

**U.S. Department of the Interior
Office of Inspector General**

Audit Report

Qualifying Certificate Program Guam Economic Development Authority Government of Guam



**Report No. 01-I-419
September 2001**



United States Department of the Interior

OFFICE OF INSPECTOR GENERAL

Pacific Field Office
415 Chalan San Antonio
Baltej Pavilion, Suite 306
Tamuning, Guam 96913

September 30, 2001

Mr. Chris Murphy
Chairman, Board of Directors
Guam Economic Development Authority
ITC Building, Suite 511
590 South Marine Drive
Tamuning, Guam 96911

Subject: Audit Report on the Qualifying Certificate Program, Guam Economic
Development Authority, Government of Guam (Report No. 01-I-419)

Dear Mr. Murphy:

This report presents the results of our audit of the Qualifying Certificate Program administered by the Guam Economic Development Authority.

Please provide a response to this report by November 21, 2001. The response should provide the information requested in Appendix 3 and should be addressed to our Pacific Field Office, 415 Chalan San Antonio, Baltej Pavilion - Suite 306, Tamuning, Guam 96913.

Section 5(a) of the Inspector General Act (5 U.S.C. app. 3) requires the Office of Inspector General to list this report in its semiannual report to the U.S. Congress. In addition, the Office of Inspector General provides audit reports to the Congress.

Sincerely,

Arnold E. van Beverhoudt, Jr.
Audit Manager for Insular Areas

cc: Honorable Carl T.C. Gutierrez, Governor of Guam

EXECUTIVE SUMMARY

**Qualifying Certificate Program,
Guam Economic Development Authority,
Government of Guam
Report No. 01-I-419
September 2001**

The Guam Economic Development Authority was established in August 1965 as a public corporation "to assist in the implementation of an integrated program for the economic development of Guam" and "to be a catalyst in the economic development" of Guam by "aiding private enterprise without unfairly competing with it." The Authority is authorized to provide loans, issue revenue bonds, purchase mortgages, and function as the Government's financial advisor and as manager of industrial park leases. In addition, the Authority encourages private sector investment by granting tax rebates and abatements to qualifying businesses under the Qualifying Certificate Program.

The objective of our audit was to determine whether the Guam Economic Development Authority (1) effectively administered the Qualifying Certificate Program and (2) achieved the objectives for which the Program was established.

Although the Qualifying Certificate Program provided significant benefits to the Guam economy, we found that there was a need for improvements in the Program. Specifically:

- 9 The Government of Guam lost tax revenues of at least \$769,650 and could lose future tax revenues totaling about \$70.8 million because the Authority recommended the approval of Qualifying Certificates with unnecessarily generous tax benefits to hotel and tourist industry firms that may not have needed the level of tax benefits given.
- 9 The Authority improperly granted tax abatements of \$459,777 to beneficiaries that were not in compliance with their Qualifying Certificates, apparently used surveillance fees of about \$220,000 for purposes other than monitoring beneficiary compliance, and authorized beneficiaries to receive additional tax benefits of at least \$815,990 while concurrently allowing the beneficiaries to not employ about 371 Guam residents.
- 9 Gross receipts taxes of more than \$5 million and an undetermined amount of use taxes were abated improperly and without verification of the amount or eligibility.
- 9 Legally mandated investments in Guam's economy totaling at least \$2.3 million may not have taken place because the Authority did not include language in Qualifying Certificates

requiring beneficiaries to reinvest tax benefits and, for those Certificates that included the reinvestment requirement, did not monitor the beneficiaries' compliance.

We made 14 recommendations to the Chairman of the Authority's Board of Directors to address these issues by seeking changes to the Qualifying Certificate law, developing standard operating procedures for some of the Authority's activities, providing formal training to compliance monitoring staff, and coordinating with the Division of Revenue and Taxation and the Customs and Quarantine Agency regarding gross receipts and use tax abatements.

AUDITEE COMMENTS AND OFFICE OF INSPECTOR GENERAL EVALUATION

The Authority concurred with 8 of the report's 14 recommendations, partially concurred with 1 recommendation, and expressed nonconcurrence with the other 5 recommendations. Based on the response, we considered 6 recommendations unresolved and requested additional information for 8 recommendations.

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INTRODUCTION

BACKGROUND

The Guam Economic Development Authority was established in August 1965 as a public corporation "to assist in the implementation of an integrated program for the economic development of Guam" and "to be a catalyst in the economic development" of Guam by "aiding private enterprise without unfairly competing with it." The Authority is authorized to provide loans, issue revenue bonds, purchase mortgages, and function as the Government's financial advisor and as manager of industrial park leases. In addition, the Authority encourages private sector investment by granting tax rebates and abatements to qualifying businesses under the Qualifying Certificate Program.

Title 12, Chapter 58, of the Guam Code Annotated established the Qualifying Certificate Program to provide eligible businesses with financial assistance through rebates (refunds) of income taxes paid and abatements (forgiveness) of property taxes owed. Under the original law, which was in effect from 1965 to 1994, the Government of Guam granted these tax benefits through Qualifying Certificate contracts with Guam-based corporations engaged or to be engaged in the service, manufacturing, agriculture, and fishing industries. To be eligible under the Program, businesses had to either create new employment, replace imports, reduce consumer prices, or create vitally needed facilities. The first Qualifying Certificate was issued in 1965, and three Qualifying Certificate beneficiaries have continued to receive tax benefits under the Program for more than 30 years. During the period of December 31, 1989 to September 5, 1997, the Authority's Board of Directors imposed a moratorium on the issuance of Qualifying Certificates to hotels.

In December 1994, the Guam Legislature amended the sections of the Guam Code Annotated establishing the Qualifying Certificate Program. The amendments included expanding the available tax benefits by adding gross receipts taxes to the types of taxes eligible for abatement and adding domestic insurance, captive insurance, nonhotel-tourism related housing development, communication, and trust companies to the list of eligible industries. The Guam Code Annotated provides that a Qualifying Certificate may be suspended, rescinded, or revoked by the Governor of Guam on the recommendation of the Authority for "failure to comply with any condition or obligation set out in the Certificate after having been notified by the Authority in writing of such failure to comply and after having been given by the Authority a reasonable period of time within which to correct such a failure."

As of December 31, 1999, the Authority had 31 active Qualifying Certificates and 10 Qualifying Certificate applications in process. During fiscal years 1997, 1998, and 1999, the Authority collected certificate surveillance fees totaling \$683,605 and the 31 beneficiary companies received tax abatements and rebates totaling at least \$18 million, as shown in Table 1.

**Table 1. Qualifying Certificates, Surveillance Fees, and Tax Benefits
for Fiscal Years 1997, 1998, and 1999**

<u>Certificate Categories</u>	<u>Certificates Outstanding</u>	<u>Applications In Process</u>	<u>Surveillance Fees Received***</u>	<u>Tax Benefits Granted****</u>
Hotel	15	5	\$636,355	\$9,638,574*
Tourist Facility	3	3	24,000	1,221,871
Domestic Insurance	6	0	14,500	5,389,606
Captive Insurance	1	0	1,750	0
Medical Facility	2	0	1,000	0
Communications	4**	0	6,000	1,864,253
Manufacturing	0	1	0	0
Housing	<u>0</u>	<u>1</u>	<u>0</u>	<u>0</u>
Total	<u>31</u>	<u>10</u>	<u>\$683,605</u>	<u>\$18,114,304</u>

* Includes benefits for 20 Certificates of Exemption issued to contractors on one hotel development project as part of a hotel's Qualifying Certificate.

** Includes three Qualifying Certificates issued to corporate shareholders.

*** Consists of legally required fees collected from Certificate holders to defray the cost of performing monitoring.

**** Consists of estimates, based on the best available information from the Department of Revenue and Taxation, of the value of tax rebates and abatements granted to Certificate holders.

OBJECTIVE AND SCOPE

The objective of our audit was to determine whether the Guam Economic Development Authority (1) effectively administered the Qualifying Certificate Program and (2) achieved the objectives for which the Program was established. The original scope of the audit included a review of the Qualifying Certificates issued during fiscal years 1997, 1998, 1999, and 2000 (through December 31, 1999). We subsequently expanded the audit scope to include the applications for Qualifying Certificates in process, the monitoring actions taken, and the tax abatement and rebate transactions processed through June 30, 2000. This is the second of three reports we plan to issue on the operations of the Guam Economic Development Authority. The other two reports will cover (1) economic development loan programs and (2) bonds, leases, and financial activities.

To obtain information on the processing and issuance of Qualifying Certificates and the administration of the Qualifying Certificate Program, we interviewed officials and/or reviewed records at the offices of the Guam Economic Development Authority, the Authority's independent public accounting firm, the Guam Department of Revenue and Taxation, the Guam Customs and Quarantine Agency, the Guam Department of Public Works, and two beneficiary hotels.

Our review was made, as applicable, in accordance with the "Government Auditing Standards," issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures that were considered necessary under the circumstances.

As part of the audit, we evaluated the system of internal controls related to the financial and operational management of the Qualifying Certificate Program to the extent that we considered necessary to accomplish the audit objective. Based on our review, we determined that the Authority generally achieved the purposes of the Qualifying Certificate Program. However, we identified internal control weaknesses in the areas of the approval of Qualifying Certificates, the monitoring of beneficiary compliance, the abatement of gross receipts and use taxes, and the reinvestment of tax abatements. These weaknesses are discussed in the Findings and Recommendations section of this report. Our recommendations, if implemented, should improve the internal controls in these areas.

PRIOR AUDIT COVERAGE

During the past 5 years, neither the U.S. General Accounting Office nor the Office of Inspector General has issued an audit report on the Guam Economic Development Authority. However, in November 1990, the Office of Inspector General issued the audit report "Followup Review of the Guam Economic Development Authority's Administration of the Qualifying Certificate Program" (No. 91-I-162). The report discussed the status of recommendations contained in the October 1987 report "Guam Economic Development Authority's Administration of the Qualifying Certificate Program" (No. 88-04). The followup report stated that, although 6 of the 10 prior recommendations had been implemented, the Authority continued to (1) issue Qualifying Certificates to ineligible businesses; (2) grant recipients the maximum level of benefits allowed without consideration of limiting tax benefits to the level necessary for businesses to recover the amount of capital invested; and (3) approve Qualifying Certificates for the hotel industry, which no longer needed tax benefits. The followup report stated that the deficiencies related to the Qualifying Certificate Program resulted in potential lost revenues to the Government of Guam totaling at least \$89.7 million. The followup report made six recommendations, and based on our current review, we determined that four of the six recommendations had not been implemented.

FINDINGS AND RECOMMENDATIONS

A. APPROVAL OF QUALIFYING CERTIFICATES

The Government of Guam lost tax revenues of at least \$769,650 and could lose future tax revenues totaling about \$70.8 million because the Guam Economic Development Authority recommended the approval of Qualifying Certificates with unnecessarily generous tax benefits to hotel and tourist industry firms that may not have needed the level of tax benefits given. This occurred because the Authority interpreted the Qualifying Certificate law as not allowing the Authority sufficient flexibility in specifying the terms and conditions of Qualifying Certificates.

Controlling Law

On December 29, 1994, the Guam Legislature amended the 1965 law that established the Qualifying Certificate Program. The statute (12 G.C.A. § 58105) provides that no Qualifying Certificate shall be issued unless the Authority finds it will promote the general economic development by the creation of employment and either (1) the replacement of imports, (2) the reduction in consumer prices, (3) the creation of affordable housing or other vital facilities, (4) the creation of economic activity, or (5) the establishment of Guam as a financial/insurance center for the Pacific and increasing the availability or lowering the cost of insurance. Additionally, the statute (12 G.C.A. § 58109) requires that the Authority consider several factors and make specific findings on (1) the impact of the Beneficiary's proposed activities upon established businesses and markets in Guam, (2) the financial risk facing the Beneficiary in undertaking the proposed activities, (3) the location of the proposed activities, and (4) the importance of the proposed activities to the economy of Guam and to the official economic policies of Guam. Lastly, the statute (12 G.C.A. § 58110) requires that the Authority consider several factors as terms and conditions of the specific tax benefits, including limiting the benefits to a certain percentage, varying the rate of the tax benefit, limiting the benefit to a fixed dollar amount, and conditioning the tax benefits on the Beneficiary investing in or creating public improvements separate from the proposed activities.

Based on the law, we believe that the Legislature granted the Authority sufficient flexibility to decide the terms and conditions of Qualifying Certificates and did not limit the Authority to granting Certificates only for the maximum allowable level of tax benefits.

Projects in Tourist Areas

During the period of September 5, 1997¹ to December 31, 1999, the Authority recommended issuing Qualifying Certificates, which did not appear to consider the factors in the statute, to two hotel expansion projects and one tourist attraction project. In addition, as of June 30, 2000, the Authority was considering two additional hotel projects that had applied for Qualifying Certificates

¹The date when the Government of Guam issued the first hotel project qualifying certificate following the moratorium.

but which also did not appear to consider the statutory factors. According to the Authority's Administrator, the legislation establishing the Qualifying Certificate Program required the Authority to issue certificates even in instances when the Authority did not believe they should be recommended. The Administrator stated that the portion of the hotel industry located in the Tumon Bay and Agana Bay areas was well established and that incentives were therefore not necessary to attract new investments to these areas. The Administrator also noted that a tourist attraction development at one of Guam's major tourist sites did not need a Qualifying Certificate in order to be financially viable. However, as a result of the Authority's recommendations for approval, the Government of Guam lost tax revenues of at least \$769,650 and may lose future tax revenues of about \$28.5 million on the three projects.

In addition to not considering the statutory factors, economic considerations did not justify the three Qualifying Certificates. We identified 15 hotels that were constructed during the decade of the 1990s without receiving Qualifying Certificates. Further, the low demand for Guam hotel rooms during the latter part of the decade, resulting from the Asian economic downturn, did not justify foregoing future potential tax revenues to increase the level of hotel construction. Specifically, although the number of hotel rooms increased from 7,052 in 1996 to 9,238 in 1999, the room occupancy rate decreased from 85 percent in 1996 to 61 percent in 1999.² Further, by recommending Qualifying Certificates for hotel projects in the same general area as other hotels that were constructed and continued to operate without similar tax benefits, the Authority gave an unfair competitive advantage to the hotels with Qualifying Certificates and tax benefits -- a factor which the Authority should have considered in accordance with the statute (12 G.C.A. § 58109).

Hotel Construction Projects. For comparison with hotel construction projects that benefitted from Qualifying Certificates, we identified two large resort hotels that were constructed during the 1990s and were operating in the Tumon Bay and Agana Bay tourist areas without receiving Qualifying Certificates. A 455-room hotel was constructed at Tumon Bay without a Qualifying Certificate and tax benefits and has been in operation since 1994 (Figure 1).

²Hotel statistics are from the Guam Hotel & Restaurant Association.



Figure 1. *This 455-room hotel was constructed at Tumon Bay and began operations in 1994 without a Qualifying Certificate and tax benefits. (Office of Inspector General photograph)*

Another hotel was constructed at Agana Bay without benefit of a Qualifying Certificate and tax benefits and has been in operation since 1992 (Figure 2). In 1996 this hotel constructed a water park, and as of June 2000, the hotel was constructing a 144-room addition -- both without the benefit of Qualifying Certificates or tax benefits.



