Online Travel Companies and Hotel Occupancy Taxes: Merely Syntax or a Question of Ethics?

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Abstract

This manuscript discusses the dispute between the Online Travel Companies (OTCs) and taxing authorities related to hotel occupancy taxes. It explains the business models utilized by the OTCs, which allows them to compete directly with the hotel companies to market and sell hotel accommodations, and quantifies the outstanding tax liability. Finally, the manuscript suggests that the OTCs, hotels, and taxing authorities work together toward an equitable resolution, which is ultimately in everyone's best interest.

Introduction

Online Travel Companies (OTCs) are engaged in litigation with taxing authorities in various jurisdictions throughout the Unites States—the dispute involves hotel occupancy taxes. Many tax authorities, including municipal, county, and state governments have filed claims against the OTCs alleging under-payment of hotel occupancy tax liabilities. In some cases, courts have ruled in the favor of the taxing authorities; in others, the OTCs have been found to not be responsible for any further tax payments; while in other instances, out-of-court settlements have been reached or are being considered and negotiated. The purpose of this manuscript is as follows:

1. Outline the two primary business models utilized by OTCs
2. Explain the reason for the tax dispute
3. Estimate the value of the liability

4. Discuss the legal and ethical considerations

Reach of the Online Travel Companies (OTCs)

In less than fifteen (15) years, Online Travel Companies (OTCs) have revolutionized the way that travel products and services are marketed, sold, and purchased. Travel is the ideal product to sell online since it is an information exchange, which requires 'no trucks'; physical products do not need to be stored in or shipped from warehouses since online marketers of travel services utilize e-tickets and electronic confirmations. Consequently, OTCs were some of the earliest e-commerce firms to operate profitably with Expedia and Travelocity reporting profits, before non-cash items, as early as the March quarter, 2001 (Zellner, 2001). Between 1998 and 2001, the use of the internet to aid in booking hotel rooms reached a 'flashpoint', experiencing a fifty-four percent (54%) increase (Gregory & Breiter, 2001). It was estimated that nearly thirty cents ($0.30) of every dollar ($1.00) spent on travel by U.S. consumers was spent online as early as 2001 (Zellner, 2001). The online exchange of travel products and services has continued to grow over the past decade with the OTC Expedia reporting that in 2010 OTCs controlled fifty-four (54%) of all travel sales in the United States and thirty-eight (38%) of revenue share in the U.S., Europe, and Asian-Pacific regions combined (Expedia, 2011). Smith Travel Research estimates that OTCs accounted for $8.64 billion or 7.2% of the $120 billion in hotel revenue generated in 2010 (King, 2011). Two different business models are typically employed by OTCs when selling hotel accommodations—the 'agency' model and the 'merchant' model.

Initially, many of the Internet travel websites operated as online travel agencies accessible to anyone with Internet access. With the agency model, OTCs allow travelers to access the hotel room rates and availability information, which the OTCs access through the Global Distribution System (GDS), originally developed by the airlines to serve the travel agency community, and to book hotel reservations online. In exchange for facilitating the transaction, OTCs receive commissions from the hotel like a traditional travel agent. Hotel room rates in this model are 'transparent', which means that the hotel, travel website, and consumer are each aware of the room rate that is being charged to the consumer by the hotel; the applicable sales tax and hotel occupancy taxes are collected from the consumer and paid to the appropriate taxing authorities by the hotel on the retail room rate booked on the website.

OTCs also employ the merchant model. In the merchant model, OTCs take advantage of the perishability of hotel accommodations and negotiate extremely competitive wholesale guestroom rates, utilizing the large volume of customers that utilize their sites as leverage. The OTC marks-up the price of the room and re-sells the room at a higher price on their site; the margin on this room sale exceeds the traditional ten percent (10%) travel agent commission, typically running twenty-five percent (25%). Since the room rate offered to the customer through the merchant model is often competitive with the agency model guestroom rate, while the margin earned by the OTCs utilizing the merchant model is much greater, some OTCs are employing strategies to aggressively increase this source of revenue as a percentage of total revenue. For Expedia, Inc., the largest global OTC, hotel bookings represented sixty-three percent (63%) of the firm's total revenue in 2010 and the firm has identified a desire to grow hotel bookings, along with advertising and media charges, as a proportion of their total sales mix due to the strong contribution margin generated by this business model (Expedia, 2011).

