

WITHER THE DEED OF COVENANT?!

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Introduction

Despite the reluctance shown by the Inland Revenue during the consultation process, the Finance Act 2000 will bring to an end tax relief for payments made to charities under the Deed of Covenant regime. This does not mean that Deeds of Covenant are no longer legally effective. It also does not mean that Deeds of Covenant need stop being tax effective. What it does mean is that as from 1st April this year for companies, and 6th April this year for individuals, a payment under a Deed of Covenant will only be relieved from tax if that payment qualifies as a Gift Aid payment.

The purpose of this article is to outline what this means for charities in the administration of their existing Deeds of Covenant, and the role that Deeds of Covenant can continue to play. In order to understand this, one must first understand the new Gift Aid regime.

The New Gift Aid Regime

The Finance Act will make some important changes to the Gift Aid regime, so that it is far more flexible and easier to use. It is also now the only regime under which charities can reclaim tax on donations, at the basic rate, from the Inland Revenue. Important new features are as follows:

- There is no longer a minimum amount for a Gift Aid payment. Any donation of cash to a charity can now qualify as a Gift Aid payment.

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- The payment no longer needs to be made by an individual out of income that has suffered tax at the basic rate. Instead, the payment will qualify provided the donor has paid sufficient income and/or capital gains tax to cover the amount that the charity reclaims from the Revenue at the basic rate.
- Individuals now obtain higher rate relief not only for their income but also their capital gains.
- For 'companies' (used in this article to refer to corporation tax payers generally), a Gift Aid payment can only now be paid gross (i.e. there is no longer a requirement, or facility for the donor to deduct tax at source). The amount paid by the company is deductible against its profits for corporation tax purposes.
- The gift, as always, is deductible in the accounting period in which it is made. However, charity trading subsidiaries will be able to make Gift Aid payments up to nine months after their year end and read the payment back into their preceding accounting period.
- Companies no longer have to complete a Gift Aid certificate (as, for the charity, there is no tax to recover).
- Individuals still need to make what is now called a Gift Aid declaration. However, the form of declaration has been simplified considerably (e.g. it no longer needs to be signed). Moreover, a single declaration can now cover a series of donations or, indeed, any future donations made to a charity. A donor has the right to cancel an ongoing declaration, but that will only effect for tax purposes any payments made after notice of the cancellation has been received by the charity.

Clearly the intention is for the Gift Aid regime to provide a modern, flexible and simple system for giving to charity. Guidance notes on the new regime are available from the Inland Revenue and can be downloaded from their website (details at the end of this article).

Clearly under the Gift Aid regime a charity can create a continuing relationship with a donor akin to that achieved under a Deed of Covenant. A common example already being marketed is a direct debit supported by a continuing Gift Aid declaration. Instead of a legal obligation to give, the charity relies on the donor's inertia not to cancel the direct debit. What the fund-raiser cannot do any longer, of course, is persuade donors to give future commitments on the grounds that such a commitment was tax effective for both donor and charity.

However, this does not mean that existing Deeds of Covenant are now defunct, or that Deeds of Covenant no longer have a role for charities. The next two sections of this article look at each of these issues in turn.

Existing Deeds of Covenant

Existing Deeds of Covenant are still legally enforceable. There is also no need for charities to replace existing Deeds of Covenant with a Gift Aid arrangement. Indeed, charity trustees must think very carefully before replacing an arrangement which constitutes a binding promise to give (ie the Deed of Covenant) with an arrangement that does not create a continuing obligation to give (i.e. Gift Aid). This is because charity trustees have a duty to maximise the charity's assets, which might well be breached by the release of a binding obligation.

The following is a brief summary of how to approach Deeds of Covenant in favour of a charity that run on after April this year:

(a) Covenants by individuals

As from 6th April, a payment made under a Deed of Covenant by an individual can only qualify for tax relief under the new Gift Aid regime. However, the Revenue have indicated that a charity may take an existing Deed of Covenant to constitute a sufficient Gift Aid declaration.

