GMG ARTICLE:

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SOUTH AFRICANS WITH RESIDENTIAL PROPERTY IN THE UNITED KINGDOM NEED TO BE AWARE OF THE REVISED INHERITANCE TAX REGIME

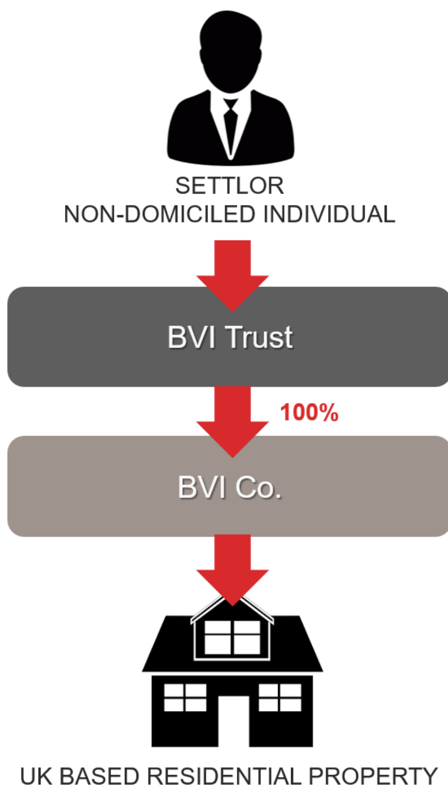
Impending changes to the Inheritance Tax ("**IHT**") regime in the United Kingdom ("**UK**") will affect, *inter alia*, South African residents indirectly owning residential property situated in the UK through offshore companies, offshore partnerships or offshore trust structures. It is the intention of Her Majesty's Revenue and Customs ("**HMRC**") to extend the scope of IHT to non-domiciled individuals owning residential property in the UK through offshore structures, whether or not the individual is tax resident in the UK and irrespective of the value of the residential property.

The new IHT rules, forming part of a wider reform process affecting non-domiciled individuals, will come into effect on 6 April 2017 and apply in respect of chargeable events (discussed below), on or after that date. The change in the IHT regime requires South Africans (and in fact any non-domiciled individual) with residential properties in the UK, held indirectly through offshore structures, to re-evaluate its efficiency from an estate planning and tax perspective – and do so quickly. It is important to note that commercial property situated in the UK remains unaffected, but tenanted residential property will be caught under the revised IHT regime, which is not the case under the UK's current Annual Tax on Enveloped Dwellings ("**ATED**") regime.

In order to place IHT and ATED into perspective, IHT is levied at the rate of 40% on 'chargeable events' (see below), whereas ATED is an annual tax charge payable by companies, partnerships with a corporate member or collective investment scheme vehicles owning UK based 'dwellings', valued at more than £500,000 (with effect from 1 April 2016). A UK based property is regarded as a 'dwelling' where all or a part of the property is used, or could be used as a residence. The ATED charge ranges between £3,500 for properties valued between £500,000 and £1,000,000 staggering upwards through a banding system to £220,350 for properties valued in excess £20 million.

As stated above, any 'dwelling' which is let as part of a property rental business does not fall within the ambit of ATED, nor does it apply to trustees through an offshore trust holding structure. This is however not the case under the IHT regime as it applies to trustees holding residential property through an offshore structure, has no minimum property value and does not intend excluding residential properties that are let out on an arm's length basis to independent third parties. It is clear that the IHT net is significantly wider than ATED and requires careful planning going forward. Affected South Africans may need to consider 'de-enveloping' their indirectly held residential properties situated in the UK.

Although more complex scenarios exist, the general structure for purposes of this article, forming the subject matter of the revised IHT regime, is set out below (a British Virgin Island ("**BVI**") structure is used for illustrative purposes) –



CURRENT IHT REGIME

Currently, the IHT regime in the UK provides for an exemption from IHT for residential property situated outside the UK, in respect of a non-domiciled individual. Similar treatment is afforded to residential property held by a settlor of an offshore trust, where that settlor or beneficiary is domiciled outside the UK. Under current IHT law, a residential property is regarded as being situated outside the UK, where it is indirectly held by a non-domiciled individual through an offshore structure (e.g. offshore trust or offshore company structure or a combination of both, per the illustration above).

