Reform Lodging

Sales and Use Tax Avoidance Implications of Directly Sold Loyalty Points by Hotel Franchisors & Franchise Model

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I. Introduction

The hospitality industry, historically rooted in principles of service and trust, has witnessed a paradigm shift in its revenue models, particularly concerning loyalty programs. Traditionally designed as tools for customer retention, these programs have morphed into intricate financial instruments. A concerning evolution in this space is the direct sale of loyalty points by hotel franchisors to guests, bypassing the conventional earning mechanism. This practice has significant implications for sales and use tax, hotel franchisee revenues, and the broader dynamics of the hotel industry.

II. Background: The Traditional Loyalty Points Model

Loyalty programs have been a cornerstone of the hospitality industry for decades. These programs were designed to incentivize repeat business, offering guests points for each stay, which could later be redeemed for rewards. The underlying principle was simple: reward customer loyalty with perks and benefits.

- **Earning Mechanism:** Traditionally, points are accrued over time, based on the number and type of transactions. For instance, a longer stay or a stay during peak seasons might earn more points than a single night's stay during the off-season.
- **Redemption:** Once a certain threshold is reached, these points can be redeemed. The redemption could be in the form of discounted stays, free nights, or other services like spa treatments or dining credits.
- **Tax Implications:** In this traditional model, the earned points do not have an immediate monetary value. They represent a potential future service, and thus, are not subject to sales

tax upon earning. However, their redemption might alter the taxable base of a transaction, contingent on jurisdictional specifics.

III. The Direct Sale of Loyalty Points: An Anomalous Model (THE PROBLEM EXPLAINED)

In recent years, a deviation from the traditional model has emerged. Some hotel franchisors have begun to sell loyalty points directly to guests, devoid of any associated stay or transaction.

1. Nature of Transaction: The Direct Sale of Points as a Pre-Sale of Hotel Services

The direct sale of loyalty points by hotel franchisors represents a significant departure from the traditional understanding and purpose of loyalty programs. Historically, loyalty points were earned as a result of a transaction, acting as a reward or incentive for continued patronage. However, the direct sale of these points has transformed their very essence, leading to critical implications for taxation, business practices, and consumer perceptions.

1.1. Commodification of Loyalty Points:

When loyalty points are directly sold to guests, they cease to be mere tokens of appreciation or incentives. Instead, they become commodities in their own right, akin to gift cards or vouchers. Guests are no longer just earning these points as a byproduct of their patronage; they are purchasing them with a clear monetary value attached.

1.2. Pre-Sale of Hotel Services:

By purchasing these points, guests are essentially pre-buying hotel services for future use. For instance, a guest who buys loyalty points worth $500 is, in effect, pre-purchasing hotel stays or services equivalent to that value. This transactional nature is no different from a guest booking a hotel room in advance.

1.3. Implications for Revenue Recognition: Accounting Ambiguities and Potential Red Flags

From an accounting and financial standpoint, the direct sale of loyalty points introduces a myriad of complexities, particularly concerning revenue recognition. The traditional accounting practices for loyalty points, when earned as rewards, are well-established. However, when these points are directly sold, it brings forth a set of challenges that can potentially distort financial statements and mislead stakeholders.

When a hotel franchisor sells these points, they receive immediate revenue. However, the corresponding service (i.e., the hotel stay or other services the points can be redeemed for) has not yet been provided. This creates a deferred service obligation. In essence, the franchisor owes a service in the future for the revenue they've recognized now.

Here's where the potential accounting ambiguity arises: Instead of treating the revenue from the direct sale of points as an immediate income, some franchisors might be tempted to treat it as a balance sheet item, specifically as a liability, given that there's a future service obligation attached to it. While this might seem like a prudent approach at first glance, it can lead to significant distortions in financial reporting.

