
Revised September 18, 2009

BANNING TAXATION OF ONLINE HOTEL RESERVATIONS IS UNWARRANTED AND COULD COST STATES AND LOCALITIES BILLIONS OF DOLLARS

By Michael Mazerov

Summary

For the past two years, online travel companies like Expedia and Priceline have been seeking enactment of federal legislation that would ban state and local taxation of hotel room rentals when booked by such a company or by a conventional travel agent. Most recently, the legislation was circulated as a potential amendment to the Senate version of the Travel Promotion Act of 2009. Although this particular attempt failed, it seems likely these efforts will continue.

In its most recent form the legislation would immediately deprive states and localities of more than \$680 million in annual hotel tax receipts. It would also prevent them from collecting at least an additional \$180 million in annual revenue they are potentially owed under current law. Ultimately, it could put at risk states' and localities' entire revenue stream from hotel taxes — some \$8.5 billion per year. These revenue losses, occurring when state and local governments are experiencing their worst fiscal crisis since the Depression, would likely deepen the cuts they are being forced to make in education, health care, and other vital public services.

The apparent impetus for the proposed amendment is an ongoing dispute between online travel companies (OTCs) and a number of state and local governments. OTCs claim that, under current law, hotel taxes are due only on the “wholesale” room rate OTCs pay hotels, not the higher “retail” rate OTCs charge the renter of the room. Numerous cities and a few states have sued or initiated administrative proceedings against the OTCs, asserting that they owe back taxes on their “mark-ups” (the difference between the wholesale and retail rates). Hotel taxes have always applied to the full retail room rate when a traditional travel agent books the room or the customer rents the room in person at the registration desk.

While the OTC industry claims the amendment is intended only to bar taxes on the OTCs' mark-ups, its language is so broad that it effectively prohibits taxation of the *entire* retail charge for hotel rooms that conventional travel agents or OTCs book. The proposed amendment also would bar state and local governments from initiating new legal actions to collect taxes they believe OTCs should have paid in the past — a level of federal interference in state tax administration with little or no precedent.

Overall, the amendment would:

- **Immediately and permanently deprive states and localities of more than \$680 million in annual revenues** they now receive from taxes imposed on the “wholesale” room rates that OTCs pay. (There would be an additional revenue loss of unknown size from taxes paid on the “retail rates” charged for rooms that conventional travel agents book.)
- **Prevent states and localities from establishing clearer laws and rules clarifying OTCs’ obligation to collect taxes on the full retail charge for room rentals**, consistent with longstanding practice regarding taxation of other goods and services. Stripping state and local governments of the right to tax OTCs’ wholesale-to-resale mark-ups would cost them over \$180 million per year in potential revenue, on top of the more than \$680 million in existing revenue they would lose from the prohibition on taxing OTCs on their wholesale room costs.
- **Prevent states and localities from recovering many millions of dollars in back taxes** that some of them believe they are owed due to OTCs’ alleged non-compliance with existing tax laws.
- **Give OTCs an unfair competitive advantage** by providing them with preferential tax treatment.
- **Place at risk most of the estimated \$7.5 billion in state and local taxes** that hotels collect each year on the rooms they lease themselves, by encouraging them to form their own “captive OTC” subsidiaries that would market their rooms online in the same tax-free manner as independent OTCs would be authorized to do. When added to the lost revenue from the ban on taxation of OTC-booked rooms, the state and local revenue at risk from the amendment thus approaches \$8.5 billion annually.

Federal restrictions on state and local taxation of consumer purchases are rare; they currently apply only to Internet access service and interstate transportation. Congress would be no more justified in limiting hotel taxes to the wholesale price of a room than it would be in limiting state sales taxes to the wholesale price of any other good or service. The fact that hotel rooms are sold by intermediaries does not make them any different; states tax the full retail price for transactions effected by other kinds of intermediaries, such as consignment shops and auctioneers.

Despite the high stakes and complex issues involved, this proposal has never received a committee hearing. To enact it would set dangerous and far-reaching precedents and would be fiscally irresponsible.

Online Travel Companies Reject Responsibility to Collect Taxes on Rooms’ Full Price

The proposed draft amendment to the Travel Promotion Act was the latest iteration of similar proposals that have been floated off and on for at least two years.¹ It represents an attempt to

¹ For an early example, see: “Several Senators to Push Legislation Banning Tax on Online Hotel Firms’ Fees,” *BNA Daily Tax Report*, July 31, 2007.

resolve in favor of the online travel companies a dispute between them and a number of state and local governments about how hotel rooms booked online *are* taxed under existing law and *should be* taxed as a matter of policy.

Nearly all states and many local governments tax short-term hotel room rentals. In some cases the applicable taxes are traditional retail sales taxes; in other cases they are separate excise taxes levied on “transient accommodations” or room “occupancy”; in still other cases both the sales tax and an excise tax apply.² Localities sometimes dedicate occupancy tax revenues to tourism-related purposes (like repaying bonds that financed a convention center), while most *state* taxes applicable to hotel rooms flow into the state General Fund that finances education, health care, corrections, and other services.

