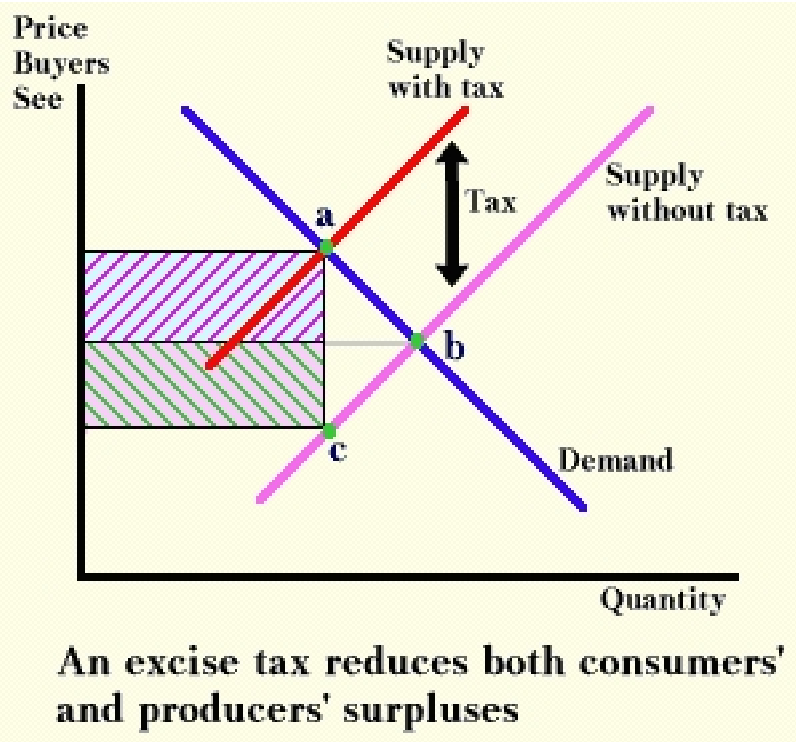

We quote from the February 22, 2012 **Federal Register notice** of a proposed FAR revision to implement FAR Case 2011-011—

The James Zadroga 9/11 Health and Compensation Act of 2010 (Pub. L. 111–347) was signed into law and effective on January 2, 2011. Section 301 of the law amends the Internal Revenue Code of 1986 by adding a new Section 5000C, Imposition of tax on certain foreign procurements (26 U.S.C. 5000C). This new section imposes on any foreign person that receives a specified Federal procurement payment a tax equal to 2 percent of the amount of such specified Federal procurement payment. Additionally, the law stipulates that no funds are to be disbursed to any foreign contractor in order to reimburse the tax imposed.

According to the proposed rule, the 2 percent tax on payments to foreign "persons" will not only be unallowable, it also cannot be proposed in estimates for fixed-price proposals (even if the FAR Cost Principles do not apply to the procurement). The proposed rule specifies that "the costs for the 2 percent tax [cannot be] included in foreign fixed-price contracts and foreign fixed-price contracts with foreign governments."

The foregoing summary is perhaps superficial, and likely omits nuances and complexities that matter to compliance professionals. So with your kind permission, we'll take some time and dig into this a little bit.

Importantly, the excise tax does not apply to *every* contract with a foreign entity. Instead, it is imposed on contracts for (a) goods that are manufactured by foreign entities outside the United States, or (b) services performed by foreign entities outside the United States, when the country in which the goods are produced (or services provided) is not "party to an international procurement agreement" with the United States.

Unfortunately for us all, the statute fails to define what is meant by the term "international procurement agreement," so we are left in the wilderness of ignorance, searching for direction. Fortunately for us all, the "Big 4" accounting and professional services firm, Deloitte, thinks it has some good direction to give us, which you can find **right here** . The folks at Deloitte assert—

Although a payment can be received tax free if a relevant 'international procurement agreement with the United States' applies, the Act does not provide any definition of that term. We understand, however, that it was intended to include the World Trade Organization's (WTO) Agreement on Government Procurement (GPA), as well as free trade agreements (FTAs) between the U.S. and other countries that contain government procurement-related obligations.

- The GPA is a 'plurilateral agreement' of the WTO in which a signatory country agrees not to discriminate against suppliers of goods and services in other signatory countries in the area of government procurement. As a plurilateral agreement, some, but not all, of the WTO members have agreed to be bound by its provisions. To date, 40 WTO members have signed the GPA, including Canada, Israel, Japan, Korea, the 27 EU Member States and the U.S. However, many major trading partners of the U.S. have not signed the GPA, including China, Brazil, India and countries in the Middle East (although a number of these countries are currently negotiating accession).

