
The Personal Tax Planning Review

DEEDS OF COVENANT IN FAVOUR OF CHARITY

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One of the most popular methods of persuading donors to give to charity is by means of a deed of covenant. Many of us at some stage or other have been sent appeals by national charities or by our old school, former university or university college together with a deed of covenant. Subtle refinements of the law governing such covenants take place with regularity and it is sensible to review once again the current position with regard to deeds of covenant in favour of charities, and the rules to be obeyed if such covenants are to attract relief.

Qualification for Relief

A covenant qualifies for relief if it (1) is gratuitous (2) is to last for a period which may exceed three years and either (3) is not unilaterally revocable by the settlor within three years of commencement or (4) is unilaterally revocable by the settlor within three years of commencement and is after 6th May 1992 unrevoked.²

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² ICTA 1988 ss.660(3) and 671(2); Finance (No.2) Act 1992 s.27.

Relief

Where there is a qualifying covenant to pay an annual sum to a charity out of the income of the covenantor, the covenantee charity can reclaim basic rate income tax withheld by the covenantor when making the payment covenanted.³ It follows that when making a payment in performance of the covenant the covenantor must withhold basic rate tax. Only tax at the basic rate can be withheld by the covenantor and reclaimed by the charity, even if the covenantor has paid income tax at the higher rate. However, the income tax payer can set off such a covenanted annual payment to charity against any income he may have which is liable to tax at the higher rate.⁴

Year to Which Covenanted Payments are Related

For tax purposes payments under a deed of covenant are related to the year in which they are *due*, even if that year is not the year in which the relevant payment is made. So if the covenantor fails to pay in the year when the payment was due but pays later, income tax must be deducted at the rate appropriate to the year in which the payment should have been made.

If payment is made more than six years late, the claim of the charity to repayment of tax is barred.⁵ Charities should be on their guard about this limitation point and enforce the covenant before it is too late.

Gratuitous Element: Benefits for Covenants

A vexed question is the extent to which benefits may accrue to a covenantor from the charity to which he makes a payment by covenant.⁶ There is no simple answer to this question.

There are three special cases falling outside the rule which should be mentioned at the outset. The first special case concerns charities for the preservation of

³ ICTA 1988 s.660 amended by FA 1989 s.60(3).

⁴ ICTA 1988 s.683 (3) (4) (10) (c).

⁵ *IRC v Crawley* [1987] STC 147.

⁶ See especially Debra Morris "Charitable Covenants: A Benefit or Not" (1989) Conv 321; James Kessler "Benefits for Covenants" (1992) 1 CL&PR 55.

property or for the conservation of wildlife.⁷ Many such charities may offer rights of admission to their premises in return for covenant. The Natural Trust and the London Zoo here spring to mind. Secondly, there is an exception (sometimes called the *de minimis* exemption) for small benefits. The Revenue disregard benefits worth less than 25% of ordinary small subscriptions.⁸ Thirdly, the Revenue generally disregard benefits in the form of literature so long as these benefits are relevant to the charity's work.⁹

Benefits Bargained for and Benefits Not Bargained For

The clear case is where the relevant covenant actually contains a counter-stipulation for a benefit to enure to the covenantor. In such a case neither the charity nor the covenantor can claim tax relief even though the payments under the covenant may have been made out of income. The provision of a benefit as part of the overall bargain is a consideration in money or money's worth and a covenanted payment to charity ranking for relief must be "a payment made under a covenant *made otherwise than for consideration in money or money's worth*". The presence of consideration, a bargained for benefit, results in the loss of tax relief. So if prospective members of a charity are inveigled into making deeds of covenant by a *promise* that they will get membership privileges or benefits, the covenant will not rank for tax relief. If on the other hand a reduction is in fact later given to covenantors with no advance publicity, in other words where the benefit is adventitious and not contracted for, the covenant is not made for consideration. Likewise, even if the covenantor knows that the charity gives the benefit but no promise or undertaking is given that such a benefit will accrue, the covenant will not be one for consideration.

The Revenue do not accept all of these propositions. In particular, they seek to cast the net wider and to argue that any benefit accruing to the covenantor will sabotage the tax relief.

In effect, the argument deployed is that any benefit accruing *in consequence of* making the covenant prevents tax relief. Now that particular test is certainly

⁷ FA 1989 s.59.

⁸ Press Release 14th February 1989.

