Fundamentals of Estate Planning

Often times, people think that estate planning only concerns ultra high net worth individuals or, at the very least, individuals whose assets exceed the federal estate tax exemption amount. Though the most sophisticated estate planning strategies may only be appropriate for the ultra high net worth population, there are certain documents that should be in place and strategies that should be implemented by all individuals, including those with more modest wealth.

Surely, minimizing and avoiding transfer taxes can be the chief motivator for individuals to engage in estate planning. However, tax efficiency only creates the context in which to begin the estate planning discussion; it does not necessarily accomplish familial goals and objectives. This paper will address basic estate planning considerations for all individuals and will provide an overview of more advanced strategies for those individuals whose wealth profiles warrant additional planning. In addition, this paper will review the current transfer tax system and its significance when contemplating how wealth is owned and passed on to future generations.

How does the transfer tax system work?

Let’s consider the transfer tax system. The federal transfer tax system is comprised primarily of three taxes:

<table>
<thead>
<tr>
<th>Type of Tax</th>
<th>Description of Tax</th>
<th>Highest Tax Rate</th>
<th>Exemption Amount in 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift Tax</td>
<td>Applies to transfers made during a person’s life to non-spousal/non-charitable beneficiaries</td>
<td>40%</td>
<td>$5.43 million per person</td>
</tr>
<tr>
<td>Estate Tax</td>
<td>Applies to transfers made upon death to non-spousal/non-charitable beneficiaries</td>
<td>40%</td>
<td>$5.43 million per person</td>
</tr>
<tr>
<td>Generation-Skipping Transfer Tax (“GST tax”)</td>
<td>Applies to both lifetime gifts and transfers upon death made to or for the benefit of beneficiaries who are more than one generation removed from the donor/decedent</td>
<td>40% (no graduated tax rates)</td>
<td>$5.43 million per person</td>
</tr>
</tbody>
</table>

Source: Internal Revenue Service

Either the gift tax or the estate tax (but not both) will apply to any non-spousal and non-charitable transfer; however, the GST tax may also apply to such transfer, depending on the relationship between the individual making the gift or bequest (the donor/decedent) and the beneficiary. Therefore, two federal taxes (i.e., the gift and GST tax, or the estate and GST tax) could potentially apply to any single transfer.

1 Neither Barclays in the US nor its Wealth and Investment Management employees in the US render tax or legal advice. You should consult with your accountant, tax advisor, and/or attorney for advice concerning your particular circumstances.

2 These amounts are expected to adjust annually for inflation.

3 Note that for a US citizen and non-US citizen married couple, there could be a gift-tax implication for gifts between spouses exceeding an IRS prescribed threshold.
If your assets do not exceed $5.43 million, do you have to worry about estate taxes?

Even though you may currently be in the clear from a federal transfer tax perspective, there is an additional state level of transfer taxation that could apply to all lifetime gifts and transfers on death, even in cases where there may not be a federal tax due. As mentioned above, the first $5.43 million of a person’s aggregate lifetime gifts and transfers upon death are exempt from federal transfer taxation, with the excess taxed at a 40% rate. This means that a married couple can gift or bequeath up to $10.86 million free of any federal transfer tax. At the state level, there are currently twelve states and the District of Columbia that impose only a state estate tax, five states that impose only a state inheritance tax, and two states that impose both.\(^4\)

<table>
<thead>
<tr>
<th>State Estate Tax</th>
<th>State Inheritance Tax</th>
<th>State Estate and Inheritance Tax</th>
</tr>
</thead>
</table>

Source: Survey of State Estate, Inheritance, and Gift Taxes, Minnesota House of Representatives Research Department\(^6\)

In most instances, the state level estate tax exemption amount is substantially lower than the federal level exemption amount. (Such state level estate tax exemptions range from $675,000 up to the current federal exemption amount, with the highest maximum state estate tax rate of 20%.) Only one state, Connecticut, imposes a state gift tax for gifts that exceed, in the aggregate, $2 million. As a result, people need to be mindful of the impact of state level taxes when considering making lifetime gifts and transfers upon death.

