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## Memo

To: Expedia  
 From: Mike Roben & Traci Minkin  
 Date: January 31, 2003  
 Subject: Transaction Tax Risk Narrative

### Executive Summary

The purpose of this memorandum to summarize the contents of the transaction tax risk matrix (see attached) prepared for Travelscape, a wholly owned subsidiary of Expedia. The tax risk assessment is based upon the facts presented in the Travelscape business model memorandum dated as of November 26, 2002. Based upon the merchant revenues provided by Expedia, the states below represent approximately 85% of domestic merchant hotel revenue and 74% total merchant hotel revenue.

The analysis herein assumes that Travelscape has nexus, or a taxable presence, in each jurisdiction discussed. Although Travelscape may have some arguments to defend this nexus assumption, it is likely the applicable jurisdictions will aggressively pursue tax collection, given Expedia's continued presence in each of these markets, if the jurisdiction determines the services are taxable.

**In order to put the risk levels in context of FAS 5 we believe the risk levels are as follows:**

- Low – Less than 20% or Remote
- Medium – greater than 20 but less than 50% or low end of Reasonably Possible
- High – greater than 49% but less than 70% or high end of Reasonably Possible
- **Very High – 70% or greater or Probable.**

Expedia has taken the position that FAS 5 definition of probable (FAS 5 para. 3 a. *Probable*. The future event or events are likely to occur) should be interpreted to mean a greater than



70% chance of the liability being realized and so is booking reserves for each jurisdictions tax which is considered a Very High risk.

### California

California does not impose a state or local sales or use tax on the sale or license to use a hotel room. However, most local jurisdictions within California generally impose an occupancy, or other similar type of excise tax, on the sale or license to use a hotel room. Each local jurisdiction in California is authorized to impose and administer these local taxes.

Under San Francisco Business and Tax Regulations Code §502, an occupancy tax is imposed "...on the rent for every occupancy of...guest rooms in a hotel in the City and County..." San Francisco Business and Tax Regulations Code §503 provides that every occupant is required to pay such tax to the operator, defined by §501(a) as "(a)ny person operating a hotel in the City and County of San Francisco, including, but not limited to, the owner or proprietor of such premises, lessee, sublessee, mortgagee in possession, licensee, or any other person otherwise operating such hotel." Rent is defined by §501(f) 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, and also the amount for which credit is allowed by the operator to the occupant, without any deduction therefrom whatsoever."

Similarly, Los Angeles imposes a transient occupancy tax on the privilege of occupancy in any hotel based on the rent charged by the operator. Los Angeles Municipal Code §21.7.2 & §21.7.3. Every transient is required to pay the tax to the operator, defined by §21.7.2, as the person who is the proprietor of the hotel, whether in the capacity or owner, lessee, mortgagee in possession, licensee, or any other capacity.

Obviously the cities did not contemplate sales of rooms by persons other than the operator when developing the underlying ordinances imposing occupancy taxes. As such, depending on the how these ordinances are interpreted and applied; there is a possibility that tax could be due on the total amount paid to Travelscape for a hotel room. In an article appearing in the New York Times on December 23, 2002, the City of San Francisco treasurer stated, "the tax is due on what the occupant paid," which she would consider to be the amount paid to Travelscape.

Based on our review of the law and the subsequent interpretation that appeared in the article mentioned above, we determined that there is a Medium level of risk associated with the tax imposed by San Francisco. Incorporated into such risk level is the imposition of the tax (i.e., the tax is imposed on the rent for occupancy), as well as the fact that the ordinances broadly define the term operator. It appears that the cities would either have to assert that Travelscape is an "operator" doing business in the city or that the hotel is responsible for tax at the full retail price paid by the occupant. Neither of these interpretations are directly supported by the



ordinances. If the tax is imposed on Travelscape, it is likely that the city would allow a credit for taxes paid to the hotels. If additional tax is imposed on the hotels, reimbursement by Travelscape would likely depend on the contractual relationship with the hotel.

