



OFFICE OF THE PUBLIC AUDITOR
REPUBLIC OF PALAU

AUDIT REPORT

ON

IMPORT AND EXCISE TAXES
ON TOBACCO PRODUCTS

BUREAU OF CUSTOMS AND BORDER PROTECTION

MINISTRY OF FINANCE
REPUBLIC OF PALAU

FISCAL YEARS 2012 THROUGH JANUARY 30, 2016

Performed by the Office of the Public Auditor

MOF-IETTP-16-02P*00

REPUBLIC OF PALAU



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Office of the Public Auditor

March 08, 2017
Serial#: opa17-068au

Mr. John Tarkong, Jr.
Director
Bureau of Customs and Border Protection
Ministry of Finance
Koror, Republic of Palau

Subject: Final Report on the Audit of Import and Excise Taxes on Tobacco Products

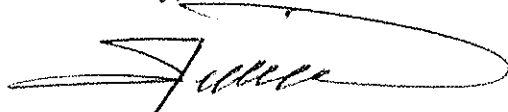
Dear Director Tarkong:

Transmitted herewith is the final audit report on Import and Excise Taxes on Tobacco Products.

The Office of the Public Auditor (OPA) received your response to the Draft Audit Report. The response is published in verbatim in the final report.

If you have any questions regarding the report or subject matters discussed therein, the OPA will be available to discuss them at your request.

Sincerely,



Satrunino Tewid
Public Auditor, ROP

Table of Contents

Results in Brief	1
Introduction.....	2
A. Objective	2
B. Background	2
Executive Branch Reorganization.....	2
Import Tax on Tobacco.....	3
Revised Excise Tax on Tobacco	3
Tax Information System	4
C. Findings.....	4
Finding No. 1: Conflict in Legal Mandate	4
Finding No. 2: Outdated Rules and Regulations.....	5
Finding No. 3: Import and Excise Taxes Not Collected and Reported Fairly and Evenly	7
Finding No. 4: Quarterly Financial Report to Congress Did Not Disclose Open Contracts	10
Finding No. 5: New Import Tax Rates Not Imposed on One Importer.....	12
Finding No. 6: Imported Goods Released upon Partial Payment of Taxes.....	14
Finding No. 7: Contractual Agreements Waived Interest Charges	15
Finding No. 8: Tax Records Not Effectively Filed and Maintained	17
Finding No. 9: Lack of Enforcement of Import Tax Liability Agreement.....	18
D. Conclusion and Recommendations.....	19
Conclusion	19
Recommendations Summary	20
Appendix 1: Scope and Methodology.....	22
Scope.....	22
Methodology	22
Prior Audit Coverage	22

Results in Brief

The Office of Public Auditor, Republic of Palau (“OPA” or “We”) audited the Bureau of Revenue, Customs and Taxation and the Bureau of Customs and Border Protection (Bureau) to determine whether it—

- has a legal framework for implementing and enforcing tax laws;
- assessed and collected import and excise taxes in accordance with laws and regulations;
- assessed and collected import and excise taxes fairly and applied them evenly; and
- reported import and excise taxes accurately in the accounting records of National Treasury.

OPA found that the Bureau has inconsistencies in its legal framework that could affect its mandate to implement and enforce tax laws and develop the necessary rules and regulations to guide its enforcement responsibilities. In addition, we found that the Bureau improperly entered into contractual agreements with select importers, allowing them to pay installments on import and excise taxes owed without interest. The Bureau also allowed one importer to pay the old tax rate when it should have charged the new rate, resulting in tax revenue loss of \$566,165.17, and failed to pursue outstanding balance of another importer who passed away owing \$38,091.36. Further, the Bureau does not have a file management system and its records were disorganized, misplaced or misfiled. This delayed the Bureau’s ability to provide requested documents during our audit. The Bureau was never able to find some documents that we requested.

With inconsistencies in its legal framework and outdated rules and regulations, the existing conditions impede the Bureau’s efforts to effectively and efficiently implement and enforce its mandate. As such, OPA issues 14 recommendations that could strengthen the Bureau’s effort to carry-out its mandate and improve its assessment, collection, and reporting of import and excise taxes.

Introduction

A. Objective

The objective of the audit was to determine whether the Bureau of Revenue, Customs and Taxation and Bureau of Customs and Border Protection (Bureau):

- (1) has a legal framework for implementing and enforcing tax laws;
- (2) assessed and collected import and excise taxes in accordance with laws and regulations;
- (3) Assessed and collected import and excise taxes fairly and applied them evenly;
- (4) Reported import and excise taxes accurately in the accounting records of National Treasury.

B. Background

On January 28, 2016, the Chairman of the Senate Committee on Ways and Means of the Ninth Palau National Congress, Mr. Surangel Whipps, Jr., wrote the Public Auditor requesting an audit on tobacco import and excise taxes being administered by the Bureau of Revenue, Customs and Taxation. The Chairman requested the audit because the Palau National Congress was considering a bill allocating some of the revenues generated through these taxes to fund public health programs. Table I below shows total revenues generated from tobacco import and excise taxes for fiscal years 2012 through January 30, 2016.

Table I: TOTAL REVENUES FROM TOBACCO IMPORT AND EXCISE TAXES

Fiscal Year	Amount
2012	\$ 2,673,555.11
2013	2,744,958.37
2014	4,342,584.27
2015	6,675,589.98
2016	2,316,683.20*
Total	\$ 18,753,370.93

Table I: *This amount only covered the period of October 01, 2015 through January 30, 2016.

Source: ROP Cash Receipts Report

Executive Branch Reorganization

On September 21, 2015, the President of the Republic of Palau signed Executive Order No. 381, which reorganized the Executive Branch and transformed the former Bureau of Revenue, Customs and Taxation into two Bureaus under the Ministry of Finance:

1. Bureau of Revenue and Taxation, and
2. Bureau of Customs and Border Protection.

B. Background *(Continued)*

The Executive Order specified that the Director of the Bureau of Customs and Border Protection would be responsible for the daily operations involving the administration and collection of revenues from tariffs, among other responsibilities.

