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Taxing Hotel Room Sales by Online Travel Companies: What Should Be the Appropriate Tax Base?

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Abstract

This essay examines the current dispute between state and local governments in the U.S. and online travel companies (OTCs) over the appropriate hotel occupancy tax base for online hotel bookings. It addresses the question of what should be the appropriate tax base in designing hotel occupancy tax statutes. It argues that the appropriate tax base should be the full rental prices of the hotel rooms paid by consumers inclusive of online travel company markups and service fees and not the discounted net rates paid by the OTCs to their hotel suppliers.

I. Introduction

The internet spurred the creation of e-commerce, which has experienced spectacular growth over the past two decades. In the travel industry, consumers increasingly find it beneficial to book their hotel rooms with online travel companies (OTCs)—also referred to as online travel agencies (OTAs)—such as Expedia, Hotels.com, Orbitz, and Travelocity rather than booking directly with hotels or with traditional brick-and-mortar travel agencies. Green and Lomanno (2012, Appendix 1) find that the growth of OTCs has benefited both consumers and hoteliers. But there is a downside as well. This involves a reduction in tax revenues for many state and local governments.

In recent years, many state and local governments in the U.S. have sued online travel companies allegedly for not remitting the correct amount of hotel occupancy tax revenues on their hotel room bookings/sales. Los Angeles was one of the first cities to file suit against OTCs in late 2004, followed quickly by San Diego, San Francisco, and Anaheim (Butler and Abrams, 2009). By March 1, 2010, state and local governments from 22 states had initiated ligation against the OTCs demanding the OTCs pay alleged back taxes owed (Henchman, 2010). In March 2011, Washington D.C. and Hawaii became the latest jurisdictions to pursue online travel companies for alleged unpaid hotel occupancy taxes (Neibauer, 2011; Hawaii Reporter, 2011). To date there have been more than 70 litigations and most of them are either on appeal or are still at the trial level (Reagan, 2011). In these lawsuits, local governments claim that the OTCs should have remitted hotel occupancy taxes based on the total “retail prices” paid by their customers rather than the lower "wholesale prices" that OTCs pay to hotel suppliers. OTCs disagree.

OTCs through their trade association, the Interactive Travel Services Association (ITSA), explain that the price that they charge their customers for a hotel booking includes the discounted price of the room they have negotiated directly with the hotel, an added margin which comprises a markup and a separate service fee (called "fees") as the "facilitator" of the transaction, and applicable taxes (called "tax recovery charge"). Taxes and fees are not separately itemized.[1] OTCs argue that since they neither own nor operate hotels, they should not be taxed under state and local hotel room tax statutes. They note that traditional travel agents do not pay hotel room occupancy taxes on their commissions; neither should they have to pay occupancy taxes on the value of their services.[2] In cases that have been decided to date, both sides have earned victories.[3] The outcomes in these cases have been decided by the courts' interpretations of the wordings

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[1] Mazerov (2011, Figure 1, p. 3) provides the following comparison of prices for a standard two queen bedroom at the Courtyard Marriott Hotel in downtown Silver Spring, Maryland (check-in on April 15, 2011): Hotel website: $139.00 (retail room charge)+$18.07 (taxes at 13 percent)=$157.07 (total cost to consumer). Expedia website: $111.20 (Expedia's "wholesale" room cost) + $27.80 (markup, assuming Expedia marks up by 25 percent)=$139.00 (Expedia's basic room charge shown to consumer) + $18.84 ("Taxes and Service Fees" shown to consumer)= $157.84 total cost to consumer. The amount of the OTC markup and service fees are not separately shown to the consumer. Both Marriott and Expedia's websites display the same basic room rate of $139. Expedia's total (tax and service fee-inclusive) price to the consumer is 77 cents more.

[2] See http://www.interactivetravel.org/IndustryBackground/Hotel_Occupancy_Taxes.asp. (Last accessed on November 23, 2011). Also King (2011). OTCs have also raised the issue of constitutional nexus as a reason for not taxing their margins, but they have not prevailed in court (Commonwealth of Virginia, 2010, pp. ix. and 15-17).

[3] Reagan, 2011; King, 2011; Commonwealth of Virginia, 2010; and ITLA's website at http://www.interactivetravel.org/

of local hotel occupancy statutes/ordinances. The current status of the cases that have or are still under litigation as of early 2011 can be seen at Reagan (2011).

