

## **GOVERNMENT & ADMINISTRATION COMMITTEE**

### ***City of South Lake Tahoe Transient Occupancy Tax (TOT)***

Citizen Complaint #C7-02/03

#### **Reason for the Report**

The Grand Jury received a citizen's complaint alleging that a City of South Lake Tahoe (SLT) vacation rental agency was not paying the full amount of the Transient Occupancy Tax (TOT) as required by Law. The complainant also raised the possibility that other rental agencies were not paying the full tax as well.

#### **Scope of the Investigation**

The Grand Jury interviewed the following persons:

- City Attorney, City of South Lake Tahoe;
- Two current City Council members, City of South Lake Tahoe;
- Senior Accounting Technician, City of South Lake Tahoe;
- Former City Council member, City of South Lake Tahoe;
- Complainant;
- County Counsel, El Dorado County;
- Chief Assistant District Attorney, El Dorado County;
- Auditor-Controller, El Dorado County;
- Former City Manager;
- Former Accounting Manager, City of South Lake Tahoe;
- Revenue Supervisor, City of South Lake Tahoe;
- Private Investigator/Auditor, contracted by the 2002-03 Grand Jury.

The Grand Jury also reviewed the following items:

- South Lake Tahoe City Occupancy/Lodging Code Sections (Chapter 28A et seq.);
- City of South Lake Tahoe Policy and Procedures regarding TOTs;
- Transient Occupancy Tax Code, El Dorado County, California;
- City of South Lake Tahoe & Lodging Association clarification of TOT;
- Transient Occupancy Tax Ordinance, Douglas County, Nevada;
- Videotapes of the City of South Lake Tahoe Council Meeting discussing TOTs;
- Transient Occupancy Tax Report Form;
- Audit report by the Private Investigator/Auditor;
- City of SLT Ordinance Amending Vacation Home Rentals ;
- A letter attempting to define SLT City Code 28A-3, which defines "rent," written by an attorney who represents two of the rental agencies;
- A legal opinion from County Counsel defining "rent" as it pertains to El Dorado County's Code.

## **Background**

Chapter 28A-3 of the City of South Lake Tahoe's City Code defining "rent" reads as follows: "Rent' means the consideration charged, whether or not received, for the occupancy of space in a transient lodging facility valued in money, whether to be received in money, goods, labor or otherwise, including all receipts, cash, credits and property and services of any kind or nature, without any deduction therefore whatsoever."

Exactly what items are considered as "rent" under that code section is an apparent problem within the City. Some vacation home agencies charge Transient Occupancy Tax (TOT) on the extras, such as cleaning fees, booking fees, pet fees, spa maintenance fees, extra cots, etc. Others do not and take the position that "rent" means only the amount paid for the room. This leads to an unequal playing field. In addition, the City is inconsistent as to who owes "rent" and the definition of rent. Hotels and motels that delineate the extra charges are required by the City to pay the TOT of those charges. However, when it comes to rental agencies, that decision is left to the individual rental agencies. Therefore, some pay TOT on the additional charges, and others do not.

It appears that in May 2001 the City of SLT and the South Lake Tahoe Lodging Association arrived at a "clarification" regarding the TOT. This clarification states, in part:

"If a lodging property collects revenue for a room, then TOT tax be charged." In addition, the "clarification" also states "If a property charges an additional amount for rollaway, refrigerator, utility surcharge, guest amenities, towels, etc., then that charge is taxable."

The County of El Dorado has a TOT ordinance and the definition of rent is almost identical to that of SLT. At the request of the Grand Jury, County Counsel provided a legal opinion as to the definition of "rent", as it pertains to the County of El Dorado. The opinion states, in part, "...the definition of taxable "rent"; focuses on what the renter is charged rather than what the facility owner, operator or subcontractor may receive, and it is written to be as broad as possible to capture everything "of any kind or nature" that the renter pays in order to occupy the premises "without any deduction therefrom whatsoever."

The definition of "rent" pursuant to the SLT City Code, the "clarification" between the city of SLT and the South Lake Tahoe Lodging Association appears to include any revenue generated by the rental of the room is taxable.

