



## **ROYAL LONDON POLICY PAPER 14**

**Could living together in later life seriously damage your wealth?**



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## COULD LIVING TOGETHER IN LATER LIFE SERIOUSLY DAMAGE YOUR WEALTH?

### Executive Summary

Recent decades have seen a profound change in the way we live our lives. One of the biggest changes has been the fall in the proportion of people living as part of a married couple and the rise in the proportion choosing to cohabit outside marriage. This trend matters for a number of reasons, not least that we have a tax and social security system which was largely designed for a world where people were either single or married, and which does not always cope well with newer family structures.

The rise in cohabitation has, however, been unevenly distributed.

Whilst the rate of cohabitation has risen by around one third since the turn of the century, the rate amongst those over state pension age has trebled. Cohabitation has moved from being a temporary state - typically followed either by marriage or the break-up of a relationship - into being a long-term feature of the lives of millions of people.

The growth in cohabitation among pensioners is of particular importance because of the poor fit between tax and benefit rules with particular relevance to older people and the increased likelihood of older people living together outside marriage. We are talking about roughly one third of a million people over the age of 65 who are living together as couples. This number is growing steadily each year.

In this paper we highlight three main areas where cohabiting couples may suffer relative to those who are married. These are:

- a) **Inheritance tax (IHT)** – married couples have several advantages when it comes to IHT;
  - where an estate is passed in its entirety to a spouse (or civil partner<sup>1</sup>), the surviving spouse pays no IHT; but where the estate is passed to a cohabiting partner, the whole estate can be liable to IHT;
  - for married couples, any unused IHT allowance can be transferred to a surviving spouse; cohabiting couples do not qualify for this transfer;
  - the new ‘nil rate band’ for residential property applies only to married couples, and will eventually allow such couples to pass on a family home worth £1 million free of IHT; cohabiting couples are excluded from this new concession;

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<sup>1</sup> Unless otherwise stated, references to ‘married couples’ in this document always include those who have entered into registered civil partnerships.

- b) **Income tax** – there are two separate tax allowances available to married couples but not to cohabiting couples; the first is the Married Couples Allowance which is gradually being phased out, but which is available to married couples where one partner was born before 6 April 1935; this can be worth up to £844.50 per year; the second is the recently-introduced ‘Marriage Allowance’ whereby a low income spouse can transfer any unused personal allowance to his/her taxpaying wife or husband; this can be worth up to £230 a year but is not available to cohabiting couples;
  
- c) **State Pension inheritance** – although the new state pension system (for those reaching pension age after 5th April 2016) has very limited provision to inherit any state pension from a spouse, the system for those who reached pension age before that date contains extensive inheritance provisions; but these only apply to married couples and not to cohabiting couples; for example, a member of a married couple can see their basic state pension boosted to the full rate based on the National Insurance Contributions of a late spouse, and a married person can inherit anything between 50% and 100% of the state earnings related pension (SERPS) of their late partner, depending on age; neither of these concessions applies to cohabiting partners.

It is clearly a matter for individuals to choose whether they wish to marry or to live as partners. The purpose of this paper is twofold. First, it is to alert the growing number of people over state pension age who are living together as couples to the financial problems which they may face as a result. And, second, it is a further<sup>2</sup> prod to policy-makers to reflect on whether the rules and regulations around tax and benefits are any longer fit for the modern world.

