BloomsburyWealth®

The Bloomsbury Wealth

GUIDE TO ESTATE PLANNING

This guide will help you to consider the options available to protect your family's wealth for future generations.

INTRODUCTION

Estate planning is all about ensuring that the right people get the right financial assets and/or financial assistance at the right time. Losing family wealth to inheritance tax or hostile creditors can have a very significant negative impact on achieving your wider wealth planning objectives.

Helping the younger generation

Given the high cost of housing, it is now common to provide financial assistance with funding for a young person's first home. Typically this happens at the same time as they form their first serious relationship. However we all know that good relationships can quickly turn bad, which can have serious consequences for family wealth when half of the funds previously gifted could pass out of the family in a divorce settlement.

Family misfortunes

Your elderly parent needs a new car; your son needs help funding his house extension; your best friend needs help funding a knee operation; your brother's business goes bust. As a successful person, naturally you'll wish to assist family and close friends, within reason. That said, you do not want to affect the recipient's entitlement to state benefits or see your own hard-earned wealth disappear in their bankruptcy proceedings or to meet their care fees.

The big day

The average cost of a wedding in 2018 was £30,355[1] but it may be that your children's or grandchildren's weddings won't be average! The survey found that over 50% of brides expect to go over their budget and 20% would rather borrow than compromise their plans. In any case, if you can afford to do so, you may wish to make a financial contribution to help the happy couple to have a day they will not forget.

[1] Bridebook.co.uk - National Wedding Survey 2018

Education, education, education

Helping to fund the education costs of your children, grandchildren and other close relatives may be an important objective. The average annual fees for a day pupil at an independent school in 2018 were £14,562[2]. This represented an average annual increase of 5.8% from 1990 fees, which was significantly ahead of UK price inflation over the same period[3]. Most of the leading universities are now charging the maximum annual tuition fee of £9,250 and university students will typically need to meet additional payments for accommodation and general living costs, so the true cost far exceeds the annual fees.

[2] Independent Schools Council https://www.isc.co.uk/media/4890/isc_census_2018_report.pdf
[3] Bloomsbury. Based on annual census data from Independent Schools Council

Don't get around much any more

Seventy might be the new fifty but the fact remains that as we age the chances of requiring some sort of long term care increases. We are all living longer due to medical advances and healthier lifestyles and outliving our wealth may be a real concern. Currently UK state funding of long term care fees is very limited and any changes are likely to offer limited improvements, particularly for affluent families. Even those who qualify for state financial assistance may have a very different idea of what constitutes 'quality' long term care from that of the local authority funding it. The ability to choose what type of care you need is likely to form a key consideration in your estate plan.

Over to you

It is common for married couples and civil partners to avoid substantial estate planning until the death of the first partner. The issue here is that it simply defers the problem to a time when making important financial decisions may be more difficult. The current inheritance tax (IHT) regime is, however, relatively benign, particularly when compared with that which prevailed prior to 1984, with many legitimate and well established planning opportunities available to reduce or avoid the IHT burden. However, with government finances under severe strain, it is highly unlikely that the current regime will remain unchanged, especially as dead people have no vote!

This guide sets out the basic rules of IHT, including the main exemptions and reliefs. It also explains the main non-contentious, tried and tested investment- and insurance-based solutions which you might consider. Additionally it identifies some lesser known trust-based IHT planning ideas that may be worth further consideration if you have property or investments that are impractical to sell, or where investment- and/or insurance-based solutions are not suitable or not desired.

While this guide aims to inform and educate, you should not take or refrain from taking any action based on its contents. Instead you should use it as a basis for further discussion with your professional advisers in the context of your personal circumstances, preferences, tax position and overall wealth planning strategy.

With warm regards,

The Bloomsbury Wealth Team

TABLE OF CONTENTS

	Page
Overview of the basics	2-6
• Main residence band • Exemptions and reliefs • Trusts • Charitable (and political) giving	
Investment and insurance based solutions	7-8
• Insuring the liability • Discounted value arrangement • A & M Plan • IHT exempt portfolio services and investments	
Standard trust based solutions	10
• Gift and loan • Discounted gift • Reversionary trust	
Bespoke trust and other solutions	11-15
• Borrow and gift • Spouse/civil partner asset transfer • Investment property standing at a gain • Double dip • Gift and rent • Gift and buyback • Settlor interested trust • Wealth preservation trust	
About Bloomsbury	16

OVERVIEW OF THE BASICS

Inheritance tax (IHT) is a tax applied on the death of UK domiciled individuals on most types of wealth above a certain level (currently £325,000 per person).

