Montana Department of Revenue

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To: Dan Bucks, Director

From: Dan Dodds, Tax Policy Analyst

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Subject: Impacts of Requiring, or Providing an Incentive for, Married Taxpayers to Use the Same Filing Status for State Tax Returns as They Use on Federal Tax Returns

More than 55 percent of married couples in Montana file separate state income tax returns, while most couples file joint federal returns. Montana does not require married taxpayers to use the same filing status for state tax returns as they use for federal tax returns.

This presents several questions: Why do married couples in Montana file differently for state as compared to federal purposes? What are the benefits and drawbacks in revising Montana income-tax filing law for married couples? What are the impacts on revenue?

Key findings

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.

Eliminating the incentive for married couples to file separately 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 separate-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.

Reasons for filing state and federal returns differently

Federal returns

Nationally, most couples file joint federal returns because there is almost never an advantage to filing separate federal returns.

Federal rate tables are designed so that taxes on any amount of taxable income are never lower when a couple files separate returns. There are only two reasons to file separate federal returns: A couple is keeping their finances separate for nontax reasons, or filing separate returns results in lower taxable income, which is rare.

Separate return vs. joint return
Federal rate tables never produce lower tax for separate returns because the rate brackets for a joint return are twice as wide as the rate brackets for a separate return.

Federal Income Tax Rates, 2008

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

Different taxable incomes
With this rate structure, joint and separate returns produce the same tax when a couple has the same taxable income.

If the couple's taxable incomes are different, this type of rate structure may produce lower tax with a joint return. To illustrate, we will look at federal income tax on $100,000 of taxable income using two different couples and compare the outcomes of filing joint and separate returns.

Federal income tax on $100,000 of taxable income for a joint return

Rate	Taxable Income	Tax
10%	First $16,050	$1,605.00
15%	From $16,051 to $65,100	$7,357.50
25%	From $65,101 to $131,450	$8,725.00
28%	From $131,451 to $200,300	$0.00
33%	From $200,301 to $357,700	$0.00
35%	Over $357,700	$0.00
Total		$17,687.50

Income tax is calculated by applying each rate sequentially until the taxable income is reached. A couple with $100,000 of taxable income would pay 10 percent on the first $16,050 of taxable income ($1,605), 15 percent on the next $49,050 of taxable income, from $16,051 to $65,100 ($7,357.50), and 25 percent on 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).

Equal income

In Example 1, below, the spouses each have $50,000 of taxable income. The couple's tax is the same as if they had filed a joint return because the same amount of income is subject to each rate in both cases.

Example 1: Federal return with equal income

Rate	Taxable Income	*Spouse A* **$50,000 Taxable Income**	*Spouse B* **$50,000 Taxable Income**
10%	First $8,025	$802.50	$802.50
15%	From $8,026 to $32,550	$3,678.75	$3,678.75
25%	From $32,551 to $65,725	$4,362.50	$4,362.50
28%	From $65,726 to $100,150	$0.00	$0.00
33%	From $100,151 to $178,850	$0.00	$0.00
35%	Over $178,850	$0.00	$0.00
Total		$8,843.75	$8,843.75
		Combined Total Tax	$17,687.50

Unequal income

The second couple in our examples has unequal income. One spouse has $70,000 of taxable income and the other has $30,000. Filing separate returns results in higher federal income tax in this case, as illustrated in Example 2, below. This is primarily because filing separate returns puts part of their income in a higher rate bracket.

Example 2: Federal return with unequal income

Rate	Taxable Income	*Spouse A* **$70,000 Taxable Income**	*Spouse B* **$30,000 Taxable Income**
10%	First $8,025	$802.50	$802.50
15%	From $8,026 to $32,550	$3,678.75	$3,296.25
25%	From $32,551 to $65,725	$8,293.75	$0.00
28%	From $65,726 to $100,150	$1,197.00	$0.00
33%	From $100,151 to $178,850	$0.00	$0.00
35%	Over $178,850	$0.00	$0.00
Total		$13,972.00	$4,098.75
		Combined Total Tax	$18,070.75

Montana returns

Half of married couples in Montana file a joint federal return and separate state returns. Nationally, almost all married couples file joint returns.

