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United States Department of State
and the Broadcasting Board of Governors
Office of Inspector General

# Report of Audit

## Assessment of Value-Added Tax Exemption and Reimbursement Efforts

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# SUMMARY


In accordance with its FY 2004 Audit Plan, the Office of Inspector General (OIG) conducted a survey to determine the extent to which the Department of State (Department) had established guidance and mechanisms to track and manage value-added tax (VAT) exemptions, expenditures, and reimbursements.

Many foreign governments assess VAT on the goods and services purchased by the Department's missions, unless there are bilateral agreements to exempt the missions from paying VAT or to provide reimbursements. In 2002, a Department contractor conservatively estimated that the Department loses $24 million a year in unreimbursed VAT payments on its overseas purchases of goods and services, and that the Bureau of Overseas Buildings Operations was facing potential VAT expenditures of $220 million for $2 billion in approved building projects.[1]

The Bureau of Diplomatic Security, Office of Foreign Missions is responsible for ensuring reciprocity in the treatment of U.S. missions abroad, including tax exemptions. The Chief Financial Officer is responsible for implementing procedures to track and control funds within the Department.[2] During the survey, OIG reviewed regulations and policies pertinent to VAT exemptions and obtained information on the Department's VAT process from relevant bureaus.

OIG determined that the Department did not have adequate oversight of the VAT process; its financial management systems were not flexible enough to identify and track VAT reimbursements; and it had not developed the necessary policies, procedures, and controls related to VAT. For instance, OIG found that the Bureau of Diplomatic Security, Office of Foreign Missions had not created guidance on how posts should handle reciprocity issues and was not always involved in reciprocity negotiations at post. In addition, the bureau had not developed and disseminated formal policies and procedures on how bureaus and posts should manage negotiating and processing VAT reimbursements. OIG recommends that the Bureau of Diplomatic Security, Office of Foreign Missions provide guidance and training to bureaus and posts on managing reciprocity issues and seeking VAT exemptions and reimbursements.


[1] Department of State, Office of Foreign Missions, *VAT Exposure Analysis* (June 2002).
[2] See Appendix A for a fuller description of VAT roles and responsibilities within the Department.

According to bureau and program officials, the Bureau of Resource Management had not established a financial system for easily accounting for VAT payments and reimbursements in accordance with the Department's Foreign Affairs Manual and had not provided policies, procedures, and training needed for effective and efficient administrative control of VAT reimbursements. Posts had to develop and implement their own manual and automated "cuff" records. OIG recommends that the Bureau of Resource Management expand the financial management systems, policies and procedures, and training for required accounting and reporting VAT of payments and reimbursements at each post.

# OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with its FY 2004 Audit Plan, OIG conducted a survey of the Department's VAT processes. The overall objective of the survey was to determine if the Department was adequately managing the Department's VAT exemption and reimbursement efforts under its overall mission of ensuring appropriate levels of reciprocity for U.S. missions abroad. Within the overall objective, the survey subobjectives were to determine the extent to which the Department:

- adequately managed the VAT exemption and reimbursement process;
- sufficiently identified, recovered, and distributed reimbursable VAT payments in its accounting system;
- properly accounted for and reported VAT transactions in the financial statements;[3] and
- established and implemented VAT policies, procedures, and controls.

To accomplish the objective and subobjectives, OIG analyzed the Foreign Missions Act and related Department policies and program plans and interviewed officials in geographic, functional, and program bureaus on their experiences addressing VAT exemption and reimbursement issues, and where appropriate, accounting for VAT transactions. OIG also reviewed a sample of bilateral agreements, studies, OIG inspection reports, cables, and other supporting documentation to document VAT reimbursement program issues. OIG met with officials from the Bureau of Diplomatic Security, Office of Foreign Missions (DS/OFM) to ascertain their procedures for negotiating VAT exemptions and reimbursements, and using reciprocity, with foreign governments and their missions here.

