

**Department of Revenue and Taxation
Bonded Warehouses
for Tobacco Products**

**Performance Audit
October 2018 – September 2019**

**OPA Report No. 19-07
November 2019**



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Distribution via E-Mail:

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EXECUTIVE SUMMARY

Department of Revenue and Taxation Bonded Warehouses for Tobacco Products OPA Report No. 19-07, November 2019

Since the tobacco bonded warehouse's enactment 60 years ago, the Department of Revenue and Taxation (DRT) still has not submitted any rules, regulations, and formally adopted policies that establish the official requirements for granting certification to and monitoring bonded warehouses for tobacco products. While DRT attempted to improve its bonded warehouse oversight, its current practices are not enough to provide reasonable assurance that all tobacco taxes are complete and properly accounted for. Furthermore, the Government of Guam (GovGuam) is not guaranteed to recover the full amount of any tobacco tax defaults because DRT does not have an official mechanism to define the standard amount of a surety bond.

After Office of Public Accountability Report No. 18-04, *DRT Tobacco Tax*, DRT has since implemented control procedures to help account for tobacco product quantities. Although DRT personnel spends significant hours in monitoring the movement of tobacco in and out of the bonded warehouse, and in conducting inventory count, DRT does not have personnel trained to properly monitor the bonded warehouses' accountability. We see loopholes where a wholesaler might underreport taxes.

The untimely reconciliation of tobacco withdrawn against the GRT-3 filing, coupled with unreliable inventory count, makes other control procedures useless. In addition, with the exclusion of tobacco products meant for drawbacks, there are opportunities for tax evasion because DRT does not verify whether the tobacco was actually exported or sold to the U.S. Military or Guam Airport concessionaires.

Although not directly related to our audit objective, we became aware of other issues related to certain wholesalers. We believe DRT incorrectly concluded that free tobacco samples were not subject to tobacco tax and might have inappropriately allowed Wholesaler O to discount tobacco products. As such, we recommend the DRT Director re-evaluate its conclusion on the taxation of free tobacco products and seek the Attorney General of Guam's opinion concerning the Master Settlement Agreement's authority and impact over Guam's taxation of tobacco products. Additionally, we recommend the DRT Director evaluate the circumstances in which tobacco wholesalers are selling tobacco at a discount.

Meanwhile, DRT did not examine 36 months of Wholesaler Z's incorrect tax filings and did not verify that the amended liability was in fact *all* that was owed by Wholesaler Z or any other wholesaler. As such, we recommend the DRT Director verify if Wholesaler Z's amended tax liability was accurate and complete. Additionally, we recommend the DRT Director create and implement a policy that all unusual and/or substantial amendments to tax liabilities be examined and verified for accuracy and completeness.

The law does not require a bonded warehouse from tobacco wholesalers. Deferring tobacco tax payments by having a bonded warehouse is a privilege, ***not a right***, afforded by Guam law for the wholesaler's benefit. DRT's oversight of the bonded warehouses requires additional control procedures needed to account for all tobacco movement despite no identifiable benefit to GovGuam. Considering the control procedures needed to monitor the bonded warehouses, we recommend the Legislative Committee Chairperson on Revenue and Taxation repeal the bonded warehouse provision for tobacco tax. Once repealed, DRT must collect tobacco taxes immediately upon import from all tobacco wholesalers. As provided in the Tobacco Tax law, DRT will consider any export or consignment a drawback, where the burden of proof is on the taxpayer to provide.

Overall, we observed that DRT does not verify accuracy and completeness of tobacco tax filings. In this audit, the lack of verification stood out in several instances. DRT did not verify: (1) changes made by the wholesalers on the inventory count sheet, (2) actual deliveries of tobacco products outside of Guam, (3) actual sale of tobacco products to any U.S. Military or Guam Airport concessionaires, and (4) amended tax filings by Wholesaler Z. DRT could easily check the accuracy and completeness, or at least the reasonableness, of tobacco tax filings because it has direct monitoring responsibilities over the tobacco stored in the bonded warehouse. Still, it relied on the voluntary compliance of the wholesalers. Guam may be collecting \$23.5 million in tobacco tax revenue per year, but is this all?

Benjamin J.F. Cruz
Public Auditor

Introduction

This report presents the results of our audit on the Department of Revenue and Taxation's (DRT) oversight over bonded warehouses for tobacco products. We conducted this audit in response to the DRT Director's request to audit the tobacco industry. The DRT Director's request came after the Office of Public Accountability's (OPA) preliminary inquiries to DRT concerning the tobacco tax delinquencies of two wholesalers, each with a bonded warehouse.

Our audit objective was to determine DRT's policies and practices for granting certification to and monitoring all bonded warehouses for tobacco products. Our scope was from October 2018, the period DRT reported process improvements in their bonded warehouse oversight, through September 2019, which covered all four tobacco wholesalers with a bonded warehouse. Two of four wholesalers had actual or alleged tobacco tax delinquencies.

We detailed the objective, scope, and methodology in Appendix 1.

Background

Under Title 11 of the Guam Code Annotated (GCA) Chapter 26 Article 6, *Tobacco Tax*, tobacco tax is charged and collected when tobacco products are discharged from its carrier. Before the Guam Customs and Quarantine Agency (CQA) can release a tobacco wholesaler's cargo, the wholesaler must first pay the taxes on its tobacco imports. Based on our prior audit, CQA uses Form GRT-3 (Monthly Tobacco and Alcoholic Beverages Tax Return) to charge and collect tobacco tax payments at the ports. If the wholesaler paid tobacco taxes at either port, then they would not need to file another Form GRT-3.

