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Highlights

Highlights of GAO-10-327, a report to congressional committees

Why GAO Did This Study

Many federal contractors establish offshore subsidiaries to take advantage of labor and market conditions. GAO has found that they also use offshore subsidiaries to reduce their U.S. tax burdens. In 2008, Congress passed the Heroes Earnings Assistance and Relief Tax (HEART) Act which resulted in contractor offshore subsidiaries paying certain payroll taxes for U.S. personnel working abroad.

Fiscal year 2009's National Defense Authorization Act required GAO to report on the rationales, implications, and costs and benefits of defense contractors' use of offshore subsidiaries. We (1) assessed trends and purposes for contractors' offshore subsidiaries; (2) identified how contractors use subsidiaries to support defense contracts; (3) assessed DOD's oversight of contractors' use of offshore subsidiaries.

To conduct our work, we reviewed data for the 29 U.S. publicly traded contractors with at least $1 billion in DOD spending in fiscal year 2008, reviewed several illustrative contracts selected based on categories of DOD services most often performed overseas, reviewed audit documents, and interviewed DOD officials about oversight.

What GAO Recommends

Congress should consider whether further legislative action is needed to address contractor avoidance of unemployment taxes for U.S. workers.

View GAO-10-327 or key components.

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DEFENSE CONTRACTING

Recent Law Has Impacted Contractor Use of Offshore Subsidiaries to Avoid Certain Payroll Taxes

What GAO Found

Many of the top 29 U.S. publicly traded defense contractors—those with $1 billion or more in DOD contracts in fiscal year 2008—have created offshore subsidiaries to facilitate global operations. Between fiscal years 2003 and 2008, they increased their use of these subsidiaries by 26 percent, maintaining at least 1,194 in 2008. We interviewed 13 of the 29 contractors based on a range of the amount of government work, locations of subsidiaries, and industry types; they reported that 97 percent of the subsidiaries generally supported global commercial and foreign government clients, while the remaining 3 percent supported DOD contracts performed overseas. These subsidiaries also helped the 29 contractors reduce taxes, with about one-third decreasing their effective U.S. corporate tax rates in 2008 in part through the use of foreign affiliates, lower foreign tax rates, and indefinite reinvestment of foreign income outside of the United States.

For five of the DOD contracts we reviewed, companies principally used offshore subsidiaries to hire U.S. workers providing services overseas on U.S. government contracts in order to avoid Social Security, Medicare—known as Federal Insurance Contributions Act (FICA)—and other payroll taxes. This practice allowed contractors to offer lower bids when competing for certain services and thereby reduce costs for DOD. Our analysis of two contracts showed that the use of offshore subsidiaries saved DOD at least $110 million annually prior to the HEART Act, through payroll tax avoidance. While this practice provided contract cost savings for DOD, it resulted in these companies avoiding payroll taxes that would have contributed to the Social Security and Medicare Trust Funds. The 2008 HEART Act resulted in offshore subsidiaries of U.S. companies paying FICA taxes for U.S. workers performing services overseas on U.S. government contracts. As a result, in fiscal year 2009, four of the case study contractors using offshore subsidiaries to support DOD work requested reimbursement from DOD of at least $140 million for new FICA payments. Federal and state unemployment payroll taxes, however, were not covered by the HEART Act, and several contractors that used offshore subsidiaries have continued to avoid these taxes. In one state, we reviewed documentation for about 140 former employees of several contractors who were denied unemployment benefits in 2009. State workforce officials indicated these benefits were denied because the employees worked for a foreign subsidiary and not an American employer.

DOD officials were aware of the roles offshore subsidiaries played in the DOD contracts we reviewed and stated that oversight mechanisms, such as the Defense Contract Audit Agency's reviews of incurred costs and oversight documents, inform them of the activities of offshore subsidiaries. In contracts we reviewed, evidence of offshore subsidiaries was present in contractor labor rates, cost accounting disclosures, and contractor price proposals. Contracting officials stated that the use of offshore subsidiaries did not negatively impact contract schedule or performance.