ARIZONA SUPREME COURT

DOVE MOUNTAIN HOTELCO, LLC, d/b/a RITZ-CARLTON DOVE MOUNTAIN HOTEL and SPA, a Delaware LLC, and HSL COTTONWOOD RC HOTEL, LLC, an Arizona LLC, Plaintiffs/Appellants, v. ARIZONA DEPARTMENT OF REVENUE, an agency of the State of Arizona, Defendant/Appellee.	No. CV-23-0176-PR Court of Appeals No. 1 CA-TX 22-0003 Arizona Tax Court No. TX2019-000448

RESPONSE TO PETITION FOR REVIEW

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INTRODUCTION

Defendant Arizona Department of Revenue (the "Department") opposes Plaintiffs Dove Mountain HotelCo LLC, et al. ("Dove Mountain")'s Petition for Review ("Petition"). The court of appeals correctly held that revenue Dove Mountain received from a rewards program is taxable and that payments made into the program are not deductible. This Court should therefore deny the Petition.

ISSUES PRESENTED FOR REVIEW

1. Whether the Court of Appeals properly affirmed summary judgment for the Department raises the following subissues:

a. Is revenue that Dove Mountain receives from the third-party Marriott Rewards Program ("Rewards Program") to pay for hotel stays a part of the tax bases under the state and city transient lodging classifications, A.R.S. § 42-5070 and Model City Tax Code ("MCTC") §§ 444 and 447?

b. Are Dove Mountain's payments into the Rewards Program to pay for "points" earned by program members for paid stays deductible under A.R.S. § 42-5070 and MCTC §§ 444 and 447?

c. Was Dove Mountain subjected to double taxation?

MATERIAL FACTS

Dove Mountain operated a hotel-resort located in Marana, Arizona. (IR 40, ¶ 19.) It filed returns with multiple tax code classifications, with its primary business being under the Transient Lodging Classification, A.R.S. § 42-5070. (*Id*.)

Dove Mountain participates in the Marriott Rewards Program, a loyalty marketing program operated and administered by a third party, Marriott Rewards, LLC, that allows members to earn points from hotel stays, car rentals, branded credit card use, etc., and to use their points to pay for lodging, car rentals, gift cards, etc. (IR 36, ¶¶ 13-16, 19-21; IR 40, ¶¶ 12-13.)

Rewards Program members can use points to pay for lodging at Marriott branded hotels and for other items including merchandise, airline miles, and car rentals. (IR 36, ¶ 22.) Dove Mountain receives monthly revenue from the Rewards Program when members redeem points for lodging. (IR 36, ¶¶ 32-33; IR 40, ¶¶ 9-10, 14-17.)

Dove Mountain cannot identify the underlying transactions in which points were earned or identify whether they were earned at Dove Mountain (IR 40, ¶ 1) and does not have "any documents showing the underlying transactions related to Points redeemed by members to stay" at Dove Mountain "under the Program" (*id.* ¶ 5). As a result, points redeemed for stays at Dove Mountain (1) may not have been earned there, (2) may not be from the business of transient lodging or from any business subjected to transaction privilege tax ("TPT") under a different classification in Arizona, or (3) may have been earned through transactions outside Arizona (i.e., may not have been subjected to any Arizona or city TPT). (*Id.* ¶¶ 4, 6-7.)

Dove Mountain pays 4.5% of its revenue from member-paid stays to the Rewards Program, which pays for the points in program members' accounts. (IR 36, ¶ 28.) Its expenses for customers' program points may not have anything to do with a later stay in which a guest uses "points" and for which Dove Mountain receives revenue from the Rewards Program because there is no tracking of where points are earned. (IR 40, ¶¶ 1, 5, 16.)