For non-UK domiciled individuals IHT only applies on their UK assets. The tax rate is currently 40% on all assets above £325,000, unless they qualify for exemption. Chargeable gifts made within the last seven years are taken into account for this purpose.

Exemptions and reliefs

- Exempt estate amount is £325,000 per person;
- There is a sliding timescale of implementation of an extra £175,000 of nil rate band for property owners who pass their main residence or a share of the property on death to direct descendants; however, its full implementation has been deferred until April 2020. The rules are highly complex and the additional relief is withdrawn at a rate of £1 for every £2 by which the estate's value exceeds £2m. In 2019/20, therefore, it will not apply to estates over £2.3m and in 2020/21, to those over £2.35m.
- Transfers between UK domiciled spouses and civil partners, whether in lifetime or on death, are exempt from IHT (they are limited to £325,000 where the recipient is non-UK domiciled);
- A non UK domiciled spouse/civil partner with a UK domiciled spouse/civil partner (or their legal personal representatives within two years of their death) may make an irrevocable election to be treated as UK domiciled for IHT purposes only. This will retrospectively apply to the previous seven years. The election will cease to apply if the individual ceases to be UK tax resident for at least four successive tax years after the election;
- The tax treatment of non-UK domiciles has recently been reviewed and the period of UK residence after which an individual is deemed to be UK domiciled for IHT purposes has reduced from 17 to 15 years from April 2017.

- Married couples and civil partners may carry forward their deceased spouse or civil partner's unused nil rate band, with the amount of the nil rate band determined by the exemption applicable at the time of the second death;

- The estates of members of the armed forces whose death can be attributed to, or was hastened by, injury or illness suffered whilst on active service or other service of a warlike nature are exempt from IHT. This exemption has also been extended to members of the emergency services and humanitarian aid workers responding to 'emergency circumstances'. However, it is the responsibility of the deceased's estate to make such a claim; it is important to note that the injury or illness may have occurred many years prior to death;

- There is also an exemption for medals and other decorations awarded to armed forces or emergency services personnel for valour or gallantry and to awards made by the Crown for achievements and service in public life, provided that they have not been purchased by the owner;

- An annual gift of £3,000 is immediately exempt, plus £3,000 if not used from the previous tax year. Any unused exemption can be carried forward for one year but it must be used after the £3,000 exemption for that year;

- Regular gifts which meet, or are intended to meet, the definition of being from 'normal expenditure out of income' are immediately exempt, whether they are paid to a trust or an individual. These should be documented at outset in case the donor does not survive beyond the first gift;

- Qualifying business or agricultural assets benefit from business or agricultural relief (BR or AR) and are exempt at the rate of either 50% or 100%. More detail is provided below;

- Gifts in consideration of marriage are immediately exempt from the donor's estate: from parents £5,000, from grandparents £2,500 and from anyone else £1,000;

- Loans are deductible from the deceased's estate for IHT calculation purposes, as long as they are actually repaid on death and have not been used to acquire, enhance or maintain excluded property (property situated outside the UK and held by a non-UK domiciled person or settled into a trust by such a person) or for loans taken out after 6th April 2013 (or whose terms have changed after that date) where they were used to acquire assets already subject to IHT relief (such as BR or AR).

BR & AR

Business relief (formerly business property relief or BPR) and agricultural relief (formerly agricultural property relief or APR) reduce the value of certain qualifying assets when calculating their value for inheritance tax purposes.

Business relief (BR)

The relief is applied at a rate of either 50% or 100% according to the category into which the asset falls and it applies both during lifetime and on death.

100% BR is available for:

1. a sole trader's or partner's interest in a business;
2. a trust life tenant's interest in a business;
3. a holding of unquoted securities which forms part of the owner's controlling interest in a company

and

4. unquoted shares.

50% BR is available for:

1. a holding of quoted securities which forms part of the owner's controlling interest in a company;
2. land, buildings, plan or machinery used by a business and owned by a controlling shareholder or partner where the business interest qualifies for BR and
3. as for 2 but for a life tenant of a trust.

