

Defense Contractor Special Series Release 3: Continuation of Pre-2015 Tax Dispute May Prevent Licenses Being Renewed But Resolution of Dispute May Be Possible Through Independent International Tribunal

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A large number of defense contractors obtained their investment licenses from the Afghanistan Investment Support Agency in 2015. These licenses have a term of 3 years and therefore, expire in 2018. At that time, if contractors want to continue operating in Afghanistan, they are required to renew their licenses.¹

In practice, operating under an expired license can lead to a number of difficulties including an inability to obtain visas, weapons/communications equipment registration, and possibly increased tax burdens and penalties.² Moreover, contractors operating under an expired license may be in breach of contract with their clients and may have difficulty gaining new work in Afghanistan whilst their licenses remain expired.

The process for renewing a license is fairly straightforward.³ However, before a license can be renewed a tax clearance certificate must be obtained from the Ministry of Finance (**MoF**). And before a tax clearance certificate can be obtained, all outstanding tax obligations must be settled, starting with confirming tax exemptions with the MoF.

A delay in obtaining a tax clearance certificate will delay renewal of a license. Having tax exemptions confirmed and complying with withholding, remittance and filing obligations takes time. Unless contractors have already confirmed their tax exemptions and have been regularly meeting their withholding, remittance and filing obligations, obtaining a tax clearance certificate may take at least 2 months.

Contractors (especially subcontractors) that operated in Afghanistan prior to 2015 may encounter additional problems in obtaining a tax clearance certificate. It appears to be settled that prime contractors are exempt from paying taxes on pre-2015 revenues but are otherwise subject to a range of withholding, remittance and filing obligations.

However, prior to 2015, many prime contractors believed that they did not have any pre-2015 tax related obligations in Afghanistan. Consequently, many may not have complied with their pre-2015 withholding, remittance and filing obligations.⁴ The MoF's position is that prime contractors must settle these pre-2015 obligations, with penalties, before a tax exemption certificate is issued.

In addition, according to the Government of Afghanistan (**GoA**), subcontractors are not entitled to any tax exemptions on pre-2015 revenues. They are, it is argued, required to pay tax and comply with all relevant withholding,

¹ If they no longer want to operate in Afghanistan, they are required to close their Afghanistan branch, which, requires a tax clearance certificate. The requirements for obtaining a tax clearance certificate is discussed later in this Release.

² Unfortunately, these problems cannot be avoided by simply registering another group entity in Afghanistan and obtaining a license for the new entity. The Afghan authorities will not knowingly allow a new group entity to be registered whilst an existing group company's license remains expired.

³ The Afghanistan Investment Support Agency ceased operating in 2016. All licenses must now be issued or renewed through the Ministry of Commerce & Industries. Procedures and requirements are substantially the same.

⁴ If prime contractors have not withheld from relevant third-party payments, the MoF will require them to gross up the payments and remit an amount in lieu of amount that should have been withheld. When combined with penalties accruing over several years, potential liabilities for some prime contractors may be significant.

remittance and filing obligations. The GoA's position is disputed by the United States Government (**USG**). According to the USG, subcontractors are entitled to the same exemptions as prime contractors on pre-2015 revenues.

Prior to 2015, many subcontractors believed that they were exempt from all Afghan tax related obligations. Consequently, many may not have paid any pre-2015 taxes nor complied with their withholding, remittance and filing obligations.⁵ The MoF's position is that subcontractors must settle these pre-2015 obligations, with penalties, before a tax exemption certificate is issued.

A Tax Working Group comprised of representatives of the USG and the GoA was formed in 2015 with a view to resolving this dispute. In late 2016, the Group agreed on a proposal⁶ for settling this dispute subject to approval by the Afghan Cabinet.⁷

Cabinet approved the proposal. However, only 31 contractor entities,⁸ specifically named, were approved for tax exemptions on pre-2015 revenues. On about March 14, 2017, the MoF issued the Legacy Tax Exemption Group Ruling to give effect to the proposal, as approved by Cabinet.

According to the MoF, save for those subcontractors, if any, among the 31 entities specifically named in the approval,⁹ all other subcontractors are liable for all Afghan taxes on pre-2015 revenues. The USG continues to dispute this.

According to the USG, the proposal was intended and should apply to all subcontractors. Therefore, all subcontractors should be entitled to the tax exemptions on pre-2015 revenues.

The USG's position is, at first glance, supported by Afghan law. Afghan law requires the GoA to apply the law, including the tax law, equally and fairly to all similarly situated private investors (contractors and subcontractors who have registered branches in Afghanistan are private investors). Therefore, it may be argued, the GoA is acting in breach of Afghan law by exempting some, but not all, subcontractors from compliance with the tax laws.¹⁰

These issues may come to a head in 2018 as prime contractors and subcontractors with, according to the GoA, outstanding pre-2015 tax obligations start applying for tax clearance certificates as part of the license renewal procedure.¹¹

Until the dispute is resolved, prime contractors and subcontractors with alleged outstanding pre-2015 tax liabilities are in a precarious position. The GoA is also in a difficult position and has a clear interest in having this dispute

⁵ According to the GoA, and with respect to pre-2015 revenues only, subcontractors are liable to pay 20% profit, 2% business receipts tax on gross revenue, in addition to complying with withholding, remittance and filing obligations. With penalties accruing over several years, there is a very large potential liability for subcontractors on pre-2015 revenues.

⁶ Under this proposal, according to the USG, subcontractors would be entitled to the same tax exemptions as prime contractors with respect to pre-2015 revenues.

⁷ We understand that the arrangement was without prejudice and both parties reserved all rights.

⁸ It is unclear how many of these entities, if any, are subcontractors.

⁹ The number of subcontractors among the 31 named entities may be 'nil'.

¹⁰ One possible way the GoA could address this alleged breach is by extending the pre-2015 tax exemptions to all subcontractors. Another way might be to withdraw the tax exemptions from the subcontractors among the 31 named entities, if any, so that no subcontractors are entitled to pre-2015 tax exemptions.

¹¹ The MoF has indicated that it will refuse to issue tax clearance certificates until alleged pre-2015 tax liabilities are settled. The MoF may also audit specific contractors and subcontractors with respect to their pre-2015 operations.

finally resolved. It is not clear when, if at all, the dispute may be resolved through the Tax Working Group or other G2G channels.¹²

The parties, including the GoA, may wish to consider other options for the resolution of this dispute. For example, Afghan law provides access to an independent international tribunal through which this dispute may potentially be resolved on application by one or more contractors, or the GoA. However, the dispute is not likely to be resolved in time for the licenses to be renewed in 2018. Nevertheless, the tribunal may issue interim directions regarding license renewals pending final resolution of the dispute. In the circumstances, this might be the only viable option for the parties.

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¹² At present we are not aware of any further G2G discussions or negotiations regarding this issue.