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Inheritance tax and the question of domicile

Inheritance tax (IHT) can significantly diminish the amount passing to a person’s beneficiaries on death. On a person’s death, IHT applies at a flat rate of 40% on the excess over the nil rate band. This is £325,000 for the 2012/13 tax year and will remain frozen until 6 April 2015.

However, persons who are not domiciled in the UK are only potentially subject to IHT on assets situated in the UK, although the Finance Act 2003 extended this by providing that non-UK domiciliaries will not be subject to IHT on UK authorised unit trusts and OEICs. Subject to this exemption, it therefore makes good tax sense from an IHT standpoint for a non-UK domiciled person to hold non-UK sited assets so they remain outside the IHT net. However, for persons who are UK domiciled, IHT applies to their worldwide assets and so the ownership of such assets gives no IHT advantage.

Domicile – the rules

As stated above, a person’s domicile is fundamental for UK inheritance tax purposes. Under UK law, domicile will normally be established under general law but is supplemented by certain statutory rules that apply for tax purposes.

First, there is the general law of domicile. This is based on case law developed over a long period of time and although in many cases the law is straightforward, in some cases it can be complicated to state and/or difficult to apply. Generally, when a person is born, he/she takes the domicile of his or her father. This is known as a domicile of origin. This domicile can be displaced by a domicile of choice which involves the individual having a physical presence in another country with the intention to reside there permanently. In practice, it is not easy to establish a new domicile of choice.

Second, there are special rules laid down by statute that apply only for IHT purposes. The basic effect of these statutory rules is that an individual who is not domiciled in the UK as a matter of general UK law may, nevertheless, be treated as domiciled in the UK for IHT purposes if either:

(a) they have been resident in the UK for not less than 17 of the previous 20 tax years, or
(b) having previously been domiciled in the UK as a matter of general law, they have ceased to be so domiciled within the last three calendar years.

These ‘deeming’ rules are subject to any contrary provision in a double taxation agreement.

Having a foreign domicile for IHT purposes is critical to the effectiveness of the EPT and therefore any person proposing to use the EPT with a Zurich International Portfolio Bond (the Plan) should take professional advice as to their domicile for IHT purposes before establishing the Trust.

In the remainder of this guide, when reference is made to a non-UK domiciled person, this refers to a person not domiciled in the UK for IHT purposes.

Using Excluded Property Trusts to protect assets from IHT in the future

As stated above, even if a person is non-UK domiciled under the general law they can be ‘deemed’ to be UK domiciled for IHT purposes after a period of long-term residence.

So, where an individual is currently non-UK domiciled but may become UK domiciled in the future, what action can be taken? One solution is to preserve the IHT free status of their assets whilst they are non-UK domiciled and before they are treated as UK domiciled. This can be achieved by establishing an Excluded Property Trust.

Introduction
1. The main benefits of the Excluded Property Trust (EPT) – investor suitability

The EPT enables a non-UK domiciled investor (called ‘the Settlor’) to:

• make a lifetime gift of the Plan whilst retaining flexibility over who will ultimately benefit from the gift;

• be able to benefit from all or part of the Trust Fund at the discretion of the Trustees throughout their lifetime; and

• ensure the Plan is protected from possible liability to IHT if the Settlor becomes UK-domiciled in the future.

2. Who is the EPT not suitable for?

Broadly speaking, where the benefits summarised above are not required or valued by the investor, the EPT will not be suitable.

More particularly, the EPT is not suitable if the investor is currently UK domiciled for IHT purposes, or if they wish to make a gift to a specific beneficiary absolutely.

3. How does the EPT work?

(i) The Plan

The underlying investment of the EPT is a Zurich International Portfolio Bond (the Plan) that, depending on the version chosen by the Settlor, will be a whole of life insurance policy or a capital redemption policy. An investment in a non-income producing asset, such as a life insurance policy or capital redemption policy, means that trust administration is minimised and the investor is substantially sheltered from any personal income tax during the Plan’s existence.

Under the EPT, the Settlor can transfer a new or existing Plan to the Trust. However, a new Plan can only be transferred if the cheque for the payment is drawn on an offshore bank account. This is because it is essential that only assets that qualify as excluded property are put into this Trust.