Figure 2. *This hotel was constructed at Agana Bay and began operations in 1992 without a Qualifying Certificate and tax benefits. An adjacent water park (left side) was completed in 1996, and a 144-room addition was under construction as of June 2000 -- both without Qualifying Certificates and tax benefits. (Office of Inspector General photograph)*

In contrast, in proximity to these hotels were other hotel projects that received or were considered for Qualifying Certificates by the Authority. For example:

- In June 1998, the Government of Guam issued a Qualifying Certificate to a 500-room hotel for a project to construct an additional 292-room tower (Figure 3). At the time, the hotel had almost 8 years remaining on an existing Qualifying Certificate, which was extended for almost 12 additional years under the new Qualifying Certificate. The tax revenues lost by the Government as a result of the new tax benefits totaled at least \$588,000 through June 30, 2000 and will total an estimated \$16.9 million through the almost 20-year life of the new Qualifying Certificate.



Figure 3. A 292-room tower was added to this hotel and began operations in November 1999 with a Qualifying Certificate and tax benefits that apply to the entire hotel complex. (Office of Inspector General photograph)

- In September 1997, the Government of Guam issued a Qualifying Certificate to a hotel for a water park that had already been constructed and had opened for operations in July 1997 (Figure 4). At the time, the hotel had 5 years remaining on an existing Qualifying Certificate, which was extended for 15 additional years under the new Qualifying Certificate. The tax revenues lost by the Government as a result of the new tax benefits totaled \$181,650 through June 30, 2000 and will total an estimated \$10.7 million through the 20-year life of the new Qualifying Certificate.



Figure 4. This water park (right side) was built adjacent to an existing hotel at Tumon Bay, which is 3.5 miles from the hotel and water park shown in Figure 2. The water park and hotel now operate with a Qualifying Certificate and tax benefits that apply to both. (Office of Inspector General photograph)

Tourist Attraction Project. In March 1999, the Board recommended approval of a Qualifying Certificate to a Guam-based company for development of tourist facilities at the site of one of Guam's most prominent tourist attractions (Figure 5). The Board's recommendation for approval reversed the Administrator's recommendation not to approve the application during a February 23, 1999 meeting of the Authority's Credit Review Committee. In that meeting, the Administrator noted:

Local residents can no longer visit the site free of charge. [The beneficiary] will now derive profit from local persons who were previously able to visit this historical cultural point free of charge.

The certificate beneficiaries controlled only 6 percent of the project site and the Government of Guam owned the other 94 percent.

On December 30, 1998, the Government of Guam authorized (and expended) \$1.5 million to improve the site.

[The developer's financial] projections and public hearing testimony indicate [the] project will be immediately profitable.

[The net future value of the Government's \$1.5 million] contribution based on the average 20 year Q.C. [Qualifying Certificate] term is \$3,623,000. . . . The granting

of a Q.C. on top of this contribution . . . would produce gross inequity between [the developer] and other Q.C. beneficiaries.



Figure 5. This tourist attraction project included a parking lot and buildings constructed on Government of Guam property and an overlook platform and ticket booth/souvenir shop located on the beneficiary company's property. (Office of Inspector General photograph)

Although at its February 23, 1999 meeting the Authority's Credit Review Committee recommended rejecting the application for Qualifying Certificate, on March 15, 1999 the Committee reversed its previous decision and recommended approval of the Qualifying Certificate for the tourist attraction project. This action was taken after the beneficiary had made several minor concessions, such as agreeing to provide security for the complex, provide a local resident entrance fee, and contribute funds for cultural programs. In our opinion, the Authority unnecessarily recommended approval of tax benefits that will result in the potential loss of at least \$900,406 in tax revenues over the 20-year life of the Qualifying Certificate. The location of the facilities should have been considered and the Authority should have made a specific finding of fact on that issue in accordance with the statute (12 G.C.A. § 58109).

Timing of Application Filings

Based on our review of 13 Qualifying Certificate application files, we concluded that the Authority had granted Qualifying Certificates and tax benefits to 10 of the businesses although it appears the businesses did not need the tax benefits to attract investors, as set forth in the statute (12 G.C.A. § 58100). In each of these cases, the companies had essentially completed their financial and architectural planning and obtained building permits prior to applying for Qualifying Certificates. For example:

- A hotel affiliated with a major chain did not file a Qualifying Certificate application for a 600-room, 22-floor hotel complex until August 1998, although the necessary building permits had been approved by the Department of Public Works in 1996 and the project was already under construction (Figure 6). The Qualifying Certificate was approved in April 2000, or 10 months after the hotel had already started operations. Based on the timing of the Qualifying Certificate application, we believe that the hotel would have been constructed even without a Qualifying Certificate and tax benefits. Based on information in the Authority's files, we estimate that the Government will lose tax revenues of at least \$24.3 million over the 20-year life of the Qualifying Certificate. Additionally, the 1994 Qualifying Certificate law (12 G.C.A. § 58100) explicitly states that the program was being restructured to increase participation by people who live and work on Guam, as opposed to helping foreign entrepreneurs and off-island investors.



Figure 6. *The Authority recommended this hotel project for a Qualifying Certificate in April 2000. The hotel opened for business in June 1999. An adjacent hotel (shown in Figure 1) was constructed and operates without a Qualifying Certificate. (Office of Inspector General photograph)*

- Another business did not file a Qualifying Certificate application for a tourist attraction at Two Lovers Point until November 1998, or 8 months after it had received the necessary building permit from the Department of Public Works. Prior to receiving the Qualifying Certificate, the company's Attorney was quoted in the Pacific Daily News on February 5, 1999 as having stated that his company would invest in the project whether or not the company received a Qualifying

Certificate. Based on information in the Authority's files, we estimate that the Government will lose tax revenues of at least \$900,406³ over the 20-year life of the Qualifying Certificate.

In September 1999, the Authority's Board of Directors passed Resolution 99-040, which amended the Authority's standard operating procedures to require applicants to submit the application for a Qualifying Certificate with property appraisal within 90 days after the building permits had been issued by the Guam Department of Public works. Although the establishment of this time requirement was a positive action, we recommend that the Authority further amend its standard operating procedures to include the requirement for a letter of intent to be submitted 180 days prior to the approval of building permits and amend its rules and regulations to include these requirements. We believe that the lead time of 180 days would help to ensure that businesses considered the need for tax benefits early in their investment planning process and did not file applications for Qualifying Certificates "after the fact" simply because the related tax benefits were available.

Negotiation of Tax Benefits

Although the Authority negotiated with Qualifying Certificate applicants on non-tax-related benefits, Authority records indicated that little negotiation was made with applicants to limit the amount and time period of tax benefits recommended on either new or modified Qualifying Certificates. In addition, the Authority had not identified or estimated all direct and indirect costs to the Government of either new or renovation projects. In our opinion, the Authority cannot effectively negotiate or recommend the granting of tax benefits, potentially worth millions of dollars, to businesses without identifying all related Government costs.

Level of Tax Benefits. During the period of October 1, 1996 to December 31, 1999, the Authority recommended issuing Qualifying Certificates to seven businesses, excluding insurance companies. Of the seven businesses, the Authority proposed granting the maximum percentage of income tax rebates (75 percent) to all seven recipients and the maximum period (20 years in four cases and 19 years in one case) to five of the seven recipients. In addition, in at least six instances, the Authority recommended that beneficiary firms receive extensions of existing tax benefits to include both the new project renovations/additions and the original hotel properties that had been included in prior Certificates. As a result, the six beneficiaries received tax benefits on essentially the same properties for more than 25 years. For example:

- A hotel first received a Qualifying Certificate in 1968, and when the hotel was subsequently sold, the Certificate was assumed by the new owner. In 1979, the new owner applied for and received a new Certificate consequent to a major expansion. In 1985, a third Certificate was issued consequent to a 100-room expansion. Most recently, in 1998, a fourth Certificate was issued based on a 292-room expansion. Each of the four Certificates encompassed the entire hotel

³To avoid duplicate counting elsewhere in this finding, this amount was not included in Appendix 1, "Classification of Monetary Amounts."

and provided a rebate of 75 percent of corporate income taxes and abatement of 100 percent of property taxes, and the final three Certificates also granted a rebate of 75 percent of income taxes on dividends. Although the terms of the rebates/abatements varied slightly, with the three extensions the hotel will receive a total of at least 48 years of income tax rebates, 36 years of property tax abatements, and 15 years of dividend tax rebates. As a result, and assuming additional extensions will not be granted, from June 1998 through June 2000 this hotel received tax benefits of at least \$588,000 and from July 2000 through May 2017 will receive an additional tax benefits estimated to total \$16.9 million.⁴

As of June 30, 2000, another beneficiary had an application under review to receive similar extended benefits (estimated to total \$18 million in tax benefits).

The Guam Code Annotated (12 G.C.A. § 58132(c)) states, "The tax benefits applicable to the additional activities may be at rates or for a term different from those tax benefits applicable to the activities described in the original Qualifying Certificate, and the new Qualifying Certificate may include terms, conditions, rebates or abatements different from those in the original Qualifying Certificate." The Authority's Administrator stated that the Authority should have "looked at the application more closely" before recommending the Qualifying Certificate discussed in the example above. He further stated that in a similar application now under review, the Authority "is against" including existing facilities in a new Qualifying Certificate for an addition to the hotel.

Cost/Benefit Analyses

In arriving at the level and terms of tax benefits, the Authority did not adequately consider the estimated direct and indirect costs to the Government applicable to the capital projects. The Authority's Administrator stated that the Authority did not have an economic model to estimate short- and long-term direct and indirect costs to the Government inherent in large development projects and to match these costs to potential economic benefits of the projects. Although the Guam Code Annotated (12 G.C.A. § 58110) and the Authority's Qualifying Certificate Rules and Regulations allow the Authority to limit and vary the level and length of tax benefits, the Qualifying Certificate files we reviewed did not indicate that the Authority had considered recommending benefit rates and time periods at any levels below the maximums allowed. As a result, the Authority could not ensure that the tax revenues foregone plus additional related infrastructure and social costs did not negate the economic benefits resulting from the development projects. Additionally, although the Government had a voluntary program for beneficiary firms to contribute toward defraying such related infrastructure costs, the Authority could not provide information on the amounts, if any, that were contributed by the Qualifying Certificate beneficiaries.

The Guam Code Annotated appears to give the Authority adequate legal authority to negotiate the level of Qualifying Certificate benefits, terms, and conditions with applicants. However, because the Authority has not often issued Qualifying Certificates with tax benefits at levels less than the

⁴To avoid duplicate counting elsewhere in the finding, these amounts were not included in Appendix 1.

maximums allowable, it may be beneficial to amend the Code to clearly delineate the circumstances under which lower-than-maximum-level tax benefits can be granted. In addition, the Authority could benefit from better information and analytical tools, such as economic models, to estimate and compare the costs of additional demand on public infrastructure (power, water, and sewer service) and government services (health, education, and police services) to determine the economic benefits to be provided by the Qualifying Certificates.

Recommendations

We recommend that the Chairman and the members of the Board of Directors of the Guam Economic Development Authority, along with the Administrator:

1. Work with the Guam Legislature to amend Title 12, Chapter 58, of the Guam Code Annotated (the Qualifying Certificate Law) and related regulations to exclude from program eligibility tourism projects in established tourist areas of Guam, exclude previously existing facilities from eligibility for new Qualifying Certificates, require that businesses submit letters of intent to apply for Qualifying Certificates no less than 180 days prior to obtaining related building permits, and clearly define the circumstances under which lower than maximum-level tax benefits can be granted.

We recommend that the Chairman of the Board of Directors of the Guam Economic Development Authority direct the Authority's Administrator to:

2. Establish procedures and develop methods, such as economic models and procedures, to calculate the economic benefits of tax rebates and abatements by considering the costs to the Government, including the amount of taxes foregone and the indirect infrastructure and social costs involved.

3. Adopt procedures to require that negotiations with Qualifying Certificate applicants are documented and that the negotiations include the use of all relevant analyses, as described in Recommendation 2, to ensure that the estimated direct and indirect costs to the Government do not negate the economic benefits of the Qualifying Certificates.

Guam Economic Development Authority Response and Office of Inspector General Reply

In the August 10, 2001 response (Appendix 2) to the draft report from the Authority's Chairman of the Board, the Authority concurred with Recommendations 2 and 3, and partially concurred with Recommendation 1. Based on the response, we requested additional information for Recommendations 2 and 3, and requested that the Authority reconsider Recommendation 1, which is unresolved (see Appendix 3).

Recommendation 1. Partial concurrence.

Guam Economic Development Authority Response. The Authority disagreed with the part of the recommendation to amend the Qualifying Certificate law to exclude from program eligibility new tourism projects in established tourist areas of Guam. As justification for continuing to approve Qualifying Certificates for tourism projects in established tourist areas, the Authority cited various natural and economic disasters, such as Typhoon Paka, the Korean Air Lines Flight 801 crash, and the Asian economic downturn, all of which affected the tourism market on Guam. Although the Authority concurred with the part of the recommendation to exclude previously existing facilities from eligibility for new Qualifying Certificates, it disagreed with excluding established businesses undergoing qualified expansion projects. The Authority also disagreed with the part of the recommendation to require applicants to submit letters of intent to apply for a Qualifying Certificate no less than 180 days prior to obtaining the related building permits. According to the response, standard operating procedures that the Board approved in September 1999 require an applicant to submit a letter of intent 90 days prior to receiving a building permit and submit the Qualifying Certificate application within 90 days of receiving the building permit. To support the 90-day lead time, the Authority stated that investors preferred to maintain their confidentiality for competitive protection for as long as possible, but acknowledged that investors for construction-intensive projects usually announce plans 6 months in advance. The Authority concurred with the part of the recommendation to clearly define the circumstances under which lower than maximum tax benefits can be granted. The Authority criticized the report by stating that it focused entirely on tax revenue generation and did not consider other economic aspects such as job generation, cash injection, circulation of money in the economy, and other taxes generated. The Authority questioned the report's figure of 15 hotels constructed during the decade of the 1990s without Qualifying Certificates. The Authority also stated that the finding gave "no credence . . . to the fact that all economic indicators provided by the Guam Visitors Bureau in the latter part of 1995 indicated that visitors to Guam would exceed 2 million by the year 2000."

Office of Inspector General Reply. Although not specifically stated in the body of the report, we acknowledge that businesses participating in the Qualifying Certificate Program contribute significantly to the economy of Guam, both in terms of net taxes paid and employment opportunities for Guam residents. However, we believe that the Authority should also attempt to maximize revenues for the Government of Guam to the greatest extent possible. This is especially important at a time when the Government of Guam is experiencing serious financial problems and is having difficulty meeting day-to-day operating expenses. The focus of this report has been to recommend changes to the Qualifying Certificate Program that should help to generate additional tax revenues from program participants.