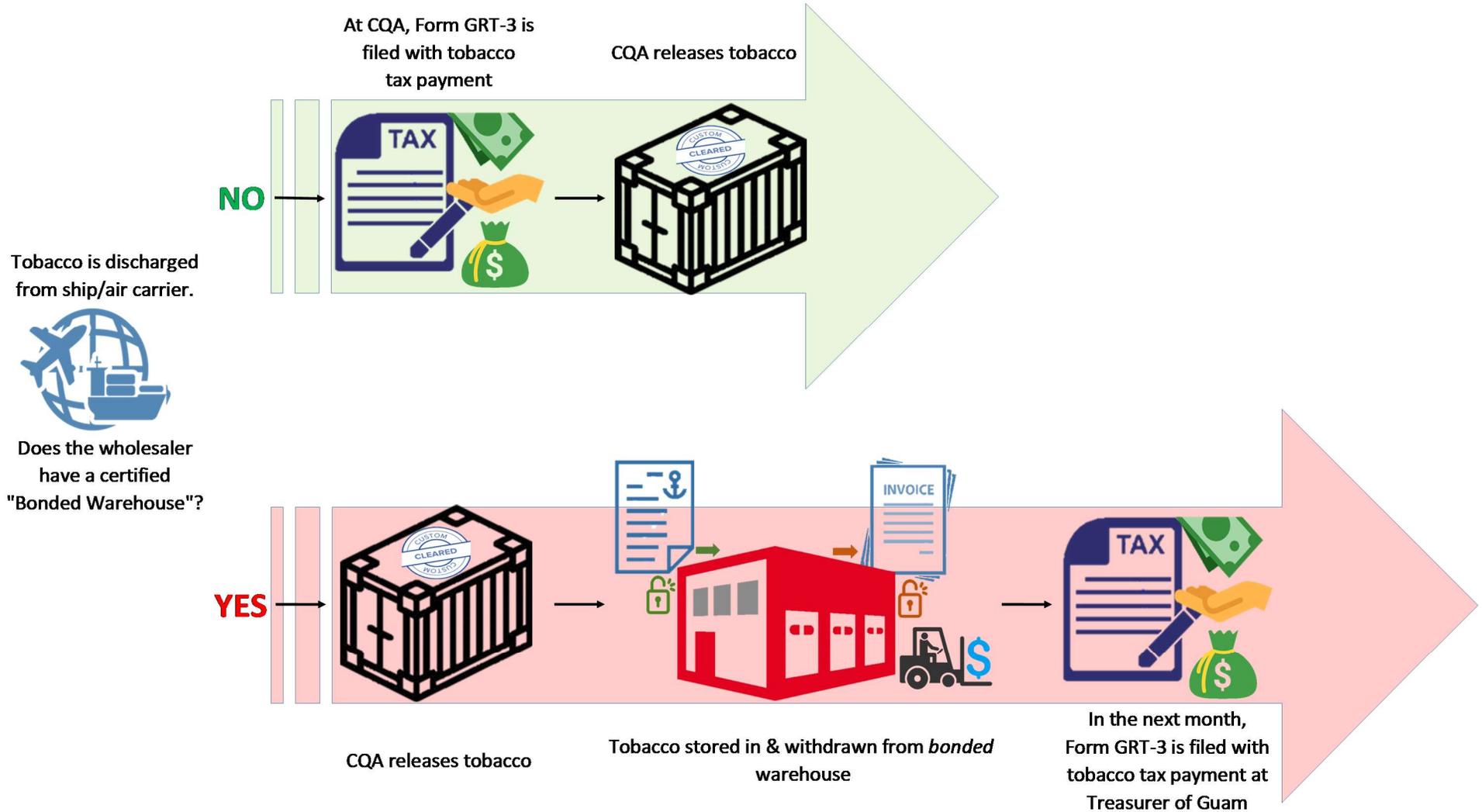
Option to Delay Tobacco Tax Payment

Since its enactment in March 1960, a law provision has allowed tobacco wholesalers to delay tax payments on tobacco products stored in a bonded warehouse. A wholesaler may delay its tobacco tax payment and GRT-3 filing until the 20th of the following month after the tobacco products are released by CQA and withdrawn from the bonded warehouse. Refer to Figure 1 for clarification on the timing differences in payment.

The law does not require a bonded warehouse from tobacco wholesalers. Deferring tobacco tax payments by having a bonded warehouse is a privilege, ***not a right***, afforded by Guam law for the wholesaler's benefit. The law does not set out the requirements of a bonded warehouse.

As of September 2019, four wholesalers are certified to operate a bonded warehouse for tobacco products.

Figure 1: Timing Differences of Tobacco Tax Payments



Source: OPA Report No. 18-04, *Department of Revenue and Taxation Tobacco Tax*

Tobacco Taxed by Quantities and Weight

DRT taxes tobacco products by the quantities or weight imported. Figure 2 shows the tobacco tax rates beginning in August 2018.

Figure 2: Tobacco Tax Rates

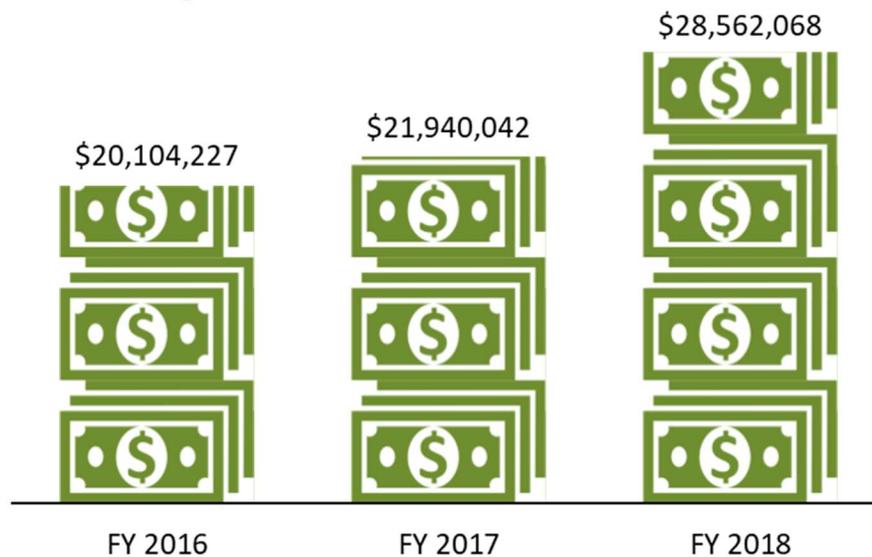


Source: 11 GCA Ch. 26 §26603

The Guam Legislature made several amendments to the rates over the years. The most notable changes in tax rates were on cigarettes and other tobacco products.

The Government of Guam (GovGuam) received an annual average of \$23.5 million (M) in tobacco tax revenue for fiscal year (FY) 2016 through FY 2018. Tobacco tax revenues are dedicated to specific programs focused on health, prevention, and treatment of addiction, cancer outreach, and the Guam Memorial Hospital Authority. Refer to Figure 3 for GovGuam tobacco tax revenues.