For cash strapped state and local governments, the potential tax revenues lost from untaxed OTC markups and service fees are substantial. Green and Lomanno (2012, Exhibits 17 and 18, pp. 37-38) estimate that in 2010 the difference in the amount consumers paid to the OTCs at retail room rates and the amount that OTCs paid to hoteliers at negotiated (wholesale) rates was $2.7 billion (=$10.4 billion minus $7.7 billion). The difference in tax revenues collectively amounts to roughly $340 million, assuming an average hotel occupancy tax rate of 12.62 percent, which was the average tax rate in the U.S. in 2008 (AH&LA, 2008).

OTCs have taken the dispute to a higher level. They are lobbying Congress to enact national legislation that would prohibit state and local governments from imposing hotel occupancy taxes on bookings with them (Mazerov, 2009; Kokinis-Graves, 2009; Buhl, 2009). Their proposal is opposed by the American Hotel & Lodging Association (American Hotel & Lodging Association, 2010) as well as a coalition of state and local government organizations that include the Federation of Tax Administrators, the National Association of Counties, National League of Cities, the National Governors' Association and the U.S. Conference of Mayors (Kokinis-Graves, 2009; De Lollis, 2010). Hoteliers regard this as a "tax equity" issue. They fear that an exemption for the OTCs might result in a shift of the tax burden to them.[4] State and local governments argue that it would pre-empt their taxing powers.

This paper has two objectives. First, it describes how OTCs operate, and then show why the emergence of merchant model OTCs led to the current tax dispute between state and local governments, hoteliers and the OTCs (Section II).

Second, and more importantly, this paper looks beyond the current tax dispute to provide an economic rationale for what should be the tax base for OTC hotel room sales (Section III). While the solution to the governments' current fiscal dilemma is to rewrite their hotel occupancy statutes/ordinances in more specific language as a few jurisdictions have already done,[5] it is still necessary to provide sound theoretical justification for the change. This paper finds no convincing rationale for the preferential tax treatment of OTCs. Instead, it argues that the appropriate tax base should be the full (retail) prices, inclusive of the OTC markups and fees, and not the wholesale prices paid by the OTCs to hotel suppliers. Section IV concludes.

II. OTC Merchant Model of Hotel Distribution and the Current Tax Dispute

The Internet has spawned a tremendous increase in electronic travel distribution. In the U.S. lodging industry, internet-based travel distribution companies or third party

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[4] De Lollis (2010). Colucci (2011) reports that the City of San Francisco is suing hotels for room taxes that it believes the OTCs have collected from consumers but have not remitted the full amounts.

[5] More on this in the concluding section of this paper. In the current highly polarized political environment, raising taxes is not easily achieved. Rice (2012) reports that attempts to increase taxes on OTCs in Tennessee, Connecticut, Oregon, Virginia, Texas, Pennsylvania, Utah, and Massachusetts so far have failed.

distributors, travel agents, and hotels compete to direct hotel bookings to their own websites.[6] Online travel companies such as Travelocity, Expedia, and Orbitz did not even exist before 1996.

The timing of the emergence of OTCs as a major hotel distribution channel has been attributed to the sharp decline in travel and the rise in hotel vacancy rates following the 9/11 terrorist attacks (Butler and Abrams, 2005; Stanford, 2005; and Starkov and Price, 2005). At the time many hotel operators did not have their own websites. In 2000, Internet sites accounted for only 1 to 2 percent of hotel bookings (Green and Lomanno, 2012, p. 14). OTCs provided another market outlet for a perishable commodity. By 2010, OTC hotel room sales had risen to 10.7 percent of total hotel room nights sold in the U.S. and 7.7 percent of total hotel room revenues (Green and Lomanno, 2012, p. 76). Hotels' own websites and telephone reservation systems and traditional travel agencies still provide the lion's share of hotel bookings. The senior research director of PhoCusWright notes (King, 2011) that currently OTCs "Generally… have a countercyclical role." Hotels pick up market share on their own distribution channels when the economy is robust, but during slow business periods, OTCs offer improved sales opportunities to hoteliers.[7] Thus, hoteliers and OTCs both benefit from their relationship.

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[6] Green and Lomanno (2012) recently published the most comprehensive comparative study to date of hotel distribution channels in the U.S.

[7] See, for example, Douglas (2011).