REASONS WHY THE COURT SHOULD DENY REVIEW

I. The Court of Appeals Properly Affirmed Summary Judgment for the Department.

A. Dove Mountain's Rewards Program Revenues Are Part of the Taxable Gross Income of Its Transient Lodging Business.

1. The TPT tax base is a tax on the gross income derived from the business activities.

"The [TPT] is an excise tax on the privilege or right to engage in an occupation or business in the State of Arizona. It is not a tax upon the sale itself [or] upon the property sold." *Ariz. Dep't of Revenue v. Mountain States Tel. & Tel. Co.*, 113 Ariz. 467, 468 (1976) (citations omitted). "'Business' includes all activities or acts, personal or corporate, that are engaged in or caused to be engaged in with the object of gain, benefit or advantage, either directly or indirectly . . . ." A.R.S. § 42-5001(1).

The state TPT is levied under A.R.S. § 42-5008. The transient lodging classification is "comprised of the business of operating, for occupancy by transients, a hotel or motel." A.R.S. § 42-5070. For purposes of this classification, a "transient" is "any person who either at the person's own expense or at the expense of another obtains lodging space or the use of lodging space on a daily or weekly basis, or on any other basis for less than thirty consecutive days." A.R.S. § 42-5070(E). The tax base for the transient lodging classification is "the gross proceeds of sales or gross income derived from the business." A.R.S. § 42-5070.

"Gross income" means "the gross receipts of a taxpayer derived from trade, business, commerce or sales and the value proceeding or accruing from the sale of tangible personal property or service, or both, and *without any deduction on account of losses*." A.R.S. § 42-5001(4) (emphasis added).

"Gross receipts" means

> the total amount of the sale, lease or rental price . . . including any services that are a part of the sales, valued in money, whether received in money or otherwise, including all receipts, cash, credits and property of every kind or nature, and any amount for which credit is allowed by the seller to the purchaser *without any deduction from the amount on account of* the cost of the property sold, materials used, labor or service performed, interest paid, losses or *any other expense*. Gross receipts do not include cash discounts allowed and taken . . . .

A.R.S. § 42-5001(7) (emphasis added).

The TPT is a tax on the gross income that the business generates, and it is not like a corporate income tax that taxes only the "net" after deductions of expenses. The statutory deductions allowed are those stated in the particular classification, and the transient lodging classification has no applicable deduction that would apply for the costs of payments into the Rewards Program or other marketing program.

Dove Mountain is in the transient lodging classification and has revenue from the Rewards Program that it recorded in its books and records and on which it remitted taxes. It bears the burden of proving the exemption. *See* A.R.S. § 42-5023. Exemptions are strictly construed against the taxpayer. *Carter Oil Co. v. Ariz. Dep't of Revenue*, 248 Ariz. 339, 341-42, ¶ 5 (App. 2020).

2. Dove Mountain's payments into the Rewards Program are not deductible.

Dove Mountain, in effect, seeks to offset payments it made to the program from revenue it received from the program. Essentially, this position concedes that the program revenue is taxable, but seeks to deduct expenses for payments to the program.[1] This is not allowable under the statutes. Expenses for marketing programs are not deductible from the gross income and gross revenue making up the tax base.

[1] Because some hotels pay in more to the program than they receive, under Dove Mountain's approach, they would be deducting these costs against revenue that was not from the program.

The Rewards Program is not a (two-party) vendor discount program in which the vendor simply offers something for free as a "reward" for patronage. A vendor discount program would involve Dove Mountain providing free stays with no new consideration as a reward for prior stays, with no taxable revenue being earned from the "free" stay. Such a two-party program involves only the vendor and the customer and can take many forms, including a points-based program. It also does not result in revenue being received and recorded on books and records.[2] The Rewards Program, however, has a third-party payor that pays Dove Mountain for guest stays when points are redeemed—generating revenue. It does not involve a vendor giving away something for free as a reward for patronage—generating no revenue. That Dove Mountain bears some of the expense to participate in that marketing program is irrelevant because those expenses are not deductible from the defined tax base.