Additional research will be necessary to assess the relative risk of other cities imposing similar taxes.

### Florida

Florida imposes a transient rentals tax (sales tax) on every person engaged in the business of renting, leasing, letting, or granting a license to use any transient accommodations including hotels. The owner, lessor, or person receiving the rent shall remit the tax to the Department §212.03, F.S. The tax is imposed on the total rental charge, defined as the total consideration received solely for the use, possession or the right of use or possession of any transient room rentals. This includes any prepayments, deposits, or reservation vouchers that guarantee the person the license to use a hotel room. 12A-1.061(2)(e), F.A.C. In **Technical Assistance Advisement ("TAA") No. 00A-007**, the Florida Department of Revenue concluded that hotels were required to collect the transient rentals tax on deposits that were kept by brokers as a reservation commissions because the deposits were part of the total consideration the hotels received. Although the facts of this ruling are different from Travelscape, the technical analysis provides that Florida will impose the tax on the gross proceeds received from the customer.

In the New York Times article mentioned above, a spokesperson for the Department of Revenue stated, "tax is due on the full price paid for hotel accommodations by the consumer of those services." The spokesman went on to explain that although the Department had not reviewed the specifics of on line travel agent sales, it has taxed the mark-up on other companies that have bought and resold hotel rooms.

Based on our review of the statute, regulations, the TAA discussed above, and discussions with Dan Megathlin, a Senior Manager in our Miami SALT practice, the transient rentals tax is likely due on the total charge made to the customer therefore the risk is considered **Very High**. If Travelscape registers as a dealer with the Florida Department of Revenue, they would be entitled to issue a resale certificate to the vendor to purchase accommodations tax-free. If a resale certificate is not provided, a credit for taxes paid to the hotels may be taken on the sales and use tax return.

Various local taxes are imposed and administered by the respective locality. The imposition of the tax is identical to the state. Therefore, the local taxes are also likely due on the total charge to the customer. Travelscape would be entitled to a credit for local taxes paid to the hotels if a resale certificate is not provided to the vendor.



### Georgia

Georgia imposes a sales tax on the sale or charges for any room, lodging, or accommodation furnished to transients by any hotel, inn, tourist camp, tourist cabin, or any other place in which rooms, lodgings, or accommodations are regularly furnished to transients for a consideration. Code of Georgia §48-8-2(6)(C). There are no local sales taxes in Georgia. The tax is imposed on the gross charge made, and is paid by the person purchasing or receiving the service to the person furnishing the service. The person furnishing the service as a dealer, shall remit the tax to the state less a credit claimed for taxes imposed on the person furnishing the service. Code of Georgia §48-8-30(f)(1). Georgia defines a "dealer" as a person that solicits business or engages in systematic solicitation of a consumer market in Georgia. Code of Georgia §48-8-2(3)(H).

The state imposes the sales tax on lodging as measured by the consideration charged. The State also broadly defines the term "dealer." Travelscape would likely be defined as a dealer and would be required to collect and remit the sales tax to the state. Based on our review of the law, and discussions with our experts in Georgia, we determined that there is a Very High level of risk that Travelscape may be required to collect and remit sales tax on its gross receipts. Travelscape would be entitled a credit for sales tax paid to the hotels.

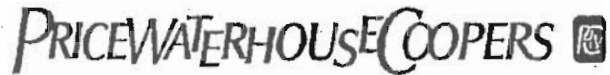
Additional research will be necessary to determine the relative tax risk in other local jurisdictions.

### Hawaii

Hawaii imposes a gross receipts tax, referred to as the state general excise tax ("GET"), on the privilege of engaging in any service business performed in Hawaii; this tax is imposed in lieu of a sales tax. There are no sales or gross receipts taxes imposed at the local level.

