

TESTIMONY OF RICHARD A. LEAVY
BEFORE THE
MULTISTATE TAX COMMISSION ON THE
MODEL STATUTE ON THE TAX COLLECTION RESPONSIBILITIES OF
ACCOMMODATIONS
SUBMITTED ON BEHALF OF ORBITZ WORLDWIDE, INC.

July 21, 2009

I. Nature of the Online Travel Company Industry

Online travel companies, such as Expedia, Orbitz, and Travelocity, generally operate as service providers. They provide their customers with Internet-based search, comparison shopping, booking request communication, and booking payment services; they act as intermediaries between consumers and providers of travel accommodations. The services provided by the online travel companies are used by their customers to make airline, hotel, tour, cruise ship, rental car, and other travel bookings and arrangements as well as to facilitate the payment for these bookings.

The online travel companies are not operators of aircraft, cruise ships, hotels, or rental car fleets; they are merely intermediary sellers of administrative services that provide convenience to their customers and reduce the time, effort, and costs associated with performing comparison shopping and requesting and paying for travel bookings. The services provided by online travel companies are analogous to the services offered by interior decorators, consultants, and personal shoppers. They do not sell travel accommodations, they sell services for use in connection with the selection and purchase of travel accommodations.

A. Three Different Business Models

Online travel companies generally use one or more of three different business models for their web-based businesses. Not all online travel companies employ each business model. The service provider model is the business model most commonly employed by online travel companies.

1. Service Provider Model

In the service provider business model, the online travel company operates as an independent service provider that acts for its own account, selling services to customers in connection with the customers' purchase of accommodations directly from third-party hotel operators as well as cruise, airline, tour, and rental car accommodations providers. The online travel company offers the services that are outlined below, which include searching, comparison shopping, booking request communication, and payment processing, all as an independent service provider. The accommodations provider and not the online travel company has discretion to accept or reject the booking communicated to it by the online travel company.

As demonstrated below, a crucial distinction must be recognized that under the service provider model, the online travel companies only provide services and the service and booking fees charged by the online travel companies in any way paid for the hotel accommodations. The economics underlying the charges for online travel services, as compared to the charges for hotel accommodations, are easily distinguished by asking why the customers visit the online travel company website? The customers seek information and convenience, which the online travel companies provide through their services.

The method of payment by the customers for the hotel accommodations together with the payment for services provided by the online travel company should not have any impact on the taxability of each charge. The taxation should follow the true economics of the transaction and the application of the occupancy tax on the provision of accommodations should be limited to the provision of accommodations and not also encompass services provided that relate to the accommodations.

a. Services Provided

The contract entered into by Orbitz and accommodations providers states that:

A. SUPPLIER is in the business of providing lodging services to customers through hotel properties that are owned, operated, managed by or affiliated with SUPPLIER and/or through hotel properties that are franchised by independent third parties under franchise agreements with SUPPLIER (each, a “**Property**” and collectively, the “**Properties**”);

B. Orbitz, through the various travel distribution channels owned, controlled or operated by Orbitz and/or its affiliates, subsidiaries, group companies, clients, parent company and distribution partners (including but not limited to Orbitz.com, HotelClub.com, ebookers.com and Cheaptickets.com) (each, an “**Orbitz Distribution Channel**”), operates and provides software, databases, services and other systems that enable users to search, reserve and confirm prepaid hotel room reservations through internet web sites or telephone call centers (collectively, the “**Services**”); and

C. Orbitz and SUPPLIER desire to promote one or more of the Properties to customers through the Orbitz Distribution Channels in accordance with the terms of this Agreement.

The service fees paid by the customers to the online travel companies are paid in compensation for the following services:

- The online travel companies locate available hotel accommodations with the specified search criteria requested by the customer.

