



Office Of The Arizona Attorney General
Appeals & Constitutional Litigation Division
Government Accountability Unit

**Report Regarding The City Of Sedona's Tourism
Promotion Agreement With The Sedona Chamber Of
Commerce & Tourism Bureau**

August 15, 2019

I. Summary

This report details the Arizona Attorney General’s Office’s (“Office”) investigation into the City of Sedona’s (“City”) Tourism Promotion & Visitor Services Agreement (“Agreement”) with the Sedona Chamber of Commerce & Tourism Bureau (“Chamber”), which between 2014 and 2019 required the City to pay the Chamber 55% of collected annual transient bed tax. The investigation reviewed whether the Agreement gave rise to a claim under A.R.S. § 35-212, which authorizes the Office to bring a claim to enjoin or recover the illegal payment of public money. As set forth herein, the Office reviewed information and documentation provided by the City and spoke with City officials regarding the Agreement. The Office concludes that although the payment structure established by the Agreement twice caused the City to pay more to the Chamber than was due to be paid under the Chamber’s City-approved budget, an illegal payment of public money did not occur because the City ultimately accounted for the overpayment through additional appropriations. In addition, on July 10, 2019, the City approved changes to the Agreement that eliminated the requirement to provide 55% of bed tax revenues to the Chamber and established that, beginning with Fiscal Year 2020, the Chamber would receive only what the City approves via the annual budgeting process that the City and Chamber undertake.

II. Background

A. The Office’s Investigation

On July 17, 2018, Senator Judy Burgess submitted a request to the Office pursuant to A.R.S. § 41-194.01 for legal review of the Agreement and other matters not addressed in this Report (“Request”). As relevant here, the Request asserted that the Agreement may have violated the Arizona Constitution’s Gift Clause. *See* Ariz. Const. art. 9 § 7. Although the Request was subsequently withdrawn, the Office opened an inquiry into whether the Agreement implicated A.R.S. § 35-212. The Office asked the City to provide a voluntary response, and the City fully cooperated with the Office’s review, including by providing a voluntary response and supporting materials. Those materials included quarterly and annual reports the Chamber submitted to the City, the City’s Comprehensive Annual Financial Report for fiscal year 2018, City meeting agendas and minutes related to approving the Chamber’s annual budget proposals, records of payments made to the Chamber by the City, the City’s bed tax accounting for fiscal years 2015-2019, and the Agreement itself. In addition, the Office conducted multiple phone calls with City personnel regarding the materials provided.

B. The Agreement’s Factual Context

In 2013, the City Council adopted Ordinance 2013-07 (“Ordinance”), which amended Section 8-447 of the City Tax Code to increase the tax rate on transient lodging from 3% to 3.5% of gross income. In relevant part, the Ordinance states:

In addition to the taxes levied as provided in Section 8-444, there is hereby levied and shall be collected an additional tax in an amount equal to (3.5%) of the gross

income from the business activity of any hotel engaging or continuing with the City in the business of charging for lodging space furnished by any transient.

Pursuant to A.R.S. § 9-500.06(C), which was in place when the Ordinance was adopted, the City was subject to certain expenditure requirements for the funds collected through the raised tax:

On or after the effective date of this amendment to this section, if a city or town, by passing an ordinance or charter amendment by its governing council or by a public vote, establishes a discriminatory transaction privilege tax or increases its existing discriminatory transaction privilege tax on hospitality industry businesses greater than any increase imposed on other types of businesses in the city or town, the proceeds of the established discriminatory transaction privilege tax, except as provided in subsection D, and the proceeds of any increase above the existing discriminatory transaction privilege tax shall be used exclusively by the city or town for the promotion of tourism. For the purposes of this section a tax which is in effect on April 1, 1990 and is subsequently renewed by a majority of qualified electors voting at an election to approve the renewal is not considered a tax increase.

