

Chapter 1

Understanding the U.S. Tax System

In This Chapter

- ▶ Making sense of the U.S. tax system
- ▶ Managing your taxes year-round
- ▶ Understanding the importance of “marginal” taxes
- ▶ Comprehending state taxes and the Alternative Minimum Tax

Most everyone — including your humble authors — finds taxes to be a pain. First, everyone faces the chore of gathering various complicated-looking documents to complete the annual ritual of filling out IRS Form 1040 and whatever form your state may require. You may need to become acquainted with some forms that are new to you. Perhaps you need to figure out how to submit a quarterly tax payment when you no longer work for a company and now receive self-employment income from independent contract work. Maybe you sold some investments (such as stocks, mutual funds, or real estate) at a profit (or loss), and you must calculate how much tax you owe (or loss you can write off).

Whenever money passes through your hands, it seems that you pay some kind of tax. Consider the following:

- ✓ When you work and get paid, you pay federal, state, and local taxes (on top of having to deal with the migraines your bosses and difficult customers give you).
- ✓ After paying taxes on your earnings and then spending money on things you need and want (and paying more taxes in the process), you may have some money left over for investing. Guess what? Your reward for being a saver is that you also pay tax on some of the earnings on your savings.

Even if your financial life is stagnant, tax law changes during the past year may require you to complete some new forms and calculations. And, if you're like most people, you're currently missing out on some legal tax reduction tactics.

Unfortunately, too many people think of taxes only in spring, when it comes time to file that dreadful annual return. Throughout this book, you can find all sorts of tips, suggestions, and warnings that help you discover the important role that your taxes play in your entire personal financial situation year-round. In fact, we devote Part V of the book to showing you how to accomplish important financial goals while legally reducing your taxes.

A brief history of U.S. income taxes

Federal income taxes haven't always been a certainty. In the early 20th century, people lived without being bothered by the federal income tax — or by televisions, microwaves, computers, voice mail, and all those other complications. Beginning in 1913, Congress set up a system of graduated tax rates, starting with a rate of only 1 percent and going up to 7 percent.

This tax system was enacted through the 16th Amendment to the Constitution, which was suggested by President Teddy Roosevelt (a Republican), and pushed through by his successor, President William H. Taft (another Republican), and ultimately ratified by two-thirds of the states. (Sorry, Mr. Forbes, Mr. Bush, and Mr. Limbaugh — not all Republicans have been anti-tax-and-spend!) Note that we, your good authors, are independents, which means that we happily take swipes at Republicans, Democrats, and other political pundits throughout our book.

In fairness, we must tell you that the 1913 federal income tax wasn't the first U.S. income tax. President Abraham Lincoln (Republican) signed a Civil War income tax in 1861, which was abandoned a decade later.

Prior to 1913, the vast majority of tax dollars collected by the federal government came from taxes levied on goods, such as liquor, tobacco, and imports. Today, personal income taxes, including Social Security taxes, account for about 85 percent of federal government revenue.

In 1913, the forms, instructions, and clarifications for the entire federal tax system would have filled just one small, three-ring binder! (And we're not even sure that three-ring binders existed back then.) Those were, indeed, the good old days. Since then, thanks to endless revisions, enhancements, and simplifications, the federal tax laws — along with the IRS and court clarifications of those laws — can (and should) fill several dump trucks. Since World War II, the size of the federal tax code has swelled by more than 400 percent! And, according to the Tax Foundation — a nonprofit, nonpartisan policy research organization — complying with the tax laws costs everyone more than \$200 billion annually.

Figuring Out the U.S. Tax System

You'll pay more in taxes than you need to if you don't understand the tax system. Who wants to pay more when you already feel like you're paying plenty and you work hard for what money you do earn?

When you try to read and make sense of the tax laws, you quickly realize that you're more likely to win the lottery than figure out some parts of the tax code! That's one of the reasons that tax attorneys and accountants are paid so much — to compensate them for their intense and prolonged agony of deciphering the tax code!

But here's a little secret to make you feel much better: You don't need to read the dreadful tax laws. Most tax advisors don't read them themselves. Instead, they rely upon summaries prepared by organizations and people who have more of a knack for explaining things clearly and concisely than the IRS does. CCH Inc. — the organization responsible for technically reviewing this fine book — has compiled a *Federal Tax Reporter* publication that details all federal tax laws. This publication now has in excess of 55,000 pages!

