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STATE AND LOCAL GOVERNMENTS SHOULD CLOSE ONLINE HOTEL TAX LOOPHOLE AND COLLECT TAXES OWED

By Michael Mazerov

State and local governments throughout the United States are losing roughly $275 million to $400 million in revenue each year because of their failure to ensure that online travel companies like Expedia, Orbitz, and Priceline collect and remit the appropriate amount of tax on hotel room bookings.

Online travel companies (OTCs) typically pay applicable sales and lodging taxes only on the "wholesale" room rate they pay hotels for the right to rent the rooms, not the higher "retail" room rate they actually charge renters. They argue that this fulfils their legal obligation to collect tax. There is no tax policy justification whatsoever for this practice, however; states routinely tax the full retail price charged to consumers for other types of sales transactions executed by intermediaries analogous to the OTCs.

States and localities that tax hotel room rentals should take appropriate steps to ensure that the full retail room charge is taxed when the room is booked through an OTC — just as it is when the room is booked by a conventional travel agent or the renter herself. Such steps may include initiating lawsuits to enforce payment of the tax on the retail room charge by the OTCs. Or, if states and localities believe their laws as currently worded do not clearly mandate collection on the retail amount, they may need to modernize their laws to ensure that result. (New York recently enacted a law that provides a good model.) At a time when sharply reduced revenues are forcing states and localities to cut health care for the poor, lay off teachers, close fire stations, and increase tuition at state universities and community colleges, all of which are reducing economic growth, it is counterproductive to permit OTCs to exploit a tax loophole that pads their profits at the public's expense.

Hotel Taxes: An Important Revenue Source for States and Localities

Taxes on hotel room rentals are an important part of the revenue stream that states and localities use to finance schools, roads, public safety, and other infrastructure. Every state except Alaska, California, and Nevada taxes hotel room rentals, as do thousands of cities and counties in every state except Connecticut, Delaware, Hawaii, Maine, and New Hampshire. Hotel taxes take the form of general sales taxes and excise taxes that apply only to room rentals; the excise taxes are often called "transient occupancy taxes" or "lodging taxes." General sales taxes and lodging taxes frequently both apply to room rentals at both the state and local level. Hotels collect the taxes from the

occupant and remit them to the state and locality. Lodging taxes are often earmarked for tourism promotion and related purposes (for example, paying off bonds on a convention center). This report's references to "hotel taxes" encompass both sales and lodging taxes at both levels of government.

Room rentals generate over $100 billion in receipts for hotels annually.[1] Given the widespread taxation of these rentals, hotel taxes generate at least $8.5 billion in annual receipts for state and local governments.[2] To put that figure in perspective, it is almost 50 percent greater than what states and localities raised by imposing excise taxes on alcohol in 2008.

Room rentals booked through OTCs represent a significant and growing share of the market – an estimated 14 percent of total rental receipts in 2011.[3] Hotels contract with OTCs to market hotel rooms, in order to supplement the hotels' own marketing efforts. OTCs obtain the rooms from the hotels at a discount and then mark up the price when consumers make reservations through OTC websites or call centers. In addition to being compensated by the hotels through this authorized wholesale-to-retail mark-up, the OTCs typically charge renters a separate fee for unspecified "services and taxes."

Why Don't OTCs Collect Hotel Tax on Rooms' Full Retail Cost?

At present, OTCs pay hotel taxes only on the wholesale room rate they pay the hotels, not the higher retail room rate they charge renters. The OTCs pay the tax to the hotels, which in turn pay the government. Figure 1 illustrates a typical transaction, in which an OTC retains an extra $3.61 in revenue by paying taxes only on a $111.20 wholesale room charge while setting the "taxes and services" fee at a level sufficient to cover the taxes that would have been due on the $139 retail room charge. The extra $3.61 is on top of the OTC's $27.80 commission from the hotel obtained via the mark-up of the room charge. With OTC bookings representing roughly one-seventh of all domestic hotel room reservations, even a few dollars in additional profits per room rental add up quickly for the companies.

Scores of local governments have filed lawsuits against OTCs claiming that their hotel taxes are due on the full retail room rate, not the wholesale rate. More recently, a few states have sued or prepared to sue the OTCs as well. The court cases have revealed that regardless of the wording of the particular state or locality's tax statute or ordinance, the OTCs take the position that they are never obligated to pay taxes based on the full retail room rate. They maintain that their wholesale-

[1] William Carroll and Lorraine Sileo, "PhoCusWright's U.S. Online Travel Overview Tenth Edition: Hotel & Lodging," November 2010, Figure 2.5, p. 27. PhoCusWright predicts that room rentals will generate $106 billion in receipts in 2011, just shy of the $108 billion generated prior to the financial crisis and recession of 2008. The industry consulting firm predicts $115 billion in receipts in 2012.

[2] Michael Mazerov, "Banning Taxation of Online Hotel Reservations Is Unwarranted and Could Cost States and Localities Billions of Dollars," Center on Budget and Policy Priorities, Revised September 18, 2009; available at http://www.cbpp.org/files/9-2-09sfp.pdf.