- The online travel companies provide web-based tools to review, sort, and compare offerings from the identified travel accommodations providers.
- The online travel companies negotiate the lowest available prices that accommodations providers are willing to accept for the sale of their accommodations, which are less than the "rack rate" offered to the general public, on behalf of the online customers. (The hotels offer a reduction in their room rates to the customers of the independent service providers in a mutually beneficial arrangement whereby the accommodations providers obtain increased exposure and marketing to prospective guests seeking to make hotel bookings.)
- The online travel companies communicate requests for bookings to hotels on behalf of their service customers. The communication of the booking request by the online travel company to the hotel on behalf of the prospective guest is merely a request for a booking, which the hotel may choose to reject.
- The online travel companies operate as processors and transmitters of payments to hotels on behalf of their customers, as an adjunct to transmitting the booking request to the hotel. If a booking request is declined, the online travel company claims a refund of the advance payment to the accommodations provider on behalf of the service recipient.

b. Compensation Types

The online travel companies are paid a service fee in exchange for the services they provide to their customers. The online travel companies may collect a service fee, an explicit booking fee, and a payment from the accommodations provider.

The service fee is the charge by the online travel company for services measured by the difference between the price that the online travel company negotiates for which the accommodations provider is willing to accept for the sale of its accommodations to the customer and the amount that the customer is willing to pay for the bundle of the travel accommodations and the online travel company's services.

The booking fee is the separately stated charge by the online travel company for services.

The commission is a variable percentage or fixed amount paid with respect to some transactions to the online travel company from the accommodations provider for each booking.

2. Reseller Model

In the reseller business model, which is used by some online travel companies, the online travel company purchases hotel "inventory" and resells that inventory to customers. In the reseller business model, the online travel company has discretion to accept or reject the booking inasmuch as the accommodations inventory being resold is the property of the online travel company.

Under the reseller model, the online travel company purchases blocks of rooms for a discounted amount from the hotels with no cancellation rights and takes ownership rights with respect to the right to occupy the rooms and inventory risk with respect to any remaining unsold rooms.

The rooms are resold by the online travel company to service customers with no further accounting or payment to the hotel operator. These transactions entail both individual room sales as well as group and package sales.

3. Traditional Agency Model

Under the traditional agency model, which is used by some online travel companies, the online travel company acts as the agent of the accommodations provider and represents the provider in the marketing of accommodations. The online travel company acts as a service provider to the accommodations provider, such that all compensation collected is legally owned by the accommodation provider and the compensation for the provision of the services by the online travel company is paid by the accommodations provider from out of the amount collected by the online travel company on its behalf.

B. Separate Services Relationship

Like their brick-and-mortar counterparts, online travel companies transact business with respect to single provider accommodations as well as bundled together with accommodations provided by other accommodations providers.

1. Separate Accommodations

Similar to the services provided by a traditional travel agent, online travel companies provide services with respect to individual travel accommodations with a discernable price indicated for the provision of the services by the online travel company and the provision of accommodations by the accommodations provider. Some of the individual accommodations elements with respect to which online travel companies provide services are airline travel, hotel accommodations, car rentals, cruise ship accommodations, and tours.

2. Package Accommodations

Similar to the services provided by a traditional travel agent, online travel companies provide services with respect to bundled travel accommodations with a single price indicated for the provision of the services by the online travel company and the provision of multiple accommodations by multiple accommodations providers. Some of the package accommodations elements with respect to which online travel companies provide services are airline travel, hotel accommodations, car rentals, cruise ship accommodations, and tours.

Under certain circumstances, the online travel companies may operate under a restricted agreement requiring bundled marketing communication of a single bundled price for accommodations provided by a provider.

Under certain circumstances, the online travel companies are offered different pricing terms by the accommodations providers for the sale of accommodations as a part of a package of two or more items (i.e., hotel, air, cruise, and car rental).

The online travel companies may not be permitted by the contract entered into with the accommodations provider to separately show pricing with respect to a component part of a bundled accommodations transaction.

C. Payment Retention

There are three different types of market participants with different contractual relationships, different economic models, and presumably different taxation, whether provided using the Internet or otherwise.

