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## Chapter 1

# Understanding the U.S. Tax System

**M**ost people — including your humble authors — find taxes to be tedious. 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).

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 5 of the book to showing you how to accomplish important financial goals while legally reducing your taxes.

We hope that you include our book as an understandable resource you can count on. *Taxes 2024 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.

# Figuring Out the U.S. Tax System

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.

You'll pay more in taxes than you need to if you don't understand the tax system. Unfortunately, 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!

## 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, smartphones, 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, pushed through by his successor (President William H. Taft), and ultimately ratified by two-thirds of the states.

In fairness, we must tell you that the 1913 federal income tax wasn't the first U.S. income tax. President Abraham Lincoln instituted 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.

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. Wolters Kluwer — the organization responsible for technically reviewing this fine book — has compiled a *Federal Tax Reporter* publication that details and explains all federal tax laws. This publication now has in excess of 80,000 pages!

Even if your financial life is stagnant, recent tax law changes 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.

## You can reduce your taxes



REMEMBER

The tax system 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 numerous tax benefits (*allowable deductions*) to encourage people to own homes (see Chapter 25). 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, interest, and possibly penalties. Ouch!



REMEMBER

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. Here are some things to consider:

- » You may be able to tax-shelter your employment earnings into various retirement accounts such as 401(k) and SEP-IRA 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 costly, 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 tens of billions of dollars 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.



WARNING

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 ignoring the whole tax topic until next year. Such avoidance, however, is a costly mistake.

During the tax year, you can take steps to ensure not only that you're 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.



WARNING

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. (**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 may 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.

» Loss of future investment earnings, which means that over time Sheila and Peter actually lost 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



WARNING

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 sought counsel 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 lad was actually a broker (someone who earns commissions from the financial products that they peddle) who 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 can invest in a retirement account on a tax-deductible basis. However, the broker conveniently overlooked this avenue — after all, the broker can'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, not to mention those fat, and unnecessary, commissions.

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 22 to find out more about retirement accounts and check out Chapter 24 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 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 when they get refunds, you shouldn't. All a refund indicates is that you overpaid your taxes during the previous year. When you file your income tax return, 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.

## Adding up your 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, well before the end, is a line that shows the

total tax. 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 (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 2023, single people receive an automatic \$13,850 *standard deduction*, heads of household qualify for \$20,800, and married couples filing jointly get \$27,700. (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.



REMEMBER

A personal budget or spending plan that doesn't address your income taxes may be doomed to failure. 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.

## Following your marginal income tax rate

*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 taxes, *marginal* has a different meaning. The government charges you different income tax rates for different portions 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*, a system noted 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. 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 reduced during the past generation. Still, the highest income earners continue to pay the lion's share of taxes. In fact, using the latest IRS data, the Tax Foundation recently found the top 1 percent of all income earners pay about 42 percent of all federal taxes (while earning 22 percent of all income). The top 10 percent pay about 74 percent of the total individual income taxes collected (while earning 49 percent of all income).

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 2023 federal income tax rates for singles and for married people filing jointly.

**Table 1-1 2023 Federal Income Tax Brackets and Rates**

Federal Income Tax Rate	Single Filers Tax Brackets	Married Couples Filing Jointly Tax Brackets
10%	Up to \$11,000	Up to \$22,000
12%	\$11,000 to \$44,725	\$22,000 to \$89,450
22%	\$44,725 to \$95,375	\$89,450 to \$190,750
24%	\$95,375 to \$182,100	\$190,750 to \$364,200
32%	\$182,100 to \$231,250	\$364,200 to \$462,500
35%	\$231,250 to \$578,125	\$462,500 to \$693,750
37%	\$578,125 or more	\$693,750 or more



REMEMBER

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 2023 totals \$60,000, for example, you pay federal income tax at the rate of 10 percent on the first \$11,000 of taxable income. You then pay 12 percent on the amount from \$11,000 to \$44,725 and 22 percent on income from \$44,725 up to \$60,000. In other words, you effectively pay a marginal federal tax rate of 22 percent on your last dollars of income — those dollars in excess of \$44,725.

After you understand the powerful concept of marginal tax rates, you can 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 higher income earner, see 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:

- » **Education tax breaks:** There are numerous education tax deductions and credits, the rules for which continue to evolve and change. All of these helpful tax breaks, however, are subject to income limitations (see Chapter 26 to plan ahead and get more specifics).
- » **Saver's credit:** The saver's credit rewards lower-income earners with federal income tax credits on Form 8880 (Credit for Qualified Retirement Savings Contributions). This credit

phases out in 2023 for single taxpayers with adjusted gross income (AGI) above \$36,500 and for married couples filing jointly at AGIs above \$73,000.

» **Rental real estate losses:** 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.

» **Roth IRA contributions:** Your eligibility to fully contribute to Roth individual retirement accounts (IRAs; see Chapter 20) for 2023 depends on your modified AGI being less than or equal to \$153,000 if you're a single taxpayer or \$228,000 if you're married. Beyond these amounts, allowable contributions are phased out.