Import Tax on Tobacco

Prior to the Chairman's request for the audit, on July 23, 2013, the Palau National Congress passed Republic of Palau Public Law No. 9-7 (RPPL No. 9-7), which amended Title 40 of Palau National Code (PNC) subsection 1301 (a)(1) and (a)(2) increasing import tax on tobacco and all tobacco-related products. From July 31, 2013 through December 31, 2013, the import tax rate would be set at \$2.00 per 0.017 kilograms (kg) of tobacco, which is the approximate weight of a conventional pack of cigarettes containing 20 sticks of cigarettes (about 2 inches long). Then, the rate would increase to \$3.00 per 0.017 kg from January 01, 2014 through December 31, 2014. From January 01, 2015 onward, the rate would increase to \$4.00 per 0.017 kg. The RPPL No. 9-7 became effective on July 31, 2013, when it was signed into law by the President of Republic of Palau. However, according to Customs officials, the implementation of the RPPL No. 9-7 was necessarily postponed for 30 days to provide a grace period for importers to continue to be assessed and pay import taxes under the old rate (RPPL No. 6-37) and the Bureau of Customs and Border Protection to recalibrate its Tax Information System to align with the rates required under RPPL No. 9-7.

Revised Excise Tax on Tobacco

Subsequently, on September 23, 2013, the Palau National Congress again repealed subsection (a)(1) and (a)(2) of RPPL No. 9-7 and replaced it with RPPL No. 9-15. The new law introduced new rates under Section 26, subsection (a) (1) and (a) (2).

From January 01, 2014 through December 31, 2014, the excise tax rate would be \$3.50 per 0.017 kg of tobacco. From January 01, 2015 onward, the rate would increase to \$5.00 per 0.017 kg of tobacco. On September 10, 2013, the President of the Republic of Palau signed this Act into law. The new rates took effect on January 01, 2014. Table II below shows amendments to the Tobacco Import and Excise Taxes rates:

Table II: AMENDMENTS TO TOBACCO IMPORT AND EXCISE TAX RATES

RPPL No.	Effective Date	Import and Excise Tax Rate
RPPL No. 6-35	July 03, 2003	\$.50 per every 20 cigarette
		150 percent ad valorem
RPPL No. 6-37	September 29, 2003	\$ 2.00 per every 20 cigarette
RPPL No. 9-7	July 31, 2013 to December 31, 2013	\$ 2.00 per 0.017 kg.
	January 01, 2014 to December 31, 2014	\$ 3.00 per 0.017 kg.
	January 01, 2015 onward	\$ 4.00 per 0.017 kg.
RPPL No. 9-15	January 01, 2014 to December 31, 2014	\$ 3.50 per 0.017 kg.
	January 01, 2015 onward	\$ 5.00 per 0.017 kg.

B. Background *(Continued)*

Tax Information System

To improve and strengthen the implementation and enforcement of import and excise taxes, the Bureau implemented a Tax Information System, a computerized information system for processing the importation of goods into Palau and the assessment and collection of import and excise taxes on those goods. The system was implemented on October 1, 2015. The Tax Information System has fully automated the process for declaration of imported goods by importers and the assessment and collection of applicable import and excise taxes by customs authorities.

C. Findings

OPA found conflicts and discrepancies in the Bureau's legal framework that could impede its ability to implement and enforce import tax laws and develop internal rules and regulations to guide its operations. In addition, we found that the Bureau improperly entered into contractual agreements with select importers, allowing them to make installment payments on import and excise taxes owed without interest. The Bureau also allowed one importer to pay the old tax rate when it should have charged the new rate, resulting in tax revenue loss of \$566,165.17, and another \$38,019.36 owed by another importer who passed away without the Bureau taking action to recover the amount. Further, the Bureau did not transmit records of contractual agreements for installment payment of import taxes to the Bureau of National Treasury for recording into the National Treasury's accounting system. Finally, the Bureau did not have a file management system and its records were disorganized. This delayed the Bureau's ability to provide requested documents during our audit. The Bureau was never able to find some documents that we requested.

Finding No. 1: Conflict in Legal Mandate

A consistent legal framework is essential for the Bureau to implement and carry out its mandate of assessing, collecting, and reporting import and excise taxes revenues. Further, the legal framework should be clear and explicit with respect to the delegation of authority and responsibility for the enforcement of import and excise taxes.

OPA found that the Bureau of Customs and Border Protection (BCBP) is operating under Executive Order No. 381, Section 6, responsible for the enforcement of import and excise taxes laws. However, 40 PNCA § 1301, delegates that responsibility to the Bureau of Revenue, Customs and Taxation (BRCT). This creates conflicts and inconsistencies as to which agency has the proper authority and responsibility for the enforcement of Republic of Palau's import and excise taxes laws.

This occurred because the President of the Republic did not introduce Executive Order No. 381 as a measure to the Palau National Congress for adoption to align Executive Order No. 381 with the existing law.

Without a clear and robust framework, the BCBP does not have a clear understanding of its authority and responsibility for the enforcement of import and excise taxes laws. This confusion hinders the Bureau's ability to effectively and efficiently carry out the functions of assessing, collecting and reporting import and excise taxes. Further, this could lead to lower outcomes and loss of potential revenues, and could eventually compromise the Bureau's accountability and integrity.

Recommendations

We recommend that:

1. The Director of Bureau of Customs and Border Protection work with the Minister of Finance, Office of the President and the Palau National Congress (OEK) to align Executive Order No. 381 to the existing law and/or resolve the inconsistency pertaining to the authority and responsibility for the enforcement of Republic of Palau's import and excise taxes laws.

