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Audit Report

**HOTEL OCCUPANCY TAX:
COLLECTION AND REMITTANCE
AUDIT, PHASE III**

August 22, 2006

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Austin, Texas**

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Date: August 22, 2006
To: Mayor and Council
From: Stephen L. Morgan, City Auditor
Subject: Hotel Occupancy Tax Collection and Remittance Audit

I am pleased to present this third audit report on our hotel occupancy tax audit. For this audit, we examined 33 hotels to determine whether they were properly collecting and remitting City hotel occupancy taxes.

Of the 33 hotels selected, 28 hotels were found to have compliance issues and/or additional tax liability totaling close to \$186,000. Of the remaining hotels, 4 demonstrated compliance. Five hotel audits, continued from Phase II, with additional tax liability totaling over \$77,000, were also completed. Total tax liability exceeds \$263,000. Liability issues primarily arose from improper application of exclusions and exemptions to the tax and failure to maintain adequate documentation of non-taxable revenue reported.

In the previous Hotel Occupancy Tax Collection and Remittance Audit (Phase II), we issued two recommendations to improve collection and remittance of the hotel occupancy tax (HOT). The first recommendation was to rewrite the Hotel Occupancy Tax ordinance for increased clarification and tentative work has begun on this. The second recommendation was to increase oversight of the collection and remittance of the Hotel Occupancy Tax and funding for an audit position is requested in the OCA proposed budget.

We appreciate the cooperation and assistance we received from staff in the Financial and Administrative Services Department and the Law Department during this audit.

The three audits conducted to date have been very successful and City has seen a gain of \$1.5 million in additional revenue from them.

Stephen L. Morgan, CIA, CGAP, CFE, CGFM
City Auditor

COUNCIL SUMMARY

This report presents the results of the third in a series of hotel occupancy tax audits. It is the second Hotel Occupancy Tax Collection and Remittance Audit. The goal of this audit is to determine if hotels are properly collecting and remitting City hotel occupancy taxes.

Of the 33 hotels selected, 4 demonstrated compliance and were assessed no additional tax liability. The other 28 hotels were found to have compliance issues and/or additional tax liability and 1 hotel audit was suspended due to bankruptcy issues. Our audits indicated that these 28 hotels owed additional taxes ranging from about \$650 to \$25,290. Total deficiencies are close to \$186,000. Audit work on 5 hotels, begun in the Phase II audit, was also completed with a total liability exceeding \$77,000. Thus, total revenue for this audit exceeds \$263,000.

The scope of this audit centered on claimed exemptions and exclusions. The understanding and application of rules related to exempt guests varied across hotels. Guests qualifying as permanent residents are entitled to a hotel occupancy tax exclusion. However, some hotels incorrectly apply the exclusions for such guests. Guests who are employees of certain agencies and organizations are also exempt from the tax. We found multiple instances in which hotels were offering exemption for ineligible guests.

In addition to misapplication of exemptions and exclusions, we also encountered several other issues with hotel owners including:

- Lack of reliable documentation for the entire 4 year audit scope period;
- Potential fraud in questionable records; and
- Failure to ensure that a prior owner did not owe taxes at the time of purchase.

Austin hotels operate in an environment of lenient enforcement and insufficient communication with regard to the hotel occupancy tax, which may contribute to the level and types of compliance problems identified.

As a result of our prior work, we made recommendations to strengthen the City ordinance guiding the hotel occupancy tax and to enhance monitoring of the tax. Tentative work has begun on writing a new ordinance, funding was provided at mid-year to conduct the Phase III audit, and the OCA has requested funding in the FY 2007 proposed budget for a revenue auditor to conduct the next series of audits.

The three audits conducted to date have identified \$1.5 million in additional hotel occupancy tax revenue for the City.

