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FEATURE COMMENT: U.S. Restrictions On Offshore Sourcing Of Services—How Do They Affect Government Contractors?

The Political Context—Offshoring of services has been an economic fact of life for decades, yet political debate concerning this issue is a relatively recent phenomenon. There were just four state bills restricting offshore sourcing—the practice of acquiring services from a non-U.S. vendor—introduced in 2003. Last year, however, over 40 federal bills and 200 state bills significantly affecting offshore sourcing of goods or services were proposed. For example, Sen. Christopher Dodd (D-Conn.) introduced the U.S. Workers Protection Act on February 12, 2004 (S. 2094), and Reps. Rosa DeLauro (D-Conn.) and John Dingell (D-Mich.) introduced similar legislation in the House (H.R. 3820) on February 24, 2004. This proposed legislation, although it was not finally enacted, would have restricted the performance of both federal and state contracts outside the U.S. See 46 GC ¶ 109. In addition, Sen. Dodd's amendment to the Jumpstart Our Business Strength Act (S. 1637), which ultimately became part of the American Jobs Creation Act of 2004 (P.L. 108-357), although it failed in committee, would have prohibited any federal agency, or state agency using federal funds, from contracting with a foreign entity. Finally, last year Sens. Craig Thomas (R-Wyo.) and George Voinovich (R-Ohio) successfully added language to the Consolidated Appropriations Act for Fiscal Year 2004 (P.L. 108-199) prohibiting many federal agencies from using FY 2004 funds for offshoring functions under Office of Management and Budget Circular A-76 that were not previously performed by federal employees outside the U.S.

The 2004 presidential campaign also included much rhetoric concerning offshore sourcing, and the effect of this practice on American workers was a topic in two of the three presidential debates. Much of this rhetoric continues today. Offshoring proponents praise offshore sourcing, recognizing the expanding global market and economic stagnation that trade barriers might produce, while opponents blame offshore sourcing for the loss of U.S. jobs and the "jobless recovery" from the recent recession. Yet advocates of both views appear to admit to flaws in their positions. For example, critics—such as Sen. John Kerry (D-Mass.)—have admitted that "you can't stop all outsourcing" and "outsourcing is going to happen," while President Bush said during the 2004 campaign that he is "as concerned about outsourcing as the next person but the way to deal with outsourcing is to make America a better place to do business, not a worse place."

A number of recent studies have added fuel to this political debate. For example, the Government Accountability Office reported last year that causes of offshoring—such as technology advances, growth and stabilization of some developing countries, decreased labor costs, and access to skilled workers—are well understood, but the effects of offshoring remain unknown. See *International Trade: Current Government Data Provide Limited Insight into Offshoring of Services* (GAO-04-932), at *http://www.gao.gov/new.items/d04932.pdf*. Opponents of offshoring cited GAO's finding that offshoring of services increased by 76.8 percent, from $21.2 billion in 1997 to $37.5 billion in 2002, while proponents of offshoring focused on GAO's conclusion that Government data were limited and that, of the 1.5 million layoffs reported in 2003, most of which were manufacturing jobs, only 0.9 percent were due to offshoring.

Early last year, the U.S. Chamber of Commerce (Chamber) joined the fray with its own report. See *U.S. Chamber of Commerce, Jobs, Trade, Sourcing,*

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and the Future of the American Workforce (April 2004), at *http://www.uschamber.com/media/pdfs/outsourcing.pdf*. The Chamber report included Department of Commerce data indicating that the U.S. enjoyed a roughly $60 billion surplus in international trade of services in 2003. The Chamber also released factual updates and analyses of offshoring's effects on the U.S. economy. See, e.g., *U.S. Chamber of Commerce, Global Sourcing Update* (Fall 2004), at *http://www.uschamber.com/issues/index/labor/0410sourcing_newsletter.htm*.

Most recently, the Congressional Research Service issued a May 2, 2005 report, *Offshoring (a/k/a Offshore Outsourcing) and Job Insecurity Among U.S. Workers*. This report updated the existing data on worker displacement due to offshoring and analyzed a number of proposals designed to assist affected workers.