BCBP's Response: *Management concurs with the recommendation. It should be noted that on September 23, 2015, the Minister of Finance issued a letter appointing as Acting Director of the newly established Bureau of Customs and Border Protection. The day to day management responsibilities were laid out for both the Acting Director Tarkong (Customs) and Director Silas (Tax). (Please see attached letter).*

We will work with the Minister of Finance, Office of the President and OEK to align Executive Order No. 381 to the existing law and/or resolve the inconsistencies pertaining to the authority and responsibility for the enforcement of import and excise tax laws.

Finding No. 2: Outdated Rules and Regulations

RPPL No. 9-7 states that the Director of the Bureau of Revenue, Customs and Taxation is responsible for establishing the rules and regulations necessary for implementing Section 1 of RPPL No. 9-7. In addition, RPPL No. 9-15 also states that the Bureau should establish regulations implementing the tobacco excise tax.

The Bureau of Revenue, Customs and Taxation (BRCT) had not revised and updated its 2006 Customs Regulations before it was reorganized and the regulations implemented. The rules and regulations should have been revised and updated to align with Executive Order No. 381, to designate the authority and responsibility over customs enforcement to the Bureau of Customs

and Border Protection (BCBP). In its present structure, BCBP is using the BRCT's 2006 Rules and Regulations to enforce import and excise taxes laws; however, these old rules and regulations designate that responsibility to the BRCT. In addition, the BCBP was in the process of revising and updating these rules and regulations, however, that responsibility falls upon the BRCT as spelled out in RPPL Nos. 9-7 and 9-15 above.

This occurred because the Bureau of Revenue, Customs and Taxation did not revise and update the Customs Regulations to align with Executive Order No. 381, delegating the authority and responsibility over customs enforcement to BCBP, thereby creating conflict and confusion between Customs Regulations and the agency responsible for enforcement of these regulations. In addition, the BCBP lacked the authority and resources to develop the necessary rules and regulations. For example, according to the Director (BCBP), its lawyer was supposed to be working to develop the rules and regulations, but left before completing the task.

The conflict in law and regulations regarding the authority and responsibility over customs enforcement hinders the BCBP's ability to effectively and efficiently carry out its functions. Further, rules and regulations are a necessary tool to make sound management decisions and set guidelines for daily operations of the BCBP. Without these tools and guidelines, the BCBP's operations are prone to ineffectiveness and inefficiency, with unclear direction, which could lead to a lack of accountability, transparency, and abuse of resources.

Recommendation

We recommend that:

2. The Director of Bureau of Customs and Border Protection work with the Minister of Finance to resolve the inconsistencies between Executive Order No. 381 and the Customs rules and regulations and to ensure that the rules and regulations are timely established and implemented.

BCBP's Response: *Management concurs with the recommendation and will work with the Minister of Finance to resolve any inconsistencies between Executive Order No. 381 and promulgating regulations. It should be noted that in the past we were without a legal adviser and in order to draft and implement the regulations, we will seek assistance from Minister of Finance and obtain legal advice from the Office of the Attorney General.*

Finding No. 3: Import and Excise Taxes Not Collected and Reported Fairly and Evenly

Improper Contractual Agreements Allowed Installment Payments

RPPL No. 9-15, Section 26 (b) requires any person bringing tobacco products into the Republic of Palau to pay the applicable excise tax at the point when the products enter the Republic and Section 26 (c) when any licensed seller or acquirer takes into possession of any tobacco products. In addition, Section 27 states that no person or entity is exempt from the tobacco excise tax.

Further, 40 PNCA §1801(h) states: The Director of Bureau of Revenue, Customs and Taxation shall have the power to enter binding agreements for the installment liquidation of any tax liability due the Bureau...Finally, 40 PNCA and Executive Order No. 288 requires review and certification by the Attorney General of every government contract for legal form and substance.

We found 12 importers that entered into contractual agreements with the Bureau of Customs and Border Protection for installment payments of tobacco import and excise taxes liabilities. Based on customs documents, the importers imported tobacco products into Palau and did not pay the applicable import and excise taxes upfront but instead were allowed to enter into contractual agreements for installment payment of taxes owed. We reviewed six of these contractual agreements, which occurred between October 01, 2011 and January 31, 2016. We found \$3,060,186.17 in import and excise taxes liabilities that were improperly approved for installment payments for the following reasons:

- (1) The contracts were approved by Customs officials other than the Director of Bureau of Revenue, Customs and Taxation,
- (2) There was no documentation to substantiate that proper delegation of authority was done to effect (1) above,
- (3) The agreements lacked certification by the Attorney General for legal form and substance.

At the time of our audit, these importers had paid \$2,404,698.25 in prior installment payments and had a remaining balance of \$655,487.92 that was scheduled to be paid off by February, April, June, and August of 2016 based on the contractual agreements. Please refer to Table III below for details.

**Table III: SCHEDULE OF TOBACCO IMPORT AND EXCISE TAXES
LIABILITIES AND PAYMENTS
OCTOBER 01, 2011 THROUGH JANUARY 30, 2016**

Fiscal Year	Contract Date	Contract No.	Entry No.	Contract Amount	Amount Paid	Balance	Status
2013	10/4/2013		HQ080668	\$ 33,849.83	\$ 33,849.83	\$ 0.00	10/4/2013 (Finding No. 5)
2013	6/28/2013	ITA06-13-002	HQ076752	39,091.36	1,000.00	38,091.36	Not paid as of today (Person deceased)

