



# Results of Transient Occupancy Tax Agreed-Upon Procedures

For a selection of hotels for  
calendar years 2017-2019

# REPORT

February 2021

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Report 2020-03

# INTRODUCTION

## Objective, scope and methodology

Transient occupancy taxes, known as TOT, comprise a significant portion of the revenues in the city's governmental funds. Because of this, it is important for the city to ensure hotels are complying with the Carlsbad Municipal Code chapter regarding transient occupancy taxes and remitting TOT appropriately.

The objective of this engagement was to determine if a selection of hotels in the City of Carlsbad properly reported and remitted TOT and assessments for the Carlsbad Tourism Business Improvement District, known as CTBID, and the Carlsbad Golf Lodging Business Improvement District, known as CGLBID, in compliance with the municipal code for calendar years 2017 through 2019.

To fulfill this objective, the city worked with the firm CliftonLarsonAllen, LLP, formerly called White Nelson Diehl Evans, LLP, to perform a set of agreed-upon procedures for a selection of 12 hotels located in the city, as outlined in the appendix. This report summarizes the results of those procedures. Although this is not a full audit and therefore limited in scope – that is, it does not include a risk assessment or an opinion, etc. – the agreed-upon procedures determined transient occupancy taxes owed to the city by the selected hotels. Had an audit been performed, other matters might have come to the internal auditor's attention and would have been reported.

Over the next few years, the city's internal auditor plans to continue working with an external firm to perform these agreed-upon procedures for the remaining hotels in the city. For this year's engagement, the internal auditor selected hotels to represent a variety of large and small properties.

The scope of this review excludes short-term vacation rentals for several reasons. First, TOT revenue from hotels comprises the vast majority of total TOT revenue received by the city. The city also has agreements with several third-party platforms that collect and remit these payments to the city on behalf of vacation rental owners. And the city's code enforcement division uses software to help identify short-term rentals not remitting TOT.

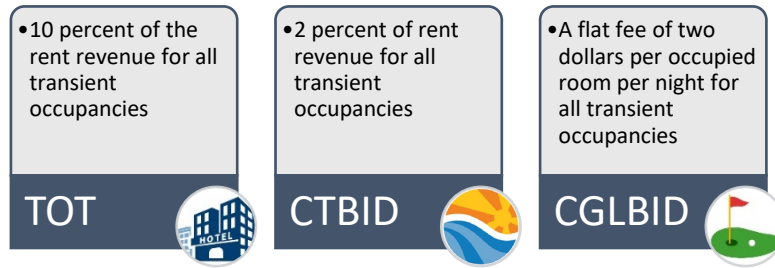
## Background

California Revenue & Taxation Code Sections 7280-7283.51 set forth the state's regulations for transient occupancy taxes, and Chapter 3.12 of the Carlsbad Municipal Code sets forth the city's regulations on its TOT. This tax applies to any person who occupies a hotel for a period of 30 days or less and is not exempt based upon 10 percent of the rent charged by the hotel operator. Typical exemptions for paying TOT are for federal or state employees when staying on official business. TOT revenue is allocated to the city's General Fund.

The city also collects assessments to support its tourism and golf lodging business improvement districts. The regulations governing these districts are set forth, respectively in Carlsbad Municipal Code Chapters 3.37 and 3.38. Proceeds from the CTBID assessment are used to administer marketing and visitor programs to promote the City of Carlsbad as a tourism visitor destination and to fund projects, programs and activities, including appropriate administrative charges, that benefit hotels within the boundaries of the district. Funds collected for the CGLBID are used to promote golf-related tourism within the district, as well as marketing-related capital improvements such as golf-related signage, golf-related equipment and to pay for related administrative costs.

Hotels are also required to report and remit these assessments according to the following:

- For the CTBID, effective Nov. 1, 2020 all hotel businesses in the City of Carlsbad must pay two percent of gross revenues. For the review period, prior to this increase, the assessment was based upon a flat fee of one dollar per occupied room per night for all transient occupancies.
- For the CGLBID, hotels in the city that have elected to be part of the district for the fiscal year pay a flat fee of two dollars per occupied room per night for all transient occupancies. Six hotels participated in the CGLBID as of 2019-20 fiscal year end.



