



City of Morgan Hill

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CITY COUNCIL STAFF REPORT MEETING DATE: SEPTEMBER 21, 2016

PREPARED BY: Edith Ramirez/Economic Development Director
APPROVED BY: City Manager

TRANSIENT OCCUPANCY TAX COMPLIANCE AUDIT REPORT

RECOMMENDATION(S)

1. Receive the Transient Occupancy Tax (TOT) compliance audit report; and
2. Provide direction to staff to further review the City's TOT Ordinance (Municipal Code Chapter 3.24) and present recommendations on modifying the 30+ day exemptions policy.

COUNCIL PRIORITIES, GOALS & STRATEGIES:

Ongoing Priorities

Enhancing public safety
Maintaining fiscal responsibility
Preserving and cultivating public trust

2016 Focus Areas

Developing Our Community
Improving Our Communication

REPORT NARRATIVE:

The City collects a 10% transient occupancy tax (TOT) which is added to hotel/motel room night fees and is collected by the hotels to be transferred to the City. This revenue should correlate to occupied room nights. Morgan Hill has a total of 16 facilities that function as hotels, motels, or RV parks that rent rooms and collect TOT. The TOT collected goes directly to the General Fund to help pay for

services provided to the community.

In May 2015, the City Council authorized the City Manager to negotiate and execute a contract with Hotel Appraisers and Advisors (HA&A) to perform a hotel market and TOT analysis to ascertain the strength of the hotel market in Morgan Hill. HA&A quickly ascertained that three hotels were largely functioning as de-facto housing facilities and did not include them in its study. The study of the 13 remaining hotels that collectively offer nearly 800 hotel rooms identified some discrepancies between hotel revenue and TOT collection, suggesting issues with under-reporting as well as over-collecting. HA&A's TOT analysis recommended the following: 1) periodic auditing to measure the accuracy of TOT collections, 2) improving reporting guidelines to quantify exemptions such as extended stays, and 3) working with the hotel industry to use consistent language on receipts to explain taxes to customers.

On November 18, 2015, the City Council directed staff to engage the services of a qualified firm to perform an audit of TOT reporting and remittance. On March 16, 2016, the Council approved a three-year contract with an option to renew for two one-year terms with DavisFarr.

The main purpose of this report is to provide the City Council with the findings of the DavisFarr TOT compliance audit, which offers the City independent and objective analyses, recommendations, and other information concerning the activities reviewed. The audit included a review of sixteen properties and their records for a three-year period from January 1, 2013 to December 31, 2015. Below are the key highlights of the audit findings:

- Hotels/motels reported \$56.7 million in taxable receipts and paid approximately \$5.7 million in TOT for the period covered by the audit
- The audit identified an under-reporting for a total combined amount of \$136,194
 - One operator did not provide required documentation to the auditor to perform the audit
 - Unallowable exemptions, such as those claimed for members of the state or federal governments, and/or unsupported or undocumented 30-day exemptions accounted for the largest portion of the under-reported findings, totaling \$34,488
 - Calculation errors amounted to \$16,347
 - In addition to under-reporting, the audit found some over-collecting being performed by two operators. One claimed an "Energy Surcharge" of 2.5% which it failed to include as taxable receipts, resulting in \$9,684 due to the City. The other operator over-collected \$37,003 which was claimed as a California Tourism Assessment, which must be remitted to the City or the State
 - Seven operators failed to identify pet, cancellation, no show, and late check-out fees in the taxable receipts, which resulted in \$8,527 due to the City
 - Penalties, interest, and audit recovery fees amounted to \$30,145

The DavisFarr Audit noted that four (4) hotels had substantial long term residency programs and generate more than 50% of their revenues from these long-term guests. This is problematic for the City for a number of reasons. If a commercial lodging facility has transitioned into an alternate housing use, families may be living in substandard conditions and in facilities not in conformance with the State Building Code or the City's General Plan and Zoning. Additionally, it means that we have an inaccurate picture of available hotel rooms, misrepresenting the hotel market potential for the community. In addition, the City's General Fund will not obtain the proper TOT revenue for those facilities.

