Considering lifetime mortgages in estate planning

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Introduction

Housing wealth is the second largest asset for over 55s. In fact, post-pandemic property price growth has seen the over 55's housing wealth reach £4.4 trillion. However, greater financial capital implies greater inheritance tax implications. This is where an adviser's role can be crucial in navigating individual circumstances including potential IHT liabilities.

During the financial year 2021 to 2022, HMRC collected £6.1 billion in IHT – the largest single-year increase since the 2015-2016 financial year. To reduce the IHT bill for many households, the Government introduced the residence nil rate band (RNRB) in 2017. This was designed to pass a home to immediate family without a tax charge. Despite its introduction, the RNRB did little more than counter the freezing of the nil rate band (NRB) since 2009, which has now been extended until 2026. With this in mind, your clients with larger estates will benefit from an all-asset approach, especially when it comes to drawing down income, or passing on assets to loved ones. The difficulty is that many do not have the capital to make lifetime gifts.

According to HMRC, UK residential property accounts for more than half of gross estate assets. Yet IHT planning with the family home has traditionally been difficult. This is in part due to issues around gifts with reservation (GWR) and pre-owned assets tax (POAT). However, for many people, their home may be largely paid off or mortgage free by the time they reach retirement. So, when taking an all-asset approach to estate planning, it's important to consider your client's main residence.

A lifetime mortgage is a loan secured against the home. As a form of equity release, it allows your clients to unlock some of the wealth tied up in their home. It is usually repaid upon death or when your client moves into long term care. While there may be cheaper ways of borrowing, with the right advice, equity release can deliver meaningful benefits. With interest rates being fixed for life – a lifetime mortgage could be a viable option to provide capital for lifetime gifting or supplementing a retirement income.

It's important to remember that if your client gifts the money away, there may still be inheritance tax to pay in the future. Interest is charged on the total loan amount plus any interest already added. This means a lifetime mortgage will reduce the value of the estate.

Lifetime mortgages are not a panacea, but in the right circumstances, they could offer a useful way to provide an early inheritance to loved ones. The following example explores these circumstances in greater depth.

Meet Simon

Case Study

Simon is 68 and in a bind. He divorced his wife of 33 years shortly before he retired. This became costly to his pension share and investments. He decided to keep the family home, so he now has a property worth £750,000 and fixed interest investments of £200,000. He uses these to supplement his pension.

His only child, Sarah, has recently given birth, and is desperate to upsize from the 1 bedroom flat she currently owns. Ideally, she needs £200,000.

Simon would like to help and understands the tax benefits of making lifetime gifts. But he cannot afford to give away any of his capital. He decides to take £200,000 in a lifetime mortgage at an interest rate of 3.11% AER. If Simon dies 18 years later, at age 86, his ONS life expectancy, then this would be Sarah's inheritance, based on the assumptions below:

	No Mortgage (£)	Lifetime Mortgage
Value of property	1,071,185	1,071,185
Outstanding loan	-	349,370
Net property value	1,071,185	721,815
Investments	200,000	200,000
Taxable estate	1,271,185	921,815
IHT*	(244,578)	(104,830)
Net estate	1,026,607	816,985
Lifetime Gift in 2020	-	200,000
Total benefit	**1,026,607**	**1,016,985**

Assumptions: CPI, property value growth 2%. IHT rate 40%. Investment return 0% as all taken as income. Initial fees £1,313 added to debt. *IHT calculation is after the application of RNRB and NRB, and is based on a 2% CPI growth from 2026 onwards; allowing for the freeze in both NRBs until April 2026.

At first sight this example does not appear to produce a great benefit. But that ignores the timing of the £200,000 gift. In theory, Sarah could save 18 years of mortgage interest on £200,000 and is likely to secure a lower rate on the new mortgage taken. There is also the emotional value of buying a family home to consider. Sarah's interest savings, would potentially be considerably more than the £9,662 shortfall shown above. This may equate to only a few years of the mortgage interest she would have to pay.

The lifetime mortgage works in this case because:

1. Simon is single.

If he was married or in a civil partnership, IHT would not be an immediate issue because there would be £1,000,000 of NRB and RNRB, all CPI-linked. For couples with children, IHT problems begin further up the wealth scale – once an (index-linked) estate threshold of £2m is reached. At this point, the RNRB taper starts to apply. For childless couples, RNRB generally does not enter the IHT calculations, as it only applies if the property is "closely inherited".

2. The RNRB is not lost.

The RNRB will be CPI-linked from April 2026, so by the time Simon is 86, it will be just short of £231,000 (assuming 2% CPI). The benefit provided by a lifetime mortgage is eroded if it ultimately means that all or part of the RNRB is wasted (it can only be set against a home, subject to the complex downsizing rules).

3. The NRB is fully useable.

This is a similar point to 2. The estate net of mortgage debt at death needs to be more than the sum of NRB and RNRB for a lifetime mortgage to have the greatest benefit. It helps that Simon has £200,000 assets in addition to his home.

4. The lifetime mortgage interest rate is close to the assumed property value growth.

The greater the gap between the mortgage rate and property growth, the faster net equity erodes. It is then more likely that the RNRB is not fully useable.

Over time, a mortgage rate higher than the property growth rate will reach a point where net equity drops below the RNRB (plus NRB, if appropriate).

5. Simon outlives the seven-year gifting window.

The £200,000 lifetime gift will fall back into Simon's estate unless he survives seven years after making it. Within that timeframe, there is no IHT saving. Simon will have also incurred the expenses of arranging the mortgage. Whether that leaves Sarah worse off depends on her mortgage interest savings.

Points to consider

It's important to remember that a lifetime mortgage may not always be the best approach. For example, if Simon were in poor health and unlikely to survive seven years, there would be no financial benefit from the lifetime gift. The lifetime mortgage option is also unlikely to make sense if his property value was lower, and the accumulating mortgage leaves insufficient equity to cover his single RNRB (plus NRB, if appropriate).

The five points highlight how the various factors can interreact, but also how a lifetime mortgage should be considered on an individual basis. For many retirees, their bricks and mortar could be one of their most valuable assets, and equally one that cannot be ignored in financial planning conversations.

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