

Defense Contracting Special Series – Release 1: Contractor and Subcontractor Tax Liabilities on Pre- and Post-2015 Revenues

A proper understanding of the issues surrounding the applicability of Afghan taxes on revenues generated under defense contracts is essential - especially for defense contractors and subcontractors that operated in Afghanistan prior to January 1, 2015.

Introduction

Many contractors and subcontractors remain confused, understandably, about the applicability of Afghan taxes on revenues generated under defense contracts and subcontracts performed in Afghanistan, both before and after January 1, 2015.

Under Afghan law, in the absence of specific tax exemptions granted by law, all contractor and subcontractor revenues earned by providing goods or services in Afghanistan are subject to Afghan taxes.

In relation to revenues that were earned after January 1, 2015, there is a framework in place that recognizes limited tax exemptions on revenues from work on specific military contracts and subcontracts subject to such tax exemptions being confirmed by the Ministry of Finance (**MoF**).

Nevertheless, even if exemptions are confirmed, contractors and subcontractors may be required to withhold from certain payments to third parties, transfer those withholdings to the tax office, and comply with a number of filing obligations.

Revenues earned from work on military contracts before January 1, 2015 are governed under a framework that is similar, although not identical, to the framework that governs post January 1, 2015 revenues. However, according to the Government of Afghanistan (**GoA**), exemptions under this framework are available to prime contractors only, not to subcontractors.

Therefore, subcontractors are liable to pay all Afghan taxes on revenues earned from providing goods or services in Afghanistan prior to January 1, 2015.

This release discusses the following.

- The background to the legal frameworks governing defense contractor and subcontractor tax exemptions in Afghanistan (**Part 1**).
- The primary tax obligations under the Income Tax Law 2009 (**ITL**) that apply to all contractors and subcontractors operating in Afghanistan (**Part 2**).
- The nature and extent of tax exemptions available to contractors and subcontractors on revenues earned after January 1, 2015 (**Part 3**).
- The nature and extent of tax exemptions available to contractors and subcontractors on revenues earned before January 1, 2015 (**Part 4**).
- The measures that may be available to contractors and subcontractors under United States law and Afghan law to possibly reduce the financial burden of an Afghan tax liability (**Part 5**).
- A summary (**Part 6**).

Part 1 – Background

ITL governs tax obligations in Afghanistan.

Under ITL, all revenues earned from providing goods or services in Afghanistan, including those earned by contractors and subcontractors under military contracts, are subject to taxes and tax related obligations, unless they are specifically exempt.

Limited tax exemptions are granted under the Bilateral Security Agreement (**BSA**)¹ and the Agreement on the Status of NATO Forces and NATO Personnel Conducting Mutually Agreed NATO-Led Activities in Afghanistan (**SoFA**)² for revenues earned under BSA or SoFA contracts or subcontracts after January 1, 2015.

There does not, at this stage, appear to be any significant disagreement between the United States Government (**USG**), North Atlantic Treaty Organization (**NATO**) and GoA regarding the extent and nature of BSA and SoFA contractor and subcontractor tax exemptions and tax obligations on revenues earned after January 1, 2015³.

However, there is a significant disagreement regarding revenues earned prior to January 1, 2015.

The tax exemptions available to USG and International Security Assistance Force (**ISAF**) contractors for revenues earned prior to January 1, 2015, are contained within the Status of Forces Agreement (**DN 202**)⁴ and the Military Technical Agreement (**MTA**)⁵ respectively.

Initially, the position of USG and ISAF appeared to be that contractors and subcontractors were exempt from all tax related obligations in Afghanistan, including withholding obligations. Subsequently, there was an acknowledgement that contractors and subcontractors had limited withholding obligations but were otherwise entitled to broad exemptions.

GoA's position has consistently been that only prime contractors are entitled to income and revenue tax exemptions⁶ on revenues earned from activities in Afghanistan before January 1, 2015, but otherwise had a number of withholding and filing obligations.

GoA has never recognized any tax exemptions for subcontractors with respect to revenues earned prior to January 1, 2015. Thus, according to GoA, subcontractors are liable to pay all Afghan taxes on revenues earned prior to January 1, 2015, as well as being subject to all relevant withholding and filing obligations.