For instance, by treating the sale as a balance sheet item and not a revenue item, franchisors can effectively defer the recognition of this income. This can have multiple implications:

- **Tax Implications:** By deferring the recognition of this income, franchisors might be able to defer associated tax liabilities. This is a significant concern for tax authorities, especially the IRS. If franchisors are manipulating revenue recognition to gain tax advantages, it's a clear red flag that warrants thorough auditing.
- **Misleading Financial Statements:** Stakeholders, including investors, creditors, and analysts, rely on financial statements to make informed decisions. If large sums are being deferred as liabilities when they should be recognized as revenue, it can paint an inaccurate picture of the company's financial health and performance.
- **Erosion of Trust:** Transparent financial reporting is the bedrock of stakeholder trust. Any practices that deviate from standard accounting principles can erode this trust, leading to reduced investor confidence and potential legal repercussions.

In light of these concerns, it's imperative for regulatory bodies and industry watchdogs to scrutinize the accounting practices associated with the direct sale of loyalty points. Ensuring that franchisors adhere to transparent and standard revenue recognition practices is crucial for the integrity of the industry and the protection of stakeholders.

1.4. Consumer Perception and Trust:

For consumers, the direct sale of loyalty points can blur the lines between loyalty rewards and straightforward transactions. This might lead to a shift in how consumers perceive loyalty programs. Instead of viewing them as rewards for their loyalty, they might begin to see them as mere financial transactions, potentially eroding the trust and goodwill associated with such programs.

1.5. Legal and Tax Implications:

The transactional nature of directly sold loyalty points brings them under the purview of sales and other applicable taxes. If these transactions are not recognized and taxed appropriately, it can lead to significant revenue losses for municipalities and create legal complications for hotel franchisors.

In summary, the direct sale of loyalty points is not a mere extension of traditional loyalty programs. It represents a fundamental shift in the nature of the transaction, with wide-ranging implications for taxation, business operations, and consumer trust. Recognizing and addressing this shift is crucial for ensuring fairness, transparency, and compliance in the hotel industry.

2. Impact on Franchisees

The direct sale of loyalty points by hotel franchisors, especially when aggressively marketed through mass emails and other digital channels, has profound implications for hotel franchisees. This model can significantly impact hotel franchisees in various ways, from financial disparities to long-term brand implications. This section delves deeper into the multifaceted impact on franchisees, highlighting the financial, operational, and competitive challenges they face due to this practice.

2.1. Financial Disparities: An Urgent and Escalating Concern

The direct sale of loyalty points by hotel franchisors has introduced a concerning financial disparity that is severely affecting hotel franchisees. This disparity is not just a minor discrepancy in revenue allocation but represents a significant and growing financial drain on franchisees, necessitating immediate attention and intervention.

When guests redeem loyalty points that they have directly purchased, the financial arrangement that unfolds is alarmingly skewed against the franchisees. Traditionally, when a guest books a room, the franchisee receives the full room rate, ensuring a fair profit for their services. However, with the direct sale model, the financial dynamics have been turned on their head.

Example: Let's delve into a practical scenario to understand the gravity of the situation. Imagine a guest who decides to purchase loyalty points from a hotel franchisor for an amount of $250. Now, when the time comes for this guest to redeem these points for a stay, the franchisor, instead of compensating the franchisee based on the actual value of the points, reimburses them a paltry sum of $25 for the room. This means that the franchisor retains a staggering $225 from the transaction. What's even more concerning is that this entire process is presented under the guise of a loyalty point redemption, cleverly masking the true nature of the transaction.

Such practices don't just rob the franchisee of a one-time revenue; they set a dangerous precedent. Over time, as more guests opt for this method, the cumulative loss for franchisees can be astronomical. Especially during high-demand periods or peak seasons, when rooms are at a premium, this model can result in revenue losses that run into the hundreds of millions of dollars. The implications of this are far-reaching. Franchisees, who often operate on thin margins, are deprived of revenue that is rightfully theirs. This can affect their ability to maintain their establishments, pay staff, and provide quality service. Over time, this can erode the very foundation of the franchisor-franchisee relationship, leading to mistrust, dissatisfaction, and potential legal disputes.