Priceline.com popularized a variation on the merchant model through its 'name your own price' strategy. In this situation, the consumer bids on a hotel room within a specific category and then, based upon the bid that is received from the consumer, the travel website selects the specific hotel in which the consumer will stay and purchases the appropriate accommodations at the OTC's negotiated wholesale rate once the consumer has committed to purchasing the accommodations. For obvious reasons, it is not in the best interest of Priceline and OTCs employing the merchant model for the consumer to know the actual room rate that the travel websites are paying the hotel. As a result, guestroom rates under this model are 'opaque' and not shared directly with the customer; the OTCs insist that hotels keep these rates strictly confidential. Any changes made to the reservation, including extending the guests' stays for additional nights, are to be referred by hotel personnel back to the OTC since hotel personnel cannot share or discuss the room rate and typically do not even have direct knowledge of what rate the guest has actually paid for the room. Room charges as well as sales and hotel occupancy tax charges are paid directly to the OTC at the time the reservation is made for the entire stay; the travel website then pays the hotel the wholesale rate and sales and hotel occupancy tax on the wholesale rate for each night of the guests' stay. Hotels are required to keep the rate confidential due to their contractual obligation and share a vested interest in maintaining its confidentiality since hotels do not want guests to know that they are often willing to accept far less than the lowest available published rate.

The tax dispute

The dispute between the taxing authorities and the OTCs concerns bookings utilizing the 'merchant model'. The OTCs utilize the gross, retail room rate charged to the customer as the basis for calculating the hotel occupancy tax liability owed for 'taxes and fees' on the rental of the room accommodations, while they forward to the hotels the hotel occupancy taxes based upon the wholesale room rate charged by the hotels to the OTCs for rental of the accommodations. For example, in a jurisdiction in which hotel occupancy taxes total fifteen percent (15%) of the room rate and the customer is charged a $100.00 retail room rate, the OTC will typically charge the customer $15.00 for hotel occupancy 'taxes and fees'. Yet, the OTC will forward to the hotel the negotiated room rate, which would typically run $80.00, assuming the OTC is taking a twenty-five percent (25%) mark-up, and taxes of $12.00 to be forwarded to the tax authority. The $3.00 difference between the 'taxes and fees' collected and the taxes forwarded to the hotel for payment to the tax authority is retained by the OTC as a "tax recovery fee" (Healy & Nelson, 2006). Many taxing authorities throughout the United States have filed lawsuits against the OTCs, taking the position that hotel taxes are due on the full retail room rate charged to the customer by the OTCs as opposed to net rate charged to the OTCs by hotels.

Financial impact of the dispute

While the amount of the dispute, based upon the example provided above, may seem to be relatively small, the potential unpaid tax liability is actually quite substantial. In the example provided, a $3.00 increase in the $20.00 per room night margin that the OTC earns on the room represents a fifteen percent (15%) increase in the OTC's margin on the transaction. Hotel transactions generated over $2.1 billion of Expedia, Inc.'s revenue alone in 2010 (Expedia, 2011). If just this one OTC retains a portion of the taxes collected and increases their hotel revenues by only ten percent (10%) due to this strategy, this represents over $200 million in lost tax revenue by the various tax jurisdictions and an increase of equal amount in the OTC's profitability. Smith Travel Research, a hotel industry research firm, estimates that the OTCs cost hotels $2.5 billion in 2010, due to the 22% - 25% markups that the OTCs enjoy; this is the difference between the room rate charged to guests and the room rental charges paid by the OTCs to hotels (King, 2011). Based upon an average U.S. hotel occupancy tax rate of 13.4% (Sturken, 2011), the outstanding tax liability on this mark-up may total approximately $335 million.

Discussion

A variety of court rulings have favored litigants on both sides of the issue. The Supreme Court of the State of South Carolina upheld a decision that awarded the State's Department of Revenue $6.376 million in assessment and penalty (Anderson, 2011) while other jurisdictions have not been so fortunate. For example, courts in Arizona, Massachusetts and New York, have ruled in favor of Online Travel Companies (OTCs) (Healy & Nelson, 2006). Meanwhile, the OTCs have settled out-of-court with the City of Charleston, South Carolina for over $600,000 and Horry County, South Carolina was awarded over $1.7 million (Dickerson, 2011). One salient factor in the various rulings is related to the treatment of the mark-up—whether it is considered room revenue, which is subject to an occupancy tax, or a service fee, which is not taxable (Healy & Nelson, 2006). In other jurisdictions, the primary issue centers on whether an OTC may be considered a hotel operator or innkeeper since tax ordinances in many jurisdictions specify that operators of hotels, motels, inns, and other lodging establishments are responsible for paying occupancy taxes on rents collected; the OTCs have successfully argued that they are not hotel operators or innkeepers. South Carolina appears to have been successful in collecting taxes due to the South Carolina Sales and Use Tax Act, which stipulates that taxes are to be paid on “the gross proceeds derived from the rental or charges for any rooms…or sleeping accommodations furnished to transients for a consideration” [S.C. Code Ann. Section 2336-920(A)]. The South Carolina tax code also specifies that “every person engaged…in the business of furnishing accommodations to transients for consideration” is subject to the tax [S.C. Code Ann. Section 2336-920(E)] (Anderson, 2011). Gross proceeds may be considered to include room rental as well as any additional fees or mark-up that may be collected in consideration for furnishing accommodations and the OTCs as a person engaged in the business of furnishing accommodations. Whether an OTC may be considered a hotel operator may be more debatable.

