Montana Department of Revenue

Dan Bucks
Director

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To: Dan Bucks, Director

From: Dan Dodds, Tax Policy Analyst

Date: September 18, 2009

Subject: Impacts of Requiring Married Taxpayers to Make the Same Choice Between Joint and Separate Filing as on Their Federal Returns

Most married couples file joint federal returns. Montana does not require married taxpayers to make the same choice between joint and separate returns as they do for the federal income tax. A majority of married couples file separate Montana returns.

This paper examines the reasons why married couples file differently at the state and federal level and options for changing Montana law to either encourage or require married couples to file the same way on their state and federal returns. The key findings are as follows:

- Federal income tax rates are structured so that married couples with the same taxable income have the same taxes whether they file a joint return or separate returns.
- Montana rates and exemptions are structured so that most two-income couples have lower taxes if they file separate returns, and most single-income couples have lower taxes if they file a joint return.
- Eliminating the incentives for married couples to file one way or the other would require having different rate tables for joint and separate filers, with the brackets in the joint-filer table being twice as wide as the brackets in the single-filer table.
- Creating a new rate table for joint filers with rate brackets twice as wide as the existing rate table's would reduce taxes for couples who file joint returns under current law and reduce general fund revenue by about $40 million.
- Creating a new rate table for separate filers with rate brackets half as wide as the existing rate table's would increase taxes for couples who file separate returns under current law and increase general fund revenue by about $40 million.
- A revenue neutral change would require new rate tables for both joint and separate filers and would result in higher taxes for some taxpayers and lower taxes for others.

How Married Couples File and Why

Table 1 shows the percent of married couples who filed joint and separate returns for their 2007 federal and Montana income tax returns.

Table 1
Federal and Montana Returns of Married Couples, 2007

	Federal		Montana	
Returns of Married Couples	N	%	N	%
Filing a Joint Return	54,151,953	97.5%	83,090	44.3%
Filing Separate Returns	1,365,468	2.5%	104,331	55.7%
Total	55,517,421		187,421	

Nationwide, almost all couples file joint federal returns. The IRS has not published a detailed breakdown of types of returns for individual states, but has published the total number of returns and the number of joint returns. Joint returns are 37.9% of the national total and 39.7% of the total with Montana addresses. This means that the proportions of Montana couples filing joint and separate returns will be close to the national proportions.

A majority of couples file separate Montana returns. With only about 2% to 3% filing separate federal returns, about half of Montana married couples file separate Montana returns and a joint federal return.

Many more couples choose the added complexity of filing separate returns for their Montana taxes than for their federal taxes because filing separate returns results in lower state taxes for many couples but results in lower federal taxes for very few couples. This is true because of the difference in rate structures. Federal law provides different rate tables for separate and joint returns, and the rates are designed so that couples with the same combined taxable income pay the same taxes whether they file separate or joint returns. Montana law provides a single rate table for all taxpayers, and many couples have different tax liability filing separate returns rather than a joint return.

Table 2, on the next page, shows federal rate tables for joint and separate returns for 2008. The left-hand column shows the six federal rates, the center column shows the individual income ranges where each rate applies for a married person filing a separate return, and the right-hand column shows the ranges of combined income where each rate applies for a married couple filing a joint return.

Table 2
Federal Income Tax Rates, 2008

	Rate Applies to This Range of Taxable Income	
Rate	Separate Return	Joint Return
10%	First $8,025	First $16,050
15%	From $8,026 to $32,550	From $16,051 to $65,100
25%	From $32,551 to $65,725	From $65,101 to $131,450
28%	From $65,726 to $100,150	From $131,451 to $200,300
33%	From $100,151 to $178,850	From $200,301 to $357,700
35%	Over $178,850	Over $357,700

Tax is calculated by applying each rate sequentially until the taxable income is reached. For example, a couple with $100,000 of taxable income filing a joint return would pay 10% of the first $16,050 of taxable income ($1,605), 15% of the next $49,050 of taxable income, from $16,051 to $65,100 ($7,357.50), and 25% of the $34,900 of taxable income above $65,100 ($8,725), for total tax of $17,687.50 ($1,605 + $7,357.50 + $8,725).

Each of the rate brackets in the rate table for a joint return begins and ends at exactly twice the income where the corresponding bracket in the rate table for separate returns begins and ends. Because of this, couples with the same combined taxable income pay the same taxes, regardless of how that taxable income is divided between the two spouses. A couple with $100,000 of taxable income who file separate returns pay 10% on the first $16,050 of combined taxable income, 15% on the next $49,050 of combined taxable income, and 25% on the remaining $34,900 of combined taxable income. This is the same tax as if they had filed a joint return, regardless of how much of the $100,000 is attributed to each spouse.

