



JONES LANG
LASALLE HOTELS®

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UK REAL ESTATE INVESTMENT TRUSTS:

ISSUES IN RELATION TO HOTELS

A RESPONSE IN RELATION TO HOTELS TO THE
GOVERNMENT'S DISCUSSION PAPER

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1. Executive Summary

Following consultation, this paper represents the views of a cross section within the hotel industry.

- Hotels tend to suffer higher levels of wear and tear than many other buildings. The continued quality of the real estate is central to the success in this sector and it is not thought that retention of 5% of earnings would be sufficient to maintain hotel stock at the required level of quality.
- It is suggested that either the requirement to distribute is fixed at 90% rather than 95%, or alternatively, that the 95% distribution requirement is kept but that “appropriate deductions” would include an allowance sufficient to ensure the proper maintenance of the hotel and its fixtures, fittings and equipment.
- In general it is thought that a hotels UK REIT would be able to operate within the 75% gross assets and gross income tests proposed in the discussion paper. However, it is thought desirable that there should be some flexibility in the rules. In particular instead of an annual application of the gross assets test it is suggested that it should be applied on a rolling 3 or 5-year average so as to avoid the need for the REIT to make adverse investment decisions.
- It is also suggested that there should be specific rules that provide for what is to happen if the tests are breached. Where this is the case it is suggested that there should be a “safety net” so that within defined parameters, REIT status is not lost entirely.
- It is not thought that the requirement for the REIT to hold more than one property is necessary.
- It is thought important that the REIT legislation permits REIT status to be obtained for more than one property company within a group.
- It is not thought necessary for limits to be placed on the level of borrowing within the REIT.
- In relation to the conversion charge it is only asked that the Government takes into account the way in which hotels tend to have been acquired, namely through the acquisition of special purpose companies rather than through the acquisition of real estate, when deciding the fairest way of basing the charge.



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2. Whose views does this paper represent?

- 2.1 This paper has been written to reflect the views of owners, investors, operators and professionals within the hotel industry whom CMS Cameron McKenna LLP, Jones Lang LaSalle Hotels and Hotel Analyst have consulted.

That consultation involved detailed discussions amongst a representative consultation group taken from across the industry.

- 2.2 This paper is a distillation of the views expressed through the consultation process. It does not, and is not intended to, represent the detailed views of everyone consulted.

- 2.3 The names of those who formed the consultation group and have indicated their broad support for the proposals contained in this paper are listed in appendix 1. Other consultees in the industry who specifically wish to confirm broad support for the paper are listed in appendix 2.

- 2.4 This paper is written purely from the point of view of hotels as an asset class, though much of the content of this paper would be relevant to other leisure assets. As a result of the particular focus of the paper, it deliberately does not address all the questions posed by the discussion paper, which are better addressed by other bodies representing a wider range of real estate investors.

- 2.5 On 16th July 2004, CMS Cameron McKenna LLP, Jones Lang LaSalle Hotels and Hotel Analyst submitted a detailed response to the Government's original consultation paper on Property Investment Funds dated March 2004. A number of the people consulted in the preparation of the earlier paper were also consulted for the purposes of the preparation of this paper.

3. General

- 3.1 The consultation group has taken note of the Treasury's hope that there will be fewer and shorter responses to the March 2005 discussion paper than there were in response to the March 2004 consultation document. To this end, we do not propose to comment on issues that do not specifically affect the hotel sector or issues that are covered by the joint response of the BPF, IPF and RICS (a draft of which we have seen). In particular, we broadly support the representations made by the BPF, IPF and RICS in relation to the taxation of non-resident investors in non-UK and UK REITs as well as the representations on the requirement that where capital gains are distributed they should be distributed as income. Therefore, we only provide specific comments on the following issues:

- ▀ the requirement to distribute 95% of income



- the 75% gross assets/income tests
- the level of permitted borrowing, and
- the conversion charge.

3.2 The consultation group recognises the considerable amount of work that the Government has carried out in taking forward the proposal to introduce the REIT into the UK and are appreciative of the apparent willingness of the Government to put in place a legislative framework that is not overly prescriptive and which will help ensure the success of the REIT. We particularly welcome the Government's acceptance that specific sectors (such as hotels and leisure) should not be excluded from access to the UK REIT (subject to meeting the detailed tests).

3.3 Whilst the consultation group does not wish to comment (in detail) on the Government's concern about the taxation of non-resident investors, it hopes that this issue does not unduly delay the introduction of the enabling legislation. Given the progress made to date, there is a growing expectation that the UK REIT will be introduced and that this will happen next year. There is belief that the availability of the UK REIT will help achieve the Government's aims set out in the original consultation document.

