

Legal Structures Can Influence Cost Allocations

Written by Nick Sanders
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Most of the time, cost allocations for a government contractor don't care about legal structures. Legal structures are the province of lawyers and tax accountants, for the most part. When we talk about FAR and CAS allocation requirements, we talk about functions and activities, and home offices and segments and business units. We talk about cost objectives—both intermediate and final. We don't talk about the legal structure of the corporate entity. One legal entity or one hundred: it really doesn't affect how costs are collected and allocated to places where the costs get collected and billed.

Most of the time.

Recently, though, [a dispute](#) at the Civilian Board of Contract Appeals (CBCA) turned on a contractor's legal structure. The dispute involved payment of taxes to the Afghanistan government. Having dealt with the topic in the past (to a small extent) I was interested in what the Board thought of the situation. What I learned, when reading the case, was that the Board seemed to be frustrated by the lack of information and facts. In particular, the Board seemed to be frustrated and confused over the Appellant's legal structure.

(If you're going to read the rest of this blog article, I suspect you will be similarly frustrated. You may want to keep a separate list of all the legal entities involved.)

The Appellant, International Development Solutions, LLC (IDS), provided security services to the Department of State in the country of Afghanistan. According to IDS, the Afghani government imposed taxes on it based on the contract work it had performed in country. The Board wrote that IDS "seeks payment for three years of tax and penalty payments under cost-reimbursement provisions of two task orders."

The Board found that IDS had not provided sufficient evidence that it had actually incurred the costs associated with those tax payments, or that the tax payments related to the two task orders. A particular concern of the Board seemed to be the lack of transparency of the legal structure of the contractor—a lack of transparency that was exacerbated by testimony.

Legal entities mentioned during the case included: ACADEMI Training Center, Inc.; ACADEMI LLC; Constellis Holdings LLC; and Constellis LLC. The Board was clearly confused in trying to trace the relationships between the entities.

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It was undisputed that the Department of State awarded a contract to IDS in 2010, and that IDS provided the services under the contract. The two task orders at issue were worth \$400 million. It seemed that the corporate headquarters of IDS was located in McLean, Virginia.

Then things got murky.

Less than two years later (May, 2012)—

... a person signing as director of contracts for “ACADEMI” wrote to the State Department contracting officer [stating], ‘As of May 10, 2012, ACADEMI Training Center, Inc. (‘ACADEMI’), previously the 49% owner of [IDS], purchased the remaining 51% membership interest . . . to become the sole owner. ACADEMI now requests a novation of the 2010 contract and associated task orders ‘from its subsidiary, IDS, to itself’.

(Footnotes and internal citations omitted, as always.)

Thus, it appears that IDS was, itself, a partially owned subsidiary of an entity called ACADEMI Training Center, Inc. (“ACADEMI”) when it won the original contract. Was that disclosed to the Department of State prior to contract award? We don’t know. Was a 49 percent ownership enough to exert control over IDS? Again, we don’t know.

But we do know that, less than two years later, ACADEMI purchased the remaining 51% of the ‘membership interest’ of IDS. (N.B.: According to the Board, “it appears that a Delaware limited liability company has ‘member’ interests rather than ‘stock’ shares.) Purchased from whom? We don’t know.

After the purchase of the remaining membership interests, IDS was 100% owned by ACADEMI and ACADEMI requested that the State Department acknowledge that ownership through a novation. A novation, of course, “is the act of replacing a contract with another contractual obligation, requiring the consent of all parties involved.” Novations are discussed at FAR 42.12. Let’s quote from that FAR Subpart, below—

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The Government may, when in its interest, recognize a third party as the successor in interest to a Government contract when the third party's interest in the contract arises out of the transfer of-

(1) All the contractor's assets; or

(2) The entire portion of the assets involved in performing the contract. ... Examples of such transactions include, but are not limited to-

(i) Sale of these assets with a provision for assuming liabilities;

(ii) Transfer of these assets incident to a merger or corporate consolidation; and

(iii) Incorporation of a proprietorship or partnership, or formation of a partnership.

(b) ***A novation agreement is unnecessary when there is a change in the ownership of a contractor as a result of a stock purchase, with no legal change in the contracting party, and when that contracting party remains in control of the assets and is the party performing the contract.*** However, whether there is a purchase of assets or a stock purchase, there may be issues related to the change in ownership that appropriately should be addressed in a formal agreement between the contractor and the Government (see 42.1203(e)).

(c) When it is in the Government's interest not to concur in the transfer of a contract from one company to another company, the original contractor remains under contractual obligation to the Government, and the contract may be terminated for reasons of default, should the original contractor not perform.

