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DEPARTMENT OF TAXATION ANNOUNCEMENT NO. 2016-06

RE: Summary and Digest of the Hawaii Supreme Court decision in *Travelocity.com, L.P. v. Director of Taxation*, 135 Hawaii 88 (2015).

Summary

On March 17, 2015, the Supreme Court of Hawaii issued its decision in *Travelocity.com, L.P. v. Director of Taxation*, 135 Hawaii 88 (2015), holding that online travel companies (OTCs), including Travelocity.com, LLP, Expedia, Inc., Orbitz, LLC, Hotwire, Inc., and Priceline.com, are subject to Hawaii's general excise tax (GET), but not subject to Hawaii's transient accommodations tax (TAT).

The Hawaii Supreme Court states that the OTCs operate websites where transients can research destinations and make reservations for airfare, car rentals, and hotels. The Department of Taxation (Department) assessed the OTCs in connection with income derived from the sales of room accommodations in Hawaii under a business model whereby hotels granted the OTCs the right to sell occupancy for a hotel room and the OTCs then sold the right to occupy the room to a transient.

The court held that the OTCs were engaged in business in the state and therefore subject to the GET. The court further held that the OTCs' services were used or consumed in Hawaii. Accordingly, the OTCs' income was sourced to Hawaii and application of the exported services exemption was disallowed. The court also held that the OTCs were only subject to GET on their share of the gross income because the income-splitting provision in section 237-18(g), Hawaii Revised Statutes (HRS), applied. With respect to the TAT, the court held that the OTCs were not operators and therefore not subject to the TAT.

As discussed in detail below, the following are key points from the court's decision:

- Physical presence in Hawaii is not required to satisfy the statutory "in the State" requirement in section 237-13, HRS, and be subject to the GET's "wide and tight net"
- For purposes of the income-splitting provision in section 237-18(g), HRS, the term "travel agency" means an "enterprise engaged in arranging and selling travel services" and does not exclude an entity in direct contractual privity with the transient
- The TAT is imposed once on a single operator of a transient accommodation
- The Department's assessment of penalties for failure to pay taxes is presumed correct, thereby imposing the burden on the taxpayer to prove that the failure to pay was not due to negligence or intentional disregard of the rules

General Excise Tax

A. Physical Presence is Not Required

The GET is a privilege tax imposed on all business and other activities "in the State."[1] The OTCs asserted that the statutory phrase "in the State" means that a taxpayer must have a physical presence in Hawaii (i.e. a taxpayer's business activities must be performed in Hawaii) in order to be subject to the GET.[2] The OTCs claimed that their services, performed outside Hawaii, were not subject to the GET despite the fact that the travel occurred within Hawaii.[3] The court rejected the OTCs' argument, explaining that the GET, a tax designed to reach "virtually every economic activity imaginable," does not have any physical geographical limitation.[4]

The court held that the OTCs had sufficient business and other activities in the state to subject them to the GET.[5] Specifically, the court explained that the taxable event—the receipt of income from transients for providing accommodations in hotel rooms in Hawaii—provided the OTCs with an economic gain arising from property located in Hawaii.[6] Additionally, although the agreements between the OTCs and transients took place outside of Hawaii, the intent was that "performance would occur entirely in Hawaii," where the occupancy rights were "wholly consumable and only consumable in Hawaii."[7] The court also noted that the OTCs were not passive sellers of services to Hawaii consumers, as they actively solicited customers for Hawaii hotel rooms and actively solicited hotels to allow them to sell occupancy rights.[8] Further, the court explained, the OTCs constructively benefited through the transients' use and benefit of state services, such as the use of roads and access to police, fire, and lifeguard protection services.[9] Accordingly, the OTCs were engaged in business "in the State."[10]

B. Sourcing and Exported Services Exemption

The court next rejected the OTCs' argument that the GET did not apply because the OTCs' services were used or consumed outside of the State.[11] The OTCs, relying on the exported services exemption in section 237-29.53, HRS, and the offset for taxes paid to other states provided for in section 237-22, HRS, asserted that their services were not used or consumed in Hawaii, but rather, in

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[1] Haw. Rev. Stat. § 237-13.
[2] *Travelocity*, 135 Hawaii at 103.
[3] *Id.* at 100.
[4] *Id.* at 103-105.
[5] *Id.* at 105.
[6] *Id.* at 104-105 (discussing similarities with *In re Tax Appeal of Subway Real Estate Corp. v. Director of Taxation*, 110 Hawaii 25 (2006)).
[7] *Travelocity*, 135 Hawaii at 105 (discussing similarities with *In re Tax Appeal of Heftel Broadcasting Honolulu, Inc.*, 57 Haw. 175 (1976)).
[8] *Travelocity*, 135 Hawaii at 105 (discussing similarities with *In re Tax Appeal of Baker & Taylor, Inc.*, 103 359 (2004)).
[9] *Travelocity* Hawaii, 135 Hawaii at 105 (discussing similarities with *In re Tax Appeal of Grayco Land Escrow, Ltd.*, 57 Haw. 436 (1977)).
[10] *Travelocity*, 135 Hawaii at 105.
[11] *Id.* at 100, 105 n.20.