We hope that you include our book as a comprehensible resource you can count on. *Taxes 2007 For Dummies* helps you discover how the tax system works and how to legally make the system work for *you*. You'll quite possibly be bothered by some of the things this book shows you that don't seem fair. But getting angry enough to make the veins in your neck bulge definitely won't help your financial situation or your blood pressure. (We don't want to see your medical deductions increase!) Even if you don't agree with the entire tax system, you still have to play by the rules.

You can reduce your taxes



The tax system, like other public policies, is built around incentives to encourage desirable behavior and activity. Home ownership, for example, is considered good because it encourages people to take more responsibility for maintaining properties and neighborhoods. Therefore, the government offers all sorts of tax benefits (*allowable deductions*) to encourage people to own homes (see Chapter 23). But if you don't understand these tax benefits, you probably don't know how to take full advantage of them, either.

Even when you're an honest, earnest, well-intentioned, and law-abiding citizen, odds are that you don't completely understand the tax system. This ignorance wreaks havoc with your personal finances because you end up paying more in taxes than you need to.

Adding insult to injury, you may step on a tax land mine. Like millions of taxpayers before you, you can unwittingly be in noncompliance with the ever-changing tax laws at the federal, state, and local levels. Your tax ignorance can cause mistakes that may be costly if the IRS and your state government catch your errors. With the proliferation of computerized data tracking, discovering errors has never been easier for the tax cops at the IRS. And when they uncover your boo-boos, you have to pay the tax you originally owed *and* interest *and*, possibly, penalties. Ouch!



So don't feel dumb when it comes to understanding the tax system. You're not the problem — the complexity of the income tax system is. Making sense of the tax jungle is more daunting than hacking your way out of a triple-canopy rain forest with a dinner knife. That's why, throughout this book, we help you understand the tax system, and we promise not to make you read the actual tax laws.

You should be able to keep much more of your money by applying the tax-reducing strategies we present in this book.

- ✔ You may be able to tax shelter your employment earnings into various retirement accounts such as 401(k) and Keogh plans. This strategy slashes your current income taxes, enables your money to grow tax-free, and helps you save toward the goal of retirement.
- ✔ The less you buy, the less sales tax you pay. You can buy a less expensive, more fuel-efficient car, for example. (You'll spend less on gasoline, including gasoline taxes, as well.)
- ✔ When you invest, you can invest in a way that fits your tax situation. This strategy can make you happier and wealthier come tax time. For example, you can choose tax-friendly investments (such as tax-free bonds) that reduce your tax bill and increase your after-tax investment returns.

Beyond April 15: What you don't know can cost you

Every spring, more than 100 million tax returns (and several million extension requests) are filed with the IRS. The byproduct of this effort is guaranteed employment for the nation's more than 1 million accountants and auditors, and 2 million bookkeeping and accounting clerks (not to mention more than a few tax-book authors and their editors). Accounting firms rake in more than \$30 billion annually, helping bewildered and desperately confused taxpayers figure out all those tax laws. So that you can feel okay about this situation, keep in mind that at least some of the money you pay in income taxes actually winds up in the government coffers for some useful purposes.



Given all the hours that you work each year just to pay your taxes and the time you spend actually completing the dreaded return, on April 16, you may feel like tossing the whole tax topic into a drawer or closet until next year. Such avoidance, however, is a costly mistake.

During the tax year, you can take steps to ensure that you're not only in compliance with the ever-changing tax laws, but also that you're minimizing your tax burden. If your income — like that of nearly everyone we know — is limited, you need to understand the tax code to make it work for you and help you accomplish your financial goals. The following case studies demonstrate the importance of keeping in mind the tax implications of your financial decisions throughout the year.

The costs of procrastination

Consider the case of Sheila and Peter, the proud owners of a successful and rapidly growing small business. They became so busy running the business and taking care of their children that they hardly had time to call a tax advisor. In fact, not only did they fail to file for an extension by April 15, but they also didn't pay any federal or state income taxes.



By August, Peter and Sheila finally had time to focus on the prior year's income taxes, but by then they had gotten themselves into some problems and incurred these costs:

- ✓ **A penalty for failure to file**, which is 5 percent per month of the amount due, up to a maximum of 25 percent (for five months).
- ✓ **Interest on the amount due**, which at that time was running about 9 percent per year. (*Note:* This rate is adjusted over time based on current interest rate levels.)
- ✓ **A larger tax bill** (also caused by lack of planning), which turned out to be far more expensive than the first two expenses. Because they had incorporated their business, Peter and Sheila were on the payroll for salary during the year. Despite the high level of profitability of their business, they had set their pay at too low a level.