[3] See the source cited in Note 1.

FIGURE 1:

Example: How OTCs Increase Revenue by Paying Tax Only on "Wholesale" Room Rates

Standard two queen bed room, Courtyard Marriott Hotel, downtown Silver Spring, Maryland
Check-in April 15, 2011, one night, advance purchase, fully refundable
Figures below reflect actual comparison of Marriott and Expedia websites

Hotel website:

$139.00	Retail room charge to consumer
18.07	Taxes (at 13%)
$157.07	Total cost to consumer

Expedia website:

$111.20	Expedia's "wholesale" room cost (assuming Expedia marks up by 25%)
27.80	Expedia's 25% mark-up
$139.00	Expedia's room charge shown to consumer
18.84	Expedia's "Taxes and Service Fees" shown to consumer
$157.84	Total cost to consumer

Expedia pays $14.46 in taxes on the room (13 percent of the $111.20 wholesale cost), or $3.61 less than the $18.07 it would pay if it paid tax on the room's full retail cost. This $3.61 is retained by Expedia in addition to the $27.80 Expedia receives through its wholesale-to-retail markup.

to-retail mark-ups and the service fees they charge renters are compensation for their marketing, information, and booking services, and that applicable taxes on hotel room rentals should be calculated after subtracting OTC compensation. That is, the tax should be based on the wholesale room charge from the hotels to the OTCs.

Failure to Tax the Total Retail Charge Undermines the Integrity of the Hotel Tax

Many of the applicable laws imposing state and local hotel taxes were written before the advent of the OTC industry and did not contemplate that an intermediary rather than the hotel might actually bill the renter for the room. Since many of these laws indicate that the tax collection obligation lies with the hotel, the OTCs have sometimes prevailed in court cases on that basis. The OTCs have won other cases on the grounds that localities did not use proper administrative procedures to compel them to pay tax on the retail charge.

OTC wins in some of these cases are irrelevant with respect to the policy merits of their position, however. The OTCs' position that hotel taxes should only apply to the wholesale room rate is contradicted by standard state approaches to taxing analogous sales transactions.

First, in the most general sense, *all* retailers serve as intermediaries between producers and consumers. There is no more justification for the claim that states or localities should tax only the wholesale price of a room rental than there would be for the claim that they should tax only the wholesale price of a car.[4] The OTCs are providing the same kinds of marketing and room booking

[4] As an academic expert on state and local taxation argues:

services that the hotels themselves engage in. If the hotels may not deduct a pro-rated amount of their advertising and website operation expenses from the retail room charge prior to calculating applicable hotel taxes when they incur such expenses directly, there is no possible justification for compelling such a deduction when hotels pay an OTC to provide the same services. This uneven treatment of OTCs and the hotels themselves helps explain why many major hotel chains and their principal trade association, the American Hotel and Lodging Association, are among those fighting for the closing of the OTC loophole.[5]

Second, conventional (that is, non-Internet based) travel agents have served as intermediaries between room renters and hotels for decades, and hotel taxes have always applied to the room rate charged to the consumer, *with no prior deduction of the travel agent's commission.*[6] The fact that OTCs are compensated by the hotels for their services by being allowed to retain a mark-up rather than through an explicit commission does not change the substance of the transaction, and tax should therefore apply to the retail room rate as it always has.

Third, several other types of sales transactions effected by intermediaries that never take legal title to the items they are selling are subject to tax on the full price charged to the consumer.[7] One common example is a consignment sale: a potter, for example, might enter into an agreement with a

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> From a normative perspective, hotel taxes are consumption taxes, which should be measured by the value of the consumption to the consumer. Therefore, tax should be imposed on the retail amount — the gross amount the consumer pays the travel company for the accommodation. Thus, at least on a prospective basis, it is appropriate for [state] lawmakers to include the total consideration paid by consumers for hotel lodging in the measure of the tax and to impose the tax collection obligation on the [online] travel companies and/or the hotels, whichever is most administratively convenient.

John A. Swain, "Internet Travel Companies — Taxing the Middleman," *State Tax Notes*, February 14, 2005, p. 480.

[5] See, for example, a joint letter dated January 20, 2011 from the American Hotel and Lodging Association, Hilton, Marriott, and several other hotel chains to Virginia Governor Bob McDonnell in support of Virginia Senate Bill 972.

[6] "Prior to the advent of the Internet and online travel intermediaries, the taxation of receipts that traditional travel agents derived from their services in facilitating the sale of hotel accommodations to consumers was not a contentious one. . . . [T]he full amount paid by the consumer for taxable hotel accommodations booked through a travel agent was subject to sales or accommodations tax, and it was not reduced by the commission generally remitted by the hotel operator to the travel agent." Walter Hellerstein, memorandum to the National Conference of State Legislatures Re: "Travel Intermediaries," July 16, 2009. See also: Beth Anne Stanford, "State and Local Efforts to Collect Additional Tax on Hotel Rooms Booked Online," *State Tax Notes*, January 31, 2005, p. 319.