U.S. Agency for International Development, Bureau for International Narcotics and Law Enforcement Affairs (INL), and Bureau of Resource Management, Office of Foreign Assistance Programs and Budget (RM/FA) provided information on accounting for VAT in foreign assistance programs under the provisions of the FY

[3] OIG plans to review this in future work.



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2003 Foreign Operations Appropriations Act and the Consolidated Appropriations Resolution, 2003.[4] The Office of the Legal Adviser (L) provided insight on U.S. bilateral agreements and the VAT exemption and reimbursement negotiation process. The Bureau of Overseas Buildings Operations (OBO) provided information on the Department's potential VAT exposure for upcoming construction projects and OBO's challenges in negotiating VAT agreements with host governments.

OIG's Office of Audits, Financial Management Division, conducted the survey from June through October 2004 in accordance with government auditing standards. The fieldwork focused on domestic operations. OIG plans additional work at overseas posts in FY 2005. OIG discussed the audit findings with RM and DS in January 2005 and provided copies of the draft report to DS, RM, and the Foreign Service Institute (FSI) on April 13, 2005. DS, RM, and FSI agreed with OIG's recommendations, and their comments on the draft are included as Appendices B, C, and D.

[4] P.L. 108-7. This legislation also requires accounting for customs duties imposed on commodities financed with appropriated foreign assistance funds. This audit examined only VAT exemption and reimbursement efforts, however.

# BACKGROUND

## VAT Exemptions and Reimbursements

VAT is currently the dominant tax structure worldwide. VAT is a multistage goods and services tax whereby increments of tax are collected numerous times before goods and services are sold to consumers, who ultimately bear the full tax burden. An accounting firm estimates that 120 or more nations[5] charge VAT on the purchase of goods and services, and the VAT rate can go up to 25 percent. The United States does not use a VAT system.

Tax exemptions or reimbursements, including those for VAT, may be granted or withheld on a reciprocal basis between the United States and foreign governments. Such arrangements are usually documented in bilateral agreements or, in some cases, bilateral notes. The U.S. government asserts that VAT is a direct tax eligible for exemption or reimbursement under the Vienna Conventions on Diplomatic and Consular Relations, rather than an exempt indirect tax.

To clarify the extent and process of tax relief, the United States obtains a bilateral agreement with host governments. For VAT reimbursement agreements, the missions must make periodic requests for reimbursements to host government finance ministries with the required supporting documentation. Depending on the country, the VAT refund can range from 100 percent to substantially less, and it can take from two months to more than a year to collect.[6]

KPMG, a contractor hired by DS/OFM in 2002 to review unrecovered VAT costs, found that the Department loses an estimated $24 million annually in unreimbursed VAT payments. The contractor was conservative in its estimate and stated that the loss could be 50 percent higher. KPMG found that DS/OFM had

[5] STATE 118019, VAT Basics, May 6, 2003.
[6] 6 FAH-5 H-809.1-3a Value Added Tax.

no effective mechanism for tracking and monitoring VAT, limited tax expertise at posts, no resources dedicated to managing VAT, and no adequate system to track and monitor VAT transactions. The study also revealed that bureaus and posts were unable to identify the total VAT expenditures and reimbursements for any given year.

# PROGRAM ADMINISTRATION

In 1982, the Foreign Missions Act[7] created the Office of Foreign Missions (OFM) within the Department to review and control the operations and benefits of foreign missions in the United States and to ensure reciprocity in the treatment of U.S. missions and diplomats abroad. The Secretary of State delegated OFM responsibilities to the Under Secretary for Management (M), who redelegated them to the Assistant Secretary for Diplomatic Security, who serves as OFM Director.

The Foreign Missions Act is based on a policy of reciprocity, whereby the treatment accorded foreign missions in the United States will be determined after due consideration of the benefits, privileges, and immunities, including relief from paying VAT, customs duties, and other government levies, provided U.S. missions in the country represented by the foreign missions. DS/OFM is expected to pursue reciprocity on a broad range of privileges and immunities granted to U.S. mission personnel abroad and foreign mission personnel in the United States.