A low salary wouldn't seem to be a problem for the owner and only employee of a company. The worst that you'd think could happen to Peter and Sheila is that they might have to eat more peanut butter and jelly sandwiches during the year. But because they received small salaries, the contributions they could make to tax-deductible retirement accounts were based on a percentage of only their small salaries.

The rest of the business profits, however, had to be taken by Sheila and Peter as taxable income, because they had their company set up as an S Corporation. (We explain the different types of corporations and their tax consequences in Chapter 21.) This gaffe caused Sheila and Peter to pay thousands in additional taxes, which they could've legally — and easily — avoided.

- ✓ **Loss of future investment earnings**, which means that over time Sheila and Peter actually lose more than the additional taxes. Not only did Peter and Sheila miss out on an opportunity to reduce their taxes by making larger deductible contributions to their tax-sheltered retirement accounts, but they also lost the chance for the money to compound (tax-deferred) over time.

The consequences of poor advice



Getting bad advice, especially from someone with a vested interest in your decisions, is another leading cause of tax mistakes. Consider the case of George, who wanted advice about investing and other financial matters. When he received a solicitation from a financial advisor at a well-known firm, he bit. The polished, well-dressed advisor, who was actually a *broker* (someone who earns commissions from the financial products that he or she peddles), prepared a voluminous report complete with scads of retirement projections for George.

Part of the advice in this report was for George to purchase some cash-value life insurance and various investments from the broker. The broker pitched the insurance as a great way to save, invest, and reduce George's tax burden.

Through his employer, George could invest in a retirement account on a tax-deductible basis. However, the broker conveniently overlooked this avenue — after all, the broker couldn't earn fat commissions by telling people like George to fund their employers' retirement accounts. As a result, George paid thousands of dollars more in taxes annually than he needed to.

Funding the life insurance policy was a terrible decision for George, in large part because doing so offered no upfront tax breaks. When you contribute money to tax-deductible retirement accounts, such as 401(k) plans, you get to keep and invest money you normally would've owed in federal and state income taxes. (See Chapter 20 to find out more about retirement accounts and check out Chapter 22 for the other reasons why life insurance generally shouldn't be used as an investment.)

Understanding Your Income Tax Rates

Many people remember only whether they received tax refunds or owed money on their tax returns. But you *should* care how much you pay in taxes, and you need to understand the total and the *marginal* taxes that you pay, so you can make financial decisions that lessen your tax load.

Although some people feel happy or fortunate when they get refunds, you shouldn't feel so good. All a refund really indicates is that you overpaid your taxes during the prior year. When you file your income tax return, all you do is balance your tax checkbook, so to speak, against the federal and state governments' versions of your tax checkbook. You settle up with tax authorities regarding the amount of taxes you paid during the past year versus the total tax that you actually are required to pay, based on your income and deductions.

Last year, the IRS issued more than \$200 billion in individual income tax refunds. If you figure just a 5 percent interest rate from a money market fund, taxpayers threw away more than \$10 billion in interest on money that they could've invested.

Total taxes

The only way to determine the total amount of income taxes you pay is to get out your federal and state tax returns. On each of those returns is a line that shows the *total tax* (line 62 on Form 1040 returns). Add the totals from your federal and state tax returns, and you probably have one of the largest expenses of your financial life (unless you have an expensive home or a huge gambling habit).

You need to note that your taxable income is different from the amount of money you earned during the tax year from employment and investments. *Taxable income* is defined as the amount of income on which you actually pay income taxes. You don't pay taxes on your total income for the following two reasons. First, not all income is taxable. For example, you pay federal income tax on the interest that you earn on a bank savings account but not on the interest from municipal bonds (which are essentially loans that you, as a bond buyer, make to state and local governments).

A second reason that you don't pay taxes on all your income is that you get to subtract deductions from your income. Some deductions are available just for being a living, breathing human being. For tax year 2006, single people receive an automatic \$5,150 *standard deduction*, and married couples filing jointly get \$10,300. (People older than 65 and those who are blind get slightly higher deductions.) Other expenses, such as mortgage interest and property taxes, are deductible to the extent that your total itemized deductions exceed the standard deductions.



A personal budget or spending plan that doesn't address, contain, and reduce your income taxes may be doomed to failure. Taxes are such a major portion of most people's expenditures that throughout this book we highlight strategies for reducing your taxable income and income taxes right now and in the future. Doing so is vital to your ability to save and invest money to accomplish important financial and personal goals.