However, in late February 2003, because of the inconsistencies in the interpretation of "rent," this Committee asked the SLT City Attorney for her opinion as to the definition of "rent" and, although one was promised, as of May 31<sup>st</sup>, it has not been received.

Vacation rentals are private residences that are rented out for less than 30 days. The term also includes motels and hotels. A TOT is collected from all such vacation rentals as well as hotels and motels. Although the TOT represents a significant portion of South Lake Tahoe's revenue, there has not been an audit of these businesses for many years.

The City began an audit on motels and hotels but declined the Grand Jury's request to reassign or hire an auditor for auditing vacation rentals until the motel/hotel audits were completed. The City Attorney made the suggestion that if the Grand Jury had the funds with which to hire an auditor, they would be happy to assist with the administrative subpoenas.

Based on the City auditor's preliminary reports on the collection of TOT at motels and hotels, it became apparent there was an under-collection of TOTs. These under-collections contribute to the ongoing shortfall of revenues for the City of SLT.

There is an inherent difficulty in determining the full amount of tax to be collected for the rental of vacation homes. An honor system prevails with the owners or their representatives informing the City when a given house has been rented. Most rentals are handled by rental agencies, which collect the rent, pay the TOT, and then forward the difference minus their fee and other costs to the respective owner.

On several occasions this committee requested the El Dorado County Auditor-Controller for assistance in conducting audits of several vacation rental agencies. These requests were denied.

In order to ascertain whether in fact the agencies have been collecting and/or paying the TOT, the Grand Jury had no other recourse but to retain the services of a skilled investigator/auditor. He was retained to conduct an audit on a representative sampling of five agencies doing business in the City of SLT.

In summary, the methodology used by the Investigator included the following steps:

- Met with the person in charge of overseeing the rental of vacation homes to receive an overview of the agency's rental procedures and the collection of TOT. This included identifying which charges the agency subjected to TOT collection and which they did not.
- Reviewed a sampling of rental records from June, July and August 2002 and compared the agency's actual practice with stated procedures. This included reviewing the following records:
  - All rental registration forms and renter bills for one month, of the sample period, to determine if the actual charges were consistent with the agencies stated procedures.
  - Ten percent of the "owner folders," which each agency maintains for the individual properties they represent. This was done to verify the accuracy of the rental activity recorded on the renter bills, to verify that all rental activity was being recorded and to determine if the charges for all rentals occurring in the entire three-month sample period were consistent with the agency's stated practices.

- Property cleaning records to determine if unreported rentals might be occurring.
- Month-end rental recaps to ensure TOT was remitted for all qualifying rentals during the sample period.
- Individual rental records to resolve discrepancies discovered during the review process.
- Records listing the amount of money collected for cleaning, booking and other fees during calendar year 2002.

During the course of the investigation, the Investigator determined that a large number of vacation homes were being rented directly by the owners.

City records reflect that in January 2003, there were a total of 1191 vacation homes registered with the City with 843 being handled by rental agents and 348 being handled by the owners directly. These numbers fluctuate slightly throughout the year as homes are added and removed but remain fairly constant.

One common way owners rent their homes is to advertise them on the Internet.

The Investigator checked Internet listings for “vacation homes in South Lake Tahoe” and located two large and many small Web sites with rental listings. The two largest sources of listings were found at <http://www.vrbo.com> and <http://www.avacationrental.com>.

The <http://www.vrbo.com> site stands for “vacation rentals by owner” and contains approximately 125 separate homes under their SLT listing. The <http://www.avacationrental.com> site stands for “A Vacation Rental” and lists 66 homes in the Lake Tahoe area. These Web sites list homes in the City of SLT, the unincorporated area of El Dorado County, as well as in Alpine County and Nevada.

Usually, an address is not part of the Internet listing so it is necessary to contact the owner to determine where the property is located.

