

## Hamilton, Cassandra (TAX)

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**From:** Peterson, Kristen (TAX)  
**Sent:** Tuesday, October 19, 2010 11:50 AM  
**To:** Hamilton, Cassandra (TAX)  
**Subject:** FW: Arlington Treasurer's Response to proposed Report  
**Attachments:** image001.gif; OTC Study Draft 092010 - Revision.doc

**From:** Frank OLeary [mailto:Foleary@arlingtonva.us]

**Sent:** Friday, October 01, 2010 5:04 PM

**To:** Peterson, Kristen (TAX)

**Cc:** jmallan@jonesday.com; abezik@principle-advantage.com; delbrink@comcast.net; mitchell.bryk@starwoodhotels.com; Patricia Carroll; BCovey@sfc.virginia.gov; Carla DeLaPava; sdelbianco@netchoice.org; bdendy@vectrecorp.com; medwards@vaco.org; annflan@principle-advantage.com; district24@senate.virginia.gov; Katie@vhta.org; thill@williamsmullen.com; kilday@visitloudoun.org; tlisk@eckertseamans.com; cloyd@mwcllc.com; RMatthia@vbgov.com; nmenkes@vml.org; Cindy.Ohlenforst@klgates.com; Frank OLeary; DelBPurkey@house.virginia.gov; jputney@dls.virginia.gov; drosenberg@dls.virginia.gov; pruden@asta.org; asackler@interactivetravel.org; cshelton@williamsburgva.gov; aspinelli31@gmail.com; MVucci@dls.virginia.gov; Raymond A. Warren; district31@senate.virginia.gov; ryoung@dls.virginia.gov; cwhyte@vectrecorp.com; Jean Crawford  
**Subject:** Arlington Treasurer's Response to proposed Report

Dear Ms. Peterson:

Attached is your proposed Study on the Feasibility of Implementing Senate Bill 452. My comments and questions and those of my staff have been inserted and are shaded in red to address the study point shaded in yellow. We are quite perplexed by the study's emphasis on "nexus." The nexus argument raised repeatedly in your report was dismissed in the Georgia case (see the opinion of Justice Benham, S09A0567. *Expedia v. City of Columbus*, point 6). The lead attorney, who won the \$21,000,000 suit for San Diego also agrees, as does attorney Jeffrey Scharf, one of Virginia's leading tax authorities. There also exists considerable confusion regarding the "OTC merchant model." For example, the statement, "hotels set aside a block of their rooms for OTC's," is completely erroneous. Similarly, the section entitled, "**SECTION III, POSSIBLE ISSUES WITH TAXING ONLINE RESERVATION FEES,**" makes no sense as no one is considering taxing reservation fees. Our intent is simply to compel the OTCs to render to local and state government the taxes which they collected from the occupant of an hotel room. In any event, please review the attached for a complete set of our comments.

Let me now turn to another issue. Your report concludes that the total loss of revenue to the State and local governments is less than \$5,000,000, annually. I believe that this is clearly only a fraction of the true figure. Let me give you several examples.

**Example 1: Using Your Parameters** – You state, without attribution, that "OTC's make up approximately 10.3% of all hotel transactions in Virginia." You further assume a "retail mark-up of 32.5%." Without showing the math, you then state your conclusion of less than \$5,000,000,

annually. You have in your possession the June 2008 report of the American Hotel & Lodging Educational Foundation (AHLEF). On page 14 of that report Virginia's estimated hotel revenues for 2008 are reported as \$1,939,000,000. Applying the rate of 10.3%, \$199,717,000 would be associated with OTCs. To this amount, we apply your estimated mark-up of 32.5%, which results in \$96,160,037. It is this amount upon which the OTCs claim no taxes are due. As we all know, the sales tax is 5%. When that rate is multiplied by \$96,160,037, the loss in sales tax revenue, alone, is \$4,808,002. The loss to localities varies between 5% and 6% or between \$4,808,002 and \$5,769,602. **Total losses, using your parameters, are thus estimated as between \$9,616,004 and \$10,577,604 for the year 2008.**


My sources in the hotel industry, however, dispute your contention that OTCs account for only 10.3% of current bookings. They state, that about seven years ago the OTCs peaked at between 45% and 50%. They further state that due to the rise of their own booking services (e.g., Marriott.com) that the current level of OTC bookings range between 25% and 28%. This has a common sense ring to it and is a far cry from your unattributed estimate of 10.3%. **Assuming this level of activity, the estimate of losses in 2008 rises to between \$23,339,815 and \$28,754,465.**

**Example 2: Using AHLEF Data Only** – Take the 2008, AHLEF estimate of \$1,939,000,000 and multiply it by 11% (5% plus 6%). That means tax revenues of \$213,290,000 should have resulted. AHLEF, on page 19, states that total tax revenue in Virginia in 2008 is estimated at \$178,517,400. **That represents a shortfall in tax revenue of \$34,726,000 (surprisingly close to my estimate six months ago of \$33,000,000). If we are to argue that 6% is on the high side for localities and use 5%, the total loss is \$31,611,455.**

I would appreciate if you would share the methodology you employed in obtaining your estimate of annual losses of less than \$5,000,000.

In closing, I wish to thank you for allowing us to participate in this process. I hope that you and the other authors of the report will carefully consider the points that we raise.

Sincerely,  
Frank O'Leary  
Arlington Treasurer

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*Want a signature like this?*

## CONCLUSION AND RECOMMENDATION

The taxability of mark-up fees imposed by online travel companies continues to be a controversial issue. The numerous lawsuits and legislation throughout the country testifies to this point. We believe that any consideration to move forward with any meaningful legislation must be concerned with a variety of factors discussed in this study, including constitutional nexus, consistent application with the Commonwealth's tax policies, whether the bill would bring in additional revenue to states and localities, and how the bill would impact businesses and citizens of the Commonwealth. We must also look to the intent of the statutory language as it applies to the taxation of the total room revenue paid for by a customer, not only the discounted rate that was unforeseen at the time the statutory language was adopted.

One of our goals must be to achieve equity among consumers renting accommodations, whether booked through an accommodation provider's reservation site, travel agent, OTC or some other source. **(WHY IS THIS A GOAL?, HOW COULD WE POSSIBLY ACHIEVE IT?)** We must also strive for predictability and stability of state and local tax local revenues.

This study presents many arguments for and against the proposal to require online travel companies to compute the retail sales and use taxes and local transient occupancy taxes on charges for accommodations. The fact that the Commonwealth has historically authorized the taxation of additional charges that are bundled transaction (i.e. the bundling of rental accommodations with service charges that are not directly related to the provision of accommodations) draws a direct comparison to the OTC's practice of bundling rental accommodations with a "mark-up" in what the OTC's contends is a charge for services rendered and presents a logical argument for pursuing this issue.

Although there are no definitive answers in this study to all of the issues discussed, the working group recommends that the legislation proceed requiring online travel companies to compute the retail sales and use taxes and local transient occupancy taxes on charges for accommodations.

## Authority

During the 2010 Virginia legislative session, Senate Bill 452, and House Bills 791 and 893 were introduced to require online travel companies to compute the Retail Sales and Use Taxes and local transient occupancy taxes on charges for accommodations, such as hotel and motel rooms, based upon the total price paid for the use or possession of the accommodation, including any mark-up fees, tax recovery charges, or other named fees imposed by the online travel companies. These companies contract with hotels and other accommodations providers to allow guests to reserve accommodations online through the online travel companies' websites. While both House Bills were laid on the table in subcommittee, Senate Bill 452 passed the Senate unanimously, before being carried over by the House Finance Committee until next year's legislative session. The Chairman of the House Finance Committee directed the Department of Taxation to form a working group to study the implications of enacting the legislation.

## Staff Assigned to Report

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# STUDY ON THE FEASIBILITY OF IMPLEMENTING SENATE BILL 452

## EXECUTIVE SUMMARY

During the 2010 Virginia General Assembly session, several bills were introduced that sought to clarify the taxability of certain fees imposed by online travel companies (“OTC’s”). Generally, OTC’s contract with hotels and other accommodation providers to allow guests to reserve accommodations online through the OTC’s websites. Hotels and other accommodations providers set aside a block of rooms at a discounted rate, which the OTC can make available to its customers for reservation online. While the OTC collects sales or occupancy taxes on the room rate that the accommodations provider charges the OTC, as well as any charges associated with the rental of the room and any taxes associated with those charges, the OTC does not charge or collect tax on the separate charge for providing the online reservation, despite that this charge is embedded in the total amount the guest is charged for the room. Because most state sales tax statutes and local occupancy tax ordinances were drafted prior to the advent of the Internet, they do not address the taxability of these online reservation fees (mark-up fees).

