FACING UP TO THE STATE AND LOCAL TAX HEADACHE THE INTERNET ERA SERVES UP TO THE HOSPITALITY INDUSTRY

HOTEL OPERATORS WOULD BENEFIT FROM A “STATE AND LOCAL TAX SAFETY CHECK” TO ENSURE THEY ARE NOT BEING UNDER- OR OVER-TAXED

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The hotel you operate sold a block of rooms through Expedia. Expedia charged consumers $100 per night. You received a discounted rate of $80 per room per night from Expedia – discounted because Expedia went to the effort of advertising and booking the rooms for you. In addition, Expedia paid you $8 per room per night to cover the 10 percent occupancy tax – based on the discounted rate of $80 per night. Expedia keeps $22 per room per night for itself, as its fee. Has Expedia done the right thing? Or has it underpaid you for the occupancy tax?

You purchased a license for a software package to run your reservation system. The vendor is based in California, and the software runs on a server located in Utah. Your reservation office is based in New York. Do you owe sales tax on the purchase of the license? If so, should the tax be paid in New York, California or Utah?

Your hotel’s accounting software is “cloud-based” – that is, it runs on the vendor’s remote server, and you never download it onto your own computers. The software is used in your business offices in New York and Illinois. Is the purchase taxable? If so, where?

Last month, your accounting software vendor switched to a Software as a Service (SaaS) model. Instead of buying a license, you now pay a monthly service fee for use of the software. How does that change the tax picture?

You bought a list of potential guests from a third-party vendor. You want to use it as the basis for a promotional mailing. Is the purchase subject to sales tax? Does it make a difference if the list was personal and individual in nature, and cannot be incorporated into reports sold to other hotels? What if the vendor gave you advice about how best to use the list?

For hotel operators, state and local taxation has always been a complex issue. But now, thanks to the even greater use of the Internet in the hospitality industry, the tax picture is even more confusing. New players, new laws, new products and new services have obscured the question of whether a transaction is locally taxable, in what jurisdictions, and for how much. Hotel owners are at risk of being overtaxed in some cases…and of under-paying state and local tax in other instances. Owners would do well to consider a “state and local tax safety check” to make sure they are not at risk.

The Internet Creates Confusion about State and Local Taxes

Why is the Internet a source of fresh confusion? Traditionally, the question of whether a business or a transaction is taxable at the state and local level was determined by geography. Location – of a customer, a transaction or a concentration of business activity (a “business nexus”) – was the factor that established whether tax was due in a given jurisdiction.

The hotel industry, by its nature, complicates these matters. The hotel business stretches across borders. Guests come from every state in the union. Vendors are far-flung as well. And back-office operations often are scattered across multiple jurisdictions. Even in the pre-Internet world, this made for intricate questions of tax liability. But the law, with its focus on geography, at least provided a framework for addressing the issue.

That’s not necessarily the case once you factor in the Internet. Its prominence as a business platform has made state and local taxation still more complex, by at least an order of magnitude. As the examples above show, the Internet confuses and clouds the critical tax question – where in physical space does a transaction or business activity take place? Is a vendor’s server the location of the transaction? Or is it the vendor’s business office address? What if there are multiple servers or multiple business offices?
In addition, the Internet has given rise to new kinds of businesses, such as online booking giants Expedia, Travelocity, Orbitz, Priceline and their ilk. Thanks to their power to reach millions of Internet customers, these online corporations have the market power to challenge the traditional terms by which transactions are made – including the power to challenge the tax code. Will they succeed? The jury is still out – in some cases literally.

All of this confusion isn’t unique to the hospitality industry – it applies to many businesses in many industries. E-commerce is a vortex of confused tax rulemaking and enforcement. Nevertheless, the complexities for hotel operators are particularly challenging.

The challenges are compounded by economic and political realities. **As a result of the prolonged economic downturn, states and municipalities are hard pressed for revenue.** They are aggressively trying to increase their revenue through strict enforcement of existing statutes and the creation of new tax codes specifically aimed at online revenue. Local jurisdictions do not want to miss out on the revenue potential of commerce generated in the online space, where taxation has been unclear.