OTCs work with two distinct business models, the “agency model” and the “merchant model.”[8] Under the agency model, OTCs act as brokers and receive a commission from hotels when they book a room on behalf of their clients. Under the merchant model, OTCs are principals; they buy rooms from hotels at large discounts and resell them at marked up prices to consumers. Commissions earned by OTCs working as brokers (agents) are not required to pay state and local hotel occupancy taxes. At dispute is what portion of the merchant model OTC room revenues is subject to hotel taxes.

OTCs prefer to do business under the merchant model because it is far more profitable than the agency model. Green and Lomanno (2012, pp. 75 and 99) estimate that the traditional agency model currently provides “discounts” of 10 to 17 percent versus 15 to 35 percent for the merchant model.[9] In 2005, a hotel industry official wrote (Stanford, 2005, p. 320): “In the last several years, the final selling price on a merchant model room has averaged approximately 25 percent to 40 percent above the net rate amount paid to the hotel operator. That is an extraordinary return on the distribution of rooms when compared with the 10 percent return received under the traditional travel

[8] Green and Lomanno (2012) differentiate three models: the retail (traditional agency) model, the merchant model, and the opaque (auction) model. In the opaque model, the consumer bids on a room based on a hotel’s general location but may not know the hotel’s brand or name. Opaque purchases are not refundable. Like their merchant model OTCs, the OTC vendor using the opaque model purchases rooms from hotels at discounted (wholesale) rates and resells them to consumers at (higher) retail rates. The vendor is the merchant of record. The tax base issue discussed in this paper applies to both their “merchant” and “opaque” models. The United States District Court Western District of Texas, San Antonio Division (2011) only distinguish between two models, the agency model and the merchant model.

[9] Auction sites such as Priceline.com sell rooms at cut-rate prices and typically keep between 30 and 50 percent of the revenues. In 2010 opaque room sales accounted for 2.3 percent of total U.S. hotel room nights booked but only 1.3 percent of total hotel room revenues (Green and Lomanno, 2012, pp. 75 and 95).

agent commission model." The July, 2011 U.S. District Court of San Antonio's *Findings of Fact and Conclusions of Law* in a lawsuit brought by the City of San Antonio and 172 other Texas cities against the OTCs (United States District Court Western District of Texas, San Antonio Division, 2011 hereafter referred to in this paper as SA v Hotels.com et. al. and page numbers in ( ) refer to the report containing these factual findings) cited a witness from Travelocity who testified that the company easily doubles its revenue under the merchant model (p. 22, fn # 7). A witness from Hotels.com testified that profitability under the merchant model is approximately 18 to 22 percent compared to 8.93 percent under the agency model (p. 22, fn #8). In 2010 the "agency model" accounted for 12.1 percent of room nights sold by OTCs (Green and Lomanno, 2012, Exhibit 26, p. 95). Paying hotel taxes on a lower tax base—i.e. on wholesale prices rather than on retail prices—has, no doubt, increased the profitability of merchant model room sales.

The best comparison of the OTCs' methods of operation under the two models can be found in the factual findings from the San Antonio lawsuit.

Under the agency model, a consumer who wishes to book a room at a hotel can call up the hotel to make a reservation, and at checkout pay for the room and applicable occupancy taxes to the hotel based on the retail price of the room. (It is assumed throughout this article that the room tax is an *ad valorem* tax expressed as a percentage of the rental price.) The hotel remits the collected taxes to the local tax authority. Alternatively, the consumer can book a room through a traditional travel agent using the agency model. At checkout the consumer again pays for the room at the price set by the hotel plus applicable taxes to the hotel; the hotel pays a commission to the travel agent from the room revenues received. Whether the consumer books directly with the hotel or via a travel agent working on commission, the amount of the occupancy tax is calculated as the product of the statutory tax rate and the price of the room paid by the consumer. Thus, under the agency model, the hotel occupancy tax base is the same whether the room is booked directly with the hotel or through a travel agent. The hotel is the merchant of record and is the responsible party for calculating and collecting the occupancy tax from the guest and then remitting the revenue to the government.

Under the merchant model employed by the OTCs, the OTCs (and not the hotels) are the merchants of record when they sell hotel rooms to consumers. In SA v Hotels.com. et. al, the Court finds (p. 12) that "The merchant model is a uniform, nationwide model that operates the same for all OTC's in all jurisdictions." Under the merchant model, the OTCs negotiate discounted room rates (called "net rates") in advance with individual hotels/hotel chains.[10] With rare exception, the contracts between the OTCs and hotels include a "most favored nation" clause meaning that the hotels guarantee that an OTC will receive at least as favorable a price as any other OTC. Thus (p. 14), "the various OTC's have the same wholesale or 'net' rate with the hotels and/or hotel chains." The contracts allow OTCs access to the hotels' room inventories on a "nonexclusive basis," and they are not required to purchase a minimum number of rooms (Swain, 2005, p. 477).

