

When is equity release a good idea?

Outline

Equity release is a solution that enables you to unlock tax-free cash tied up in your main residence, while you continue to live in your home. Historically, some forms of equity release were a bad choice for consumers, but shortcomings in the market have been addressed of late, and eq-

uity release is now a valid solution for certain situations, depending on personal circumstances. In this factsheet we explain how equity release works, and examine some of the scenarios that it might be appropriate for.

How does equity release work

You must be aged 55 or over to be eligible. The most popular form of equity release is a lifetime mortgage. This sees a loan secured against your main property, which is either taken as a lump sum or in flexible chunks (drawdown) up to a set amount (drawdown sums are subject to interest rates at the time of drawdown). The younger you are, the less you can borrow.

The maximum loan amount is often between 25% and 50% of the property value. The mortgage is repaid from the proceeds of the property sale when

the last person either dies, or moves into long-term care. If you move to a smaller property at a later date then conditions may apply.

In the case of long-term care, the product will usually be unchanged if care is provided within the home, or if one of the spouses or partners moves to a residential or nursing home. If both partners move into a care home then the scheme typically ends, the property is sold, and the mortgage is repaid via the proceeds, with the remaining equity being returned to you.

Interest payments

You can opt to make regular interest payments, in which case the mortgage balance remains constant. Most prefer to add (or 'roll up') interest to the mortgage balance, so as not to compromise monthly expenditure, meaning the loan amount and compounded interest are repaid in full via the proceeds of the property sale.

The eventual loan amount can be much larger than the initial amount, as interest builds up over

time. But the amount of net equity (property value minus outstanding mortgage) remaining in the home does not necessarily decrease, depending on house price growth (see page 2).

The interest rate is typically fixed for life and higher than regular mortgage rates. Interest is only levied on the amount drawn down. Interest rates on lifetime mortgages had fallen in recent years, but have increased substantially over the past year.

Unlocked cash: The uses

Property often makes up a large part of a household's net wealth – see pie chart, right. Many people therefore opt to free up cash trapped in the family home to fund one-off expenses, such as home improvements, clearing a traditional residential mortgage, or paying off debts.

Another common reason is a desire to help children onto the property ladder. Others wish to boost their retirement provisions, or preserve pension funds for later on in retirement.

While pensions are currently outside of the estate for inheritance tax (IHT) purposes, property is not (above available allowances). Implementing equity release and a gifting strategy can substantially reduce IHT liabilities (see page 2).

Property often accounts for a large part of household net wealth

Example: Total net wealth £4,000,000; property £2,000,000; pensions £1,500,000; ISAs/non pension assets £500,000.



Utilising your asset mix efficiently

Depending on your specific circumstances, it may make more sense to unlock the maximum lump sum of cash via a lifetime mortgage at a fixed rate of interest – while preserving tax-efficient assets such as ISAs and your pension – rather than ‘drawing down’ as and when you need cash sums. This is because lifetime mortgage ‘chunks’ taken via drawdown are subject to the interest rates at the time, which may be higher than a fixed rate.

The timing and order of drawing on assets is a crucial part of any effective retirement plan. Mapping out the order and timing of capital withdrawals can substantially reduce your tax liabilities. Cashflow planning can clarify the interplay between your income needs and asset consumption. Visit luminwealth.co.uk/cashflow-planning to learn more.

Reducing inheritance tax bills

For many families, property accounts for a large part of household wealth. Unlocking tax-free cash from the family home via equity release could mitigate a large IHT liability and provide more flexibility when passing down wealth. The threshold above which IHT is payable is £325,000. This nil-rate band allowance is transferable to a spouse or civil partner on death, giving couples a potential combined nil-rate band of £650,000.

Pensions aren't currently part of the estate (although unused pension assets will be from April 2027, unless left to a spouse or civil partner), so the taxable estate is £2,500,000. When an estate is valued at more than £2,000,000, the RNRB tapers away by £1 for every £2 above £2,000,000, meaning £250,000 of the £350,000 residence allowance is lost. An IHT charge of 40% on the taxable assets results in a tax liability of £700,000.

If the beneficiaries of the family home are children or grandchildren then the main residence nil-rate band (RNRB) of £175,000 per person can boost the total IHT-free threshold for a married couple or civil partners to £1,000,000.