There may be cases where a couple's taxable income is slightly higher or lower if they file separate returns instead of a joint return. For example, some itemized deductions are subject to an income ceiling, and a couple could have lower taxable income filing separately if these deductions are attributable to the spouse with the lower income. However, most couples who file separate federal returns probably do so because they have chosen to keep their finances separate for non-tax reasons.

For federal taxes, the only reasons to file separate returns are that a couple is keeping their finances separate for non-tax reasons or that filing separate returns results in lower taxable income, which is very rare.

Table 3 shows the single rate table that applies to all Montana income tax returns for 2008. Tax is calculated the same way as with the federal rate table.[1]

Table 3
Montana Income Tax Rates, 2008

Rate	Rate Applies to This Range of Taxable Income
1%	First $2,600
2%	From $2,601 to $4,600
3%	From $4,601 to $7,000
4%	From $7,001 to $9,500
5%	From $9,501 to $12,200
6%	From $12,201 to $15,600
6.9%	Over $15,600

For many couples, the tax they pay is different depending on whether they file separate returns or a joint return.

Most two-income couples will have lower taxes if they file separate returns. Table 4 shows an example. Both spouses have adjusted gross income of $20,000. The couple have four exemptions, which they split evenly when filing separate returns. They take the standard deduction, which at their income level is 20% of adjusted gross income.

Table 4
Example of Couple with Lower Taxes on Separate Returns

	Separate Tax Calculations		Joint Tax Calculation
	Spouse A	Spouse B	Combined
Adjusted Gross Income	$20,000	$20,000	$40,000
- Value of Exemptions (4)	$4,280	$4,280	$8,560
- Standard Deduction	$4,000	$4,000	$8,000
= Taxable Income	$11,720	$11,720	$23,440
Tax from Table	$353	$353	$1,118
Combined Tax Liability	$706		$1,118

[1] The rate tables on returns have some steps of the calculation already done. The Montana return asks taxpayers to multiply taxable income by the marginal rate and subtract an amount that equals the difference between tax on income in the lower brackets at the marginal rate and actual tax on that income. The federal return asks taxpayers to multiply income in their bracket by the marginal rate and then add an amount equal to the tax on income in any lower brackets. The two procedures look different but produce the same result.

This couple's combined income puts them in the top tax bracket, and their tax liability on a joint return is $1,118. If they file separate returns, each is in the 5% tax bracket, and their combined tax liability is $706. The difference of $412 is 37% of their tax liability on a joint return. Most of the difference for this couple comes from the fact that filing separate returns moves them to a lower rate bracket.

Couples who are both individually in the top rate bracket will have lower taxes if they file separately because a smaller percentage of their combined income is taxed at the top rate. Table 5 shows an example where both spouses have adjusted gross income of $100,000. As in Table 4, the couple have four exemptions and take the standard deduction, which at this income is at the maximum amount.

Table 5
Example of High-Income Couple with Lower Taxes on Separate Returns

	Separate Tax Calculations		Joint Tax Calculation
	Spouse A	Spouse B	Combined
Adjusted Gross Income	$100,000	$100,000	$200,000
- Value of Exemptions (4)	$4,280	$4,280	$8,560
- Standard Deduction	$4,010	$4,010	$8,020
= Taxable Income	$91,710	$91,710	$183,420
Tax from Table	$5,829	$5,829	$12,157
Combined Tax Liability	$11,658		$12,157

This couple's combined tax liability is $499 lower if they file separate returns. This is 4% of their tax liability on a joint return.

Couples where only one spouse would owe tax if they filed separately may have lower taxes if they file a joint return. This is because filing a joint return allows them to apply the exemptions and deductions for the spouse with lower or no income to their combined income.

Table 6 shows an example. Like the couple in Table 4, the couple in Table 6 has $40,000 of adjusted gross income, has four exemptions, and takes the standard deduction. Unlike the couple in Table 4, one spouse receives most of the income.

Table 6
Example of Couple with Higher Taxes on Separate Returns

	Separate Tax Calculations		Joint Tax Calculation
	Spouse A	Spouse B	Combined
Adjusted Gross Income	$38,000	$2,000	$40,000
- Value of Exemptions (4)	$6,420	$2,140	$8,560
- Standard Deduction	$4,010	$1,780	$8,000
= Taxable Income	$27,570	$0	$23,440
Tax from Table	$1,403	$0	$1,118
Combined Tax Liability	$1,403		$1,118

If this couple file a joint return, their tax liability is the same as was calculated for the joint return in Table 4, $1,118. If they file separate returns, their tax liability is $1,403. This is $285, or 25%, higher.