The financial disparities arising from the direct sale of loyalty points are not just a matter of lost revenue; they represent a systemic issue that threatens the very fabric of the hotel franchising model. Immediate regulatory and industry intervention is imperative to rectify this situation and ensure a fair and sustainable business environment.

2.2. Competitive Disadvantages: Franchisors, Consumers, and the Tax Evasion Dilemma

The direct sale of loyalty points by hotel franchisors has introduced a concerning dynamic that not only places franchisees at a competitive disadvantage but also inadvertently involves consumers in questionable tax practices. This strategy, while seemingly offering a superficial benefit to the consumer, primarily serves the interests of the franchisors at the expense of the franchisees and the broader tax system.

Consider the scenario: A leading hotel franchisor, "HotelX," prominently displays an enticing "Points Plus Cash" option on its website. To the unsuspecting consumer, this appears as a hybrid loyalty scheme, allowing them to utilize some accumulated points and complement with cash for a booking. However, beneath this facade lies a mechanism primarily designed for the direct sale of loyalty points.

When a guest opts for the **"Points Plus Cash" scheme**, they are, in essence, purchasing loyalty points which allow them to secure a room at a seemingly reduced rate. This reduction isn't just a result of the points used but is significantly influenced by the absence of various sales taxes that would typically apply to standard room bookings.

Herein lies the crux of the issue: The franchisor, through this scheme, is not only diverting revenue that would traditionally belong to the franchisee but is also making the consumer an unwitting participant in tax evasion tactics. The consumer, while benefiting from the tax not levied on the transaction, doesn't gain any substantial advantage from this scheme. The primary beneficiary remains the franchisor, who pockets a significant portion of the revenue, depriving the franchisee of their rightful earnings.

Furthermore, this practice creates an uneven playing field. While the franchisor can offer rooms through the "Points Plus Cash" scheme without the associated sales tax, all other booking channels, including direct bookings with the franchisee, remain subject to this tax. This not only places the franchisee at a distinct competitive disadvantage but also raises serious questions about the fairness and integrity of such practices.

In summary, the direct sale of loyalty points, especially through schemes like "Points Plus Cash," presents a multifaceted problem. ***It not only deprives franchisees of their due revenue but also embroils consumers in a web of tax evasion, all while disproportionately benefiting the franchisor.*** This is a clear and pressing issue that demands immediate attention and rectification for the sake of fairness, transparency, and the overall health of the hotel industry.

2.3. Loyalty Points and Gift Cards: A Technical Overview

Directly sold loyalty points by hotel franchisors can be likened to the sale of gift cards in other sectors. Both represent an upfront payment for future services. While a gift card's value is straightforward and explicit, the value of loyalty points is often associated with specific services or stays, making it less direct. A significant difference emerges during redemption. When a gift card is redeemed, franchisees typically receive its full value. However, with loyalty points, the scenario changes. Franchisees often receive an amount that is less than the value the consumer initially paid for, leading to a notable discrepancy.

From a taxation perspective, the sale of gift cards usually has clear sales tax implications right at the point of sale. In contrast, the tax landscape for loyalty points is more complex. This complexity suggests that loyalty points, like gift cards, should be subject to sales tax upon their initial sale, but this practice is not consistently followed.

Another parallel between the two is the concept of a deferred service obligation. Both loyalty points and gift cards indicate a promise of future service. Yet, the accounting treatment for these future obligations can differ, especially for loyalty points, which can be more ambiguous. In essence, while there are foundational similarities between loyalty points and gift cards, the way they are treated, particularly concerning franchisee compensation and taxation, showcases significant inconsistencies that need thorough examination and rectification.

2.4. Strained Franchisor-Franchisee Relations: The Deep Loss Dilemma

The direct sale of loyalty points by franchisors has introduced a glaring imbalance in the franchisor-franchisee dynamic. Alarmingly, in almost all instances, when these points are redeemed, franchisees are compensated at rates that are not just below market value, but significantly under the actual cost of the room. This results in franchisees incurring a deep loss on each transaction, while the franchisor reaps undue benefits, a stark example of unfair enrichment. Such a system leaves franchisees shouldering the financial burden. They find themselves subsidizing guest stays, often at rates that make the business unsustainable. This isn't just about reduced profits; it's about operating at a loss. And the kicker? These transactions are predominantly dictated by the franchisor, leaving the franchisee with little say.

