

ORDINANCES

The Online Travel Gang Meets Its Match

by Erich R. Eiselt, Assistant General Counsel and Editor

Ten years ago, Priceline was a young Nasdaq company, pioneering the sale of discounted hotel rooms, rental cars and airline seats via the internet. Its 2003 profits were somewhat short of $12 million, and its stock price ("PCLN" on the Nasdaq) was $18 per share.

A decade later, the power of cyber-negotiating and web-fueled bargain hunting is unquestioned. Via Priceline, Expedia, Travelocity, Orbitz and Hotels.com and a host of others, the online travel companies (so-called "OTC's") offer savvy travelers the tools to drive prices down. Rather than leave a room empty or a seat vacant, hotels, airlines and car rental companies slice prices, covering base costs and plumping occupancy statistics.

Priceline was in the right place at the right time. Travelers flocked to the internet in search of deals and OTC revenues soared. In 2012, the company reported net income of $1.4 billion. Today, one share of PCLN sells for well over $1,100—a 60-fold increase in ten years. And with good reason—as OTC proponents correctly point out, travel providers are more efficient, consumers save money and have more choices, investors are happy--everybody wins.

In theory. Behind the scenes, however, each of these constituents has benefitted at the expense of states and localities, which have been systematically deprived of their fair share of taxes as the discount-travel feeding frenzy rolls merrily on. One facet of PCLN's profitability—and that of its fellow OTC's—is a mechanism which avoids the payment of lodging taxes. The OTC model splits the amount paid by the traveler for lodging into two components-- a hotel room cost and a service fee. Most municipalities have long had in place an occupancy tax, which functioned well enough when consumers bought directly from hotels—the city would reap 6%, or 10%, or more—on the price paid to the hotel. This helped cover the cost of safe streets, clean parks, public transit, emergency response and so on that a traveler might expect when venturing to another town.

As recounted in various articles in prior issues of *Municipal Lawyer*,[1] the OTC's model is different. The OTC pays the hotel only a portion of what the traveler pays the OTC, with the rest being a 'service fee' or the like: Assume that the hotel makes available, at the last minute, an unfilled room that normally fetches $200 per night. The seasoned traveler notices the room on an OTC website for $160, and happily pays that price. Had the traveler directly paid for the room, the hotel would have charged local occupancy tax on that amount—say 10 percent, yielding $16 in taxes to the city. But behind the scenes, an OTC may have hypothetically purchased the room from the hotel for only $120—and added a $40 service fee on top, creating the $160 price paid by the traveler. The OTC would only collect the 10 percent tax on the $120 room fee it paid to the hotel, and pocket the $40 without paying any occupancy tax whatsoever on that portion. Instead of receiving $16 in lodging taxes, the city would receive $12.

When the exercise is repeated at tens of thousands of hotel rooms across the nation every day, the lost occupancy tax revenues are staggering. For example, estimates are that the OTC's generated more than $2.7 billion in hotel lodging fees in 2010. At a nationwide average occupancy tax rate of 12.6 percent, that $2.7 in fees would have generated some $340 million in local taxes--for a single year.[2]

The problem lies in terminology. Most hotel occupancy tax statutes impose taxes on the price collected for "rent" or "lodging" -- or to amounts received by the hotel's "owner" or "operator." In most instances, Priceline, Expedia and their colleagues have successfully argued that they are not owners or operators,[3] and the fees they charge are not remuneration for lodging but for services. Across the country, municipalities have been deprived of tens of millions of dollars as they lose case after case to the OTCs' well-oiled litigation machinery. Indeed, according to a study in May 2012 by the pro-OTC Tax Foundation, out of 70 actions brought by revenue authorities in 25 jurisdictions to collect OTC occupancy taxes, only 4 of them had succeeded. The OTC's had won outright in 18 jurisdictions, with cases still underway in a handful of states.[4] Among its "Key Findings" the Tax Foundation concluded that the real motivation behind taxing internet-based travel services was to shift the tax burden to nonresidents, "burdening the flow of interstate commerce;" and it advised "Local governments should not expect easy revenue from pursuing such claims."[5]

But the tide may be turning. In August last year, Hawaii won a $246 million judgment against the OTC's for unpaid excise taxes on hotel rooms from 2000 through 2011. As Hawaii's Attorney General stated in a press release touting the victory, the State is still pursuing another $200 million-plus in "Transient Accommodation Taxes" for the same period.[6]

And last November, New York City became the most recent victor in the battle against OTC's. *Expedia v. City of New York*,[7] which reversed a lower court ruling, exhibited some now-familiar tactics of the OTC's. They argued that the City taxing statute was too vague to permit an impost on the *service* component of the hotel room transaction, and applied only to "occupancy." Furthermore, even if the statute did allow a tax on intermediary booking services, the tax was not permitted under the New York State constitution, which required that the State legislature expressly grant

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2013). "Objectivity and independence require that members be free from conflicts of interest in discharging professional responsibilities." AICPA Code of Prof. Standards § 50, ET 57.01, online at http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_section_57__article_vi_scope_and_nature_of_services.aspx (last visited Nov. 2, 2013).

