No. S218400

IN THE SUPREME COURT OF CALIFORNIA

In Re Coordinated Proceeding Special Title (Rule 3.550(c))
TRANSIENT OCCUPANCY TAX CASES

CITY OF SAN DIEGO, CALIFORNIA,

Appellant,

v.

HOTELS.COM, L.P., et al.,

Respondents.

SUPREME COURT
FILED

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Appeal from the Los Angeles County Superior Court
Hon. Elihu M. Berle, Judge, Case Number: GIC861117
(Judicial Council Coordination Proceedings No. JCCP4472)

PETITIONER'S REPLY BRIEF ON THE MERITS

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TABLE OF CONTENTS

TABLE OF CONTENTS

PAGE

TABLE OF CONTENTS

PAGE

TABLE OF CONTENTS

TABLE OF AUTHORITIES

PAGE

CASES

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES

PAGE

STATUTES

INTRODUCTION

This case presents a straightforward question and an equally straightforward answer.

The Question: Is the tax base for calculating room tax the amount that a customer is charged and must pay to rent a hotel room—i.e., his room rate? Or is the tax base some lesser amount that the customer knows nothing about, an amount based only on the portion of the customer's room rate that the hotel ultimately receives after the OTCs have taken their cut?

The Answer: The tax base is the room rate charged to and paid by the customer to gain the privilege of occupancy. Nothing less.

This is the only answer consistent with the manifest purpose and plain language of the room-tax ordinance, as well as with common sense. Historically, the rate that the customer must pay to rent a room has been the tax base, regardless of whether the transaction was completed by a hotel or by a third-party sales agent. There is no reason why the introduction of new technology (Internet room bookings) or the use of a different booking model (the "merchant model") should change anything. New technology cannot alter what the law demands.

The OTCs offer no explanation why customers, the only taxpayers, would expect to pay room taxes based on something less than the quoted room rates. Nor do the OTCs explain why a city would ever choose to tax amounts that are less than the room rates that the customers actually pay.

Instead of addressing these common sense issues, the OTCs use semantic games to argue they may calculate taxes based on only the share of the rental proceeds that the hotels have agreed to receive after the OTCs have taken their cut. These games don't work. The ordinance plainly imposes tax on what the taxpaying customer is charged and must pay to obtain a room. How that rent is split between the hotels and third-party sales agents like the OTCs is immaterial under the ordinace.

For years, the OTCs have underpaid millions of dollars in taxes, depriving the City and its residents of funds needed for important public services. It is time for the OTCs to remit what they owe.

ARGUMENT

I. UNDER THE PLAIN TERMS OF THE ORDINANCE, THE TAX BASE IS THE ROOM RATE THAT THE CUSTOMER IS QUOTED, IS CHARGED AND MUST PAY TO RENT A ROOM, *NOT* SOME HIDDEN, LESSER AMOUNT THAT THE HOTEL RETAINS AFTER SPLITTING RENTAL REVENUE WITH THE OTCS.

A. The Plain Terms And Clear Intent Of The Room-Tax Ordinance Are To Levy A Tax On The Room Rate The Customer Is Charged And Must Pay To Get His Room.

When a customer reads on an OTC's website that he must pay a $100 "room rate" to book a room, and the customer's guest receipt recites that he has been charged $100 for his room, then that $100 is the taxable "rent." (Opening Brief ["OB"] 29-46.) Indeed, the room-tax ordinance states that the tax is based on the amount of rent a customer is charged by the operator to obtain the privilege of occupancy, as that amount is shown on a guest receipt. (§§35.0102, 35.0103.) And the ordinance states that the tax must be levied at the time the customer books his room and pays his rent. (§ 35.0112, subd. (a).)[1] Thus, the tax base is the amount the customer is quoted, is charged, and must pay for his room, not some lesser amount.

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[1] The OTCs claim the City "rewr[o]te the definition of Rent by ellipsis" when it quoted the ordinance provisions defining "Rent" as the "*total* consideration charged to a Transient as shown on the guest receipt for the Occupancy of a room . . . without any deduction therefrom." (Answering

The OTCs argue that the City relies on "a supposed implied intent" of the ordinance. (AB21-22.) But there is nothing "implied" about what the ordinance plainly declares.

