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January 8, 2013

VIA FEDEX

The Honorable Chief Justice Tani Cantil-Sakauye
and Honorable Associate Justices of the
Supreme Court of the State of California
350 McAllister Street
San Francisco, CA 94102-4783

Re: *In re TRANSIENT OCCUPANCY CASES (City of Santa Monica v. Priceline.com, Inc., et al)*, Case No. S207199 ("Opinion").
Letter Brief of the League of California Cities in Support of Petition for Review

To the Honorable Chief Justice and Associate Justices of the Supreme Court:

The League of California Cities ("League") respectfully submits this letter brief in support of the petition for review filed by the City of Santa Monica ("Santa Monica") in the matter referenced above.

THE LEAGUE OF CALIFORNIA CITIES' INTEREST IN THIS CASE. The League is an association of 467 California cities dedicated to protecting and restoring local control to provide for the public health, safety, and welfare of their residents, and to enhance the quality of life for all Californians. The League is advised by its Legal Advocacy Committee, comprised of 24 city attorneys from all regions of the State. The Committee monitors litigation of concern to

municipalities, and identifies those cases that have statewide or nationwide significance. The Committee has identified this case as having such significance.

The League is interested in this matter for both financial and policy reasons. The appellate decision here affects a majority of the League's members, approximately 90% of which have adopted ordinances imposing transient occupancy taxes. At a time when cities are under severe economic duress and the ability to provide basic municipal services is dependent on diligently collecting all revenue sources, California cities will lose tens of millions of dollars a year because the decision here sanctions manipulation by online travel companies ("OTCs") of their business models to evade taxes and violate local tax ordinances. Moreover, and perhaps more importantly, the decision ignores pertinent provisions of the local ordinance and in doing so allows private, third parties to usurp the role of the legislative bodies in establishing tax policy and controlling the flow of information to taxpayers.

THIS CASE MERITS REVIEW TO SETTLE IMPORTANT QUESTIONS OF LAW AND SECURE UNIFORMITY OF DECISION. This case merits review to settle important questions of law and to secure uniformity of decision. (Cal. Rules of Court, rule 8.500, subd. (b)(1).) If review is granted, the League intends to request leave to submit an amicus curiae brief in support of Santa Monica on the merits.

Local governments around California urgently require resolution of this conflict involving many millions of dollars in general fund revenues statewide and a clear statement of the law on their power to interpret ordinances establishing local taxes in light of technological and economic change and to retain control over tax policy, including required disclosure to taxpayers of the amounts being charged to them. Resolving these important issues now, rather than through repeated lower court litigation, will benefit all the litigants in these and similar cases, the lower courts, and California taxpayers.

THE COURT OVERLOOKED IMPORTANT PROVISIONS OF THE ORDINANCE. The heart of the ordinance ("Ordinance") is a tax on "each and every transient." Indeed, the section of the ordinance imposing the tax clearly and expressly imposes the tax on the transient and is based upon the amount

paid by the transient. Santa Monica Municipal Code §6.68.020 ("there is hereby imposed and levied on each and every transient a tax equivalent to fourteen percent of the total amount paid for room rental by or for such transient to any hotel"). The code section does include the words "to the hotel" — upon which the Appellate Court below so heavily relied, but the primary emphasis is on the transient: a tax **on** the transient based upon the amount paid **by** the transient. Moreover, the Ordinance demands that the transient be plainly informed of the amount of the rent and the amount of the tax. If the charge made to the transient "includes any charge for services or accommodations in addition to that of lodging, and/or the use of lodging space, then such portion as represents only room and/or lodging space shall be **distinctly set out** and billed to such transient by such hotel **as a separate item.**" ". § 6.68.010 (emphasis added).

Thus, the primary provisions of the Ordinance expressly and exclusively pertain to a tax **on** the transient, amounts paid **by** the transient and the information provided **to** the transient. Under the express wording of the Ordinance, at the moment the transient pays money for lodging – with the intent that it be provided to a hotel – the tax is imposed and the fact that some of it is diverted, with the hotel's consent, before it reaches the hotel should be irrelevant. Yet, the Court of Appeal overlooked the ordinance's repeated emphasis on the amount paid **by the transient** and the focus on disclosure **to the transient**, and instead asserted that the "tax is imposed on the amount received by the hotel." (Opinion at p. 5.) To the contrary, under the plain language of the Ordinance, the focus is on the transient and the tax is imposed on the amount paid by the transient with an express requirement of transparency to the transient.

