

Sonoma County

Auditor-Controller-Treasurer-Tax Collector

Internal Audit Report

Compliance Audit: Transient Occupancy Tax Operator Collections & Remittances

For the Calendar Year Ended
December 31, 2022

Engagement No: 3565
Report Date: January 24, 2025



Erick Roeser

Auditor-Controller-Treasurer-Tax Collector

ERICK ROESER
AUDITOR-CONTROLLER
TREASURER-TAX COLLECTOR

585 FISCAL DRIVE, SUITE 100
SANTA ROSA, CA 95403
PHONE (707) 565-2631
FAX (707) 565-3489



AMANDA RUCH, CPA
ASSISTANT AUDITOR-CONTROLLER
TREASURER-TAX COLLECTOR

BROOKE KOOP, CPA
ASSISTANT AUDITOR-CONTROLLER
TREASURER-TAX COLLECTOR

KATHLEEN PARNELL
ASSISTANT AUDITOR-CONTROLLER
TREASURER-TAX COLLECTOR

Assigned Audit Team Staff

Damian Gonshorowski, CPA, CIA

Audit Manager

Venina Ranadi

Auditor-In-Charge

Auditor-Controller-Treasurer-Tax Collector Web Site

<http://sonomacounty.ca.gov/Auditor-Controller-Treasurer-Tax-Collector/>

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Executive Summary

The Audit Division of the Sonoma County Auditor-Controller-Treasurer-Tax Collector's Office (Internal Audit) has completed a compliance audit of collections and remittances of certain operator entities subject to the Sonoma County (County) Transient Occupancy Tax (TOT) Ordinance.

Current Year Operator Audits

For the period January 1, 2022, to December 31, 2022, twenty-two (22) entities were selected for a detailed review where twenty-one (21) operators collected TOT and one (1) operator, Ratna Ling Retreat Center collected a Condition 91 fee.

Ratna Ling Retreat Center failed to annually adjust their fees as required by the agreement with the County, as a result we reviewed their Condition 91 fees for calendar years 2019 through 2023. Ratna Ling Retreat Center entered into an agreement (effective January 1, 2017) with the County which requires Ratna Ling Retreat Center to pay a fee to the County equal to and in lieu of Transient Occupancy Tax. The agreement requires Ratna Ling Retreat Center to utilize the TOT forms to report and submit quarterly fees for the retreat/camping uses authorized by the Master Use Permit ("Condition 91 Fee").

The current year highlights are provided below:

- Three (3) out of the twenty-one (21) audited properties generally complied with the TOT Ordinance.
- We were unable to audit one (1) operator due to insufficient records. Seventeen (17) operators underpaid TOT by approximately \$48k and Business Improvement Area Assessment (BIA) by approximately \$8k.
- Unpaid TOT was due to a combination of factors such as reporting errors, underreporting of gross rent, and collection but non-remittance of TOT on fees such as cleaning and services fees.
- Ratna Ling Retreat Center underpaid the Condition 91 fee by approximately \$14k between January 1, 2019 – December 31, 2023.
- KVR managed operators collected TOT and BIA on certain rental charges but failed to remit that TOT and BIA to the County.
- Audited properties reported approximately \$600k in Airbnb gross rent exemptions which we were unable to audit, because Airbnb does not provide detailed records when they remit TOT.

Summary of Recommendations for Current Year Operator Audit:

TOT Administration should:

- Settle the under payments with respective Operators as appropriate.
- Implement a process where staff review and monitor special arrangements between the County and other operators such as the Condition 91 Fee Agreement the financial provisions of the Agreement are complied with.
- TOT Administration should enforce Sec. 12-15 of the TOT Ordinance, which requires all operators to report and remit gross rents and TOT based on when rents are charged, received and the amount of TOT is collected for transient occupancies. Compel operators to provide required records.