The fallout is immediate and damaging. Feeling exploited and operating at consistent losses, franchisees might cut back on essential services, maintenance, or even staff. This degradation in service quality directly impacts the guest experience and can lead to long-term brand erosion. In short, the franchisor's strategy of selling loyalty points, while seemingly profitable in the short term, is causing significant financial harm and discord within the franchise system. Addressing this glaring inequity is not just essential—it's urgent for the brand's sustainability and the survival of its franchisees.

It's an open secret in the hotel industry: due to the commingling of reward night and point sale transactions, loyal guests who redeem points often receive the least desirable rooms in the hotel.

IV. The Expedia Precedent and the Imperative for Regulatory Clarity: Addressing the Tax Implications of Loyalty Points Sales in the Hospitality Industry

The ***Expedia v. New York City Department of Finance*** case serves as a pivotal reference point in understanding the tax implications surrounding unconventional sales practices in the hospitality industry. This precedent, when juxtaposed against the direct sale of loyalty points by hotel franchisors, reveals glaring inconsistencies that necessitate a deeper analytical exploration.

1. **Overview of the Expedia Precedent**

1.1. Nature of Dispute: Central to the Expedia case was the issue of hotel occupancy tax on the differential between the rate charged to consumers and the rate remitted to hotels. Expedia, acting as a broker, sold rooms at a markup, deriving profit from the difference.

1.2. Court's Ruling: The New York State Court of Appeals determined that the tax should be levied on the entire amount paid by the consumer, not merely the portion remitted to the hotel. This ruling underscored the principle that the tax obligation is tied to the totality of the consumer's payment for occupancy.

1.3. Underlying Principle: The court's stance was rooted in the idea that the full amount a consumer pays for a service, especially related to occupancy, should be subject to tax. Any differential, irrespective of whether retained by a broker or a franchisor, doesn't diminish the transaction's full tax liability.

2. Parallels with Loyalty Points Sales

2.1. Transactional Nature: The sale of loyalty points, especially when they can be redeemed for services, is akin to the provision of hotel services. The essence of the transaction is not merely the sale of points but the sale of a service, specifically, the hotel room.

2.2. The Concealed Differential: Analogous to the differential in the Expedia case, the gap between the value of loyalty points sold and the compensation provided to franchisees represents a hidden markup. This differential, while subtle, is where a substantial portion of the revenue resides.

2.3. Integrity of Loyalty Programs: Historically, loyalty programs were instruments to reward repeat customers. However, when points are directly sold, it alters the foundational purpose of these programs. They transition from being rewards to direct transactional mechanisms.

3. Implications for the Broader Hospitality Industry

3.1. Potential for Similar Tactics: If the sale of loyalty points isn't recognized as a direct sale of hotel services, it sets a precedent for similar tax avoidance strategies. Other entities in the hospitality sector could adopt analogous models, selling tokens or points, to sidestep sales tax obligations.

3.2. Questioning the Nature of the Transaction: The direct sale of loyalty points raises questions about the true nature of the transaction. Is it a mere sale of points, or is it, in essence, a sale of hotel services? The Expedia precedent suggests that the focus should be on the totality of the consumer's payment and the value derived from it.

The ***Expedia v. New York City Department of Finance*** case provides a lens through which the direct sale of loyalty points by hotel franchisors can be critically examined. By drawing parallels between the two scenarios, it becomes evident that there are significant overlaps, especially concerning the nature of the transaction and the associated tax implications. This analytical exploration underscores the need for a more nuanced understanding of such unconventional sales practices in the hospitality industry.