If you don’t believe that you need to undertake any wealth or tax planning, why should you contemplate estate planning under the current legislative backdrop?

People often neglect to consider certain assets that they do not believe are includible in their taxable estate, which causes them to believe that they do not need to worry about estate taxes. However, certain assets, including (without limitation) life insurance proceeds, some trust interests, and retirement assets, can in fact be includible in one’s estate for estate tax purposes, depending on how such assets are held. Such often neglected assets could total several million dollars, even for the otherwise non-ultra high net worth population. This could result in a person’s estate being taxable without proper planning. In addition, as described below, state law can often step in when a person does not otherwise provide for the distribution of his or her assets upon death, which can result...

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\(^5\) Tennessee’s inheritance tax is set to expire on December 31, 2015. Tennessee Legislature HB3760/SB3762.

\(^6\) See [http://www.house.leg.state.mn.us/hrd/pubs/estatesurv.pdf](http://www.house.leg.state.mn.us/hrd/pubs/estatesurv.pdf)
in assets being distributed to unintended beneficiaries. As a result, it behooves you to connect with your legal and tax counsel to discuss your particular circumstances and to determine the appropriate level of engagement in holistic wealth planning. Consider the following checklist, which describes the basic estate planning documents that are essential for almost all individuals:

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### Figure 3: Verify your checklist of estate planning essentials

<table>
<thead>
<tr>
<th>Document Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Basic will</strong></td>
<td>Outlines distribution of estate upon death (and appoints fiduciaries/guardians)</td>
</tr>
<tr>
<td><strong>Revocable or living trust</strong></td>
<td>Avoids the time-consuming probate process (upon death)</td>
</tr>
<tr>
<td><strong>Durable power of attorney</strong></td>
<td>Appoints an agent to act on your behalf (when necessary)</td>
</tr>
<tr>
<td><strong>Healthcare proxy</strong></td>
<td>Appoints an agent to make healthcare decisions on your behalf (when necessary)</td>
</tr>
<tr>
<td><strong>Listing of financial records</strong></td>
<td>Provides a clear listing of financial information to assist fiduciaries (upon death)</td>
</tr>
<tr>
<td><strong>Irrevocable life insurance trust</strong></td>
<td>Removes insurance proceeds from your taxable estate</td>
</tr>
</tbody>
</table>

Source: Barclays Wealth and Investment Management

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### Distribution of Assets

It is important for you to have a will (and revocable or living trust, if appropriate)\(^7\) in place, since it will help facilitate the disposition of your assets upon death and can help maximize the tax efficiency with which your assets pass. If you die without having such a plan in place, your assets will, by default, be distributed as directed by the relevant state’s statutes (the “intestacy statute”). Typically, a state’s intestacy statute will dispose of a person’s estate among his or her closest living relatives. This could create unintended results. Consider a hypothetical New York resident who dies without a will and is survived by a spouse and children. The New York statute provides that such person’s estate will, in large part, be divided equally among the surviving spouse and children, regardless of the size of the estate and the age of the children. This may not only disinherit a spouse in part but may also create an immediate estate tax liability (as a result of the children receiving a substantial portion of the estate) that could otherwise have been delayed until the death of both spouses. Having a properly drafted and executed will can help to protect against these otherwise avoidable outcomes.

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\(^7\) In addition to facilitating the disposition of a person’s assets upon death, revocable trusts may provide additional benefits, including, without limitation, protection against incapacity, probate avoidance, ease of estate administration, and privacy.
Appointment of Trusted Agents

You should have a power of attorney and health care proxy in effect, since these documents authorize a representative to make financial and health care decisions, respectively, on your behalf if you are unable to make such decisions. The power of attorney can be especially useful not only when you are ill or incapacitated, but also when you are traveling or simply unable to tend to certain pressing financial matters. It is best to execute these documents in advance of when they are needed so that ample time and consideration is given to determine whom to name as your representative. Often times, people need to execute these documents rather quickly and are forced to name individuals as representatives whom they may not have otherwise named.

