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## Key Money and Exclusivity Arrangements— What You Need to Know

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### Key Money Overview

The payment of key money (KM) by hotel operating companies is an increasingly regular aspect of securing hotel management agreements, particularly in the luxury hotel sector. In the typical transaction, a hotel management company will pay an upfront fee to the hotel owner in order to secure a long-term management agreement; the fee will be refunded on a pro-rata basis if the management agreement is terminated prior to the full term stated in the management agreement. These fees can be substantial—often in the millions, or tens of millions, of pounds.

### VAT issues

The payment of KM raises tax issues that should be considered early in the potential transaction, preferably at the stage when heads of terms are being negotiated. In terms of corporate taxes, one issue that can arise is whether the relevant jurisdiction considers the payment of KM to be a loan that is forgiven pro-rata over the term and what impact this may have on the taxable income of the hotel owner. However, here we focus on the Value Added Tax (VAT) position. VAT can be a surprise, especially if the entity paying KM is not already registered for VAT; for example, a small North American or Asian brand opening its first hotel in the UK.

### *Is UK VAT Relevant?*

1. If the manager or franchisor and the owner are located in the United Kingdom, UK VAT is a relevant consideration.
2. If either party is based in another EU Member State, the interaction between the VAT rules in that jurisdiction and the United Kingdom will need to be considered. Under current law, the VAT rules and principles of other EU Member States should be similar to those of the United Kingdom as they derive from the same EU Directives.
3. Brexit—the overall effect of VAT may well change as Brexit is implemented and the VAT Directives cease to apply to the United Kingdom. Our focus here is on the current UK VAT regime, but the impact of Brexit will need to be monitored and understood in the coming months. Compliance and structuring advice will need to be taken by both hotel owners and managers.

### *Is UK VAT Chargeable on KM?*

1. In order to ascertain whether or not VAT needs to be charged, one needs to ask why KM is being paid.

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- (a) In commercial terms, why is the hotel operator or franchisor paying KM? What benefit does it expect to secure by paying it?
  - (b) How is the KM or its purpose described in the hotel management agreement? This may be stated in the payment clause but there also may be clues in other provisions of the contract.
  - (c) Is it a discount against the headline rate of fees payable?
  - (d) Is the KM structured as an upfront cash payment, loan or deferred fees? Is it repayable if the hotel meets certain performance thresholds or metrics or on early termination of the management agreement? Is the KM amortised? Is there a right to convert KM into equity? Does the structure offer any clues as to its intended purpose?
2. If KM is paid as an inducement to enter into the contract, it is likely to be subject to VAT. Alternatively, is it possible to regard the KM as not payable for a service (or, “supply” in VAT terms), such that the payment is outside the scope of VAT?
  3. If in doubt, professional advisers will often suggest charging VAT on the basis of prudence. The question would then be whether the VAT can be recovered—on which, see below.

### *VAT Recoverability?*

1. VAT that can be recovered by the payer from HM Revenue & Customs (HMRC) should be a cashflow/timing inconvenience rather than an absolute cost. However, this can become a material issue for smaller brands that are disproportionately affected by disruptions to cashflow, especially in cases where the manager’s financial model has not fully anticipated the timing difference imposed by the need to pay VAT and then recover it.
2. Can the contract be structured so that the cashflow impact is minimized? This may require commercial, lawyer and tax adviser discussions between the contracting parties in order to ensure that the payment schedule under the contract adequately takes account of the manager’s VAT return dates and its VAT recovery position, so that cashflow disruption is minimized.

### **Exclusivity Agreements Overview**

Exclusivity agreements are a tried and tested method of entering into discussions early with a party, for a specified period of time, in order to ensure that a party negotiates solely with you and, from a seller’s perspective, the prospective buyer will comply with its obligations to progress the transaction. These agreements are increasingly common place in the current market. In their simplest form, heads of terms attempt to incorporate some form of exclusivity arrangement which states that the parties will deal with each other exclusively for a certain period of time although they are generally not legally binding.

Where the parties wish to ensure that such arrangement is more robust and detailed, a separate exclusivity agreement should be entered into.

The content of an exclusivity agreement should cover the following fundamental aspects:

1. comply with general rules of contract;
2. obligations on the seller to provide information, respond to enquiries and not to deal with any other third party during the exclusivity period; and
3. obligations on the prospective buyer to investigate title, raise enquiries and negotiate the contractual documentation in a timely manner.

However, more sophisticated exclusivity agreements will deal with the following:

1. Enabling the prospective buyer to allow its affiliate to enter into the final agreed contract—this will be an absolute requirement where the special purchase vehicle is not known at the time of entering into the exclusivity agreement.
2. Include some form of confidentiality wording.

3. Increasingly, an exclusivity fee (“ExFee”) also is payable by the prospective buyer to the seller, in monetary consideration for the entering into of the exclusivity agreement. The key issue here is, in what circumstances is the ExFee refundable:
  - (a) Clearly, if the seller breaches the terms of the exclusivity agreement or withdraws from dealing with the prospective buyer within the exclusivity period (other than due to the prospective buyer default), then the ExFee should be refundable.
  - (b) A prospective buyer will want to ensure that the exclusivity fee will be refunded if, for example, it has carried out its due diligence and something has been revealed which materially adversely affects value.

The VAT implications of any ExFee should be considered in advance of entering into an exclusivity agreement.

## VAT Issues

The legal position on whether VAT arises on an ExFee is often not clear.

### *Location of the Parties—Is UK VAT Relevant?*

1. If the parties are both located in the United Kingdom, then UK VAT could arise if the ExFee is paid for a service.
2. Where the seller is based outside the United Kingdom and the buyer is a UK company, the buyer (i.e., the payer of the ExFee) may not be charged VAT by the seller but may actually have to pay VAT directly to HMRC under the “reverse charge” procedure.

### *What Are the Terms of the Exclusivity Agreement?*

The main factor in determining the VAT position is looking at the terms of the exclusivity agreement and what the ExFee is paid for. Is it consideration for a supply? If so, what supply? Is the ExFee to be set-off against the deposit or purchase price under any future sale contract? Is it described as the VAT-inclusive/exclusive amount? If the ExFee is paid by a buyer in exchange for the seller agreeing not to negotiate the sale of real estate property with any other parties during the exclusivity period then a prudent VAT position is that standard rate VAT arises on the ExFee.

### *Is the ExFee Actually a Prepayment?*

In certain scenarios the ExFee may constitute a prepayment of the deposit or balance payable under the sale contract. If so, there is possibly no tax point for VAT until completion. In such circumstances, VAT arguably does not arise until the completion of the sale and the payment of the deposit and balance to the seller.

## Conclusion

The detail of key money and exclusivity arrangements may not always be front of mind when parties are focusing on the bigger picture of a commercial opportunity, but both sides of the transaction should take a second look and consider not only the particular terms of such contracts but also the possible tax implications.

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