Office of the Public Auditor

Fiscal Year	Contract Date	Contract No.	Entry No.	Contract Amount	Amount Paid	Balance	Status
2014	6/25/14	ITA014-614-02-001	HQ0087491	\$ 5,132.32	\$ 5,132.32	\$0.00	Last payment 8/30/2014
2014	12/9/2014	ITA010-838-00-0003	HQ0096506	392,365.07	392,365.07	0.00	Last payment 2/3/2015
2014	10/29/2014	ITA010-838-00-0002	HQ0094365	160,145.64	160,145.64	0.00	Last payment 12/9/2014
2015	7/2/2015	ITA010-838-00-0006	HQ0105645	318,090.93	318,090.93	0.00	Last payment 9/15/2015
2015	8/5/2015	ITA010-838-00-0007	HQ0107602	357,782.50	357,782.50	0.00	Last payment 9/18/2015
2016	10/6/2015	ITA010-838-00-0008	HQ0109808	359,643.41	226,939.08	132,704.33	To be paid off on 4/25/2016
2016	11/11/2015	ITA010-838-00-0009	HQ0111772	355,801.61	137,371.88	218,429.73	To be paid off on 6/25/2016
2016	1/4/2016	ITA010-838-00-0010	HQ0114304	343,262.50	100,000.00	243,262.50	To be paid off on 6/15/2016
2015	1/28/2015	ITA014-160-00-001	HQ0098775, HQ0098776	125,006.00	125,006.00	0.00	Last payment 4/24/2015
2015	1/28/2015	ITA014-160-00-0002	HQ0100021	77,503.00	77,503.00	0.00	Last payment 5/26/2015
2015	5/26/2015	ITA014-160-00-0003	HQ0104244	75,003.00	75,003.00	0.00	Last payment 8/26/2015
2015	7/1/2015	ITA014-160-00-0004	HQ01106149	62,503.00	62,503.00	0.00	Last payment 9/10/2015
2016	10/13/2015	ITA014-160-00-0005	HQ0110488	92,503.00	69,503.00	23,000.00	To be paid off on 2/25/2016
2015	10/6/2015	ITA011-239-00-0001	HQ0110345	<u>262,503.00</u>	<u>262,503.00</u>	<u>0.00</u>	To be paid off on 3/25/2016
TOTALS				\$3,060,186.17	\$2,404,698.25	\$ 655,487.92	Totals covered in audit scope

OPA reviewed subsequent months including February through May 2016 and found one importer that had entered into several new contractual agreements worth \$1,363,115.56 in taxes, while still paying for previous contracts. Moreover, of those six contractual agreements that we examined, we found that all of the agreements were not reviewed and certified by the Attorney General for their legal form and substance. Based on a legal opinion the Office of the Public Auditor obtained from its legal counsel, the agreements required certification by the Office of the Attorney General. Accordingly, we could not determine if the contractual agreements between the Bureau and local importers were valid.

The Bureau of Customs and Border Protection instead of assessing and collecting import and excise taxes payments upfront decided to enter into contractual agreements to assist some local importers with installment payments of their taxes. In addition, the Bureau did not consult with the Office of the Attorney General, in light of the reorganization by Executive Order No. 381, to determine the proper official to execute the contractual agreements and to obtain the required certification on the contracts.

Recommendations

We recommend that:

3. The Director seek legal advice from the Attorney General (AG) regarding the legality of the contractual agreements before executing any future agreements. We further recommend that the Director require importers to pay off any remaining balances on existing contracts immediately if the contractual agreements are declared illegal by the Attorney General.
4. The Bureau Director transmit any future contractual agreements through the Office of the Attorney General for proper review and certification for legal form and substance.
5. The Attorney General or Special Prosecutor investigate this matter and take appropriate action for any violation of laws and regulations.

BCBP's Response: *The BCBP concurs with the recommendations. Management was able to consult with the Minister of Finance upon receipt of the Audit Report. On December 29, 2016, I was able to seek legal advice from the Attorney General (AG). Based on my discussion with the AG, their office does not need to review the contractual agreements. This is normally done within the discretion of each Ministry, unless the contracts have to do with procurement or disposal of government property. In addition, there is currently no requirement under the law or request from the President directing the Office of the AG to review and approve such contractual agreements. However, it is agreed by the Office of the AG that Customs would provide them with a standardized Contractual Agreement Form in order for them to review the original format. Then, the Office of the AG will provide input and ensure that all legal questions on the form can be enforced in the event that future collections may arise. Once approved by the Office of the AG, then Customs will be able to continue to engage in the contractual agreements without submitting the contractual agreements to the Office of the AG. The AG advised Customs that as long as we are not waiving taxes and unless there is some directive or law that says otherwise, we can continue with such arrangements. Customs will also issue a notice to the public and the information necessary in the event importers wish to engage in such contractual agreements. The AG advised Customs that the cigarettes and tobacco imports must be paid in accordance with RPPL No. 9-15 and no contractual agreements are allowed unless such law is amended or repealed.*

As in past practices, Customs entered into contractual agreements based on 40 PNCA §1801 that list the powers and duties of the Director as well as offering discretion to the Director as to whether to impose the interest and penalty. It was our interpretation that RPPL No. 9-7 and 9-15

Office of the Public Auditor

did not repeal 40 PNCA §1801 and until such clarification could be made the Director would continue to exercise such statutory powers with such contractual agreements unless instructed by the Minister of Finance or the Attorney General.

It should be noted that an official notice letter was issued by the Acting Director of Customs to two of the main tobacco companies informing them that Customs will no longer be able to enter into any future agreements until further clarification is provided by the Minister of Finance and the Attorney General.

It is my understanding that on October 13, 2016, the Special Prosecutor already investigated this matter and concluded that there were no criminal violations.

OPA's Comments: Although the contractual agreements for the installment payment of import and excise taxes may not require certification for legal form and substance by the Attorney General, it makes practical sense that the contracts do so to protect the ROP and to ensure that the contracts comply with the law. A standard contract is practical but such a document can be easily amended, and without proper review by the AG, risk exposing the ROP to potential problems. The contractual agreement the BCBP is presently using is a "Standard Contract" but obviously, due to the absence of the AG's review, caused these problems. The ROP has standard employment contracts and other service contracts but these contracts must still undergo the AG's review and certification.