In whatever form they take, hotel taxes are calculated by multiplying the combined, applicable state and local tax rates by the room rental charge the customer pays.³ The hotel calculates the tax on this basis, collects it from the customer along with the room charge, and remits it to the state and/or locality.⁴

The same rules have long applied with respect to hotel rooms that traditional travel agents book on behalf of a customer. As a leading authority on state taxation recently explained:

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.⁵

When online travel companies like Expedia, Travelocity, and Priceline went into business in the mid-1990s, however, they structured their hotel-booking transactions in a different manner than traditional travel agents and interpreted their tax-collection obligations differently as well.⁶ Unlike travel agents, OTCs contract with hotels for the right to lease rooms the hotel has been unable to lease itself, at rates the OTCs themselves determine. OTCs agree to pay the hotel a “wholesale” rate

² There are varying patterns and combinations of state and local hotel taxes. For example, in some states the state tax that applies is the state sales tax and the local tax is an occupancy tax. Alaska, California, and Nevada completely exempt hotel room rentals from state taxes and cede all taxation of hotel rooms to local governments.

³ In rare instances hotel taxes are a flat amount per room per day.

⁴ In some states, local sales and/or occupancy taxes are remitted to the state, which in turn remits them to the localities to which they are due. Such centralized state administration eliminates the need for hotel chains to file separate returns with individual local governments.

⁵ 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.

⁶ The second source cited in the previous note asserts that the OTC “merchant model” described in this section did not actually come into widespread use until after the September 11, 2001 terrorist attacks, when the sharp drop in tourism and hotel room bookings made hotels willing to discount their rooms much more deeply than they had before. The author of that article was employed by the InterContinental Hotels Group, making her a credible source on the issue.

for any rooms they are able to book; they keep the difference — the “wholesale-to-retail mark-up” — between that amount and what they charge the customer.⁷

The only hotel taxes paid on the transaction are paid by the OTC to the hotel on the *wholesale* room rate it paid; *OTCs do not acknowledge any liability to collect from the renter — or to pay themselves — any hotel taxes on the wholesale-to-retail mark-up.*⁸ OTCs maintain that they are not renting hotel rooms but rather are acting as “intermediaries” between hotels and renters, so their commission is not subject to hotel taxes under current law and should not be subject to hotel taxes as a matter of policy.

Over the past several years, dozens of local governments and some states have sued or initiated administrative proceedings against the OTCs, maintaining that their sales and occupancy tax laws require OTCs to charge renters the applicable hotel taxes on the renters’ full retail cost of the room. The court decisions so far have been mixed, with some upholding the government position and some upholding the OTCs’ position. Only a few of the cases have been finally adjudicated.

Proposal Would Ban Taxes on *Entire* Charge for Room Booked Through OTC or Travel Agent

The proposed amendment has been described by its advocates as having the principal goal of barring hotel taxes on OTCs’ wholesale-to-retail mark-ups, but it actually goes much further. In fact, it appears to ban taxation of the *entire* room charge when an OTC or a conventional travel agent books the room. In other words, states and localities would be barred from levying any taxes whatsoever on any part of the cost of hotel rooms that happen to be booked through an OTC or a travel agent.

The draft amendment to the Travel Promotion Act read:

A State or a political subdivision of a State may not levy or collect any occupancy tax or lodging fee, directly or indirectly, on travel booking or travel agency services provided by a travel agent or intermediary, *including* on facilitation fees related to such services, regardless of the terminology used to describe the tax or fee or whether such tax or fee is imposed on a transaction or on a consumer, a travel agent or intermediary, or a provider of sleeping accommodations. [Emphasis added.]

Further:

The term “travel booking” or “travel agency services” *includes* any act performed by an intermediary between a provider of sleeping accommodations and a consumer to facilitate the provision of such accommodations, for which remuneration is in the form of—

⁷ In the case of Priceline and a few other less well-known OTCs, the customer charge is determined in a bidding process rather than set by the OTC up front.

⁸ For example, a white paper by an ad hoc “Coalition for Internet Travel Tax Fairness” circulating in support of the proposed amendment states, “Hotel taxes are due and, therefore, paid on rent received by a hotel operator. The fees and margins a consumer pays an OTC is to compensate the OTC for rendering travel booking services. Such compensation is not rent and is therefore not subject to hotel taxes.”

- (A) a commission paid by the provider of such accommodations, a facilitation fee paid by the consumer of such accommodations, or both; or
- (B) the retention by such intermediary of the excess, if any, of—
 - (i) the total amount paid by such consumer to such intermediary for such accommodations, including any facilitation fee; over
 - (ii) the total amount described in paragraph (3)(B) with respect to such provider [i.e., the wholesale charge for the room from the hotel to the OTC]... [Emphasis added.]