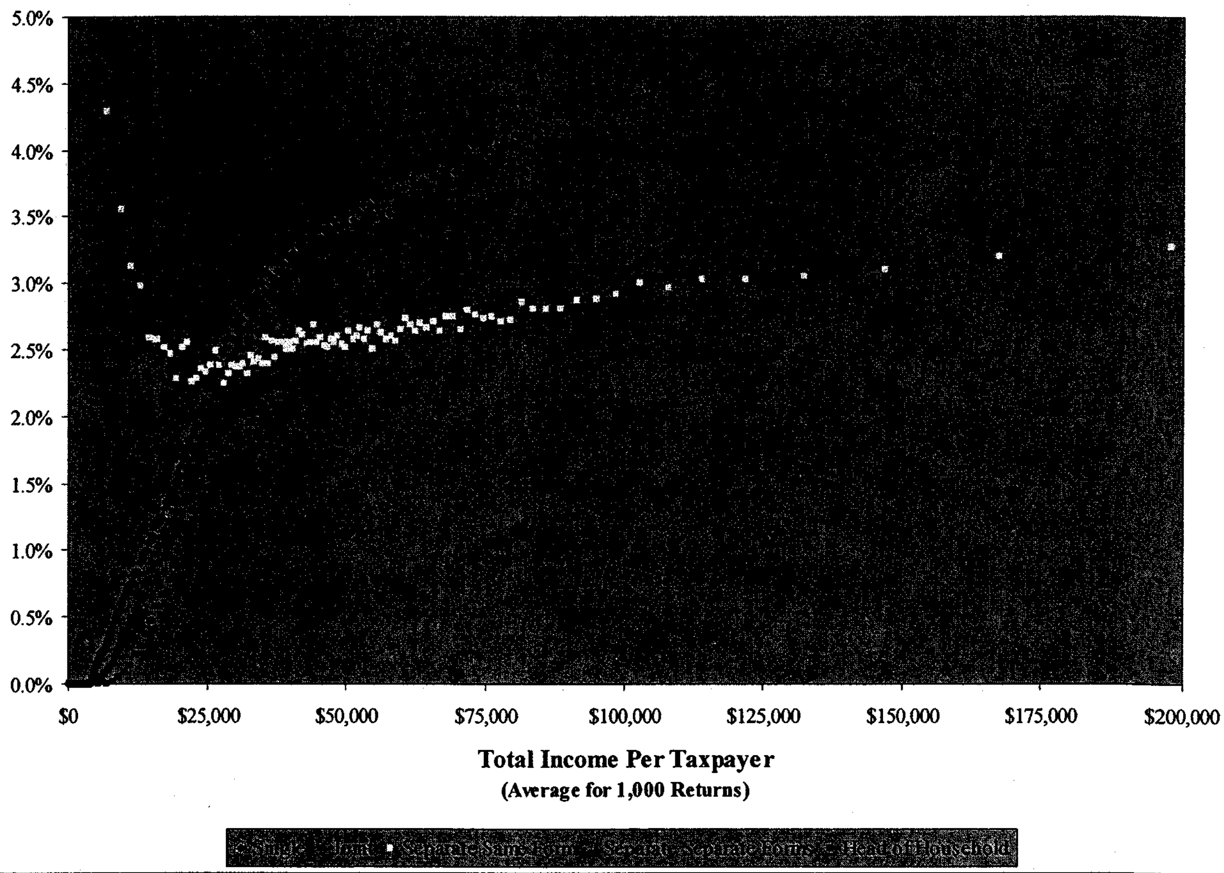
There are two reasons for this. One is that the spouse with most of the income in Table 6 is in the 6.9% tax bracket while both spouses in Table 4 are in the 5% tax bracket.

The other is that filing separate returns actually increases this couple's taxable income. Spouse B's exemptions and deductions are more than adjusted gross income, so only part of them reduces taxes by offsetting income. In addition, this couple's combined standard deduction is lower if they file separate returns. In Table 4, both spouses are in the range where their standard deduction is 20% of adjusted gross income. Their combined standard deductions are $8,000 whether they file separate returns or a joint return. In Table 6, Spouse A is able to claim only the maximum standard deduction, and the couple's combined standard deductions are $5,790 if they file separate returns.

Individual married couples pay different taxes depending on whether they file separate returns or a joint return. The two groups of taxpayers who choose to file separate returns and who choose to file joint returns also pay different taxes. This is partly because the two groups have different characteristics and partly because their different characteristics give them incentives to file differently.

Figure 1 shows average effective tax rates for single taxpayers, married taxpayers filing joint returns, married taxpayers filing separate returns on the same form, married taxpayers filing separate returns on separate forms, and taxpayers filing as head of household. Average effective tax rate is tax divided by total income.[2] The horizontal axis shows total income per taxpayer to make the chart comparable for single and married taxpayers. Each dot shows the average total income per taxpayer and the average effective tax rate for 1000 returns with similar incomes.

Fig. 1 Average Effective Tax Rate, 2007



The average effective tax rate is always lower than the marginal rate for the same income because taxable income is less than total income and because, for taxpayers who are not in the lowest tax bracket, part of their income is taxed at rates lower than the marginal rate for their bracket.