All of the contractual agreements that we reviewed relate to the import of tobacco products which, according to your response, the AG advised is not allowed. This could have been easily prevented by having the AG review the agreements.

Based on your response to Finding No. 7, "Contractual Agreements Waived Interest Charges", the Office of the Public Auditor strongly feels that interest should be charged for outstanding import and excise taxes, including installment payments.

Finding No. 4: Quarterly Financial Report to Congress Did Not Disclose Open Contracts

Tax Receivable not disclosed in Ministry of Finance's Quarterly Report

Transactions should be properly recorded into the National Treasury's accounting system to support the accuracy of the Republic of Palau's financial statements at any point in time.

OPA found that import and excise taxes receivables totaling \$515,443.76, which were reportable within fiscal year 2016, were not disclosed in the Ministry of Finance's Quarterly Report to the Olbiil Era Kelulau for the quarter ended March 31, 2016. The receivables represent the outstanding import and excise taxes owed the government from the contractual agreements as of March 31, 2016 as shown in Table IV below:

**Table IV: SCHEDULE OF IMPORT AND EXCISE TAXES RECEIVABLE
AS OF MARCH 31, 2016**

Date	Entry No.	Agreement No.	Amount
3/15/2016	HQ0118035	ITA013-658-00-0001	\$ 125,541.06
3/17/2016	HQ0100795	ITA010-838-00-0004	\$ 245,902.70
3/30/2016	HQ0118553	011-239-00-0002	\$ 144,000.00
TOTAL			\$ 515,443.76

The Bureau of Customs and Border Protection did not transmit the contractual agreements and related documents to the Bureau of National Treasury for proper recording into the National Treasury’s accounting system.

As a result, the Ministry of Finance’s Quarterly report was misstated by the amount of outstanding tax receivables.

Recommendations
<p>We recommend that:</p> <ol style="list-style-type: none"> 6. The Bureau of Customs and Border Protection transmit contractual agreements to the Bureau of National Treasury for recording into the National Treasury’s accounting system to ensure that tax receivables are properly disclosed in the Republic of Palau’s financial reports. 7. The Minister of Finance include all outstanding tax receivables in its quarterly financial reports to the Olbiil Era Kelulau.

BCBP’s Response: *I concur with the recommendation. Immediately following the Congressional hearing this issue was addressed by Customs and the National Treasury. As of June 28, 2016, in communication with the Director of National Treasury, any and all outstanding import tax liabilities were transmitted to the Ministry of Finance to be included in the financial reports to the President and OEK. In coordination with Finance, they will be responsible for obtaining such reports from Customs for all outstanding agreements at end of the quarter reported. Customs will have the report ready by the 10th of the month for each quarter.*

OPA’s Comments: We commend the BCBP for taking the corrective action to ensure that tax receivables stemming from Contractual Agreements for the Installment payment of Import and Excise Taxes are timely transmitted to the Bureau of National Treasury for recording into the National Treasury’s accounting system. The accuracy and quality of the ROP’s financial statements can only be achieved if financial transactions are properly recorded into the National Treasury’s underlying accounting records. The OPA will conduct follow up inspections to ensure that corrective action has been implemented and maintained.

Finding No. 5: New Import Tax Rates Not Imposed on One Importer

RPPL No. 9-7, Section 1(a) requires that every person or entity that imports tobacco products into the Republic of Palau shall be assessed and shall pay import tax.

Further, Customs Regulations Part 4.10.6, Time of Imports, states: The date on which the incoming vessel or aircraft was granted clearance by the Division of Customs to unload cargo will be treated as the time of imports for the imposition of tax rates... RPPL No. 9-7 amended 40 PNCA section 1301 (a) setting forth new import tax rates. The new rates became effective on July 31, 2013.

The audit revealed that the Bureau used the old import tax rate (RPPL No. 6-35) to assess taxes for one importer (Customs Import Entry Form No. HQ080668, dated October 02, 2013)) contrary to the requirements of RPPL No. 9-7. Import Entry Form No. HQ080668 was processed on October 02, 2013, showing an assessment of \$33,849.83 on the imported tobacco products based on RPPL No. 6-35 rates. If the assessment had been done using RPPL No. 9-7 rates, the amount of the assessment would have been \$600,015, a difference of \$566,165.17. Subsequently, on October 29, 2013, the Director of Bureau of Revenue, Customs and Taxation issued a Public Notice stating: "any shipment of tobacco ordered prior to July 31, 2013 (effective date of RPPL No. 9-7), regardless of its arrival date, will not be subject to the tax imposed by RPPL No. 9-7." The Public Notice, however, contradicts with Part 4.10.6 of Customs Regulations set forth above. The Notice goes further to state that any person claiming to have ordered a shipment of tobacco prior to July 31, 2013, such that it will not be taxed under RPPL No. 9-7, must provide clear documentation of the date the tobacco products were ordered in order to qualify for this limited exemption from the tax.

According to the IT specialist at the Bureau of Customs and Border Protection, because the Tax Information System was already calibrated to process import entry documents based on the new rates under the RPPL No. 9-15, she was instructed to override the system to enable the processing of this particular import entry using the RPPL No. 6-35 rates. We also found that the importer's tax assessment payment was deferred until the return of the Director of Bureau of Revenue, Customs and Taxation and Minister of Finance from their off-island trip. In addition, we found that the importer entered into a conditional agreement with the Acting Director of Bureau of Revenue, Customs and Taxation to release the imported goods to his warehouse until the matter is resolved. However, instead of resolving the issue, the Director issued the aforementioned Public Notice to justify the treatment of this particular import entry. Further, we found that the conditional agreement was signed on October 09, 2013 and the issue had not been resolved or corrected by the Director or the Minister of Finance at the time of our audit.

