

Glossary of Terms

Note: The italicized words are also defined in this glossary.

401(k) Plan

An employer-provided retirement savings plan through which employees divert part of their pay to a tax-deferred investment account. Salary put in the plan is not taxed until it is later withdrawn, presumably in retirement. Employers often match part or all of the employee's deposits. Penalties usually apply to withdrawals before age 55, although most plans allow employees to borrow tax- and penalty-free from their accounts. The amount workers can set aside in these plans are gradually increasing. For 2004, the limit for employees was \$13,000 -- plus an extra \$3,000 for those age 50 and older. For 2005, the basic limit is \$14,000, and those 50 and older can contribute an extra \$4,000, for a maximum contribution of up to \$18,000. For 2006, the limit for employees will be \$15,000, and for those 50 and older an additional \$5,000 can be contributed.

Accelerated Depreciation

For most business property, except real estate, the law allows you to depreciate the cost at a rate faster than would be allowed under straight-line *depreciation*. For example, automobiles and computers are assumed to have a five-year life for tax purposes. With straight-line depreciation you would be permitted to write off 20% of the cost each year; the accelerated method generally lets you deduct 20% of the business cost the first year, 32% the second, 19.2% the third, 11.52% in years four and five, and the remaining 5.8% in the sixth year. It takes six years to fully depreciate the property, thanks to the "midyear convention," which, for simplicity, basically assumes that business assets are put into service in the middle of the year. In response to the September 11 terrorist attacks, Congress approved an extra 30% first-year depreciation for qualifying business assets put into use after September 10, 2001 and before September 11, 2004.

Acquisition Indebtedness

This is the technical term that Congress uses for what most of us call home mortgage debt on which the interest is deductible. To qualify, the debt must be used to buy, build or substantially improve your principal residence or a second home and must be secured by the property. The interest on up to \$1 million of acquisition indebtedness is deductible.

Active Participation

The level of involvement that real estate owners must meet to qualify to deduct up to \$25,000 of losses from rental real estate. Failure to pass this test could make such losses nondeductible under *passive-loss rules*.

Adjusted Basis

Your basis in property is the stepping-off point for determining taxable gain or loss when you sell it. The basis generally starts out as what you pay for the property, although special rules apply to assets you inherit or receive as a gift. Your basis can be adjusted while you own property. When you buy rental property, for example, the basis begins at what you pay for the place, including certain buying expenses and it is adjusted upward by the cost of permanent improvements. The basis is reduced by the amount of any *depreciation* you are allowed to deduct while you own the property. You use your adjusted basis to figure the gain or loss on the sale. When stock or mutual fund shares are involved, your adjusted basis is the cost of the shares plus any brokerage commissions or load fees minus any return of capital payouts.

Adjusted Gross Income (AGI)

This is your income from all taxable sources minus certain adjustments and is the key to determining your eligibility for certain tax benefits and the phase-out of your eligibility for others. It's the amount from which deductions (the standard deduction or itemized deductions) and the value of personal and dependent exemptions are deducted to arrive at the amount that will be taxed. The adjustments - sometimes called above-the-line deductions because you can claim them whether or not you itemize deductions - include deductible contributions to *IRAs* (individual retirement accounts), *SIMPLE* and *Keogh* plans, job-related moving expenses, any penalty paid on early withdrawal of savings, the deduction for 50% of the *self-employment tax* paid by self-employed taxpayers, *alimony* payments and up to \$2,500 of interest on higher education loans.

Adoption Credit

This credit effectively refunds to you part of what you pay to adopt a qualifying child. Starting in 2005, the size of the maximum credit increased to \$10,390. An eligible child

is generally one under age 18 or one who is physically or mentally incapable of caring for him or herself.

Advocate

See *Taxpayer Advocate*.

Alimony

Qualifying payments to an ex-spouse that can be deducted as adjustments to income whether or not you itemize. The recipient must include the payments in his or her *taxable income*.

Alternative Minimum Tax (AMT)

A special tax designed primarily to prevent the wealthy from using so many tax breaks that their regular tax bill is reduced to little or nothing. In recent years, it has hit more and more taxpayers who exercised incentive stock options at work. The AMT ignores certain tax benefits allowed by the regular rules and applies special rates - 26% and 28% - to a larger amount of income than is hit by the regular tax.