Part 2 – Tax Obligations Under ITL

GoA requires contractors and subcontractors to apply to MoF for confirmation of tax exemptions for all military contracts or subcontracts under which they provide goods or services in Afghanistan. In the absence of confirmations issued by MoF, contractors and subcontractors are liable to pay all Afghan taxes, as well as being subject to all withholding and filing obligations.

¹ An international treaty between the United States Government and the Government of Afghanistan signed on September 30, 2014 and entered force on January 1, 2015, after being ratified by the Afghan parliament under Article 90(5) of the Constitution 2004.

² An international treaty between the North Atlantic Treaty Organization and the Government of Afghanistan signed on September 30, 2014, and entered force on January 1, 2015, after being ratified by Afghan parliament under Article 90(5) of the Constitution 2004.

³ ITL, BSA and SoFA, read together, effectively provide that contractors and subcontractors are entitled to limited exemptions, but may be required to withhold amounts from certain payments and transfer such amounts to the Afghanistan Ministry of Finance.

⁴ An international treaty between the United States Government and the Government of Afghanistan that came into force on May 28, 2003.

⁵ An international treaty between ISAF and the Government of Afghanistan that came into effect on January 4, 2002.

⁶ Exemptions with respect to salary and wage payments to employees arose by ordinary operation of ITL. This is because DN202 and MTA granted income tax exemptions to employees (both foreign and local in the case of MTA and foreign only in the case of DN202) and therefore, there was no obligation on the part of employers to withhold from salary and wage payments.

Therefore, in the absence of tax exemptions confirmed by MoF, contractors and subcontractors are subject to the following obligations under ITL⁷.

- (1) Payment of 20% corporate income tax assessed on net income, paid annually – Article 4.
- (2) Payment of 2%, 5% or 10% business receipts tax assessed on gross revenue before any deductions, paid quarterly – Article 66⁸.
- (3) Withholding of 10% or 15% on rental payments, transferred to MoF monthly – Article 59⁹.
- (4) Withholding of 0%, 2%, 10% or 20% from salary and wage payments, transferred to MoF monthly – Article 58.
- (5) Withholding of 2% or 7% from payments to suppliers of goods and services, transferred to MoF monthly – Article 72¹⁰.
- (6) Obligation to file monthly, quarterly, and annual tax returns.
- (7) Obligation to maintain records.
- (8) Penalties for late payment of taxes, late transfer of withholdings and late submission of filings¹¹.

Part 3 - Post January 1, 2015

Under BSA and SoFA, contractors and subcontractors are entitled to the following exemptions.

- (1) Payment of 20% corporate income tax assessed on net income, paid annually – Article 4.
- (2) Payment of 2%, 5% or 10% business receipts tax assessed on gross revenue before any deductions, paid quarterly – Article 66.
- (3) Withholding of 0%, 2%, 10% or 20% from salary and wage payments to foreign employees that do not normally reside in Afghanistan, transferred to MoF monthly – Article 58¹².
- (4) Withholding of 2% or 7% from payments to foreign suppliers of goods and services, transferred to MoF monthly – Article 72¹³.

Therefore, under BSA and SoFA, contractors and subcontractors have the following obligations under ITL.

- (1) Withholding of 10% or 15% on rental payments, transferred to MoF monthly – Article 59.
- (2) Withholding of 0%, 2%, 10% or 20% from salary and wage payments to local employees, and foreign employees that normally reside in Afghanistan, transferred to MoF monthly – Article 58.
- (3) Withholding of 2% or 7% from payment made to local suppliers¹⁴ of goods and services, transferred to MoF monthly – Article 72.
- (4) Obligation to file monthly, quarterly, and annual tax returns.
- (5) Obligation to maintain records.
- (6) Penalties for late transfer of withholdings and late submission of filings.

Part 4 – Pre-January 1, 2015

This release is based on GoA's interpretation and application of DN 202 and MTA¹⁵.

⁷ Under ITL, there are further tax related obligations. However, we have only highlighted the obligations that we consider most relevant to contractors and subcontractors.

⁸ Unless they are providing hotel, telecommunications, airline or other specialized services, the vast majority of contractors and subcontractors are likely to fall within the 2% category.

⁹ As the majority of contractors and subcontractors are accommodated within military bases, and do not pay rent, they are not required to make any withholdings. However, if contractors and subcontractors do make rental payments, it is likely that they will fall within the 15% withholding category.

¹⁰ If the supplier is validly licensed to do business in Afghanistan, the obligation is 2%, if not validly licensed, the obligation is 7%.

