# Business License Tax on Internet Companies; Transient Occupancy Tax from Online Hotel Brokers and VRBO-type Web-Based Rentals

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**Notes:**

**Business License Tax on Internet Companies; Transient Occupancy Tax from Online Hotel Brokers and VRBO-type Web-Based Rentals**

*By Benjamin Fay and Gabriel McWhirter*[*]

The growth of the internet economy presents a number of legal questions for cities regarding the application of local taxes to internet-based businesses. This paper addresses two such questions: (1) to what extent can a city impose a business license tax on an internet-based company, and (2) how can transient occupancy taxes be applied to online hotel brokers?

Applying business license taxes to internet companies—companies that sell goods or services over the internet—can be a significant revenue source, particularly if the tax is based on gross receipts. A single office of an internet company might handle millions of dollars in sales, much more than a similarly-sized brick-and-mortar store. The main impediment to applying business license taxes to internet companies is the Dormant Commerce Clause of the United States Constitution and its corollary in the California Constitution. To satisfy the restrictions imposed by these provisions, the activity of the business must have a "substantial nexus" with the city. This generally means that the business must have a physical presence in the city, such as an office or warehouse. The tax must also be apportioned between business conducted in the city and business conducted outside the city. A time-tested and approved method of apportionment is the Uniform Division of Income for Tax Purposes Act (UDITPA) three-factor apportionment formula, which considers sales, payroll, and property as factors in apportionment.

The application of transient occupancy taxes (TOTs) to online hotel brokers has been a source of significant dispute nationwide in recent years. Online hotel brokers, or Online Travel Companies (OTCs) as they are commonly called, obtain rooms from hotels at a discount, which they then sell to customers at higher rates. These OTCs will generally collect TOT based only on the discount prices that they pay the hotels, and not at the increased prices that they charge their customers. The OTCs have been able to do this because of the wording of TOT ordinances, which usually predate the internet economy. TOT ordinances can be drafted so that OTCs have to collect taxes based on the prices they charge customers, and many jurisdictions are updating their ordinances to capture the full consumer price. However, in California, due to Propositions 62 and 218, any amendment to a TOT that shifts the TOT base from the discounted charge to the full charge paid by the customer requires a vote of the electorate.

## I. Imposing Business License Taxes on Internet Companies

### A. Business License Taxes Generally

"A business or occupation tax is usually defined as a revenue-raising levy upon the privilege of doing business within the taxing jurisdiction."[1] "[T]he power of a governmental entity to tax the privilege of engaging in any and all types of trade or business within its

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[1] *Weekes v. City of Oakland*, 21 Cal. 3d 386, 394 (1978).

jurisdiction is not open to serious question. Indeed, the power to impose a reasonable privilege tax extends even to those activities which the city can neither forbid . . . nor regulate."[2] This power allows for the imposition of business license taxes by a city on internet companies operating within the city's borders.

### B. Dormant Commerce Clause Restrictions on Business Licenses Taxes: The *Complete Auto* Test

Unless there is express preemption by some state or federal law, the primary impediment to imposing business license taxes on internet companies is the Dormant Commerce Clause in the United States Constitution, and its corollary in the California Constitution.

The modern test for determining whether a tax violates the Dormant Commerce Clause is set forth in *Complete Auto Transit, Inc. v. Brady*.[3] Under this four-part test, a tax will be upheld if it "[1] is 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."[4] Although the California Constitution does not contain its own commerce clause, the courts have found that a state corollary to the Dormant Commerce Clause is implied in the California Constitution, and that this corollary prohibits taxes that burden intercity commerce within the state.[5] Thus, when analyzing a city's business license tax under the California Constitution, "city" is substituted for "state" in the *Complete Auto* test.

#### 1. *The first prong: the nexus requirement*

The first prong of the *Complete Auto* test requires that the business being taxed must have sufficient contacts, or a "substantial nexus," with the taxing jurisdiction to warrant the application of the tax. For an internet company to be taxed by a city, the company must have a physical presence in that city. Simply interacting with customers within the city over the internet or delivering products to customers in the city through the mail or by common carrier is not in itself a sufficient nexus to enable a city to apply its business license tax to an internet company.

This bright-line rule arises out of the United States Supreme Court's decision in *Quill Corporation v. North Dakota*.[6] Quill Corporation was an office supply company that sold to customers across the United States through catalogs, flyers, magazine advertisements, and telephone calls. It had offices and warehouses in Illinois, California, and Georgia. It did not have employees or any other physical presence in North Dakota, but it had about 3,000 customers in the state, with annual gross sales to those customers of almost $1 million, making it

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[2] *Id.* at 395; *see also Oakland Raiders v. City of Berkeley*, 65 Cal.App.3d 623, 627 (1976).

[3] 430 U.S. 274 (1977).

[4] *Id.* at 279.

[5] *General Motors Corporation v. City of Los Angeles*, 35 Cal.App.4th 1736, 1742-43 (1995).

