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TRANSIENT OCCUPANCY TAX AND ONLINE SELLERS: ARE YOUR HOTEL TAX REVENUES CHECKING OUT?

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INTRODUCTION

In today's economic climate, localities face continued shrinkage of tax revenues from an eroding tax base while pressures on them to perform functions once the responsibility of state government increase. Given the prevailing political climate allowing no tax increases in existing tax sources and no ability to develop new revenue sources, localities are left to scour current sources of revenue to ensure that all taxes due are collected.

ONLINE TRAVEL COMPANIES (OTC) AND TRANSIENT OCCUPANCY TAX (TOT)

- One major loss of revenue for localities is the failure of online travel companies (OTC's) such as Expedia, Travelocity and others to properly account for and pay to localities the applicable transient occupancy tax (TOT) due on rooms rented in the locality.

- Statutes of the Commonwealth of Virginia provide that any locality may levy a TOT on the occupancy of hotels, motels, boarding houses, travel campgrounds and other facilities offering guest rooms rented out for continuous occupancy for fewer than 30 consecutive days. All TOT collections shall be deemed to be held in trust for the county, city, or town imposing the tax. Imposition of the TOT by cities may be regulated by their charter or by other provisions of law. As to counties, there are statutes which limit the amount of tax which can be imposed. The statutory authority provides that the tax is to be imposed upon "the amount of the charge for the occupancy of the room." See §§ 58.1- 3822, 3823 of the Code of Virginia, but is dependent upon localities adopting appropriate enabling legislation.

- OTC's sell hotel rooms throughout Virginia. They contract with hotels operating in Virginia for rooms at negotiated discount room rates. OTC's then mark up the prices on the rooms and sell them at a higher price online to consumers. When the consumer presents his/her credit card to the OTC, the transaction is complete - he/she can check in and check out of the hotel without paying any additional money.

- OTC's also charge consumers "fees" and "taxes."' OTC's charge and collect these fees and taxes at the time of sale. The TOT is usually hidden in the "fees and taxes" part of the transaction. OTC's remit to the hotels the TOT calculated on the lower negotiated (wholesale) room rate, which the hotels then remit to the local jurisdictions. The OTC's keep the difference between the price they charge the online consumer and the wholesale amount they pay the hotels. In addition, OTC's keep the "fees" charged the consumer, and importantly, they keep the difference between the amount of the TOT charged to the consumer and the amount of TOT remitted to the hotels. The difference between the TOT that should be paid for the amount of the charge for the occupancy of the room and the discounted rate paid by the OTC's to the hotels and then remitted to the locality can be substantial and represents a large loss of revenue to the locality.

- As an example, if a consumer books a hotel room with an OTC for a nightly charge of $100.00, the OTC charges the consumer $100.00 plus a "service fee," for "taxes and fees." If the OTC has an arrangement with the hotel to pay a $50.00 wholesale price for the room, it would remit $50.00 plus the local TOT on $50.00 to the hotel, and keep the difference as profit. The jurisdiction does not receive the TOT on $100.00- <u>"the amount of charge for the occupancy of the room"</u> but rather the tax on the $50.00 discounted rate. The TOT may have been paid by the consumer to the OTC based on the relevant charge in the local ordinance, but it is not remitted to the local taxing authorities. This is not the fault of the local hotels, they pay the TOT on the amount they are paid, but that amount is not the amount upon which the TOT should have been calculated and paid.

- Given that OTC's and other providers sell millions of rooms per year the loss of tax revenue for localities can be extreme. For example, in Arlington County, the TOT rate is 5.25% and generated over $21 million revenue for the County in Fiscal Year 2009. The Arlington Treasure has estimated that the model of business of not remitting the full TOT to the County has, using a conservative estimate, resulted in a loss of revenue due the County in FY2009 alone on the order of $2.1 million and over the last five years, total losses could be on the order of $10 million.

<u>EXPERIENCE IN JURISDICTION OTHER THAN VIRGINIA</u>

- This loss of revenue has not escaped the notice of localities across the United States. TOT litigation against OTC's goes back to 2004 and before. OTC's have put up a vigorous defense of these claims with extensive motions and hearings to dismiss on various grounds with results usually turning on the language of the state enabling statute(s) and the applicable local ordinances. The usual defense raised by OTC's in these cases is that they are not "operators" of hotels in the local jurisdiction and they do not sell rooms on the internet. They argue that the differential between the retail price they are charging the online consumer and the wholesale price they pay the hotels ($50.00 in the above example) is a "service charge" or "facilitation fee," and as such, not taxable under the local ordinances. Their characterization of the differential is based on their contention that they are following a certain "business model."