If the life insurance version is chosen, the Plan should be effected on the lives of some or all of the Beneficiaries on a joint lives last survivor basis so that the Plan can continue until the last Beneficiary dies. Up to ten lives can be included. No life insured is necessary under the capital redemption version.
(ii) The Trust
The Settlor and additional Trustees appointed by the Settlor execute a Deed of Trust which sets out the terms of the gift. The Trust Deed is called the ‘Discretionary Gift Trust Deed (Settlor included)’. The Trust operates as follows:

- The Trust Fund is held on discretionary trust. This means that no Beneficiary has a fixed right to any benefit. The Trustees decide who, from the class of Discretionary Beneficiaries (which includes the Settlor), should receive what benefit from the Trust and when.

- The Settlor names the Default Beneficiary(ies) at outset. This is/These are the person/people the Settlor would ultimately like to benefit from the Trust after their death. However, the Default Beneficiary(ies) will only benefit if the Trustees make an absolute appointment to them or when the Trust ends after 125 years with no appointment having been made by the Trustees.

4. The inheritance tax effects of the EPT

(i) Establishing the Trust
The creation of the Trust will not give rise to any transfer of value by the Settlor for IHT purposes, provided the Settlor is non-UK domiciled when the Trust is established and the assets transferred to the Trust are excluded property (as will be the case with the Plan).

(ii) Does HM Revenue & Customs (HMRC) need to be informed about the EPT?
There is no need to report the creation of the EPT to HMRC because:

- No transfer of value for IHT takes place provided the Settlor is non-UK domiciled and the asset is ‘excluded property’, and
- The Plan will not produce any taxable income or capital gains.

(iii) What are the IHT implications of the Settlor’s death after establishing the EPT?
On the basis that the Settlor was non-UK domiciled when they created the EPT, the Settlor transferred excluded property in the form of the Plan to the Trust and the EPT remains invested in excluded property, the Settlor’s death should not have any impact for IHT purposes. The assets may continue to be held in the Trust after the Settlor’s death up to the end of the Trust Period. Whilst they remain in the Trust they will continue to be excluded property for IHT purposes, even though the Settlor has died. This applies even if the remaining Beneficiaries are UK domiciled.
(iv) What are the IHT implications for the Trust itself?
As this is a discretionary trust, this means that special IHT charging rules could potentially apply. Under these rules there could be IHT charges:

- on every ten-year anniversary of the Trust – ‘the Periodic Charge’ and/or,
- whenever property leaves the Trust (e.g. when capital is advanced to a Beneficiary) – ‘the Exit Charge’.

However, provided the trust property remains invested in the Plan, which is ‘excluded property’, none of these IHT charges should arise. Once a Beneficiary becomes entitled to trust assets, the IHT treatment of those assets will depend on his or her personal circumstances.

(v) What are the implications of the inclusion of the Settlor as a Beneficiary?
Provided the EPT holds non-UK sited investments, such as the Plan, and the Settlor is non-UK domiciled when they create the Trust, under current legislation and HMRC practice, the value of the investment held subject to the EPT will not be included in the taxable estate of the Settlor for IHT purposes, even though he or she may later become UK domiciled for IHT purposes.

This is so even though the Settlor is a Beneficiary under the Trust. The official practice of HMRC is that because the Trust holds excluded property, this overrides the gift with reservation of benefit provisions in relation to charges arising on a Settlor’s death. This will be so even though the Settlor subsequently becomes domiciled in the UK, e.g. because of long-standing UK residence. The position is not so clear where the Settlor ceases to benefit during the Settlor’s lifetime, for example if assets are given out to another Beneficiary or the Settlor is excluded as a Beneficiary, and advice should be taken where this action is contemplated.

As has been stated, the Settlor is a Beneficiary under the EPT and it is unlikely that the Settlor would ever wish to be removed as a Beneficiary. Great care should be taken if the Settlor is ever to be removed as a Beneficiary of the EPT in part or in whole (and this can extend to cases where trust capital is appointed absolutely to a Beneficiary and so the Settlor is indirectly excluded as a Beneficiary of that property). Whilst there exist contradictory legal views, HMRC have stated it is open to them to pursue the cessation of the Settlor’s benefit as a potentially exempt transfer. Independent professional advice should be sought if such circumstances arise or this is a matter of concern.

