

Sonoma County

Auditor-Controller-Treasurer-Tax Collector

Internal Audit Report

**Follow-Up:
Transient Occupancy Tax –
Administration Function Audit**

From the Period: July 1, 2010 – June 30, 2013

Engagement No: 3565
Report Date: September 15, 2016



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Executive Summary

As part of the 2015/2016 annual Audit Plan, the Internal Audit Division of the Sonoma County Auditor-Controller-Treasurer-Tax Collector's Office (ACTTC) conducted a follow-up audit of the Transient Occupancy Tax (TOT) – Administration Function Audit report dated September 2014. The original report contained 14 recommendations which were accepted by management. The following observations are noted as a result of this follow-up:

- Five recommendations were implemented
- Four recommendations are in the process of being implemented
- One recommendation has not been implemented
- Four recommendations will not be implemented

We will continue to follow up until all recommendations have either been implemented, management has accepted the risk of not implementing them or new evidence supports that the recommendations are no longer applicable.

Our follow up shows that the Investment and Debt Division of the Sonoma County Auditor-Controller-Treasurer-Tax Collector's Office (TOT Administration), has made significant improvements in its procedures to improve compliance with the TOT ordinance.

Background, Objective, Scope, and Methodology

Background

At the request of TOT Administration, ACTTC performed audits of selected TOT returns and plan on providing such assistance in the future. We do not believe that performing these audits constitute assuming responsibility for the design, implementation, or operation of any part of TOT Administration's internal control system. The TOT Administration selects the audit candidates and agrees to the audit scopes proposed by ACTTC.

In FY12/13, there were approximately 686 operators registered with TOT Administration, including hotels, motels, bed & breakfasts, inns, recreational vehicle parks (RV parks), campgrounds, vacation rentals, and property management firms. The total collection of TOT for FY12/13 was \$9,705,030, an increase of 11% over FY11/12. TOT Administration is responsible for the administration and enforcement of TOT and works closely with the Permit and Resource Management Department to ensure that all vacation rentals registered by them obtain a TOT certificate. For FY 15/16, there were approximately 2200 operators with a total collection of TOT of approximately \$13,930,007.

Objective

The objective of this follow-up audit was to determine the status of implementation of recommendations contained in the TOT – Administration Function Audit report dated September 2014 and, where applicable, the impact of actions taken by management.

Scope

Our procedures were limited to reviewing evidence supporting the actions taken by the TOT Administration towards implementation of the report recommendations. We reviewed TOT Administration's records and conducted interviews with staff and management. Where available, we reviewed documentation supporting implementation of the recommendations.

Methodology

We conducted the follow-up audit in accordance with the International Standards for the Professional Practice of Internal Auditing (Standards). These Standards require that we identify, analyze, evaluate, and document sufficient information and evidence to achieve audit objectives. We believe that the evidence obtained provides a reasonable basis for the conclusion contained in our audit report. The Standards require that we establish a follow-up process to monitor and ensure that management has effectively implemented actions or that senior management has accepted the risk of not taking action. We conducted this follow-up audit from May 2016 through August 2016.

Prior Recommendations and Current Status

The following is a discussion of the status of implementation of the prior audit report recommendations. Each recommendation is referenced to the prior audit report.

A) Non-filing of tax gap (TOT not collected from operators of unregistered properties)

Recommendation No. A-1. Upgrade the current collection and reporting system

We recommend that management develop a system requirements document to support the strategies discussed in the report dated September 2014 and either upgrade the current system or search for systems that would best meet their needs. It may be helpful to find out about systems other jurisdictions currently use.

Status: In Process:

TOT Administration has not been able to find an off the shelf system that will meet its needs and is currently working with PRMD to determine if its permitting system would be a viable option.

Recommendation No. A-2. Engage outside contractors to help update the inventory of properties

We recommend that management investigate to determine if there are vendors who are able to offer a cost effective solution as discussed in recommendation A-1.

Status: In Process:

TOT Administration is currently working with two outside vendors to determine if they could cost effectively provide the support discussed in this recommendation. As a first step, these vendors will perform a data “scrape” of the vacation rental websites and compare the results with TOT Administration’s operator data base. The number of potentially unregistered operators identified through this exercise will provide support for hiring one or both of these vendors and/or implementing other strategies contained in this report.