REMEMBER

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 24 percent tax bracket, for every \$1,000 that you can reduce your taxable income, you shave \$240 off your federal income tax bill.

## States want in on the income tax action, too

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, Tennessee, Texas, 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.



TIP

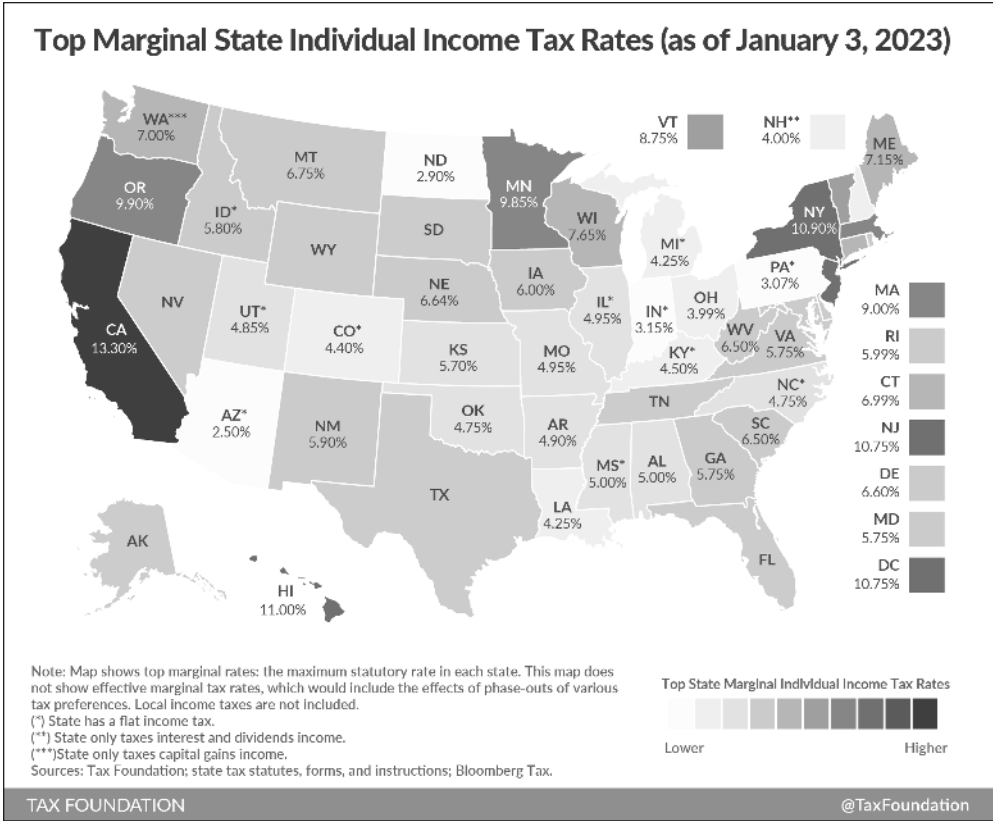
You can look up your state tax rate by getting out your most recent year's state income tax preparation booklet. Alternatively, check out the map showing the top marginal income tax rates (see Figure 1-1). This chart reflects state individual income taxes. Some states impose other taxes, such as local, county, or city taxes, special taxes for nonresidents, or capital gains taxes, which aren't included in this table.

## The second tax system: Alternative Minimum Tax

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.

In 1969, Congress 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.



**FIGURE 1-1:**  
Income state  
tax rates for  
each state.

Source: TaxFoundation.org

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).

## Noting the Forever Changing Tax Laws

Since tax law changes are passed by Congress, they change as the makeup of Congress changes. The most recent major piece of tax legislation was the Tax Cuts and Jobs Act of 2017, which took affect for tax years 2018 and beyond. There have been some smaller pieces of legislation since, addressing retirement accounts and savings and the COVID-19 pandemic. This section provides the highlights for this more recent legislation and associated tax law changes.

### The Tax Cuts and Jobs Act of 2017

For most individuals, the biggest change from the Tax Cuts and Jobs Act bill was the lowering of tax rates. The lower tax brackets were lowered by three full percentage points (for example,

from 15 percent down to 12 percent, from 25 percent down to 22 percent), and the next income bracket up from that was cut four full percentage points from 28 percent down to 24 percent, which produced substantial tax savings for lower- and moderate-income earners. The highest income earning taxpayers saw smaller reductions in their tax brackets.

According to Brian Riedl, a senior fellow at the Manhattan Institute, a greater share of the individual income tax benefits from this bill went to lower- and moderate-income earners.