Hotel operators collect and remit taxes to the city on a monthly basis. The city’s Finance Department is responsible for the collection and administration of TOT and assessments. Table 1 summarizes total TOT and assessment revenue received by the city in fiscal years 2017-18 through 2019-20.

**Table 1: Revenue received from transient occupancy taxes and assessments from the tourism and golf lodging business improvement districts for fiscal years 2017-18 through 2019-20**

Fiscal year	TOT	CTBID	CGLBID
2017-18	\$24,233,536	\$1,246,944	\$681,703
2018-19	26,320,645	1,333,001	719,740
2019-20	18,898,325	1,086,188	534,241
<b>Total</b>	<b>\$69,452,506</b>	<b>\$3,666,133</b>	<b>\$1,935,684</b>

**Source:** City of Carlsbad comprehensive annual financial reports for fiscal years 2017-18 through 2019-20 and the districts’ annual reports.

## SUMMARY OF RESULTS

### Results of agreed-upon procedures

The procedures performed for the selection of 12 hotels for calendar years 2017 through 2019 identified additional revenue owed to the city and associated penalties and interest. The results are presented in Tables 2 and 3 on the following page. Hotel names are omitted from the tables. Of the 12 hotels selected, only two participated in the CGLBID and neither owed additional assessments as a result of this engagement.<sup>1</sup>

<sup>1</sup> Of the 12 hotels included in this engagement, the two properties that are members of the Carlsbad Golf Lodging Business Improvement District collectively paid \$809,812 in CGLBID assessments to the city for calendar years 2017 through 2019.

In general, the hotel operators owed additional TOT to the city for a few reasons:

- Underreported transient rent for income from extra fees and charges
- Overreported tax-exempt rent because the hotel could not provide adequate or accurate supporting documentation
- Variances found when reviewing the mathematical accuracy and timeliness of tax forms

**Table 2: TOT underpaid or overpaid by hotel for calendar years 2017 through 2019**

Hotel	TOT collected for calendar year 2017-19	TOT underpaid (overpaid) by hotel	Penalties and interest	Total due to city (owed by city)
1	\$1,199,340	\$4,176	\$2,266	\$6,442
2	129,771	2,489	1,707	4,197
3	268,320	1,382	1,043	2,426
4	1,212,638	(48)		(48)
5	1,363,375	4,246	2,747	6,992
6	1,105,377	2,337	919	3,255
7	947,770			
8	1,198,875	244	8,059*	8,302
9	1,810,852	(315)		(315)
10	10,753,916	19,572	9,941	29,513
11	155,259	3,454	1,117	4,571
12	1,210,206	15,273	8,266	23,539
Total	\$21,355,699	\$52,809	\$36,651	\$88,875

**Table 3: CTBID overpaid or underpaid by hotel for calendar years 2017 through 2019**

Hotel	CTBID collected for CY 2017-19	CTBID underpaid (overpaid) by hotel	Penalties and interest	Total due to city (owed by city)
1	\$36,689			
2	6,563	\$288	\$29	\$317
3	24,651			
4	88,960	189	97	286
5	36,953			
6	71,220			
7	43,280			
8	89,445		732*	732
9	125,836	(641)		(641)
10	399,224	(1,827)		(1,827)
11	22,492	455	178	633
12	71,184	(57)		(57)
Total	\$1,016,497	\$(1,593)	\$1,036	\$(557)

\*This hotel underpaid TOT by a small amount and did not owe additional assessments for CTBID. The penalties and interest are assessed because the hotel made several late payments.  
 Source: Selected hotels' tax returns for calendar years 2017 to 2019, agreed-upon procedures reports provided by firm and city internal auditor's calculations.

When a deficiency is determined after an audit, the Carlsbad Municipal Code Section 3.12.080(C) requires the tax administrator to immediately invoice hotel operators for the:

- Net deficiency
- A penalty of 10% of the net deficiency

If the hotel operators do not pay the deficient amount and penalties within 14 days of the invoice date, they are subject to an additional penalty of one percent of the net deficiency per day, not to exceed 10% of the net deficiency.

Carlsbad Municipal Code Section 3.12.080(E) states that in addition to the imposed penalties, hotel operators who fail to remit taxes must pay interest at the rate of one and one-half percent per month or fraction of a month, on the amount of the tax, exclusive of penalties, from the date on which the remittance first became delinquent until paid.