Amended Return

A revised tax return, filed on Form 1040X, to correct an error on a return filed during the previous three years. An amended return can result in owing added tax or deserving a refund, depending on the mistake you are correcting.

Audit

As if you didn't know, this is a review of your tax return by the IRS, during which you are asked to prove that you have correctly reported your income and *deductions*.

Bargain Sale to Charity

Selling property to a charity for less than the property's actual worth. Depending on the circumstances, this could result in a tax deduction or extra *taxable income*.

Basis

See *Adjusted Basis*.

Below-Market-Rate Loans

If you make an interest-free or bargain-rate loan to a friend or relative, you may be required to include in your *taxable income* some of the interest the IRS figures you should have charged.

Blind

A person is considered legally blind if:

- You are totally blind.
- You can't see better than 20/200 in your better eye with glasses or contact lenses,
or
- Your field of vision is 20 degrees or less.

Bond Premium

The amount over face value that you pay to buy a bond paying higher than current market rates. With taxable bonds, a portion of the premium can be deducted each year that you own the securities.

Burden of Proof

The responsibility of the taxpayer to prove that his or her tax return is accurate, rather than the IRS having to provide convincing evidence that it is inaccurate. Although Congress, with great fanfare, recently shifted the burden of proof to the IRS in certain tax disputes, don't throw away your records. The change will have no effect on the vast majority of taxpayers. The burden shifts only if a case gets to court -- which happens very rarely -- and then only if the taxpayer has complied with all record keeping requirements and has cooperated with IRS requests for information. In almost all cases, then, the burden of proof remains on your shoulders.

Capital Expenditure

The cost of a permanent improvement to property. Such expenses increase the property's *adjusted basis*.

Capital Gain

The profit from the sale of such property as stocks, mutual-fund shares and real estate. Gains from the sale of assets owned for 12 months or less are "short-term gains" and are taxed in your top tax bracket, just like salary. For most assets owned more than 12 months, profits upon sale are considered "long-term gains" and are taxed at a flat rate of 15%, unless you are in the 10% or 15% bracket, in which case a 5% rate applies. Assets owned more than five years before sale can produce "five-year gain," which enjoys even lower rates.

Capital Loss

The loss from the sale of assets such as stocks, bonds, mutual funds and real estate. Such losses are first used to offset capital gains and then up to \$3,000 of excess losses can be deducted against other income, such as your salary. Long- and short-term losses (distinguished by whether the property was held for more than one year or a shorter period of time) are first used to offset gains of a similar nature. Any excess first offsets the other kind of gain, then other types of income.

Capital-Loss Carryover

Capital losses can be used to offset capital gains, and up to \$3,000 of any excess loss can be deducted against other income, such as your salary. Losses not currently deductible because of the \$3,000 limit can be carried over to future years.

Casualty Loss

Damage that results from a sudden or unusual event. After being reduced by \$100, such losses are deductible to the extent that they exceed 10% of your *adjusted gross income*.

Charitable Contribution

A gift of cash or property to a qualified charity for which a tax deduction is allowed. A receipt is required as proof for any single contribution of \$250 or more.

Child Credit

For 2002, this credit is \$600 for each child under age 17 you claim as a dependent on your return. It will rise to \$700 in 2005 and ultimately to \$1,000 in 2010 (assuming your kids don't hit age 17 before then). The right to this credit is phased out as adjusted gross income rises over \$110,000 on a joint return, \$75,000 on an individual return or head of household return and \$55,000 if you're married filing separately. For each \$1,000 (or part thereof) that your AGI exceeds the threshold, you lose \$50 of credit.

Child- and Dependent-Care Credit

Not to be confused with the child credit, this one offsets part of the cost of paying for care for a child under the age of 13 or disabled *dependent* while you work. For 2005, the credit can shave as much as \$3,000 off your tax bill if you pay for the care of one individual or as much as \$6,000 if you pay for the care of two or more

Child Support

Payments made under a divorce or separation agreement for the support of a child. The payments are neither deductible by the person who pays them nor considered *taxable income* to the person who receives the money.