In their Securities Exchange Commission (SEC) filings, Expedia and Hotels.com explain (p. 19) that the OTC "acts as a principal and not as an agent or broker, and

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[10] Toh et. al. (2011, p. 183) note that OTCs are able to obtain more favorable discounts from smaller hotels than from large hotel chains because smaller hotels are more dependent on OTCs to gain exposure.

assumes the risks and rewards of its hotel reservation transactions with customers." Expedia's 2001 filings with the Securities Exchange Commission (SEC) acknowledged (p. 13) that "Under the merchant model we are the merchant in the transaction. Our suppliers make inventory available to us at wholesale or net rates. We then determine the retail price that the customer pays and we then process the transaction by buying the inventory and selling it to the customer." Similarly, according to Travelocity (p. 12), "Travelocity negotiates with hotels for rooms on a net basis. This means we pay the hotel a flat rate for each room sold. We then have control over the price we offer to the customer and, therefore, control the profit we make from the markup." In actual practice, OTCs purchase the rooms from the hotels only after they are sold (Toh, et. al. 2011, p. 183). In the San Antonio case, the Court concludes (p. 30): "While 'facilitator' or 'intermediary' may accurately describe the OTC's role under the agency model, it does not accurately describe the role under the merchant model."

OTCs collect all the monies for the rooms and taxes from their customers in advance, i.e. at the time of booking.[11] Under the merchant model, the OTC—and not the hotel—calculates and is responsible for collecting the occupancy tax from the consumer. In SA v Hotels.com. et. al, the Court notes (p.50) that "As part of their contracts [with individual hotels/hotel chains], the OTC's also agree to collect occupancy taxes on the rooms they sell at the rate they determine." (The words in [ ] have been added.) Thus, "the collection of hotel occupancy tax is a fundamental part of the OTC's business practice under the merchant model (p. 50).

[11] The merchant model is sometimes referred to as a prepaid model.

OTCs (p. 17) have "sole discretion in determining whether to apply the tax to the wholesale rate…as opposed to the retail rate." At check out, the hotel does not bill the occupant for the room or the occupancy tax. It only collects from the guest payment for incidental (non-lodging) items such as long distance telephone calls, pay-to-view premium movies, room service, or drinks from the mini-bar purchased during the visit. After the hotel guest has checked out, the hotel invoices the OTC for the room at the negotiated wholesale price. The OTC (p. 27) "transfers the wholesale rate of the room and hotel occupancy tax on the wholesale rate to the hotel. The hotel then remits the taxes on the wholesale rate to the City."[12]

Thus, when a consumer books a hotel room directly with a hotel (either via its call center or the hotel's website) or with the assistance of a (traditional) travel agent, the hotel room tax base is the retail price of the room, but when he/she books the same room at the same base rate with a merchant model OTC, the OTC remits tax revenues on the discounted wholesale rate. Curiously, the same hotel room booked online can yield different tax revenues depending which online distribution channel is used. The reason for the discrepancy is because hotel tax statutes in the U.S. typically (but not in all tax jurisdictions) specify tax liabilities based on the room rental revenues hotels receive (Henchman, 2010, p. 633).[13] Hotels receive the full retail room rates from their guests

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[12] In SA v. Hotels.com et. al, the Court notes (p. 55) that recently in some cities OTCs are remitting occupancy taxes directly to the cities.

[13] Hotel occupancy tax statutes in most local jurisdictions were enacted long before the arrival of online travel companies. New York City was the first to levy a hotel occupancy tax in 1946; by 1983, every state except Wyoming had hotel occupancy taxes either at the local or state level, or both. (Knipe, 2011). Currently, every state except

when guests book directly with the hotels or with traditional travel agents, but they receive only the lower net rates when rooms are sold to merchant model OTCs. Some state and local governments believe that OTCs should remit hotel occupancy taxes based on the higher retail room rates consumers pay to them and not on the lower wholesale rates. Instead, OTCs have elected to remit occupancy taxes based on the discounted wholesale prices.[14] At issue in the current litigations pitting state and local governments against the OTCs is whether the language of local hotel occupancy tax statutes requires OTCs to remit taxes based on retail or wholesale room rates.