Federal and Montana Returns of Married Couples, 2007

Returns of Married Couples	Federal N	Federal %	Montana N	Montana %
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	

The Internal Revenue Service has not published a detailed breakdown of filing status at the state level, but the limited information that is available does not show large differences between Montana and the country as a whole. About 55.7 percent of Montana couples file separate state returns and only about 2 percent to 3 percent file separate federal returns.

Montana's rate structure

Unlike federal returns, Montana couples may pay lower state taxes if they file separate Montana returns under the current rate structure.

Montana has a single income tax rate table for all taxpayers. If a couple files a joint return, the rate table applies to their combined taxable income. If they file separate returns, the same rate table applies to each of their individual taxable incomes. In most cases, two-earner couples filing separate state returns results in lower state income tax; in some cases, filing separate state returns results in higher state income tax.

Montana Income Tax Rates — 2008

Rate	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

Separate-return advantage

Montana couples who have two incomes that are similar generally pay lower state taxes if they file separate Montana returns.

For many couples, each spouse's individual income will be in a lower tax bracket if they file separate returns than their combined income would be if they filed a joint return. You can see this in Example 3, below.

Both spouses have adjusted gross income of $20,000. The couple has four exemptions, which they split evenly when filing separate returns. They take the standard deduction, which at their income level is 20 percent of adjusted gross income.

This couple's combined income puts them in the top state tax bracket, and their state tax liability on a joint return is $1,118. If they file separate Montana returns, each spouse is in the 5 percent tax bracket, and their combined state tax liability is $698. The difference of $420 is 38 percent of their tax liability on a joint return. Filing separate returns moves this couple to a lower rate bracket, which is most of the difference.

Example 3: 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	$349	$349	$1,118
Combined Tax Liability	$698		$1,118

Two-earner couples who are both 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.

Example 4, on the top of the next page, shows a scenario where both spouses have adjusted gross income of $100,000. As in Example 3, this couple has four exemptions and takes the standard deduction, which is at the maximum amount at their income level.

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

Example 4: 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

Joint-return advantage
Couples with one spouse in a very low tax bracket pay less state income tax 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.

We can see this scenario in Example 5, below. Like the couple in Example 3, the couple in Example 5 has $40,000 of adjusted gross income, has four exemptions, and takes the standard deduction. Unlike the couple in Example 3, one spouse receives most of the income.

Example 5: Couple with lower taxes on a joint return

	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 the couple in Example 5 files a joint Montana return, their state tax liability is the same as calculated for the joint return in Example 3, $1,118. If they file separate Montana returns, their state tax liability is $1,403. This is $285, or 25 percent, higher.

Filing separate Montana returns would increase this couple's taxable income for state taxes. Spouse B's exemptions and deductions are more than adjusted gross income, so only part of them reduces state taxes by offsetting income. In addition, this couple's combined standard deduction is lower if they file separate returns. In Example 3, spouses are in the range where their standard deduction is 20% of adjusted gross income. Their combined standard deduction is $8,000 whether they file separate returns or a joint return. In Example 5, Spouse A is able to claim the maximum standard deduction, and the couple's combined standard deductions are $5,790 if they file separate returns.

Unknown advantage
For many couples, it is not clear without actually calculating taxes both ways whether filing a joint Montana return or filing separate Montana returns will result in lower state taxes. These couples typically have two incomes, but one income will be much higher than the other.

The two Montana couples in the following examples have combined adjusted gross income of $60,000, four exemptions, and take the standard deduction. The only difference is that in Example 6 Spouse A has $1,000 more of the combined income than in Example 7.

For the couple in Example 6, a joint Montana return results in $31 lower state tax liability. For the couple in Example 7, separate Montana returns result in $23 lower state tax liability. The difference is not large for either couple, but there is no way for them to know that, or which filing method produces lower taxes, without calculating their taxes both ways.