Your marginal income tax rate

"What's marginal about my taxes?" we hear you asking. "They're huge! They aren't marginal at all!" *Marginal* is a word that people often use when they mean small or barely acceptable. Sort of like getting a C- on a school report card (or "just" an A- if you're from an overachieving family).

But when we're talking about taxes, *marginal* has a different meaning. The government charges you different income tax rates for different parts of your annual income. So your *marginal tax rate* is the rate that you pay on the last dollars you earn. You generally pay less tax on your *first*, or lowest, dollars of earnings and more tax on your *last*, or highest, dollars of earnings. This system is known as a graduated income tax. Graduated tax brackets are recorded in Greece as far back as 2400 B.C.

Our advice is to keep an open mind, listen to all sides, and remember the big picture. Back in the 1950s (an economic boom time), for example, the highest federal income tax rate was a whopping 90 percent, more than double its current level. And whereas during most of the past century the highest income earners paid a marginal rate that was double to triple the rate paid by moderate income earners of the time, that gap was greatly reduced during the past generation. Still, the highest income earners continue to pay the lion's share of taxes. In fact, the Congressional Budget Office recently found the top 1 percent of all income earners pay about 20 percent of all federal taxes. The top 20 percent pay slightly less than two-thirds of the total individual income taxes collected.

Are your income tax rates fair? You be the judge

Like most Americans, you probably think you pay too much in taxes. It may not be much comfort to you, but the average total taxes that citizens in the United States pay are low when compared with what citizens of other industrialized countries in Europe and Asia pay. However, low and moderate income earners in the United States pay higher income taxes than their overseas friends, and high-income earners generally pay less.

A tremendous debate rages, and much gnashing of teeth is heard, about how much high-income earners and the wealthy (relative to other taxpayers) should pay in taxes. On the far right of the political spectrum, politicians and commentators argue that burdening the people who work hard and generate jobs (that is, the high-income earners) with oppressive taxes is unfair and economically harmful. At the other end of the spectrum, you hear diehard liberals pleading that the well-heeled don't pay their fair share and need to face higher taxes to help pay for deserving programs for the poor and disadvantaged.

As with many disagreements, the people at the polar extremes think they're right (intellectually, not politically speaking) and that the other side is wrong. The politically liberal have a tendency to idealize how well government solves problems, and they therefore advocate more taxes for more programs. On the other hand, the politically conservative have a tendency to idealize how well the private sector meets the needs of society at large in the absence of government oversight and programs.

Although we can agree that easy access to tax revenue encourages some wasteful government spending and pork-laden programs, we also know that taxes must come from somewhere. The questions are how much and from whom? Equity, fairness, and stimulation of economic growth are concerns in the design of a tax system. You rarely hear blustery commentators or news programs thoughtfully discuss these issues.

The fact that *not all income is treated equally* under the current tax system isn't evident to most people. When you work for an employer and have a reasonably constant salary during the course of a year, a stable amount of federal and state taxes is deducted from each of your paychecks. Therefore, you may have the false impression that all your earned income is being taxed equally.

Table 1-1 gives the 2006 federal income tax rates for singles and for married people filing jointly.

Table 1-1 2006 Federal Income Tax Brackets and Rates		
<i>Singles Taxable Income</i>	<i>Married-Filing-Jointly Taxable Income</i>	<i>Federal Tax Rate</i>
Less than \$7,550	Less than \$15,100	10%
\$7,550 to \$30,650	\$15,100 to \$61,300	15%
\$30,650 to \$74,200	\$61,300 to \$123,700	25%
\$74,200 to \$154,800	\$123,700 to \$188,450	28%
\$154,800 to \$336,550	\$188,450 to \$336,550	33%
More than \$336,550	More than \$336,550	35%



Remember that your marginal tax rate is the rate of tax that you pay on your last, or so-called highest, dollars of taxable income. So, according to Table 1-1, if you're single and your taxable income during 2006 totals \$36,000, for example, you pay federal income tax at the rate of 10 percent on the first \$7,550 of taxable income. You then pay 15 percent on the amount from \$7,550 to \$30,650 and 25 percent on income from \$30,650 up to \$36,000. In other words, you effectively pay a marginal federal tax rate of 25 percent on your last dollars of income — those dollars in excess of \$30,650.

