Virtual Intermediaries II - Canadian Solutions (Drop Shipments) Compared with US, Japanese & EU Approaches

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VIRTUAL INTERMEDIARIES II – CANADIAN SOLUTIONS (DROP SHIPMENTS) COMPARED WITH US, JAPANESE & EU APPROACHES

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INTRODUCTION

Marketplace technology is (inadvertently) chipping away at the effectiveness of consumption taxes. This can be seen in a number of economic sectors, but a case in point is the impact that virtual intermediaries are having on the collection of lodging (or accommodations) taxes. Both the American sales tax (ST) and the Japanese Consumption Tax (CT) are experiencing difficulty with (and revenue losses because of) online travel agents. Neither the European value added tax (VAT) nor the Canadian hotel tax (HT) are having similar problems – but the reasons are very different.

Although each of the consumption taxes considered in this paper (ST, CT, VAT and HT) are based on the same premise – that a full measure of tax should be imposed on consumption when and where it occurs – each of these systems differ importantly in the way in which they seek to achieve this objective. Virtual intermediaries are slipping through the cracks in some systems, but not in others. Tax design (not tax theory) is the problem.

By contrasting consumption tax systems this paper demonstrates how technology-patches or statutory design changes can be identified that minimize the tax-damage that results from technology-facilitated advances in business methods. This paper indicates that American and Japanese tax administrations should look to the EU or Canada for solutions on how to deal with virtual travel agents. Knowing what can be done and how it is working elsewhere is always helpful, even though political realities may make local adoption of a solution difficult.
The Canadian experience with intermediaries is very informative. It is the only system considered here where there are consumption taxes on accommodations at three levels of government (federal, provincial and local). As a result, a considerable amount of Canadian thought has gone into how to harmonize these taxes, how to deal with compliance and enforcement issues, as well as what to do about the very difficult problem of the non-resident, non-registered intermediary engaged in reselling accommodations at a discount.

The case of consumption taxation the US lodging industry is almost the complete opposite of the Canadian and European. If litigation is the litmus test for frustration with an unclear statute, then the US has an exceptionally frustrating system. Many US jurisdictions are having difficulty determining the applicability of lodging taxes for accommodations sold over the internet. There is US litigation from coast to coast. The fact that there is no similar litigation in Canada or the EU is at least an indication that there may be something to be learned from a comparison of systems. The Japanese National Tax Administration has just begun to take note of virtual intermediaries in the lodging industry, and it is not clear how they will proceed.

ANALYTICAL FRAMEWORK:
DROP SHIPMENT NOT ADD-ON SERVICES

This paper contends that it is analytically more helpful to consider virtual intermediaries (in the travel reservation, lodging, and accommodations industry) as middlemen in a drop shipment transaction, rather than as add-on providers of services related to another or primary supply. This is more than a difference in perspective.

In the days before the internet (or before virtual travel agents provided travelers with heavy discounts when they booked accommodations on-line) a different paradigm described the travel agent’s relationship with travelers. In those brick-and-mortar days the travel agent provided a distinctly separate add-on service.

Traditional travel agents offered help with reservations (for a fee). Two simple contracts describe this industry: (1) the customer’s contract with travel agent (as re-seller or as agent) to secure (2) a contract for accommodations with a provider. The important point was always the accommodations – did they meet the traveler’s needs (room size, amenities, and proximity to business locations)? Saving money was also a factor, but what was normally sought was knowledge and experience. There was a value added service.

The consumption tax framework that worked best this setting was sequential or linear. The travel agent could be taxed on services, measure by the fee they charge. The lodging or accommodations could also be taxed, based on a distinct rental charge. Different tax rules could be applied to each part. The whole exchange naturally fell into two discrete parts.

Virtual travel agents are different. They are opportunistic agents. Their goal is to create a mutually beneficial three-party transaction that secures accommodations: (a) that meets the traveler’s requirements at a discounted charge, (b) that fills vacant room at a hotel with guests

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4 It is also possible to see the traditional travel agent as independently offering services that have been severed from a unitary supply, but the result is the same – two contracts, or two transactions considered independently and analyzed sequentially.
that are paying fees reasonably above standard costs, and (c) that has enough extra cash in the transaction to provide the intermediary with a profit. The virtual intermediary’s eye is always on the discount. Knowledgeable travel assistance is not what is being sold.

The internet brought a fundamental change to the travel agent’s industry. In 2000 Harvard Business School (HBS) case studies began dissecting the landscape as it was developing. Virtual intermediaries demanded executive attention, because something new was happening. These enterprises were selling more than traditional services, and executives needed to understand what they did and how they made a profit. Business models were changing.

In terms of consumption taxes, anything that reduced the prices of accommodations will reduce revenue – the question is how low should the tax base fall? Should the tax base be limited to the amount the hotel receives, or should the tax base be measure by how much the guest pays? In a traditional transaction the amount the guest pays is the amount the hotel receives, but when a discounting intermediary becomes a middleman in this transaction the amount the guest pays for the accommodations is less than the fair market value of the room, but more than the hotel receives.

Older statutes are frequently written with the equivalence of amount paid and amount received in mind. Transposed to a modern context where virtual intermediaries are engaged in reducing prices the amount received becomes a poor proxy for consumption if what we are trying to measure (and tax) is the amount the guest pays for a room.

Thus, the analytical framework has changed, and this should change how tax policy is implemented. We need a non-linear way of looking at this problem. The fact pattern has changed from two sets of binary contracts to a single triangular relationship. Some of this analysis can be seen in the letter Walter Hellerstein drafted for the National Conference of State Legislatures (NCSL) when they were considering the taxation of travel intermediary services. Two model statutes, one by the Multistate Tax Commission (MTC), the other advanced by the travel industry were under review. Neither proposal framed the issue in a triangular fashion – as a drop shipment. Both saw the issue in linear terms. The intermediary’s services were severed from the rental transaction. Both simply asked – how should the intermediary’s margin be taxed?

The MTC proposal deemed the travel intermediary’s margin to be taxable in the jurisdiction where the accommodations were located. The industry proposal deemed these receipts taxable in the intermediary’s jurisdiction. Because virtual intermediaries can easily be located in a no tax jurisdictions, the industry proposal effectively allowed the intermediary’s margin to escape taxation.

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Electronic copy available at: https://ssrn.com/abstract=1525457
In his letter\(^6\) (referencing his treatise\(^7\)) Hellerstein preferred the industry proposal “… as a matter of sound tax policy and, … administrative convenience.” This may not have been the answer the NCSL wanted to hear, but it was the best answer given the choices. However, in a closing footnote Hellerstein offers a third approach:

In my treatise, in offering a “normative” approach to the issue addressed in this memorandum, [citations omitted] I suggested a “practical approach” [citation omitted] to taxing the travel intermediaries’ margin that neither the MTC nor the industry proposal has embraced, namely, requiring the hotel operator to add a presumed markup to the travel intermediary’s price, and collect tax on the marked-up price, subject to the hotel’s establishment of an actual markup that is different. This would remove the travel intermediary from the tax collection process altogether and was addressed to the concern that there might otherwise be constitutional problems with asserting tax collection nexus over out-of-state travel intermediaries.\(^8\)

Where did this third option come from? The treatise has more detail. Hellerstein’s markup proposal comes from the “analogous issues in the context of drop shipments.” In other words, Hellerstein is saying, if you change the paradigm (from \textit{add-on} services to a \textit{drop shipment} transaction) you can change your policy options.

Hellerstein then cites the California Regulation that adopts this approach (in a drop shipment of goods context, not in a hotel tax fact pattern).\(^9\) If we want to see Hellerstein’s solution in the hotel tax we need to go to Canada. Both the federal GST/HST and the Province of Quebec use a drop shipment template when considering intermediaries. Quebec’s is specific to the local room tax.\(^10\)

INTERMEDIARIES AND CONSUMPTION TAXES

\textit{Intermediaries – Generally.} All consumption taxes have problems with intermediaries when sales cross jurisdictional boundaries. The most challenging problems involve drop shipments – transactions where an intermediary is contractually involved in two legs of a three-party transaction, but is not directly (physically) involved in making the supply.

Suppose “A” agrees to supply “B” at an agreed price (100),\(^11\) and then “B,” acting as an intermediary, marks-up the supply (to 150) and re-sells to “C.” Suppose further that “C” is a final consumer and consumes in its domestic jurisdiction. This three-party transaction is a drop shipment transaction if “B” instructs “A” to deliver directly to “C.”

Problems arise because the second sales contract (“B” to “C”) is uncoupled from the delivery (“A” to “C”). Said another way, both “A” and “B” know half the information. “A”

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\(^7\) Hellerstein, \textit{supra} note 1.

\(^8\) Hellerstein, \textit{supra} note 6 n. 11.

\(^9\) Hellerstein, \textit{supra} note 1 at ¶ 19.03[6][c] n. 534 (referencing Cal. Code Regs. tit. 18, §1706(c)(2)).

\(^10\) Revised Statute of Quebec, c. T-0.1, §541.24.

\(^11\) For ease of analysis all examples are drafted generically in “currency units.”
knows when the supply is made, but does not know the price that “C” pays. “B” knows the price “C” paid, but does not know when delivery is made.

The tax problem is to align substantive jurisdiction with enforcement jurisdiction. In other words, how can we align “the right to tax,” determined by the place of consumption, with the right to compel the taxpayer (or a withholding agent) to collect the tax?

### DIAGRAM 1

![Diagram 1](image)

Virtual intermediaries in travel accommodations work from a variant of this pattern. Using the diagram above A is the hotel, B the internet intermediary and C is the traveler. The key to understanding its application in a hotel accommodations context is in (a) adding to this diagram the market price of the hotel room (its fair market value) and (b) in turning the delivery arrow around.

Thus, if A normally sells these rooms for 175, but is willing to sell them to B for 100 (a publicly undisclosed price), and if the traveler (C) agrees to pay 150 for the room through B’s internet site, then B’s margin is 50. This is a drop shipment in the sense that A makes the delivery for B when C shows up at A’s registration desk on the appointed day. C travels to A’s premises and accepts delivery at A’s establishment. The diagram is modified below.

### DIAGRAM 2

![Diagram 2](image)
The question posed by this fact pattern is – what is the consumption base in A’s jurisdiction? It should be no surprise that we can find three answers: 100, 150, and 175.12

**Intermediaries – EU background.** The EU VAT always reaches a full-tax result in drop shipment transactions. Substantive tax jurisdiction aligns with enforcement jurisdiction (that is, tax is collected in the jurisdiction that has enforcement jurisdiction). Mandatory EU-wide rules control the outcome.13 The measure of the tax base is subjective (the amount the customer paid for the supply).14

The VAT is premised on the supplier (not the customer) being the taxpayer.15 Thus, if “C” is a final consumer, then “B” (the intermediary) is obliged to collect VAT based on the invoice price and is required to remit the funds to “C’s” jurisdiction. An exception applies for sales of goods below a threshold (100,000 or 35,000 euro), and some additional refinements apply, but none of them result in the full-tax being uncollected.

In the case of a sale of goods (within the EU), if “C” was a business then the cross-border (intra-community) supply becomes a zero-rated sale by “B,”16 and “C” is required to self-assess (reverse charge) the VAT and remit the tax to “C’s” jurisdiction.17

If services (instead of goods) are involved the EU VAT still assures collection of the VAT. Depending on the nature of the services, and the status of the customer (business or final consumer) proxy rules source the transaction either to the buyer’s or seller’s jurisdiction.18 Depending on the facts either the seller is required to collect the VAT, or the buyer is obligated to perform a reverse charge. However, no transaction escapes tax (unless the place of supply for the services is deemed to be outside the EU and in a jurisdiction that does not have a VAT).