Figure 3: GovGuam Tobacco Tax Revenues



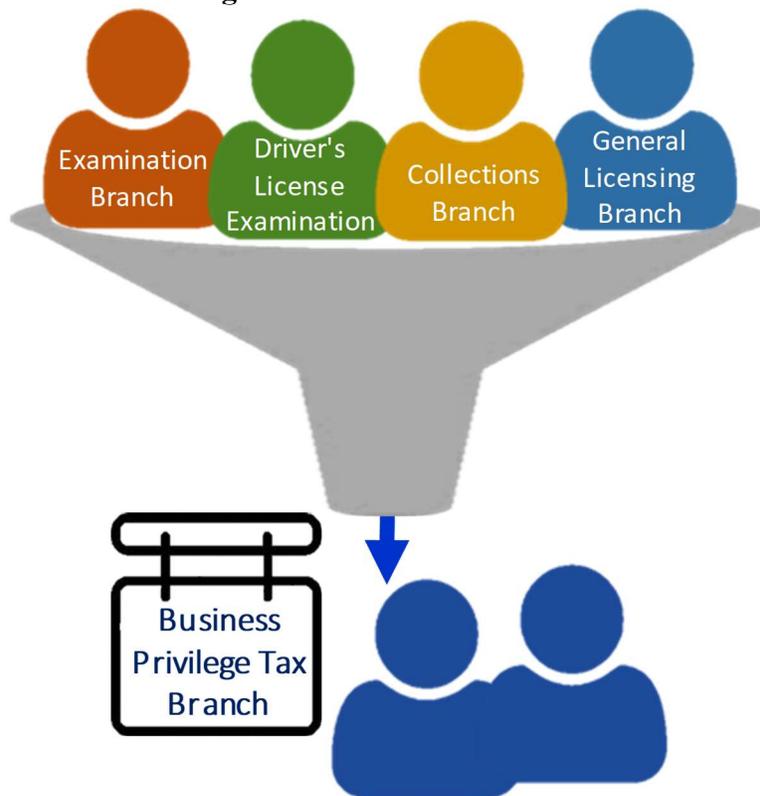
Source: GovGuam Financial Audit Reports

BPT Branch Responsible for the Bonded Warehouses for Tobacco Products

The Business Privilege Tax (BPT) Branch, which is responsible for the administration and enforcement of the Business Privilege Tax Law (11 GCA Chapter 26), falls under the Taxpayer Services Division (TSD). Business privilege taxes cover various industries with gross receipts tax (GRT), use tax, hotel occupancy tax, liquid fuel tax, automotive surcharges, limited gaming tax, alcoholic beverage tax, and tobacco tax. To ensure these taxes are assessed, the BPT Branch must manually key in the data from the monthly GRT returns filed.

At the start of our audit, there were seven employees physically detailed to the BPT Branch. One BPT employee has since retired, leaving only six employees detailed to the BPT Branch. However, based on DRT’s staffing pattern, only two now belong to the BPT Branch. For five years now, the BPT Branch has been borrowing employees from other DRT branches to help manually key in GRT returns. Currently, the BPT Branch is borrowing employees from the Driver's License Examination Branch, General Licensing Branch, and Collections Branch. The BPT Branch was also borrowing a Management Analyst to act in a supervisory role. As of report issuance, this Management Analyst moved to another GovGuam agency.

Figure 4: BPT Branch Detail



Source: DRT’s Acting BPT Branch Supervisor

Although the TSD Administrator could not pinpoint any DRT policies regarding the start of the bonded warehouse program and how it should be run, the BPT Branch has been responsible for everything to do with the bonded warehouses.

Prior Audit: DRT Relied on Wholesalers' Self-Reporting of Tobacco Taxes

In our prior audit – OPA Report No. 18-04, *Department of Revenue and Taxation Tobacco Tax* – we observed that a “bonded warehouse” was an area within the wholesaler’s warehouse isolated and caged off with padlock keys supposedly under DRT’s sole custody. One BPT Branch employee had to be present to verify any tobacco products stored or withdrawn from the bonded area.

During that audit, DRT certified five tobacco wholesalers to operate a bonded warehouse for tobacco products. These five wholesalers reported tobacco tax that accounted for 99% (or \$76.4M) of the tobacco tax due between FY 2013 and FY 2016. However, DRT was not assessing tobacco tax during the storage or withdrawal of the tobacco. Nor was DRT verifying the wholesaler’s GRT-3 filing against the withdrawals from the warehouse. Essentially, DRT had been relying on the wholesalers voluntarily reporting tobacco taxes in full compliance with the Tobacco Tax law.

Resulting from our audit recommendations in OPA Report No. 18-04, DRT made the following improvements for the monitoring of tobacco stored in bonded warehouses:

- DRT is to conduct monthly counts of the bonded warehouses’ tobacco inventory. The inventory counts are to determine the accuracy of the bonded warehouse’s remaining inventory after the previous month's storage and withdrawal activities.
- DRT is to reconcile tobacco withdrawals to the wholesalers’ GRT-3 filings.
- DRT updated withdrawal slips to distinguish withdrawals for local, military, and export sales.
- DRT requires an employee from DRT’s Compliance Branch to accompany the BPT representative to the storage, withdrawals, and inventory count at the bonded warehouses.

Results of Audit

Our audit found that DRT still has not submitted any rules, regulations, and formally adopted policies that establish the official requirements for granting certification to and monitoring bonded warehouses for tobacco products. While DRT attempted to improve its bonded warehouse oversight, its current practices are not enough to provide reasonable assurance that all tobacco taxes are complete and properly accounted for. Specifically, we found:

- Weaknesses in DRT's inventory count practices.
- Delays in reconciling tobacco withdrawals against the tobacco reported in the GRT-3 returns.
- Opportunities for tax evasion on the tobacco withdrawn for export or sale to the U.S. Military or Guam Airport concessionaires.
- DRT spends significant resources monitoring the movement of tobacco products in and out of the bonded warehouses.

We also identified that:

- DRT did not tax Wholesaler O's free samples of tobacco.
- DRT did not examine the circumstances in which Wholesaler O could sell tobacco products at a discounted price.
- DRT did not examine 36 months of Wholesaler Z's incorrect tobacco tax filings.
- DRT has not implemented the cigarette tax stamp.

No Rules, Regulations, and Official Policies for Bonded Warehouses

To apply for a bonded warehouse certification, the wholesaler needs only a valid (current) business license for tobacco wholesale and a request letter addressed to the DRT Director, who gives the final approval of the certification. To obtain a new business license for tobacco wholesale, the applicant is required to get clearances from the BPT Branch, Income Tax and Processing Branch, Collections Branch, and the Guam Attorney General's (AG) Office. The certification to operate a bonded warehouse for tobacco products does not expire. However, DRT can cancel the certification if the tobacco wholesale business license was canceled.

Of the four wholesalers certified to operate bonded warehouses, only two have been purchasing and renewing surety bonds on the tobacco they store in the bonded warehouses. DRT does not know the measurement rate on which these two wholesalers purchased their surety bonds. For these two wholesalers, GovGuam could call upon the surety bond to pay for the tobacco taxes that were defaulted. However, with no required amount or percentage formally defined for the surety bonding, GovGuam might not recover the full amount of tobacco taxes owed. The Deputy Tax Commissioner reminded us that the law does not indicate an amount or percentage required for bonding. It is DRT's lack of rules, regulations, and official policies [or official standard operating procedures (SOPs)] for bonded warehouses that allowed the other two wholesalers to question DRT's surety bond requirement.

Based on 11 GCA Chapter 26 §26102(b)(7) and (8), the Tax Commissioner must make rules and regulations within the scope of the law to carry out the purpose of the Tobacco Tax law effectually.

These rules and regulations are subject to the approval of the DRT Director and the Governor of Guam. The Tax Commissioner must also set, in regulations, the forms required for the administration and collection of tobacco taxes.

Despite the enactment of the bonded warehouse provision almost 60 years ago, DRT has not submitted any rules and regulations concerning the bonded warehouses. DRT management places responsibility on the Tobacco Tax law to define the requirements of certifying and monitoring a bonded warehouse. The Deputy Tax Commissioner pointed out that the Tobacco Tax law allows bonded warehouses, but does not define the requirements to become a bonded warehouse in either the GCA or the Guam Administrative Rules and Regulations (GARR).