In 2006, the Tax Commissioner issued Public Document (“PD”) 06-139, which concluded that mark-up fees are not subject to the Retail Sales and Use Tax, based upon the definition of “retail sale,” in *Va. Code* § 58.1-602 and the language in the Retail Sales and Use Tax imposition statute. Because the statute defines retail sale as “the sale or charges for any room or rooms...**by** any hotel, motel...or any other place in which rooms, lodging, space or accommodations are regularly furnished to transients for a consideration,” the Tax Commissioner concluded that accommodations charges

must be imposed by the entity providing the accommodations in order to be subject to the tax. As OTC's do not own or operate the place in which the accommodations are being provided, the Tax Commissioner found that OTC's are not required to collect and remit the applicable sales taxes.

In 2010, Senate Bill 452 and House Bills 791 and 893 were introduced in the Virginia General Assembly to change the policy established in PD 06-139. The bills would have mandated that OTC's separately state and collect the Retail Sales and Use Tax and the applicable transient occupancy taxes on the mark-up fees imposed by OTC's. Senate Bill 452 passed the Senate unanimously before the full Finance Committee of the House voted to hold the bill over until the next year's legislative session and directed the Virginia Department of Taxation to study the implications of enacting the legislation.

States and localities have differed in their approaches to determining whether mark-up fees are subject to sales and occupancy taxes. Many localities have sought clarification through litigation, and the decisions in the court cases have turned on a host of factors, including the language of the statute or ordinance, whether the locality complied with mandatory administrative tax assessment procedures prior to bringing suit against the taxpayers, and the degree of control the OTC exercises with respect to the room rentals. Generally, where the statute or ordinance's language requires that the charge be imposed by the operators or owners of the accommodations, the courts have often dismissed the local government's suit seeking to impose the local sales or occupancy tax on the mark-up fee, concluding that OTC's are not operators or owners of the accommodations.

Some states and localities have made determinations as to the taxability of these charges administratively. As with the courts, states and localities generally look to the language in the statute or ordinance or the structure of the transactions to determine the taxability of the fees.

Several states and localities have recently sought to enact legislation imposing the tax on these mark-up fees. To date, New York and North Carolina are the only states that have enacted legislation taxing the OTC's mark-up fees, and **neither of these bills has taken effect.** **NY TOOK EFFECT 9/1/10.** Bills introduced in 2010 in the state of Florida and Minnesota ultimately failed. A bill introduced and passed during Missouri's 2010 legislative session is one of the few bills that declares that these fees are not subject to state sales or local transient occupancy taxes.

With only two states having enacted laws imposing the tax on the mark-up, there is little guidance as to how to structure such provisions, so as to properly address the possible issues that have been identified as potential impediments to the enactment of legislation, or that may decrease the potential revenue of imposing the Retail Sales and Use Tax and local transient occupancy taxes on the mark-up fees charged by OTC's.

Virginia stands to gain an additional \$4.61 million in Fiscal Year 2012, \$4.76 million in Fiscal Year 2013, and \$4.91 million in Fiscal Year 2014 in Retail Sales and Use Tax and local transient occupancy tax revenues from the passage of this bill. **HOW WERE THESE ESTIMATES CALCULATED?** However, other factors could potentially decrease or diminish this additional revenue. For example, out-of-state OTC's that do not have nexus with Virginia could be exempted from the requirement to charge or

collect the tax, which would eliminate any possibility of additional revenue in Virginia.

**THE NEXUS OF THE OTC IS IRRELEVANT, THE ROOM OCCUPANT IS THE**

**TAXPAYER** Thus far, none of the court cases addressing the taxability of these fees

has raised the issue of nexus. **NOT TRUE, SEE OPINION OF JUSTICE BENHAM,**

**S09A0567. EXPEDIA, INC. V. CITY OF COLUMBUS, POINT 5** Without guidance

from the courts, it is difficult to determine scenarios in which the nexus hurdle could be overcome. Further, OTC's are currently seeking federal legislation that would prevent states and localities from imposing their sales, use, or occupancy taxes on the OTCs' reservation fees. Any such legislation, if enacted, would preempt a Virginia statute authorizing the imposition of these taxes.

States and localities must give additional consideration to the impact legislation will have on their current taxing structures. Some OTC's contend that they are providing services; thus, they argue that taxing the fees for these services as a component part of the accommodations is a departure from Retail Sales and Use Tax conventions. This report addresses Virginia's current treatment of unrelated services bundled with the provision of accommodations. As these transactions are included in the taxable base, and thus, subject to tax in Virginia, imposing the tax on the mark-up fee would not significantly depart from Virginia's Retail Sales and Use Tax conventions in this regard.

State and local governments must also give consideration to the impact such legislation would have on the taxing jurisdiction, travel intermediaries, and accommodations providers. The online travel industry will be most heavily impacted by a bill of this nature, as it would be subject to additional administrative burdens in filing

taxes for each local jurisdiction. In addition, if the bill is drafted to require the OTC to separately state the tax for each individual charge, OTC's may be forced to reveal their confidential negotiated discount rates at which the accommodations providers make their rooms available. This could discourage travelers from using OTC's and could prove detrimental to the business model.

These considerations must be balanced against the local objectives for future legislation. Transparency in Virginia's taxing systems, equity among consumers renting accommodations, and predictability and stability of local revenues are among the chief goals localities have expressed for future legislation. Not surprisingly, some of these goals are in direct conflict with the concerns that have been expressed by OTC's.

## STUDY ON THE FEASIBILITY OF IMPLEMENTING SENATE BILL 452

### SECTION I OVERVIEW OF THE ISSUE

#### Introduction

In the past two decades, the United States has experienced an overwhelming increase in electronic commerce. When the Internet was first opened to commercial use twenty years ago, few households were familiar with it. By 1999, e-commerce sales had grown to \$995.0 billion, and by 2006, that number had increased to 2,385 billion.<sup>1</sup>

Like many other areas of commerce, travel purchases have migrated to the Internet. This has prompted the emergence of “online travel companies” (“OTC’s”). OTC’s are companies that contract with hotels and other accommodation providers to allow guests to reserve accommodations online through the OTC’s company websites. The accommodations providers generally set aside a block of rooms at a discounted rate, which the OTC can make available to its customers for reservation online. When an OTC collects payment from its customers, the payment generally includes the total charge for the room, which consists of the room rate, a separate charge for the service of providing the reservation online, and any taxes associated with the room charge. The OTC collects the required state and local taxes on the room rate and associated room charges, but does not charge or collect tax on the separate charge for providing the online reservation. Instead, the OTC’s contend that this “mark-up” constitutes a charge for services rendered and is not subject to the Retail Sales and Use Tax or any local taxes collected on accommodations transactions.

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<sup>1</sup> Bruce, Donald *et.al.* “State and Local Government Sales Tax Revenue Losses from Electronic Commerce,” University of Tennessee (2009).

According to a report by the Center on Budget and Policy Priorities, issued in September, 2009, states' and localities' entire revenue stream from hotel taxes equals some \$8.5 billion per year.<sup>2</sup> Some state and local governments contend that the OTC mark-up should be subject to state sales and local occupancy taxes. As the provision of accommodations is a multibillion dollar industry, states and localities maintain that they are losing millions in revenue. State and local governments have therefore initiated administrative proceedings or filed suit against the OTC's, contending that their sales and hotel occupancy tax laws require the companies to charge their customers the applicable hotel taxes on the service fees that the OTC's impose. Others have sought to introduce legislation that would explicitly impose sales or local occupancy taxes upon these fees and mandate that the OTC's be responsible for collecting and remitting the applicable taxes. Courts have differed in their opinions as to whether these fees should be subject to state and local sales and occupancy taxes.

### **OTC's**

Historically, the travel intermediary industry has employed three business models to facilitate the reservation of accommodations: the traditional commission model, the tour operator model, and the merchant model.

Prior to September 11, 2001, the commission model was the traditional means employed by travel agents to facilitate accommodations reservations. Travel agencies would arrange reservations for accommodations providers, who would set the retail pricing and serve as the merchant of record for these transactions. Upon the guest's departure, the accommodations provider would charge the customer's credit card for

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<sup>2</sup> Mazerov, Michael: "Banning Taxation of Online Hotel Reservations is Unwarranted and Could Cost States and Localities Billions of Dollars." Center on Budget and Policy Priorities. September 18, 2009.

the room charge and subsequently pay the travel agency a previously negotiated commission on the revenue received from the customer. Under this business model, the agent's commission is paid by the accommodations provider, not the customer, and the accommodations provider bears the entire risk of loss.