[6] 504 U.S. 298 (1992) ["*Quill Corp.*"].

the sixth largest vendor of office supplies in North Dakota. Quill Corporation delivered its products to its North Dakota customers from out-of-state locations by mail or common carrier. North Dakota sought to require Quill Corporation to collect its use tax. Upholding its earlier decision in *National Bellas Hess, Inc. v. Department of Revenue of Illinois,*[7] the Supreme Court held that a business whose only connection to customers in a jurisdiction is by telephone, the mail, or common carrier does not have sufficient contacts with that jurisdiction under the Commerce Clause to be subject to taxes imposed by that jurisdiction.[8]

The Court explained that the minimum contacts required by the Commerce Clause is different from the minimum contacts required by the Due Process Clause, because the two clauses address different concerns. The primary concern under the Due Process Clause is fairness, with the primary question being whether a business's contacts with a jurisdiction are sufficient such that it would be fair for the jurisdiction to exercise power over the business. In contrast, the primary concern under the Commerce Clause is not the effect on the business, but the effect on the national economy.[9] The Court held that while Quill Corporation did have sufficient minimum contacts with North Dakota under the Due Process Clause, it did not have sufficient contacts under the Commerce Clause.

Although *Quill Corp.* dealt with a pre-internet mail-order catalog business, its bright line rule applies equally to internet companies. A mail-order catalog business is closely analogous to an internet retail company with regard to the extent of its contacts with a jurisdiction in which it has customers but no physical presence. Therefore, under *Quill Corp*, an internet company may only be taxed by a jurisdiction in which it has a physical presence.

This rule, however, can be changed by Congress. In *Quill Corp.*, the Court explained that although Congress cannot lower the minimum contacts requirement of the Due Process Clause, it can lower the Commerce Clause's nexus requirement under its constitutional authority to regulate interstate commerce.[10] Therefore, Congress could allow for the local taxation of internet companies that do not have a physical presence in the taxing jurisdiction.

#### 2. ***The second prong: apportionment***

The second prong of the *Complete Auto* test requires that a tax be fairly apportioned between taxing jurisdictions. The Supreme Court has explained that "the central purpose behind the apportionment requirement is to ensure that each State taxes only its fair share of an interstate transaction."[11] However, the Constitution does not impose any particular apportionment formula

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[7] 386 U.S. 753 (1967).

[8] *Quill Corp.*, *supra*, 504 U.S. at 301-02. Although the *Quill Corp.* decision addressed whether a company could be compelled to collect a use tax, rather than whether it could be compelled to pay a license tax, the Court's holding concerning the Commerce Clause's nexus requirement would apply to a business license tax.

[9] *Id.* at 312.

[10] *Id.* at 318.

[11] *Goldberg v. Sweet*, 488 U.S. 252, 260-61 (1989) (citations omitted).

on the States, and the Supreme Court has "declined to undertake the essentially legislative task of establishing a 'single constitutionally mandated method of taxation.'"[12]

Apportionment analysis can be complicated. As the Supreme Court has observed, "[a]llocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow."[13] With this observation in mind, there are two main tests to determine whether a tax is being properly apportioned: the internal consistency test and the external consistency test.

### a. *The internal consistency test*

To apply the internal consistency test, you imagine that all jurisdictions have imposed the exact same tax, and then ask whether the resulting tax structure would burden inter-jurisdictional commerce more than commerce that stays completely within one jurisdiction. The Supreme Court has explained the internal consistency test as follows:

> Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear. This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State . . . would place interstate commerce at a disadvantage as compared with commerce intrastate. A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax.[14]

Flat taxes are a good example of taxes that raise "internal consistency" problems. A flat tax of $500 on every person conducting business in a city would violate the internal consistency test because a company operating only within one city would pay $500, while a company operating in four cities would pay $2000, even if the total amount of business conducted by the second business was less than that conducted by the first.[15] Tax exemptions that are only available to locally-based businesses can also be sources of internal consistency.[16]

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[12] *Id.*

[13] *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 192 (1983).

[14] *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

[15] *See, e.g., City of San Jose v. Ruthroff & Englekirk Consulting Structural Engineers, Inc.*, 131 Cal.App.3d 462 (1982).

[16] *See, e.g., Union Oil Company of California v. City of Los Angeles*, 79 Cal.App.4th 383, 387-89 (2000) (exempting businesses that paid payroll tax from a business license tax created internal inconsistency).

### b. *The external consistency test and the UDITPA three-factor apportionment formula*

The external consistency test looks to whether a taxing jurisdiction unfairly taxes more business activity than is taking place within the jurisdiction. "External consistency . . . looks not to the logical consequences of cloning, but to the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State."[17] In the context of an internet company, this test is generally addressed through the application of an apportionment formula.