In other words, there is no need for charities to replace Deeds of Covenant. If the Deed of Covenant expresses the form of payment as a gross sum (e.g. £100 before the deduction of tax at the basic rate) the Finance Act will maintain the right for the donor to deduct tax at the basic rate from the amount.

As far as tax reclaims are concerned, if a payment the charity receives now was due before 6th April the Revenue (by concession) will allow the charity to reclaim basic rate tax on that payment at 23%. The old claim form R68 should be used.

If the payment under the Deed of Covenant falls due after 6th April, the rate at which tax on that payment can be reclaimed is the new basic rate of 22%. The reclaim can be made as soon as the payment is received (rather than the charity needing to wait until after the due date has passed) and the new form R68 should be used. These can now be obtained from the Inland Revenue at Bootle. There is no longer any need to schedule covenanted donations separately from Gift Aid donations.

(b) Covenants by companies

As mentioned above, companies are no longer able, or required, to deduct tax at the basic rate on covenanted payments to charity. No tax can be reclaimed by charities on payments made under a deed of covenant by a company after 1st April. On the other hand, the deduction of basic rate tax is something that every existing Deed of Covenant by a company to a charity will usually contemplate whether it is a gross Deed of Covenant, a net Deed of Covenant or a profit-shedding Deed of Covenant.

Ideally, this means that a charity should contact all of its existing corporate covenantors to explain the change in the regime. In some cases (particularly with net Deeds of Covenant) it might be arguable that the fact basic rate tax is no longer deductible at source automatically grosses up the amount payable under the Deed. This will depend upon how the Deed is drafted. However, it is unlikely any charity will want to take such an aggressive stance with its corporate supporters.

A better approach is likely to involve simply explaining to the company the new regime, and the fact that they should now be paying a gross sum in order for the charity to be receiving the same benefit.

So, should charities cancel existing Deeds of Covenant with companies? As for individuals, the answer to this is probably not, unless there is a clear justification for cancelling the obligation to give to the charity.

Given that Deeds of Covenant from companies will now not quite make sense, should a charity seek to vary them? In most cases, this is going to be an unnecessary waste of resources. The Deed could only be varied by a further Deed. The Gift Aid regime does not require there to be a Deed or, indeed, any form of written agreement between the charity and the company. The only circumstance in which it might be suitable would be if there was genuine doubt about the future validity of the Deed without variation, or if it was important for the charity to procure that the legal obligation clearly related to a gross sum.

(c) Profit-Shedding Deeds

As for company deeds generally, these will probably not quite make sense under the new regime, as they tend to contemplate deduction of tax at the basic rate, at source. There are two basic options for a charity and its trading subsidiary to contemplate.

The first is for the subsidiary to Gift Aid its profits to the charity within nine months of its year end. If it does this, there will be no profits on which the Deed of Covenant will bite. It will still be there, but it will be irrelevant. If it is not a rolling deed, it will in due course expire anyway.

The second option is for the Deed of Covenant to be varied or replaced so that payments under it make sense and qualify as Gift Aid payments. For a suggested form, see the next section of this bulletin.

For purists, the first option is the less desirable. This is because the ongoing profit shedding Deed of Covenant will also contemplate the payments being made before the subsidiary's year end. As will be recalled, the legislation giving trading subsidiaries nine months grace after the year end in order to shed their profits accurately required the Deed of Covenant to require the payments to be made before the year end. The first option set out above will perpetuate the nonsense of a Deed of Covenant requiring something that neither party has any intention of doing.

On the other hand, it should be noted that we are not suggesting that a charity and its subsidiary should do away entirely with the profit shedding Deed of Covenant. This is partly due to the reassurance that a Deed of Covenant offers to a charity that it will receive all the taxable profits of its subsidiary. This should perhaps only be given up if the charity trustees are satisfied that the Gift Aid regime should be adopted wholesale, in order (say) to facilitate more easily profit retention – when this might be justified - in the subsidiary.