The Director of Bureau of Revenue, Customs and Taxation agreed with the importer's asserted claim that the imported tobacco were purchased and ordered before the new law became effective and therefore the import tax should be assessed using the old rate. However, we found this claim unreasonable and unwarranted since customs laws and regulations require that the applicable rate be the rate at the time of entry of imported goods.

As a result, the Bureau assessed import tax using the old rate and the importer paid \$33,849.83 (old rate) instead of \$600,015.00 (new rate), a difference of \$566,165.17 of lost revenues to the Republic.

Recommendations

We recommend that:

8. The Bureau Director consult with the Minister of Finance on this issue, as agreed in the letter dated October 9, 2013, and discuss their decision with the importer and resolve any outstanding balances as needed.
9. The Bureau Director enforce the applicable import and excise taxes rates and Customs Regulations when assessing import and excise taxes on tobacco products.
10. The Attorney General or Special Prosecutor investigate this matter and take appropriate action for any violation of laws and regulations.

BCBP's Response: *I concur with the recommendations and will consult with the Minister of Finance on this issue in order to align Executive Order No. 381 to the existing law and resolve any outstanding inconsistencies pertaining to the authority and responsibility for the enforcement of import and excise tax laws.*

On December 20, 2016, I was able to meet with the Attorney General to review the concerns raised from the Public Auditor. It was noted that under 40 PNCA §1801, such law was never repealed and the powers and duties of the Director provides discretion to compromise claims. It was recommended by the Office of the AG, that the case file be sent to their office for further review.

OPA's Comments: The basis for this finding pertains to the import tax rate that was assessed on the imported tobacco products upon entry, not compromising claims. The law requires the assessment of applicable import tax rate at the time of entry of goods. Further, Customs Regulations Part 4.10.6, Time of Imports, states: The date on which the incoming vessel or aircraft was granted clearance by the Division of Customs to unload cargo will be treated as the *time of imports for the imposition of tax rates*. This was not followed by the BCBP in assessing import taxes on Customs Import Entry Form No. HQ080668.

Finding No. 6: Imported Goods Released upon Partial Payment of Taxes

40 PNCA §1304 (e) and Customs Regulations state: Cargo shall be retained at the place of unloading until the import tax has been paid...

The audit revealed that for those importers that entered into contractual agreements for the installment payment of import tax liabilities (tobacco products), the Bureau released cargo to the importer upon down payment of import taxes owed on those goods. This arrangement is specifically stated in the agreement. However, based on a legal opinion the Office of the Public Auditor obtained from its legal counsel, the cargo cannot be released until the import tax has been paid.

This condition arose due to the Bureau bypassing the Office of the Attorney General's review and certification of the contracts for legal form and substance.

The release of cargo to importers prior to the payment of import taxes is not in compliance with the intent 40 PNCA §1304 (e) and Customs Regulations.

Recommendations

We recommend that:

11. The Bureau only release cargo to the importer upon payment of import and excise taxes assessed on those cargo. In addition, we recommend the Bureau transmit all contractual agreements through the Office of the Attorney General for review and certification for legal form and substance.

BCBP's Response: *Management concurs with the recommendations. While it is reasonably understood that the import tax is to be paid before the release of cargo, it should be noted that as in past practices our former legal advisors who were also the recognized as the Assistant AG's provided us with the guidance in terms of drafting, reviewing and finalizing of such agreements since year 2000. As a result, Customs was able to release cargo and execute agreements based on 40 PNCA §1801 (g) and (h) that allowed the Director to compromise claims, penalties and interest....to include the amount of tax assessed....interest and penalties imposed, the reasons for the compromise, and the approval of the Minister.*

Under the Custom Rules and Regulations it states the following.

4.3.3 Removal of Goods from Port. If the situation deems necessary, the Director or his designee may remove goods from the original port of entry at the time of import and store in a place designated by the Division of Customs.

While I understand the strong concerns that have been raised, it should be noted that BCBP has undertaken efforts to focus its enforcement on selecting and inspecting high risk cargo while enabling legitimate cargo to be cleared in a timely manner. The purpose of these agreements were done in accordance with the statutory law 40 PNCA §1801 (g) and (h). From my experience, Customs is responsible for expediting the movement, release and clearance of goods without delay. It may be difficult to require all goods to be paid prior to their release only because of a number of circumstances and issues that the importer may face and did not expect when the goods arrive in Palau. This may include the status of the cargo or goods pending at the time because the importer may claim or dispute that such cargo are not taxable and Customs may disagree that such items are dutiable or taxable; the importer not having a business or import license or they may need to obtain an FIB license; incorrect tariff headings or concession codes that delay their entries from being processed; undervaluation or wrong assessment of duty; temporary imports; unclaimed or damaged goods. Agreements are also done when penalizing or issuing administrative penalties on importers for Customs violations to include undeclared cargo, misclassification, false invoices, smuggling, breaking seal, undervaluation, etc.

Based on our meeting with the AG, it was agreed that Customs would provide them with the Contractual Agreement Forms in order for them to provide input and ensure that all legal questions on the form can be enforced in the event that future collections may arise. The AG advised Customs that we can continue to engage in the contractual agreements as long as we are not waiving taxes and unless there is some directive or law that says otherwise. The AG advised Customs that the cigarettes and tobacco imports must be paid in accordance with RPPL No. 9-15 and no contractual agreements are allowed.

OPA's Comments: The imports that we examined relate to tobacco products and therefore, based on the AG's advice, should not have been allowed installment payment contractual agreements, meaning importers should have been assessed and paid relevant import and excise taxes upfront. Further, the contractual agreements, which waived interest assessment, lacked approval by the Minister of Finance as required by law.

Finding No. 7: Contractual Agreements Waived Interest Charges

40 PNCA §1702, Interest, states: "If any tax or penalty imposed by this division is not paid on or before the date prescribed for such payment, there shall be assessed and collected, in addition to such tax liability, at the rate of three percent per month from its due date until it is paid."

