



City of Chattanooga

INTERNAL AUDIT

City Hall

Chattanooga, Tennessee 37402

Stan Sewell
Director

Ron Littlefield
Mayor

October 21, 2010

Mayor and City Council
City of Chattanooga
City Hall
Chattanooga, TN 37402

RE: PILOT Collection Process, Audit 10-01

Dear Mayor Littlefield and City Council Members:

Attached is the Internal Audit Division's report on PILOT Collection Process.

We thank the management and staff of the Finance department, RiverCity Company, Hamilton County Trustee's office, and Hamilton County Tax Assessor's office for their cooperation and assistance during this audit.

Sincerely,

Stan Sewell, CPA, CGFM
Director of Internal Audit

cc: Dan Johnson, Chief of Staff
Audit Committee Members
Daisy Madison, City Finance Officer
Michael McMahan, City Attorney

**FINANCE DEPARTMENT
PILOT COLLECTION PROCESS
AUDIT 10-01
JUNE 23, 2010**

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Auditor



Audit Director

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INTRODUCTION

Tennessee State Law provides exemptions from ad valorem tax for property owned by housing authorities (T.C.A. 67-5-206), and property of a Tennessee nonprofit corporation used for permanent housing of low income persons with disabilities, low income elderly or handicapped persons (T.C.A. 67-5-207) provided, that, they agree to make in lieu of tax payments for services, improvements or facilities furnished by the local governments. The City Treasurer's office maintains all relevant agreements and collects the in lieu of tax payments from the organizations each year. Further, in lieu of tax payments are received quarterly from Tennessee Valley Authority and annually from Electric Power Board in accordance with T.C.A. 67-9-101 and 67-9-102 (for TVA) and T.C.A. 7-52-304 (for EPB).

Through a City ordinance, the City delegates to the Industrial Development Board and/or Health, Educational and Housing Facility Board the authority to negotiate and accept payments in lieu of ad valorem taxes (PILOTs) from lessees of the respective Boards. The structure of this type of PILOT agreement includes the assumption of a property ownership by the Board and an accompanied lease of the property to the operating business. Typically, the business makes commitments outlined in the PILOT agreement (i.e. real and personal property investment dollars, number of newly created jobs, and average annual wage dollars) and in exchange the local governments abate a percentage of the companies ad valorem taxes related to the real and personal property investments. Both the City and County governing bodies must approve the PILOT agreement. Under the agreements, the Board designates the County Assessor to appraise the property and assess a percentage of its value under the terms of the agreement. Further, the Companies and the Board agree that in lieu of tax payments will be paid to the Hamilton County Trustee, who will disburse the City's portion in accordance with the requirements of the agreement.

Through the series of tax incentives and agreements the City received in lieu of tax payments of \$2,603,899 in FY09. These in lieu of tax collections accounted for 1.27% of the 2009 operating budget.

STATEMENT OF OBJECTIVES

This audit was conducted in accordance with the Internal Audit Division's 2010 Audit Agenda. The objectives of this audit were to determine if:

1. All current PILOT agreements have been accounted for and billed to the taxpayer.
2. PILOT payments have been calculated in accordance with the PILOT agreement.

3. Property associated with an expired PILOT agreement was timely returned to the property tax roll.

STATEMENT OF SCOPE

Based on the work performed during the preliminary survey and the assessment of risk, the audit will cover the PILOT collection process from July 1, 2008 through June 30, 2009. Source documentation was obtained from the Finance department, City Attorney, Hamilton County and other sources as necessary. Original records as well as copies were used as evidence and verified through physical examination. The scope was expanded as necessary to meet the objectives of the audit.

STATEMENT OF METHODOLOGY

We reviewed the written policies/procedures and interviewed staff to gain an understanding of the PILOT collection process by the Treasurer's Office. Further, we interviewed staff with the Hamilton County Trustee's office and Tax Assessor's office to obtain relevant information to the assessments and billing processes performed by the County.

We compiled a listing of fifty-three (53) PILOT agreements that were billed and collected by the County Trustee and reviewed a sample of twenty-seven (27) PILOT agreements. Further, we reviewed all available PILOT agreements collected by the City Treasurer. We reviewed the tax billings for tax year 2008 (FY09) and tax year 2009 (FY10). The tax calculations were verified and compared to the PILOT agreements for accuracy.

The sample size and selection were statistically generated using a desired confidence level of 90 percent, expected error rate of 5 percent, and a desired precision of 5 percent. Statistical sampling was used in order to infer the conclusions of test work performed on a sample to the population from which it was drawn and to obtain estimates of sampling error involved. When appropriate, judgmental sampling was used to improve the overall efficiency of the audit.