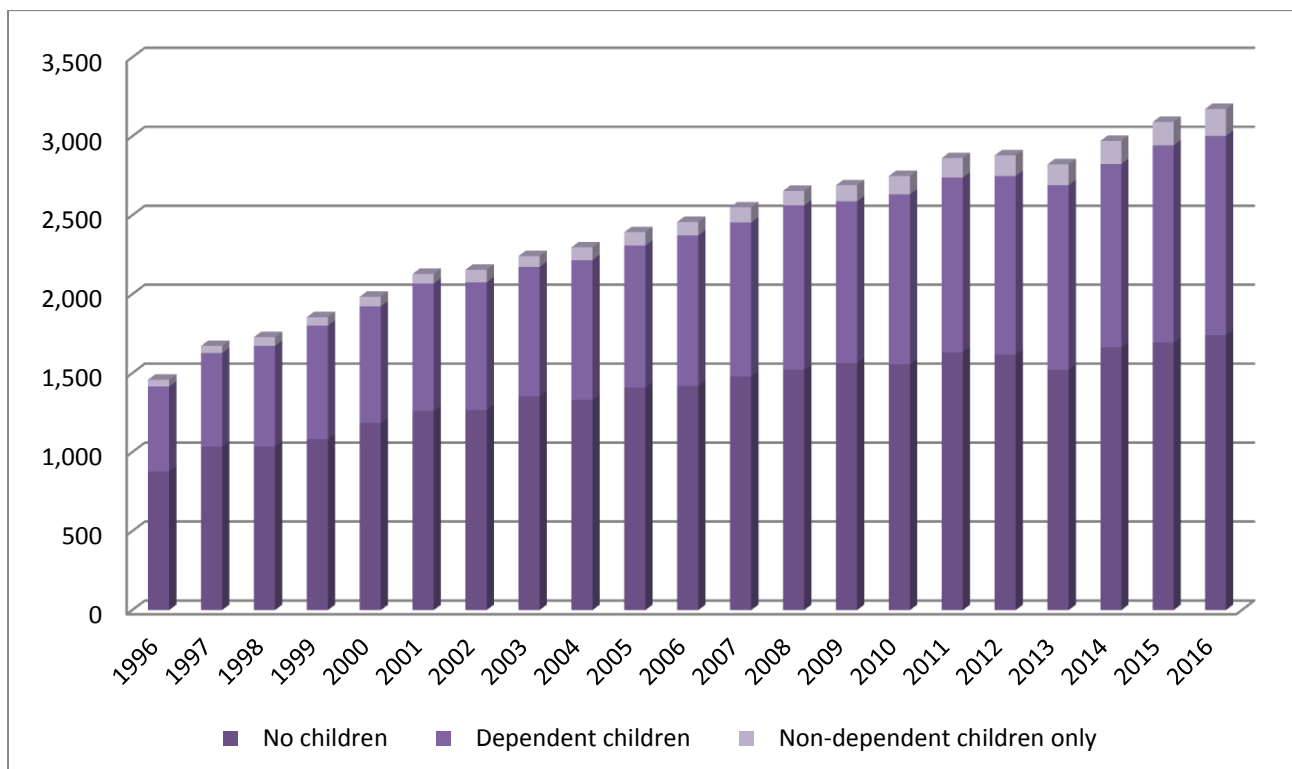
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<sup>2</sup> Our first Royal London Policy Paper ‘The Living Together Penalty’ published in 2016 highlighted the loss to working age cohabiting couples from the fact that they are excluded from National Insurance bereavement benefits. The paper can be found at [www.royallondon.com/policy-papers](http://www.royallondon.com/policy-papers)

**1. What do we know about cohabitation trends?**

Figures from the Office for National Statistics<sup>3</sup> show that the number of cohabiting couples in the UK has more than doubled over the last twenty years. In 2016, there were an estimated 3.2 million cohabiting couples, compared with around 1.5 million in 1996. Figure 1 shows how the total has grown, and provides a breakdown between couples without children, couples with dependent children and couples with non-dependent (i.e. grown-up) children.

**Figure 1. Cohabiting couples in the UK: 1996-2016 (millions)**



Source: ONS Labour Force Survey (4<sup>th</sup> November 2016)

Apart from relatively small year-to-year fluctuations, the figures show a remorseless rise, with the total number of cohabiting couples rising by an average of around 85,000 per year for the last twenty years.

There is however a change over that period in the mix between couples with and without dependent children. In the earlier part of the period, a clear majority of cohabiting couples had no dependent children. These would typically have been younger couples for whom cohabitation may have been a transitional phase before marriage and/or starting a family. But, as time has gone by, the balance has shifted gradually towards couples with children. In round numbers, the number of cohabiting couples

<sup>3</sup><https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/families/datasets/familiesandhouseholds/familiesandhouseholds>

