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Contractors in Afghanistan Should Prepare for the Termination of Private Security Contracts and Taxation of Subcontractors

Summary

Contractors performing under U.S. government contracts in Afghanistan are accustomed to working under adverse conditions and dealing with the considerable uncertainty in performing in a hostile environment. Recent developments are likely to further complicate contractors' efforts in Afghanistan, particularly contractors that are currently required to use private security contractors to support development projects and those that employ subcontractors to perform work in-country.

On August 16, 2010, Afghan President Hamid Karzai announced that all private security contracts in Afghanistan were to end by December 2010. The security role, it was said, would be fulfilled by Afghan National Army (ANA) troops and Afghan National Police (ANP). On October 27, 2010, the deadline for transitioning all security contracts was extended and United States officials have negotiated an exception for private security contractors supporting diplomats and military bases. President Karzai, while agreeing to a limited and temporary exception to the ban on private security contractors stated unequivocally that development contractors, including those operating under contracts from the U.S. Department of Defense (DoD) and U.S. Agency for International Development (USAID), would need to perform their contracts without private security starting in February 2011. Prior to the Karzai regime's decision to postpone the ban, we are aware of instances in which prime and subcontractors simply received e-mails or other informal notices advising them that they must terminate any private security subcontracts and simply contact a named ANA or ANP official to arrange for security.

Since President Karzai's announcement, contractors have been reacting to the new reality that they must trust their security to Afghan forces rather than dedicated private security contractors. A transition of development projects takes time and at least some contractors are considering seeking termination or suspension of projects. This changed circumstance will certainly affect contractors who choose to stay and perform in Afghanistan. Under current arrangements, prime contractors are responsible for obtaining and maintaining site security. This can be accomplished with comparative ease when security is provided by a private company that is contractually obligated to perform as a subcontractor, but is far less certain if security is provided by a sovereign entity that has no contractual privity with the prime contractor. It remains to be seen whether the U.S. government will agree to revise existing contractual requirements to account for this new reality.

In addition, the Afghan Ministry of Finance (MoF) has begun demanding tax payments from subcontractors who perform work under U.S. and other nations' government contracts in Afghanistan. It is unclear, at this point, whether and how contractors will be able to operate in the new security environment or how contractors and subcontractors should deal with tax bills issued by the MoF, and there has been no uniform guidance provided by the U.S. government.

Private Security Contractors

The relationship between private security contractors and the Afghan government has been problematic for a long time, owing in large part to highly public incidents in which private security contractors were alleged to have caused a significant number of Afghan deaths. The Senate Armed Services Committee, in a recently released report, quoted a former U.S. Forces – Afghanistan Commander as saying that the private security contractors are "just not right for a country that is growing law and order."

Notwithstanding President Karzai's and possibly the U.S. government's motivations for phasing out the use of private security contractors, the security situation in many parts of Afghanistan appears to be beyond the capabilities of the Afghan military and police forces, even with the assistance of U.S. and international troops. Thus, contractors who are engaged in long-term projects to benefit the Afghan people are left in the difficult position of operating in a dangerous environment with no contractually dedicated security force, and facing potential punishment under Afghan and U.S. law if they take up arms in defense of themselves.

Afghan Taxation of Subcontractors

Under international agreements, U.S. military and diplomatic personnel, and normally the civilians and companies that accompany them, receive certain benefits including exemption from host nation taxation. The Exchange of Diplomatic Notes between the U.S. and Afghanistan dated May 28, 2003 effected "An agreement regarding the status of U.S. military and civilian personnel of the U.S. Department of Defense present in Afghanistan..." That agreement provides relief from Afghan taxes and states specifically that "Acquisition of articles and services in the Republic of Afghanistan **by or on behalf of** the Government of the United States of America in implementing this agreement shall not be subject to any taxes, customs duties or similar charges in Afghanistan." That agreement may be read to pertain only to DoD contracts, but would suggest that at least DoD contractors at all levels would be free from taxes for any work in support of the U.S. government. Similarly, a Military Technical Agreement (MTA) between International Security Assistance Force (ISAF) and Interim Administration of Afghanistan clearly exempted all contractors supporting ISAF from Afghan taxes. The ISAF Commander empowered to interpret the MTA determined that the tax exemption applied equally to subcontractors.

The MoF, however, has taken the position that all subcontractors are subject to taxes under Afghan law. In some cases, contractors have received notice from the MoF that back taxes are due from prior years. No U.S. government official has endorsed this view on

taxation; however, to our knowledge the U.S. authorities are taking no meaningful action to address the taxation of subcontractors by the MoF.

For prime and subcontractors, the practical effect of the MoF's tax policy is the clear potential for increased costs. If subcontractors refuse to pay contested tax bills, the Afghan government may not issue, or may cancel, the required business license. Prime contractors may be left in the difficult position of advising subcontractors to challenge the MoF or reimbursing subcontractors' tax claims but finding the U.S. government unwilling to reimburse the cost. FAR 52.229-6, which should appear in any contract performed in Afghanistan provides for reimbursement of after-imposed taxes under certain conditions. Whether a contractor will be able to recover will not only depend upon satisfaction of these conditions, but also a determination of whether the tax on subcontractors is valid in the eyes of the Contracting Officer.

Practice Tips

- Prime and subcontractors performing in Afghanistan will need to monitor these developments closely, and should identify the performance, cost, and schedule impact associated with these changes as early as possible.
- Any contractor must diligently account for its increased costs of performance associated with these developments and should communicate potential changes to the cognizant Contracting Officer as soon as possible. Potential cost increases may include:
 - insurance;
 - salary;
 - personnel turnover;
 - equipment damage or loss; and
 - training.
- Similarly, upon receipt of direction from the U.S. government or prime contractor that contracts or subcontracts with private security contractors must be terminated, prompt arrangements must be made to notify the security contractors of the termination and to prepare and submit termination settlement proposals to the Contracting Officer.
- Contractors should examine their current contracts to understand their obligations regarding security and examine FAR 52.229-6 and any records or communications relevant to that provision.

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