Further, there are no available records to show that any of the points that customers spent at Dove Mountain were points earned from transactions at Dove Mountain or in what amounts they were earned. The points spent in a particular

[2] This distinguishes *State Tax Commission v. Consumers Market, Inc.*, 87 Ariz. 376 (1960), in which Consumers Market had not received any revenue when it redeemed the trading stamps that it had issued. The Tax Commission attempted to infer a revenue amount based on the value of the items that the customers received "computed on the value of merchandise given as premiums to its customers . . . ." *Id.* at 377. In contrast, when a third party pays the hotel for the "free" room, there is revenue.

transaction (and the monies paid into the program) could also have been from payments for other travel goods or services or from credit-card points—all unrelated to Dove Mountain or even to lodging with third parties. Yet, when points are redeemed for a room, Dove Mountain receives money from the Rewards Program. It is not a self-issuer and self-redeemer of points, thus differentiating it from two-party (business-customer) programs that do not provide a business with revenue.

Dove Mountain and the Dissent below rely on a contorted understanding of *Consumers Market* to claim that the Rewards Program functions similarly to the trading stamps program in that case. (Petition at 8, 11; Dissent ¶¶ 37-39.) Consumers Market "was a 'self-redeemer' of 'trading stamps.'" 87 Ariz. at 377. That is, it issued and redeemed its own trading stamps, receiving no revenue from the redemption transaction. *Id*. Thus, it was receiving consideration only once for both the initial purchase transaction and the merchandise that it was giving later in exchange for the stamps that it had issued. There was no new gross income involved—unlike the situation where a third-party rewards program pays a business for redemption-paid purchases.

In this case, the scheme is a much more complex third-party program: the first transaction occurs when a program member participates in some points-generating activity. The second transaction occurs when some participating

business pays the Rewards Program an amount as part of participating in the program to pay for the customer's points and fund the program. The third transaction occurs when the Rewards Program issues points to the customer's account. The fourth transaction occurs when the customer redeems points to pay for something of value. And the fifth transaction occurs when the Rewards Program pays a participating business an amount of revenue.

Consumers Market involved only two parties—with the merchant providing free merchandise for stamps given out when prior purchases were made. It issued the stamps, and it was not paid by anyone else when the stamps were used. Thus, Consumers Market was a classic self-issuer, self-redeemer.[3] Whereas Dove Mountain is paid when the points are redeemed, and nothing shows that any of the points redeemed and the associated payments were related to a prior Dove Mountain guest-paid stay.

The *Consumers Market* Court analyzed the statutory definition of "sale": "any transfer of title or possession, or both, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatever . . . of tangible personal property . . . for a consideration." A.R.S. § 42-5001(18) (formerly A.R.S. § 42-1301). The Court focused on whether consideration was paid in the second

[3] Other similar programs include coffee shops that offer a free item after a number of purchases or hotels that offer a free night after a number of days. In all such cases, there is no new revenue to the business from the customer or a third-party payor.

transaction and concluded that redemption of the stamps was not a new consideration. 87 Ariz. at 379-80. Consumers Market was a "self redeemer" of its trading stamps (*id*. at 377) that received no revenue on redemption, and its program was simply not analogous to a third-party program that pays new cash consideration to the merchant. This is particularly true when the "points" redeemed have no proven relationship to an earlier transaction with Dove Mountain.

In *Consumers Market*, the market was paid once, remitted taxes on that transaction, and later on provided a deferred benefit in the form of a gift. Here, Dove Mountain is paid new revenue when it provides accommodations to a program member using the member's points and receives payment from the Rewards Program. Thus, Dove Mountain itself does not provide a deferred "free" benefit for upfront payment as the market did. Instead, it receives a payment each time that it provides accommodation to a program member using the member's points. A "transient" for this classification includes "any person who either at the person's own expense *or at the expense of another* obtains lodging space . . . ." A.R.S. § 42-5070(F) (emphasis added). The statute therefore taxes third-party-paid stays.