Coincidentally, as this report was being finalized for issuance in September 2001, the Bank of Hawaii had recently issued a report⁵ on the economy of Guam that painted a rather bleak picture for the near-term future of Guam's hotel/tourist industry. The report cited statistics, provided by

⁵"Guam Economic Report, 2001" issued by the Bank of Hawaii in August 2001.

the Guam Visitors Bureau, which indicate that in the year 2000 there were only 1.2 million (rather than the hoped for 2 million) visitors, on average only 63 percent of Guam's 10,050 existing hotel rooms were occupied, and average room rates had dropped to \$100 per night from \$130 per night in 1999. All of these numbers suggest that, at least until a turnaround is experienced in the Asian (and primarily Japanese) economies, the Guam hotel/tourist industry may have reached a saturation point. Even the Authority's response acknowledges that development in the primary Tumon tourist district may have reached a saturation point. In that light, we made the recommendation that the Authority stop issuing Qualifying Certificates for new projects in established tourist areas of Guam. We believe that this would be a prudent course of action, at least until such time as there are positive signs that the number of visitors to Guam is again on the increase and that the demand for additional hotel rooms and tourist facilities will also increase beyond existing capacities.

We likewise believe that it would be a prudent course of action, in order to maximize tax revenues, to refrain from granting Qualifying Certificates to hotels and other tourist facilities that are already operational. During the audit period, 10 of the 13 applicants that were approved for Qualifying Certificates in the hotel/tourist business were either already established on Guam or already committed to starting their projects, as evidenced by their having completed financial and architectural plans and secured building permits or leases. These businesses hired employees and invested funds to maintain a predetermined level of service and paid the requisite taxes thereon, and would have done so even without receiving Qualifying Certificates. Additionally, our audit disclosed (and we confirmed, despite the questions raised in the Authority's response) that 15 hotels were constructed during the decade of the 1990s without receiving Qualifying Certificates, that 11 of the 15 hotels met the Authority's 100-room minimum eligibility requirement, and that 6 of those 11 hotels also met the Authority's requirements to be classified as "First Class Hotels." The other 5 hotels met lesser requirements for classification as "Business Class Hotels" or "Motels."

Lastly, the amendments to the standard operating procedure that were approved by the Authority's Board on September 24, 1999 did not include any requirement for a letter of intent, as the Authority claimed in its response. Since our recommendation ties the lead time of 180 days to the building permit issuance date, the recommended requirement for a letter of intent would involve only applicants who were constructing new or expanded facilities. Because the Authority conceded, in its response, that investors for such projects generally announce construction plans about 6 months (180 days) in advance, we stand by our recommendation for a 180-day lead time for the submission of letters of intent.

Recommendation 2. Concurrence.

Guam Economic Development Authority Response. The Authority stated that it will continue to refine, improve, and expand its existing economic model to more accurately quantify all direct and indirect costs of the Qualifying Certificate Program.

Office of Inspector General Reply. We acknowledge that the Authority uses an economic model for comparing the benefits to be gained by Guam with the tax incentives granted Qualifying Certificate recipients. However, that model is flawed in that it does not include

infrastructure impact costs that are to be borne by the Government to upgrade such utilities as power, water, and sewerage treatment. Also absent from the existing model are the costs of other Government services, such as police and fire protection. As a result, the actual cost to the Government for granting tax incentives is understated, and any decision to recommend approval for granting Qualifying Certificates based on the existing model will be made without complete information.

Recommendation 3. Concurrence.

Guam Economic Development Authority Response. The Authority stated that since 1995, it had develop its own form for providing economic analyses of the costs and benefits of Qualifying Certificates and that this form considers the Government's permitting process through the Territorial Land Use Commission and the economic impact to Guam's infrastructure. The Authority also stated that it will continue to improve its methods to provide a more comprehensive model that will account for other direct and indirect costs to the Government.

Office of Inspector General Reply. Our review of the analysis form used by the Authority for reviewing applications processed during the audit period disclosed that the form did not quantify any of the costs that may have been identified in the Territorial Land Use Commission's permitting process, nor does it address the economic impact to Guam's infrastructure as claimed by the Authority in its response.

B. COMPLIANCE WITH QUALIFYING CERTIFICATES

The Guam Economic Development Authority improperly granted tax abatements of \$459,777 to beneficiaries that were not in compliance with their Qualifying Certificates, apparently used surveillance fees of about \$220,000 for purposes other than monitoring beneficiary compliance, and authorized beneficiaries to receive additional tax benefits of at least \$815,990⁶ while concurrently allowing the beneficiaries to not employ about 371 Guam residents. This occurred because the Authority did not effectively monitor Qualifying Certificate beneficiaries to ensure that they complied with their contractual commitments, including their agreements to employ a specified number of Guam residents. Instead, the Authority recommended that the Governor grant the beneficiaries temporary employment waivers. Additionally, the Authority apparently did not use available financial resources to employ and train compliance staff.

Legal Requirements

The Guam Code Annotated (12 G.C.A. § 58111) provides that a Qualifying Certificate can be suspended, rescinded or revoked by the Governor, upon the recommendation of the Authority, for fraud, noncompliance with the Certificate, bankruptcy, dissolution or death, or noncompliance with laws and rules. Part II, Section 6, of the Authority's Rules and Regulations provides that when the Authority has determined that the terms and conditions of a Qualifying Certificate have been fulfilled by the recipient, the Authority "shall forward a 'Certificate of Compliance' together with a copy of the recipients' corporate income tax return and certified financial statements to the Department of Revenue and Taxation." Section 7a states, "When it has been determined by the Administrator that the terms and conditions stipulated on the Qualifying Certificate, a provision of law or a requirement imposed by these rules have not been met, then the Administrator shall notify the Beneficiary in writing of the specifics of the non-compliance and provide reasonable time limit in which to correct the discrepancy."

Compliance Monitoring

We examined the Authority's compliance monitoring for 25⁷ of the 31 Qualifying Certificates active during fiscal years 1997, 1998, and 1999. During the 3 fiscal years, the Authority (1) did not have a formal inspection program in place; (2) did not perform all required inspections; (3) did not prepare written inspection reports; and (4) issued Certificates of Compliance authorizing five beneficiaries to receive tax benefits, although the beneficiaries were not in compliance. Further,

⁶The actual total of tax benefits may be significantly greater. Information on income tax and dividend income tax rebates for 1999 was not available because beneficiaries had filed extensions to file income tax returns. Also, information was not available on tax benefits from business privilege (gross receipts) and use taxes that could be due to one beneficiary.

⁷The 25 Qualifying Certificates reviewed consisted of 8 held by corporations in the hotel industry: 2 held by other non-hotel tourism corporations; 9 held by medical industry, insurance, and communications industry corporations; and 6 held by shareholders of corporations holding qualifying certificates.

the Authority used an estimated \$220,000 in surveillance fees for other Authority operations. The Administrator stated that the Authority's compliance monitoring efforts were hindered by a shortage of trained personnel but that efforts were ongoing to improve the monitoring program. In August 1999, the Authority increased its monitoring efforts, and we therefore extended the period of our review to evaluate these efforts. Although significant progress was made, as of June 30, 2000, additional improvements were still needed. As a result of the deficiencies noted, the Government of Guam may lose tax revenues of at least \$459,777.

Inspections. Section 3a of the Rules and Regulations requires that on-site inspections be performed at least semiannually, and Section 4 requires that detailed inspection reports be prepared within 15 working days of the dates of inspections. Despite these requirements, during fiscal years 1997, 1998, and 1999, the Authority documented that it had performed only 31 of the 90 required on-site inspections. Since only inspection dates were documented, we could not determine if the reports were prepared in a timely manner.

According to the Authority's Chief Financial Officer, beginning in August 1999, the Authority increased the amount of resources and the priority given to its compliance monitoring program. Therefore, we extended our review to assess compliance monitoring efforts through December 31, 1999 and the Authority's actions through June 30, 2000 related to identified monitoring issues. Although the level and the effectiveness of monitoring activity increased during fiscal year 1999 and the first 3 months of fiscal year 2000, as of June 30, 2000, the Authority had not adopted a formal monitoring program, had performed only 6 of the 38 required inspections, and had not issued written monitoring reports on 32 inspections performed during calendar year 1999. The Authority's Programs and Compliance Officer stated that the requirement for semiannual inspections could not be met with the available staff and that the procedures to formalize the compliance monitoring process were still in the draft stage.

Certificates of Compliance. During fiscal years 1997 and 1998, the Authority determined that five beneficiaries were not in compliance with their Qualifying Certificates but did not issue notices of noncompliance in a timely manner. Further, in three instances in fiscal year 1997 and four instances in fiscal year 1998, the Authority issued Certificates of Compliance although the recipients were not in compliance with requirements of their Qualifying Certificates. Based on these incorrectly issued Certificates of Compliance, as of June 30, 2000 the beneficiaries had improperly received abatements of property taxes and/or rebates of income taxes totaling \$459,777. The Authority subsequently recommended granting waivers to two beneficiaries for another eight instances of noncompliance during fiscal years 1998 and 1999 (see "Temporary Employment Waivers" in this finding).

Surveillance Fees. The Guam Code Annotated (12 G.C.A. § 58144 and 58145) provides for the recovery of extraordinary costs incurred to "process the application or monitor the Beneficiary's performance of the terms and conditions of the Qualifying Certificate" and for a periodic adjustment of fees "upon demonstration to the Authority by the Administrator that the cost of performing the services covered by the fees is greater than the amount of the fees." Although there was no specific legal requirement to restrict the use of the surveillance fees to compliance

monitoring, the cited provisions clearly allow the use of the fees to finance the Authority's monitoring efforts, particularly since Authority officials cited the lack of adequate staff to effectively carry out the monitoring program. Despite these factors, during fiscal years 1997, 1998, and 1999, the Authority used only \$463,706⁸ of the surveillance fee collections totaling \$683,605 to cover the costs of the compliance process. The approximately \$220,000 balance of the surveillance fees was apparently used to fund other Authority operations. According to the Deputy Administrator and the Chief Financial Officer, the Authority needed these funds for nonmonitoring expenses because other funding sources were inadequate to cover the Authority's operating expenses.

Temporary Employment Waivers

During fiscal year 2000, the Authority recommended that the Governor retroactively approve temporary employment waivers for seven beneficiaries included in our review. The seven beneficiaries⁹ requested the waivers after the Authority issued a total of 21 letters of noncompliance to them during fiscal year 1999. The letters notified the beneficiaries that they had not met the minimum employment levels required in their Qualifying Certificates. According to the Qualifying Certificates, six of the seven beneficiaries¹⁰ were required to employ a total of 1,777 Guam residents. However, the Authority determined that during fiscal year 1999, the six beneficiaries employed an average total of only 1,504 Guam residents, or 273 fewer than required by the Qualifying Certificates.

As of June 30, 2000, the Governor had approved four waivers and was considering two other waiver recommendations. The written justifications for the waivers stated that six of the waivers were necessary because of declining economic conditions on Guam and that the other waiver was necessary because of damage from the December 1997 Typhoon Paka. Further, the waivers retroactively approved the beneficiaries' receipt of fiscal year 1998 tax abatements totaling \$481,495. However, we noted that the four businesses whose waivers had expired had still not hired the required number of employees. As a result of the waivers, the Government of Guam lost tax revenues of at least \$815,990,¹¹ and as of June 30, 2000, the six beneficiaries employed 371 fewer employees than required in their contracts, as shown in Table 2.

⁸Since the Authority did not identify its costs for the compliance process, we estimated these costs by allocating personnel and administrative expenditures based on observations and employee interviews. For the three fiscal years, we estimated that the Authority incurred \$278,472 in personnel and \$185,234 in administrative costs for compliance monitoring.

⁹The Authority recommended temporary employment waivers for eight beneficiaries, including the seven in our sample. As of June 30, 2000, the one beneficiary not included in our review employed 55 fewer persons than the number required in the Qualifying Certificate and received tax benefits totaling at least \$186,789.

¹⁰We did not include one of the seven beneficiaries because the Qualifying Certificate was unclear regarding the employment requirements.

¹¹To avoid duplicate counting elsewhere in this finding, only \$634,340 of this amount was included in Appendix 1.

Table 2. Qualifying Certificate Waivers of Employment Requirements

Effective Date of QC	Number of Employees Required	Average No. of Employees in FY 1999	Date Waiver Requested	Calender Year Period of Waiver	Number of Employees at 06/30/00	Difference From No. Required
10/24/86	280	274	11/26/99*	1999	272	8
06/12/87	360	330	02/16/00**	1999/2000	283	77
04/11/91	327	219	11/09/99*	1998/1999	223	104
05/01/96	150	133	01/12/00**	1999/2000	140	10
09/05/97	520	422	10/19/99*	1998/1999	364	156
05/01/98	<u>140</u>	<u>126</u>	01/13/00*	1999	<u>124</u>	<u>16</u>
Total	<u>1,777</u>	<u>1,504</u>			<u>1,406</u>	<u>371</u>

* Waivers were approved by the Governor of Guam on March 22, 2000.

** Waivers were approved by the Authority but, as of June 30, 2000, were still awaiting the Governor's approval.

According to Authority records, in one instance a beneficiary with a required employment level of 520 fell below the required level for the first time in January 1998. Subsequently, the beneficiary's employment level steadily dropped to 440 by January 1999 and to 390 by January 2000. During the period of March 3, 1999 to November 26, 1999, the Authority issued six letters of noncompliance to the beneficiary. On October 19, 1999, the beneficiary applied for a temporary employment waiver for calender years 1998 and 1999. On November 30, 1999, the Authority recommended that the waiver be approved because of "Guam's current economic condition" and the beneficiary's operating losses following a large investment in facility expansion. The Governor approved the waiver on March 22, 2000. Because of the waiver, the beneficiary received tax benefits of at least \$237,825 for fiscal year 1998 and at least \$90,825¹² for fiscal year 1999. The 2-year retroactive waiver expired on December 31, 1999, but the beneficiary continued to reduce the number of employees rather than increase employment in compliance with the Qualifying Certificate. As of June 30, 2000, the beneficiary's total employment was 364, or 156 (30 percent) below the required level.

In our opinion, the Authority should have either negotiated with the beneficiaries to reduce the value of the tax benefits received or suspended the Qualifying Certificates until such time as the beneficiaries meet the hiring levels. Under the law, the Governor of Guam upon recommendation of the Authority also could revoke or the beneficiaries could relinquish their certificates. By granting waivers to the noncompliant beneficiaries, the Authority unilaterally gave up at least 371 jobs the beneficiaries had agreed to provide to Guam residents while allowing the same businesses to continue receiving their full tax benefits. We believe that these actions also could have provided the beneficiaries a competitive advantage versus other similar businesses by allowing them to reduce their operating costs while continuing to receive the tax benefits.

¹² Additional tax benefits may have been received from income tax rebates and business privilege (gross receipts) and use tax abatements. However, we were unable to readily quantify such benefits based on available Government of Guam records.

Recommendations

We recommend that the Chairman of the Board of Directors of the Guam Economic Development Authority direct the Authority's Administrator to:

1. Develop and submit to the Board for adoption policies and standard operating procedures to ensure that the Authority limits the use of surveillance fees to pay personnel and other expenses related to monitoring the compliance of beneficiaries with the requirements of their Qualifying Certificates and tracks surveillance costs to determine if surveillance fees need to be adjusted.