[7] A number of states have quite detailed laws or regulations spelling out the obligation of various kinds of non-retailer intermediaries to collect applicable sales taxes on the total retail charge. For example, California Board of Equalization Sales and Use Tax Regulation 1569 provides: "A person who has possession of property owned by another, and also the power to cause title to that property to be transferred to a third person without any further action on the part of its owner, and who exercises such power, is a retailer when the party to whom title is transferred is a consumer. Tax applies to his *gross receipts* from such a sale." [Emphasis added.]

Georgia Regulation 560-12-2-.07 provides: "Auctioneers, agents, or factors selling tangible personal property are liable for collection and payment of the sales tax. *The tax applies to the gross sales prices of each single sale without deduction for commissions, service charges or any other expenses.*" [Emphasis added.]

Texas Administrative Code Section 3.311 provides:

> (b) Responsibility of an auctioneer.
>
> (1) Sales tax is due from the purchaser *on the sales price* of taxable items sold at auction.
>
> (2) An auctioneer is responsible for collecting and remitting to the comptroller any tax due on the sale of taxable items sold at auction by the auctioneer. [Emphasis added.]

craft store to sell her wares without the store purchasing them for resale. If the item sells, the store charges the purchaser the retail price and retains a commission for making its premises and retailing services available to the potter. In such a transaction, sales taxes would be calculated on the full retail charge to the purchaser. The same would be true with respect to a sale effected through an auctioneer — another intermediary that never owns the item being sold. The OTCs argue that they are merely "intermediaries," do not own the rooms whose rentals they broker, are not legal agents of the hotels, and do not lease the rooms from hotels and sublet them to renters. But such disclaimers also could apply to consignment and auction sales, and yet both are taxable on the total retail sales amount.

Finally, it is a standard feature of many states' sales tax laws that if a tax-exempt charge is not separately stated to the consumer but rather is bundled with a taxable charge, the entire transaction is taxable. Even if one accepted for the sake of argument that OTC services are being provided solely to the room renter (that is, that they provide no benefit to the hotel), the OTC's "service charge" (i.e., its mark-up) is bundled with the room charge in the bill the customer pays. On that basis alone the standard treatment would be to charge tax on the total retail amount. Similarly, the "Streamlined Sales and Use Tax Agreement," which 23 states have incorporated into their own sales tax codes, provides that the "sales price" on which the tax is based may *not* include any deduction for "charges by the seller for any services necessary to complete the sale" unless they are "separately stated on the invoice . . . given to the purchaser."

In sum, whether OTCs *currently* are required to calculate applicable hotel taxes on rooms they rent based on the retail charge to the renter may well be a matter of law that courts will have to decide for particular states and localities. Going forward, however, as a matter of *tax policy*, the proper approach is to base the tax on the full retail room rate, just as it is calculated for rooms booked by traditional travel agents and room occupants themselves.

States and Localities Are Losing Several Hundred Million Dollars Annually

State and local governments in the United States collectively are losing at least $276 million to $396 million in hotel tax revenues each year due to the failure of OTCs to charge tax on their wholesale-to-retail mark-ups (see Table 1).[8] Moreover, these figures are an underestimate, for two reasons:

- No data could be obtained from 11 states on current local hotel tax collections. (Local revenue losses in those states are shown as Not Available in Table 1.) Without these data, it is impossible to estimate the amount of local tax going uncollected on OTC mark-ups.

[8] It is necessary to provide a range of estimated revenue losses rather than a specific "point" estimate because the average (untaxed) OTC wholesale-to-resale mark-up is proprietary information and there is no recent publicly-available estimate of what it might be. See the Appendix of the source cited in Note 2 for a detailed discussion of the estimating methodology – including support for the 25 percent to 40 percent mark-ups that are assumed and that underlie this particular range.

TABLE 1:

Estimated State and Local Revenue Loss ($Millions), 2010, from Failure to Tax Full Retail Value of Rooms Booked Through OTCs