Finally:

The term “facilitation fee”—

- (A) includes *all amounts* charged for travel booking or travel agency services, whether or not separately stated; and
- (B) does not include those amounts remitted to a provider of sleeping accommodations for furnishing or supplying such accommodations. . . . [Emphasis added.]

The use of the word “including” in the first paragraph — which lays out which taxes are banned — indicates that “facilitation fees related to such [travel booking or travel agency] services” are a *subcategory* or *subset* of “travel booking or travel agency services” rather than being synonymous with them. The first paragraph also states explicitly that all travel booking/agency services, not just facilitation fees, are exempt from hotel taxes. This leaves open the possibility that the total charge for a hotel room from an OTC to a renter could also be a charge for tax-exempt “travel booking or travel agency services.” Certainly, a charge to a consumer from an OTC that included both the cost of the hotel room itself and the OTCs’ compensation would be viewed as a charge for a “travel booking” service, at least, under a plain English reading of those two words.

There is nothing in the second or third paragraphs that undermines this interpretation; indeed both paragraphs arguably reinforce the conclusion that a bundled charge to a consumer for a hotel room rental and an OTC mark-up is a tax-exempt travel booking/agency service. The second paragraph states that the terms “travel booking” and “travel agency services” *include* the acts of an intermediary between a hotel and a consumer without also stating that such services are *synonymous* with or *limited* to such acts. Again, this leaves open the possibility that a bundled charge that includes the cost of the hotel room is a charge for a tax-exempt “travel booking service,” at least. Finally, a non-taxable “facilitation fee” — the OTC’s mark-up — is effectively defined in the third paragraph above as the total amount charged for a “travel booking or travel agency service” *minus* the amount paid to the “provider of sleeping accommodations” — that is, the hotel. Thus, a charge to a consumer by an OTC for the *total* cost of the room *is* a charge for “travel booking or travel agency services;” again, under the first paragraph, *such a charge may not be taxed at all*.

Finally, the first paragraph above prohibits “indirect” taxation of “travel booking or travel agency services.” This effectively bars the imposition of currently-collected taxes on the hotel room rental charge from the hotel to the OTC.

In sum, in the amendment’s current form, OTCs could stop paying taxes not only on their mark-ups but also on the wholesale room cost that hotels charge them. There would be no effective way around this prohibition, since the amendment bans *indirect* taxes on the OTCs as well that might be implemented by taxing the “consumer” (that is, the room renter) or the “provider of sleeping

accommodations” (that is, the hotel). No hotel taxes would apply to rooms booked through an OTC, period. The same is true with respect to hotel rooms booked by traditional travel agents who typically are paid direct commissions by the hotels and are also explicitly covered by the amendment.

Proposal Would Worsen State and Local Revenue Problems

By undermining states’ and localities’ hotel taxes, the amendment would significantly reduce state and local revenues, which are already declining because of the recession. Local governments would be especially hard hit. For many localities, hotel occupancy taxes are among the few non-property taxes they are authorized to levy.

Table 1 provides state-by-state estimates of the immediate combined state and local revenue losses under the amendment. (The methodology underlying these estimates is set forth in the Appendix.)

The first four columns estimate the annual losses from banning taxes on hotels’ wholesale room charges to OTCs. Since OTCs now pay these taxes, banning them would have an immediate impact on state and local revenues. *Had the amendment been in effect in 2007, state and local governments would have lost between \$682 million and \$761 million in sales and occupancy tax revenues they received that year from OTCs.*

These estimates are significantly understated for three reasons. First, because of lack of available data, they reflect local revenue losses in only 17 of the 40 states that levy *local* hotel taxes. Second, even for these 17 states, the available data were often incomplete. Third, the amounts shown are only for rooms booked through OTCs; no reliable data were available to estimate the revenue losses associated with rooms booked by traditional travel agents.

The second set of four columns in Table 1 estimate the annual revenue losses associated with the amendment’s prohibition on taxing the OTCs’ wholesale-to-retail mark-ups. These estimates assume that taxes are currently due on the mark-ups under existing law. Since at present these taxes are not generally being collected (because OTCs do not acknowledge they owe them), the revenue losses shown here — which range from \$180 million to \$258 million for 2007 — represent forgone future revenue rather than lost current revenue.

The total revenue loss shown in Table 1 — i.e., the amount of tax that OTCs now pay on the wholesale value of the rooms they sell plus the tax that may be due on the wholesale-to-retail mark-up — is \$941 million annually. Adding in taxes paid on rooms booked by traditional travel agents plus taxes collected by local governments for which data were not available, the actual likely loss of revenue undoubtedly is well in excess of \$1 billion annually.