Under the traditional travel agency model, the travel agent makes a booking on behalf of an accommodations provider, and in some instances collects payment for the booking on behalf of the accommodations provider. The travel agent is employed by and is compensated by the accommodations provider based on a per-transaction or percentage basis. This compensation payable to the travel agent is not separately stated. If the booking is cancelled, the compensation paid to the travel agent is refunded.

Under the purchaser service provider model, the service provider is compensated by the accommodations recipient based on a transactional or percentage basis. This compensation payable to the service provider may or may not be separately stated. If the booking is cancelled, the compensation paid to the service provider is generally not refunded.

Under the tour operator/package aggregator model, there is a purchase and resale of the accommodations and income is derived from the mark-up that results from taking the inventory risk. If the booking is cancelled, the compensation paid to the tour operator/package aggregator is generally refunded.

II. Proposed Legislation Issues for Consideration

There are several general tax policy considerations and technical issues raised by the proposed legislation.

A. Tax Policy Issues

Sound tax policy principles require that a taxing statute respect the form and substance of the transaction. For online travel companies, the taxation of their transactions should follow the contractual rights, obligations, and form of the transactions that they enter into. For the purchaser service provider model, the form and substance of the transaction as a fee for the provision of services by the online travel company should be respected, otherwise the tax will be arbitrary and very difficult if not impossible to administrate and audit.

Sound tax policy principles require that the tax imposed on a transaction be based on the true object and nature of the transaction. For online travel companies, the taxation of their transactions should follow their true object, which in most cases is the provision of a package of

services. If it were otherwise, the tax will distort markets and provide a competitive disadvantage to some market participants by taxing similarly situated information service providers and other e-commerce service providers on a disparate basis.

Sound tax policy principles require that the tax imposed on a transaction be based on its connections with the taxing jurisdiction. For online travel companies, the taxation of their transactions should be governed by the location of the delivery of the service, if that is what they are selling. This will avoid an unconstitutional imposition of tax, which does not respect the physical presence nexus requirement. It will also eliminate the risk of multiple taxation resulting from taxation of the services as services as well as taxation of the services as accommodations.

Sound tax policy principles require that the tax imposed on a transaction be formulated in a way to facilitate ease of compliance. For online travel companies, tax compliance issues should not be created with respect to the more than 7,000 taxing jurisdictions that impose local occupancy taxes.

Sound tax policy principles require that the tax imposed on a transaction be formulated in a way to facilitate ease of governmental audit and administration relative to the amount of collected revenue. The burden and expense of audit and administration of the hotel accommodations taxes should not be increased to include hundreds of additional market participants and the reporting of transactions by two different tax collectors, which would increase the potential for preparer error and also create a dubious exercise of jurisdiction by the local taxing authorities.

B. Technical Issues with the Legislation

1. Definitions

The provider versus intermediary definitional distinction demonstrates that the model statute is not attempting to address the taxation of receipts from the sale of accommodations, but is attempting to tax services provided by a third-party service provider. In most instances the accommodations provider is the only party selling accommodations.

The definition of an accommodations intermediary is overly broad and covers any service provider that "facilitates" a sale. To be an accommodations intermediary, the service provider must merely charge a room to a customer and because the definition is overly broad, the tax may apply to credit card and other financial services companies such as American Express, Visa, and MasterCard. The definition of the term "accommodations fee" is broad enough to encompass the merchant's discount received by these credit card companies, causing the tax to apply to the difference between the room charges and the merchant's discount.

The application of the tax under the model statute to credit card companies demonstrates that the accommodations intermediary encompasses the provider of a service and is not limited to those that provide accommodations.

The definitions of accommodations fee, room charge, and discount room charge in the model statute are circular. The discount room charge is clearly defined and the accommodations fee is defined as the room charge less the discount room charge. The room charge is defined as the discount room charge plus the accommodations fee.

2. Operative Provisions

a. Responsibility for Collection of Tax

The model statute creates the risk of inconsistent tax treatment because the tax is imposed on the transaction as a single sale for imposition and measurement, even if there is a separate statement of the price of the online travel company provided services. The model statute attempts to create a default tax treatment of two separate transactions as one transaction. If an occupancy tax properly applies to both transactions merely because they are billed together, the hotel accommodations transaction and the booking services transaction should be taxed separately if the prices are separately stated.

