Donations of LDC debt by banks to charities

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Gifts by banks of LDC debt to charities are increasingly in the news.

As the debt problem enters into its seventh year, there is widespread recognition that some of the debts — particularly of low-income, foreign exchange constrained countries — can never be paid. The industrial governments in Toronto, in mid-1988, agreed an important measure of official debt relief for low-income heavily indebted countries in sub-Saharan Africa.

Complementary action is beginning to be taken by some commercial banks which are donating parts of their developing country exposure to charities. The charities then have a special arrangement with the developing country government to get the debt (or part of it) serviced in local currency. The local cash is then used to fund projects in the developing country which are of high development priority (either by focusing on some of the poorest people in the society and/or by taking action that protects the natural environment). There is in these cases a direct link between debt reduction and high priority development expenditure.

These type of deals have some clear advantages for the enlightened commercial banks which decide to pursue such a path. Firstly, the bank can *save* on fairly high expenses and administration costs relating to debt rescheduling and processing of arrears linked to small amounts of debt — where repayment prospects are in any case very doubtful; perhaps even more importantly, it can save on scarce and valuable senior management time that can be more productively used in other, more profitable, activities. This gain is particularly clear if all of a bank's exposure to a particular country is donated at a particular time. Secondly, the bank will benefit from a large amount of goodwill generated by such a donation which will enhance the bank's image in its host country, in the developing country and in the world at large. Indeed, the donations made so far have attracted a lot of interest in the media. Thirdly, the bank's management will know that the debt donation will be used for purposes that benefit long-term development in the debtor country. Finally, in some cases the bank may obtain an important percentage reduction in its tax obligations.

Below, we will describe several of the "debt for development swap operations" that have taken place. Particular emphasis will be placed on the debt for child development deal done by Midland Bank, Unicef and the government of Sudan, which is being used to fund a health, water and reforestation programme in the Sudan.

Finally we will analyse in some detail the potential tax advantages which such debt for development swaps may have for UK banks.

Debt for development swap questions

The first reported debt for development swap was the donation made in February 1988 by Fleet/Norstar Financial Group in Providence, Rhode Island, of US$250,000 in Costa Rican debt, to a conservation effort in that country. The debts were donated to Nature Conservancy, an environmental charity based in Washington; the charity then swapped the debt for bonds issued by the Costa Rican government. The bonds were used to finance conservation efforts in a 25,000 acre jungle habitat.

Under the US Internal Revenue Service (IRS) ruling made in November 1987, such a donation, because it is a charitable contribution, is tax deductible.

The second reported debt donation was made by American Express Bank Ltd, which gave US$1m in Nigerian obligations to the International Foundation for Education and Self Help, an institution which will use the funds as part of a programme to fight hunger, health problems, unemployment and illiteracy in Nigeria. With this donation, American Express Bank Ltd also took advantage of the 1987 IRS ruling that allows donations of Third World debt and other obligations in exchange for tax breaks.

In December 1988, Midland Bank handed over its total loan exposure in Sudan (amounting to US$800,000) to the United Nations Children's Fund (Unicef), which simultaneously arranged for the Sudanese government to service them in local currency. The Bank of Sudan is paying Unicef local currency and the funds are being solely invested in water, sanitation, reforestation and health education programmes in the Kordofan region of Sudan, and administered by Unicef. Unicef assumes accountability for the use of funds. The Sudanese government has cooperated fully with Unicef to establish the programme and is collaborating with Unicef to implement it.

The Midland Bank donation was the first one made by a European bank, and the first time that Unicef got involved with debt development swaps. However, Unicef hopes that further such debt donations can be arranged, both for the Sudan and for other low-income debt distressed countries, to finance urgently needed projects that benefit poor people (particularly children and women) and protect the natural environment. Indeed two other European banks — Hambro's and Deutsche Bank — have donated debts to Unicef. The breakthrough implied by the donation from Midland seems thus to have set an important precedent that other banks are interested in following.

Though the Midland Bank donation does not lead to a significant reduction in Sudan's large total external debt, it is extremely valuable because the health, water and reforestation scheme it is financing will benefit 5,000 people, and will bring clean water supplies, sanitation and improved environmental conditions to 10 villages.

The resources being made available for improvements in rural water, sanitation and reforestation as a result of the debt for development donation will be additional to resources previously allocated or available to Sudan. Thus, Unicef, the government of Sudan and the Midland Group are contributing to more growth-oriented adjustment, with outcomes that particularly benefit the rural poor.

Currently, only about 30% of the rural population in Sudan is served with improved water, with less than 15% of Kordofan's population having easy access to water. For this reason, both the Sudanese government and international institutions such as Unicef and the World Bank have given very high priority to a clean water supply in rural areas. In support of the national sector development programmes to improve water supply to the rural population, various bilateral and multilateral institutions are providing financial and technical assistance. Unicef is the largest donor, in terms of the number of rural communities served annually.

The main uses of the funds are: the digging of 25 hand pumps, with provision for adequate tools for maintenance; digging of 500 pit latrines; the development of 10 village seedling nurseries, which will receive water from the hand pump run-off; the plantation of 10 village wood lots and the formation of 10 village health committees to strengthen community participation in the project.

All this will lead to forestation, thus improving the natural environment. In many villages, a tree seedling nursery will be established to produce a minimum of 2,000 seedlings annually. The seedlings will then be planted in the village wood lot and eventually provide renewable energy for the local community.