3. The Department's treatment of Rewards Program revenue is consistent with its treatment of revenue from other similar programs, like coupons.

Arizona treats "points"-type reward/consumer loyalty programs such as the Rewards Program like it treats coupons. Coupons that provide something free or discounted and that are issued and redeemed by the same business are treated as nontaxable price reductions because they act just like cash discounts off the price and therefore are not revenue. However, third-party coupons that result in payment to the business on redemption generate revenues that are taxable. Arizona Administrative Code R15-5-129 states as follows:

> C. When coupons issued by a manufacturer are redeemed by a retailer the amounts refunded to the purchaser are not permissible as deductions from the selling price of articles sold by the retailer. In these cases, the gross selling price is taxable.
>
> D. Coupons issued by a retailer and later redeemed by the retailer as a discount on the price of merchandise sold by him are considered a reduction of the selling price. In such cases the net selling price is subject to tax.

Points programs for which the business gets a consideration from a third party generate taxable revenue because the business receives consideration from a third party when customers redeem their points, like the consideration that retailers receive for coupons under A.A.C. R15-5-129(C). This is so even if some of the

costs of the coupon or points program are passed on to the merchants that participate in it.

While Dove Mountain makes payments to the Rewards Program and thus incurs marketing expenses, it is not offering cash discounts or free stays. Rather, when customers redeem points, Dove Mountain receives a payment. And the points redeemed may have no relation to an earlier transaction with Dove Mountain or to any taxed transaction.

Dove Mountain's position below was that hotels should be taxed only on the amount of program revenue that exceeds their payments into the program. (IR 35 at 7:15-8:3.) This position admits that program revenue is taxable, but seeks to deduct expenses. Under that approach, knowing what percentage of tax to charge on program transactions is impossible since the ratio for a month is not known in advance. While Florida has a regulation taxing only a percentage of proceeds from similar programs based on a prior year's ratios (*see, e.g.*, Fla. Admin. Code 12A-1.0615(3)(b)),[4] the Department lacks authority to create such a structure to generate a nonstatutory ratio of nontaxable proceeds.

[4] "Total Reimbursements Received During the Initial Twelve Months – Total Annual Contributions Paid During the Initial Twelve Months
[÷] Total Reimbursements Received During the Initial Twelve Months
= Percentage to be Applied to Reimbursements Received in the Initial Twelve Months[.] Fla. Admin. Code 12-A-1.0615(3)(d(1).

Taxes are paid monthly, and a taxpayer is not going to know the monthly percentage ratio of payments from and payments into the program until the month is over. Consequently, it will not know what net rate to charge customers. The plan would apparently be to charge the customers TPT at the full rate, but then to remit tax only on part of the revenues from the program once a ratio for the month can be determined. They would therefore be collecting tax from customers that they would not then be remitting. That would violate A.R.S. § 42-5002(A)(1), which provides that a person collecting an amount purporting to be for TPT "shall not remit less than the amount so collected to the department." While the Dissent credited a statement at oral argument as establishing a percentage for lodging-related points (Dissent ¶¶ 30-32), no points "spent" were traceable to underlying transactions. (IR 40, ¶¶ 1, 5.) For any given transaction the "ratio" of lodging or nonlodging points or whether tax was paid is unknown.

The Department's treatment of "points-based" customer loyalty programs is supported by the way that other states treat similar programs. If a hotel is paid by a third party (e.g., the Marriott Rewards, LLC) when points are redeemed, the consideration is taxable. *See* Georgia Letter Ruling: LR SUT-2015-22, https://dor.georgia.gov/lr-sut-2015-22 ("Even though a party other than the purchaser provides the reimbursement, the reimbursement amount is included in the taxable sales price of the accommodation as consideration received from a

