

## **Hamilton, Cassandra (TAX)**

---

**From:** Peterson, Kristen (TAX)  
**Sent:** Tuesday, October 19, 2010 11:51 AM  
**To:** Hamilton, Cassandra (TAX)  
**Subject:** FW: Comments on the Study on the Feasibility of Implementing Senate Bill 452  
**Attachments:** Response\_to\_Study\_on\_Feasibility\_of\_Senate\_Bill\_45211-revised.oct1.DOC

---

**From:** Ben Dendy [mailto:bdendy@vectrecorp.com]  
**Sent:** Friday, October 01, 2010 4:06 PM  
**To:** Peterson, Kristen (TAX)  
**Subject:** Comments on the Study on the Feasibility of Implementing Senate Bill 452

Orbitz Worldwide, Inc. has asked me to forward these comments to you. Please confirm receipt. Many thanks.

H. Benson Dendy III

The Vectre Corporation  
823 East Main Street  
Suite 1700  
Richmond, Virginia 23219  
(804) 644-6600  
(804) 644-6628 fax

**SUBMISSION BY ORBITZ WORLDWIDE, INC.  
IN RESPONSE TO STUDY ON THE FEASIBILITY  
OF IMPLEMENTING SENATE BILL 452**

**OCTOBER 1, 2010**

## I. PRELIMINARY STATEMENT

Orbitz Worldwide, Inc. (“Orbitz”) submits this response to the Study on Feasibility of Senate Bill 452 (the “Study”). Orbitz urges the Virginia legislature not to try to amend its Retail Sales and Use Taxes and local transient occupancy taxes in an effort to attempt to tax the services that Orbitz and other online travel companies (“OTCs”) charge their customers. Rather, the proper basis for the tax is on the local commercial activity occurring in the state – the amount charged by the local hotel for accommodations. Any attempt by the legislature to expand the tax beyond the local commercial activity would be counterproductive and will have an adverse impact on tourism within the state. In particular, as the Study correctly points out, consideration of Senate Bill 452 raises serious issues as to: (1) “how constitutional nexus requirements would impact the potential revenue for the state and localities;” (2) “whether the tax is consistent with Virginia’s tax policies;” (3) “whether the bill would bring in additional revenue to states and localities;” and (4) “how the bill would impact businesses and citizens in the Commonwealth.” (Study, p. 42). As the Study concludes, “there are no definitive answers to these issues.” Furthermore, the passing of Senate Bill 452 (as drafted) will likely lead to litigation, as it raises a number of legal issues, including constitutional issues over nexus and the fair apportionment of taxes. Also, the Study fails to consider how the OTCs’ merchant model helps increase tax revenue to the state and localities by helping hotels rent rooms that would otherwise go vacant and how the bill could possibly result in less tax revenue in the state and localities.

Orbitz has prepared this response to provide the legislators with a more complete picture of how the OTCs’ merchant model works and how that model assists Virginia’s travel industry. Imposing the tax on the commercial activity taking place in the local jurisdiction (*i.e.*, the amount charged by the local hotel for accommodations), as Virginia has historically done, makes

sense and avoids numerous legal, administrative and economic problems. Efforts to expand sales transient occupancy taxes to cover the OTCs' services may very well damage Virginia's robust and important travel industry.

## **II. HISTORICAL TAX TREATMENT OF ONLINE RESERVATION FEES IN VIRGINIA**

As an initial matter, Orbitz agrees that most states' (including Virginia's) state and local occupancy tax ordinances were drafted prior to the advent of the Internet, and therefore were not intended to apply to the OTC's online reservation fees. Further, Orbitz agrees with the Tax Commissioner's Public Document ("PD") 06-139, in which she concluded that mark-up fees are not subject to Retail Sales and Use Tax, based upon the definition of "retail sale," in Virginia Code § 58.1-602 and the language in the Retail Sales and Use Tax imposition statute. The basis of such a conclusion was that the OTCs are not the entity providing the accommodations and therefore are not required to collect and remit the applicable sales tax.

For this same reasoning, Orbitz urges the legislature not to expand its sales tax to those entities beyond those that provide the accommodations. The purpose of the occupancy tax is and always has been, to tax the privilege of providing hotel accommodations. That privilege is exercised by hoteliers not intermediaries that facilitate reservations, such as Orbitz. As the Commissioner has already concluded, OTCs are not exercising such taxable privilege. Rather, the OTCs are providing travel services that occur out-of-state.