After you understand the powerful concept of marginal tax rates, you can begin to see the value of the many financial strategies that affect the amount of taxes you pay. Because you pay taxes on your employment income and on the earnings from your investments other than retirement accounts, many of your personal financial decisions need to be made with your marginal tax rate in mind. For example, when you have the opportunity to moonlight and earn some extra money, how much of that extra compensation you get to keep depends on your marginal tax rate. Your marginal income tax rate enables you to quickly calculate the additional taxes you'd pay on the additional income.

Conversely, you quantify the amount of taxes that you save by reducing your taxable income, either by decreasing your income — for example, with pretax contributions to retirement accounts — or by increasing your deductions.

Actually, you can make even more of your marginal taxes. In the next section, we detail the painful realities of income taxes levied by most states that add to your federal income burden. If you're a middle-to-higher income earner, pay close attention to the section later in this chapter where we discuss the *Alternative Minimum Tax*. And as we discuss elsewhere in this book, some tax breaks are reduced when your income exceeds a particular level — here are some examples:

- ✓ Itemized deductions, which we discuss in Chapter 9 and record on Schedule A, are reduced for tax year 2006 when your *adjusted gross income* (AGI — total income before subtracting deductions) exceeds \$150,500 (\$75,250 for married persons filing separately).

- ✓ Personal exemptions are a freebie — they're a write-off of \$3,300 in tax year 2006 just because you're a living, breathing, human being. However, personal exemptions are whittled away for single-income earners with AGIs of more than \$150,500, married people filing jointly with AGIs of more than \$225,750, and married persons filing separately with AGIs of more than \$112,875.
- ✓ If you own rental real estate, you may normally take up to a \$25,000 annual loss when your expenses exceed your rental income. Your ability to deduct this loss begins to be limited when your AGI exceeds \$100,000.
- ✓ Your eligibility to fully contribute to *Roth Individual Retirement Accounts* (see Chapter 20) depends on your AGI being less than or equal to \$95,000 if you're a single taxpayer or \$150,000 if you're married. Beyond these amounts, allowable contributions are phased out.



Your marginal income tax rate — the rate of tax you pay on your last dollars of income — should be higher than your average tax rate — the rate you pay, on average, on all your earnings. The reason your marginal tax rate is more important for you to know is that it tells you the value of legally reducing your taxable income. So, for example, if you're in the federal 28 percent tax bracket, for every \$1,000 that you can reduce your taxable income, you shave \$280 off your federal income tax bill.

State income taxes

Note that your *total marginal rate* includes your federal and state income tax rates. As you may already be painfully aware, you don't pay only federal income taxes. You also get hit with state income taxes — that is, unless you live in Alaska, Florida, Nevada, South Dakota, Texas, Washington, or Wyoming. Those states have no state income taxes. As is true with federal income taxes, state income taxes have been around since the early 1900s.



You can look up your state tax rate by getting out your most recent year's state income tax preparation booklet. Alternatively, we've been crazy — but kind — enough to prepare a helpful little (okay, not so little) table that can give you a rough idea of your state tax rates (see Table 1-2). This table reflects state individual income taxes. Some states impose other taxes, such as local, county, or city taxes, special taxes for nonresidents, or capital gains taxes, which aren't included in this table.

Table 1-2 State Marginal Tax Rates

State	Filing Status*	Taxable Income			
		\$25,000+	\$50,000+	\$100,000+	\$250,000+
Alabama	All	5%	5%	5%	5%
Alaska		(No personal income tax)			
Arizona	Singles	3.74%	4.72%	4.72%	5.04%
	Marrieds	3.2%	3.2%	3.74%	4.72%
Arkansas	All	6%	7%	7%	7%
California	Singles	6%	9.3%	9.3%	9.3%
	Marrieds	2%	6%	9.3%	9.3%
Colorado	All	4.63%	4.63%	4.63%	4.63%

