SELECTED AREAS OF COST

Chapter 68 – Taxes

Authoritative Sources

FAR 31.205-41 Taxes

FAR 31.201-5, Credits

FAR 31.205-6, Compensation for Personal Services

FAR 31.205-7, Contingencies

FAR 31.205-15, Fines, Penalties, and Mischarging Costs

FAR 31.205-20, Interest and Other Financial Costs

FAR 31.205-27, Organization Costs

FAR 52.229-6, Taxes – Foreign Fixed-Price Contracts

FAR 52.229-9, Taxes – Cost-Reimbursement Contracts with Foreign Governments

48 CFR 9904.403, Allocation of Home Office Expenses to Segments

48 CFR 9904.406, Cost Accounting Period

26 U.S.C. 5000C, Imposition of Tax on Certain Foreign Procurement

26 U.S.C. Section 59A, "Tax on Erosion Payments of Taxpayers with Substantial Gross Receipts"

26 U.S.C. Chapter 43, "Qualified Pension, ETC., Plans"

This chapter provides general guidance in reviewing the allocability and allowability of taxes, including Federal, state, and local taxes.

This chapter addresses the following topics:

68-1 General Information

FAR 31.205-41, Taxes, identifies allowable and expressly unallowable taxes. For additional information on expressly unallowable costs, see DCAA CAM Appendix A-100. The cost principle does not provide guidance on accounting treatment or calculation of taxes.

68-2 Relevant Cost Principles

- **31.201-5, Credits** – Any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor shall be credited to the Government.

- **31.205-6, Compensation for Personal Services – Foreign differential pay** – The difference between the employee’s total foreign income tax payment and the amount the employee would have incurred had the employee remained on domestic assignment, is allowable.

- **31.205-7, Contingencies** – Income tax accruals designed to estimate additional taxes to be paid from tax audits by the state or local tax authorities are considered contingencies, and thus, unallowable.

- **31.205-15**, **Fines, Penalties, and Mischarging Costs** – Generally, penalties assessed by state or local tax authorities are unallowable in accordance with FAR 31.205-15 even if they are unavoidable or incurred inadvertently. Penalties and fines are allowable if assess as a result of complying with specific terms and conditions of the contract or following written instructions from the contracting officer.

- **31.205-20, Interest and Other Financial Costs** – Interest incurred as a result of late payments (e.g., not paying financial obligations by the due date) represents “interest on borrowings” and is, therefore, unallowable per FAR 31.205-20. However, interest incurred as a result of complying with specific terms and conditions of the contract or following written instructions from the contracting officer is allowable.

- **31.205-27, Organization Costs** – Taxes associated with organization of a business, including mergers and acquisitions, are unallowable.

68-3 General Audit Guidelines

68-3.1 Allowable Taxes

The following taxes are generally allowable on Government contracts:

1. Federal, State, and local taxes that are required to be paid or accrued per generally accepted accounting principles (GAAP). State and local taxes including property, franchise, and income taxes. Federal income taxes are unallowable (See 68-3.2).

2. Taxes with a claim of illegality or erroneous assessment, if the contractor has done the following prior to payment:

   a. Requested instructions from the contracting officer regarding such taxes and performed all actions requested by the contracting officer; or

   b. Received a decision from the Government to determine the legality of the assessment or secured a refund of such taxes.

3. Tax related interest, fine, and penalties are allowable when incurred provided those costs resulted from compliance with specific terms and conditions of the contract or written instructions from the contracting officer (FAR 31.205-15(a)).

4. The Environmental Tax found at section 59A of the Internal Revenue Code, also called the "Superfund Tax is an allowable cost for contracts awarded after January 22, 1991.

68-3.2 Unallowable Taxes

The following taxes are expressly unallowable:

1. Federal income and excess profits taxes.

2. Taxes in connection with financing, refinancing, or refunding of operations, or reorganizations (see also FAR 31.205-20 and 31.205-27).

3. Taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government, except when the contracting officer determines that the administrative burden of obtaining the exemption outweighs the benefits accruing to the Government (When the administrative exceeds its value, the claimed amount may be found immaterial).

4. Special assessments on land that represent capital improvements.

5. Taxes (including excises) on real or personal property or on the value, use, possession or sale thereof, which is used solely in connection with work other than on Government contracts.

6. Any excise tax in Subtitle D, Chapter 43 of Title 26 of the U.S. Code. This chapter describes excise taxes imposed in connection with qualified pension plans, welfare plans, deferred compensation plans, or other similar types of plans.

7. Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income as reflected by the books of account and financial statements.

8. Any tax imposed under 26 U.S.C. 5000C on any Federal procurement payment to any foreign persons. The tax is collected via withholdings on applicable payments.

68-3.3 Tax Credits and Refunds

The Government's right to share in these refunds is covered by FAR 31.205-41(d), which provides that "…taxes, interest, or penalties that were allowed as contract costs and are refunded to the contractor shall be credited or paid to the Government in the manner it directs."

Accordingly, if the contractor receives a refund of previously reimbursed tax, the auditor should determine the Government's share of the refund based on the

Government reimbursement of that expense in the year in which the cost was originally incurred.

68-3.4 Multi-State Taxes

A corporation’s tax burden depends on the share of total income derived from business in each state. Contractors often include the state taxes, along with other indirect expenses, in an established burden center for allocation to operating divisions in various states. In reviewing these allocations, the general rule for the auditor to follow is to determine that the amount allocated to operations within a particular state approximates the amount of tax paid to such state. The further allocation of this amount to cost centers or contracts within the state should be made through divisional G&A.

However, in those cases where a division is doing business in several states, the auditor may find that more equitable results are obtained by applying the method used by the state in assessing the tax, or through an established burden center of the contractor other than G&A.

For a contractor subject to full CAS requirements, CAS 403.40(b)(4) requires that central payments or accruals (which may include state and local income taxes and franchise taxes) made by a home office on behalf of its segments shall be allocated directly to segments to the extent that all such payments or accruals of a given type or class can be identified specifically with individual segments. Any such types of payments or accruals which cannot be identified specifically with individual segments shall be allocated to benefited segments using an allocation base representative of the factors on which the total payment is based.