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GLOSSARY OF TAX TERMS SOURCE: ENTREPRENEUR

Accelerated depreciation. A depreciation method that allows larger deductions in the early years of an asset's "life" and smaller deductions at the end of the period. (See "Straight-line depreciation.")

Accrual method (or accrual basis). One of two main accounting methods for determining when a transaction has tax significance. The accrual method says that a transaction is taxed when an obligation to pay or a right to receive payment is created (for example, at the time products are delivered, services rendered, billings sent, etc.). This method is used by all but the smallest businesses. (See "Cash method (or cash basis).")

Adjusted basis. The cost of property (or a substitute figure-see "Basis") with adjustments made to account for depreciation (in the case of business property), improvements (in the case of real estate), withdrawals or reinvestment (in the case of securities, funds, accounts, insurance or annuities), etc. Adjusted basis is part of the computation for determining gain or loss on a sale or exchange and for depreciation.

Adjusted gross income. The amount of income considered actually "available" to be taxed. Adjusted gross income is gross income reduced principally by business expenses incurred to earn the income and other specified reductions (such as alimony).

Alternative minimum tax. An alternative tax system that says: your tax shall not go below this level. The alternative minimum tax works by negating (or minimizing) the effects of tax preferences or loopholes.

Amortization. The write-off of an amount spent for certain capital assets, similar to depreciation. This tax meaning is different from the common meaning of the term that describes, for example, payment schedules of loans.

Applicable Federal Rates (AFRs). Minimum interest rates that must be charged on various transactions that involve payments over a number of years. If the parties to a transaction do not adhere to these rates, the IRS will impute the interest. (See "Imputed interest.")

At-risk rules. Rules that limit an investor's deductible losses from an investment to the amount invested. Complications arise when investors finance their investment through loans that they are not personally on the hook for (nonrecourse financing). Without these rules, investors could raise their deduction limit considerably without being at-risk for the actual loss.

Basis. The starting point for computing gain or loss on a sale or exchange of property or for depreciation. (See "Adjusted basis.") For property that is purchased, basis is its cost. The basis of inherited property is its value at the date of death (or alternative valuation date). The basis of property received as a gift or a nontaxable transaction is based on the adjusted basis of the transferor (with some adjustments). Special rules govern property transferred between corporations and their shareholders, partners and their partnership, etc.

Cafeteria plan. A plan maintained by an employer that allows employees to select from a menu of taxable and nontaxable benefits.

Capital expenditures. Amounts spent to acquire or improve assets with useful lives of more than one year. These expenditures may not be deducted, but are added to the basis of the property (See "Adjusted basis.") and, for business property, may be converted into deductions through depreciation or amortization.

Capital gain or loss. Gain or loss from the sale or exchange of investment property, personal property (such as a home) or other "capital asset," which is often entitled to preferential tax treatment.

Carrybacks and carryforwards. Deductions that may be transferred to a year other than the current year because they exceeded certain limits. These deductions are typically carried back to earlier years first and, if they exceed the limits for those years, are then carried forward to later years until the deduction is used up. Charitable contributions and net operating losses are examples of deductions that may be carried back or forward.

Cash method (or cash basis). One of two main accounting methods for determining when a transaction has tax significance. The cash method says that a transaction is taxed when payment is made. This method is used by most individuals. (See "Accrual method (or accrual basis).")

Community property. A system governing spousal ownership of property and income that is the law in certain western and southern states and Wisconsin. The differences between community property and "common law" can change how federal tax law applies to spouses. For example: married taxpayers filing separately in a common law state do not have to report income earned by the other spouse. They do have to report income earned in a community property state.

Deferred compensation. An arrangement that allows an employee to receive part of a year's pay in a later year and not be taxed in the year the money was earned.

Depletion. A system similar to depreciation that allows the owner of natural resources (for example: a coal mine or an oil well) to deduct a portion of the cost of the asset during each year of its presumed productive life.

Depreciation. A system that allows a business or individual to deduct a portion of the cost of an asset ("recover its cost") during each year of its predetermined "life" (or "recovery period").

Earned income. Income earned by working for it. Interest, dividends and other kinds of profits are examples of unearned income.