Current Restrictions on Government Contractor Offshoring of Services—Regardless of the causes or effects of offshoring of services, the fallout from this debate has begun to impact Government contractors. Following the September 11, 2001 terrorist attacks on New York City and the Pentagon, Congress enacted the Homeland Security Act of 2002 (P.L. 107-296) and established the Department of Homeland Security to consolidate domestic resources for the Global War on Terrorism. Section 835 of the Homeland Security Act (6 USCA § 395) prohibited DHS from entering into any contract with a foreign incorporated entity that was found to be an "inverted domestic corporation" (IDC). The Act provided that a foreign entity would be treated as an IDC if, after the Act's November 25, 2002 date of enactment, it engaged in a transaction that met certain statutory criteria for a "corporate inversion" as described in § 835(b) of the Act. This prohibition was implemented in the Homeland Security Acquisition Regulation at HSAR 3009.104-70 and HSAR clause 3052.209-70 "Prohibition on Contracts with Corporate Expatriates." However, as implemented, the restriction had a number of exceptions and waiver provisions, including that it only applied to foreign parent corporations and not to their U.S. subsidiaries, which virtually eliminated its effectiveness. When a U.S. subsidiary of Accenture, a company incorporated in Bermuda, won the $10 billion US VISIT contract awarded by DHS last year, an amendment to the Department of Homeland Security Appropriations Act of 2005 (H.R. 4567) was introduced to prohibit DHS from contracting with IDCs or their subsidiaries. As initially proposed, the amendment to H.R. 4567 also would have retroactively nullified the award to Accenture. See H. Amdt. 580, 108th Cong. (2004); 46 GC ¶ 231(b) and 46 GC ¶ 238. Although the amendment was rejected during floor debate, H.R. 4567 was later revised to prohibit the award of such contracts in the future. As enacted, the 2005 DHS Appropriations Act amended § 835 of the Homeland Security Act of 2002 to prohibit DHS from contracting with both IDCs and their subsidiaries. See § 523 of the 2005 Department of Homeland Security Appropriations Act (P.L. 108-334), 46 GC ¶ 247 and 46 GC ¶ 415. In addition, the Appropriations Act deleted the Homeland Security Act's grandfather provision, which had allowed DHS to contract with IDCs created before the Act's passage. Thus, DHS now is prohibited from contracting with all IDCs, regardless of when the corporate inversion occurred. The effect of these amendments on DHS contractors remains to be seen.

The chart on the opposite page summarizes some of the recent federal statutory and regulatory restrictions affecting Government contractors that source services offshore.

Although a detailed analysis of the state legislation affecting offshore sourcing of services is beyond the scope of this FEATURE COMMENT, it appears that very few of the state bills introduced over the past several years have been enacted. In addition, commentators have noted that the state bills that have become law are vulnerable to constitutional challenge under a number of theories. See National Foundation for American Policy Policy Brief, "Proposed Restrictions on Global Sourcing Continue at High Level in 2005" (April 2005), at *www.nfap.net*.

Laws Indirectly Affecting Contractor Offshoring of Services—In addition to the legislation described above, laws and regulations that do not prohibit the offshoring of services can have an indirect impact on contractors that source services offshore. For example, U.S. export control laws and regulations can restrict or inhibit contractors from offshore sourcing of services. While the Export Administration Regulations (EAR) and the International Traffic in Arms Regulations (ITAR) restrict the physical export of dual-use (potential for commercial or defense purposes) and defense-