4. The requirement to distribute 95% of income

4.1 The Government's paper proposes that a UK REIT would be required to distribute at least 95% of its net ring-fenced income to investors, calculated by reference to "Schedule A profits" (and its equivalent for overseas properties) after appropriate deductions and capital allowances.

4.2 We would refer you to Appendix 5 of our response to the March 2004 consultation document, which provides an analysis of the UK tourism and hotel industry. We would emphasize the importance of the contribution to the economy made by the UK tourism and hotel industry. There is considerable scope for investment in hotel real estate to grow with consequent significant levels of additional employment and increased tax takes. Thus the consultation group is concerned to ensure that the hotels sector is not disadvantaged (as against other sectors) by the operation of the requirement to distribute 95% of income.

4.3 Given the use to which hotels are put, it is perhaps not surprising that hotel buildings tend to suffer higher levels of wear and tear than many other buildings. Also there is a constant need to maintain star ratings and brand standards and to ensure that the fabric and contents of hotels continue to meet market and sector requirements. The appearance and standard of fit out of hotels is very important in attracting custom and this means obsolescent items must be replaced promptly.



The result is the need for high levels of repair and maintenance and the regular replacement of fittings, furnishings and equipment (FF&E). As a result hotel owners have planned ongoing repairs and maintenance and capital expenditure programmes. The continued quality of the real estate is central to the success of this sector.

- 4.4 The consultation group believes that a requirement to distribute 95% of income is too high and will mean that the retained earnings of the UK REIT will be insufficient to maintain the hotel real estate assets. This is certainly the experience of hotel REITs in the USA where there is a 90% requirement to distribute which for certain types of hotel does not provide a sufficient retention. It is accepted that improvements where the return on investment can be measured, for example, adding an additional floor to a hotel, should be funded by an injection of capital (either equity or loan) but would suggest that capital expenditure on the maintenance of the hotel standard should also be capable of being funded from retained earnings. It is acknowledged that the base figure postulated in the discussion paper, of which 95% must be distributed, is after the deduction of capital allowances and “appropriate deductions” and that “appropriate deductions” is not yet defined. It is assumed that this would be after interest at the very least. However, it is the experience of the consultation group that even the 90% distribution requirement that applies in the US is insufficient to allow retained earnings to finance expenditure on the levels of capital maintenance of the asset typical for the hotel sector.
- 4.5 In broad terms, in the case of hotels, repairs and reserves to cover depreciation and replacement of FF&E and capital items consumed in the operation of the hotels will almost invariably exceed the depreciation charge and a retention of 5% of earnings is unlikely to be sufficient adequately to fund this gap particularly when calculated after interest and capital allowances. In the view of those consulted, this would severely limit the extent to which the UK REIT will be used in the hotel sector.
- 4.6 The consultation group would therefore suggest either a requirement to distribute at least 90% after appropriate deductions and capital allowances or, alternatively, that 95% is distributed but with “an appropriate deduction” that would include an allowance sufficient to ensure the proper maintenance of the hotel and its FF&E. Although the Government may prefer to have a “one size fits all” regime it is believed that there is merit in adopting industry specific deductions where these can be justified. The consultation group further believes that a suitable definition of “appropriate deduction” can be provided to allow scope for sectoral standards or special concessions to be agreed with sector representatives and applied appropriately to relevant building classes. As we say, we do believe this is



necessary to allow hotels to compete equally with the other real estate sectors and grow so as to produce the sector expansion desirable to all.