Earned income credit. A tax credit available to individuals with low earned income. An individual is entitled to the full amount of this credit even if it exceeds the amount of tax otherwise due.

Employee stock ownership plan (ESOP). A type of profit-sharing plan in which benefits come in the form of stock in the employer.

Estimated tax. Quarterly down payments on a year's taxes that are required (on April 15, June 15, September 15, and January 15) if the total year's taxes will exceed $1,000 and the amount is not covered by withholding.

Federal Insurance Contributions Act (FICA). Social security taxes (for both old-age, survivors and disability insurance-OASDI-and Medicare).

Federal Unemployment Tax Act (FUTA). Unemployment taxes.

Filing status. One of four tax ranks determined by your marital status, your dependents and the way you file your tax return: (1) single, (2) married filing jointly, (3) married filing separately and (4) head of household. Filing status determines your tax rates and your eligibility for various tax benefits (for example: alimony deduction, IRA deduction, standard deduction, etc.).

First-in, first-out (FIFO). A rule that applies to the sale of part of a group of similar items (such as inventory, shares of the same stock, etc.) that assumes the first ones acquired were the first ones sold. This is important if the items in the group were acquired or manufactured at different times or for different costs. The rule may be overridden by identifying the specific item sold, if possible. (See "Last-in, first-out (LIFO).")

Generation-skipping transfer tax. An extra tax on gifts or on-death transfers of money or property that would otherwise escape the once-per-generation transfer taxes that apply to gifts and estates. For example: a gift from a grandfather to a granddaughter skips a generation and might be subject to this tax.

Golden parachutes. Bonuses payable to key executives in the event control of their corporation changes, as in the case of a takeover. "Excess" golden parachute payments are subject to tax penalties.

Gross income. All income that might be subject to tax. Most "realized" increases in wealth are considered income. The main exceptions for individuals are gifts, inheritances, increases in value of property prior to sale, loan repayments and some personal injury awards. For businesses, investments in their capital are not considered income.

Head of household. A filing status available to qualifying single parents (or others supporting certain dependents) that allows lower taxes than the normal rates for singles.

Imputed interest. A portion of a future payment that is treated as interest if parties to the transaction do not provide a stated amount of interest at a rate acceptable to the IRS. (See "Applicable Federal Rates (AFRs).") This prevents improper use of certain tax advantages (capital gains rates or tax deferral). For example: if a business sells an asset on the installment basis, part of all future payments is treated as interest whether the transaction states it or not.

Incentive stock option. A stock option that may be granted to an employee under tax-favored terms.

Itemized deductions. Personal deductions that may be taken if they total more than the standard deduction. (See "Standard deduction.") The following deductions are then itemized or listed on Schedule A of Form 1040: medical expenses, charitable contributions, state and local taxes, home mortgage interest, real estate taxes, casualty losses, unreimbursed employee expenses, investment expenses and others.

Investment credit. A credit against tax available for investment in a limited range of business property. The general investment credit was repealed in 1986, but this type of credit has been enacted and repealed repeatedly throughout history.

Involuntary conversion. The conversion of property into money under circumstances beyond the control of the owner. For example: (1) property that is destroyed and "converted" into an insurance settlement or (2) property that is seized by the government and "converted" into a condemnation award. Owners may avoid tax on any gain that may result (if the insurance settlement or condemnation award exceeds the adjusted basis of the property) by reinvesting in similar property within certain time limits.

Joint return. An optional filing status available to married taxpayers that offers generally (but not always) lower taxes than "married filing separately."

Keogh plan. A retirement plan available to self-employed individuals.

Last-in, first-out (LIFO). A rule that applies to the sale of part of a group of similar items in an inventory that assumes the last ones acquired were the first ones sold. This is important if the items in the group were acquired or manufactured at different times or for different costs. (See "First-in, first-out (FIFO).")

Like-kind exchanges. Tax-free swaps of investment property. Commonly used for real estate.

Limited liability company (LLC). A legal structure that allows a business to be taxed like a partnership but function generally like a corporation. An LLC offers members (among other things) protection against liability for claims against the business that is not available in a partnership.

