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Office of Inspector General

Office of Audits

**Audit of the Department's Identification and Collection
of Value-Added Taxes Overseas**

AUD/FM-06-38

September 2006

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Summary

Many foreign governments assess a value-added tax (VAT) on the goods and services purchased by the Department's missions. 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.

As part of its responsibility to provide oversight to Department management, the Office of Inspector General (OIG) conducted the second phase of an audit of VAT. The first phase of this audit focused on domestic issues and noted concerns with the Department's oversight of VAT, financial management systems, and policies and procedures.¹ The second phase of this audit focused on overseas issues. Specifically, OIG determined whether the Department was properly identifying and collecting VAT reimbursements and accounting for VAT transactions.

OIG found that the Department did not have an adequate process to identify and collect VAT reimbursements. At four posts, OIG noted instances where staff was not processing requests for VAT reimbursements in a timely manner. In addition, OIG found that the process for overseas construction projects could be improved by requiring missions to reach agreement with host governments on tax relief before beginning construction and incorporate standard language into the formal procedures for future construction contracts and solicitations. OIG also found at Frankfurt that problems in obtaining the necessary documentation related to a construction contract could impact the Department's ability to collect an estimated \$5.9 million in VAT reimbursements.

OIG recommended that the Department implement standard policies for submitting requests for reimbursement from host governments; require tax relief agreements before beginning construction projects; include revised contract clauses related to VAT in new construction contracts; and review ongoing construction projects to identify opportunities for collecting additional VAT reimbursements.

In addition, the Department did not have an adequate process in place to account for VAT. Posts were not effectively recording, tracking, and maintaining controls over VAT transaction data because of limitations with the overseas financial management system. Further, the Department had not effectively tracked and reported the amount of VAT that it had requested but had not yet received from the host government. Also, the Department could not determine the total amount of VAT reimbursements that were owed to it, and VAT receivable were not included on the Department's financial statements. OIG recommended that the Department implement a solution so that its financial management system allows posts to record, track, and maintain control over VAT transactions; issue standard policies on recording VAT receivable; and accurately report VAT receivable on the Department's annual financial statements.

OIG met with officials from the Bureau of Diplomatic Security on July 15, 2005, the Bureau of Resource Management on August 8, 2005, and the Bureau of Overseas Buildings Operations on August 18, 2005, to discuss its findings and proposed recommendations.

¹ *Assessment of Value-Added Tax Exemption and Reimbursement Efforts* (AUD/FM-05-33, July 2005).

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Discussions with RM and OBO officials continued until October 2005. Comments from DS, RM, and OBO are included in this report where applicable.

Background

VAT is used worldwide, but not in the United States. It is a multistage tax on goods and services that involve collecting increments of tax numerous times before selling goods and services to consumers, who ultimately bear the full tax burden. Accounting firms estimate that 120 or more nations charge VAT on the purchase of goods and services, and the VAT rate can be as high as 25 percent.

Generally under the VAT system, the Department must first pay the taxes and then request reimbursement. To receive VAT reimbursements, the U.S. government must enter into bilateral agreements with the host governments. The missions then must periodically request reimbursement from the host governments. Depending on the country, the VAT refunds can range from 100 percent to substantially less, and they can take from one month to over a year to collect.

KPMG, a contractor hired by the Bureau of Diplomatic Security, Office of Foreign Missions (DS/OFM) in April 2002 to review unrecovered VAT costs, reported that the Department loses an estimated \$24 million annually in unreimbursed VAT payments. The contractor was conservative in its estimate and said that the loss could be 50 percent higher. KPMG found that the Department did not have an adequate system to track and monitor VAT transactions and reported that bureaus and posts were unable to identify the total VAT expenditures and reimbursements for any given year.

Program Administration

Several bureaus and offices are responsible for or affected by VAT. (See Appendix A, VAT Roles and Responsibilities.) 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. 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. To persuade foreign governments to grant tax exemptions and customs privileges, the Tax and Customs Division administers a program that imposes reciprocal tax and importation restrictions on foreign missions in the United States. The division periodically surveys tax restrictions at missions abroad.

Overseas missions are responsible for tracking and collecting VAT reimbursements from foreign governments. They provide the required documentation to the local governments to support the request for VAT reimbursement.

The Bureau of Overseas Buildings Operations (OBO) directs the worldwide overseas buildings program for the Department. It works with local governments and contractors at overseas missions to collect VAT reimbursements through post budget and fiscal offices on

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OBO contracts. In 2005, the Department instituted a Capital Security Cost Sharing Program that will accelerate the building of 150 secure embassies and consulates around the world over the next 14 years.

The Bureau of International Narcotics and Law Enforcement Affairs (INL) has broad responsibility for developing policies and coordinating programs to combat international narcotics and organized crime. Many of INL's programs are implemented through bilateral agreements with foreign governments, which allow INL to procure overseas goods and services that are subject to VAT in a manner that incorporates reimbursements for the VAT expenditures.

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 preparing the Department's financial statements² and designing, developing, and documenting the Department's financial systems.³

Prior Reports

OIG identified VAT-related problems in reciprocity, reimbursements, and accounting in 12 embassy inspection reports. Many embassies had to deal with host governments that denied reciprocity or instituted vague bilateral agreements. OIG recommended that these embassies work with DS/OFM to pursue tax exemptions or reimbursements. OIG advised other embassies with untimely VAT reimbursements to accelerate the reimbursement process.

OIG conducted an audit in 2004⁴ and found that the Department did not adequately oversee 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. OIG recommended that the Department expand its financial management systems and provide guidance and training to bureaus and posts on managing reciprocity issues and reporting VAT payments and reimbursements.

Objectives, Scope, and Methodology

As part of its responsibility to provide oversight to Department management, OIG conducted the second phase of an audit of VAT. The first phase of this audit focused on domestic issues and noted concerns with the Department's oversight of VAT, financial management systems, and policies and procedures. The second phase of this audit focused on overseas issues. Specifically, OIG determined whether the Department was properly

- identifying and collecting VAT reimbursements, and
- accounting for VAT transactions.