- 4.7 In the time available, it has not been possible to carry out a detailed analysis of how this proposal would affect a cross-section of the hotel industry, complicated not least by the taxable profit benchmark rather than accounting profit. However, this issue is regarded as fundamental to the likely success of the REIT in the hotel sector and we would propose that the British Hospitality Association co-ordinate a more in depth analysis and meet with you as we believe this would be helpful for all concerned.
- 4.8 The consultation group would stress that, in its view and based on the US experience, REITs will not generally be used as a high leveraged, high risk, tax advantaged bodies such that profit/cash retention in a tax free environment is a key aim of the managers. Rather they will be viewed as a lower risk high distribution alternative to debt or bond investments. It would be wrong to assume therefore that any reduction in the level of distribution required is designed to and will be abused so as to allow stockpiling of cash. Our point is that in the hotel sector continued significant expenditure on the building stock is essential.
- 5. The 75% gross assets and gross income tests**
- 5.1 The Government's paper proposes that at least 75% of the UK REIT's total gross income must derive from and at least 75% of the UK REIT's gross value of assets must relate to, the ring-fenced business.
- 5.2 In general, it is believed that a hotels UK REIT would be able to operate within these parameters.
- 5.3 The consultation group would, however, like to see an element of flexibility in the detailed rules. In particular, in relation to the 75% gross assets test, it is suggested that it should not be an annual test but should instead be a rolling 3 or 5-year average that has to be satisfied. Real estate, by its nature, is an illiquid asset whose market operates cyclically and commercially it makes sense to leave a gap between the disposal of a hotel (perhaps at the top of the market) and the acquisition of a replacement hotel (perhaps, when the market has cooled). So one could envisage a situation where a downward fluctuation of real estate values resulted in the 75% gross assets test being breached. Management might expect values to return in 2 or 3 years and might not wish to be forced to sell assets in a difficult market merely to satisfy an arbitrary figure. Also, unnecessary additional costs would be incurred if annual valuation were required.
- 5.4 The consultation group would also like to see the rules provide for what is to happen if the tests are not met. It is suggested that a "safety net" might be



introduced under which if, say, ring-fenced income or assets fell under 75% but, say, were still over 65% then REIT status would not be lost entirely. Instead the “penalty” could be to tax the income (or capital gain) by reference to the percentage by which the test was failed. For example, if ring-fenced income dropped to 70%, 5% of ring-fenced income would become taxable. If the level of ring-fenced income or assets fell below the safety net threshold then REIT status would be lost and the REIT would become taxable in the same way as an ordinary company.

- 5.5 It would not be helpful for an unwise or ill-timed business decision to be made simply to ensure that the tests are met. This will be of even more importance if property derivatives are not to be permitted or are not to be treated as ring-fenced. Further, US and other experience indicate that an enforced sale so as to comply with investment (or borrowing) limits is likely to prejudice the stability and value of the REIT. Indeed at its extreme, forced sales of property in whatever sector can trigger a spiral of declining values that merely exacerbate the risk/prejudice to investors. Thus we consider the suggestions above are of importance to the real estate market generally as well as to the hotel sector with which we are primarily concerned here.
- 5.6 The consultation group are unclear as to why it should be necessary for a company to hold more than one property to obtain REIT status. It believes that this is something that should be left to the market. As long as the investment profile of the REIT is clear to potential investors we see no objection to a single asset REIT. In any event, it does not follow that a single property REIT is any more of a risk to an investor than a multi-property REIT; indeed a single flagship hotel REIT could be regarded as a more secure investment than a multi-hotel REIT where the stock of hotels comprised, perhaps, a chain of unfashionable hotels in questionable geographical locations.
- 5.7 Similarly, the consultation group could see no need for the REIT legislation to prescribe that no single property should exceed a specified percentage of the gross value of the real estate held. This would be very restrictive particularly to portfolio investments where one or two assets might represent a very significant part of the value of the portfolio.
- 5.8 Hotel assets are typically held in ring-fenced SPVs as indeed are many other real estate investments. This may be because of banking requirements, non-contamination by poor performance in one hotel or simply sector norms. It is thus important that the REIT legislation allows the REIT status to be obtained for more than one property company in a group and, we would suggest, that REITs should be able to sit within group structures subject to proper protections to the investor and government.



5.9 Some members of the consultation group raised a question in relation to subsidiaries carrying on non-ring fenced activities. In the context of hotels it would be permissible for the REIT to own a subsidiary that operates the business (subject to meeting the 75% tests). The hotel sector includes both owner operators who, in general, would be able to operate within the model referred to in paragraph 4.2 above and brand operators that essentially own the hotel brand and manage the business but do not own hotel real estate. Clearly, transfer pricing rules will have to be applied or strengthened in such a way as to prevent an unfair advantage being obtained by those operating through REITs so that there is a level playing field for those who operate hotels outside a REIT structure.

