April 28, 2000

The Honorable Pat Roberts
Chairman, Subcommittee on Emerging Threats and Capabilities
Committee on Armed Services
United States Senate

Subject: Weapons of Mass Destruction: Some U.S. Assistance to Redirect Russian Scientists Taxed by Russia

Dear Mr. Chairman:

Since 1992, Congress has provided funding to the Departments of Defense, Energy, and State to address the proliferation of weapons of mass destruction technology and expertise from the former Soviet Union. Through 1999, these agencies have provided about $200 million to provide peaceful research opportunities to former Soviet weapons scientists and redirect their skills away from producing weapons of mass destruction. U.S. funds are used to pay for salaries, equipment, supplies, and other items.

You asked us to review whether the Russian government has taxed assistance provided by two programs that were designed to fund former Soviet weapons scientists. As agreed with your office, this report discusses two U.S.-funded nonproliferation programs that have been taxed by the Russian government—the Department of Energy's Initiatives for Proliferation Prevention program and the International Science and Technology Center in Moscow. The Science Center was established by the United States, the European Union, Russia, and Japan in November 1992 as a multilateral, tax-exempt organization to provide peaceful research opportunities to former Soviet weapons scientists and engineers. Our companion report discusses our review of the U.S. efforts to address the proliferation of biological weapons in the former Soviet Union.1

RESULTS IN BRIEF

Some of the assistance provided to support the two key U.S. nonproliferation programs2 that fund collaborative research projects involving former Soviet weapons scientists has been taxed by the Russian government.


2 The United States also funds nonproliferation assistance programs to former Soviet weapons scientists through the Department of Energy's Nuclear Cities Initiative ($15 million in 1999) and the U.S. Civilian Research and Development Foundation for the Independent States of the former Soviet Union's Cooperative Grants Program ($5.3 million, 1994-99).
used directly and indirectly to pay Russian taxes. For example, the Science Center and at least one Initiatives for Proliferation Prevention funded institute paid direct value-added taxes on equipment purchased in Russia, while the Initiatives for Proliferation Prevention program paid taxes indirectly through payroll and income taxes on its project participants. According to a 1998 Department of Energy report, 3 a survey of Russian institutes that received Initiatives for Proliferation Prevention project funds from the Sandia National Laboratories indicated that as much as one-half to three-quarters of U.S. assistance received by the Russian institutes were used to pay various payroll and income taxes. Initiatives for Proliferation Prevention program officials could not provide quantifiable data on the total amount of taxes paid by Russian institutes that have received their assistance; however, they have taken corrective action to eliminate the payment of income and payroll taxes. The Energy Department contracted with a U.S.-based tax-exempt organization to provide direct tax-free payments to participating Russian scientists and other staff in November 1999.

The International Science and Technology Center, a multilateral organization whose grant recipients have not been subject to income taxes, has paid about $270,000 in value-added taxes for equipment or services purchased in Russia from 1994 through 1999. While the Department of Energy does not track taxes paid by institutes receiving program funds, our February 1999 report 4 identified one Russian institute that received Initiatives for Proliferation Prevention funding as having paid value-added taxes. Although the Russian government has recently passed legislation that requires reimbursement for all value-added taxes paid using donor assistance, neither the Science Center nor the Energy Department has received any reimbursements. Officials from the State Department and the U.S. embassy in Moscow are working with Russian government officials to develop implementing regulations that address the reimbursement of value-added taxes and the exemption of certified tax-exempt entities from paying value-added taxes at the time of purchase.

BACKGROUND
The United States funds several nonproliferation programs that provide project grants to former Soviet weapons scientists to redirect their skills away from producing weapons of mass destruction including nuclear, chemical, and biological weapons. We reviewed two of these programs as part of our work dealing with U.S. efforts to reduce the threat of biological weapons. 5 These programs include the Department of Energy's Initiatives for Proliferation Prevention program and the International Science and Technology Center.

- The Department of Energy launched the Initiatives for Proliferation Prevention program in 1994 to engage former Soviet nuclear, chemical, and biological weapons scientists in projects that are oriented toward commercial activities. U.S. national laboratories take the lead in working with former Soviet weapons institutes. The program funds its projects through fixed-price contracts with the institutes. Payment is contingent on


5 Biological Weapons: Effort to Reduce Former Soviet Threat Offers Benefits, Poses New Risks.
deliverables from the institutes. For fiscal years 1994 through 1999, the Department of Energy's Initiatives for Proliferation Prevention provided about $100 million\(^6\) to fund nuclear, chemical, and biotechnology projects in Russia. Our 1999 review of the program raised numerous concerns, including the extent to which program funds were being taxed by Russian authorities.\(^7\)

- Since 1994, the United States has provided assistance to former Soviet weapons of mass destruction scientists and engineers through the International Science and Technology Center in Moscow. The United States supports the Science Center through FREEDOM Support Act\(^6\) and the Department of Defense's Cooperative Threat Reduction program funds that provide collaborative research project grants to former Soviet weapons scientists to redirect their skills away from producing weapons of mass destruction. The Department of State serves as the U.S. assistance coordinator to the Science Center. The Science Center provides most of its assistance in the form of tax-free grants that are deposited directly into the individual accounts of participating scientists, engineers, and support staff. From 1994 through 1999, the United States provided about $80 million to the Science Center for nuclear, chemical, and biotechnology research projects in Russia.