2. Finalize and submit to the Board for adoption formal procedures for the compliance monitoring program.

3. Provide training to compliance monitoring staff to ensure that all aspects of the monitoring process are performed in a consistent and timely manner.

4. Develop and submit to the Board for adoption regulations to quantify the cost to the Government of Guam and to the Guam workforce of temporary waivers and require negotiations to ensure that beneficiaries either give up a portion of their benefits in exchange for waivers of certificate requirements or suspend certificate benefits pending correction of the noncompliance issues.

Guam Economic Development Authority Response and Office of Inspector General Reply

In the August 10, 2001 response (Appendix 2) to the draft report from the Authority's Chairman of the Board, the Authority concurred with Recommendations 2 and 3, and did not concur with Recommendations 1 and 4. Based on the response, we requested additional information for Recommendations 2 and 3, and requested that the Authority reconsider Recommendations 1 and 4, which are unresolved (see Appendix 3).

Recommendation 1. Nonconcurrence.

Guam Economic Development Authority Response. The Authority stated that the recommendation was unnecessary because the costs of the monitoring function exceeded the revenues from surveillance fees. Furthermore, Authority stated that the annual salaries and benefits of the division manager and the four full-time staff personnel exceeded the average annual surveillance fee collections.

Office of Inspector General Reply. The Authority's response allocated 100 percent of the salary and fringe benefit costs for the compliance division manager and staff to Qualifying Certificate monitoring activities and concluded that those costs exceeded surveillance fee

collections. However, in addition to the Qualifying Certificate Program, the compliance division was also responsible for performing compliance monitoring activities for the Authority's loan and leasing programs. Because the surveillance fees were collected solely under the Qualifying Certificate Program, we believe that, for comparative purposes, only the costs associated with Qualifying Certificate compliance monitoring efforts should be considered. Therefore, we estimated that the Authority applied about \$220,000, almost one-third of the surveillance fees collected, to other operations.

Recommendation 2. Concurrence.

Guam Economic Development Authority Response. The Authority agreed that the adoption of formal standard operating procedures for compliance monitoring is essential, and stated that it had drafted standard operating procedures for compliance monitoring of the Qualifying Certificate Program. The Authority stated that the standard operating procedures will add to the already-developed and approved procedures for the underwriting process, as developed by the Authority's Industry Development Division. The Authority also stated that its objective was to obtain Board approval of the compliance monitoring procedures before the end of fiscal year 2001.

Office of Inspector General Reply. The response did not specifically state when the Administrator will finalize and submit the compliance monitoring procedures to the Board for approval.

Recommendation 3. Concurrence.

Guam Economic Development Authority Response. The Authority agreed that formal training was needed for maintaining professional development in all aspects of the work place. However it disagreed that compliance monitoring was not done in a consistent and timely manner as a result of not having training opportunities. The Authority stated that monthly reports were provided to the Board on a timely basis and that annual compliance reports were completed in accordance with Part 2 of the Rules. The Authority also stated that the economic hardship experienced by the entire Government of Guam minimized some costly training opportunities, but that cross-training, statutory review, program evaluation, and assessment training were provided to the compliance staff.

Office of Inspector General Reply. Although we commend the Authority for providing informal, on-the-job training opportunities to the compliance staff, the response did not indicate if and when formal training would be provided.

Recommendation 4. Nonconcurrency.

Guam Economic Development Authority Response. The Authority stated that the law already provides it with the authority to negotiate the specific conditions of Qualifying Certificates. The Authority also asserted that it acted in accordance with the Qualifying Certificate law when

issuing the temporary waivers. With regard to the related finding, the Authority stated that the correct legal citation for the finding is 12 G.C.A. § 58126, and not 12 G.C.A. § 58111.

Office of Inspector General Reply. We cited 12 G.C.A. § 58111 because this provision lists the grounds, most notably noncompliance, for which a Qualifying Certificate can be suspended, rescinded, or revoked. Such remedial action can be taken when the certificate holder has not corrected its noncompliance with the Qualifying Certificate law, applicable rules and regulations, or any condition or obligation in the Certificate after having been notified by the Authority in writing of such failure to comply and after having been given by the Authority a reasonable period of time within which to correct such failure. This provision of the law was therefore cited as the criteria for actions the Authority should take in enforcing compliance with the terms and conditions of Qualifying Certificates. In contrast, 12 G.C.A. § 58126, which was cited by the Authority, relates to actions (issuance, modification, renovation, and suspension) on Qualifying Certificates that may be recommended by the Board to the Governor of Guam and the timetable for the Governor's approval or disapproval of such action.

The Authority processed temporary waivers from employment or other conditions in the Qualifying Certificates as modifications to the Certificates. In our opinion, it was not a good policy for the Authority to routinely recommend such modifications to ease the Certificate terms and conditions without negotiating corresponding reductions of tax benefits granted to the certificate holders whenever the holders did not meet the requirements it had agreed to at the time the Qualifying Certificates were issued. The temporary waivers cited in the finding were granted primarily to certificate holders who were chronically in a noncompliance status. By definition, the Qualifying Certificate is a contract between the Government of Guam and a beneficiary who has qualified for tax rebates and/or abatements in return for meeting certain employment, investment, and other requirements. The seemingly routine retroactive approval of waivers by the Authority, as disclosed in the finding, negated the rationale for the beneficiary to comply with its obligations (i.e., the terms and conditions of the Qualifying Certificate) and reduced compliance monitoring to a "window-dressing" process. There should be a penalty (such as relinquishment or reduction of tax benefits) associated with the waiver of Certificate requirements, especially in the case of chronically noncompliant beneficiaries.

C. ABATEMENT OF GROSS RECEIPTS AND USE TAXES

Gross receipts taxes of more than \$5 million and an undetermined amount of use taxes were abated improperly and without verification of the amount or eligibility. This occurred because the Guam Economic Development Authority did not ensure that the Guam Department of Revenue and Taxation and the Guam Customs and Quarantine Agency correctly granted Qualifying Certificate abatements of gross receipts and use taxes. Because of an oversight, the Authority had not initiated action to coordinate and develop monitoring procedures with these two agencies to ensure that gross receipts and use taxes were abated only on eligible expenditures. In addition, the Authority had misinterpreted a Board of Director's resolution and thought it had removed the requirement to monitor contractor claims for gross receipt tax abatements.

Gross Receipts Taxes

The Guam Code Annotated (12 G.C.A. § 58127.5) provides that gross receipts taxes may be abated for periods of up to 20 years (renewable for additional 20-year periods) for qualified insurance companies. The Code (12 G.C.A. § 70105(a)) also provides that contractors working on hotels, other tourist facilities, or affordable housing developments may also receive gross receipts tax abatements. In both instances, eligibility for the abatements is to be evidenced by Qualifying Certificates issued by the Authority.

Of the 31 Qualifying Certificates active as of December 31, 1999, 6 Certificates included the abatement of gross receipts taxes for insurance companies and 1 included the abatement of gross receipts taxes for 20 contractors working on a hotel expansion project. To evaluate the abatement process and determine the amount of gross receipts taxes abated, we reviewed available records at the Business Privilege Branch of the Department of Revenue and Taxation.

Insurance Companies. During fiscal years 1998 and 1999, Revenue and Taxation officials incorrectly accepted and processed claims for gross receipts tax abatements from four of the six insurance company beneficiaries based on copies of the beneficiaries' Qualifying Certificates that were attached to gross receipts tax returns. The Supervisor of the Business Privilege Branch said she did not know that the Authority issued Certificates of Compliance which were required before tax abatements should be approved. The Deputy Tax Commissioner, Department of Revenue and Taxation, stated that the Department did not have procedures for administering gross receipts tax abatement claims and that he had understood that the Authority would draft such procedures. In addition, until May 2000, Authority personnel had not coordinated with Revenue and Taxation gross receipts tax personnel to assist in processing gross receipts tax abatement claims. Further, according to the Authority's Compliance and Internal Auditing Supervisor, the Authority had not prepared or adopted procedures to either monitor or process the actual granting of gross receipts tax abatements. As a result, Revenue and Taxation officials incorrectly authorized abatements of gross receipts taxes totaling at least \$2,902,598, including \$677,802 to three beneficiaries whom the Authority had determined were not in compliance with their Qualifying Certificates, as shown in Table 3.

Table 3. Insurance Company Gross Receipts Taxes Improperly Abated

<u>Effective Date of QC</u>	<u>Amount of Taxes Abated</u>	<u>Taxes Abated Although</u>		<u>Tax Revenue At Risk of Loss</u>
		<u>Not in Compliance</u>	<u>Unauthorized*</u>	
12/02/97	\$679,528	\$171,313	\$508,215	\$679,528
01/01/98	1,008,749	478,774	292,605	771,379**
01/01/98	1,281,112	-	1,281,112	1,281,112
10/01/98	<u>170,579</u>	<u>27,715</u>	<u>142,864</u>	<u>170,579</u>
Total	<u>\$3,139,968</u>	<u>\$677,802</u>	<u>\$2,224,796</u>	<u>\$2,902,598</u>

* The Authority had not made a determination of compliance or issued certificates of compliance on these abatements. Therefore, some or all of these amounts may retroactively be determined to be authorized.

** This company subsequently declared bankruptcy.

Construction Companies. On June 5, 1998, the Authority issued a Qualifying Certificate to a corporation for a major hotel expansion project. Through the Qualifying Certificate, 20 different contractors received special certificates authorizing each contractor to receive a tax abatement for work related to the expansion project. The contractors were required to certify that all tax abatements received were passed on to the hotel. Based on documents obtained from the Department of Revenue and Taxation, as of March 31, 2000, 11 of the 20 contractors had made a total of 55 claims for abatement of gross receipts taxes. Only 1 of the 55 abatement claims was supported by a Certificate of Compliance issued by the Authority. Instead, the 11 contractors submitted gross receipts tax returns with copies of the Qualifying Certificates and claimed tax abatements of at least \$2,116,966. As of the time of our review, Revenue and Taxation had processed and approved the tax returns related to abatements totaling \$432,782 but had not yet processed the tax returns for the remaining \$1,682,184 in claimed abatements.

According to Authority personnel, the Authority had not implemented a compliance review process because they thought that a Board of Director's resolution exempted the contractors from all monitoring requirements. However, although Board of Director's Resolution 99-030, approved on June 23, 1999, exempted the contractors from complying with four Qualifying Certificate requirements, the resolution added a requirement that the contractors were to submit statements prepared by independent accountants documenting the amount of expenditures qualifying for the gross receipts tax abatements. As of June 30, 2000, the Authority had not received any of the required independent accountants' statements. Without a review process for the tax abatement claims, the validity of the claims could not be determined and there was a potential for a contractor to claim abatements for taxes based on revenues from sources other than the hotel expansion project. For example, we noted that 4 of the 11 contractors who submitted claims had included gross receipts tax abatements totaling \$21,788 more than the Authority had initially authorized based on the approved construction contracts provided to the Authority.

Use Taxes

The Guam Code Annotated (11G.C.A. § 28103 and § 28104) provides that an excise tax of 4 percent will be levied on the use or consumption of all property brought into Guam. In accordance with the Code (11G.C.A. § 28105(e)), the tax is collected by the Guam Customs and Quarantine Agency on behalf of the Department of Revenue and Taxation. The Code (12 G.C.A. § 70105 (b)) also provides for an exemption (abatement) for property to be used to construct, furnish, and equip hotels and tourist facilities. Lastly, the Code (11 G.C.A. § 28105(f)) authorized the Department of Revenue and Taxation to promulgate rules and regulations to enforce the use tax law.

During fiscal years 1997 and 1998, the Authority issued Qualifying Certificates to two beneficiaries granting them the right to receive use tax abatements on the hotel renovation projects. The Director of the Guam Customs and Quarantine Agency stated that Customs did not determine and could not provide information on the total amount of use taxes abated for the two beneficiaries because the agency collects information only on taxes collected. The Director also said that, as of June 30, 2000, the Department of Revenue and Taxation had not provided rules and regulations for collection of the use tax, as required by the Guam Code Annotated.

Although specific information was not available to determine the amount of use tax abatements, we estimated that the amount of use tax eligible for abatement for one of the two hotel projects was about \$180,000, based on an estimated cost for furniture and fixtures of \$4.5 million and taxed at a 4 percent rate. According to a Customs official, Customs personnel authorized companies to receive, without payment of the use tax, otherwise taxable property based on photocopies of their Qualifying Certificates. There were no procedures to ensure that the recipients of the tax abatements were in compliance with the Qualifying Certificates or that the furniture and fixtures were destined for projects included in the Qualifying Certificates. Although the unavailability of appropriate documents prevented us from specifically identifying potential improper abatements, in our opinion, the lack of adequate internal control procedures may have allowed otherwise taxable furniture and fixtures to avoid taxation.

Recommendations

We recommend that the Chairman of the Board of Directors of the Guam Economic Development Authority direct the Authority's Administrator to:

1. Coordinate with the Department of Revenue and Taxation to develop and implement procedures to ensure that gross receipts tax abatements are granted only to applicants who comply with their Qualifying Certificate requirements.
2. Coordinate with the Director of the Customs and Quarantine Agency to develop and implement procedures to ensure that use tax abatements are granted only to applicants who comply with their Qualifying Certificate requirements.

3. Develop and implement procedures to ensure that contractors submit the required independent accountants' statements, that the statements are matched with tax abatement claims before Certificates of Compliance are issued, and that the original Qualifying Certificate beneficiaries are notified of the amount of tax abatements received by each subcontractor covered under the primary Qualifying Certificates.

4. Review the questioned gross receipts tax and use tax abatements discussed in this finding to determine whether the tax abatements were allowable and, if not allowable, apprise the Department of Revenue and Taxation of the need to collect the improperly abated taxes.

Guam Economic Development Authority Response and Office of Inspector General Reply

In the August 10, 2001 response (Appendix 2) to the draft report from the Authority's Chairman of the Board, the Authority concurred with Recommendations 1 and 2, and did not concur with Recommendations 3 and 4. Based on the response, we requested additional information for Recommendations 1 and 2, and requested that the Authority reconsider Recommendations 3 and 4, which are unresolved (see Appendix 3).

Recommendations 1 and 2. Concurrence.

Guam Economic Development Authority Response. The Authority stated that it is critical for all agencies to meet regularly to develop and implement procedures not only for the issuance of gross receipts tax exemptions, but for other tax incentives offered by the Qualifying Certificate Program. The Authority also stated that it has regularly coordinated with the Department of Revenue and Taxation to discuss program guidelines and the compliance status of each beneficiaries. The Authority further stated that Qualifying Certificate Program guidelines and policies only require the Authority to coordinate with the Department of Revenue and Taxation, but that the Authority will "make a more concerted effort to involve the Customs and Quarantine Agency in its meetings and to better establish program control measures."