**Intermediaries – US background.** The American ST does not always reach a taxable result in a drop shipment transaction. It is easy to see why. At its core, the ST relies on a jurisdictional mismatch. The customer (not the supplier) is the taxpayer under the ST, and

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12 See infra at notes 28 through 33 and accompanying text. 175 would be the Canadian solution. It is also the result under any VAT that generally values supplies on an objective rather than a subjective basis, and is very common VATs generally when problematical valuation issues arise (as is the case in Canada).
14 Case 230/87, Naturally Yours Cosmetics Ltd. v. Commissioners of Customs and Excises, 1988 E.C.R. 6365 at ¶ 16 (expressly holding that a subjective valuation, not an objective valuation applies in EU VAT, “… since the basis of assessment is the consideration actually received and not a value estimated according to objective criteria.”).
15 RVD Art. 9(1).
16 ‘Taxable person’ shall mean any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity.
17 RVD Art. 138(1).
18 RVD Art. 197(1)(b).
19 RVD Art. 43 sets out the main rule for all services. RVD Art. 56(1) contains exceptions for intangible services – there are additional exceptions applicable to other services. The main (and therefore fall-back) rule deems all services to be supplied at the seller’s location. RVD 56(1) isolates miscellaneous services (sometimes called intangible services) and provides a different proxy. Intangible services are deemed to be supplied at the buyer’s location.
substantive jurisdiction is premised on consumption occurring within the jurisdiction. However, the vendor is the collection agent for the ST, and when the vendor and the customer are not located within the taxing jurisdiction there are difficulties.

The constitutional linchpin in this misalignment is the “substantial nexus” requirement locked in place by Quill Corp. v. North Dakota. Quill makes it clear that US states cannot enforce collection of the ST unless the vendor is “physically present” in the state. Imposing a collection obligation on an out-of-state business making $10 million in sales into a state (as was the case in Quill) is unconstitutional (it unduly burdens interstate commerce) if the vendor lacks physical presence.

This is a particular problem for drop shipment transactions. Assume that a consumer (C) orders goods from an out-of-state intermediary (B) that has no physical presence in C’s jurisdiction. Assume further that B does not keep these goods in inventory, but secures them on an “as needed” basis from a wholesaler that also has no physical presence in C’s jurisdiction. In this case taxing jurisdiction is in C’s state. C is a final consumer. However, there is no third party enforcement jurisdiction. All that can be hoped is for C to volunteer payment.

This outcome encourages states to stretch nexus rules. One approach has been to apply common law agency principles and attribute nexus to out of state retailers (B) based on the activities of a related party within the state. In other instances states have transferred collection responsibility to the drop shipper (A) making deliveries. A third option, referenced by Walter Hellerstein in his letter to the NCSL, is to adopt a “presumed markup … subject to the hotel’s establishment of an actual markup” as is done by regulation in California. Recently, a “flash title” argument has been developed that endeavors to satisfy Quill’s “substantial” nexus test by finding “physical presence” of inventory within the state for a moment (a flash). The end result has been to make drop shipments a difficult area of ST compliance.

Intermediaries – Japanese background. Like the VAT the CT aligns substantive and enforcement jurisdiction. The taxpayer under the CT is the seller, but the seller is present for CT purposes only if it is present for income tax purposes. Thus, like the ST, the CT is very concerned about the “physical presence” of the intermediary.

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20 Id., at 317.
21 Attributional (agency) nexus takes many forms, but all center on the degree of control the out-of-state seller exercises over an in-state entity. Simply common ownership is not enough. RESTATEMENT (SECOND) CONFLICT OF LAWS, §52 at comment b. ("[J]urisdictional jurisdiction over a subsidiary corporation does not of itself give a state jurisdictional jurisdiction over the parent corporation. [However], juridical jurisdiction over a subsidiary corporation will ... give the state juridical jurisdiction over the parent corporation if the parent so controls and dominates the subsidiary as in effect to disregard the latter’s independent legal existence.")
22 Requiring the drop shipper to collect tax is problematical. It is unlikely that the manufacturer or wholesaler would know the tax base (the price charged the in-state customer by the out-of-state retailer). Nevertheless, a number of states have taken this approach: WIS. STAT. § 77.51(14)(d); WIS. ADMIN. CODE TAX 11.94(1)(e); CONN. GEN. STAT. § 12-407(a)(3); CONN. LEGAL RUL. 2003-2 (May 30, 2003); CONN. LEGAL RUL No. 90-16, (Feb. 5, 1990); RI Gen. Laws §44-18-8; KAN. REV. DEP. PUB. NOTICE No. 03-09 (June 25, 2003); MASS. DEPT. REV. DIR. 86-5; CAL. SALES & USE TAX REG. § 1706(c)(2); NEV. REV. STAT. § 372.050(2);NEV. REV. STAT. § 374.055(2).
23 Supra note 6 and accompanying text.
24 Id.
In the Amazon case referenced above, the NTA attributes presence to Amazon based on the activities of related parties. If Amazon is within the scope of the income tax, then it is within the ambit of the CT. But, if the CT were more like the VAT than the ST then transactions (particularly services transactions) would be sourced rather than simply associated with an entity based on physical presence. As a result, more transactions would be captured. In other words, the question in Japan is could the CT be assessed based on economic presence? Could this be determined based on Amazon’s aggregate sales into Japan?

Intermediaries – Canadian background. The Canadian case is unique among the tax systems considered here. Canada has federal and provincial consumption taxes, and both are applied to drop shipments. There are also local hotel or accommodations taxes that sometimes follow, but at other times depart from solutions used at the federal or provincial levels. Provincial GSTs follow federal drop shipment rules when those GSTs piggy-back the federal system (called the Harmonized Sales Tax or HST). In provinces where a retail sales tax rather than a GST is used the drop shipment rules are similar to those under the US ST.

Under the Canadian GST the customer is the taxpayer. In this respect the Canadian tax is more similar to an American consumption tax than it is to the EU VAT or the Japanese CT (where the supplier is the taxpayer). This means that the Canadian system (like the US) has a difficult time aligning enforcement and substantive tax jurisdiction.

Canada however, has less of a problem with this misalignment for two reasons: (a) it is not burdened with Quill-type jurisprudence, and (b) it is willing to switch to an objective valuation of the supply. Canada requires remote vendor to collect and remit consumption taxes under a far more liberal economic nexus standard. The Canadian rule is that every person who makes a taxable supply in Canada in the course of a commercial activity has nexus. This standard considerably narrows the field (compared with the US) but it still leaves open the possibility that an unregistered, non-resident intermediary may make a Canadian drop shipment.

Canada solves this more limited set of problematical drop shipment transactions in a unique manner. Canada’s solution is to deem the first leg of the drop shipment transaction (the


Two Japanese subsidiaries of Amazon – Amazon Japan and Amazon Japan Logistics -- managed sales, merchandise distribution, and logistics operations in Japan. The sales income from the Japanese business was reported in the United States by Amazon.com International Sales.

The Tokyo Regional Taxation Bureau reportedly determined that the Japanese operations constituted a permanent establishment of Amazon.com International Sales in Japan under the Japan-U.S. income tax treaty and that the income should have been reported in Japan. Japanese tax officials found that employees of Amazon Japan Logistics received instructions from Amazon.com International Sales via e-mails at a distribution center in Ichikawa, Chiba Prefecture, and that approval from the U.S. company was required when the distribution center assigned its employees to new posts, according to media reports.


registered Canadian business’ sale to the unregistered, non-resident intermediary) to be taxable, and then changes the valuation methodology from subjective (the value of the consideration paid) to objective (the fair market value of the supply received).

In other words, even though the main rule for determining the tax base under the GST is subjective – tax is based on the value of the consideration paid for the supply – when a Canadian business makes a supply to an unregistered, non-resident intermediary, but delivers on behalf of the intermediary to a Canadian person, the tax base is valued objectively. The Canadian supplier is required to collect GST from unregistered, non-resident intermediary on the fair market value of the supply.

Consider the diagram below. Assume a Canadian business (A) supplies an unregistered, non-resident intermediary (B) for 100. Then assume the intermediary (B) re-sells to another Canadian (C) for 150, but requires (A) to deliver directly to (C). Under these facts (A) is required to collect GST from (B), and the tax base is not measured by the subjective value of the supply – the 100 that (B) was willing to pay (A). Instead, the tax base is measured by the objective value of the supply – the 150 that (C) was willing to pay (B).

**DIAGRAM 3**

![Diagram](https://ssrn.com/abstract=1525457)

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28 EXCISE TAX ACT, R.S.C., ch. E-15, § 154(1) (1985) (Can.) sets out the main Canadian rule that:

…every recipient of a taxable supply made in Canada shall pay … tax in respect of the supply calculated … on the value of the consideration for the supply.

And as § 153(1) further clarifies:

… the value of the consideration, or any part thereof, for a supply shall, for the purposes of this Part, be deemed to be equal to

(a) where the consideration or that part is expressed in money, the amount of the money; and

(b) where the consideration or that part is other than money, the fair market value of the consideration or that part at the time the supply was made.


30 EXCISE TAX ACT, R.S.C., ch. E-15, § 179(1)(c.2) (1985) (Can.) states:

… that supply [from A to B in the diagram] is deemed to have been made for consideration, that becomes due and is paid at that time, equal to …

(ii) … the fair market value of the property at that time,
In cases where (C) is a consumer, the Canadian rules assumes that (B) will pass the GST through to (C) in its cost of goods sold.31 Because (B) is a non-registered entity, it cannot file a return and claim a refund for the GST paid. The Canadian tax achieves a normatively correct result. A full measure of the GST is imposed on the consumer (C), based on the full amount of consumption.

In cases where (C) is a Canadian business, an exception applies.32 If (C) provides (A) with a certificate acknowledging that it is a registered business and that it will assume responsibility for the GST, then (B) will be exempt from the GST.33 (A) will collect no GST. (C) will self-assess (or reverse charge).

TRAVEL AGENTS AS VIRTUAL INTERMEDIARIES

By the end of 2000 Harvard Business School (HBS) was dissecting the internet’s impact on prices and market-making. One HBS Note “prepared as the basis of class discussion” assessed seven different market-making/ internet-sensitive mechanisms and argued that business professionals should move their thinking away from a “commodity selling mentality” in the Internet era.34

When business professionals change how they think about commercial transactions, tax regimes need to follow suit. This is the old “dot com” lesson.

But the thrust of the HBS Note was that internet-based market mechanisms were doing more than disintermediation. Virtual intermediaries were offering new products (not just lower prices on existing commodities). Teaching Notes indicated that, “[t]he ‘ah-ha’ [moment] for most [students came] from seeing that this is not merely a pricing story … but rather a product story … [a story that is] of great interest to suppliers.”35 HBS saw this change of thinking most clearly in the travel industry.

The virtual travel reservation industry is dominated by four internet-based intermediaries. The largest, Priceline.com and Expedia.com are independent of the major airlines; the others, Orbitz.com and Travelocity.com, began as wholly owned airline subsidiaries. Where Orbitz.com and Trevelocity.com began as disintermediation agents (cutting out independent ticket agents) this was not the Priceline.com and Expedia.com business model.

Priceline.com used a “buyer driven” business model. Priceline.com sold a new product – units of demand. Traditionally units of supply are offered (a specific seat on an airline going from Boston to New York, on a specified day and at a specific time).

31 GST/HST Memoranda Series, 3.3.1 Drop Shipments (June 2008).
32 EXCISE TAX ACT, R.S.C., ch. E-15, § 179(2) (1985) (Can.)
33 GST/HST Memoranda Series, 3.3.1 Drop Shipments 15 & 16 (June 2008).
34 Robert J. Dolan & Youngme Moon, Pricing and Market Making on the Internet, HARVARD BUSINESS SCHOOL NOTE 20 (No. 9-500-065, Nov. 9, 2000).
Under the Priceline.com model consumers offer a unit of demand – the demand for a specific seat. The customer specifies the price. With multiple airlines traveling the same routes, one may have an unsold seat on the designated day. If there is a match and the price is acceptable, the consumer’s demand will be satisfied.