There will be no income tax charge under the pre-owned assets tax (POAT) rules because a specific exemption exists for this type of trust.
5. The Trustees and Beneficiaries

(i) Who can be Trustees of the EPT?
The Settlor will automatically be a Trustee. Additional Trustees must be appointed and this is contemplated in the Trust Deed at outset. Anyone over 18 years old and of sound mind may be appointed. It may be appropriate to appoint a professional adviser, such as a solicitor or accountant, as a Trustee, although such a person is likely to charge a fee for acting as Trustee.

It is essential that at least one additional Trustee is appointed and survives the Settlor if probate is to be avoided following the Settlor’s death. In addition, certain trust powers, including the power of appointment, are exercised by the Trustees jointly and at least two Trustees must exist if any appointment is to be made to the Settlor.

(ii) Who are the Beneficiaries under the Trust?
The trust benefits are held on discretionary trust for such of the Beneficiaries as the Trustees decide. As the Trust is discretionary, no Beneficiary is entitled to anything until the Trustees make an appointment in their favour. If any income arises to the Trustees from the trust investments (not relevant while the sole trust asset is the Zurich International Portfolio Bond), they can either accumulate it during the Trust Period or distribute it (or some of it) to whichever Beneficiary they decide. However, no Beneficiary will have the right to any income – distributions will be at the discretion of the Trustees.

The Trustees have powers to deal with the trust property, including wide powers to invest, as well as the power to advance capital to any Beneficiary.

Discretionary Beneficiaries are the people to whom the Trustees can appoint benefits and include the following persons:

- The Settlor.
- The Settlor’s spouse/civil partner.
- Children and remoter issue of the Settlor.
- Any spouse, widow or widower of the Settlor’s children and remoter issue. For this purpose spouse includes a registered civil partner.
- Any other person whom the Settlor may appoint to the class of potential Beneficiaries.

An appointment can only be made to the Settlor if there are at least two Trustees and one of them is not the Settlor or the Settlor’s spouse. This is to ensure that the Trust is not treated as a sham – such a possibility could arise if the Settlor could simply make appointments in their own favour by themselves.

The Settlor names (as ‘Default Beneficiaries’) the individual or individuals who the Settlor would like to benefit from the Trust Fund if no other appointment is made. However, in order for these people to become entitled to benefits, the Trustees must appoint benefits in their favour. If no appointment is made during the Trust Period, they will become entitled to the Trust Fund at the end of the Trust Period.
6. The investments of the EPT

(i) What investments can be held in the EPT?

The Trust is only available with a Zurich International Portfolio Bond (the Plan), regardless of whether the life insurance or capital redemption version is used. To ensure that the Trust is effective for IHT purposes, only assets that qualify as ‘excluded property’ should be held by the Trustees. An existing Plan qualifies as excluded property. If a new Plan is being effected, the investment funds must come from an offshore bank account.

(ii) What are the income tax implications of the EPT?

An income tax chargeable event gain can arise in the event of the Plan being encashed or a part surrender of more than the cumulative 5% tax-deferred annual allowances being taken.

If the life insurance version is chosen, the death of the last life insured will also be a chargeable event. For a capital redemption policy, the maturity will be a chargeable event. Chargeable event gains are not taxed on the remittance basis.

As the Plan is an offshore investment plan, there is no UK tax deemed to have been paid on any gain, with the result that the full amount of the gain is subject to UK income tax. Whether any tax is payable and, if so, how much, will depend on the circumstances.

Chargeable event gains will be taxed on the Settlor if alive and UK resident in the tax year in which they arise. Liability to tax will be at the Settlor’s marginal rate(s). For the purposes of the liability to higher rate or additional rate (income over £150,000) tax only, top-slicing relief will apply so, in general, the gain will be divided by the number of whole years the Plan has been in force.

If the Settlor is not alive in the tax year in which the chargeable event occurs, or is not resident in the UK for tax purposes, the Trustees, if they are UK resident, will be liable for any tax on the gain. The gain will be taxed at the trust rate – currently 50% (reducing to 45% from 6 April 2013) – except for the gains falling within the £1,000 standard rate tax band available to the Trustees, where the tax charge will be at the rate of 20% only.

If the Trustees are not UK resident, the chargeable event gains will be assessed on any UK ordinarily resident Beneficiaries when, and to the extent that, they receive any benefits from the Trust.

The above rules apply regardless of whether the Plan is based on the life insurance or capital redemption version.
7. Other important questions

(i) Should spouses each set up their own individual EPT?
There is no reason why both spouses should not establish their own Trust provided neither is domiciled in the UK. The EPT is for a single Settlor only and not for joint Settlors.