The OTCs are clearly in the hotel business and are engaged in many business activities that are typically reserved for hotel operators—the OTCs advertise hotel rooms, price hotel rooms, sell overnight accommodations, collect sales and hotel occupancy taxes on hotel rooms, compete with other hotel operators for market share, control access to hotel guestroom inventory, and even provide direction to hotel personnel. The OTCs’ clients access the Internet travel websites specifically to book hotel rooms, to make other travel related purchases or arrangements, and/or to obtain travel related information (for which there is not a fee charged by the OTCs). Although OTCs earn income in other ways, through paid advertising on their site and the like, one of their primary sources of income is through the profits that they earn by renting hotel rooms and other overnight lodging accommodations to their clients. The clients that book hotel rooms via the Internet travel sites access the sites to purchase hotel accommodations not to pay fees. The OTCs make it appear as though the bulk of the funds that they collect from their clients are for room charges since the bulk of the revenue collected by the OTCs is labeled on the Internet travel websites as room revenue. Many clients booking hotel rooms on the travel websites may not be aware that a portion of the room revenue collected by OTCs, utilizing the merchant model, is actually retained by the OTC, while others may assume that a commission is paid to the OTCs by the hotels. Taxes and fees that are collected closely mirror the actual tax liability that is incurred at the retail rate of the room. Consequently, some clients may be left with the impression that the fees collected by the OTC is merely the difference between the actual tax liability incurred due to the associated room charges and the tax recovery fee that the client pays on a per night basis to the OTC. As a result, clients may perceive that the bulk of the money that the client pays to an OTC to rent a hotel room is to pay the lodging property for the overnight accommodations and the associated tax liability, which leaves only a small fee that is collected by the OTC for their services; however, the previous explanations provide insight as to how this perception is not reality.

In reality, the OTCs receive a significant portion of the room revenue. One additional indication of the OTCs role as a hotel operator, as opposed to being strictly a travel intermediary that merely provides a service in exchange for a fee, is the fact that OTCs earn contribution margin for each night of a hotel guest's stay as opposed to earning a fee for each reservation that is provided to a hotel regardless the length of the guest's stay. Typically, the central reservation offices (CROs) for the hotel chains charge a fee-per-reservation since the CROs' cost of acquiring and transmitting a reservation is the same whether they are transmitting a reservation for a one-night or multiple-night stay. If the OTCs are operating strictly as online reservation centers, perhaps the OTCs would expect to be compensated on a fee-per-transaction basis not based upon the retail rate that the OTC is able to charge, less the wholesale rate that they are able to negotiate, for each night of the client's stay.

Hotel operators do not typically own the hotel real estate that they manage. Consequently, it is not a requirement that a hotel operator owns a hotel(s) or any other real estate asset(s), which eliminates this potential argument by the OTCs. As previously stated, OTCs advertise hotel rooms, price hotel rooms, sell overnight accommodations, collect sales and hotel occupancy taxes on hotel rooms, compete with other hotel operators for market share, and even provide direction to hotel personnel, which are all business activities typically reserved for hotel operators. In addition, OTCs control unsold hotel guestroom inventory in selected markets. Looking at each of these activities individually: Hotel operators engage in advertising and other marketing activities in an effort to attract customers to purchase the hotel rooms that they have available within their inventory—OTC's engage in this activity (e.g. an abundance of television advertising is aired each day by the OTCs to encourage consumers to utilize their sites to purchase hotel accommodations). Hotel operators price hotel rooms—OTC's engage in this activity when setting retail room rates on their sites, when operating under the merchant model, or even when they allow customers to "set their own price" since OTCs are making a pricing decision by allowing customers to suggest the price, which the OTC sometimes reject. The OTCs engage in selling overnight accommodations; the clients of the OTCs book and pay for hotel accommodations directly on the OTC's website. The OTCs also collect hotel sales and occupancy taxes via their Internet travel websites. The OTCs compete with the hotel chains for market share. As previously outlined, it is more profitable for the hotels to sell their accommodations directly to the consumer, through their propriety and/or branded website, in-house reservation office, or central reservation office, than to provide the room to an OTC at a wholesale rate for the OTC to re-sell. As a result, the hotel chains implement strategies to encourage guests to book reservations directly with them or on their brands' respective websites as opposed to utilizing an Internet travel site. The OTCs have countered these efforts by matching or closely matching the rates that are available on the hotel sites and by charging taxes and fees that are actually slightly below the tax rate that the hotel sites must charge, which the OTCs have been able to do since the OTCs are only paying taxes on wholesale versus retail room rates; this actually makes the total purchase, for the combined room and tax charges, less expensive for the customer when the customer purchases the room from an Internet travel site as opposed to booking on a hotel's proprietary site at the exact same retail room rate. These practices, coupled with the aggressive advertising strategies employed by the Internet travel sites, illustrate just some of the ways that OTCs are engaged in competing directly with the hotel companies in attracting customers to their respective booking sites. The OTCs also provide direction to hotel personnel regarding their clients. The Internet travel companies' contracts with hotels require that the wholesale rates that the OTCs pay for accommodations remain confidential. In addition, for guests that purchase their accommodations through an Internet travel site, hotel staff members are instructed to direct customer requests for changes to the reservations, additional nights, as well as other inquires about room rates, refunds, and/or payment for the room directly to the Internet travel website's (OTC's) personnel. Additional nights, once the guest is in-house, are not to be extended at the OTCs' wholesale rate, but typically at the hotels prevailing rates for the given date. Finally, like other hotel operators, the OTCs control and manage unsold guestroom inventory. In high volume destinations, OTCs often have contracts in place with hotels and other lodging facilities to provide them with guaranteed access to a specific number of guestrooms at the negotiated wholesale rate; this ensures the OTCs that they will have room inventory available to re-sell in specific markets even during high demand periods. From this discussion, it is clear that the OTCs are not merely facilitating an information exchange between travelers and hotels for a small fee—OTCs are actively engaged as operators in the hotel business.