Moreover, the court below ignored that the "preferred merchant model" conceived by the OTCs violates the transparency requirements of the Ordinance. Under the plain requirements of the Ordinance, the tax base must be "distinctly set out" and billed as a "separate item." Yet, no such disclosure is made to the transients under the preferred merchant model and, indeed, the transient is utterly unaware of the amount upon which the OTCs contend the tax should be based. The Court of Appeal acknowledged Santa Monica's "concern throughout its briefs" that the "OTC's and the hotels are hiding the tax base, which is unknown to the transient." Opinion at p11, fn. 3. Inexplicably, however, the court

concluded that "the city has not been injured by any such obfuscation." *Id.* As set forth below, the League strongly disagrees; local agencies have a direct and important interest in assuring that the transparency requirements of their tax ordinances are adhered to.

Thus, the Ordinance taxes the amount paid by the transient for lodging, yet under a preferred merchant model transaction the transient is unaware whether or what portion of the money he paid for lodging was diverted before it ever reached the hotel. In short, the business practices of the hotels and the OTCs violate both the spirit and the letter of the Ordinance.

THE DECISION UNDERMINES TAX POLICY OF LOCAL GOVERNMENTS AND INTERFERES WITH THE RELATIONSHIP BETWEEN TAXING AGENCIES AND TAXPAYERS. By emphasizing the language "to the hotel" to the exclusion of the language focusing on the amounts paid by the transient and ignoring the patent violations of the disclosure provisions of the Ordinance, the court below has improperly infringed on the local agency's authority to make tax policy. As set forth in Santa Monica's petition for review, this reading of the Ordinance allows OTCs to violate the disclosure requirements of the Ordinance and to evade taxes. It is simply not the OTCs' — nor the courts' — province to determine whether the disclosure required by the Ordinance may be sacrificed to the OTC's desire to evade taxes and thereby gain an advantage against their competitors in the transient lodging business who use more traditional models. These are policy issues reserved to cities as taxing agencies.

Indeed, as this Court has explained, the California Constitution expressly reserves these rights to charter cities, such as Santa Monica. "The taxation power is vital and is granted to charter cities by the Constitution." *The Pines v. City of Santa Monica* (1981) 29 Cal.3d 656, 660; Cal. Const., art. XI, § 5, subd. (a); art. XI, § 12. This Court has further held that "levying taxes to support local expenditures qualifies as a 'municipal affair' within the meaning of the home rule provision of our Constitution" (*Cal. Fed. Sav. & Loan Ass'n v. City of Los Angeles* (1991) 54 Cal. 3d 1, 13) and observed that "the power of taxation is a power appropriate for a municipality to possess" and that such proposition was "too obvious to merit discussion." (*Ex parte Braun* (1903) 141 Cal. 204, 209.) This Court has thus repeatedly held that matters of local taxation are municipal affairs

and that even the State cannot "decree the essentials of municipal tax policy." *Cal. Fed. Sav. & Loan Ass'n,* supra, 54 Cal.3d at 14.

Here, the decision to shift the emphasis of the Ordinance from the amounts paid by the transient to the amount received by the hotel and sacrifice the disclosure expressly required by the city unnecessarily intrudes on the tax policies of local agencies and disrupts the fundamental relationship between a taxing agency and its taxpayers. As stated by the Court of Appeal, "The purpose of the statute 'will not be sacrificed to a literal construction' of any part of the statute." Opinion at p. 8.

Furthermore, disclosure requirements are not unique to Santa Monica but rather reflect a common policy determination by cities and a commitment by numerous agencies to fairness and transparency in their relationships with their taxpayers. To cite but a few examples:

- Los Angeles Municipal Code § 21.7.5 ("The amount of tax shall be separately stated from the amount of the rent charged and each transient shall receive a receipt for payment from the operator");
- San Diego Municipal Code § 35.0112 ("The amount of tax charged each Transient shall be separately stated from the amount of Rent charged, and each Transient shall receive a receipt");
- San Jose Municipal Code § 4.72.050 ("The amount of tax shall be separately stated from the amount of the rent charged");
- Sacramento Municipal Code § 3.28.070 ("The amount of tax shall be separately stated from the amount of the rent charged, and each transient shall receive a receipt for payment from the operator").

