

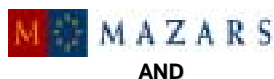


TAX RELIEFS ON HOTEL DEVELOPMENTS

SUBMISSION TO THE DEPARTMENT OF FINANCE

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PREPARED WITH THE ASSISTANCE OF



AND

**Anthony Foley
Dublin City University Business School**

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1. Introduction

The Irish Hotels Federation (IHF) welcomes the opportunity of submitting its views to the Minister for Finance in respect of its review of a range of capital allowances schemes. The IHF agrees that it is appropriate and timely to review these schemes. We recognise that schemes such as these can narrow the tax base, thereby raising the average tax rate and can result in adverse equity consequences. However, it must also be realised that measures such as capital allowances promote desirable investment, encourage risk-taking and generate increased economic activity which in turn increases general tax revenue.

Investment incentives can deal with market failure and promoter investment with desirable social returns. The introduction and retention, over many years, of hotel capital allowances is recognition that it is economically efficient and strategically sensible to promote development in this sector at levels greater than market forces themselves would generate.

- ***The case for Accelerated Capital Allowances for Investors***

This submission argues that there is a strong case for continuing with hotel capital allowances in a modified, focussed and targeted way to enhance the ongoing viability and development of the hotel stock. This modified form of the allowances scheme is itself due to the success of the current scheme in increasing the quantity of hotel rooms in the economy. Specifically the IHF argues for the retention of accelerated capital allowances for:

- Investment to raise the size of the small hotels
- Investment by existing hotels in major additional facilities such as conference centres, leisure facilities and health facilities
- Investment in major upgrading and refurbishment

This approach is consistent with the three fundamental guiding principles of the “New Horizons for Irish Tourism” report of 2003 (Tourism Policy Review Group), namely:

- Tourism growth is driven by private sector enterprise, innovation and investment

- The need for a consistent framework of well chosen actions across all areas of Government activity
- Targeted public sector interventions to be confined to market failure in close partnership with the industry

Our proposals acknowledge that private investment will be the key driver of development. This private investment should be promoted and supported by Government. The proposed measures are part of a consistent tourism development strategy. The proposals are specifically targeted in areas where market forces will be inappropriate to generate the necessary result.

The IHF does not accept the view that fiscal measures should be neutral between sectors. The tourism sector is an internationally competing sector which faces higher risk and greater competition than sheltered or non-internationally competing sectors. This principle is reflected in the existence of a range of policy instruments and initiatives to support manufacturing and international services as opposed to local services.

- ***Competition in the Tourism Sector***

The tourism sector is exposed to substantial levels of international competition. Domestic and foreign tourists have an array of competing locations from which to choose. Tourism has a particular challenge in that it is marketing services that are delivered in Ireland to customers and potential customers that, in many cases, are based in other countries. There is continuous growth in the degree of competition and in the range of locations. Investment in tourism and hotel facilities is a riskier and less certain activity than investment in many other sectors of the economy.

Capital allowances increase the volume of investment funds, generate a higher return on investment and contribute to investment in the sector.

The enhancement and development of tourism is strategically important to Ireland. It is essential that the internationally competing sectors should develop and thrive to sustain the longer-term level of economic activity.

Overall, the IHF bases its recommendations on

- a) the national strategic importance of the internationally competing tourism sector
- b) the ambitious growth targets set by the Tourism Policy Review Group
- c) the role of the hotel sector in both a) and b) above
- d) the need to enhance the viability of small hotels and the need to improve the quality of the hotel stock
- e) the growing intensity of competition in the international tourism market and a deteriorating domestic business environment, and
- f) the particular features of the Irish hotel sector.

The IHF is acutely conscious of the possible displacement and deadweight consequences of any form of incentive. Clearly, if the required investment would have arisen anyway, in the absence of the incentive, there would be no economic or exchequer rationale in having the incentive. It would simply be a windfall gain for the investors. Equally there is no economic gain if the incentives displace investment from other desirable sectors which do not have incentives. However, the analysis shown later also shows that the investments generally show taxation benefits that more than outweigh the cost to the exchequer of allowing the tax benefits in the first place.

The original introduction and ongoing retention of the hotel capital allowances reflected the view that socially desirable levels of tourism investment would not arise because of its risk/return situation relative to other types of investment. The IHF argues that this will continue to be an issue in the future in the three recommended areas. The displacement effect will not be significant in terms of reducing investment in other strategically important internationally competing sectors. There is little evidence of a shortage of financing for good quality manufacturing and international services projects. The problem seems to be a shortage of sound projects rather than a capital shortage. The concern would be that a reduction in the attractiveness of investing in hotels would result in a flow of funds externally or into the non-internationally competing sector of the economy.

The IHF argues that there is a strong case for continuing to support hotel investment in the three specified areas. The remainder of this submission outlines the role of the tourism and hotel sectors, identifies the challenges facing the sector, identifies the structure of the hotel sector, examines the role of the capital allowances and deals with the exchequer return.

2. Summary and Key Points

This submission puts forward the argument that there is a strong case for continuing with hotel capital allowances in a modified, focussed and targeted way to enhance the development of the hotel stock and tourism product in Ireland. Specifically the Irish Hotels Federation recommends the retention of accelerated capital allowances for

- Investment to increase the size of small hotels to more viable sizes to strengthen the overall performance of the sector
- Investment by existing hotels in additional facilities such as conference centres, leisure facilities and health facilities to develop the national tourism product
- Investment in major upgrading and refurbishment, again to develop the national tourism offering.