After the release of OPA Report No. 18-04 (*DRT Tobacco Tax*), the BPT Branch made efforts to document policies and create template forms for the certification and monitoring of bonded warehouses, but these have not been officially adopted. According to 1 GCA Chapter 19 §1923, DRT's SOPs must be posted on its website for public view. These SOPs should include how DRT performs certain actions necessary to carry out government policies within DRT's jurisdiction, and the specific actions authorized in DRT's enabling act. Formal SOPs provide consistency and



reliability in the performance of services, removes questions about who is responsible for what, and provides a mechanism to enforce good and fair practices. Formal SOPs also help operations continue despite any change in administration.

DRT has been certifying bonded warehouses and cooperating with wholesalers without any rules, regulations, and official policies (or official SOPs). Lack thereof opens doors for anybody to question DRT's certification and monitoring as preference could come into play.

Weaknesses in DRT's Inventory Count Practices

Although four wholesalers have certified bonded warehouses, DRT has not done an inventory count on Wholesaler O's bonded warehouse. According to the Acting BPT Branch Supervisor, Wholesaler O's warehouse layout limits DRT from doing a thorough count of the entire stock, which consists mostly of spoiled tobacco.

In July 2019, we observed two DRT representatives conducting their monthly inventory count of only three bonded warehouses. We observed the following main weaknesses:

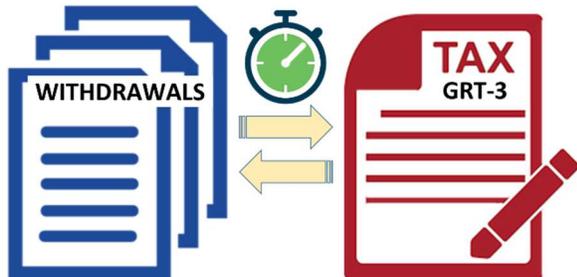
- One of the DRT representatives maintained responsibility for counting and making notations on the inventory sheet, while the other representative did not provide sufficient attention to the count procedures. This defeats the purpose of having a second DRT representative in the field, whose presence should provide a check and balance.
- The DRT representatives would sign the wholesaler's inventory count sheet without first verifying the wholesaler's numbers against their own inventory count sheet.
- When one of the wholesalers changed some of DRT's count, the DRT representatives accepted the changes without a verified recount.



We learned that DRT representatives did not receive any formal training on how to conduct a proper inventory count. Monthly inventory counts should help determine whether the wholesalers accurately reported their tobacco withdrawals on the GRT returns. However, with the noted weaknesses in DRT's inventory count practices, DRT cannot have reasonable assurance as to the correct amount of the inventory balance as of the count date, and accordingly, the quantities withdrawn.

Delays in Reconciling Tobacco Withdrawals to GRT-3 Returns

DRT is delayed in its reconciliation of tobacco withdrawals to the wholesalers' GRT-3 filings. In June 2019, we learned that the last reconciliation completed was for the December 2018 tax period. In September 2019, we were informed that reconciliations were completed up to the July 2019 tax period. Upon further inquiry, we learned that these reconciliations were not fully matched against



the GRT-3 filings because of the long process before the GRT-3 return gets to the BPT Branch. Basically, the Acting BPT Branch Supervisor was just summarizing the withdrawal quantities per wholesaler per month and checking the system as to whether the wholesaler made payments for a particular month.

When a wholesaler files its GRT-3 return along with the tax payment, it goes first to the Treasurer of Guam, who keys in the amount paid; then to DRT's Accounting Branch; and finally to the BPT Branch, who keys in the data found on the GRT return. However, because the BPT Branch has piles of GRT returns to manually key in their system, it takes months before a GRT return gets inputted.

Furthermore, the Acting BPT Branch Supervisor prepared the withdrawal summary (supposed to be a full reconciliation) without further review by another official. She did not delegate this task because it requires data input and analysis on a Microsoft Excel program. DRT has yet to provide formal training to its employees before the Acting BPT Branch Supervisor could have delegated this task.

The untimely reconciliation of tobacco withdrawals to GRT-3 filings makes other control procedures useless. As such, DRT could not determine any variances in the wholesalers' GRT-3 returns in a timely manner.

Opportunities for Tax Evasion on Tobacco Tax Drawbacks

The Tobacco Tax law allows a drawback (refund) of the full tax amount paid on tobacco products. However, it has been the industry's practice to claim exemptions instead of applying for drawbacks because the bonded warehouses have allowed tax deferment.

To obtain a drawback:

- For tobacco exported (sold or consigned) from Guam, the tobacco must have been *duly delivered* to a point outside Guam to be allowed a tobacco tax refund [§26604(a)];

- For tobacco sold or consigned to any U.S. Military Concessionaire in Guam, a tobacco tax refund is allowed *upon a satisfactory showing* that the tobacco had been *duly delivered* to a U.S. Military Concessionaire in Guam [§26605(a)].
- For tobacco products sold to licensed concessionaires at the Guam International Air Terminal, a tobacco tax refund is allowed *upon a satisfactory showing* that the tobacco had been sold to licensed concessionaires of the Guam International Air Terminal [§26606].
- For tobacco spoilage, a tobacco tax refund is allowed *upon a satisfactory showing* that the tobacco was destroyed under the Tax Commissioner’s (or his representative’s) supervision [§26607(a)].

It is within DRT’s power and responsibility to follow through with a *satisfactory showing* that said tobacco products were *duly delivered* to a point outside of Guam or to a licensed concessionaire of either the U.S. Military or the Guam Airport. While this type of verification is beyond the BPT Branch’s administrative capacity, DRT has other branches with civil and criminal capacities to follow through. However, DRT does not verify that the wholesaler actually delivered the tobacco products outside of Guam. Nor does DRT verify that the wholesaler actually sold the tobacco products to any U.S. Military or Guam Airport concessionaires.

DRT Does Not Verify the Actual Export of Tobacco

When making withdrawals for export, the wholesaler will show the DRT representatives their Export Certificate. The Export Certificate is a template form found on DRT’s website, which provides no proof of actual exportation at the time the wholesaler shows the certificate to DRT. In addition, DRT does not reconcile the tobacco withdrawn for export with the GRT-3 return.

Refer to Appendix 2 for an Export Certificate provided to DRT upon withdrawal from the bonded warehouse.

DRT Does Not Verify Tobacco Sales to the U.S. Military or Guam Airport Concessionaires

When making withdrawals for sales to the concessionaires of the U.S. Military or the Guam Airport, the wholesaler will show the DRT representatives their Order Invoice. At the withdrawal phase, the Order Invoice is a document created by the wholesaler, which provides no proof that the concessionaire purchased or even agreed to purchase the tobacco described. As anyone could print an Order Invoice, we question how DRT verifies actual deliveries to a concessionaire of the U.S. Military or the Guam Airport. Similar to exports, DRT does not reconcile the tobacco withdrawn for sale to the U.S. Military or Guam Airport concessionaires.

Without verification and reconciliation of the tobacco withdrawn for export or sale to the U.S. Military or Guam Airport concessionaires, there are opportunities for tax evasion. Unless DRT was present when the withdrawals were placed in the shipping container, sealed, and followed to CQA, a wholesaler might evade paying the tobacco tax if it decides – after DRT’s acknowledgment on the Export Certificate – to sell the tobacco in Guam instead.