² 1 FAM 221.3.

³ 4 FAM 082.1.

⁴ AUD/FM-05-33, July 2005.

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OIG relied on FY 2003 information obtained during the first phase of the audit on how domestic bureaus oversee the VAT process. During the second phase of the audit, OIG obtained FY 2004-05 information from domestic bureaus. For instance, DS/OFM provided information on bilateral agreements and general information on the missions visited. Officials from INL and OBO provided their perspectives on identifying and collecting VAT at overseas missions. The Bureau of Resource Management (RM) provided information on using the financial management systems to identify and report VAT.

OIG focused its overseas work on posts in countries with a high VAT rate that paid a substantial amount of VAT annually. In addition, OIG chose posts that either had an INL presence or had an ongoing construction project. To accomplish the audit objectives, OIG performed overseas fieldwork in Berlin and Frankfurt, Germany; Budapest, Hungary; Lima, Peru; and Mexico City, Mexico. INL had a presence in both Lima and Mexico City and had piloted a new financial reporting system in both locations. OBO had construction projects in both Frankfurt and Budapest. Table 1 shows the VAT rate and VAT paid in FY 2003 for each of these posts, the latest available data at the time of OIG's audit. This amount is the total VAT reported for the Department's allotments at each post, and it is intended to reflect the VAT paid on all the departmental expenditures at post.

Table 1: VAT Rate and VAT Paid for Posts Included in Audit

Post	VAT Rate FY 2004	VAT Paid FY 2003
Berlin/Frankfurt	16%	\$13,000,164
Budapest	25%	\$ 2,918,198
Lima	19%	\$ 2,654,065
Mexico City	15%	\$ 6,241,815

Source: VAT rate, Deloitte Touche (Apr. 2004); VAT paid, RM's Regional Financial Management System (Apr. 2004).

At all overseas locations, OIG met with program officials and reviewed relevant documentation. OIG obtained an understanding of the internal controls for identifying, recovering, and distributing reimbursable VAT, including a walkthrough of the VAT process. OIG obtained post-specific policies and procedures when available. OIG also obtained FY 2004 information on VAT at each post, including:

- schedules or other documentation used to identify VAT paid;
- examples of VAT submissions; and
- schedules or other documentation used to distribute VAT reimbursements.

To review the entire VAT process from submission to reimbursement in each country, OIG judgmentally sampled invoices at four of the five missions visited.⁵ OIG determined the period of elapsed time for each of the following steps:

⁵ OIG was unable to perform any sampling at Frankfurt because of time constraints.

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- paying VAT;
- applying for VAT reimbursement; and
- obtaining VAT reimbursement.

In addition, OIG analyzed the sampled items for accuracy and completeness.

In Lima and Mexico City, OIG interviewed INL officials to determine how VAT was processed and recorded in their financial system. In Berlin, Frankfurt, and Budapest, OIG interviewed OBO officials about ongoing construction projects.

OIG's Office of Audits, Financial Management Division conducted fieldwork from April through October 2005 in accordance with government auditing standards and included such tests and other auditing procedures as were considered necessary under the circumstances. OIG met with DS officials on July 15, 2005, RM officials on August 8, 2005, and OBO officials on August 18, 2005, to discuss its findings and proposed recommendations. Discussions with RM and OBO officials continued until October 2005. RM, OBO, and DS provided formal comments to the draft report, which are incorporated where applicable and included in their entirety as Appendices B, C, and D, respectively.

Audit Results

Identifying and Collecting VAT Reimbursements

OIG found that the Department does not have an adequate process to identify and collect VAT reimbursements. At four posts, OIG noted instances where staff was not processing requests for VAT reimbursement in a timely manner. OIG also found that the process for overseas construction projects could be improved by requiring missions to reach agreement with host governments on tax relief before beginning construction and incorporate standard language into the formal procedures for future construction contracts and solicitations. In addition, OIG found that problems in obtaining necessary documentation related to a construction contract could impact the Department's ability to collect an estimated \$5.9 million in VAT reimbursements.

Timeliness of Submissions for VAT Reimbursement

To obtain VAT reimbursements, missions visited must submit original invoices to the host government. Missions log each invoice, create summaries of all invoices, and copy the invoices before submission. OIG found that missions were not managing and processing VAT reimbursement submissions in a timely manner.

To assess the timeliness of preparing and submitting information to host governments, OIG judgmentally sampled invoices at four of the five missions visited.⁶ OIG selected invoices that included the entire process from submission to reimbursement and that contained high VAT costs.

⁶ OIG was unable to perform any sampling at Frankfurt because of time constraints.

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OIG calculated the number of days between the date an invoice was paid and the date the host government received a request for VAT reimbursement. Overall, submissions ranged from seven to more than 300 days after an invoice had been paid. OIG also found that the timeliness of submissions varied considerably among the four missions reviewed, as indicated in Table 2.

Table 2: Timeliness for Submitting Invoices to Host Governments in FY 2004

Post	Universe of Invoices	Sample Size^a	Invoices That Took More Than 100 Days To Submit to Host Government	Percentage of Sample That Took More Than 100 Days To Submit to Host Government
Berlin	5,126	17	9	53
Budapest	8,818	19	4	21
Lima	209	20	13	65
Mexico City	11,240	19	5	26

^a Although OIG originally selected 20 invoices at each of the four posts, it was only able to review all the invoices at Lima. Five cases (three at Berlin, one at Budapest, and one at Mexico City) were not readily available and were not replaced because of time constraints.

Source: Embassies Berlin, Budapest, Lima, and Mexico City.