In the alternative scenario, a £500,000 equity release lifetime mortgage is implemented, and this tax-free lump sum is gifted to family members, reducing the taxable part of the estate by £500,000. Because the full nil-rate band allowances are now available, this reduces the IHT liability by £300,000. Gifts of more than £3,000 may be subject to an IHT charge if you pass away within seven years of making the gift.

IHT bills can be large, even when allowances are used. In the example below, the ‘current situation’ shows the liability a family with £4,000,000 in as-

How equity release can cut IHT liabilities

Assumptions: Family with total assets of £4,000,000; figures rounded.

	Current situation	With equity release and gift
Property	£2,000,000	£1,500,000
Pensions	£1,500,000	£1,500,000
ISAs/non-pension assets	£500,000	£500,000
Total wealth	£4,000,000	£3,500,000
IHT estate	£2,500,000	£2,000,000
NRB/RNRB	£750,000	£1,000,000
Potential IHT liabilities ¹	£700,000	£400,000 ²

¹ Based on current allowances, exemptions and 40% tax rate
² If the gift (in this example £500,000) is survived for at least 7 years; otherwise potential IHT liabilities are not mitigated

House price value vs. mortgage debt

Many people worry that the mortgage debt may erode the value of an inheritance. People can forget the compounding effect on the full value of the property. They generally assume that the increase in the lifetime mortgage debt will erode all of the remaining equity in the home, leaving nothing for potential beneficiaries (for more on common myths and misunderstandings, see the table on page 3). In reality, the amount of net equity (property value minus outstanding mort-

gage) remaining in the home, once a lifetime mortgage has been taken out, may remain stable or even increase over the longer term, due to the conservative loan to values that lenders impose.

Historical house price growth in the UK has averaged between 3–5% over long periods, but just a small increase in house price value (for example, 1–2%) is often enough to maintain, or even grow, the net equity.

Common equity release myths/misunderstandings

Myth	Fact
I no longer own my home	With a lifetime mortgage, you still own 100% of the property
I can't move home	You can move home and transfer the lifetime mortgage to suitable properties with Equity Release Council (ERC)-approved providers
The debt will balloon over time	You can opt to make regular interest payments rather than rolling up interest. You might be able to repay up to 10% of the initial mortgage without early repayment charges
My children might inherit debt	'No negative equity guarantees', which are offered by ERC-approved providers, mean your estate will never owe more than the value of your home.

Downsizing protection

Providers approved by the Equity Release Council offer 'portable' lifetime mortgages. This means you can transfer an existing lifetime mortgage over to a new property when you move home. Many lifetime mortgages also include an option to repay the loan, without an early repayment charge being levied, if you sell your family home and move to a new property due to a specific life-style event. A minimum number of years usually applies before this option can be implemented.

Downsizing protection, which is offered by some lenders, allows you to pay the mortgage debt off early (again subject to a minimum qualification period), without facing early repayment charges, if you're leaving your home to move into a smaller property that isn't acceptable to the lender because of certain conditions. Not all providers offer downsizing protection, and the process can be complicated, so we recommend consulting a financial adviser if you wish to explore this option.

Equity release assistance

Equity release is a big decision and it's advisable to involve your family if you are considering a lifetime mortgage. It won't be right for everyone, but it can provide an effective solution to meet expenditure needs – such as home renovations or assisting children with first property purchases – in a tax-efficient manner. Equity release can also mitigate inheritance tax liabilities when combined with a gifting strategy, which can help you provide the right legacy for loved ones. Hundreds

of products are available on the marketplace from a large number of providers, so an independent financial adviser can help you choose the solution that best suits your needs and circumstances.

The Financial Conduct Authority stipulates that financial advisers must be certified to provide equity release advice. Lumin has a number of qualified experts who can provide professional, independent advice around equity release.

Lifetime mortgages: Pros and cons

Typical advantages	Potential drawbacks
Liquidity and flexibility from converting wealth tied up in property into cash	Set-up costs (arrangement fees, valuation fee and legal fees); potential early repayment charges
Can stay in the home for life rather than downsizing to a smaller home	Inheritance could be eroded through interest costs; potential lack of ability to inherit the family home
Can still move home with a lifetime mortgage	Specific terms and conditions, eg. lender's rights to carry out essential building repairs
Diversify asset mix (household net wealth is often dominated by property)	Impact on entitlements to welfare/ State Benefits
No negative equity guarantee in many plans, meaning you will never owe more than the value of your house	For home reversion plans (another form of equity release), capital raised may not fully reflect the value of the property

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