It is the view of HMRC that non-domiciled individuals enjoy a significant tax advantage over UK domiciled individuals, on the basis that the latter are subject to IHT on their worldwide assets. As discussed above, non-domiciled individuals are only subject to IHT on property which is situated inside the UK and held directly in their individual capacities. In order to avoid the IHT charge where property is held directly by a non-domiciled individual, many have structured their affairs in such a way to 'envelop' a residential property within an offshore structure, effectively sterilising the IHT provisions.

Given the change in IHT regime, the question now turns to whether the non-domiciled individuals, indirectly holding residential property in the UK through offshore structures, should maintain the *status quo* or 'de-envelop' before 6 April 2017?

CHANGE TO IHT REGIME

To level the playing field, the IHT regime will be amended with effect from 6 April 2017 to effectively bring property of a non-domiciled individual within the scope of IHT, but only to the extent that the value of his / her property is attributable to residential property situated in the UK. In essence, the revised legislation brings the residential property situated in the UK, but held through an offshore structure, within the IHT net by treating the interests of participants in a 'close company' or members of an offshore partnership to be attributable to that residential property. A 'close company' is broadly regarded as a company that is controlled by five or fewer persons. Turning to the illustrative example above, a simple offshore trust structure holding 100% of an underlying subsidiary that invested in UK residential property, will be regarded as a 'close company'.

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By effecting the change in regime, the indirect interest of the non-domiciled individual is brought squarely within the IHT net and the UK residential property held through an offshore structure, will no longer be excluded from IHT. As stated above, IHT will be triggered on 'chargeable events' which include –

- the death of a non-domiciled individual holding shares in an offshore 'close company' that owns UK based residential property;
- the redistribution of the share capital of an offshore 'close company' that owns UK based residential property;
- the death of a donor making a gift of shares in a 'close company' that owns UK based residential property, where that gift was made within 7 years of death;
- a gift made by a non-domiciled individual of shares in a 'close company' that owns UK based residential property;
- the death of a donor or settlor who benefits from a gift of UK based residential property or of shares in a 'close company', which owned the relevant property within 7 years of death;
- **any 10-year anniversary of an offshore trust holding UK based residential property through an offshore company**; or
- the death of a life tenant with a pre-March 2006 qualifying interest in possession in a trust from which they have an entitlement to income.

The 10-year anniversary charge is of particular importance at it entails an IHT rate of 6% every 10 years of the excess value of the property above £325,000 – this scenario only applies where a discretionary offshore trust holds the UK based residential property directly (and the charge will be reduced if assets are not relevant property for the full ten years). The 10-year charge may be more financially palatable than the 40% IHT charge, especially where institutional debt exists to reduce the value of the property (see below).

VALUATION FOR IHT PURPOSES

The change in IHT regime necessitates a change in the valuation regime for residential properties held by non-domiciled individuals through offshore structures. The general approach would be to calculate the IHT liability of the open market of the property or the shares, where the property is held through an offshore corporate structure (see illustrative example). The value of the property will be reduced by any debt attributable to that residential property, however, connected party debt will be disregarded.

CONCLUSION

Affected non-domiciled individuals holding UK based residential property through offshore structures should engage their tax and estate planning advisors as a matter of urgency, in order to find the optimum solution for dealing with the impending changes to the IHT regime. Consideration could be given to 'de-enveloping' the UK based residential property through personal direct ownership, coupled with a life insurance product to fund any potential IHT charge or to restructure the ownership of the offshore company that holds the UK based residential property.

Geneva Management Group will be making direct contact with clients potentially affected by the impending IHT regime to discuss the various options available. Affected clients are welcome to contact my office directly for assistance.

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