



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Richard Doyle
City Attorney

SUBJECT: Amendments to Titles 1, 2 and 4
Related to Tax Collection

RECOMMENDATION

Approve an ordinance of the City of San José amending Titles 1, 2 and 4 of the San José Municipal Code to: (1) provide for personal liability for the payment of unpaid taxes by certain responsible parties; (2) provide, where not otherwise in conflict or specified in the Municipal Code, that the Director of Finance has the authority to promulgate and publish regulations related to the administration, collection and enforcement of City taxes; (3) clarify the hotel operator's and utility service supplier's obligation to hold taxes collected on City's behalf in trust for City's benefit; (4) provide that the Director of Finance's decision following a tax assessment hearing is final and conclusive in order to expedite the resolution of disputes; (5) set forth the responsibility of successor hotel operators for unpaid taxes; (6) clarify the definition of operator for purposes of the Transient Occupancy Tax; and (7) clarify that payment of a disputed City tax is required prior to filing a lawsuit to challenge the tax.

OUTCOME

The proposed ordinance changes would amend the City's Municipal Code to address various issues related to tax enforcement and collection, including amendments to the City's Transient Occupancy Tax ("TOT"), Utility Users Tax ("UUT"), Telecommunications Users Tax ("TUT") and Telephone Line Tax ("TLT") in order to improve the collection procedures specific to these taxes.

BACKGROUND

The City Attorney's Office has worked with Finance Department staff in recent months on various tax collection matters involving the City's TOT, which is often referred to as the hotel tax, as well as other City taxes. Through this process, we have identified a number of changes that should be made to the Municipal Code to streamline and improve the collection of the City's taxes.

ANALYSIS

Several amendments to the Municipal Code are recommended which provide the City with more efficient tools to collect taxes due to the City. These amendments include streamlining the administrative process for collection of the TOT and UUT, clarifying that taxes collected on the City's behalf by hotel operators and utility service suppliers are held in trust for the City, specifying the duty and liability of successor hotel operators for unpaid taxes, and clarification of the term "operator" as used in the TOT. Additionally, the proposed ordinance adds a new section to provide for the personal liability of persons responsible for the collection of City taxes, and amends the existing tax refund procedures in the Municipal Code to require payment of taxes in dispute prior to filing any lawsuit contesting the taxes due.

The proposed amendments are discussed more fully below.

A. Amendments Applicable to Transient Occupancy Tax (TOT), Utility Users Tax (UUT), Telecommunications Users Tax (TUT) and Telephone Line Tax (TLT)

The TOT is a tax imposed on a hotel guest (transient) that the hotel operators collect and remit to the City on a monthly or quarterly basis. In San José, there are two separate TOT taxes under Chapters 4.72 and 4.74 of the Municipal Code.¹ Chapter 4.72 provides for TOT at 6% of the room rent and Chapter 4.74 provides for a TOT at 4% of the room rent for a combined rate of 10%.² The taxes collected pursuant to Chapter 4.72 are required to be spent on specified purposes and the taxes collected under Chapter 4.74 are for general purposes. Other than the tax rate and expenditures of the tax proceeds, Chapters 4.72 and 4.74 have identical provisions.

The City also imposes taxes on users of various utility services that are collected by the utility service supplier on the City's behalf. The UUT is a tax imposed on a user of gas, electric and water utility services at the rate of 5% of the charges billed pursuant to Chapter 4.68. The TUT is a tax imposed on the consumption of telecommunication services at the rate of 4.5% of the charges billed pursuant to Chapter 4.70, and the TLT is a tax imposed at a rate of \$1.57 per month per telephone access line or \$11.82 per month per telephone trunk line pursuant to Chapter 4.52.

¹ All references are to the San José Municipal Code, unless otherwise stated.

² The Convention Center Facilities District Tax is a special tax on hotel/motel property owners and some hotel/motel property owners pass the CCFD Tax to the guests. The CCFD Tax is a separate special tax and is not an additional TOT. Accordingly, there are separate provisions that govern collection of this tax.

1. *Streamlining Administrative Process for collection of UUT and TOT*

The Director of Finance is authorized to issue a notice of a tax assessment, specifying the amount of tax, penalties and interest owed in the event that a utility service supplier or hotel operator fails to remit payment of the taxes owed to the City pursuant to the applicable chapter of the Municipal Code. The operator or utility service supplier must request a hearing before the Director to contest the amount of the tax assessed within a specified deadline. Currently, the operator and utility service supplier may appeal the Director's determination after the assessment hearing to the City Council; otherwise, it becomes final.

The proposed amendments to the UUT and TOT (Chapters 4.68, 4.72 and 4.74) would eliminate the appeal to the City Council. This change will streamline the process and enable the City to resolve disputes more quickly. State law requires that the administrative appeal process be concluded prior to the City filing a lawsuit to collect the delinquent taxes or the taxpayer from filing a lawsuit to challenge the tax.