Office of Inspector General Reply. Had good coordination occurred between the Authority and the Department of Revenue and Taxation, there would not have been the situation where beneficiaries were able to file for and obtain the abatements from Revenue and Taxation without input from the Authority as to the beneficiaries' compliance status. Apparently, there was inadequate communication between the two agencies as to the requirements for abatement filing. This is why we believe that the Authority should ensure that the coordination procedures are formalized in writing and approved by the Department of Revenue and Taxation, the Custom and Quarantine Agency, and the Authority's Board.

Recommendation 3. Nonconcurrence.

Guam Economic Development Authority Response. The Authority agreed that procedures are needed to ensure that the accountants' statements are matched to tax abatement claims, and stated that this practice has been addressed in draft standard operating procedures.

However, the Authority disagreed that a Certificate of Compliance must be issued prior to the tax abatement claims. The Authority indicated that if the beneficiary is found to be in noncompliance at the year-end review, the tax incentives must be reimbursed with penalties.

Office of Inspector General Reply. Beneficiaries are already required to submit detailed monthly reports to the Compliance Division, therefore the monthly accountants' financial statements should not be an undue burden for the beneficiaries to submit or for the Authority to review. Additionally, we found no indication during the audit that the Authority had matched the accountants' statements with the contractors' abatements.

Recommendation 4. Nonconcurrency.

Guam Economic Development Authority Response. The Authority stated that the recommendation should be addressed to the Department of Revenue and Taxation, but stated that it "does take note of this issue and will separately discuss the issue" with the Department of Revenue and Taxation. The Authority also stated that the Qualifying Certificate law authorizes the Tax Commissioner of Guam to issue rules as deemed necessary to implement the procedures outlined in Chapter 58 of the Qualifying Certificate law.

Office of Inspector General Reply. The issue is not the need for the issuance of rules to implement the procedures outlined in the Qualifying Certificate law (12 G.C.A. Chapter 58), but the need for the Authority to coordinate with the Department of Revenue and Taxation regarding the questioned tax abatements discussed in the finding. We have revised the recommendation to require that the Authority review the questioned gross receipts tax and use tax abatements to determine whether the tax abatements were allowable and, if not allowable, to apprise the Department of Revenue and Taxation of the need to collect the improperly abated taxes.

D. REINVESTMENT OF TAX BENEFITS

Legally mandated investments in Guam's economy totaling at least \$2.3 million may not have taken place because the Guam Economic Development Authority did not include language in Qualifying Certificates requiring beneficiaries to reinvest tax benefits and, for those Certificates that included the reinvestment requirement, did not monitor the beneficiaries' compliance. This occurred because the Authority's (1) procedures did not require and staff neglected to include the necessary language in Certificates amended after passage of the law requiring benefit reinvestment and (2) management was unclear on how to determine compliance with the reinvestment requirement.

Reinvestment Requirement

The Guam Code Annotated (12 G.C.A. § 58142) requires that each recipient of a Qualifying Certificate, except insurance carriers, invest in the Guam economy no less than 50 percent of any taxes rebated or abated for a period of 5 years following the rebate or abatement. Beneficiaries are also required to provide reports identifying the amounts reinvested during each fiscal year. The law became effective on December 29, 1994, and the Authority should have included this requirement in all applicable Qualifying Certificates issued or amended after that date.

During the period of December 29, 1994 to December 31, 1999, the Authority issued or amended eight Qualifying Certificates that appear to be subject to the reinvestment requirement law. We determined that the Authority included the required language in six new Qualifying Certificates that were issued during this period. However, the Authority did not include the requirement in two Qualifying Certificates that were amended in November 1995 and June 1998, respectively. The Authority's Deputy Administrator and the Chief Financial Officer could not explain how this oversight occurred. However, we noted that the Authority's Rules and Regulations and standard operating procedures for issuance of Qualifying Certificates did not include a requirement to ensure that the required reinvestment clause was included in all new and amended Qualifying Certificates. The Authority's Administrator stated that the Authority could amend the Certificates to include the 50 percent reinvestment requirement.

Based on tax information available as of June 30, 2000, we determined that the two beneficiaries with amended Qualifying Certificates had received rebates and abatements for fiscal years 1997 and 1998 that totaled \$3,626,027 and that the beneficiaries may receive substantial future rebates and abatements. As a result of not including the reinvestment clause in the two amended Qualifying Certificates, Guam's economy may lose additional investments of at least \$1,813,013¹³ as follows:

- Effective November 28, 1995, the Authority issued an amendment to a hotel's existing Qualifying Certificate, incorporating the hotel's new expansion and existing facilities for an additional 5 years. The amended Certificate did not include a clause requiring the hotel to reinvest

¹³To avoid duplicate counting elsewhere in this finding, only \$1,472,530 of this amount was included in Appendix 1.

50 percent of tax benefits. We determined that the hotel received corporate income tax rebates of \$2,945,060 for fiscal years 1997 and 1998, and we estimated that the hotel should have reinvested about \$1,472,530 of the tax benefits in the island's economy.

- Effective June 5, 1998, the Authority issued a new Qualifying Certificate to another hotel, incorporating the hotel's new expansion and existing facilities for an additional 20 years. The new Qualifying Certificate did not include a clause requiring reinvestment of 50 percent of tax benefits. We determined that the hotel received tax abatements and rebates of at least \$680,967 for fiscal years 1997, 1998 and 1999,¹⁴ and we estimated that the hotel should have reinvested about \$340,483 of the tax benefits in the island economy.

Reinvestment Monitoring

The Authority was unable to document that any of the six beneficiaries with the reinvestment clause in their Qualifying Certificates had actually reinvested the required 50 percent of their tax benefits because none of the six beneficiaries had submitted the required reinvestment reports. Of the six beneficiaries, the Authority had determined that four were not in compliance with their Qualifying Certificates for fiscal years 1997, 1998 and 1999. Therefore, only two beneficiaries were authorized to receive and did receive tax benefits. Although the Authority began monitoring the reinvestment clause in August 1999, the Deputy Administrator and the Chief Financial Officer said that the law was ambiguous. The two officials said that there are many ways to "reinvest" and that there was not a clear definition in the law of the type of "reinvestment" that was to occur. They also said that without more detailed guidance, the Authority would find it difficult to enforce the reinvestment requirement. However, if the Authority does not enforce the reinvestment provision, the beneficiaries' 5-year reinvestment period could expire without any reinvestment occurring. As a result of not effectively monitoring and enforcing the reinvestment clause for the six beneficiaries, Guam's economy could lose at least \$526,633¹⁵ of additional investments, as shown in Table 4.

¹⁴The \$680,967 represents use tax exemptions, real property tax abatements and income tax rebates for fiscal years 1997, 1998 and 1999. Possible additional benefits from income tax rebates for fiscal year 1999 were not known at June 30, 2000.

¹⁵To avoid duplicate counting elsewhere in this finding, only \$265,948 was included in Appendix 1.

Table 4. Required Investment of Abated/Rebated Taxes

<u>Effective Date of Qualifying Certificate</u>	<u>Amount of Abated or Rebated Taxes</u>	<u>Reinvestment Amount at Risk of Loss</u>
05/01/96	\$192,720	\$96,360
09/05/97	<u>860,546</u>	<u>430,273</u>
Total	<u>\$1,053,266</u>	<u>\$526,633</u>

In our opinion, if the Authority had acted in an expeditious manner to resolve questions regarding the reinvestment law and enforced the reinvestment provision, Guam's economy would have benefitted from additional investments. Further inaction could deprive the economy of additional reinvestment opportunities. Although the exact definition of the 5-year reinvestment period is unclear, we presume that the period applies to the tax benefits received on a year-by-year basis. Therefore, it is possible that the 5-year period could act as a statute of limitations that relieves the beneficiaries of having to comply with the reinvestment requirement for each year in order to receive that year's tax benefits.

Recommendations

We recommend that the Chairman of the Board of Directors of the Guam Economic Development Authority direct the Authority's Administrator to:

1. Request that the Guam Legislature amend the Guam Code Annotated (12 G.C.A. § 58142) to clarify the types of reinvestment to be required of Qualifying Certificate beneficiaries and the meaning of the 5-year reinvestment period.
2. Amend the Qualifying Certificates that were issued after December 29, 1994, to include the reinvestment requirement mandated by the Guam Code Annotated.
3. Develop and implement rules and regulations and standard operating procedures to ensure that the Authority includes the reinvestment clause in all new and amended Qualifying Certificates and has a process to monitor compliance with the reinvestment requirement.

Guam Economic Development Authority Response and Office of Inspector General Reply

In the August 10, 2001 response (Appendix 2) to the draft report from the Authority's Chairman of the Board, the Authority concurred with Recommendations 1 and 3, and did not concur with Recommendation 2. Based on the response, we requested additional information for

Recommendations 1 and 3, and requested that the Authority reconsider Recommendation 2, which is unresolved (see Appendix 3).

Recommendation 2. Nonconcurrence.

Guam Economic Development Authority Response. The Authority stated that because the 5-year moratorium was lifted and the first Qualifying Certificate was issued in the summer of 1996, all Certificates include the reinvestment requirement in accordance with the Qualifying Certificate law. The Authority claimed that only one Qualifying Certificate (No. 219) did not include the reinvestment provision, but that the Certificate included the requirement that the recipient "comply with all laws of Guam and the rules and regulations of its various agencies, including and not limited to those set out in the [Qualifying Certificate] law, and in applicable rules and regulations." The Authority concluded that because of this general requirement, a specific reinvestment provision was not needed.

Office of Inspector General Reply. Despite the Authority's statement, two (not one) Qualifying Certificates did not include the reinvestment provision. The second such Certificate (No. 169) was an amendment to a prior Certificate that was essentially a new Certificate because it contained completely new terms and conditions and became effective on November 28, 1995, after the December 29, 1994 effective date of the revised Qualifying Certificate law (P.L. 22-159). Therefore, this Qualifying Certificate also should have included the reinvestment provision required by the new law. We acknowledge that the general compliance provision contained in Qualifying Certificate No. 219 requires the beneficiary to comply with provisions of the Qualifying Certificate law and applicable rules and regulations. However, in our opinion, it would be preferable for the Authority to amend the two Qualifying Certificates (Nos. 219 and 169) to specifically include the reinvestment provision.

CLASSIFICATION OF MONETARY AMOUNTS*

<u>Finding Area</u>	<u>Unrealized Revenues</u>	<u>Funds to Be Put To Better Use</u>
A. Approval of Qualifying Certificates		
Projects in Tourist Areas	769,650	\$28,528,822
Timing of Application Filings		24,266,430
Negotiation of Tax Benefits		17,966,784
B. Compliance with Qualifying Certificates		
Compliance Monitoring		459,777
Temporary Employment Waivers	634,340	
C. Abatement of Gross Receipts and Use Taxes		
Gross Receipts Taxes		5,019,564
D. Reinvestment of Tax Benefits		
Reinvestment Requirement		1,472,530
Reinvestment Monitoring		<u>265,948</u>
Total	<u>\$1,403,990</u>	<u>\$77,979,855</u>

*All amounts represent local funds.

GUAM ECONOMIC DEVELOPMENT AUTHORITY RESPONSE

Governor
Carl L. Gutierrez

Aturidad Inadilanton



Ikunumihan Guahan

Lieutenant Governor
Marilyn Z. Bordallo

August 10, 2001

Mr. Arnold L. Van Beverhout, Jr.
United States Department of the Interior
Office of Inspector General
North Pacific Region
415 Chalan San Antonio
Baltej Pavilion, Suite 306
Tamuning, Guam 96911

Dear Mr. Van Beverhout:

Attached, please find the Guam Economic Development Authority's (GEDA) "Response to the Department of Interior Inspector General's Preliminary Draft Report" for the draft audit submitted by you to the GEDA Chairman of the Board on June 25, 2001. This report is hereby submitted in compliance with your requested deadline of today.

If you should have any questions, please do not hesitate to call me at 647-4318.

Sincerely,

Eric Cepeda
Acting Administrator

Attachments

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**RESPONSE TO THE
DEPARTMENT OF INTERIOR
INSPECTOR GENERAL'S
PRELIMINARY DRAFT REPORT**

Response to the Department of Interior
Inspector General's Preliminary Draft Report

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PART I - INTRODUCTION

EXECUTIVE SUMMARY

This document is the Guam Economic Development Authority's (GEDA) response to the Department of Interior, Inspector General's "Preliminary Draft," audit report regarding the administration of the Qualifying Certificates Program and Loan Programs.

GEDA finds it necessary to expound on the intent of the statutory language and policy for the GEDA operates and disclose more of Guam's economic climate during the period for the scope of the audit to clarify or avoid any issues reported in the "Preliminary Draft," from being misconstrued by any reader of the report.

Statutory and Policy Intent

The intent of the Legislature for the Qualifying Certificate (QC) Program was to be used as an economic incentive tool to entice investors into Guam, and authorizes GEDA to administer, promote, and monitor the program necessary to establish or expand industries and services industries and services, to diversify Guam's economy, enrich its growth and enhance the quality of life in Guam. The Legislature at the time the law was adjudicated, affirms that the program must be expanded to attract investments in order to diversify Guam's economy.

At the conception of the QC Program, Guam's main focus was only on one industry. During the 1997, 1998, and 1999 period the program was evaluated, Guam's economy was at its lowest. Following a five moratorium (1990-1995) on issuing QCs, the government of Guam revitalized the program and developed additional legislation that promotes other industries through the QC Program. Such diversification has stimulated Guam's business climate and has created jobs that will provide benefits to the community. Insurance Business, Affordable Housing, Tourist Attraction, Guam-Based Trust, Captive Insurance, Telecommunication and soon, E Commerce activities are industries promoted by GEDA to diversify Guam's existing tourism industry.

VISION 2001 was the catalyst for developing additional industries through the program. The QC Program is only one avenue, which Guam was able to achieve its goal in the past four years. Other government of Guam agencies networked with GEDA to provide a holistic approach to economic development.

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The networking of resources between agencies was necessary to build and diversify Guam's industries. Through these programs, other industries are being developed. The report does not recognize the many accomplishments achieved by GEDA. The QC Program has evolved in its current state of complexity. As industries are developed and diversified, compliance monitoring procedures will develop and change. Complex tax issues, corporate structures, employee to room ratios, employee to service ratios, cross training, new technology, and economic models are constantly being addressed by GEDA. As the industry develops and changes so do our programs and procedures.

Key points noted in the audit report regarding the QC Program are the recognition of the legal mandate for GEDA to serve as a catalyst in the economic development of the island, and to do so by providing incentives to qualifying businesses under the QC program.

The report repeatedly asserts that GEDA has "foregone" revenues critical to the island, and strongly implies that certificates have been issued to companies not qualified for benefits. It is imperative for the integrity of the program, the public image of GEDA, and the overall economic health of Guam that this response adequately and undeniably establish that all certificates issued have been to the benefit of Guam to qualified businesses under the laws of Guam.

GEDA will demonstrate in this response the ways in which it has served as a true catalyst for significant (and positive) change¹ in Guam's recent economic history. While the report submitted by the Inspector General does provide a cursory overview of relative points about the QC program during the evaluation period, it offers no study of the significant changes that occurred in Guam's economy during the same period. No adequate assessment of successful economic catalyst activity can be made without recognizing the nearly insurmountable obstacles Guam faced in maintaining social order due to natural disaster and other unforeseen challenges, much less achieve economic growth during the audit reporting period (beginning of fiscal year 1997 through June 30, 2000).