- This argument, however, is flawed in several respects. First, the model they say they are using is not the one they use when the online consumer purchases the room. At the time of sale in our example, the $50.00 differential is in the gross price of the room, and is not included in the "fees and taxes" portion of the transaction. In other words, the business model is being employed after the sale of the room to the consumer, as if the ordinance imposed an income tax. Instead, the ordinance imposes an excise tax, which requires the tax to be imposed on the gross price of the room.

- Moreover, if the OTC's are allowed to characterize part of the gross price of the rooms they sell on the internet as a "fee after the sale of the room is consummated," it will not be long before all the hotels, including your local and chain hotels, adopt this "business model" and characterize a portion of their revenue on selling rooms as a nontaxable "fee."

LITIGATION

- Litigation seeking to impose the TOT on the OTC's by solely utilizing the localities' applicable ordinances as the only offensive weapon has resulted in mixed results on motions filed by the OTC's. The Fourth Circuit Court of Appeals has determined that the North Carolina statute only imposes a TOT on "retailers" and that under the applicable statutes that OTC's are not "retailers" and therefore not subject to the TOT.[1] Likewise, in an action brought by Orange, Texas, the United States District Court for the Eastern District of Texas determined that the applicable ordinance imposed the TOT only upon the consideration paid to a hotel or motel. Because of the language of that ordinance the case against the OTC's was dismissed because the OTC's were able to show that they did pay to the hotels the amount of tax on the fee that they transferred to the hotel.[2] Based upon the applicable ordinances, the United States District Court for the Southern District of Illinois has determined that the City of Fairview Heights' ordinance did not limit the tax to the consideration paid to the hotel. It broadly provided for "a tax of five percent (5%) of the rent charged for the privilege and use of renting a hotel or motel room" and another section of the ordinance identified only one taxable amount "which was to be borne by the person who seeks the privilege [of] occupying the hotel or motel room." Given this language, the district court held that it made little sense to surmise that the ordinance's drafters intended those consumers to pay taxes only on the "net" costs of the room (i.e., the cost paid by the OTC's to the hotels) and not on the full amount paid by the consumer. [3]

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[1] *Pitt County v. Hotels.com, L.P.*, No. 4:06 CV-30-BO, slip op. at 10 (E.D.N.C. Aug. 12, 2007)

[2] *City of Orange v Hotels.com, L.P.*, No. 1:06-CV-413, 2007 U.S. Dist. LEXIS 70482, 2007 WL 2787985 (E.D.Tex. Sept. 5, 2007)

[3] In *City of Fairview Heights v. Orbitz, Inc.*, No. 05-CV-840-DRH, 2007 U.S. Dist. LEXIS 26736, 2007 WL 1100619 (S.D. Ill. July 12, 2006)

- Localities have also sought to impose the TOT on OTC's under a theory of trust, in that because the OTC's collect (even under their theory of defense) a portion of the TOT due, that they are thereby chargeable to collect and remit to the locality the entire tax due. Just like a meals tax, the allegations of the localities are that the taxes are collected and held in trust for the locality and if the collecting entity, in this case the OTC's, error in either collecting the correct amount of tax due or remitting the full amount to the localities then the OTC's are charged with paying the correct amount of tax to the locality even if not collected. The United States District Court for the Northern District of Georgia held that the relevant taxing statute specifically provided that the person collecting the tax shall remit the tax. The district court held that, taking the allegations set forth in the City's complaint as true, regardless of whether the OTC's could be considered to be "hotels" under the City's ordinance, the City properly pled that the OTC's were collecting excise taxes from consumers and failing to remit those monies to the taxing entity in violation of the ordinance.[4] Likewise the United States District Court for the Northern District of Ohio concluded that the City of Findlay's transient guest tax ordinance did not impose a direct tax obligation on the web-based resellers. However, the district court determined that the city properly pled that the OTC's were collecting taxes as required by the ordinance and denominating it as a sales and/or bed tax and that even when a taxing statute fixes no liability, the collector is responsible for its payment to the proper taxing authority so long as the collection purports to be a collection of a tax. [5]

- All of the decisions to date have occurred on motions to dismiss filed by the OTC's. However, the first jury trial for collection of TOT against OTC's was tried in San Antonio, Texas and resulted in a victory for the City of San Antonio.[6] Before setting the case for trial the district court denied the OTC's' motion to dismiss for failure to state a claim holding that the City properly alleged facts relating to the issue of whether the OTC's "controlled" a hotel or motel in San Antonio and that the ordinance of the city was broad and did not specifically limit the tax to be paid to the city to be only based on the amount of consideration paid to the hotel or motel. The case is still pending awaiting disposition of post trial motions.