Such polices are designed as consumer protection to prevent the kind of shell games that the OTCs engaged in here by concealing from their customers the distinction between taxes paid to government and "fees" pocketed by the OTCs. In addition, they are intended to facilitate enforcement of the tax by leaving a clear audit trail for the City to ensure its tax is properly collected and remitted to the City. The practice countenanced here frustrates both goals.

The extent to which a private third party may undermine these requirements by a carefully crafted business model, and the extent to which the

courts may condone such manipulation by elevating some provisions of an ordinance over others, are thus important questions of statewide significance.

Finally, established tax doctrines allow courts to avoid unnecessary intrusion into the local agencies' domains. These rules will allow this Court on review to reconcile all of the provisions of the tax ordinance and to preserve the role afforded by our Constitution to local legislators to establish tax policy.

As discussed in Santa Monica's petition for review, the step transaction doctrine allows the court to view the entire series of steps as a single transaction. Doing so, would bring the entire transaction into compliance with all provisions of the tax ordinance because the amount of the hotel charge stated to the transient by the OTC would, in fact, be the taxable amount. Unfortunately, the Court of Appeal rejected this doctrine, stating it was inapplicable because "the hotels and the OTCs have not structured the preferred merchant model transactions for the purpose of avoiding tax liability. Nor do preferred merchant model transactions lie 'outside the plain intent of the statute.'" Opinion at p. 20. The League respectfully disagrees. Quite the contrary, the preferred merchant model transactions are not only designed to evade taxes, but on their face violate the plain intent of the Ordinance to require those in the transient lodging business to plainly disclose to transients the tax base and to base the tax on the amount the transient pays for lodging. A business model designed to ignore the amount the transient intended to pay to the hotel and defeat this disclosure requirement is improper and should not be condoned. It alone is sufficient to justify application of the step transaction doctrine.

Similarly, the court below erred in concluding that the OTCs are not agents of hotels. As discussed in the city's petition for review, the OTCs were clearly acting as the agents of the hotels in selling the rights to occupy rooms in the hotel. To use industry parlance, the OTCs "put heads in beds" for their profit and that of the hotel, just as surely as the hotels' own direct marketing efforts do. From the transient's perspective – the perspective from which the Ordinance is drafted – when he pays money to the OTC as agent for the hotel he is paying money to the hotel; when the OTC charges money from the transient on behalf of the hotel, it is a charge by the hotel. Accordingly, Santa Monica has determined that, under the terms of its tax ordinance, when a transient pays money for

lodging to an agent of a hotel, it should be considered a payment "by a transient to a hotel" for lodging. That interpretation is not only reasonable, it is compelling. Moreover, it reconciles the tax and disclosure requirements of the Ordinance, providing for compliance with both. For the courts to override the city's determination in order to impose an interpretation that both ignores the agency relationship and violates the disclosure requirements of the Ordinance is an unnecessary and unwarranted intrusion on the discretion of the local agency.

By contrast, the Opinion gives inappropriate deference to the OTCs' characterization of the payments they receive. Were all taxes so easily avoided by the mere labels devised by those whose service or product is taxed, no government could survive. It is not the goal of judicial review of tax legislation to reward the clever; but to serve the social and policy goals stated here. The appellate court simply failed to give proper consideration to the broader case law concerning agency and the goals of tax law to provide a level playing field for those in a taxed industry and to ensure a predictable, transparent and rational flow of revenues to fund essential government services.

What matters is not the cleverness or opaqueness of the labels chosen by the brick and mortar hoteliers and their on-line marketing agents, but the economic substance of the transaction. Transients rent rooms and the consideration they pay for the privilege of occupancy is intended to be taxed, without respect to the labels the tax collector may devise to fatten its bottom line at the expense of the public fisc. The proper question here is not whether the OTCs' charges are taxable in isolation, but whether they become taxable when bundled with other taxable transactions and not segregated. The issue is economic substance, not self-serving labels chosen by those with an enormous incentive to evade tax.

Indeed, the OTCs' argument ignores fundamental law and policy that one may not benefit by obscuring the distinction between taxable and non-taxable transactions. A taxpayer seeking to exclude amounts from taxation bears both the burden of proof and the burden of production to establish the proper amount of tax that was due. See, e.g., 18 Cal. Code of Regs., § 5541 ("[e]xcept as otherwise specifically provided by law, the burden of proof is on the taxpayer as to all issues of fact"); *Flying Tiger Line v. State Board of Equalization*, (1958) 157

Cal.App.2d 85, 99 (burden of proof is on the taxpayer); *People v. Schwartz*, (1947) 31 Cal.2d 59, 64 (same); *Hall v. Franchise Tax Board*, (1966) 244 Cal.App.2d 843, 848 (same). This is because the taxpayer is typically in possession of the information necessary to prove these things while the government is not. Here, a taxpayer transient could never carry the burden of proving that some portion of the payment he or she made was non-taxable, because the taxpayer was never given a breakdown of the charges as the Ordinance requires!