Recommendation No. A-3. Amnesty

A limited one time amnesty program, forgiving penalties and interest for those registering during the program period, would be likely to increase property registrations. We recommend that management consult with other jurisdictions that have had success with amnesty programs and draft a plan for the County.

Status: Not Implemented:

TOT Administration will determine the cost effectiveness of an amnesty program versus other approaches once it has an accurate estimate of the rate of non-compliance per data analysis as noted in Recommendation A-2 above.

Recommendation No. A-4. Require property owners to post registration numbers on their online advertisements

1. All operators should be required to post registration numbers on the websites (current County Ordinance Section 26-88-120 requires operators of only non-owner occupied properties to post registration numbers on advertisements).
2. Management should investigate the applicability of image recognition in its strategy for identifying unregistered properties. If applicable, the capability to store and track pictures by property should be a part of the system requirement discussed above.

Prior Recommendations and Current Status

Status: A-4.1:In Process:

The requirement to post registration numbers was included in changes to the Vacation Rental ordinance approved by the Board (March 15, 2016) for PRMD. TOT Administration is proposing similar language for inclusion in the upcoming TOT ordinance revision and plans to present to the Board November 2016 for approval. PRMD is actively enforcing this provision.

Status: A-4.2:Will Not Be Implemented:

As discussed above in Recommendation A-2, TOT Administration is working with outside vendors to estimate the number of unregistered operators and determining a cost effective means to increase compliance. As such, the recommendation to investigate an image recognition strategy is no longer applicable.

Recommendation No. A-5. Increase advertising and outreach

A sustained advertising and outreach campaign should be conducted to educate and inform the operators and vacation rental organizations about ordinance requirements, enforcement activities, and the consequences of noncompliance.

Status: Implemented:

TOT Administration includes such information with the TOT tax returns mailed out each quarter. In Fiscal Year 2015-16 all secured property tax bills sent out by the Tax Collector contained information relating to TOT program compliance.

Recommendation No. A-6. Seek partnership with vacation rental websites

The County may benefit with partnerships with companies such as VRBO and Airbnb such as an agreement by organizations to collect and remit the TOT. In return, the County could offer compensation. Other possible arrangements, such as a partnership to disseminate TOT information to property owners on an ongoing basis, should be explored as well.

Status: In Process:

TOT Administration is currently working with Airbnb to obtain its help in ensuring its customers comply with the County's TOT ordinance. Additionally, TOT Administration has been working with other counties with the intent of developing a collective agreement with other online operators.

Recommendation No. A-7. Develop procedures for application and approval for properties claimed exempt from the requirements of the TOT ordinance

The TOT ordinance exempts "organized camps", as defined by California Health and Safety Code Section 18897, from collecting TOT. The California Code of Regulations Title 17, Subchapter 6, Section 30704, requires annual registration with the local health officer. We confirmed with the County Health Officer that at least one camp is neither registered as an "organized camp" nor is paying TOT.

Treasury Staff should maintain documentation for organizations claiming to be exempt from the requirements of the TOT ordinance. Those that do not provide documentation supporting their status as organized camps should be required to file TOT returns.

Prior Recommendations and Current Status

Status: Implemented:

TOT Administration followed up and obtained documentation supporting the exempt status of one organization that had not been paying TOT and was not registered as an “organized camp” at the time of our audit. The County Counsel concluded, based on the documents submitted by the organization in question, that this organization is exempt from paying TOT as its members are considered owners of the facility.

In TOT Administration’s estimate, there are very few such organizations in this County and therefore a robust program to identify them and obtain appropriate support would not be cost effective. Appropriate supporting documents will be requested if such organizations are identified via other enforcement activities.

B) Under-reporting tax gap (TOT not collected from operators of properties who are registered but are underreporting gross receipts or overstating exempt revenue)

Recommendation No. B-1. Develop property rent profiles

Property rent profiles could be created to accurately estimate gross rents and TOT due. This will allow the TOT Administration to better identify and follow up on properties with potentially understated gross receipts, exemptions, or TOT liability.