Law, Regulation or Policy	Description	Status
DHS Appropriations Act, 2005, P.L. 108-334, § 523, 118 Stat. 1298, 1320 (2004)	Amending the Homeland Security Act of 2002 (P.L. 107-296) to prohibit DHS from contracting with inverted domestic entities or their subsidiaries, regardless of when the corporate inversion occurred.	Amendment effective 10/18/04.
Department of Homeland Security Acquisition Regulations, 48 CFR §§ 3004.470 4, 3037.110-70 (2004)	Requiring DHS to include in all solicitations or contracts a clause found at 48 CFR § 3052.237-70 (class deviation Nov. 8, 2004) that requires all contractor employees with access to sensitive information or Government facilities to be U.S. citizens or lawful permanent residents; requiring DHS to include in all solicitations or contracts involving IT resources to include a clause found at 48 CFR § 3052.237-71 (class deviation Nov. 8, 2004) that requires contractors to identify the names and citizenship of all non-U.S. citizens in proposals and prohibiting non-U.S. citizen employees of the contractor from accessing or developing DHS IT systems.	Effective 11/8/04.
DHS Management Directive Number 11042.1	Requiring all contractors with DHS that possess access to sensitive but unclassified (SBU) information to undergo formal training, sign a nondisclosure agreement before accessing SBU information, handle the information in certain ways and report any suspected compromise or disclosure of SBU information to DHS within one duty day.	Effective 1/6/05.
Military Construction Appropriations and Emergency Hurricane Supplemental Appropriations Act, 2005, P.L. 108-324, §§ 111, 112, 118 Stat. 1220, 1226 (2004)	Restricting the use of appropriated funds to contract with certain foreign contractors for projects to be completed in Japan that exceed $500,000; restricting contracts exceeding $1 million from being awarded to foreign contractors for projects in the Pacific and countries bordering the Arabian Sea.	Effective 10/1/04 for FY 2005.
American Jobs Creation Act of 2004, P.L. 108-357, §§ 801-802, 118 Stat. 1418, 1562-69 (2004)	Amending the tax code, in part, to treat foreign expatriate corporations as domestic corporations; imposing excise taxes on executive stock-based compensation plans of expatriate corporations.	Amendments effective 3/4/03.
Department of State Acquisition Regulation; Service Contracting, 48 CFR § 637.102-70 (2004)	Implementing 22 USCA § 4864 to provide U.S. persons and qualified U.S. joint-venture persons with a 10 percent price preference reduction for certain security contracts performed overseas under diplomatic security programs.	Final Rule effective 4/13/04.
Consolidated Appropriations Act, 2004, P.L. 108-199, § 647(e), 118 Stat. 3, 362 (2004)	Prohibiting contractors from performing, outside of the U.S., any activity converted to contractor performance under OMB Circular A-76 unless the activity was previously performed outside of the U.S.	Effective 1/23/04 for FY 2004.
Department of Defense Federal Acquisition Regulation Supplement; Foreign Acquisition, 48 CFR pts. 225, 252 (2004) (as amended by 70 Fed. Reg. 20838 (April 22, 2005))	Implementing 10 USCA § 2410g to require reporting of certain defense contracts exceeding $10 million in value when any part exceeding $500,000 in value will be performed outside of the U.S. or Canada, but could be performed in the U.S. or Cansada; implementing DOD policy requiring reporting of certain contracts exceeding $500,000 in value when any part of the contract will be performed outside of the U.S.	Final Rule effective 4/22/05.

related goods and services, the EAR and the ITAR also regulate "deemed exports." 15 CFR § 734.2(b)(2) (EAR); 22 CFR § 120.17 (ITAR). Deemed exports occur when a U.S. entity releases export-controlled technology to foreign nationals either within the U.S. or abroad. A release can occur when a foreign national actually accesses—or could potentially access—controlled technology. A contractor sourcing services offshore must be careful not to violate these regulations and should closely monitor regulatory changes. Penalties for violations of deemed export regulations are severe, and both agencies administrating the regulations (the Bureau of Industry and Security (BIS) within the Department of Commerce administers the EAR; the Directorate of Defense Trade Controls within the Department of State administers the ITAR) have increased their efforts to strengthen and enforce the regulations in the past few years. For example, on March 28, BIS proposed changes to its "deemed export" rules that could significantly expand the activities and persons subject to export licensing requirements. The deadline for comments on these proposed rules was recently extended to June 27. See 70 Fed. Reg. 15607 (March 28, 2005); 70 Fed. Reg. 30655 (May 27, 2005); 47 GC ¶ 258.

Recent Offshoring Developments—Proposals for legislation aimed at curbing offshore sourcing continue unabated in 2005. In the past several months, more than eight federal bills and more than 100 state bills concerning offshore sourcing potentially affecting Government contractors have been introduced. Not surprisingly, Sen. Dodd on June 7, 2005, reintroduced the U.S. Workers Protection Act to prohibit both federal contracts and state contracts using federal funds from being awarded to contractors that source services offshore (S. 1185), and, earlier this year, Rep. DeLauro successfully added language to the House Report that accompanies the House's proposed budget for FY 2006, expressing a need to restrict Government contracts with entities offshoring work. See H.R. Rep. No. 109-17 (2005).

In addition, on February 15, Rep. Maxine Waters (D-Calif.) introduced two bills that would prohibit most Government contractors from offshore sourcing of services. As proposed, H.R. 829 would prohibit the Federal Government, with certain exceptions, from contracting with any "company of interest" that had sourced jobs offshore within the past five years and provide fines of up to 125 percent of the contract value for violations. See 47 GC ¶ 103. H.R. 828 would establish a "Commission on American Jobs" to study offshoring by any "company of interest," recommend methods of preventing offshoring of jobs and require all companies of interest to submit annual reports of data concerning jobs sourced offshore. The bills define a "company of interest" as an entity that is organized under U.S. law, or any subsidiary thereof, has fifty or more employees in the U.S. at any time after 1979 or earns $1 million or more in annual income connected with business activities within the U.S. Rep. Waters introduced similar bills last year, but they died in committee.