The tourism sector is exposed to substantial levels of international competition and has a particular challenge in that it is marketing a tourism product and tourist services that are delivered in Ireland to customers and potential customers that, in many cases, are based in other countries. Investment in tourism and hotel facilities is a riskier and less certain activity than investment in many other sectors of the economy.

Reports and surveys from a range of bodies have clearly and unequivocally established that tourism makes a substantial economic contribution.

The sector has ambitious annual growth targets, particularly the annual growth of 6.9% in overseas visitors spend in Ireland up to 2012.

Tax reliefs for investors facilitate investment such as that described earlier in this Summary which would be unlikely to take place if such schemes were not in place. Our analysis shows that such tax relief schemes have a strong likelihood of being revenue neutral or being beneficial to the Exchequer when the streams of additional tax revenues from a range of sources is taken into account.

3. Challenges Facing the Sector

- **Economic Contribution**

Reports such as the Irish Tourist Industry Confederation's "The Impact of Tourism on the Economy" and "New Horizons for Irish Tourism," as well as research by Fáilte Ireland and the Irish Hotels Federation have established that tourism makes a substantial economic contribution. The hotel sector plays a pivotal role in that contribution.

Fáilte Ireland and CSO data show that Irish tourism

- had 6.574 million overseas tourists in 2004
- had 6.225 million overseas tourists who stayed at least one night in 2004
- of a total of 46.6M bed nights, 10.7 million or 22.9% were in hotels, a further 15.0% were in guesthouses and bed and breakfasts
- the hotel sector provides 23.7% of British tourist bed nights, 17.0% of rest of Europe tourists and 36.4% of North American tourist bed nights
- generated €4.073 billion in foreign exchange and non domestic earnings in 2004
- provided €2.3 billion to the exchequer in tax revenue in 2003 according to Fáilte Ireland
- generated a tax revenue return of 52 cent for every euro spent by foreign visitors
- generated a domestic tourism spend of €971 million
- accounted for over 4% of GNP in 2004 including multiplier effects
- is responsible for over 140,000 jobs of which
- hotels account for over 50,000.

Overall the tourism and hotel sectors generate substantial economic returns in GNP, foreign exchange/non domestic earnings, employment and tax revenue. The Report of the Tourism Policy Review Group described tourism as a "significant instrument of national and regional economic development" and the "largest Irish-owned internationally-traded services sector in the economy."

In addition to the above, tourism is an important instrument of regional development. In recent years the geographic concentration of tourism has increased but it still has a substantial regional spread and has the potential to further contribute to regional development.

The regional spread of overseas and domestic tourism revenue is shown below

Regional Spread of Tourism Revenue 2003

	Overseas	Domestic
Dublin	32.6 %	14.2 %
Midlands/East	9.6 %	9.3 %
S-E	8.3 %	14.2 %
S-W	19.2 %	23.9 %
Shannon	10.4 %	11.8 %
West	14.1 %	21.0 %
N-W	5.8 %	7.9 %
Total	100.0 %	100.0 %

Source: Fáilte Ireland

Over two thirds of overseas revenues arise outside the Dublin area and 86% of domestic tourism revenue arises outside Dublin. Tourism can play a very important role in achieving the National Spatial Strategy objective of a more even geographic spread of population and economic activity.

The relative net foreign exchange earnings of tourism are higher than other sectors because of the high domestic content of the activity.

The tourism industry is strategically important on a range of measures. It is large; therefore changes have a substantial national impact. Its economic competitiveness is deeply rooted in the Irish economy. It is a deeply embedded sector. Its actual and potential regional impact is substantial.

There are also important social and external benefits. Local communities can benefit from investment in tourism facilities such as leisure and sporting facilities. Tourism supports local traditions and culture and has a strong role to play in sustainable development.

The economic role of the sector is significant, it has grown substantially in the past decade as will be shown in the next section, and it has the potential to grow further if certain major concerns are addressed.

An initial examination of tourism performance shows evidence of strong growth over the long-term and more recently, recovery from the negative impact of 9/11, foot and mouth and SARS in 2001. This masks a number of worrying features such as weak growth in tourism revenue, declining length of stay and decline in the British market.

The operating environment has deteriorated because of adverse exchange rate changes and domestic cost increases. This worrying situation arises at the time when the industry is expected to move towards the demanding targets of “New Horizons for Irish Tourism”. Detailed elaboration of these points has been made in recent budget submissions by the IHF.

Between 1990 and 2000 overseas visitor numbers more than doubled (+103.8%). Due to many negative features numbers declined by 5% in 2001. Since 2001 numbers have increased and are now above the 2000 level.

Overseas Tourism 2003/04

	Overseas Visits (000)	Expenditure (€billion)	Length of Stay - days	Exp. Per visitor (€)	Bednights (00)
2003	6,369	4,057	7.8	637	46,846
2004	6,574	4,073	7.5	620	46,604
% change	+3.2 %	+0.4 %	-3.8	-2.7	-0.5

Source: CSO

The number of visitors grew by 3.2% in 2004 but revenue barely increased. Length of stay declined in 2004 by 3.8% and total bed nights declined. Revenue per visitor declined in nominal terms by 2.7% in 2004.

