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July 25, 2018

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Office of the Arizona Attorney General
2005 N. Central Ave.
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Re: Written Response to Legislator Request for Investigation Pursuant to A.R.S. § 41-194.01

Dear Mr. Skinner:

This letter is written, pursuant to the Notice of Submission of Legislator Request for Investigation Pursuant to A.R.S. § 41-194.01; Request for Written Response; and Public Records Request, dated July 17, 2018, as the City of Sedona's formal response.

Although we understand the obligation of the Attorney General's Office to investigate this matter under A.R.S. § 41-194.01, it should be noted once again how patently flawed this process is when a legislator from a district that has no relationship with or accountability to the municipality being investigated is given unlimited authority to allege wrongdoing by that municipality.

The process is made all the more difficult when the conduct of the complainant is something less than genuine. In this case, the material submitted in support of the allegations omitted critical facts and documentary evidence that was damaging to the Complainant's argument. Specifically, the copy of the City's contract with the Sedona Chamber of Commerce & Tourism Bureau provided by the Complainant as an attachment in support of a specific allegation was incomplete, with the most relevant parts (e.g. performance metrics, reporting, auditing and financial review, etc.) not included. This is an egregious abuse of an already difficult process and it is most unfortunate that some penalty is not available against complainants in circumstances like this where documents appear to have been withheld in a deliberate attempt to skew the facts.

Background

The Legislator Request for Investigation (Complaint) in this matter focuses on the collection of a discriminatory transaction privilege tax by the City of Sedona (City), the City's Tourism Promotion and Visitor Services Agreement with the Sedona Chamber of Commerce and Tourism Bureau (Chamber), and the acquisition of certain real property by the Chamber in the mutual interest of both the City and the Chamber. These activities, it is alleged, all have occurred in violation of Article IX § 7 of the Arizona Constitution. The fatal flaw in the Complaint is that it alleges a violation of state law when, in fact, all of the actions complained of are pursuant to and in strict conformance with state law.

As will be described in greater detail below, the City adopted what is known as a discriminatory transaction privilege tax on hospitality industry businesses (commonly referred to as a "bed tax") at the time of incorporation in 1988.[1] Since 1988, revenue generated from the bed tax has been used to promote tourism.

The City has had a longstanding relationship with the Sedona Chamber of Commerce & Tourism Bureau (Chamber) whereby the Chamber and City have worked cooperatively to promote tourism through destination marketing and product development efforts.[2] The most recent contract which documents the City/Chamber relationship was approved by the Sedona City Council on April 11, 2017.[3]

In conjunction with the City and Chamber efforts to promote tourism through destination marketing and product development, the parties executed a Memorandum of Understanding (MOU) in July of 2017 wherein the Chamber agreed to acquire certain real property for uses consistent with the Destination Marketing and Development Plan approved by the Sedona City Council.[4]

Each of the preceding activities are alleged by the Complainant to be in violation of the Gift Clause identified in Article IX § 7 of the Arizona Constitution. The balance of this correspondence will explain why those allegations are not supported by the facts, circumstances and applicable legal authorities.

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[1] See Ordinance No. 88-04 attached hereto as "Exhibit 1"

[2] A destination marketing organization is a non-profit entity charged with marketing and providing visitor services locally. Source: Destination Marketing Association International

[3] See Tourism Promotion & Visitor Services Agreement attached hereto as "Exhibit 2"

[4] See Memorandum of Understanding attached hereto as "Exhibit 3"

Relevant Authorities

Ariz. Const. Art. IX, § 7, in part provides:

> "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 an donation or grant, by subsidy or otherwise, to any individual, association, or corporation, or become a subscriber to, or a shareholder in, an company or corporation, or become a joint owner with any person, company, or corporation… "

The City was incorporated in 1988. Shortly after its incorporation, a series of ordinances were adopted so as to allow for the general operations. One of these ordinances was Ordinance No. 88-04, which adopted the City Tax Code and became effective on March 1, 1988. Included in the adopted City Tax Code in 1988 was Section 447 relating to rental, leasing, and licensing for use of real property. Section 447 states as follows:

> "In addition to the taxes levied as provided in Section 8-445, there is hereby levied and shall be collected an additional tax in an amount equal to three percent (3%) of the gross income from the business activity of any hotel engaging or continuing within the City in the business of charging for lodging and/or lodging space furnished to any transient. "Transient" means any person who, for any period of not more than thirty (30) consecutive days, either at his own expense or at the expense of another, obtains lodging or the use of any lodging space in any hotel for which lodging or use of lodging space a charge is made.