INITIATIVES FOR PROLIFERATION PREVENTION PROGRAM ASSISTANCE HAS BEEN TAXED BY RUSSIA, BUT CORRECTIVE ACTIONS ARE UNDERWAY

The Department of Energy's Initiatives for Proliferation Prevention program assistance has been used to supplement Russian scientists' salaries, which have sometimes been subject to Russian income and payroll taxes. While a 1992 bilateral agreement\(^8\) between the United States and the Russian Federation states that "commodities, supplies, or property provided or utilized in connection with the U.S. assistance programs" should be tax free, it does not specifically address the issue of income or payroll taxes for Russian citizens receiving U.S. assistance. Nonetheless, Energy and State Department officials told us that they view the assistance funds provided to the former Soviet weapons scientists as a "commodity" that should be exempt from taxes.

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\(^6\)These funds are divided between the institutes, the U.S. national laboratories that develop and manage the projects, and to support U.S. industries participation in the program.

\(^7\)Nuclear Nonproliferation: Concerns With DOE's Efforts to Reduce the Risks Posed by Russia's Unemployed Weapons Scientists.

\(^8\)The Freedom for Russia and Emerging Eurasian Democracies and Open Markets Support Act of 1992, or the FREEDOM Support Act (P.L. 102-511) provides for economic and nonproliferation assistance to the independent states of the former Soviet Union.

During 1994-99, the Initiatives for Proliferation Prevention program provided contracts to former Soviet institutes rather than to the individual scientists, with the understanding that the institutes would produce specified deliverables such as hardware, software, data, or reports and pay their scientists. A 1998 Energy Department report referred to a survey by Sandia National Laboratories of institutes that received assistance for Initiatives for Proliferation Prevention research projects. In April 2000, the author of the report told us that the taxation information included in the report was based on responses from three institutes—Sarov (formerly Arzamas-16), Snezhinsk (formerly Chelyabinsk-70), and the Kurchatov Institute. She added that these institutes were key Russian nuclear facilities that receive a large portion of the program funds. These institutes indicated that income taxes and payroll deductions, such as pension and medical fund costs, consumed as much as 53 to 76 percent of the funds intended for the scientists' salaries. The institutes did not provide quantifiable data on the total amount of taxes paid.

To address taxation of the Initiative for Proliferation Prevention program's assistance, Congress included a provision in the fiscal year 2000 National Defense Authorization Act that prohibits the Energy Department from using Initiatives for Proliferation Prevention program funds to pay taxes or customs duties levied by the Russian government. In November 1999, following this legislation, Energy Department officials contracted with the U.S. Civilian Research and Development Foundation, a U.S. nonprofit organization, to provide tax-exempt payments directly into the Russian project participants' bank accounts. The Russian Ministry of Finance and the State Tax Service have recognized the Foundation as a charitable organization that may provide tax-exempt assistance to Russian entities. The Foundation conducted a pilot project at the State Research Institute of Virology and Biotechnology (Vector) in Koltsovo, Russia, which was completed in November 1999. During the pilot, the Foundation provided tax-free payments to about 50 Vector staff participating in an Initiative for Proliferation Prevention project. During our December 1999 visit to Koltsovo, we interviewed several of the project participants, who reported that they had received their payment free of taxes, which increased their take home pay by as much as 40 percent. The scientists noted, however, that they had to go to the bank in Novosibirsk (about 18 miles away) to receive the money and redeposit it into their personal accounts. Department of Energy and Foundation officials told us that they ultimately plan to establish individual bank accounts for all participants. We did not assess the Foundation's work at other institutes and therefore cannot comment as to whether the taxation issue has been effectively resolved for all institutes receiving Initiatives for Proliferation Prevention program assistance.

The 1998 Department of Energy taxation report also said the three institutes had not paid value-added taxes for equipment purchased in Russia under the Initiatives for Proliferation Prevention program. However, our February 1999 report identified one institute that had paid value-added taxes for equipment purchases under the Initiatives for Proliferation Prevention program. Program officials said that most of their assistance projects do not purchase goods or services in Russia. They acknowledged, however, that they have not tracked how the institutes spend the funds received, including payment of taxes.