Example 6: Couple with lower taxes on joint return

	Separate Tax Calculations		*Joint Tax Calculation*
	Spouse A	**Spouse B**	**Combined**
Adjusted Gross Income	$54,000	$6,000	$60,000
- Value of Exemptions (4)	$6,420	$2,140	$8,560
- Standard Deduction	$4,010	$1,780	$8,020
= Taxable Income	$43,570	$2,080	$43,420
Tax from Table	$2,507	$21	$2,497
Combined Tax Liability	$2,528		$2,497

Example 7: Couple with higher taxes on joint return

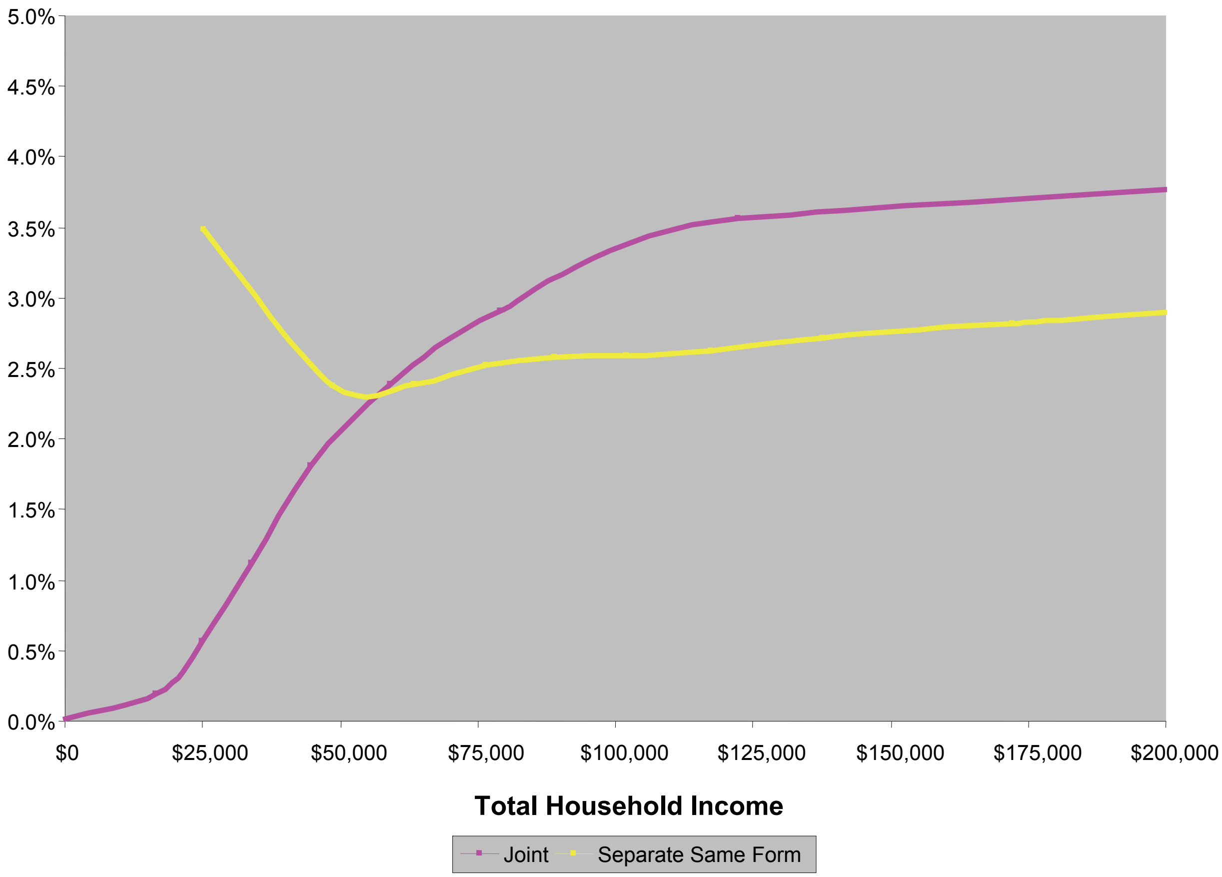
	Separate Tax Calculations		*Joint Tax Calculation*
	Spouse A	**Spouse B**	**Combined**
Adjusted Gross Income	$53,000	$7,000	$60,000
- Value of Exemptions (4)	$6,420	$2,140	$8,560
- Standard Deduction	$4,010	$1,780	$8,020
= Taxable Income	$42,570	$3,080	$43,420
Tax from Table	$2,438	$36	$2,497
Combined Tax Liability	$2,474		$2,497

Different taxes for joint and separate filers

Many married couples file separate Montana tax returns because their taxes are lower with separate returns than with joint returns. As a group, couples who file separate returns generally pay lower taxes than couples with the same income who file joint returns. Figure 1, below, shows average effective tax rates for married taxpayers filing joint returns and married taxpayers filing separate returns on the same form.

