



Government Contracts Advisory

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New Tax Requirements for Foreign Workers on Federal Government Contracts

The Heroes Earning Assistance and Relief Act of 2008 (the "HEART Act"), signed by President Bush on June 17, 2008, now mandates that U.S. companies who use a foreign subsidiary to employ workers performing services in connection with its or its affiliates' federal government contracts pay payroll taxes on behalf of those workers. This mandate closes what Congress perceived as a tax loophole that previously allowed government contractors to avoid paying payroll taxes for their workers by setting up foreign subsidiaries.

Earlier this year, a Senate investigatory panel began looking into government defense contractors' practice of using overseas subsidiaries to eliminate the cost of payroll taxes last year by treating the overseas subsidiaries' employees as foreign employees not subject to U.S. payroll taxes. The Senate investigatory panel ultimately expanded its inquiry to include more than 14 large government defense contractors, finding that several were using the same practice to eliminate the payroll tax. Senators John Kerry and Barack Obama proposed legislation to close what they perceived as a tax loophole, estimating that this mandate will generate \$846 million in tax revenue over 10 years. The legislation does not discuss the ability of many government contractor affected by the legislation to simply include the new tax as an allowable cost in their future contract billings. The Kerry-Obama legislation was included in the recently passed HEART Act.

These new payroll tax provisions treat a foreign entity as a U.S. employer for purposes of Social Security and Medicare taxes on certain employees if: (1) the foreign entity is part of a controlled group (based on 50% direct or indirect ownership), the common parent of which is a U.S. company; (2) a member of the controlled group has entered into a contract with the U.S. government (or any instrumentality thereof); and (3) the employees for whom the payroll taxes are owed perform services in connection with the U.S. government contract. The new provisions also make the U.S. parent company jointly and severally liable for the payroll taxes and any penalties for failure to pay the tax or file any related return or statement. Certain exceptions may exist if the foreign entity can show that the services are properly taxable by a foreign country.

This portion of the HEART Act is effective for services performed on or after August 1, 2008. It is unclear if the legislation is intended to apply to current contracts, but contractors should be prepared to respond promptly if any agency so applies to the new law.

It should be noted that, while the original intent of the legislation appears to target those companies providing military services to the U.S. in Iraq and Afghanistan, the language is broad and far-reaching and not limited to government defense contractors. The new rules can apply to any U.S. company and/or its affiliates that use workers of a 50% or more owned foreign entity (including partnerships) to perform services in connection with any federal government contract. The rule is not retroactive, so companies

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employing this practice will need to increase their appropriate rates to reflect the increased cost.

We believe the legislation also raises the possibility that the IRS may begin looking more closely at the classification of workers performing foreign services. Thus, if your foreign subsidiary contracts with one or more independent contractors to perform work under government contracts, we recommend that you closely review your arrangements to make sure that the classification as “independent contractors” and not “employees” is correct.

If you have questions or would like to discuss the implications of the HEART Act on your business, please contact us.

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