The result is a tangled and confused tax situation. **New laws are on the books. Many are the subject of court challenges. Traditional tax laws are also challenged as new kinds of vendors argue that the old definitions don’t apply to them, and as technology gives birth to new kinds of products and services.**

Given this level of argument, fear, uncertainty and doubt, what is the responsibility of the hotel owner? The answer, obviously, will vary from one situation to the next. Overall, it’s important to be aware of disputes and areas of confusion, and stay in close touch with tax professionals as these situations evolve. In most of the cases we’ll discuss, it is ultimately the hotel owners’ responsibility to collect the appropriate sales tax or hotel occupancy tax from their customers. Confusion about state and local tax might be a mitigating factor, but in the end it will not be an excuse.

**Online Giants Such as Expedia, Orbitz and Priceline Argue for Lower Occupancy Tax Rates: Litigation Will Determine if They are Underpaying You**

The hotel occupancy tax should be a straightforward matter. But like so much of modern life, it isn’t.

The logic of the occupancy tax is simple. The customer – a guest – books a room. The hotel owner charges a fee for the room and is expected to collect the occupancy tax for the transaction. The tax is generally added to the room fee charged to the customer and paid to the local jurisdiction by the hotel.

If the room is booked through a traditional travel agent, the arrangement has generally been similar. The travel agent considers itself a partner in booking the room. Even though the transaction is more complicated – the booking flows through the travel agent, and the agent takes a commission – the agent collects the tax and pays it to the hotel, based on the full rate charged to the guest.

The online travel services see it differently. They argue that they are not travel agents, and that they are not actually booking the room. They say instead that they are online corporations, providing a business service to the hotel. Unlike a traditional travel agent, they generally buy the room at a discounted rate. Because of their size and market power – a consequence of the vast reach and minimal cost of the Internet – they are able to command profound discounts. Hotel operators generally feel they have no choice but to take advantage of the service – if they don’t, then they cut themselves off from hundreds of thousands of potential guests.
The online services companies then resell the room to a guest at a higher rate, and take the difference as a fee for their service. But, they argue, the actual booking of the room takes place between them and the hotel at the lower rate – and therefore, only the lower rate should be taxable. This has significant implications for tax rates, and for the ability of local jurisdictions to generate revenue.

The online services companies have made exactly this argument in court – with success. In 2009, Expedia and Priceline were among 10 online travel services that sued in New York City to challenge the local 6 percent occupancy tax. The trial court found against them, stating that the whole fee charged to the customer was taxable – that the tax should be based on the full fee charged to the guest, including the online service’s commission, rather than the discounted rate paid to the hotel.

But on appeal, the New York State Supreme Court Appellate Division reversed the lower court, agreed with the online services companies, and went so far as to declare the City’s occupancy tax unconstitutional. One more appeal is possible, to the New York State Court of Appeals. It remains to be seen if the City will appeal, but it is likely, given the current state of the law, which is costing the City revenue. For the moment, the online services companies have prevailed.

Expedia also found success in Pennsylvania, where, in February 2012, the Commonwealth Court ruled that Expedia was not the operator of a hotel for the purpose of collecting the Philadelphia occupancy tax. Here, as in New York, the court ruled that only the discounted fee is subject to tax.

Not every court agrees. In a case brought against Priceline, a federal court in Rosemont, Illinois held that the full room rental fee was subject to the local 7 percent tax, and that the tax based on the full amount charged to the guest represented a validly imposed use tax for the rental of the room. Florida settled out of court with Expedia for $9 million on the Orange County hotel occupancy tax, but litigation against Orbitz is ongoing.

Litigation is likely to continue, and as a result, the basis for the hotel occupancy tax will remain unclear. The state of the law will vary from one jurisdiction to the next, perhaps until the US Supreme Court weighs in, if that ever happens.