The overall hotel performance was mixed in 2004. While overall hotel bed nights grew by 3.7%, better than the total tourism performance, this was mainly due to the first quarter and to a lesser extent the fourth quarter. The peak season was weak.

Hotel Bednights 2003/04 (K)

	Q1	Q2	Q3	Q4	Total
2003	1,523	2,935	3,833	1,987	10,278
2004	1,697	2,977	3,867	2,121	10,663
% Change	+11.4 %	+1.4 %	+0.9 %	+6.7 %	+3.7 %

Source: CSO

The key issues for tourism are not its historic performance, which is excellent, but how it will cope with the future in a more competitive and inhospitable environment and if it can deliver on the New Horizons targets. In addition the role of incentives in supporting tourism is critical.

- **Tourism Targets**

The targets which have been proposed for the sector are shown below.

Targets in New Horizons for Irish Tourism (2002-04)

	Actual 2002 €M	Actual 2004 €M	Target 2012 €M	Avg. Annual Growth %
Overseas Exp. (2002 prices) (Excl. NI and travel receipts)	3088	3200 (est.)	6000	6.9
No. of Visitors (million)	5.9	6.6	10.0	5.4
Great Britain	3.5	3.7	5.5	4.8
Rest of Europe	1.4	1.6	2.3	5.3
North America	0.8	1.0	1.8	7.6
Other	0.2	0.3	0.5	6.3

Source: New Horizons for Irish Tourism

The targets are to almost double both expenditure and visitors. The visitor target is 69% of an increase and the expenditure growth is 94% between 2002 and 2012. This implies a growth of expenditure per visitor of 15% in real terms over the period. As already noted the average spends in nominal terms declined in 2004. It is highly likely that higher spend per visitor, in the context of a likely decline in the length of stay, can only be achieved by increasing the role and quality of hotel tourism in the overall tourism product. The review of the capital allowances must be undertaken with due regard to the desired performance of the tourism and hotel sector.

- **Issues Facing the Sector**

The difficulties facing the tourism sector have been identified by the Review Group and by IHF submissions Domestic inflation, especially public sector price increases, labour cost pressures and the exchange rate changes have fundamentally altered the cost competitiveness of Irish tourism. It has reduced hotel profit levels. Profits before tax fell by 7.3% between 2001 and 2003. The exchange rate situation illustrates the changed environment clearly.

Euro Exchange Rate 02/05

	Sept 02	Sept 04	March 05
Dollar	0.991	1.2175	1.3175
Sterling	0.6363	0.6799	0.6941

The two main tourism markets are the UK and the USA. Between Sept 02 and March 05 the Euro appreciated by 33% and Sterling by 9%. In the past six months the appreciations were 8% and 2% respectively. The value of the euro is not something that the Irish government can influence. Adjustment to the new exchange rate regime requires an industry response in terms of product improvement, cost control and efficiency. Consideration of the role of the capital allowances must take into account the changed cost environment.

The hotel and tourism industry is at a cross roads. The operating environment has generally worsened, except for the low rate of profits tax which is a very welcome feature of the fiscal policy. The exchange rate and domestic inflation has eroded cost competitiveness. The accelerated rate of Irish economic growth has eroded some of the traditional appeal of the Irish tourism product. There are very many additional competing tourism locations. The overseas ethnic link with Ireland has been reduced compared to the past. At the same time very demanding targets have been set for the industry. The hotel sector has a major part to play in growing the number of visitors and in raising revenue per visitor.

Of concern is the growth of outward tourism. At present there is a tourism deficit in the balance of payments. Tourism within Ireland needs to grow substantially to keep pace with outward tourism and ultimately to return to surplus.

4. Structure of the Sector and Future Needs

The hotel sector already plays a significant role in the tourism industry. It is likely that it will have to play a greater role in the future. There is a need to increase yield per visitor. Product enhancement in the hotel sector is a plausible way of achieving this. Better quality hotels command higher returns to a greater extent than improvements in other tourism sectors. The corporate hospitality and conference sector is one with strong potential. Hitherto Ireland has not been very successful in attracting this segment. Likely improvements require a range of initiatives such as VAT refunding, promotion and a conference centre. It also requires good quality hotels with a range of facilities. The capital allowances scheme can be used in a targeted way to achieve this upgrading.

Customer expectations of hotel standards and facilities are continuously rising. In addition to food and shelter there is an expectation of best quality guest facilities, business centres, leisure and sports facilities, conference/seminar facilities and health and beauty services and facilities. A failure to substantially upgrade across the board will have a strong negative impact on the possibility of realising the overall targets and generating the hotel sector's contribution.

In addition, individual businesses will need to increase their size to a viable sustainable scale capable of supporting a range of facilities and ongoing investment. Small establishments, even if generating an adequate return on capital and revenue, are less likely to accumulate the critical mass of financial, human and other resources which will be needed to upgrade and cope with the changed environment.

To an increasing extent the competitive hotel of the future will need to be of a sufficient scale to support a range of facilities and to accumulate an adequate level of resources to meet increasingly demanding customers. The Irish hotel sector currently is some way off that objective for many establishments.