(Figure 1)

Joint and separate filers: Average effective tax rates, 2007



Average effective tax rate is tax divided by total household income. Two taxpayers with equal total household income may have different average effective tax rates, because taxable income is a different fraction of their total household incomes. 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 taxpayers who are not in the lowest tax bracket have part of their income taxed at rates lower than the marginal rate for their bracket. Figure 1 was constructed by sorting returns by total household income, calculating average effective tax rates for groups of 1,000 sorted returns, and then "smoothing" the resulting graph.

The pink line shows income and average effective tax rates for married taxpayers filing joint returns. The average effective tax rate is close to zero for very low incomes. It rises steeply with total household income between about $20,000 and $40,000 as taxpayers move into higher rate brackets. Above about $40,000, the curve becomes flatter because most 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 yellow line — married taxpayers filing separate returns on the same form — has a very different pattern. At total household incomes above about $60,000, average effective tax rates for this group are lower than for married couples filing joint returns and rise more slowly with income. Below total household income of $60,000, there are relatively few married couples filing separate returns on the same form, but their average effective tax rates are much higher than joint-filers' and are higher at lower income.

An examination of a sample of separate returns with income per household 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.

Married taxpayers filing separate returns on the same form with total household income above $60,000 have lower average effective tax rates than joint-filers 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. Changing Montana's income tax structure so that there is no advantage to filing separate returns would eliminate one difference between these groups, but they may still pay different taxes for other reasons, such as having different average numbers of dependents or different average deductions.

Options for couples to file the same on both returns

There are several ways the Legislature could restructure Montana income tax to either encourage or require married couples to make the same choice on both state and federal returns. Below, we lay out the range of options and show how they would affect taxpayers and state revenue.

Option that requires couples to file the same on both returns
1. Change state law so that married couples must file the same as on their federal return with the current rate table.

Options that encourage couples to file the same on both returns
2. Create a new rate table for joint returns that makes tax from a joint return the same as tax from separate returns.

3. Create a new rate table for separate returns that makes tax from separate returns the same as tax from a joint return.

Alternate option that includes several approaches
4. Create new rate tables for all return types that make tax from separate and joint returns the same. There are several ways to accomplish this.

Option 1

This option would require married couples to file the same as on their federal return while using the current state rate table. Taking away the option for married couples to file differently than they do on their federal returns would likely result in most couples who choose to file separate returns under current law filing joint returns. Some couples probably would respond by continuing to file separate state returns and switching to filing separate federal returns.

Effect on revenue
This option would increase state income tax revenue. The size of the increase would depend on how many and which taxpayers change to filing joint returns. It would also reduce the percentage of Montana couples who file separate returns to somewhere between the current 55.7% and the 2.5% rate for federal returns.

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.

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.

Option 2

This option creates a 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 in Montana 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.

Effect on revenue
If the 2011 Legislature enacted this option to take effect in 2012, it would reduce income tax liability in 2012 by about $40 million, and $41 million in 2013.

Winners and losers
Married couples who choose to file separate returns under current law generally would pay no more under this option, and some would have lower taxes. 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 pink joint-filer line and the yellow separate-filer line in Figure 1 by moving the pink line down.

A very small number of households would pay more under this option.