Under the tour operator model, the travel intermediary contracts with the accommodations provider to purchase the room or rooms, then subsequently resells them to tourists. The customer pays the intermediary directly, both for his administrative services and for a hotel room, which the tour operator has previously rented from the hotel for a lower rate. The tour operator bears the entire loss for any rooms that go unsold.

The September 11 terrorists' attacks caused a dramatic decline in the number of people traveling and staying in hotels. In an effort to curb this decline, accommodations providers began negotiating the distribution of rooms through the Internet intermediaries' newly developed merchant model distribution format,<sup>3</sup> named so because the intermediary is the merchant of record, and under its contract with the accommodations provider, is required to collect the proceeds from the consumers at the time the rooms are booked. Under the merchant model, accommodations providers contractually agree to set aside a portion of their rooms, which they make available to third party intermediaries at a discounted rate, so as to allow them to market to consumers the accommodation providers, would normally be unable to reach. The intermediaries then compile a list of rooms on a central website that travelers can visit to search for available rooms at multiple hotels, compare rates and amenities, and

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<sup>3</sup> Stanford, Beth Anne: "State and Local Efforts to Collect Additional Tax on Hotel Rooms Booked Online." STATE TAX NOTES, 319, (2005).

ultimately book a reservation. The intermediary collects the sales and transient occupancy taxes on the discounted room charge from the customer, and remits the tax to the accommodations provider. The amount of tax is generally bundled with other fees and charges. Under this model, if the ultimate consumer's payment does not clear, the intermediary bears the loss of the commission (A commission is not part of the OTC merchant model. Commissions are part of the travel agent model. The travel agent is paid a commission from a room rate that is fully taxed.) and the hotel bears the loss of the room rental. The travel intermediary does not disclose the amount of the discounted rate to the ultimate consumer. The final price imposed upon the ultimate consumer is left to the discretion of the intermediary, which generally marks up the price to compensate itself for the online reservation service provided. The merchant model is the most widely used model among intermediaries today.

### Historical Tax Treatment of Online Reservation Fees in Virginia

The Retail Sales and Use taxation of accommodations in Virginia is governed by *Va. Code* § 58.1-603, which imposes the Retail Sales and Use Tax on the "gross proceeds derived from the sale or charges for rooms, lodgings, or accommodations furnished to transients as set out in the Code's definition of "retail sale.'" *Va. Code* § 58.1-602 defines "retail sale" to specifically include

[T]he sale or charges for any room or rooms, lodgings, or accommodations furnished to transients for less than 90 continuous days by any hotel, motel, inn, tourist camp, tourist cabin, camping grounds, club, or any other place in which rooms, lodging, space, or accommodations are regularly furnished to transients for a consideration.

In October, 2003, an out-of-state online travel company requested guidance from the Virginia Department of Taxation as to whether the Virginia Retail Sales and Use Tax applies to the marked-up amount the OTC charges its customers for the services rendered in facilitating the reservation process.

In October 2006, the Tax Commissioner issued Public Document (“PD”) 06-139<sup>4</sup>, in which she concluded that, based on the language in the imposition statute; charges must be imposed by the entity providing the accommodations in order to be subject to the tax. Because the OTC did not own or operate the place in which the accommodations were provided, the Tax Commissioner found that the OTC was not required to collect and remit the applicable sales taxes.

Thereafter, TAX confirmed that this same treatment would apply to the rental of private facilities when it issued PD 07-8, in which the Tax Commissioner ruled that a broker who facilitates rentals of private residences is not required to collect the tax on the rentals because the broker does not own or operate the private residences where the accommodations are being furnished.<sup>5</sup>

## 2010 Virginia Legislation

During the 2010 Virginia legislative session, several bills were introduced to change the policy established in PD 06-139. (THE STUDY IS NOT THE ISSUE, THE INTENT IS TO ENACT A LAW TO COMPEL OTCs TO TURN OVER TO STATE AND LOCAL GOVERNMENT ALL THE TAXES THEY HAVE COLLECTED ON OUR BEHALF FROM THEIR CUSTOMERS) Senate Bill 452 (introduced by Senator Mary

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<sup>4</sup> Public Document 06-139 (October 24, 2006).

<sup>5</sup> Public Document 07-8 (March 9, 2007).

Margaret Whipple)<sup>6</sup>, and House Bills 791 and 893 (introduced by Delegates Robert H. Brink and William H. Barlow, respectively) were drafted identically to require online travel companies to compute the Retail Sales and Use Tax and local transient occupancy taxes on charges for accommodations based upon the total price paid for the use or possession of the accommodation, including the mark-up fees, tax recovery charges, or other named fees imposed by OTC's. Had they been enacted, these bills would have required accommodations providers to separately state the amount of the tax on the patron's bill, invoice, or similar documentation, and to collect and remit the tax to the Virginia Department of Taxation and/or the locality. The bills separately addressed the Retail Sales and Use Tax and the local transient occupancy taxes. While both House bills were laid on the table in subcommittee, Senate Bill 452 passed the Senate unanimously.<sup>7</sup> A House Finance subcommittee thereafter recommended it by a 10-0 vote, but the full Finance Committee voted 13 to 9 to hold the bill over until the next year's legislative session and directed the Tax Department to form a working group to study the implications of enacting the legislation.<sup>8</sup>

### Retail Sales and Use Tax Provisions

Each bill proposed to remove the statutory language that currently limits the application of the Retail Sales and Use Tax to charges for accommodations made by accommodation providers and explicitly authorized the imposition of the tax on accommodations charges imposed by OTC's. In addition, the bills outlined the

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<sup>6</sup> See Appendix I

<sup>7</sup> See Appendix II

<sup>8</sup> See Appendices III and IV.

procedures OTC's would need to follow in collecting and remitting taxes and fees on accommodations charges and mark-up fees.

The bills would not have changed the types of rentals that were subject to the Retail Sales and Use Tax, as the bills defined "accommodations," to include, "any room or rooms, lodgings, or accommodations in any hotel, motel, inn, tourist camp, tourist cabin, camping grounds, club, or any other place in which rooms, lodging, space, or accommodations are regularly furnished to transients for a consideration." This is the same language that is used in the current statute.

Under the terms of each bill, depending on how the transaction is structured, either accommodations providers and/or accommodations intermediaries could be required to collect the tax on the charges and fees for these accommodations. The bills defined "accommodations provider" as any person that furnishes accommodations to the general public for compensation." An "accommodations intermediary" was defined as "any person, other than an accommodations provider, that facilitated the sale of an accommodation and charged a room charge to the customer." The bills' intent was to classify OTC's as accommodations intermediaries.

The bills also identified several charges an accommodations provider or accommodations intermediary may impose upon its customers. The bills defined a "room charge" as the full retail price charged to the customer by the accommodations intermediary for the use of the accommodations, including any accommodations fee before taxes." Thus, the "room charge" was intended to represent the total amount on the customer's invoice, excluding taxes. The "discount room charge" was defined as the "full amount charged by the accommodations provider to the accommodations

intermediary for furnishing the accommodation.” This amount represented the discounted prices at which hotels and other accommodations providers make rooms available to OTC’s to market their rooms. The “accommodations fee” was defined as the room charge less the discount room charge, if any, provided that the accommodations fee shall not be less than \$0.” This amount was intended to represent the online reservation fee, or mark-up, imposed by the OTC’s.

The bills provided that, where an intermediary was not involved in the rental of the accommodations, the accommodations provider was required to collect and remit the Retail Sales and Use Taxes, and was held liable for these taxes. Alternatively, where an intermediary facilitated the sale, the bills required that the intermediary collect the room charge and the tax computed on the room charge from the guest. The intermediary was required to remit the discount room charge and the tax collected on the discount room charge to the accommodations provider, which, in turn, would remit such tax to the Tax Department. The intermediary was also required to remit the portion of the taxes relating to the accommodations fee and the difference between the room charge and the discount room charge directly to the Tax Department. For all retail sales of accommodations, the bills also required that both the accommodations provider and the intermediary separately state the amount of the tax on the bill, invoice, or similar documentation and add the tax to whichever charge it was required to collect.