Listed property. Property listed in the tax code or by the IRS that must comply with special rules before depreciation may be claimed. Cars and personal computers are examples of listed property. The special rules are designed to prevent deductions where the property is used for personal rather than business purposes.

Medical Spending Accounts (MSAs). An investment fund similar to an IRA that can be used to pay more routine medical expenses, when used in conjunction with "high-deductible" health insurance, which pays the big bills. Only 750,000 of these MSAs are available nationwide under a pilot program that runs through the year 2000. To qualify, you have to be self-employed or employed by a small employer that offers the program.

Modified Accelerated Cost Recovery System (MACRS). The system for computing depreciation for most business assets.

Net operating loss. The excess of business expenses over income. A business may apply a net operating loss to get a refund of past taxes (or a reduction of future taxes) by carrying it back to profitable years as an additional deduction (or by carrying it forward as a deduction to future years).

Original issue discount (OID). The purchase discount offered on some bonds (and similar obligations) in lieu of interest. For example: zero-coupon bonds. OID is generally treated as interest income to the holder rather than as a capital gain.

Passive activity loss (PAL). Loss on an investment that is deductible only up to the limit of gains from similar investments. The limit mainly affects tax shelters and does not apply to stocks, bonds or investments in businesses in which the investor materially participates. Special rules apply to investments in real estate.

Qualified plan. A retirement or profit-sharing plan that meets requirements about who must be covered, the amount of benefits that are paid, information that must be given to plan participants, etc. Qualified plans are entitled to tax benefits unavailable to nonqualified plans.

Real estate investment trust (REIT). A kind of "mutual fund" that invests in real estate rather than stocks and bonds.

Real estate mortgage investment conduit (REMIC). A kind of "mutual fund" that invests in real estate mortgages rather than stocks and bonds.

Recapture. The undoing of a tax benefit if certain requirements are not met in future years. For example: (1) The low-income housing credit may be recaptured or added back to tax if the credit property ceases to be used as low-income housing for a minimum number of years. (2) The alimony deduction may be retroactively lost or recaptured if payments do not continue at the requisite level for a minimum number of years.

Regulated investment company (RIC). A mutual fund.

Rollover. The tax-free termination of one investment and reinvestment of the proceeds. For example: An individual may roll over a lump-sum distribution from an employer's retirement plan into an IRA.

S corporation. A corporation with no more than 35 shareholders that is not taxed, but treated similarly to a partnership, if other requirements are met.

Savings Incentive Match Plan for Employees (SIMPLE plans). A simplified retirement arrangement for small businesses that comes in two varieties: one similar to a 401(k) plan and one that funds IRAs for employees.

Standard deduction. A deduction allowed individuals instead of listing or itemizing deductible personal expenses. (See "Itemized deductions.") The amount depends on the individual's filing status. Additional amounts are available for taxpayers who are blind or are age 65 or over. Individuals may deduct either their standard deduction or the total of their itemized deductions, whichever is greater.

Straight-line depreciation. A depreciation method that allows equal deductions in each year of an asset's "life" or recovery period. (See "Accelerated depreciation.")

Swaps, tax-free. (1) Exchanges of like-kind property that result in no capital gains tax (commonly used for real estate). (2) Sales and repurchases of stock (or other securities) designed to realize a tax loss without discontinuing the investment. Transactions must comply with the wash sale rules to be effective. (See "Wash sales.")

Taxable income. What is left after all deductions are taken. This is the amount upon which tax is computed.

Taxpayer identification number (TIN). In the case of an individual, the Social Security number. In the case of a business (even an individual in business), the employer identification number.

Top-heavy plan. An employee retirement or profit-sharing plan that disproportionately benefits top executives.

Uniform capitalization rules (Unicap). A set of uniform rules for computing the cost of goods produced by a business that prevents current deductions for costs that must be capitalized (See "Capital expenditures.") or added to inventory.

Wash sales. Simultaneous or near-simultaneous purchases and sales of the same property, usually stocks or bonds, made to generate deductible tax losses without discontinuing the investment. Losses on the transactions are ignored for tax purposes, however, unless a 30-day waiting period is observed between them.

Withholding allowances. Adjustments made to assure correct withholding on wages for individuals who may have unusually large deductions or who may be subject to other special circumstances.

Source: CCH Inc.