An established method for apportioning business activity is the UDITPA (Uniform Division of Income for Tax Purposes Act) three-factor apportionment formula. This formula is primarily used to apportion corporate income taxes between states, and it is used by many states, usually by joining the Multistate Tax Compact. Although use of the UDITPA formula has decreased in recent years, its validity as a method of apportionment is unquestioned, and since 1942 it has been repeatedly upheld as constitutional by the United States Supreme Court.[18] "[N]ot only has the three-factor formula met our approval, but it has become . . . something of a benchmark against which other apportionment formulas are judged." [19]

The UDITPA formula uses three factors that are weighted evenly: sales, payroll, and property. It is applied by first determining for each factor the proportion of the factor that can be attributed to the taxing jurisdiction. For sales, this is a fraction in which the numerator is the total sales occurring in the jurisdiction and the denominator is the company's total sales everywhere. The calculation is similar for payroll and property. For payroll, the numerator is the total payroll occurring in the jurisdiction and the denominator is the company's total payroll everywhere; and for property, the numerator is the total property owned in the jurisdiction and the denominator is the company's total property owned everywhere.[20] Rented property is valued at eight times the annual rental rate.[21] The three factors are then added together and divided by three. The formula can be expressed as follows:

$$\text{Apportionment Factor} = \frac{\dfrac{\text{Sales in City}}{\text{Total sales}} + \dfrac{\text{Payroll in City}}{\text{Total payroll}} + \dfrac{\text{Property in City}}{\text{Total property}}}{3}$$

[17] *Oklahoma Tax Commission v. Jefferson Lines*, *supra*, 514 U.S. at 185.

[18] *Trinova Corp. v. Michigan Dept. of Treasury,* 498 U.S. 358, 380-81 (1991).

[19] *Container Corporation of America v. Franchise Tax Board*, *supra*, 463 U.S. at 170.

[20] *See Microsoft Corp. v. Franchise Tax Board*, 39 Cal.4th 750, 756 (2006).

[21] Rev. & Tax Code § 25130.

Although usually applied to income taxes, the formula can be applied to any tax that needs to be apportioned between business conducted both inside and outside the taxing jurisdiction.[22]

A city can decide to use only one or two of these factors or to weight the factors differently. In *Moorman Manufacturing Co. v. Bair*, the Supreme Court upheld Iowa's decision to stop using the three-factor formula and to use only the sales factor.[23] The plaintiff challenged the change, arguing that the state had to continue using all three factors. In upholding Iowa's formula, the Court explained "that a single factor formula is presumptively valid."[24] Using a single factor could violate the Due Process Clause, but only if it resulted in an apportionment "out of all proportion" to the business activity conducted in the jurisdiction. The Court further held that "a formula-produced assessment will only be disturbed when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted . . . in that State[,]'" and cited as an example a case in which a formula was invalidated under the Due Process Clause because it produced a tax on 87% of the taxpayer's income, when only 17% of the income had its source in the state. [25] The Court in *Moorman* concluded that the plaintiff had not made such a showing.

The selection of the apportionment formula can have a significant impact on the amount of business license tax collected from an internet company, particularly if the tax is measured by gross receipts. Internet companies can generate gross receipts that are much larger than a similarly sized brick-and-mortar store. The payroll and property factors will be very high for the city in which the company is located, while the sales factor will be very low, since most sales will be to customers outside the city. A taxing city will therefore want to avoid too much emphasis on the sales factor, although it should also be careful about ignoring or too heavily downplaying the sales factor, since that could result in almost no apportionment of the tax.

Cities can delegate the power to determine what formula to use to their tax collectors. In *Times Mirror Co. v. City of Los Angeles*, the California Court of Appeal held that the City of Los Angeles could validly delegate to its clerk the authority to craft an apportionment formula.[26] However, once a formula has been selected, it can be difficult to change, as any change in formula that results in increased tax bills for tax payers must be approved by the voters under Proposition 218. [27]

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[22] *See Trinova Corp. v. Michigan Dept. of Treasury*, *supra*, 498 U.S. at 380-81 (upholding application of three-factor formula to a Value Added Tax).

[23] 437 U.S. 267 (1978).

[24] *Id.* at 273. In 1993, California modified the formula to double the weight given to sales, and then in 2011 California started phasing in a formula that uses only the sales factor. Rev. & Tax Code §§ 25128.5, 25128.7

[25] *Moorman Manufacturing Co. v. Bair, supra*, 437 U.S. at 274.

[26] 192 Cal.App.3d 170, 188 (1987).

[27] Cal. Const. Art. XIIIC, § 2(b); *see, e.g.*, *AB Cellular LA, LLC v. City of Los Angeles*, 150 Cal.App.4th 747, 760 (2007).

### 3. *The third prong: no discrimination against interstate commerce*

"[T]he third prong of the Complete Auto test . . . prohibits a State from imposing a discriminatory tax on interstate commerce." [28] This test is usually satisfied by the apportionment requirement and the internal and external consistency tests. [29] Although it is conceivable that a tax could pass the first and second prongs of the test and yet still discriminate against interstate commerce, it is unlikely that a properly apportioned tax on internet companies that satisfies both the internal and external consistency tests would be found to be discriminatory.