Amendment Would Bar New Lawsuits Aimed at Recovering Back Taxes

Another major effect of the proposed amendment would be to prevent additional states and localities from initiating legal action to recover back taxes they believe OTCs owe them under existing law. At present, it appears that many states and localities are taking a “wait and see” attitude while current cases wind their way through the courts. The proposed amendment to the Travel Promotion Act stated:

**TABLE 1: ESTIMATED STATE AND LOCAL REVENUE LOSS (\$MILLIONS), 2007,
FROM ENACTMENT OF THE PROPOSED OTC AMENDMENT**

	Revenue Loss from Tax Exemption for Wholesale Value of Rooms				Revenue Loss from Tax Exemption for Wholesale-to-Retail Mark-ups				Total Revenue Loss
	Assumed OTC mark-up				Assumed OTC mark-up				
	25%	30%	35%	40%	25%	30%	35%	40%	
Alabama	3	2	2	2	1	1	1	1	3
Alaska	0	0	0	0	0	0	0	0	0
Arizona	13	12	12	11	3	4	4	5	16
Arkansas	4	3	3	3	1	1	1	1	4
California	95	92	88	86	24	27	31	34	119
Colorado	7	6	6	6	2	2	2	2	8
Connecticut	23	22	21	21	6	7	7	8	29
Delaware	1	1	1	1	0	0	0	0	1
District of Columbia	19	18	17	17	5	5	6	7	23
Florida	58	55	53	51	14	17	19	21	72
Georgia	24	23	22	21	6	7	8	8	30
Hawaii	36	34	33	32	9	10	12	13	44
Idaho	3	3	3	2	1	1	1	1	3
Illinois	31	30	29	28	8	9	10	11	39
Indiana	8	7	7	7	2	2	2	3	10
Iowa	6	6	6	6	2	2	2	2	8
Kansas	6	6	5	5	1	2	2	2	7
Kentucky	5	5	5	5	1	1	2	2	6
Louisiana	16	16	15	14	4	5	5	6	20
Maine	4	3	3	3	1	1	1	1	4
Maryland	9	9	8	8	2	3	3	3	11
Massachusetts	21	20	19	19	5	6	7	7	26
Michigan	8	8	7	7	2	2	3	3	10
Minnesota	13	13	12	12	3	4	4	5	17
Mississippi	6	6	6	5	2	2	2	2	8
Missouri	6	6	6	6	2	2	2	2	8
Montana	1	1	1	1	0	0	0	1	2
Nebraska	2	2	2	2	0	1	1	1	2
Nevada	0	0	0	0	0	0	0	0	0
New Hampshire	3	3	3	3	1	1	1	1	4
New Jersey	37	36	34	33	9	11	12	13	46
New Mexico	3	3	3	3	1	1	1	1	4
New York	91	87	84	81	16	19	21	24	107
North Carolina	22	21	21	20	6	6	7	8	28
North Dakota	1	1	1	1	0	0	0	0	1
Ohio	21	20	19	19	5	6	7	7	26
Oklahoma	2	2	2	2	1	1	1	1	3
Oregon	1	1	1	1	0	0	0	0	1
Pennsylvania	17	16	15	15	4	5	5	6	21
Rhode Island	3	3	3	3	1	1	1	1	4
South Carolina	10	10	9	9	3	3	3	4	13
South Dakota	1	1	1	1	0	0	0	0	2
Tennessee	12	11	11	10	3	3	4	4	15
Texas	51	49	47	45	13	15	16	18	63
Utah	4	3	3	3	1	1	1	1	4
Vermont	4	4	4	4	1	1	1	1	5
Virginia	30	29	28	27	4	5	5	6	34
Washington	13	12	12	11	3	4	4	5	16
West Virginia	3	2	2	2	1	1	1	1	3
Wisconsin	6	5	5	5	1	2	2	2	7
Wyoming	2	2	2	2	0	1	1	1	2
US TOTAL	761	733	706	682	180	208	234	258	941

A State or a political subdivision of a State may not levy *or collect* any occupancy tax or lodging fee, directly or indirectly, on travel booking or travel agency services provided by a travel agent or intermediary, including on facilitation fees related to such services. . . . [Emphasis added.]

It also stated:

Nothing herein shall be construed to invalidate, vitiate, or otherwise interfere with any legal or administrative proceeding *initiated prior to the effective date* of this section to *collect* a tax or fee imposed or accrued before such effective date. [Emphasis added.]

The retroactive effective date in the draft amendment was August 4, 2009.

In combination, these provisions would bar a state or locality from collecting tax on the mark-up unless it had initiated legal action before August 4 to recover the tax. Thus, the amendment not only would mandate a total tax exemption for hotel rooms that OTCs book in the future, but would also effectively adopt the OTCs' position that state and local hotel tax laws do not apply to OTCs' mark-ups under *current* law, except in the relatively few jurisdictions that have initiated legal action. Such congressional intervention in an ongoing legal controversy between state and local governments and private taxpayers about whether a tax should have been collected in the past would be virtually or completely unprecedented. It effectively would have Congress taking on a judicial rather than a legislative function.