Life Insurance Protection

Finally, life insurance is often an essential piece of the estate plan, as it can serve many purposes. Life insurance can be used to ensure that there is sufficient liquidity to cover the payment of estate taxes or outstanding debts upon the insured’s death. Figure 4: Various types of insurance coverage

First, life insurance can be used to ensure that there is sufficient liquidity to cover the payment of estate taxes or outstanding debts upon the insured’s death. In addition, in the case of a married couple in which one spouse is the primary earner, life insurance can provide an income stream for the surviving spouse in case of the untimely passing of the primary earner. Keep in mind that your life insurance needs may change over time, as certain life milestones are reached. For this reason, you should be sure to assess your coverage periodically to ensure that you continue to be protected adequately. In addition, it is important to understand how life insurance policies are owned in order to assess how such policies might impact the taxability of the insured’s estate.

If you already have all of these documents in place, do you need to consider any additional planning?

The federal estate tax exemption can shelter a meaningful amount of assets from estate tax exposure. The federal estate tax exemption is extremely valuable in that it can shelter a meaningful amount of assets from estate tax exposure. However, asset values fluctuate over time, and, therefore, though you may not need to plan around estate taxes early on in your career, you may ultimately need to do so in the future if your assets appreciate substantially before death. As a result, it is imperative that you review your estate plan periodically, to ensure that your tax exposure is managed.

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How can you preemptively mitigate potential estate tax exposure?

As mentioned above, obtaining a sufficient amount of life insurance (and owning such life insurance in the correct vehicle – such as a trust⁹) could be a way to ensure adequate liquidity to cover a future estate tax liability. However, life insurance does not minimize an estate tax liability, but rather only provides the coverage and liquidity for it. To minimize the actual liability, you need to minimize the portion of your estate that is subject to estate tax (i.e., the portion of your estate that is not covered by the estate tax exemption amount and that is not distributed to your spouse or charitable beneficiaries). Gifting early can often be an effective solution.

Estate taxes are assessed on the value of assets owned by you at the time of death, after the application of the appropriate estate tax exemptions and deductions. Gifts that are structured appropriately remove the future date of death value of the gifted asset from the estate tax net, regardless of how much the asset has appreciated or depreciated from the date of the gift through the date of death.

Consider a hypothetical individual who has an estate that is currently valued at $10 million but will appreciate in value to $30 million at the time of his or her death. In addition, let’s assume a $5 million federal estate tax exemption amount, no state gift tax, and a combined federal state and estate tax rate of 50%. If such individual gifts $5 million to a trust for his children now, so that the trust will not be included in his estate for estate tax purposes in the future (and in doing so, uses up his federal gift/estate tax exemption amount), his estate may only be valued at $15 million at the time of his death. (Note that the $5 million that he gifted away, plus the appreciation thereon, will not be subject to estate tax upon his death and will continue to benefit his descendants without any additional transfer tax liability.) Based on our assumptions, such individual’s estate tax liability will be $7.5 million (i.e., 50% of $15 million). If such individual had not made the $5 million gift and instead died with a $30 million estate, the first $5 million of his estate would be protected from estate tax by the federal exemption, and the remaining $25 million would be subject to estate tax. Based on our assumptions, such individual’s estate tax liability would be $12.5 million (i.e., 50% of $25 million).

As illustrated by this scenario, gifting early, before assets have fully appreciated, can be an impactful method of reducing estate tax exposure. By making such a gift early on, the individual in the previous example would have been able to save $5 million in estate taxes (i.e., the difference between $12.5 million and $7.5 million) and thereby pass on more assets to his descendants. It is important to speak with your legal and tax advisors to determine whether gifting is appropriate in your circumstances and the most effective way of doing so.

How can you structure your gifting program?