On its face, the ordinance taxes what the customer is charged and must pay for his room. That's why the opening brief correctly describes the tax base as the amount of rent the taxpaying customer is charged for his room, viewed from his perspective, and as reflected on his guest receipt. (OB29-31.) That's why the opening brief correctly explains that the "taxable moment" occurs at the second step of the merchant-model transaction, when the customer pays the quoted room rate and obtains a right of occupancy—and not at the third step of the transaction, when the hotel and OTC divvy up that rental payment, or even at the first step, when the hotel and OTC enter into an agreement. (OB36-37.) And that's why the opening brief correctly notes that the tax is imposed on what the customer is *charged* for occupancy, not on what the hotel *receives* at the end of the day. (OB38-40.)

It is undisputed that under every other room-rental model (i.e., the agency model), the room rate is the tax base, without regard to what portion of that amount the hotel ultimately keeps after sharing rental proceeds with third-party sales agents. (See OB11-12.) There is no possible justification

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Brief ["AB"] AB23-24.) The City stands by its appropriate use of ellipses to eliminate words that are immaterial to the issues presented.

for treating merchant-model transactions any differently, nor have the OTCs proffered any tenable justification for doing so.

B. The City Seeks To Tax Only The *Room Rate.* The City Does Not Seek To Tax The *Service Fees* That The OTCs Independently Charge Customers On Top Of That Room Rate As A Separate Line Item.

Just to be clear: The City did not assert in its opening brief any entitlement to taxes on the OTCs "service fees," nor does it do so now.

When a customer visits an OTC website to rent a hotel room, he sees two line items: a "room rate" line item and a "taxes and fees" line item. (OB11-12.) As the City explained in its opening brief, the ordinance levies a tax on the former, i.e., the "room rate." (OB30, 31, 36, 37, 43.) The City has not urged that the ordinance entitles it to taxes on the "service fees" that the OTCs separately charge customers who use the OTCs' websites or call centers.[2]

This distinction is important because the OTCs attempt to conflate the two line items. They fault the City for trying to tax "[t]he amount an OTC charges a customer for its services." (AB19; *id.* at pp. 4, 5, 23, 25.) They argue that such service fees are not taxable because they are not

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[2] Below, the City sought taxes based on both the room rate and the service fees. The City argued that, at the very least, the room rate was taxable. In these proceedings before this Court, the City argues only that the room rate charged to and paid by the customer is taxable. The City no longer seeks to impose a tax on the OTCs' service fees.

charged by the operator (the hotel). (E.g., AB 23 ["'[t]he OTC service charges are *not* charged by the Operator'"].)

But saying the City seeks to tax the OTCs' service fees does not make it so, no matter how often the OTCs repeat it. In these proceedings, the City does *not* claim that the OTCs' service fees are taxable. Indeed, the OTCs do not act as the hotel's agents for purposes of collecting the OTCs' service fees. Nor are those fees governed by the rate-parity agreements, pursuant to which the hotels dictate the room rates quoted to customers.

But the opposite is true for the room rate. While the hotels do not "charge" the service fees, there is no question that the hotels do "charge" the room rate. The law of agency compels this conclusion, as do the rate-parity agreements between the hotels and OTCs, as we now explain.

C. The Hotels "Charge" The "Room Rate" Quoted On The OTCs' Websites And That The Customer Must Pay To Obtain A Privilege Of Occupancy.

1. Because the OTCs act as the hotels' agents for purposes of charging the room rate, it is the hotels themselves who are charging the room rate—thus establishing that the tax base is the room rate, not just some portion of it.

The first reason why it is *the hotels* that are charging the room rate quoted to customers on OTC websites is that the OTCs act as the hotels' agents for purposes of charging and collecting rent, and under longestablished agency law, the acts of an agent are legally equivalent to the acts of the principal. (OB33-35.)

The OTCs concede that the acts of an agent in the scope of his agency are tantamount to and must be treated as the acts of the principal. (See AB30, citing *Columbia Pictures Corp. v. DeToth* (1948) 87 Cal.App.2d 620; see also *Atkinson v. Foote* (1919) 44 Cal.App. 149, 165 [same]; see also OB34-35.)

This rule governs the result here. Both the hearing officer's factual findings and the law governing the creation of agency relationships, independently compel that when the OTCs charge customers for rooms, it is the same thing as the hotels charging those amounts for rooms.

a. The hearing officer's undisputed factual finding that the OTCs act as the hotels' agents for purposes of charging customers the "room price," dictates that the room rate that the OTCs collect is taxable "rent."