### Transient Occupancy Tax Provisions

Virginia law authorizes counties to levy occupancy taxes on hotels, motels, boarding houses, travel campgrounds, and other guest room facilities rented out for

continuous occupancy of less than 30 days.<sup>9</sup> Under current law, with some exceptions, counties are authorized to levy the transient occupancy tax at a maximum rate of two percent “of the amount of charge for the occupancy of any room or space occupied.”<sup>10</sup> This language limits the application of the local transient occupancy tax in counties to charges for the **occupancy** of a room. Each bill would have changed the wording of the current county transient occupancy statutes<sup>11</sup> to impose the tax on the total price paid by the ultimate consumer for the use or possession of the room or space occupied in a retail sale, rather than imposing the tax solely on charge for the occupancy of the room.

Similarly, cities and towns are granted the authority to impose tax on the charges for transient accommodations. As with counties, the law limits the application of the tax to the “**occupancy** of any room or space...”<sup>12</sup> Thus, each bill would have changed the wording of the current city and town transient occupancy tax statutes to impose the tax on the total price paid by the ultimate consumer for the use or possession of the room or space.

Finally, each bill would have set forth the same requirements for collecting and remitting local transient occupancy taxes as the provisions for collecting the state sales taxes, except that the parties would be required to remit such taxes to the local taxing authority, rather than to the Virginia Department of Taxation.

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<sup>9</sup> Va. Code § 58.1-3819.

<sup>10</sup> *Id.*

<sup>11</sup> The county transient occupancy tax statutes specifically enumerate the counties that are authorized to impose the transient occupancy tax at a rate that exceeds 2%, and in each case, impose the tax on occupancy charges. In order to ensure that the mark-up charges would be subject to the tax in each of these counties, the language had to be changed for every county transient occupancy tax provision. See e.g., Va. Code § 58.1-3820 *et. seq.*

<sup>12</sup> Va. Code § 58.1-3843.

## SECTION II OTHER STATES

### State and Local Attempts to Determine the Taxability of Online Reservation Fees

Given that most local ordinances and state statutes were drafted long before the inception of the Internet, there is little clear guidance as to the taxability of mark-up fees imposed by OTC's. States, localities, and taxpayers have thus sought to address the taxability of these fees judicially, administratively, and by legislative enactments.

#### Litigation

Litigation has thus far been the most common method by which localities and taxpayers have sought to determine the taxability of fees imposed by online travel companies. In cities in 22 states, local officials have filed suit against OTC's, contending that the mark-up fees are subject to tax. Currently, more than forty court cases are pending across the country. Thus far, Florida is the only state that has filed a similar suit. The cases vary in result, with the determination ultimately turning on the specific language of the taxing statute or ordinance.

Much like Virginia's Retail Sales and Use Tax and local occupancy tax statutes, many local ordinances in other states require that the local sales or occupancy tax be charged by the operators or owners of the accommodations. Thus, courts have had to address the issue of whether online travel companies constitute operators for purposes of these ordinances. Often, when an ordinance contains this language, the courts have dismissed the local government's suit seeking to impose the local sales or occupancy tax on the mark-up fee, concluding that OTC's are not operators or owners of the accommodations. For example, in *Louisville/Jefferson County v. Hotels.com*, the Sixth

Circuit United States Court of Appeals granted Hotels.com's motion to dismiss on the basis that OTC's do not physically control or furnish the rooms they advertise, as required by the county ordinance.<sup>13</sup> Similarly, in *City of Gallup v. Hotels.com*, the United States District Court determined that OTC's are not hotel operators under the city's Lodger's Tax Ordinance, and therefore, the tax is only imposed on the amount paid to the hotel operators, and not the full amount charged to the customer.<sup>14</sup> In *City of Orange v. Hotels.com*, the U.S. District Court granted the OTC's motion to dismiss the case because the ordinance imposed the occupancy tax on the consideration paid to the hotel or motel, and OTC's were not included in this class.<sup>15</sup>

In some cases, however, courts have denied motions to dismiss filed by OTC's that have raised the argument that they do not own or operate the applicable accommodation. For example, in *Leon County v. Hotels.com*, the county's ordinance placed the duties of charging, collecting and remitting the tax on "the person receiving the consideration for the lease or rental." Despite the OTC's contention that the hotels were the only entities subject to the foregoing duties, the United States District Court ruled that the OTC's qualified as entities that "received the consideration for the lease or rental" because they purchased rooms at a discounted rate and subsequently rented, leased or let the rooms to their customers.<sup>16</sup> Similarly, in *City of Antonio v. Hotels.com*, the United States District Court denied the OTC's motion to dismiss, despite language in the ordinance levying the tax on any person or entity owning, operating, managing, or controlling any hotel. Based on San Antonio's allegation that the OTC's had a right to

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<sup>13</sup> *Louisville/Jefferson County Metro Gov't v. Hotels.com*, 590 F.3d (381) (2009).

<sup>14</sup> *City of Gallup v. Hotels.com*, (2:07-cv-00644-JEC-RLP) District of New Mexico (2007).

<sup>15</sup> *City of Orange v. Hotels.com*, 2007 WL 2787985 (E.D. Tex.) (2007).

<sup>16</sup> *Leon County v. Hotels.com, L.P.*, 2006 WL 3519102, (2006).

control occupancy as a result of their contracts with the hotels, the Court concluded that San Antonio could recover given the right facts.<sup>17</sup> In *City of Charleston v. Hotels.com*, in which Charleston's ordinance imposed the tax on entities engaged in furnishing accommodations to transients, the United States District Court denied Hotels.com's motion to dismiss because the court concluded they had received money in exchange for "supplying" hotel rooms.<sup>18</sup>

Some ordinances that require owners or operators to charge the tax extend the same authority to "similar type businesses." Based on this language, localities have contended that online travel companies are required to charge the tax because they are businesses that are of a similar type to hotels, motels, or other accommodation providers. Thus far, the courts have not been persuaded by this argument.<sup>19</sup>

Alternatively, some court decisions have turned on whether the locality complied with mandatory administrative tax assessment procedures prior to bringing suit against the taxpayers. While courts have sometimes remanded or dismissed cases based on a city's failure to comply with these procedures, others have ruled that this does not bar a locality's ability to bring suit. In *City of Rome, Georgia v. Hotels.com*, Georgia law mandated that the city first estimate, assess, and attempt to collect the excise taxes at issue from the defendants before pursuing litigation against the defendants for violating Georgia's Excise Tax Act. The United States District Court stayed the case pending the

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<sup>17</sup> *City of San Antonio v. Hotels.com* 2007 WL 1541184 (2007)

<sup>18</sup> *City of Charleston v. Hotels.com*, 586 F.Supp.2d 538 (2008).

<sup>19</sup> See *Pitt County v. Hotels.com, L.P.*, 553 F.3d 308 (2009), in which the U.S. Court of Appeals, 4<sup>th</sup> Circuit, ruled that hotels, motels, tourist homes, and tourist camps all provide lodging to patrons on site and are all physical establishments with rooms where guests can stay. Because OTC's do not physically provide the rooms, the court ruled that they are not a business that is of a similar type to a hotel, motel, or tourist home or camp.

city's exhaustion of administrative remedies.<sup>20</sup> In *City of Atlanta v. Hotels.com*, a Fulton County judge granted the OTC's motion to dismiss, declaring that the city must first exhaust its administrative remedies before pursuing litigation, and the Georgia Court of Appeals affirmed the lower court's decision. The Georgia Supreme Court overturned this decision, holding that the city's failure to exhaust administrative remedies did not preclude adjudication of the claim for declaratory judgment as to threshold legal issues regarding the applicability of hotel tax ordinances. The Supreme Court vacated the lower court's judgment and directed the trial court to adjudicate the city's claim for declaratory judgment as to the applicability of the hotel tax ordinance.<sup>21</sup>

### Administrative Responses

Some states have chosen to address the taxability of mark-up fees by issuing regulations, private letter rulings, tax bulletins, or similar guidance. As with the courts, states and localities generally look to the language in the statute or ordinance when providing administrative guidance as to the taxability of the fees.

In a January 1, 2009 Letter of Finding, the Indiana Department of State Revenue determined that the total charges imposed by the third party intermediary were subject to Indiana's sales tax.<sup>22</sup> Further, because these charges were paid to the third party intermediary, the intermediary was responsible for the collection and remittance of the sales tax to the Indiana Department of State Revenue. Language in Indiana's sales tax code provided that every rental or furnishing by a retail merchant is a separate unitary

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<sup>20</sup> *City of Rome, Georgia v. Hotels.com*, 2007 WL 6887932 (N.D.Ga.) (2007).