This is a “reverse auction.” Priceline.com characterizes its business process as a “demand collection system.” It works because there are an estimated 500,000 unfilled airline seats each day that have a near zero marginal cost. Priceline.com collects demand for these seats. If a Priceline.com consumer makes a low, but irrevocable offer to purchase one of these seats – airlines listen.

Priceline.com’s business process is patented. The patent attracted academic attention when Priceline.com sued Microsoft and Expedia.com for infringement when Expedia.com rolled out a demand collection system for hotel reservations – Hotel Match Maker. The suit was settled. Expedia.com was allowed to continue to use Hotel Match Maker, but it had to pay a royalty back to Priceline.com.

Virtual (travel) intermediaries and the EU VAT. From its earliest days the EU VAT anticipated that travel agents, functioning as intermediaries, would need to be treated under a special scheme. In 1977 there were two concerns: (1) simplification and (2) sourcing revenue to the place of consumption.

The solution was to make the travel agent a final consumer of tickets and reservations. VAT paid by the agent was not deductible (not allowed as input credit on the agent’s return, nor did it qualify for refund in any Member State). When tickets and reservations were resold the

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36 Jay Walker, the founder and vice chairman of Priceline.com explains what a “demand collection system” means as follows:

In the traditional model of commerce, a seller advertises a unit of supply in the marketplace at a specified price, and a buyer takes it or leaves it. Priceline turns that model around. We allow a buyer to advertise a unit of demand to a group of sellers. The seller can then decide whether to fill that demand or not. In effect, we provide a mechanism for collecting and forwarding units of demand to interested sellers – a demand collection system.


37 Under the Priceline.com system consumers could only offer to purchase round-trip tickets, and could only specify the day of travel. The consumer would provide a credit card which would be charged immediately (without possibility of refund) when a qualifying flight was found. Consumers are only allowed to make one offer in a seven day period. These rules forced the customer to make a serious “best offer.” It standardized demand.

Because the seller (airline) is anonymous it gets two clear benefits (in addition to incremental sales). First, it gets a brand shield. If it had publicly advertised a lower price for its product, it would have eroded brand value. Secondly, it gets a price shield. It can maintain the integrity of its established prices because it never advertises that a lower price can be secured.


39 RVD Art. 310.
agent was required to determine its margin and remit VAT based on this amount. The margin was defined as the total cost of tickets purchased (plus VAT and related operational costs) less the total price paid by the traveler (without VAT). Although VAT on this margin is not stated on the traveler’s invoice, it is (most likely) “passed through” to the traveler. There is an assumption that the “traveler” is not traveling for business.\(^{40}\)

An example is helpful. Assume a travel agent in the UK purchases the following items for a package tour: round trip train tickets from Brussels to Copenhagen (50); lodging reservations in Copenhagen (30); and meals at various German restaurants (20). The total cost is 100. The package tour is sold to travelers for 150 (the VAT exclusive amount). Operational expenses are 5. The agent will pay VAT of 22.\(^{41}\)

Additionally, there is UK VAT on travel services of 15%, so the agent must remit 3.45 in VAT on each package sold. 3.45 is 15% of the agent’s margin of 23 (150 – 127).\(^{42}\) Assuming the VAT is “passed through” to the traveler, the invoice will be for 153.45 (150 + 3.45).\(^{43}\) The invoice will not specify the VAT. VAT is fully collected, but the markup is not revealed.

This scheme simplifies compliance (only one return is filed domestically) and we have sourced VAT on travel,\(^ {44}\) lodging\(^ {45}\) and meals\(^ {46}\) to the jurisdictions where consumption occurs. The details can be diagramed as follows:

**DIAGRAM 4**

![Diagram](https://ssrn.com/abstract=1525457)

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\(^{40}\) If a business traveler was involved then the travel agent would not make purchases in its own name. Instead the agent would disclose that they were purchasing on behalf of another (RVD Art. 309), set up a suspense account for those purchases (RVD Art. 153), and then pass these invoices to the business traveler along with a separate invoice (and VAT) for its services.

\(^ {41}\) Assuming that the train travels 30% in Belgium, 40% in Germany, and 30% in Denmark, then the VAT on the 50 euro train ticket is 10.70 (50 x 30% x 21% = 3.15 Belgian VAT + 50 x 40% x 19% = 3.80 German VAT + 50 x 30% x 25% = 3.75 Danish VAT); the VAT on the 30 euro hotel reservation is 7.50 (30 x 25% = 7.50); the VAT on the 20 euro meals is 3.80 (20 x 19% = 3.80).

\(^ {42}\) 127 is the sum of 100 in direct ticket costs, plus 22 in non-deductible, non-refundable VAT charged to the travel agent on these tickets, plus 5 in office operating expenses.

\(^ {43}\) RVD Art. 308.

\(^ {44}\) Intra-community transportation is subject to VAT in proportion to the distance traveled, RVD Art. 46.

\(^ {45}\) Lodging is sourced to the location of the hotel, RVD Art. 47.

\(^ {46}\) Meals are sourced to the place of establishment of the restaurant, RVD Art. 43. This rule is scheduled to change on January 1, 2010 so that the place of supply will be the place where the restaurant is located COUNCIL DIRECTIVE 2008/8/EC amending Directive 2006/112/EC as regards the place of supply of services, Sec. 7, (new Art. 57) available at: [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:044:0011:0022:EN:PDF](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:044:0011:0022:EN:PDF).
Presently, this scheme is not functioning optimally. There are three areas of concern: derogations, vertical integration of the industry, and the Internet. Most notably, the EU has permitted a large number of derogations that were expected to be temporary. The derogations have remained, and have made the scheme uneven among the Member States.

The Commission has proposed a Directive, and a Regulation that will resolve these issues.\(^{47}\) The Directive would eliminate derogations and extend the margin scheme to business customers. Although VAT-inclusive invoicing of travelers would remain, an opt-out rule allows businesses to receive a pass-through of the VAT charges on a service-by-service basis. There are also changes in the place of supply for transactions involving non-EU travel agents.

This last change targets virtual intermediaries. The place of supply will move from the place where the agent is established or has a fixed establishment out of which services are provided\(^ {48}\) to the place where the customer is established.

To see how this will work, consider the earlier example. Under the current margin scheme a 3.45 UK VAT is due on the travel agent’s services. If the agent performing these services moves to the US, these services will not be subject to VAT. Thus, if the package tour sells for 153.45 (with a margin of 23), it now has a profit of 26.45.

But, what happens if instead of moving to the US the agency moves to a low cost (as well as no tax) jurisdiction? Operating costs will be cut. Suppose operating expenses are cut by 40% to 3. The profit margin increases to 28.85. Is this all?

Each of these adjustments is a disintermediation activity. They are important, but their overall impact is minor. The internet allows travel agents to easily move into no tax/low cost jurisdictions. However, travel agents like Priceline.com are doing much more; they are using reverse auctions to reduce the base prices for travel commodities.

Thus, what happens if we extend the example further and fold in the kinds of price reductions that Priceline.com considers “normal”-30% reductions?\(^ {49}\)

\(^{48}\) RVD Art. 43.
\(^{49}\) 30% is the figure used by Robert J. Dolan, in the HBS case study Priceline.com: Name Your Own Price, at 7, n. 15, supra note 35, referencing the Priceline.com Form 10-Q (Nov. 15, 1999) at the Overview, which stated: [W]e also analyze the percentage of "reasonable" offers that we are able to fill. We consider an offer for an airline ticket to be "reasonable" when it is no more than 30% lower than the lowest generally available advance-purchase fare for the same route. Using this standard, the overall percentage of offers considered reasonable for the nine-month period ended September 30, 1999 was approximately 50.0%.

Priceline.com now advertises 40% reductions in airfare, 50% reductions in hotels, and 30% reduction in car rentals.
When we modify the travel package by 30% - travel that had cost 50 now costs 35; lodging that had cost 30 now costs 21; and meals that had cost 20 now cost 14. The total VAT is reduced – it is 15.40 instead of 22. The total cost reduction that a virtual intermediary would expect to realize is 38.6.

This means that the travel agent’s profits can potentially be as large as 65.05. This is considerably higher than the profit of 28.45 that the agent would have by simply moving out of the UK, and more than the margin of 23 of the “traditional” UK agent. This result is diagramed as follows:

DIAGRAM 5

Travel/tour agent

Third Country
(no VAT & low cost)

EU

Travel 35
VAT 21% + 19% + 25%

Lodging 21
VAT 25%

Meals 14
VAT 19%

No VAT

Re-sale for 150

Perhaps a better way of seeing this is to imagine that the travel agent is back in the UK. The “traditional” travel agent would pay UK VAT of 3.45. A travel agent following the Priceline.com business model would pay UK VAT of 8.94.

In other words, under current rules the EU VAT captures the entire margin of the Priceline.com business model but only if the travel agent is established in the EU. Reductions in

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50 Assuming that the train travels 30% in Belgium, 40% in Germany, and 30% in Denmark, then the VAT on the 35 euro train ticket is 7.49 (35 x 30% x 21% = 2.205 Belgian VAT + 35 x 40% x 19% = 2.660 German VAT + 35 x 30% x 25% = 2.625 Danish VAT); the VAT on the 21 euro hotel reservation is 5.25 (21 x 25% = 5.25); the VAT on the 14 euro meals is 2.66 (14 x 19% = 2.66).

51 38.6 = 30 (tickets and reservations savings) + 6.60 (VAT savings on these purchases) + 2 (savings in the cost of operations).

52 Full selling price of 153.45 reduced by the cost of ticket and reservation (35 + 21 + 14), reduced by the VAT charge (15.40), and reduced by the cost of office operations (3).

53 28.45 is the sum of the original margin 23, plus the cost savings from moving to a low cost third-country jurisdiction of 2, plus cost saving of the UK VAT that is no longer due on the margin of 3.45.

54 15% x 59.6 = 8.94. 59.6 (150 – 90.4) is the result of subtracting all costs (70 for tickets and reservation + 15.40 VAT on those purchases + 5 UK operating costs) from the VAT exclusive cost of the travel package.
the VAT base for travel, lodging and meals is matched by an increase in the VAT base for travel agent services.

Now consider the Commission’s proposals. Once again the entire margin is taxed, but this time it is taxed even if a Priceline.com-type of travel agent sells from a no tax/low cost jurisdiction. The rate on the margin would vary depending on the place of establishment of the traveler. If a UK traveler purchased the package VAT of 9.7575 would be due. If a Swedish traveler purchased the same package, VAT of 16.2625 would be payable. Under the Commission’s proposal the travel packages must be for travel within the EU, but the problem posed by the virtual intermediary in the EU VAT is solved.

On January 1, 2010 the place of supply rules for services in the EU will change. The impact of this change in the travel industry is to nearly put into effect the Commission’s 2002 directive, although derogations will not be overridden, and the administrative solution of a one-stop-shop for travel agents to use for filing multi-jurisdictional returns is not included. There is also a dispute among the Member States over sourcing the travel agent’s service. Some (including the UK) believe the intent is to source the travel agent’s supply to the location of the traveler (following new Article 44) whereas others (including Germany) believe the intent is to source the supply to the location of the hotel (following new Article 47).

Virtual (travel) intermediaries and the US ST. It is safe to say that the US consumption tax never anticipated that it would have problems with travel agents. After all, traditional travel agents are service providers who primarily resell services (tickets for passenger travel, accommodations, or admission to entertainment venues), and as a general rule services are not subject to tax under American consumption taxes.