This aspect of the proposed amendment would also unfairly penalize jurisdictions that have not initiated legal action against OTCs because their own legal issues are identical to those in already-filed cases and they have seen no value in "piling on." And it could also encourage states and localities to file lawsuits immediately when they face similar disputes in the future in order to protect their legal claims from congressional preemption, which would increase legal costs both for states and localities and for businesses.

Substantial revenues are at stake in just this aspect of the proposed amendment. As discussed in the previous section, if existing state and local hotel taxes do, in fact, apply to OTC mark-ups (except in those states in which explicit written rulings have been issued to the contrary), states and localities should have received between \$180 million and \$258 million in additional revenue in 2007 alone. Already-filed lawsuits not voided by the amendment likely could recover only a small share of these amounts.

No Justification for Taxing Only the Wholesale Price of a Hotel Room

Even if Congress redrafted the amendment to allow states and localities to continue taxing OTCs' wholesale cost of hotel rooms (while prohibiting the taxation of OTCs' wholesale-to-retail mark-ups), there would still be no justification for the amendment on policy grounds.

As noted above, hotel taxes are a widespread and important source of revenue for schools, police and fire departments, transportation, tourism promotion, and other services. Whether imposed in the form of a general sales tax or a hotel-specific excise tax, hotel taxes are taxes on consumption.

The proper base of a consumption tax is the amount the consumer spends for the product or service.⁹

Some of the litigation has turned on the question of whether an OTC is an intermediary between the consumer and the hotel (as OTCs contend) or an entity that effectively rents the room from the hotel and sublets it to the consumer. While that may be important for resolving some of the court cases interpreting existing hotel tax laws, it is irrelevant to the question of how hotel rooms *should be* taxed going forward. Ultimately, all independent retailers are intermediaries between final consumers of goods and services and the businesses that produce them. There is no more policy justification for applying hotel taxes only to the wholesale price that an OTC pays for a room than there would be for applying a general sales tax only to the wholesale price that a car dealership pays for a car, rather than to the price the consumer pays.

The OTCs stress that they do not own the hotel rooms and do not lose any money if they are unable to rent some or all of them. But there are several other types of transactions in which intermediaries sell things they do not own, collect the purchase price from the purchaser, and receive a commission; consignment shops and auctioneers are just two examples. In all such cases, the sales tax applies to the *full amount* the customer paid.¹⁰ So even if one chooses to characterize OTCs as intermediaries rather than as re-renting hotel rooms, limiting hotel taxes to the wholesale room cost the OTC pays would be inconsistent with how consumption taxes apply to other

⁹ As an academic expert on state and local taxation argues:

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.

¹⁰ A number of states have fairly 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.]

analogous transactions, including the renting of hotel rooms through conventional, commission-remunerated travel agents.¹¹

The preceding discussion is not meant to suggest that there is one right way for states and localities to levy their hotel taxes on rooms booked through OTCs and other intermediaries going forward. However, for Congress to impose a particular hotel tax structure on states and localities when the federal government has no experience in levying such taxes would be heavy-handed and imprudent. This issue is better left to the states, the hotels, and the OTCs to work out together — as the Multistate Tax Commission is currently attempting to do.¹² Moreover, enacting the proposed amendment could encourage other industries to seek congressional intervention as well; an Internet auctioneer like eBay, for example, would no doubt welcome a federal law that could encourage more auctions by allowing sellers to deduct sales commissions to eBay before calculating sales taxes. Given the potentially enormous revenue and tax policy implications for state and local governments, it would be particularly ill-advised for Congress to enact the OTCs' proposal as a floor amendment without having held a single public hearing.

Hotels Might Respond by Forming Own OTCs, Magnifying Revenue Loss

At present, hotels have largely succeeded in preventing OTCs from undercutting their room rates despite the significant discounts at which OTCs are able to obtain the rooms.¹³ For example, a 2005 Cornell University study found that in more than half of the transactions sampled, the cost of a room booked directly through the hotel's website was identical to or better than the best price charged by all four of the largest OTCs.¹⁴ Similarly, a summer 2009 survey of six hotels by the Washington Consumers' Checkbook organization found that the hotel's quoted price was identical to the price quoted by four major OTCs — Expedia, Hotels.com, Orbitz, and Travelocity.¹⁵

While OTCs' failure to collect taxes on their mark-up gives them a potential price advantage over hotels, that advantage is quite modest, and OTCs generally effectively retain the uncollected taxes as profit rather than share them with the consumer in the form of a lower room rental charge.

That could very well change, however, if the amendment were to be enacted in its current form, which bars *all* taxes on hotel rooms that OTCs book. These taxes can be significant. If they are banned, OTCs might well choose to share some of the savings with customers by reducing their room rates to a degree that would make it difficult for the hotels to compete.

¹¹ See the quote on p. 3, above.

¹² Materials developed and submitted in connection with the Multistate Tax Commission's current project to develop a model statute governing the taxation of hotel rooms booked through "accommodation intermediaries" are available at www.mtc.gov/Uniformity.aspx?id=1822.