The second reason for retaining a Deed of Covenant is a matter of VAT. The supply of donated goods to trading subsidiaries of charities and the sale of those goods by those trading subsidiaries is zero-rated for VAT purposes. The relevant VAT legislation used to describe a subsidiary as being a company that covenants its profits to its parent charity. Now that this definition is redundant, Customs are proposing to replace it with a broader definition that defines an appropriate subsidiary as one that has agreed in some shape or form to give all its profits to its parent charity. The easiest way to demonstrate that that agreement subsists is for there to be a Deed of Covenant!

In the light of these points the better option is probably to put in place a 'gift aid compliant' Deed of Covenant. If cash is needed by the charity before the Deed bites, the subsidiary can (as it always could) use Gift Aid to pass up the profits early.

(d) Covenants by Charities

In certain circumstances, charities have in the past used Deeds of Covenant to profit-shed taxable income to another charity.

The difficulty is that under the Gift Aid regime there is a specific prohibition on charitable companies making Gift Aid payments. As this is now the only regime under which profit shedding can take place, charities that used to rely on such a Deed of Covenant can no longer do so. The change in the law will leave charities with such a covenant in a difficult position. The covenantor charity will no longer be able to obtain tax relief on the payments it is obliged to make. On the other hand, the covenantee charity might have some difficulty justifying giving up the covenantor's commitment to make donations to it.

(e) Deposit/Loan Deeds of Covenants

Before the introduction of Gift Aid, a reasonably popular means of giving to charity was the deposited Deed of Covenant. This involved the donor making an up front loan of a capital sum to a charity repayable over (say) four years. The donor would then also enter into a Deed of Covenant under which he or she would agree to pay to the charity the amount repayable by the charity in each year. Thus, the charity had immediate use of the whole capital sum and the donor could take advantage of a tax effective means of giving to the charity. It also, incidentally, spread the benefit of the tax relief.

Under these arrangements charities rarely bothered to repay the money to the donor for him/her to then repay it under the Deed of Covenant. Indeed, the whole point was to give the charity up-front use of the whole capital sum. However, where these arrangements are still in place, it is now extremely important for the charity to repay and the donor to give each time this is due. This is because, under the Gift Aid regime, tax relief is only afforded to Gift Aid payments. For this to apply, the Inland Revenue take the view that a *payment* has to be made. As the Revenue have in the past been willing to support this assertion, in proceedings charities who ignore this process will be doing so at their own risk.

New Deeds of Covenant

The Deed of Covenant is essentially a very simple instrument. It is a legally enforceable promise to give. A Deed of Covenant was only ever a complicated

document because of the tax rules that it had to comply with in order for it to be tax effective. Now that those tax rules have gone, a Deed of Covenant can be as simple, or as sophisticated as you want it to be.

In particular:

- It no longer has to last for over three years;
- It can be terminable by the donor;
- The sum calculated under it can be determined by whatever formula the donor wishes;
- The payments under it can be as regular or irregular as the donor wishes.

So in what circumstances will a Deed of Covenant continue to be useful? At its simplest, the answer is:

- Whenever it is important for the donor or donee to create a legally binding obligation to give (e.g. large sums are involved, the charity's projects depend upon the cashflow it is being promised, or the donor is backing up a vow of poverty to a religious community); and
- In cases where a VAT registered trading subsidiary deals in donated goods.

At the end of this article there are three basic forms of Deeds of Covenant – by an individual, by a company, and by a subsidiary for the purpose of profit shedding – in order to illustrate how simple it is to prepare a Deed of Covenant that complies with the Gift Aid rules. In the case of an individual, the Deed itself constitutes a valid Gift Aid declaration as it contains the necessary statements. In the other two cases no declaration is, of course, necessary. These forms should not be taken as universal precedents – as a Deed of Covenant is only now appropriate in more specialised circumstances it would be unwise to use any form of precedent without professional assistance. On the other hand, we hope they do show the rather different format and functions of Covenants under the new Gift Aid regime.