DS/OFM is responsible for formulating and implementing tax reciprocity policies and programs that affect foreign missions in the United States and U.S. missions abroad. First, the DS/OFM Tax and Customs Division works to ensure that U.S. diplomatic missions and personnel overseas receive all tax exemptions and importation privileges allowed under the Vienna Conventions of Diplomatic and Consular Privileges. Second, the division administers a program that imposes the same tax and importation restrictions on foreign missions in the United States as are applied to U.S. diplomatic missions abroad if necessary to persuade foreign governments to grant tax exemptions and customs privileges. Third, the division periodically surveys importation and tax restrictions at missions abroad.

The Chief Financial Officer (CFO) is responsible for implementing regulations and procedures that provide effective and efficient administrative controls of funds available to the Department. The CFO is also responsible for the Department's financial systems.[8]

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[7] P.L. 97-241.

[8] 4 FAM 082.1b Fund Control Responsibilities.

RM/FA collects data from embassies on unreimbursed VAT for foreign assistance programs to comply with the Consolidated Appropriations Resolution for FY 2003.

## Prior Report Coverage

During a 2003 inspection of DS/OFM, OIG found that VAT expenditures for the construction of new U.S. chanceries overseas would skyrocket to over $200 million. However, the inspection also revealed that DS/OFM did not have sufficient staff or expertise to conduct or support an extensive program of tax negotiations. OIG reported that DS/OFM needed to ensure that the Department and its overseas missions were adequately prepared to negotiate with foreign governments.

OIG embassy inspections have reported VAT-related problems in reciprocity, reimbursements, and accounting. Many embassies had to deal with host governments that denied reciprocity or instituted vague bilateral agreements. OIG recommended the embassies work with DS/OFM to pursue tax exemptions or reimbursements. OIG advised other embassies with untimely VAT reimbursements to accelerate the reimbursement process. One embassy needed to develop updated user-friendly software to record reimbursements.

# FINDINGS

## OFM Oversight of VAT Reciprocity

OIG determined that DS/OFM did not have adequate oversight of the VAT process and had not developed necessary policies, procedures, and controls related to VAT. DS/OFM had not provided guidance in the form of formal policies and procedures, and training on how posts should negotiate reciprocity with foreign host governments. In addition, DS/OFM had not always been appropriately involved in reciprocity negotiations at posts and had not maintained copies of bilateral agreements and notes. As a result, the Department had no assurance that posts were following formal protocols during reciprocity negotiations or that DS/OFM was obtaining the best tax reciprocity treatment for the U.S. government. The OIG findings are consistent with the 2002 report prepared by KPMG that identified a number of ways DS/OFM could improve management and oversight of the VAT reciprocity process.

## Reciprocity Negotiations

According to geographic and program bureau officials, posts often have to negotiate with foreign governments on reciprocity issues and bilateral agreements without the support and assistance of DS/OFM. The Department's Foreign Affairs Manual (FAM) states that the Director of DS/OFM is responsible for providing and implementing policy for reciprocity between U.S. missions abroad and foreign missions in the United States.[9] However, DS/OFM had not established and implemented a formal reciprocity policy.

DS/OFM sent a cable to all posts in November 2001 that offered limited guidance for negotiating with foreign finance ministries.[10] The cable outlined zero-rated, or exempt, and VAT reimbursement statuses for tax relief in foreign coun-

[9] 1 FAM 264 Office of Foreign Missions Director.
[10] 2001 STATE 206158 Fresh Approach on VAT Relief Negotiations.

tries. However, the cable only defined the statuses and did not offer guidelines the posts could use to negotiate such statuses. Further, the cable stated "the mission (post) is free to make whatever improvements in its situation that host government tax authorities will agree to." This statement defers all responsibility to the posts for negotiating with the foreign governments.

Without a formal policy, the Department has no assurance that missions will follow formal protocols during reciprocity negotiations or that they will obtain the optimum tax reciprocity for the United States. Formal guidelines for documenting negotiations and agreements would help eliminate miscommunication between the United States and foreign governments and would help ensure that posts know how to negotiate reciprocity and what benefits or taxes can be leveraged in pursuing reciprocity.