In fact, the biggest ticket item for travel agents – passenger travel – is substantially off limits. Federal legislation prohibits states and localities from taxing the sale or resale of inter-

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55 The UK VAT is higher in this example because the UK is effectively able to tax the benefit of the lower cost structure in the third country. In other words, assuming the maximum margin (selling the package tour for the market rate of 153.45) the 15% UK VAT would require a payment of 9.7575 based on a margin of 65.05. It seems something of an anomaly, but the UK will collect more VAT (not less) if its travel agents adopt a Priceline.com business model and move off shore (the difference is between 9.7575 and 8.94).

56 Under the same assumptions, a margin of 65.05 would return a Swedish VAT obligation of 16.2626.

57 Id., at Art.1, proposed Art. 26(2)(b) (applying an EU-wide “use and enjoyment” rule, such that the purchase of travel services from a non-EU travel agent that would be used and enjoyed in any EU jurisdiction would sufficient to require VAT to be applied to the travel agent’s margin at the rate applicable in the traveler’s jurisdiction).


61 The normal rule in the RST is that sales of tangible personal property to final consumers are taxed – unless specifically excluded, but that sales of services are excluded – unless specifically included. Hellerstein, 2 State Taxation at ¶ 12.05.
state passenger tickets. Hotel accommodations, frequently the second largest expense in a travel package, are the problem. They are normally taxed through a separate statute rather than the general retail sales tax (largely because states and localities impose tax on hotel rooms at rates that are higher than those on most other taxable sales in the jurisdiction) and virtual intermediaries appear to be taking advantage of ambiguities in these laws to improve margins.

Recall diagram 2. When virtual intermediaries reduce the overall price for hotel accommodations from 175 to 150, and then sever from the tax base an additional 50 for intermediation services, they seriously impact the revenue base in the jurisdiction where the hotel is located.

![Diagram 6](https://ssrn.com/abstract=1525457)

Although the base reduction from 175 to 150 would seem to be appropriate (acceptable) as the measure of consumption, many US jurisdictions are resisting the further reduction to 100. Under most general sales taxes an intermediary’s markup (commission, fee or other service charges) are included in the sale price.

In the EU VAT where both goods and services are taxable this reduction is not problematical (although under the sourcing rules effective January 1, 2010 it appears that Germany would prefer to tax these services in A’s jurisdiction, and the UK would tax them in C’s jurisdiction).

Virtual intermediaries disrupt the alignment of substantive tax jurisdiction with enforcement tax jurisdiction that had been worked out under the traditional travel agent model. Rather than having the physical hotel operator collect hotel tax from the guest after consumption,

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62 Interstate Commerce Commission Termination Act of 1995, 49 USCA § 14505 (prohibiting states and governments from levying a sales tax on inter-state passenger travel after the Supreme Court had determined that such a tax would be constitutional in Jefferson Lines Inc. v. Oklahoma State Tax Commission, 514 U.S. 1135 (1995)).
63 Hellerstein, 2 State Taxation at ¶ 19.03[6][a].
64 Id.
65 See supra notes 58 to 60 and accompanying text.
the virtual intermediary collects the tax remotely. The intermediary remits to the hotel only the tax due on the reduced base (100) that is billed through to the intermediary. Most [but not all66] hotel taxes place collection responsibility on the hotel, not the intermediary. Full payment however, has been made by the traveler in advance (online with a credit card).57 It is unclear in some cases whether or not the intermediary collects tax from the traveler only on the reduced base (100) or on the full charge to the traveler (150).

The VAT never has this problem. If a virtual intermediary reduces prices through a “demand collection system,” the full tax is always collected, if the customer or the hotel is located in the EU.

Virtual intermediaries in the US are not always able to mount the best defenses when state and local tax authorities come knocking. By injecting itself into in-state transactions as a voluntary tax collector virtual intermediary concede nexus. In other words, the virtual intermediary cannot resist compliance responsibilities under Quill. The virtual intermediary must respond, and if its’ service fees are properly taxable it must remit the tax.68 There is coast-to-coast litigation.

Early litigation was ineffective, but recently tax authorities are collecting million dollar judgments.69 The resource commitment is huge. For example, in the State of Texas as of the

66 Texas is a notable exception. At the state level collecting and remitting the hotel occupancy tax is frequently the responsibility of both the hotel and the virtual intermediary – the hotel’s responsibility is for the tax on the discounted price and the virtual intermediary for the margin. See: Texas Comptroller of Public Accounts, Texas Policy Letter Rulings 200603503L (Mar. 20, 2006); 200310132L (Oct. 7, 2003); 200307995L (Jul. 10, 2003); 200212648L (Dec. 19, 2002); 200209424L (Sept. 12, 2002); 2002083791 (Aug. 22, 2002).
67 There are significant cash flow advantages to this structure for the intermediary. Payments are made by the traveler considerably in advance of the invoice from the retail merchant, the due date of the related tax returns and the remission of taxes collected.
68 In certifying a class action against all the major virtual intermediaries in the travel agent industry Judge Orlando L. Garcia characterized the nexus argument based in Quill as a “red herring.” He stated:
    Defendants contend they cannot be "taxed" on activities in cities with which they have no substantial nexus. Again, this argument is a red herring because the occupant of the room (who is the taxpayer) is already being taxed, and the Defendants have already been collecting and remitting taxes on the rooms they sell. The only question in this lawsuit is whether the Defendants have an obligation to collect and remit occupancy tax on the higher sell rate, rather than on the lower net rate. If Defendants believed that they had no obligation whatsoever to collect and remit occupancy taxes, they would not have been doing so.
    D.C., as one of the nation’s top tourist destinations, could be owed more than $100 million in back taxes and penalties but — despite an anticipated budget deficit of $967 million in fiscal 2011 — it has yet to join the fray.

Electronic copy available at: https://ssrn.com/abstract=1525457
end of 2002 there were 417 jurisdictions that levied a hotel tax. The city of San Antonio, brought suit against Hotels.com (and other web-base hotel booking companies) in 2007 for unpaid occupancy taxes, and the class certified by the court contains 175 cities divided into two sub-classes of 47 and 128. The 242 other jurisdictions face the same issues, but they cannot be joined until local remedies are exhausted. As a result, there is the distinct possibility that we will see up to 200 more law suits on this issue in Texas alone.

Virtual (travel) intermediaries and the Japanese CT. Each of the major internet travel agencies provide discounted hotel rooms in Japan. Are virtual travel intermediaries minimizing the CT revenue collected on hotel rooms in Japan in the same manner as they do in the US? There have been no court cases or official statements on this issue. There is no way to know from the outside.

However, if we assume that virtual travel intermediaries apply the same business model in Japan as they do in the US, and virtual intermediaries are structured to have no Japanese taxable presence (no permanent establishment), then the CT on the service element of a room reservation will be avoided. In aggregate these amounts could be significant. One would expect that these intermediaries would avoid the 5% CT if possible because it would be a direct cost of doing business in Japan.

For example, assume a Tokyo hotel has a room that is:
- Regularly offered to the public at ¥50,000 (per night);
- The unsold room is offered to a virtual intermediary at a 50% discount (or ¥25,000); and then
- The room is resold to a guest at a 30% discount from the published price (or ¥35,000).

Under the standard virtual intermediary business model, the CT base will be ¥25,000 because that is what the hotel will bill the virtual intermediary. The CT is ¥1,190 of this amount.

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70 Research Division, Texas Legislative Council, Overview of Local Taxes in Texas (Nov. 2002) at 5 & Table 1 (indicating that in addition to the state hotel tax of 6% there are 20 counties, 392 cities and 5 special districts that impose a hotel tax with county rates ranging from 1% to 8%; city rates ranging 2% to 13%. Because these jurisdictions overlap there is additional complexity in the Texas system. With one exception there is no maximum combined rate. The exception involves the extraterritorial jurisdiction of cities with a population base under 35,000. In this case the combined rate may not exceed 15%) available at: http://www.tlc.state.tx.us/pubspol/localtaxes.pdf
73 The other counties, cities, and special districts with occupancy taxes cannot be joined because of local exhaustion of remedies issues. The class specified makes this clear:

Texas cities whose ordinances contain language that requires every person owning, operating, managing or controlling any hotel to collect and remit hotel occupancy taxes and whose ordinances do not contain administrative prerequisites to filing a lawsuit for the failure to collect or remit hotel occupancy taxes.

The guest has paid ¥35,000. If a guest needed to determine the amount of CT paid (as a business expense or for other reasons) he would probably assume that a CT of ¥1,667 had been paid on the tax-inclusive base of ¥35,000. This amount exceeds the actually remission by ¥477.

Is this significant? Without more data it is difficult to tell, however aggregate CT losses could be roughly estimated at ¥26,532 million per year.74

Virtual (travel) intermediaries and the Canadian HT. In each Canadian province (except Alberta75) three levels of consumption tax on accommodations are possible – not every city levies a local tax. The federal GST applies throughout Canada to rooms and lodging, and in each province (except Alberta) a provincial tax also applies (fashioned either as a VAT like the federal GST76 or a retail sales tax as in the US77). The third level of consumption tax is at the local level and one or more localities in each province may impose a supplemental room tax or destination marketing fund (DMF)78 levy on the same lodging.79

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74 This figure is arrived at in the following manner. Assume that 20% of Japanese hotel rooms are purchased through online intermediaries, discounts of 50% are given to virtual intermediaries, and that average Priceline.com price reductions of 30% are achieved. If we apply these assumptions to total annual hotel sales (2004 figures are the most recent) we get the following:

- Total annual hotel sales = ¥6.63 trillion (¥6,632,920 million)
- 20% of these sales = ¥1,326,584 million
- CT reported on these sales = ¥66,329 million [5% x ¥1,326,584 = ¥66,329]
- Amount paid by guests for these hotel rooms = ¥3,714,435 million [2 x ¥1,326,584 million = ¥2,653,168 million and 70% of ¥2,653,168 = ¥1,857,218 million]
- CT collected by virtual intermediaries on these sales = ¥92,861 million [5% x ¥1,857,218 million = ¥92,861 million]
- Underreported CT = ¥26,532 million [¥92,861 million less ¥66,329 million = ¥26,532 million (roughly $292 million)].

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75 Alberta does not have a provincial level consumption tax, although it does have a local level rooms tax at 4% and an additional 1% DMF in the cities of Calgary and Edmonton.

76 This is the case of the Harmonized Sales Tax (HST) in New Brunswick, Nova Scotia and Newfoundland. As of July 1, 2010 British Columbia and Ontario will also have a HST. In Quebec a VAT-like Quebec Sales Tax (QST) is harmonized with the federal GST, however administration of the QST is provincial not federal as with the HST.

77 A Provincial Sales Tax (PST) is in use in British Columbia and Ontario (until July 1, 2010) and Saskatchewan, Manitoba and Prince Edward Island.

78 A Destination Marketing Fund is a fund voluntarily charged and collected by an agreed-upon organization and used to support tourism development, marketing and/or infrastructure in a region. The DMF is usually in the form of a percentage charge on room rates for accommodations. The decision whether or not to implement a DMF is a local or regional one. In 2004 hotels in Ottawa, Toronto and Kingston introduced a 3% DMF to generate funds for the local tourism promotion agency to allow cities to market themselves to potential visitors, tour operators and convention planners. The fee is normally a percent of the room only portion of a guest’s bill. This amount is remitted by the participating hotel to be used by the local tourism promotion agency to promote the city as destination. It is not used for marketing specific hotels.