2. *Clarification Regarding Trust Requirement*

The proposed ordinance makes certain changes to the TLT, UUT TUT and TOT (Chapters 4.52, 4.68, 4.70, 4.72 and 4.74) to clarify that the taxes collected by the utility service supplier and hotel operator are the property of the City and must be held in trust for the benefit of the City. The purpose of this revision is to ensure that in the event a utility service supplier or hotel operator declares bankruptcy, any taxes still in their possession do not become part of the bankruptcy estate to be distributed to their creditors.

3. *Liability of Successor Hotels for Payment of TOT*

The proposed ordinance adds new Sections 4.72.145 and 4.74.145 specifying the duty and liability of successor hotel operators for unpaid TOT taxes. Oftentimes, when a hotel is being sold, an issue arises as to whether the current operator or the successor operator is responsible for any unpaid TOT taxes owed the City. The proposed ordinance requires the successor operator to withhold from the current operator a portion of the purchase price sufficient to pay the amount of TOT tax owed to the City until the current operator secures from the Director of Finance a "Transient Occupancy Tax Clearance Certificate" stating that no tax is due from the current operator through the date of the sale. If no Transient Occupancy tax Clearance Certificate is presented by the current operator to the successor within 30 days after the successor commences operation of the hotel, the successor is required to immediately deposit with the Director of Finance the amount withheld from the purchase price to be applied to the amount of TOT tax owed by the prior operator. If the successor operator fails

to withhold the amount required by this new Section, the successor is liable to City for payment of the TOT tax owed.

4. *Amendment to TOT Definition of Hotel Operator Managing Agents*

The TOT (Chapters 4.72 and 4.74) defines the term “operator” when referring to hotel operators to include managing agents. However, the term “managing agent” excludes employees. In light of the amendment discussed below to provide for personal liability of responsible parties, including key employees, the proposed ordinance deletes the phrase “other than employees” from the definition of the term “operator.”

B. Amendment to Chapter 1.08 – Personal Liability of Responsible Parties

Chapter 1.08 provides a number of tools for enforcement of the Municipal Code. The proposed ordinance adds a new Section 1.08.015.5 to this Chapter in order to assist the City when a company official fails to properly pay taxes owed to the City. This issue has arisen in the context of the TOT where individual corporate officers of a hotel company failed to pay the TOT owed to the City and instead used the tax proceeds funds for other purposes.

Because this situation can arise with a number of City taxes that are collected by others on the City’s behalf, the proposed amendment specifies that any person required to collect, account for, and pay over any tax imposed by the City’s Municipal Code who willfully fails to collect such tax, or truthfully account for and pay over such tax or willfully attempts in any manner to evade or defeat the payment thereof, shall be personally liable for the unpaid tax. For purposes of this new Section, “person” is broadly defined and includes, but is not limited to, an officer or employee of a corporation or a member or employee of a partnership, who as such officer, employee, or member is under a duty to collect, truthfully account for and pay over the tax to the City. This language is modeled after federal and state laws which impose, for example, liability on employers who fail to remit employee withholding taxes to the IRS and retailers who fail to remit sales and use taxes to the state.

C. Amendment to Section 2.04.2020 – Functions, Powers and Duties of the Director of Finance

Section 2.04.2020 provides a list of the functions, powers and duties of the Director of Finance including, but not limited to, administering and enforcing all ordinances and regulations of the City relating to the imposition and collection of City taxes. The proposed ordinance amends Section 2.04.2020 to provide that the Director, with the concurrence of the City Attorney, has the authority to promulgate and publish regulations related to the collection and enforcement of City’s taxes, where not otherwise in conflict or specified in the Municipal Code.

D. Amendment to Chapter 4.82 – Pay First Rule

Chapter 4.82 sets forth the refund procedures for City taxes that a taxpayer claims were erroneously paid. The proposed ordinance adds a new Section 4.82.305 which clarifies that payment of a disputed City tax is required prior to filing a lawsuit to challenge the tax, oftentimes referred to as the “pay first litigate later” rule. There are a number of California court decisions holding that a taxpayer may not sue the taxing entity to challenge the imposition of a tax without first paying the disputed tax. The courts’ opinions have stressed the importance of restraining courts from allowing plaintiffs from filing suit without paying the disputed tax first, thereby interfering with the flow of tax dollars that fund government operations, and disrupting essential public services. Despite this longstanding rule, a Southern California appellate court did not apply the pay first rule because the city imposing the tax did not have the pay first rule or refund procedures specified in its Municipal Code. In order to ensure that the pay first rule applies to disputes involving the City’s taxes, the proposed ordinance amends the Municipal Code to include the pay first rule in the City’s existing refund procedures.

E. Declaration of Existing Law

The final section of the proposed ordinance provides that the amendments related to holding the taxes collected in trust, and the pay first rule are “declaratory of existing law” and are not a substantive change to the Municipal Code since they are intended to clarify the City’s existing interpretation of these provisions.

PUBLIC OUTREACH/INTEREST

This memorandum and the proposed ordinance have been posted on the City’s website for the September 18, 2012 City Council agenda.

COORDINATION

The proposed ordinance has been coordinated with the Finance Department.

CEQA

Not a project; File No. PP10-068c, Municipal Code or Policy.

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