**What to Do About It:** What can hotel owners do to protect themselves? The industry has little power here – hotel operators need the market reach and volume-producing potential of the online corporations. But clearly, owners need to keep on top of the situation and make sure that the online corporations are paying them the full amount due to cover the tax – and to know what that amount is, based on the latest court decisions.

**Sales Tax for Software Gets More Complicated as Online Delivery Becomes the Norm**

Let’s say you purchased a software package to run your hotel’s reservation system or to keep track of your staffing and make sure shifts run smoothly. What sales tax, if any, do you need to pay on the purchase?

As in so many tax matters, especially those involving software, the answer is “it depends.” In this instance, there are several variables: Where was the software purchased? And, was the software customized for your hotel, or is it a “canned,” off-the-shelf product?

If the software was customized, then in most states, it is not subject to sales tax. It is considered an intangible. **But if the software is an off-the-shelf commercial package, used without customization, then in most states it is considered tangible personal property, and the purchase**
is sales taxable. This is true even if the software is specific to the industry – to qualify as an intangible, it would have to be customized for the particular hotel.

What about the way the software is delivered? Here, the tax picture is murkier. New York State considers the purchase taxable no matter whether the software is provided in tangible physical form – for example, on a DVD – or whether it was downloaded. But California exempts the purchase from sales tax if it was transmitted electronically. Only the sale of the product on disk is taxable.

The location of the purchase for sales tax purposes also varies from state to state. In New York State, the location of the customer is what matters. In California, the location of the purchase is based on the location of the seller’s server. Obviously, this becomes challenging for hotel chains that operate in several states. If a hotel has locations in both New York and California and the seller’s server is in California, then the purchase will be subject to double taxation. The hotel will pay double sales tax, then take a credit on the sales tax return for the state with the higher tax.

In a complex purchase, involving the license, maintenance and future upgrades to purchased or licensed software, some elements will be taxable and others may not. As a rule, if maintenance is mandatory with the software purchase, then it is considered a sales taxable service. But optional maintenance is not. Upgrades are sales taxable unless they are broken out on the invoice as a separate line item – in that case, they are not subject to sales tax in most states.

What to Do About It: The key point here for hotel operators to remember is that the software vendor is merely a collector of sales tax. Vendors may not have a significant interest in determining the taxability of the purchase. That responsibility lies with the purchaser – in this case, the hotel. That means it’s necessary to do a sales taxability study on all software purchases and upgrades. The proof of taxability is the contract with the seller and how the invoice is written. Clearly, these matters lie partly or wholly in control of the seller. But the seller may not be careful about how the contract and invoice are written, or just may be indifferent. Many problems can result – not just the underpayment of tax but also excessive taxation if, for example, optional maintenance (which is generally not taxable) is lumped in with the initial sale and is not properly broken out as a line item. The onus is on you, the buyer, to make sure the invoice is worded correctly.

New Online Delivery Models Such as “Cloud Computing” and “Software as a Service” Result in an Even More Tangled Local Sales Tax Picture

The idea of buying software in a box seems archaic. Downloading software to your own computers may be a thing of the past, too. “Cloud computing” – the use of software that you do not download, but rather access on the vendor’s server – is, increasingly, the new model for business applications.

How does cloud computing affect taxability? You might assume that in the cloud computing model – where nothing tangible is transferred, all interactions are conducted virtually via the Internet, and contact between seller and buyer is minimal – that the purchase is not subject to sales tax. But in New York City and New York State, you would be wrong. Both jurisdictions have moved to make software purchased “in the cloud” sales taxable, using the standard of “constructive possession” – that is, the effective control over tangible personal property, in the same way that you would have constructive possession of a car if the owner lent it to you. The New York tax laws governing cloud computing represent an expanded definition of constructive possession. It would be possible to challenge the use of the standard, but New York doesn’t distinguish between these virtual interactions and the purchase of downloadable software. Simply put, New York needs the revenue, and so the definition is aggressive.
The standard of constructive possession is also invoked in several jurisdictions to govern the sales taxability of a software model related to cloud computing – “software as a service” or SaaS. In the software industry, software as a service refers to a model in which there is no purchase – instead, the customer effectively subscribes to the software, and the software vendor recasts himself as a service provider – the software is the service that is provided, in the same way that an accounting firm provides accounting services.

