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Hotels Win Big on Taxation Of Loyalty Programs

by Timothy P. Noonan

Regular readers of this publication and other kindred souls who take interest in nationwide sales tax developments have no doubt been following the plight of online hotel travel companies and their battles with state and local tax departments in the sales tax area. But while these skirmishes have gotten most of the attention in tax practitioner circles, an issue of similar importance was quietly brewing in several states. That issue relates to the taxation of hotel loyalty programs, and how sales taxes are supposed to work when members of these programs receive "free rooms" by redeeming points. In particular, several hotel chains, with help from their counsel, have been pursuing significant refund claims through New York's Division of Tax Appeals, seeking refunds for taxes paid on funds flowing to hotels under the terms of hotel loyalty programs. (The author represented the hotel chains in this litigation.)

Last month, the hotels' long battle came to an end when the New York State Tax Appeals Tribunal held that amounts paid to hotels under one hotel chain's loyalty program were not subject to sales tax.[1] And while the decision obviously addresses only the taxation of loyalty programs under New York's sales tax rules, there is potential for its effects to be felt nationwide.

So while the online retailers get most of the attention, those with interest in important developments in the sales tax area should pay attention to this case as well. In this article, I'll review what happened in the *Marriott* case and discuss its implications for the future.

Background on Loyalty Programs

So how do these programs work? Anyone who is a member of a hotel loyalty program has a pretty good idea of that. The basic idea is this: A member of a program earns points by being loyal to a particular brand. Members do this in large part by patronizing particular hotel chains, earning points for staying and spending money in specific hotels. To a lesser extent, members can also earn points by using specific credit cards, airlines, or other services provided by companies that have entered into an arrangement with the hotel chain to allow for the issuance of points. The bottom line, though, is that when members earn enough points, they are entitled to a free room at a hotel at any one of the hotels participating in the chain's loyalty program. Again, to a lesser extent, members can also use these points to acquire things other than hotel rooms, such as merchandise, rental cars, and vacations. But the record in the *Marriott* litigation made clear that the vast majority of points were used to acquire "free" hotel rooms. As a frequent traveler and member of a loyalty program myself, I can attest to this. The Noonan family (all 11 of us) has taken full advantage of the points I earn in my travels to acquire hotel rooms (we usually need two) for family vacations.

But as noted by the Tax Appeals Tribunal in the *Marriott* litigation, these programs are marketing programs. The whole point is to encourage members to choose hotels in a specific chain over other hotels. Indeed, when I travel on business, I really don't care where I stay. But for the ability to earn points at a specific hotel chain, there generally would be no compelling motivation to choose one hotel over another (other than cost, obviously). But I choose to patronize one particular chain almost exclusively because of my ability to earn points and later acquire free rooms. All hotels in a chain benefit from this, and from the existence of these marketing programs. And as we'll see, the marketing aspect to

[1] *See In the Matter of the Petitions of Marriott International, Inc. et al.* (Tax Appeals Tribunal, Jan. 14, 2010). (For the decision, see *Doc 2010-1503* or *2010 STT 14-24*.)

the programs had a direct effect on these sales tax arguments presented in the *Marriott* litigation.

In any event, what happens on the back end? Clearly a hotel is not going to give the Noonan family two hotel rooms out of the goodness of its heart. Rather, as seen in the *Marriott* litigation, the hotel chains have set up a mechanism for the reimbursement of costs associated with the hotels' participation in these marketing programs. Really, it's pretty simple. On the front end, when a member stays in a participating hotel and earns points, that hotel is required to pay some agreed percentage of the hotel folio (generally 4 percent or 5 percent) into a fund that is usually a separate entity established by the hotel chain to administer the provision of the program. The job of this fund is to collect these contributions from all hotels in the chain and then administer the program by paying marketing expenses, operating costs, and handling the reimbursement system when members ultimately redeem points for free rooms.

And this reimbursement system is the back end of the transaction that occurs in these loyalty programs. Indeed, because the hotel is essentially providing a free room to a redeeming member, the fund provides for a reimbursement to the redeeming hotel. This reimbursement is designed to cover the cost of the hotel's participation in the program, but as the tribunal found in *Marriott*, it is never a separate payment for a specific hotel room, nor is it designed to equal the charges that a hotel would get from a full paying member on the day in question. Instead, the reimbursement is based on a formula that takes into account many factors, and is generally thought of as a return of the money the hotel originally contributed to the fund (the 4 percent-5 percent contribution payment) in the first place. Also, as the facts in the *Marriott* litigation showed, never is a separate payment made. Instead, under the Marriott Rewards Program, a calculation was done 13 times a year. And since reimbursements were netted against the contributions owed by the particular hotel for each reporting period, often a participating hotel received no payment because the contributions to the fund in a particular reporting period would exceed whatever reimbursement it was entitled to.

The Sales Tax Issue

Historically, hotel chains had been paying full sales or occupancy taxes on the amount of reimbursements calculated to be paid by the fund to the particular hotel. Basically, the hotels were treating this reimbursement as the purchase of a hotel room by the fund. At some point, however, many hotel chains realized that this was a mistake, since the fund really wasn't buying a room, and since in many cases the "reimbursement" a particular hotel was receiving was just a return of the funds contributed by the hotel in the first place. So refund claims were filed in many states, including New York.