### 4. *The fourth prong: fair relation to services provided by the city*

The fourth prong of the *Complete Auto* test asks whether the tax "is fairly related to the presence and activities of the taxpayer within the [jurisdiction]."[30] This requirement will generally be met if the the nexus requirement has been met. "The purpose of this test is to ensure that a [jurisdiction's] tax burden is not placed upon persons who do not benefit from services provided by the [jurisdiction]."[31] However, the amount of the tax is not limited to the cost of the services received by the particular taxpayer or to costs caused by the taxpayer's business activity in the jurisdiction. "[A] taxpayer's receipt of police and fire protection, the use of public roads and mass transit, and the other advantages of civilized society satisf[y] the requirement that the tax be fairly related to benefits provided by the [jurisdiction] to the taxpayer."[32]

## II. Collecting TOT from Online Hotel Brokers and VRBO-type Web-Based Rentals

### A. Statutory and Constitutional Authority to Impose the TOT

Transient occupancy taxes or TOTs are taxes imposed by local governments on visitors (i.e., transients) for the privilege of staying in a local hotel or other paid accommodations.[33] General law cities in California derive their authority to impose TOTs from Revenue and Taxation Code section 7280(a), which permits municipalities to "levy a tax on the privilege of occupying a room or rooms, or other living space, in a hotel, inn, tourist home or house, or other lodging." Charter cities derive their authority to impose TOTs from their "home rule" powers

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[28] *Goldberg v. Sweet*, *supra*, 488 U.S. 252, 265.

[29] *See, e.g., Goldberg v. Sweet*, *supra*, 488 U.S. 252; *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 266 (1987)

[30] *Goldberg v. Sweet*, *supra*, 488 U.S. at 266.

[31] *Id.* at 266-67.

[32] *Id.* at 267.

[33] *See, e.g., City of San Bernardino Hotel/Motel Assn. v. City of San Bernardino*, 59 Cal.App.4th 237, 241 (1997).

under the California Constitution.[34] Like utility users' taxes and similar tax schemes, TOTs are typically paid by the consumer and collected by the hotel owner or operator.[35]

### B. The Online Travel Companies' Business Models [36]

Online hotel brokers, often referred to as online travel companies or OTCs, generally operate under one of two business models: the "agency" model or the "merchant" model. The difference between these models has a significant impact on the proper calculation of TOTs.

In the "agency" model, the OTC acts as a hotel's agent, charging fees to the hotel (and sometimes the consumer) for facilitating bookings. The hotel is the merchant of record in the transaction with the consumer, and it sets the price for the room, which is paid by the consumer directly to the hotel. Under this model, the hotel collects and remits TOTs based on a percentage of the full amount of money the consumer is charged for the room rental (the "retail" rate).

In the "merchant" model, the OTC contracts with a hotel, agreeing to pay the hotel a negotiated "wholesale" rate for a room or block of rooms. The OTC then allows consumers to book rooms using its website, acting as the merchant of record in the transaction with the consumer.[37] Subject to any contractual limitations, the OTC may charge whatever it wants for room reservations, and the hotel is obligated to honor reservations made through the OTC's website. OTCs do not actually purchase or take title to any rooms, nor do they take possession or control of any rooms. Typically, they do not pay for a room before it is actually booked, and they suffer no penalty for failing to book rooms. Under this model, the OTC collects and remits TOTs pursuant to its contract with the hotel, but it only remits TOTs based on the "wholesale" rate it pays the hotel, not the higher "retail" rate it charges the consumer.[38]

### C. Drafting the Right TOT Ordinance

Many TOT ordinances were drafted long before the online "merchant" model became widespread. Relying on these anachronistic laws, OTCs on the whole tend to collect and remit TOTs based solely on the "wholesale" rate they pay to hotels. Because the "wholesale" rate is

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[34] Cal. Const. Art. XI, § 5(a).

[35] *City of San Bernardino Hotel/Motel Assn. v. City of San Bernardino*, *supra*, 59 Cal.App.4th at 241.

[36] This section is only intended to provide a general overview of OTCs' businesses models. It is based primarily on descriptions provided by courts in the summary judgment context—in particular, *City of Goodlettsville, Tenn. v. Priceline, Inc.*, 844 F.Supp.2d 897, 900-03 (M.D. Tenn. 2012) and *In re Transient Occupancy Tax Cases*, Case No. B243800, 2014 WL 1274131, at 8-9 (Mar. 27, 2014) (published decision, but no California Reports or West's California Reporter citations available at the time of writing). Cities involved in litigation with OTCs should utilize the discovery process to determine the specific models employed by each OTC.

[37] To make a reservation, consumers must accept an OTC's terms and conditions. *City of Goodlettesville, Tenn. v. Priceline, Inc.*, *supra*, 844 F.Supp.2d at 901.

[38] Some hotels use a "modified merchant" model, in which the OTC acts as the merchant of record in the transaction with the consumer, but gives the hotel the full amount of money it collects from the consumer. The hotel then pays the OTC a "back end" commission and remits taxes based on the full "retail" rate. This model is very similar to the agency model. *In re Transient Occupancy Tax Cases, supra*, 2014 WL 1274131, at 8.

discounted from the "retail" rate charged by OTCs to the consumer, most litigation regarding the application of TOTs to OTCs is centered on whether taxes should be calculated as a percentage of the "retail" rate, or a percentage of the "wholesale" rate. Jurisdictions wishing to tax the "retail" rate charged by OTCs must carefully craft their TOT ordinances to accomplish the desired result.