- **Hotels by Grade**

Based on Fáilte Ireland data in 2003, 22% of hotels were not classified, 29% had one or two stars, 37% had three stars, 10% had four stars and 2% had five stars. Almost half had less than three stars. This category accounted for 29% of the room stock. The average size of hotels in the different categories is shown below.

Average Size of Hotel 2003 (bedrooms)

Five Star	138
Four Star	88
Three Star	64
Two and One Star	21
Unclassified	40

Source: Fáilte Ireland Hotel Survey (HBC)

The two star, one star and unclassified hotels are relatively small, with between 20 and 40 rooms. As is shown in section 5 small hotels do not generate strong profit levels.

- **Financial Performance**

The Howarth Bastow Charlton Hotel (HBC) survey shows that margins are higher in the larger hotels. The margins referred to below do not allow for depreciation, loan interest or rent. The more appropriate measures of profit in section 5 show that profit rates are well below the survey measures. In the present case we are only concerned with the relativities between the size categories.

Hotel Returns by Size

	All	1-49 rooms	50-99 rooms	100+ rooms
Annual Occupancy	64.8 %	57.4 %	64.3 %	66.3 %
EBITDA/Sales Ratio	17.5 %	13.9 %	15.8 %	19.4 %
Profits per room (€)	€8,853	€7,395	€8,622	€9,219

Source: Fáilte Ireland Hotel Survey (HBC)

The small hotels have a lower occupancy rate, a lower profits/sales ratio and a lower level of profit per room compared to larger hotels.

- **Business Mix**

The same survey source shows that small hotels have a different mix of business to larger hotels.

Mix of Business by Hotel Size %

	All	1-49	50-99	100+
Business Travellers	29.4 %	21.5 %	27.2 %	34.1 %
Foreign Tourists	11.1 %	8.4 %	13.1 %	10.2 %

Source: Fáilte Ireland Hotel Survey

Two of the main potential sectors for the ongoing growth of tourism are the business and foreign tourist segments. The small hotels get only 30% of their business from these two segments compared to 40% and 44% in the two larger segments.

There are substantial differences in room occupancy rates between Dublin (70%) and the rest of the country (between 51% and 62%). Revenue per room is €29,000 in Dublin compared to €17,000 to €18,000 elsewhere. The cost base in Dublin is higher but there is still a substantial EBITDA gap (20.7% in Dublin compared to 15% to 16% in the other regions.)

• ***Supply of Hotels Rooms***

Between January 2000 and January 2004 there has been little change in the number of registered hotels, 845 in 2000 and 849 in 2004. However the numbers of rooms grew from 38,100 to 43,900, an increase of 15.2%. A substantial increase is evident in the January 2005 return which shows 862 hotels with 45,600 rooms. There is continuing growth in the number of rooms.

Hotels and Hotel Rooms 1998-2005

	1998	2000	2005	% change 98/04	% change 00/04
Hotels	771	845	862	10.1 %	2.0 %
Rooms (000)	30.4	38.1	45.6	44.4 %	19.7 %

Since 1998 there has been a 12% growth in the number of hotels but since 2000 there has been little change. This is a net change as new hotels have replaced some closures. The number of rooms continued to increase after 2000 but at a lower rate than 1998/00.

Room capacity increased in all regions over the 2000/04 period. Dublin had 25% of the room in 1998 and 30% in 2004.

Many factors influenced the growth in hotel capacity including the growth in economic activity, the growth in personal incomes, the population and labour force growth, the growth in travel demand and the favourable capital allowances/tax situation.

- **Room Occupancy Rates**

Room occupancy rates have declined over the past few years reflecting the failure of demand growth to match supply growth. In 1997 the rate was 65% by 2003 this had declined to 60% (it was 59% in 2002). The decline was most marked in Dublin (77% to 68%).

The room occupancy rate for the smaller hotels declined greatly according to Fáilte Ireland data.

Room Occupancy 1998/2004 %

Size	1998	2003
1-20	55 %	39 %
21-49	59 %	54 %
50-99	65 %	61 %
100+	70 %	66 %
Total	63 %	60 %

Source: Fáilte Ireland Hotel Survey

The smallest category's occupancy rate declined from 55% to 39% over the period. There were smaller declines in the other categories.

The empirical trends would seem to indicate that supply has grown quicker than demand. This would suggest that until capacity utilization increases there is limited justification for continued blanket incentives for general capacity expansion. However, the data also indicate weaknesses in the smaller hotels. Profit ratios are lower, there is less ability to attract foreign and business tourism and capacity utilization is low. Any capacity increasing support should be targeted at smaller hotels to enable them to reach larger more sustainable scale.

In addition, in light of the need to upgrade the quality of the tourism product, raise revenue per visitor and win larger market share it is necessary for hotels to provide facilities such as business centres/conference rooms and leisure facilities. Capital allowances should be used to support this development.

Hotels must continually upgrade their basic accommodation to achieve the higher revenue per visitor targets, improve occupancy rates and be competitive at the higher end of the market.