(ii) What are the capital gains tax implications of the EPT?
A life insurance or capital redemption bond, such as the Zurich International Portfolio Bond, does not produce gains that are subject to capital gains tax. Of course, a capital gains tax charge may arise if the Settlor realises a gain on encashment or sale of UK-sited (and possibly non-UK sited) investments in order to invest in the Plan. Following the introduction of the complex remittance rules in the Finance Act 2008, professional advice should be taken if non-UK sited assets are being realised to invest in the Plan.

(iii) Is stamp duty payable?
With effect from 1 December 2003, stamp duty on documents was abolished which means that a declaration of trust no longer needs stamping.

(iv) Can the Plan be added to at a future date?
Further investments in the Plan are permitted but only if the cheque in payment is drawn on an offshore bank account and only as long as the Settlor remains non-UK domiciled for IHT purposes.

(v) Can the Trustees encash segments of the Plan and pay the proceeds to the Beneficiaries?
If the Trustees wish to make an advancement of capital to a Beneficiary they can encash a part of or the whole of the Plan and advance cash to the Beneficiary. Alternatively, the Trustees could make an absolute appointment of capital to an adult Beneficiary and assign segments to that Beneficiary in satisfaction of their interest. The Beneficiary must then encash the segments themselves and, in such a case, chargeable event gains will be taxed on that Beneficiary which may produce a lower tax liability than if the Trustees had encashed.

However care should be exercised if the intended Beneficiary is other than the Settlor and the Settlor is still alive as this may have other tax consequences – see question (v) in section 4 above for an explanation of this point.

(vi) Why can the appointment of benefits only be made by the Trustees and not the Settlor?
To ensure that the Trust is effective for all tax purposes it is essential that it is legally valid. If the Settlor could simply make appointments of benefits in their own favour it could be argued that the whole arrangement is a sham and not a proper trust. In addition, if the Settlor retained a power to appoint benefits amongst Beneficiaries including himself, this would be treated as a ‘general power’ and in such a case the trust assets will be treated as part of the Settlor’s estate for probate purposes.
(vii) Can an investor get their money back after making the investment?
Yes, they can. When we issue the Plan documents, we’ll send your client details of how to cancel their Plan. They will have 30 days from receiving these documents to do this.

If they decide to cancel, we’ll give them their money back. However, what they get back may not be the amount they invested – they may get back less.

The amount they will get back will be the lower of the amount they invested and the value of their transaction account after we have sold the assets that they have already invested in.

They can also cancel before they receive their Plan documents by calling us, or you notifying us on their behalf.

If they invest in assets that are not priced daily, there may be a delay in paying the cancellation value until all trades have been completed.

Please refer to the Plan’s Terms and Conditions for full details.

(viii) Is there any income tax on final encashment of the Plan?
Chargeable event gains arising on full encashment of the Plan can be taxable. The full implications were described in the answer to the above question ‘What are the income tax implications of the EPT?’ in section 6(ii).

(ix) What are the charges associated with an investment in the EPT?
You should look at Zurich Life Assurance plc’s literature on the International Portfolio Bond in order to determine the charges made on such an investment.

(x) How do you set up an EPT?
The Settlor and the additional Trustees complete the Trust Deed titled ‘Discretionary Gift Trust Deed (Settlor included)’. Completion instructions are included in the Trust Deed.
Important notes

Creating a trust is an important matter and has lasting legal and tax consequences. This guide is for your general information only and cannot cover every situation. If you are in any doubt about the purpose or effect of this Trust, you should consult your own legal advisers.

The Trust, once created, is irrevocable and the Plan and its benefits must be held according to the terms of the Trust. The Trustees will be in control of the operation of the Trust, which means that they may need to set up a Trustee bank account. Any benefits arising because of the exercise of options available under the Plan will also be held subject to the Trust.

Taxation law is subject to change. Such changes cannot be foreseen. The information in this guide is based on our understanding of current law and HMRC practice (November 2012). Although every care has been taken in the preparation of this guide and the draft Trust Deed, neither Zurich Life Assurance plc nor any of its officers, employees or agents accept responsibility for the operation of the Trust.

Your attention is drawn to the ‘Important information for the Settlor’ section of the Trust Deed.
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