<sup>21</sup> See also *Anaheim v. Super. Ct*, 179 Cal. App. 4<sup>th</sup> 825 (2009), *Affirmed Orange County Super. Ct trial judge's ruling that OTC's were entitled to challenge the tax, despite that they had not paid the totality of the assessment.*

<sup>22</sup> *Indiana Letter of Finding No. 08-0434* (February 1, 2009).

transaction, regardless of whether consideration is paid to an independent contractor or directly to the retail merchant. The statute defined unitary transaction to include all items of property and/or services for which a total combined charge or selling price is computed for payment, irrespective of the fact that services which would not otherwise be taxable are included in the charge or selling price.

Other states have sought to establish policies based upon the structure of the transactions between the OTC and the accommodations provider. The state of Texas, for example, has opined that a travel company is subject to tax if it contracts with hotels for a block of hotel rooms; is guaranteed access to the rooms; bears an inventory risk for the rooms; or is required to pay for every room in a block, even if some go unoccupied or are canceled.<sup>23</sup> In Texas, the key factor in determining the tax responsibility of a hotel reservation service company is whether the company is acting as an agent for guests in obtaining hotel accommodations or is acting as a hotel that rents rooms to guests.<sup>24</sup>

### State and Local Government Legislative Enactments

As the number of online accommodation reservations continues to increase, many states and localities have sought to enact legislation that would impose the tax on the OTC's mark-ups. Currently, only two states have been successful in this endeavor. In 2010, the state of North Carolina incorporated language into its budget indicating that facilitation fees and similar fees are considered charges necessary to complete the

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<sup>23</sup> *Texas Policy Letter Ruling 200308379L*, August 22, 2002.

<sup>24</sup> *Texas Policy Letter Ruling 200310132L*

rental of the accommodation, and are included in the sales price.<sup>25</sup> The budget bill further provides that persons authorized to facilitate the rental of an accommodation are included under the definition of a retailer. The budget further requires the third party intermediary to report the sales price to the accommodations provider, who is liable for the tax. If the third party intermediary fails to report the sales price to the provider or understates the sales price reported to the accommodations provider, the intermediary becomes liable for tax due on the unreported or underreported sales price. The provisions of the budget bill require OTCs to comply beginning January 1, 2011. North Carolina anticipates that this change will increase revenues by \$1.7 million.<sup>26</sup>

On August 11, 2010, the state of New York's 2010-2011 revenue budget was approved. The budget contains provisions requiring that room remarketers charge and collect sales tax on the mark-up fees. "Room remarketer" is defined as a person who reserves, arranges for, conveys, or furnishes occupancy, whether directly or indirectly, to an occupant for rent in an amount determined by the room remarketer, directly or indirectly, whether pursuant to a written or other agreement." The legislation also amends New York City's locally-administered hotel room occupancy tax to conform it to the methodology of the state tax in regard to room remarketers. The legislation will take effect on September 1, 2010.<sup>27</sup>

Several other states introduced bills in their legislative bodies in 2010 that ultimately failed. In Florida, House Bill 335 would have required online travel companies to collect tax on the full amount paid by customers. The bill died in the House Finance

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<sup>25</sup> Current Operations and Capital Improvements Appropriations Act of 2010, SB 897, S.L. 2010-31

<sup>26</sup> The Joint Conference Committee Report on the Continuation, Expansion and Capital Budgets, Senate Bill 897, North Carolina General Assembly, June 28, 2010, p 5, Line 25.

<sup>27</sup> New York Budget Bill, A09710D (2010).

& Tax Council Committee.<sup>28</sup> An opposing bill, which would have clarified that sales tax is due only on the wholesale accommodations price, passed the Florida House, but died in the Senate Messages Committee.<sup>29</sup> In Minnesota, H.F. 3687 would have clarified that the Minnesota sales tax applies to the full price that an online or similar travel service charges for Minnesota hotel rooms. The bill failed to make it out of the House policy committees.<sup>30</sup>

Missouri is one of the few states that has enacted legislation declaring that the fees imposed by travel agents or intermediaries are not subject to state or local transient occupancy taxes. House Bill 1442, enacted during the 2010 legislative session, specifies that any state or local tax imposed on transient accommodations would only apply to amounts actually received by the operator of an accommodation, and precludes travel agents and intermediaries from being deemed operators of a hotel, motel, inn, tourist camp, or similar business, unless the travel agent or intermediary actually operates the facility.<sup>31</sup>

As with states, some local governments have enacted ordinances to clarify the local sales and transient occupancy tax treatment of these facilitation fees. For example, on November 3, 2009, voters in the city of South San Francisco approved a measure that expressly made hotels responsible for payment of the transient occupancy tax applicable to the entire amount that a guest ultimately pays for the use of a room. In a subsequently issued Administrative Interpretation of this measure, the City Finance Director clarified that the City would apply the tax only to the net room rate, after some

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<sup>28</sup> H.B. 335, 2010 Leg. (FL. 2010) .

<sup>29</sup> H.B. 1241, 2010 Leg. (FL. 2010).

<sup>30</sup> H.F. 3687, 2010 Leg., 86<sup>th</sup> Sess. (Mn. 2010).

<sup>31</sup> H.B. 1442, 95<sup>th</sup> Gen. Assem. Sess. (Mo, 2010).

online entities removed South San Francisco hotels from their websites in response to the measure.

New York and North Carolina's budget provisions have yet to take effect. As these are the only states that have enacted laws imposing the tax on the mark-up, this leaves other states hoping to enact similar provisions with little guidance as to how to structure such provisions to ensure significant revenue gain for the state and its localities and to avoid litigation.

### **Multistate Tax Commission Efforts**

In 2004, the Uniformity Committee of the Multistate Tax Commission ("MTC") commenced efforts to develop a Model Statute for collecting and remitting tax on the mark-up fee.<sup>32</sup> Under the terms of the Model Statute, the intermediary would collect tax on the full retail price charged to its customers, remit the tax on the discounted rate to the accommodations provider, and remit the tax on the mark-up fee to the appropriate taxing agency. The provisions of the Model statute differ from Senate Bill 452 in that the Model Statute contains additional safe harbor provisions as well as provisions addressing bundling.

Multistate Tax Commission proposals must undergo an extensive review process before being recommended to the states. The uniformity committee reviews the proposal and subsequently solicits public comments from the general public. Later, a public participation working group is created and a formal public hearing is conducted. Based on information presented at the public hearing, the hearing officer or hearing

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<sup>32</sup> Hearing Officer's Report, Proposed Model Statute on the tax Collection Responsibilities of Accommodations Intermediaries. Multistate Tax Commission

panel makes a recommendation on the draft, which the Executive Committee reviews and uses to determine whether it will pass the proposal on to the Commission. Before passing the proposal on to the Commission, the Executive Committee must authorize a polling of the affected Commission Member States to ensure that a majority of the affected States would consider adoption of the draft proposal. Currently, the OTC model statute is in this step of the review process.<sup>33</sup>

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<sup>33</sup> Uniformity Recommendation Development Process, available at [www.mtc.gov/Uniformity.aspx?id=448](http://www.mtc.gov/Uniformity.aspx?id=448)

**SECTION III**  
**POSSIBLE ISSUES WITH TAXING ONLINE RESERVATION FEES**  
**“RESERVATION FEES” ARE NOT BEING TAXED**

### Constitutional Nexus

Most OTC’s do not have physical places of business in Virginia. This raises the issue as to whether it is constitutionally permissible for Virginia to require these nonresident entities to collect Virginia’s Retail Sales and Use Tax on the mark-ups they impose.

The Commerce Clause of the United States Constitution reserves to Congress the power to regulate commerce among the states and with foreign nations. The U.S. Supreme Court has established a four-prong test to be used in determining whether a state tax on an out-of-state corporation’s activities in interstate commerce violates the Commerce Clause. A state may require an entity engaged in interstate commerce to collect taxes on its behalf provided the tax is 1) applied to an activity with a substantial nexus with the taxing State; 2) is fairly apportioned; 3) does not discriminate against interstate commerce; and 4) is fairly related to the services provided by the state.

*Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The U.S. Supreme Court has also determined, in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) that the Commerce Clause barred a state from requiring an out-of-state mail-order company to collect use tax on goods sold to customers located within the state when the company had no outlets, sales representatives, or significant property in the state **(UNLIKE A HOTEL ROOM-NIGHT THE GOODS IN QUESTION WERE NOT PRODUCED, NOR WAREHOUSED, WITHIN NORTH DAKOTA)**. In this case, the Court determined that

only Congress has the authority to require out-of-state vendors, without a physical presence in a state, to register and collect that state's tax.