Outright Gifts

Outright gifting is the simplest and often quickest way of making a gift, since it generally does not require creating structures in advance of the transaction. This is often the method that donors choose when they want to minimize costs associated with making such gifts or need to complete such gifts in advance of a designated deadline (e.g., year-end). Despite these benefits, outright gifting may not be appropriate if you wish to place certain

⁹ Some important considerations for trusts exist. Trusts have inherent limitations and requirements that must be acknowledged/fulfilled in order for these structures to accomplish their purposes. Trusts are not suitable for all individuals. For additional details about these considerations, please reference the back page of this document.
restrictions or other limitations on the use or timing of the gift. In particular, if parents wish to make gifts to minor children, they may wish to ensure that they have some continued control over the gift in case the minor children grow up to be irresponsible adults. In addition, if you were to make an outright gift, you would surrender any investment control over the funds unless the recipient designates you to continue investing such gift on his or her behalf. Finally, outright gifts may not be protected from the claims of the beneficiary’s creditors, including a divorcing spouse. As a result, if your primary concerns include continued control over the assets and protection from creditors, outright gifting may not be the most appropriate structure for your personal gifting program.

Gifts in trust

In its basic form, a trust denotes a relationship between three parties – the donor (the individual gifting to the trust), the trustee (the trust fiduciary), and the beneficiary (the ultimate recipient of trust assets) – and is a vehicle that operates from an investment perspective in much the same way as an individual. To set up a trust, the donor transfers property (the “gift”) to the trustee, who holds legal title to the property in his or her fiduciary capacity on behalf of the beneficiaries. By virtue of this division of beneficial title from legal title, a gift held in trust should be protected from a beneficiary’s creditors, since the beneficiary cannot unilaterally access the trust funds.

Even though the Trustee often has discretion in terms of the manner and extent of distributions from the trust, a donor can often include timing, incentive, or other restrictions on such distributions in the trust agreement, thereby giving the donor indirect control over distributions to trust beneficiaries. In addition, since the donor dictates the terms of the trust agreement at the outset, he or she can often reserve the right to control trust investments over the term of the trust. As a result, a donor need not surrender all control when making a gift in trust.

Finally, assets held in trust upon the death of a beneficiary may escape inclusion in the beneficiary’s taxable estate at that time (assuming proper structuring). In this way, trusts can be a tax-efficient way of passing assets.

Notwithstanding that a trust can accomplish many of your personal goals, there are many considerations involved when establishing, funding, and administering a trust. First, trusts involve legal, accounting and trustee fees that can far exceed similar fees associated with making outright gifts (particularly since such fees are often annually recurring). In addition,

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10 It is important to remember that a child is able to access funds held in a custodial account (a/k/a UGMA or UTMA account) for his or her benefit unilaterally upon reaching age 18 or 21 (depending on his or her state of residence), and so the custodial account may not give the control that a donor expects.
trusts are generally irrevocable from the time they are created. Though there can be some flexibility built into the trust agreement to adapt the terms over time as your investment and distribution strategy evolves, the trust will likely never be completely flexible. Finally, as described above, the trust structure imports a relationship of trust. Often times, donors do not trust anyone to manage, invest, and distribute trust funds to, or for the benefit of, the trust beneficiaries in the manner that he or she would have done so. This inability to trust others can often paralyze a donor from gifting in trust.

Philanthropic Gifts

Other than gifts that make use of the applicable transfer tax exemptions, charitable gifts are one of the two ways that a gift can avoid the transfer tax system. For those who wish to reduce a potential estate tax bill, philanthropic planning can be key. In addition to estate tax planning, charitable planning can import income tax benefits as well under certain circumstances.

Figure 6: A spectrum of philanthropic structuring opportunities

<table>
<thead>
<tr>
<th>Decreasing flexibility</th>
<th>Increasing flexibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decreasing complexity</td>
<td>Increasing complexity</td>
</tr>
<tr>
<td>Decreasing cost</td>
<td>Increasing cost</td>
</tr>
</tbody>
</table>

Source: Barclays Wealth and Investment Management.