More specifically, Lima, despite having the smallest universe of invoices (209), was the least timely with 65 percent of the sampled invoices taking at least 100 days to submit to the host government, while Budapest, with a much larger universe (8,818), had the most timely at 21 percent. OIG attributes Lima's high rate to a backlog of transactions. Berlin was the second least timely with 53 percent, despite Berlin's policy for submitting invoices twice a week to the host government.

Although the five missions OIG visited had their own informal processes for submitting invoices and obtaining VAT reimbursements, two of the five posts did not have formal procedures for processing VAT. None of the five missions had established written deadlines for submitting invoices to the host government. Such documentation is necessary to establish VAT requirements and appropriate timeframes for performing this function, delineate the roles and responsibilities of staff, and provide for consistency in carrying out the VAT reimbursement functions at the missions. In addition, establishing performance measures assists managers in tracking progress, establishing accountability, and meeting objectives.

For posts included in the audit, the host governments were taking from one to eight months to review VAT invoice submissions and provide VAT reimbursements, according to mission staff OIG interviewed. As the host government's review process might take months, missions should submit invoices as soon as possible in order to comply with host government requirements and to obtain VAT reimbursements within the fiscal year.

Missions must use federal resources efficiently and effectively. OIG concluded that having clear, documented procedures would minimize the potential for waste and abuse, achieve desired objectives, and allow managers to monitor their internal control environment.

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Recommendation 1: OIG recommends that the Bureau of Resource Management develop standard policies and procedures, for missions to use internally, for preparing and submitting documentation to host governments for value-added tax reimbursements.

RM agreed with the intent of recommendation 1 and said that it will prepare general policy for the Foreign Affairs Manual (FAM) concerning submitting claims for reimbursement of host country taxes. However, the detailed procedures vary among posts, which will require each post to develop a procedure that is consistent with the overall policy. On the basis of RM's response, this recommendation is resolved pending completion of the new policy.

Tax Relief Agreements for Embassy Construction

The Department was not consistently developing tax relief agreements with local governments before beginning major construction projects overseas. The Under Secretary for Management created the Diplomatic Tax Relief Initiative (DTRI) group in September 2004 to more aggressively identify and collect reimbursable taxes paid overseas. DTRI includes representatives from a number of bureaus and offices.⁷ DTRI recognized the need to reach agreement with local governments before beginning construction projects and made obtaining tax agreements for capital construction projects one of its priorities.

Initially, DTRI's focus was ongoing OBO construction projects. A DTRI cable released October 20, 2004, stated that the Department had 30 major construction projects scheduled for FYs 2004-06 for which the Department did not yet have tax relief agreements. The value of the projects was \$2.37 billion, with an estimated foreign tax exposure of \$94 million. The cable further stated that as the Department's construction program escalated in FY 2007 and beyond, the urgency of negotiating favorable tax relief agreements would increase.

OIG applauds DTRI's efforts, which have resulted in 28 bilateral tax relief agreements, with an estimated savings of \$105 million. Although the DTRI had initiated a number of improvements in the VAT reimbursement process, OIG found that the Department had not developed a policy that would require obtaining a tax relief agreement before beginning construction. The Department has implemented a multibillion-dollar program to build 150 new secure embassies and consulates around the world in the next 14 years.⁸ The VAT exposure for these projects will be in the millions, and the Department will be taking a financial risk in proceeding with the construction contracts without having tax relief agreements.

Recommendation 2: OIG recommends that the Bureau of Diplomatic Security, Office of Foreign Missions, in conjunction with the Bureau of Overseas Buildings Operations, work within the Diplomatic Tax Relief Initiative group to establish a policy that requires that tax relief agreements be aggressively pursued before beginning construction projects overseas. If a tax relief agreement cannot be established, the Bureau of Diplomatic Security, Office of Foreign Missions should document its efforts and the reasons an agreement could not be established and inform the Bureau of Overseas Buildings Operations.

⁷ Bureaus and offices include RM, OBO, DS, Administration, and Office of the Legal Adviser (L).

⁸ The Capital Security Cost Sharing Program is estimated to cost \$17.5 billion.

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DS disagreed with the original wording of recommendation 2 and said that it would be difficult or impossible to secure a tax relief agreement before beginning Department construction projects in some situations, such as in countries that refuse to provide relief to foreign missions for value-added taxes. DS suggested that OIG modify the recommendation, which OIG has done.

OBO said that in its opinion, recommendation 2 had in effect already been satisfied. DTRI had developed a generic contract clause that is now in use in all contracts where a formal agreement has been negotiated by post and DS/OFM with the host country. OBO is currently developing an internal policy directive that will formalize the process.

On the basis of DS's and OBO's responses, this recommendation is resolved. This recommendation can be closed once the Department provides supporting documentation to show that it has developed a policy that requires that tax relief agreements be aggressively pursued before beginning construction projects overseas.

VAT Language in Construction Contracts

OIG found that not all construction contracts included language related to the contractor's responsibility to assist the Department in identifying and collecting VAT. DTRI also identified this as an issue and reported that existing construction contracts were too broadly worded and confusing, which caused problems for all parties involved.

For instance, OIG found that the contract to renovate Embassy Budapest did not include any requirements related to VAT, such as requiring that the contractor provide invoices that the embassy could use to obtain a VAT reimbursement. OBO assumed that it could use existing reciprocity procedures at the embassy. However, those procedures were not applicable to construction projects. The Department was able to collect more than \$124,000 over a three-year period (FYs 2002-04) in VAT reimbursements on the contract because of the contractor's willingness to provide most of the invoices to the embassy, even though the contractor was under no obligation to do this.

DS/OFM asked the Under Secretary for Management to task OBO with forming a working group with other offices to develop revised contract clauses that would clarify the responsibilities of the Department and the contractors in obtaining VAT reimbursements. The working group developed contract language, in terms of taxation and other issues, tailored to specific countries. Subsequently, OBO began using the clauses in its solicitations and contracts. However, OBO had not incorporated these changes into its formal procedures for soliciting and awarding construction contracts, which OIG is recommending be done. In addition, OIG encourages OBO to review its ongoing contracts that do not include VAT language and determine whether they include opportunities to obtain VAT reimbursements from foreign governments.