Virginia law specifically sets out the standards for requiring out-of-state dealers to collect the Virginia Retail Sales and Use Tax on sales into the Commonwealth. The law provides that a dealer is deemed to have sufficient activity within the Commonwealth to require that dealer to register to collect the Virginia Retail Sales and Use Tax if the dealer:

- Maintains an office, warehouse, or place of business in the Commonwealth;
- Solicits business in the Commonwealth, by employees, independent contractors, agents, or other representatives;
- Advertises in Commonwealth publications, on billboards or posters located in the Commonwealth, or through materials distributed in the Commonwealth;
- Regularly makes deliveries into the Commonwealth by means other than common carrier;
- Continuously, regularly, seasonally, or systematically solicits business in the Commonwealth through broadcast advertising;
- Solicits business in the Commonwealth by mail, provided the solicitations are continuous, regular, seasonal, or systematic and the dealer benefits from any banking, financing, debt collection, or marketing activities occurring in the Commonwealth;
- Is owned or controlled by the same interests which own or control a business located within this Commonwealth;
- Has a franchisee or licensee operating under the same trade name in the Commonwealth, if the franchisee or licensee is required to obtain a certificate of registration; or

- Owns tangible personal property that is rented or leased to a consumer in the Commonwealth, or offers tangible personal property, on approval, to consumers in the Commonwealth.<sup>34</sup>

Because OTC's rarely maintain physical places of business in the states in which the sales and occupancy taxes are collected, some OTC's may contend that they are not required to collect the state's or localities' taxes because they have no nexus in the given state **(IRRELEVANT, SEE ABOVE)**. With respect to the ongoing national litigation, OTC's have rarely cited this argument in their motions to dismiss. Similarly, courts have tended not to address the nexus issue, opting instead to determine whether the state statute or local ordinance requires the OTC to collect the sales or occupancy taxes.

While the nexus argument has yet to reach the courts **(SEE COLUMBUS, ABOVE)**, the issue has surfaced as part of the debate as to the taxability of online intermediary fees. Because some OTC's hire independent inspectors or other representatives to visit hotels in their databases and verify the amenities and quality of the applicable properties,<sup>35</sup> some localities contend that this is sufficient to give the OTC's nexus in the states where the hotel inspections take place.

Virginia's nexus statute provides that if an independent contractor, employee, or other representative of an OTC travels to Virginia to solicit sales or business in the Commonwealth, this would provide sufficient nexus to require the out-of-state OTC to collect Virginia's sales and use taxes. However, it is not likely that an OTC inspector's activities would rise to the level of soliciting business, as contemplated by the statute.

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<sup>34</sup> Va. Code § 58.1-612.

<sup>35</sup> Stanford, *supra* note 3, at 322.

In an administrative ruling issued by TAX in 1998,<sup>36</sup> an interior decorator located outside of Virginia periodically visited Virginia customers as a part of its consulting service. The Tax Commissioner determined that “the fact that the taxpayer makes periodic visits to its customers as a part of its consulting services does not, by itself, create nexus with Virginia. However, if the taxpayer’s employees, agents or other representatives solicit sales while in Virginia, nexus is created.” Thus, the statute requires that the Virginia visits have a solicitation component involving more than simply meeting and consulting with clients.

Some commentators have also argued that when hotels set aside a block of their rooms for OTC’s (HOTELS DO NOT SET ASIDE BLOCKS OF ROOMS FOR OTCs.) the OTC’s are essentially granted property rights in these rooms, located in Virginia, which, they argue, gives the OTC physical presence in the taxing state. If OTC’s are granted a property right in the rooms that are set aside, this satisfies Virginia’s nexus statute. Of course, this argument would only be valid for those OTC’s that are determined to be engaged as “resellers” of rooms.

As more states enact legislation imposing the tax on OTC’s mark-up fees, the courts will likely resolve the question of nexus.

### **Inclusion of Separate Services in the Accommodations Tax Base**

In Virginia, charges for services are generally exempted from the Retail Sales and Use Tax. Services provided in connection with sales of tangible personal property, however, are taxable. The determination as to whether the fee imposed by OTC’s

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<sup>36</sup> Public Document 98-147 (October 10, 1998)

constitutes a charge for a service is thus relevant to the discussion as to the sales tax implications of these fees. **(NOT TRUE, THE FEES CHARGED BY OTCs ARE IRRELEVANT AND IN NO WAY PERTINENT TO THIS MATTER, THE ISSUE IS THEIR FAILURE TO RENDER 100 PERCENT OF THE APPLICABLE TAX)**

OTC's provide their customers a means of reserving hotel rooms in remote locations without having to use the long process that was often undertaken prior to the advent of OTC's, of researching and determining which hotels are located in an area, individually contacting hotels in the area to determine the availability and room rates, analyzing the information to judge which facility is most appropriate, and then calling the selected hotel and making a room reservation.<sup>37</sup> Using an OTC, a customer can locate available hotel accommodations based on specified search criteria, use web-based tools to review, sort, and compare offerings from the identified travel accommodations providers, and have access to the lowest available prices that accommodations providers are willing to accept for the sale of their accommodations. The OTC's also process and transmit payments to hotels on behalf of the customers. OTC's thus argue that they are providing a service to their customers, in that the customers can now obtain this information and make a reservation via the OTC's website. They argue that because these fees are services, taxing them as a component part of the accommodations constitutes a departure from Retail Sales and Use Tax conventions.

While services in Virginia are generally not taxable, there are certain exceptions, particularly the provision of accommodations to transients for less than 90 days.

Virginia also authorizes the taxation of additional charges that are bundled together with

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<sup>37</sup> Memorandum from Jonathan E. Perkel, Senior Vice President of Travelocity, to Roxanne Bland, Multistate Tax Commission (August 20, 2009).

the rental of accommodations,<sup>38</sup> and sometimes, the charges are for services that are not directly related to the provision of accommodations and are imposed by unrelated third-parties. For example, in PD 06-1 (January 4, 2006), a rental car that was bundled into the price of a hotel room was subject to Virginia's Retail Sales and Use Tax, despite that the rental car charge was imposed by a separate third party entity.<sup>39</sup> Thus, even if these fees are imposed on services that are not directly related to the provision of accommodations, including these services in the tax base would not be a departure from the current policy in Virginia.

### **Resellers or Intermediaries**

There is also little authority in Virginia as to whether OTC's are serving in the capacity of resellers or intermediaries. OTC's assert that they are not resellers, but rather independent service providers acting for their own accounts, selling services to customers in connection with the customers' purchase of accommodations. For example, Travelocity uses a global distribution system, through which it transmits a customer's information to the hotel in which the customer makes the reservation. The hotel does not give Travelocity the authority to assign customers to particular rooms, nor can Travelocity perform any other activities that would indicate ownership or control of the rooms at issue.<sup>40</sup>

Virginia provides neither a statutory nor regulatory definition of "resale." The law defines a "retail sale" or "sale at retail" as "any transfer of title or possession, or both,

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<sup>38</sup> 23 VAC § 10-210-730(C).

<sup>39</sup> Also see *e.g.*, Public Document 95-17 (February 2, 1995), *entire charge for hotel room, breakfast, a round of golf and a complimentary tee gift was subject to the tax.*

<sup>40</sup> Perkel, *supra* note 33 at 1.

exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means, whatsoever, of tangible personal property, and any rendition of a taxable service for a consideration.”<sup>41</sup> The definition further provides that “all sales for resale must be made in strict compliance with regulations applicable to this chapter.”<sup>42</sup>

Nor has the Virginia Supreme Court had occasion to address the issue of whether a third party intermediary marketing rooms online for travelers is a reseller of rooms. The Court has laid out some facts that may indicate that a company should be characterized as a reseller. For example, in *Commonwealth of Virginia v. United Airlines*,<sup>43</sup> the Virginia Supreme Court held that an airline’s purchase of food for service to its passengers on airline flights constitutes a “sale at retail” to the airline for its use and consumption, rather than a sale for resale. The Court determined that this was not a sale for resale based on the fact that: 1) the airlines did not separately consider and charge for the meals, but rather, treated the meals as a commercial amenity and operating expense, necessary in the field of air transportation; 2) there was no fixed agreement as to the meal the airline would serve the passenger and the charge he would pay; 3) the airline did not acquire the food from the vendor for resale to its passengers for a valuable consideration, which is required to meet the definition of retail; and 4) the airline was selling transportation by air, not meals.

Similarly, in transactions between OTC’s and travelers, the OTC’s do not separately consider and charge for the facilitation services. Rather, they lump these fees in with the other accommodations charges. The Court also pointed out that the

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<sup>41</sup> Va. Code § 58.1-602.