Thus, the Ordinance provided that the proceeds resulting from the 0.5% increase in tax be devoted to tourism promotion. *See* Ordinance 2013-07 § 2 (“per A.R.S. § 9-500.06, the proceeds resulting from the 0.5% increase in the bed tax shall be devoted to the promotion of tourism”). In addition, the Ordinance also adopted “a policy that a minimum of 55% of all revenue generated from the new 3.5% bed tax rate shall be devoted to the promotion of tourism and allocated to a contracted destination marketing organization.” *Id.*

Under A.R.S. § 9-500.06(D), “tourism promotion” includes:

1. Direct expenditures by the city or town to promote tourism, including but not limited to sporting events or cultural exhibits.
2. Contracts between the city or town and nonprofit organizations or associations for the promotion of tourism by the nonprofit organization or association.
3. Expenditures by the city or town to develop, improve or operate tourism related attractions or facilities or to assist in the planning and promotion of such attractions and facilities.

Consistent with those provisions, the City and Chamber entered into the Agreement, effective July 1, 2014, to establish that the Chamber would provide destination marketing, product development, and visitor services to the City in exchange for 55% of the bed tax funds collected each year. The Agreement was renewed on April 11, 2017 for a seven-year term with automatic two-year renewals until a cancellation notice is provided. Agreement at 1, 9.

C. Material Terms of the Agreement

The Agreement requires the City and the Chamber to have joint work sessions each year by the end of January where the City must identify priorities and provide policy direction to assist the Chamber in developing a budget, specific strategies, and tourism programs that align with City goals and objectives. Agreement at 2. Based on the joint work sessions, the Chamber then manages a marketing committee and tourism product development committee (“TPDC”) to evaluate and create marketing strategies and prioritize new product development initiatives in accordance with the City’s goals. *Id.*

Each year, the Chamber also must prepare a Destination Marketing and Development Plan (“Plan”) to present to the City before June 1 and submit for final approval before July 1. Agreement at 2. The Plan must include marketing components to promote the City as a travel destination through various events, marketing campaigns, and business relationships. *Id.* at 3-4. The Plan also must include product development to enhance existing products, identify new areas of development, and direct resources toward ameliorating negative impacts of high visitation. In addition, the Plan must present potential options for product development programs and suggest an allocation of funds to visitor services and product development initiatives. The Chamber is required to coordinate with the City Manager concerning product development recommendations, and the parties must agree about whether the City or the Chamber should be assigned to execute the Chamber’s recommended projects. *Id.* at 4-5.

The Agreement also requires the Chamber to maintain and staff a public visitor center in Sedona to answer all inquiries and provide general information. Agreement at 5. The Agreement provides that the City will pay for utilities, telephone, facility repairs and maintenance, janitorial services for public restrooms, insurance, wages and benefits for staff, supplies and copier, rent, costs for managing sales, postage, mailing costs, freight, and fulfillment pieces. *Id.*

Before the City voted to change the Agreement in July 2019, how much the City paid to the Chamber each year was determined by an estimation and reconciliation process that resulted in different amounts paid each fiscal year. The process began with the Chamber proposing a line item budget by June 1—before the start of each fiscal year. Agreement at 6. The budget must have included a description of the proposed programs, staffing requirements, and itemized budgeted amounts. *Id.* It also must have differentiated between funds allocated to destination marketing, product development, and visitor services and identified resources for direct and indirect costs for each allocation. *Id.* And it also must have listed all funds the Chamber expected to receive or expend under the Agreement from the City, with the annual bed tax revenue listed separately. Finally, the Chamber must have stated the allocation of any bed tax funds that the City would retain to execute product development initiatives that the Chamber and City mutually agreed would be better performed by the City.¹ *Id.*

The Agreement further provides that the City and the Chamber meet twice annually to discuss future budgets based on the actual amount of the bed tax collected, with the City

¹ This is referenced to as the “hold-back” provision of the contract.

providing the Chamber an estimate of bed tax funds for the following fiscal year. Agreement at 8. The Chamber's proposed budget is ultimately reconciled and based on the City's estimate. *Id.* The final budget and Plan is presented to the City for approval before July 1 of each year. Agreement at 6.