⁹ There is an unpublished extra-statutory concession.

laid down in relation to gift aid¹⁰ but no such rule applies to covenants. Case law is prayed in aid by the Revenue as authority for the proposition that annual payments must be "pure income profit" and that in consequence any payments lacking that quality do not satisfy the "pure bounty rule". However this proposition falls foul of the language in *IRC v National Book League* (1957) 45 TC 466. In that case Lord Evershed MR underlined that merely because a covenantor receives benefits from a charity that does not, of itself, prevent the payments from being annual payments:

"I must guard myself against saying that whenever you find a covenantor in favour of a charity getting allowed to him certain privileges it therefore follows that such a covenantor no longer can say that he was paid without conditions or counter stipulations".¹¹

Again, in *Campbell v IRC* (1968) 45 TC 466 the House of Lords comprehensively rejected in this context the so called pure bounty rule invoked by the Revenue. For that reason it is submitted that there is indeed no warrant either in statute or in the cases for saying that benefits accruing in consequence of the covenant, rather than in consideration of the covenant, can ever disqualify the covenanted payment from enjoying tax relief. It follows that Revenue arguments inconsistent with the two cases just cited must be rejected. Only benefits given for consideration can disqualify.

Membership Covenants

Uncertainty also surrounded membership covenants under which either the donor was to make payments to the charity for the duration of his membership or the donor had to make payments to a charity for a period of four years or the duration of his membership of the charity, whichever was the longer. In 1992 the Budget Press Release provided as follows:

"Deeds of Covenant

3. Under present rules charitable covenants which are written to last for four years or until some later event (for example, the donor giving up membership of the charity) cease to be effective for tax

¹⁰ FA 1990 s.25(2)(c).

¹¹ *Earl Howe v IRGC* 7 TC 289.

purposes after four years. If charities want to continue to receive tax relief, they have to get donors to sign new covenants every four years.

4. The Chancellor's proposal will allow tax relief for covenants of this type to run on without covenants having to be renewed or replaced, provided the donor's power to stop making payments cannot be exercised within the four year period. This will simplify the present rules and reduce administration for charities, particularly those which operate membership covenants."

So it appears that the four year initial period will be necessary.

Tax Repayment Claims: the New Procedure

The 1992 Budget Press Release also dealt with repayment claims by charities and read as follows:

"Repayment claims by charities

5. The Inland Revenue propose to make improvements in their current procedures for dealing with tax repayment claims by charities. These are designed to reduce the routine paperwork which charities now have to send in with their claims, and to make better use of Inland Revenue resources.

6. In order to check claims, the Revenue will continue the visits they already make to look at charities records. These visits will help charities to get their tax claims right first time. The existing power to inspect charities' records of gift aid donations (section 94 FA 1990) will be extended to cover covenants and other income on which charities claim tax repayments.

7. New fuller guidance for charities on making covenants, and running covenants schemes will be available from Claims Branch, in time for the start of the new procedures which will apply to claims made on or after 1 July 1992.

8. New telephone helplines will also be available. Charities will be able to phone if they have questions about their tax repayment claims or about the rules for tax relief. The numbers will be included in the new guidance."

1993 Press Release

In a Press Release on 2nd March 1993 the Inland Revenue gave the further promised guidance as follows:

1. F(No.2)A 1992 s.27 relaxes the rules for tax relief for certain charitable covenants.
2. Some charitable covenants are written to last for four years or until some later event (for example, the donor giving up membership of the charity at some time after the end of the four years). Under the previous rules these covenants ceased to be effective for tax purposes after four years, whether or not the power to terminate the covenant was actually exercised. If charities wanted to continue to receive tax relief on covenants of this type, they had to get donors to sign new covenants every four years.
3. For covenants which include such powers of termination, the new rules introduced in 1992 will allow tax relief to run on without the covenant having to be renewed or replaced, provided the donor's power to stop making payments cannot be exercised within the four year period. The tax relief can continue until the covenant is actually terminated. This simplifies the previous rules and will reduce administration for charities, particularly those which operate membership covenants.
4. The change applies to new covenants made on the or after 7th May 1992. It also applies to existing covenants where the power to terminate the covenant could not have been exercised before 7th May 1992.
5. Some enquirers have asked whether this change means that a covenant which is written to run for four years only (with no alternative termination date) will be regarded as continuing after the end of the four years. The new rule does not have that effect. Such covenants will, as now, need to be renewed at the end of the four years if the donor wishes to continue the payments. The new rule can apply only where the terms of the covenant itself provide for the covenant to continue until a later event.
6. Some charities have asked what form of words should be used in a deed of covenant which is to continue after the first four years until the donor terminates it at a later date. The appropriate form of words in

any particular case will depend on precisely what result the donor wishes to achieve - for example, the nature of the event on which he or she wishes to be able to terminate the covenant. If the donor does not want to specify a particular event, a possible form of words would be -

"I promise to pay [the charity] during my lifetime, such a sum as after deduction of income tax at the basic rate amounts to £..... per annum provided that I may revoke in writing this deed of covenant at any time after the expiry of four years from... [enter here the date on which the first payment is due to be made under the deed]."