## **III. BACKGROUND**

### **A. Functions and Operations of Hotels**

Hotels perform numerous functions in order to rent hotel rooms to guests. They secure, equip and maintain physical structures built out in a manner and design appropriate for the level of hotel services they desire to offer. They perform the daily operations necessary to rent hotel

rooms to guests, such as guest arrival and registration services (e.g., bellman, front desk, parking and ground transportation), guest services and amenities (e.g., room service, maid service, food and beverage, concierge, telephone, in-room TV, video and internet access, fitness centers and spas, beach facilities). They also establish all the policies and procedures related to the occupancy of the hotel rooms (including minimum age requirements, room capacity, length of stay requirements, permissibility of pets, and prohibited activities)

Operating a hotel is a complex business. The complexity arises in part from the number of hotels competing for business and the size and scope of their operations, as well as changing trends in consumer demand. Operating hotels today requires the essential task of revenue management – setting, monitoring and adjusting the room rates, and deciding which distribution channels it will use to fill those rooms. It is common for hotels to increase or decrease their room rates on a reservation-by-reservation basis to fill unreserved rooms and maximize revenue to the hotel. This means that (not unlike commercial airlines) similar rooms at a hotel on the same day may be priced differently for different customers, particularly if they stay for different lengths of time, and book via different channels.

A hotel – and more particularly, the hotel's revenue manager(s) – determines which distribution channels it will utilize to fill its rooms and maximize its total revenue. A hotel may accept direct reservations in person, via mail, by phone or on its own website. In addition, a hotel has numerous other distribution channels available through which to offer reservations for its rooms. A hotel may use one or more third-party travel intermediaries, including travel agents or the OTCs, wholesalers and consolidators, tour operators, corporate websites, specialty websites, and group booking agencies.

Although a hotel may use multiple distribution channels, what remains constant is that

the hotel is in complete control of the rate and room availability. Most major hotel brands use their own central reservation system to manage room occupancy and revenue. For example, Marriott uses a central reservation system known as MARSHA, Hilton uses OnQ Property Management, and Red Lion uses OSCAR. A hotel loads onto its central reservation system the number, if any, of reservations it wishes to make available for booking and at what rate. The hotel also decides which distribution channel will be given access to which reservations and rates it loaded onto the central reservation system. Not all OTCs have access to the same number of reservations at the same rental rates. When a traveler attempts to make a reservation, either through an OTC website or offline distribution channel such as a travel agent, the travel intermediary accesses the hotel's central reservation system to determine if a room is available for booking. If a room is available, the hotel will also include information about what rental rate it will charge for the room.

Thus, there are many travel intermediaries (not just the OTCs) authorized to make reservations at hotels for various rental rates at any one point in time. Multiple intermediaries exist because travelers and hotels find them to be useful for their own reasons. Travelers enjoy the benefits of one-stop comparison shopping (be it by price, location, star rating or amenities) from the convenience of their own homes, and hotels receive the benefits of new customers and increased rentals. Yet regardless of the source of the reservation, it is the hotel that retains the right to actually rent its rooms to travelers whether they booked direct with the hotel, through the local convention bureau, through AAA, a mom-and-pop travel agency, a large-scale tour operator or through an OTC.

**B. The OTCs' Travel Services**

During the 1990s, the growing availability of personal computers and increased access to the internet revolutionized many American industries. The travel services industry was no

exception. This period of rapid technological innovation led to unprecedented disintermediation, as a number of companies began employing new technologies to market hotel and other travel-related products and services directly to consumers online. Over the past three decades, these OTCs have grown dramatically.

The reasons for this growth are simple. OTCs provide substantial benefits to consumers, hoteliers, and other travel providers. For consumers, OTCs provide one-stop virtual marketplaces, with access to a large number of alternatives for hotels, air travel, and rental cars. With direct access to unprecedented information, consumers can now research travel destinations and comparison shop for travel-related products and services from the comfort of their homes and offices. In short, OTCs provide today's consumers ready access to the information that they need to make informed and deliberate choices about where they will travel, how they will get there, and where they will spend their time and money once they arrive.

For hotels and other suppliers, OTCs provide unprecedented access to consumers and markets throughout the country and around the globe. Virginia hotels that might not otherwise be considered by travelers using traditional marketing and distribution channels can now be seen and considered by any consumer with access to the internet, no matter how far away they live. In addition, the advanced technologies and systems developed by OTCs have also reduced or eliminated many of the administrative burdens previously associated with remote hotel bookings.

In addition to the benefits to business and consumers, the growth of the online travel business has provided a range of benefits to the Commonwealth of Virginia through increased business for the travel industry, and thus increased jobs and revenues in Virginia. Indeed, Virginia has been particularly well-positioned to benefit from the increased exposure that OTCs provide. There can be no doubt that OTCs have played an important role in Virginia's

successful efforts to showcase both its natural beauty and its vibrant economy to business and leisure travelers around the world.