CLT refers to a Charitable Lead Trust and CRT refers to a Charitable Remainder Trust.

There are different vehicles that you may wish to consider when determining how and to what extent to incorporate philanthropic planning in your gifting program. These vehicles differ not only in terms of the costs and requirements associated with making the gift, but also with respect to ongoing administrative duties, privacy issues, continued investment discretion, and the ability to control how, and in what manner, your charitable gifts can further your philanthropic vision. In addition, the upfront and ongoing income tax consequences of making charitable gifts are often determined by the recipient vehicle. Finally, aside from the tax benefits, philanthropy can be a means through which to create a family legacy that will last for generations. In this way, you can involve children in your philanthropic program and instill proper values through engagement in the charitable, governance, and investment processes at an early age.

11 The other way is a spousal transfer.
12 For additional information regarding specific philanthropic opportunities, please see (i) Charitable Planning with Donor Advised Funds, (ii) The Charitable Lead Annuity Trust (CLAT), (iii) Organizing Your Wealth: Charitable Remainder Trust (CRT), and (iv) Organizing Your Wealth: Private Foundation Overview.
What type of gifts will not cause you to incur an immediate gift tax liability but will still allow you to shrink your taxable estate?

**Annual Exclusion Gifts**

Each year, you can give the annual exclusion amount (currently, $14,000, or $28,000 in the aggregate for married couples) to any number of people without incurring any gift tax liability. To the extent that you do not maximize these gifts in any given year, the exclusion for such year expires and does not carry over to subsequent years. For married individuals with many children and grandchildren, the gross amount of annual exclusion gifts can be quite impactful. Consider a hypothetical married person with 3 children and 10 grandchildren. On an annual basis, the couple can gift $364,000 without paying gift tax (i.e., gifts of $28,000 to each of 13 beneficiaries), simply by maximizing their annual exclusion gifts to family members. Over a 10-year period, and after considering the cost-of-living adjustments of the annual exclusion amount, such married couple could transfer close to $4 million to their descendants free of gift and estate tax.

Annual exclusion gifts can be made either outright to individuals, or in trusts or to custodians for their benefit. If annual exclusion gifts are made in trust, the trust agreements must include certain administrative provisions (so-called “Crummey Powers”) in order for the gifts to qualify for the annual gift tax exclusion. Often times, people will make annual exclusion gifts to life insurance trusts to fund annual premium payments. In addition, people can fund qualified tuition plans (so-called “529 plans”) for their children with annual exclusion gifts. However, to the extent that the annual exclusion amount is utilized to pay life insurance premiums on policies held in trust or to fund a 529 plan in any given year, such amount will not also be available to give outright to a recipient or to a trust for his or her benefit.

**Gift Tax Exemption Transfers**

As mentioned above, substantial gifting can make a big impact on a person’s future estate tax liability. Any gifts to or in trust for individuals that exceed the annual exclusion amount in any given year will exhaust a portion of your available gift tax exemption amount. The best assets to gift are generally those that you anticipate will appreciate substantially in value, since the amount of the gift and the appreciation on such gifted assets from the date of the gift through the date of death will escape estate taxation if the gift is structured properly. In many instances, gift tax exemption transfers are made in trust not only because of their magnitude, but also because of the hope that the gifted assets will be able to benefit multiple generations. These generational trusts are often called dynasty trusts and typically use up a person’s gift tax exemption and GST tax exemption amounts.

The impact of gifting assets that are expected to appreciate substantially in value can be even more meaningful if the value of those assets can be discounted for gift tax purposes. Valuation discounts could apply to assets held through family limited partnerships, minority interests in entities, large blocks of publicly traded stock, and assets for which there is no readily available market. Nevertheless, the IRS closely scrutinizes the use of valuation discounts, and, as a result, they should be used with caution and after appropriate consultation with legal and tax advisors.