Under Hawaii Revised Statutes ("HRS") §237-13, HRS §237-18, Opinion of the Attorney General 65-6, Department of Taxation Announcement 99-12, and Tax Information Release 91-8, the taxable gross receipts of a travel agent or tour packager would not include amounts paid to third party providers of tourism related services, such as hotels. The activities engaged in by Travelscape would probably be classified as travel agent services or tour packaging; therefore, to the extent that the gross receipts are from Hawaii business (which we discuss in the next paragraph), the tax base would not be Travelscape's entire gross receipts but, rather, its share of the gross receipts, namely its mark-up.

Furthermore, under HRS §237-13, GET is imposed on gross receipts from doing business in Hawaii and is not imposed on other gross receipts. According to Opinion of the Attorney General 65-6, it appears that Hawaii is likely to allocate commissions derived from travel agent services based on customer location. Hawaii would likely accept the customer billing address as the equivalent of the customer location.



Hawaii also imposes a state level transient accommodations tax under HRS §237D-2(b). The tax is imposed on the operator of hotel transient accommodations. Operator is defined in HRS §237D-1 as "any person operating a transient accommodation, whether as owner or proprietor or as lessee, sublessee, mortgagee in possession, licensee, or otherwise, or engaging or continuing in any service business which involves the actual furnishing of transient accommodation." Thus, the tax should not be imposed on tour packagers or travel agents such as Travelscape.

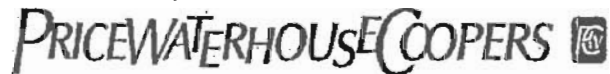
Based on our review of the law and discussions with our experts in Hawaii, we determined that there is a High level of risk that tax is due on Travelscape's margin related to receipts derived from customers located in Hawaii. However, the amount of tax liability should be minimal due to the favorable method of allocating receipts as described above. The tax risk is predominantly associated with the GET rather than the transient accommodations tax. Travelscape has a Low level of risk that the transient accommodations tax is due on its gross receipts.

#### Illinois

Illinois imposes a hotel operators' occupation tax upon persons (hotel operators') engaged in the business of renting, leasing or letting rooms in a hotel. 35 Ill. Comp. Stat. 145/3. The tax is imposed on the gross rental receipts from such renting leasing or letting by the lessor of the rooms. Ill. Admin. Code tit. 86, §480.101. While 35 Ill. Comp. Stat. 145/2 defines the term operator as any person operating a hotel, the tax is imposed on "persons engaged in the business of renting, leasing or letting rooms" and the term operator is not mentioned in the imposition statute except with reference to over collection of tax. In addition, there are several local taxes administered by the state and imposed on all persons engaged in the City of Chicago in the business of renting, leasing, or letting rooms in a hotel, as defined in the Hotel Operators' Occupation Tax Act. 70 Ill. Comp. Stat. 3205/19; 70 Ill. Comp. Stat. 210/13.

The City of Chicago imposes a tax upon the rental or leasing of any hotel accommodations on the gross rental or leasing charge. Chicago Code of Ordinances §3-24-030. Ultimate payment for the tax is borne by the lessee or tenant of any such hotel accommodations, but it is the duty of every owner, manager, or operator of hotel accommodations to secure the tax from the lessee or tenant. Chicago Code of Ordinances §3-24-040. The Chicago Code of Ordinances does not define the term operator.

For a client with a nearly identical fact pattern, we spoke with the Deputy General Counsel for Sales/Excise Taxes about the application of the Hotel Operators' Occupation Tax. While conceding that the issue had not arisen previously, he asserted that a company selling hotel rooms to the public would fall under the statute and would be required to charge and collect the tax from its customers, despite not operating any hotel. Furthermore, he noted that the Hotel tax did not incorporate Sec. 2 of the Retailers' Occupation Tax, the section that provided



an exemption for items to be resold, so that Illinois would have an argument that it could also impose tax on the transaction between the hotel operator and Travelscape. The tax provides a credit mechanism, through the incorporation of Sec. 6 of the Retailers Occupation Tax, only with respect to tax paid in error, so that the possibility exists that no credit would be provided to Travelscape on its liability for tax that it has paid to other hotels. [While we are not aware of any instance where the ILDOR has sought to collect the Hotel Operators' Occupation Tax from non-facilities based sellers of hotel rooms, the Department is aware of the issue, believes it has the right to impose the tax, and Illinois is in a fiscal crunch and is actively seeking ways to collect additional revenue.]