- FTAs that contain government procurement obligations include the North American Free Trade Agreement (NAFTA), the Dominican Republic-Central America-U.S. Free Trade Agreement (CAFTA-DR), and bilateral FTAs between the U.S. and Australia, Bahrain, Chile, Israel, Morocco, Oman, Peru and Singapore.

The folks on the FAR Councils were smart enough not to try to define terms that weren't otherwise defined for them, even if that meant that we compliance practitioners would be left in the wilderness of ignorance. As a result, they have proposed to revise the Cost Principle at 31.205-41 ("Taxes") to state that "any tax imposed under 26 U.S.C. 5000C" will be unallowable. Similarly, several solicitation provisions and contract clauses were proposed to be revised by making reference that same section of the Internal Revenue Code. (See, *e.g.*, 55.229-3, -4, -6, and -7.)

Consequently, in order to determine whether or not an excise tax should be imposed, and whether or not estimated project margins should be reduced by the value of that 2 percent excise tax, you first need to know (a) the country involved, and (b) whether that country has signed a Trade Agreement with the U.S.A. These decision points will need to be addressed at the time the proposal is being prepared—or, even better, at the time of the bid/no bid decision.

Remembering that this is a proposed rule—and *not* a final rule—readers may want to offer comments to the FAR Councils regarding FAR Case 2011-011.

Were we to offer our comments, we might focus on addressing the inequities involved in mandating a tax and then making it unallowable—especially when the tax appears to be applied somewhat inequitably only on foreign concerns of certain countries. The obvious result of the imposition of the excise tax would be to hurt the ability of foreign contractors to compete with U.S.-based contractors. But the other, perhaps unintended, result would be to make it harder for U.S. contractors to sell their goods and services in the international marketplace.

“How so?” you well may ask. Let us explain our thinking.

In 2010, the United States of America exported about $170 Billion worth of military goods and services to other nations (according to **this article**). As U.S. defense budgets decline, U.S. aerospace and defense companies (such as Lockheed Martin, Northrop Grumman and Raytheon—to name just a few of the biggies) must rely more and more on their international sales in order to maintain top-line revenue, their stock prices, and their workforces. It is axiomatic that international sales are key to maintaining, or growing, existing market share.

Frequently, in order to close an international deal, companies must agree to a certain amount (or percentage) of “ **offset** ” work. As the Wikipedia article we linked-to explains—

As an example of a defense offset proposal we could describe a hypothetical case of Nation *P* (Purchaser) buying 300 tanks from defense company
S
(Seller, of Nation S). The total sale contract is $400 and Nation
P
(Purchaser) requests 120 % of offset. Defense Company
S

(Seller) is obliged to fulfill an offset equal to 120% of the sales contract, that is 480 M USD. Nation *P* agrees on a list of specific offset deals and programs to fulfill the agreed total obligation with Company *S* (Seller). The offset agreement includes both direct and indirect offsets.

The point is, in the foregoing example, Company S is obligated to provide (among other things) a certain amount of subcontracted work to companies located *within* Nation P. Under the proposed FAR rule (and pursuant to the requirements of the Public Law), unless Nation P is a signatory to a Trade Agreement with the U.S.A., its offset work will be subject to the 2 percent excise tax, which will come out of the profit of the foreign entities, since it neither can be priced-in to bids nor claimed as a reimbursable expense.

That's going to make executing offset agreements harder, which is going to make exporting defense goods and services harder. A slow-down in exports is going to put additional pressure on the future revenue of U.S.-based A&D companies, which is going to lead to further cost-cutting measures such as workforce reductions.

So that's our thinking. As you might guess, we are not big fans of this proposed rule, or of the statutory provision that mandated it.

We could mention that including this particular provision in a statute designed to compensate 9/11 First Responders might create the perception that it is a thinly veiled attempt at retaliation aimed at certain countries. We'll give the drafters the benefit of the doubt on that one. But it might also reasonably be viewed as one more attempt to protect the U.S.-based A&D industry from international competition. If so, wouldn't it be ironic that the same provision designed to protect U.S.-based contractors might end up hurting them in the long-run?

The foregoing situation is sometimes called creating "unintended consequences."

So that's what we would say, if we were submitting comments on this proposed rule. The thing is, since the rule-making is mandated by Public Law, we don't believe that the Councils have much latitude in the changes they can make. The time to have commented was when the Bill was being considered by Congress. Now it’s pretty much a done-deal.