[2] Total income is total income as reported on line 22 of the taxpayer's federal tax return plus Montana-specific additions to income from Schedule I of the Montana Return. It is used as the income measure for analysis of income tax proposals by income group because proposed law changes may affect the definitions of adjusted gross income or taxable income.

The dark blue dots show income and average effective tax rates for groups of 1,000 single taxpayers. The average effective tax rate is zero for incomes lower than the sum of the exemption amount and the minimum standard deduction. It rises steeply with income up to about $30,000 as taxpayers move into higher rate brackets. Above about $30,000, the average effective tax rate rises more slowly because most or all taxpayers are in the top rate bracket, and the only change is that at higher incomes a smaller proportion of income is taxed at lower rates.

The pink dots for joint filers, the light blue dots for married taxpayers who file separate returns on separate forms, and the maroon dots for head-of-household filers follow the same pattern, but these groups generally have lower average effective tax rates than single filers with the same income because they have more exemptions and may have more of some kinds of itemized deductions.

The yellow dots for married taxpayers filing separate returns on the same form have a very different pattern. At incomes per taxpayer above about $25,000, average effective tax rates for this group rise more slowly with income, and above income per taxpayer of $50,000, are much lower than for the other groups. Below income per taxpayer of $25,000, there are relatively few married couples filing separate returns on the same form, but their average effective tax rates are much higher than the other groups' and are higher at lower income.

Married taxpayers filing separate returns on the same form with income per taxpayer above $25,000 have lower average affective tax rates than other taxpayers because they have chosen the filing method that gives them lower taxes and because they have the household characteristics that make it advantageous for them to file separate returns. For example, single income couples are more likely to file a joint return, and couples with two similar incomes are more likely to file separate returns on the same form. A two income couple where both spouses are in the top rate bracket will have approximately twice as much of their income subject to lower tax rates if they file separate returns than if they file a joint return.

An examination of a sample of separate returns with income per taxpayer below $25,000 showed that, for many of these couples, one spouse had positive income while the other had negative income from business losses. In many of these cases, the couple may have decided to file separately so that the spouse with the business losses could carry them forward to offset against that spouse's income in other years rather than offsetting them against the other spouse's income in the current year. This strategy may result in higher taxes in the current year but lower taxes over a period of several years. It is also possible that some of these couples automatically file separate returns every year rather than calculating taxes both ways and filing the way that results in lower taxes.

Options for Requiring or Encouraging Couples to File the Same as on their Federal Returns

There are many ways that the Montana income tax could be restructured to either induce or require married couples to make the same choice between joint and separate returns as they make for their federal taxes. This section attempts to lay out the range of options and show how different types of options affect taxpayers and state revenue. It considers three extreme options and the range of intermediate options:

- Extreme Option 1 – New rate table for joint returns that makes tax from a joint return the same as tax from separate returns

- Extreme Option 2 – New rate table for separate returns that makes tax from separate returns the same as tax from a joint return

- Extreme Option 3 – Require married couples to file the same as on their federal return with the current rate table

- Intermediate Options – New rate tables for all return types that make tax from separate and joint returns the same

The rest of this section presents information on these options and the results of adopting them.

Extreme Option 1 – New rate table for joint returns that makes tax from a joint return the same as tax from separate returns