5. Role of Capital Allowances in Developing the Hotel Sector

• Objectives

This section has five objectives:

- to show that the level of hotel profitability is low relative to the need for investment
- to show that investment in major facilities is not often commercially justified
- to show the impact on profit levels of increased scale
- to show the impact of the capital allowances on returns
- to show the net exchequer impact of the tax lost through the allowances and the tax gained through increased economic activity

The earlier sections have examined the broad sectoral and national data. A “case study” or “representative case” approach is adopted in this section. The net exchequer impact reflects assumptions about the level of activity which would have arisen in the absence of the allowances. If there was no tourism investment without the allowances and if the finance was not used elsewhere the exchequer would gain the forgone income tax but would lose the tax revenue flows generated by the new economic activity. If all of the investment was to occur without the allowances the exchequer would lose the foregone income tax without any corresponding new revenue flow.

It is important to note that a hotel investment is entitled to the normal capital allowances arising from any investment even if the income tax related allowance is not used.

The income tax related capital allowance has two benefits. It facilitates the financing of a project which would not attract financing from the regular financial/banking mechanisms and it increases the after tax return from the investment. In other words, individuals would be willing to advance the money because of the income tax returns whereas banks might not be willing to lend the finance on a business case basis.

The Irish Hotels Federation is committed to achieving the ambitious targets of “New Horizons for Irish Tourism.” This will require the hotel sector to increase its contribution to Irish tourism. The way forward is to attract higher expenditure visitors and enhance the quality of the Irish tourism and hotel experience. There are many determinants of the ability to achieve this. One such determinant is the provision of best quality hotel facilities and accommodation. In addition it is necessary for small establishments to achieve higher scale to allow the accumulation of core resource levels. It has been shown in section 5 that market generated returns in the hotel sector are often not large enough to justify facilities investment and high quality refurbishment. Improvements in returns come from increased scale as shown in section 5. Capacity utilisation has worsened over the medium term due to the supply increase.

There are substantial strategic gains and external benefits from supporting tourism. Consequently, based on the foregoing analysis, we recommend that accelerated capital allowances be retained for three targeted categories, namely

1. small hotels and guesthouses (below 50 rooms) which are expanding to a larger scale
2. investment in major facilities such as leisure centres and business facilities
3. general upgrading and refurbishment work of a major nature

It is recognised that even with capital allowances many establishments will not be able to justify facilities investment because of location and local market conditions. Many small establishments will still not secure the necessary finance to increase scale even with allowances. However, for many establishments, the retention of the targeted capital allowances will facilitate the upgrading which is necessary to maintain and grow the tourism business.

Case 1: Expansion of a Small Hotel

Case 1 is an example of a small hotel expanding to a larger scale as shown in tables 5.1 to 5.3 following.

The basic assumptions on which this model is built are as follows:

1. The financial performance data are taken from the Howarth Bastow Charlton Annual Review of Hotels in Ireland – 2004.
2. The “small” hotel is defined as one with 38 rooms. This is the average size of hotel with up to 49 bedrooms as shown in the Annual Review.
3. A “medium” sized hotel is defined as 74 rooms, the average size of hotels on the 50 to 99 room category.
4. The annual review does not provide industry data for interest or depreciation. We make provision for these as shown in table 5.1.
5. We assume that the full cost of proposed investment will qualify for tax relief for investors. This is unlikely to be the case however, if such is not the case, then the income tax foregone through tax reliefs for investors in practice will be less than that provided for in our models. In effect, our models are less beneficial to the Exchequer than reality is likely to be.

- **Comparable performance of small and medium hotels.**

Table 5.1 shows the comparable performance of the different sizes of hotel. Firstly it is noted that the larger hotels achieve a higher occupancy rate and consequently achieve higher room revenue. Many small hotels close during part of the year and consequently their occupancy figures would fall. It is not feasible for some small hotels to remain open all year.

The comparison shows that increasing capacity from 38 to 74 bedrooms would more than double the hotel revenue, even though drink and food revenue per room is slightly lower for the larger hotel.

It can be seen that direct costs per room fall as hotel size increases. Other costs are higher on a per room basis for the larger hotels – though this mirrors a substantially higher spend in areas such as marketing and upkeep of the hotel.

In overall terms, the profit before tax, interest and depreciation is substantially higher at €690,000 for the larger hotel compare to €303,000 for the smaller hotel.

- **Profit Performance**

To assess the profit performance of the hotel before and after expansion we assumed:

- The small hotel is carrying some €2 million of debt and pays interest of €80,000 in our standard year.
- The hotel shows a depreciation charge of €190,000, however we assume that it has sufficient capital allowances from previous investment so that it has no liability for corporation tax in the current year.

The outcome from these assumptions is that the profit before and after tax is just over €83,000. The cash generated by the small hotel is €223,000 which is equivalent to the profit before tax and depreciation.

- **The Investment Proposal**

The small hotel proposes to expand from 38 to 74 bedrooms. The cost of such an expansion is provided for at €80,000 per room, to include provision of some common areas. The total cost of the development is therefore €2.88 million.

We assume that if the hotel were to seek a loan from a financial institution, that it would be offered a 10 year loan at 4.75%. We assume that the loan would be for 100% of the cost of the development.

The annual repayments on such a loan would be €362,254, which is substantially in excess of the €223,249 cash generated by the hotel at present.