Once the budget is approved, the Agreement provides that the City make two installment payments to the Chamber for the total estimated 55% of bed tax revenues for the fiscal year. Agreement at 7-8.² The Agreement provides that the first payment will consist of the collected bed tax funds for the previous fiscal year and is to be made within 30 days of budget approval. Agreement at 8. The second payment is to be made by January 1 of each fiscal year and is to be adjusted based on actual bed tax funds collected the previous fiscal year, which are calculated by December 15 of the following fiscal year by reconciling bed tax receipts for the previous fiscal year (the "true-up"). *Id.* Those reconciled calculations are meant to become the basis for the following fiscal year's budget, with any excess distributions from the previous fiscal year credited against the following year's budget. *Id.*³

Between FY15 and FY19, the City deviated from the payment schedule established in the Agreement by making the two installment payments in equal amounts of one half of the approved budget for a given fiscal year (as opposed to the full amount of owed bed tax funds as the Agreement sets forth). As a result, the City ultimately made three payments to the Chamber each fiscal year: the year's estimated bed tax funds by the City in two equal installments and a third "true-up" payment, which was the difference in funds owed by the City to the Chamber for the previous fiscal year's actual bed tax collections after performing the reconciliation.

III. Analysis

A. Bed Tax Ordinance

The City's bed tax ordinance was adopted consistent with state law, which requires that any funds collected from the imposition or increase of a tax on hospitality industry businesses must be used exclusively for tourism promotion. *See* A.R.S. § 9-500.06. Before 2013, the City had an existing 3% tax on transient lodging. *See* Sedona City Tax Code § 8-447 (2013). Effective January 1, 2014, the bed tax ordinance increased the tax by 0.5%. Thus, consistent with A.R.S. § 9-500.06(C), the City allocated the 0.5% increase to tourism promotion through its ordinance. After July 2, 2014, the City allocated 55% of all generated revenue from the total

² Starting in Fiscal Year 2020 ("FY20"), the amount "shall be as agreed upon in the Annual Budget to provide the specific services identified in the program of work." July 10 Amendment, §7.1.2.

³ The Agreement also requires annual audits and quarterly and annual reports from the Chamber to the City. The Chamber was required to perform a full audit for the first year of the Agreement, and for the remaining years the City can request a full audit or the Chamber must have a CPA annually review its financials. Agreement at 6-7. All review materials must be provided to the City. *Id.*

3.5% bed tax rate to the promotion of tourism through a contracted destination marketing organization—the Chamber. Per A.R.S. § 9-500.06(D), contracts between a city and a nonprofit organization for tourism promotion are a permissible means of complying with the requirement to devote the funds to tourism promotion. As such, the Office’s review centered on the payments made to the Chamber to review whether impermissible subsidies were provided.

B. Relevant Law

The Arizona Constitution, Article 9, Section 7 (“Gift Clause”) forbids government entities from gifting funds to private entities:

Neither the state, nor any county, city, town, municipality, or other subdivision of the state shall ever give or loan its credit in the aid of, or make any donation or grant, by subsidy or otherwise, to any individual, association, or corporation, or become a subscriber to, or a shareholder in, any company or corporation, or become a joint owner with any person, company, or corporation, except as to such ownerships as may accrue to the state by operation or provision of law or as authorized by law solely for investment of the monies in the various funds of the state.