Given the unique economic challenges COVID-19 has placed on the hospitality industry, the internal auditor — in discussions with city leadership — determined it was best to first brief the City Council and offer an opportunity for feedback before providing the results to the Finance Department to invoice hotel operators. Additionally, the COVID-19 pandemic resulted in delays in the auditing and reporting process. To prevent hotel operators from being subject to undue penalties and interest pending the City Council's receipt and approval of this transient occupancy tax review report, the internal auditor is recommending the City Council pass a resolution advising the tax administrator to invoice hotel operators for any net audit deficiencies and penalties under Carlsbad Municipal Code Section 3.12.080(C) as of the date the City Council approves the transient occupancy review report and to assess interest under Carlsbad Municipal Code Section 3.12.080(E) as of the completion date of each hotel operator's transient occupancy tax review.

Hotel operators who do not pay the invoices and interest assessments within the appropriate time frame will still be subject to any additional penalties, interest and remedies provided for in the municipal code.

Therefore, based on the results of this engagement, and the City Council's response to this recommendation and any other feedback provided, the Finance Department should immediately invoice and refund or credit hotel operators as appropriate.

**Recommendation #1:** To ensure that hotels are not charged interest for a period in which they were not yet invoiced for audit deficiencies, the City Council should consider passing a resolution to assess interest for deficiencies identified as part of this engagement as of each hotel's final report date instead of the date paid.

Staff will present this recommendation to the City Council at an upcoming public meeting and request the City Council's guidance.

**Recommendation #2:** To collect the TOT and assessment revenue owed to the city, the Finance Department should immediately work with hotel operators to invoice and refund or credit hotel operators as appropriate, following any additional guidance provided by the City Council.

**Management's Response:** City staff will work with and invoice hotel operators in accordance with the results of the TOT audit and any additional guidance provided by the City Council.

## How the city communicates its TOT guidance

There is an opportunity for the city to make improvements in how it communicates its TOT guidance to hotels. The results of the agreed-upon procedures in the engagement indicated that hotel operators may be unclear about the taxability of certain extra fees and charges. The Carlsbad Municipal Code contains a definition of what is considered “rent” and therefore taxable. Additionally, a memo in the Finance Department’s records further elaborates that all fees or charges that are suggested as mandatory for the privilege of occupancy should be considered taxable for TOT and the CTBID assessment, such as resort fees, no-show fees, attrition fees, cancellation charges, late check-out fees, cleaning fees, extra person charges, pet-in-room fees, rollaway bed charges, etc.

However, approximately half of the hotels reviewed owed additional TOT for certain miscellaneous revenue excluded from taxable rent. In fact, several hotel operators requested a copy of the Finance Department memo about extra fees and charges for clarification on the taxability of this miscellaneous revenue. The absence of clear guidance about the taxability of certain extra fees and charges may result in hotels inadvertently excluding income from the calculation of TOT and ultimately, less TOT revenue for the city. Therefore, the Finance Department should update the city’s website to explain that separate charges levied for items or services which are part of such accommodations are considered rent and therefore taxable.

Although an update to the city’s website can provide additional clarity in the short-term, the city should consider performing a comprehensive review of Chapter 3.12 of the Carlsbad Municipal Code that addresses TOT. This update could further clarify the definition of taxable rent. Additionally, it could address how interest is assessed when deficiencies are identified as part of an audit, as discussed earlier. Historical documents indicate that the city has used the final report date as the date for calculating interest in past TOT reviews, rather than the date the remittance was paid. Therefore, the city should consider updating the relevant section of the municipal code when it performs a comprehensive review to align with the city’s practices.

**Recommendation #3:** To ensure the city receives all revenue owed to it for mandatory charges and extra fees considered taxable for the transient occupancy tax, the Finance Department should clarify this information for hotels. In the short-term, the Finance Department could update the transient occupancy tax page on the city’s website clarifying this information. Long term, the Finance Department could work with Carlsbad Municipal Code and City Council Policy Update Subcommittee to clarify this information in the city’s municipal code.

**Management’s Response:** The Finance Department has added clarifying information on the city’s transient occupancy tax webpage clarifying which charges and fees are considered taxable for the transient occupancy tax. The Finance Department will review the Carlsbad Municipal Code and consider recommending clarifying language to the Carlsbad Municipal Code and City Council Policy Update Subcommittee.