Status of Prior Year Operator Audit Recommendations:

- Of the four (4) prior year recommendations, three (3) have been implemented and one has been partially implemented.
- We followed up with the ten (10) operators who failed to provide records in the prior year audit. Six (6) operators provided records while two (2) reported that they were not operating and two (2) did not respond. A total of \$2,825 in underpaid TOT and \$471 in underpaid BIA were identified.

Introduction & Background

Introduction

Internal Audit has completed a compliance audit of the collections and remittances of certain operator entities, (operators), subject to the County TOT Ordinance. We designed this internal audit to identify, analyze, evaluate, and document sufficient information and evidence to achieve our audit objectives. We believe that the evidence obtained provides a reasonable basis for the results, findings and recommendations contained in our report.

The purpose of this audit report is to furnish management independent and objective analyses, recommendations, and other information concerning the activities reviewed. The audit report is a tool to help management identify and implement improvements.

Occasionally, to fulfill its risk management responsibilities, management requests Internal Audit to perform studies, analysis, or audits. In responding to these requests, we ensure that we do not take on any responsibilities for designing, implementing, or operating any part of internal control systems so that our independence regarding those systems is not impaired.

At the request of the County Administrator's Office, we have performed audits of entities subject to TOT and plan on providing such assistance in the future. For purposes of this report, TOT Administration is handled by the Auditor-Controller-Treasurer-Tax Collector's Revenue Accounting Division. We do not believe that performing these audits constitutes assuming responsibility for the design, implementation, or operation of any part of TOT Administration's internal control system. Internal Audit analyzes TOT data collection and proposes an audit scope which is agreed to by TOT Administration.

Background

The assessment and collection of TOT is authorized under California State Revenue and Taxation Code Section 7280, as an additional source of non-property tax revenue to local governments. TOT is assessed by operators on transients who occupy lodging facilities (e.g. hotels, motels, campgrounds, or vacation rental homes) in the unincorporated areas of the County for fewer than 30 consecutive calendar days. In Sonoma County, this tax was levied at a rate of 12%, for this audit period. TOT funds are discretionary, in that the Board of Supervisors may direct use of these funds for any legitimate county expense. The tax code does not require any specific use of TOT funds.

As of December 31, 2022, there were two thousand seven hundred twenty-seven (2,727) operators, registered with the County, including hotels, motels, bed & breakfasts, inns, recreational parks, campgrounds, vacation rentals, and property management firms. The total collection of TOT for the calendar year 2022 was \$33.1 million, as compared to 2021 which had revenue of approximately \$31.8 million. TOT for booking transactions completed by hosts and guests for the unincorporated areas of Sonoma County via the Airbnb internet-based platform is collected, reported, and remitted in aggregate by Airbnb to the County on the TOT return form. The TOT Administration is responsible for the administration and enforcement of TOT and works closely with Permit Sonoma to ensure that all vacation rentals registered by them obtain a TOT certificate. Each operator is required to report and remit TOT on a quarterly basis, or a shorter basis as directed by the TOT Administration.

Objective, Scope & Methodology

Objective

The primary objective of this audit was to determine whether selected entities filed timely and accurate returns and paid the amounts due in compliance with the financial provisions of the TOT Ordinance.

Scope

The audit covered the period January 1, 2022, to December 31, 2022, for twenty-two (22) entities. The scope was expanded to the period January 1, 2019, to December 31, 2023 for Ratna Ling Retreat Center after discovering they failed to adjust fees paid to the County as required by their agreement with the County. We followed-up on prior year recommendations including requesting gross rents records for the period January 1, 2021, to December 31, 2021, for entities that failed to provide records during the prior audit.

Methodology

We reviewed and analyzed the 2022 TOT collections by performing a trend analysis of all collections for all properties. We considered prior audit findings and results of the trend analysis to select a sample of establishments for a detailed review. A sample of 22 establishments was judgmentally selected, we reviewed the following documentation.