The hearing officer made an unchallenged factual finding that the OTCs act as the hotels' agents for purposes of "assuming essentially (or absolutely) all of the marketing, reservation, room price collection, tax collection, and customer service functions as to those Transients who book online through the OTCs. . . . All dealings are with and through the OTCs as the authorized agents of the hotels." (1JA207; OB24-25 & fn. 17.)

Since the OTCs concede this finding is binding (AB4-5) and that the OTCs are the hotels' "agent[s] for the limited purpose of collecting the amount charged by the hotel for providing Occupancy of a room, plus the tax the hotel will owe on that amount" (AB30), this should end the inquiry. As agents for the hotels in charging room rates, the OTCs' acts are equivalent to the hotels' own acts. In the ordinance's terms, that room rate is the "Rent" the "Operator" (the hotel) charges "for the Occupancy of a room." (See §§35.0102-35.0108.)[3]

b. Even if there wasn't an undisputed agency finding in this case, the OTCs would still be the hotels' agents as a matter of law for purposes of charging rent.

In addition, governing law establishes that when someone collects funds for someone else, he becomes an agent, such that his act of collecting funds is tantamount to the principal's own act. (See *Scholastic Book Clubs, Inc. v. State Bd. of Equalization* (1989) 207 Cal.App.3d 734, 739-740 [involving use tax which, like hotel bed tax, is legally incident on buyers but collected by vendors or their agents]; OB34-35.) Thus, even if there

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[3] In a bizarre argument accompanied by a Request for Judicial Notice, the OTCs claim the City should be bound by an argument made by its counsel while representing a different client in a different proceeding involving the application of the laws of Hawaii. (AB27.) The City is not a party to the Hawaii proceeding, its ordinance was not subject to interpretation in that proceeding, and its lawyers speak for the City only in *this* proceeding. Regardless, there is no inconsistency between the Hawaii statement that the hotels have delegated room-charging responsibilities to the OTCs and the City's position here that the OTCs are the hotels' agents and, thus, that the OTCs' actions within the scope of that agency are tantamount to the hotels' acts. (See RJN, Ex. 1, pp. 5-6.)

were not an undisputed finding that the OTCs act as the hotels' agents for purposes of collecting the room price, the OTCs would be the hotels' agents for that purpose as a matter of law.

The OTCs' response to *Scholastic* is that the court there "answered only whether 'use of California's teachers and school librarians to solicit sales from California students constitutes a sufficient nexus for the imposition of . . . use taxes.'" (AB32.) This is immaterial. *Scholastic*'s holding depended on the court's determination that an agency relationship had been been formed between teachers and Scholastic. (See *Scholastic, supra*, 207 Cal.App.3d at p. 738.)

Because the OTCs charge and collect the room rate for the hotels, the OTCs are the hotels' agents as a matter of law. The OTCs' acts are treated as the hotels' own acts. Since the hotels, through their agents, "charge" the room rate, that room rate constitutes taxable "rent."

2. Under the rate-parity agreements between the hotels and the OTCs, the hotels set the floor "room rate" that the OTCs must quote and charge to customers—such that the hotels are the ones doing the "charging" of that room rate.

Separate and independent from the agency relationship between the hotels and OTCs, there is another reason why it is the hotels that charge and collect the room rate from customers: Under the rate-parity agreements, the hotels mandate the minimum room rate that the OTCs may quote, charge and collect from customers. (See OB13-15, 31-33.)

a. The OTCs concede the rate-parity agreements require them to quote room rates that do not undercut the hotels' own customer-direct room rates.

The OTCs concede that the rate-parity provisions are designed "to ensure that the 'room rate' shown to customers by the OTC is not less than the rate offered to customers by the hotel on its own website, because the hotel and OTCs are competitors for customers seeking reservations." (AB26-27.) These OTC concessions establish that the OTCs do not have the freedom to charge whatever they want. Rather, the hotels constrain that freedom by dictating the minimum room rate that must be charged before the hotels will confer occupancy.

Not only does the OTCs' Answer concede this, so too, do the OTCs' and hotels' executives; and courts from other jurisdictions confirm the concession is accurate.

OTC Executives: The OTCs' executives testified that the rate-parity agreements preclude the OTCs from ever charging less than what the hotels charge customers directly. (E.g., 26AR3427-3428 [rate-parity agreements mean "you cannot sell a room at the sell rate for less than the hotel"]; see also OB8-9, 13-16, citing additional testimony.)

Hotel Executives: The hotels' executives testified that the rate-parity agreements ensure that customers see "the same sell rate, no matter what channel they actually go, whether through a travel agent, through [an OTC], or on [the hotel's own] branded website direct."