Having a personal stake in the outcome of an audit deprives an auditor of the required independence. If while working on an audit, an ostensibly independent auditor plans to use the information to profit as a relator in a qui tam suit, how can that auditor be independent?

Before the *Quest Diagnostics* decision, this lack of independence probably would not have disqualified the government auditor from being a qui tam relator – in analogous situations, federal courts have rejected a federal government argument "that a [federal] government employee who obtains information about fraud in the scope of his or her employment and who is required to report that fraud is not a 'person' entitled to bring a civil action under § 3730(b)(1)." *United States ex rel. Holmes v. Consumer Ins. Group*, 318 F.3d 1199, 1208 (10th Cir. 2003); *see United States ex rel. Maxwell v. Kerr-McGee Oil & Gas Corp.*, 540 F.3d 1180, 1184 (10th Cir. 2008).[4] Now, a defendant in a qui tam action brought by its own auditor should assert the *Quest Diagnostics* argument – and seek dismissal for the unethical conduct of the relator in gathering the information on which the FCA claim rests. This argument would focus on the deception practiced by the auditor in allowing the audit to proceed knowing that the future-relator's lack of independence would render the audit useless. A secondary line of argument would be that the local government would have reported the alleged fraud upon completion of the audit and therefore should not be sanctioned under the FCA. But that latter argument has never worked so far as I know.[5]

Even if a motion to dismiss fails, perhaps the local government defendant could cite *Quest Diagnostics* for the proposition that the court should at least bar the auditor-relator from sharing in any proceeds. Perhaps too the defendant could counterclaim or setoff against the auditor-relator for the cost of the useless non-independent audit and the expense of having to re-audit the transactions with properly independent personnel. Moreover, the *Quest Diagnostics* rationale could at least preclude a preemption defense if the local government lodged an ethics grievance against the auditor-relator with the state agency regulating CPAs.

I emphasize that defending an FCA case is very high risk because of the exposure to treble damages, civil penalties, and expensive ancillary federal program disqualification or compliance monitoring sanctions. If there is any reasonable basis for settling an FCA claim, that approach is almost always more prudent that litigation. However, if settlement proves impossible, in addition to defenses on the merits and to other available jurisdictional and procedural defenses, it cannot hurt to make *Quest Diagnostics* arguments in appropriate cases.

Notes

1. "Qui tam" is short for "qui tam pro domino rege quam pro se ipso in hac parte sequitur" which means "who pursues this action on our lord the king's behalf as well as his own."
2. I have simplified this discussion by ignoring the fact that the former inside counsel partnered with two former company executives to form a limited partnership that sued as the formal relator. *Quest Diagnostics*, 734 F.3d at 159.
3. *Cf.*, 31 USCA § 3730(d)(3) ("If the person bringing the action is convicted of criminal conduct arising from his or her role in the violation of section 3729, that person shall be dismissed from the civil action and shall not receive any share of the proceeds of the action. *Such dismissal shall not prejudice the right of the United States to continue the action, represented by the Department of Justice*." (emphasis added)).
4. However, the Ninth Circuit disagreed with this approach, holding, under a prior version of the FCA, that where the relator was a government employee whose job was to investigate fraud, the information relied upon by the employee as a plaintiff was publicly disclosed (*i.e.*, by the disclosure to the relator), and therefore the employee-plaintiff could not qualify as an "original source" of that information, thus divesting the court of jurisdiction over a claim brought by such an employee as a relator. *United States ex rel. Chevron, U.S.A., Inc.*, 72 F.3d 740 (9th Cir. 1995). *Cf., United States v. CAC-Ramsay, Inc.*, 744 F. Supp. 1158 (S.D. Fla. 1990), *aff'd*, 963 F.2d 384 (11th Cir. 1992) (awarding former HHS healthcare fraud investigator five percent of settlement of FCA litigation because that relator voluntarily disclosed her information to the government but government failed follow up).
5. Of course I would not know about cases that DOJ refused to bring or voluntarily dismissed because the FCA defendant was in the process of a good faith audit that would have disclosed overpayments to the federal government. Such situations would not surprise me. But that result is not mandated by the FCA. **M.**

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the City the latitude to craft such an encompassing tax law—which, they claimed, the State had never done.