¹³ The exception to this is auction sites like Priceline and Hotwire.

¹⁴ Gary M. Thompson and Alexandra Failmezger, "Why Customers Shop Around: A Comparison of Hotel Room Rates and Availability across Booking Channels," Center for Hospitality Research, School of Hotel Administration, Cornell University, 2005.

¹⁵ "Priceline Can Deliver Incredibly Low Rates on Hotel Rooms — If You Use It Wisely," Washington Consumers' Checkbook Update, Summer 2009, p. 5.

For example, in August 2009 the author conducted a price comparison for a hotel room in his neighborhood. Expedia and the hotel itself both quoted a room rate of \$199; the taxes quoted by the hotel were \$25.87 (a rate of 13 percent) and Expedia’s combined tax and service fee was \$26.97. Assume for the sake of argument that Expedia pays the hotel \$160 for this room, for which it would be charged \$20.80 in taxes (\$160 times 13 percent). Were Expedia relieved of the obligation to pay that \$20.80 in taxes, it could reduce its room charge by, say, \$15 (from \$199 to \$184), pocket \$5.80 in additional profit, *and* generate a significant amount of new, profitable sales by undercutting the hotel’s price by \$15. Although not all hotel tax rates are this high, they generally are high enough that OTCs could reduce their prices to an economically significant extent if they were no longer required to pay taxes on the wholesale room cost.

Hotels that saw an increasing share of their room sales shifting from their own in-house reservation systems to OTCs might not be able to simply stop doing business with the OTCs. The OTCs are well-established and sell a significant share of all hotel rooms — an estimated 11 percent in 2007 — even when they do not appear to be significantly cheaper than the hotels themselves.¹⁶ As an alternative, therefore, hotels might form their own “captive OTC” subsidiaries that would qualify for a complete tax exemption. The hotels would then direct all of their telephone and Internet bookings to these subsidiaries. The draft amendment effectively acknowledges the potential for this scenario by including a provision aimed at preventing it:

(c) STATE AUTHORITY TO PREVENT ABUSE. — A State may, at the discretion of the State, limit the application of this section [i.e., the entire proposed amendment] to transactions involving a travel agent or intermediary and a provider of sleeping accommodations that are *not related persons* (within the meaning of section 267(b) or section 707(b) of the Internal Revenue Code of 1986). [Emphasis added]

However, this language would only be effective if the “captive OTC” were a subsidiary in which the hotels owned more than a 50 percent interest (as provided in the two Internal Revenue Code sections cited). Two or more hotel chains could easily nullify this provision by forming a partnership or joint venture in which none of them owned more than a 50 percent interest. This new entity, which would allow the hotels to avoid all state and local hotel taxes in the same way independent OTCs would be able to do, would require no fundamental change in the hotels’ underlying economic arrangements. Indeed, it is already extremely common for multiple airlines and hotel chains to establish joint ventures to operate computerized reservation systems.

If this quite-plausible “captive OTC” scenario were to become a reality, the adverse impact on state and local revenues could be substantial. Table 2 provides state-by-state estimates of state and local hotel tax revenues from room bookings through all channels other than OTCs — for example, through the hotels themselves and traditional travel agents. (As in Table 1, the estimated local hotel taxes are only for those 17 states for which any data on local collections could be obtained.) Nationally, approximately \$7.5 billion in state and local hotel taxes are remitted each year through those channels. If hotels were free to form their own tax-exempt OTCs to market their rooms, virtually all of this revenue would be at risk. The only rooms that might still be fully taxable would be those that walk-ins reserve at the hotel registration counter. Revenue losses of that magnitude would seriously impair the fiscal health of states and localities and force significant additional cuts in critical services like education and health care (and/or offsetting tax increases).

¹⁶ PhoCusWright’s “U.S. Online Travel Overview, Seventh Edition, November 2007.

TABLE 2: ESTIMATED STATE AND LOCAL HOTEL TAXES CHARGED BY HOTELS ON ROOMS BOOKED BY ALL METHODS OTHER THAN OTCS (\$MILLIONS)

	Estimated State Taxes Charged by Hotels	Estimated Local Taxes Charged by Hotels	Estimated State and Local Taxes Charged by Hotels
Alabama	26	NA	26
Alaska	0	NA	0
Arizona	128	NA	128
Arkansas	36	NA	36
California	0	956	956
Colorado	63	3	66
Connecticut	84	0	84
Delaware	15	0	15
District of Columbia	189	0	189
Florida	581	NA	581
Georgia	105	134	239
Hawaii	359	0	359
Idaho	27	NA	27
Illinois	222	93	314
Indiana	77	NA	77
Iowa	30	35	64
Kansas	23	36	60
Kentucky	52	NA	52
Louisiana	69	94	162
Maine	35	0	35
Maryland	91	NA	91
Massachusetts	130	80	210
Michigan	79	NA	79
Minnesota	88	45	134
Mississippi	62	NA	62
Missouri	63	NA	63
Montana	15	NA	15
Nebraska	19	NA	19
Nevada	0	NA	0
New Hampshire	32	0	32
New Jersey	336	38	374
New Mexico	32	NA	32
New York	254	659	913
North Carolina	83	140	223
North Dakota	9	NA	9
Ohio	99	111	210
Oklahoma	22	1	22
Oregon	10	NA	10
Pennsylvania	168	NA	168
Rhode Island	33	0	33
South Carolina	102	NA	102
South Dakota	14	NA	14
Tennessee	119	NA	119
Texas	314	197	512
Utah	36	NA	36
Vermont	40	NA	40
Virginia	139	161	300
Washington	103	26	129
West Virginia	25	NA	25
Wisconsin	57	NA	57
Wyoming	18	NA	18
US TOTAL	4715	2810	7525