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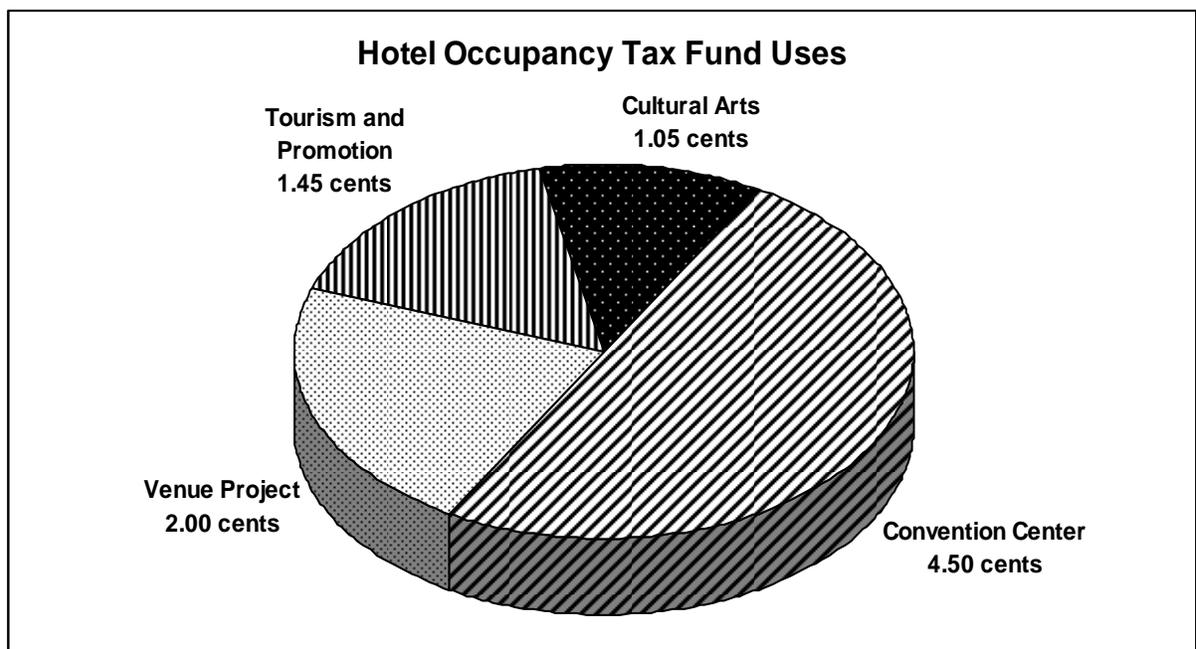
BACKGROUND

Revenue from the City hotel occupancy tax funds the Convention Center and venue related projects, tourism and promotion, and cultural arts programs.

Municipal hotel occupancy tax (HOT) collection and uses are authorized by State statute and City ordinance. Effective management of the tax program requires coordination across various City functions, and the cooperation of hotel management who collect this tax from the guests. Hotels are required to collect a nine percent tax from their guests on hotel accommodations and remit the tax proceeds to the City on a quarterly basis.

The recipients of these revenues include the Convention Center Department, the Venue Project (the Convention Center expansion project and the Waller Creek project), the Austin Convention and Visitors Bureau, and the cultural arts program.