Based on our review of the law and discussions with our experts in Illinois, we determined that there is a High level of risk that the taxes imposed at the state level would be imposed on Travelscape's gross receipts derived in Illinois. We have determined that there is a Medium level of risk associated with the tax imposed by the City of Chicago. Incorporated into such risk level is the imposition of the tax (i.e., the tax is imposed on the rental or leasing of any hotel accommodations), as well as the lack of definitional guidance with respect to the term operator or manager. It appears that Chicago would either have to assert that Travelscape is an "operator" or "manager" doing business in the city or that the hotel is responsible for tax at the full retail price paid by the occupant. Neither of these interpretations are directly supported by the ordinances. If the tax is imposed on Travelscape, it is unclear whether the city would allow a credit for taxes paid to the hotels. If additional tax is imposed on the hotels, reimbursement by Travelscape would likely depend on the contractual relationship with the hotel.

#### Massachusetts

In general, Massachusetts imposes a room occupancy excise tax upon "the transfer of occupancy of any room or rooms in a bed and breakfast establishment, hotel, lodging house, or motel in this commonwealth by any operator" on the total amount of the rent for each such occupancy. Mass. Gen. Laws ch. 64G, §3. The term "occupancy" refers to the use or possession or *the right* of use or possession of any room or rooms. Mass. Gen. Laws ch. 64G, § 1(g) (emphasis added). "Operator" is defined as any person operating a bed and breakfast establishment, hotel, lodging house or motel in the commonwealth, including, but not limited to, the owner or proprietor of such premises and the lessee or any other person otherwise operating such. Mass. Gen. Laws ch. 64G, §1(f). "Rent" is defined as the consideration received for occupancy valued in money including all receipts, cash, credits and property or services of any kind or nature, without any deduction whatsoever. Mass. Gen. Laws ch. 64G, §1(j).

Under Mass. Gen. Laws ch. 64G, §3A, any city or town which accepts the occupancy tax provisions is authorized to impose a local excise tax upon the transfer of the use or possession or right of use or possession of any room or rooms located within such city or town. The



operator must pay the local excise tax to the state commissioner at the same time and in the same manner as the excise tax due the commonwealth.

In a 1984 letter ruling, Massachusetts directly addressed the tax collection duties of a non-operator who collected commissions for running a reservation service for several bed and breakfast accommodations. Mass. Letter Ruling 1984-90 (October 4, 1984). The state determined that the total charge guests paid for their accommodations was subject to the room occupancy tax. *Id.* No deduction from the taxable base was allowed for the charges for commissions paid to the reservation service. *Id.* Furthermore, since the reservation service collected the charges for the rooms on behalf of the operators, the reservation service was also responsible for collecting the room occupancy excise from the patrons and remitting the excise to the Commonwealth. *Id.* In addition, it should be noted that because the Massachusetts room occupancy excise is imposed on the *right* of use or possession of a room, the tax is also due on any forfeited reservation deposit. Mass. Letter Ruling 1985-32 (February 21, 1985).

Based on our review of the law and discussions with our experts in Massachusetts, we have determined that there is a High level of risk associated with the tax imposed by Massachusetts. Incorporated into such risk level is the fairly broad imposition of the tax (i.e., the tax is imposed on the "right of use or possession") and the fact that the duty to collect the tax has been imposed on non-operators. It is unclear whether the state would attempt to impose the tax directly on Travelscape or on the hotels. If the tax is imposed on Travelscape, it is unclear whether the state would allow a credit for taxes paid to the hotels. If additional tax is imposed on the hotels, reimbursement by Travelscape would likely depend on the contractual relationship with the hotel.