State	State Revenue Loss Assumed OTC mark-up 25%	30%	35%	40%	Local Revenue Loss Assumed OTC mark-up 25%	30%	35%	40%	Combined Revenue Loss
Alabama	1	1	1	1	NA	NA	NA	NA	1
Alaska	NT	NT	NT	NT	NA	NA	NA	NA	NA
Arizona	4	5	5	6	1	2	2	2	5-8
Arkansas	1	1	1	2	NA	NA	NA	NA	1-2
California	NT	NT	NT	NT	34	40	45	50	34-50
Colorado	2	2	2	2	0	0	0	0	2
Connecticut	3	3	4	4	NT	NT	NT	NT	3-4
Delaware	0	1	1	1	NT	NT	NT	NT	0-1
District of Columbia	NT	NT	NT	NT	6	7	7	8	6-8
Florida	16	18	21	23	15	18	20	22	31-45
Georgia	3	4	4	5	4	5	6	7	8-11
Hawaii	14	16	18	20	NT	NT	NT	NT	14-20
Idaho	1	1	1	2	NA	NA	NA	NA	1-2
Illinois	6	7	8	9	3	3	3	4	9-12
Indiana	2	3	3	3	NA	NA	NA	NA	2-3
Iowa	1	1	1	1	1	1	1	2	2-3
Kansas	1	1	1	1	1	1	1	1	1-2
Kentucky	2	2	2	2	0	0	0	0	2-3
Louisiana	2	2	2	2	3	3	4	4	5-7
Maine	1	1	1	1	NT	NT	NT	NT	1
Maryland	3	3	4	4	2	3	3	3	5-7
Massachusetts	4	4	5	5	3	3	4	4	6-9
Michigan	3	3	3	4	1	1	1	1	4-5
Minnesota	3	3	3	4	1	1	2	2	4-6
Mississippi	1	2	2	2	0	0	0	0	1-2
Missouri	2	2	2	2	0	0	0	0	2-3
Montana	0	1	1	1	0	0	0	0	0-1
Nebraska	1	1	1	1	NA	NA	NA	NA	1
Nevada	NT	NT	NT	NT	NA	NA	NA	NA	NA
New Hampshire	1	1	1	1	NT	NT	NT	NT	1
New Jersey	7	9	10	11	1	1	1	1	8-12
New Mexico	1	1	1	2	1	1	1	2	2-3
New York	9	11	12	14	21	25	28	31	31-45
North Carolina	4	4	4	5	4	5	5	6	8-12
North Dakota	0	0	0	0	NA	NA	NA	NA	0
Ohio	3	3	4	4	4	4	5	5	7-10
Oklahoma	1	1	1	1	1	1	1	1	2
Oregon	0	0	0	0	3	3	4	4	3-4
Pennsylvania	5	5	6	7	2	2	2	2	6-9
Rhode Island	1	1	1	2	0	1	1	1	2
South Carolina	3	4	4	5	1	1	1	2	4-6
South Dakota	0	1	1	1	NA	NA	NA	NA	0-1
Tennessee	3	4	4	5	NA	NA	NA	NA	3-5
Texas	11	12	14	15	13	15	17	19	24-34
Utah	1	1	1	1	1	1	1	1	2-3
Vermont	1	1	1	1	NA	NA	NA	NA	1
Virginia	4	5	6	6	5	6	7	7	9-13
Washington	4	4	5	5	1	1	1	1	5-7
West Virginia	1	1	1	1	0	1	1	1	1-2
Wisconsin	2	2	2	3	2	2	2	3	4-5
Wyoming	1	1	1	1	0	0	0	0	1
US TOTAL	**144**	**167**	**187**	**206**	**131**	**152**	**172**	**190**	**276-396**

Estimates are rounded to nearest $1M NT=No tax NA=Not available (cannot be estimated)

- With respect to the other 39 states, it is not possible to reliably estimate revenue losses from uncollected taxes on OTC mark-ups when those taxes take the form of general sales taxes imposed by local governments (as opposed to excise taxes that apply only to room rentals). Local hotel taxes in thousands of localities take this form. No reliable data exist with which to break out the share of local general sales tax collections that is attributable to room rentals in specific jurisdictions. Because of these limitations, the estimated local government revenue losses shown in Table 1 do not include *any* losses in local general sales taxes imposed on room rentals.

Table 1 indicates that *state* government revenue losses range between $144 million and $206 million annually. These estimates are substantially reliable because they are based on applying the applicable statewide statutory sales and/or hotel tax rate to the state's estimated amount of OTC room bookings. (The latter is based on the state's overall share of hotel room rental receipts reported in the 2007 Economic Census.) Because local governments have taken the lead in bringing court cases against the OTCs, there has been a widespread misperception that uncollected taxes on OTC mark-ups are only a local problem. In reality, however, state hotel taxes exist in every state except Alaska, California, and Nevada, and OTCs refuse to collect state taxes on their mark-ups just as they refuse to collect local taxes.

Table 1 indicates that annual local revenue losses range between $131 million and $190 million. Again, these figures substantially underestimate the actual local revenue losses because they do not include lost revenue from local general sales taxes that apply to hotel room rentals.

Would Taxing OTC Mark-Ups Hurt Tourism and the Economy?

The OTCs argue that if they are required to remit tax on their wholesale-to-retail mark-ups, they will have no choice but to pass that new expense to their customers. They argue that this would reduce tourist travel and therefore be self-defeating for the governments that impose this policy because marginally higher hotel tax revenues would be more than offset by lower tax collections on meals, car rentals, and other things tourists buy. They also argue that reduced tourism would cost states and localities jobs. The latter argument is one of the main justifications they offer for federal legislation they are seeking that would prohibit state and local taxation of their mark-ups.[9]

These arguments are not credible, and in fact are likely to be backwards, for several reasons.