**C. The "Prepaid" or "Merchant" Model Used By The OTCs**

Most OTCs conduct the bulk of their hotel booking business through the so-called "merchant" or "pre-paid" model although each OTC tweaks various aspects of the model. Using this model, hotels contract with OTCs to promote and market their hotels to customers who visit websites maintained by the OTC. The hotel agrees in advance to accept a certain amount of money for the rental of the room (net rate), usually at a rate that is discounted from the rate that the hotel is willing to accept if they booked the room directly. When a customer books a room through the OTC website using the prepaid model, the OTC bills the customer a "room rate" and an additional amount for "taxes and services." The "room rate" that the customer pays is composed of the underlying net rate that the hotel charges for the room that will be occupied by the customer, plus a facilitation fee or mark-up that the OTC retains for its services. The customer pre-pays the OTC online, before occupying the room. After the customer's stay has concluded, the hotel invoices the OTC for the agreed upon net room rate plus the occupancy and other taxes that the hotel calculates based on that amount. The OTC pays the invoice, and the hotel remits taxes to the appropriate authority and retains the net rate charged for its room.

The Study wrongly states that hotels "set aside a block or rooms at a discount rate." (Study, p. i, 1). However, regardless of the model used, Orbitz has never purchased or sold hotel rooms, nor have hotels ever "set aside" a specific block of rooms for Orbitz. Rather, Orbitz operates like a traditional brick-and-mortar travel agents -- it never takes inventory of hotel rooms, but instead helps customers book reservations at hotels.



It is important to note that the OTCs did not invent the prepaid model. The OTCs simply adopted a well-established model and put it online. Indeed, more than 40 years before the OTCs used the prepaid model, hotel wholesalers and other intermediaries used the same basic framework to facilitate transactions between hotels and their customers. Although Virginia hotel occupancy tax ordinances were first enacted decades ago, no local government has ever attempted to apply its ordinance to the amounts collected by these traditional intermediaries who operated under the same basic business model used by OTCs today.

**D. The OTCs Maximization of Revenue to the Hotel, and, In Turn, the State**

Third-party intermediaries (including OTCs) are valuable tools in assisting hotels increase their revenue. Hotels use the OTCs to help rent rooms that otherwise may go vacant. Hotels are revenue and profit maximizing entities: they will agree to accept less for the rental of a hotel room only if that hotel thinks that it cannot rent that room through other distribution channels, including the hotel itself, at a higher rate. Hotels are willing to accept less for the rental of rooms made available through OTCs because OTCs provide hotels with widespread access to consumers and markets through the country and the globe, and help hotels fill rooms that otherwise may have gone vacant. The Study incorrectly treats this type of transaction as a zero sum game in which the OTC is taking revenue at the expense of the taxing authority. That is simply not the case. Because OTCs help hotels fill rooms that would otherwise go vacant, OTCs increase hotel revenue and, in turn, increase aggregate tax revenue.

**IV. VIRGINIA'S ESTIMATES OF ADDITIONAL TAX REVENUES ARE WRONG AND FAIL TO ACCOUNT FOR THE IMPACT ANY LEGISLATION MAY HAVE**

The Study overestimates the likely tax revenue to be derived from the OTCs for several reasons:

(1) The Study states that "[s]ales transacted through OTCs make up approximately 10.3% of all hotel transactions in Virginia." (Study, p, 30). This percentage is entirely too high and inconsistent with the OTCs' data. This percentage may likely include transactions that use a different model, in addition to the prepaid or merchant model.

(2) The Study's estimates improperly ignore the impact the new proposed tax, either through the administrative burden imposed on the OTCs in trying to comply with this as well as other similar legislation or through the added taxes that will be passed onto customers, may have on the demand for hotels booked through the OTCs. In particular, complying with this tax and other similar taxes could significantly reduce demand resulting in much less revenue than estimated by the Study.

(3) The Study discusses the burden upon the OTCs and then states that the uniform local rates will likely ease the difficulty. This ignores the fact that Virginia is not the only state and other states may pass similar laws. The cost of complying and filing returns in all of these states and localities may either force a change in the OTCs business model or significantly increase the cost of providing the service – both of which could significantly impact future tax revenue.

(4) If OTCs stop doing business because of the burden and expense or if the increased cost due to taxation drives down demand, it will not only lead to lower estimates of taxes from the OTCs, but also lower taxes from hotels as the OTCs will likely not be able to help hotels rent as many unused rooms.