¹¹ The topic of penalties under ITL and the manner in which MoF applies penalties shall be the subject of a further release in the near future.

¹² This exemption arises by ordinary operation of ITL. This is because BSA and SoFA grant income tax exemptions to foreign employees that do not normally reside in Afghanistan and therefore, there is no obligation on the part of employers to withhold from salary and wage payments to such employees.

¹³ For this exemption to apply, we believe that the Government of Afghanistan is likely to adopt the position that the subcontractor to whom the payment is being made must also be exempt from income tax, either under BSA or SoFA, or otherwise.

¹⁴ And probably any supplier that is not exempt from income tax.

¹⁵ There are unsubstantiated media reports that the United States Government and Government of Afghanistan may be discussing a possible solution to their disagreement regarding pre-2015 tax liabilities under DN202 and MTA – including a possible immunity for pre-2015 tax liabilities. We do not profess to be able to predict the outcome of such discussions, if indeed they are taking place but note the following.

Under DN202 and MTA, contractors are entitled to the following exemptions.

- (1) Payment of 20% corporate income tax assessed on net income, paid annually – Article 4.
- (2) Payment of 2%, 5% or 10% business receipts tax assessed on gross revenue before any deductions, paid quarterly – Article 66.
- (3) Withholding of 0%, 2%, 10% or 20% from salary and wage payments to employees (all employees under MTA and only foreign employees under DN202), transferred to MoF monthly – Article 58¹⁶.

Therefore, under DN202 and MTA, according to GoA, prime contractors have the following obligations under ITL.

- (1) Withholding of 10% or 15% on rental payments, transferred to MoF monthly – Article 59.
- (2) With respect to MTA only, withholding of 0%, 2%, 10% or 20% from salary and wage payments to local employees, transferred to MoF monthly – Article 58.
- (3) Withholding of 2% or 7% from payments made to suppliers of goods and services, transferred to MoF monthly – Article 72. (As MoF does not issue exemptions to subcontractors under DN202 or MTA, MoF will always consider a prime contractor as having an obligation to withhold and remit taxes from payments made to its subcontractors under Article 72 of ITL.)
- (4) Obligation to file monthly, quarterly, and annual tax returns.
- (5) Obligation to maintain records.
- (6) Penalties for late payment of taxes, late transfer of withholdings and late submission of filings.

The position of GoA is that subcontractors are not entitled to any exemptions under DN202 and MTA and are therefore subject to the following obligations under ITL.

- (1) Payment of 20% corporate income tax assessed on net income, paid annually – Article 4.
- (2) Payment of 2%, 5% or 10% business receipts tax assessed on gross revenue before any deductions, paid quarterly – Article 66.
- (3) Withholding of 10% or 15% on rental payments, transferred to MoF monthly – Article 59.
- (4) Withholding of 0%, 2%, 10% or 20% from salary and wage payments, transferred to MoF monthly – Article 58.
- (5) Withholding of 2% or 7% from payments made to suppliers of goods and services, transferred to MoF monthly – Article 72.
- (6) Obligation to file monthly, quarterly, and annual tax returns.
- (7) Obligation to maintain records.
- (8) Penalties for late transfer of withholdings and late submission of filings.

Part 5 – Reducing Financial Burden of Afghan Tax Liability

Contractors and subcontractors may wish to consider one or more of the following with advice from qualified United States and Afghan counsel.

- (a) The Government of Afghanistan is under significant pressure internally and from the international community to increase tax collections and other than the defense contracting sector, there does not currently appear to be any other sector that can provide a significant source of tax revenue in Afghanistan.
- (b) Similar discussions have taken place at very senior levels between the respective governments for several years and as far as we are aware, the Government of Afghanistan has not moved from its position, which it has consistently defended.
- (c) Notwithstanding the discussions in (b) above, the Government of Afghanistan has pursued recovery against contractors and subcontractors for alleged pre-2015 tax liabilities based on its interpretation of DN 202 and MTA as set out in Part 4 above. The Government of Afghanistan has not postponed its attempts at recovery pending the outcome of such discussions, and we do not believe that it will postpone attempts at recovery going forward, pending outcome of the current discussions, if they are taking place.
- (d) Notwithstanding the disagreement between the respective governments regarding DN202 and MTA, a large number of United States Government and ISAF contractors and subcontractors have paid taxes to the Government of Afghanistan, and otherwise complied with their withholding obligations, at significant financial cost. If an immunity is now granted, such contractors and subcontractors may have to be reimbursed – which is not likely to happen – this may further reduce prospects of any immunity being granted.
- (e) Importantly, based on the wording of DN202, MTA and ITL, from a strictly legal perspective, the Government of Afghanistan's interpretation of DN202 and MTA is not unreasonable.