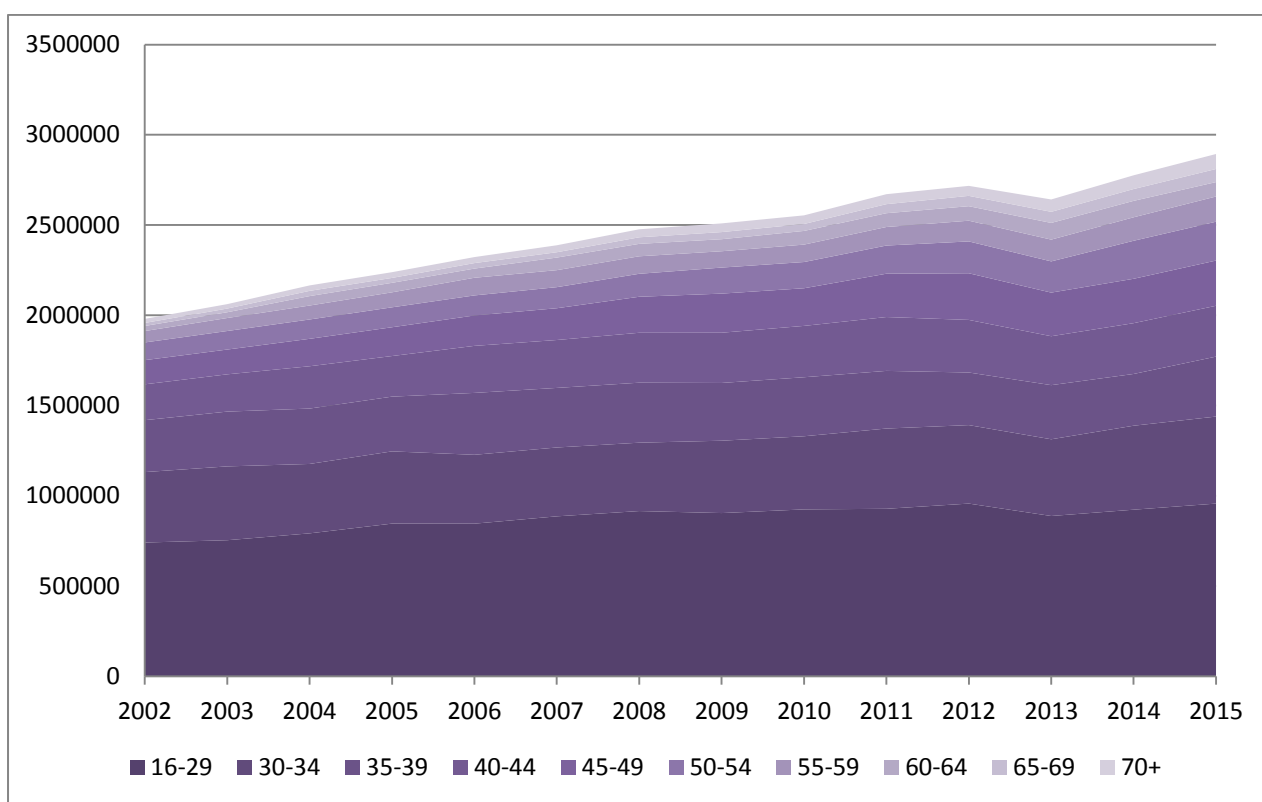
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without dependent children has risen by around 100%, whilst the number with dependent children has risen by around 135%. The numbers with grown-up children living at home are still relatively small but have risen sharply, and this reflects the rise in the number of much older cohabiting couples.

As well as looking at the family circumstances of cohabiting couples we can also look at the age distribution of such couples. The best data on this is for England and Wales only and covers the period 2002-2015 but it allows us to look both at the ages of such couples and also whether or not they have previously been married.

Figure 2 shows the total number of cohabiting couples in England and Wales, split by age.

**Figure 2. Number of cohabiting couples by age England & Wales 2002-2015**



As Figure 2 shows, at the turn of the century, cohabitation was primarily something that people did earlier in life. Out of around two million cohabiting couples in England and Wales in 2002, well over half (57%) were under the age of 35. By 2015, a narrow majority of cohabiting couples are now over the age of 35.