One preliminary point is worth emphasizing, as it might help to explain some of the divergent results in the cases discussed below. TOT ordinances must clearly demonstrate an intent to the tax the full "retail" rate, as a reviewing court will likely interpret any ambiguities against the taxing entity under established rules of statutory interpretation. For instance, in the most recent *In re Transient Occupancy Tax Cases* decision, the Court of Appeal emphasized that "[i]n every case involving 'the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen.'" [39]

### 1. *In re Transient Occupancy Tax Cases*

A number of California cities have filed suit challenging the OTCs' practice of collecting and remitting taxes as a percentage of the "wholesale" room rental rate. Many of these cases have been coordinated in the Los Angeles Superior Court in a coordinated proceeding known as *In re Transient Occupancy Tax Cases*. This coordinated proceeding resulted in two unpublished appellate decisions issued in late 2012, dealing with TOT ordinances enacted by Santa Monica and Anaheim, and a third decision, published in March 2014, dealing with San Diego's TOT ordinance.

#### a. *City of Santa Monica* (2012)

In the *Santa Monica* case, the City of Santa Monica issued assessments against a number of OTCs, requiring them to pay the difference between previously-remitted TOTs based on "wholesale" room rates and TOTs based on "retail" rates charged to consumers.[40] The OTCs refused to pay the assessments, and the city filed a collection action.

The Court of Appeal concluded that the city's ordinance only imposed tax on the "wholesale" rate paid by the OTCs to hotels. Santa Monica's ordinance provided: "[T]here is hereby imposed and levied upon each and every transient a tax equivalent to fourteen percent (14%) of the total amount paid for room rental by or for any such transient to any hotel."[41] "Room rental" was defined as "[t]he total charge made by [a] . . . hotel for lodging and/or lodging space furnished any such transient."[42] Relying on the ordinance's plain language, the court noted that the city's tax was defined as a percentage of the amount paid to and charged by

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[39] 2014 WL 850726 at 3, *quoting Pioneer Express Co. v. Riley*, 208 Cal. 677, 687 (1930).

[40] *In re Transient Occupancy Tax Cases*, Case No. B236166, 2012 WL 5360882, at 2 (Nov. 1, 2012).

[41] *Id.* at 5.

[42] *Id.*

the hotel, not as a percentage of the amount paid by the consumer.[43] The court also noted that the ordinance expressly contemplated that an intermediary might be involved in the transaction—that the rental payment could be made "by or for" a transient—but that the tax was nonetheless based on the amount paid to the hotel, exclusive of amounts paid to the intermediary.[44]

**b. *City of Anaheim* (2012)**

In the *Anaheim* case, the City of Anaheim, like Santa Monica, issued assessments for unremitted TOTs covering the difference between the OTCs' "wholesale" and "retail" rates.[45] The OTCs challenged the assessments by seeking a writ of administrative mandamus.[46]

Anaheim's ordinance provided: "For the privilege of occupancy of space in any hotel, each transient is subject to and shall pay a tax in the amount of fifteen percent of the rent."[47] Rent was defined as "the consideration charged by an operator for accommodations, including without limitation any . . . separate charges levied for items or services which are part of such accommodations . . . [,]" and "operator" was defined as "any person, corporation, entity or partnership which is the proprietor of the hotel."[48] The court concluded that the OTCs were only obligated to collect and remit taxes based on the "wholesale" rate they paid to local hotels. It emphasized that the city's ordinance was "drafted with a focus on the amount of consideration charged by the operator," and that the definition of "operator" only encompassed entities that own or have a legal right to physically possess hotel rooms, so as to exclude OTCs.[49]

**c. *City of San Diego* (2014)**

In the recently published *San Diego* case, the City of San Diego issued assessments for unremitted taxes covering the difference between the OTCs' "wholesale" and "retail" rates.[50] The OTCs challenged the assessments by seeking a writ of administrative mandamus.[51]

San Diego's ordinance provided: "For the privilege of Occupancy in any Hotel located in the City of San Diego, each Transient is subject to and shall pay a tax in the amount of six

[43] *Id.* at 5-6.

[44] *Id.* at 6-8.

[45] *In re Transient Occupancy Tax Cases*, Case No. B230457, 2012 WL 5360907, at 2 (Nov. 1, 2012).

[46] *Id.* at 2-3.

[47] *Id.* at 4.

[48] *Id.* at 5.

[49] *Id.* at 5-7, 11.

[50] *In re Transient Occupancy Tax Cases, supra*, 2014 WL 1274131, at 2-3.

[51] *Id.* at 2-3.

percent (6%) of the Rent charged by the Operator."[52] "Rent" was defined as "the total consideration charged to a Transient as shown on the guest receipt for the Occupancy of a room[,]" and "[o]perator" was defined as "the Person who is the proprietor of the Hotel," or "a managing agent, a resident manager, or a resident agent, of any type of character, other than an employee without management responsibility."[53] As it had previously, the Court of Appeal concluded that the OTCs were only obligated to collect taxes based on the "wholesale" rate. The court found no substantive difference between San Diego's ordinance and the Anaheim and Santa Monica ordinances.[54] Notably, it rejected the assertion that the "retail" rate should be taxed because the ordinance referred to "consideration *charged to a Transient as shown on the guest receipt*," emphasizing that, notwithstanding this language, the tax was expressly limited to a percentage of the rent "charged by the Operator," and that OTCs are not hotel proprietors.[55]

### 2. *Other Jurisdictions*

Unlike the *In re Transient Occupancy Tax Cases*, in which the California Court of Appeal has so far uniformly held that TOTs need only be calculated as a percentage of "wholesale" rental rates, lawsuits in other jurisdictions have produced mixed results.