¹⁶ This exemption arises by ordinary operation of ITL. This is because the DN202 and MTA grant income tax exemptions to relevant employees and therefore, there is no obligation on the part of employers to withholding from salary and wage payments to such employees.

- (1) *Tax credits or itemized deductions:* Contractors and subcontractors that pay taxes in Afghanistan may be able to obtain a tax credit or itemized deduction with respect to their United States tax liabilities. Under United States tax laws, if a taxpayer has paid or accrued foreign taxes to a foreign country on foreign source income and is subject to United States tax on the same income, the taxpayer may be able to take either a credit or an itemized deduction for those taxes.
- (2) *Recovery from USG, NATO, ISAF, or prime contractor:* Contractors and subcontractors may wish to explore claims against USG, NATO, ISAF or, in the case of a subcontractor, a relevant prime contractor, for recovery of an amount equal to, or contribution towards, the taxes and related liabilities paid in Afghanistan. Such a claim may possibly be based on misrepresentation, breach of contract or simply, a claim for an allowable cost or expense under the relevant contract.
- (3) *Disclosing only Afghan source revenues:* On a proper application of Afghan law, generally only revenues and payments with an Afghan source are subject to Afghan taxes and withholding obligations. A correct application of this principle may significantly reduce contractor and subcontractor tax related liabilities.
- (4) *Penalties:* A proper understanding of the penalty provisions under ITL and the circumstances in which they apply may also result in reducing contractor and subcontractor tax related liabilities.
- (5) *Other measures:* There may be other measures available to lawfully reduce the financial burden of an Afghan tax liability.

Contractors and subcontractors should obtain advice from qualified counsel as to which, if any, of the above options may be available and appropriate for their circumstances.

Part 6 – Summary

The following table summarizes the primary tax obligations of contractors and subcontractors on post January 1, 2015, revenues.

POST-2015	Income Tax	BRT	Foreign Employee WHT ¹⁷	Local Employee WHT	Rental WHT	Foreign Contractor WHT	Local Contractor WHT
BSA	Exempt	Exempt	Exempt	Obligated	Obligated	Exempt ¹⁸	Obligated
SoFA	Exempt	Exempt	Exempt	Obligated	Obligated	Exempt ¹⁹	Obligated

The following table summarizes the primary tax obligations of prime contractors on pre-January 1, 2015, revenues.

PRE- 2015	Income Tax	BRT	Foreign Employee WHT	Local Employee WHT	Rental WHT	Foreign Contractor WHT	Local Contractor WHT
DN202	Exempt	Exempt	Exempt	Exempt	Obligated	Obligated	Obligated
MTA	Exempt	Exempt	Exempt	Obligated	Obligated	Obligated	Obligated

The following table summarizes the primary tax obligations of subcontractors on pre-January 1, 2015, revenues.

PRE- 2015	Income Tax	BRT	Foreign Employee WHT	Local Employee WHT	Rental WHT	Foreign Contractor WHT	Local Contractor WHT
DN202	Obligated	Obligated	Obligated	Obligated	Obligated	Obligated	Obligated
MTA	Obligated	Obligated	Obligated	Obligated	Obligated	Obligated	Obligated

¹⁷ The exemptions are limited to foreign employees that do not normally reside in Afghanistan. The term “normally reside” is not defined.

¹⁸ Assumes that payments made to BSA or NATO subcontractors or suppliers that are otherwise exempt from income tax.

¹⁹ Ibid

The options listed in Part 5 of this release may be available to contractors and subcontractors to lawfully reduce the financial burden of an Afghan tax liability. Contractors and subcontractors should obtain advice from qualified counsel as to which, if any, of those options may be available and appropriate for their circumstances.

For a confidential discussion of your circumstances, contact Afghanistan Lawyers International.