- There is another interesting theory of ligation against OTC's over the TOT. Consumers have brought litigation seeking a share of funds retained by OTC's and charged to the consumers. Essentially, this is a consumer action against OTC's and are based on the theory that the consumers were charged taxes by the OTC's and that these taxes were not paid to the localities. In 2005, one class action lawsuit on this

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[4] *City of Rome v. Hotels.com, L.P.*, No. 4:05-CV-249-HLM, 2006 U.S. Dist. LEXIS 56369 (N.D. Ga. May 8, 2006);
[5] *City of Findlay v. Hotels.com, L.P.*, 441 F.Supp.2d 855 (N.D. Ohio 2006);
[6] *City of San Antonio v. Hotels.com*, No. SA-06-CA-381-OG, 2007 U.S. Dist. LEXIS 39757, 2007 WL 1541184 (W.D.Tex. Mar. 16, 2007)

theory of recovery was filed seeking reimbursement to consumers who purchased rooms from Expedia in the amount of $123.4 million in cash and Expedia credits.[7]

- Because of the very large amount of funds involved, OTC's have joined forces and been very active in defending any effort to impose direct liability on them for TOT. They have changed their terms and conditions of sale (read the fine print) to better create a more defensible position. They hope to better shield liability through the change of terms, at least from a consumer action. They also rely upon the passage of time to shield assets from recovery by localities, since almost all enabling legislation imposes time limits on the ability to seek past payment of TOT. They have fought every action brought against them in every court on every issue and through every appeal process in an effort to make the litigation as lengthy and expensive for the localities as possible. The OTC's have also turned to Congress, so far without result, to shield them from liability through federal legislation under the interstate commerce clause. Just this year, United States Senators Bunning and Wyden attempted to introduce an amendment to the economic stimulus bill banning local authorities from taxing OTC's. Their amendment was struck from the bill.

- Just as OTC's have joined forces to attempt to avoid liability and payment of past due and future TOT to localities, localities have joined together through the employment of outside counsel to undertake litigation to collect the TOT not paid and establish the obligation of OTC's to pay future TOT. Because of the large amounts involved, most of these outside counsels accept these actions on a contingency basis.

VIRGINIA AND COLLECTION OF TOT

- In Virginia, the statute imposes the TOT on the amount of the charge for the occupancy of the room and appears to impose the TOT on that amount regardless of what entity collects that charge and that the "charge" is what the consumer pays. Legislation was sponsored in the recent session of the General Assembly to make explicit that OTC's as "booking agents" shall charge, collect and remit the appropriate TOT to the applicable locality. The bill appeared on its way to passage, having been approved by the Virginia Senate 40-0 and the House of Delegates subcommittee 10-0 when it was met with a concerted lobbying effort before the House Finance Committee. The House Finance Committee reversed the subcommittee's unanimous recommendation and voted 12-8 to carry over the bill to the 2011 session.

[7] In re: Expedia Hotal Taxes and Fees Litigation, Case No. 05-2-02060-1 SEA (Superior Court of Washington in and for King County)

CONCLUSION

It remains to be seen if this failure to clarify the state statute would have any effect upon any effort in Virginia to collect the Virginia TOT in any litigation which may be filed. Regardless of the terms of the statute, review of local ordinances should be undertaken to ensure statutory compliance and a broad interpretation. Local counsel should consult with their local Treasurer or other TOT collecting official to calculate missing and unpaid TOT revenue not remitted by OTC's and other collecting entities and develop a strategy for collection, which may involve consultation with outside counsel. It is highly likely that a significant amount of what should be local revenue through the excise tax is checking out of your jurisdiction without being remitted.

Jim Cornwell, a shareholder at Sands Anderson Marks & Miller, P.C. manages the Blacksburg office of the firm. He has provided legal representation for localities in Virginia for over 35 years. He currently serves as county, city or town attorney for seven Virginia localities and provides legal services on tax collections matters for those and several additional Virginia localities. He can be reached at JCornwell@SandsAnderson.com or (540) 443-9800. We gratefully acknowledge the help of attorney Ronnie D. Bonds, Esq. for assistance in this article. Ronnie has his office in South Carolina and represents several North and South Carolina localities in the collection of transient occupancy tax from online providers.