Further, unless DRT receives reasonable assurance that the tobacco had been sold to or duly delivered to a U.S. Military or Guam Airport concessionaire – in the quantities claimed by the wholesaler – a wholesaler might sell the tobacco locally.



The Acting BPT Branch Supervisor asked what the return would be on DRT's cost to follow through with verifying these types of withdrawals. If all tobacco is taxed up front, then the burden of proof is on the taxpayer to show actual export or sales to the U.S. Military or Guam Airport concessionaires. These would then be *true* drawbacks (refunds).

Monitoring Bonded Warehouses Takes Up Significant DRT Resources

DRT's oversight of the bonded warehouses requires additional control procedures needed to account for all tobacco movement despite no identifiable benefit to GovGuam.

From September 2018 through August 2019, DRT spent an average of 78 hours per month monitoring the movement of tobacco in and out of the bonded warehouses. The 78 hours did not include internal administrative tasks related to the bonded warehouses.

With at least two employees representing DRT at the warehouses, and one employee reconciling the local tobacco withdrawals to the GRT-3 returns, DRT spent at least \$2,853 in salaries per month monitoring the bonded warehouses. The \$2,853 was 11% of BPT Branch's monthly salaries. DRT could not provide other costs associated with the monitoring of the bonded warehouses, such as the use of a government vehicle, fuel card, or mileage reimbursement for the use of personal vehicles.



While it may sound small, the Acting BPT Branch Supervisor believed 11% was significant, considering the branch's other responsibilities. For instance, the BPT Branch has had to borrow personnel from other branches to manually key in the data found on monthly GRT returns. The BPT Branch is responsible for the tax assessment of use tax, hotel occupancy tax, liquid fuel tax, automotive surcharges, limited gaming tax, alcoholic beverage tax, and tobacco tax – all of which are filled out on several different forms.

Relevant to business privilege taxes, the BPT Branch is charged with providing comprehensive year-round taxpayer services, which include counter services, timely assessment of taxes, identification of non-filers, tax compliance clearances, and the maintenance and storage of all taxpayer records. According to several interviews with DRT's executive management and the Acting BPT Branch Supervisor, the BPT Branch is not fully equipped to handle these responsibilities, let alone monitor the bonded warehouses. Therefore, risking the BPT Branch's ability to properly provide the services it is tasked to perform.

Considering the control procedures needed to monitor the bonded warehouses, we recommend the Legislative Committee Chairperson on Revenue and Taxation repeal the bonded warehouse provision for tobacco tax.

Other Matters

We became aware of actual and alleged tobacco taxes owed by two specific wholesalers, both of which operated bonded warehouses. Although not directly related to our audit objectives, we looked into how DRT concluded on Wholesaler O and Wholesaler Z's cases.

DRT Did Not Tax Wholesaler O's Free Samples of Tobacco

Prior to the enactment of Public Law (P.L.) 32-200 in October 2014, Wholesaler O was selling cigarettes in multi-pack discounts, e.g. "buy two, get one free." P.L. 32-200 added §26609 under 11 GCA Chapter 26 to ban the distribution of tobacco as free or as a multi-pack discount to retailers and consumers.

According to the DRT Examination Branch's evaluation, Wholesaler O had not reported tobacco tax on the free tobacco products it promoted prior to October 2014. DRT concluded that Wholesaler O's free samples of tobacco products were not subject to tax based on the definition of "free samples" in the Tobacco Master Settlement Agreement (MSA). The DRT Examiner interpreted Part III, Section (g) of the MSA to mean that the "free samples" attached to tobacco product sales are not considered "tobacco products", and therefore not taxable. Refer to Appendix 3 for the MSA excerpt. DRT's Examination Branch is under the impression that the MSA has authority over how Guam taxes tobacco products.

According to 11 GCA Chapter 26 Article 6, tobacco products are charged a tobacco tax when entering Guam's economy, which is upon (1) completed production in Guam or (2) discharge from its carrier when brought into Guam. Unlike other GRTs, the taxation of tobacco products is not dependent on whether the tobacco was sold/distributed or not. The only exclusions available were for drawbacks of the full tax amount paid on exports, military sales, sales to departing passengers, and spoilage. As such, we are not convinced on the conclusion reached by DRT's Examination Branch because the Guam law did not have specific language that excluded taxation on "free samples" even prior to P.L. 32-200.

We recommend the DRT Director re-evaluate its conclusion on the taxation of free tobacco products and seek the Attorney General of Guam's opinion concerning MSA's authority and impact over Guam's taxation of tobacco products.



DRT Did Not Examine Circumstances in Which Wholesaler O Could Sell Discounted Tobacco

According to 11 GCA Chapter 26 §26609, the following are banned: (a) selling tobacco in multi-pack discounts (e.g. "buy two, get one free"), and (b) selling tobacco at a discount. However, §26609(d) allows selling discounted tobacco if the discount is *not* attached to selling another tobacco product. Refer to Appendix 4 for the language in 11 GCA Chapter 26 §26609.

While evaluating whether free samples should have been taxed, DRT found that Wholesaler O stopped the multi-pack discounts but sold the cartons at a discounted price. However, the case files did not include support or DRT documentations to show that Wholesaler O's discounted sales

were *not* attached to another tobacco product, which would fit only the §26609(d) provision. Based on the case files, DRT did not explore the circumstances in which Wholesaler O was selling tobacco at a discounted price. Therefore, Wholesaler O may be in violation of 11 GCA Chapter 26 §26609(b) and (d).



We recommend the DRT Director re-evaluate the circumstances in which Wholesaler O and other wholesalers are selling tobacco at a discount.

DRT Did Not Examine 36 Months of Wholesaler Z’s Incorrect Tax Filings

In May 2017, Wholesaler Z filed 36 months of amended GRT-3 returns, which resulted in an additional \$12.4M tax liability. Following the amended filing, Wholesaler Z filed a request for DRT to waive any penalty or interest imposed on the additional tax liability. Because Wholesaler Z voluntarily came forward to correct its tax filings, DRT approved the waiver of \$3.4M in penalties and interest. If Wholesaler Z had not voluntarily amended its GRT-3 returns, then DRT’s lack of (or untimely) review of tax filings might have resulted in unrealized revenue to GovGuam.

According to the Examination Branch Supervisor, amended returns that result in a claim for abatement or refund are referred to the Examination Branch, while those that increase tax liability are not. Amendments that increase tax liability are viewed by the Examination Branch as low-risk.

The case files did not include an examination into how DRT missed 36 months of Wholesaler Z’s incorrect tax filings. Furthermore, there was no indication that the Collection Branch coordinated with the BPT Branch to verify if the amended liability was in fact *all* that was owed by Wholesaler Z. DRT accepted the amended filings as is and worked with Wholesaler Z on the installment payment agreement. As such, DRT does not have reasonable assurance that Wholesaler Z’s voluntarily-amended tax liability is accurate and complete.