(Figure 2)
Option 2: Winners and Losers from Eliminating Married Filing Separate

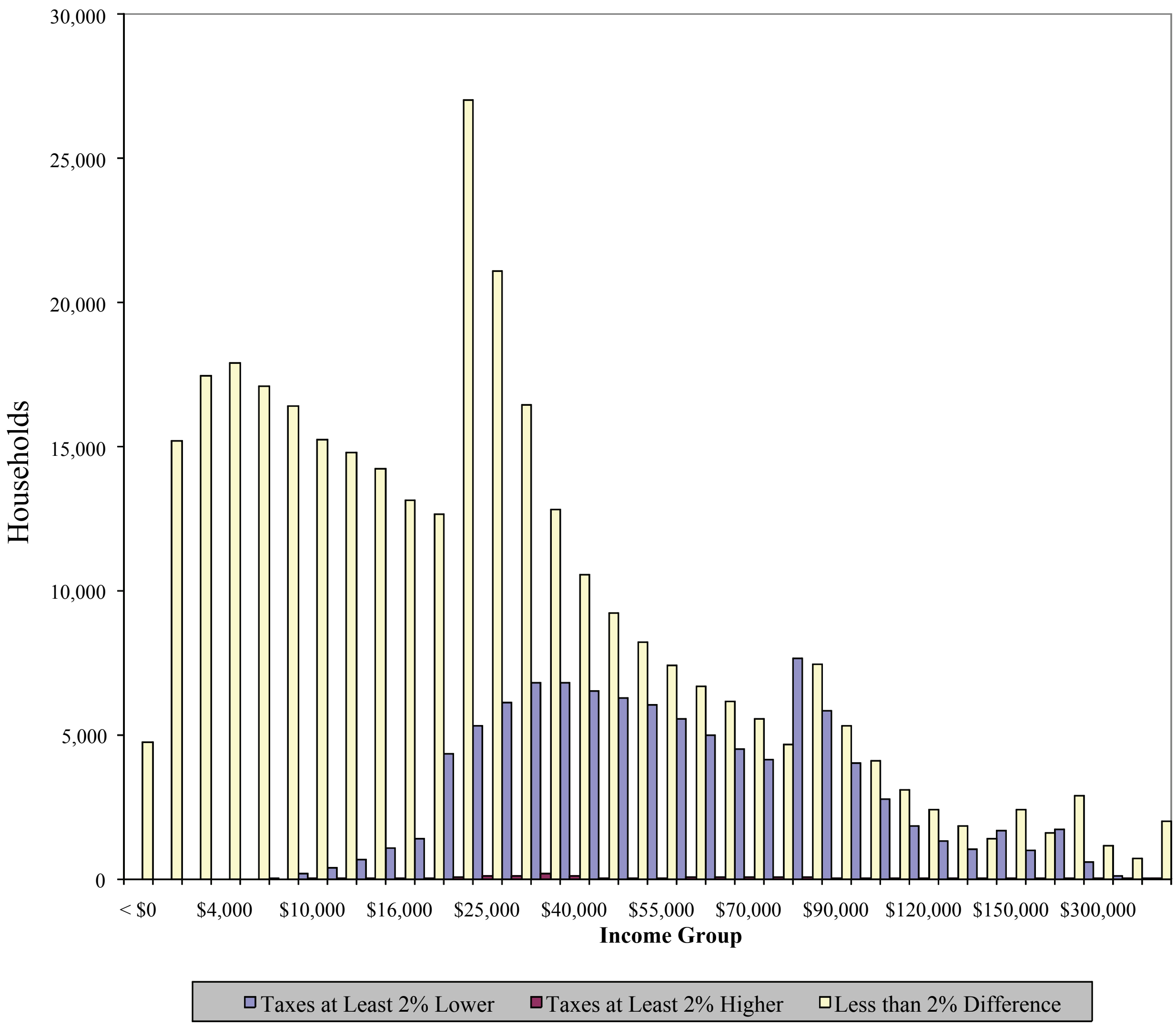


Figure 2, below, shows the number of households that would have taxes at least 2 percent lower under this option, the number that would have taxes at least 2 percent higher, and the number with a change of less than 2 percent.

