When married couples should file separate returns

Here is an overview on whether you and your spouse should file a joint tax return or separate returns. As is often the case with tax questions, the answer depends on your particular tax picture.

In general, your decision will depend upon which filing status results in the lowest tax. But bear in mind that, if you and your spouse file a joint return, each of you is jointly and severally liable for the tax on your combined income, including any additional tax that IRS assesses, plus interest and most penalties. This means that IRS can come after either of you to collect the full amount. Although there are provisions in the law that offer relief from joint and several liability, each of those provisions has its limitations. Thus, even if a joint return results in less tax, you may choose to file a separate return if you want to be certain of being responsible only for your own tax.

In most cases, filing jointly offers the most tax savings, particularly where the spouses have different income levels. The “averaging” effect of combining the two incomes can bring some of it out of a higher tax bracket. For example, if one spouse has $75,000 of taxable income and the other has just $15,000, filing jointly instead of separately for 2009 can save $2,089 in taxes ($2,033 for 2008).

Note that filing separately doesn't mean you go back to using the “single” rates that applied before you were married. Instead, each spouse must use the “married filing separately” rates. These rates are based on brackets that are exactly half of the married filing joint brackets but are still less favorable than the “single” rates. This means the “marriage penalty” (which requires some marrieds to pay at a higher tax rate on the same total income than they would pay if each were single) isn't eliminated by filing separate returns. Although Congress has provided relief from the marriage penalty in the tax rates, those changes don't provide a complete solution.

There is a potential for tax savings from filing separately, however, where one spouse has significant amounts of medical expenses, casualty losses, or “miscellaneous itemized deductions.” These deductions are reduced by a percentage of adjusted gross income (AGI). Medical expenses are deductible only to the extent they exceed 7.5% of AGI, and casualty losses must exceed 10% of AGI. Miscellaneous itemized deductions, which include a variety of deductions such as investment expenses (other than investment interest), unreimbursed employee expenses, and tax return preparation costs, are deductible to the extent their combined total exceeds 2% of AGI (often referred to as a “2% floor”).

If these deductions are isolated on the separate return of a spouse, that spouse's lower (separate) AGI, as compared to the higher joint AGI, can result in larger total deductions. For example, if one spouse has $7,000 in medical expenses and joint income is $90,000, then only $250 is deductible on a joint return, because 7.5% of $90,000 is $6,750 (and $7,000 − $6,750 = $250). But if the income of the spouse with the medical expenses is separately only $15,000, the deduction increases to $5,875 on a separate return, because 7.5% of $15,000 is only $1,125 (and $7,000 − $1,125 = $5,875).

On the other hand, the amounts you claim as a deduction for exemptions and for certain itemized deductions, including miscellaneous itemized deductions, are phased out (i.e., reduced) once your AGI goes above a certain threshold, depending upon your filing status. The AGI threshold at which phaseout of exemptions and itemized deductions begins is higher for joint returns than for separate returns. For example, in the case of exemptions, the threshold in 2009 for joint returns is $250,200 ($239,950 for 2008) as compared to only $125,100 ($119,975 for 2008) for separate returns. Thus, if you file a separate return, your deduction for exemptions begins to phase out if your AGI exceeds $125,100 ($119,975 for 2008). But if you and your spouse file a joint return, your deduction for exemptions doesn't begin to phase out until your AGI exceeds $250,200 ($239,950 for 2008). This means that a phaseout which might be suffered on a separate return may be avoided if you and your spouse file a joint return. The tax savings at stake will vary depending on how many exemptions are claimed and your income levels.

3%/80% reduction: Generally, if an individual's AGI exceeds the phaseout limit (for 2009, $83,400 for marrieds filing separately, $166,800 for other taxpayers), the amount of the itemized deductions otherwise allowed for the tax year is reduced by the lesser of: (a) 3% of the excess of AGI over the applicable amount, or (b) 80% of the amount of itemized deductions otherwise allowable for the tax year. For 2008, the phaseout limit was $79,875 for marrieds filing separately, $159,950 for other taxpayers.

For tax years beginning before 2010, the itemized deduction and personal exemption phaseout amounts are themselves reduced by an applicable percentage. In 2008 and 2009, the reduction amount equals one-third of the otherwise applicable reduction amount. Thus, the otherwise applicable personal exemption and itemized deduction phaseouts are reduced by two-thirds in 2008 and 2009.

Other tax factors may point to the advisability of filing a joint return. For example, the child and dependent care credit, adoption expense credit, American Opportunity tax credit (i.e., the Hope credit as modified for 2009 and 2010), and Lifetime learning credit are available to a married couple only on a joint return. And you can't take the credit for the elderly or the disabled if you file separate returns unless you and your spouse lived apart for the entire year. Nor can you deduct qualified education loan interest unless a joint return is filed. You may also not be able to deduct contributions to your IRA if either you or your spouse was covered by an employer retirement plan and you file separate returns. Nor can you exclude adoption assistance payments or any interest income from series EE savings bonds that you used for higher education expenses if you file separate returns.

In addition, social security benefits may be more heavily taxed to a couple that files separately. The benefits are tax-free if your “provisional income” (your adjusted gross income with certain modifications plus half of your social security benefits) doesn't exceed a “base amount.” The base amount is $32,000 on a joint return, but zero on separate return (or $25,000 if the spouses didn't live together for the entire year).

The decision you make for federal income tax purposes may have an impact on your state or local income tax bill, so the total tax impact has to be compared. For example, an overall federal tax saving by filing separately might be offset by an overall state tax increase, or a state tax saving might offset a federal tax increase.

Unfortunately, I can't give you any hard and fast rules of thumb for when it pays to file separately. The tax laws have grown so complex over the years that there are often a number of different factors at play for any given situation. However, there is one approach guaranteed to come up with the correct decision. We can simply calculate your tax bill both ways: jointly and separately. Then the approach that leads to overall tax savings could be used.

We'd be happy to run the numbers for you to make sure you pay the minimum amount of taxes possible. Please call to schedule a consultation or if you have any additional questions.

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