In addition, 40 PNCA §1801(g) states: the Director shall have the power, with approval of the Minister of Administration, to compromise claims, penalties and interest arising out of any levy in the case of any such compromise he shall place on file for public inspection a statement setting forth:

- (1) The amount of tax assessed or which could have been assessed by or in accordance with this division;

- (2) The amount of penalties and interest imposed, or which could have been imposed in accordance with this division;
- (3) The reasons for the compromise; and
- (4) The approval of the Minister of Administration.

OPA found that the contractual agreements for the installment payment of import tax liabilities specifically waived interest charges, which tantamount to an interest-free loan. We found only one (1) Import Tax Liability Agreement with a condition imposing a 3% interest charge; however, all the other agreements waived interest charges. In addition, there was no file containing the amount of interest imposed or which could have been imposed or the approval of the Minister of Administration as required by 40 PNCA §1801.

This condition arose due to the Bureau bypassing the Office of the Attorney General's review and certification of the contracts for legal form and substance. By failing to do so, the Bureau also was deprived of legal advice from the Attorney General concerning the process of compromising interests on tax levies.

As a result, the agreements to waive the interest charges are inconsistent with the intent of the law and as was the process for compromising interests levies.

Recommendations

We recommend that:

12. The Bureau Director enforces import tax laws in accordance with the Republic of Palau laws and regulations. In addition, we recommend the Bureau to transmit all contractual agreements through the Office of the Attorney General for review and certification for legal form and substance. Further, the Bureau should seek legal advice from the Attorney General when compromising tax levies and related issues.

BCBP's Response: *Management concurs with the recommendations. Based on my meeting with the AG, 40 PNC§1702 should be applied without discretion. The law allows the Director to impose the 3% monthly interest rate and penalties in the event the importer fails to make payment.*

Customs will provide the Contractual Agreement Forms to the Office of the AG for review and approval in order to ensure and enforce all import tax laws in accordance with the laws and regulations.

OPA's Comments: As stated in your previous responses regarding the BCBP's use of "form or standard" contracts, even if such a contract has undergone preliminary review by the AG, the final contract upon execution by the BCBP and the importer should still undergo a final review and certification by the AG to ensure its legal form and content and ensure consistent and unbiased application of the law.

Finding No. 8: Tax Records Not Effectively Filed and Maintained

No File Management System and Records Disorganized

Internal control standards dictate that the Bureau of Customs and Border Protection establish a file management system in which records are organized, filed and maintained in an orderly fashion to support revenue assessments, collection and transmittal to National Treasury.

OPA found that the Bureau of Customs and Border Protection did not have a file management system in place to ensure that records are organized, filed and properly maintained to support import and excise taxes assessment, collection and transmittal to National Treasury. For example, the Bureau's staff had difficulty locating 27 import entry records from October 01, 2011 through January 30, 2016 and 61 deposit transmittals from October 01, 2013 through January 30, 2016 for our review. In addition, we observed that records were disorganized and stacked on the floor in a room used by tax verification staff and in the conference room.

According to the Bureau, it has limited space, resources, and dedicated staff to handle records management.

As a result, we were unable to verify the accuracy of the above-noted import and excise taxes assessments during those periods, as well as their collection and transmittal to the National Treasury.

Recommendation

We recommend that:

13. The Bureau Director establish a file management system and develop policies and procedures for the maintenance and safeguarding of its records and files.

BCBP's Response: *The BCCBP concurs with the recommendations. It should be noted that Customs does have a filing management system in place. The Post Audit Section is responsible for maintain and ensuring all files are stored properly. However, due to the lack of resources to include personal, limited space and lack of funding this became an issue.*

Management has taken notice of this issue and will make improvements and correction action to include new policies and procedures for filing.

OPA's Comments: A properly maintained and operating record-keeping system is critical to the operations of the BCBP to support audits, potential lawsuits, contested assessments and other related issues.

Finding No. 9: Lack of Enforcement of Import Tax Liability Agreement

Import Tax Liability Agreement No. ITA06-13-002 under Section 8 stipulates the following provision: “In case of death, the Government reserves the right to collect any balance due from the importer by way of acquiring any assets or inventory of the businesses of the importer for the purpose of liquidating such assets or inventory to recover any amount owed to the Government.”

OPA found that this particular importer passed away owing approximately \$38,091.36 in import taxes. Despite entering into an Import Tax Liability Agreement with the importer, the Bureau of Customs and Border Protection did not pursue the importer or his estate to recover the import taxes owed.

We were unable to determine the reason for the lack of action by the Bureau of Customs and Border Protection to recover the amount owed on this particular agreement.

As a result, the Government lost out on the \$38,091.36 import taxes owed.

Recommendation

We recommend that:

14. If the Bureau of Customs and Border Protection enters into an Import Tax Liability Agreement on behalf of the Government, that it acts to enforce its rights under the Agreement by pursuing the recovery of outstanding import and excise taxes due the government.

BCBP’s Response: *Management concurs with such findings and recommendations. Management did make an attempt to recover the balance due from the importer. However, the importer left to Guam and remained there until he passed away. The case file was provided to our former legal adviser for his proper action. However, we were advised that the importer had no estate and we could not legally recover any amount owed from him.*

I concur with the recommendation to enforce its right under the agreement to protect and serve the interest of the Government. Management will meet with the Minister to discuss this case and determine the appropriate action to be taken.

D. Conclusion and Recommendations

Conclusion

The effectiveness and efficiency of the Bureau of Customs and Border Protection to enforce the assessment and collection of import and excise taxes is contingent on a clear and robust mandate. The inconsistencies and conflicts between Executive Order No. 381 and RPPL No's 9-7 and 9-15 and the Customs Rules and Regulations pertaining to Bureau of Revenue, Customs and Taxation's and Bureau of Customs and Border Protection's mandates clearly demonstrate the need for the Executive Branch and the Palau National Congress to collaborate and create a legal framework that clearly and distinctively define and spells out the mandates, authorities and responsibilities of these two Bureaus.