third party."). Several other states also treat revenue from similar loyalty programs as taxable. *See, e.g., Choice Hotels Int'l, Inc. v. S.D. Dep't of Revenue & Regul.*, 711 N.W.2d 926, 930 (S.D. 2006) (revenue from rewards program for cost of guest's room is taxable); Policy Statement 2007(5), Connecticut Department of Revenue, https://portal.ct.gov/-/media/DRS/Publications/pubsps/2007/PS075pdf.pdf?la=en (self-issued points are treated like cash discounts; while third-party points such as credit-card points are treated as cash equivalents); Washington Excise Tax Advisory 3191, https://taxpedia.dor.wa.gov/documents/current%20eta/3191.pdf (stating that "[i]f a seller receives third-party consideration for a sale, the seller must include the value of the third-party consideration in the sales price of the sale" and including third-party consideration from rewards program administrators as taxable).

B. The Program Revenue Is Also Subject to City Taxes.

The Rewards Program revenues are also taxable under MCTC §§ 400, 444, and 447 and applicable definitions, as adopted by Marana. Section 400(a)-(a)(1) imposes privilege taxes on gross income. Marana taxes Dove Mountain under MCTC §§ 444 (Hotels) (https://modelcitytaxcode.az.gov/articles/4-444.htm) and 447 (Additional Tax on Hotels) (https://modelcitytaxcode.az.gov/articles/4-447.htm). Under MCTC § 100's definitions of "hotel", "lodging space", and

"transient", renting a room to "any person who either at the person's own expense or at the expense of another" is taxable.

The MCTC tax base is "gross income," which is analogous to the state tax base in breadth and exclusion of deductions for expenses and credits. MCTC § 200(a)-(c). Rewards Program payments to Dove Mountain are within this definition. Neither expenses (i.e., payments to the Rewards Program) nor credits granted are deductible. The MCTC approach to "coupons" or "rebates" is the same as state law. *See* MCTC § 240. Revenue from third parties is therefore part of the tax base.

C. There Is No Double Taxation.

Dove Mountain and the Dissent below contend that double taxation exists because Dove Mountain pays tax on revenue when a Rewards Member pays for a room and earns points and it is then taxed on revenues from the program when points are spent at Dove Mountain. (Petition at 11; Dissent ¶ 49.) This ignores two points: there is no showing that any points redeemed at Dove Mountain were earned there and because points are not traceable, there is no evidence that any tax was paid in obtaining them. Each transaction stands alone, occurs in different tax months and often with different customers, and involves different vendors in points-earning transactions. "[D]ouble taxation occurs [only] when the same property or person is taxed twice for the same purpose for the same taxing period

by the same taxing authority." *US W. Commc'ns, Inc. v. City of Tucson*, 198 Ariz. 515, 524, ¶ 33 (App. 2000) (internal quotation marks omitted). Points-earning and points-spending transactions are separate, usually occur at different merchants, and do not result in Dove Mountain being taxed twice for the same revenue in the same period. Dove Mountain is little different from any business that incurs marketing expenses to generate income in later periods.

Even if a taxable Arizona transaction at some unidentified Arizona business was involved in the points-earning transaction, that does not prove that the tax due on lodging was paid. Points earned on a taxable retail transaction would be taxed at a lower rate because cities tax lodging under two classifications, §§ 444 and 447. And points-earning transactions might not have been taxed at all. So it cannot be said that the transient lodging "tax was already paid" in the earlier points-generating transaction in the Rewards Program. And the clear command of the statutes applies even if there is double taxation. *See, e.g.*, *US W. Commc'ns*, 198 Ariz. at 525, ¶ 35.

Even if a Dove Mountain customer earned points at Dove Mountain and used the points in a later month, there is separate revenue from separate transactions for both periods. It is well-established law that each tax period stands on its own. *Stearns v. Ariz. Dep't of Revenue*, 231 Ariz. 172, 178, ¶ 27 (App. 2012).

CONCLUSION

The petition should be denied.

Respectfully submitted this 14th day of August, 2023.

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