None of these claims resulted in reported cases or other litigation of any consequence. But a couple of jurisdictions addressed the issue more informally. For instance, Florida issued a pronouncement in a 2006 informational publication addressing the applicability of Florida sales tax (called the transient rental tax) on lodging provided to members of hotel rewards programs.[2] In this publication, the Florida Department of Revenue held that some sales tax was due, but only to the extent that a particular hotel's reimbursements from the fund exceeded contributions in a particular reporting period. Texas took a similar approach. In a 2004 publication, it stated that reimbursements from a rewards fund for the provision of free rooms would not be taxable, provided such reimbursements did not exceed amounts previously contributed to the fund at a particular reporting period.[3]

And closer to home, this issue was addressed head on by the New York City Department of Finance in a finance memorandum addressing the taxation of hotel loyalty programs for purposes of the New York City hotel room occupancy tax.[4] In that finance memorandum, the Department of Finance took the position that when a member redeems points for a room, the hotel is not required to collect any taxes from anybody. Under the city's logic, the hotel room occupancy tax was a transaction tax imposed on the rent for occupancy of hotel rooms in the city, and the original payments for rooms rented in the city by members were already taxed in full (provided the occupancy occurred in New York). As to the contribution to the hotels from the fund and the corresponding reimbursements, New York City held that the contributions and credits against those contributions "serve to redistribute money that was either actually subject to tax or would have been subject to tax if the occupancy had been in New York City." Thus, under New York City's rationale, the hotel chains should not have been paying tax on any portion of these reimbursements.

New York Litigation

But never had the issue been addressed by any judicial or quasi-judicial body in a litigated matter. That is, until *Marriott* went forward with its case in New York's Division of Tax Appeals.

The first step in the Division of Tax Appeals process involves a hearing before an administrative

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[2]*See* Florida Tax Information Publication #06 (A 01-01, Mar. 17, 2006).

[3]*See* Texas Tax Policy News (May 1, 2004).

[4]*See* Finance Memorandum 06-2, "Hotel Rewards Point Programs Under Hotel Occupancy Tax."

law judge. In late 2008 the ALJ assigned to the *Marriott* matter found in favor of Marriott, determining that under rules of statutory construction, the reimbursements received by hotels from the Marriott Rewards Fund were not consideration for hotel occupancy within the meaning of Tax Law section 1105(e). Instead, the ALJ found that the Marriott Rewards Program was a marketing tool designed to increase stays at Marriott Hotels, and that any payments between the Marriott Rewards Program and the hotels were simply designed as a method of reimbursing the hotels for the cost of participating in the program. The fact that the reimbursements received by the hotels were based on a formula that factored in occupancy was not determinative since, as the ALJ held, it would be erroneous to tax a transaction as consideration for a stay in a hotel room when the primary purpose was not the sale of a room, but reimbursement for the cost of participating in a marketing program.[5]

After the determination of the ALJ, the tax department filed an appeal to New York's Tax Appeals Tribunal, bringing the issue front and center in New York's highest administrative tax court. There, the tax department argued, as it did to the ALJ, that since the reimbursements determined under the terms of the Marriott Rewards Program were based on members' occupancy in a hotel room, they must be consideration for hotel occupancy.

The Tax Appeals Tribunal disagreed. And in a decision issued in January, it upheld the ALJ's determination that for a tax to apply on funds flowing between the Marriott Rewards Fund and the participating hotels, there had to be a separate transaction that had as its primary purpose the furnishing of something taxable. But in the case of the Marriott Rewards Program, the tribunal found that the members themselves provided the consideration for occupancy of the hotel rooms by earning points through their repeated stays at participating hotels. This is the exact argument that Marriott had been making throughout the entire appeals process. The argument, actually, is quite simple, and is based on the notion that there is no such thing as a free room. Program members get a free room at a participating Marriott Hotel not because some mystery rewards fund is buying it for them. Instead, the member gets a free room in the hotel because the member earned the right to that room by their previous stays within the chain. That, the tribunal found, is the consideration for the hotel occupancy. And since full sales taxes were paid by the member on these point-earning stays (provided the occupancy occurred in New York state), no further sales taxes needed to be collected.

Accordingly, since the tribunal held that the funds flowing between the Marriott Rewards Fund in the participating hotels weren't consideration for hotel occupancy because that consideration for the "free room" had been already provided by the member, Marriott's refund claims were granted in full.

Implications Elsewhere?

As a result of this litigation, Marriott and other hotels received significant refunds (plus interest) over the course of many tax years. It was a huge win for all of these hotels. And since decisions of the Tax Appeals Tribunal are binding, the tribunal's decision in *Marriott* is now the law of the land (at least the land in New York state). As for the effect of this decision in other jurisdictions, that remains to be seen. But given that this issue is percolating in many other states, the tribunal's decision in *Marriott* could have repercussions across the nation.

Indeed, although there is widespread disparity in the types and nature of sales taxes imposed on hotel room occupancy across the country, almost every jurisdiction that has a tax on hotel rooms bases it on the payment of some form of rent or consideration. In *Marriott* the tribunal made a factual determination that the consideration for free rooms provided under the terms of the Marriott Rewards Program came directly from the member, not from a rewards fund. Again, this really wasn't a determination steeped in the vagaries of New York tax law. That may be why the tribunal didn't need to cite any case law in support of its decision. Instead, just by looking at the nature of the programs and the agreements between the parties, the tribunal was able to make the determination that the consideration for the hotel room occupancy came from the member. And since many other states base their hotel occupancy taxes on the provision of consideration, there is no reason to think that the factual determination by the tribunal in *Marriott* should not apply to other states' sales taxes. ☆

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[5]*See In the Matter of the Petition of Marriott International, Inc., et al.,* Administrative Law Judge (Nov. 26, 2008).