Ariz. Const. art. 9 § 7. In *Turken v. Gordon*, 223 Ariz. 342 (2010), the Arizona Supreme Court recognized a two-part test for analyzing Gift Clause claims: first, the expenditure must be for a public purpose; second, the consideration the government receives from the private entity must not be grossly disproportionate to the government’s payment. 223 Ariz. at 348. The Court has repeatedly emphasized the “determination of whether a specific purpose constitutes a ‘public purpose’ is assigned to the political branches of government” and “only in those rare cases in which the governmental body’s discretion has been unquestionably abused” will a public purpose be found lacking. See *Cheatham v. DiCiccio*, 240 Ariz. 314, 320 (2016) (quoting *Turken*). In analyzing whether consideration is adequate in a contractual agreement, the focus is on “the objective fair market value of what the private party has promised to provide in return for the public entity’s payment.” *Turken*, 223 Ariz. at 350. The expenditure must not amount to a subsidy. *Id.* at 348. Here, the Agreement appears to deal with a valid public purpose; the City’s payments to the Chamber are being made consistent with and pursuant to a valid state law. Accordingly, whether the payments provide an unlawful subsidy ultimately depends on whether the payments are grossly disproportionate. To that end, the key question is whether the payments to the Chamber are ultimately accounted for by the City, either through specific City appropriations or by contracted-for services provided by the Chamber.

C. Payments to the Chamber

After reviewing the materials provided for each fiscal year since the Ordinance was adopted, all funds remitted to the Chamber can be accounted for through specific appropriations, although some of these appropriations occur after an apparent overpayment for budgeted services. Overpayments occurred in two separate fiscal years because: (1) the City’s initial payments are calculated based on an intentionally conservative estimate of fiscal year bed tax

revenue despite budget approval at a higher amount; and (2) actual bed tax collection, which is not known for the fiscal year until December (halfway through the following fiscal year), results in payments that, combined with the initial payments, result in remittances to the Chamber above the City-approved budget amount.

Through conversations with City personnel, review of a City audit and general bookkeeping materials, and review of publicly available information, it was determined that the fiscal year (“FY”) bed tax accounting is as follows:

Year	Chamber’s Approved Budget	FY City Payments to Chamber	True-Up Owed from Previous Year’s Reconciliation	55% of Actual Bed Tax Collection	Excess Funds ⁴ Paid to Chamber
FY15	\$1,248,500	\$1,248,500	N/A for FY14 ⁵	\$1,462,609	\$0.00
FY16	\$1,453,100	\$1,419,000	\$214,109 for FY15	\$1,656,234	\$180,009 ⁶
FY17	\$2,009,828	\$1,720,000	\$237,234 for FY16	\$2,096,450	\$0.00
FY18	\$2,386,700 ⁷	\$2,126,400	\$376,450 for FY17	\$2,437,424	\$116,150
FY19	\$2,445,300 ⁸	\$2,176,400	\$272,946 for FY18 ⁹	Pending	\$0.00

1. FY15 (July 1, 2014 – June 30, 2015)

In the new bed tax rate’s inaugural year, the City, at its June 10, 2014 meeting, approved the Agreement, the FY15 Plan, and a draft budget between the Chamber and the City for tourism promotion services for FY15-FY17 based on the Ordinance. *See* discussion *supra* II, B. The contract for FY15 included two automatic renewals for FY16 and FY17.

⁴ Excess funds are determined by adding “FY City Payments to Chamber” and “True-Up” columns and subtracting the sum of those figures from the “Chamber Approved Budget” column. The “True-Up” is determined by subtracting the “FY City Payments to Chamber” column from the “55%” column.

⁵ The 3.5% bed tax rate became effective July 3, 2014, resulting in no first-year true-up amount.

⁶ The excess funds were restricted net assets to the Chamber in FY16 despite receipt and were released in 2017 pursuant to a memorandum of understanding between the City and the Chamber whereby the Chamber would purchase identified land at 401 Jordan Road, Sedona, AZ (“Jordan Road”) for the City to develop for tourism purposes.

⁷ The actual budget was for \$2,386,700 but because the City decided to exercise its “hold-back” of \$50,000 for parking improvements to Jordan Road, the City’s scheduled remittance to the Chamber based on estimates was only \$2,336,700, though for some reason unknown to the City, the Chamber invoiced the City for (and therefore received) payments that totaled \$2,176,400.

