding the assessment and payment of Afghan taxes to continue into the foreseeable future. Contractors can best protect themselves by obtaining a tax-exemption certificate for the program they are supporting and communicating any issues with the Afghan MOF to their contracting officer.