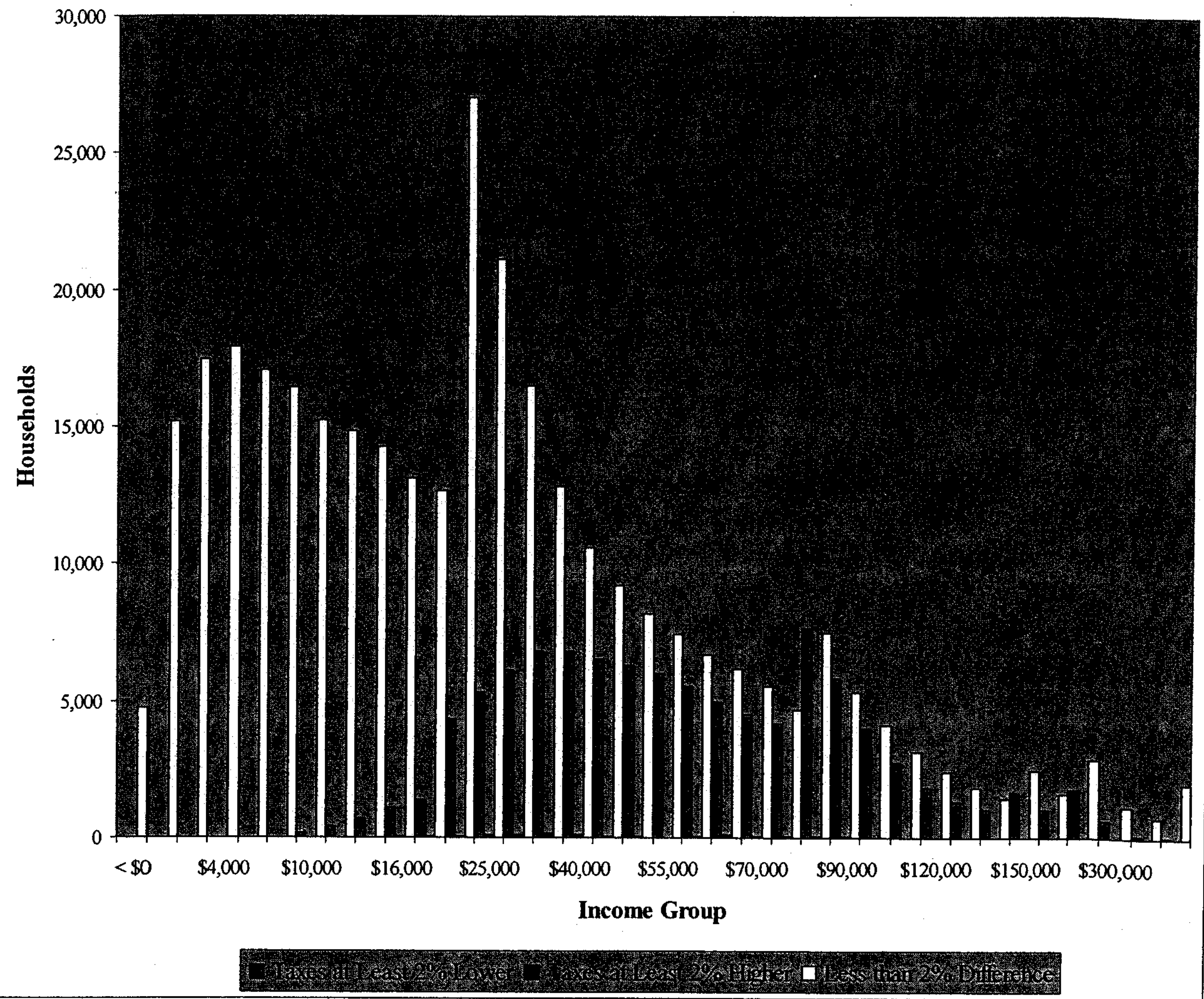
The federal rate tables for joint and separate returns result in the same tax. Creating a new rate table for joint filers, with rate brackets that are twice as wide as the rate brackets for other taxpayers would eliminate the incentive for most married couples to file separate Montana tax returns.

Married couples who choose to file separate returns under current law would not be affected by this option, and they would pay the same tax as under current law. Most couples who choose to file joint returns under current law would have their taxes reduced by this option. This option would close the gap between the red joint-filer line and the yellow separate-filer line in Figure 1 by moving the red line down.

If this option were enacted by the 2011 legislature income tax revenue to take effect for 2012, income tax revenue would be reduced by about $40 million for 2012 and $41 million for 2013.

Figure 2 shows the number of taxpayers who would have taxes at least 2% lower under this option, the number who would have taxes at least 2% higher, and the number with a change of less than 2%.