The Bureau of Customs and Border Protection needs to follow the law in the assessment and collection of import and excise taxes, which requires importers to pay taxes upfront, contrary to the contractual agreements for installment payments that creates uncertainty over their collection, delays cash flow to the National Treasury and creates additional administrative burden on the Bureau. Further, the Import Tax Liability Agreements should not waive interest charges and the Bureau should act to exercise its rights under the agreements to recover import taxes owed. Accordingly, the Bureau should immediately consult the Attorney General regarding the legality of the contractual agreements and to take appropriate action following the outcome of such discussions. In addition, all future agreements should be cleared through the Office of the Attorney General for review and certification for legal form and substance. Further, import tax rates should be applied based on the entry of goods, not when the purchase or order was placed by the importer.

To support the accuracy of financial reports, contractual agreements need to be communicated with the Bureau of National Treasury to ensure that transactions are recorded into the National Treasury's accounting records. Further, a records management system needs to be established to ensure that records of import and excise taxes assessment, collection and deposit to National Treasury are properly filed and maintained in an orderly fashion.

A clear and robust legal framework complemented with rules and regulations will establish a strong foundation for the Bureau of Customs and Border Protection to carry-out its mandate effectively and efficiently.

Recommendations Summary

OPA recommends that:

1. The Director of Bureau of Customs and Border Protection work with the Minister of Finance, Office of the President and the Palau National Congress (OEK) to align Executive Order No. 381 to the existing law and/or resolve the inconsistency pertaining to the authority and responsibility for the enforcement of import and excise taxes laws.
2. The Director of Bureau of Customs and Border Protection work with the Minister of Finance to resolve the inconsistencies between Executive Order No. 381 and the Customs rules and regulations and to ensure that the rules and regulations are timely established and implemented.
3. The Director seek legal advice from the Attorney General regarding the legality of the contractual agreements before executing any future agreements. We further recommend that the Director require importers to pay off any open contracts immediately if the contractual agreements are declared illegal by the Attorney General.
4. The Bureau Director transmit any future contractual agreements through the office of the Attorney General for proper review and certification for legal form and substance.
5. The Attorney General or Special Prosecutor investigate this matter and take appropriate action for any violation of laws and regulations.
6. The Bureau of Customs and Border Protection transmit contractual agreements to the National Treasury for recording into the National Treasury's accounting system to ensure that tax receivables are disclosed in the Republic of Palau's financial reports.
7. The Minister of Finance include all outstanding tax receivable balances in its quarterly financial reports to the Olbiil Era Kelulau.
8. The Bureau Director consult with the Minister of Finance on this issue, as agreed in the letter dated October 9, 2013, discuss their decision with the importer and resolve any outstanding balance as needed.
9. The Bureau Director enforce the applicable import and excise taxes rates and Customs Regulations when assessing import and excise taxes on tobacco products.
10. The Attorney General or Special Prosecutor investigate this matter and take appropriate action for any violation of laws and regulations.

Recommendations Summary (Continued)

11. The Bureau only release cargo to the importer upon payment of import and excise taxes assessed on those cargo. In addition, we recommend the Bureau transmit all contractual agreements through the Office of the Attorney General for review and certification for legal form and substance.
12. The Bureau Director enforces import tax laws in accordance with the Republic of Palau laws and regulations. In addition, we recommend the Bureau to transmit all contractual agreements through the Office of the Attorney General for review and certification for legal form and substance. Further, the Bureau should seek legal advice from the Attorney General when compromising tax levies and related issues.
13. The Bureau Director establish a file management system and develop policies and procedures for the maintenance and safeguarding of its records and files.
14. If the Bureau of Customs and Border Protection enters into an Import Tax Liability Agreement on behalf of the Government, that it acts to enforce its rights under the Agreement by pursuing the recovery of outstanding import taxes due the government.

Appendix 1: Scope and Methodology

Scope

The scope of the audit covered the period of October 01, 2011 through January 30, 2016.

Due to the state of the Bureau of Customs and Border Protection's record-keeping system, the Bureau did not provide import and excise taxes records and files for the period from October 01, 2011 to December 31, 2013. Hence, we were unable to examine and verify daily deposit transmittals from the Bureau to the National Treasury for this period because the records were disorganized, misplaced, or misfiled.

Methodology

To accomplish our audit objective, we—

- interviewed the Bureau of Customs and Border Protection officials;
- examined the Bureau's assessments and collection records and reports on import and excise taxes on tobacco products maintained at the Bureau and the National Treasury;
- inspected the Bureau's new automated accounting system to gain an understanding of the processes and forms used;
- examined applicable import and excise taxes laws and regulations on tobacco products, including RPPL Nos. 9-7 and 9-15; and
- conducted other audit-related procedures as necessary.

As the Bureau of Customs and Border Protection uses the centralized National Treasury's accounting system (no separate financial statements), we did not assess the fairness of its revenues and expenditures or any other accounts within the government-wide financial statements and therefore, express no opinion on the financial statements.

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

Prior Audit Coverage

The activities of the Bureau of Customs and Border Protection are subject to the annual Single Audit of the government-wide financial statements. The most recent Single Audit was completed and issued for the fiscal year that ended on September 30, 2015. The Office of the Public Auditor previously conducted an audit of the Division of Revenue and Taxation and issued a report dated October 30, 2006.



**ILLEGAL OR WASTEFUL ACTIVITIES
SHOULD BE REPORTED TO:**

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**MONDAY THRU FRIDAY
7:30 a.m. - 4:30 p.m.**

(Closed on Legal Holidays)