<sup>42</sup> *Id.*

<sup>43</sup> *Commonwealth of Virginia v. United Airlines, Inc.*, 219 Va. 374, 248 S.E.2d 124 (1978).

airline was selling transportation by air, not meals; much like the OTC is selling the service of facilitation reservations for hotel accommodations, rather than the actual accommodations.

Because Virginia's law is silent as to the definition of resale, absent some interpretation by the Virginia courts, it will be left to the legislature to clarify whether OTC's are acting in the capacity of resellers.

### **Possibility of Federal Legislation**

While states and localities have sought to address this issue through statutes, ordinances, and litigation, OTC's are seeking a federal legislative solution. Language for a federal bill, referred to as the "Internet Travel Tax Fairness Act, that would prevent states and localities from imposing their sales, use, or occupancy taxes on the online travel companies' reservation fees has been circulating on Capitol Hill. Under the proposal, taxes on hotel accommodations would be computed based on the amount that the hotel receives in payment from the hotel occupant, rather than the total amount that the online travel company receives. The proposal is drafted to preclude hotels and other accommodation providers from creating a joint venture or affiliate to shelter amounts paid by consumers from occupancy tax. The proposal also gives states discretion to tax online travel booking services, provided the state generally taxes services.

OTC's have made several similar attempts to shield their reservation fees from state and local taxes through federal legislation. During Senate Finance Committee proceedings, several OTC's proposed an amendment to the American Recovery and

Reinvestment Act of 2009, to eliminate hotel room rental taxes and sales taxes associated with room rentals, whenever the rentals were facilitated through a travel agent or OTC, but the amendment was ultimately not offered. Prior to that, during the 2007 and 2008 sessions of Congress, similar amendments were withdrawn from consideration. The Internet Travel Tax Fairness Act is still being drafted, and has yet to be introduced in Congress this year.

Clearly, if federal legislation prohibits states from imposing the tax on these fees, a Virginia statute authorizing the imposition of these taxes would be pre-empted.

### **Right of Localities to Impose the Transient Occupancy Tax Directly on Consumers**

Virginia law authorizes counties, cities, and towns to impose transient occupancy taxes through their local ordinances. The language used in the enabling statutes to grant counties the authority to impose these taxes differs from the language of the enabling statutes granting cities these powers. *Va. Code* § 58.1-3819, subsection (A) provides that any county, by duly adopted ordinance, may levy a transient occupancy tax on hotels, motels, . . . and other facilities offering guest rooms.” (*Emphasis added*).

Subsection (D) of the statute provides:

[A]ny county, city or town which requires local hotel and motel businesses, or any class thereof, to collect, account for and remit to such locality a local tax imposed on the **consumer**, may allow such businesses a commission for such service in the form of a deduction from the tax remitted.” (*Emphasis added*)

Because there are specific references to hotels and consumers in subsections A and D respectively, the Virginia Supreme Court has interpreted these provisions to

authorize counties to enact transient occupancy tax ordinances holding either the consumer, the hotel, or both liable for the payment of the taxes.<sup>44</sup> Thus, an Arlington County ordinance that allowed a hotel to collect the tax from the consumer, but required the tax to be accounted for and paid by the hotel, regardless of whether the hotel collected the tax from the consumer of the services was deemed permissible by the Court.<sup>45</sup>

By contrast, *Va. Code*, § 58.1-3840 provides in part: “[A]ny city or town having general taxing powers...may impose excise taxes on ...**transient room rentals**.” (*Emphasis added*). Because the language imposes the tax on transient room rentals, it is unclear whether this gives cities the authority to impose the tax on hotels only, on the consumer only, or, as with counties, on both entities. The language does not specifically preclude any of these scenarios.

Thus the enabling statutes for counties, cities, and towns could potentially result in courts rendering different decisions as to which entity is required to pay the local occupancy tax. The Virginia Supreme Court has not ruled on the issue of whether excise taxes imposed on transient room rentals gives a city or town the authority to impose the tax on hotels or on the consumer. If the Virginia Supreme Court were to interpret *Va. Code* § 58.1-3840’s reference to “transient room rentals” to allow a direct tax only on hotels, then city and town ordinances authorizing the tax directly on consumers could be declared invalid. Because there is little guidance as to how “transient room rentals” should be interpreted, the Virginia General Assembly should

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<sup>44</sup> *Delta Air Lines, Inc. v. County Board of Arlington County*, 242 Va. 209, 409 S.E. 2d 130 (1991).

<sup>45</sup> *Id.*

exercise caution in conforming the language in the county enabling statute to mirror the language of the enabling statute for cities and towns.

Several local ordinances impose the tax directly on the transient and mandate that the accommodation provider collect the tax. In most of these ordinances, the tax is deemed “held in trust” until the accommodations provider remits the tax to the local taxing jurisdiction.<sup>46</sup> Because the vast majority of ordinances tend to address whether these taxes are to be held in trust, this does not need to be clarified in the enabling statutes.

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<sup>46</sup> See e.g., ALEXANDRIA, VA., CODE §§ 3-2-142 and 3-2-144; ALTA VISTA, VA., CODE §§ 70-82 and 70-85; CHARLOTTESVILLE, VA., CODE §§ 30-253 and 30-255; NORFOLK, VA., CODE §§ 24-234 and 24-235; VIRGINIA BEACH, VA., CODE §§ 35-159 and 35-161; *But see* ARLINGTON, VA., CODE § 40-2; FAIRFAX, VA., CODE § 4-13-2 (*imposing the tax on ‘every transient,’ but not specifying that the tax is to be collected by the accommodation provider and held in trust*).

## SECTION IV IMPACT OF TAXING ONLINE RESERVATION FEES

### Fiscal Impact on States and Localities

#### Breakdown of State and Local Impact

	<b>FY 2012</b>	<b>FY 2013</b>	<b>FY 2014</b>
Sales and Use Tax Breakdown			
<i>General Fund-Unrestricted</i>	\$1.08	\$1.12	\$1.15
<i>General Fund-Restricted</i>	\$0.43	\$0.44	\$0.46
<i>Transportation Trust Fund</i>	\$0.22	\$0.23	\$0.24
<i>Local Option</i>	\$0.44	\$0.46	\$0.47
Total Sales and Use Tax	\$2.17	\$2.24	\$2.31
Local Transient Occupancy Tax	\$2.43	\$2.51	\$2.59
<b>Total Sales and Transient Occupancy Taxes</b>	<b>\$4.61</b>	<b>\$4.76</b>	<b>\$4.91</b>

#### Total State and Local Impact of Sales and Transient Occupancy Taxes

	<b>FY 2012</b>	<b>FY 2013</b>	<b>FY 2014</b>
State Impact	\$1.73	\$1.79	\$1.84
Local Impact (Transient Occupancy and Local Option)	\$2.88	\$2.97	\$3.06
<b>Total Sales and Transient Occupancy Taxes</b>	<b>\$4.61</b>	<b>\$4.76</b>	<b>\$4.91</b>

\*Estimates were rounded to the nearest \$10,000.

### Total State and Local Impact

There are approximately 233 online travel agencies doing business in the United States. Sales transacted through OTC's make up approximately 10.3% of all hotel transactions in Virginia. (SOURCE?) The difference between the prices the accommodations providers charge the OTC's and the final price the OTC's charge consumers has been estimated to fall between 25 and 40%.<sup>47</sup> As shown in the table above, assuming a retail mark-up of 32.5 %, if the fees imposed by OTC's were subject to tax effective July 1, 2011, Virginia's state and local governments would experience an

<sup>47</sup> Stanford, *supra* note 3 at 320.

increase in revenue totaling \$4.61 million in Fiscal Year 2012, \$4.76 million in Fiscal Year 2013, and \$4.91 million in Fiscal Year 2014. This total estimate includes revenue from the state and local Retail Sales and Use Tax and the local transient occupancy taxes. The Virginia Department of Taxation has not factored in any potential revenue loss resulting from OTC's that are not subject to the tax because they lack nexus or OTC's that boycott a state or locality as a result of legislation imposing the tax on the mark-up fees.

#### Total Retail Sales and Use Tax Impact

Using the same assumptions as set forth above, if the fees imposed by OTC's were subject to tax in Virginia, there would be an increase in Retail Sales and Use Tax revenue of \$2.17 million in Fiscal Year 2012, \$2.24 million in Fiscal Year 2013, and \$2.31 million in Fiscal Year 2014. This estimate includes revenue from the 1% local Retail Sales and Use Tax.