The finding of the transition of uses of certain facilities was first highlighted by HA&A's Hotel Market Study in 2015 and confirmed by DavisFarr's Audit. With this information on hand, the City will need to address these changes in use and work with the hotel owners to either bring the facilities into commercial use or explore other alternatives to bring these facilities into compliance.

The municipal code, in conformance with state law, defines a transient as any person exercising occupancy in a City Hotel for a "period of thirty consecutive calendar days or less." Once the consecutive 30 days have passed, the guest is no longer considered a "Transient" and no longer subject to the Transient Occupancy Tax. The City's Ordinance, Section 3.24.010G, specifies that "any such person so occupying space in a hotel shall be deemed to be a transient until the period of thirty days has expired, unless there is an agreement in writing between the operator and the occupant providing for a longer period of occupancy." The findings of the audit showed that many hotels did not have agreements with 30+ day guests. DavisFarr recommends that the City revise the City's Ordinance to expand and specify what constitutes an "agreement," or require guests to re-register after 30 days.

Since this 30-day exemption is directly linked to the transition of commercial facilities to residential facilities and has greater implications beyond the TOT revenue, Staff recommends the City Council direct staff to further analyze ways to address and better implement the 30-day exemption and explore if the City could prohibit or limit 30+ day stays.

The DavisFarr Compliance Audit also provided additional recommendations to the TOT Ordinance (Municipal Code Chapter 3.24) and provided suggestions to help improve compliance with the Ordinance and ease of monitoring. Recommendations include the following:

1. Revising the TOT returns to require reporting of gross rental receipts and listing of exemptions
2. Expanding the TOT Ordinance to clarify taxable revenues/fees
3. Specifying what constitutes a written agreement for 30+ day exemptions (as explained above)
4. Expanding the City's definition of "government exemptions" to include state and federal employees
5. Modifying the City's TOT returns form to better monitor exemptions, hotel capacity and occupancy, and types of revenues collected, and better tracking of long-term stays
6. Requiring a TOT audit when a transfer in hotel ownership takes place

All of the listed recommendations would improve the management and oversight of TOT collection. City teammates would return to the Council with proposed revisions to the TOT Ordinance regarding the 30+ day exemption policy following the Council's direction. Finally, Finance and Economic Development teammates will work closely with the City Attorney and hotel operators to collect outstanding TOT identified in the DavisFarr compliance audit.

COMMUNITY ENGAGEMENT: Collaborate

City teammates held two meetings with hotel operators to discuss the TOT compliance audit and help hoteliers collect necessary data and be prepared for the auditor's visit. The City also discussed concerns associated with life-safety, Building Code compliance, and public safety issues.

ALTERNATIVE ACTIONS:

The City Council may choose to direct teammates not to collect outstanding TOT or to not further

review the 30+day exemptions policy and propose any related Ordinance changes.

PRIOR CITY COUNCIL AND COMMISSION ACTIONS:

- In May 2015, the City Council authorized the City Manager to negotiate and execute a contract with Hotel Appraisers and Advisors (HA&A) to perform a hotel market and TOT analysis to ascertain the strength of the hotel market in Morgan Hill.
- On November 18, 2015, the City Council directed staff to engage the services of a qualified firm to perform an audit on TOT reporting and remittance.
- On March 16, 2016, the Council approved a contract with DavisFarr to perform the audit on TOT reporting and remittance.

FISCAL AND RESOURCE IMPACT:

The TOT compliance audit identified an amount of \$136,194 due to the City for the reporting period of January 1, 2013 to December 31, 2015.

CEQA (California Environmental Quality Act):

Not a Project

This report is not a project, as defined in Section 15378 of the State CEQA Guidelines.

LINKS/ATTACHMENTS:

DavisFarr TOT compliance audit