In an attempt to determine how many of these owners collect and remit the required TOT, the Investigator posed as a potential renter and sent emails to 27 properties listed on the <http://www.vrbo.com> Web site. The e-mail requested the address of the home and a breakdown of all charges. The following results were achieved:

- Twenty of the 27 property owners responded to the Investigator’s inquiry:

- Of those 20:
  - 4 did not provide addresses as requested.
  - 11 were located within the City of SLT.
  - 5 were located outside the City of SLT.
- Of the 11 within the City of SLT, City records revealed that:
  - 4 had a history of paying TOT tax.
  - 7 were not remitting TOT.
- Of the 7 not remitting TOT:
  - 3 were also represented by rental agencies.
  - 2 indicated that tax was included in the quoted rate, however, TOT was not remitted to the City.
  - 2 were not registered with the City as vacation rentals as required by City law.

While sampling the rental records at the various rental agencies, the Investigator noted a number of properties with high usage by “guests of the owner.” Rental agency personnel believe that many of these uses were actually rentals booked directly by the owners.

The Investigator selected 12 properties with high “guest” usage and checked City records to determine if the owners were remitting TOT. Only 3 of the 12 of the owners paid TOT during 2002.

It should be noted that the failure to pay TOT by the owners of homes with high “guest” usage might not be improper. Non-renting guests may have used the homes. However, this type of usage most likely involves some amount of tax avoidance and is worthy of more in-depth scrutiny by City staff.

Presently, all homes used as vacation rentals are required to be registered with the City (SLTCC 28A). During 2002, there was no charge to register a home. However, on January 21, 2003, Ordinance No. 928 was adopted by the City Council. This ordinance enacts a \$75 fee to register a vacation home. It also places restrictions on the number of people who can stay in a vacation home, regulates parking and makes owners responsible for the conduct of their renters. City staff mailed a packet of information to all vacation rental property owners and managers in April 2003.

Rental agencies representing vacation homes are required to have a City business license.

Vacation rental agencies collect and remit the TOT for rentals they handle. Individual property owners are responsible for collecting and remitting the TOT for rentals they book on their own.

Vacation home rental agencies are required to remit TOT on a monthly basis. TOT for vacation homes rented directly by the owners is remitted on a quarterly basis. Payments are due by the tenth day of the month following the end of the reporting period. Late payments are subject to penalty and interest charges.

Remittance of TOT by vacation home rental agencies and owners can best be described as being based on the “honor” system. Historically, the remittance of TOT for vacation homes has not been the subject of audit by the City.

The City generates and sends TOT remittance forms to each rental agency and registered homeowner each billing cycle. The same form is used for both types of TOT payments.

The form contains a series of 8 lines that are filled out to calculate the proper amount of TOT. The lines include spaces to list the gross rent, allowable deductions, the tax due and any penalties and/or interest due. A payment envelope is attached to each form.

The rental of vacation homes is big business in the City of SLT. According to City records, there are 1191 vacation homes and over 20 rental businesses registered with the City. There are also a small number of additional homes being rented that are not registered.

TOT collected from all sources amounted to almost \$9 million in fiscal year 2001-02. This is approximately 40 percent of the entire City budget.

It would appear, however, that a substantial portion of TOT is not being collected. This is evident by the under-payment of TOT by most rental agencies based on their interpretation of which charges are subject to TOT collection and the non-payment of TOT by some homeowners who rent their homes without using an agent.

The 5 agencies surveyed for this report handled 426 of the 843 homes registered with the City as being represented by rental agents.

If the fees the 5 surveyed agencies charged for cleaning, booking and hot tub usage are subject to the 10 per cent TOT tax, those 5 agencies should have paid the following additional TOT in 2002:

Agency 1	\$ 7,600
Agency 2	61,327
Agency 3	27,020
Agency 4	360
Agency 5	<u>000</u>
Additional TOT due:	\$ 96,307

Note: One of the above agencies, which handled 110 vacation homes, paid TOT on all extra costs. Therefore, the amount of unpaid TOT per home handled by the surveyed agencies is \$374.76 (426 total homes – 110 homes for which total tax was paid = 316 homes for which total

tax was not paid. Additional tax owed of \$96,307 divided by 316 homes equals \$304.76 per home.).

The rental agencies not surveyed for this report handled 417 homes. For the purposes of this report, it has been assumed that the rental agencies not surveyed have similar charges to those surveyed, have a rental frequency similar to that of the surveyed agencies and only collect TOT on the daily rental rate. Based on those assumptions, the non-surveyed agencies owe an estimated additional TOT of \$127,085 (\$304.76 per home multiplied by 417 homes).