** Nuclear Nonproliferation: Concerns With DOE's Efforts to Reduce the Risks Posed by Russia's Unemployed Weapons Scientists.
SCIENCE CENTER GRANT RECIPIENTS NOT SUBJECT TO INCOME TAXES, BUT SCIENCE CENTER PAID VALUE-ADDED TAXES FOR EQUIPMENT

As a multilateral organization, the International Science and Technology Center has an intergovernmental agreement with the Russian Federation that allows the Science Center to provide tax-exempt funds to legal entities and persons involved with its projects. To ensure the scientists’ grant payments are not taxed, the Center has established individual bank accounts for its project participants and transfers funds directly into their accounts. Project participants at the six institutes we visited told us that the Center’s payment system has successfully provided funds that are not taxed. Many scientists noted that the tax-free payments were a significant benefit to them.

The Science Center, however, has paid value-added taxes on equipment purchased in Russia. According to the Center’s Chief Financial Officer, the Russian Ministry of Taxation acknowledges the Center’s tax-exempt status but requires it to pay value-added taxes at the time of purchase and subsequently request reimbursement from the Ministry of Finance. The Center paid about $270,000 in value-added taxes during 1994-99 and has applied for reimbursement. The Chief Financial Officer said the Science Center has not yet received any reimbursements from the Ministry of Finance. He said reimbursement of value-added taxes is unlikely because the Russian government has not yet provided instructions to the state and local tax authorities regarding how such reimbursements will be made.

Despite a 1992 bilateral agreement between the United States and the Russian Federation that U.S. assistance is to be exempt from Russian taxes and customs duties, State Department officials said that Russia has only recently approved legislation to implement the provisions of the 1992 agreement. After years of proposals and interim agreements, in May 1999 then-President Boris Yeltsin signed legislation addressing the issue of tax exemptions for foreign assistance. State Department officials said that although the legislation requires reimbursement of value-added taxes, it does not include implementing procedures to address how these taxes will be reimbursed. Officials from the U.S. embassy in Moscow are working with Russian government officials to develop implementing regulations that address the issue. These officials would ultimately like for certified assistance activities to be exempt from paying value-added taxes when goods or services are purchased.

AGENCY COMMENTS

Program directors from the Department of Energy’s Initiatives for Proliferation Prevention program, and the Department of State’s Office of the Coordinator of U.S. Assistance to the Newly Independent States’ Economic Programs, provided oral comments on a draft of this report. In addition, the Executive Director and the Chief Financial Officer of the International Science and Technology Center, and the Senior Vice President of the U.S. Civilian Research and Development Foundation, also provided oral comments on a draft of this report. These officials concurred with our findings and provided technical comments that we incorporated into the report as appropriate.

SCOPE AND METHODOLOGY

To determine whether Russia has taxed U.S. nonproliferation programs, we met with senior officials from the Department of Energy’s Initiatives for Proliferation Prevention program in Washington, D.C.; the U.S. Civilian Research and Development Foundation in Arlington,
Virginia; and the International Science and Technology Center in Moscow, Russia. We also discussed the taxation issue with an economics official at the U.S. Embassy in Moscow and with officials from the State Department's Bureau of Nonproliferation and the Office of the Coordinator of U.S. Assistance to the Newly Independent States in Washington, D.C..

During our December 1999 visit to Russia, we discussed the taxation issue with officials and senior scientists at the six institutes we visited. The institutes included the (1) State Research Center for Virology and Biotechnology (Vector) in Koltsovo, (2) State Research Center for Applied Microbiology in Obolensk, (3) State Research Center for Ultra Pure Biopreparations in St. Petersburg, (4) State Research Center for Toxicology and Hygienic Regulation of Biopreparations in Serpukhov, (5) State Research Center for Molecular Diagnostics and Therapy in Moscow, and (6) Puschino branch of the Shemyakin-Ovchinnikov Institute of Bioorganic Chemistry. In Koltsovo, we interviewed scientists involved in the Initiatives for Proliferation Prevention program's pilot project to discuss the direct deposit of funds into their individual bank accounts.

We also reviewed financial and reporting documents from the Departments of State and Energy and from the Science Center from 1994-99 to develop information on taxes paid by the respective programs. In addition, we reviewed tax exemption agreements between the Russian Federation and the Science Center and between the Russian Ministry of Finance and the U.S. Civilian Research and Development Foundation. We also reviewed pertinent bilateral agreements between the United States and the Russian Federation as well as Russian legislation addressing tax exemptions for donor assistance programs and discussed the impact on U.S. nonproliferation programs with officials from the Departments of State and Energy.

We performed our work from December 1999 through April 2000 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Honorable Madeleine K. Albright, Secretary of State; the Honorable William S. Cohen, Secretary of Defense; and the Honorable Bill Richardson, Secretary of Energy. Copies will also be made available to other interested parties upon request.

If you or your staff have any questions concerning this report, please call me at (202) 512-4128. Major contributors to this letter were Boris L. Kachura and Jodi M. Prosser.

Sincerely yours,

Harold J. Johnson
Associate Director,
International Relations and Trade Issues
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