In summary, this section shows that the emergence of merchant model OTCs has dramatically changed the institutional landscape in the U.S. lodging distribution business. State and local governments find their hotel occupancy tax statutes designed for an earlier era and a different set of institutions no longer serve their original purposes and need to be changed. The next section examines the question of what should be the appropriate tax base for hotel occupancy.

III. The Appropriate Tax Base on OTC Hotel Room Sales

Alaska, California and Nevada, and thousands of cities and counties in every state except Connecticut, Delaware, Hawaii, Maine, and New Hampshire tax hotel room rentals (Mazerov, 2011, p. 1).

[14] It has been alleged that some consumers purchasing rooms from OTCs have been charged occupancy taxes on the retail prices they paid for the rooms but OTCs have remitted tax revenues on the wholesale prices. In a nationwide class action suit against Expedia filed in U.S. District Court in Washington State in August, 2005 on behalf of consumers (rather than local governments), plaintiffs claimed that hotel occupancy taxes were collected based on retail prices but Expedia remitted tax revenues based on wholesale prices. See http://www.hbsslaw.com/cases-and-investigations/expedia (Accessed on November 11, 2011). A recent settlement was reported between Expedia and Florida's Orange County (King, 2011).

The hotel occupancy tax has been viewed as a "transaction tax" (Kokinis-Graves, 2009, p. 13). Economists view taxes as imposed either on consumption, capital, or wealth. Hotel occupancy taxes are meant to be borne by hotel guests. Indeed, research on hotel room tax incidence in the U.S. has shown that the burden of the tax falls largely on buyers rather than sellers whether the tax is levied directly on the consumer or on the hotel supplier; hence it is a tax on consumption (Bonham, et. al. 1992; Fujii, et. al. 1985; Mak, 2006; Mak, 2005).[15]

A consumption tax may be based on the "origin principle" whereby the tax is determined by where the good is sold/purchased, or it may be based on the "destination principle" whereby the tax is based on where the good is consumed (Fisher, 2007, p. 381). Under the destination principle, the same tax rate would apply to all hotel room rentals; by contrast, under the origin principle, hotel room rentals would be subject to widely varying rates from zero percent to well over 10 percent depending on where the hotel rooms were booked.

Behrens, et. al. (2009) have studied the differential effects of origin versus destination taxation on tax competition among taxing jurisdictions. In the short-run, Behrens, et. al. (2009, p. 431) surmise that the most likely impact of switching from one tax principle to the other changes the distribution of tax revenues between taxing jurisdictions. Thus, a switch from (say) origin to destination taxation redistributes tax revenues from where the goods are purchased to where they are delivered. In the long run, and assuming that firms are mobile, Behrens, et. al. (2009) conclude that a switch

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[15] See also Swain, 2005.

from destination to origin taxation encourages governments to engage in harmful tax competition in a ‘race to the bottom’ as they compete to lower their tax rates to attract firms resulting in an erosion of tax revenues. Not surprisingly, in the U.S., state and local sales taxes are consumption taxes based on the destination principle. Hence, sales taxes are levied on goods consumed in the taxing jurisdiction but are not applied to goods delivered to buyers in other jurisdictions; however, a use tax at the same rate is applied to goods imported into the taxing jurisdiction.[16] Taxation of hotel room rentals also follows the destination principle.

In the destination market, should goods be taxed at uniform rates or at different rates? How about the same good purchased from different sales channels? The theory of optimal commodity taxation argues that, generally, neutral taxation—i.e. taxation of all goods and services at the same rate--is inefficient (Rosen, Chapter 14).[17] To minimize distorting consumer behavior, the Ramsey rule—also known as the “inverse elasticity rule”—requires that, if goods are unrelated in consumption, higher tax rates should be set on goods that are relatively more price inelastic. Higher taxes on inelastic goods induce less drastic changes in consumer behavior and thus minimize total excess burden. Theoretically, the Ramsey rule opens the possibility for hotel rooms sold by hoteliers and OTCs to be taxed differently, provided restrictive conditions in the theory are met.

For optimal tax theory to apply, goods must be unrelated in consumption. In other words, they have to be different goods. In the distribution of hotel rooms, is a room

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[16] However, there is widespread evasion in the payment of use taxes.