⁸ The Chamber estimated 55% of FY19 bed tax revenue to be \$2,445,300 but agreed that the City need only pay \$2,176,400. The \$268,900 difference was retained by the City to use for projects the City will be responsible for executing.

⁹ City personnel confirmed that the FY18 “true-up” was never remitted to the Chamber.

The approved FY15 budget estimated 55% of bed tax revenue at \$1,248,500 with \$925,000 allocated to tourism and \$323,500 allocated to the visitor center. June 9, 2015 City Meeting Packet, pg. 248. In response, on July 11, 2014, the City made two payments to the Chamber: \$462,500 (representing half of the destination marketing budget amount) and \$161,750 (representing half of the visitor center budget amount). Then, on February 6, 2015, the City made two additional payments of \$462,500 and \$161,750 to finalize its FY15 payments to the Chamber. As this was the first full fiscal year the new 3.5% bed tax rate was effective, there was no “true-up” amount paid to the Chamber and therefore no payment over the approved budget.

2. FY16 (July 1, 2015 – June 30, 2016)

On June 9, 2015, the City considered and approved the Chamber’s FY16 proposed Plan and budget with 55% of bed tax revenue estimated at \$1,453,100 in FY15. June 9, 2015 City Meeting Packet, pg. 130. However, the City allocated only \$1,419,000 of the total proposed budget to the Chamber. Accordingly, the City made two payments to the Chamber; the first on July 24, 2015 comprising half of the total \$1,419,000 (\$549,500 in destination marketing funds and \$160,000 in visitor center funds). Then, on January 21, 2016, the City paid the other half in two payments of \$549,500 and \$160,000 respectively. Additionally, the City made a third payment on February 4, 2016 of \$214,109 constituting the “true-up” payment for FY15 actual bed tax collections. Once the City made that payment, it resulted in payment of \$180,009 over the budget amount to the Chamber in FY16.

The overpayment eventually was accounted for by the City through an appropriation toward the purchase of real estate for the City in FY18, which the City made after asking the Chamber to sequester the funds for that purpose. At the City’s June 13, 2017 meeting, as part of Chamber’s Plan and budget for FY18, the Chamber included a Memorandum of Understanding (“MOU”) under which the Chamber would acquire real property located at 401 Jordan Road and convey it to the City. June 13, 2017 City Meeting Packet, pg. 155-58. The FY18 Program of Work for Product Development also listed acquisition of 401 Jordan Road in July and August of 2017. FY18 Destination Marketing Plan, Appendix F. The City approved the Plan, budget, and MOU at the meeting.

In October 2017, to demonstrate further how the funds were spent, the Chamber presented an annual report to the City regarding FY17 results. The Chamber included its financial statements for FY16 and FY17, which had been reviewed by independent accountants. In the notes to the statements, the overpayment of \$180,009 by the City was addressed as follows: “A portion of the funds paid to the Chamber for the year ended June 30, 2016, \$180,000, was restricted for funding promotional product development in line with the services associated with the contract. These funds are shown as temporarily restricted net assets at June 30, 2016 and were released in 2017.” FY17 Annual Report, Appendix A at 14. The Chamber’s financial report as part of the annual report also notes that in line 24 (product development), “an additional \$180,000 was spent per our agreement (from the TPDC reserve account) toward the purchase of the 401

Jordan Road property and is not illustrated in the P&L, but recorded on the balance sheet.”¹⁰
FY17 Annual Report at 20.