(Emphasis added.)

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As we highlighted above, there is no need to process a novation agreement when there is a stock purchase with no change in the contracting party. Indeed, that is the rationale used by the contracting officer to reject the request for novation, writing “Given that IDS still exists . . . and has all of the necessary resources and support of ACADEMI to continue fully meeting its contractual obligations . . . no action [by] the Government is required. Therefore, IDS should continue to fulfill its contractual obligation as agreed to under the [2010] contract.”

The murk continued to grow, as the Board wrote in its decision.

Notwithstanding State’s July 2012 letter, IDS contends that ‘following denial of the requested novation . . . ACADEMI Training Center, Inc. became prime contractor and real party in interest In the alternative, IDS remained prime contractor with ACADEMI Training Center, Inc. as subcontractor[.]’ By contrast, a former board member and ‘lead investor’ of a company he called simply ‘Academi’ testified at the hearing, when asked ‘which entity still legally held the . . . contract and the task orders’ after July 2012, ‘Well, since [the contract] wasn’t novated IDS did. And the only way to get that out to a different name was if they [State] agreed to novate it.’

The Board was getting frustrating at the lack of opacity. The Board’s frustration was expressed in Footnote #3.

The record is rife with ambiguity and confusion as to which entity witnesses meant when they referred to ‘Academi.’ The former board member testified when asked to clarify to which board he belonged, ‘That was, well, there’s so many names of these companies. At the time I believe it was Academi. . . . It was Xe Services, and then Academi, and then Constellis. For that period of time [2010 to 2013] I don’t think Constellis was relevant. It was Academi.’ He was asked on cross-examination, ‘[D]id you purchase an interest in one of the entities with the name Academi?’ He answered, ‘I believe Academi was formed as successor entity or it was renamed. I can’t remember to be honest with you.’ Asked when he acquired an interest in ‘Academi LLC,’ he testified, ‘I don’t know if we ever acquired that entity. I believe we created that entity . . . at the end of 2011.’ Asked to distinguish ‘between Academi LLC and Academi Training Center,’ he testified, ‘If those two entities exist, which I trust they do because you’re referring to them,’ the latter ‘would have been [only] the actual training center in Moyock, North Carolina.’ We gather from this that by ‘Academi’ this witness primarily meant ACADEMI LLC.

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It was unclear as to whether IDS even existed. The Board's decision included this quote from testimony—

Q And how were payments from the State Department handled . . . after the State Department rejected the proposed novation?

A Well, they continued to pay IDS, because it held the contract. So, that's the entity they paid. It was paid literally to an account that was only set up to receive payments. And then those payments were transferred to Academi, because Academi paid all the bills. And we had all the—incurring a lot of costs. Being a wholly owned entity it was more of a balance sheet checking account mission for us, and more headaches.

That sounds like an accountant testifying, doesn't it? It seems that nobody cares about the accounting workload when they start playing legal and tax games with the corporate structure. (But perhaps we digress.)

Now Constellis comes into play. As the Board wrote—

Another witness for IDS, who said he had been vice president of financial compliance since November 2020 of an entity he called simply 'Constellis' (see below), testified based on his knowledge of 'Constellis' records:

Q As of or after the Department declined to sign the proposed novation agreement, what changes, if any, were made to the IDS accounting system?

A There are no changes made to the IDS accounting system per se. However, from, you know, flow of funds there's a slight change. For example, invoices continued to be generated from IDS. The State Department would make payments to an IDS bank account, but . . . [t]hose funds that went into the IDS receipts account would be swept into an Academi account out of which disbursements were made.

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Q Could you describe that a little bit more, what you meant when you said that the payments were deposited in an IDS account and then swept into the Academi account?

A Yes. Due in part to the fact that the contracts were not novated, the original contract was awarded to IDS. And so, the company then maintained that structure adding IDS, the legal entity, that would invoice the State Department. The remittance went to a legacy IDS bank account. But then, after Academi acquired them, they converted that account to what's referred to as a zero balance account, meaning that funds would come into that account but then get swept into a master Academi account and reimbursements on behalf of the company would go into the Academi account.

Q And, just to clarify, you referenced a zero balance account. Which company had what you referred to as the zero balance account?

A So, the IDS bank account, essentially, was the zero balance account, meaning that payments would be made into that, wired into that account, but they were transferred into an Academi account.

The lack of transparency caused the presiding judge to get involved.

JUDGE CHADWICK: . . . Does there currently exist an entity called Academi LLC?

THE WITNESS: Yes, sir. A legal entity, Academi LLC.

JUDGE CHADWICK: Does that Academi LLC, does that own Academi Training Center LLC?