EXHIBIT 1

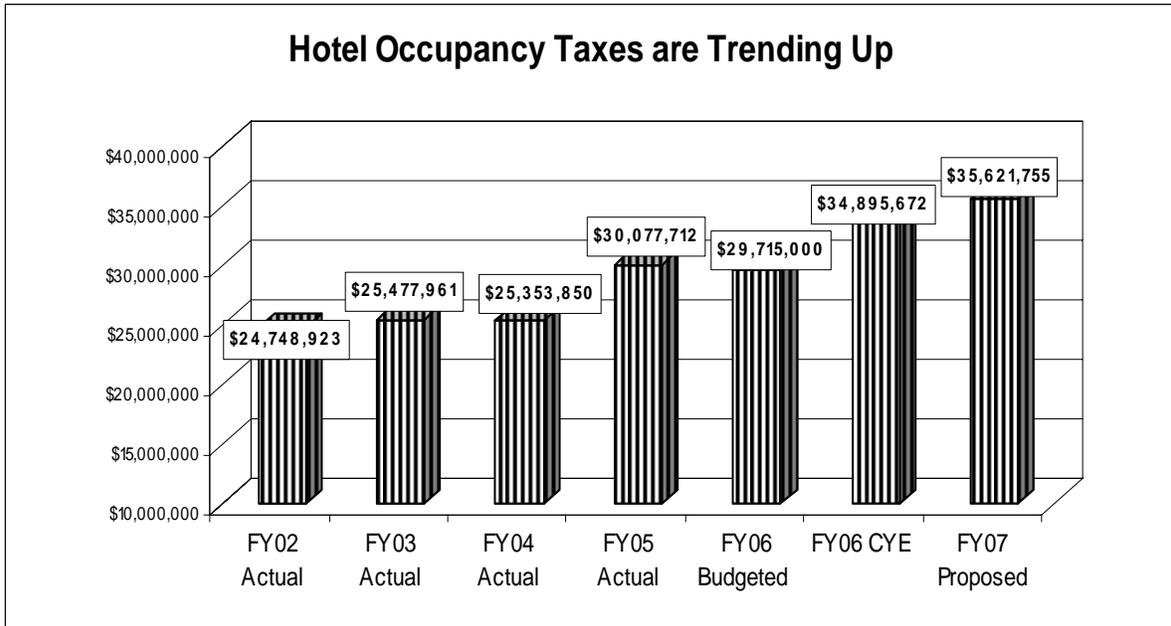


SOURCE: Auditor analysis of Chapter 11-2 of the Austin City Code.

All rules and regulations governing the collection and allocation of Austin's hotel occupancy tax are located in Chapter 351 of the Texas Tax Code, Chapter 334 of the Texas Local Government Code, and Chapter 11-2 of the Austin City Code of Ordinances.

Hotel occupancy taxes are a significant revenue source that is sensitive to trends in the hotel industry and to the effectiveness of City collection programs. Revenue increased dramatically beginning in fiscal year 2004 and that trend continues. From Fiscal Year 2004 to the Fiscal Year 2007 Proposed Budget, hotel occupancy tax revenue has increased 40.5 percent. Total revenue from the hotel occupancy tax has yielded over \$115 million in the past four years, with Fiscal Year 2007 projected to exceed \$35 million for the City. A strong local economy, increased hotel room rates and hotel occupancy rates, combined with increased audit activity and publicity may be contributing factors in this uptrend.

EXHIBIT 2



Source: City of Austin Convention Center Department

OBJECTIVES, SCOPE, AND METHODOLOGY

In this audit we continued our process of verifying hotel management understanding of and compliance with the ordinance and State statute.

This is the third audit in a series of audits related to the hotel occupancy tax. In the first audit we reviewed activities of the City's Financial and Administrative Services Department and the Law Department related to hotel occupancy tax administration, and made management recommendations to improve internal processes. Internal processes were improved, delinquent revenue was identified totaling approximately \$695,000, and collection activities were initiated.

In the second audit, Phase II, we initiated field audits of 28 local hotels, identified 13 hotels that were not in compliance with City ordinance, and assessed \$508,340 in back taxes. At the end of the Phase II audit there were five hotel audits that were not completed and one hotel audit that was postponed. Auditing activity on these hotels was carried over to the third audit, Phase III.

Objectives

1. Determine whether selected hotels properly collect and remit the municipal hotel occupancy tax.
 - a) Assess whether hotel management and relevant staff of selected hotels understand requirements for collecting and remitting the municipal hotel occupancy tax under the State statute and City Ordinance.
 - b) Verify compliance with the taxing requirements for transient and resident guests, and determine tax liability where hotels cannot support claims, made on quarterly City tax reports, of 30-day exclusions.
 - c) Verify compliance with the requirements for treating tax-exempt guests, and determine tax liability where hotels cannot support claims, made on City tax reports, of tax exemptions.
2. Inform and discuss with hotels key compliance issues, with a view to future compliance. The approach to the audits included an emphasis on both detection (objective 1) and prevention (objective 2). Findings were discussed with hotel managers and information about applicable State law and the City ordinance was shared to help ensure future compliance.