First, it is the OTCs themselves and not their customers that will pay most or all of the taxes. The hotel market is extremely competitive in most areas, and the vast majority of room bookings are still controlled by the hotels themselves. OTCs are presumably already charging their customers what they perceive to be profit-maximizing room rates, factoring in both the taxes they pay now on the wholesale room charge and the fact that it is extremely easy for customers to compare the price charged by the OTC to the price charged by the hotel on its own website for a specific room configuration on a specific date. The services OTCs provide that hotel websites don't provide — identifying all the hotels in a particular locality and comparing their room rates — can be obtained for free from the OTCs' websites or a conventional travel agent. Thus, if OTCs attempted to raise prices to recover the additional taxes, they would only drive their customers to book their rooms on

[9] See the source cited in Note 2 above.

the hotels' own websites, since the hotels are already charging tax on the retail rate and would have no reason and little ability (given robust competition in the marketplace) to increase their rates further.

In short, ensuring that OTCs charge tax on the retail room rate would, in most cases, eliminate a windfall they are currently enjoying and reduce their profits; it would not have a significant impact on the total cost of hotel rooms. This is why the OTCs have opposed this requirement so aggressively in the courts, in state legislatures and city councils, and in the halls of Congress. If the OTCs could, in fact, pass the cost of paying taxes on the retail room rate onto their customers, they would have little reason to oppose the change as vigorously as they do.

Second, the additional taxes that state and local government collect can be used for purposes that will boost tourism and the economy. For instance, the additional tax collections might be spent specifically for tourism promotion or tourist-oriented investments such as convention centers (in many places they are earmarked for that purpose). Alternatively, they might be used to enhance public services from which tourists and residents alike benefit — police protection, transportation, etc. — or to avert cuts in such services. The job-creation potential of such expenditures is clear.

Finally, states and localities could choose to use some or all of the added revenue to reduce the tax rates paid by everyone.

In short, closing the OTC loopholes will cost the OTCs money, but will likely lead to some combination of enhanced tourism, improved public services, and/or reduced tax rates for everyone else.

How Can States and Localities Close the Online Hotel Tax Loophole?

While there is no policy merit to the OTCs' position that hotel taxes should apply only to the wholesale room rate, the evidence suggests that OTCs will not change their tax collection practices until compelled to do so. So what should state and local governments do?

First, Do No Harm

One thing they should *not* do is ratify the OTCs' current practices, as would occur under legislation introduced in a number of states that would expressly exempt OTC mark-ups from state and/or local sales and lodging taxes.[10] Missouri enacted such legislation in 2010, and a pitched battle over such a proposal is currently being fought in Florida; similar legislation has been introduced in Georgia. The American Legislative Exchange Council (ALEC), an organization of anti-tax state legislators, has approved a model "Travel Agent Fairness Act" that also would prohibit state and local taxation of OTC mark-ups.

[10] State and local government officials should also support efforts of such organizations as the Federation of Tax Administrators, National Association of Counties, U.S. Conference of Mayors, and National League of Cities to block analogous federal legislation banning taxation of OTC mark-ups that the companies have been seeking for several years. See the source cited in Note 2.

Litigation

With respect to proactive responses to the problem, states and localities have two options: litigation and legislation. As previously discussed, local governments in numerous states have initiated lawsuits — often in the form of class action suits with numerous localities as plaintiffs — to compel OTCs to collect and remit taxes on the retail rate. In states in which such litigation is in process, there is probably little to be gained by additional localities initiating lawsuits, because the existing cases are likely to answer the fundamental legal questions involved.[11] However, in states in which *no* cases have been brought (see Figure 2), it is time for local governments to step up to the plate.[12]

The potential cost of litigation need not be a major constraint. Many of the existing cases have been filed on behalf of multiple local governments by private attorneys willing to work on a contingency fee basis. Class-action suits brought on a contingency basis are entirely appropriate where a large number of potential plaintiffs with few financial resources and suffering relatively little financial loss individually confront an opposing party with deep pockets and a great deal of profit at stake. Contingency fee litigation is a widespread phenomenon in the private sector, and those who assert that "government should be run more like a business" should support this approach.

FIGURE 2:
States with Local Hotel Taxes in Which No Localities Have Yet Sued OTCs

Alaska
Arizona
Arkansas
Colorado
Idaho
Iowa
Kansas
Louisiana
Massachusetts
Minnesota
Mississippi
Montana
Nebraska
North Dakota
Oklahoma
Oregon
South Dakota
Utah
Vermont
Virginia
Washington
Wisconsin
Wyoming

States have been much more passive than localities in confronting this issue. To date, it appears that only six states — Hawaii, Indiana, Montana, Oklahoma, Pennsylvania, and South Carolina — have sued or filed formal tax assessments against the OTCs.[13] A number of other states may be laying the groundwork for tax assessments through audits of the companies.[14]

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[11] Additional litigation is probably unwarranted at this time even in those states in which localities are authorized to write their own lodging tax ordinances and the laws therefore end up with somewhat different wording in different cities and counties. Notwithstanding slightly different wording, any precedents established by the outcome of current litigation are likely to control what happens in future cases.