79 In most instances these taxes cascade. For example, in Prince Edward Island the PST is charged on a base that includes the federal GST, and in Quebec the local lodging tax is included in the base for the federal GST, and then both are included in the base for the Quebec Sale Tax (QST).
Federal. Virtual intermediaries that assist travelers with Canadian lodgings must register under the federal GST. 80 This is clearly the case when the contract between the hotel and the intermediary is a direct lease of the room to the intermediary who then re-leases to the traveler. 81 But it is also the case when an intermediary enters into a service contract that is related to Canadian real property (whether that agency relationship is primarily with the hotel or with the traveler). This remains true even if the services are performed entirely outside of Canada. 82 In either instance the virtual intermediary is carrying on business in Canada when they find guests for Canadian hotels.

Commentators have observed that the Canadian rules on doing business and the drop shipment rules are drafted to encourage non-resident intermediaries to register. To not register could well increase the aggregate tax burden on the guest. Audrey Diamant in her analysis of GST/HST Policy Statement P-051R2 Carrying On Business In Canada notes that, “… there appears to be a lacuna between the drop shipment rules and the carry on business analysis.” 83

The lacuna (unarticulated link) she identifies is embedded in the binary expression “non-resident non-registrant.” The term is repeatedly used as a distinguishing factor in the drop shipment rules. Non-residents who are registrants remit GST on intermediation services related to real property leased in Canada. Non-residents who are not registrants are exempt. However, the exemption has the effect of obligating the hotel (as a drop shipper) to collect GST on the (higher) fair market value of the room from the intermediary. 84

Diagram 6 makes this clearer. Assume Canadian hotel (A) offers rooms to the public for 175. Also assume that A enters into an agreement with a virtual travel intermediary (B) located in the USA, and promises that the intermediary will be charged 100 for each room they successfully rent out to travelers (C). If B finds a traveler who is willing to pay 150 then one of two results are possible:

- **GST will be imposed on 150.** This will occur if the intermediary registers for GST. As a registered non-resident, the intermediary will report sales of 50, plus the hotel will report sales of 100.

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80 EXCISE TAX ACT, R.S.C., ch. E-15 § 240(1) & 123(1) (1985) (Can.); GST/HST Memoranda Series, 2.1 Required Registration 1 & 5 (May 1999) (any person engaged in commercial activity in Canada must register; commercial activity includes making a supply with the expectation of making a profit on a regular basis and specifically includes any supply of Canadian real property).


82 EXCISE TAX ACT, R.S.C., ch. E-15 § 142(1)(g) & (1)(d) (1985) (Can.); GST/HST Memoranda Series, 3.3 Place of Supply 3 & 7 (Apr. 2000) (generally a supply of any service is deemed to be made in Canada only if the service is performed in Canada, however a specific exception applies for the provision of service in relation to real property in Canada and these services are sourced to Canada).


84 In Canadian case law and regulation this distinction turns on the location of the “profit-making apparatus.” This principle derives from analysis of Lord Russell in a case that distinguishing between a payment received as income or as capital. The question turned on whether or not a “profit-making apparatus” was destroyed, and this in turn was determined to be the location of the business. Commissioners of Inland Revenue v. Fleming & Co. (Machinery), Ltd. (1951), 33 T.C. 57 (Ct. of Sess.).
- **GST will be imposed on 175.** This will occur if the intermediary does not register for GST. As a non-registered non-resident, the intermediary will report no sales, but the hotel as a drop shipper of leased property to a Canadian lessee in Canada, will be required to report sales of 175 (the fair market value of the room).

**DIAGRAM 7**

In other words, the Canadian GST rules have been designed to create incentives to register and collect tax on the full measure of consumption. If a virtual intermediary is successful in arguing that it is a non-resident non-registrant, then drop shipment rules should apply to the hotel and the effective tax base is higher. The American rules (in contrast) create just the opposite incentive. By avoiding registration and collection responsibility under *Quill* virtual intermediaries reduce the effective tax base.

**CHART 1: GST/HST**

<table>
<thead>
<tr>
<th></th>
<th>Canada (federal)</th>
<th>Nova Scotia, New Brunswick, Newfoundland/ Labrador &amp; Quebec (Provincial)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>175</td>
<td>150</td>
</tr>
<tr>
<td>Intermediary does NOT register</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Intermediary registers</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Provincial.** The second level of Canadian consumption tax on rooms and accommodations is at the provincial level. In the four provinces with provincial GSTs (or HSTs) federal treatment is followed. In the five provinces with PSTs the taxability of the virtual intermediary’s margin depends on (a) whether or not the sales tax extends to hotels and other accommodations, and then (b) whether the language of the statute is broad enough to reach both

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85 An argument could be made that its “profit-making apparatus” is its computer system, and that is located in the US rather than Canada.
the price paid by the virtual intermediary to the hotel as well as the additional margin paid by the
guest to the intermediary (in other words both the 100 and the 50 amounts in Diagram 7).86

The first requirement is met in all provinces. All PSTs tax accommodations. The second
requirement is met in Saskatchewan and Manitoba, but is not met in Ontario, and British
Columbia. The Prince Edward Island statute is relatively thin, but appears to reach a result that
is similar to Ontario’s and British Columbia’s.

Saskatchewan (Manitoba considered in notes). Saskatchewan’s statute reaches a full
measure of consumption. Eighteen services are taxable in Saskatchewan, and one of them is
“lodging in hotels, motels, hostels, apartment houses, lodging homes, cabins, cottages, clubs and
other similar accommodations whether or not a membership is required for the lodging …”87
Tax is imposed on the user88 (the term “consumer” is reserved in the statute for purchasers of
tangible personal property).89 The tax base is subjectively measured – it is the “value”90 or the
consideration paid.91

Thus, the key to the Saskatchewan statute is who is the vendor? Who is person to whom
the tax is paid? Is it the hotel or the virtual intermediary? Saskatchewan deems the virtual
intermediary to be the vendor:

“vendor” means any person who, within the province in the course of his business
or in the course of continuous or successive acts: … (ii) sells or leases taxable
services to a user at a retail sale in the province for purposes of end use and not
for resale; … 92

86 It is assumed that the federal level incentives are sufficient to get virtual intermediary to register in each province
where they are facilitating room rentals. To do otherwise would directly increase customer costs (or reduce profit
margins of the virtual intermediary).
87 Saskatchewan Provincial Sale Tax Act, R.S.S. ch P-34.1 § 3(1)(k)(v). See also Manitoba Retail Sale Tax Act,
R.S.M., c. 28 §4(1)(a); Alberta Tourism Levy Act, R.S.A. c. T-5.5, §1(1)(a).
88 Saskatchewan Provincial Sale Tax Act, R.S.S. ch P-34.1 § 1(m) (“user means any person who within the
province: …(iii) … purchases or leases a taxable service from a vendor for consideration for his own use or the use
of other persons at his expense …”). See also Manitoba Retail Sale Tax Act, R.S.M., c. 28 §2(1)(“Every purchaser of
tangible personal property or a taxable service shall pay … a tax in respect of the purchase thereof, computed at
the rate of 7% of the fair value thereof.”). Alberta Tourism Levy Act, R.S.A. c. T-5.5, §1(1)(j)(“purchaser means a
person who acquires accommodation for the purchaser’s own use or for use by another …”).
89 Saskatchewan Provincial Sale Tax Act, R.S.S. ch P-34.1 § 1(c).
90 Saskatchewan Provincial Sale Tax Act, R.S.S. ch P-34.1 § 5(3)(“… every user of a taxable service purchased at a
retail sale in the province shall pay … a tax … computed at the rate of 5% of the value of the taxable service.”).
91 Saskatchewan Provincial Sale Tax Act, R.S.S. ch P-34.1 § 3(1)(n) (“… value means, … the consideration given or
agreed to be given by the consumer or user for a taxable service …”) See also Manitoba Retail Sale Tax Act,
R.S.M., c. 28 §1 (“fair value," except as otherwise provided in section 2.2, means … the purchase price …); Alberta
Tourism Levy Act, R.S.A. c. T-5.5, §1(1)(i) (“purchase price means the consideration given for the accommodation
…”)
92 Saskatchewan Provincial Sale Tax Act, R.S.S. ch P-34.1 § 3(1)(o). See also Manitoba Retail Sale Tax Act,
R.S.M., c. 28 §1 “vendor” means a person who in the course of business … (b) sells a taxable service, or offers a
taxable service for sale, directly to a purchaser at a retail sale in the province, and includes a
person who … (c) collects from a purchaser an amount paid as tax under this Act, … (f) as a
broker or agent for a vendor, enters into an agreement for the sale of … a taxable service, or (g) as
a broker or agent
But what if the vendor is not present in the province?93 Does this matter? Although the regulations do not specifically take up the virtual travel agent scenario, they come very close in a parallel discussion of the taxability of legal services. If legal services are rendered with respect to “real property situated in Saskatchewan” then even if neither the purchaser nor the recipient of the legal services “… resides, ordinarily resides, or carries on business in Saskatchewan, [the] tax on the legal services must be paid by the purchaser …”94

By simple analogy then, if the services of a virtual intermediary are rendered with respect to the lease of a hotel room (real property) in Saskatchewan, then these services would be subject to the PST. This is the case even though the virtual intermediary may not be (otherwise) doing business in Saskatchewan.95

Ontario (British Columbia & Prince Edward Island considered in notes). In Ontario and British Columbia the statutes are equally clear that the virtual intermediary’s margin is not subject to the PST. Because of its brevity the Prince Edward Island statute is less clear. These provinces consider the intermediary’s margin to be to be a payment for an independent add-on service, and not a payment that is taxable together with the lease of a hotel room. The Ontario PST presents the typical case.

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93 This is not an ambiguous point in Manitoba. See: Manitoba Retail Sale Tax Act, R.S.M., c. 28 §2(6)
   Retail sale out of province.
   Every retail sale to a purchaser in the province by a person who is not resident within the province,
   or carrying on business within the province, shall be deemed to be a retail sale in the province for
   the purposes of applying the tax under this section.

95 This is the position of the Saskatchewan Ministry of Finance. The virtual intermediary is a vendor in the province
   if it sells accommodations to guests staying in Saskatchewan establishments. It will be obligated to collect and remit
   the tax due on the full amount charged to the guest. Personal e-mail communication from Greg Flottorp, CMA,
   Manager Tax Information Services, Saskatchewan Ministry of Finance (December 8, 2009) (on file with author). It
   is also the position of the Alberta Department of Finance and Enterprise,
   The purchaser would pay tourism levy on the amount paid to the Internet re-seller. However, the
   Internet re-seller would not be registered as a provider of accommodation. The actual hotel is
   registered as a provider, and the Internet re-seller should be acting as a collector of the tax and
   providing the collected tax to the hotel for remittance of the Tourism Levy.
   Personal e-mail communication from AlbertaConnects (Nov. 5, 2009) (on file with author)
   This response follows a traditional drop shipment analysis but does not specifically indicate that this is the
   reasoning. It simply indicates that the hotel must collect the tax, based on the price paid by the customer to the
   intermediary. It does not explain how the hotel will determine the intermediary’s margin. Under the federal GST
   the hotel would force this issue by charging the intermediary tax on the fair market value of the room, subject to the
   intermediary identifying the actual price.
   Alberta’s statute has a provision that would allow this. In the definition of “purchase price” the statute has
   an exception that states [Alberta Tourism Levy Act, R.S.A. c. T-5.5, §1(1)(i)]:
   if any portion of the consideration given for accommodation is other than money, the purchase
   price is the price
   (A) of similar accommodation rented or available for rent to another person by the same
       operator on the day or days the purchaser occupies the accommodation, or
   (B) that is, in the Minister's opinion, reasonably attributable to the accommodation;
   Because a portion of the consideration paid by the virtual intermediary for the accommodation is the service of
   finding a guest for the room, the full amount of the consideration could be either (A) the fair market value of the
   room (175 in our examples) or the amount paid by the consumer for (150 in our examples).
In Ontario only three services are taxable – and one of them is “transient accommodations.” Tax is imposed on the purchaser, collected by the vendor. The tax base is the “fair value” of the accommodations. Fair value means:

the *price* for which the *taxable service* was purchased, including the value in terms of Canadian money of services rendered and things exchanged and other considerations accepted by the vendor or person from whom the *taxable services* were rendered as the price or on account of the price of the *taxable service* received,…(emphasis added)

This is a subjective valuation provision. Considered in terms of Diagram 7, the tax base cannot be 175 (this is an objective value of the accommodations, or their fair market value). There are two other possible prices; both are subjective valuations. 100 is the value of the accommodations to the virtual intermediary (this is the price that the virtual intermediary paid to the hotel for the room). 150 is the value of the accommodations to the guest (this is the price that the guest was willing to pay to the virtual intermediary to secure the room).