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(1) Afghanistan Lawyers International is an Afghan legal, tax and government affairs advisory firm staffed by experienced lawyers with qualifications from Afghanistan, the United States and Australia. The firm provides legal and regulatory advice and strategic government advisory services on complex and significant matters for the Afghanistan market.

(2) **Personnel:**

- The firm's partners and senior staff have extensive experience in advising on legal, taxation and government affairs matters in Afghanistan.

- *Zmarak Zhouand*

Mr. Zhouand is Afghan-Australian. He was admitted as a barrister and solicitor in New South Wales, Australia, in 2001, and as an Attorney and Counselor in New York, United States, in 2014. Between 2001 and 2008, Mr. Zhouand worked with Henry Davis York and Gadens Lawyers, both leading Australian corporate law firms, where he represented blue-chip national and international clients across the corporate, commercial, banking and finance and litigation practice areas.

Mr. Zhouand returned to Afghanistan in 2008 to work with Roshan, where, until early 2011, he co- led Roshan's legal and government affairs team and was also in charge of the legal and regulatory function for Roshan's wholly owned subsidiary, M-Paisa, before re-entering private practice, as a partner, at the beginning of 2011. Mr. Zhouand regularly represents and advises United States and NATO contractors, donor agencies and their implementing partners, development finance institutions, foreign investors, Government of Afghanistan agencies, foreign governments, and non- governmental organizations.

Mr. Zhouand focuses on significant and complex Afghanistan related matters and transactions – primarily with respect to tax, general corporate, banking and finance, mergers and acquisitions and projects (telecommunications, mining and infrastructure, energy).

He is widely recognized as one of Afghanistan's leading corporate, finance and mining lawyers by a number of publications including Chambers Global, Chambers Asia Pacific and IFLR 1000.

- *Prof. Abdul Shukor Mahjoor*

Prof. Mahjoor is an Afghan-American advocate registered with the Afghanistan Independent Bar Association. He has worked extensively in Afghanistan in the legal and government affairs environments over several years.

Prior to forming ALI with Mr. Zhouand, Prof. Mahjoor was, for a period of almost 3 years, Managing Partner of a specialist dispute resolution law firm in Kabul, Afghanistan.

Prof. Mahjoor is Chancellor of, and Professor of Law at, Karwan University, Kabul, Afghanistan. In addition to lecturing at Karwan University, Professor Mahjoor is frequently called upon to train high-ranking Government of Afghanistan officials on legal and diplomatic matters. He is a regular speaker at conferences on issues relating to rule of law and economic development and often features on television programs where topical legal issues are discussed.

He frequently represents United States Government implementing partners and contractors, their foreign employees, and foreign legal and natural persons generally in relation to multi-million-dollar disputes with Afghan counterparties, and in relation to Office of the Attorney-General investigations and commercial and criminal court proceedings up to and including the Supreme Court of Afghanistan.

Prof. Mahjoor is a dispute resolution specialist, and arguably one of Afghanistan's most effective dispute resolution lawyers.

- The firm's practice is supported by a number of commercially experienced international and locally admitted lawyers and tax specialists.

(3) **Sectors:** defense contracting, telecommunications, mining, and infrastructure, oil and gas, information technology, banking and financial services, media, intellectual property, security, logistics, commercial aviation, contracting and non-governmental sectors.

(4) **Services:**

- (a) Tax: the firm specializes in the full range of tax issues such as tax exemptions, BRT, withholding taxes, corporate income tax, customs, and tax dispute resolution.
- (b) Corporate and investment: specific and integrated full legal services to organizations doing business, and overseas investors looking to do business, in Afghanistan.
- (c) Projects: providing local counsel support for large and complex projects across a range of industries including mining and infrastructure, oil and gas and telecommunications.
- (d) Donor funds/PPP: advisory and transactional support to participants engaged in in donor funded projects including complex Public Private Partnerships (i.e. donors, public entities, private entities, prime grantees, and downstream grantees).
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- (f) Banking and finance: acting for financiers, borrowers and other intermediaries, strategic advice and practical structuring solutions, opinions, as well as documentation, for all types of transactions.
- (g) Dispute resolution: negotiation, mediation, arbitration, specialist tribunals, primary and appellate courts.
- (h) Lobbying services: including advising clients on devising engagement strategies with the Government of Afghanistan at the ministerial and deputy ministerial levels.
- (i) Employment: including drafting standard employment agreements, human resources policies and procedures, advising on compliance and managing employee exits and disputes.