#### Local Tax Revenues

Using the same assumptions as set forth above, if the fees imposed by OTC's were subject to tax in Virginia's localities, there would be an increase in 1% local sales taxes and occupancy taxes totaling \$2.88 million in Fiscal Year 2012, \$2.97 million in Fiscal Year 2013, and \$3.06 million in 2014. This total includes an increase in transient occupancy tax revenues of \$2.43 million in Fiscal Year 2012, \$2.51 million in Fiscal Year 2013, and \$2.59 million in Fiscal Year 2014.

## Impact on OTC's

Not surprisingly, online travel companies oppose the imposition of state and local taxes on their mark-ups, primarily because they believe that filing local tax returns in 7,000 local jurisdictions across the country, each with varying tax rates and compliance requirements, would create an unmanageable and costly administrative burden.<sup>48</sup>

OTC's would need to change their software in order for the tax to be properly calculated, collected, reported, and remitted on the fees for booking services.<sup>49</sup> For example, while fees for hotel rooms are generally refunded if the booking for the accommodation is canceled prior to the provision of accommodations, generally, the fees OTC's impose for booking services are non-refundable.<sup>50</sup> **(How do OTCs currently obtain the tax rates for the 7,000 jurisdictions in which they now do business and how do they currently calculate the tax? Obviously, the hotels provide the OTCs with the rate and these would be the same rates they would use for applying tax to their mark-up. Were this truly an issue, the natural question is, "How then do the OTCs calculate the taxes that they are currently rendering?" Further, with modern technology, there are a plethora of software companies and solutions to solve this issue. As an example, local treasurer's offices work with "tax services" which routinely keep track of property values and tax rates, globally.)**

Some OTC's suggest that the difficulty in tracking the various rules and rates for the collection of taxes across cities, counties, and states may inadvertently lead to

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<sup>48</sup> See Perkel, *supra*, note 33 at 2.

<sup>49</sup> Leavy, *supra* note 37 at 7.

<sup>50</sup> *Id.*

double taxation. (There is no double taxation and this argument should be eliminated because it is baseless. Under the current scenario, whether rooms are sold directly by the hotel or via an OTC, the customer is charged the sales and occupancy tax and the hotel remits the tax to the correct jurisdiction. The legal entity recording the revenue for this hotel then calculates federal and state income tax on the net income earned, like every other corporation in America. Under the proposal to tax the OTCs, it is the same scenario. The sales and occupancy tax would be collected from the guest. The OTC would hold this tax in trust and remit the tax to the correct jurisdiction. The legal entity recording the revenue for this OTC then calculates federal and state income tax on the net income earned, just like the hotels do. The OTCs argue that they pay income tax – but so does every other corporation. There is no double taxation here.) They argue that local occupancy tax ordinances are designed to apply to hotel owners and operators that have physical premises in the various taxing jurisdictions, and therefore may reasonably be expected to know the tax rates and requirements for the jurisdiction, and are better equipped to comply with the tax collection and filing requirements in each jurisdiction.

In Virginia, the local sales and use tax rates are uniform across the state. Local transient occupancy tax rates, however, vary across the state. If Senate Bill 452 were enacted, uniform local sales tax rates would likely ease the difficulty in tracing and complying with the tax filing and collection requirements in Virginia localities, but due to the varying transient occupancy tax rates, some difficulty would remain.

OTC's are also concerned that this type of legislation may force them to reveal the negotiated discount rate at which the accommodation providers make their rooms available. OTC's argue that if this information is disclosed to their customers, it may discourage the use of OTC's and could be detrimental to their business model. This is not an issue under Senate Bill 452, as drafted, because the bill only requires that the accommodations intermediary separately state the amount of the tax on the bill and add the tax to the room charge. There is no requirement that the tax be separately itemized for each individual charge.

### **Potential to Reach Traditional Travel Agents**

Senate Bill 452 defines "accommodations intermediary" as any person, other than an accommodations provider, that facilitates the sale of an accommodation and charges a room charge to the customer." "Facilitating the sale" is intended to include brokering, coordinating, or in any other way arranging for the purchase of, or the right to use accommodations by a customer. The Virginia Department of Taxation understands that the intent of Senate Bill 452 was to reach intermediaries that use the merchant model; nevertheless, the bill's language arguably encompasses traditional travel agents, consolidators, and other brokers, and would exceed the intended scope of the bill. If the legislature does not intend to reach traditional travel agents, consolidators, and other brokers, the term "accommodations intermediary" and the definition for such term should be stricken from the Retail Sales and Use Tax and local transient occupancy tax provisions.

In addition, each reference to “accommodations intermediaries” currently contained in the bill should be replaced with the term, “online travel intermediary.”

### Impact on Time Shares and other Vacation Rentals

Generally, Virginia law treats the rental of vacation homes the same as the rental of hotel rooms and other accommodations for state sales tax purposes. Under *Va. Code* § 58.1-602, the Retail Sales and Use Tax is imposed on the rental of any room or rooms, lodgings, or accommodations furnished to transients for less than 90 continuous days, which includes charges imposed by any “hotel, motel, inn, tourist camp, tourist cabin, camping grounds, club, **or any other place in which rooms, lodging, space or accommodations are regularly furnished to transients for a consideration.**” (*Emphasis added*). Provided the rental accommodations are furnished to the transient for less than 90 continuous days, and the transient has not obtained an interest in the property,<sup>51</sup> the rental of vacation properties will generally be subject to the Retail Sales and Use Tax in Virginia.

County transient occupancy taxes apply to a more limited category of accommodations. *Va. Code* § 58.1-3819 authorizes localities to impose a transient occupancy tax on hotels, motels, boarding houses, travel campgrounds, and other facilities offering guest rooms rented out for continuous occupancy. Vacation rentals are not included in the list, and are not subject to county occupancy taxes. This conclusion is supported by the fact that a bill was introduced during the 2010 General

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<sup>51</sup> *Va. Code* § 58.1-602 excludes from the definition of “transient” “a purchaser of camping memberships, time-shares, condominiums, or other similar contracts or interests that permit the use of, or constitute an interest in, real estate. See also PD 06-145 (December 8, 2006).

Assembly Session that would have added single-family residences to the list of accommodations rentals that are subject to the county occupancy tax.<sup>52</sup> The bill was defeated in the House.

The enabling statute authorizing the imposition of transient occupancy taxes in cities and counties does not provide an enumerated list of accommodations that are subject to transient occupancy tax. *Va. Code* § 58.1-3840 authorizes the imposition of transient occupancy taxes on “transient room rentals,” but the statute does not provide a definition for this term. Thus, there is no statutory provision prohibiting localities from imposing the tax on the rental of vacation homes.

If Virginia’s legislature changed the law to render mark-up fees imposed by OTC’s subject to the transient occupancy tax, the rental of vacation homes would not be impacted. As counties are not currently authorized to impose the transient occupancy tax on vacation rentals, rental properties located in counties would not be subject to the tax. Nor would vacation rental properties located in cities and towns be impacted by this legislation. Transactions for the rental of vacation properties are generally structured so that the brokerage fee is built into the total cost of the rental. For example, in Virginia Beach, if an owner of a vacation rental hopes to net \$1,000 and the broker hopes to net \$100 for the rental, the broker will set the rental price at \$1,100, and the family renting will be subject to Virginia Beach’s transient occupancy tax on the full \$1,100 price. Because the mark-up fee is already included in the taxable base, legislation taxing the mark-up fee would have no visible impact in these cities.

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<sup>52</sup> See S.B. 342, 2010 Gen. Assem. Reg. Sess. (Va. 2010).

Further, under their current business models, OTC's do not market vacation rental homes. Unless OTC's changed their business models to advertise for the rental of vacation homes, these properties would not be impacted by legislation imposing sales and occupancy taxes on mark-up fees.

### **Impact on the Hotel Industry**

Senate Bill 452 outlined the process by which accommodation providers and intermediaries would be required to collect and remit the sales and occupancy taxes, as well as the liability imposed upon each party. The bill required the accommodation provider to collect from the intermediary the discount room charge, any additional charges imposed for use of the room, and any taxes associated with these charges, and to remit those taxes to the Department of Taxation or the local taxing authority. The bill specified that the accommodations provider would not be relieved of liability for additional charges imposed in connection with the use of the room. The bill also required that the accommodations provider separately state the amount of the tax on the bill or invoice and add the tax to the discount room charge, if applicable. The bill imposed the same requirements on the OTC with respect to the marked-up charge and the applicable taxes. Because the statute made each party independently liable for the charges they imposed and the taxes associated with those charges, the bill should not place any additional administrative burdens or liability on hotels.

















