Indeed, one of the main reasons why the Midland group decided to make the debt donation to Unicef, and why other European banks are currently expressing an interest in similar deals with that institution, is because the funds released are being channelled towards a clearly defined, cost-effective and worthwhile project by Unicef, with strong backing and cooperation from the country's government. As Jacques de Mandat-Grancy, Midland's developing countries director said at the time the deal was finalised, "Midland is delighted to have been able to free funds for such a practical purpose."[11]

As we describe in detail below, important tax advantages can be obtained from debt donations to charitable institutions. However, in the case of the donation by Midland Bank to Unicef, tax advantages appear not to have been an incentive, as Midland is understood not to have received any tax reduction related to the Unicef deal.

The tax advantages

In the UK, there are tax as well as other advantages for donor and recipient — but our tax system is sufficiently incomprehensible and enmeshed in jargon that use of an illustration is the only way through which an innocent bystander is likely to be able to understand what these are.

Suppose that a bank agrees to donate to charity one tenth of the $lm (nominal) owed to it by Country X. The first question is what type of charity is an appropriate recipient. Only a charity recognised by the UK Charity Commissioners will qualify for the benefits set out below (and will qualify for the bank's donation). and then only if that charity is able to make use of that territory's own currency within Country X will it be an appropriate recipient. It seems, therefore, that one obvious class is the supranational organisations' charitable funds — the UN children's fund, Unicef, for instance. The UK recognises it as a charity. Another category is a UK charity, one of whose major objects is the relief of suffering and illness outside the UK, and which is geared and staffed to achieve this — Oxfam is a prime example.

The most straightforward procedure is that made available by Section 339 of the Taxes Act 1988. The bank and Unicef (for example) agree that $100,000 (nominal) of Country X's debt is to be given to the charity, and Unicef obtains Country X's confirmation that it will then repay this nominal amount, not in convertible US dollars but in local currency, provided that Unicef uses those funds for the benefit of Country X's children.

One part of the agreement between the bank and Unicef must put a value on what is being given and received. It seems appropriate that this value should be the figure at which the bank had been carrying the debt concerned on its balance sheet, that is to say the figure net after any specific provisions made against it to date by the bank. If that amount is less (as it will usually be) than the local currency repayable to Unicef translated at the official rate of exchange, the difference can be rationalised as the disadvantage of non-convertibility. The bank's gift is made (and the charity's receipt is similarly located) in the UK, and Country X's local currency is of less value and utility there than the official exchange rate might indicate.

Suppose, therefore, that the bank has put a figure of $65,000 (£36,720) on its gift. Section 339 of the Taxes Act 1988 requires that the bank make its gift "under deduction of income tax", that is to say that it regard its total gift as being £48,960; that it pays over 25% of that £12,240, being income tax at the basic rate, to the UK Inland Revenue authorities; and that only the "net" value of £36,720 is passed to Unicef.

The bank's cost in its profit and loss account is thus £48,960 pre-tax. What level of tax relief it obtains depends whether the revenue authorities have or have not given it full tax relief for its 35% provision against the debt concerned. Let us assume that they had in fact only allowed 30% — so that the effective "tax carrying value" was $70,000, or £39,545. The bank's aggregate tax-effective deductions would thus be £39,945 plus £12,240 (income tax as before) and its tax relief on its gift, at 35%, would therefore be £18,130. The net cost to the bank is thus £30,830.

One point which must be made clear is that the Section 339 route is only available if the bank's total donations (£48,960 plus whatever other charitable gifts it makes by this route) are 3% or less of the dividends paid in the same year.

Unicef's receipt compares very favourably with the bank's net cost of £30,830. First, as a charity, Unicef can potentially reclaim from the UK Inland Revenue the £12,240 of income tax suffered by deduction from its receipt. That amount of sterling can clearly be spent in the UK, or elsewhere, on food, medicines and equipment which it can import into Country X in pursuit of its charitable aims. Within that country it can convert its $100,000 (nominal) of debt into local currency. Allowing perhaps for a charge of a few percent as a fee for that conversion, the sterling equivalent of the currency actually received might be £54,000.

Unicef can therefore benefit to the extent of £66,240, towards which the bank contributes £30,830, and the UK revenue authorities give corporation tax relief of £18,130. (Their income tax refund of £12,240 does not in fact cost the revenue authorities anything, since they receive it with one hand and refund it with the other.)

The figure work is still almost totally incomprehensible, but for those who want to reconcile what has occurred, the clearest way to set it out is as follows in Figure 1.

Figure 1: How Unicef benefits

Aggregate (nominal) donated $100,000, equivalent to £56,495		Bank	Revenue
Because this is tax deductible the bank bears 65% and revenue 35%		£36,720	£19,775
But bank had previously written off 35%	£19,775		
And revenue given corporation tax relief for 30%	5,930	13,845	5,930
The cost of giving the remainder is		22,875	13,845
In addition bank gives income income tax	12,240		
But revenue allow corporation tax relief	4,285	7,955	4,285
		30,830	18,130
This is of course the aggregate donation		48,960	
Adding in the amount the bank had previously written off		19,775	
		68,735	
And deducting the charge for conversion to local currency		2,495	
Shows how Unicef benefits		£66,240	

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