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13 This amount will adjust over time for cost-of-living in $1,000 increments.
14 Certain substantial gifts in trust may not use up a portion of a person’s gift tax exemption amount, if they are structured properly and “zeroed out”. For additional information concerning the opportunities when a gift can be zeroed out, please see *Organizing Your Wealth: Grantor Retained Annuity Trusts (GRATs)* and *Organizing Your Wealth: Charitable Lead Annuity Trusts (CLATs)*.
15 The amount of a valuation discount should be determined by a professional appraiser and, if determined in the context of a gift, reported on the corresponding IRS Form 709 (the so-called gift tax return).
Payments of Medical and Tuition Expenses

Payments of medical and tuition expenses that you make directly to a medical or educational provider are exempt from federal gift tax and do not offset your gift tax exemption or use up your annual exclusion amount. As a result, it generally does not make sense for a parent to arrange for such medical and tuition payments to be made from funds that have previously been gifted in trust, since, in most cases, such gifts in trust will already be excluded from the parent’s estate for gift and estate tax purposes.

How can Barclays help?

The Wealth Advisory team in the Americas works with Investment Representatives and our clients to help provide education and insight concerning wealth structuring and wealth preservation strategies. Strategies can be employed to help preserve and enhance wealth across generations effectively, through thoughtful trust and estate planning. For additional information regarding the advantages and considerations associated with specific planning strategies, including different trust structures and philanthropic vehicles, you should consult more specialized thought leadership papers published by the Wealth Advisory team.

This paper has touched briefly on the ways to incorporate gifting into an effective estate plan, but has not conveyed the significant requirements, advantages, disadvantages, and related risks associated with implementing various wealth planning strategies. Please consult your legal and tax advisor before making any transfers to determine how best to accomplish your wealth planning objectives.
Important Considerations

General Disclaimer
This glossary of important considerations is intended to provide a brief summary of certain attributes associated with various terms and structures referenced in this document. Many of the below terms relate to sophisticated legal structures that impact the legal rights and obligations of multiple parties. These summaries are not comprehensive. Please consult with your accountant, tax advisor, and/or attorney for advice concerning your particular circumstances.

Direct Gifting
If the value of the gift exceeds the grantor’s lifetime gift exemption, then the grantor may be exposed to unwanted taxation. Although direct gifting is an effective strategy, it may not be suitable for all individuals. There are limitations and considerations to be aware of, as direct gifting will remove assets from an individual’s estate (thereby generally removing the individual’s control over these assets). This could potentially reduce access to future liquidity. Consult with your legal and tax advisors for more complete information.

Irrevocable Life Insurance Trust (ILIT)
An ILIT is an irrevocable trust that is primarily set up for the purpose of holding a life insurance policy. In order to accomplish its intended purpose, such a trust is often the owner and beneficiary of the life insurance policies, in order for the life insurance proceeds to be excluded from the insured’s taxable estate (subject to the “look-back period” discussed below). Gifts to the trust to pay annual premiums should be structured to qualify for the annual gift tax exclusion. Trusts are not suitable for all individuals and the specific terms of the ILIT may limit certain activity by the insured or other party to the trust. If the insured gifts the life insurance policies to the ILIT, he or she will have to survive three years (i.e., the “look-back period”) in order for the life insurance proceeds to be excluded from his or her taxable estate. If the insured has not already purchased the life insurance policies, it may be beneficial for the ILIT, rather than the insured, to purchase it in order to avoid the “look-back” period. Please consult with your legal and tax advisors for more complete information.

Trust Structure
A trust is a useful planning tool for the purpose of estate and wealth planning; however, trusts may not be suitable for all individuals. Many trusts are irrevocable and cannot be retracted once they are put in place. There may also be a mortality risk associated with some trust planning. In such instances, the purpose of a trust may not be fulfilled if the grantor passes away prior to the trust’s termination date. Consult with your legal and tax advisors for more complete information.
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