Status: Will Not Be Implemented:

TOT Administration believes that there aren’t sufficient common factors amongst vacation rental properties that correlate with gross revenues earned. As such, effective property profiles cannot be developed and used to produce actionable information such as potential underreporting of gross receipts in a cost effective manner.

Recommendation No. B-2. Periodically calculate the total under-reporting tax gap

The total underreporting tax gap would be the sum of negative variances of all properties calculated as described above. When monitored over time, this measure will indicate the effectiveness of strategies employed to discourage operators from underreporting.

Status: Will Not Be Implemented:

As discussed above in recommendation B-1, TOT Administration believes that effective property profiles cannot be developed that will help provide reasonable estimates of under-reporting tax gap.

Recommendation No. B-3. Collect occupancy data with the tax returns

The property owners/managers are not required to provide occupancy data. Occupancy data is useful in performing analytical procedures to test the reasonability of reported rent.

Occupancy data should be collected and taken into consideration to accurately estimate the tax gap, perform variance analysis and direct audit resources. The occupancy data could also be used to explain material variances, thereby avoiding the cost of an audit.

Status: Will Not Be Implemented:

TOT Administration believes that gross receipts are not being materially under reported. Past operator audits have not identified material underreporting.

Prior Recommendations and Current Status

Per TOT Administration, the tourism industry stake holders are strongly opposed to the County collecting occupancy data.

Recommendation No. B-4. Require all property managers to submit separate returns for each property

Currently, TOT return data by property is not being recorded for some 1,500 properties that are managed by professional property managers.

To more accurately develop property rent profiles and perform variance analysis, the TOT return data should be recorded separately for each property. Currently, TOT data is aggregated for multiple properties when all are being managed by a single property manager.

Status: Implemented:

TOT Administration has fully implemented procedures to require unique certificates for each property as opposed to one certificate per operator or manager. The number of certificates issued increased from 774 at the time of the audit to 2,200 as of June 30, 2016. This change greatly reduces the risk of uncollectable TOT and provides the basis for improved data analysis.

C) Non-payment tax gap (TOT not collected from delinquent operators)

Recommendation No. C-1. The County should maintain tax return information on each property

Detailed TOT tax return information is not maintained for approximately 1,500 properties. Without detailed rent and TOT collection history, it will be difficult for the County to estimate amounts due from specific properties for purposes of filing liens and pursuing collection through other means.

Status: Implemented:

As noted above in recommendation B-4, the individual properties were assigned their own certificate numbers. Individual properties are now easily identifiable for tax reporting. TOT Administration is now able to timely proceed with collection efforts on delinquent accounts, significantly reducing the risk of uncollectable TOT.

Recommendation No. C-2. Policies and procedure should be developed for writing off uncollectible accounts

Management should develop policies and procedures for writing off uncollectible accounts. For the inactive delinquent account that has a balance of \$700k, County Counsel should be consulted to determine if there are any remaining practical options for pursuing collection. After all reasonable options have been pursued, the account should be written off in accordance with the County policy.

Status: Implemented:

Based on justification provided by TOT Administration, as required by the County's policy for discharge of accountability for collections (Policy B-1), ACTTC approved a discharge from accountability for the \$700k in delinquent collectables.

TOT Administration is currently utilizing the ACTTC Fiscal Policy Manual Policy for Discharge of Accountability for Collections (B-1) and does not see a need to develop a policy specific to TOT.

Prior Recommendations, Current Status and Staff Acknowledgement

D) Overall

Recommendation No. D-1. Consider collaborating with the cities in the County who collect TOT

The County should explore the feasibility of a joint TOT administration with local cities to reduce administration costs.

Status: Will Not Be Implemented:

TOT Administration, consulted with local cities that collect TOT and found no support for a joint TOT Administration. Obstacles noted included differing TOT rules, varying tax rates, unwillingness by the cities to reimburse the County for cost of the program, and the lack of resources dedicated to the TOT programs at several cities.

Staff Acknowledgement

We would like to thank TOT Administration Management and Staff for their helpfulness and cooperation in conducting this follow-up audit. If you have any further questions regarding this report, please contact the auditor-in-charge, Ryan Burns, at (707) 565-8304.