6. Borrowing levels

- 6.1 The consultation group notes that the Government is in favour of allowing the market to operate flexibly but that it has concerns that the level of borrowing within a UK REIT could have a direct impact on the overall tax position. The discussion paper is concerned that higher levels of borrowing within UK REITs would reduce the amount of income distributed to investors and therefore ultimately the overall level of tax receipts. Further, there is concern that artificially increased borrowing could allow companies to channel interest and property income payments separately to different types of investor in order to achieve the most tax efficient position. Accordingly, the Government wishes to consider what mechanisms would be needed to ensure that tax continues to be collected at the investor level.
- 6.2 Fundamentally, the consultation group questions the need for specific measures to restrict the level of borrowing undertaken by the REIT. It is noted that the Government's concern is with a potential loss of tax take but we can see no potential tax leakage to the Government as the recipient of the interest would be subject to tax on that interest under the normal rules. Indeed, assuming a large number of exempt investors, higher interest returns may increase the tax take. If the Government's concern is that lending arrangements are put in place in circumstances where one of the main benefits of the lending is to secure a tax advantage then we would suggest that this would be better dealt with by targeted anti-avoidance legislation. It does not seem sensible for the commercially motivated majority of REIT users to be disadvantaged by the few who may be looking to secure tax advantage.
- 6.3 So far as listed REITs are concerned, experience in other countries such as the US has shown that the market is perfectly capable of determining the most appropriate level of borrowing. The most successful US REITs tend to borrow at 50 to 55% of gross asset value. More highly geared REITs tend to reflect the gearing through their share price. However, businesses need to be able to adapt



to changes in circumstances such as an economic downturn. For example, it would not make sense for a REIT to be required to sell a property at the bottom of the market simply to repay indebtedness and reduce the borrowing ratios. Existence of borrowing restrictions could turn a good investment into a bad investment. Please also see paragraph 5.5 above in this respect.

7. The conversion charge

- 7.1 The March 2004 consultation document made it clear that the Government intends to apply a charge on those companies seeking to convert into UK REIT status. It identified two possibilities: either there would be a charge based on the value of the unrealised capital gains liability ("an exit charge") or a one-off charge based on the value of the property assets transferred into a UK REIT ("an entry charge"). It noted that the conversion charge was designed to ensure that there would be no overall cost to the Exchequer in introducing the UK REIT. The March 2005 discussion paper did not put forward any proposal for the basis upon which the charge should be set.
- 7.2 This is not a hotels specific issue and therefore no substantial comment is offered. However, the consultation group believes that it is in everybody's interest for the REIT to succeed and that for this to happen it is important that there should be a buoyant market in REITs. It is not thought that this will happen simply from the establishment of start-up REITs but can only happen if there is a reasonable level of conversion. So far as the hotel sector is concerned, it is not thought that there would be a significant number of conversions if the conversion charge were set too high. On the other hand, the French model shows how successful the REIT launch can be if the representations of industry are taken on board. The consultation group would question the need of the Government to use the conversion charge as a sort of balancer as has been suggested. We believe that a well debated and negotiated regime will be successful and will in no way reduce the overall tax take of the Government. On the other hand, an excessive conversion charge will stifle activity, will not produce the initial tax take expected and risks a repeat of the failing of the Housing Investment Trust. It is felt that it would be better for the Government to keep the performance of and tax take from REITs under review such that if any abuses or imbalances arise they can be dealt with by targeted legislation
- 7.3 We would make one specific point in relation to hotels. Generally, for a number of years, hotels have been acquired through the acquisition of special purpose companies rather than through the acquisition of real estate. This no doubt reflects in part the tendency for hotel transactions to be portfolio based. Therefore the capital gains base cost of hotels tends to be relatively low. Further, many corporate disposals will nowadays attract the substantial shareholders



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exemption from capital gains thereby enabling the seller to dispose of the hotel company free of capital gains tax. If the proposal were to be the adoption of an exit charge along the lines of the French SIIC model, there is every likelihood that the UK REIT would not become a favoured vehicle within the hotel industry save for start up ventures.



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Appendix 1

Consultation Group

The names of those who formed the consultation group and support this paper:

Name	Title	Company
Bob Cotton	Chief Executive	British Hospitality Association
Charles Romney	Partner	CMS Cameron McKenna LLP
Mark Nichols	Partner	CMS Cameron McKenna LLP
Bill Waite	Managing Director	Consumer Growth CIBC World Markets plc
Andrew Sangster	Editor	Hotel Analyst
Mike Goodson	Senior Vice President, Capital & Asset Management	InterContinental Hotels
Rob Seabrook	Executive Vice President, investment team	Jones Lang LaSalle Hotels
Ian Chappell	Senior Vice President, UK investment team	Jones Lang LaSalle Hotels
Christine Witter	Consultant	Jones Lang LaSalle Hotels
Chris Eddis	Managing Director	Mornington Capital



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Appendix 2

Other supporters of the response paper

List of others (not named in Appendix 1) supporting this paper

Name	Title	Company
Tim Walton	Vice President, Development	Le Méridien Hotels & Resorts
Marty Kandrac	Vice President	The Blackstone Group
Gabriel Peterson	Director of Corporate Planning	Westmont Hospitality Group