Recommendation 3: OIG recommends that the Bureau of Overseas Buildings Operations, in coordination with members of the Diplomatic Tax Relief Initiative group,

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incorporate a requirement to include revised contract clauses related to Department and contractor responsibilities for obtaining value-added tax reimbursements into its formal procedures for soliciting and awarding construction contracts.

OBO agreed with recommendation 3 and indicated that it has already incorporated newly developed language as a matter of practice whenever a formal agreement is negotiated with a host country. On the basis of OBO's response, this recommendation is resolved. Once OBO provides supporting documentation that it has incorporated revised language for obtaining value-added tax reimbursements into its formal procedures, this recommendation can be closed.

Recommendation 4: OIG recommends that the Bureau of Overseas Buildings Operations, in coordination with the Office of the Legal Adviser, review its ongoing contracts and determine whether it could obtain value-added tax reimbursements from foreign governments.

OBO agreed with recommendation 4 and stated that it had been working with L and the Bureau of Administration, Office of Logistics Management, to review ongoing contracts. On the basis of OBO's response, this recommendation is resolved. Once OBO provides details on its efforts to review ongoing contracts for potential VAT reimbursements, this recommendation can be closed.

VAT Reimbursement for OBO Project in Germany

In September 2003, before creating the DTRI, the Department awarded a contract to a U.S. contractor to design and renovate a multi-building facility in Frankfurt, Germany. Following the award, the contractor entered into a joint venture agreement with a German contractor. In January 2004, the German government issued a joint venture tax identification number for the purpose of "renovation and construction of the U.S. Consulate Frankfurt."

In FY 2004, officials in Frankfurt's Financial Management Center (FMC) advised OBO that it had to submit the original invoices addressed to the American consulate general in order to obtain a VAT reimbursement from Germany. Frankfurt's FMC also noted that the consulate would probably encounter difficulties in obtaining VAT refund payments processed by OBO in the United States rather than by the FMC in Germany. In November 2004, OBO submitted invoices totaling several hundred thousand dollars that Frankfurt's FMC indicated were not in accordance with Germany's requirements. As a result, it returned the invoices to OBO.

In March 2005, Frankfurt transferred the issue to the Berlin FMC for resolution. Berlin found that the invoices had been sent by the U.S. contractor, not the joint venture that had a German tax identification number. The Berlin FMC indicated that Germany would not reimburse the VAT unless the U.S. contractor registered and obtained a separate tax identification number or the joint venture submitted the invoices. OBO disagreed with the Berlin FMC's determination and said that in its opinion, the contractor complied with Germany's requirements. Embassy officials met with German officials in June 2005 on this issue. The German officials indicated that the invoices did not meet the requirements, and they were not willing to grant an exception.

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The Department could lose an estimated \$5.9 million in VAT reimbursements for the Frankfurt project because the contractor did not prepare invoices in accordance with Germany's VAT requirements. OBO should not have approved and paid contractor invoices that did not meet the VAT requirements. Although OBO and Embassy Berlin were working to address this issue, they were not able to come to an agreement on how to proceed. OIG recommended that OBO work with the contractor to obtain invoices for the construction that are acceptable to the German government. If the Department implements recommendations 2 and 3 in this report, this situation should not occur again. However, because of the size of the potential reimbursements, OBO should resolve this issue.

Recommendation 5: OIG recommends that the Bureau of Overseas Buildings Operations obtain the necessary invoices from the contractor and then work with Embassy Berlin to obtain the value-added tax reimbursements for the Frankfurt construction project.

OBO agreed with recommendation 5 and said that it is continuing to work with Embassy Berlin and the contractor to recover VAT for the Frankfurt project. OBO added that the VAT recovery project is now under way on this issue. On the basis of OBO's response, this recommendation is resolved. Once OBO completes its efforts and the Department obtains the tax reimbursements, this recommendation can be closed.

Accounting for VAT

OIG found that the Department did not have an adequate process to account for VAT. Posts were not effectively recording, tracking, and maintaining controls over VAT transaction data because of limitations with the overseas financial management system. In addition, the Department had not effectively tracked and reported the amount of VAT that had been requested but not yet obtained from the host government.

Accounting for VAT Transactions

During OIG's audit in July 2005, RM issued a cable to missions outlining the proper methods for recording VAT obligations and payments in the Department's automated financial management systems. The cable explained that missions must separately identify VAT obligations, either individually or in bulk, and deobligate the obligations when they pay the VAT charges at the same time as the charges for goods and services. Missions are then supposed to debit VAT receivable. When received, VAT reimbursements are credited to the original obligations as expenditure refunds. Any unreimbursed VAT is charged to the cost of goods and services (net).⁹

⁹ 6 FAH-5 H-809 Exhibit H-809.1-3.

Accounting for VAT at Posts

OIG found that posts were not effectively recording, tracking, and maintaining controls over VAT transaction data because of limitations with the overseas financial management system. According to officials at posts visited by OIG, the Department's financial management system only allowed access to summary data and not to transaction-level data needed by missions to track VAT. As a result, missions were using offline financial spreadsheets or databases to track VAT transactions. This wastes time and resources and increases the risk that data are not accurate and reliable.

Although posts were entering VAT transactions into the Department's financial management systems, at each mission included in the audit, OIG found that staff also recorded and tracked VAT obligations, payments, and reimbursements in spreadsheets or databases that were separate from the accounting system. Post officials reported that the Department's financial management system did not contain the detailed information needed for the posts to prepare the official request for a VAT refund from local governments. In addition, posts reported that it was difficult to reconcile the VAT refund amounts to the amount requested using information from the financial management system. Therefore, the posts that OIG reviewed were using their separate spreadsheets or databases to perform this reconciliation. Because of the volume of transactions, it could take weeks to review and log this information manually.