(E.g., 51AR8144-8148 [rate-parity contracts mean customers "get the same price available for all of those, so that it's more of a level playing field in the channel"]; see also OB8-9, 13-16, citing additional testimony.)

The Courts: Courts across the country have held that rate-parity agreements are ubiquitous and have the uniform effect of requiring the OTCs to charge a room rate equal to what the hotel charges customers directly. (E.g., *Expedia, Inc. v. City of Columbus* (Ga. 2009) 681 S.E.2d 122, 124, fn. 1 ["In most of its contracts with hotels, however, there is 'rate parity' language which prohibits Expedia from charging a room rate that is less than the rate the hotel would charge the consumer directly for occupancy of the room"]; see also OB8-9, 13-16, citing additional courts.)

The OTCs note the rate-parity agreements "do not address how much an OTC can charge a customer for its services." (AB26.) So what? The City does not suggest that the rate-parity agreements affect the service fees that the OTCs charge as a part of the "taxes/fees" amount. The City's position is simply that the rate-parity agreements dictate the floor *room rate* that the OTC can quote to customers and that, for this reason, it is the hotels that are doing the "charging" of the floor room rate that the customer must pay. Under the ordinance, this room rate, charged by the hotel and paid by the customer, necessarily establishes the tax base.

b. The OTCs' assertions regarding the number of contracts containing rate-parity provisions are unsupported and wrong.

As shown, rate-parity agreements are the norm in the industry. The record in the present case bears this out: Fifty-nine of the 63 standard merchant-model contracts, each cited in this proceeding, include rate-parity provisions dictating the minimum room rate that the OTCs must charge customers. (OB13-16.)[4] The wording of the provisions varies from contract to contract, but all dictate in substance that an OTC cannot sell a room for rent that is less than the hotel's own customer-facing rate. (*Ibid.*)

As the opening brief showed, rate-parity agreements uniformly require OTCs to charge customers at least as much as the hotels charge customers directly via their own websites. These agreements establish that it is the hotels who control the minimum room rate quoted to customers, such that the hotels are the ones "charging" the minimum room rate. It is this hotel-mandated rate on which taxes must be calculated.

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[4] While OTCs concede that 38 (i.e., 60%) of the contracts include rate-parity provisions, they assert that the other contracts do not. (AB26 & fn. 10.) The OTCs provide no record citations to support their assertions or their calculations, and thus, they should be disregarded. (See *SCC Acquisitions, Inc. v. Central Pacific Bank* (2012) 207 Cal.App.4th 859, 863 [reviewing court will not consider factual allegations "unsupported by reference to the record"].)

c. Because the rate-parity provisions are not relevant to opaque transactions, the City did not reference those transactions when discussing rate-parity agreements in its opening brief.

The OTCs fault the City for not including so-called opaque-model transactions as part of the number of contracts the City asserted contained rate-parity provisions. (AB26.) The opaque-model transactions were not included because they are irrelevant to transactions covered by the rate-parity agreements. This is so because in opaque-model transactions, the OTCs do not quote a room rate. Instead, the OTCs allow the customer to specify the room rate he is prepared to pay and, after he does this, the OTC finds a hotel willing to allow a room to be rented at the rate specified by the customer. (See 1JA61, 207.) When this model is used, customers do not know in advance the identity of the hotel where the booking will be made. (1JA207.)

Given the nature of opaque transactions, there is no danger that an OTC will compete with hotels by quoting a room rate that undercuts the hotel's publicly available rate—i.e., the concern that drives the rate-parity provisions in standard merchant-model contracts. Simply put, opaque transactions don't fit what rate-parity provisions are designed to address.

Nonetheless, the room rates that customers pay in opaque transactions are still taxable, since agency law establishes that it is the hotels, acting through their OTC agents, who are "charging" that rent.

Indeed, this is so in opaque transactions, just as it is so in standard merchant-model transactions.

3. None of the OTCs' other arguments undercut the conclusive effect of either the OTCs' agency relationship with the hotels, or the rate-parity agreements.

a. The OTCs' attempts to dissect and rename the room rate in their contracts with the hotels do not govern the extent to which the room rate is taxable.

The OTCs point to their secondary payment arrangements with the hotels (which divvy up and rename portions of the rental payment), and argue that these arrangments establish the tax base as the lower amount that the hotel retains after the OTCs have taken their cut.