The relevant asset must have been owned for at least two years or have replaced other qualifying assets of which one or other has been held for at least two of the previous five years. Where acquired on the death of a spouse or civil partner, the new owner is treated as having owned it since the previous owner acquired it.

Relief is not available in most cases where the business is engaged principally in the trading of securities, land or buildings or in making or holding investments. Since the extent to which this applies can vary according to the particular circumstances, it is necessary to consider these in some detail to make a fair conclusion.

Agricultural relief (AR)

Agricultural relief applies to agricultural property in the European Economic Area, Channel Islands and the Isle of Man, whether owned, occupied or let, during lifetime and on death. The value used is the 'agricultural value', which is based on the premise that it will be used perpetually for agricultural purposes.

A number of cases have considered the question of whether a house on a farm is a farmhouse (and thus qualifying) or not and the outcomes took into account the extent to which they are 'character appropriate to the property', an important factor being whether the farm business is actually run from it. Even if AR is permitted, a discount to its value may be applied by HMRC for IHT purposes.

The property must either have been occupied by the current owner for agricultural purposes for at least two years or have been owned and used for agricultural purposes throughout the last seven years (whether or not by the donor or current owner).

Where an asset's value is partly attributable to AR and to BR, AR takes priority and BR is applied to the remainder. For example, a farm's land and buildings would be eligible for AR while the remaining assets attract BR.

7 YEARS

A trust which receives assets which qualify for BR or AR will avoid IHT if the donor survives for seven complete years, or if they die within seven years of the gift but the assets remain BR/AR qualifying.

Trusts

- Gifts to most types of trusts are taxable at the rate of 20% at the time they are made, unless they are within the available IHT nil rate band (when aggregated with any previous gifts to trusts made within the previous seven years), in which case there is no immediate tax charge;

- If the donor survives a gift made to most types of trusts (whether or not tax was payable at the time the gift was made) by seven complete years, then IHT is restricted to a periodic charge every 10 years equal to a maximum of 6% of the value of the trust above the then applicable nil rate band;

- Capital gifts to most types of trusts avoid the immediate 20% IHT tax charge if they are:

  – of business or agricultural assets which qualify for 100% relief; or
  – funded from regular gifts out of surplus income; or
  – paid from a pension trust which itself meets the IHT exemption rules.

- A trust which receives assets which qualify for BR or AR will avoid IHT if the donor survives for seven complete years, or if they die within seven years of the gift but the assets remain BR/AR qualifying;

- Gifts of other assets to individuals or to the trustees of bare trusts (trusts under which the beneficiary has the absolute right to the trust assets and the income generated from them) are known as potentially exempt transfers (PETs) and are exempt if the donor survives for seven complete years;

- If the donor does not survive a PET by seven years, then it will become subject to IHT to the extent that it exceeds the available nil rate band at the date of death. Any tax due will benefit from a reduction (known as taper relief) on a sliding scale from 20% to 80% if death occurs after the first three years;

- Any lump sum death benefits paid from a registered pension scheme set up under a single or master trust will be exempt from IHT as long as they are distributed within two years of the member's death and the plan contributions (or any transfer in from a previous pension scheme) were not made while the member was in serious ill health, i.e. their life expectancy was shorter than two years;

- A life insurance policy which is assigned to a suitable trust when it does not have a surrender value and where the premiums are either within the annual gift exemption (£3,000) or payable from normal surplus income should not form part of the donor's estate for IHT.

Charitable (and political) giving

- Gifts made to registered charities or qualifying political parties in lifetime or via a will are immediately exempt from IHT;
- If at least 10% of an individual's taxable estate is left to a registered charity via their will then the residual IHT liability is reduced by 10%, i.e. from 40% to 36%.

Capital gifts to most types of trusts avoid the immediate 20% IHT tax charge if they are:

- of business or agricultural assets which qualify for relief;
- funded from regular gifts out of surplus income or;
- paid from a pension trust which itself meets the IHT exemption rules.

INVESTMENT AND INSURANCE BASED SOLUTIONS

There are a number of Investment - and insurance - based solutions available, some of which are briefly described below.