OIG also found that INL was using a separate application at overseas posts for tracking its financial transactions, including VAT. According to INL officials, the Department's financial management systems were unable to support INL's needs for recording project obligations, running queries, and producing custom reports. INL officials said that this duplicate process was time-consuming and inefficient.

In July 2005, RM issued a cable to missions outlining the proper methods for recording VAT obligations and payments in the Department's automated financial management systems. The cable explained that missions must separately identify VAT obligations, either individually or in bulk, and cross-reference VAT payments and reimbursements to the original VAT obligations. However, the cable failed to explain how missions should track VAT data in the Department's financial management systems between the payment and reimbursement.

Missions need a single automated financial system that will effectively and efficiently record and track all financial transactions, including VAT. Having to input VAT transaction data in two different financial systems is time-consuming and wastes resources. It also increases the risk of data entry error and misstatements. Mitigating such risks should be a Department priority.

Recommendation 6: OIG recommends that the Bureau of Resource Management review the Department's financial management system to identify and implement a reasonable solution for posts to record, track, and maintain control over value-added tax transactions.

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RM concurred in principle with recommendation 6. Although RM believes that the existing process can allow posts to determine the amount of VAT paid and reimbursed, it agreed that posts may need to extract data in different ways to assist in the reimbursement submission process. RM also stated that improvements could be made to the systems and processes for tracking VAT, including tools to maximize the use of automated data to facilitate the reimbursement submission process and a mechanism for recording receivable. On the basis of RM's response, this recommendation is resolved and can be closed once RM determines and implements a method that will assist posts in tracking VAT transactions.

Accounting for VAT Receivable

At the time of the audit, the Department was not properly tracking or recording VAT receivable in its automated financial management systems. According to the FAM, "amounts arising from value added tax payments to foreign governments should be booked as receivable even though they are not considered budgetary resources until received."¹⁰ Further, these payments should be promptly recorded when it is determined that VAT reimbursements will occur.

The FAM also requires that each overseas and domestic organization be "responsible for developing procedures to accurately track known accounts receivable and to record accounts receivable in the subsidiary ledger whether automated or manual in a timely manner."¹¹ OIG found that only two of the five missions tracked VAT receivable; however, none of the missions reviewed recorded VAT receivable in the Department's automated financial management systems.

OIG asked RM how it reported VAT accounts receivable on its annual financial statements when the posts were not tracking this information. RM officials said that the Department did not collect VAT receivable data because the amount was not material enough to warrant the cost of collecting the information. The Department could not determine the total amount of VAT reimbursements that were owed to it, and this receivable was not included on the Department's financial statements.

OIG used a rough estimation technique on a list of all expenditures¹² and found that the amount of VAT receivable could in fact be significant enough to impact the Department's financial statements. OIG raised its concerns with its independent contractor, who audited the financial statements, and RM, who developed and implemented an estimation methodology for VAT receivable. Using this estimation methodology, for the FY 2005 principal financial statements, RM identified a net VAT receivable of approximately \$21 million.¹³ In addition, the

¹⁰ 4 FAM 033.2-2.

¹¹ 4 FAM 033.2-6.

¹² OIG used an independent contractor's list of all expenses reported by the Department for the first three quarters of 2005 and an average worldwide VAT rate to determine a conservative amount for estimated VAT receivable.

¹³ For FY 2005, RM estimated VAT accounts receivable totaling approximately \$26 million and estimated approximately \$5 million as an allowance for uncollectible receivable. OIG's independent contractor concurred with RM's estimate.

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Department restated the FY 2004 principal financial statements by approximately \$19.5 million¹⁴ to reflect the VAT receivable.

Although the American Institute of Certified Public Accountants standards allow organizations to include estimates in a financial statement when relevant data cannot be accumulated on a timely, cost-effective basis,¹⁵ OIG recommends that the Department establish a process to identify and record actual VAT receivable. Missions need this information to track unreimbursed submissions and assess the probability of collecting the reimbursements. In addition, missions could use the information in trend analyses to obtain more timely VAT reimbursements. OBO officials added that collecting this data would help OBO monitor project costs and funds availability that it currently does manually, which is cumbersome.

Although the Department's internal policy guidance provides some information on tracking accounts receivable, the guidance is not adequate for posts to use to track VAT receivable. Formal guidance is needed to provide mission personnel with the instructions and detail they need to track and report VAT receivable. In addition, a formal process should be developed to report the actual amount of VAT payments that have not yet been reimbursed by the host government on the Department's annual financial statements.

Recommendation 7: OIG recommends that the Bureau of Resource Management develop and distribute standard policies and procedures that posts can use to track and record accounts receivable related to the value-added tax.

RM agreed with recommendation 7 and said that it would develop and distribute policies and procedures once it identified the mechanism for posts to use for recording and tracking accounts receivable for host country taxation in the financial management system. On the basis of RM's response, this recommendation is resolved pending completion of these policies and procedures.

Recommendation 8: OIG recommends that the Bureau of Resource Management develop a process to include the actual amount of accounts receivable related to the value-added tax on the Department's annual financial statements.

RM indicated that once a process is developed to record the receivable directly in the financial management system, it would include those amounts in the financial statements. However, until then, RM will record an adjusting entry in the financial management system to reflect the estimated amount of accounts receivable. On the basis of RM's response, this recommendation is resolved until an actual amount of accounts receivable for VAT is included in the Department's financial statements.

¹⁴ For FY 2004, RM estimated VAT accounts receivable totaling approximately \$24.4 million and estimated approximately \$5 million as an allowance for uncollectible receivable. OIG's independent contractor concurred with RM's estimate.

¹⁵ AU Section 342, *Auditing Accounting Estimates*.