College Credits

The Hope credit is worth up to \$1,500 per year per student and is available for the first two years of vocational school or college. A lifetime learning credit is worth up to \$1,000 per year for additional schooling. You can claim a Hope credit for each qualifying student (including yourself, your spouse or your dependent child) for whom you pay tuition and other qualifying fees (but not the cost of books or room and board), so three children in college at the same time could earn you \$4,500 of credit. Only one lifetime learning credit can be claimed each year, however, for a maximum credit of \$1,000 per tax return. The right to these credits disappears as adjusted gross income rises between \$40,000 and \$50,000 on an individual return and between \$80,000 and \$100,000 on a joint return.

Combat Pay

Pay received by members of the U.S. Armed Forces and support personnel in combat zones, including peacekeeping efforts. Military pay received by enlisted personnel serving in combat or designated peacekeeping efforts is tax-free. Officer pay is tax-free up to the maximum pay for enlisted personnel (plus imminent danger/ hostile fire pay).

Constructive Receipt

A concept of tax law that taxes income at the time you could have received it, even if you don't actually have it. A paycheck you could pick up in December is considered constructively received and taxed in that year, even if don't get and cash the check until the following January. Also, interest paid on a savings account is considered constructively received and taxable in the year it is credited to your account, whether or not you withdraw the money.

Consumer Interest

See *Personal interest*.

Declaration Control Number (DCN)

A 14-digit number assigned to your return by your intermediate service provider and/or transmitter.

Deductions

Expenses you are permitted to subtract from your *taxable income*. All taxpayers may claim a standard deduction amount - \$4,850 (single), \$7,150 (HOH), \$9,700 (Jt) for 2005 for example. If your qualifying expenses exceed your *standard deduction*, you may claim the higher amount by itemizing your deductions. Although no records are needed to back up your right to the standard deduction, you must maintain records of qualifying expenditures if you itemize.

Dependent

Someone you support and for whom you can claim a dependency exemption on your tax return. For each dependent you claim, the exemption knocks \$3,100 off your *taxable income* in 2004. The value increases each year with inflation.

Depreciation

A deduction to reflect the gradual loss of value of business property as it wears out. The law assigns a tax life to various types of property, and your basis in such property is deducted over that period of time. (See "Accelerated Depreciation.")

Direct Transfer

A method to move funds from one individual retirement account or *Keogh plan* to another. You can also use this method to move money from a company retirement plan to an *IRA*. With a direct transfer, you order one sponsor to transfer the money directly to your new *IRA*; you do not take possession of the funds. There is no limit on the number of times you can move your money via direct transfer. However, if you take possession of the funds and personally deposit them in the new *IRA*, the switch is considered a *rollover*. You can use the rollover method only once each year for each *IRA* account you own. The direct transfer method must be used to move funds from a company retirement plan to an *IRA*, or else 20% of the money withdrawn from the company plan will be withheld for the IRS, even if no taxes are due.

Disabled

A person is permanently and totally disabled if both of the following apply:

1. He or she cannot engage in any substantial gainful activity because of a physical or mental condition; and
2. A physician determines that the condition has lasted or can be expected to last continuously for at least a year or can lead to death.

Earned Income

Compensation, such as salary, commissions and tips, you receive for your personal services. This is distinguished from "unearned" income such as interest, dividends and capital gains.

Education Interest

Interest on college loans can be deducted as an adjustment to income, so you get a benefit even if you don't itemize deductions. To qualify for the write off, the debt had to be incurred to pay higher education expenses for you, your spouse or your dependent. Up to \$2,500 of such interest can be deducted in 2004.

Education Savings Account (Coverdell IRA)

Formerly known as the education IRA, even though it has nothing to do with retirement. In 2002, an ESA allows you to put up to \$2,000 a year in a special account that will be

used to pay a student's school bills. There's no deduction for contributions but if the money is used to pay qualifying expenses, withdrawals are tax-free. The \$2,000 cap is the limit on how much can be set-aside for any student in one year, regardless of how many people contribute. Now, primary and high school bills count, too, and even the cost of a computer can qualify.

Enrolled Agent

A tax preparer who, by virtue of passing a tough IRS test or IRS experience, can represent clients at IRS audits and appeals.