#### a. *"Wholesale" rate cases*

Many courts in other jurisdictions have joined California's courts and concluded, when faced with statutory language similar to the Santa Monica, Anaheim, and San Diego TOT ordinances, that taxes should be calculated based solely on the "wholesale" rate.

- *City of Goodlettsville, Tenn. v. Priceline, Inc.*: An ordinance imposing "a privilege tax upon the privilege of occupancy in any hotel of each transient in an amount equal to three percent . . . of the consideration *charged by the operator*" and defining "operator" as "the person operating the hotel whether as owner, lessee, or otherwise";[56]

- *Louisville/Jefferson County Metro Government v. Hotels.com, L.P.*: An ordinance passed under a statute authorizing a transient room tax on "the rent for every occupancy of a suite, room, or rooms, charged by all persons . . . *doing business as motor courts, motels, hotels, inns or like or similar accommodations*";[57]

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[52] *Id.* at 4.

[53] *Id.* at 5.

[54] *Id.* at 4-5.

[55] *Id.* at 5-9.

[56] *Supra*, 844 F.Supp.2d at 902.

[57] 590 F.3d 381 (6th Cir. 2009).

- *City of Houston v. Hotels.com, L.P.*: An ordinance imposing a tax "upon the cost of occupancy of any room furnished by any hotel . . .[,] such tax to be equal to seven percent of the consideration paid by the occupant of such room *to such hotel*";[58]

- *Pitt County v. Hotels.com, L.P.*: An enabling act authorizing the imposition of a 3% tax on "the gross receipts derived from the rental of any room, lodging, or similar accommodation furnished *by a hotel, motel, inn, or similar place*[.]"[59]

#### b. *"Retail" rate cases*

Other courts have reached different conclusions. For instance, in *City of Atlanta v. Hotels.com*, the Georgia Supreme Court held that taxes should be calculated as a percentage of the "retail" rate based on language imposing a tax "of seven percent of the rent for every occupancy of a guest room in a hotel in the city," with "rent" defined as "the consideration received for occupancy." Atlanta's ordinance was authorized under an enabling state statute that allowed municipalities to impose taxes on "lodging charges *actually collected*."[60] The court emphasized that "[t]he tax is on the consumer. The statute and ordinance do not tax any transaction between a non-occupant such as an OTC and the hotel . . . . Since the consumer cannot obtain the right to occupy the room without paying the retail room rate charged by the OTC, it is the retail room rate that is the taxable amount or 'rent' . . . ."[61] The Georgia Supreme Court reached a similar conclusion with respect to an ordinance, enacted under the same enabling statute, that imposed a tax "in the amount of seven percent *of the charge to the public* upon the furnishing for value of any room or rooms or lodging or accommodations . . . ."[62]

The South Carolina Supreme Court similarly held that a hotel tax applied to the "retail" rate charged by OTCs because the authorizing statute imposed a seven percent tax on "the gross proceeds derived from the rental or charges for any rooms . . . furnished to transients by any . . . place in which rooms, lodgings, or sleeping accommodations are furnished to transients for consideration." The court relied heavily on a definition of "gross proceeds of sale" that encompassed "the value proceeding or accruing from the sale, lease, or rental of . . . property . . . without any deduction for . . . the cost of materials, labor, or service."[63]

A case in the United States District Court for the District of Maryland provides a good contrast between TOT ordinances found to apply to "retail" rates charged to consumers by OTCs

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[58] 357 S.W.3d 706, 713 (Tx. Ct. App. 2011).

[59] 553 F.3d 308, 311-12, 313-15 (4th Cir. 2009).

[60] *City of Atlanta v. Hotels.com*, 710 S.E.2d 766, 769 (Ga. 2011).

[61] *Id.*

[62] *Expedia, Inc. v. City of Columbus*, 681 S.E.2d 122 (Ga. 2009).

[63] *Travelscape, LLC v. South Carolina Dept. of Revenue*, 705 S.E.2d 28, 32-33 (S.C. 2011). *Travelscape* is one of the few cases dealing with a tax that is imposed directly on the entity furnishing rooms, as opposed to a tax on the consumers renting the room. *Id.* at 33-35.

and ordinances limited to the "wholesale" rates paid by OTCs to hotels.[64] Prior to 2007, the City of Baltimore imposed a tax on "all gross amounts of money paid to the owners or operators of hotels in the City by transient guests or tenants for renting, using, or occupying a room or rooms in those hotels."[65] Although "owner" and "operator" were not statutorily defined, the court concluded that the TOT was properly calculated based solely on the "wholesale" rate, because the OTCs were neither hotel "owners," with "owner" defined as "one who has the right to possess, use, and convey something," nor "operators," with "operator" defined as "a person or company that engages in or runs a business or enterprise."[66]