Obviously, the business model is different for the Internet travel websites as to how they are engaged in the hotel business. OTCs do not own, build, or develop hotels and they do not operate like more traditional hotel management companies; however, OTCs are clearly engaged in the sale, management, and control of hotel accommodations. Traditional hotel operators, such as hotel management companies, typically control the hotel facilities by contracting to manage hotel properties for the owners of the hotel real estate. OTCs have created a new business model through which they actively engage in the hotel industry by controlling large numbers of consumers of hotel room nights. The OTCs merely pay others to provide, clean, and maintain the actual hotel accommodations. Once an OTC sells accommodations at a specific hotel, the OTC controls the hotel room. That reservation cannot be cancelled, changed, or refunded to the customer by the hotel; the customer must work directly with the OTC. In many cases, the hotel is not even aware of the actual room rate that the guest has paid for the room. In addition to controlling the rooms that have been sold by the OTCs, the OTCs often control unsold room inventory, of a specified quantity, in selected hotels as well through their contractual relationships with hotels. In exchange for access to a hotel's room inventory, the OTCs provide the hotel with incremental revenue and exposure on its website(s), which has been demonstrated to increase a hotel's bookings even on the hotel's own or branded website (King, 2011).

Semantics or ethics

Ultimately, the tax liability debate comes down to a question of semantics—what does the tax ordinance state and what is the meaning of each of the words utilized within the given context? When substantial funds are involved, each interested party tends to interpret the meaning of the words included in an ordinance in a manner that is most beneficial to their preferred position. In the preceding paragraphs, arguments have been made to justify the classification of OTCs as hotel operators, which the OTCs may wish to avoid in an effort to minimize their tax liability. In addition, it appears as though the OTCs may not fully disclose the details of a hotel transaction that occurs on their websites perhaps to camouflage the share of the room and tax transaction that they retain. Hotel companies, such as Intercontinental Hotel Group—owner of the Holiday Inn brands among others, pulled their inventory from OTC websites for a period of time due to the dispute (King, 2011) and has required that the OTCs indemnify them against any tax liability related to OTC transactions since they may be of the opinion that the taxing authorities may be owed taxes on more than net rate charged by hotels to the OTCs. And hotel companies and OTCs are now involved in lobbying efforts related to laws that may provide the OTCs with cover on the issue (Serlen, 2011). Many taxing authorities may respond to the recent South Carolina hotel occupancy tax rulings by re-writing their tax ordinances to ensure that OTCs pay their fair share.

Any student of business ethics is aware that firms must obey the law; however, it is sometimes a challenge to do what is right. As firms work to gain competitive advantage, it becomes easier to justify or rationalize a position based upon the semantics of an ordinance or debate; however, a truly ethical business leader consistently strives to do what is right. Hotel occupancy taxes are collected to assist in funding many of the services needed to support travelers. In addition, a portion of many hotel taxes are utilized to promote travel to the given market and/or to fund convention centers as well as visitor and convention bureaus. Ultimately, hotel occupancy taxes are paid by the consumer—not the hotels or OTCs. Hotel taxes add to the overall cost of travel and, if they are too high, may discourage travel. Therefore, it is in the best interest of hotels, OTCs and taxing authorities to work together to ensure that hotel occupancy taxes are responsibly established and fully disclosed so that all parties, including the consumer, understand the amount, purpose, and rationale of the tax.

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