V. The Franchisor-Franchisee Imbalance: A Call for Transparency & Equitable Practices

The hospitality industry, with its intricate web of franchisor-franchisee relationships, is built on mutual trust and shared goals. However, recent practices, particularly concerning the sale and redemption of loyalty points, have highlighted significant disparities that threaten this foundational relationship. Delving deeper into the dynamics, several critical issues emerge:

1. **Anticompetitive Practices and Brand Standards:** Dominant franchisors, leveraging their position, have sometimes set forth practices that can stifle healthy competition. One glaring manifestation of this is the imposition of brand standards that might not always align with the franchisees' best interests. Mandating unreasonably high occupancy rates for full reimbursement, especially when juxtaposed against the franchisor's system-wide lower occupancy, is a case in point. Such standards not only place undue financial strain on franchisees but can also be seen as punitive measures that don't consider market realities or the unique challenges of individual hotel locations.
2. **Revenue Disparities and Unfair Enrichment:** The direct sale of loyalty points, a practice that has gained traction, has introduced significant revenue imbalances. When these points, often sold without transparent disclosure to franchisees, are redeemed, the franchisee's share is frequently a mere fraction of the room's actual value. This skewed distribution sees franchisors retaining a disproportionate revenue share, leading to situations of unfair enrichment. The practice of commingling traditional reward club reservations with point sales further muddies the waters, depriving franchisees of clarity on their rightful earnings.
3. **Transparency Deficits:** A relationship as pivotal as that between a franchisor and franchisee should be rooted in transparency. Yet, the omission of clear disclosures about direct point sales to consumers in foundational documents like the FDD is concerning. Such documents are meant to offer a holistic view of the franchisor's operations, and any significant revenue streams should be candidly disclosed.
4. **Legal and Regulatory Implications:** The culmination of these practices could potentially open the doors to legal challenges. Franchisees, feeling the pinch of revenue losses and the weight of opaque practices, might seek legal redress. Beyond individual grievances, regulatory bodies could also step into the fray, especially if there's a whiff of anticompetitive behavior or if there are indications of tax-related discrepancies.

It becomes evident that the current trajectory is unsustainable and potentially detrimental to the very fabric of the hospitality industry. The need of the hour is a recalibration of the franchisor-franchisee relationship, anchored in transparency, fairness, and mutual respect. Only through such a realignment can the industry hope to thrive, with both franchisors and franchisees reaping the rewards of their collective efforts, all while upholding the trust of their most valued stakeholders - the guests.

VI. Legal and Regulatory Recommendations

The direct sale of loyalty points by hotel franchisors has raised significant concerns, especially regarding the financial implications for franchisees and potential tax evasion. To address these concerns, a comprehensive set of legal and regulatory recommendations is proposed:

1. **Clarification on the Nature of Loyalty Points Sales:**

Local and State Authorities:

- Local and state tax authorities should recognize that the direct sale of loyalty points, especially when tied to specific room bookings, is a taxable transaction akin to the sale of gift cards.
- Regulations should be introduced to ensure that loyalty points sold directly to consumers are treated as pre-sales of hotel services, similar to gift cards, and are subject to sales tax.

2. **Revenue Recognition Principles:**

Federal Action:

- The Federal Trade Commission (FTC) and the Securities and Exchange Commission (SEC) should provide clear guidelines on the revenue recognition for the direct sale of loyalty points.
- Franchisors should be mandated to recognize revenue from the direct sale of loyalty points when the points are sold, mirroring the revenue recognition for gift card sales.

3. **Distinct Treatment of Earned and Purchased Points:**

Industry Guidelines:

- Hotel industry associations should advocate for clear differentiation between loyalty points earned through stays and other activities and those purchased directly.
- Franchisors should be mandated to maintain separate accounts for earned and purchased points. This ensures transparency and fairness in redemption.
- For the redemption of purchased points, franchisees should be reimbursed at the full value of the points, akin to the redemption of gift cards. This ensures that franchisees are fairly compensated for the services they provide.
- Even in cases where a booking involves a mix of earned and purchased points, franchisors should ensure that there is no commingling in terms of reimbursement. Each set of points should be treated distinctly, with franchisees receiving appropriate compensation for each. This approach is not novel; some brands have historically reimbursed purchased points at full value to franchisees, treating them similarly to gift cards.