[12] Some states have been excluded from Figure 2 because official rulings have been issued stating that local hotel taxes are not due on OTC mark-ups. Such rulings may also have been issued with respect to some states included in the list.

[13] South Carolina won its case on January 18, 2011, its state Supreme Court holding that Expedia was obligated under state law to collect state sales tax on both the retail room charge and the separate services fee. The Court also rejected the company's claims that various provisions of the U.S. Constitution barred these taxes. In contrast, on March 11, 2011 a trial court judge in Oklahoma dismissed the state's claim in a case against Priceline that sales tax applied to the OTCs' mark-ups. It seems likely that both decisions will be appealed.

[14] Expedia's annual "10-K" report to the Securities and Exchange Commission for the year ended December 31, 2010 indicates that in addition to the states that have initiated formal legal action against the company, the states of Texas, Florida, Georgia, New Mexico, New York, West Virginia, Wisconsin, Kansas, Colorado, Wyoming, Alabama, Louisiana, and Ohio "have begun or attempted to pursue formal or informal audits or administrative procedures, or state that they may assert claims against us relating to allegedly unpaid state. . . hotel occupancy or related taxes."

Changing State and Local Hotel Tax Laws

Some states and localities may have failed to act because their tax administrators are not confident that their existing statutes and ordinances do, in fact, obligate OTCs to collect and remit taxes based on the retail rate. Indeed, tax administrators in several states have issued formal determinations that only the wholesale room rate is taxable. In these latter states, legislators should revise state statutes imposing state hotel taxes and/or authorizing local hotel taxes to clarify that the taxes apply to the retail rate and that the OTCs are obligated to collect and remit them. In the states without such rulings, policymakers need to ask their Attorneys General or the legal staffs of their departments of revenue to assess the likelihood that the state and its local governments would prevail in litigation aimed at compelling OTCs to collect and remit tax on the retail room rate under the existing statutory language. If they are not sufficiently confident to be willing to initiate litigation, legislators should move forward to make the necessary statutory changes.

It is true that enacting such legislation might have an adverse impact on the future ability of the state and/or its localities to recover back taxes, because a judge might view it as a tacit acknowledgment that the prior legislative language did not provide for taxation of the mark-up. Nonetheless, it has been clear since at least 2004 that OTCs are not collecting tax on the retail rate anywhere, and there is no sense in allowing the issue to remain in limbo in hopes that sufficient resources may be available someday to initiate a suit to recover back taxes or that litigation in some other state may establish a favorable precedent.[15]

How Should Statutes Be Reworded to Achieve Proper Taxation of Rooms Booked by OTCs?

To date, only two states (New York and North Carolina) and a handful of localities (including New York City and the District of Columbia) have amended their hotel tax statutes with the explicit goal of ensuring taxation of the retail room rate charged by the OTCs.[16] In addition, the Multistate Tax Commission (MTC) — an organization of state revenue departments whose purpose is to help states achieve more uniform taxation of multistate businesses — has drafted model statutory language aimed at achieving the same objective.[17] Bills to fix the problem have also been introduced in a number of states in recent years, including such bills in 2011 legislative sessions as Raised Bill 6624 in Connecticut, Senate Bill 1577 and House Bill 1454 in Texas, Senate Bill 296 in Utah, and Senate Bill 972 in Virginia.

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[15] It should be acknowledged that strengthening statutory language is no guarantee that litigation will be avoided. Indeed, some OTCs have filed suits challenging, on various grounds, the legality of new laws enacted in New York, New York City, and North Carolina.

[16] The New York State legislation was enacted by Part AA of Chapter 57 of the Laws of 2010; available at https://nysosc9.osc.state.ny.us/product/mbrdoc.nsf/0f9d113765ae06b58525666700653b6d/7e49f152a07e8e8e85257782005ff86c/$FILE/LAWS%20OF%20NEW%20YORK-2010-CHAPTER%2057%20%20.doc . The relevant language begins on p. 60 of this document. The North Carolina language is embodied in Section 105-164.4 of the General Statutes; available at http://www.ncga.state.nc.us/EnactedLegislation/Statutes/PDF/BySection/Chapter_105/GS_105-164.4.pdf .

[17] See Exhibit A to this document: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/Current_Projects/HO%20Rpt4.pdf . The draft bill is not, however, an official product of the Commission because it has not yet gone through the complete official MTC adoption process for model tax laws. The proposal is undergoing further revision.

Can States Require OTCs to Collect Hotel Taxes?

One question that has been raised in the debate about the proper taxation of hotel rooms booked through OTCs is whether federal law allows states to require the companies to charge taxes to their customers at all.

The U.S. Supreme Court has ruled that sellers cannot be required to collect and remit a state's sales tax when they sell taxable goods across state lines to the state's residents unless the seller has a "substantial nexus" — "physical presence" in the form of property, employees, and/or representatives — within the state's borders. In response to some of the lawsuits that states and localities have brought against the OTCs, the companies claim that they do not have any physical presence in the states in which the hotels are located and therefore cannot be compelled to collect tax on their mark-ups from their customers.