DRT could have exercised a questioning mind and documented reasons for Wholesaler Z’s actions, especially for amendments as unusual and substantial as Wholesaler Z’s. For instance, we can assume that Wholesaler Z’s increased GRT liability would decrease its 2017 taxable corporate income by at least \$12.4M. With the Tax Cuts and Jobs Act taking effect in 2018, it might have been beneficial for Wholesaler Z to amend its GRT-3 returns in 2017 if its corporate tax rate was over 21%. The tax implications could be more complicated and is beyond the scope of this audit.



Because we still found weaknesses in the current practices and processes by which DRT conducts its oversight of the bonded warehouses, incorrect filings by the wholesalers (whether intentional or not) and unrealized revenue could still escape DRT’s purview.

As such, we recommend the DRT Director verify if Wholesaler Z’s amended tax liability was accurate and complete, as well as create and implement a policy that all unusual and/or substantial amendments to tax liabilities be examined and verified for accuracy and completeness.

DRT Has Not Implemented the Cigarette Tax Stamp

In October 2017, P.L. No. 34-55 lapsed into law, enacting a cigarette tax stamp, under 11 GCA Chapter 6 Article 7, *Cigarette Stamp Tax Law*, and Article 8, *Stamping of Cigarettes*. It was the Guam Legislature’s intent to improve tobacco tax collections and promote fairness for businesses that comply with Guam’s laws. In P.L. 34-55, the Guam Legislature acknowledged that the current system of taxing cigarettes relies on voluntary compliance, which unfairly benefits those tobacco wholesalers that do not comply with the law. The Guam Legislature also intended for the cigarette tax stamp to be implemented no later than October 2018 with DRT submitting an implementation plan to the Governor of Guam and the Guam Legislature Speaker no later than 90 days after P.L. No. 34-55 was enacted.

However, DRT has not implemented the cigarette tax stamp yet. Further, DRT has yet to submit a plan and proposed rules and regulations for the implementation of the tax stamp. These cigarette tax stamp laws add enforcement responsibilities to DRT while it is still unable to enforce effectively its oversight of the bonded warehouses.



Both the *Cigarette Stamp Tax Law* and the *Stamping of Cigarettes* law allow the wholesaler to defer payment for the tax stamps in the month *after* the wholesaler “purchased” the stamps. Similar to the current bonded warehouse provision, both laws defer the purchase and payment of tax stamps if the cigarettes were stored in a bonded warehouse.

Based on both laws, *purchasing* the tax stamps does not include immediate payment of the tax stamps. Whether stored in a bonded warehouse or not, the wholesaler may defer payment for the tax stamps until the 20th of the month *after* the tax stamps were “purchased” from DRT. Refer to Appendix 4 for the language in 11 GCA Chapter 6 §§ 6703 and 6805 that allows the wholesaler to defer tax stamp payments.

Conclusion and Recommendations

DRT still has not submitted any rules, regulations, and formally adopted policies that establish the official requirements for granting certification to and monitoring bonded warehouses for tobacco products. While DRT attempted to improve its bonded warehouse oversight, its current practices are not enough to provide reasonable assurance that all tobacco taxes are complete and properly accounted for.

Considering the control procedures needed to monitor the bonded warehouses, we recommend the Legislative Committee Chairperson on Revenue and Taxation:

1. Repeal the bonded warehouse provision for tobacco tax.

We also looked into the DRT case files of two tobacco wholesalers for whom tobacco tax delinquencies were actual or alleged. As a result of our review, we recommend the DRT Director:

1. Re-evaluate its conclusion on the taxation of free tobacco products and seek the Attorney General of Guam's opinion concerning the MSA's authority and impact over Guam's taxation of tobacco products.
2. Evaluate the circumstances in which tobacco wholesalers are selling tobacco at a discount.
3. Verify if Wholesaler Z's amended tax liability was accurate and complete.
4. Create and implement a policy that all unusual and/or substantial amendments to tax liabilities be examined and verified for accuracy and completeness.

Classification of Monetary Amounts

	Finding Description	Questioned Costs	Potential Savings	Unrealized Revenues	Other Financial Impacts	Total Financial Impacts
1.	No Rules, Regulations, & Official Policies for Bonded Warehouses	\$ -	\$ -	\$ -	\$ -	\$ -
2.	Weaknesses in DRT's Inventory Count Practices	\$ -	\$ -	\$ -	\$ -	\$ -
3.	Delays in Reconciling Tobacco Withdrawals to GRT-3 Returns	\$ -	\$ -	\$ -	\$ -	\$ -
4.	Opportunities for Tax Evasion on Tobacco Tax Drawbacks	\$ -	\$ -	\$ -	\$ -	\$ -
5.	Monitoring Bonded Warehouses Takes Up Significant DRT Resources	\$ -	\$ -	\$ -	\$ -	\$ -
6.	Other Matters	\$ -	\$ -	\$ -	\$ -	\$ -
	Total	\$ -	\$ -	\$ -	\$ -	\$ -

Management Response and OPA Reply

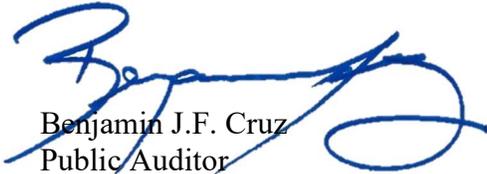
In October 2019, we provided draft reports to the DRT Director and the Oversight Chairperson on Revenue and Taxation of the 35th Guam Legislature. In the same month, we met with DRT's management, as well as with the Oversight Chairperson, to discuss the findings and recommendations.

In DRT's management response, DRT's Deputy Director agreed with our recommendations and generally agreed with our findings. Refer to Appendix 5 for DRT's official management response.

The legislation creating the Office of Public Accountability requires agencies to prepare a corrective action plan to implement audit recommendations, document the progress in implementing the recommendations, and endeavor to have implementation completed no later than the beginning of the next fiscal year. Accordingly, we will be contacting DRT to provide us with a target date and title of the official(s) responsible for implementing the recommendations.

We appreciate the cooperation and assistance from the staff and management of DRT.

OFFICE OF PUBLIC ACCOUNTABILITY



Benjamin J.F. Cruz
Public Auditor

**Appendix 1:
Objective, Scope, & Methodology**

Our audit objective was to determine DRT’s policies and practices for granting certification to and monitoring all bonded warehouses for tobacco products.

We looked into DRT’s current practices for monitoring the bonded warehouses. Our audit scope was from October 2018 – when DRT reported process improvements in their bonded warehouse oversight – through September 2019. We made our observations and inquiries between May and July 2019.

Our audit included a review of documents pertinent to the tobacco tax delinquencies of two tobacco wholesalers.