We consider therefore that it would be very difficult, if indeed it is possible, for the hotel to secure the funding needed for the expansion.

- **The Tax Based Funding Option**

If it is assumed that an arrangement is entered into whereby individuals may assist in the funding of the proposed expansion and receive the capital allowances arising from the expansion we would find that

1. On an investment of €2.88 million, the expanded hotel would pay a rent of €106,704 to the investors, which when added to the existing loan would increase the interest / rent outlay to €186,704 as shown in table 5.1.
2. The depreciation shown is a “book” figure and the “book” profit is therefore €230,772.
3. The taxable profit is calculated as

Profit before interest and depreciation
less Interest and rent
less 15% of the existing (i.e. pre expansion) capital allowances

On this basis, the tax liability will be €25,425 and the profit after tax would be €205,346.

- **Impact of the Funding Scheme on the Exchequer**

The impact of the funding schemes on the Exchequer is shown in table 5.3. This table is developed as follows:

1. Income tax foregone assumes that investors utilise 15% of the capital allowances of €2.88 million in each year 1 to 6, and 10% in year 7. It is assumed that relief is at an effective rate of 44%.
2. Our assumptions shown previously show that the tax liability of the hotel after the expansion in a standard year would be €25,425. We estimate that the tax liability in year 1 would be about half of the standard year liability as the business is being built up during year 1.

3. The construction of the extension takes place during year 0 and the business of the existing hotel is not impacted in any way. We conclude from data supplied by the Construction Industry Federation that the tax derived from construction activity, i.e. from income tax, PRSI, planning fees and levies etc., but not including VAT equates to some 27.5% of the net of VAT cost of the extension. This implies that the tax gained from the construction activity is €792,000.

4. The gross increase in VAT, PAYE/PRSI and excise duty is estimated to be €400,460 in a standard year. In our model, for illustration purposes only, we assume that 10% of the business attracted to the extended hotel is new business and the balance is displacement from other hotels. Consequently we provide for an annual tax take increase of just €40,046 from VAT, PAYE/PRSI and excise duty.

5. Table 5.3 shows that taking a Net Present Value rate of 4.75%, the same as the assumed borrowing rate, the Exchequer would have a positive gain of €84,470 over the eight year period – i.e. one year for construction and seven years in which the capital allowances are set against income tax.

The key point of this analysis is that even at very high levels of displacement – i.e. that the Exchequer would have gained the relevant taxes in any event – and consequently very low levels of new business, the Exchequer would be a net beneficiary of a capital allowances scheme. The table following shows the sensitivity of the Exchequer benefit to the varying levels of “new” business:

Level of “new” Business	Net Benefit to the Exchequer €
10%	84,470
20%	298,578
30%	512,686

Table 5.1 Comparison of Performance before and after Expansion

	Hotel A per Room 38	Hotel A Total	Hotel B per Room 74	Hotel B Total
Rooms				
Revenue per Room per night	€72.37		€91.39	
Occupancy	57.4%		64.3%	
Revenues				
Revenue - Room	€15,162.24	€576,165.07	€21,448.78	€1,587,209.43
Revenue - Food	€23,680.00	€899,840.00	€17,279.00	€1,278,646.00
Revenue - Beverage	€13,246.00	€503,348.00	€12,145.00	€898,730.00
Revenue - Other	€1,810.00	€68,780.00	€4,568.00	€338,032.00
Total	€3,898.24	€2,048,133.07	€5,440.78	€4,102,617.43
Direct Costs				
Rooms	€5,806.00	€220,628.00	€6,643.00	€491,582.00
Food & Beverage	€25,722.00	€977,436.00	€20,991.00	€1,553,334.00
Other	€587.00	€22,306.00	€2,475.00	€183,150.00
Total	€32,115.00	€1,220,370.00	€30,109.00	€2,228,066.00
Other Costs				
Admin	€5,560.00	€211,280.00	€6,353.00	€470,122.00
Marketing	€488.00	€18,544.00	€1,850.00	€136,900.00
Utility	€1,597.00	€60,686.00	€1,637.00	€121,138.00
Property Ops and Maintenance	€2,262.00	€85,956.00	€2,337.00	€172,938.00
Total	€9,907.00	€376,466.00	€12,177.00	€901,098.00
Operating Profit	€11,876.24	€451,297.07	€13,154.78	€973,453.43
Fixed Charges	€3,896.00	€148,048.00	€3,829.00	€283,346.00
Profit before Interest, Tax and Depreciation	€7,980.24	€303,249.07	€9,325.78	€690,107.43
Interest / Rent Depreciation		€30,000.00		€186,704.00
		€140,000.00		€272,631.58
Profit before Tax		€3,249.07		€30,771.85
Tax		€0.00		€25,425.43
Profit after Tax		€3,249.07		€205,346.42
Cash Generated		€223,249.07		€477,978.00

Table 5.2 Investment Proposal

Capital Costs of Expansion	
per room cost, incl common areas	€80,000.00
Investment	€2,880,000.00
Interest Rate	4.75%
Loan period - months	120
Monthly Repayment	€30,196.15
Annual Repayment	€362,353.80