- Guest registry / financial system report of rent collected
- Online travel company revenue statements
- Property Management revenue statements
- Sample of guest invoices/folios
- Contracts and other supporting documentation for exempt stays

Using records obtained from establishments we calculated amounts owed and compared it to amounts reported in TOT returns, results of our reviews were discussed with management of the establishments and reported in the results and other matters section of this report.

Results & Other Matters

Results of 2022

Three (3) operators filed timely accurate returns and paid TOT due in compliance with the financial provisions of the TOT ordinance. The remaining nineteen (19) operators did not comply with one or more financial provisions and or returns were not supported by records provided by the operators, resulting in additional TOT and Condition 91 fees owed to the County.

The Airbnb and VRBO Reporting Instructions on the ACTTC website instructed operators "TOT should be reported when the stay occurs". Nearly all of the operators we reviewed, reported gross rent based on check-in date instead of the date that rent was collected from transients, as required by Sec. 12-15 of the TOT Ordinance.

The details related to operators who had one or more instances of non-compliance or whose records did not support the gross rent and TOT reported on the TOT Tax Return are listed below:

Gehricke 2

TOT was underpaid by \$367, based on the check in method of reporting gross rent. The property manager was unable to provide collection system records for Gehricke 2 separately from other properties recorded in their financial system, as a result we are unable to determine whether all gross rents and TOT was reported and remitted in compliance with the TOT ordinance. The property manager for the operator did not separately report Airbnb exemptions but instead netted Airbnb rent with other rent for quarters 1-3. Service fees and credit card fees required to be paid by transients was excluded from gross rent reported in TOT returns.

Elder Properties

We were unable to complete an audit of this property because the records provided by the operator appear to exclude some gross rent transactions. The records that were provided during the audit do not support gross room rent and TOT reported/remitted to the County. The current preparer of the operator's returns was not in charge of filing the operator's 2022 TOT returns which made it difficult to determine the unexplained differences.

Bovill on Shell Beach

TOT was underpaid by \$3,200. The operator appears to have systematically collected 18% tax from transients and remitted 14% (12% TOT + 2% BIA) to the County. Records provided by the operator include a tax line item which represents 18% of the gross rent, TOT and BIA account for 14%. The operator claimed the remaining 4% was for fees, however no additional information was provided to support that claim.

Results & Other Matters

5455 Gates Road

Records provided during the audit do not match gross room rent and TOT reported/remitted to the County. The Operator incorrectly reported exemptions in its quarter 4 returns. The operator also lacked adequate record keeping internal controls. There are unexplained differences between gross rent reported in the TOT returns and the gross rent records provided for this audit. Using the 2022 VRBO records provided by the operator, TOT was underreported/underpaid between \$8,501 and \$8,629 based on the check in date or payout date methods of reporting gross rent.

Laguna Country House

TOT was underpaid by \$85. At least one VRBO transaction was not included in a quarterly TOT return. The property manager did not separately report Airbnb exemptions but instead netted Airbnb rents with other rent for all quarters.

KVR Management Inc.

Calendar year 2022 TOT was underpaid by \$38,032 for 13 properties. The property manager collected TOT (on certain fees and charges) but did not report/remit it to the County for thirteen (13) properties. Records provided during the audit do not match gross room rent and TOT reported/remitted to the County. Similar to the 2021 audit findings, TOT and BIA were charged and collected on cleaning, service & supply and processing fees however, it was systematically excluded from amounts remitted to the County.

Results of 2021 Follow-up

Miraval

Calendar year 2021 TOT was underpaid by \$2,636. This was a result of not reporting certain amounts charged to transients. The operator charged 18% tax on gross rent instead of 12% TOT and 2% BIA. This additional 4% or \$21,965 was classified as "taxes" and was not reported on TOT returns, the operator claims this additional 4% represents service fees that were paid by transients.

Kenwood Knoll

Calendar year 2021 TOT was overpaid by \$236, as result of calculating Airbnb exemptions \$1,966 lower in the property manager's TOT returns, than what was shown on their records.