Figure 2
Winners and Losers from Eliminating Married Filing Separate
Option 1

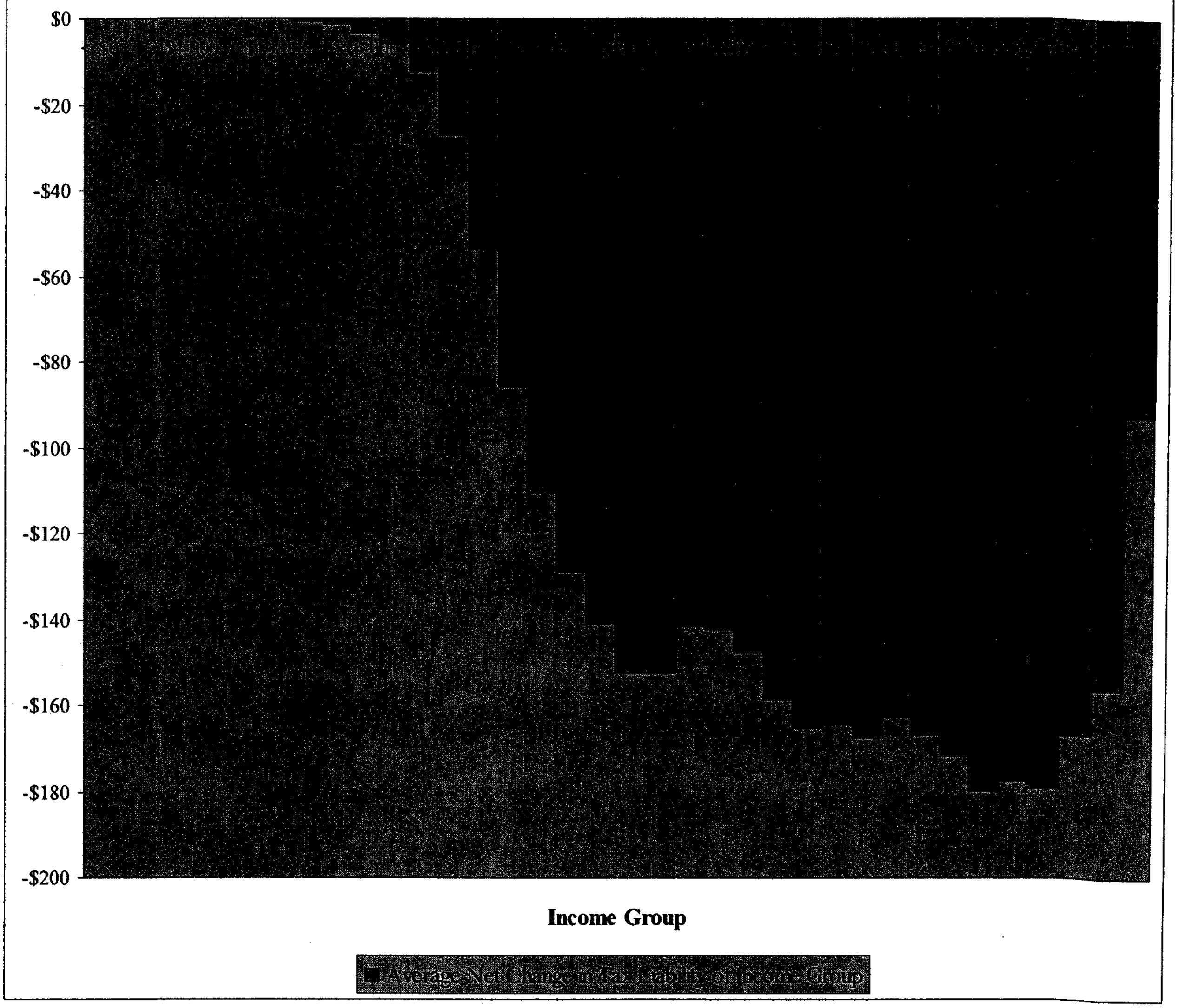


A very small number of taxpayers would pay more under this option. Examining why they pay more may identify other features of the Montana tax system that interact with taxpayers' choice of whether to file separate or joint returns.

At lower incomes and very high incomes, all taxpayers have less than a 2% change. The proportion of taxpayers with a tax reduction of at least 2% generally increases up to $70,000 of total income and then varies up and down at higher incomes.

Figure 3 shows the average change in tax liability in each income group.

Figure 3
Average Change in Tax Liability from Eliminating Married Filing Separate
Option 1



The average change is between $140 and $180 for income groups with between $45,000 and $300,000 of total income and is smaller for higher and lower incomes. This reflects both the smaller proportion of taxpayers with a tax reduction at high and low incomes and differences in average tax reductions for taxpayers who would see a change.

Extreme Option 2 – New rate table for separate returns that makes tax from separate returns the same as tax from a joint return