4. **Addressing Unfair Business Practices:**

Federal Trade Commission (FTC) Involvement:

- The FTC should investigate the direct sale of loyalty points to determine if such practices are deceptive or unfair to franchisees.
- If found to be unfair, the FTC should provide guidelines to franchisors to ensure that the sale of loyalty points does not harm franchisees or distort market dynamics.

State-Level Action:

- State attorneys general should be empowered to investigate and, if necessary, prosecute franchisors who engage in deceptive practices related to the direct sale of loyalty points.
- States should consider introducing legislation that ensures franchisees are fairly compensated when loyalty points, whether earned or purchased, are redeemed.

5. **Consumer Protection and Transparency:**

Federal and State Action:

- Both federal and state consumer protection agencies should ensure that consumers are fully informed about the nature of loyalty points, especially the difference between earned and purchased points.
- Franchisors should be required to provide clear information to consumers about the terms and conditions of loyalty point sales and redemptions.

The objective is not to disrupt the traditional loyalty points model but to rectify specific practices that disadvantage franchisees, evade taxes, and negatively affect hospitality employees. By ensuring that earned and purchased points are treated distinctly, even within the same booking, we can ensure fairness, transparency, and justice for all stakeholders in the hospitality industry.

VII. Consumer Wins in the Suggested Approach

In the discourse surrounding the direct sale of loyalty points and its implications, franchisors often raise the specter of potential harm to the consumer as a counterargument to any proposed changes. This narrative, however, is more a diversionary tactic than a genuine concern for consumer welfare. A closer examination reveals that the approach advocated by franchisees not only safeguards consumer interests but actively enhances them.

1. **Consumer Benefit Through Tax Compliance:** By ensuring that the direct sale of loyalty points is subject to appropriate sales tax, we eliminate the murky realm of tax evasion. This fosters a transparent business environment where consumers can trust that their transactions are above board and compliant with all regulatory standards.
2. **Enhanced Service Quality:** When franchisees are fairly compensated for the redemption of loyalty points, they have more resources at their disposal. This directly translates to better maintenance, timely renovations, and overall improved service quality. A hotel that is financially stable can invest more in enhancing the guest experience, ensuring that consumers enjoy top-tier amenities and services.
3. **Strengthened Trust in Loyalty Programs:** By rectifying the imbalances in the loyalty points system, consumers can have renewed faith in these programs. They can trust that

their loyalty is genuinely valued and that the points they earn or purchase have a transparent and fair value. This strengthens the bond between the consumer and the hotel, fostering long-term loyalty.

4. **Consumer-Centric Approach of Franchisees:** Contrary to the narrative propagated by some franchisors, franchisees are inherently more consumer-focused. Their success is directly tied to guest satisfaction. While franchisors might be several steps removed from the on-ground realities of hotel operations, franchisees interact with guests daily, understand their needs, and are committed to ensuring their satisfaction. Their advocacy for a fairer loyalty points system stems from this commitment to the consumer.

VIII. Conclusion

The unchecked evolution of loyalty programs with motives to shortchange the franchisee and local municipalities poses a threat to the hospitality industry's core values. Drawing from the Expedia precedent and recognizing the multifaceted implications of the direct sale of loyalty points, it is incumbent upon regulators to intervene, ensuring fairness, transparency, and justice for all industry stakeholders.

About Reform Lodging: *Reform Lodging is a nonprofit hospitality industry think tank and owner advocacy organization fueled by the youthful exuberance of millennial hoteliers, backed by the wisdom of industry luminaries. The organization was founded in April 2020 by Rich Gandhi, Sagar Shah, and Dharam Goragandhi and has over 1,700 members from across the United States and overseas. Reform Lodging's website is www.reformlodging.org*