"whatever out-of-state location the transient is located at the time of purchase."[12] The court rejected the OTCs' argument, holding that it was "clear that the Assessed Transactions are business transactions that continue in the state," where the hotel rooms are used or consumed.[13]

C. Division of Income Under Section 237-18(g), HRS

The GET is imposed on a business' gross proceeds or gross income, which is defined as all gross receipts "without any deduction on account of the cost of the property sold, the cost of materials used, labor cost, taxes, royalties, interest, or discount paid or any other expenses whatsoever."[14] In limited circumstances, however, and only as provided by statute, a business will be subject to the GET only for its share of gross income.

Section 237-18(g), HRS, provides such an exception: "Where transient accommodations are furnished through arrangements made by a travel agency or tour packager at noncommissioned negotiated contract rates and the gross income is divided between the operator of transient accommodations on the one hand and the travel agency or tour packager on the other hand, the tax imposed by this chapter shall apply to each such person with respect to such person's respective portion of the proceeds, and no more."

The court held that section 237-18(g), HRS, applied to the assessed transactions, clarifying that the OTCs fell within the ordinary definition of "travel agency"—an "enterprise engaged in arranging and selling travel services."[15] The court explained that the fact that the OTCs were in direct contractual privity with the transients (as opposed to merely being an intermediary between the hotels and the transients) did not preclude them from qualifying as travel agents.[16] The court also clarified that a noncommissioned rate is an amount of money paid to an entity or person other than an agent or employee.[17] The court explained that unlike a commissioned transaction, in which a fee is usually paid as a percentage of the income received, in a noncommissioned transaction, a hotel has no means of knowing what the travel agent's mark-up will be.[18] Because the court found the OTCs operated as travel agents, divided income with the hotels, and furnished transient accommodations at noncommissioned negotiated contract rates in the assessed transactions, the court held that the OTCs were subject to the GET for their share of the gross income.[19]

Transient Accommodations Tax

The TAT is imposed on the gross proceeds derived from furnishing transient accommodations.[20] The TAT is payable by operators, defined in section 237D-1, HRS, as "any person operating a transient accommodation, whether as owner or proprietor or as lessee, sublessee,

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[12] *Id.*
[13] *Id.* at 105 n.20.
[14] Haw. Rev. Stat. § 237-3.
[15] *Id.* at 106-108.
[16] *Id.* at 108.
[17] *Id.* at 111.
[18] *Id.* at 111-13.
[19] *Id.* at 113.
[20] Haw. Rev. Stat. § 237D-2(a).

mortgagee in possession, licensee, or otherwise, or engaging or continuing in any service business which involves the actual furnishing of transient accommodation."[21] The court held that the OTCs were not operators, as defined by statute, because there can only be a single operator that furnishes transient accommodations.[22] Because it was undisputed that the hotels were operators, the OTCs could not also be operators.[23] Accordingly, the court held that the OTCs were not subject to the TAT.[24]

Penalties

The Supreme Court, having determined that the OTCs were subject to the GET, affirmed the Tax Appeal Court's ruling that the OTCs were subject to penalties under section 231-39(b)(1), HRS, for failing to timely file a tax return.[25] The court held that the OTCs failed to demonstrate an honest belief that they were not responsible for filing a GET return and were therefore subject to the failure to file penalty.[26]

The Supreme Court also affirmed the Tax Appeal Court's ruling that the OTCs were subject to penalties under section 231-39(b)(2)(A), HRS, for underpayment of tax due to negligence or intentional disregard.[27] The court explained that because the Department's assessments are prima facie correct, the burden is on the taxpayer to prove that the failure to pay was not due to negligence or intentional disregard of the rules.[28] Because the OTCs failed to present any evidence to rebut the presumed validity of the penalty, the Tax Appeal Court's ruling was affirmed.[29]

This Tax Announcement is a summary and digest of the Hawaii Supreme Court decision in *Travelocity.com, L.P. v. Director of Taxation*, 135 Hawaii 88 (2015) and should not be relied upon as a statement of law or fact. For more information please refer to the decision or call the Administrative Rules Office at 808-587-1530.

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[21] Haw. Rev. Stat. §§ 237D-1, 237D-2(a).
[22] *Travelocity*, 135 Hawaii at 127.
[23] *Id.*
[24] *Id.*
[25] *Id.* at 113-14.
[26] *Id.*
[27] *Id.* at 114-15.
[28] *Id.* (citing Haw. Rev. Stat. § 231-20).
[29] *Travelocity*, 135 Hawaii at 114-15.