## **V. OTHER STATES**

### **A. Litigation**

The Study correctly points out that through litigation most courts have concluded that the OTCs are not operators and are not subject to the ordinances. To date, the only appellate courts (federal or state) that have reviewed the issue -- the United States Court of Appeals for the

Fourth Circuit and the United States Court of Appeals for the Sixth Circuit -- have held that hotel tax ordinances did not apply to the OTCs. In fact, over 75% of all decisions on the merits in the litigation have been in favor of the OTCs.

The paper also points to some decisions on motions to dismiss. It is important to note that those decisions were not on the merits. Rather, they simply ruled that the plaintiff has stated enough in its complaint to survive a motion to dismiss. By ruling on the motions to dismiss, not one of the courts have found that the OTCs owe occupancy tax (or found anything for that matter). Discovery is being conducted in these cases and certainly, the merits have not already been determined. Importantly, in the cases in which motions to dismiss were denied, there have been no final decisions.

Moreover, the OTCs have many constitutional defenses to the application of occupancy taxes to their out-of-state services. These defenses include, but are not limited to, equal protection, nexus and fair apportionment of taxes. For example, the United States Supreme Court has established that a state may not impose a tax that "reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State." *Oklahoma State Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 185, 115 S. Ct. 1331, 1338 (1995). The Commerce Clause does not prohibit states from taxing interstate businesses but the tax must be fairly apportioned to represent the economic activity in the state. The goal is the avoidance of a tax scheme that imposes a greater tax burden on an interstate business than is borne by a business that operates only in the taxing state.

Indeed, as pointed out by Joseph Henchman in his article "*Cities Pursue Discriminatory Taxation of Online Travel Services*," STATE TAX NOTES, 632 (2010), permitting states to adopt an economic nexus standard (rather than a geographic standard as the US. Constitution requires)

will only hinder electronic commerce. The Internet has seen an increased amount of commerce, but this commerce will be greatly damaged if states like Virginia attempt to reach across state borders to tax out-of-state transactions.

At this time, no court of appeals has analyzed and ruled upon the merits of any of the OTCs' constitutional defenses. However, the OTCs believe that these are strong defenses and provide yet another reason why the OTCs should prevail in the tax litigation.

**B. Administrative Responses**

When states have chosen to address the taxability of the OTCs' fees by issuing assessments or other rulings, these administrative responses have resulted in litigation. The Study mentions the Indiana Department of Revenue's determination. It is currently being challenged in the Indiana Tax Court. No final determination has been made concerning the correctness of that finding and the parties continue to litigate the issue.

The Study also mentions the administrative proceeding from Anaheim, California. However, it is important to note that on February 1, 2010, the California Superior Court of the County of Los Angeles in a 31-page opinion overturned the City of Anaheim's Hearing Officer's decision, ruling that the OTCs were not subject to Anaheim's hotel tax ordinance. *See Transient Occupancy Tax Cases*, Case No. JCCP 4472 (Cal. Super. Ct., County of Los Angeles Feb. 1, 2010). The Honorable Judge Carolyn B. Kuhl held that the Hearing Officer's decision "cannot stand because it is contrary to law, having incorrectly construed the Anaheim ordinance." (Opinion at p. 30). Judge Kuhl ruled that the OTCs are not hotel "operators' or "managing agents" for purposes of Anaheim's municipal hotel tax ordinance, and thus not required to pay taxes on the compensation they receive for their services.

Finally, some of the administrative bodies themselves have reviewed the issue and found that the OTCs are not subject to the tax -- even without litigation. For example, in Philadelphia,

the City of Philadelphia’s Tax Review Board (“TRB”) recently invalidated a hotel room rental tax assessment against one of the OTCs, concluding that it was not a hotel “operator,” under the city’s ordinance, defined as those who “maintain, operate, manage, own, have custody of, or otherwise possess the right to rent or lease overnight accommodations in any hotel.” The TRB reviewed the OTCs’ contracts with hotels, and concluded that it “does not acquire the ‘right to rent or lease’ hotel accommodations.”

**C. State and Local Legislative Enactments**

As the Study correctly points out, only a few states have tried to amend their statutes to try to capture the OTCs’ services – New York and North Carolina. Orbitz believes that these enactments raise significant legal and constitutional issues and Orbitz is strongly considering legal challenges to these enactments. Moreover, even if legally enacted, these legislative enactments will impose an enormous administrative burden on the OTCs – the impact of which could dramatically alter how (and perhaps whether) the OTCs do business and the prices the OTCs charge for their services. It is very possible that these states’ new legislation will negatively impact the OTCs’ continued ability to drive tourism to these jurisdictions.