[17] This paper focuses on hotel tax bases and not hotel tax rates. However, allowing OTCs to pay taxes on wholesale room prices amounts to taxing them at lower *effective* tax rates.

booked by a consumer directly from a hotel chain through its telephone reservation system (or via the hotel's online website) and the same room purchased from a merchant model OTC different goods? If they are different goods, firms can treat each distribution channel as a totally separate market without any connection between them (Lieber and Syverson, 2011). (Two goods are in the same market if they are close substitutes.) This allows firms in one channel to freely make decisions on advertising and pricing without regard to how firms in other channels might respond. Not so in the distribution of hotel rooms. Contracts between hoteliers and merchant model OTCs specify agreed upon OTC markups over the negotiated net rates to ensure rate parity (i.e. similar room rates) among distribution channels (Toh et. al., 2011, p. 183; Anderson, 2003). Toh et. al. (2011, p. 183) note that "The larger hotel chains therefore typically insist on rate parity among all the channels." The current tax dispute between hoteliers and OTCs provides further evidence that hoteliers and OTCs do not operate in separate markets.

There are a few particularly interesting examples of interdependence between hotel distribution channels, both on the demand side and on the supply side (Green and Lomanno, 2012; Toh et. al., 2001; Toh, et. al., 2011a; Thompson and Failmezger, 2005; Anderson, 2003; Carroll and Siguaw, 2003). On the demand side, consumers are known to search different distribution channels to find the best deals. Many are also known to use the web to find the best rate at a hotel and then call the hotel to try to negotiate an even lower rate before booking. Indeed, shopping around is advisable as different channels may not provide the same information. For example, a hotel's telephone call center, its own website, and OTC websites may provide conflicting information on room availability (Thompson and Failmezger, 2005).[18]

On the supply side hotels still maintain their telephone reservation systems at the same time they have developed their own Internet websites to compete with other electronic distribution channels. While the new online initiative may cannibalize some business from their call centers, hoteliers hope to divert even more customers from OTCs. Information gathered on customers online can also help hoteliers develop tailored marketing strategies to increase sales in both channels. Hoteliers also report that web informed customers spend less time when they call their telephone reservation systems for information or to book a room thus increasing call center productivity (Carroll and Siguaw, 2003, p. 11). Thus, hoteliers have come to recognize the advantage of "technological complementary" between offline and online sales technology and expand into online distribution (Lieber and Syverson, 2011, pp. 26-27).

In sum, evidence shows that offline and online hotel distribution channels do not operate in isolation. Hence, optimal tax theory cannot be invoked as justification to give OTCs preferential tax treatment in the sale of hotel rooms.

Finally, in separate papers that relate to the hotel tax base issue, Bruce et. al. (2003) and Zodrow (2006) examine whether electronic commerce should be granted preferential tax treatment compared to traditional commerce when it comes to paying sales taxes. In the U.S., most consumers who purchase goods online pay no state/local sales taxes. Since sales taxes increase consumer prices (Poterba, 1996; Besley and

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[18] Thompson and Failmezger (2005) found that calling the hotel is the best way to ascertain room availability.

Rosen, 1999), the exemption of Internet purchases from sales taxes gives consumers the incentive to buy online rather than from traditional brick-and-mortar businesses. Indeed, Goolsbee (2000) find that consumers who live in high sales tax states are significantly more likely to make purchases online. After considering issues of efficiency, equity, administrative and compliance (and non-compliance) costs, Bruce et. al. conclude (p. 38) that "The practical issue remains as to whether e-commerce should be favored through tax policy, and the assessments presented here suggests it is a particularly difficult case to make." Zodrow (2006) extends Bruce et. al.'s analysis using more rigorous methodology and takes an even stronger stance in support of neutral taxation. He writes (p. 7): "The analysis concludes that tax exemption of electronic commerce is unlikely to be even close to optimal, with the optimal tax differentials calculated suggesting that the traditional prescription of uniform taxation of traditional and electronic commerce should not be overridden by optimal taxation concerns." The two articles also provide strong support for uniform tax treatment of hotel rooms sold through hotel telephone reservation systems, hotel websites, OTCs and other electronic distributors.