3. FY17 (July 1, 2016 – June 30, 2017)

The City approved the Chamber’s Plan and budget for FY17 at its June 14, 2016 meeting. The budget submitted was for \$2,009,828, comprised of FY17 estimated bed tax collections of \$1,734,919 plus an additional \$274,909 from FY16’s projected “true-up” amount. June 14, 2016 City Meeting Packet, pg. 50. On July 20, 2016, the City paid the Chamber \$662,200 for destination marketing and \$197,800 for the visitor center as its first installment of the FY17 budget. On December 22, 2016, the City paid the second installment of \$662,200 and \$197,800. Then, on April 13, 2017, the City paid FY16’s “true-up” amount of \$237,234. As a result, the total amount paid out by the City to the Chamber in FY17 was \$1,957,234, which was lower than the budgeted amount.

4. FY18 (July 1, 2017 – June 30, 2018)

On June 13, 2017, the City approved the Chamber’s Plan, budget, and MOU for the purchase of 401 Jordan Road. The budget was estimated at \$2,386,700 including \$2,141,700 for FY18 bed tax collections and \$245,000 from the projected FY17 “true-up” payment. June 13, 2017 City Meeting Packet, pg. 60. Because the City exercised the Agreement’s “hold-back” clause to set aside \$50,000 for parking improvements at 401 Jordan Road, the Chamber agreed to receive installment payments of \$2,336,700. The Chamber received \$865,400 in destination marketing funds and \$197,800 in visitor center funds as the first installment on July 5, 2017. The second installment of the same amounts was paid on December 7, 2017. *See supra* n.7. The final payment was made on January 18, 2018 for FY17’s “true-up” payment of \$376,450. Thus, the Chamber received a total of \$2,502,850 in FY18 which was \$116,150 over the approved budget amount of \$2,386,700. The City addressed the overpayment in FY19 as discussed below.

5. FY19 (July 1, 2018 – June 30, 2019)

At its June 12, 2018 meeting, the City approved the Chamber’s FY19 Plan and budget. Although the budget originally estimated FY19 bed tax revenues at \$2,445,300, the Chamber agreed to accept less than the full 55% of bed tax revenue for FY19 after conversations with the City. June 12, 2018 City Meeting Packet, pg. 116. As a result, the Chamber submitted a budget of \$2,176,400 with \$268,900 being a “hold-back” for the City’s use in its “Sedona in Motion” projects. *Id.* The budget of \$2,176,400 was based on the budget amounts for FY18. *Id.*

In addition to the “hold-back” of \$268,900, the City did not make the “true-up” amount of \$272,946 for FY18. The City paid the Chamber’s FY19’s budgeted amount of \$2,176,400 with payments on July 10, 2018 (of \$883,200 for tourism promotion and \$205,000 for visitor services) and on January 31, 2019 for the same amounts. Given the “hold-back” and unpaid “true-up,” the City more than accounted for the FY18 overpayment.

¹⁰ Note that the City paid \$180,009 over FY16’s budget and \$180,000 was allocated toward the purchase of 401 Jordan Rd. The \$9 difference is *de minimis*.

IV. Conclusion

In each fiscal year since the Ordinance's adoption, the City has paid the Chamber at least the total estimated amount of bed tax revenue at or below the Chamber's submitted annual budget. However, in the situations where the City generated more-than-projected revenue, and thereby had a larger than expected "true-up" payment, overpayments were made to the Chamber above the approved line item budget. In both instances, the City took steps to manage the excess funds. In FY16, the excess funds of \$180,009 were restricted for use and only released for the Chamber to purchase the Jordan Road property in FY18 on the City's behalf. In FY18, the City exercised its contractual "hold-back" from the FY19 budget to reserve \$268,900 of the estimated bed tax collection, thereby accounting for the \$116,150 overpayment made for FY18.

The Office concludes that the Agreement between the City and the Chamber is not itself illegal or necessarily causes illegal payments of public monies under A.R.S. § 35-212. Although the pattern of overpayments resulting from greater-than-anticipated bed tax revenues created significant potential for a Gift Clause violation, the City appears to have mitigated that potential by reworking the Agreement to eliminate the automatic remittance of 55% of bed tax revenues to the Chamber. And because the City also took steps to effectively claw back funds that were overpaid, no basis currently exists for further action by the Office on this matter.