

Hotel Business Review

Original & Exclusive Content

Article: Lawsuits Target Online Travel Providers

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May 10-16, 2006

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YOU SAY TOMĀTO, I SAY TOMĀTO. CITIES SQUARE OFF AGAINST INTERNET TRAVEL PROVIDERS OVER OCCUPANCY TAXES.

Across the United States municipalities are suing Internet travel companies including Orbitz, Expedia, and Travelocity over hotel bookings. The reason? What they claim is a substantial underpayment of occupancy taxes. Cities like Los Angeles claim that the online sites pay occupancy taxes to the hotels based on the discounted rate at which they purchase or arrange rooms for the hotel, not at the alleged “retail” rate that they charge the customer. They claim the difference can amount to millions that rightfully belong in city coffers. Are the lawsuits a slam dunk? Not according to the Internet companies. They claim they merely add a service fee to the room rate and pass that charge on to the customer.

1. Framing the debate: Wherein a travel agent becomes a travel merchant.

In an amended complaint filed in February 2006 in the Los Angeles action, the City claims the websites operate in two ways: some it claims, purchase rooms and offer them for resale to their customers. Others “arrange” the reservation for their customers, informing the hotel of the booking and the customers’ relevant information. In either case plaintiff’s lawyer, Paul Kiesel, claims the occupancy taxes are owed on the rate ultimately charged the customer, not the lower rate at which the Internet travel companies contract with the hotel. He explains that transient occupancy tax (“TOC”) statutes require the occupant to pay taxes based on the rate paid by the occupant. Similar lawsuits are currently pending in San Diego, Philadelphia and the city of Fairview in Illinois.

Art Sackler, the Executive Director of Interactive Travel Services Association (“ITSA”), an industry trade group that represents Orbitz, Expedia and other online companies, claims the suits are based on a misconception. He says that occupancy taxes are included in the hotel prices listed online, and are then passed on to the hotels, which are responsible for remitting the taxes to municipalities. He explains that there are two basic models used for Internet hotel sales. The first, an “agent” model, simply charges a rate for the hotel to which occupancy taxes are added. This model does not appear to be implicated in most of the lawsuits. The second, the “merchant” model, is the bigger target. Under that model, the hotel and the Internet travel company negotiate a rate for the hotel room. The online provider then adds a service charge to the room rate and offers it at that higher price to the consumers. Sackler explains that the added service charge should not be subject to occupancy taxes because it is not part of the room rate. The service charge reflects the costs associated with operating and marketing the Internet-based travel company.

How will this issue be resolved? A judge may try to compare the practices of Internet travel providers with the model of traditional travel agents, ignoring the “merchant” model, where the Internet travel company casts itself as a reseller that adds a service charge for the room. In such an analysis, a judge would focus solely on the room rate ultimately paid by the customer, and ignore any component claimed to be a service charge.

How are occupancy taxes paid on rooms arranged by traditional travel agents? Carole

Friedman, a travel agent with Trident Travel in Los Angeles, explains that their agency does not charge service fees to the clients for whom it arranges hotel accommodations. They are paid a traditional commission, generally 8-10% of a hotel’s published room rate, for introducing its clients to the hotels. So does the hotel pay occupancy taxes on the full rate paid by the customer, or the rate less the commission paid to the travel agent? James Abrams, the President and CEO of the California Hotel & Lodging Association, says it’s the latter. “Hotels pay occupancy taxes on the entire amount the customer pays, including the commission.”

Although Sackler distinguishes between the “agent” model and the “merchant” model, a commission is arguably the travel agent’s “service fee.” And in the traditional model, that amount is subject to tax. The “service charge” argument advanced by the Internet travel providers seems weakened when the typical compensation arrangement of travel agents is considered. Whether the traditional commission compensation is termed a service charge or not, that reduction in what the hotels receive for the room is still taxed.

On the other hand, the traditional travel agent is an intermediary, not a reseller. It never

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contracts to, in effect, “purchase” the room. And, of course, its customer, not the hotel, is paying its “service charge.” Presumably the courts will have to decide whether those distinctions are enough to merit nonpayment of occupancy taxes on the service charge.

Which argument will prevail? The courts have yet to decide and there is no guarantee they will all view the issue in the same way, in any event. As the analysis may turn on local and state revenue laws, a decision in one jurisdiction may not be persuasive in another.

In the meantime, municipalities in California, Georgia, Illinois and Pennsylvania have filed lawsuits against Internet travel providers, hoping to reap what could be billions in unpaid occupancy taxes. More suits are expected.

2. Some municipalities are not “following suit” based on advice from their own taxing authorities.

In spite of recent filings, a number of jurisdictions have declined to file suit. In at least two cases, they have followed the advice of their own revenue officials. Southern Nevada boasts 133,000 hotel rooms and a successful suit there could enrich municipalities with hundreds of millions of dollars. Yet in a January 19, 2006 article in the *Las Vegas Sun*, county officials were quoted as concluding they would ultimately *lose* a court battle, in part due to an advisory opinion from their Taxation Department which concluded the fees charged by Internet travel providers are not subject to room occupancy taxes.