This makes the estimated additional TOT due from rental agencies \$223,392 (\$96,307 plus \$127,085).

Estimating the amount of tax owed by those owners who rent their homes directly is a difficult area in which to make an accurate estimate because there is no norm to follow and there is little documentation on which to predict the amount of rental activity.

City records reflect 348 vacation rental homes being rented directly by the owners.

City TOT payment records reflect that 201 individual property owners paid a total of \$209,330 in TOT during 2002. This equates to an average of \$1041 per home (\$209,330 divided by 201).

However, City records also disclosed that rental agencies were listed as handling 58 of the 201 properties. Therefore, 59 percent (205 of 348) of the property owners who are registered as handling their own rental bookings did not pay any TOT in 2002.

TOT payments were checked for 12 of the properties with the highest usage and only 3 were remitting TOT. The remaining 9 properties had 64 “guest of owner” uses totaling 479 days during the 3-month sample period.

Given the high level of non-payment in the above two examples, it would not be unrealistic to assume that half of the homeowners who did not remit TOT in 2002 had some unreported rental activity.

A conservative approach to estimating the amount of TOT those homeowners may not have remitted would be to multiply the average TOT paid by individual homeowners in 2002 (\$1041) by a number equal to 40 percent of homeowners who did not pay TOT in 2002 (205 x 40% = 82). This makes the estimated additional TOT due from individual homeowners \$85,362 (\$1041 x 82).

Therefore, the total estimated additional TOT due from rental agencies and individual homeowners is \$308,754 (\$223,392 + \$85,362).

A survey of 11 homes advertised for rent on the Internet revealed that 7 (64%) were not remitting TOT to the City. If this percentage is even close to actual number of the individual homeowners not remitting TOT, then the City is losing a significant amount of tax revenue. This area is worthy of additional scrutiny by the City.

There is a lack of consistency within the City in collecting delinquent accounts. Pursuant to Chapter 28 A, the City has several options available for this. These include (1) offer a prepayment plan, (2) place a lien on the property, (3) revoke the motel/hotel license or permit, and (4) arrange for the sale of the property to pay for delinquent back taxes. As of this date, options 3 and 4 have not been used.

In one instance, an owner owed the City \$65,000 for delinquent TOT payments and penalties. This party was habitually delinquent in paying the TOTs he collected on behalf of the City. Because of this, the City Attorney placed a lien to be placed on this particular property. Thereafter, the City Attorney met with the owner, who asked the City Attorney to remove the lien in order for him to re-finance that particular property. Although the owner refused to tell the City Attorney the amount for which he was re-financing the property, she agreed to temporarily remove the lien based on his oral agreement to pay the money owed to the City. After the owner refinanced his property, he did not live up to the oral agreement and only paid \$5,000 towards his delinquent taxes. The City Attorney then placed another lien on the property. To date, the money is still owed.

It should be noted that the councilpersons interviewed stated they were not aware of the above transaction. In addition, one councilperson was under the mistaken impression that the City's lien on property for failure to pay taxes superceded the Mortgage holder of the property. However, all councilpersons interviewed said they would immediately pursue the TOT issues.

During this investigation it was discovered that the City of SLT is using "reserve funds" to cover budget deficits. This has amounted to approximately four million dollars in the past two years. If the City of SLT continues on its present course, the reserve fund will be depleted within the next two years.

**Findings:**

- F1. The City of South Lake Tahoe is inconsistent in their collection of TOTs due to the definition as to what is considered "rent."
- F2. At present, the City is not following their own clarification along with the South Lake Tahoe Lodging Association's recommendations as to what is to be considered as "rent."
- F3. City records show there are 1,191 vacation rental homes in SLT.
- F4. Rental agencies handle bookings for 843 of the registered vacation rental homes.
- F5. Individual homeowners account for the remaining 348 registered vacation rental homes.
- F6. Some individual homeowners are renting their property as a vacation home without registering with the City.
- F7. Some individual homeowners are renting their property without collecting TOT.