THE WITNESS: Again, I'd have to look at the—or that's more a question for our legal team, in terms of that structure.

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JUDGE CHADWICK: Is there an entity currently in existence called Constellis LLC?

THE WITNESS: Yes, Your Honor.

JUDGE CHADWICK: Is there also something called Constellis Holdings, with some corporate designator?

THE WITNESS: Yes, Your Honor.

JUDGE CHADWICK: What, if any, ownership relationship exists between Constellis LLC and Constellis Holdings?

THE WITNESS: Actually, I can't confirm what the—I mean, you have the umbrella company and I'm embarrassed to say I forget which one is the umbrella company with all the affiliates below it.

JUDGE CHADWICK: . . . As between Constellis LLC and Academi LLC, does one own the other?

THE WITNESS: Constellis is the holding company of Academi LLC, is my understanding.

JUDGE CHADWICK: Okay, but you just said Constellis again, and we're not clear—it sounds to me from your previous answer, you said Constellis, but you may not be sure whether you mean Constellis Holdings or Constellis LLC.

THE WITNESS: That is correct. It's a complex legal structure.

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Turning to the entity that was taxed by the Afghani government, the record was similarly muddled. For example—

In approximately 2017, Afghanistan issued assessments of taxes and penalties to ACADEMI LLC for Afghan tax years 1389 to 1394 (roughly March 2010 to March 2015). The taxpayer used an outside lawyer based in Washington, D.C., to address the tax issues. The lawyer testified in the hearing that his client in the engagement was ‘Constellis Holdings.’ Throughout his testimony, he referred to the taxpayer as ‘Academi.’ ...

Bank records show that in January, April, May, and July 2017 and July and September 2018, Academi LLC and Constellis Holdings LLC wired six payments denominated in dollars to the Afghan Ministry of Finance. Academi LLC made the first three payments; Constellis Holdings LLC made the last three. Each transfer record lists the ‘Debit Account Name’ as ‘Academi Training Center Inc [sic] AP [accounts payable].’

In summary, the government of Afghanistan levied taxes against ACADEMI LLC. The taxpayer was ACADEMI. The payments were made to the Afghani government by two legal entities: Academi LLC and Constellis Holdings LLC. The payments were then recorded as costs of Academi Training Center Inc.

Thus, when IDS submitted claims for \$36.7 million related to those tax payments, the Board was naturally confused. As a Footnote stated—

The Constellis witness testified that the organization internally ‘allocated’ the tax payments to the two task orders ‘[o]n a revenue basis, so, basically, as mentioned, within the system they accumulate revenue for their respective task orders. And so, it’s kind of pro rata allocation.’ IDS does not rely on this testimony, which we understand to mean that the organization had already decided that the payments related to the two task orders and chose an accounting method to record that conclusion.

It should not be surprising to our readers to learn that the CBCA found that IDS had not incurred any costs, either on its own or via allocation from a home office. “We further find no basis to allocate the payments made to Afghanistan by the two holding companies to IDS’s performance of task orders 9 and 11. ... IDS’s failure to meet its ‘burden of proving’ that the claimed ‘costs

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were . . . allocable to this [particular] contract’ and the task orders is an independent basis to deny relief.” The Board continued, writing—

Were we able to find that IDS incurred the costs and that they were allocable, substantial doubt as to IDS’s entitlement to reimbursement would remain. Among other issues, although we know ACADEMI LLC and Constellis Holdings LLC settled assessments by the Afghan Government of taxes and penalties, we fundamentally do not know why those companies did so. The Board learned nothing, via expert testimony or otherwise, about the tax laws of Afghanistan in this case. We do not know on what basis in Afghan law the Afghan officials issued the demands to ACADEMI LLC to begin with. . . . As there is ‘no presumption of reasonableness . . . simply because [a contractor] incurred . . . costs,’ this would be a challenging record on which to show reasonableness, even without reaching the issue of allowability under the task orders.

So, yeah. No.

Which brings us back to our initial thoughts. Legal structures don’t normally impact on government contract cost accounting concerns—until they do. Taxes are one area in which cost accounting is impacted, since legal entities are taxable entities.

As government contract cost accountants, it’s important to be able to trace tax payments from the legal entity making them to the cost accounting entity in which costs are being accumulated (and/or allocated). In that regard, see the cost principle at FAR 31.205-41, CAS 403, and the DCAA Selected Areas of Cost Guidebook (Chapter 68). Those reference sources lead to an inescapable conclusion that proper and compliant allocation of tax payments is a complex undertaking.

Don’t make the effort to properly allocate tax payments even more difficult by creating complex, opaque, legal structures.