Here, as in the broader category of cloud computing, the software is hosted on a remote server, very likely out of state. No property is transmitted – access to the software does not go through the customer’s firewall. Is that constructive possession, or is it a non-sales-taxable service, the way accounting or legal services would be? New York State says that software as a service is sales taxable if the software is accessed from a New York State location. In other words, software as a service, if used in New York State, represents constructive possession for sales tax purposes. Vermont, Massachusetts and Texas follow the same rule.

Not all remote software comes under the constructive possession standard. In New York City and New York State, use of an online data storage service, and the use of software to retrieve the data, is considered an “exempt service.” Similarly, e-book sales and the sale of streaming media – such as a hotel might use for promotional purposes – is considered exempt from sales tax in New York.

What to Do About It: Obviously, all of this leads to a complex sales tax picture for hotel operators, especially those who operate in multiple states and who use many different kinds of remotely-accessed software. A detailed sales taxability analysis, conducted by an experienced tax professional, is the only way to be sure that you are in compliance with all sales tax requirements for cloud computing purchases and software as a service throughout your operations.

Information Might Be Taxable or Not, Depending on Degree of Customization

Lastly, there is the matter of information services. Let’s return to the example of a database used to market the hotel to prospective guests. Is the use of this common database an information service, which New York State and City consider sales taxable, or is it a non-taxable service akin to a professional service? The answer in New York depends on a two-part test. If the information is 1) personal and individual in nature, and 2) can’t be incorporated into reports sold to others, then New York does not consider it sales taxable. So if you bought a prospect list obtained from a common database, and used it to generate a promotional mailing, you would pay sales tax on that purchase in New York, since it is considered a sales taxable information service. If, however, you asked the information provider to customize the list – perhaps narrowing it down to guests who had stayed in your hotel before, or who had showed favorability toward your brand in their responses to surveys – and if the vendor provided recommendations about how to use the data, perhaps ranking the prospects in priority order – then the purchase would not be sales taxable. It would be similar to a custom report provided by an investment house about the likelihood of certain investors to buy a particular stock. The analysis constitutes a form of professional service, and as such, it is not sales taxable. When the data is personalized and individualized, then you are purchasing, not a list, but the intellectual capital of the professional who provided it. Like an attorney’s fee, that is not sales taxable. In short, common data is taxable, custom data is not.

This distinction is particular to New York State and City. Other jurisdictions are more liberal. California and Illinois consider all information services to be non-taxable, no matter whether the data is custom or not.
What to Do About It: Here as in our previous examples, the presence of fine distinctions and the problem of divergent standards in different jurisdictions make it imperative that a careful sales tax analysis is done.

Conclusion

The Internet's capacity to challenge and transform business models is well known. Its ability to challenge and transform state and local taxation is no less powerful. State and local taxability has always been a serious issue for hotel owners, particularly those who operate in many different jurisdictions. While the occupancy tax issue will probably be settled in court or by laws passed by the legislature, many other local tax issues, particularly those involving software and online services, remain unsettled and are likely to remain so for the foreseeable future. It's a serious mistake for hotel owners to rely on their vendors to identify and collect the correct amounts of state and local sales or hotel occupancy taxes. That responsibility resides with the owner – as it should, because only you as the owner are equipped to look after your own best tax interests. An aggressive approach – getting ahead of state and local tax issues and knowing where you stand, with the help of a tax professional – is the best-practice approach to state and local taxation in the brave new Internet era. Wise hotel owners will move quickly to conduct a "state and local tax safety check" to make sure they are collecting or paying neither too much nor too little, and to be certain that initial confusion does not lead to error, or to risk.

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Steven P. Bryde, JD, is a lawyer and a Principal in the Tax Practice at Marks Paneth & Shron LLP. He specializes in state and local taxation for corporations and flow-through entities in a cross section of industries as well as for individuals.

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