

Deeds of Covenant for surplus income



What is a Deed of Covenant?

It is a binding agreement made by an individual to pay a regular sum to a specified recipient.

Why is it needed?

A Deed of Covenant provides a means of making tax efficient lifetime gifts and, crucially, a way of ensuring those gifts can continue to be made even in the event of the Donor losing the capacity to make the gifts themselves.

Under Section 21 Inheritance Tax Act 1984, an individual can make a gift that is exempt from inheritance tax provided it can be shown that:

1. It forms part of the Donor's normal expenditure (i.e. as part of a regular pattern of giving).
2. It is made out of income.
3. It leaves the Donor with enough income for them to maintain their normal standard of living.

An individual can take advantage of this valuable exemption while they have the capacity to calculate their surplus income and gift it.

Problems arise in the event of the Donor losing capacity. In those circumstances, even if the Donor has an Enduring Power of Attorney ("EPA") or Lasting Power of Attorney ("LPA") in place, the Mental Capacity Act 2005 ("the MCA") restricts the gifts an Attorney can make (they may only make gifts on customary occasions to relatives and gifts to charity if the value of such gifts are not considered unreasonable having regard to the Donor's particular circumstances).

The solution is for the Donor to execute a Deed of Covenant to supplement his or her EPA/LPA. The Deed would create a contractual obligation under which the Donor would agree to gift their surplus income each year. This would achieve the following:

- Provide evidence of the intention to make regular gifts (this would need to be demonstrated in order to satisfy part (a) of the Section 21 criteria referred to above).
- Enable an Attorney acting on the Donor's behalf (in the event of the Donor losing capacity) to continue to pay the surplus income, on the basis that he or she would not be making "gifts" that contravene the MCA but instead be making contractual payments in accordance with the terms of a binding agreement.

What are the tax implications for the Donor entering into the Deed?

By entering into the covenant, the Donor will not be diminishing the value of their estate for inheritance tax purposes. Under Section 5(5) of the Inheritance Tax Act 1984, when it comes to valuing a person's estate, only liabilities that are incurred for consideration in money or money's worth are to be taken into account.

In addition, each time a payment is made in accordance with the Deed, there will be no transfer of value on the basis that the criteria in Section 21 will be satisfied and the transfer will therefore be exempt from inheritance tax.

What would happen to the payments if the Donor ceased to have surplus income after signing the deed?

The Deed of Covenant would be carefully worded so as to gift only the Donor's surplus income calculated on an annual basis by reference to the Section 21 exemption.

In that sense, the arrangement is self-regulating as, if the Donor ceases to receive surplus income (e.g. in the event of going into a care home), the payments stop.

What clients would this be suitable for?

Deeds of Covenant should be considered for clients in later life that receive significant surplus income and have estates with an overall value in excess of their available nil rate band allowances.

It is important to note that, once in place, the Donor can only cease to make payments under the Deed of Covenant if they cease to have surplus income or with the consent of the Covenantee.

What information would be needed to put a Deed of Covenant in place?

In order to ensure payments may continue to be made in the event of the Donor losing capacity, it will be necessary to ensure the Donor has an EPA or LPA in place.

With regard to the drafting of the document, the M&R precedent defines the surplus income, confirms payments should endure beyond the loss of capacity and details the circumstances in which the payments should be stopped. The only details that should need to be added are the donor's full name and address and the proposed recipient(s).

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