From the time of implementation of Ordinance No. 88-04 and its associated Section 447, the additional tax levied on transient lodging activities has been commonly referred to as the "bed tax."

Sedona's bed tax remained at 3% from 1988 until 2013, at which time the City adopted Ordinance No. 2013-17 which increased the bed tax from 3% to 3.5%.[5] The ordinance further designated that a minimum of 55% of the total revenue generated from the 3.5% bed tax would be dedicated to destination marketing and the promotion of tourism. The purpose, as stated in the ordinance, was "to attract greater numbers of visitors and tourists and thereby generate increase sales and bed tax revenues thus adding to the strength and economic vitality of the City and its citizens."

[5] See Ordinance No. 2013-17 attached hereto as "Exhibit 4"

The adoption of Ordinance No. 2013-17 was preceded by several months of discussions between the Sedona Chamber of Commerce, the Sedona Lodging Council, representatives of the business community, local elected officials and City staff. These discussions were designed to measure support for increases in the bed tax and the sales tax and to study options for increasing expenditures for destination marketing activities. The ultimate recommendation from the aforementioned group was to increase the bed tax by 0.5% and, further, that the City should set a minimum funding level for destination marketing activities at 55% of the total bed tax revenue collected.[6]

In 1990, the Thirty-Ninth Legislature in its Second Regular Session enacted HB 2681 relating to cities and towns, providing for promotion of tourism and prescribing the use of certain tax proceeds. 1990 Ariz. HB 2681. The legislative intent of HB 2681, codified as A.R.S. § 9-500.06, included as findings "... that tourism is one of the most important industries to the entire state of Arizona...," and declared that "the subject of fair transaction privilege taxes and fees by municipalities on hospitality industry businesses to be an issue of statewide concern." 1990 Ariz. HB 2681.

In pertinent part, A.R.S. § 9-500.06, as enacted in 1990, stated:

> "On or after April 1, 1990, if a city or town 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...and the increase above the existing discriminatory transaction privilege tax shall be used exclusively by the city or town for the promotion of tourism..." A.R.S. § 9-500.06(B).

The original language excluded cities or towns with populations of fifty-five thousand persons or less according to the 1980 United States decennial census. A.R.S. § 9-500.06(E).

The population-based exclusion was eliminated in a revised version of A.R.S. § 9-500.06 enacted through SB 1460 in 2011.

Further amendments were enacted in 2012 through HB 2606, which added language limiting any increase in fees on hospitality businesses by no greater than a five year consumer price index comparison. A.R.S. § 9-500.06(B); and, specified that a

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[6] See Sedona City Council Agenda Bill 1683 and minutes from meeting dated October 8, 2013 attached hereto as "Exhibit 5"

discriminatory transaction privilege tax is adopted by ordinance or charter amendment by a governing body or council or by a public vote. A.R.S. § 9-500(C).

Most importantly, the enabling legislation clearly specifies how revenues generated by a discriminatory transaction privilege tax on hospitality industry businesses *must* be spent. A.R.S. § 9-500.06(D) states:

> For the purposes of subsection C, expenditures by a city or town for the promotion of tourism include:
>
> 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.

A.R.S. § 9-500.06(D) (Emphasis added).

The effective date of A.R.S. § 9-500.06 is also significant in that revenues generated by a discriminatory transaction privilege tax adopted **after April 1, 1990**, and any increases to such a tax which occurs after April 1, 1990, must be used for the purposes described in the statute. A.R.S. § 9-500.06(C). (Emphasis added)

The result of the City's adoption of its 3% bed tax prior to April 1, 1990, and the subsequent increase of the bed tax to 3.5% in 2013, considering the application of A.R.S. § 9-500.06 to the 3.5% bed tax, is that all of the .5% increased (which occurred after April 1, 1990) must be used for the promotion of tourism. The original 3% bed tax adopted in 1988 is not so restricted.