The model statute creates a division of the tax for remittance purposes because the tax on the booking services fees are required to be remitted to the state agency by the online travel company and the tax on the actual accommodations are required to be collected by the online travel company and remitted to the hotel that provides the room. This formulation will be costly for the online travel companies to comply with and costly for taxing authorities to audit.

The model statute requires costly changes to the software used by the online travel companies in order for the tax to be properly calculated, collected, reported, and remitted on the fees for booking services. The software would need to provide the customers with rates of taxation for each jurisdiction as well as communicate and properly reflect the tax treatment of cancellations, which vary from jurisdiction to jurisdiction. Generally, if the booking for the accommodation is canceled prior to the provision of such accommodations, the fees for the hotel room are refunded but the fees for the booking services provided by the online travel company are non-refundable. Taxing services for accommodations when no accommodations are provided creates a paradox. Furthermore, this inconsistent tax treatment will add to the complications and expense of the software modifications to enable the software to properly determine the tax implications upon the cancellation of booked hotel accommodations.

The inconsistent treatment of the booking services transaction and the hotel accommodations transaction also creates irreconcilable complexities in the compliance and audit of the transactions for online travel services purchased by prospective travelers seeking to minimize their transaction costs. For example, if a customer of an online travel company purchases a travel package including hotel accommodations, air travel, car rental, touring services, and pays a service fee related to each of these separate travel arrangements, the online travel company will potentially be required to collect tax on the entire service fee even though it should not collect tax to the extent that the service fee is related to each of the separate travel arrangements that do not relate to hotel accommodations.

b. Constitutional Nexus

The ability of states to impose income, franchise, and other taxes is constrained by their geographic boundaries. For a state to be able to impose tax on an out-of-state entity, the tax imposition must satisfy the nexus requirements of the Due Process and the Commerce Clauses of the United States Constitution.

The Commerce Clause expressly authorizes Congress to "regulate Commerce ... among the several States." By negative implication, the Commerce Clause has been interpreted to prohibit any state action that unduly burdens or interferes with interstate commerce. In *Complete Auto Transit, Inc. v. Brady*, the United States Supreme Court set forth a four-part test for determining whether a state tax imposed on an out-of-state business unduly burdened interstate commerce and, as a result, ran afoul of the Commerce Clause. As a threshold matter, the Court held that for a tax to pass constitutional muster under the Commerce Clause, it must be "applied to an activity with a substantial nexus with the taxing state."

Although the Supreme Court majority opinion made it clear in *Quill* that it was establishing the criterion of "physical presence" only in the context of a state imposing a duty to collect use tax, this analysis should apply to any transaction-based tax such as a hotel occupancy tax.

The accommodations tax is an occupation tax, not a sales and use tax. The accommodations tax is limited to the occupation of providing hotel accommodations and does not apply to the provision of online travel services. Additionally, there is generally no use tax for accommodations taxes.

The application of an accommodations rate to the provision of services by an unrelated service provider ignores (i) the transaction's form and substance and (ii) the fact that the service transaction is complete upon booking.

The services of the online travel companies are delivered to the jurisdiction in which the guest makes the booking from on their computer, which has no relation to where the accommodations are delivered. The accommodations are delivered in the jurisdiction in which the hotel is located. The tax on accommodations under the model statute should be limited to the jurisdiction where such accommodations are delivered as the jurisdiction where the taxable transaction takes place.

Because the online travel company and the hotel are not agents of one another, there should be no agency or other attributional nexus passing between them. As a result, any tax on the transaction must be imposed on the online travel services based on the location of the delivery of the services to prevent the tax from being unconstitutional as a consequence of not respecting the physical presence nexus requirement and potentially creating a double taxation as a service as well as a hotel occupation. If the tax is not imposed on the online travel services in the location of the delivery of such services, the tax imposed under the model statute fails the physical presence nexus requirement and is unconstitutional.