The *Expedia* case began more than 5 years ago. At its heart was New York City's Local Law number 43. In its original incarnation, that law would have been vulnerable against the OTC's legal maneuvering. It stated that the City's 6 percent occupancy tax could be imposed on "the rent or charge per day" for a hotel room, to be collected from "any person entitled to be paid the rent or charge for the hotel room." But in 2009 the New York City Council passed a "supertax" version of Law number 43 with language vectored directly at the OTF's: it defined "rent" as "[t]he consideration received for occupancy valued in money, whether received in money or otherwise, including all receipts, cash, credits, and property or services of any kind or nature, **including any service and/or booking fees that are a condition of occupancy**[.]" (emphasis added).

New York's highest court noted that,

where amounts paid were not a condition of occupancy, Local Law 43 would not apply. *"However, where the plaintiffs' charge is, indeed, "a condition for occupancy," it falls squarely within the category of payments subject to taxation as a "rent or charge."* (emphasis added). The Court of Appeals held that, despite technological innovations which allow consumers to use OTC's to book reservations from their homes or offices, "that innovation has not changed the main purpose of a hotel reservations process: selecting and paying for a room for future occupancy. Local Law 43 adheres to its enabling purpose, the taxation of hotel occupancy rent and charges, by taxing everything a hotel occupant actually pays for occupancy when booking online."

That language, plus the explicit clarification by the New York State legislature that the City *was* empowered to enact such a purposeful tax law, effectively derailed the OTC juggernaut in the Big Apple.

The New York City statute would seem to offer guideposts for other taxing jurisdictions. But amending tax laws is by no means an easy process. The OTC's, through the Interactive Travel Services Association (ITSA), have effectively deployed lobbyists to blunt modification efforts in many states (the Tax Foundation study listed at least 8 states where OTC tax laws had stalled). ITSA has also pushed the OTC agenda in Congress, looking for nationwide legislative protection. On the other side, the state and municipal voices have not been as unified. But at its meeting last year in Atlanta, the National Conference of State Legislators passed a resolution sponsored by a South Dakota Republican, urging states to amend their tax laws to close the OTC loophole. The National Association of Counties and the National League of Cities have taken a similar stance.

The New York State legislature and New York City have demonstrated one approach which will generate significant occupancy tax revenue. Other municipalities around the country are to make similar modifications to their outdated hotel occupancy tax statutes. While some jurisdictions are ostensibly prohibited from taxing "services" per se, it should be possible to craft language, like New York City's, that taxes a "condition for occupancy" and at least offers the possibility of outmaneuvering the OTC's now-familiar defenses. Such a move may shift some of the billions in profits away from Expedia, Priceline and the other OTC's ~back to the cities and towns charged with protecting the travelers sent their way. There should be ample margins to go around.

Notes

1. As early as its July-August 2007 issue, *Municipal Lawyer* included an article authored by Steven D. Wolens and Gary Cruciani entitled "Municipal Hotel Occupancy Tax Litigation Against Online Travel Companies." Virtually all of the tax collection actions against the OTC's described in that article ended in defeat for the municipalities.
2. Mak, James, "Taxing Hotel Sales by Online Travel Companies: What Should be the Appropriate Tax Base?" August 2012, Economic Research Organization at the University of Hawaii http://www.uhero.hawaii.edu/assets/WP_2012-5R.pdf (last accessed Jan. 2, 2014).
3. A June 2013 decision in Cook County Circuit Court found that OTC's are "operators" for purposes of the Chicago Hotel Accomodations Tax Ordinance; that case is currently on appeal. http://articles.chicagotribune.com/20-06-21/business/chi-online-travel-agencies-underpaying-chicago-taxes-200621_1_robin-reck-online-travel-agencies-travel-technology-association (last accessed Dec. 21, 2013).
4. Tax Foundation, "Taxation of Online Travel Services: Lawsuits Generally Not Succeeding In Effort to Expand Hotel Taxes" May 2012, http://taxfoundation.org/article/taxation-online-travel-services-lawsuits-generally-not-succeeding-effort-expand-hotel-taxes (last accessed Dec. 20, 2013).
5. *Id.*
6. http://ag.hawaii.gov/wp-content/uploads/20/01/News-Release-20-11.pdf (last accessed Jan. 2, 2014).
7. Expedia v. City of New York, No. 180 (N.Y., Nov. 21, 2013). http://www.nycourts.gov/ctapps/Decisions/20/Nov/180opn-Decision.pdf (last accessed Jan. 3, 2014). ML

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