In a January 2011 decision, however, the South Carolina Supreme Court rejected Expedia's claim that it does not have nexus in the states in which its customers are located. There are good reasons to think that other courts that might be called upon to address this issue in the future would come to the same conclusion.

First, the fact that OTCs already pay tax to hotels on the wholesale room rate arguably gives them physical presence, for the following reason: By paying the tax on an amount that is, in effect, their rental payment, they are acknowledging that they are in a position tantamount to a renter (one who is then subletting the room to someone else). Renting property in a state satisfies the "physical presence" standard for a tax collection obligation in the same way that ownership of in-state property does. The OTC's effective status as a renter is reinforced by the significant ongoing control they exercise over the rooms. For example, the OTCs, not the hotels, determine the cancellation policies and penalties that apply to the rooms the OTCs book.

Second, OTCs *do* periodically send their own employees into states where hotels are located, or hire third parties in such states, to inspect the quality of the hotels and/or negotiate room rates. (Indeed, Expedia acknowledged this in the South Carolina litigation.) If the OTCs use their own employees to do this, it would clearly obligate them to collect hotel taxes. Even if they hired independent contractors, the Supreme Court has also held that if in-state persons engage in activities on behalf of an out-of-state company that are "significantly associated" with the out-of-state company's ability to "establish and maintain a market" in the state, the latter is required to collect applicable taxes on its sales. Inspections conducted by third parties on behalf of the OTCs should satisfy this standard, since OTCs obviously must be confident of the cleanliness, level of maintenance, safety, and security of the hotels they book.

Finally, this latter Supreme Court ruling may obligate the OTCs to collect tax on the grounds that the hotels themselves are furnishing a service to the OTCs that is essential to the OTCs' ability to "establish and maintain a market" in the states where the hotels are located — that is, making hotel rooms available to the OTCs' customers. This reasoning was the basis of the South Carolina Supreme Court's rejection of Expedia's "no nexus" claim.

Whether OTCs can be required to charge taxes directly to their customers will remain an open question until several state supreme courts issue clear rulings on it. However, there are good reasons to doubt that the OTCs will prevail on this issue, and states should accordingly proceed to redraft their hotel tax laws in ways that put the tax collection obligation completely or partially on the OTCs.

All of the proposals explicitly state that OTCs (carefully defined and variously termed "room remarketers," "accommodations intermediaries," or "facilitators") are obligated to charge tax on the full amount they collect from room renters. In all cases, tax is due on the full retail charge, regardless of how that amount is split between the stated room rate and a separate "taxes and services" fee. The proposals differ, however, in the types of information that must be shared among

hotel owners, OTCs, and room renters and in how the tax payment is actually transmitted to the relevant state or local taxing agency.

While all of the proposals appear to achieve the basic objective of making unmistakably clear that the applicable tax is due on the full retail rate when an OTC bills a customer for the room, the New York State law adopted in 2010 has at least two advantages over the others:

- **The New York law contains a "back-stop" should courts rule that the OTCs are not required to charge tax to their customers.** The New York law requires both the hotels and the OTCs to charge tax on their gross sales. That is, it requires the hotels to charge the OTCs the applicable tax on the wholesale room rate and the OTCs to charge tax on the retail room rate. To prevent double taxation of the wholesale charge, the OTCs are permitted to subtract the tax they have already paid the hotels from the tax they have collected from their customers and would otherwise remit.

  By maintaining the status quo under which hotels remit the tax due on the wholesale room rate, this mechanism preserves the existing revenue stream should a court ever rule that the OTCs are not legally obligated to collect tax from their customers at all — a position that the OTCs have articulated and that they are beginning to pursue in court (see the text box on the previous page).

- **The New York law ensures that OTCs will not have to independently acquire current information about applicable hotel tax rates.** At present, the hotels charge tax to the OTCs on the wholesale room rate, which provides the OTCs with information about the applicable tax rates at every hotel location. This will continue in states that model their reform on the New York law (because hotels will continue to charge tax to the OTCs on the wholesale rate), and the OTCs can use this information to calculate the tax they must charge on the *retail* room rate. Because they are "on the ground" in each taxing jurisdiction that levies a hotel tax, it is somewhat easier for the hotels to obtain and monitor hotel tax rate information than it would be for the OTCs.

How Should Explicit OTC Fees to Consumers Be Taxed?

As noted above, OTCs generally charge an explicit "taxes and services fee" to the renter in addition to the compensation they receive from retaining the wholesale-to-retail mark-up. The OTCs claim that the non-tax portion of the fee is a charge for the service they provide in helping customers identify particular hotels, compare prices, and reserve rooms. If that is the case, states and localities still could tax the purchase of this particular service as they might any other service. (Many state sales taxes are levied on some services as well as goods.) But an argument could be made that the fee should be taxed at the general sales tax rate, rather than at the often higher hotel tax rate imposed on the actual occupancy of a room. And, according to at least one legal expert, that tax would appropriately be levied by the jurisdiction where the renter resides rather than the one in which the hotel is located.[18]

[18] Professor Walter Hellerstein has opined (see Note 6) that both the fee and the mark-up arguably should be taxed by the state in which the renter resides, since the OTC's services are provided to the renter at that location. This argument ignores the fact that OTC services primarily benefit the *hotels*; that is why hotels allow OTCs to market rooms for them.