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

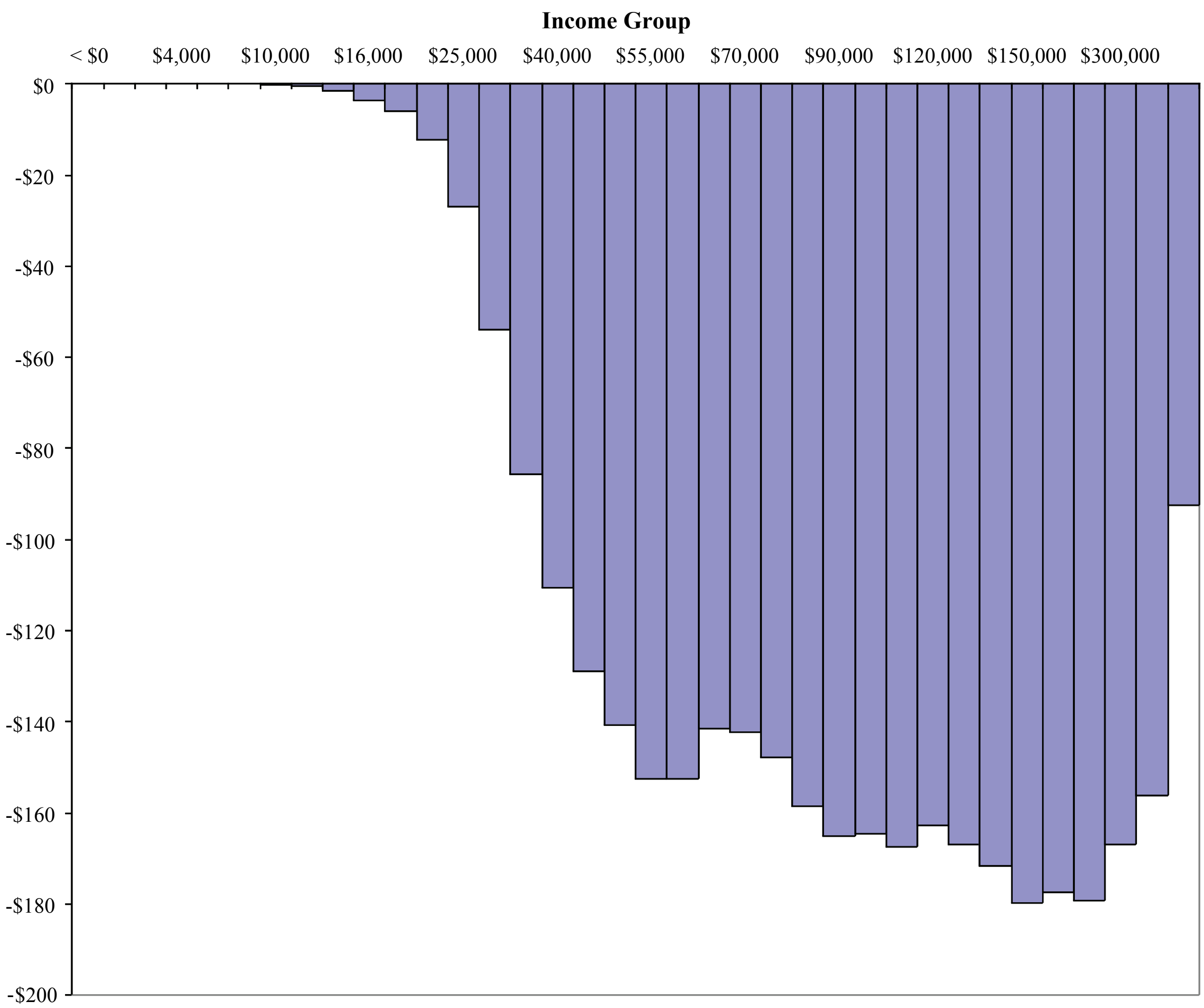
Average change in tax liability

As seen in Figure 3 below, the average change in tax liability is between $140 and $180 for income groups with total income between $45,000 and $300,000, and is smaller for higher and lower incomes. This reflects both the smaller proportion of households with a tax reduction at high and low incomes and differences in average tax reductions for households who would see a change.

(Figure 3)

Option 2: Average change in tax liability for all households

(Including single filers and heads of households)



Option 3

This option creates a new rate table for separate returns that makes tax from separate returns the same as tax from a joint return.

By creating a new rate table for separate returns with rate brackets that are half as wide as the rate brackets for other taxpayers, couples would not have an incentive to file separate returns.

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 pink joint-filer line and the yellow separate-filer line in Figure 1 by moving the yellow line up.