The city of Bellingham, in Washington State, filed a federal lawsuit against a number of Internet travel providers in February 2006. But the Washington State Department of Revenue officials were quoted by reporter Jon Gambrell in *The Bellingham Herald*, as saying the city should withdraw the lawsuit, at its request, over concerns that the issues should be resolved administratively, not through the courts. The lawsuit sought class action status for 176 cities and counties across the state. Concern was expressed by Mike Gowrylow, a spokesman for the state Department of Revenue, that federal judges should not determine the applicability of state sales and hotel and motel taxes. Apparently Washington state officials had not yet decided whether the additional charges customers paid to Internet travel companies represent the actual rental of a hotel room, or a service charge. Gowrylow also raised the difficulty of any determina-

tion by Internet travel companies of applicable tax rates, especially as they vary for each city and county in the country. *The Bellingham Herald* has since reported that the action has been withdrawn to give the state Department of Revenue control.

By contrast, however, Sackler noted that a Philadelphia action runs counter to a Pennsylvania Department of Revenue ruling in June 2004. That ruling essentially agreed with ITSA’s position that the difference in room rates is a service fee that the online agencies charge hotels and is not part of the rate.

Nor did advice from revenue officials stop municipalities in Georgia from filing suit. The city of Atlanta joined its counterparts in other Georgia cities by filing a complaint on March 29, 2006, accusing Expedia, Hotels.com, Travelocity, Orbitz and Priceline of failing to remit the full 7% occupancy taxes required by city statutes. It followed a Hart county suit filed November 18, 2005, which joined other Georgia cities, Rome and Cartersville, and seeks class action status. (The attorney for the city of Rome, Bob Brinson, doubted a nationwide class action would be filed, however, as the suits involve local and state taxes.)

But the Atlanta suit was more unusual, because it followed legislative hearings where liability for additional taxes was far from clear. According to the *Atlanta Business Chronicle*, at those hearings Ed Many, the Georgia Department of Revenue’s deputy commissioner for tax administration, told the House Ways and Means Committee that there is uncertainty about whether the taxes are owed because of how the current law is written.

3. Would taxing Internet travel companies violate laws requiring a physical presence in the municipality?

In *Quill Corp. v. North Dakota*, 505 U.S. 298 (1992) the U.S. Supreme Court ruled that under the Commerce Clause, companies do not have to collect taxes in jurisdictions where they have no physical presence. Arguably, as between the hotel on the ground in Boise, Idaho, and the Internet travel site that “sold” the hotel room, only the hotel can be forced to collect taxes from the customer and remit them to a local taxing authority. This would appear to raise a second line of defense for Internet travel companies: if they are deemed to be no different than traditional travel companies, and their service charges are subject to occupancy tax assessments, they should nevertheless be let off the hook, as they have no physical presence in the jurisdiction, and no

obligation to collect occupancy taxes.

This protection for Internet companies seemed to be one of the concerns expressed by Ed Many, the Georgia Department of Revenue’s deputy commissioner for tax administration. He was reported as stating that there is no bright line that would require an Internet company to pay state or local occupancy taxes, even if the service charge they claim is ultimately determined by a court to be an additional charge for the hotel room.

Could this lead local taxing authorities to seek the hotel taxes they claim are unpaid by the Internet travel companies, directly from the hotels? And will hotels, in turn, seek recompense from the Internet travel companies? Those questions would appear to be part of the chess game now being played out in the courts and state legislatures.

4. The road ahead.

Until there are court rulings, it can be presumed that some municipalities will continue to pursue online travel service providers for return of what they deem are unpaid taxes. What is unclear is who will win the underlying argument and where.

Should a hospitality lawyer, in spite of the uncertainty, do anything in reaction to the lawsuits being filed? They may want to follow the lead of Lodgian, an Atlanta-based company that owns 70 hotels and contracts with several Internet travel companies. Grace Feel Regan, an in-house attorney with Lodgian, amended all of those contracts in 2003 to provide that the Internet companies would be responsible for any state or local taxes imposed by municipalities and they would further indemnify Lodgian from any liability. If court rulings start to go against Internet travel providers, however, they may themselves attempt to negotiate their own remedies against hotel clients for indemnification or other relief. Both parties, however, will likely work together to market hotel rooms and to make disclosures that will ultimately reduce the “net” room rate and any ultimate taxes that must be paid. There will likely be a restructuring of market models. At least some municipalities, for their part, will also attempt to draft revenue regulations to target any attempts to reduce occupancy taxes. In the meantime, more municipalities, lured by the prospect of large revenue increases, will continue to initiate actions. Adverse rulings may stem the tide, while favorable rulings could set off a torrent of litigation that would invite a legislative resolution on a national level. To be continued...