April 2, 2012

Tennessee House of Representatives
Nashville, Tennessee

Dear Representative,

I am writing in regards to HB 3319, a proposal that would apply hotel occupancy taxes to services not provided by the hotel but rather by marketing partners -- a tax increase on those who are driving business and vacationers to Tennessee.

The Institute for Policy Innovation (IPI) is a 25 year-old free market policy organization. IPI does not lobby and does not engage in political activity. We are, however, free to analyze legislation and share our input with you, which we hope you will consider. Our analysis of the proposed legislation is that 1) it is a new tax, and 2) it is a tax being applied inappropriately because of a misunderstanding of how the online travel agent marketplace operates.

Thousands of Americans use services such as Hotels.com and Travelocity.com to book hotel rooms. It's just one of many ways shopping on-line has resulted in more choice and lower prices for consumers, including Tennesseans. Yet the proposed new tax would inappropriately limit this advantage to consumers and to Tennessee businesses.

Inappropriately expanded tax
This same attempt was made in Texas not long ago, so we are well aware of the drive behind such a proposal. In fact, several local jurisdictions in several states went to court to force hotel-booking Internet companies to pay occupancy tax on the value of the room plus the same occupancy tax on the service fee charged by the Web site, rather than on the price the consumer actually paid for the room (the appropriate basis to which to apply an OCCUPANCY tax). As the courts threw out the cases, the trial lawyers behind the scene switched to lobbying state legislatures. Some Texas House of Representatives members even fell for this shell game.

How well would this model work in other situations?

Suppose on the way to Knoxville some tourists stop to fill up their truck with gasoline and to grab some milk for the kids. The clerk rings up the total sale and happily announces you owe 30.8% tax on the whole purchase (21.4% gas tax + 9.4% average food tax). When they point out that milk is not gasoline, the clerk smiles and asks for the 30.8% tax anyway.

Policy makers should not stand by as such an insidious and discriminatory scheme to expand taxes is foisted upon the taxpayers, and which most often would hurt small

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inns and bed and breakfast homes the most as they see big cost increases for potential guests.

Service fees are not part of the cost of a hotel room. No room--no tax. Room?--tax. Simple.

Hence, a new tax

The new proposal calls for applying a "hotel occupancy tax" to a service, in this case specifically to a service provided by an online, or other, travel agent. This expanded repurposing of a tax on a clearly defined event is inappropriate, and clearly so when a thorough examination of the online travel agency's business model is examined.

Traditionally, including in Tennessee, the purpose of the occupancy tax was to tax the temporary use of a room to a guest. Taxing a service provided by a travel agent moves well beyond the original design and purpose of such a tax. Rather than the tax being applied only to the rental of the room, the proposal now seeks to expand to include what is essentially an advertising service fee to help find someone to rent the room in the first place.

Further, as always with a new tax the benefits derived do not live up to expectations. For example, instituting a new and higher tax in Tennessee leads to locations such as Went Memphis, AR, Fort Olgethorpe, GA, or Bristol, VA to be a better value by comparison and still ideally located. Hence, some revenue ends up in other jurisdictions.

Some have argued that this is merely an exercise in closing what is otherwise a tax loophole. However, in this case, there is no loophole as the transaction to be taxed is far outside of the definition of occupancy. Truthfully, this is only an opportunity to expand a tax beyond its traditional and defined base.

Similarly inappropriate is the argument that the state needs more revenue. This argument may be relevant in a larger context; that is, perhaps the state does need more tax from taxpayers to pay for state programs, but as a justification to support broadening an occupancy tax to include third party services it is merely a red herring. At the very least a tax should be honest on its face as to what is being taxed and why. Lower hotel prices must be seen as the economic benefit that they are, and not just seen as lost revenue to the state treasury—lost revenue that somehow belongs to the state and to which it is entitled to reclaim. Online travel agency services help fill the 40% of rooms that go empty each night, which of course means more tax revenue overall, even without the sleight of hand required to apply occupancy taxes to third party marketing partners.

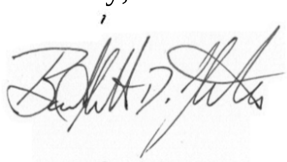
And yes they really are third party services only
These services do not buy rooms at some reduced wholesale and then sell them to consumers after marking them up. Instead, these companies enter into contracts to be the marketers of rooms offered at a certain rate, a rate which includes a fee for service. They then additionally take care of the transaction with the consumer. Following that the online travel agency sends the room rent and all of the appropriate taxes owed to the hotel and the hotel then remits the appropriate taxes to the appropriate municipality.

The retained service fee is then taxed as income.

Taken all together, tax schemes such as proposed in HR 3319 violate basic tax principles of transparency, predictability and fairness. The losers in the scheme are the local small hotel operators, Tennessee taxpayers trying to find a good deal, and those out of state who may be considering Tennessee as a vacation destination.

If you have any questions please do not hesitate to contact us. We are always ready to explain our insights and our work to further.

Sincerely,



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