It is far from clear, however, that taxing these fees differently than the room rental itself is worth the problems it could create. One likely result, for example, would be an additional loss of revenue. If the mark-up is taxed at the hotel room rate but the fee is taxed at a lower general sales tax rate (or not at all), the OTC will have an incentive to mark up the wholesale room rate less and charge a higher fee instead. This would be especially likely to occur if states continue to allow OTCs to lump "taxes and services fees" together in consumers' bills rather than show them separately.[19]

Other problems would arise if the fees were taxed in whole or in part by the state or locality in which the renter resides rather than the one in which the hotel is located. Such an approach could substantially increase the compliance burdens on the OTCs, which would have to track and collect not only the correct hotel tax for all of the localities in which hotels are located, but also the applicable local sales tax on the services fee for all of the localities in which room renters reside and the fee is made taxable. Moreover, some jurisdictions in which hotels are located are unlikely to cede taxation of the fees to the jurisdictions in which room renters reside, creating the potential for double taxation.

Moreover, the portion of the OTCs' "taxes and services" fees that is truly for OTC services appears to be very small. In the transaction laid out in Figure 1, for example, the true "service fee" portion of the $18.84 Expedia "taxes and services fee" is only $0.77. That is, if Expedia were required to charge the applicable 13 percent tax on the $139 room charge it quotes to the renter, equal to $18.07, it would only pocket $0.77 from the fee. The few cents of tax that would be due on that $0.77 in any jurisdiction arguably would not be worth the additional compliance and enforcement costs that would arise from trying to tax it at a different rate or in a different jurisdiction than the basic room rental itself.

In sum, while a theoretical tax policy argument can be made for taxing explicit OTC fees charged to consumers differently than the room charges themselves, attempting to do so is not worth the trouble. The fees should be taxed by the same jurisdiction(s) in which the hotel is located, and at the same rate as the room. A state or locality that does not tax services under a general sales tax can, however, legitimately decide not to tax the service fee either.

As discussed above, the mark-up should be viewed as the hotel's commission to the OTC and non-deductible in calculating the tax, just as traditional travel agent commissions are non-deductible. Hellerstein's argument that a charge to the renter that is explicitly identified to her as a service fee separate from the room charge should therefore be taxed separately and at the renter's location is conceptually defensible. As the rest of this section discusses, however, the potential practical drawbacks of such tax treatment appear to outweigh the conceptual arguments in favor.

[19] States should prohibit the OTCs' current practice of blending the applicable hotel taxes and the charge for the reservation service into one "taxes and services" fee. The OTCs do this now to prevent consumers from calculating the price at which the hotels are willing to make the rooms available to the OTCs (by dividing the tax charge by the tax rate). Armed with such information, consumers could try to "cut out the middleman" (that is, the OTC) and strike a bargain with the hotels directly. Virtually all state sales tax laws expressly prohibit merchants from stating a price in which "applicable sales tax is included," which makes it difficult for consumers to discern how much the merchant is really charging them. This prohibition should be expressly extended to the OTCs. If they are charged tax on the full retail room rate, consumers cannot determine what the wholesale room rate is; accordingly, there would no longer be any possible justification for allowing OTCs to combine the charge for taxes and services in one fee.

Another Step States and Localities Can Take to Pressure OTCs to Collect the Proper Tax

Compelling the OTCs to charge applicable hotel taxes on the full retail room rate is likely to require initiating litigation and, in many states and localities, updating current hotel tax laws. States and localities can also encourage the OTCs to begin collecting the appropriate tax by ceasing to do business with them. Some states and localities likely allow their personnel and consultants to use OTCs to make travel arrangements — not only hotel room bookings, but flight and rental car reservations as well. With reasonable notice to such personnel, these governments should change their travel rules to make clear that payments to OTCs will not be reimbursed; if statutory changes to procurement laws and ordinances are required, these should be enacted. At least 14 states have enacted analogous rules to bar government purchases from Internet merchants that refuse to collect and remit applicable sales and use taxes on their sales to non-government customers located within the state.

OTCs should not expect to benefit from having state and local governments as clients if they are unwilling to assist those governments in collecting taxes as bricks-and-mortar hoteliers do.

Conclusion

The widespread attention given to current litigation aimed at determining whether existing law obligates OTCs to charge hotel taxes on their retail room rates has distracted policymakers from addressing how rooms booked online should be taxed *going forward*. The failure of states and localities to tax the full retail charge is costing them hundreds of millions of dollars annually at a time of fiscal crisis when they can ill-afford it. Now is the time for them to take decisive legal and/or legislative action to close this loophole. A number of legislative models are available, with the approach recently enacted by the State of New York offering some important advantages.