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Equity Release in Inheritance Tax planning

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If you are a homeowner with significant wealth built up in your property, you may be thinking about how you can reduce the potential Inheritance Tax (IHT) liability for your beneficiaries.

Careful estate planning can reduce or even eliminate this tax liability and equity release is an increasingly popular part of such planning. This short guide explains the options available and the next steps, if you are thinking about unlocking your property wealth as part of IHT planning.

What is equity release?

'Equity' is the value of your property minus any mortgages or other debts secured on it. The term 'Equity Release' is used to describe two products; lifetime mortgages and home reversion plans, which provide you with a way of releasing the wealth built up in your home (and other properties in the UK), providing you are over the age of 55. The most common form of equity release is a lifetime mortgage.

What is a lifetime mortgage?

A lifetime mortgage is a loan secured against your main home. It differs from a regular mortgage because there is no fixed term and the lender does not expect the loan to be paid back until the youngest applicant either passes away or moves into long-term care. The mortgage is normally repaid from the sale of the house, and interest can either be paid monthly or rolled up so there are no monthly payments to worry about. Modern lifetime mortgage products include a wide range of flexible features, meaning we can tailor a solution that best meets your needs both now and into the future.

What is Inheritance Tax planning?

When we die the value of our estate becomes liable for inheritance tax (IHT). Our estate includes everything we own, including our home, our other properties and our financial assets. We can all pass on assets up to the Nil Rate Band (NRB) (currently up to £325,000*) without any IHT, and property owners can also make use of the Residence Nil rate Band (RNRB) (currently up to £175,000*). On top of these Nil Rate Bands there are reliefs and exemptions that, with careful planning, can be used to further reduce your inheritance tax bill. Certain Trust structures can also form part of a wider plan.

How can equity release help?

If the value of your estate exceeds £2million* your RNRB will reduce. Raising a debt against your property could bring your estate back to this level, thereby maximising your RNRB. Equity release can also turn illiquid assets into liquid funds for use in other IHT planning tools. Most of us expect to wait until death before passing on wealth to our beneficiaries through their wills. However, it can be more tax-efficient for IHT purposes to gift money while you are still alive. Equity release can allow you to make such gifts, as long as it is done with careful consideration.

Is it safe?

Providers and advisers in equity release must be authorised by the Financial Conduct Authority (FCA). Advisers must hold an additional qualification and follow the FCA rules. This means your adviser must take you through a careful process, assessing all the pros and cons with you. The trade body, the Equity Release Council, introduced a new standards framework in January 2020. All providers have signed up to a set of product standards. We are members of the Council and we believe the equity release market is better regulated today than it has ever been.

How does it work?

The following examples are fictitious and designed to illustrate how a lifetime mortgage could be used to compliment your inheritance tax (IHT) planning. Everyone is different and, for your IHT planning, we will work closely with your trusted advisers to ensure you have an appropriate solution. If equity release is not suitable, we will inform you.

Example 1. Using a lifetime mortgage to reduce inheritance tax

Mrs A is 80 years old. She was widowed three years ago, and her late husband left all of his wealth to her. She owns a cottage worth £1.8million and her assets are worth around £200,000. She has two sons who will be the sole beneficiaries of her estate. Without any IHT planning her sons could be faced with a large IHT bill (£400,000* or more based on a £2million estate). Raising a lifetime mortgage of £1million has allowed her to make gifts of £500,000 to each of her sons while still retaining equity of £800,000 in case she needs to downsize or move into care. In return her sons have agreed to pay the interest on the lifetime mortgage each month, keeping it at £1million. Providing she lives for at least seven years, these gifts will fall outside of her estate. The remaining debt will reduce the value of her estate by £1million, which in turn will reduce or even eliminate the IHT bill, saving around £400,000.

Example 2. Using a lifetime mortgage to maximise lifetime gift allowances

Mr & Mrs B are both 75 and own their home outright. It is worth £1,250,000. They have a comfortable income to cover their regular expenses and pay for holidays, but very little surplus. They have two children and five grandchildren. A lifetime mortgage with a reserve facility would allow them to drawdown small amounts (typically £2000 to £5000) when they wanted. This could allow them to make use of the various gift allowances available. Each year they can make gifts of £3,000* each without it being subject to IHT. This means they can give away £6,000 between them. In addition, they can make as many small gifts of £250* as they like, and £2,500* to each grandchild as a wedding gift. Any gifts to charities or political parties are also tax free.

*All figures and calculations are based on the tax rules at the time of publishing but may be subject to change. Speak to your financial adviser for details of the latest Nil Rate Bands, limits and other tax considerations.

Knight Frank Finance do not give advice on tax planning, Trusts, investments or pensions, but we will work closely with your trusted adviser to ensure we recommend the most suitable solution for you. Make sure you seek professional advice so the most tax efficient solution can be tailored to your own circumstances.

Contact us, we'd love to help you.

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Mortgage advice; the choice of interest rate and product terms will depend on your circumstances and the amount of the mortgage. Before you make a mortgage application, we will carry out a full review to establish your needs and preferences and if you meet the criteria, we will give advice and make a recommendation to you. There may be a fee for mortgage advice. The precise amount will depend on individual circumstances but we estimate that it will be up to 1% of the agreed mortgage. All mortgages are subject to status. Please note that these are indicative rates only. Products are subject to withdrawal without notice. You must be 18 or over.

YOUR HOME MAY BE REPOSSESSED IF YOU DO NOT KEEP UP REPAYMENTS ON YOUR MORTGAGE.

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