Accumulation & maintenance plan

This arrangement involves investing into a specially modified offshore insurance bond (which gives a wide choice of investment) which you then assign as an outright gift to your chosen beneficiary or beneficiaries. The policy conditions are such that the surrender value of the bond is suppressed until a future date stipulated by you at outset, to coincide with the age that you feel comfortable with the beneficiary or beneficiaries having access to the bond. This solution is ideal where you wish to make an outright gift now but want to avoid the recipient gaining access at a young age and either do not want, or are unable (because you have already made a gift to trust up to the nil rate band within the past seven years), to gift to a discretionary trust.

IHT-exempt portfolio services and investments

These are investments which qualify for either BR or AR once you have owned them for two years. If the new investment is made within three years of the disposal of an asset which you had owned for at least two years, which itself qualified for 100% BR or AR, then the new investment will be immediately exempt from IHT.

The three main types of exempt investments are as follows on the next page:

EIS

Enterprise investment scheme (EIS)

These are individual and usually unquoted companies which are targeting growth and in which an investor faces a significant risk to their capital. If you also pay income tax you can obtain up to 30% tax relief on investments of up to £2m per tax year, although anything after the first £1m must be invested in knowledge-intensive companies. If not already used you can also make an investment and carry this back to the previous tax year. Seed enterprise investment schemes (SEIS), which are restricted to start-up and early stage businesses, provide the same IHT benefits but carry higher risk than EIS, albeit with up to 50% tax relief on investments up to £100,000 per year. In both cases you could potentially lose the entire investment.

AIM

AIM portfolios

These are portfolios of BR-qualifying shares quoted on the alternative investment market (AIM). These shares are generally high risk as they represent smaller and less established companies. As well as spectacular returns you can (and sometimes do) lose all of your investment if an investee company goes bust.

IHT

IHT portfolios

These are special purpose companies (overseen by professional investment managers and independent directors) which wholly own several other companies that carry out trades generating high levels of cash and which seek to preserve capital and ensure maximum liquidity. While not without risk, the wide diversification, high cashflow nature of the trades and the fact that there are usually many more new investors than sellers mean these can be considered the lowest risk type of IHT-exempt investment. Despite this, you could still potentially lose your original capital.

If you are unable or unwilling to do more substantial or complicated planning and are in reasonable health, you (or your beneficiaries) might prefer to take out life insurance to meet the cost of some or all of the IHT liability.

Insuring the liability

If you are unable or unwilling to do more substantial or complicated planning and are in reasonable health, you (or your beneficiaries) might prefer to take out life insurance to meet the cost of some or all of the IHT liability. The cost depends on your age, health and lifestyle factors. You should expect premiums (unless they are fixed throughout the policy term) to increase significantly once you reach 75.

If you effect a policy for this purpose, it should be placed in a trust that excludes you from any benefit to ensure that it remains outside your estate. If your beneficiaries want to effect the cover then they would own the policy but you would be the life assured (known as a 'life of another' policy) and a trust is not required.

STANDARD TRUST-BASED SOLUTIONS

Gift and loan

This is where you make a small gift to either a trust or a family investment company (FIC – further information can be found in the 'Bloomsbury Guide to Family Investment Companies') and then loan additional capital to it, which it then invests for the benefit of your chosen beneficiary or beneficiaries. You retain access to the original capital loaned and can take regular and/or ad hoc repayments to meet your own needs. This is particularly suitable where you have no nil rate band available but want to avoid the initial IHT charge on a gift to a trust or you wish to gift shares in an FIC to individuals or a trust without giving away significant value initially. The main benefit of a gift and loan arrangement is that future growth arises outside the estate from outset. In addition, to the extent that the loan remains outstanding, you retain full access to your capital.

Discounted gift

This is where you make a gift to a trust which is invested into an insurance bond in which you retain rights to a pre-determined and fixed 'income' (actually regular withdrawals of capital). You can choose the level of withdrawals within a certain range and this entitles you to an immediate discount on the value of the gift for the purposes of calculating any IHT that might be due in the event of your death within seven years. The greater the amount of withdrawals and the younger your age, the bigger the discount. As a general rule this type of solution is most effective for those under age 75 and who are in good health.