Effect on revenue

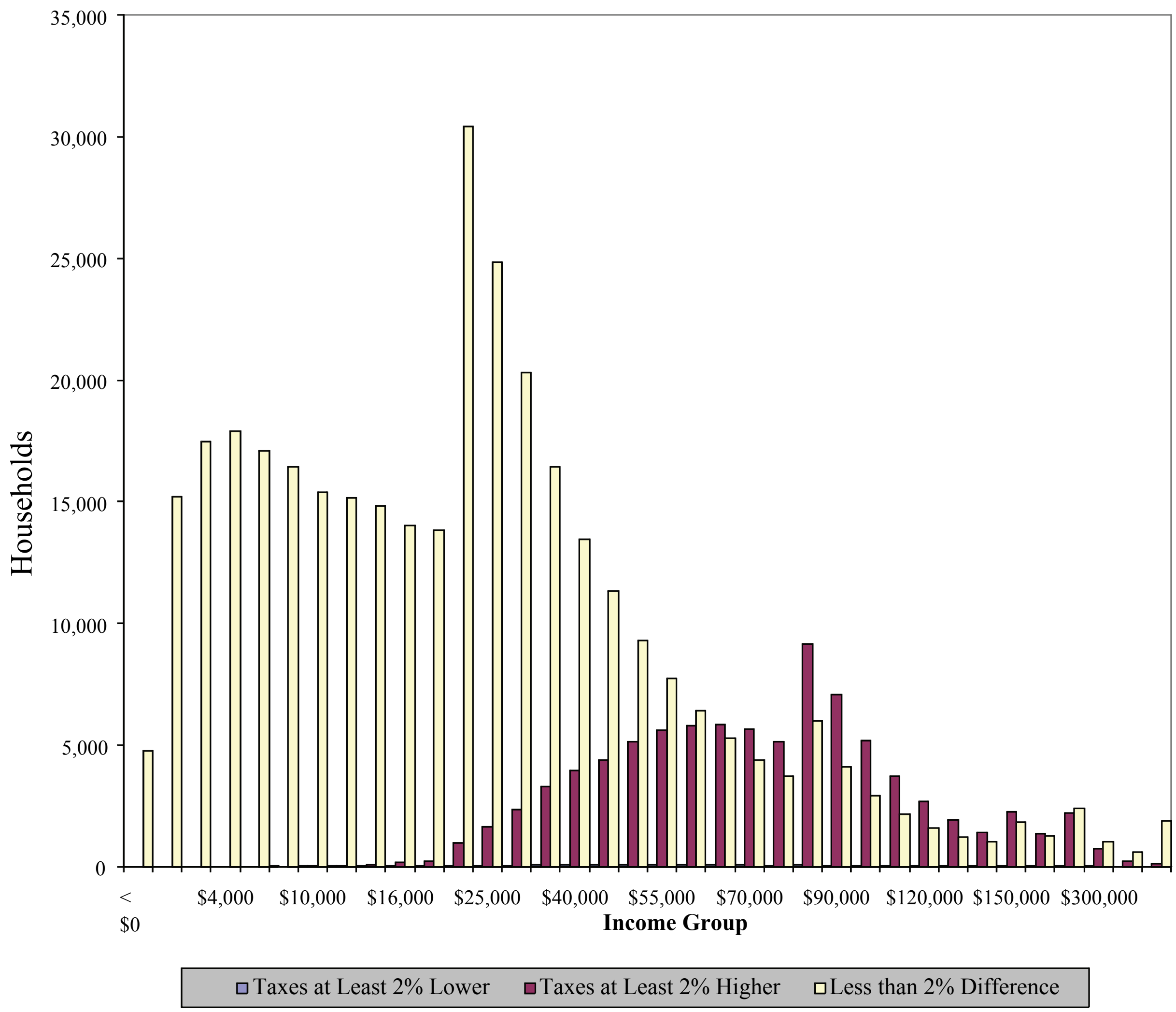
This option would increase state income tax liability by about $38 million for 2012 and $39 million for 2013.

Winners and losers

Figure 4, below, shows households that have tax increases or decreases of 2 percent or more and taxpayers with no change. No households would have taxes at least 2 percent lower.

(Figure 4)

Option 3: Winners and Losers from Eliminating Married Filing Separate



Very few households with total household income of $20,000 or less would pay at least 2 percent more. The proportion of households paying at least 2 percent more under this option increases up to $100,000 of total household income and then decreases. More than half of households with total household income between about $60,000 and $175,000 would pay at least 2 percent more.