Gift Clause

The Complaint urges the Attorney General to find that the City has violated the Constitutional Gift Clause in each of the three (3) circumstances described in the Complaint. Accordingly, a brief summary of Arizona gift clause jurisprudence is necessary in order to compare the City's actions against an objective legal standard.

In *Wistuber v. Paradise Valley Unified School District*, 141 Ariz. 346, 687 P.2d 354 (1984), the Arizona Supreme Court set forth a two-pronged test in analyzing Gift Clause challenges, holding that "a governmental expenditure does not violate the Gift Clause if (1) it has a public purpose, and (2) in return for its expenditure, the governmental entity receives consideration that 'is not so inequitable and unreasonable that it amounts to an abuse of discretion, thus providing a subsidy to a private entity.'" *Id.* at 349, 357.

In *Turken v. Gordon*, 223 Ariz. 342, 224 P.3d 158 (2010), the Arizona Supreme Court, in expounding on *Wisturber*, *Supra*, noted that "cases interpreting the Gift and Tax Clauses have struggled to define 'public purpose.'" *Turken* at 346,162. The *Turken* Court further recognized that "although determining whether governmental expenditures serve a public purpose is ultimately the province of the judiciary, courts owe deference to the judgments of elected officials." *Turken* at 346,162. *Wistuber* also stated that "courts must not be overly technical and must give appropriate deference to the findings of the government entity. *Turken* at 347,163; See also *Wistuber* at 349, 357.

With respect to the second prong of the *Wistuber* test, *Turken* ultimately held that "the most objective and reliable way to determine whether the private party has received a forbidden subsidy is to compare the public expenditure to what the government receives under the contract. When government payment is grossly disproportionate to what is received in return, the payment violates the Gift Clause." *Turken* at 348, 164.

The Complaint urges the Attorney General to consider the persuasive authority of *Smith v. Pigeon Forge*, 600 S.W.2d 231 (Tenn. 1980) to support the allegation that no direct benefit is received by the City in the various circumstances described in the Complaint and, therefore, the Gift Clause is violated. The Complaint's reliance on *Smith, Id.* is misplaced. Aside from the fact that *Turken*, *Supra,* gives binding guidance on the evaluation of public expenditures for Gift Clause purposes in Arizona, the Complainant fails to understand a critical distinction in *Smith* that renders its application inapposite to Complainant's argument. In fact, *Smith* actually supports the conclusion that the City implicitly complied with the public purpose element of the *Wisturber* analysis.

Although the conclusion in *Smith, Supra* was that the lack of a direct benefit to the public at large resulted in a violation of Tenessee's Gift Clause, the Court also distinguished that result from *McConnell v. City of Lebanon*, 203 Tenn. 498. 314 S.W.2d, 12 (1958), and *Mayor and Aldermen of the City of Fayetteville v. Wilson*, 212 Tenn. 55, 367 S.W.2d 772 (1963). In each of those cited cases, the Court found that **the expenditures were authorized pursuant to clearly established public policy of**

the State..." *Smith* at 6-7 (emphasis added). This distinction not only renders the Complainant's reliance on this authority useless to support its allegations, as will be show below it thoroughly validates the City's expenditures in the circumstances.

Discussion

In applying the foregoing legal precedents to the issues that are the subject of the Complaint, each of the allegations must fail. All of the actions complained of have been taken pursuant to the express delegation of authority given to cities and towns by the Arizona Legislature or the Arizona Constitution.

Bed Tax

The City's bed tax is the product of the express authority granted to cities and towns by virtue of A.R.S. § 9-500.06. The legislature recognized in enacting A.R.S. § 9-500.06 that tourism is one of the most important industries in our state. This is especially true in the City of Sedona, a community of approximately 10,000 residents which welcomes over 3.5 million visitors each year.