Both OIG and KPMG found that DS/OFM had not provided for training employees who manage the VAT process. KPMG recommended that DS/OFM develop and provide specific and targeted tax training to administrative, financial, budget, and contracting officers. KPMG noted that the primary aim of the training would be to increase tax awareness among those making decisions that have tax consequences. In addition, bureau officials indicated to OIG that employees handling VAT (mostly Foreign Service nationals) have not received formal training, and many employees do not have backgrounds or experience in taxes. Formal training that explains how reciprocity works, including the interactions of posts and foreign governments, would assist employee effectiveness in handling VAT and reciprocity issues. KPMG noted that DS/OFM would need to collaborate with an external provider to deliver such training given the logistical difficulties in training individuals in multiple locations. FSI told OIG that it could provide this training by working it into current courses.

The geographic and program bureau officials generally thought DS/OFM should be more involved in negotiations with foreign governments. Unusual or difficult reciprocity issues often occur, and Department officials believed DS/OFM or higher level officials should provide more assistance in these cases. For example, one bureau estimated that it loses between $5 million and $6 million annually in unreimbursed VAT expenditures because some countries do not make timely reimbursements, which results in the funds being returned to the U.S. Treasury without direct benefit to the Department. Some countries reimburse in local currency while others are willing to reimburse in U.S. dollars. One bureau indicated that the United States loses money due to currency conversion costs.

OBO officials told OIG that DS/OFM should negotiate for reciprocity before OBO begins planning large construction projects. In the past, DS/OFM considered itself a reactive group, and only became involved in VAT reciprocity negotiations when called upon by posts and when problems arose in negotiations. In September 2004, DS/OFM appointed a new Director for the Diplomatic Tax and Customs Programs. The director is working to be more responsive to OBO's needs and more involved in the negotiation process. For example, DS/OFM officials recently traveled to 16 posts to negotiate tax exemptions for 18 capital construction projects by obtaining agreements with the host governments, confirming that the diplomatic tax privileges of the Vienna Conventions would be available for the OBO capital construction projects scheduled for the countries, and to clarify the processes by which the United States would obtain the tax relief. They also hoped to resolve any general problems concerning the U.S. missions' tax relief status in these countries.

DS/OFM began assisting OBO with reciprocity negotiations in 2004, and it needs to expand its assistance to other bureaus to improve the Department's overall reciprocity negotiation process with foreign governments. Establishing a formal process in the FAM that outlines the roles and responsibilities for the Department's bureaus, including DS/OFM, would further ensure that reciprocity issues are optimally addressed.

OIG found that over a recent three-year period, DS/OFM had not documented any bilateral agreements with other countries. In addition, a contractor hired by DS/OFM to review the VAT issue found there were many undocumented side and oral bilateral agreements at posts. Documenting bilateral agreements is essential to ensure the parties understand and comply with the agreements. Posts are at a disadvantage during negotiations with foreign governments when the details of existing bilateral agreements are not available. DS/OFM recently recognized this oversight and has been striving to obtain and maintain data on bilateral agreements and notes. DS/OFM drafted a cable to all posts in December 2004 requesting information on reciprocity and other issues. DS/OFM will maintain this information for future negotiations.

OIG commends DS/OFM's increasing involvement in negotiations and obtaining data and maintaining records on bilateral agreements and notes. Therefore, OIG is not making any recommendations regarding these two issues. However, DS/OFM needs to continue to improve the process and provide more guidance and training to posts.

**Recommendation 1**: OIG recommends that the Bureau of Diplomatic Security, Office of Foreign Missions document the Department's policy on reciprocity negotiations in the Foreign Affairs Manual. (Action: DS/OFM)

DS agreed with recommendation 1 and said that it was working to update the FAM and establish policies for the diplomatic tax relief effort. On the basis of DS' response, this recommendation is resolved, pending completion of DS' initiatives.