#### Nevada

Nevada does not impose a state or local sales or use tax on the sale or license to use a hotel room. However, local jurisdictions impose several types of room taxes on the sale or license to use a hotel room. For example, under Las Vegas Code §6.46.040, a room tax is imposed on the room revenues derived by each establishment. In the New York Times article mentioned above, the executive director of the Nevada Department of Taxation said that his state's taxes were due only on the gross receipts to the hotel. Therefore, Travelscape's mark-up would not be taxable.

Based on our review of the statute and comments that appeared in the article mentioned above, we determined that there is a Low level of risk that the tax would be imposed on Travelscape's gross receipts derived in Las Vegas.



### New York

New York State and City impose a sales tax on the rent for every occupancy of a room or rooms in a hotel in the state. Consolidated Laws of New York §1105; Administrative Code for the City of New York §11-2002. The state and local sales tax is administered by the state. Additionally, local jurisdictions may also impose a tax on the occupancy of a hotel measured by the rent or charge for each such room. The local occupancy tax is administered by the applicable cities. See for example, Administrative Code for the City of New York §11-2502. According to discussions with Diego Cinquemani and Al Cornell, our New York tax experts, and the New York City Statement of Audit Procedure 01-2-HTX, occupancy taxes are not imposed on resale value of the room.

Currently, Travelscape is under audit by the State of New York for sales tax. During this process, the auditor has drafted a position paper indicating he believes sales tax is due on Travelscape's gross receipts. Travelscape is vigorously defending the initial opinion of the auditor and has a conference scheduled with the Field Audit Management on February 12, 2003, to discuss the issues involved in the audit, as well as its current business model.

Based on our review of the law, and discussions with our experts in New York, we determined that there is a Very High level of risk that Travelscape may be required to collect and remit sales tax on its gross receipts. Travelscape would be entitled a credit for sales tax paid to the hotels.

Additional research will be necessary to determine the relative tax risk in other local jurisdictions.

### Texas

Texas imposes a state occupancy tax on the person who, under lease, concession, permit, right of access, license, contract or agreement, pays for the use or possession or for the right to the use or possession of a room or space in a hotel. Texas Code §156.051. The tax is imposed and administered by the State. The tax is on the price paid for a room in a hotel. Texas Code §156.052. Local jurisdictions may also impose a similar tax. The local tax is administered by the applicable cities. For example, Dallas imposes a tax upon the occupant of any room that is in a hotel. Dallas City Code §44-35. Such tax is based on the consideration paid by the occupant of the room to the hotel. *Id.* Texas does not impose a sales or use tax on the sale or license to use a hotel room.

A no-named ruling was obtained from the state in which the Comptroller's office took the position that state and local taxes would be due on the entire amount paid to Travelscape. The rationale for such position rested solely upon the fact that since Travelscape has set its own cancellation policy rather than adopt that of the hotel, it is not merely acting as an agent but as a hotel that rents rooms to guests. Travelscape vigorously disagrees with the basis for the





conclusion reached in the ruling and is currently in discussions with the state on a no-name basis.

Based on our review of the law, discussions with Pat McCown, SALT Senior Manager in our Dallas office, and the position taken by the Comptroller's office, we have determined that there is a **Medium** level of risk associated with the state and local taxes imposed in Texas. According to discussions with Pat McCown and the no-named ruling discussed above, Travelscape would be entitled to a credit for taxes paid to the hotels.

Additional research will be necessary to determine the relative tax risk in other local jurisdictions.

#### Washington

A state and local sales tax is imposed on the sale of or charge made for the furnishing of lodging and all other services by a hotel, rooming house, tourist court, motel, trailer camp, and the granting of any similar license to use real property. RCW 82.04.050; WAC 458-20-166. A convention center tax and/or special hotel/motel tax may also be imposed, depending upon a hotel's specific geographic location, upon the sale of or charge made for the furnishing of lodging by a hotel, rooming house, tourist court, motel, trailer camp, and the granting of any similar license to use real property. RCW 67.40.090; RCW 67.28.180. There is no published guidance on the sales tax or convention center tax consequences of Travelscape's business. However, based on the plain language of the statutes, persons responsible for such taxes would likely be the hotels that actually furnish the lodging. Therefore, it is not likely that Travelscape would be responsible to collect and remit such taxes.