Since its incorporation, the City has adapted to the demands placed on its resources by tourism, and has developed processes by which to nurture and manage the industry. A critical component to the overall management process is the bed tax. It is an allowable, discriminatory tax because it achieves the fairness that the Legislature described in enacting the enabling legislation. In essence, tourism helps to financially manage tourism by the additional tax levied on hospitality industry businesses.

As it relates to the Gift Clause analysis, the public purpose for the City's bed tax is evidenced by the enactment of A.R.S. § 9-500.06. The Legislature declared in enacting the statute that fair transaction privilege taxes and fees by municipalities on hospitality industry businesses is a matter of statewide concern.

Because bed taxes are expressly authorized in statute, providing any justification for the amount collected does not appear relevant to this discussion. The amount of any discriminatory transaction privilege tax on hospitality industry businesses is a matter to be determined by the particular city or town. Had the Legislature intended to limit the amount that can be collected, it would have included such a limitation in A.R.S. § 9-500.06. Instead, the Legislature simply took care to ensure that the expenditure of such revenues was appropriately made.

Chamber Contract

As mentioned in the introductory comments of this correspondence, the contract document provided by the Complainant in support of the allegations is grossly deficient. While the Complaint alleges the absence of any specific performance metrics by which the Chamber is accountable to the City, the Complaint conveniently did not include pages 4-8 of the contract which specifically and in great detail outline the performance metrics required under the agreement. It can only be inferred that this was an intentional omission done to misrepresent the facts and mislead the investigation. Regardless, the City not only has nothing to hide in its account of the relationship it has with the Chamber, but the City is duly proud of the accomplishments achieved in the promotion of tourism through said relationship.

As the City has evolved and grown its tourism efforts, the Chamber has been a critical resource. The Chamber is the only accredited destination marketing organization in the greater Verde Valley. They have a specialized knowledge of what attracts tourists to Sedona and what tourists expect to experience while in Sedona. The Chamber also understands the specific markets from which the City desires to attract visitors.

As a nonprofit organization, the Chamber fits squarely into the definition of entities with which cities may contract for the promotion of tourism as described in A.R.S. § 9-500.06(D)(2).

The scope of the tourism promotional activities required of the Chamber through its contract with the City is well defined. The contract requires the City and Chamber to collaborate each year, in a joint work session, to set specific goals and objectives for tourism. It is the City Council which identifies priorities and policy direction to assist the Chamber in accomplishing the outcome desired by the City. While the Chamber develops the destination marketing and product development plan, it is based on the expected results identified by the City.

Interestingly, the Complaint seems to focus on the fact that 55% of the revenues generated by the bed tax must be distributed to the Chamber pursuant to its contract with the City. As has been previously stated, the 55% figure resulted from a public and comprehensive stakeholder process in which all interests were welcome to participate.

What the complainant appears to disregard is the fact that had the City adopted its bed tax after April 1, 1990, rather than in 1988 as it did, 100% of the bed tax would be spent on the promotion of tourism, either through the Chamber pursuant to A.R.S. § 9-500.06(D)(1), or through some other means identified in A.R..S. § 9-500.06(D)(1)-(3)

As with the bed tax issue previously mentioned, the identified purpose for contracting with a nonprofit organization or association for the promotion of tourism is expressly given to cities and towns by the Legislature though A.R.S. § 9-500.06. However, it is worth reinforcing the fact that only slightly more than half of the bed tax collected is actually expended through the Chamber for the promotion of tourism.[7]

On the question of the value received by the City through its contract with the Chamber, that is reviewed and assessed annually by the City Council through the joint work session process. It is at that time each year that the City determines whether or not the results achieved by the Chamber are of sufficient value as related to the expenditure. Absent some "gross disproportionality," that is a decision appropriately left to the City. Further, the Chamber appears before the City Council and delivers quarterly reports with an in-depth statistical analysis of tourism promotion activities and the benefits received by the City through the contract. A sample of this is provided in the form of the most recent presentation made by the Chamber to the City Council.[8]

During more recent discussions regarding the appropriate amount of funding to be directed toward destination marketing, as opposed to product development, the decision has been made to share the product development responsibilities on an ad hoc basis determined by whether the City or the Chamber is most qualified to undertake any given activity.[9] This approach is the most fiscally responsible way of ensuring that an appropriate balance is achieved and the potential negative aspects of destination marketing (overcrowding) can be avoided.

