Consequences of Filing Married Separate

Article Highlights:

- Joint & Several Liability
- Exemptions
- Itemizing Deductions
- Social Security Income
- Section 179 Deduction
- Special Passive Loss Allowance
- Traditional IRA Deduction Phase-Out
- Roth IRA Contribution Phase-Out
- Coverdell Education Accounts
- Education Tax Credits
- Higher Education Interest
- Education Exclusion for U.S. Savings Bond Interest
- Premium Tax Credit
- Earned Income Tax Credit
- Child Care Credit
- Halved Deductions & Credits
- Head of Household Filing Status

If you are married and thinking about not filing a joint return with your spouse, you will most likely use the married filing separate (MFS) filing status. If you are considering filing MFS, then you should be aware that the tax code is laced with special restrictions so that married individuals cannot benefit by filing MFS. This article describes some of the more frequently encountered issues when making the choice of filing status. Note: dollar amounts are those for 2017.

Joint & Several Liability - When married taxpayers file joint returns, both spouses are responsible for the tax on that return. What this means is that one spouse may be held liable for all the tax due on a return, even if the other spouse earned all the income on that return. In some marriages, this becomes an issue and causes the spouses to decide to file separately. In other cases, especially second marriages, the couple may want to keep their finances separate. Unless all the income, exemptions, credits and deductions are divided equally, which usually happens in community property states, this generally causes the incomes to be distorted and could easily push one of the spouses into a higher tax bracket and create a greater combined tax than filing jointly. Being in a separate property state, where each spouse claims their own earnings, can also create an uneven allocation of income and a higher tax bracket for one of the spouses.

Exemptions – Taxpayers are allowed a $4,050 tax exemption for each of their dependents. However, the $4,050 allowance cannot be divided between the MFS filers, so only one of the filers can claim a dependent's exemption, and where there are multiple dependents, the spouses would need to allocate the exemptions between them.

Itemizing Deductions – To prevent taxpayers from filing MFS and one spouse taking advantage of itemized deductions and the other utilizing the standard deduction, the tax regulations require both to itemize if one of them does.

Social Security Income – When filing a joint return, Social Security (SS) income is not taxable until the modified AGI (MAGI) – which is regular AGI (without Social Security income) plus 50% of the couple's Social Security income plus tax-exempt interest income and plus certain other infrequently encountered additions – exceeds a taxable threshold of $32,000. However, for married taxpayers who have lived together at any time during the year and are filing married separate, the threshold is zero, generally making more of the Social Security income taxable.

Section 179 Deduction – Businesses can elect to expense, instead of depreciate, up to $510,000 of business purchases, generally including equipment, certain qualified leasehold property and off-the-shelf computer software. The $510,000 cap is reduced by $1 for every $1 that the qualifying purchases exceed $2,030,000 for the year. Married taxpayers are treated as one taxpayer for purposes of the Section 179 expense limit. Thus, they generally must split the limit equally unless they can agree upon and elect an unequal split.

Special Passive Loss Allowance – Passive losses are generally losses from business and rental activities in which a taxpayer does not materially participate. Those losses are not allowed except to offset income from other passive activities. Rental property is an example of a passive activity, and for lower-income taxpayers, a special allowance permits taxpayers who are actively involved in the rental activity to currently deduct a loss of up to $25,000 if their AGI does not exceed $100,000. That $25,000 special loss allowance phases out by 50 cents for each $1 of AGI over $100,000 and is completely eliminated when the AGI reaches $150,000. When filing separately, this special allowance is not allowed unless the spouses live apart the entire year, and then the allowance is reduced to $12,500 each.

Traditional IRA Deduction Phase-Out – If a married taxpayer filing jointly is participating in a qualified employer pension plan, the deductibility of a traditional IRA contribution is phased out ratably for an AGI between $99,000 and $119,000. If the taxpayers file married separate, the phase-out begins at $0 if the taxpayer participates in their employer's plan, and when the AGI reaches $10,000, no traditional IRA deduction is allowed. So little, if any, IRA deduction will be available to such an MFS filer.

Roth IRA Contribution Phase-Out – Taxpayers may choose to contribute to a non-deductible Roth IRA. However, Roth IRA contributions are ratably phased out for higher-income married filing jointly taxpayers with an AGI between $186,000 and $196,000. For a married taxpayer filing MFS status, that AGI phase-out range drops to $0 through $9,999, virtually eliminating the possibility of a Roth contribution.

Coverdell Education Accounts – Taxpayers are allowed to contribute up to $2,000 per beneficiary to a Coverdell education savings account annually. However for joint filers, the amount that can be contributed ratably phases out for AGIs between $190,000 and $220,000. For married filing separate taxpayers, the phase-out is half that amount, from $95,000 to $110,000.

Education Tax Credits – Taxpayers are allowed a tax credit, called the American Opportunity Tax Credit, of up to $2,500 per family member enrolled at least half-time in college for the cost of tuition and qualified expenses. This credit phases out ratably for higher-income married taxpayers filing jointly with an AGI between $160,000 and $180,000.

There is a second higher-education credit called the Lifetime Learning Credit, which provides a credit of up to $2,000 per family. This credit also phases out ratably for higher-income married taxpayers filing jointly with an AGI between $112,000 and $132,000.

However, neither credit is allowed for married filing separate taxpayers.

Higher Education Interest – Taxpayers can take a deduction of up to $2,500 for student loan interest paid on higher-education loans. Like other benefits, it is phased out for higher-income married taxpayers filing jointly, in this instance when the AGI is between $135,000 and $165,000. It is not allowed at all for taxpayers filing as married separate.

Education Exclusion For U.S. Savings Bond Interest – Although not frequently encountered, interest from certain U.S. Savings Bonds can be excluded if used to pay higher-education expenses for the taxpayers and their dependents. The exclusion phases out for married taxpayers with an AGI between $117,250 and $147,250. This deduction is not allowed at all when filing married separate.

Premium Tax Credit – For married taxpayers who qualify for the PTC (health insurance subsidy) under Obamacare, if they file married separate, they may be required to repay the subsidy.

Earned Income Tax Credit – This is a refundable tax credit that rewards lower-income taxpayers for working and can be as much $6,318 for families with three or more qualifying children. Taxpayers filing as married separate are not qualified for this credit.

Child Care Credit – If both spouses work and incur child care expenses, they qualify for the child care credit. However, for those married filing separate, the credit is not allowed.

Halved Deductions & Credits – Many of the deductions and credits allowed to a married couple filing jointly are cut in half for the married filing separate filing status. They include:

- Standard Deduction
- Standard Deduction Phase-Out
- Alternative Minimum Tax Exemptions
- Alternative Minimum Tax Exemptions Phase-Outs
- Child Tax Credit Phase-Out

Head of Household Filing Status – Where a married couple is not filing jointly, one or both spouses may qualify for the more beneficial Head of Household (HH) filing status rather than having to file using the MFS status. A married individual may use the HH status if they lived apart from their spouse for at least the last six months of the year and paid more than one-half of the cost of maintaining his or her home as a principal place of abode for more than one-half the year of a child, stepchild or eligible foster child for whom the taxpayer may claim a dependency exemption. (A nondependent child only qualifies if the custodial parent gave written consent to allow the dependency to the non-custodial parent or if the non-custodial parent has the right to claim the dependency under a pre-'85 divorce agreement.)

As you can see, there are a significant number of issues that need to be considered when making the decision to use the married filing separate status. And these are not all of them, but only the more significant ones. The filing status decision should not be made nonchalantly, as it can have significant impact on your taxes. Please contact this office for assistance in making that crucial decision.