Table 5.3 Tax Revenue Implications

Cost/Benefit to Exchequer								
Year	0	1	2	3	4	5	6	7
Income Tax Foregone	0	190,080	190,080	190,080	190,080	190,080	190,080	126,720
Less Corporation Tax Gained		25,425	25,425	25,425	25,425	25,425	25,425	25,425
Net Tax Foregone		164,655	164,655	164,655	164,655	164,655	164,655	101,295
Less								
VAT - Hotel	0	190,986	254,649	254,649	254,649	254,649	254,649	254,649
Excise Duty	0	39,821	53,094	53,094	53,094	53,094	53,094	53,094
PAYE/PRSI	0	69,538	92,718	92,718	92,718	92,718	92,718	92,718
Tax Gained from Construction	792,000							
Potential Tax Intake	792,000	300,345	400,460	400,460	400,460	400,460	400,460	400,460
Tax Intake from New Business	792,000	30,035	40,046	40,046	40,046	40,046	40,046	40,046
Net Tax Intake	792,000	-134,620	-124,609	-124,609	-124,609	-124,609	-124,609	-61,249
	4.75%							
NPV 7 year	96,056							
New Business	10%							

Case 2: Addition of Visitor Leisure Facilities

Case 2 is an example of a medium sized hotel adding a leisure centre with associated leisure and fitness facilities. We have developed this case on the assumption that the full amount of the investment will be eligible for capital allowances to investors.

The basic assumptions on which this model is built are as follows:

1. The financial performance data are taken from the Howarth Bastow Charlton Annual review of Hotels in Ireland – 2004.
2. The hotel has 74 bedrooms at present, the average size of a hotel in the 50 to 99 room category.
3. As in our previous example, the annual review does not provide industry data for interest or depreciation. We make provision for these as shown in table 5.4.
4. We use actual operating costs and income generation figures from a sample of similar sized leisure facilities that have been developed within the industry in the recent past
5. We again assume that the full cost of proposed investment will qualify for tax relief for investors. This is unlikely to be the case, so the income tax foregone through tax reliefs for investors in practice should be less than that provided for in our models. In effect, our models are less beneficial to the Exchequer than reality is likely to be.

- **Comparable performance of Hotels with and without Leisure Facilities.**

Table 5.4 shows the comparable performance of hotels with and without leisure facilities.

The comparison shows that leisure centres reward the hotels by increasing occupancy as well as generating business from the local population.

We have shown the additional revenues as “Other”. Revenues derived from leisure centres comprise memberships (including a membership “churn” factor); and visitor fees. We assume that hotel residents will not have to pay for the use of the facilities.

In overall terms, the profit before tax, interest and depreciation is substantially higher at €1.03 million for the hotel with a leisure centre compared to €690,000 for a similar hotel without such a centre.

- **Profit Performance**

To assess the profit performance of the hotel before and after the development of a leisure centre we have assumed:

- The hotel is carrying some €3.3 million of debt before the development of the leisure centre and pays interest of €155,789 in our standard year.
- The hotel shows a depreciation charge of €272,631, however we assume that it has sufficient capital allowances from the previous investment so that it has no liability for Corporation tax in the current year.

The outcome from these assumptions is that the profit before and after tax is €261,686. The cash generated by the small hotel is €534,318 which is equivalent to the profit before tax and depreciation.

- **The Investment Proposal**

The hotel proposes to develop a leisure centre that will accommodate both hotel residents and occasional users. The cost of such a development is estimated to be €7,000,000. This is at the lower end of the range of leisure centre development costs within the industry. As noted previously, we assume that the full cost will be allowable for investor tax relief. If this is not the case, then we would assume that the non-eligible allowances would be available to the hotel which would claim relief at 12.5%. This scenario would reduce the income tax losses on the part of the Exchequer and be more beneficial to the Exchequer than our model following.

We assume that if the hotel were to seek a loan from a financial institution, that it would be offered a 10 year loan at 4.75%. We assume that the loan will be for 100% of the cost of the development. The annual repayments on such a loan would be €880,721, which is substantially in excess of the €534,318 cash generated by the hotel prior to the leisure centre development.

We consider therefore that it would be very difficult, if indeed it is possible, for the hotel to secure the funding needed for the expansion.

- **The Tax Based Funding Option**

If it is assumed that an arrangement is entered into whereby individuals may assist in the funding of the proposed expansion and receive the capital allowances arising from the expansion we would find that

1. On an investment of €7.0 million, the hotel would pay a rent of €259,350 to the investors, which when added to the existing loan would increase the interest / rent outlay to €415,139 as shown in table 5.4.
2. The Depreciation shown is a “book” figure and the “book” profit is therefore €341,712.
3. The taxable profit is calculated as

Profit before interest and depreciation
less Interest and rent
less 15% of the existing (i.e. pre expansion) capital allowances

On this basis, the tax liability will be €15,297 and the profit after tax would be €326,414.

- **Impact of the Funding Scheme on the Exchequer**

The impact of the funding schemes on the Exchequer is shown in table 5.5. This table is explained as follows:

1. Income tax foregone assumes that investors utilise 15% of the capital allowances of €7.0 million in each year 1 to 6, and 10% in year 7. It is assumed that relief is at an effective rate of 44%.
2. Our assumptions shown previously show that the tax liability of the hotel after the expansion in a standard year would be €15,297.