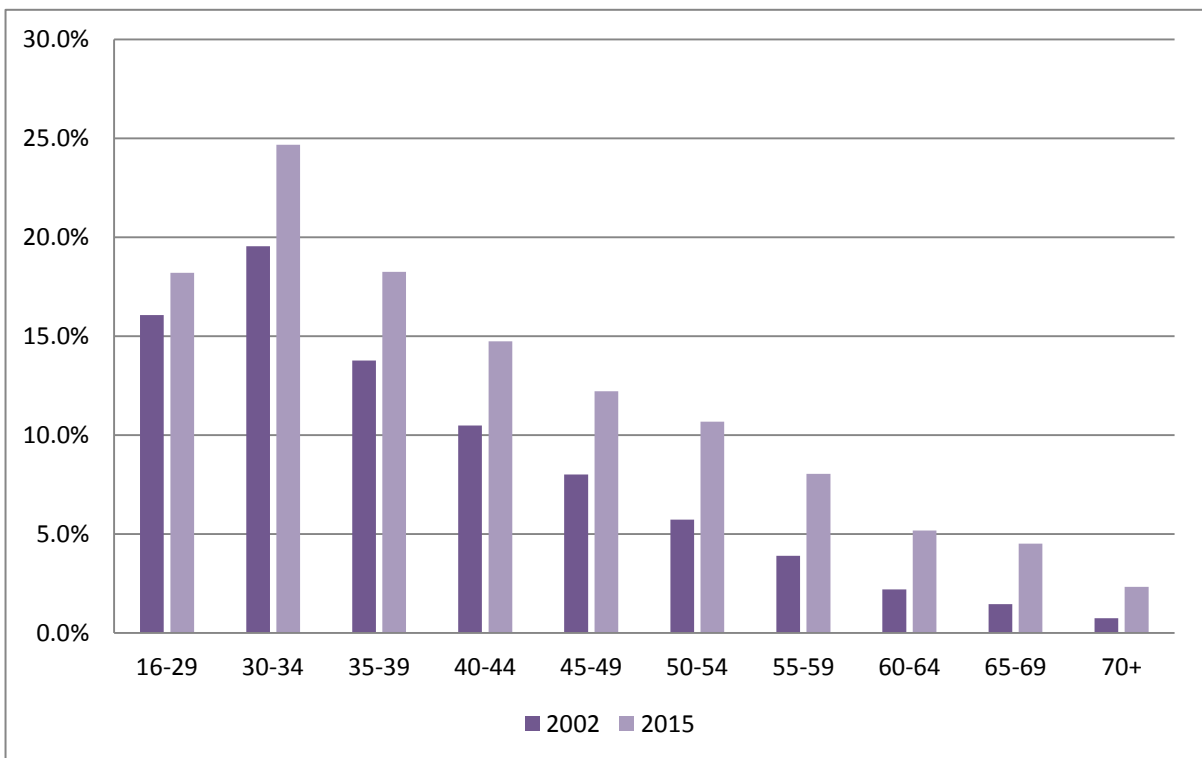
Of particular interest for our purposes is the growth in older cohabiting couples. Although the numbers are modest relative to the working age population they have been growing rapidly. By 2015 there are over 150,000 cohabiting couples over pension age, with a narrow majority of these containing someone aged 70 or over.

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All of these figures are slightly distorted by the general growth in the population of England and Wales over the same period. We can strip out general population growth by looking at cohabitation rates by age at the start and end of the period, which we do in Figure 3.