The statute does not specify which price is the correct price – instead it specifies the party who receives the correct price. This person is the “vendor” of the transient accommodations. Even though either the hotel or the intermediary could arguably be the vendor this term is not defined. However, other statutory provisions make it clear that vendors must have a physical location in Ontario. Because a virtual intermediary will not have a physical location in

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96 Retail Sale Tax Act, R.S.O. ch. R.31 §1 ("taxable service" means, … (b) transient accommodations, …"). British Columbia achieves the same result, but not in the same way. Taxable services in British Columbia do not include hotel accommodation. British Columbia, Social Services Tax Act, R.S.B.C. c. 431 § 1 (""taxable service" means any service provided to install, assemble, dismantle, repair, adjust, restore, recondition, refinish or maintain tangible personal property …"). Instead British Columbia imposes the Hotel Room Tax at a higher rate. Prince Edward Island reaches this result by defining goods to include accommodations. See Prince Edward Island, Revenue Tax Act, P.E.I.S. c. 54, § 1(e) ("goods" includes … (ii) accommodation charges …)

97 Retail Sale Tax Act, R.S.O. ch. R.31 § 2(1). See also British Columbia Hotel Room Tax Act, R.S.B.C., c. 207 (1996) §§ 2 & 2(1) (Tax Imposed on Purchaser …. A purchaser must, at the time of making a purchase of accommodation …) See Prince Edward Island, Revenue Tax Act, P.E.I.S. c. 54, § 4 (Consumer tax, amount of … every consumer of goods consumed in the province shall, at the time of taking delivery …)

98 Retail Sale Tax Act, R.S.O. ch. R.31 § 10. See also British Columbia Hotel Room Tax Act, R.S.B.C., c. 207 (1996) §§ 6 & 6(2) “Operator to levy and collect tax … As an agent under subsection (1), the operator must levy and collect the tax imposed by this Act on the purchaser.”) See Prince Edward Island, Revenue Tax Act, P.E.I.S. c. 54, §§1 & 9 (imposing collection responsibilities on vendors)

99 Retail Sale Tax Act, R.S.O. ch. R.31 § 2(3). See also British Columbia Hotel Room Tax Act, R.S.B.C., c. 207 (1996) § 8 (“The tax imposed under this Act, whether the price is stipulated to be payable in cash, on terms, by installments or otherwise, must be collected at the time of the sale on the total amount of the purchase price…).

100 Retail Sale Tax Act, R.S.O. ch. R.31 § 1. See also British Columbia Hotel Room Tax Act, R.S.B.C., c. 207 (1996) § 1 ("purchase price" means the price for which accommodation is purchased, including the price in money, the value of services rendered and other consideration accepted by the operator in return for the accommodation provided.) See Prince Edward Island, Revenue Tax Act, P.E.I.S. c. 54, § 1 ("fair value" includes the price for which the goods were purchased …).

101 Retail Sale Tax Act, R.S.O. ch. R.31 § 5(6) (… every vendor shall keep at each location in Ontario where he, she or it transacts business a copy of the permit issued under this section and shall, upon the request of any purchaser, produce for such purchaser's inspection a copy of such permit…).
Ontario, and the hotel always will, the result is: (1) the vendor must be the hotel and (2) the price (or the tax base) must be 100.\textsuperscript{102}

Some would argue that this achieves the wrong result, because it is the guest not the intermediary who consumes the accommodations, and the true measure of consumption should be 150. The problem with this argument is that is not what the statute says. The guest did not pay the vendor; he paid the virtual intermediary.\textsuperscript{103} After July 1, 2010, this will no longer be a problem in Ontario. On that date both Ontario and British Columbia will abandon their PSTs in favor of an HST. One of the results of moving to a VAT will be a revenue increase from previously untaxed services, one of which will be the untaxed margin paid to virtual intermediaries for hotel accommodations.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|}
\hline
\textbf{Province} & 175 & 150 & 100 & Subjective/ Objective Valuation \\
\hline
British Columbia & 175 & 150 & 100 & Subjective \\
Alberta & X & Subjective \\
Saskatchewan & X & Subjective \\
Manitoba & X & Subjective \\
Ontario & X & Subjective \\
Prince Edward Island & X & Subjective \\
\hline
\end{tabular}
\caption{PSTs}
\end{table}

\textsuperscript{102} The Prince Edward Island statute reaches the same result but arrives at it from the direction. P.E.I. specifies the consumer who \textit{pays}, not vendor who \textit{receives} the price. Prince Edward Island, Revenue Tax Act, P.E.I.S. c. 54, §1. P.E.I. defines this person as someone who is purchasing either for his own consumption or for the consumption of another \textit{at his or her own expense}. The antecedent to this phrase (\textit{at his or her own expense}) appears to be the actual guest in the virtual intermediary fact pattern. The actual guest is another under the statute, and this is not the consumer. It is the true consumer that pays amount upon which the tax is based. The consumer is defined as:

\begin{itemize}
\item[(i)] a person who
\item[(ii)] utilizes or intends to utilize within the province goods for his or her own consumption, or for the consumption of another person at his or her expense,
\item[(iii)] utilizes or intends to utilize within the province goods on behalf of or as agent for a principal who desired or desires to so utilize the goods for consumption by the principal or by any other person at the expense of the principal,
\end{itemize}

\textsuperscript{103} British Columbia reaches the same result. Personal e-mail correspondence, Tax Inquiries Group, Policy and Legislation Branch, British Columbia Ministry of Finance (Nov. 3, 2009) (on file with author):

\begin{quote}
… when a hotel enters into an arrangement whereby a tourist information centre, or other agent (intermediary), will sell accommodation at the hotel to guests that the hotel will collect hotel room tax (HRT) from the agent and the agent will not collect HRT on the amount they charge their customer.

In this situation the tourism centre or agent meets the definition of "purchaser" under Section 1 of the \textit{Hotel Room Tax Act} (\textit{the Act}) because they are acquiring accommodation from an operator on behalf of a principal. As a result, the hotel should collect and remit tax on the amount that it bills the tourism centre or agent for the room, as this is the purchase price paid to the hotel for the accommodation. The tourism centre or agent should not collect or show tax on its invoice to the customer as it is not an operator. The tourism centre's or agent’s mark-up is considered to be an administrative fee for the service of arranging the accommodation.
\end{quote}

Electronic copy available at: https://ssrn.com/abstract=1525457
Local. The third level of Canadian consumption tax on accommodations is local. Under the Canadian system these assessments are either a tax (in the traditional sense) or a destination marketing fee (DMF).\textsuperscript{104} The provinces are split equally between these approaches – five have DMFs and five impose local taxes.

Regardless of the approach taken, the revenue raised through these levies is earmarked for local marketing (advancing the locality as a tourist destination or convention venue). The real distinction between a DMF and a tax is whether the levy is voluntarily (a DMF) or mandatorily (a taxing ordinance).

DMFs are contract-based. They are a renewable three or five year agreement among certain hotels to assess guests a fee per room-night. The proceeds are remitted to a designated marketing fund. When imposed as a tax there is very little operational difference when compared with a DMF. For most purposes these taxes are no more than mandatory DMFs.

However, they are taxes, and as a result, complications arise when these taxes do not “fit” well with the federal/provincial taxes imposed on the same transactions. There are both cascading and non-harmonized base issues.

One suspects the reason that some localities opt for a mandatory DMF (a tax) is because of resistance in the hotel sector to volunteering to collect another tax. Something is lost in this choice. Voluntary DMFs reflect the judgment of local hotel operators about the rate and base that will “work;” mandatory DMFs (taxes) reflect the judgment of local officials about what the revenues they need.

Voluntary DMFs. Voluntary DMFs are the only local levies on accommodations in Alberta,\textsuperscript{105} Saskatchewan,\textsuperscript{106} Ontario,\textsuperscript{107} New Brunswick,\textsuperscript{108} and Nova Scotia.\textsuperscript{109} In 2007 sixteen hotels (representing about 75% of the available rental rooms) in Saskatoon Saskatchewan had the most effective DMF in Canada.\textsuperscript{110}

\textsuperscript{104} Supra note 78.
\textsuperscript{105} There is a 1% DMF in Calgary and Edmonton.
\textsuperscript{106} There is a 2% DMF in Saskatoon and Regina
\textsuperscript{107} There is a 3% DMF in 12 areas: the Greater Toronto Area, Ottawa, Sault Ste. Marie, Kingston, Kenora, Hamilton, St. Catherine’s, Burlington, Stratford, Dryden, The Village at Blue Mountain (Collingwood) and Northwestern Ontario resource-based operators.
\textsuperscript{108} Both Saint John (2% of room charge) and Bathurst ($1.50 per room) have a DMF.
\textsuperscript{109} There is a 2% DMF in Halifax.
\textsuperscript{110} Lori Coolican, Convention business boosts city hotels, tourism official – Tourism Saskatoon aims to revitalize city's brand thanks to increased funding The Star Phoenix (March 11, 2008) … no other Canadian city matched Saskatoon's room-revenue growth in 2007, according to Tourism Saskatoon CEO Todd Brandt.

The busier-than-expected year means a windfall for the tourism organization's destination marketing fund (DMF), which collects revenue from member hotels through a voluntary two per cent levy on their room sales.

The levy, paid by 16 local hotels under the terms of a three-year contract with Tourism Saskatoon, pays for marketing efforts aimed at attracting more out-of-town visitors. The contract is up for renewal at the end of this year, and Brandt said he expects even more hotels will sign on for another three years.
It is highly unlikely that any hotel participating in a voluntary DMF would agree to a regime that required it to include an intermediary’s margin in the assessment base (150 in the above example). In the first place, the margin (50) is not data a hotel has on hand. In the second place, it is the intermediary’s profit, something that they are not anxious to disclose. Overall, the kind of disclosure that would be needed is one that would collapse the Priceline.com business model, and this is what sustains the virtual intermediary’s business.

As a result, DMFs uniformly use the consideration actually received by the hotel their assessment base – whether that amount is 175 (a full room charge for a room coming directly from the customer in the above example) or 100 (a reduced charge coming from an intermediary who will re-sell at a middle rate of 150 in the above example).

Mandatory DMFs (i.e., the local tax). The five provinces that have local consumption taxes present more difficult problems. As a general rule, these local taxes tend to mirror the (voluntary) DMFs they were designed to emulate. They tend not to include the intermediary’s margin in the base. Among the five provinces with local accommodation taxes British Columbia and Prince Edward Island present the least problems – neither provincial nor local taxes include the intermediary’s margin in the base. There is symmetry in the tax bases.

Manitoba, Newfoundland/Labrador, and Quebec present more complex issues. In Manitoba and Newfoundland/Labrador the provincial taxes include the intermediary’s margin; the local taxes do not. Quebec is different. Quebec is alone among the provinces in clearly addressing the intermediary issue. Quebec’s statute fairly reaches the intermediary’s margin. It does so by tracking the policy choices underlying the GST/HST approach to drop shipments.