NA: Not Available

Conclusion

When online travel companies decided they were obligated to pay state and local hotel taxes on only the wholesale cost of the rooms their customers rented, a few states and localities agreed that this was the correct interpretation of their existing laws, but many others took issue with it. Several dozen lawsuits have ensued.

The OTCs have now apparently convinced some members of Congress to address their legal problems by supporting legislation that would bar states and localities from filing new lawsuits to recover back taxes. The legislation also would permanently enshrine the OTCs' position that state and local hotel taxes should never apply as a matter of policy to the total (retail) charge for hotel rooms booked through an "intermediary."

As currently drafted, the legislation goes well beyond OTCs' claimed intent to bar taxation of their wholesale-to-retail mark-ups and voids the taxes currently paid on the rooms' wholesale cost. But even were it to be narrowed to the asserted intent, it would still be unwarranted. Congress has no more justification to tell states and localities they may only impose their hotel taxes on the wholesale price of a hotel room than it would have to tell them they may only impose their retail sales taxes on the wholesale price of a car.

The legislation would mark a deep, and arguably unprecedented, intervention into fundamental and longstanding choices state and local governments have made about how to levy consumption taxes. It would inflict immediate and substantial revenue losses on states and localities and prevent legitimate efforts to recover additional uncollected revenues at a time when they are experiencing severe fiscal problems and cutting critical services. It would also discriminate against hotels based on how consumers choose to book their rooms and could put the hotels at a serious price disadvantage vis-à-vis the OTCs. The legal and policy issues at the heart of this dispute are matters for state and local governments and the OTCs to resolve in the forums in which state and local tax policy and legal disputes are normally resolved: state legislatures and courts.

Appendix: Revenue Loss Estimating Methodology

Step 1: Estimate the amount of hotel room rental gross receipts in each state attributable to rooms booked by OTCs and rooms booked by hotels. The PhoCusWright, Inc. market research firm publishes an annual report, “U.S. Online Travel Overview,” that contains estimates of the total amount of hotel room bookings occurring in the United States as well as the amount of those bookings being obtained by the online travel companies. The national total, minus the OTC amount, is the amount of bookings received by the hotels themselves. (The latter figure includes room bookings made by conventional travel agents.) The 2007 amounts received by the hotels themselves (\$94.8 billion) and by the OTCs (\$11.8 billion, including both the OTCs’ mark-ups and the recovery of the wholesale room costs) were assigned to the states in proportion to the states’ shares of total hotel room receipts as of 2002, the most recent year for which such state shares are available from the U.S. Census Bureau’s Economic Census.¹⁷ (In other words, in the absence of data on the location of OTC bookings, it was assumed that if, for example, California received 10 percent of all U.S. hotel bookings, it also received 10 percent of hotel bookings made by OTCs.)

Step 2: Estimate for OTC-booked hotel rooms how much of the total OTC gross receipts were paid to the hotels for the wholesale cost of the rooms and how much was retained as the mark-up. The total *wholesale* room costs paid to the hotels in each state by the OTCs was then estimated by taking the total OTC hotel bookings determined in Step 1 and dividing by 1 plus the mark-up percentage for four different assumed average mark-up percentages: 25 percent, 30 percent, 35 percent, and 40 percent. The average percentage amount by which the OTCs are able to mark-up their wholesale room costs is proprietary information. However, the 25 percent to 40 percent range is consistent with estimates of the typical mark-ups that have come to light during the litigation and that can be found in other hotel industry sources.¹⁸ Similarly, the total wholesale-to-

¹⁷ The “Geographic Area Series” reports containing these data are accessible at http://www.census.gov/econ/census02/guide/EC02_72.HTM. The relevant reports are for North American Industry Classification System (NAICS) Code 72, “Accommodation and Food Services,” and the relevant state gross receipts categories are for NAICS codes 72111 (Hotels and motels except casino hotels) and 72112 (Casino hotels). The state-by-state sales figures for these two types of hotels include receipts associated with restaurants, banquet room rentals, and other services, not just sleeping room rentals to which the relevant hotel taxes apply. However, a different 2002 Economic Census publication, the “industry series” publication for NAICS Code 72 (available at <http://www.census.gov/prod/ec02/ec0272i01.pdf>) provides data, for the nation as a whole, on the share of hotel revenues attributable to sleeping rooms alone. These shares were calculated separately for regular hotels (72.7%) and casino hotels (13.9%) and assumed to apply in all states.