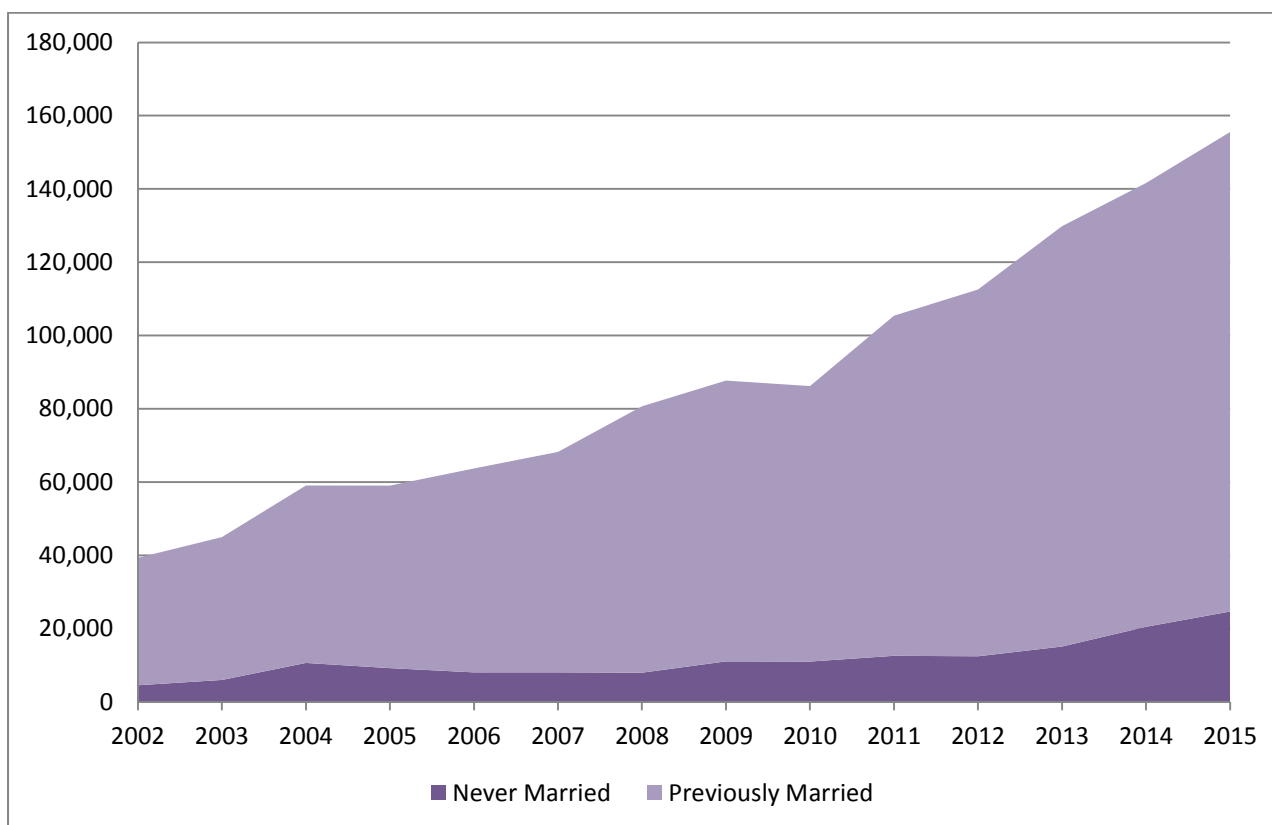
Figure 3 shows increases in cohabitation rates across all age groups and the average across the whole population is an increase of one third from 7.5% in 2002 to 10% in 2015. **But amongst 65-69s the rate has trebled from 1.5% to 4.5%, and amongst those aged seventy or more it has more than trebled, from 0.7% to 2.3%.**

**Figure 3. Cohabitation rates by age group in England and Wales: 2002 and 2015**



In order to understand more about this older age group, we can look at whether they are people who have previously been married and are now divorced or widowed or if they are people who have never been married. Figure 4 provides this data for all cohabiting couples in England and Wales aged 65 or more.

**Figure 4. Cohabiting couples aged 65 plus by whether ever married 2002-2015**



As Figure 4 shows, the overwhelming majority of older cohabiting couples are made up of people who have previously been married, though we do not know if their previous marriage(s) ended in divorce or through bereavement.

This data should be of interest to policy-makers who may see the current favourable tax and benefit treatment of married couples as designed to encourage people to either get married or to stay married. The fact that the vast majority of older cohabiting couples have previously been married but have decided now to live together outside marriage suggests that despite the financial disadvantages they now prefer not to marry again. It is not clear why the state should use the tax and benefit system to encourage them to try to change their minds.



## **2. Why does this matter?**

Members of cohabiting couples may miss out on benefits or tax breaks which they would get if they were married. In this section we discuss three main areas where cohabiting couples get different – and inferior – treatment in the tax and benefit system compared with their married counterparts. We focus in particular on issues that may be of relevance to the fastest growing group of cohabiting couples – those aged 65 or more. These are with regard to Inheritance Tax, income tax breaks for married couples, and the rights of married partners to inherit some or all of the state pension of their late spouse. We consider each in turn.

### **A. Inheritance tax**

If you are married or in a civil partnership then the estate can be passed on tax free to your partner. However, this is not the case for cohabiting couples who will be liable for a 40% inheritance tax (IHT) on estates worth more than the current threshold – otherwise known as the nil rate band.

The nil rate band currently stands at £325,000 and has been frozen since April 2009. Given the rapid rise in house prices over the last twenty years many cohabiting couples could find themselves facing a hefty tax charge they were not expecting<sup>4</sup>.

Since 9 October 2007, it has been possible to transfer any unused part of this nil rate band from a deceased spouse or civil partner to the surviving spouse/civil partner. This is known as the transferable nil rate band and is available to survivors of a marriage who die on or after 9 October 2007, regardless of when the first spouse died. It's slightly different for civil partners as the first death must have occurred on or after 5 December 2005, the date the Civil Partnership Act became law in the UK.