Nor do taxpayers realize any benefit by the decision in this case. Instead, the OTCs seek to be rewarded — by a determination that a portion of the amounts paid by the transients for the privilege of occupying a hotel room should be excluded from the definition of rent and pocketed by OTCs – for violating the Ordinance's requirement that rents and taxes be plainly disclosed. This incentive is fundamental to all third-party taxes (i.e., those collected not by government but by the purveyor of the taxed good or service) and tax law has long since found a solution. When a tax collector fails to segregate non-taxable from taxable charges the bundled charge is taxable to the taxpayer. *McDonnell Douglas Corp. v. General Telephone Company of California*, (1979) 594 F.2d 720, 723 (telephone tax collector owes no duty to segregate taxable from non-taxable service charges but failure to do so renders the whole taxable). Under such "bundling" rules, bundling taxable and non-taxable charges renders them all taxable. This promotes good record keeping, disclosure to consumers, and promotes audit and enforcement of the tax. These long-standing and fundamental tax policies do not allow those who obscure the information to benefit from their own lack of transparency. This is the rule even where separately stating charges is not required, and it applies all the more strongly here given the express requirement of the Ordinance that room rents and taxes be distinguished and disclosed.

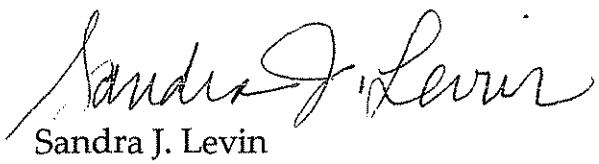
Indeed, transients are harmed by this practice —they lose the benefit of the public services that proper collection of the tax would fund. Who would visit Santa Monica's beaches, parks, restaurants and amenities if there were no streets to carry them there, police to protect them there, and fire fighters to serve them there? Yet this is the world the OTCs seek – in which hotels and their agents can

conspire to determine how much of what is fundamentally room rent they will consent to submit to tax and how much they will pocket.

In sum, the Opinion's almost exclusive focus on the three words "to the hotel," without consideration of the rest of the text and circumstances, fails to harmonize these words with more fundamental provisions of the Ordinance and long-standing common law and statutory tax rules. The instant case is not just about specific code interpretation; it is about who has the authority to reconcile competing provisions of local tax code, whether the courts will impose consequences for violation of transparency requirements and whether private, third parties may usurp the role of the legislative body in determining tax policy. These are important questions to cities.

CONCLUSION. For all these reasons, the League respectfully urges this Court to grant Santa Monica's petition for review.

Sincerely,



Sandra J. Levin

Attachment: Proof of Service

CERTIFICATE OF SERVICE U.S. MAIL

I, the undersigned, declare under penalty of perjury that I am a citizen of the United States; I am over the age of 18 years of age and not a party to the above entitled action. My business address is 300 South Grand Avenue, Suite 2700, Los Angeles, California 90071.

I caused to be served copies of the following document(s): **LETTER BRIEF OF THE LEAGUE OF CALIFORNIA CITIES IN SUPPORT OF PETITION FOR REVIEW** by placing true and correct copies of said document(s) in a sealed envelope addressed as follows:

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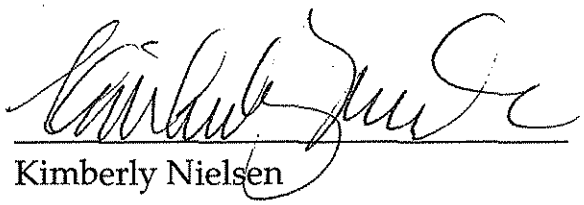
I further declare that the envelope was mailed with postage thereon fully prepaid. I am readily familiar with the business practice for collection and processing of correspondence for mailing; and that the correspondence shall be deposited with U.S. Postal Service this same day with postage thereon fully prepaid at Los Angeles, California in the ordinary course of business.

I declare under penalty of perjury under the laws of the State of California the foregoing is true and correct and that this declaration was executed this 7th day of January, 2013 at Los Angeles, California.



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