Methodology

To accomplish our objective, we performed the following pertaining to bonded warehouses for tobacco products:

- Identified and reviewed applicable laws and rules and regulations.
- Identified and reviewed prior audits and official publications.
- Met with DRT officials to gain an understanding.
- Observed DRT’s inventory count procedures for three bonded warehouses.
- Reviewed and analyzed the case files of DRT’s Criminal Investigation Branch, Examination Branch, and Collection Branch on the tobacco tax delinquencies of two tobacco wholesalers.
- Reviewed the BPT Branch’s activity log sheets to analyze the time spent on bonded warehouse field visits.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix 3:
Excerpt of MSA Part III, Section (g) Ban on Youth Access to Free Samples

Part III - Permanent Relief

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license or cause to be marketed, distributed, offered, sold or licensed (including, without limitation, by catalogue or direct mail), any apparel or other merchandise (other than Tobacco Products, items the sole function of which is to advertise Tobacco Products, or written or electronic publications) which bears a Brand Name. Provided, however, that nothing in this subsection shall (1) require any Participating Manufacturer to breach or terminate any licensing agreement or other contract in existence as of June 20, 1997 (this exception shall not apply beyond the current term of any existing contract, without regard to any renewal or option term that may be exercised by such Participating Manufacturer); (2) prohibit the distribution to any Participating Manufacturer's employee who is not Underage of any item described above that is intended for the personal use of such an employee; (3) require any Participating Manufacturer to retrieve, collect or otherwise recover any item that prior to the MSA Execution Date was marketed, distributed, offered, sold, licensed, or caused to be marketed, distributed, offered, sold or licensed by such Participating Manufacturer; (4) apply to coupons or other items used by Adults solely in connection with the purchase of Tobacco Products; or (5) apply to apparel or other merchandise used within an Adult-Only Facility that is not distributed (by sale or otherwise) to any member of the general public.

(g) Ban on Youth Access to Free Samples. After the MSA Execution Date, no Participating Manufacturer may, within any Settling State, distribute or cause to be distributed any free samples of Tobacco Products except in an Adult-Only Facility. For purposes of this Agreement, a "free sample" does not include a Tobacco Product that is provided to an Adult in connection with (1) the purchase, exchange or redemption for proof of purchase of any Tobacco Products (including, but not limited to, a free offer in connection with the purchase of Tobacco Products, such as a "two-for-one" offer), or (2) the conducting of consumer testing or evaluation of Tobacco Products with persons who certify that they are Adults.

(h) Ban on Gifts to Underage Persons Based on Proofs of Purchase. Beginning one year after the MSA Execution Date, no Participating Manufacturer may provide or

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EXH. B
(1/1)

Appendix 4:
Applicable Laws

11 GCA Chapter 6 Article 7 Cigarette Stamp Tax Law

§6703. Proof of Taxation.

- (a) The payment of taxes levied by §26602 and §26603(a) of Chapter 26, Title 11, Guam Code Annotated, shall be demonstrated by the purchase of tax stamps in Guam, which shall be affixed to each cigarette package. Nothing herein shall be construed as to levy any additional taxes on the sale of cigarettes, unless expressly stated by law.
- (b) Payment for the purchasing of stamps to be affixed to a cigarette package shall be reported each month and payable no later than the twentieth (20th) day of the month following the month in which the stamps were purchased from the Department [DRT].
- (c) The Department [DRT] is responsible for and shall effectuate the printing, distribution, and sale of tax stamps.
- (d) Any taxpayer under this Section may delay the payment of taxes in accordance with the provisions under 11 GCA §26601(c) relative to cigarettes held and sold out of a bonded warehouse.

11 GCA Chapter 6 Article 8 Stamping of Cigarettes

§6805. Price.

- (a) Stamps *shall* be sold at their denominated values as provided for herein.
- (b) Payment for the stamps *shall* be made *no later than* the twentieth (20th) day of the month following the month in which the stamps were purchased from the Department [DRT].
- (c) Any taxpayer under this Section may delay the payment of taxes in accordance with the provisions under 11 GCA § 26601(c) relative to cigarettes held and sold out of a bonded warehouse. Payment for the stamps for cigarettes held and sold out of a bonded warehouse *shall* be made *no later than* the twentieth (20th) day of the month following the month in which the stamps and associated cigarettes were issued and sold out of the bonded warehouse.

11 GCA Chapter 26 Article 6 Tobacco Tax

§26609. Tobacco Products Regulated and Taxed.

- (a) No business engaged in the manufacture, production, distribution, or importation of tobacco products, or any employee or agent of the same, shall sell such products to retailers or consumers through any multi-pack discounts (e.g., “Buy two, get one free”).
- (b) No business engaged in the manufacture, production, distribution, or importation of tobacco products, or any employee or agent of the same, shall sell, or otherwise provide or distribute to retailers or consumers, any tobacco products without charge or for less than the listed or non-discounted price, in exchange for the purchase of any other tobacco product.
- (c) For the purposes of this Section, listed or non-discounted price shall mean the higher of the prices listed for a tobacco product on its package, or the price listed on any related shelving, posting, advertising, or display at the place where the tobacco product is sold or offered for sale plus all applicable taxes if such taxes are not included in the stated price, and before the application of any discounts.
- (d) Nothing in this Act shall be construed as a prohibition on individual sales of tobacco products at a discounted rate; provided, however, that it is not attached to a sale of another tobacco product at a reduced price, or even as a give-away.



Dipáttamenton Kontribusion yan Adu'ána
DEPARTMENT OF
REVENUE AND TAXATION
GOVERNMENT OF GUAM Gubetnamenton Guåhan

LOURDES A. LEON GUERRERO, Governor *Mega'håga*
JOSHUA F. TENORIO, Lt. Governor *Sigundo Mega'tåhi*

DAFNE MANSAPIT-SHIMIZU, Director
Direktot
MICHELE B. SANTOS, Deputy Director
Sigundo Direktot

November 8, 2019

Benjamin J.F. Cruz
Public Auditor
Office of Public Accountability
Suite 401 DNA building
238 Archbishop Flores Street
Hagåtña, Guam 96910

RECEIVED
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BY: JM
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Re: DRT Response to Bonded Warehouses for Tobacco Products Performance Audit Results

Buenas Yan Saluda, Public Auditor Cruz:

Provided herein is the Department of Revenue and Taxation's (DRT) response to the audit findings of the bonded warehouses for tobacco products for the period of October 2018 through September 2019. While the audit objective was **"to determine the Department of Revenue and Taxation's (DRT) policies and practices for granting certification to and monitoring bonded warehouses for tobacco products"**, the audit also covered **"DRT case files of two tobacco wholesalers [REDACTED] for actual or alleged tobacco tax delinquencies"**.

DRT was tasked to enforce the mandates set forth by §26601(c) of Chapter 26, Title 11 of the Guam Code Annotated (GCA). Whereas this resulted in added responsibilities to the department by allowing deferred tax payment of tobacco taxes for warehouses under bond, no additional funding was provided to DRT specifically for this mandate. Nonetheless, DRT carried forward with the operations relative to bonded warehouses for tobacco products alongside the Guam's Customs and Quarantine Agency. As such, DRT welcomes the audit findings reinforcing the need for additional resources to improve efficiency in enforcing and administering all the mandates imparted upon DRT. DRT also appreciates the OPA for recognizing several improvements made in the monitoring of bonded warehouses for tobacco products.