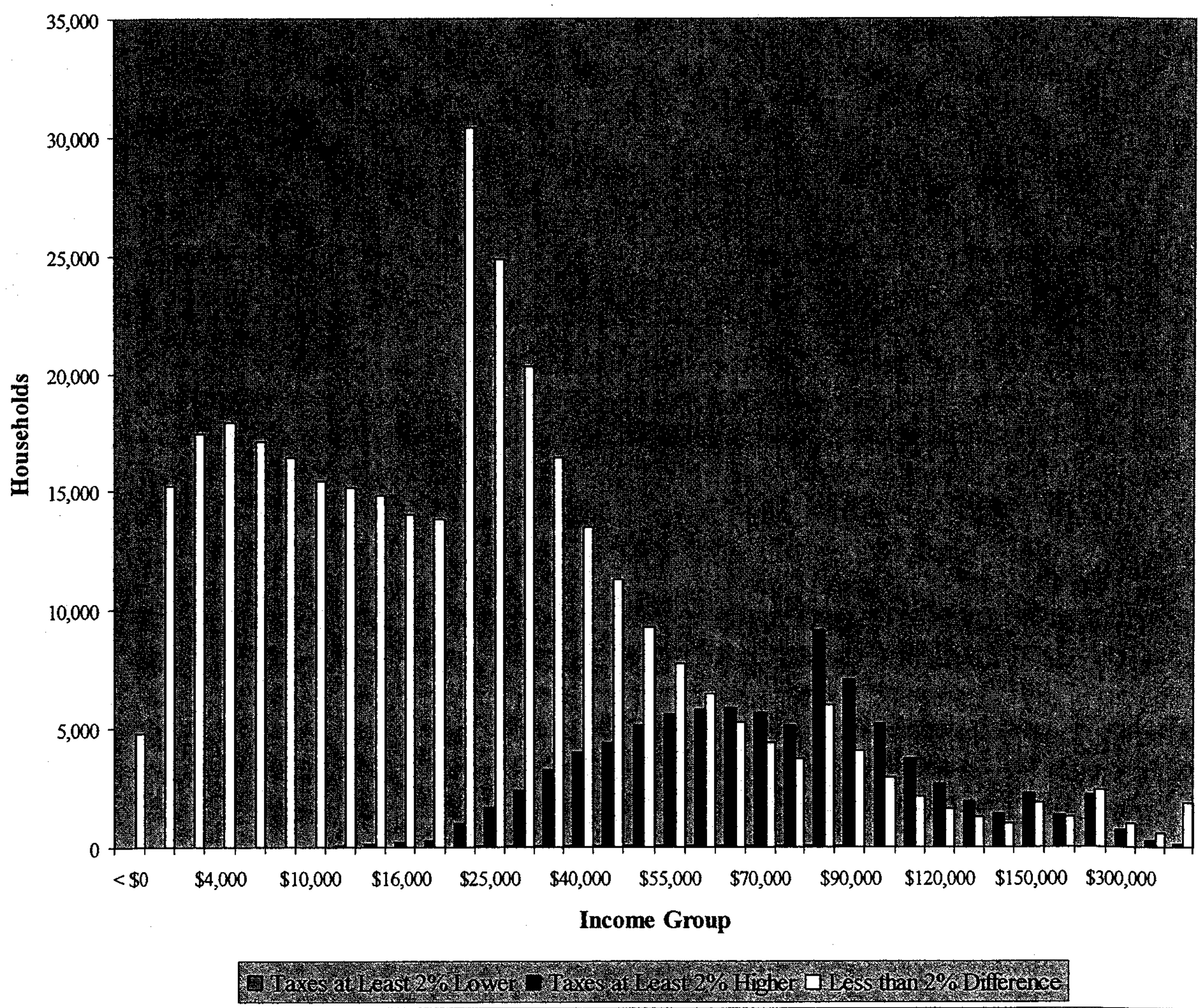
The incentive to file separate returns could also be eliminated by creating a new rate table for separate returns with rate brackets that are half as wide as the rate brackets for other taxpayers.

This option would leave taxes the same for couples who choose to file joint returns under current law and increase taxes for couples who choose to file separate returns under current law. This would close the gap between the red joint-filer line and the yellow separate-filer line in Figure 1 by moving the yellow line up.

This option would increase state income tax revenue by about $38 million for 2012 and $39 million for 2013.

Figure 4 shows taxpayers with tax increases or decreases of 2% or more and with no change.

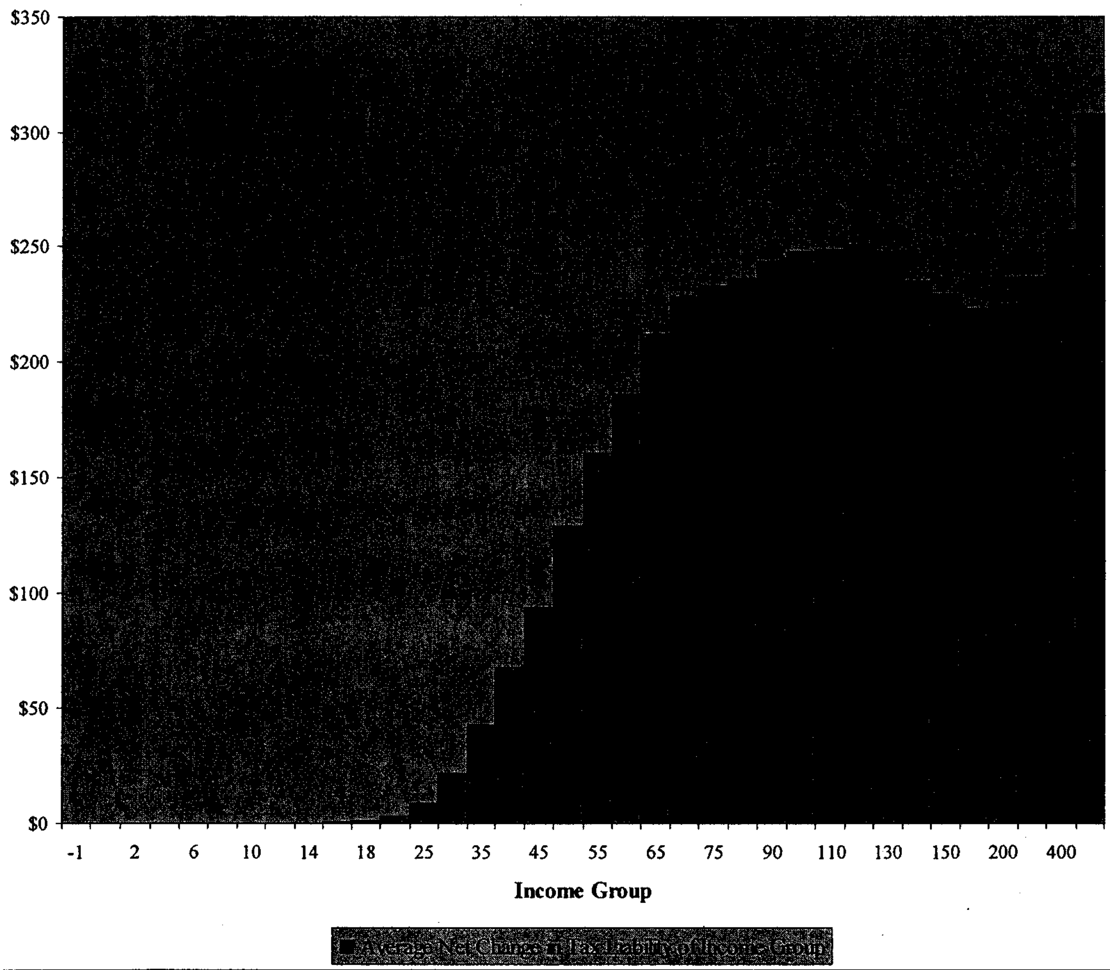
Figure 4
Winners and Losers from Eliminating Married Filing Separate
Option 2