Reversionary trust

This is a special type of trust whereby you make a gift which comprises either an insurance bond or an investment fund (which produces no, or a very low, income). Under the terms of the trust you give up all rights to the capital and income, other than on one or more pre-determined dates in the future, when the capital 'reverts' to you. Usually the reversions happen over a period of years and so the profile is similar to receiving a regular income. In the meantime the growth on the capital occurs outside your estate from outset and the gift falls out of your estate if you survive for seven years.

BESPOKE TRUST AND OTHER SOLUTIONS

There are several less well known IHT planning solutions, which are particularly useful if you have property assets.

One spouse or civil partner sells the other spouse or civil partner an asset (which could be their share of the family home) at full market value in return for an IOU of equal value. There will be no capital gains tax (CGT) implications due to the CGT spouse/civil partner exemption.

Borrow and gift

Where you have a property or asset that could act as security, you could borrow capital against that asset and then gift it to an individual or a trust as outlined earlier. As long as you, as the borrower, pay the interest arising on the loan (i.e. it is not rolled up) this is IHT-effective. This solution is particularly useful if you have an asset which is standing at a gain, as capital gains are washed out on death for CGT purposes, although the gifted monies will reduce your estate if you survive for seven years.

Spouse/civil partner asset transfer

One spouse or civil partner sells the other spouse or civil partner an asset (which could be their share of the family home) at full market value in return for an IOU of equal value. There will be no capital gains tax (CGT) implications due to the CGT spouse/civil partner exemption. The IOU can then be gifted to one or more individuals and will fall out of the donor's estate after surviving for seven years. The only downside to this idea is that stamp duty land tax must be paid on the value of the property sold to the other spouse. However this should be substantially less than the IHT otherwise payable, while allowing both parties to use or enjoy the property.

In addition, in order for it to be deductible for IHT purposes, the IOU must actually be repaid from the purchasing spouse's estate when they die. This solution is useful where the family home is the only or the main asset available for planning.

Investment property standing at a gain

Where you own an investment property which is standing at a gain but want to gift this to, say, your adult child or children, you can gift this to a special type of trust for their benefit, while at the same time making an election to defer the capital gain (known as a holdover election) to the trustees of the trust. This starts the seven-year IHT clock ticking and ensures that capital growth arises outside your estate, while ensuring that any future rental income is taxed against the beneficiaries. The trustees may, after a reasonable interval (at least four months is advisable), wish to transfer the property to the beneficiaries and at the same time defer (hold over) the latent capital gains to when the beneficiaries eventually dispose of the property. This would allow the trustees to hold over the gain to one or more beneficiaries, who can then dispose of the property at a time of their own choosing and potentially pay a lower rate of, or even no, capital gains tax (for example if they become UK non-resident).

Double dip

This approach is effective when you own assets which qualify for BR and/or AR and you are married or in a civil partnership. On your death your exempt assets are passed to a discretionary trust via your will. The surviving spouse then agrees with the trustees of that trust to swap their own taxable assets (ideally cash, or assets with no latent capital gain) for an equivalent value of the trust's BR/AR qualifying assets. As long as the surviving spouse or partner lives for a further two years, these assets will be exempt for IHT, while the taxable assets held within the trust remain exempt from IHT (although a small periodic charge will be applied on the value in excess of the then applicable nil rate band every 10 years).

A variation of the gift and rent solution involves you gifting your home to your chosen beneficiary and paying a market rent. You may then offer to buy back a right to live in the property, rent-free, for the remainder of your lifetime.

Gift and rent

With this route you gift your home to your chosen beneficiaries and pay them a market rent for the right to live in the home. The rental income is taxable in the hands of the beneficiaries but the rental payments are immediately deductible from your estate for IHT purposes. It is vital to ensure that formal valuation advice is obtained, that the rental agreement is properly drawn up, that rental payments are physically paid to the new owner of the home and that the amount of rent is periodically reviewed, otherwise it may not be IHT-effective.

Discounted gift

A variation of the gift and rent solution involves you gifting your home to your chosen beneficiary and paying a market rent. You may then offer to buy back a right to live in the property, rent-free, for the remainder of your lifetime. The value of the right to live in the home for the rest of your life rent-free is based on your life expectancy and the market rent applicable to the property. The cost of buying the right to live in the home rent-free is immediately exempt for IHT purposes, as will be any subsequent increase in value. The value of the property gift will fall out of your estate after seven years.