British Columbia. In British Columbia, local accommodation taxes simply piggy-back the provincial Hotel Room Tax.111 Provincial rules, processes, and procedures are carried over to the local tax.112 The province administers the local tax (for a fee). Fourteen municipalities in

Hotels currently paying the levy represent more than 75 per cent of all the hotel rooms in the city.

Available at: http://www.buysaskatoon.com/common/uploads/conventionbusiness_11march_08.pdf

111 The Hotel Rooms Tax is 8%, with 5% going to the general fund [British Columbia Hotel Room Tax Act, R.S.B.C., c. 207 (1996) § 2] and 3% earmarked for Tourism British Columbia [British Columbia Hotel Room Tax Act, R.S.B.C., c. 207 (1996) § 3.1].

112 The local tax is called the Additional Hotel Rooms Tax (AHRT). The ministry of Finance explains the implementation of the tax in the AHRT Guidelines as follows:

Municipalities and regional districts may request that the province levy, on their behalf, an additional tax on accommodation sold within their jurisdiction, with the funds collected being committed to a specific purpose. The tax may be levied in the whole municipality or regional district, or a prescribed area within the boundaries of the municipality or regional district.

This tax is collected by the province through the existing hotel room tax collection system run by the Ministry of Small Business and Revenue. The tax collected is then remitted to the municipality/regional district on a monthly basis. The branch charges the municipality/regional district a collection fee to recover the additional costs incurred for collection of the tax and the dissemination of the collected funds to the municipality/regional district.

The AHRT will be implemented for a period of 5 years. In order to extend the tax for an additional 5 year period, a municipality, regional district or other eligible entity must re-apply to
British Columbia add either 1% or 2% to the provincial Hotel Room Tax at hotels within their jurisdiction.113

The provincial Hotel Room Tax excludes an intermediary’s margin from the base, and as a result, so does the local levy. Local and provincial taxes are harmonized.

**Prince Edward Island.** In Prince Edward Island, only the municipality of Charlottetown imposes an accommodations tax. A 2% tax is imposed on the purchaser,114 based on the purchase price,115 and collected by hotel operators.116 Although the brief implementation statute may be open to ambiguities, the strongest reason for interpreting the ordinance’s tax base as one that excludes an intermediary’s margin is that *this is the result reached by the PST on the same transaction.* The PST limited its tax base through the definition of consumer. A consumer is a person who “… utilizes or intends to utilize goods [under the PST hotel accommodations are a good] for his or her own consumption or for the consumption of another at his or her own expense.”117

Provincial and local taxes are harmonized. Both exclude an intermediary’s margin.

**Manitoba.** In Manitoba, only Winnipeg imposes an Accommodations Tax (W-AT). The W-AT is relatively new. The ordinance passed the Winnipeg City Council on April 23, 2008, and came into force on June 1, 2008.118

The W-TA rate is 5%. The tax is imposed on the purchaser,119 based on the purchase price,120 and is collected by the operator of the hotel.121 The W-AT has some problems, the most significant is that it cascades (other accommodation taxes are imposed upon the amount paid as

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113 This tax is imposed in Chilliwack, North Vancouver, Oak Bay, Parksville, Prince Rupert, Qualicum Beach, Richmond, Rossland, Saanich, Smithers, Surrey, Vancouver, Victoria and Whistler.
114 Charlottetown Area Municipalities Act, P.E.I.S. c. C-4.1 § 35.1(2) (“… any person who, for a daily charge, fee or remuneration purchases accommodation at a tourism establishment in the city.”)
115 Charlottetown Area Municipalities Act, P.E.I.S. c. C-4.1 § 35.1(1)(c) (“purchase price means the price for which accommodation is purchased, including the price in money, the value of services rendered and other consideration accepted by the operator in return for the accommodation provided, but does not include the goods and services tax.”)
116 Charlottetown Area Municipalities Act, P.E.I.S. c. C-4.1 § 35.1(1)(b) (“operator means the operator of a tourism establishment”).
117 Supra note 105.
118 Winnipeg Accommodation Tax By-law No. 70/2008.
119 Id., at §§ 3(1) & 1 (imposing the tax on “a purchaser … at the time of purchasing accommodation” and defining a purchaser as “…a person who purchases accommodation”).
120 Id., at §§ 3(1) & 1 (indicating that the “… purchaser must …pay an accommodation tax in an amount of 5% of the purchase price of accommodation …” and defining the purchase price as “…the price for which accommodation is purchased, including the price paid in money, the value of goods provided or services rendered or other consideration accepted by the operator in return for the accommodation provided …”).
121 Id., at §§ 4(1) & 1 (indicating that “… an operator must, as an agent for the tax collector, collect the accommodation tax from the purchaser at the time the accommodation is purchased, and defining the operator as … a person who sells, offers for sale, or otherwise provides accommodation).
W-AT tax). When it was first introduced the W-TA was included in the base of both the provincial PST and the federal GST. The provincial cascading has been solved, but not the federal.\textsuperscript{122}

Does the W-AT tax the intermediary’s margin? There is no answer to this question in the ordinance. However, based on a straight forward reading of the statute, the fact that the W-AT closely resembles a voluntary DMF\textsuperscript{123} and the judicial bias that interprets ambiguous taxing statutes against the government a strong case can be made for the exclusion of the intermediary’s margin.

By itself, this is not a problem. However Manitoba’s PST makes it clear that a virtual intermediary’s margin \textit{is} included in the PST base.

**Retail sale out of province:**

Every retail sale to a purchaser in the province by a person who is not resident within the province, or carrying on business within the province, shall be deemed to be a retail sale in the province for the purposes of applying the tax under this section.\textsuperscript{124}

For businesses this is a compliance problem. Both W-AT and PST must be included on the customer’s invoice.\textsuperscript{125} There will be a single customer charge for accommodations but the specified taxes will be based on different base amounts. This also presents difficulties for government auditors. The simple solution would be for the W-AT to piggyback the PST, as is done in British Columbia.

**Newfoundland/ Labrador.** In Newfoundland only St. John’s imposes an Accommodation Tax (St.J-AT). In an exceedingly brief ordinance a 3\% tax is imposed “… upon a person who … is accommodated, lodges or stays …,”\textsuperscript{126} based on “… the amount charged for the accommodation, lodging or stay …” at a licensed tourist establishment.\textsuperscript{127} The statute does \textit{not} say that the tax is based on the \textit{amount paid by the guest}. It says the base is the amount “charged for the accommodation.”

Does the St.J-AT include the intermediary’s margin in the base? As was the case in Manitoba, a straight forward reading of the statute, the fact that the St.J-AT closely resembles a

\textsuperscript{122} On May 8, 2009 the W-AT was exempt from the Manitoba PST, but it remains in the tax base of the federal GST, although a request for federal exemption has been made. City of Winnipeg Home Page, \textit{available at}: \url{http://www.winnipegassessment.com/AsmtTax/English/Other_Taxes/Accommodation.stm}  
\textsuperscript{123} The City of Winnipeg home page indicates:  
 \text{The intent of the accommodation tax is to generate revenue to support Destination Winnipeg, the Winnipeg Convention Centre, and special events including other organizations, projects and events that will encourage tourism to Winnipeg.} \textit{Available at:} \url{http://www.winnipegassessment.com/AsmtTax/English/Other_Taxes/Accommodation.stm}  
\textsuperscript{124} Manitoba Retail Sale Tax Act, R.S.M., c. 28 §2(6)  
\textsuperscript{125} Both PST and W-AT require that the guest receive an invoice itemizing the taxes paid. Winnipeg Accommodation Tax by-law No. 70/2008 §4(2); Man. Reg. 75/88R § 9(1).  
\textsuperscript{126} City of St. John’s Act, R.S.N. 1990 c. C-17, ch. C-17.1, §28(1).  
\textsuperscript{127} City of St. John’s Act, R.S.N. 1990 c. C-17, ch. C-17.1, §28(2).
voluntary DMF and the judicial bias to interpret an ambiguous taxing statute against the government a strong case can be made for excluding the intermediary’s margin from the St.J-AT base.

However, Newfoundland is an HST jurisdiction, and under the GST/HST the virtual intermediary’s margin should be included in the tax base. As a result, the problem that Manitoba has with dual tax bases in the PST and W-AT is replicated in Prince Edward Island with the StJ-AT and the GST/HST.

Quebec. In Quebec twenty localities have a Lodging Tax. Lodging taxes are imposed on the customer. Regions can elect either (a) a flat $2 per room/ per day tax, or (b) a tax based on 3% of the purchase price – but only if the supply is made by the operator. In cases where a 3% ad valorem tax is elected – but the supply is made by an intermediary instead of an operator – the tax is $3 per room/ per day.

Intermediaries are defined. They are “… the recipient of a supply of an accommodation unit who receives the supply only to again make a supply of the accommodation unit for consideration.” An intermediary cannot be a customer. The customer is defined as “… the recipient of a supply of an accommodation unit, but does not include an intermediary.”

The key to Quebec’s approach to Lodging Taxes is that in the regions where the tax is ad valorem based, it is only an ad valorem based tax when a customer purchases directly from an operator. Whenever an intermediary purchases rooms from an operator for resale the tax is at a flat rate per room/ per day, and it is collected in advance by the operator that sells to the intermediary.

Quebec fully anticipates that the intermediary will pass the tax through to the customer. It has been collected in advance at a flat (uniform) rate. It does not matter if the intermediary providing the room is registered. If a non-registered intermediary is also a non-resident there is no difference. The non-resident will be charged the tax by the operator.

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128 All receipts from the St.J-AT are required to be used for the Avalon Convention and Visitor’s Bureau. By-Law No. 1410, St. John’s Accommodation Tax By-Law (Dec. 28, 1990), §4.
129 Supra text accompanying notes 80 to 85.
130 Act Respecting the Quebec Sales Tax, R.S.Q., c. T-0.1, §541.24.
131 There are 16 regions applying the flat $2.00 tax: Abitibi-Témiscamingue, Baie-James, Bas-Saint-Laurent, Cantons-de-l'Est, Centre-du-Québec, Charlevoix, Chaudière-Appalaches, Duplessis, Îles-de-la-Madeleine, Lanaudière, Laurentides, Manicouagan, Mauricie, Montérégie, Outaouais, and Saguenay–Lac-Saint-Jean. There are four regions applying the 3% tax: Gaspésie, Laval, Montréal, and Québec. Revenue Quebec web site, Consumption Taxes, General Information, available at: http://www.revenu.gouv.qc.ca/en/definition/regions_touristiques.aspx
132 Act Respecting the Quebec Sales Tax, R.S.Q., c. T-0.1, §541.23.
133 Value is determined by what the customer pays, but if this amount is less than the fair market value of the accommodation the Minister can determine the value. Act Respecting the Quebec Sales Tax, R.S.Q., c. T-0.1, §541.24.
134 Act Respecting the Quebec Sales Tax, R.S.Q., c. T-0.1, §541.25.
135 Revenue Quebec presents this rule and an example at its web site, Consumption Taxes, General Information, Billing the 3% tax on lodging:
This fact pattern replicates the GST drop shipment rules – when a Quebec hotel sells rooms to a non-registered non-resident, who then re-sells to a guest that consumes the accommodation in Quebec, the rooms are being drop shipped. Quebec’s requirement that the hotel pre-collect the tax from the intermediary, under the assumption that the tax will be passed through to the consumer is the same principle that underlies the GST drop shipment rules. The only difference is that the GST measures the tax objectively (fair market value); the Lodging Tax uses a flat per room/ per day assessment.137

The contrast between Quebec and the other provinces can be presented in another way. When Quebec imposes its tax on an ad valorem basis the statute is careful to specify that values are determined from the customer’s perspective (not from an intermediary’s, and not a provider’s perspective). Each of the other provinces intends to reach the same result but does so indirectly – through a proxy.138 In these provinces, the consideration is what the hotel receives, not what the customer pays. As a result, when intermediaries are involved these provinces exclude the intermediary’s margin from the base. These taxes do not fully tax consumption.139

The local accommodation taxes in Canada are summarized below.

