Winter 2022/2023

Estate Planning Update Winter 2022/2023 - Legal and Tax Issues of Unmarried Cohabiting Couples

A successful Hollywood love story comes to mind when you hear about Kurt Russell and Goldie Hawn. They blended their families and have been together for 39 years. Despite the years, they never married. They are not alone. The number of unmarried couples choosing to cohabit, whether prior to or instead of marriage, has increased greatly in recent years. While cohabiting can be beneficial to a couple on both a personal and a financial level, there are legal and tax issues that couples should consider as they build their lives with each other.

Tax Considerations

It is no secret that marriage plays a crucial role in the tax regime of the United States. Different rules apply to taxpayers depending on their marital status.

Income Taxes

While married couples may choose whether to file their income taxes "jointly" or "separately," unmarried individuals must generally file separately, regardless of their living arrangement. An exception may exist for couples enjoying a "common law marriage" if the couple resides in a state that legally recognizes or respects such a marriage. None of the states in which Day Pitney has offices permit common law marriages, although they may recognize common law marriages established in other states that allow them.

Unmarried couples, however, may have opportunities to make strategic decisions on their income tax returns. For example, unmarried couples with children can arrange for the higher-income-earning parent to file as "head of household," claiming the children as dependents to receive additional tax deductions. Because the higher-earning parent is in a higher income tax bracket, that parent will typically gain a greater benefit from the tax deduction.

A benefit may also be realized in connection with a mortgage on the shared residence. When both partners are named on the mortgage and contribute toward the payments, they can choose to share the mortgage interest deduction on their income tax returns or one partner can claim the entire deduction. If only one partner is obligated on the mortgage, only that partner can claim the mortgage interest deduction for the payments, even where the other partner contributes.

Gift Taxes

When it comes to transferring assets between spouses, married individuals can make unlimited gifts to their U.S. citizen spouses with no tax consequences. Tax-free gifts between unmarried individuals, on the other hand, are subject to limitations. Each partner can transfer up to $16,000 (in 2022, increasing to $17,000 in 2023) to the other partner annually. This is called the "annual exclusion" gift and does not require filing a gift tax return. Unmarried couples also can pay for certain tuition and medical expenses for one another, which, if paid properly, do not constitute gifts and can be unlimited in value. Each partner can give additional amounts to the other partner, but those transfers will be counted against the lifetime gift and estate tax exemption of the partner making the gift. The lifetime exemption for federal transfer tax purposes is $12,060,000 in 2022, increasing to $12,920,000 in 2023. A gift tax return has to be filed to report any gifts that do not qualify as annual exclusions. Additional limitations apply to unmarried couples with a 37-1/2-or-more-year age difference or married partners with noncitizen spouses. State inheritance tax consequences of gifts prior to death should also be considered.

Because of these rules, unmarried couples should take care in arranging ownership of their assets and paying expenses in order to avoid the unexpected consequence of making a gift that could trigger an obligation to file a gift tax return.

Estate and Inheritance Taxes

Transfers at death may be subject to federal or state estate or inheritance taxes. Similar to gift taxes, the Tax Code favors married couples when it comes to estate and inheritance taxes. When the first spouse dies, no tax will apply when assets pass to the surviving spouse who is a U.S. citizen. With proper planning, the couple's assets will only be taxed once, on the death of the surviving spouse.

Unmarried couples, however, have to take estate tax into account. For instance, if Kurt made $5,000,000 of gifts while alive and passes away in 2022, Kurt can give Goldie up to an additional $7,060,000 at death before a federal estate tax is incurred since the lifetime exemption is currently $12,060,000. If the value of property given to the surviving partner and others is more than what is left of the lifetime exemption, a 40 percent federal estate tax will apply. State estate taxes should be considered as well. Careful estate planning is essential in order to minimize tax on the death of the first partner and to avoid a second round of estate tax on the death of the second partner.

If the unmarried couple resides in a state that has an inheritance tax, such as New Jersey or Pennsylvania, assets transferred to an unmarried partner would trigger an inheritance tax as well.

Legal Considerations

Tax implications aside, unmarried couples must keep other important practical considerations in mind.

Retirement Accounts

Retirement accounts such as IRAs and 401(k)s are often among an individual's most valuable assets. As a result, planning is particularly important for unmarried couples holding retirement accounts. When a retirement account pays to a surviving spouse, that spouse can roll over the account into his or her own name to preserve potential tax benefits, including deferring payments, spreading them over a longer period of time and maximizing tax-free growth of the account. An unmarried partner, however, is a "non-spouse," and under the SECURE Act, which came into effect on January 1, 2020, with certain exceptions, a non-spouse beneficiary must generally withdraw all account funds within 10 (or in some cases five) years.

Beneficiary Designations

How an asset is titled will control how it is distributed when a person dies. Some assets, such as retirement accounts and life insurance, require beneficiary designations. Other assets do not require such designations but may nonetheless have a "transfer on death" designation that will have the same effect. These assets pass to those designated beneficiaries regardless of the provisions of a will. When a beneficiary designation is missing or faulty, applicable laws or account terms will identify "default" beneficiaries, which often mirror intestate disposition. Accordingly, unmarried couples must review and update beneficiary designations to name each other where desired.

Wills and Trusts

Unlike married couples, unmarried partners have no legal rights when it comes to the deceased partner's estate. If one partner dies without a will, the intestacy laws of the decedent's state of residence will identify who receives the deceased partner's assets. Those recipients will be determined by relationship to the decedent. An unmarried partner will not be among those recipients. If unmarried partners intend to benefit one another, proper estate planning documents are imperative.

Incapacity Documents

Living together will not give partners automatic rights to make financial and medical decisions for one another. A power of attorney is required for one partner to continue paying bills if the other cannot. Similarly, a health care proxy or medical power of attorney is necessary for one partner to speak with treating physicians about status, assess prognosis or authorize important medical care for the other partner in the event of incapacity. Hospital policies vary regarding visits from nonfamily members if the patient cannot verbalize desires. A guardianship proceeding may be required if incapacity documents do not

exist, and state laws favor the appointment of related family members as guardian, to the exclusion of a cohabiting partner. Proper planning is required in order to implement the partners' wishes.

Conclusion

Dealing with tax and legal issues as an unmarried cohabiting couple can create additional complications beyond basic estate planning. However, with adequate planning, unmarried cohabiting couples can take control to protect one another and avoid unintended consequences.

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