However, in 2007, Baltimore amended its TOT ordinance to define "gross amounts of money" as "the total gross payments of any kind or character . . . without any deduction for charges or other amounts for any services necessary to complete the transaction."[67] Similarly, the term "owner or operator" was defined to include any person "receiving any consideration for the rental of a hotel room for sleep accommodations, including, without limitation, any broker, service provider, or other intermediary . . . with which a hotel has contracted to arrange for the rental of a hotel room for sleeping accommodations."[68] Noting that the taxed transaction now expressly included the full amount paid *by* the consumer *to* anyone acting on behalf of the hotel, the Court concluded that the post-2007 ordinance covered "retail" rates charged by OTCs.[69]

## KEY ISSUES IN DRAFTING TOT ORDINANCES

- Avoid language tying the amount of the tax to the amount of money paid to or charged by the hotel's owner or operator. Instead, use language tying the amount of the tax to the amount of money actually paid by the consumer.

- Include language stating that the amount of the tax should be based on "gross payments," and specify that such payments should be calculated without deducting charges for services employed to effectuate the consumer transaction.

- Use language providing that rent is calculated based on the amount of money paid to any intermediary who facilitates rentals pursuant to a contract with a hotel, if applicable, or who served as merchant of record for the rental transaction.

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[64] *Mayor & City Council of Baltimore v. Priceline, Inc.*, 2011 WL 9961251 (D. Md. Aug. 2, 2011).

[65] *Id.* at 3.

[66] *Id.* at 3-4.

[67] *Id.* at 5.

[68] *Id.*

[69] *Id.* at 5-8.

### D. Collection Obligations

Many TOT ordinances require hotel owners or operators to collect TOT from consumers. For instance, the Anaheim ordinance at issue in the *In re Transient Occupancy Taxes* decision discussed above states that "[e]ach operator shall collect the tax to the same extent and at the same time as the rent is collected from every transient."[70] Ordinances that limit collection obligations to "operators" are potentially problematic when "operator" is defined as the "proprietor of the hotel[,]" because OTCs—the collecting entities—are not operators.[71] Many cities impose liability for unremitted taxes on the entity responsible for collecting TOTs. Although OTCs generally agree to collect TOTs at the time of the consumer transaction, and thus likely act as hotels' agents in this respect, language that limits collection obligations to owners and operators could require cities to assess unpaid taxes against hotels, rather than the OTCs. The Georgia Supreme Court reached this conclusion, explaining that the state's TOT enabling statute "does not contemplate or provide for an enforcement action against a third-party tax collector such as Expedia[.]"[72]

One solution to this problem is to broaden the entities subject to tax collection obligations. An example of language that appears to accomplish this result is Santa Monica's TOT ordinance, discussed above, which states that "every person receiving any payment for room rental with respect to which a tax is levied . . . shall collect the amount of tax hereby imposed from the transient on whom the same is levied or from the person paying for such room rental, at the time payment for such room rental be made."[73]

### E. Other Issues

#### 1. *Proposition 218*

In California, the biggest obstacle to applying TOTs to OTCs is Proposition 218.[74] Many current ordinances will not, as currently worded, cover the full "retail" rate charged by OTCs. Although a TOT ordinance can be drafted so that it will apply to the "retail" rate and not to the reduced "wholesale" rate, changing a TOT in this manner would constitute a tax increase under Proposition 218 and would therefore have to be approved by the voters.[75] However, clarifying who has the obligation to collect the tax should not implicate Proposition 218, as long as the tax itself—who pays it and how much—remains the same.

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[70] Anaheim Mun. Code § 2.12.020.010.

[71] *Id.* § 2.12.005.050.

[72] *See, e,g., id.* § 2.12.060.010 ("If any operator shall fail or refuse to collect the proper amount of tax due . . . , the City Auditor shall proceed to determine and assess the Tax due against the operator.").

[73] Santa Monica Mun. Code § 6.68.040.

[74] Cal. Const. Art. XIIIC.

[75] *AB Cellular LA, Inc. v. City of Los Angeles, supra,* 150 Cal.App.4th at 760.

### 2. *Dormant Commerce Clause*

In some cases, OTCs have challenged TOT ordinances that calculate tax based on the "retail" rate charged by OTCs on the theory that such ordinances violate the Dormant Commerce Clause. The highest state court to confront such a challenge, the South Carolina Supreme Court, squarely rejected it, noting that OTCs have a sufficient nexus with a taxing jurisdiction because they enter into contracts with local hotels, send employees or agents to negotiate with local hotels, and facilitate consumers' ability to travel to stay in local hotels.[76] The court also noted that the tax is internally consistent, in that "[i]f every State imposed a similar tax on accommodations provided within its boundaries, no multiple taxation would occur because the same accommodations cannot be furnished in two different states at one time," and externally consistent, because it is limited to hotel stays within the taxing jurisdiction.[77] Subsequent courts have also emphasized that the tax is paid by the consumer, who has an obvious connection with the taxing jurisdiction to which he or she travels, and that calculating TOT based on the "retail" rate does not discriminate against internet commerce, as it simply ensures that all consumers are taxed at approximately the same level, no matter how they book a room.[78]