The point to bear in mind is, perhaps, less the fact that a Deed of Covenant is still possible, but rather that if a Deed of Covenant is being used, the form of transaction must nonetheless comply with the Gift Aid benefit rules. Broadly speaking, these are:

- That the funding provided must not be conditional upon the charity acquiring property from the donor or a connected person;
- That the payments made must not be repayable; and
- That benefits received by the donor or a connected person in consideration for the payment must not exceed certain *de minimis* thresholds.

It is on this last point that the most significant changes have, perhaps, occurred. Any payments under a Deed of Covenant (whether under an existing Deed or under a new Deed) will only qualify as Gift Aid payments if they comply with these benefit rules. It used to be thought that for membership schemes which received subscriptions by Deed of Covenant the subscriber could receive up to 25% of the value of his covenant in return before losing tax relief. That is no longer the case. Under the Gift Aid rules, the amounts are as set out in the table below, subject to a maximum aggregate benefit per year of £250.

Value of Payment	Value of Benefit
Up to £100	25%
£101 - 1000	£25
Over £1000	2.5%

Although there is some relaxation allowed for membership – type schemes to spread benefits against donations, and donations against benefits, charities continuing to use Deeds of Covenant should bear in mind the fact that they simply cannot give as much in return as they used to be able to.

Another point to bear in mind relates to cancellation. Under the new Gift Aid regime, if an individual donor gives a charity a perpetual declaration in relation to future gifts, the donor can cancel that declaration at any time in the future. The cancellation is then effective in relation to any payments the charity nonetheless receives after that date. A Deed of Covenant does, of course, create a legal obligation to give independently of the Gift Aid declaration. This means that a donor under a Deed of Covenant could, in theory, stop the charity being able to reclaim tax at the basic rate despite still having to make payments to the charity. This needs to be borne in mind if the charity continues to collect from individuals in these (admittedly unlikely) circumstances.

Finally, it should be noted that it is still possible to enter into a loan/deposit arrangement with a charity using a Gift Aid compliant Deed of Covenant. However, this is only likely to be of interest to donors of large sums wishing to spread the tax relief over a number of years, where the charity needs the lump sum up front (say, for a capital project). There are also a number of technical pitfalls; any donor or charity contemplating such an arrangement should obtain professional advice to assist with the drafting.

Conclusion

So is this goodbye to the Deed of Covenant? As a fundraising tool, the answer is probably 'yes', on the simple premise that everyday donors are unlikely to want to bind themselves legally to a charity when there is no need, for tax purposes, to do so. On the other hand, there are a number of contexts in which the Deed of Covenant remains a useful, if not essential, tool for enabling charities to rely upon (and, if necessary, enforce) a donor's generous intentions.

Contact Details

The Inland Revenue can be contacted at:

England, Wales and Northern Ireland

FICO (Charity Repayments)
St John's House
Merton Road
Bootle
Merseyside

Tel: 0151 472 6036/6037
(Gift Aid)
0151 472 6029/6053/6370/6371
(Payroll Giving)
0151 472 6046 (Giving shares)
Fax: 0151 472 6034
Website: www.inlandrevenue.gov.uk

Scotland

FICO (Scotland)
Trinity Park House
South Trinity Road
Edinburgh
EH5 3SD

Tel: 0131 551 8127
Fax: 0131 552 0746

GROSS DEED OF COVENANT BY COMPANY (GIFT AID COMPLIANT)

DEED OF COVENANT

Notes

To ("the Charity")
[Name of Charity]

We, LIMITED ("the Company")
[Full name of company]

whose registered office is at

.....hereby promise that the
Company will pay to the Charity the sum of

£..... 1

each year from [the date shown below] [.....]
unless and until we give notice in writing that we wish to cancel this Deed. 2