In an earlier study, Mazerov (2011) argues that the hotel occupancy tax should be imposed on OTC markups but not on the separate service fees. It is unclear what are OTCs' "service fees" in merchant model room sales and why they are not included the basic retail room rates since those services are not (and cannot be) sold separately. Testimony in SA v. Hotels.com et. al. (p. 24) indicate that in the past service fees have been referred to as a "surcharge or processing fee." Further testimony (p. 24) reveal that "In merchant model transactions, the OTC's bundle the taxes and fees as a way to keep the wholesale rate of the room 'opaque.'"[19] Travelocity's website describes the company's service fee as a "Processing Service Fee" and explains its purpose as follows: "Certain service fees are charged for processing your travel reservation through our system. These are often bundled into the Taxes and Fees amount in order to maintain the opaque nature of the 'prepaid rate' as required by our contracts with our suppliers."[20] Expedia describes its services fee "as compensation in servicing your travel reservation. Our service fees vary based on the amount and type of hotel reservation." Orbitz describes its service fee as "a fee we charge and retain in exchange for the services we provide in facilitating your transaction with the hotel suppliers." To the extent that service fees represent the cost of services that OTCs provide to consumers such as "helping consumers identify particular hotels, compare prices, and reserve rooms," Mazerov argues (pp. 12-13) that on theoretical tax policy grounds one can make a case for taxing OTC service fees at the typically lower general sales tax rates instead of the higher hotel occupancy tax rates, and a jurisdiction that does not tax services can decide not to tax OTC service fees at all. He concludes (p. 13) that the fees "appear to be very small" and "attempting to do so [i.e. to tax them] is not worth the trouble." I disagree.

In SA v Hotels.com. et. al., the Court phrases it as follows (p. 45): "…the OTC's markup and service fees are part of the total retail amount paid by the consumer to the OTC for the right to occupancy. If the consumer refuses to pay any part of the retail amount charged by the OTC, he would not have a prepaid reservation and he would not

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[19] Ellison and Ellison (2009) show that firms often devise ways to disguise prices to stifle competition.

[20] See http://www.travelocity.com/info/legal_popup/0,6735,aolsvc:EN,00.html (Accessed on March 24, 2012). This and the following two quotes can be found in McGee (2009).

have the right to occupy the room." Thus, all the components of the total retail rental price should be taxed. This would require OTCs to unbundle their "service fees and taxes" into separate components.

V. Conclusion

Controversy rages over what should be the appropriate tax base for hotel rooms sold by online travel companies. In this paper I argue that the goal should be to achieve tax neutrality. This means that the appropriate tax base on the sale of hotel rooms by hoteliers and merchant model OTCs should be the full amounts (i.e. total retail price) paid by consumers to occupy their hotel rooms, inclusive of OTC margins. For many state and local governments, it means that they would have to rewrite their outdated tax statutes. Failure to do so could result in the further erosion of their tax bases.

A few jurisdictions have already amended the language of their statutes to clarify the intended tax bases. In 2009, New York City amended its hotel room occupancy tax law (Local Law 43 of 2009) to require OTCs (referred to as "room remarketers") to collect and remit occupancy taxes based on (total) retail room prices and not wholesale prices (NYC Department of Finance, 2009).[21] In the following year the New York State

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[21] Expedia and several other major OTCs filed a lawsuit against New York City alleging that the City's Local Law No. 43 (2009) violates the New York State Constitution. In October 2010, the New York County Supreme Court dismissed the lawsuit. On appeal, the dismissal was overturned on November 29, 2011. The appeals court ruled that "the enabling legislation did not clearly and unambiguously provide the City with broad taxing powers with respect to imposing a hotel occupancy tax. Rather, it permitted the City to impose the tax on 'hotel occupants.'" To extend the law to permit taxation of OTC service or booking fees would require action by the State Legislature. (At http://www.nycourts.gov/reporter/3dseries/2011/2011_08648.htm (Accessed on July 31, 2012).