<i>State</i>	<i>Filing Status*</i>	<i>Taxable Income</i>			
		<i>\$25,000+</i>	<i>\$50,000+</i>	<i>\$100,000+</i>	<i>\$250,000+</i>
Connecticut	All	5%	5%	5%	5%
Delaware	All	5.2%	5.55%	5.95%	5.95%
District of Columbia	All	7%	8.7%	8.73%	8.7%
Florida		(No personal income tax)			
Georgia	All	6%	6%	6%	6%
Hawaii	Singles	7.60%	8.25%	8.25%	8.25%
	Marrieds	6.80%	7.60%	8.25%	8.25%
Idaho	Singles	7.8%	7.8%	7.8%	7.8%
	Marrieds	7.8%	7.8%	7.8%	7.8%
Illinois	All	3%	3%	3%	3%
Indiana	All	3.4%	3.4%	3.4%	3.4%
Iowa	All	6.8%	8.98%	8.98%	8.98%
Kansas	Singles	6.25%	6.45%	6.45%	6.45%
	Marrieds	3.5%	6.25%	6.45%	6.45%
Kentucky	All	5.8%	5.8%	6%	6%
Louisiana	Singles	6%	6%	6%	6%
	Marrieds	4%	6%	6%	6%
Maine	Singles	8.5%	8.5%	8.5%	8.5%
	Marrieds	7.0%	8.5%	8.5%	8.5%
Maryland	All	4.75%	4.75%	4.75%	4.75%
Massachusetts	All	5.3%	5.3%	5.3%	5.3%
Michigan	All	3.9%	3.9%	3.9%	3.9%
Minnesota	Singles	7.05%	7.05%	7.85%	7.85%
	Marrieds	5.35%	7.05%	7.05%	7.85%
Mississippi	All	5%	5%	5%	5%
Missouri	All	6%	6%	6%	6%
Montana	All	6.9%	6.9%	6.9%	6.9%
Nebraska	Singles	5.12%	6.84%	6.84%	6.84%
	Marrieds	3.57%	6.84%	6.84%	6.84%
Nevada		(No broad-based income tax)			
New Hampshire	All	–5% only on dividend and interest income on stocks and bonds			

(continued)

Table 1-2 (continued)

<i>State</i>	<i>Filing Status*</i>	<i>Taxable Income</i>			
		<i>\$25,000+</i>	<i>\$50,000+</i>	<i>\$100,000+</i>	<i>\$250,000+</i>
New Jersey	Singles	1.75%	5.525%	6.37%	6.37%
	Marrieds	1.75%	2.45%	5.525%	6.37%
New Mexico	All	6%	6%	6%	6%
New York	Singles	6.85%	6.85%	7.25%	7.25%
	Marrieds	5.25%	6.85%	6.85%	7.25%
North Carolina	All	7%	7%	7.75%	8.25%
North Dakota	Singles	2.10%	3.92%	4.34%	5.04%
	Marrieds	2.10%	3.92%	3.92%	5.04%
Ohio	All	4.27%	4.983%	6.61%	7.185%
Oklahoma	All	6.65%	6.65%	6.65%	6.65%
Oregon	All	9%	9%	9%	9%
Pennsylvania	All	3.07%	3.07%	3.07%	3.07%
Rhode Island	All	Flat rate of 25% of federal income tax liability			
South Carolina	All	7%	7%	7%	7%
South Dakota		(No personal income tax)			
Tennessee	All	–6% on interest and dividends from stocks and bonds			
Texas		(No personal income tax)			
Utah	All	7%	7%	7%	7%
Vermont	Singles	3.6%	7.2%	8.5%	9%
	Marrieds	3.6%	7.2%	7.2%	9%
Virginia	All	5.75%	5.75%	5.75%	5.75%
Washington		(No personal income tax)			
West Virginia	All	4.5%	6%	6.5%	6.5%
Wisconsin	All	6.5%	6.5%	6.5%	6.75%
Wyoming		(No personal income tax)			

* Filing status "married" refers only to married couples who file jointly.

The second tax system: Alternative Minimum Tax

You may find this hard to believe, but there's actually a second federal income tax system (yes, we groan with you as we struggle to understand even the first complicated tax system). This second system may raise your income taxes higher than they'd otherwise be.

Through the years, as the government has grown hungrier for revenue, taxpayers who slash their taxes by claiming many deductions have come under greater scrutiny. So the government created a second tax system — the *Alternative Minimum Tax (AMT)* — to ensure that higher income earners with relatively high amounts of itemized deductions pay at least a minimum amount of taxes on their incomes.

If you have a bunch of deductions from state income taxes, real estate taxes, certain types of mortgage interest, or passive investments (such as limited partnerships or rental real estate), you may fall prey to the AMT. The AMT is a classic case of the increasing complexity of our tax code. As incentives were placed in the tax code, people took advantage of them. Then the government said, "Whoa, Nelly! We can't have people taking *that* many write-offs." Rather than doing the sensible thing and limiting some of those deductions, Congress created the AMT instead.

The AMT restricts you from claiming certain deductions and requires you to increase your taxable income. So you must figure the tax you owe under the AMT system *and* under the other system and then pay whichever amount is *higher* (ouch!). Unfortunately, the only way to know for certain whether you're ensnared by this second tax system is by completing — you guessed it — another tax form (see Chapter 8).