As estates pass between married couples and civil partners tax free the likelihood is that unless the deceased has made gifts to other parties then the entirety of their nil rate band will be transferred to their spouse/civil partner. This would give the survivor a current nil rate band of £650,000 (£325,000 x 2). However, as it currently stands co-habiting couples are not able to benefit from this.

### **Residential nil rate band**

In addition to the transferable nil rate band, from April 2017 married couples and civil partners can also benefit from a transferable 'residential nil rate band'. This comes into play when a residence is passed on death to a direct descendant.

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<sup>4</sup> One way in which some cohabiting couples mitigate this is to have any property registered jointly so that the half that is legally that of the surviving partner will not count towards the other partner's estate.

Direct descendants are described as:

- Children and their spouses or civil partners
- Grandchildren and their spouses or civil partners
- Great-grandchildren and their spouses or civil partners
- Stepchildren
- Adopted children
- Foster children
- Children who were under the guardianship of the people passing on their estate

Any unused residential nil rate band available on death can be transferred to a spouse or civil partner. This nil rate band will be:

- £100,000 in 2017 to 2018
- £125,000 in 2018 to 2019
- £150,000 in 2019 to 2020
- £175,000 in 2020 to 2021

After this point this will increase in line with the Consumer Prices Index.

The value of the transferred allowance will depend on when the second, not first, partner dies so estates can still benefit from this rule even if the first partner died prior to April 2017. However, while cohabiting couples can use the residence nil rate band to pass money on to their descendants, they will be unable to transfer any unused portion of it to their partner.

The fact married couples and civil partners can transfer these nil rate bands to each means that by 2020 they can benefit from an inheritance tax nil rate band of £1m (combined nil rate band of £650,000 plus the combined residence nil rate band of £350,000) – something cohabiting couples cannot benefit from.

## **B. Income tax breaks for married couples**

There are two separate tax allowances currently available to married couples, but not cohabiting couples:

- **Married Couples Allowance**

The Married Couples Allowance is available to married couples where one partner was born before 6 April 1935. It can reduce the tax bill for each year a person is married or in a civil partnership by 10% of the tax allowance they are entitled to.

For the 2017 to 2018 tax year, it could cut a couple's tax bill by between £326 and £844.50 a year.

For marriages before 5 December 2005, the husband would generally receive the Married Couple's Allowance. For marriage and civil partnerships after this date, it is the higher earner who receives the allowance.

- **The Marriage Allowance**

The Marriage Allowance was introduced by the Conservative government in April 2015 to incentivise marriage. It is less generous than the Married Couples Allowance but allows the transfer of unused personal allowance (up to £1,150 for the 2017-2018 tax year) to a higher earning spouse or civil partner.

This means the higher earning partner pays less income tax. It currently equates to a saving of up to £230 this tax year. To benefit from this allowance the lower earner must have an income of £11,500 or less and the higher earning partner needs to be a basic rate tax payer. In addition, married couples can backdate their claim to include any tax year since 5 April 2015 that they were eligible for the Marriage Allowance.

In April 2015 the allowance was worth £212, in April 2016 it went up to £220 and in April 2017 it went up to £230. This means that if a married couple/civil partnership decided to claim for the last three years then they stand to benefit by £662.

In terms of the total amount foregone, if we take the roughly 150,000 cohabiting couples over pension age and assume that half are too poor to pay income tax, this leaves us with 75,000. If each of these couples had been eligible for £662, the amount gained would be just under £50 million.

### **C. Inheritance of state pension rights**

The state pension system was fundamentally reformed in April 2016, and this had a significant impact on inheritance rights between married couples. The vast majority of today's pensioners reached state pension age before 6th April 2016 and come under the 'old' state pension system. However, as time goes by, more and more pensioners will come under the new system. We set out below the inheritance rights in each case – rights which apply to married couples and civil partners, but not to cohabiting couples.

#### **a) Old state pension – those reaching state pension age before 6<sup>th</sup> April 2016**

The old state pension system was designed in the 1940s on the assumption that men were the main breadwinners in households and that women would be financially dependent upon them, including in retirement. On this basis, widows (and subsequently widowers) were entitled to improved state pension rights following the death of a spouse. These relate to the basic state pension and to the earnings-related additional state pension. We consider each in turn.