- **DRT has been operating without *official* policies or *official* standard operating procedures (SOP) to grant certification to and monitor bonded warehouses for tobacco products.**
 - DRT, through its Business Privilege Tax (BPT) Branch, monitors the bonded warehouses for tobacco products with written guidelines and policies for associated tasks. Although such rules and regulations have yet to be promulgated pursuant to §26601(c) of Chapter 26, 11 GCA, and entered in the Guam Administrative Rules and Regulations (GARR), DRT representatives have the policies and procedures in writing

Page 2 of 4
DRT Response to Audit

in conjunction with the GCA to guide their actions. DRT stays true to its mission of administering tax laws business regulations with fairness and integrity to all, without preference to any party in particular.

- DRT will work towards promulgating rules and regulation through the Administrative Adjudication Act.

- **DRT spends significant resources monitoring the movement of tobacco products in and out of the bonded warehouses.**
 - Unless the statute allowing for bonded warehouses of tobacco products is repealed, DRT is bound by law to continue to monitor the movement of tobacco products in and out of the bonded warehouses to protect the government. DRT is in agreement that given the severe staff shortage, undue burden is placed on the BPT Branch to administer this unfunded mandate that benefits only a certain few. Regardless, noted improvement in the process is the addition of a representative from Compliance Branch to accompany the BPT Branch representative for any bonded warehouse activity to ensure compliance with the policies and establish checks and balances.

- **Weaknesses in DRT's inventory count practices.**
 - The incident observed is not reflective of how all representatives conduct inventory. It should be noted as well that the lack of proper training and manpower did not deter DRT from effectuating monthly inventory counts as an added control measure. DRT still continues to find ways to improve its processes even with the limited resources available.

- **Delays in reconciling tobacco withdrawals against the tobacco reported in the GRT-3 returns.**
 - Whereas no reconciliation was done in the past, BPT and Compliance Branches have since initiated the reconciliation of tobacco product withdrawals against tobacco taxes paid. It is a work in progress and is being done regardless of the numerous responsibilities and added mandates for the branch without corresponding additional funding or resources.
 - DRT respectfully disagrees with the statement that **"The untimely reconciliation of tobacco withdrawals to GRT-3 filings makes other control mechanisms useless"**. §26205 of Chapter 26, 11 GCA allows for a period of up to three years for amendments, thereby providing the means to ensure accurate assessments.

§ 26205. Statute of Limitations for Collections.

The statute of limitations for collections of unpaid taxes due on business privilege tax returns shall be ten years after the tax is assessed. **For amendment, correction, adjustment, challenge, determination of correctness of the amount of taxes paid, or audit of income reported and the correctness of the amount**

of tax liability shown on the business privilege tax returns, the statute of limitations shall be three years after filing and payment of taxes due. There shall be no statute of limitations on unfiled business privilege tax returns or on the collection of taxes on revenues not shown or reported on Business Privilege Tax Returns.

- **DRT's procedures provided opportunities for tax evasion on the tobacco withdrawn for export or sale to the U.S. Military or Guam Airport concessionaires.**
 - Guam's tax system primarily operates under the principle of voluntary compliance, which places the burden of reporting income, including exemptions claimed, on the taxpayers. While it is DRT's expectation that everyone will oblige and be truthful in their reporting, voluntary compliance [will] always leave room for possible tax evasion, which is not unique to DRT given the impossible task of auditing every single return filed. Moreover, the limited resources afforded to DRT make it impractical to follow the tobacco products to ensure actual export or sales to the military and/or airport concessionaires after withdrawal from the bonded warehouses. As such, "**DRT's procedures provided opportunities for tax evasion...**" is an unfair statement.
 - Nevertheless, should the statute that allows bonded warehouses for tobacco products remain intact, DRT is considering a policy change to disallow upfront exemptions and strictly enforce tax drawbacks moving forward.

DRT response to the additional findings listed:

- **DRT did not tax Wholesaler O's free samples of tobacco.**
 - DRT concurs with this finding. We will re-evaluate its conclusion and initiate a dialogue with the Office of the Attorney General regarding the MSA's authority and impact of the tobacco products.
- **DRT did not examine circumstances in which Wholesaler O could sell discounted tobacco.**
 - DRT concurs with this finding. We will re-evaluate the circumstances that Wholesaler O and others sell tobacco as a discount.
- **DRT did not examine how years of incorrect tobacco tax filings went unnoticed.**
 - DRT will review its current practices and processes regarding amended tax return filing. We will review the classification process currently in place for the Income Tax returns and adopt similar disciplines.
- **The cigarette tax stamp delays tobacco tax payments.**
 - DRT concurs with this finding. The intent of the Cigarette Stamp Tax Law is to improve tobacco tax collections. However, the existing provisions of said law still allows for the deferred payment of tobacco tax as tobacco tax wholesalers have up to the 20th of the month to pay for the stamps purchased in the preceding month. The

Page 4 of 4
DRT Response to Audit

Cigarette Stamp Tax Law also does not replace the bonded warehouse provision and instead adds another layer of bureaucracy in enforcing tobacco tax laws.

Regardless of the scarce resources available to DRT, we continue to implement changes and improvements in the administration and enforcement of the tobacco tax laws particularly as it pertains to the monitoring of bonded warehouses of tobacco products. While not faultless, DRT does its best to protect the interest of the government of Guam as it maintains fairness and integrity to all. However, DRT is in full support of OPA's recommendation that the "**Committee Chairperson for Revenue and Taxation repeal the bonded warehouse provision for tobacco tax**". This recommendation will ensure the immediate payment of tobacco taxes upon importation.

If you have any questions, please email me at Michele.Santos@revtax.guam.gov or contact me at (671)635-1816.

Senseramente,



Michele B. Santos
Deputy Director

**Appendix 6:
Status of Audit Recommendations**

No.	Addressee	Audit Recommendation	Status	Action Required
1.	Legislative Committee Chairperson on Revenue and Taxation	Repeal the bonded warehouse provision for tobacco tax.	OPEN	Prepare a corrective action plan.
2.	DRT Director	Re-evaluate conclusion on the taxation of free tobacco products and seek the Attorney General of Guam's opinion concerning the Master Settlement Agreement's authority and impact over Guam's taxation of tobacco products.	OPEN	Prepare a corrective action plan.
3.	DRT Director	Evaluate the circumstances in which tobacco wholesalers are selling tobacco at a discount.	OPEN	Prepare a corrective action plan.
4.	DRT Director	Verify if Wholesaler Z's amended tax liability was accurate and complete.	OPEN	Prepare a corrective action plan.
5.	DRT Director	Create and implement a policy that all unusual and/or substantial amendments to tax liabilities be examined and verified for accuracy and completeness.	OPEN	Prepare a corrective action plan.



**Department of Revenue and Taxation
Bonded Warehouses for Tobacco Products
Report No. 19-07, November 2019**

ACKNOWLEDGEMENTS

Key contributions to this report were made by:
Michele Brillante, Auditor-In-Charge
Edlyn Dalisay, CPA, CGFM, Audit Supervisor
Benjamin J.F. Cruz, Public Auditor

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