## TOT payments by credit card

The city pays a fee to process all credit card payments, including those by hotels that choose to pay TOT via credit card. Hotels are also able to remit TOT payments online with a credit card or check, or by mailing or delivering a check, money order, or cash. The city does not currently charge an administrative fee to anyone making online payments to the city by credit card, including TOT payments, although it has the authority to do so.

A representative from the Finance Department stated that the city regularly receives TOT payments by credit card for three hotels and a number of short-term vacation rental properties. The internal auditor reviewed bank records to estimate how much the city is paying to process credit card payments for TOT. Generally, cashiers at the Faraday Center are the city staff

who are responsible for processing TOT payments. According to the bank data, the city paid an average effective fee of 2.35% of gross credit card payments processed at the Faraday Center in calendar year 2020. One of the hotels in the city that regularly pays TOT by credit card paid approximately \$326,000 in TOT to the city in calendar year 2019. Using the most recent average effective fee of 2.35%, the city would have paid approximately \$7,665 for one hotel to pay one year's worth of TOT via credit card.<sup>2</sup>

Additionally, during November 2020, the city launched a payment portal to support online credit card and electronic check payments for several types of payments, including TOT. It's possible that, given the financial effect of COVID-19 on the economy and the ease of the new system supporting paying by credit card, more hotels will use the online portal to pay TOT by credit card. This may ultimately result in the city paying higher credit card fees for TOT payments than in prior years.

One option for the city to consider is charging an administrative fee to cover costs of the administration of processing credit card payments. This could apply to credit card payments for a variety of city programs, not just for TOT. Additionally, there are other considerations such as the potential savings from reducing other payment methods, fraud risks, personnel resources, etc., making this a much larger topic for discussion.

**Recommendation #4:** Based on feedback from the City Council, the Finance Department should consider options for potentially implementing an administrative fee for credit card transactions and present it to the City Council for its consideration.

**Management's Response:** If directed by the City Council, staff will return to the City Council to discuss options for potentially implementing an administrative fee for credit card transactions.

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<sup>2</sup> This calculation uses the hotel's payment records for calendar year 2019 because 2020 payments are not reflective of an average year due to the pandemic's effects on TOT.

# Transient Occupancy Tax Agreed-Upon Procedures

## APPENDIX



## Appendix: Schedule of procedures to be performed

The list below comprises the procedures that the firm now known as CliftonLarsonAllen applied as agreed upon by the City of Carlsbad.

1. We will review the City Municipal Code Title 3 Chapter 3.12 Transient Occupancy Tax and resolution related to the transient occupancy tax, as well as review the City Municipal Code Title 3 Chapter 3.37 Carlsbad Tourism Business Improvement District and Chapter 3.38 Carlsbad Golf Lodging Business Improvement District.
2. We will verify the mathematical accuracy and timeliness of the monthly transient occupancy reports filed with the City for the calendar years 2017, 2018, and 2019.
3. We will trace the transient rent receipts reported on the transient occupancy tax returns prepared by the Hotel to the transient rent receipts recorded in their accounting records and verify that these were in accordance with the City's ordinance.
4. We will select a sample of rental transactions during the review period and for each transaction selected, we will verify tax computations and trace the amounts of rental revenues and transient occupancy tax collected to the books and records of the Hotel.
5. We will trace the total number of days each unit/hotel room is occupied on the transient occupancy tax returns prepared by the Hotel to the total number of days each unit/hotel is occupied in their records and verify that these are in accordance with the City's ordinance.
6. We will review the internal control procedures of the Hotel to determine the following:
  - a. How "transient rent receipts" were accounted for and reported to the City.
  - b. What procedures were in place to identify transient and non-transient guests?
  - c. How exemptions, including complimentary rooms, were documented and reported to the City.
7. We will review the supporting documentation, on a sample basis, for exemptions claimed on the transient occupancy tax returns.
8. We will perform additional procedures that the City considers necessary to verify the reasonableness of reported revenues of the Hotel operator.
9. We will inquire how the Hotel handles reservations and payments done online through a third party such as Expedia.com and how the transient occupancy tax was collected and reported to the City for these transactions.