Legislature enacted Chapter 57 of the Laws of 2010 to insure that state and local sales taxes are paid on the retail room rates for hotel occupancy in New York State (New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, 2010). It also amended New York City's locally administered hotel room occupancy tax to conform it to the provisions of the state tax on room remarketers (NYC Department of Finance, Office of Tax Policy, 2010). In the same year, lawmakers in North Carolina amended the state's sales tax law (North Carolina General Statutes, Section 105-164.4) requiring fees paid to OTCs be included in the gross receipts of hotel operators subject to sales and hotel occupancy taxes.[22] In 2011 Washington D.C. similarly revised its hotel tax law-- D.C. Act 18-715 entitled "Payment of Full Hotel Taxes by Online Vendors Clarification Act of 2010" (Codification District of Columbia Official Code, 2011; Clausing, 2010). In 2011, Minnesota (State of Minnesota, Office of the Revisor of Statutes, 2011) amended its sales tax statute --Laws of Minnesota for 2011, Ch.7, Art 3, p. 22--to require OTCs to collect the state's sales tax "for services provided in connection with or for lodging located in this state."[23] By contrast, the state of Missouri passed legislation in 2010 stipulating that hotel occupancy taxes can only be levied on revenues actually received by the hotels (Commonwealth of Virginia, 2010, p.

[22] At http://www.ncga.state.nc.us/EnactedLegislation/Statutes/PDF/BySection/Chapter_105/GS_105-164.4.pdf, pp. 1-2. (Accessed on February 26, 2012).

[23] Russell (2011) notes that Minnesota's new state law leaves questions unanswered regarding local hotel occupancy tax ordinances. Where the Minnesota Department of Revenue collects the lodging tax for the local unit of government, the new state law apparently would apply. If the lodging tax is collected locally, the state law may or may not apply depending on the wording of the local ordinance.

13; Clausing, 2010a). In Florida, bills supporting opposite positions were introduced but did not pass (Commonwealth of Virginia, 2010, pp. 8-13). Several other jurisdictions have proposed changes to their hotel occupancy tax slaw. In 2012 a bill was introduced in the Oregon state legislature to tax OTC margins on merchant model room sales but faced opposition from the Independent Lodging Industry Association, which argued that the proposed bill will hurt small and independent hotels that are more reliant on online travel companies to market their unsold rooms (Ross, 2012). Similarly, in Tennessee a proposed amendment to Senate Bill 2663 attempts to clarify that the amount of hotel occupancy taxes owed by OTCs would be based on "the amount of consideration charged to the public." (Johnson, 2012). In Utah S.B. 70 proposes a hybrid plan that employs different tax bases depending on whether the room seller discloses separately the individual components of the selling price (State of Utah, 2012, pp. 38-39 and 50).[24] In the current anti-tax political environment, it is difficult to raise taxes. However, the issue of how best to tax OTC merchant model hotel room sales remains alive.

One option in taxing hotel occupancy is to replace the *ad valorem* tax with a flat *per diem* (i.e. per unit) tax. Tax rates would be set at specific dollars per night per occupied room to be collected by the hotel from the occupant at the time of checkout and remitted to the government treasury. Several rates could be set based on the price range/quality categories of the hotel rooms. For example, new hotel room taxes imposed

[24] The language of the bill is unclear. According to the Utah Association of Counties (2012), which opposes the bill, "SB 70 would give online travel companies the option of either remitting taxes based on the retail rate or remitting only the wholesale rate provided they disclose the various fees and taxes associated with the room rate."

in the Italian cities of Rome, Florence, and Venice beginning in 2011 are *per diem* taxes with daily rates that vary by type and location of the accommodations.

However, the fact that hotel room taxes in the U.S. are overwhelmingly *ad valorem* taxes suggests that there are significant disadvantages to *per diem* taxes (Mak, 1988). The *per diem* tax is less desirable for administrative reasons. In theory one can find per unit tax rates that would generate the same amount of revenue as the *ad valorem* rate. In practice setting the correct *per diem* rates *ex ante* and then subsequently adjusting the rates to reflect changing market conditions is not simple. As well, *per diem* taxes are often deemed to be unfair. But there are some advantages. First, by adopting a per unit tax, the taxing jurisdiction no longer requires precise information on retail room rates. This eliminates the need to separate out the retail prices of accommodations in pre-paid tour packages that bundle several items together (e.g. airfare, lodging, meals, entrance to tourist attractions, etc.) and resold at a single price.[25] Second, it also eliminates the current dispute between state and local governments and the online travel companies on whether the hotel occupancy tax base should be the wholesale price or the retail price. The tax base becomes the number of occupied room nights. Finally, the *per diem* tax option becomes more compelling if the OTCs succeed in persuading Congress to pass legislation that would prohibit state and local government from taxing them and other travel distribution businesses on their hotel bookings.

[25] New York City recognized this "unbundling" problem when it began to implement Local Law 43 of 2009 and issued guidelines on how to estimate room rent for tax purposes (NYC Department of Finance, Audit Division, 2009).

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