But *the ordinance* dictates the tax that must be paid. The parties cannot *by private agreement* alter what the ordinance compels. As this Court has held, "for tax purposes the economic reality of a transaction, not the form the parties employ, is dispositive." (*General Motors Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 773, 785.)

Here, there is only one "economic reality": The customer must pay the full amount of the "room rate" quoted on the OTCs' website to book a room. That is the sole reality that dictates the tax base.

The OTCs make much of the fact that in their private agreements with the hotels, they divide the "room rate" into two separate components:

(1) the amount the hotel retains on the room-rental transaction, which the hotel-OTC agreements name the "wholesale" price; and (2) the difference between that "wholesale" price and the room rate paid by the customer, which the hotel-OTC contracts name the "margin" or "markup." (AB14 ["The 'Room Rate,' is the Rent the hotel is charging for providing Occupancy of a room to the Transient (the 'wholesale' price), plus an amount the OTC sets and charges as compensation for its services (the 'margin,' together with the Room Rate, the 'retail' price)"].) The OTCs contend that only the amount they and the hotels have denominated, the "wholesale" price, constitutes "Rent charged by the Operator"—i.e. taxable rent. (AB23, fn. 8.)

But the terms "wholesale" and "retail" are not used in the room-tax ordinance. And it is *the ordinance* that governs, not the terms manufactured by the hotels and OTCs in their private agreements. The ordinance is as unconcerned with how the hotels and OTCs divvy up the room rate that the customer pays for occupancy, as it is with what the hotel pays its staff. The ordinance does not care what portion of the room rate the hotel pays to third-party sales agents like the OTCs as a commission for successfully renting a room that would otherwise sit empty. Rather, the sole concern of the ordinance is the amount *the customer* is charged for occupancy. (See OB29-40.)

There is no "wholesale" price from the customer's perspective. Because a customer cannot obtain a room for that price, it does not matter for tax purposes. It is just a fiction created by the OTCs to try to justify their underpayment of room taxes. That fiction cannot trump what the ordinance compels.

That the OTCs and hotels have, between themselves, dissected the room rate into "wholesale" and "retail" components and have dubbed the difference "markup," has no effect on the tax treatment of the transaction. The "economic reality of the transaction" from the taxpaying customer's perspective governs—a reality under which the only room rate is the amount the customer pays to book a room.

b. The hearing officer's factual findings do not support the OTCs' contention that the scope of the OTCs' agency was limited to collecting a mere portion of the room rate.

The OTCs argue that under the hearing officer's findings, "the scope of any purported OTC agency is limited to 'charging and collecting' the hotel's 'wholesale' price and tax on that amount." (AB31 ["Only those amounts are collected on the hotel's behalf, and therefore can be attributed to the hotel"].) This is wrong.

The hearing officer found that the OTCs act as agents for the hotels in handling "all of the marketing, reservation, room price collection, tax collection, and customer service functions as to those Transients who book online through the OTCs." (1JA207.) Thus, the scope of the OTCs' agency includes "room price collection" and "tax collection," without any limitation whatsoever. The notion that the OTCs' agency is limited to collecting only the so-called "wholesale" amount is a fabrication.

Nor is it true, as the OTCs suggest, that the hearing officer found that the only "rent" the OTCs collect for the hotels is the so-called "wholesale" rate. The hearing officer declared that the "'wholesale' price" is the amount "charged to the OTCs" for the rooms. (1JA199.) Because OTCs do not rent rooms, this "'wholesale' price" does not fall under the ordinance's definition of "rent"—i.e., the amount charged "to a Transient" for the right of occupancy. (See § 35.0102.) Thus, whatever amounts the OTCs are "charged" are irrelevant to the tax base.

c. The rules governing construction of tax ordinances do not help the OTCs here.

The OTCs invoke the principle that if there's ambiguity in a tax law, the law must be construed "'most strongly against the government, and in favor of the citizen.'" (AB39.) The argument fails.

First, there is no ambiguity in the room-tax ordinance. The ordinance plainly levies a tax on the amount that the customer is told he must pay to rent his room. (See § I.A., *ante*.) Because there is no ambiguity, there is no need to resort to rules of statutory interpretation. (*Lungren v. Deukmejian* (1988) 45 Cal.3d 727, 735.)

Second, even if the ordinance were ambiguous, the OTCs cannot invoke the "favorable to the taxpayer" rule of construction because the OTCs are not making arguments on behalf of taxpayers. Taxpayers could never argue—as the OTCs argue here—that the tax base is the "wholesale" price, since that argument is based on facts that the hotels and OTCs have