Jordan Rd. Property

The acquisition by the Chamber of the real property located at 401 Jordan Rd. in Sedona was the result of an innovative concept whereby the Chamber could assist the City in developing the products that attracts visitors to Sedona. Without the infrastructure necessary to handle the high volume of tourists visiting Sedona each year, the City would likely lose both return visitors and the word-of-mouth referrals that augment the overall marketing efforts.

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[7] By comparison it is worth noting that the Tucson Convention & Visitors Bureau receives approximately $5 million annually from the City of Tucson bed tax (34% of the base bed-tax plus revenue sharing on the City's $4 nightly surcharge, $3.2 million from Pima County (50% of base bed-tax revenue in unincorporated Pima County), and $300,000 from Oro Valley in the form of a flat investment (equal to 23% of the Town's bed-tax collection). Source: Brent DeRaad, President & CEO, Visit Tucson

[8] See "Exhibit 5" attached hereto

[9] See "Exhibit 2" at 2.3.5

The Memorandum of Understanding (MOU) that reflects the intentions of both the City and the Chamber with respect to the Jordan Rd. property was based on two (2) critical premises. First, because the funds used by the Chamber to acquire the property were in the form of bed tax revenues, the City must ultimately have the option of receiving the property by donation from the Chamber at a specifically identified point in time. Second, any interim use of the property by the Chamber must be consistent with destination marketing and development plan approved by the Sedona City Council. With each of these latter described conditions, the City retained exclusive control over how the Jordan Rd. property will be used. Further, any revenue generated by the use of the property must be used by the Chamber to reduce its indebtedness related to the financing of its acquisition until any encumbrance is satisfied.[10]

Again, at the most basic level the acquisition of the Jordan Rd. property is both authorized by and consistent with A.R.S. § 9-500.06. Expenditures by a city or town to develop, improve or operate tourism related attractions, facilities or to assist in the planning and promotion of such attractions and facilities is authorized in A.R.S. § 9-500.06(D)(3).

The high volume of transient visitors coming to Sedona each year generates more vehicle traffic than the current City infrastructure can handle. The parking lot at the Jordan Rd. property has already been designated as one of the City's public lots as a strategy to help with the City's overall parking shortage.[11] It is anticipated that the structures currently on the 401 Jordan Rd. property will eventually be utilized in such a manner as to further alleviate traffic congestion and parking problems. This may be in the form of a multi-modal facility, or something of that nature, but will again result from the priorities established by the City Council through its joint work sessions with the Chamber.

Ultimately, it is the residents of and visitors to Sedona that will benefit from the 401 Jordan Rd. property. The Chamber will realize no identifiable benefit from this arrangement outside the scope of its continuing relationship as the City's partner in tourism promotion. As with the City/Chamber contract generally, the value received by the City is appropriately determined by the City Council unless it is grossly disproportionate to the expenditure of bed tax funds.

Because the benefit received through use of the Jordan Rd. property is exclusively public, the expenditure of public funds is appropriate and there can be no Gift Clause violation associated with it.

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[10] See Memorandum of Understanding

[11] See City of Sedona Uptown Parking Map attached hereto as "Exhibit 6"

Conclusion

The City is fortunate to have a local, accredited destination marketing organization which understands the dynamics involved with Sedona's tourism industry. The residents of Sedona demand an appropriate balance between sharing Sedona's abundant natural attractions and maintaining a livable community. This is not an easy task, as is evidenced by the present complaint and the force driving it.

The relationship that has evolved over the years between the City and the Chamber is not only appropriate; it is absolutely consistent with the requirements of the law as handed down by our Legislature.

Whether it is the bed tax generally, the tourism promotion contract between the City and the Chamber, or the acquisition of an asset desperately needed to support the infrastructure demand resulting from tourism, the City has acted in a fiscally responsible and legally mandated manner in all circumstances at issue.

For the foregoing reasons, the City cannot be found to have violated any state law.

Sincerely,

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