Guam's Economic Climate 1997 - 2000

The audit submitted by the inspector general offers a simplistic and cursory proposal of perceived impacts of qualifying certificates issues, but in no way balances the decision of GEDA's board with the economic climate of an island facing military downsizing, a devastating

¹ Webster's Ninth New Collegiate Dictionary, copyright 1985, defines "catalyst" as "one that provokes significant change"

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typhoon, Korean Airline plane crash, and center point positioning for one of the most grave economic downturns faced since the Depression.

The report vaguely mentions the shattering consequences of Typhoon Paka in 1997, a storm that decimated the island with the strongest surface winds ever to hit the earth. The impact of rebuilding infrastructure, recouping tourism levels, and beautifying the island to retain investor interest can be most effectively compared to the economic impact of Hurricane Iniki on Guam's sister Pacific island of Kauai in 1992. Within three month's time, Guam's tourism industry was operating at near full capacity, and GEDA's qualifying certificate program continued to attract investors despite the multi-million dollar losses caused by Paka. Further, only three short years later, tourism levels have completely recovered. The island boasts new internationally renowned hotel chains, major attractions, and globally positioned corporations who domiciled in Guam during one of its darkest periods. Recovery of this magnitude took close to ten years for Kauai. GEDA strongly submits that this achievement is due in large part to the effective role it played in serving as a catalyst for growth during this time.

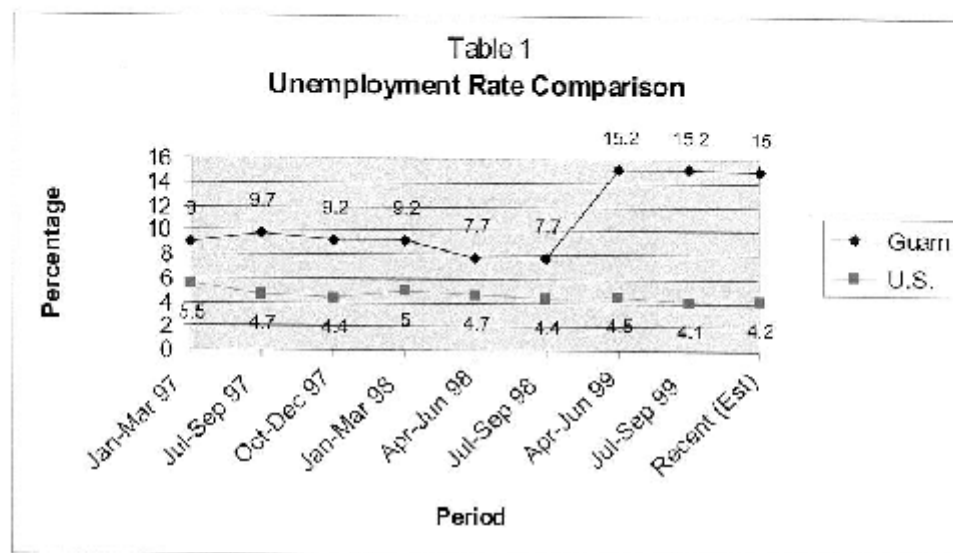
The audit report makes no mention of a cataclysmic event that totally destroyed the second largest market for Guam's lifeblood – the tourism industry. When KAL Flight 801 crashed into a Guam hillside in 1997 killing 254 passengers, the Korean market plummeted from Guam's number two visitor market position with three digit growth rates, to zero. A balanced or credible report on an effective economic response to such a disastrous economic blow would intrinsically require some commentary on the necessity of aggressive measures to fill the ensuing economic gap or at least propose more effective actions Guam could have pursued. No commentary is offered, and this response will show that all actions taken to aggressively pursue investment through the Qualifying Certificate program were not only necessary, but have already proven to provide benefit that will far surpass "foregone" taxes. Further, despite the insatiable need for investment, this report will easily demonstrate that all such certificates were afforded to qualified business as defined under the law.

Also not mentioned in the report was one of the most devastating global crises in the past two decades – the complete flattening of the Asian economy. Any factual and precise review of an economic program administered in the Pacific Rim during this period would absolutely require some analysis of what an appropriate response to maintaining a dollar based economy so closely tied to the strength of the yen, as is the case in Guam, should be.

Another key economic indicator not reflected in the report is the overall unemployment rate Guam had experienced from 1997 – 2000. The employment factor plays a key role and weighed

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heavily on decisions to provide economic incentives to businesses for job creation, employment stability or job retention. Although Guam's Department of Labor had not been able to issue consistent periodic quarterly reports, Table 1 shows the unemployment rates as compared to the U.S. rates². These figures would behoove any government entity to provide as many economic incentives as it can to stimulate some level of economic stability or recovery efforts.



Guam's rates are conducted quarterly, while the U.S. rates are monthly.
When viewing the U.S. rate, the percentage used is the end of the month for that quarter.

GEDA acknowledges that is not immune from oversight and any recommendation for improvement is always welcomed.

² Guam Department of Commerce Economic Reports and U.S. Bureau of Labor Statistics Data

PART II – QUALIFYING CERTIFICATES PROGRAM

Program Administration

The report contains no commentary of the actual “administration” of the program as it relates to processing, documentation, underwriting analysis or tracking. It is therefore presumed by GEDA that the audit found that said processes in the operations of QC applications are satisfactory.

If the ultimate decision made by GEDA’s Board of Directors in recommending or not recommending a QC is included in the audit’s definition of “effective administration”, GEDA again asserts that it has been supremely effective, given the conditions, which it faced and continues to face. While GEDA agrees with certain recommendations for refinement of the QC law it has maintained effective administration by reviving and nurturing a program that has been successful in fostering development even in the bleakest of economic times within the framework of the law. This is never disputed in the report. Without reference to other measures available to GEDA to foster development during the given time period, or even a broad reference to data substantiating the net negative impact of QC approvals, the only feasible conclusion is that the report’s findings are largely subjective.

Achievement of Objectives

§58100 of the Qualifying Certificate law establishes the legislative intent for the QC program and reads that the objective is to “diversify the island economy, enrich its growth, and enhance the quality of life on Guam.”

At the onset of the audit period, 100% of GEDA’s Qualifying Certificate beneficiaries were in the tourism industry. During the audit period, the program was used extremely effectively to diversify the island’s economic base. As a result the program successfully recruited 73 beneficiaries in the trust industry, seven in the insurance industry, two in affordable housing, three in medical services, one in manufacturing, one in telecommunications, and an additional eight in tourism related investments.

In total, these businesses in addition with existing QC beneficiaries created and/or retained a total of more than 3,700 jobs for the island during a time when double-digit unemployment rates have become the norm. Despite the fact that job creation is the primary eligibility criterion for all QC beneficiaries, the audit report makes absolutely no reference to employment generation and

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retention provided by the program. Further, the law cites no specific limitations to tax abatements and rebates, and does not even call for the tax impact analysis GEDA generates as part of its standard operating procedures. Implied in the law, as written, is the assumption that job generation of any kind (given that the law makes no specific requirement on number of jobs to be created) will generally outweigh any tax offset.

Despite the primary intent of the law, the audit focuses entirely on tax revenue generation and did not consider other economic aspects, such as job generation, cash injection and circulation of money in the economy, taxes generated beyond the scope of QC benefits (i.e. hotel occupancy tax, gross receipts taxes, payroll taxes, etc.), as well as secondary job and commercial activity generation for supporting business activity (i.e. outsourcing).

A. APPROVAL OF QUALIFYING CERTIFICATES PROGRAM

This response will quantitatively demonstrate that even if the report had addressed the aforementioned items, its numerous references to "foregone" taxes fail to take into account additional taxes (not subject to benefits under the qualifying certificate program) generated by these entities.

This response will also establish that GEDA has effectively met its mandate by playing an aggressive and successful role in generating unprecedented growth in a time when most investors would have fled. In the years reviewed, Guam's economic climate has been far from that of a perfect world, and has in fact teetered many times on the edge of ruin. Nevertheless, there is no exaggeration in stating that therefore any development obtained, any revenues procured, and jobs generated and any cash injection into the economy during this timeframe accomplished within the framework of the law did indeed meet the mandate and procedures required of this Authority.

This response will logically dispute the assertion that QCs were issued to unqualified businesses, or to businesses where need for the QC had not been established. For this, attention must be drawn to §58104 of Chapter 58, Title 12 of the Guam Code Annotated, which states eligibility for the qualifying certificate is available to qualified businesses "engaged, or about to engage in" an ensuing list of eligible industries. The audit report makes specific mention of this section of the law, but repeatedly calls into question GEDA's decision to grant certificates to established or newly established businesses. The report fails to recognize that GEDA had absolutely no legal premise upon which to base a denial of a QC to an existing business.

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Finally, this response will demonstrate that GEDA has pursued extreme due diligence in establishing a verifiable need for a Qualifying Certificate on the part of an applicant business. While there is no mandate within the law to establish specific need on the part of the business to be eligible for the QC, this report will show that GEDA has exhibited extreme caution and internal control measures to validate a beneficiary's need for benefits afforded.

Findings and Recommendations.

The summary statement of this section suggests that the Government of Guam lost tax revenues of at least \$770,000, and could lose future tax revenues totaling about \$52.8 million to hotel and tourist industry firms. No reference of how this calculation was made is provided, and GEDA is unable to determine method for reaching this quantitative conclusion.

However, as an integral part of the underwriting of every QC application, complete financial disclosure is required of the applicant as to the initial investment, financing arrangements, and 20-year pro forma projections for the business. In cases where the business has been established, actual financials are required.

Pursuant to this data collection, GEDA calculates that for hotel and tourism industry QCs granted during the audit period, the government of Guam will actually forego approximately \$137,259,330 in tax revenues via rebates and abatements of corporate income tax and real property tax abatements.

The same financial data provided by the beneficiaries shows that the government of Guam will receive approximately \$665,914,185 in tax revenues during the same period - (from the income tax remainder, gross receipts taxes, hotel occupancy tax, real property tax, withholding tax, interest earned on rebates for six months, dividend taxes, and surveillance fees).³ The total net benefit to the Government of Guam when all taxes are considered over the twenty-year period is \$528,654,855.³

Finally, the companies that received Qualifying Certificates during the review period employed more than 1,450 Guam residents. In terms of job retention during this high unemployment period, QC beneficiaries show a job loss rate of approximately 1% as compared to a 6% job loss rate in the private sector.⁴

³ See Exhibit One for data and calculations for benefits and costs to the Government of Guam.

⁴ See Exhibit Two for employment statistics.

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Controlling Law

The report correctly identifies the requirements of the QC law. It further asserts that GEDA has not taken full advantage of the flexibility afforded by the legislature to determine terms and conditions of the QC and limitation of tax benefits.

GEDA acknowledges that potential exists to further explore tiered or restricted levels of tax benefits allowed. Credit Review Committee minutes for the audit period, as well as preliminary executive summaries for the underwriting of several QCs, demonstrate that limited benefits have been considered, therefore demonstrating a willingness on the part of GEDA to consider such options.

However, as previously stated, during the rating period, all of Asia – and subsequently Guam – experienced extreme currency devaluation, serious capital development financial restraints, cash flow insufficiency, and payroll fund depletions. In the face of such economic trauma, the GEDA board of directors sought every way to provide cash influx to established, new and expanding companies to simply survive the economic crisis while maintaining all possible commercial activity on Guam. In addition to its due diligence to preserve the integrity of the program, however, the board simultaneously imposed community contributions on recipients in the form of cash or in-kind support over the life of the QC to projects that directly or indirectly benefited the actual industry receiving benefits.⁵

Projects in Tourist Areas.

The preamble to this section suggests that the expansion of two hotels and a tourist attraction created a loss of tax revenues to Guam of \$770,000, and loss of future revenues of about \$28.5 million. While the projects are not named, GEDA presumes the projects cited are the expansion of the [REDACTED], the [REDACTED], and the [REDACTED] attraction. Again, no explanation of the quantitative analysis is provided and the report does not include any mention of the taxes to be generated by these companies beyond the scope of the QC.

The report suggests that tax benefits granted to hotels during this period gave away tax dollars that Guam would have otherwise realized. The report offers no proof that the hotels built would have proceeded with plans absent the existence of the Qualifying Certificate's availability to

⁵ See Exhibit Three for required contributions of tourist-related beneficiaries.

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existing businesses under the law, and certainly does not address how significant levels of employment commitment could have been gained from these establishments without the QC.

Included in this response are GEDA's documented financial analyses of the three projects mentioned above.⁷ Total taxes to be paid to the Government of Guam over the 20 year period in excess of QC benefits exceed \$282.8 million. Total projected costs to the Government of Guam for corporate income tax rebates and real property abatements are approximately \$31.7 million. The total net benefit to the Government of Guam from these three businesses alone over the twenty-year period should exceed \$187 million. In addition, these three companies employ more than 500 Guam residents.

The report further suggests that approving QCs for hotels during the latter part of the 1990s was unwarranted. A figure of 15 hotels constructed during the decade without benefits is cited, but with no substantiated data. After thorough review, GEDA was unable to identify 15 such hotels, and can confidently report that if said number of hotels exist, they did not fall within the 100 room minimum requirement for QC eligibility.

The findings correctly point out that demand for hotel rooms did decline in the latter part of the decade, and provides a passive reference to the Asian economic crisis as the reason for the slump. However, no credence is given to the fact that all economic indicators provided by the Guam Visitors Bureau in the latter part of 1995 indicated that visitors to Guam would exceed 2 million by the year 2000.

As is logical with any prudent economic planning, GEDA drafted a three to five year plan to ready Guam for the onset of such a targeted number of tourists. As each disaster (previously mentioned in this response) ensued, projections for visitors did decline. However, as the declines occurred, the tourism industry, in conjunction with the Government of Guam, formed task forces to ensure a resurgence to meet and exceed the 2 million visitor mark.

This section of the report closes by stating that GEDA provided an unfair competitive advantage by granting hotels QCs during this period, since other hotels were previously constructed without the QC. To this, GEDA responds with the following:

1. Pursuant to the Administrative Adjudication Law, public hearings must be held for all QC applications related to the tourism industry. Aside from one public request to have one hotel provide sewer infrastructure as a condition of the QC, no existing hotels objected in the publicly provided forum to the granting of QCs to competitors.

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Further, as a group, the existing hotel community supported virtually every QC granted through an endorsement of the Guam Hotel and Restaurant Association (as documented in public hearing minutes for QCs granted). Therefore, GEDA strongly asserts that no unfair competitive advantage was created, as evidenced by the support of the granted QCs by the tourism industry.