Here are some of the other major changes in this tax bill:

- » **Increased standard deduction and eliminated personal exemption:** Proponents of the bill liked to talk about how the standard deduction nearly doubled. This amount is deducted from your income before arriving at your taxable income, so a larger standard deduction reduces your taxable income and tax bill. However, Congress also eliminated personal exemptions, which offset much of this change. Ultimately, though, far more taxpayers can simply claim the standard deduction, which is a time-saver when it comes to completing the annual federal 1040 tax form.
- » **Increased child tax credit:** The child tax credit was doubled by this legislation, and up to 70 percent of that credit was made refundable for taxpayers not otherwise owing federal income tax. Also, the incomes at which this credit starts phasing out was more than tripled for married couples and more than doubled for non-married filers.
- » **State and local taxes deduction capped at \$10,000:** This also includes property taxes on your home, and for homeowners in high cost-of-living areas with high state income taxes (for example, metro areas such as San Francisco, Los Angeles, New York, and Washington D.C.), this cap poses a modest or even significant negative change. Because these taxes are itemized deductions, only being able to take up to \$10,000 (previously unlimited) caused some taxpayers to no longer be able to itemize. Also, by reducing the tax benefits of home ownership, this change effectively raises the cost of home ownership, especially in high-cost and highly taxed areas.
- » **Mortgage-interest deduction for both primary and second homes capped at \$750,000 borrowed:** This represents a modest reduction from the previous \$1 million limit on mortgage indebtedness deductibility.

The Tax Cuts and Jobs Act also brought some long overdue corporate tax reform. For too long, the United States had way too high a corporate tax rate, which caused increasing numbers of companies to choose to do less business in the United States.

## The SECURE acts of 2019 and 2022

Retirement accounts and retirement savings rules were ripe for revisions and improvement. Some of those happened with the SECURE (Setting Every Community Up for Retirement Enhancement) Act of 2019. Of course, Congress couldn't leave well enough alone. So another bill — the SECURE Act 2.0 of 2022 — was passed to make yet more changes to retirement accounts. Here are the highlights of these two bills:

- » **Small-business owners are eligible for up to \$5,000 in tax credits when starting a retirement plan.** This credit applies to new 401(k), profit sharing, SEP, and SIMPLE plans for small employers (up to 100 employees).
- » **More workers can participate in company 401(k) plans.** Previously, employees had to work at least 1,000 hours per year to take part in a company's 401(k) plan. Now, workers who achieve at least 500 hours over three consecutive years may participate. Effective in 2025, employees must be eligible to participate in their employer's qualified retirement plans after two years of service.
- » **You can withdraw up to \$5,000 per parent penalty-free from your retirement plan for the birth or adoption of a child.** This new provision waives the normal 10 percent early withdrawal penalty and allows you to repay the withdrawn money as a rollover contribution.
- » **529 funds can be used to pay down student loans.** You can pay down up to \$10,000 in student loans and pay for qualifying apprenticeship programs.
- » **Employer matching of student loan repayments permitted.** Beginning in 2024, employers can elect to match student loan repayments in the form of retirement account contributions.
- » **Automatic employee enrollment in company 401(k) and 403(b) plans.** Beginning with new 401(k) and 403(b) plans in 2025, companies must automatically enroll eligible employees.
- » **Increase in retirement plan contribution limits for older workers.** As of 2023, workers aged 50 and older are able to contribute \$7,500 more per year (increased annually with inflation) than younger workers to most retirement plans. Beginning in 2025, the contribution limits for those aged 60 to 63 increases so that that age group may contribute up to \$10,000 more per year (increasing annually with inflation) than younger workers in most retirement plans and \$5,000 more annually for SIMPLE plans.
- » **Required minimum distributions (RMDs) from retirement accounts begin at age 72, not 70½.** Effective in 2023, the RMD increases to 73, and then to age 75 in 2033. This gives you more options and flexibility, but delaying required distributions that are based upon your life expectancy may or may not be in your best long-term interests.
- » **You can make traditional IRA contributions past age 70½ so long as you continue earning employment income.** This brings the contribution rules for these accounts into alignment with those for Roth IRAs and 401(k)s.
- » **Inherited retirement accounts must now be tapped and emptied through distributions generally within a decade.** Before when folks inherited a retirement account, the inheritor could stretch their distributions and associated tax payments out over their life expectancy. For retirement accounts now inherited from original owners who have passed away in 2020 or later years, most beneficiaries must complete withdrawals from the account within ten years of the death of the account holder. There are some exceptions to this ten-year rule for retirement accounts left to a surviving spouse, a minor child, a disabled or chronically ill beneficiary, and beneficiaries who are less than ten years younger than the original retirement account owner.

## Possible upcoming changes

Congress continually tinkers with our nation's tax laws. Bigger changes tend to occur when the same party controls both chambers of congress as well as the presidency. As this book goes to press in late 2023, we have been through a lengthy period where there has been lots of talk of tax increases by the Democrats, the party currently in control of the Senate and the presidency, but that has largely been blocked to date due to their super-slim majority in the Senate and by the Republican controlled House of Representatives.

With the 2024 elections on the horizon, history suggests that the most likely outcome for those elections will be continued divided government, which likely will mean more gridlock and less likelihood for tax increases or tax changes in general.