**V. THE CURRENT TAX STRUCTURE PROVIDES FOR EQUITY AMONG CONSUMERS RENTING ACCOMMODATIONS**

The Study states that “Advocates of the 2010 proposal are equally concerned with ensuring that consumers paying the same price for rooms in any given jurisdiction are charged the same transient occupancy and sales taxes.” (Study, p. 39). In reality, the current law ensures that consumers are charged the same transient occupancy and sales tax, as the tax base for all transactions, regardless of the distribution channel used to book a room (including using an OTC) is the same - the amount charged by the local hotel for accommodations. The current scheme not only makes legal and commercial sense, but also results in an equitable result. If the

tax is based on the local commercial activity or what the local hotel charges for the accommodations – the amount of the transient occupancy tax and sales tax paid is always based on the same amount –the amount charged by the local hotel for the accommodations. Therefore, regardless of whether a transient makes a room reservation: (1) directly with the hotel; (2) through a travel agent (or other travel intermediary); (3) or through an OTC utilizing the “merchant” or “prepaid” model, the tax base is always the same—the amount charged by the hotel. Such a tax also avoids the constitutional issues that arise if taxing activity occurs outside of the state.

Further, contrary to statements contained in the Study, resident accommodation providers are not placed at a competitive disadvantage. The resident accommodation providers are the hotels who have voluntarily entered into contracts with the OTCs to make their rooms available through the OTCs at discounted rates. It is these local accommodation providers who are the ones who are deciding when and at what price to make their rooms available through the OTCs, in an effort to maximize their revenue. Not only are these local hotels voluntarily entering into these contracts with the OTCs, these relationships significantly benefit the local hotels as the OTCs provide the hotels with unprecedented access to potential customers and allow these hotels to rent rooms that may otherwise go vacant.

Further, the Study ignores the fact that hotels routinely charge different rates for the same room, same night at the same hotel which results in different tax outcomes. Take the following example:

<u>Scenario #1:</u>	<u>Scenario #2:</u>	<u>Scenario #3</u>
Consumer transacts directly with Hotel	Consumer transacts through OTC	Consumer transacts directly with hotel but receives discount
“Retail” Rate: \$100	“Retail” Rate: \$100	“Retail” Rate: \$70
Net Rate: \$100	Net Rate: \$70	Net Rate: \$70
Margin: \$0	Margin: \$30	Margin: \$0
Tax owed: <b><u>\$15.00</u></b> (.15 <sup>1</sup> x 100)	Tax owed: <b><u>\$10.50</u></b> (.15 x 70)	Tax owed: <b><u>\$10.50</u></b> (.15 x 70)

For the same reasons that hotels make rooms available through OTCs at discounts (*i.e.*, to increase revenue), hotels routinely offer certain individuals or groups discounts. For example, many hotels will offer discounts to AAA members, senior citizens, certain industry groups (*e.g.*, American Medical Association), or corporate discounts based on frequency of expected visits (*e.g.*, employees of an airline for a hotel close to an airport). In Scenario No. 3, there is no competitive disadvantage. The same is true with respect to the OTCs’ “merchant” or “prepaid” model, in every scenario, including the OTCs’ “merchant” or “prepaid” model, the tax base is the same - the amount charged by the hotel for accommodations.

Further, as the Study points out, given nexus and other constitutional concerns, it is possible that the bill could apply to only some but not all of the OTCs or other travel intermediaries.<sup>2</sup> Given these concerns, Orbitz submits that it is bill that would likely result in some companies being placed at a competitive disadvantage over others. In particular, it is

<sup>1</sup> This example assumes a 15% tax rate.

<sup>2</sup> The Study suggests that the bill as written could reach travel agents and that the legislature could exempt traditional travel agents and only impose the tax on the OTCs. (Study pp. 33-34). Such an exemption would raise serious legal issues, such as equal protection as well as violations of the Internet Tax Freedom Act, which prohibits imposing taxes solely on internet providers.

possible that some OTCs could be found to have nexus in Virginia, while others do not. If that were to happen, then those OTCs with nexus would be placed at a competitive disadvantage.

## **VI. CONCLUSION**

Virginia's current approach has it right: the proper basis for both transient occupancy taxes and sales taxes is on the local commercial activity. That is, the amount charged by the hotel for accommodations. The OTCs' merchant model helps increase tax revenue by helping hotels rent rooms that would otherwise go vacant. Given the importance of the OTCs' merchant model to the travel industry and Virginia's economy, we urge the Commonwealth not to try to tax the OTCs' services. As the Study correctly points out there are no definitive answers to how this legislation will impact the state tourism industry and tax revenues. However, the adoption of this legislation raises a number of legal and constitutional issues, including nexus, that is only likely to lead to litigation.