¹⁸ “In the last several years, the final selling price on merchant model rooms [i.e., rooms booked through OTCs] has averaged approximately 25 percent to 40 percent above the net rate amount paid to hotel operators.” Beth Anne Stanford, “State and Local Efforts to Collect Additional Tax on Hotel Rooms Booked Online,” *State Tax Notes*, January 31, 2005, p. 320. At the time she wrote the article, Stanford was employed by the InterContinental Hotels Group. The hotels have always been in a position to know the percentage mark-ups being obtained by the OTCs, since they know the wholesale prices they are charging the OTCs and can check the OTCs’ retail charges on their websites just like any prospective customer can.

See also: Scott W. Anderson, *Online Hotel Sales and Third Parties: A Review and Analysis*, unpublished paper, October 22, 2003; http://www.hsmai.org/docs/Online_Hotel_Sales_and_3rd_Parties.pdf. The paper reports that four major OTCs receive wholesale discounts ranging from 20 percent to 30 percent off the lowest retail rate available to the public when booked by the hotel. If these rooms were then sold at the same price as the hotel does, this would correspond to mark-ups of 25 percent to 43 percent, and this does not even take into account additional mark-ups buried in OTCs’ separate “tax recovery and service fees.” Anderson has been used as an expert witness by the OTCs in at least two occupancy tax lawsuits.

retail mark-up retained by the OTCs for each of these same assumed mark-up percentages was equal to the total OTC gross receipts calculated in Step 1 minus the total estimated wholesale room costs calculated in Step 2.

Step 3: Calculate the amount of *state* hotel taxes paid on the OTCs' wholesale room costs and the amount that would have been paid on the wholesale-to-retail mark-up had the OTCs done so. The amount of *state* hotel taxes actually paid by the OTCs to the hotels on these four estimated total wholesale costs, and the amounts that would have been paid on the total statewide OTC mark-up under an assumption that tax was, in fact, legally due on the mark-up, were estimated by multiplying the amounts estimated in Step 2 by the applicable *statutory* hotel tax rates in effect in each state.¹⁹ In some states the applicable tax was the general sales tax, in some it was a hotel-specific tax only, and in others it was the sum of the two. The calculation took into account letter rulings issued by a few states that state hotel taxes are *not due* on OTC mark-ups.

Step 4: Calculate an average effective *local* hotel tax rate in each state for which data could be obtained. Unlike with state hotel taxes, where a uniform statutory rate applies throughout a state, local hotel taxes apply at different rates (including zero) in different local jurisdictions. Gathering the specific rates that apply in thousands of different local jurisdictions throughout the country that levy local hotel taxes would be an extremely time-consuming task. Moreover, the available data do not permit reliable assignment of hotel room rental receipts to specific localities. Accordingly, it was necessary to calculate an average *effective* local hotel tax rate for each state by dividing actual local hotel tax collections in the state by the estimated state-by-state room rental receipts subject to such taxes. (The latter is the sum of the rental receipts of the hotels themselves and the wholesale room costs calculated in Step 2 for rooms booked through OTCs). As discussed in the body of the report, actual local hotel tax collections could only be obtained for 17 states, and even in some of the 17 the data were incomplete. However, complete data were available for such large states as California and Texas.

Step 5: Calculate the amount of *local* taxes paid on the wholesale room costs paid by the OTCs and the amount that would have been paid on the wholesale-to-retail mark-up had the OTCs done so. The average effective local tax rates estimated in Step 4 were multiplied by the OTCs' estimated statewide wholesale costs and mark-ups estimated in Step 2. These calculations take into account that letter rulings have been issued in some states indicating that local hotel taxes are not due on the wholesale-to-retail mark-up.

Step 6: Calculate the amount of state and local taxes paid on hotel rooms booked by the hotels directly. State-by-state room rental bookings made by the hotels themselves that were estimated in Step 1 were multiplied by *statutory* state hotel tax rates and estimated effective local hotel tax rates (calculated in Step 4) to estimate the amount of state and local taxes actually paid on hotel room bookings made by the hotels. These figures appear in Table 2 in the body of the report. The results of the calculations in Steps 2 through 5 appear in Table 1.

¹⁹ The structure and applicable rates of state and local accommodations taxes as of 2007 were determined by referring to three sources: Mandy Rafool, "State Lodging Taxes," National Conference of State Legislatures "Legisbrief," January 2007; Federation of Tax Administrators survey of state sales taxation of services, www.taxadmin.org/fta/pub/services/services.html; National Conference of State Legislatures, "State and Local Accommodation Taxes — 1998," unpublished table.