**Recommendation 2**: OIG recommends that the Bureau of Diplomatic Security, Office of Foreign Missions develop and implement, with the Foreign Service Institute, reciprocity awareness and training programs for appropriate officials. (Action: DS/OFM, in coordination with FSI)

DS and FSI agreed with recommendation 2. DS said that it had expanded outreach efforts, including making presentations at conferences, in FSI management courses, and other relevant venues.

DS requested clarification of the intended distinction between the recommendation 2 reference to "reciprocity awareness" and recommendation 3. Recommendation 2 is focused on educating bureau and post officials on the services OFM can provide them to encourage VAT reimbursements from host governments. Recommendation 3 is focused on guidance and training of post officials for developing local VAT reimbursement negotiating strategies and internal procedures for processing VAT reimbursements based on local requirements.

On the basis of DS' and FSI's responses, this recommendation is resolved, pending receipt and review of specific information on DS' expanded outreach efforts, such as the scope and content of the program.

## VAT Reimbursements

According to geographic and program bureau officials interviewed, there is no consistency in how the posts manage the VAT reimbursement process. DS/OFM is responsible for formulating and implementing a policy on tax programs for foreign missions abroad. However, DS/OFM had not developed and disseminated general, formal policies and procedures for obtaining and processing VAT reimbursements.[11] The DS/OFM VAT Basics cable sent to all posts in May 2003 provided some background information on VAT. For instance, the cable described the history of VAT, explained the advantages for a foreign government to have VAT, and summarized how to compute VAT. However, this cable did not provide the detailed guidance that officials need to process VAT. One bureau mentioned that it was not sure who was responsible for VAT. Another indicated that it did not know whom to designate to send, receive, or handle VAT reimbursements overseas. This bureau said the Department should develop formal VAT guidance. Lack of guidance for bureaus and posts increases the chance for miscommunication of responsibilities and inaccurate accounting and reporting.

**Recommendation 3**: OIG recommends that the Bureau of Diplomatic Security, Office of Foreign Missions develop and implement, with the Foreign Service Institute, formal guidance and training to posts on obtaining value-added tax exemptions or reimbursements and on managing the VAT reimbursement process. (Action: DS/OFM, in coordination with FSI)

DS and FSI agreed with recommendation 3. DS said that it had expanded outreach efforts, including making presentations at conferences, in FSI management courses, and other relevant venues. DS also raised a question regarding the distinction between recommendations 2 and 3. OIG addressed this question in its comments to recommendation 2.

On the basis of DS' and FSI's responses, this recommendation is resolved, pending receipt and review of specific information on DS' expanded outreach efforts, such as the scope and content of the program.

## Tracking VAT Reimbursements in Financial Systems

OIG determined that the Department's financial management systems were not adequate to account for VAT expenditures and reimbursements, and RM had not issued policies and procedures or provided training for administrative control of VAT reimbursements. Consequently, the Department cannot ensure that all VAT payments and reimbursements are properly classified, summarized, and recorded.

[11] Such policies would need to be adapted to the requirements of individual missions as dictated by their bilateral agreements.

The objectives of federal financial reporting are to provide users with information about operating performance and stewardship, which is the foundation for budgeting, managing programs, and controlling costs. The geographic and program bureaus, however, told OIG it was difficult to use the Department's financial systems to track VAT because the systems did not maintain data and generate reports useful for managing VAT expenditures. According to officials in INL, OBO, and other bureaus, the systems capture summary data on purchases and projects, but do not account for and track all VAT transactions. RM has reported the Department cannot determine the amount of VAT that should be collected from foreign governments.

In addition, OIG found that RM had not established a formal process for recording and reporting VAT payments and reimbursements. According to the FAM, "the CFO is responsible for issuance of implementing regulations and procedures which will provide for the effective and efficient administrative control of funds available to the Department."[12]

By not establishing a formal process, the Department is not able to effectively and efficiently track and control VAT reimbursements. OBO and INL have created their own project financial management systems. OBO developed an Access Tracking System in 2003, which is used to record and track project expenditures, including VAT. INL developed a new Local Financial Management System, tested in December 2004, which it intended all posts with INL foreign assistance programs would use for maintaining consistent financial reports on INL foreign assistance projects and programs. INL's new system was planned to replace the manual systems posts were using for recording project transactions, including VAT. However, the Information Technology Change Control Board (ITCCB) disapproved of the project in April 2005 because it was potentially duplicative of other solutions and it had an inappropriate architecture.