Scope

We limited scope along the following dimensions:

1. We selected a sample of 33 hotel properties for audit, based on risk factors explained in the methodology section below.
2. We limited testing to 30-day exclusions and exemptions.
3. Where red-flags arose in the course of these tests, we expanded our scope to determine if a fraud investigation or referral was warranted.
4. The time period under review was 1st quarter of 2002 through 4th quarter of 2005.
5. The geographical scope was the City of Austin full-purpose jurisdiction.

Methodology

In the first collection and remittance audit, we conducted a risk assessment on all 180 hotels on the tax roll. Selection criteria for the judgmental sample included:

- History of delinquency or missed/late reports
- Variance with industry norms for gross revenues, for size and type of hotel
- Variance with industry norms for earnings per room, for size and type of hotel
- Exemptions and/or exclusions appearing too high for business type
- Gross revenue, exemptions/exclusions reported in round numbers
- Unexplained discrepancies between exemptions claimed on State returns and City returns

In the first collection and remittance audit (Phase II), we identified 58 hotels that would be good audit candidates and conducted 28 field audits. In this audit (Phase III), we re-examined data from the remaining hotels on the initial list plus some new candidates and selected 33 audit candidates. In order to initiate audit work, auditors sent entrance memos and held entrance meetings with on-site hotel staff generally within two weeks of the entrance letter. Some hotels needed additional time to obtain records. Where hotel records indicated compliance (within the audit period), we initiated an exit process immediately. These hotels were also sent letters of no deficiency.

Where records indicated misapplication of the exclusions and/or exemptions rules, we performed further tests to determine the significance of the misapplication. We selected sample periods to arrive at a determination of additional liability. We also delivered to the hotel contact an informational packet on key compliance issues and discussed these with auditees.

For each hotel, auditors developed findings of compliance/non-compliance and deficiency determinations of tax liability, and completed a letter of determination. We summarized our findings and determinations in the body of the report.

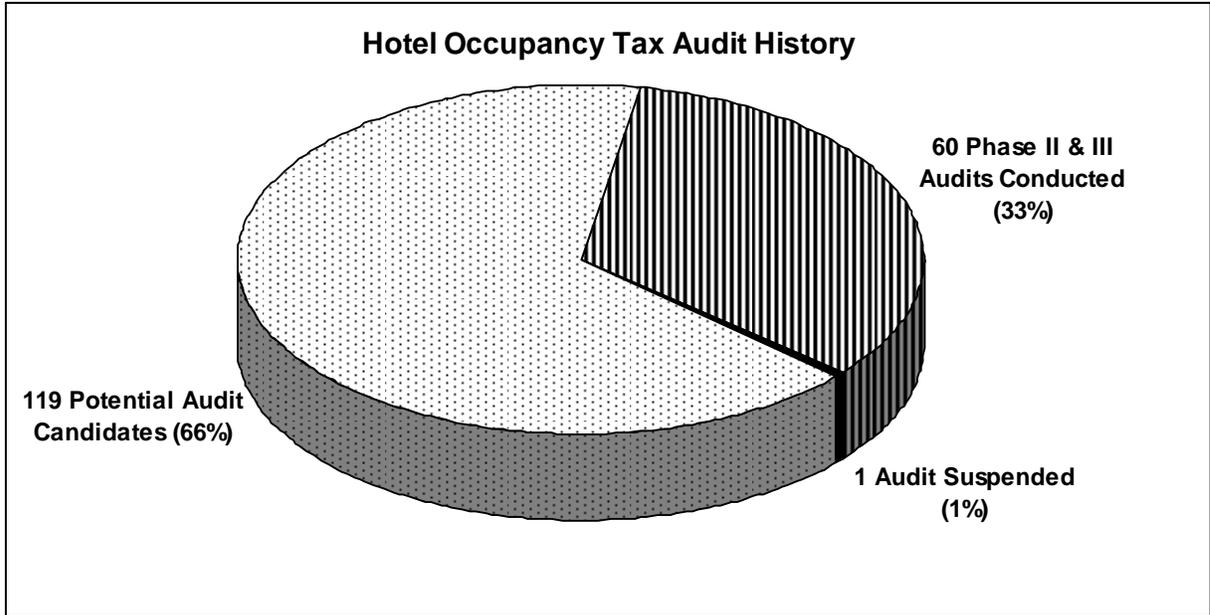
Throughout the audit, the Office of the City Auditor coordinated with the Financial and Administrative Services Department and the Law Department to ensure that the audit procedures aligned with management's current process for handling tax delinquencies. OCA gave auditees 10 business days to contest the OCA findings, and 30 days to make payment arrangements with the Controller's Office without further charges. The Controller's process currently includes steps to refer delinquent cases to the Law Department for collection.