Washington also imposes a gross receipts tax on the act or privilege of engaging in business activities (referred to as the business and occupation tax) measured by value of products, gross proceeds of sales, or gross income of the business, as the case may be. RCW 82.04.220. There is a position that Travelscape could be classified as a "tour operator" and/or a "travel agent" for B&O tax purposes.

A "travel agent business" is defined as the business activity of arranging transportation, lodging, meals, or other similar services that are purchased by the customer and where the travel agent or agency merely receives a commission for arranging the service. WAC 458-20-258. A "tour operator business" is defined as the business activity of providing directly or through third party providers, transportation, lodging, meals, guided tours, and other associated services where the tour operator purchases or itself provides any or all of the services offered, and is itself liable for the services purchased. *Id.*

In Det No. 91-211, 11 WTD 395 (1992), the Department stated that a taxpayer who sells pre-packaged tours at a markup, but is not "at risk" for payment to the third party service provider, will be subject to B&O tax under the "travel agent" classification. Analogously, Travelscape



is generally not "at risk" to third party service providers (e.g., hotels), even if the customer cancels its travel plans. Additionally, Travelscape records revenue for financial statement purposes on a "net" basis (customer payment received less amount due to hotel) because it is not "at risk" to the hotel. This method supports the position that Travelscape could be classified as a "tour operator" and/or "travel agent".

If Travelscape is deemed a "travel agent", the B&O tax measure would likely be based on "net" revenue. On the other hand, if the Department determines that Travelscape is "at risk" for charges to the hotel, Travelscape would not qualify as a "travel agent" and correspondingly could not report its B&O tax on a "net" revenue basis. In this case, Travelscape would argue that it is taxable as a "tour operator", subject to a lower B&O tax rate than it otherwise would be, on the total gross receipts received (i.e. no exclusion of hotel payments from the tax measure). If the Department does not allow Travelscape to classify its activities under either the "tour operator" or "travel agent" classification, its activities would be classified as a general service business under RCW 82.04.290 subject to B&O tax on total gross receipts received.

Assuming Travelscape has nexus and renders services both within and without Washington, it may be required to apportion some of its gross receipt to Washington. The vast majority of Travelscape's business activities occur in Nevada; it merely pays Expedia for hosting content and performing certain administrative services in Washington. Therefore, Travelscape would likely apportion or allocate the majority of its gross receipts to Nevada. Generally travel agents or tour operators allocate their revenue based on where the services are performed. In this case, Travelscape should allocate the majority of its services to Nevada. If Travelscape is treated as a service provider subject to B&O tax under the service classification, it would apportion its gross receipts according to RCW 82.04.460 and Det. No. 01-006, 20 WTD 124 (2001). Since the majority of Travelscape's activity is occurring in Nevada and the majority of the services benefit its customers are located outside of Washington, it is likely that Det. No. 01-006 would allow Travelscape to apportion the majority of its revenues outside of Washington. It should be noted that the current law governing apportionment and allocation is undergoing scrutiny by the Department and could change at some point in the near future; Travelscape's B&O tax risks could increase accordingly. Given the uncertainty of Travelscape's B&O tax classification and the appropriate apportionment method, it should consider obtaining a written ruling from the State.

Based on our review of the law, we determined that there is a Low level of risk that the sales tax or convention center tax would be due on Travelscape's gross receipts because Travelscape is not a hotel that furnishes lodging. Nonetheless, if the state did take the position that Travelscape was furnishing lodging, albeit a very broad interpretation of the statute, the risk level of such taxes would correspondingly increase. Additionally, Travelscape has a Low level of risk that a material B&O tax liability would exist because there is a position that Travelscape is a "travel agent" or "tour operator" and its services are performed in Nevada and the benefits from the services rendered occur outside of Washington.