STATEMENT OF AUDITING STANDARDS

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

AUDIT CONCLUSIONS

Based upon the test work performed and the audit findings noted below, we conclude that:

1. All current PILOT agreements have been accounted for and billed to the taxpayer.

However, we noted no property tax/PILOT payments have been made since 1991 on a parcel of property owned by Chattanooga Housing Authority and leased to RiverCity Company.

2. The in lieu of tax payments collected by the County Trustee were calculated in accordance with the PILOT agreements, with one exception. Further, we were unable to determine if all in lieu of tax payments collected by the City Treasurer were properly calculated because all original PILOT agreements could not be located.
3. Property associated with an expired PILOT agreement appears to be timely returned to the property tax roll.

While the findings discussed below may not, individually or in the aggregate, significantly impair the operations of the Finance Department, they do present risks that can be more effectively controlled.

PROPERTY TAX/PILOT PAYMENTS NOT PAID

On February 19, 1992, RiverCity Company entered into a ground lease and option to repurchase property at 1 Market Street with Chattanooga Housing Authority (The City approved an appropriation of \$350,000 to CHA for the purchase of this property). RiverCity Company agreed to develop a multi-story apartment complex with an investment of at least \$2.2 million. According to RiverCity Company's website, the Riverset Apartments were completed in 1994 and 100% occupied within eight months.

The lease agreement required RiverCity Company to lease or hold for lease at least twenty percent (20%) of the units to tenants whose income falls below eighty percent (80%) of the median income level for the Chattanooga/Hamilton County area. RiverCity Company would pay to Chattanooga Housing Authority an annual fixed rental of one dollar (\$1.00) per year plus a percentage of all net cash flows received from rentals of the units. **Further, RiverCity Company agreed to make an annual in lieu of tax payment of \$5,744.64** (adjusted for any increase in taxes allocable to the public education budgets of the City and County). Per the agreement, default in the performance of the terms of the contract by the Tenant (RiverCity) would entitle the Landlord (Chattanooga Housing Authority) to take possession of the premises.

We noted that neither the City of Chattanooga nor Hamilton County were a party to the lease agreement. We found no approval by City Council of the lease agreement or PILOT payments. Further, it appears in July 1997 an administrative judge with the Tennessee Board of Equalization mandated that RiverCity's leasehold interest in the property be assessed tax pursuant to T.C.A. 67-5-502(d). However, we found property taxes have not been assessed or paid under this assumption.

Chattanooga Housing Authority has not verified compliance with the terms of the lease agreement (low income rentals). Based on discussions with Chattanooga Housing Authority, RiverCity has never paid any lease payments. Further, an estimated \$109,000 is owed in delinquent taxes/PILOT, excluding any applicable interest and penalty, under the lease agreement. Chattanooga Housing Authority has requested financial statements from RiverCity Company to determine if any rental payments are due.

Neither RiverCity Company nor Chattanooga Housing Authority has paid property tax/PILOT payments on the property.

RECOMMENDATION 1

We recommend the Finance department consult with the City Attorney to determine the total PILOT/property taxes, interest and penalty due on the property and proceed immediately with collection efforts. Further, if collection efforts fail, we recommend the Finance department discuss with Chattanooga Housing Authority the possibility that they exercise their legal options to repossess the property.

AUDITEE RESPONSE

Finance will discuss failure to pay with the CHA with the goal of working out a payment arrangement for prior PILOTS and assurance of timely future payments. If not successful, we will discuss proposed options with the City Attorney to determine the best course of action.

ERROR IN TAX BILLINGS

We found United Packers/Coca-Cola Bottling Company had two PILOT agreements dated December 1, 2006 and December 27, 2007. The real and personal property improvements under both agreements were located at the same manufacturing facility. Based on our review of the two PILOT agreements, as well as our discussions with the County Tax Assessor and County Trustee's office, we determined an error had occurred in the tax billings. In particular, we noted the 2008 tax billing reported improvements to real property and assessed taxes under both the 2006 and 2007 PILOT agreements. However, the 2009 tax billing assessed taxes on the real property only under the (lower rate) 2007 PILOT agreement. Further, per the Tax Assessor's office, the improvements to real property related to the 2006 PILOT agreement only. Therefore, it appears the Company owes additional in lieu of tax payments.

RECOMMENDATION 2

We recommend the Finance department develop policies and procedures that ensure PILOT billings are accurate. The procedures should include annual review of calculations performed by the County Trustee along with a comparison to the PILOT agreements and past tax billings. Also, we recommend the Finance department address the billing issues of

United Packers with the County Trustee and County Assessor's office. Further, we recommend future PILOT agreements be limited to a single agreement per organization, per location.

AUDITEE RESPONSE

We concur. Will tighten existing procedures to verify accuracy of billings by County Tax Assessor.