##### **i) Basic state pension**

Many women historically reached state pension age without a full pension in their own right. This could be because of time spent out of paid work bringing up a family or because they actively opted to pay a reduced rate of National Insurance Contributions (NICs) known as the 'married woman's stamp'<sup>5</sup>. But where a woman is widowed, she can substitute her late husband's record of NICs for her own. Many married women draw what is colloquially known as a 'married woman's pension' and the current rate of this pension is £73.30. But the full rate of the basic state pension is £122.30. So it would not be unusual for a married woman on becoming widowed to see her basic state pension rise by just under £50 per week, or around £2,500 per year<sup>6</sup>.

##### **ii) State earnings-related pension (SERPS)**

In addition to the basic state pension, people on the old system also received an earnings-related pension from the state known as SERPS (and subsequently the 'state second pension'). Members of married couples can inherit at least half of their late spouse's SERPS pension and sometimes more. This depends on the date of birth of the deceased person, as shown in the Table:

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<sup>5</sup> While this option was abolished in 1977, women who were already paying the reduced level were allowed to keep on doing so.

<sup>6</sup> As time has gone by, more and more women are retiring with full (or nearly full) basic state pensions in their own right. But many older retired women still receive reduced pensions which would be increased if their husband were to die.

<b>Man's date of birth</b>	<b>Woman's date of birth</b>	<b>Maximum % of their SERPS you can inherit</b>
5 October 1937 or before	5 October 1942 or before	100%
6 October 1937 to 5 October 1939	6 October 1942 to 5 October 1944	90%
6 October 1939 to 5 October 1941	6 October 1944 to 5 October 1946	80%
6 October 1941 to 5 October 1943	6 October 1946 to 5 October 1948	70%
6 October 1943 to 5 October 1945	6 October 1948 to 6 July 1950	60%
6 October 1945 and after	6 July 1950 and after	50%

Source: Gov.uk

As noted above, the ability to receive an inherited SERPS payment applies only to married couples and not to those who are cohabiting.

#### **b) New state pension – those reaching state pension age on or after 6<sup>th</sup> April 2016**

The basic idea of the new state pension is that individuals build up a pension in their own right and are not treated as dependents of their spouse or partner. However, switching off inheritance rights abruptly on 6<sup>th</sup> April 2016 for new pensioners would have had a significant impact on the retirement planning of many couples. The new state pension therefore contains a residual element of inheritance between married partners which is described in this section.

Under the new state pension, individuals receive a flat rate amount, currently £159.55 per week, if they have made 35 years or more full -rate National Insurance Contributions, including any years for which they receive credits for things like bringing up children or caring for a disabled person<sup>7</sup>. However, some people were already expecting to get a larger pension than this. If they had built up rights to a full basic state pension of around £122.30 per week and were expecting a significant SERPS pension on top, they could easily be heading for a total state pension of £180, £190 or £200 per week. In such circumstances it would have been wrong for the government to replace this with a flat rate of £159.55. As a result, under a set of

<sup>7</sup> There is a one-off deduction from this flat-rate amount in respect of years prior to 2016 in which the individual paid a reduced rate of NICs because they or their pension scheme was 'contracted out' of part of the state pension system. This means that in the early years of the new system, many new pensioners do not receive the full flat rate amount.

complex transitional arrangements, individuals who had already built up state pension rights under the old rules in excess of the flat rate figure will get that higher amount.

In terms of inheritance rights, new state pension rights up to the flat rate of £159.55 are not inheritable. However, half of any amount in excess of £159.55 – known as the ‘protected payment’ – can be inherited. To give an example, someone with a new state pension entitlement of £179.55 has a protected payment of £20 per week, and therefore £10 per week can be inherited by a surviving spouse. Again, such provision does not apply to surviving cohabitants.

### **3. Conclusion**

There is a clear trend towards couples in later life choosing to cohabit rather than to marry, yet many may be unaware of the financial implications of doing so.

There is a myth that living together long term, especially if for those who have children, gives couples some level of “common law marriage” status and that this will give them financial rights similar to those of married couples/civil partners. However, this is simply not the case and cohabiting partners have no automatic entitlement to a partner’s finances or benefits on death.

There needs to be much more awareness of these issues so that cohabiting couples are aware of potential difficulties and can plan appropriately. It will be important that cohabiting couples pay close attention to estate planning and ensure Wills are kept up to date to ensure surviving partners receive inheritance as intended. It is also important that occupational pension schemes are notified of preferred recipients of survivor’s pensions in the event of a member’s death.

However, there is also a strong argument that government needs to recognise the trend towards cohabitation and reconsider some of the arbitrary distinctions which currently exist in tax and benefits legislation between married and cohabiting couples.

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