2. With two exceptions, all the hotels granted QCs during this period are located in the Tumon tourist district, where a majority of hotels are QC beneficiaries. The position of the applicants, staff and board of directors in most instances was that an unfair disadvantage would have been imposed on newly constructed hotels in the Tumon area that did not receive the QC. Considering that, unlike their neighbors who built during Guam's "booming" tourism era, these hotels faced a higher risk/yield exposure given the status of the economy at the time. For GEDA to refuse to grant benefits to a hotel willing to construct during a low tourism level, in the midst of an economic crisis, would have been to send a message to the world that the island of Guam was no longer interested in economic growth. In addition, this would have been in direct opposition with the Governor's Vision 2001 Strategic Plan, which calls for expanding the number of hotel rooms on Guam.
3. At the very instant the report of the auditor was received stating GEDA had been much too lax with its granting of benefits, GEDA experienced emphatic commentary to the contrary. In a review of potential benefits for new industries during a recent board meeting, the directors and commentary from outside investors firmly stated that the Qualifying Certificate program in fact borders on the edge of non-competitiveness due to its restrictive and stringent nature. It is further known to GEDA that several of the hotels pictured in the report as examples of investment "without the QC" in fact refused the QC process because of GEDA's stringent adherence to rules and regulations associated with the law. In the exit interview, IG staff reported that the [REDACTED] did indeed acknowledge that the QC was "too much trouble" with which to adhere, and GEDA staff has received that same commentary from [REDACTED]. It therefore seems illogical for the report to suggest that GEDA has been too lax in its granting of benefits.
4. In light of the above, GEDA respectfully requests that the IG consider rescinding its recommendation for more stringent measures, and suggest ways that GEDA can make the program more competitive (for example, similar to the incentives offered by the competitive domicile of Ireland) while maintaining regulatory integrity.

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Hotel Construction Projects

Pages nine and ten of the report pictures the [REDACTED] and the [REDACTED], citing that both were built without the benefit of the QC program. GEDA recognizes the significant contribution of these two integral venues in Guam's tourism landscape, and salutes both entities' contributions to the tax base.

It is imperative to point out, however, facts omitted in the report's overview:

1. Both hotels were planned and constructed at the end of Guam's tourism boom period, and while a moratorium on the granting of QCs was in place due to the influx of investment.
2. Both entities have expressed that a specific reason for not applying for the QC was because of the stringent process required for application and compliance with the certificate.
3. In the case of the [REDACTED], significant corporate backing and cash injection from off-island financing helped minimize the need for QC relief (unlike the QCs approved for [REDACTED], [REDACTED], and [REDACTED], which were all backed with limited local investor dollars. One should also note that the Hyatt was embroiled in litigation, a period for which it did not pay its construction financing debts.

Pages ten and eleven refer to the benefits granted to the Pacific Islands Club resort, and expressly disagreed with the granting of an extension of the QC for the addition of nearly 300 rooms to its inventory. To this, GEDA responds that the provision for an extension is expressly authorized in the law, and was afforded to the [REDACTED] after in-depth underwriting analysis revealed the following:

1. The expansion of nearly 300 rooms is three times the required room quota for a basic QC, which requires a minimum of 100 rooms.
2. The room count further exceeded the requirement of 200 additional rooms needed to qualify for special use and gross receipts tax benefits afforded under Public Law 24-266.
3. This expansion, again, was undertaken in the midst of an economic slump, and generated and/or retained employment for nearly 400 persons. Total investment exceeded \$70 million.

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4. The report states that the Government of Guam lost \$588,000 in tax revenues through June 30, 2000, and will lose a potential \$16.9 million over the life of the certificate. Again, these figures do not incorporate taxes actually paid by the entity. GEDA's data shows that the [REDACTED] will actually pay more than \$194 million in taxes that the Government will retain over the life of the QC, and that rebates and abatements will amount to approximately \$21.5 million. The net benefit to Guam using these projections is more than \$173 million over the life of the QC.⁵
5. Applicants for hotel expansions request consideration for extension of benefits for the entire operation for several significant reasons that include:
 - Room expansions become part of overall corporate income, and opportunity costs, sunk costs, and overhead costs are calculated as part of the whole. Separate books, accounting, administrative procedures and expenses are not accounted for as a separate entity. The applicants correctly point out that without the investment of the initial operation, expansion would not be viable, and that the success of the expansion is inherently linked to the overall health of the establishment.

Tourist Attraction Projects

Page eleven of the report cites the benefits afforded to [REDACTED] and the [REDACTED], stating that benefits were awarded unnecessarily to this hotel and tourist attraction. It is incumbent on GEDA to report that significant deliberation over the issuance of this QC did in fact occur at the staff, management and board levels. However, the overriding decision to grant the QC stemmed from visitor exit surveys providing irrefutable data that Guam required more tourist attractions to maintain or increase visitor levels and spending.

Pages twelve, thirteen, and fourteen refer to benefits approved for the [REDACTED] project. The audit takes issue with the following and GEDA responds in kind:

1. Local residents can no longer visit free of charge. True. However, the site previously exposed visitors to unsafe conditions, non-lighted facilities, and was renowned as a suicide site. The discounted rate now required for locals by the QC helps maintain the safety walls, beautification, lighting, cleanliness, etc. of the site. Further, the QC requires that the operation admit all school children free of charge.

⁵ See Exhibit One

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2. The certificate beneficiary controls only 6 percent of the project site and the Government of Guam owned the other 94 percent. True, however, the benefits apply only to the portion of the site owned by the beneficiaries.
3. The Government of Guam committed \$1.5 million to improve government lands surrounding the site. True. For this reason, conditions were added to the QC making the beneficiary responsible for the upkeep of the entire site, not just the privately owned portions of the attraction. Thus, the upkeep of the government portion of the attraction becomes a daily expense for the private operation.
4. Public hearing testimony indicated that the operation would be immediately profitable. True. Simple analysis of the benefits afforded to maintain investor confidence versus the tangible benefits to Guam, however, demonstrate the QC is a very lucrative investment in this attraction. Over the life of the QC, [REDACTED] projects tax generation not subject to benefits of more than \$65 million. Rebates and abatements will total less than \$1 million. The Government of Guam gains more than \$64 million in revenues as a result. Further, the operation provides a minimum of ten additional jobs to the economy not mentioned in the report. It should be also noted that the beneficiary experienced actual losses and thus, did not receive any net benefits, since the granting of the QC.
5. The report calculates a future value of the government's contribution to be in excess of \$3 million. Again, this cost seems more than palatable given the above referenced overall revenues to Guam. One should also note that the [REDACTED] site is the number one tourist attraction venue on Guam.
6. The report makes no mention of the local preference the law requires GEDA to grant local investors who apply for the QC. Such was an obligatory requirement in the underwriting of this QC pursuant to the law.

Timing of Application Findings

This section ciles GEDA for granting benefits to existing or newly opened businesses without recognizing that such a practice is not only allowed but explicitly promoted under the existing law. In numerous meetings with the auditors during the review process, and in the exit interview, staff and management agreed with the need to tighten regulations on the timing of QC applications to ensure the program is used as an incentive for businesses that would not otherwise establish.

Pursuant to its own internal control measures, GEDA staff and management drafted a proposed Standard Operating Procedure which the Board of Directions approved in September 1999

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requiring applicants to submit letters of intent 90 days prior to receiving a building permit, and to submit the actual QC application within 90 days of receiving the permit. The Industry Development Division was apprised of this independently pursued internal control measure, and agrees with the proposal to incorporate the requirement into the rules and regulations and the evaluate the impact of increasing the lead time requirement.

Negotiation of Tax Benefits and Cost Benefit Analyses

Significant response has been previously provided as to why tax benefits were not limited during the economic crises during which the reviewed QCs were granted. GEDA does agree, however, that tiered or limited tax benefits could become appropriate and recommended in the future as the economy of Guam improves, its allure as an investment destination improves, and unemployment figures decrease.

As for cost benefit analysis of all the QCs mentioned in the report, GEDA must take significant issue with the miscalculated return on investment of the QC in these businesses. Taxes "foregone" simply cannot be reported without taking into account the taxes generated in the areas of payroll taxes, hotel occupancy tax, income tax remainders, interest earned on rebates, etc.⁷

A more thorough analysis will reveal that not one QC has been issued that would fail to provide a positive return to the Government of Guam over the life of the contract.

Audit Recommendation 1.

"Work with the Guam Legislature to amend Title 12, Chapter 58, of the Guam Code Annotated (the Qualifying Certificate law) and related regulations to exclude from program eligibility tourism projects in established tourist areas of Guam, exclude previously existing facilities from eligibility for new Qualifying Certificates, require that businesses submit letters of intent to apply for Qualifying Certificates no less than 180 days prior to obtaining related building permits, and clearly define the circumstances under which lower than maximum-level tax benefits can be granted."

Response.

⁷ See Exhibit One.

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Non-concur with recommendation to exclude from program eligibility tourism projects in established tourist areas of Guam. The main tourism area is nearly saturated in terms of land use, and tourism attractions are still needed to boost visitor arrivals. Saturation of land use (at most, land remaining in these districts will allow for 5 additional projects of substantial size), the phase out of the program for the tourism district will take care of itself. Failing to make the incentive available for new investment provides a competitive disadvantage, as explained earlier in the report.

Concur with recommendation to exclude previously existing facilities from eligibility for new Qualifying Certificates, except for established businesses undergoing qualified expansions.

Non-concur with recommendation to require that businesses submit letters of intent to apply for a QC no less than 180 days prior to obtaining related building permits. While some investors, especially for construction intensive projects do announce plans six months in advance, GEDA's experience is that investors prefer to maintain confidentiality for competitive protection for as long as possible. To date, the 90 day period seems to be working.

Concur with recommendation to clearly define the circumstances under which lower than maximum-level tax benefits can be granted.

Audit Recommendation 2.

"Establish procedures and develop methods, such as economic models and procedures, to calculate the economic benefits of tax rebates and abatements by considering the costs to the Government, including the amount of taxes foregone and the indirect infrastructure and social costs involved."

Response.

Concur. GEDA will continue to refine, improve, and expand its existing model to more accurately quantify all direct and indirect costs. However there is one caveat: GEDA requests that the final audit report acknowledge existence of total tax analysis for each QC mentioned, and the fact that the net benefit to Guam is positive tax cash injection over the lives of the QCs.

Audit Recommendation 3.

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"Adopt procedures to require that negotiations with Qualifying Certificate applicants are documented and that the negotiations include the use of all relevant analyses, as described in Recommendation 2, to ensure that the estimated direct and indirect costs to the Government do not negate the economic benefits of the Qualifying Certificates.

Response.

Concur. Prior to 1995, there was no model to conduct any thorough analysis. Since then, GEDA has developed its own form of providing analyses, which also takes into consideration the government's permitting process through the Territorial Land Use Commission. This process does address the economic impact to Guam's infrastructure. GEDA will continue to make efforts in refining, improving and expanding its methods to provide for a more comprehensive model that will take into account other direct and indirect costs to the government.

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B. COMPLIANCE WITH QUALIFYING CERTIFICATES

GEDA has and will continue to follow its mandates and will comply with the law and rules that govern these mandates. The tax abatements were issued to those 11 beneficiaries that received temporary waivers, all in accordance with the QC law.

Legal Requirements.

The report erroneously cites §58111 of the QC law. The correct citation of the law is §58126. *"All recommendations of the Authority for issuance, **modification**, revocation, and suspension of a Qualifying Certificate shall be forwarded to the Governor of Guam, together with a memorandum of the Authority's findings in support of its recommendations."* As opined by GEDA's legal counsel, GEDA did act in accordance with the QC law when issuing the temporary waivers.

Compliance Monitoring.

GEDA has and continues to recognize the need for additional staff in the Compliance and Internal Audit Division, as well as other divisions within GEDA. The ability to employ additional staff was further hindered upon a hiring freeze mandate by the Guam Legislature. Additionally, the early out incentive programs in 1999 combined with the Governor's transfer authority over personnel through passed laws resulted in employees being bought out, retiring or transferring to other government agencies, thus reducing the available limited personnel resources. Despite the limited personnel and other resources available, the compliance monitoring of each beneficiary was performed.

GEDA did conduct its monthly reporting requirements, and performed annual certification for the compliance status of each beneficiary. Those that were in non-compliance did not receive tax incentives. Only beneficiaries under extreme financial and operational circumstances as a result of uncontrollable external circumstances received temporary waivers. Through the approved waivers there were tax incentives authorized.

The report cited GEDA for the following during the three fiscal years examined for this report:

1. Not having a formal inspection program in place
2. Not perform required inspections
3. Not having written inspections

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4. Issuing Certificates of Compliance authorizing five beneficiaries to receive tax benefits, although the beneficiaries were not in compliance.

This is an inaccurate finding. The QC law has been in existence for over 35 years. The rules that provide the mechanism for underwriting and compliance monitoring have been in existence for years. These statute and applicable rules & regulations provide GEDA with the compliance inspection and reporting guidelines. Through these documents, the staff was able and continued to monitor the conditions of each Certificate. Documents for each inspection report for the three years cited are contained in each QC beneficiary file.

The report also inaccurately states that GEDA did not adopt a formal monitoring program. Again, the formal monitoring program was developed over 35 years ago. Part 2 of the Rules and Regulations covers the compliance of the program. However, the Compliance Division began drafting standard operating procedures to document in more detail the established monitoring program in 1999. The SOPs when adopted will be an added tool for reference, however, SOPs do not have authority over the statute and rules.

The report stated that GEDA had performed only six of the 38 required inspections. The QC law requires that the inspections tie in with the beneficiaries' fiscal year end. The fiscal year-end for those six beneficiaries audited were in December, while the remaining 32 have varying year-end dates, which were outside the scope of the December 1999 – June 2000 additional auditing period. This is discounted and not considered in the report making it appear that the remaining 32 inspections were never performed, while GEDA's files reveal that they were inspected. The law makes it impractical for all recipients to be inspected in December.

Certificates of Compliance.

The reports cites GEDA for incorrectly issuing Certificates as of June 30, 2000 and that these Beneficiaries had improperly received abatements of property taxes and/or rebates of income taxes totaling \$459,777. GEDA did not incorrectly issue Certificates of Compliance to non-compliant beneficiaries, which is further discussed and substantiated in more detail below. The taxes received, as a result of temporary waivers was only for Real Property Taxes. The statement that income taxes were rebated is not factual. The corporations that were issued temporary waivers had losses carried forward and did not receiving any corporate tax rebates for the three years in question. The compliance work was conducted in accordance with the QC law.

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Surveillance Fees.

The report uses an estimate for cost allocation between personnel and administrative expenditures for three years based on observation and employee interviews. However, the current annual salaries and benefits alone for the Division Manager, and four full-time staff personnel is approximately \$294,000 per fiscal year. This amount alone already exceeds an annual surveillance fee average of \$222,000 (\$665,505 divided by the three year period).

Temporary Employment Waivers.

As stated earlier in this document, the amount of \$815,990 cited as lost tax revenues is an incorrect number. The beneficiaries received only real property tax abatements for 1998 and 1999. The amount of \$196,354.20 was received in 1998 and \$378,768 in 1999. To date, the Tax Commissioner has not released 2000 real property tax abatements. The report appears to misconstrue that the beneficiaries were only entitled to real property tax abatements and income tax rebates.