IN WITNESS whereof the Company has executed this
instrument as a Deed thisday of 3
..... 200[]

THE COMMON SEAL OF)
LIMITED)
was hereunto affixed in the)
presence of:)

.....
[Signature of Director]

.....
[Signature of Director/Secretary]

NOTES

1. Enter the amount the Company wishes to pay to the Charity each year. You pay directly to the Charity the amount you have indicated which you can then deduct from your profits when calculating the sum chargeable to Corporation Tax. Please note that the Charity cannot reclaim any tax from the Inland Revenue.
2. Delete as appropriate. If you choose to enter an actual date it must not be earlier than the date the Deed is sealed.
3. The form must be sealed in the presence of two directors of the Company, or a director and the secretary, who should sign where shown. You should enter the date the Deed is actually sealed.

CONTINUING DEED OF COVENANT BY INDIVIDUAL (GIFT AID COMPLIANT)DEED OF COVENANT

	<u>Notes</u>
To	
[Name of Charity]	1
I promise to pay you during my lifetime, or until such time as I give notice in writing, the sum of	
£.....	2
each [month] [quarter] [year]	3
from [the date shown below] [.....]	4
and I wish each such payment to be treated as a Gift Aid donation unless and until I give notice that I no longer wish the payments to be treated as such.	5
<u>Signed as a deed & delivered by:</u>	6
<u>Date</u>	
<u>Full Name</u>	7
<u>Address</u>	
<u>Witnessed by:</u>	
<u>Signed</u>	
<u>Full Name</u>	
<u>Address</u>	

NOTES

1. You may cancel this Deed at any time by giving notice in writing to the charity.
2. Enter the amount you will be paying to the charity.
3. Delete as appropriate to show how often you will make the payment.
4. Delete as appropriate. If you choose to enter an actual date it must not be earlier than the date you sign the deed.
5. You must pay an amount of income tax and/or capital gains tax at least equal to the tax that the charity reclaims on your donations in the tax year. If in the future your circumstances change and you no longer pay tax on your income and capital gains equal to the tax that the charity reclaims, you can either give notice that you wish to cancel the Deed or alternatively give notice that you no longer wish payments to be treated as Gift Aid donations. If you pay tax at the higher rate you can claim further tax relief in your Self Assessment tax return.
6. You must sign the form and enter the date you actually sign it in the presence of a witness, who should also sign where shown.
7. Please notify the charity if you change your name or address.

DEED OF COVENANT BY TRADING SUBSIDIARY (GIFT AID COMPLIANT)

THIS DEED OF COVENANT is made the _____ day of _____ 2000

BETWEEN

(1) [_____] **LIMITED** whose registered office is at _____ ("the Company") and

(2) [_____] of [_____] ("the Charity")

WHEREAS the Charity is established for charitable purposes only and the Company has resolved to donate to the Charity the whole of its taxable profits earned in the periods hereinafter specified

NOW THIS DEED WITNESSES as follows:

1. The Company **HEREBY COVENANTS** to pay annually to the Charity on the day specified in Clause 5 a sum equal to the Company's Profits earned in the Accounting Period immediately preceding each payment
2. The Company's Profits shall mean the profits of the Company for the purposes of Corporation Tax (disregarding any payment made hereunder) earned in an Accounting Period and for the avoidance of doubt shall not include any sums paid to the Charity by way of Gift Aid donations attributed to the Accounting Period to which such profits relate
3. An Accounting Period shall mean an accounting period of the Company for the purposes of the assessment of Corporation Tax
4. The covenant contained in Clause 1 hereof shall commence with a payment of the Company's Profits relating to the Accounting Period current at the date hereof and shall continue until and include a payment of the Company's Profits relating to the Accounting Period in which notice is given in writing by the Company to the Charity that it wishes to cancel this Deed