Although the value of the lifetime right to live in the property will remain in your estate for IHT purposes, this should be valued at zero on your death.

Settlor interested trust

This idea works for gifts of cash or where an asset is standing at a loss of up to the available IHT nil rate band and where you need to retain access to rental or investment income from that asset. The gift is settled into a trust of which you are the life tenant, i.e. you have the right to income from it. However, you are prohibited under the terms of the trust from having any entitlement to capital, as this is reserved for your chosen beneficiaries. The key benefit of this type of arrangement is to remove future capital growth from your estate from outset and the original capital value if you survive seven years, a potential saving of up to £130,000 after seven years, whilst still allowing you to retain access to any ongoing income.

Wealth preservation trust

This solution allows you to obtain an immediate reduction in the value of your estate whilst retaining access to the capital without falling foul of the various anti-avoidance provisions that have been introduced over the years. It also avoids the 20% initial charge on gifts to trusts above the nil rate band (currently £325,000). A trust is created by an unconnected person who is UK non-domiciled settling, say, £1m cash. The trust has two interests which are capable of being bought and sold. You then pay the trust £1m to acquire both interests in it.

The interests need to be acquired in a particular way to avoid falling foul of IHT anti-avoidance rules. The trust does not form part of your estate for IHT purposes as you did not create it or settle the original value. The amount you paid for the trust interests is immediately removed from your estate for IHT purposes. If you require access to the trust funds, then you can request a loan from the trustees at any time. This loan is also deductible from your estate for IHT purposes and repayable upon your death. The capital in the trust is protected from various 'hostile' creditors and after your death the trustees can make a tax-free capital distribution to your chosen beneficiaries or to another trust.

This solution allows you to obtain an immediate reduction in the value of your estate whilst retaining access to the capital without falling foul of the various anti-avoidance provisions that have been introduced over the years. It also avoids the 20% initial charge on gifts to trusts above the nil rate band (currently £325,000)

Buying property for children

It is very common for people to want to assist their children (or grandchildren) to purchase their first property, which is mostly done in one of two ways:

1. The property is bought in the name of the child or
2. The property is bought in the name of the parent.

However, there are drawbacks to both these approaches.

If the property is bought in the child's name, it is vulnerable to hostile creditors such as can arise from bankruptcy or subsequent relationship breakdown. The buyer also cedes control to the child, who can dispose of the property as they wish regardless of their financial maturity or vulnerability. In the event of the child's death, the value will also form part of their estate and so could be subject to inheritance tax (IHT).

If the parents buy it in their own names, there may be a stamp duty land tax (SDLT) surcharge of (currently) 3% if they already own a property (as is likely). It will also form part of their own estate for IHT purposes and on future sale, any increase in value will be subject to capital gains tax because it is not the owner's principal private residence.

An alternative solution which avoids these drawbacks is to employ a suitable worded trust structure. The parents can gift and/or lend capital to the trust according to their circumstances and preferences; if the purchase price exceeds twice the IHT nil rate band, lending rather than gifting the excess over that figure would avoid any immediate IHT liability. Once the trust has the capital, the trustees can either purchase the property or lend funds to the child to do so and take a charge over it to secure the trust's interest. Since the purchaser (whether in the form of the trustees or the child) does not already own a property, the SDLT surcharge is legitimately avoided.

This route puts the trustees (who may also be the parents) in control and so prevents the property being sold without their consent or knowledge. It should also provide a degree of protection from hostile creditors and while it remains in the trust, the property will be outside the child's estate for IHT purposes. The value of the gift will leave the parents' estate after seven years and any future increase in the property value will be outside it immediately.

As long as the property is occupied by the child, the trustees can qualify for principal private residence relief, thus avoiding capital gains tax on sale.

ABOUT BLOOMSBURY

Bloomsbury Wealth is a multi-award winning specialist wealth management and financial planning firm based in London owned and led by Charles Wood and Robert Lockie.

We specialise in helping successful business people and their families to overcome the challenges involved in managing significant wealth. We act as personal wealth advisers to a select number of families with complex affairs to deliver tangible and substantial value. This gives our clients the confidence of knowing that they can achieve all that is important to them in life.

To arrange an introductory telephone call with one of our friendly and experienced planners or if you would like more details on any of the subjects mentioned in this document please contact the Bloomsbury Wealth Marketing Department:

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