3. The construction of the leisure centre takes place during year 0 and the business of the existing hotel is not impacted in any way. We conclude from data supplied by the CIF that the tax gained from the construction activity, i.e. from income tax, PRSI, planning fees and levies etc., but not including VAT equates to some 27.5% of the net of VAT cost of the extension. This implies that the tax gained from the construction activity is €1.925 million.
4. The gross increase in VAT, PAYE/PRSI and excise duty is estimated to be €101,500 in a standard year. In our model, for illustration purposes only, we assume that 50% of the business attracted to the hotel as a result of the development of the leisure centre is new business and the balance is displacement from other hotels. This is regarded as a reasonable level of new business, given that much of the business will derive from the local population. Consequently we provide for an annual tax take increase of just €99,661 from VAT, PAYE/PRSI and excise duty.
5. The table 5.5 shows that taking a Net Present Value at 4.75%, the same as the assumed borrowing rate, the Exchequer would have a positive gain of €9,404 over the eight year period – i.e. one year for construction and seven years for the capital allowances to be set against income tax. Essentially this is a break-even scenario.

The key point of this analysis is that even at very high levels of displacement – i.e. that the Exchequer would have gained the relevant taxes in any event – and consequently very low levels of new business, the Exchequer would be a net beneficiary of a capital allowances scheme.

Table 5.4 Comparison of Hotels with and without Leisure Facilities

	Hotel C per Room	Hotel C Total w/o Leisure Centre	Hotel C Total with Leisure Centre
Rooms	74		
Revenue per Room per night	€91.39		€100.53
Occupancy	64.3%		70.7%
Revenues			
Revenue - Room	€21,448.78	€1,587,209.43	€1,745,930.37
Revenue - Food	€17,279.00	€1,278,646.00	€1,406,510.60
Revenue - Beverage	€12,145.00	€898,730.00	€988,603.00
Revenue - Other	<u>€4,568.00</u>	<u>€338,032.00</u>	<u>€1,171,835.20</u>
Total	€5,440.78	€4,102,617.43	€5,312,879.17
Direct Costs			
Rooms	€6,643.00	€491,582.00	€540,740.20
Food & Beverage	€20,991.00	€1,553,334.00	€1,708,667.40
Other	<u>€2,475.00</u>	<u>€183,150.00</u>	<u>€701,465.00</u>
Total	€30,109.00	€2,228,066.00	€2,950,872.60
Contribution per Room Night	€107.93		€123.64
Other Costs			
Admin	€6,353.00	€470,122.00	€485,236.42
Marketing	€1,850.00	€136,900.00	€141,301.34
Utility	€1,637.00	€121,138.00	€125,032.59
Property Ops and Maintenance	<u>€2,337.00</u>	<u>€172,938.00</u>	<u>€178,497.96</u>
Total	€12,177.00	€901,098.00	€930,068.30
Operating Profit	€13,154.78	€73,453.43	€1,431,938.27
Fixed Charges	€3,829.00	€283,346.00	€292,455.57
Profit before Interest, Tax and Depreciation	€9,325.78	€690,107.43	€1,029,482.70
Interest / Rent Depreciation		€155,789.47	€415,139.47
		€72,631.58	€72,631.58
Profit before Tax		€61,686.38	€341,711.64
Tax		€0.00	€15,297.25
Profit after Tax		€61,686.38	€326,414.39

Table 5.5 Tax Revenue Implications

Cost/Benefit to Exchequer								
Year	0	1	2	3	4	5	6	7
Income Tax Foregone	0	462,000	462,000	462,000	462,000	462,000	462,000	308,000
Less Corporation Tax Gained	0	15,297	15,297	15,297	15,297	15,297	15,297	15,297
Net Tax Foregone	0	446,703	446,703	446,703	446,703	446,703	446,703	292,703
Less								
VAT Increase - Hotel & Leisure Centre	0	85,753	85,753	85,753	85,753	85,753	85,753	85,753
Additional Excise Duty	0	12,069	12,069	12,069	12,069	12,069	12,069	12,069
Additional PAYE/PRSI	0	101,500	101,500	101,500	101,500	101,500	101,500	101,500
Tax Gained from Construction	1,925,000							
Potential Tax Intake	1,925,000	199,321	199,321	199,321	199,321	199,321	199,321	199,321
Tax Intake from New Business	1,925,000	99,661	99,661	99,661	99,661	99,661	99,661	99,661
Net Tax Intake	1,925,000 4.75%	-347,042	-347,042	-347,042	-347,042	-347,042	-347,042	-193,042
NPV 7 year	9,404							
New Business	50%							

6. Recommendations

In our analysis we have shown that:

- the level of hotel profitability is low relative to the need for investment
- that investment in major facilities is often likely to be difficult to finance through loans from financial institutions
- there is a strong positive impact on profit levels from increased scale of operations and additional visitor facilities
- that the net Exchequer impact of the income tax lost through investor allowances is very likely to be offset by the tax gained through increased economic activity.

We therefore recommend that accelerated capital allowances be retained for

- Investment to increase the size of small hotels to more viable sizes to improve the overall profitability of the sector
- Investment by existing hotels in additional facilities such as conference centres, leisure facilities and health facilities to develop the national tourism product, and
- Investment in major upgrading and refurbishment, again to develop the national tourism offering.