Twilight Ridge

Calendar year 2021 TOT was overpaid by \$509, as result of calculating gross rent \$4,240 higher in the property manager's TOT returns, than what was shown on their records.

Villa Carneros & the Attune Estate

Calendar year 2021 TOT was underpaid by \$189, as result of calculating Airbnb exemptions \$1,577 higher in the property manager's TOT returns, than what was shown on their records.

Results & Other Matters

Other Matters

Ratna Ling Retreat Center

For calendar years January 1, 2019, to December 31, 2023, required annual adjustments to rent were not made by Ratna Ling Retreat Center, as a result, the Condition 91 fee was underpaid by \$14,577. Ratna Ling Retreat Center paid a Condition 91 fee based on an Agreement between the County and the entity. The Agreement requires that the fee be calculated by applying the rate (12%) provided in Sonoma Code Section 12-11 to the rent charged to transients. For the purposes of the Agreement, the word 'rent' shall mean \$187.00 per night, to be annually adjusted beginning on January 1, 2018, by the most recent change in the annual average of the Consumer Price Index ("CPI") for all urban consumers in the San Francisco-Oakland-San Jose areas as published by the United State Government Bureau of Labor Statistics.

Airbnb Revenue Exemptions

Four (4) of the operators audited claimed Airbnb revenue exemptions totaling \$601,221 in 2022. The collection, reporting, and remittance of gross revenues and TOT for the booking transactions completed on the Airbnb internet-based platform is reported and remitted in aggregate by Airbnb to the County. Thus, we are unable to verify that TOT applicable to the Airbnb revenue exemptions claimed was accurately assessed, collected, and remitted to the County by Airbnb.

TOT Reporting

The Airbnb & VRBO Reporting Instructions on the ACTTC website instructs operators to report TOT based on when the stay occurs however, Section 12-15 of the TOT Ordinance requires that operators remit TOT based on when it is collected from transients. During the audit, two (2) of the operators reported TOT based on when the gross rent was collected or paid out as opposed to when the stays occurred. One (1) of the two (2) operators was reporting TOT based on the payout date for the first three quarters but was later directed by TOT Administration staff to report TOT based on check out dates in the fourth quarter which resulted in lagging payment to the County. The remaining operators reported TOT based on the check in method or when guests checked into their vacation rental.

Current Year Recommendations & Management Responses

Recommendation No. 1 (Risk Classification C: Control Weakness):

Under paid TOT and BIA should be settled with respective operators as appropriate.

Management Response No. 1:

The TOT Administration will review the audit report and send letters to the audited establishments informing the operators of the audit findings and requesting additional funds.

Recommendation No. 2 (Risk Classification C: Control Weakness):

TOT Administration should implement a process to monitor owner/operator compliance with the financial provisions of the Condition 91 Fee Agreement and other similar agreements or special arrangements between the County and entities.

Management Response No. 2:

TOT Administration agrees with this recommendation and will add an annual procedure to verify the calculation of the Condition 91 nightly fee charged to guests.

Recommendation No. 3 (Risk Classification C: Control Weakness):

TOT Administration should remove the language from the Airbnb and VRBO Reporting Instructions which states "TOT should be reported when the stay occurs". TOT Administration should communicate with all operators the requirement in Sec. 12-15 of the TOT Ordinance for operators to report and remit gross rents and TOT based on when rents are charged, received and the amount of TOT is collected for transient occupancies. The communication should give operators time to change their reporting and make it clear that reporting using other criteria such as check in date is not an acceptable basis of reporting rents and TOT.

Management Response No. 3:

TOT Administration agrees with the recommendation and will explore the best approach on timing of the communication to operators.

Recommendation No. 4 (Risk Classification C: Control Weakness):

TOT Administration should consider taking steps outlined in the ordinance, including revoking their TOT certificate, to compel Elder Properties to provide records supporting TOT returns, as required by the TOT Ordinance.

