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The Inheritance Tax perils of co-habitation for older couples

What do the Loch Ness Monster, Big Foot and "the common law spouse" have in common? None of them exist.

Co-habiting couples forgo the considerable protections of the family courts if their relationships end during their lifetime. The situation is equally negative from an IHT perspective when a co-habitee dies.

Co-habitation has traditionally been associated with younger couples, but research from Royal London (an insurer) asserts that over 300,000 people aged over 65 are now living together as unmarried couples who do not intend to marry so late in life.

<u>IHT differences between married couples/civil partners and co-habitees</u>

1. Married couples/civil partners get the IHT spouse exemption; co-habitees do not.

This means that on the first death of a married couple/civil partner any assets left to the survivor will be entirely exempt from IHT. This does not apply to co-habitees and so assets in excess of the deceased's nil rate band (see 2 below) will be taxed at 40 percent.

On the first death of a co-habiting couple jointly owning a residential property in the South East it is highly likely that, unless there are other assets, the co-habitee's home will need to be sold to pay the IHT on the first death leaving the surviving co-habitee considerably worse-off than a surviving spouse/civil partner.

2. Married couples/civil partners can transfer their unused nil rate band between themselves for use on the second death; co-habitees cannot

Every individual gets a nil rate band for IHT (currently up to £325,000) and assets up to that value can be left to anyone free of IHT. The nil rate band is reduced by the value of gifts (other than for the maintenance of family) made in the seven years prior to death.

An effective IHT planning tool is to ensure that the unused nil rate band of the first to die is transferred to the surviving spouse/civil partner for use on the second death. This can mean that up to £650,000 (two nil rate bands) of assets can be passed to children entirely free of IHT; an effective IHT saving of £260,000. Co-habitees cannot transfer any unused nil rate band between them, increasing the IHT burden on their families.

3. Married couples/civil partners can transfer their unused residence nil rate band between themselves for use on the second death; co-habitees cannot.

There is now a residence nil rate band which can be used to pass the family home to lineal descendants free of IHT. The residence nil rate band is currently £100,000 in 17/18 rising to £175,000 for deaths from 6 April 2021.

Whilst everyone has a residence nil rate band, only married couples/civil partners can transfer their residence nil rate band to the survivor; co-habitees cannot. Co-habiting couples are currently losing out, and that loss will increase to £140,000 of IHT from 6 April 2021.

<u>What can older co-habiting couples do to improve their estate planning?</u>

1. Take out life insurance to cover the higher IHT liabilities

This is common planning for younger co-habiting couples in that life insurance held on trust is outside the scope of IHT, can be used to meet IHT liabilities and ensures that the family home does not need to be sold. However, for the over 65s there may be medical conditions which mean that either life cover is not available or prohibitively expensive.

2. Invest in assets which qualify for Business Property Relief (BPR)

BPR is an exemption from IHT which very broadly applies to unquoted trading companies and partnerships. Whilst not everyone wants to start their own business post 65, shares listed on AIM do qualify for BPR if they have been held for two years prior to death.

However, managed AIM portfolios often come with high management charges and they represent high risk investments at a time when most over 65s should be moving to lower risk investments.

3. Use pension assets on death not during life

Pension funds are usually held on trust and so free of IHT; they are a good way to benefit individuals where there are no other IHT reliefs available. Furthermore if an individual dies before the age of 75, pension funds effectively can be inherited free of Income tax as well. It is therefore better to run down non-pension assets, eg ISAs, before touching your pension.

4. Get married/enter into a civil partnership

All of the abovementioned problems fall away if co-habitees marry or enter into civil partnerships; it is the best advice from an IHT perspective.

Deathbed marriages, so long as both parties have mental capacity, are valid and will bring the IHT benefits even if death occurs immediately after the ceremony, but please note that marrying revokes Wills (unless they are carefully drafted) and so new Wills may need to be made immediately after marriage.

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