Recommendations

Recommendation 1: OIG recommends that the Bureau of Resource Management develop standard policies and procedures, for missions to use internally, for preparing and submitting documentation to host governments for value-added tax reimbursements.

Recommendation 2: OIG recommends that the Bureau of Diplomatic Security, Office of Foreign Missions, in conjunction with the Bureau of Overseas Buildings Operations, work within the Diplomatic Tax Relief Initiative group to establish a policy that requires that tax relief agreements be aggressively pursued before beginning construction projects overseas. If a tax relief agreement cannot be established, the Bureau of Diplomatic Security, Office of Foreign Missions should document its efforts and the reasons an agreement could not be established and inform the Bureau of Overseas Buildings Operations.

Recommendation 3: OIG recommends that the Bureau of Overseas Buildings Operations, in coordination with members of the Diplomatic Tax Relief Initiative group, incorporate a requirement to include revised contract clauses related to Department and contractor responsibilities for obtaining value-added tax reimbursements into its formal procedures for soliciting and awarding construction contracts.

Recommendation 4: OIG recommends that the Bureau of Overseas Buildings Operations, in coordination with the Office of the Legal Adviser, review its ongoing contracts and determine whether it could obtain value-added tax reimbursements from foreign governments.

Recommendation 5: OIG recommends that the Bureau of Overseas Buildings Operations obtain the necessary invoices from the contractor and then work with Embassy Berlin to obtain the value-added tax reimbursements for the Frankfurt construction project.

Recommendation 6: OIG recommends that the Bureau of Resource Management review the Department's financial management system to identify and implement a reasonable solution for posts to record, track, and maintain control over value-added tax transactions.

Recommendation 7: OIG recommends that the Bureau of Resource Management develop and distribute standard policies and procedures that posts can use to track and record accounts receivable related to the value-added tax.

Recommendation 8: OIG recommends that the Bureau of Resource Management develop a process to include the actual amount of accounts receivable related to the value-added tax on the Department's annual financial statements.

VAT Roles and Responsibilities

Several bureaus, offices, and programs are responsible for, or affected by, VAT.

- Secretary of State delegated responsibilities to manage the Department's VAT Program under the Foreign Missions Act to the Under Secretary for Management, who redelegate them to the Assistant Secretary for DS. (1 FAM 264; DA1-198; DA1-214; H.Rept. 97-693)
- DS/OFM develops and implements policy designed to provide for reciprocity of treatment, including tax exemption, between U.S. missions abroad and foreign missions in the United States. (1 FAM 264)
- The Office of the Legal Adviser has substantive and coordinating responsibility for tax exemption accorded to U.S. representation abroad. (1 FAM 241.1)
- The CFO oversees all financial management activities relating to the Department's programs and operations. (1 FAM 221.1) The CFO is also responsible for managing and overseeing the Department's financial management personnel, activities, and operations. (1 FAM 221.2)
- Chiefs of Mission are responsible for establishing effective internal control systems to prevent waste, fraud, abuse, and mismanagement. The Chiefs of Mission also negotiate bilateral agreements with host governments for "zero-rate" VAT payments, exemptions, or reimbursements and report any significant violations of existing agreements. (2 FAM 113.1)
- Each mission is to designate an officer responsible for implementing the U.S. foreign tax relief program. The designated officer is to coordinate with representatives of other U.S. government agencies. (2 FAM 264.1)
- OBO develops and implements building policies abroad. (1 FAM 281)
- There are procedures to account for VAT incurred under the International Cooperative Administrative Support Services System. (6 FAH-5 H-809.1-3)

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Appendix B



United States Department of State

Assistant Secretary for Resource Management
and Chief Financial Officer

Washington, D.C. 20520

August 31, 2006

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MEMORANDUM

TO: OIG – Mr. Howard J. Krongard

THROUGH: RM/EX – Philip J. Schlatter, Acting *Philip Schlatter* 31 Aug 2006

FROM: RM – Bradford R. Higgins *BRH*

SUBJECT: Comments on Draft Audit Report, Identification and
Collection of Value-Added Taxes Overseas (AUD/FM-
06-XX) dated July 2005

RM appreciates the opportunity to comment on the OIG work related to this complex area. RM agrees in principle with the recommendations addressed to RM in the subject report and has provided comments addressed to each in the attachment.

In addition, RM would like to address several statements made in the text that require clarification.

- On page 2, OIG references the contractor study that cited that the Department loses \$24 million annually in unreimbursed VAT payment and that the Department did not have an adequate system to track and monitor VAT. We have concerns as to the accuracy of this statement since neither the contractor nor OIG demonstrated to what extent the U.S. Government did not recover taxes due to the accounting process rather than the lack of host country reciprocity.
- On page 6, the report states "...missions should submit invoices as soon as possible to comply with host country requirements to obtain VAT reimbursements within the fiscal year." The importance of obtaining the reimbursements in the current fiscal year relates to the availability of single year funds not a host country requirement. We suggest revising this sentence.

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Appendix B

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If you have any questions or need additional information about the response, please contact Eileen Angle, on (703) 875-5620.

Attachments:
As Stated

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**Office of Inspector General, Office of Audits
Audit of the Department's Identification and Collection of Value-Added
Taxes Overseas, AUD/FM-06-XX
RM Response**

Recommendation 1: OIG recommends that the Bureau of Resource Management develop standard policies and procedures, for missions to use internally, for preparing and submitting documentation to host governments for value-added tax reimbursements.

RM Response: RM agrees with the intent of this recommendation and will prepare general policy for the Foreign Affairs Manual concerning submitting claims for reimbursement of host country taxes. However, the detailed procedures vary among posts depending on the requirements of the host government. Therefore, rather than formulate detailed procedures, RM will require that each post develop a documented claim procedure that is consistent with the policy developed.

Recommendation 6: OIG recommends that the Bureau of Resource Management review the Department's financial management system to identify and implement a reasonable solution for posts to record, track, and maintain control over value-added tax transactions.