You are required to collect the tax on lodging even if you are not registered for the GST and the QST. Simply add the tax to the rental price.

Example:
A room in a bed and breakfast is rented for one night. The tax on lodging is calculated on the price of an overnight stay ($46.50 x 3% = $1.40).


137 See Revenue Quebec, Tax on Lodging, 11:
You must collect the tax on lodging in advance where an accommodation unit is billed to a person (such as a travel agent, convention organizer or social club) that acquires it for purposes of resale for a price.

For accommodation units located in a region where the $2 tax applies, you must add $2 to the price of each unit supplied to such a person.

For accommodation units located in a region where the 3% tax applies, instead of calculating the tax at the rate of 3%, you must collect $3 in advance for each unit billed.


138 In the normal case, where guests make a direct purchase form a hotel a proxy rule is accurate – what the guest pays is the same amount the hotel receives.

139 The proxy measure can be found in each of the following statues: (1) Charlottetown Area Municipalities Act, P.E.I.S. c. C-4.1 §§ 3.1 & 2.4 “…the rate of which, … shall be 2.0 percent (2%) of the purchase price of the accommodation purchase price … [and] purchase price means the price for which accommodation is purchased, including the price in money, the value of services rendered and other consideration accepted by the Operator in return for the accommodation provided;” (2) Winnipeg Accommodation Tax By-law No. 70/2008 §§3.1 & 2, “… a purchaser must, at the time of purchasing accommodation, pay an accommodation tax in the amount of 5% of the purchase price of accommodation provided … [and] purchase price means the price for which accommodation is purchased, including the price in money, the value of services rendered and other consideration accepted by the Operator in return for the accommodation provided …”; (3) British Columbia Hotel Room Tax Act, R.S.B.C., c. 207 (1996) § 2(1) “…a tax of 5% of the purchase price of the accommodation, … [and] purchase price means the price for which accommodation is purchased, including the price in money, the value of services rendered and other consideration accepted by the operator in return for the accommodation provided …”; (4) St. John’s Act, R.S.N. 1990 c. C-17, ch. C-17.1, § 28(2) “A tax imposed under subsection (1) shall be not more than 3% of the amount charged for the accommodation, lodging or stay referred to in that subsection …” [The St. John’s ordinance is the most cryptic, but “the amount charged” is nevertheless a proxy for the amount paid, and it leaves ambiguous whether a distinction should be made between the true customer and an intermediary.]
CHART 3: LOACL
Local DMFs and Local Taxes

<table>
<thead>
<tr>
<th>Province</th>
<th>Type</th>
<th>175</th>
<th>150</th>
<th>100</th>
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<tr>
<td>British Columbia</td>
<td>Tax Piggy-back</td>
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<tr>
<td>Alberta</td>
<td>DMF</td>
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<tr>
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<td>DMF</td>
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<td>Manitoba</td>
<td>Tax Conflict w/ PST</td>
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</table>

CONCLUSION

What could the US and Japan learn from the EU and Canada about applying consumption taxes to accommodations supplied through virtual intermediaries? Using the figures in Diagram 8 the US and Japan have three tax bases to choose from: 175, 150 and 100. No jurisdiction has difficulty imposing a tax on 100 – the amount the hotel receives from the virtual intermediary.

Thus, the question really is what can the US and Japan learn from the EU and Canada about the effectiveness of imposing consumption taxes on 150 or 175?

DIAGRAM 8

Virtual Intermediary

Published Price

Accommodations can be taxed at their fair market value. The policy argument for this is horizontal equity. For example, assume an accommodations tax of 10%. Assume further that the accommodations tax is earmarked for tourist or convention marketing or for civic...
improvements in the area where hotels are located – like any of the local taxes or DMFs in Canada and most of the local jurisdictions in the US.

If two consumers (X and Y) have equal, adjoining rooms at the same hotel, and if X purchased the room directly and paid the market price of 175, with a tax of 17.5 [175 x 10% = 17.5], and if Y purchased the room through an internet intermediary, with a tax of 10 [100 x 10% = 10], then benefits are shared equally between X and Y, but the tax burden is unequal. One solution would be to tax both X and Y on a tax base of 100; another solution would be to tax both on a tax base of 175.

Measuring consumption on the fair market value of what is received, rather than on the price paid is objective valuation. Objective valuation is common in most VAT jurisdictions. It is an alternate valuation methodology used to resolve very difficult cases. For example, if a restaurant offers meals to the public for 50, that cost 25 to prepare, but charges their own employees 10 a subjective valuation would impose tax on 10, whereas an objective valuation would impose tax on 50. The EU allows member states to use an objective measure of the tax base when transactions occur between related parties. In the EU employees and employers are considered “related,” and valuation is suspect. Similar rules are found in jurisdictions as widely separate as Canada, Barbados, and Australia.

This solution become complex when the accommodation tax is part of a larger consumption tax, but it is very easy to implement in a stand-alone tax on accommodations. Thus, if British Columbia wanted to adopt an objective valuation methodology in the Hotel Room Tax it would be a relatively easy thing to do. The same is true under most US accommodations taxes. Japan however, presents the more difficult case. Under the CT accommodations are taxed as only one part of the larger taxing regime.

**Tax Base of 150**

Accommodations can be taxed at less than fair market value but with the intermediary’s margin included in the base. The policy argument that favors this approach is this tax base represents the subjective value of the guest. There are two basic ways to accomplish this (a) impose a discrete and direct tax on the intermediary’s services, and (b) design the tax to measure the value of the accommodations subjectively, but exclusively from the guest’s perspective.

One caveat is needed. Drafting a statute that seeks to reach the intermediary’s margin must be clear about how it is treating the intermediary. Confusion arises when an intermediary can be construed to be a customer, consumer, vendor or operator. The Province of Quebec is the jurisdiction in this study that avoids this confusion the best.

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140 This is an unlikely outcome as it would mean that the hotel would charge tax to every guest based on the lowest room rental on a particular day and in a particular class of rooms. The hotel would have far too much control over tax revenue.


142 EXCISE TAX ACT, R.S.C., ch. E-15, § 153(1) (Can.).

143 VALUE ADDED TAX ACT, 1996 at § 18(1) (Barbados).

144 A NEW TAX SYSTEM (GOODS AND SERVICES TAX) ACT, 1991 at ¶ 72-5(1)(a) & (b).

145 Supra note 132 & 133 and accompanying text.
Directly taxing intermediation services. The issues here are taxability and sourcing. All VATs tax intermediation services; retail sales taxes do not, unless the services are specifically listed. Thus, for a US jurisdiction to adopt this approach would first mean that the statute would have to list travel intermediation services as taxable. Japan’s CT would not need to be modified.

Next, these services must be sourced to the location of the hotel (Germany\textsuperscript{146} and Canada\textsuperscript{147} do this with services related to real estate). If these services are sources to the place of performance, the intermediary’s margin will escape tax.

However, even if intermediation services are taxable, and even if they are sourced to the hotel’s jurisdiction, there are still issues about whether or not the intermediary can be compelled to pay the tax. In the US the intermediary is not subject to tax if it lacks physical presence under Quill.

Presence might be satisfied through the intermediary’s contract with the hotel. If the intermediary volunteers (through its’ contract) to collect the local sales tax on behalf of the hotel, then it may have conceded nexus.\textsuperscript{148} Under the Japanese CT the same “taxable presence” issue arises, but here the requirements are even steeper. The intermediary would need to have a permanent establishment in Japan (as in the Amazon.com case).\textsuperscript{149}

Subjective valuation – guest’s perspective. The issues here are to avoid proxy valuations, and then to find an effective mechanism to collect the tax. The proxy issue is that the statute needs to be clear that value is determined by what the guest pays, not by what the operator receives. It is the nature of the intermediation triangle that these amounts are different (even though in a traditional accommodation transaction these amounts are the same). A modernized accommodations taxing statute must remove this implicit proxy.

Secondly, a collection mechanism is needed. There are three variations. Each would work well in either Japan or US jurisdictions. All are based on pre-collection of the tax.

Pre-collection – Fair market value. Hotels could be required to collect tax from virtual intermediaries based on the fair market value of the rooms rented (the publicly listed price). As under the Canadian GST/HST drop shipment rules,\textsuperscript{150} this amount could either be passed through to the guest (if the intermediary wished to remain unregistered), or it could be claimed as a refundable amount on a return that would identify the amount actually charged the guest.

In the US this would incorporate a VAT-like element to the accommodations tax. For example under a 10\% tax the hotel would charge the intermediary a tax of 17.5 (on a room listed for 175). When the intermediary re-sells this room for 150 it would charge the guest 15. The

\textsuperscript{146} See text at supra note 60.
\textsuperscript{147} See text at supra note 84.
\textsuperscript{149} Supra note 25.
\textsuperscript{150} See text supra notes 26 to 33.
intermediary would then file a return that would show a tax payment of 17.5, a tax collection of 15, and then it would request a refund of the difference, or 2.5.

Alternatively, a guest could be allowed to request a refund directly from the hotel upon checking-in. The principle would be that the hotel had charged more tax than was due and the intermediary had passed this tax along. The refund would be based on the difference between the list price of the room and the amount that the guest actually paid to the intermediary. This approach would side-step objections by intermediaries that they should not be burdened with additional compliance in jurisdictions where they arguably may not be present.

In the example used above, the hotel would charge the intermediary 17.5, and return to the guest 2.5 upon proof that the intermediary charge the guest 150 for the room. These amounts would be netted on the hotel’s tax return.

Because this alternate approach would effectively reveal the intermediary’s margin to the hotel a more acceptable resolution might be to use a registration number to allow intermediaries to switch between these outcomes. If an intermediary was registered with a jurisdiction (filing returns under the primary option) guests using this intermediary would not qualify for direct refunds. Refunds would go to the intermediary when they filed a return. However, if a guest used a non-registered intermediary then they would qualify for a direct refund at the hotel’s registration counter when they checked-in.

There are two further permutations of this rule; one using a flat rate, the other using a standard mark-up.

Pre-collection – Flat rate. This is the Quebec approach. It achieves rough justice, but falls short of accurately measuring value. Quebec requires that any hotel selling to an intermediary collect a standard amount of $3.00 per room night. Quebec goes no further. $3.00 per night may or may not be the amount that would be due if the room was not purchased through an intermediary and the authorized 3% ad valorem rate applied.

However, if the flat rate were set high enough, so that it exceeded in every case the ad valorem tax for the guest, then the same mechanisms set out in the previous example could be applied and a fair and accurate result could be achieved.

Pre-collection – Standard mark-up. This is the approach suggested by Walter Hellerstein. It follows the California drop shipment regulations. Hellerstein effectively opts for a variant of the alternate mechanism set out above. He suggests, “…requiring the hotel operator to add a presumed markup to the travel intermediary’s price, and collect tax on the marked-up price, subject to the hotel’s establishment of an actual markup that is different.” Hellerstein does not grant the guest a refund. He simply allows the hotel to adjust its return based on the “establishment of an actual markup.”

This solution needs some refinement. It could undertax (if the true mark-up was 25% for example), or it could overtax the guest (if the true mark-up was 5%). In the later case, the
overtax amount would be kept by the hotel, not the government. It should be refunded to the taxpayer.

In the end, the threats to the some consumption taxes posed by virtual intermediaries has tried and tested solutions in other consumption tax systems. Internationally comparative studies can bring these solutions to the fore. In this study only virtual intermediaries in the lodging industry have been considered. There are many more, and some create just as many problems for tax payer and tax administrations. Modernization efforts are needed.