With respect to negotiations, GEDA disagrees that negotiations are necessary. In fact, GEDA's recent records of tax filings from the recipients of these temporary waivers indicate a reported net loss of over \$28 million for 1999.

The temporary waivers were not provided to all beneficiaries, but to a few businesses that had experienced severe financial and operational hardships from extenuating circumstances beyond their control. Such circumstances addressed were Super Typhoon Paka, Economic Crises in Asia, Korean Airline Crash, which resulted in an immediate "pull out" of Guam, Guam's hotel and attraction industry's economic crises. Businesses were severely impacted because of the decline in tourist arrivals and a reduction of visitor spending.

As GEDA assessed each beneficiary's need for temporary waivers, GEDA also took into consideration the operations had severe physical/structural damage to their facilities, and the cost to repair the damage and resume operations. During the years cited in this report, these beneficiaries were forced to lay-off employees until they resumed operations. After nearly \$14 million in repair work, which took over a year to complete, one of the beneficiaries was able to rehire the employees laid off and reopen the establishment. Had GEDA negotiated reduced benefits, it would have placed an additional impact on the beneficiaries' financial condition and go against GEDA's philosophical grain and priority consideration to save and retain jobs in an already damaged economy.

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The amount of tax abatements provided through these waivers are nominal, compared to the amount of capital invested in Guam and the overall benefits afforded to the Guam Community. These hotels had experienced losses that were carried forward during these tough economic times, so corporate income taxes rebates were not realized. The only incentives granted were real property tax abatements (Table 2).

Table 2
Real Property Taxes Abated through Temporary Waivers for 1998 – 2000.

1998 Real Property Taxes Abated	\$196,354.20
1999 Real Property Taxes Abated	\$378,768.00
2000 Real Property Taxes Abated	\$201,558.00

****Corporate Income Taxes Rebates were not realized during these years as losses were carried forward.

Again, these abatements issued are nominal when compared to the benefits received by the Guam community, such as employment retention, employee benefits, community contributions, local purchases, and ultimately taxes paid to government of Guam coffers. The issuance of temporary waivers, which was issued only under extenuating circumstances, is one way the government of Guam has helped mitigate Guam's unemployment rate by maintaining the employment opportunities already in existence. Approximately over \$201,000 in real property taxes will be abated in 2000. Reported benefits received by the community in 1999 were over \$42 million.

Table 3 reflects the actual reported benefits to the community during 1999:

Table 3
Benefits to the Community in 1999

QC Beneficiary (QC #)	Losses Sustained in 1999	Benefits to Community
QC No. 180	\$(2,613,656.00)	\$9,117,958.38
QC No. 185	N/A	3,398,228.44
QC No. 190	(2,609,486.00)	5,861,546.59
QC No. 199	(7,351,179.00)	6,184,892.70
QC No. 204	(8,355,014.00)	6,254,444.59
QC No. 212	(1,887,099)	9,581,879.79
QC No. 224	(5,218,536.00)	2,297,432.36
TOTAL:	\$(28,034,970.00)	\$42,696,382.65

****These figures do not include corporate income and real property taxes paid.

Audit Recommendation 1.

"Develop and submit to the Board for the adoption of policies and standard operating procedures to ensure that GEDA limits the use of surveillance fees to pay personnel and other expenses related to monitoring the compliance of beneficiaries with the requirements of their Qualifying Certificates."

Response.

Non-concur. This recommendation is unnecessary. Currently, the cost exceed the revenues generated from surveillance fees.

As the report admits, the QC law does not limit the use of the surveillance fees assessed against each applicant or beneficiary of a QC. Additionally, the law also provides for extraordinary costs to be assessed in addition to the filing and surveillance fees which may apply to the expenses incurred to process the application or monitor the beneficiary's performance of the QC. [§58144, Extraordinary Costs]

Audit Recommendation 2.

"Finalize and submit to the Board for adoption formal procedures for compliance monitoring program."

Response.

Concur. GEDA agrees that the adoption of formal SOP for ensuring compliance monitoring is essential for establishing internal procedural operations. GEDA has developed the Standard Operating Procedures for the compliance monitoring of the QC Program, which is currently in its final draft form. The SOP will add to the already developed and approved SOP for the underwriting process of the QC developed by the Industry Development Division. One of the many objectives of GEDA is to obtain Board approval before the end of this fiscal year.

Audit Recommendation 3.

"Provide training to compliance monitoring staff to ensure that all aspects of the monitoring process are performed in a consistent and timely manner."

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Response.

Concur. GEDA agrees that formal training is needed for maintaining professional development in all aspects of the work place. GEDA disagrees, however, that compliance monitoring was not performed in a consistent and timely manner as a result of having no training opportunities afforded to the Compliance staff. The monthly reports are provided to the Board on a timely basis. Annual inspections have been conducted and the annual compliance reports were completed in accordance with Part 2 of the Rules. The economic hardship experienced by the entire government of Guam has minimized some costly training opportunities. However, cross-training, statutory review, program evaluation and assessment training were provided to the Compliance staff.

Audit Recommendation 4.

"Develop and submit to the Board for adoption, regulations to quantify the cost to the Government of Guam and to the Guam workforce of temporary waivers and require negotiations to ensure that beneficiaries either give up a portion of their benefits in exchange for waivers of certificate requirements or suspend certificate benefits pending correction of the noncompliance issues."

Response.

Non-Concur. The law already provides GEDA the authority to negotiate. However, GEDA does agree that the Rules & Regulations, which deal with the compliance monitoring of the QC Program, must be updated and improved to provide a more comprehensive and quantitative approach to Guam's diverse range of industries. GEDA has drafted amendments to both the QC law and Rules, which will update and improve the underwriting and compliance of the beneficiaries' performance, and address concerns related to the specific industries, and the individual reporting requirements, in addition to providing additional analysis.

C. ABATEMENT OF GROSS RECEIPTS AND USE TAXES

The report states that GEDA did not ensure that the Department of Revenue and Taxation (DRT) and the Guam Customs and Quarantine Agency correctly granted Qualifying Certificate abatements of gross receipts and use taxes. There is no statutory authority oversight for GEDA over these entities. The QC Program guidelines and policies do not require GEDA to work with the Customs and Quarantine Agency. The law only requires the cooperation of both GEDA and the Department of Revenue & Taxation. However, GEDA will coordinate and conduct meetings with both entities so that refined control measures can be developed to avoid incorrect benefit authorizations. In addition, as more legislative changes are proposed, GEDA will ensure the identification and inclusion of the appropriate agencies to avoid or minimize any gaps within the program.

The statement that GEDA did not prepare or adopt procedures to either monitor or process the granting of gross receipt tax abatements is incorrect. GEDA has monitored all beneficiaries receiving GRT incentives under the Insurance law. Additionally, the development of the SOPs was initiated in 1999 to document the compliance procedures and processes established by GEDA. The rules and law outline the compliance monitoring procedures, the SOPs are merely to document the QC Program compliance process already established by GEDA for over 35 years.

Audit Recommendations 1 and 2.

"Coordinate with the Department of Revenue & Taxation to develop and implement procedures to ensure that gross receipts tax abatements are granted only to applicants who comply with their Qualifying Certificate requirements."

"Coordinate with the Director of the Customs and Quarantine Agency to develop and implement procedures to ensure that the use tax abatements are granted only to applicants who comply with their Qualifying Certificate requirements."

Response.

Concur. It is critical that all agencies meet regularly to develop and implement procedures not only for the issuance of gross receipts tax exemptions, but other tax incentives offered under the QC Program as well. GEDA has regularly coordinated with DRT on a routine basis to discuss the program guidelines, as well as the compliance statuses of each beneficiary. In the past year,

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this relationship has been fostered between both agencies, and between the agencies and the beneficiary. Upon the effective date of the QC, GEDA and DRT meet with the new beneficiaries to highlight the QC Program requirements, QC conditions, and issues on the taxation, and other DRT issues.

Currently the QC Program guidelines and policies only require GEDA's coordination with DRT and not with the Customs and Quarantine Agency. However, GEDA will make a more concerted effort to involve the Customs and Quarantine Agency in its meetings and to better establish program control measures.

Audit Recommendation 3.

"Develop and implement procedures to ensure that contractors submit the required accountants' statements, that the statements are matched with tax abatement claims before Certificates of Compliance are issued, and that the original Qualifying Certificate beneficiaries are notified of the amount of tax abatements received by each subcontractor under the primary Qualifying Certificates."

Response.

Non-Concur. GEDA agrees that procedures are necessary to ensure the accountants' statements are matched with the tax abatement claims. GEDA has made it a practice to match Accountant's statements with the Contractor's abatements. The practice of these procedures are addressed in the draft SOP.

GEDA disagrees, that a Certificate of Compliance must be issued *prior* to the tax abatement claims. To match an accountant's statement with the tax abatement claim prior to issuing a Certificate of Compliance would require monthly submissions and review. This would become costly and time consuming, and result in defeating the lawful purpose of an abatement benefit by converting it to a rebate. The program already addresses use tax abatements benefits, which are claimed during the year. At the compliance year-end, if the beneficiary is found to be in non-compliance, then the tax incentives must be reimbursed with penalties.

In addition, GEDA notes that the beneficiaries were either in compliance with the Certificate requirements, or received a temporary waiver.

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Audit Recommendation 4.

"Review the questioned gross receipts tax and use tax abatements discussed in the finding to determine whether the tax abatements were allowable and, if not allowable, initiate steps to collect the lost revenues."

Response.

Non-Concur. This is a DRT issue and should be stricken from the report and addressed directly to the appropriate entity, DRT. However, GEDA does take note of this issue and will separately discuss this issue with DRT. The QC law authorizes the Tax Commissioner of Guam to issue rules as deemed necessary to implement the procedures outlined in Chapter 58 of the QC law [§58140].

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D. REINVESTMENT OF TAX BENEFITS

Audit Recommendation 1.

"Request that the Guam Legislature amend the Guam Code Annotated (12 G.C.A. 58142) to clarify the types of reinvestment to be required of Qualifying Certificate (QC) beneficiaries and the meaning of the 5-year reinvestment period."

Response.

Concur.

Audit Recommendation 2.

"Amend the Qualifying Certificates that were issued after December 29, 1994, to include the reinvestment requirement mandated by the Guam Code Annotated."

Response.

Non-concur. The 5-year moratorium was lifted and the first Certificate was issued in summer of 1996. All Certificates issued by GEDA since 1996 include the reinvestment requirement as required in the QC law. The domestic insurers and captive insurers are not required to reinvest 50% of the monies rebated and abated through this program. Only one Certificate does not include this provision in the Certificate, however, it provides a condition that requires compliance of all of GEDA's program mandates: *"The Corporation shall comply with all laws of Guam and the rules and regulations of its various agencies, including and not limited to those set out in the QC law, and in applicable rules and regulations of GEDA is provided."* Through this condition, GEDA enforces the requirement for each beneficiary to adhere with the reinvestment requirement.

Audit Recommendation 3.

"Develop and implement rules and regulations and standard operating procedures to ensure that GEDA includes the reinvestment clause in all new and amended Qualifying Certificates and has a process to monitor compliance with the reinvestment requirement."

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Response.

Concur. Again, the development of the SOP is being drafted.

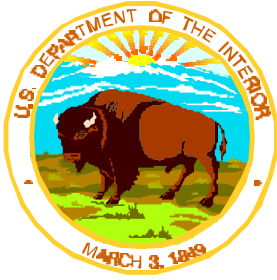
STATUS OF AUDIT REPORT RECOMMENDATIONS

Finding/Recommendation Reference	Status	Action Required
A.1	Unresolved.	Reconsider the recommendation and provide a response indicating concurrence or nonconcurrence. If concurrence is indicated, provide the target date for working with the Legislature to amend the Qualifying Certificate law and related regulations accordingly.
A.2	Management concurs; additional information requested.	Provide the target date for the Administrator to establish procedures and develop methods to include costs to the Government in the economic analysis of Qualifying Certificates.
A.3	Management concurs; additional information requested.	Provide the target date for the Administrator to adopt procedures to document negotiations on Qualifying Certificates. We request that a copy of the procedures be submitted to this office.
B.1	Unresolved.	Reconsider the recommendation and provide a response indicating concurrence or nonconcurrence. If concurrence is indicated, provide the target date for the Administrator to develop and submit to the Board for adoption policies and standard operating procedures on limiting and tracking the use of surveillance fees.
B.2	Management concurs; additional information requested.	Provide the target date for the Administrator to finalize and submit formal compliance monitoring procedures for Board adoption. We request that a copy of the Board-approved procedures be submitted to this office.

Finding/Recommendation Reference	Status	Action Required
B.3	Management concurs; additional information requested.	Provide the target date for the Administrator to provide formal training to compliance staff.
B.4	Unresolved.	Reconsider the recommendation and provide a response indicating concurrence or nonconcurrence. If concurrence is indicated, provide the target date for the Administrator to develop and submit to the Board for adoption regulations on quantifying the cost of temporary waivers and requiring negotiations. We request that copies of the Board-approved regulations be submitted to this office.
C.1	Management concurs; additional information requested.	Provide the target date for the Administrator to coordinate with the Department of Revenue and Taxation to establish procedures for granting gross receipts tax abatements only to beneficiaries who comply with their Qualifying Certificate requirements. We request that a copy of the procedures be submitted to our office.
C.2	Management concurs; additional information requested.	Provide the target date for the Administrator to coordinate with the Customs and Quarantine Agency to establish procedures for granting use tax abatements only to beneficiaries who comply with their Qualifying Certificate requirements. We request that a copy of the procedures be submitted to our office.

Finding/Recommendation Reference	Status	Action Required
C.3	Unresolved.	Reconsider the recommendation and provide a response indicating concurrence or nonconcurrence. If concurrence is indicated, provide the target date for the Administrator to establish procedures for the submission of audited financial statements by contractors, the matching of the statements with gross receipts tax abatement claims, and the notification of Qualifying Certificate beneficiaries of the abatements received. We request that a copy of the procedures be submitted to our office.
C.4	Unresolved.	Respond to the revised recommendation, indicating concurrence or nonconcurrence. If concurrence is indicated, provide the target date for the Administrator to review the gross receipts and use tax abatements questioned in the finding to determine if they are allowable and, if not allowable, coordinate with the Division of Revenue and Taxation to collect the lost revenues.
D.1	Management concurs; additional information requested.	Provide the target date for the Administrator to request the Legislature to amend the Guam Code to clarify the types of reinvestment to be required of Qualifying Certificate beneficiaries and the meaning of the 5-year reinvestment period.
D.2	Unresolved.	Reconsider the recommendation and provide a response indicating concurrence or nonconcurrence. If concurrence is indicated, provide the target date for the Administrator to amend Qualifying Certificates issued after December 29, 1994 to include the reinvestment requirement mandated by the Guam Code.

<u>Finding/Recommendation Reference</u>	<u>Status</u>	<u>Action Required</u>
D.3	Management concurs; additional information needed.	Provide the target date for the Administrator to establish rules and regulations and standard operating procedures to include the reinvestment clause in all new and amended Qualifying Certificates and a process for monitoring compliance with the investment requirement.



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