RM Response: RM concurs that improvements can be made to our systems and processes for tracking host country taxes, including tools to maximize the use of automated data to facilitate the reimbursement submission process and a mechanism for recording receivables. While we concur in principle with Recommendation 6, we believe that the narrative in this section of the report implies that the existing process for recording host country tax payments and reimbursements does not enable post to determine the amounts paid and reimbursed. It can, though currently posts may want to extract data in different ways to better assist in the reimbursement submission process. RM appreciates that OIG has recommended a "reasonable" solution given the complexity and differences in the reimbursement process from post to post, as a cost-effective system solution may not address all needs for all posts.

**Office of Inspector General, Office of Audits
Audit of The Department's Identification and Collection of Value-
Added Taxes Overseas, AUD/FM-06-XX
RM Response**

Recommendation 7: OIG recommends that the Bureau of Resource Management develop and distribute standard policies and procedures that posts can use to track and record accounts receivable related to the value-added tax.

RM Response: RM agrees to develop and distribute policies and procedures once it identifies the mechanism for posts to use for recording and tracking accounts receivable for host country taxation in the financial management system.

Recommendation 8: OIG recommends that the Bureau of Resource Management develop a process to include the actual amount of accounts receivable related to the value-added tax on the Department's annual financial statements.

RM Response: Once a process is implemented for posts to record the accounts receivable directly in the financial management system, those receivables will be included in the accounts receivable balances that are automatically included in the statements. Until such a process can be developed, RM will record an adjusting entry in the financial management system to reflect the estimated amount of the accounts receivable.



United States Department of State
Washington, D.C. 20520

AUG 31 2006

**UNCLASSIFIED
MEMORANDUM**

TO: OIG – Howard J. Krongard

FROM: OBO – General Charles E. Williams *W31*

SUBJECT: Draft Report on Audit of the Department’s Identification and
Collection of Value Added Tax Overseas (AUD/FM-06-XX)

REF: OIG Memo dated August 9, 2006

The referenced memo seeks OBO’s review and comments on the subject draft report. You are also seeking our agreement or disagreement with each of the recommendations. We appreciate the opportunity to review and comment.

I would like to acknowledge the importance of the Diplomatic Tax Relief Initiative (DTRI). It is an important initiative that has the potential to save the USG a substantial amount of money. OBO is an enthusiastic participant in this program.

OBO wholeheartedly supports the establishment of formal procedures for tax exemption or reimbursement prior to contract award. The Office of Foreign Missions (OFM) and OBO have an active partnership in the effort to obtain these agreements. OBO sets priorities as to the locations where these agreements are pursued. Follow-up with host governments is an important aspect of this effort and OBO plays a key role in that regard. Working together, OBO and OFM have completed or initiated tax relief negotiations in 14 locations just since September 2005.

In your page 1 summary with regard to the third and fourth paragraphs, we note that OBO working with OFM has been, and continues to focus on, securing tax relief agreements as soon as projects are identified – not only New Embassy Compound (NEC) projects but other types as well, e.g., Major Rehabilitation or Physical Security Upgrades. Methods for achieving this objective vary and might include a reimbursement mechanism or a “zero-rating”, the functional equivalent of charging no VAT. OBO requests OIG to re-consider the wording in its summary after reviewing our specific comments below.

At the bottom of page 2 we suggest you amend your draft to read OBO “works with local governments and contractors at overseas missions to collect *through post budget and fiscal offices* VAT reimbursement on OBO contracts.”

Per discussion between members of our staffs, we understand the Table on page 4 will be modified to make clear that the FY2003 VAT Paid figures column is for all State Department allotments and not just for specific OBO projects.

In identical footnotes on pages 4 and 5, the OIG acknowledges that they were unable to perform any sampling at Frankfurt because of time constraints. This would lead us to question any statements about the invoicing by contractors at that post. On Page 5, in the paragraph entitled, “*Identifying and Collecting VAT Reimbursements*,” the OIG states that they found problems in obtaining documentation related to a construction contract which could impact the Department’s ability to collect an estimated \$5.4 million in VAT reimbursements. This comment is clearly about the Frankfurt project where OBO had tax exposure in that amount as referenced in the report and has been encountering difficulty recovering the tax from the host country. We wonder how the OIG came to this conclusion without sampling invoices. OBO notes that the key fact is that this project preceded the Diplomatic Tax Relief Initiative and therefore did not have detailed agreements on tax recovery procedures. OBO believed that the contractor had satisfied the host country requirements. With post’s support, these requirements were clarified and VAT recovery on this project is now underway.

Also, OBO notes that procedures have been changed since the report was drafted; a procedure to reach agreement with host governments on tax relief before initiating the project and incorporating standard language has been implemented. As stated earlier, an OBO/OFM team has completed or initiated tax relief negotiations in 14 locations since September 2005.

In your discussion on page 7 in the section entitled, “*Tax Relief Agreements for Embassy Construction*,” it should be noted that the DTRI group was chaired by OBO and included members from A/LM, A/OPE, RM, M, L/BA, L/DL, and DS/OFM. In accordance with its charter, the group developed a generic contract clause template that is now in use in all contracts where a formal agreement has been negotiated by post and OFM with the host country. The generic contract clause template includes language that applies to all contracts and has a “placeholder” feature where country specific tax exemption/recovery procedures are inserted.