Sources of data for conducting the audit included:

- Historic returns data obtained from the Controller's Office
- State Comptroller's returns data on State HOT revenues
- Austin Convention and Visitor's Bureau data on rooms
- Hotel web-sites, to verify rooms data, locate the property, and other information
- City Ordinance
- State statutes (tax code and other applicable statutes)

From the initial list of 180 local hotels within the City's full-purpose jurisdiction area, 60 audits have been conducted, 1 audit suspended, and 119 potential audit candidates remain.

EXHIBIT 3



Source: Auditor summary of audit outcomes

AUDIT RESULTS

Hotel Occupancy Tax liability and compliance issues exist throughout the hotel industry in Austin.

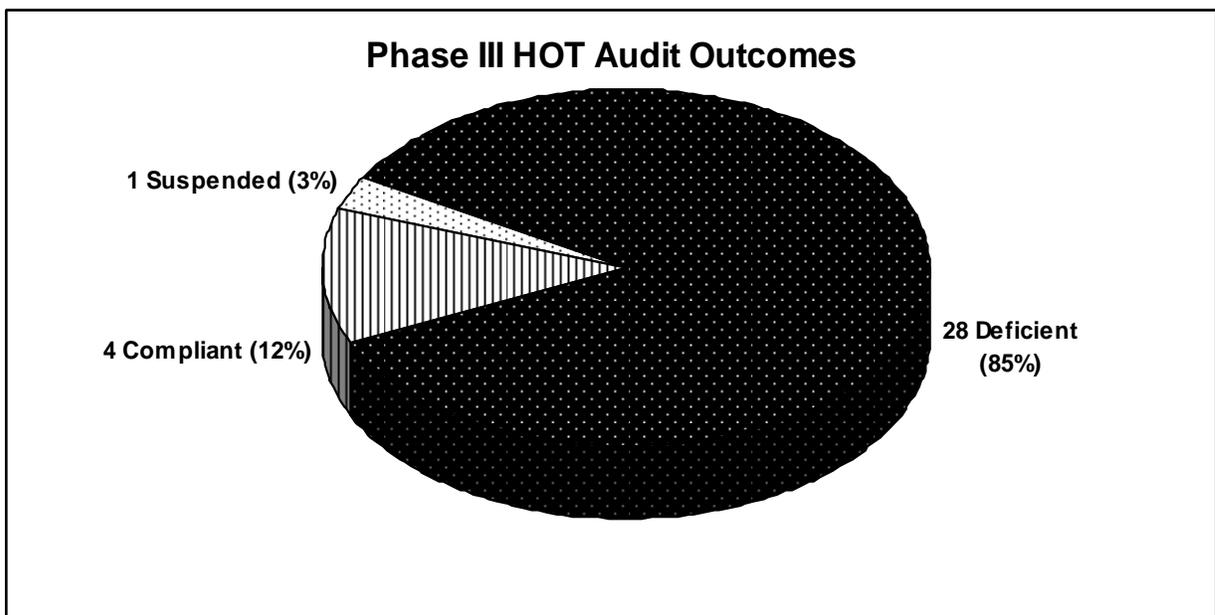
In this audit (Phase III), we identified 33 hotels to audit and completed work on five audits begun but not finished in Phase II. Tax deficiencies identified total over \$263,000. We identified four hotels out of the 33 hotels audited that were in compliance with City ordinance and had no tax deficiency. However, the number of hotels with compliance weaknesses and tax liabilities increased compared to the Phase II audit. One audit was suspended due to Federal bankruptcy protection.