## F. VRBO and Other "Sharing Economy" Websites

In the past few years, "sharing economy" businesses such as Vacation Rentals By Owner (VRBO) and Airbnb have become increasingly popular with consumers seeking travel accommodations. Both companies allow renters or homeowners to list rooms, houses, or apartments for rent on their websites. Consumers use the website to select and rent a house or room, and the companies take a cut of this list price for their role in the transaction.[79]

VRBO does not charge renters any additional fees for their services, and thus uses a business model akin to the "agency" model, acting merely as a link between owner and renter. Because the listing party sets the rental price, calculating the TOT is straightforward. Airbnb, on the other hand, acts as the merchant of record and charges a 6% to 12% "guest service fee." In this situation, the tax calculation problems discussed above come into play.[80]

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[76] *Travelscape, LLC v. South Carolina Dept. of Revenue*, 705 S.E.2d at 36-39.

[77] *Id.*

[78] *Village of Rosemont, Ill. v. Priceline.com, Inc.*, Case No. 09 C 4438, 2011 WL 4913262, at 7-8 (N.D. Ill. 2011); *Mayor & City Council of Baltimore v. Priceline.com, Inc.*, Case No. MJG–08–3319, 2012 WL 3043062, at 2-7. These courts have also rejected a similar argument that taxing the OTCs' services violates the Internet Tax Freedom Act, which prohibits states from enacting discriminatory taxes on electronic commerce, because taxing in this manner treats all consumers the same, whether they purchase from the hotel, an OTC, or a brick-and-mortar travel agent. *Village of Rosemont, Ill. v. Priceline.com, Inc.*, *supra*, 2011 WL 4913262, at 9; *Mayor & City Council of Baltimore v. Priceline.com, Inc.*, *supra*, 2012 WL 3043062, at 7-8.

[79] VRBO also allows the listing party to pay a monthly service fee in lieu of a percentage of the rental transaction. "How to Join VRBO Vacation Rentals By Owner," http://www.vrbo.com/info/list-your-property? (last accessed Mar. 21, 2014).

[80] *See, generally*, Airbnb Help Center, https://www.airbnb.com/help?cdn_spdy=1 (last accessed Mar. 21, 2014).

However, certain issues are common to both companies, the first being whether the TOT even applies to stays in rooms or houses listed on their websites. Many TOT ordinances are written broadly enough to (probably) encompass such rentals. For instance, Santa Monica's ordinance, discussed above, imposes a tax on the "total amount paid for room rental by or for any such transient to any hotel," and defines "hotel" as "[a] public or private hotel, inn, hostelry, tourist home or house motel, rooming house *or other lodging place* . . . offering lodging, wherein the owner and operator thereof, for compensation, furnishes lodging to any transient[.]"[81] It is likely that many local ordinances contain similarly broad language, but as the TOT cases make clear, seemingly innocuous details in a tax ordinance can make a big difference.

If the tax applies, then under many current TOT ordinances, the person listing the room will be considered the "operator," and Airbnb or VRBO will have no obligation to collect the tax; in fact, until recently, Airbnb has declined to do so.[82] Expanding the definition of "operator" to include website intermediaries can solve this problem, but careful review of how transactions are structured will be necessary to ensure that these companies are required to collect the tax.

Finally, local agencies should proceed carefully in extending TOTs to Airbnb and VRBO-style rentals. In many jurisdictions, it is not clear that such rentals are permitted under local health and safety or zoning laws.[83] Collecting taxes from these rentals could be seen as an implicit recognition that they are legal. Moreover, cities that decide to collect taxes on rentals should consider who, ultimately, should be liable for unremitted taxes—the website company, or the person renting the room. In the past year, Airbnb has been in discussions with San Francisco and New York officials in an attempt to resolve such policy issues, as these cities (and others) attempt to extend their TOT ordinances into the sharing economy.[84]

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[81] Santa Monica Mun. Code §§ 6.68.010(c), 6.68.020; *see also* Anaheim Mun. Code § 2.12.005.050 (defining "hotel" as "any structure or portion thereof, which is occupied by persons for lodging or sleeping purposes for periods of less than thirty consecutive days including, without limitation, any hotel, bachelor hotel, motel, lodging house, . . . *apartment house*, . . . or other similar structure or portion thereof").

[82] Verne Kopytoff, "Airbnb's Woes Show How Far the Sharing Economy Has Come," Time Business & Money (Oct. 7, 2013), available at http://business.time.com/2013/10/07/airbnbs-woes-show-how-far-the-sharing-economy-has-come/ (last accessed Mar. 18, 2014).

[83] *Siwinski v. Town of Ogden Dunes*, 949 N.E.2d 825 (Ind. 2011) (homeowners' rental of home on VRBO violated town ordinance prohibiting commercial use of property); *City of New York v. Abe Carrey*, Decision and Order on Violations # 035006622J (May 20, 2013) (condominium owner who rented unit out on Airbnb violated owners' certificate of occupancy).

[84] "Airbnb's Woes," *supra*, note 81.