Given the above, we note that Recommendation 2 has in effect already been satisfied. Not only is the procedure recommended by the OIG already in place but a Policies and Procedures Directive on VAT relief – internal guidance used by OBO – is undergoing development and will formalize the practice. On a technical note, OBO believes that OFM has the lead in reaching tax agreements with host countries, a fact the OIG acknowledges on page 2 in the first sentence in the section entitled *Program Administration*. The action office for Recommendation 2 should be OFM and not OBO. In addition, OBO notes that this Policy and Procedures Directive will not “require” a tax relief agreement. Our unequivocal goal is to have a tax relief agreement in place before starting a project; however, these agreements are affected by factors outside of the Department’s control such as the receptiveness of the host government. Please change the wording of this recommendation to read “to establish a policy *under which the Department will make every effort to obtain tax relief agreements....*”

On page 7, in the section entitled, *VAT Language in Construction Contracts*, OIG states that “OIG found that not all construction contracts included language related to the contractor’s responsibility to assist the Department in identifying and collecting VAT.” While this is true, it should also be noted that most construction contracts previously contained generic language regarding VAT and each contract typically included a separate contract line item (CLIN) that was used for tracking VAT amounts that appeared on invoices. The contract language recently developed by the DTRI working

group brought a level of detail that was previously not present. This “new” language is now used as a matter of practice whenever a formal agreement is negotiated with the host country. In the absence of a formal agreement, the older language is used.

Also, on page 8 in the first paragraph, OBO requests that a time period be associated with the “\$124,000 VAT reimbursements” phrase in third sentence. It is important to note that the \$124,000 figure is accurate for *Fiscal Years 2002 through 2004*. Please add this clarification.

With regard to Recommendation 3 on page 8, OBO agrees with the recommendation. With regard to Recommendation 4 on page 8, OBO agrees and is in fact doing what the recommendation states. OBO has been and continues to work with L and A/LM to review ongoing contracts.

With regard to the section on page 8 entitled *VAT Reimbursement for OBO Project in Germany*, this project is a perfect example of why every effort must be made to arrive at a formal agreement with the host country prior to entering into a contract. Only by establishing these tax reimbursement or exemption procedures early in the planning process can risk be allocated fairly and the terms and conditions of the contract made clear and concise so that each party understands their obligations. For this reason, OBO is working closely with OFM to establish travel priorities and teams with OFM to negotiate agreements in countries with upcoming projects.

With regard to the language in this section, OBO requests that OIG reword the first sentence in the first paragraph on page 8 to read, “In September 2003, *prior to the DTRI*, the Department awarded...”

In the second paragraph on page 9 (and elsewhere in the report), please change \$5.4 million to \$5.9 million. In addition, please reword the first sentence in the second paragraph to read, “The Department could lose an estimated \$5.9 million in VAT reimbursements *on the Frankfurt project*.” OBO did not have the ability to disapprove contractor’s invoices based on VAT requirements so the phrase “because the contractor did not prepare invoices in accordance with Germany’s VAT requirements” and the sentence in that same paragraph that reads, “OBO should not have approved and paid contractor invoices that did not meet the VAT requirements” should be deleted. Because this contract was issued in September 2003, the contractor did not explicitly define tax recovery procedures. However, the

contractor has been cooperative in modifying invoice paperwork to OBO even though it is not contractually obligated to do so.

With regard to Recommendation 5 on page 9, OBO agrees and is seeking to achieve that end. OBO is continuing to work with Post, Embassy Berlin, and the contractor to recover VAT for the Frankfurt project.

On a more general point, OBO acknowledges that Department efforts at properly recovering VAT on its projects should be a priority and, through the DTRI, is committed to doing so. OBO urges OIG to also focus on the responsibility of contractors in this regard. L/BA notes that contractors must, by the terms of the contract, properly register to conduct business in the country in which they are working when the host government so requires. In at least two instances – Astana and Berlin – OBO’s contract partners have refused to properly register – possibly to avoid significant additional tax liabilities. Such a practice prevents the contractor from receiving the proper documentation with which to supply OBO for the return of VAT from the host government which OBO has already reimbursed the contractor under the terms of the contract. OBO’s contractor partners should be properly registered where required so as to remove possible impediments to VAT recovery efforts by the USG. The OIG can be helpful to OBO by highlighting this concern during the course of audits and inspections.”

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Appendix D



United States Department of State

*Assistant Secretary of State
for Diplomatic Security*

Washington, D.C. 20520

September 6 , 2006

MEMORANDUM
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TO: OIG – Mr. Howard J. Krongard

FROM: Richard J. Griffin *RJG*

SUBJECT: Audit of the Department's Identification and Collection of
Value-Added Tax Overseas (AUD-FM-06-XX) DRAFT
August 2006

Attached is the Bureau of Diplomatic Security's response to your most recent memorandum for Recommendation 2 of the subject report.

Attachment:
DS' response to Recommendation 2

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**Audit of the Department's Identification and Collection of Value-Added
Tax Overseas (AUD-FM-06-XX) DRAFT REPORT
August 2006**

(U) **Recommendation 2:** OIG recommends that the Bureau of Overseas Buildings Operations, in conjunction with the Bureau of Diplomatic Security, Office of Foreign Missions work within the Diplomatic Tax Relief Initiative group to establish a policy that requires tax relief agreements before beginning construction projects overseas.

(U) **DS Response (8/23/06):** As currently drafted, DS/OFM management disagrees with recommendation 2.

DS/OFM's objection to this recommendation is based solely on the implied requirement that a tax-relief agreement must be secured prior to beginning of the Department's construction projects.

Whereas, most foreign governments embrace their obligations for providing diplomatic tax-relief privileges, certain governments fail to agree that an obligation exists to provide foreign missions with relief from value-added tax (VAT). In addition, a foreign government may agree that purchases made directly by the U.S. Embassy are eligible for VAT-relief, but that purchases secured by private contractors on their behalf are ineligible for this privilege. In either scenario, it would be difficult or impossible for a tax-relief agreement to be secured.

DS/OFM proposes that this recommendation be redrafted to require that a tax-relief agreement be attempted, as opposed to secured, prior to beginning construction projects overseas. If this minor revision is accepted, DS/OFM is prepared to agree with this recommendation.

Cleared: DS/OFM – John P. Gaddis OK

Drafted: DS/OFM – Cliff Seagroves
8/21/06/06, ext. 7-1395