In addition, Bureau of Resource Management/Foreign Assistance Programs and Budget (RM/FA) officials have had to collect data manually pursuant to the Consolidated Appropriation Resolution, 2003. The act requires the Department to collect data annually from its missions abroad on the amount of unreimbursed VAT expended in implementing foreign assistance programs in their host countries to provide the basis for penalizing countries who tax U.S. foreign assistance without reimbursement. RM/FA officials told OIG that manually gathering required data resulted in inaccurate and incomplete reporting by the missions. Consequently,

[12] 4 FAM 082.1.

RM/FA is unable to submit to the Secretary of State a final net tax amount for each country to be used as a basis for determining whether the Secretary withholds foreign assistance in the next fiscal year. This internal control weakness prevents the Department from complying with this part of the act.

Having a reliable and accessible automated financial system to record VAT transaction and summary data will promote more consistent analysis and reporting at posts, regional offices, and headquarters and will help the Department comply with all legal requirements. Creating multiple financial systems for individual bureaus is inefficient and uneconomical.

**Recommendation 4**: OIG recommends the Bureau of Resource Management expand its financial management system to allow reliable recording, tracking, and reporting of value-added tax transactions in accordance with the legal and management needs of bureaus and posts. This should include guidance and training for the bureaus and posts on using the expanded system. (Action: RM)

RM agreed with the intent of recommendation 4. RM said that it planned to take measures to achieve the goal of tracking and reporting VAT transactions in accordance with the legal and management needs. On the basis of RM's response, this recommendation is resolved, pending RM's development of a process that appropriately records, tracks, and reports VAT transactions.



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# OTHER MATTERS

Interviews with geographic bureau officials revealed that posts are facing various difficulties in processing VAT. Bureau officials told OIG that not all posts pursue VAT reimbursements for the fourth quarter of the year because the posts are not able to use the funds, which revert to the Department of the Treasury (Treasury). Many posts are using manual ledger systems to record and track VAT and have not automated the process. DS/OFM also indicated that the process to record the accounting transactions for VAT is complicated. OIG's survey was performed domestically, and therefore, OIG could not perform work to confirm these issues overseas. OIG will review these issues in more depth during its work on the VAT process at posts in FY 2005.

## FOURTH-QUARTER VAT REIMBURSEMENTS

Bureau officials have indicated that many posts that otherwise seek VAT reimbursements fail to pursue them in the fourth quarter of the fiscal year. VAT reimbursements received after the end of the fiscal year must be returned to the Treasury.[13] Posts have no incentive to obtain fourth-quarter VAT reimbursements they are unable to use. Bureaus told OIG that some posts budget for the potential loss of funds in the fourth quarter; a potential loss of millions of dollars to the government. Other posts arrange with their host governments to obtain some portion of their last quarter reimbursements before fiscal year end.

## ACCOUNTING FOR VAT AT POSTS

Geographic bureaus told OIG that many posts continue to maintain archaic systems for recording and tracking VAT, including cumbersome, detailed manual ledger records and binders of VAT documentation. Some bureaus indicated that recording and tracking VAT is a huge, time-consuming task.

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[13] Post operations are funded by single-year appropriations that require any funds remaining after the fiscal year to be returned to the Treasury.

A DS/OFM official told OIG that accounting for VAT is difficult at posts because it requires four separate entries: (1) record the obligation for the item, (2) record the obligation for VAT, (3) pay the bill, and (4) record the VAT reimbursement. This is even more difficult because the deobligation cannot occur until the post receives the reimbursement. With so many transactions to manually record, VAT transactions may not be properly classified and recorded.

Officials at two bureaus told OIG that some missions have implemented effective and efficient VAT financial management systems. Implementing a simple, structured, and consistent process for managing VAT at posts could enhance productivity and internal controls.