Understanding and application of State law and City ordinance still present a compliance barrier for many hotels. There has also been significant turnover in hotel ownership in recent years and owner-operators find themselves responsible for tax liabilities incurred by prior owners under successor liability laws.

Total revenue from tax deficiencies identified during the course of the Phase III audit equals \$263,531, not including penalties and interest. The chart below shows the number of audits conducted and the primary outcomes. While we found four hotels that are in compliance with the City Code and are properly collecting and remitting hotel occupancy taxes, there were 28 non-compliant hotels with tax deficiencies totaling \$185,796. One audit was suspended due to the discovery of a pending Federal bankruptcy case after audit work was initiated. Compliance problems were found in 85 percent of the Phase III hotels audited.

We also completed five audits of hotels begun, but not finished, in the Phase II collection and remittance audit. These five hotels were found to be non-compliant with a total tax deficiency of \$77,735.

EXHIBIT 4



Source: Auditor summary of audit outcomes.

EXHIBIT 5
Audit Findings and Tax Deficiencies

PHASE III AUDITS		
Hotel	Audit Result	Tax Deficiency
Hotel A	Compliant	\$0.00
Hotel B	Compliant	\$0.00
Hotel C	Compliant	\$0.00
Hotel D	Compliant	\$0.00
Hotel E	Suspended	\$0.00
Hotel F	Non-compliant	\$ 5,196.00
Hotel G	Non-compliant	\$ 1,153.07
Hotel H	Non-compliant	\$ 6,772.37
Hotel I	Non-compliant	\$ 457.64
Hotel J	Non-compliant	\$ 11,017.65
Hotel K	Non-compliant	\$ 2,810.65
Hotel L	Non-compliant	\$ 5,842.32
Hotel M	Non-compliant	\$ 5,970.44
Hotel N	Non-compliant	\$ 7,862.95
Hotel O	Non-compliant	\$ 25,293.91
Hotel P	Non-compliant	\$ 8,053.46
Hotel Q	Non-compliant	\$ 23,765.94
Hotel R	Non-compliant	\$ 1,115.42
Hotel S	Non-compliant	\$ 14,306.19
Hotel T	Non-compliant	\$ 20,146.95
Hotel U	Non-compliant	\$ 12,759.92
Hotel V	Non-compliant	\$ 651.83
Hotel W	Non-compliant	\$ 3,197.00
Hotel X	Non-compliant	\$ 575.64
Hotel Y	Non-compliant	\$ 2,809.83
Hotel Z	Non-compliant	\$ 2,622.93
Hotel AA	Non-compliant	\$ 2,661.30
Hotel AB	Non-compliant	\$ 2,412.29
Hotel AC	Non-compliant	\$ 2,520.87
Hotel AD	Non-compliant	\$ 1,400.57
Hotel AE	Non-compliant	\$ 4,821.64
Hotel AF	Non-compliant	\$ 7,813.00
Hotel AG	Non-compliant	\$ 1,783.81
		\$185,795.59
PHASE II CARRYOVER AUDITS		
Hotel AH	Non-compliant	\$ 22,837.46
Hotel AI	Non-compliant	\$ 39,899.01
Hotel AJ	Non-compliant	\$ 8,371.62
Hotel AK	Non-compliant	\$ 2,370.25
Hotel AL	Non-compliant	\$ 4,256.83
		\$ 77,735.17
TOTAL TAX DEFICIENCIES		\$ 263,530.76