Other legislative actions aimed at Government contractors this year have included an attempt to cancel the Navy's $6.1 billion contract for supplying the presidential helicopter fleet that was awarded to Lockheed Martin and its venture partner, foreign-based Agusta Westland, over Connecticut-based Sikorsky. H.R. 459, introduced by Rep. DeLauro and 44 co-sponsors on February 1, and its Senate counterpart, S. 486 (sponsored by Sens. Joseph Lieberman (D-Conn.) and Dodd on March 1), would require the Navy to buy presidential helicopters that are wholly manufactured in the U.S. See 47 GC ¶ 57 and 47 GC ¶ 69. In support of H.R. 459, Rep. Duncan Hunter (R-Calif.), chairman of the House Armed Services Committee, stated that he could not understand "why we would use U.S. tax dollars to fund development of foreign helicopter technology."

In April, Sens. Dodd and Lieberman amended the Foreign Affairs Authorization Act for FYs 2006 and 2007 (S. 600) to include a provision that would preclude any contractor from working on the Marine One contract if that company planned to conduct business with certain nations. New York's Democratic senators, Charles Schumer and Hillary Clinton, have blocked S. 600 pending the removal of the amendment from the bill. GAO has been asked to investigate this award. See 47 GC ¶ 93(a).

Despite these recent legislative initiatives, it appears likely that U.S. contractors will continue to procure services from foreign sources. For example, a recent study by the research firm Gartner, Inc. reported that, while less than five percent of infor-

mation technology jobs in developed countries currently are offshored, it is anticipated that, by 2015, developed countries will offshore 30 percent of their IT jobs. According to GAO, almost 60 of the 100 largest federal contractors have subsidiaries in offshore tax haven countries. See *International Taxation: Information on Federal Contractors with Offshore Subsidiaries* (GAO-04-293), at *http://www.gao.gov/new.items/d04293.pdf*. A second GAO study concerning Government contractors affiliated with tax haven countries suggests that these contractors have a tax advantage when competing for awards. See *International Taxation: Tax Haven Companies Were More Likely to Have a Tax Cost Advantage in Federal Contracting* (GAO-04-856), at *http://www.gao.gov/new.items/d04856.pdf*. For 2000 and 2001, GAO noted that tax haven contractors had a 150 percent greater likelihood of having no tax liability when compared to domestic contractors. Advantages such as these may allow tax haven contractors to submit cost proposals that undercut domestic contractors' cost proposals. However, GAO's study also noted that it found no evidence of income shifting by these contractors.

On the other hand, there are some signs that offshore outsourcing may be losing momentum, as suggested by a recent survey released by Deloitte Consulting of 25 organizations with a collective $1 trillion market capitalization and more than one million employees. "Calling a Change in the Outsourcing Market" (April 2005), at *http://www.deloitte.com/dtt/cda/doc/content/us_outsourcing_callingachange.pdf*. See 47 GC ¶ 206. Of those surveyed, 81 percent cited a lack of transparency of vendor costs and pricing, 44 percent mentioned a failure of realizing expected savings and roughly one-fifth noted the constraints of Sarbanes-Oxley as some of the reasons why the survey participants were becoming wary of outsourcing. In the past several months, JPMorgan Chase cancelled its $5 billion, seven-year sourcing contract with IBM, UBS Warburg opted to forego renewing its 10-year sourcing contract with Perot Systems and Sears Roebuck and Company terminated a $1.6 billion outsourcing contract with Computer Sciences Corporation.

Conclusion—Concern over the offshoring of services has led to many recent legislative initiatives and the enactment of new laws and implementing regulations. Although the impact of these restrictions appears to be limited with respect to most Government agencies, contractors should be aware of these recent developments, as well as the vast network of existing laws and regulations, including those that can indirectly affect the sourcing of services offshore. Furthermore, much of the existing legal framework concerning use of offshore services is receiving additional scrutiny, which may result in significant new legislation and increased enforcement of current laws and regulations, especially for DHS and the Department of Defense. Government contractors should, therefore, carefully monitor the political and legal developments in this area to maintain their competitive edge.

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