SUPPORT DOCUMENTATION NEEDED

During our review we noted that PILOT agreements with Chattanooga Housing Authority, Electric Power Board and Orchard Knob require in lieu of tax payments based on various financial information. We reviewed the collection reports and found adequate support documentation was not submitted with the PILOT payments. The organizations have not been required to submit adequate support documents along with their payments that would facilitate a review by City staff. Independent reviews and verification by City staff should decrease the likelihood of lost revenues.

RECOMMENDATION 3

We recommend the Finance department request organizations, with PILOT payments based on revenues, expenses and/or assets, submit their Independent Audited Financial Statements with future PILOT payments, along with a detailed reconciliation, when necessary. Further, we recommend the Finance department institute procedures to review and document the accuracy of those PILOT calculations.

AUDITEE RESPONSE

Finance will contact the EPB and Orchard Knob and require documentation supporting PILOT amount with future payments.

CHATTANOOGA HOUSING AUTHORITY

Chattanooga Housing Authority (CHA) has entered into two cooperation agreements (PILOTS) with the City of Chattanooga and Hamilton County. Each agreement relates to specific housing projects and both remain in effect. The April 1950 agreement covered "any low-rent housing hereafter developed" and included within Program Reservation No. Tenn-4-A with an aggregate of 1,200 units of low-rent housing. The 1968 agreement covers "any low-rent housing hereafter developed" comprising approximately 3,350 units. Section 3 of each agreement outlines the in lieu of tax payment calculations.

IA reviewed both PILOT agreements and noted the terms of each agreement are different. The 1950 cooperation agreement requires in lieu of tax payments equal to 10% of **shelter rent charged**. The 1968 cooperation agreement requires in lieu of tax payments based on

10% of **shelter rent actually collected** but cannot exceed 10% of **shelter rent actually charged**. Further, the 1968 cooperation agreement prohibits the assessment of penalty and interest.

It appears the PILOT payments under the 1950 agreement would result in a higher in lieu of tax payment than the 1968 agreement. However, we found CHA has based all PILOT payments on the 1968 cooperation agreement. Therefore, CHA owes additional in lieu of tax payments to the City. Additionally, because Chattanooga Housing Authority historically has paid its PILOTs late, penalty and interest charges should be due to the City for amounts related to the 1950 agreement.

RECOMMENDATION 4

We recommend the Finance department consult with both Chattanooga Housing Authority and the City Attorney to determine which housing projects are governed by each cooperation agreement. Further, we recommend the PILOT calculations be modified in accordance with those findings and collection efforts be initiated.

AUDITEE RESPONSE

We will review existing agreements with CHA and the City Attorney for clarification of payments under each. Appropriate action will be taken based upon opinion rendered by the City Attorney.

DELINQUENT PILOT PAYMENTS

We reviewed PILOT collections from tax years 2003 through 2009 and noted Chattanooga Housing Authority has consistently paid their in lieu of tax payments delinquent (on average 8 months past due). Further, the PILOT payments due for 2007 and 2008 taxes were not paid until late 2009 and early 2010, after Internal Audit addressed the issue in a memorandum in August 2009. Also, we found that Chattanooga Housing Authority has not paid penalty and interest on any delinquent PILOT payments (except the Alton Park 2009 tax bill).

RECOMMENDATION 5

We recommend the Finance department (with the assistance of the City Attorney) determine the applicable interest and penalties due from Chattanooga Housing Authority and collect all past due monies immediately. Further, we recommend the Finance department institute procedures to ensure such past due amounts are more timely identified and collected.

AUDITEE RESPONSE

Finance will calculate the amount of delinquent PILOTS and interest, if any, owed by CHA. We will meet with City Attorney and CHA to develop a plan of payment for delinquent amounts and procedures to ensure timely payments in the future.

COMPREHENSIVE COOPERATION AGREEMENT WITH CHA

The 1950 and 1968 cooperation agreements with Chattanooga Housing Authority govern projects that are low-rent housing developed by the housing authority with financial assistance from the federal government. It appears Chattanooga Housing Authority has properties that are not covered by either of these agreements (reference our previous finding related to the land at 1 Market Street that is leased to RiverCity Company). RiverCity Company erected an apartment complex called Riverset Apartments. The monthly rental rate ranges from \$850 to \$1350 (which doesn't appear to be low-income housing). City Council has not approved any PILOT agreement with RiverCity Company.

RECOMMENDATION 6

We recommend the Finance department (along with the City Attorney and Chattanooga Housing Authority) develop a comprehensive PILOT agreement that would incorporate terms of in lieu of tax payments for any properties that are not governed by the 1950 and 1968 PILOT agreements. Alternatively, we would recommend a (superseding) single PILOT agreement that includes the properties addressed in the 1950 and 1968 agreements along with any other current or future properties.

AUDITEE RESPONSE

We will work with the City Attorney to develop a comprehensive plan to address all CHA properties.