- F8. TOT collected from all rental sources amounted to almost \$9 million dollars in the fiscal year 2001-02.
- F9. The annual City budget is dependent on TOT revenues.
- F10. For the last two years, the City of SLT has had a budget shortfall in excess of \$ 2 million dollars a year.
- F11. Reserve funds are being used to balance the City's budget.
- F12. About \$ 4 million dollars is left in the City's reserve funds.
- F13. The City of SLT has not filled the Finance Director's position for the last 12 months. The City of SLT as of 5/03 presently has filled the position .
- F14. The City Council is not adequately informed regarding the delinquent TOTs.
- F15. Of the five rental agencies audited for this investigation, the Investigator estimated that nearly \$100,000 underpayment of TOT occurred in 2002.
- F16. It was further estimated that over \$224,000 was underpaid by all rental agencies in 2002.
- F17. Individual homeowners, as distinct from agencies, may have underpaid an additional TOT of approximately \$85,000.
- F18. This year the City hired an individual to audit the motels and hotels regarding payment of TOT.
- F19. In one period, fom August 2002 to March 2003, this person found uncollected tax amounting to over \$375,000.
- F20. Motels, hotels, vacation homes, and rental agencies are responsible to pay their TOTs owed on an honor system.
- F21. Although the City has stringent methods of dealing with delinquent TOTs, the prevailing method used is to put a lien on the property.
- F22. There are no written guidelines as to the definition of "rent" as expressed in Chapter 28A-3 of the City Code.
- F23. Some agencies and motels pay TOT on all revenue generated by the rental of the room, and others do not.
- F24. On several occasions, this committee requested the El Dorado County Auditor-Controller for assistance to investigate the initial complaint filed. The requests were denied.

## **Recommendations**

- R1. The City should immediately define the specific charges that are subject to the collection of TOT and inform the rental community so that all persons renting out properties are subject to the same rules.
- R2. The City should add criminal sanctions to the City Code provision dealing with the non-payment of TOT. Such a sanction would add a tool to be used with flagrant violators, particularly those who collect tax but fail to remit it to the City.
- R3. The City Council should receive monthly reports from the City Manager regarding the amount of TOT delinquencies, the length of time the facility has been delinquent and the efforts being utilized to collect those delinquencies.
- R4. The City Council should become more involved with the City Manager and City Attorney in overseeing and approving legal action against businesses and person's delinquent in their TOT payments, when it is agreed that full payment of the delinquent amount will not be made.
- R5. The City should implement a comprehensive and on-going audit program of vacation rental homes. This program should include the auditing of rental agency practices and records, the monitoring of advertisements on the Internet, in newspapers and in other publications and locations, and on-site checking of rental homes where tax avoidance is suspected.
- R6. The City should require vacation rental agencies to submit with their monthly TOT remittance, a copy of their internal month-end report which lists the specific properties rented, the dates of each rental, a breakdown of the total fees charged, by category, for each rental, and the dates any property was not available because the owner had blocked its use. This would allow City staff to be more proactive in their oversight duties without the need to go to a rental agency to review records. This would not create any additional work for most of the agencies.
- R7. A more in-depth scrutiny by the City staff should be made of high "guest" usage homes to ensure proper collection of TOT.
- R8. The City's TOT remittance form should be changed to allow sufficient space to permit the rental agents to list the total number of units rented each day and for property owners to list the total number of days the unit was rented.

**Commendations**

As a result of the Grand Jury investigation, the City Council of South Lake Tahoe now appears to be actively pursuing the Transient Occupancy Tax issue.

The Grand Jury members wish to commend the Senior Accounting Technician hired in April 2003 for her outstanding work in auditing hotels and motels of the City of SLT.

**Responses Required for Findings**

F1 1-2, 6, 10-12, 14, 17, 19, 21-23	City Council of South Lake Tahoe
F2 1-2, 6-7,14-17, 19, 23	City Manager of South Lake Tahoe
F1 and F21	City Attorney of South Lake Tahoe
F24	Auditor-Controller of El Dorado County

**Responses Required for Recommendations**

R1 though R8	City Council of South Lake Tahoe City Manager of South Lake Tahoe
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