Source: Auditor summary of hotel deficiencies

Hotels demonstrating good compliance with no tax deficiency decreased from the previous audit. We found in the Phase II audit that hotels demonstrating good compliance and having no additional tax liability share common factors; primarily, they keep good records. The types of compliance issues found in this audit are similar to those found in the Phase II audit. We identified four hotels out of 33 audited that demonstrated a good knowledge of applicable law concerning hotel occupancy taxes and maintained supporting documentation demonstrating support for representations made to the City in quarterly reports of non-taxable receipts.

The proportion of hotels with compliance weaknesses and tax liabilities increased compared to the Phase II audit. In this audit, we encountered a variety of compliance issues similar to issues discovered in the Phase II audit. These recurrent issues resulted in tax liability to area hotels.

During the course of this audit, the primary compliance problems encountered include:

- poor record keeping
- improper documentation
- missing records
- failure to file City tax reports and submit tax payments
- poor understanding and application of State law and City ordinance

Understanding and application of rules related to non-taxable guests continues to be a recurring theme contributing to tax liabilities for many hotels.

In this audit we identified 28 non-compliant hotels with tax deficiencies totaling \$185,796. While we had a few hotels with large liabilities of \$23,766 and \$25,294, the average tax deficiency was \$6,636. In the carryover work from Phase II, we also completed audit work on five hotels with tax deficiencies totaling \$77,735, with an average tax deficiency of \$15,547.

Federal bankruptcy filing presents challenges to collection activity. In the course of the audit, we encountered one hotel that had changed ownership after a Federal bankruptcy court filing or decision and been purchased by a local non-profit charitable foundation. While the charity briefly operated the hotel prior to closing it for remodeling to transitional housing, they were found to have no tax deficiency but the previous owners were found to have a tax deficiency. Due to the protection offered by the Federal bankruptcy laws, the likelihood of the City becoming a party to the bankruptcy case was very low.

Understanding and application of State law and City ordinance and successor liability still present a compliance barrier for many hotels. We continue to find multiple instances where hotels exempt guests who are not eligible for tax exemptions and fail to collect written intent to stay 30 consecutive days or longer. These are clear indicators that hotels do not understand the applicable regulatory codes. In this series of audits, we identified 28 hotels with compliance issues and worked with them to correct the deficiencies.

There has also been significant turnover in hotel ownership in recent years and owner-operators find themselves responsible for tax liabilities incurred by prior owners under successor liability laws. State law and City ordinance provide a process for hotel sellers or buyers to protect themselves from liability for past taxes from non-compliance, incomplete record keeping, or fraud by requesting a certificate of no tax due from the City Controller's Office but this has only been requested three times in the past four years.

Additionally, as in the Phase II audit, we encountered another hotel in the same chain that claimed protection from successor liability due to a real estate loophole known as a Real Estate Investment Trust (REIT). The Law Department advised us that the REIT did not provide protection for the previous owner-operator and we were able to obtain records to complete these two audits.

All of these issues reinforce the need by the City to continue a strong program of monitoring and auditing hotels. As these audits are conducted, we are educating the hotels on these issues, the applicable laws, and a strategy for limiting their liability by following the City ordinance and maintaining proper records.

In addition, staff from our office worked with the Austin Hotel & Lodging Association and staff from the State Comptroller's Office to present a Hotel Occupancy Tax seminar in April 2006 for Austin hotel owners/operators. The seminar covered hotel occupancy tax collection requirements and City and State audit procedures and was well attended by representatives of the local hotel industry.

In the previous audit we recommended that the City ordinance be revised to make it easier for the hotel owner-operators to understand and to reinforce the City's regulatory authority. Tentative work on revising the ordinance has begun by the Controller's Office and will include the Law Department. Additionally, audit resources are requested in the Office of the City Auditor's Proposed Budget to continue this series of revenue audits.