No taxpayers would have taxes at least 2% lower. Very few taxpayers with total household income of $20,000 or less would pay at least 2% more. The proportion of taxpayers paying at least 2% more under this option increases up to $100,000 of total household income and then decreases. More than half of taxpayers with total household income between about $60,000 and $175,000 would pay at least 2% more.

Figure 5 shows the average change in taxes for each income group.

Figure 5
Average Change in Tax Liability from Eliminating Married Filing Separate
Option 2



The average tax increase is less than $1 up to $16,000 in total household income, rises to about $250 at $120,000 in total household income, decreases between $120,000 and $175,000 of total household income and then increases for income groups with higher incomes. Again, this reflects both differences in average tax increase and differences in the proportion of taxpayers with a tax increase.

Extreme Option 3 – Require married couples to file the same as on their federal return with the current rate table

Taking away the option for married couples to file differently than they do on their federal returns would induce some couples who choose to file separate returns under current law to file joint returns. Some other couples probably would respond by continuing to file separate state returns and switching to filing separate federal returns.

This option would reduce the percent of Montana couples who file separate returns to somewhere between the current 55.7% and the 2.5% rate for federal returns. Instead of moving the red and yellow lines in Figure 1, this option would induce some people to move from the yellow line to the red line.

Taxpayers who change how they file their state taxes rather than how they file their federal taxes would pay more income tax. Those who consider their options carefully would make the change if their additional state taxes were less than the additional costs, including time and aggravation, of filing separate federal returns. This option would increase state income tax revenue, but by less than Option 2. The change in state revenue would depend on how many and which taxpayers change to filing joint returns.

Detailed estimates of the impacts of this or similar options would require obtaining estimates of the costs of preparing joint and separate federal returns and using the difference to estimate how many taxpayers would change the way they file their federal returns.

Intermediate Options – New rate tables for both separate and joint returns

Having married couples pay the same tax whether they file joint or separate returns requires having different rate tables for joint and separate returns, with the rate brackets for joint returns being twice as wide as the brackets for separate returns. There are many ways this could be done. An intermediate option could also follow the federal precedent of having different rate tables for single taxpayers and head-of-household taxpayers.

In an intermediate option, the new separate rate table would result in higher taxes for couples who continue to file separate returns, and the new joint rate table would result in lower taxes for couples who already file joint returns. The distributions of gains and losses among taxpayers would depend on the specific rate tables chosen and any other changes that were part of the option.

Whether an intermediate option would reduce or increase income tax revenue would depend on the details of the specific option. It would be possible to design an intermediate option that would be close to revenue neutral.

Policy Choices and Considerations

If the committee decides to develop proposals to change the structure of the income tax so that married couples pay the same tax whether they file a joint return or separate returns, most proposals will affect the amount of revenue raised by the income tax and almost all proposals will increase taxes for some taxpayers and reduce taxes for others. In developing a proposal, the committee will need to grapple with several policy issues. They include the following:

- **Options where fewer taxpayers have tax increases generally will have lower state income tax revenue. How much state revenue loss is acceptable, or can reductions in income tax revenue be made up from other sources?**

- **Under current law, many couple calculate their taxes both jointly and separately and then file the way that results in lower taxes. How large an individual tax increase for taxpayers who file separate returns under current law is an acceptable tradeoff for simplifying their taxes?**

- **Would losses from higher taxes and gains from lower taxes go disproportionately to some groups of taxpayers?**

- **Under current law, a two-income married couple may pay significantly lower taxes than a similar couple with a single income. Would eliminating this difference make the income tax more or less fair?**