Management Response No. 4:

The TOT Administration will consider taking additional steps, as outlined in the ordinance, to compel operators to provide records supporting TOT returns.

Status of Prior Year Recommendations

Recommendation No. 1 (Risk Classification C: Control Weakness):

TOT Administration should investigate the difference in Airbnb exemptions reported by establishments and the gross rent receipts reported by Airbnb.

Status No. 1: Implemented

According to TOT Administration, the difference was investigated. The gross rents calculation did not account for over 500 registered operators deemed Airbnb exclusive. Operators were not required to provide Airbnb Exemptions reports in the 2021 calendar year. Beginning with the reporting period January 1, 2023, all Operators (including Airbnb exclusive) are required to submit documentation that supports the gross rent and TOT collected from guests.

Recommendation No. 2 (Risk Classification D: Opportunity for Improvement):

TOT Administration should review the exemption treatment for Hilton Garden Inn in accordance with the TOT Ordinance and provide guidance to ensure consistent application of the exemption rule. TOT Administration should prescribe appropriate documents to support exemptions reported by the establishment.

Status No. 2: In Progress

TOT Administration reached out to Hilton Garden Inn; an overview of the exemption rules as outlined in the TOT ordinance has not been provided. According to TOT Administration, starting in January 2024, Hilton Garden Inn ceased to claim exemptions on their TOT returns.

Recommendation No. 3 (Risk Classification D: Opportunity for Improvement):

TOT Administration should review the 'Frequently Asked Questions' on the County website to help operators better interpret the TOT Ordinance. We noted the operators lack understanding of the TOT Ordinance that resulted in inaccurate calculation of the taxable gross rent and inappropriate exclusion of fees and charges.

Status No. 3: Implemented

The TOT Administration updated the 'Frequently Asked Questions' on the County website.

Recommendation No. 4 (Risk Classification D: Opportunity for Improvement):

For those entities that failed to provide requested TOT records as required by the TOT Ordinance, TOT Administration should consider taking steps outlined in the ordinance to compel the operators to provide records, including revoking their TOT certificate.

Status No. 4: Partially Implemented.

The TOT Administration has implemented a standard process to follow up with auditees that fail to respond to internal audit requested. TOT Administration sent out letters to those ten (10) operators who failed to provide records in the prior year audit. Six (6) operators provided records while two (2) reported that they were not operating. The remaining two (2) did not respond, the owner/operators for 17341 Highway 12 and Villa Vigneto have not provided records requested for the audit and continue to be out of compliance with the TOT ordinance.

Appendix A: Report Item Risk Classification

For purposes of reporting audit findings and recommendations, audit report items are classified into three distinct categories to identify the perceived risk exposure:

- **Risk Classification A: Critical Control Weakness:**
Serious audit findings or a combination of Significant Control Weaknesses that represent critical exceptions to the audit objective(s), policies, and/or business goals of a department/agency or the County as a whole. Management is expected to address Critical Control Weaknesses brought to their attention immediately.

- **Risk Classification B: Significant Control Weakness:**
Audit findings or a combination of Control Weaknesses that represent a significant deficiency in the design or operation of internal controls. Significant Control Weaknesses generally will require prompt corrective actions.

- **Risk Classification C: Control Weakness:**
Audit findings concerning internal controls, or compliance issues that require management's corrective action to implement or enhance processes and internal controls. Control Weaknesses are expected to be addressed within our follow-up process.

- **Risk Classification D: Opportunity for Improvement:**
Audit findings concerning opportunities for improvement or efficiency/effectiveness issues that require management's consideration to implement or enhance processes. Opportunities for improvement are expected to be addressed within our follow-up process.

The current status of implementation of recommendations will be followed up no later than the end of the second fiscal year after the report has been issued. Critical control weaknesses will be followed up between six months and one year of the date of the report.