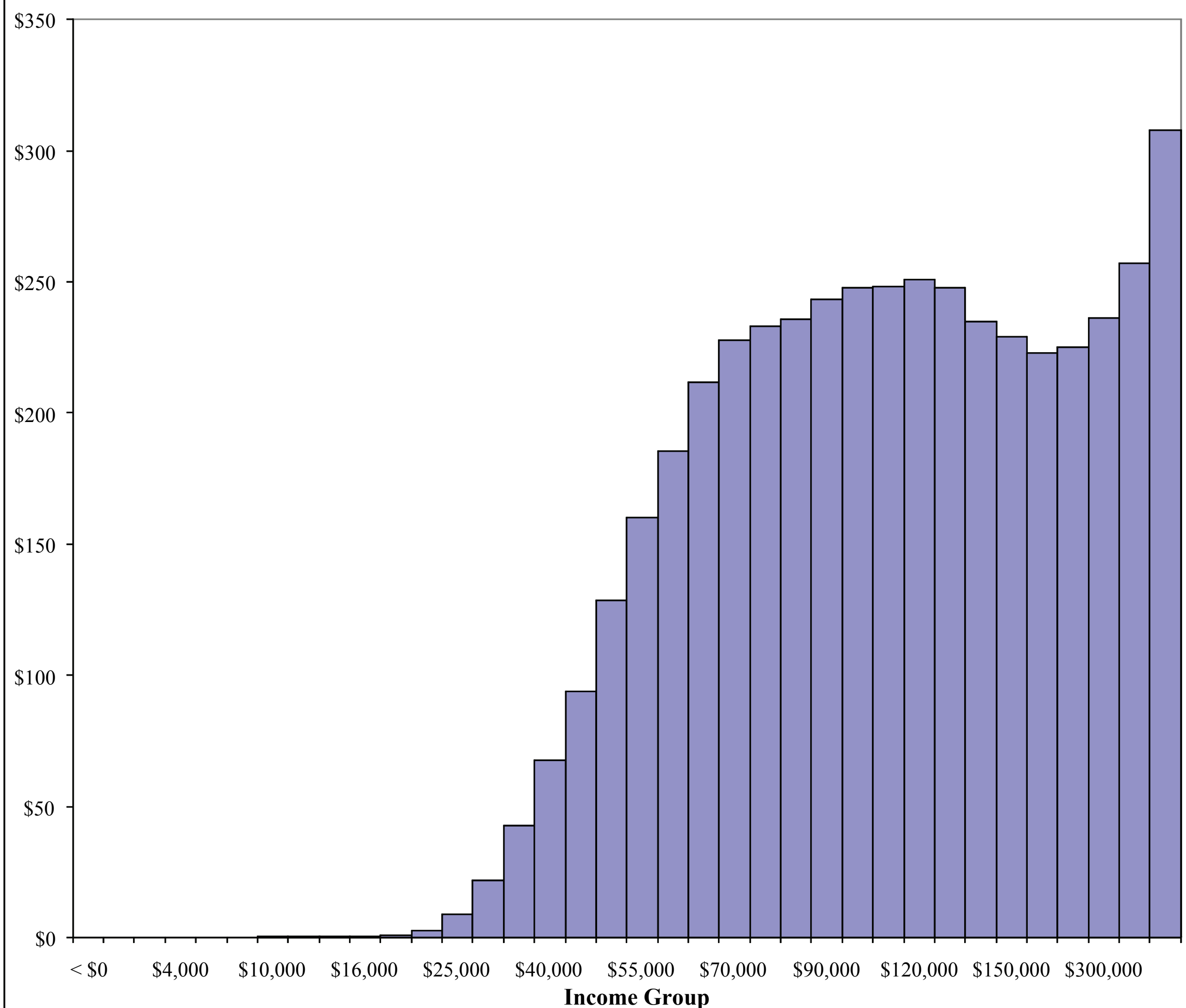
Average change in tax liability

As seen in Figure 5, below, 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.

(Figure 5)

Option 3: Average change in tax liability for all households

(Including single filers and heads of households)



Option 4

This option would create new rate tables for both separate and joint returns. There are several ways to accomplish this.

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. This option could also follow the federal precedent of having different rate tables for single taxpayers and head-of-household taxpayers.

Using this approach, the new separate rate table would result in higher taxes for some couples who continue to file separate returns, and the new joint rate table would result in lower taxes for some 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 this approach 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:

- 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 couples 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?