Estate Tax

The federal tax that applies - beginning at a 37% rate - when a decedent's taxable estate exceeds \$1.5 million in 2005 and \$2 million in 2006. That tax-free amount is scheduled to rise as part of a plan to abolish the estate tax by 2010.

Estimated Tax

If you have income not subject to *withholding*, such as investment or self-employment income, you may have to make quarterly payments of the estimated amount needed to cover your expected tax liability for the year. You can be penalized if estimated payments, combined with withholding from wages, don't come within \$1,000 of 90% of the tax owed.

Exemptions

You can claim a personal exemption for yourself. On joint returns a personal exemption is claimed for each spouse. You also get an exemption for each *dependent* you claim on your return. Each exemption reduces *taxable income* by \$3,100 in 2004. (The value of exemptions is phased out at higher income levels.)

Expensing

Also known as the Section 179 deduction, expensing lets you treat up to \$102,000 of expenditures that normally would be depreciated over a number of years as current business expenses to be deducted immediately. This is completely phased out at \$410,000.

Filing Status

Your status determines the size of your *standard deduction* and the tax-rates that apply to your income. For tax purposes, you are considered single, married filing jointly, married filing separately, *head of household* or qualifying widow or widower.

Five-Year Averaging

This special tax-computation method for qualifying *lump-sum distributions* from company retirement plans is no longer available, but see the discussion of ten-year averaging.

Flexible Spending Account

See *reimbursement account*.

Gift Tax

To prevent people from avoiding the *estate tax* by giving their property away, the law includes a gift tax, too. You may give up to \$11,000 yearly to as many people you want without worrying about this tax. The \$11,000 limit applied for the first time in 2002 and continued through 2004; in prior years it was \$10,000. Larger gifts are taxable, but a tax credit offsets the tax on the first \$1 million of lifetime taxable gifts. Any part of the credit used to protect taxable gifts will not be available to reduce estate taxes. When the gift tax is owed, it is owed by the giver, not the recipient.

Gross Income

All of your income from taxable sources, before subtracting any adjustments, *deductions* or *exemptions*.

Head of Household

A *filing status* with lower tax rates for unmarried or some married persons considered unmarried (for purposes of this filing status) who pay more than half the cost of maintaining a home, generally, for themselves and a qualifying person, for more than half the tax year.

Health Savings Accounts

HSAs are tax-favored savings accounts designed to save money to pay medical bills. They work somewhat like individual retirement accounts. Contributions are deductible and earnings inside the account are not taxed as they build up. Unlike a regular IRA, though, withdrawals are not taxed, either, if the money is used to pay medical expenses. HSAs are open only to self-employed taxpayers or employees of firms that employ 50 or fewer workers. Also, to qualify for an HSA, you must have a high-deductible medical insurance policy. Basically, that means a policy that requires you to pay at least the first \$1,500 (if you are single) or \$3,000 (if it's a family policy) of medical bills before your insurance kicks in. Money in the HSA is supposed to be used to pay those bills.

Hobby-Loss Rule

One requirement for deducting business losses is that you show you are trying to make a profit. The law presumes you're in business for profit if you report a taxable profit for three years out of any five-year period. Otherwise, your activity is assumed to be a hobby, unless you can prove otherwise. The distinction is important because if the expenses of a hobby exceed the income, the difference is considered a personal expense, not a tax-deductible loss.

Hope Credit

See *College Credits*.

Holding Period

The period of time you own an asset for purposes of determining whether profit or loss on its sale is a short- or long-term capital gain or loss. Sales of assets owned one year or less produce short-term results. The sale of assets owned more than 12 months produces long-term results. The holding period begins on the day after you purchase an asset and ends on the day you sell it. If you buy on January 4, for example, your holding period begins January 5. If you sell the following January 4, you have owned the asset for exactly one year. . .and are stuck with short-term treatment. To be eligible for the gentler long-term tax treatment, you'd need to hold on until January 5, so that you have owned the asset for more than one year. (See *Capital gain*.)

Home-Equity Loans

Debt secured by your principal residence or second home - such as a second mortgage or home-equity line of credit - that is **not** used to buy, build or substantially improve the property. Although interest on most loans is no longer deductible, interest on up to \$100,000 of home-equity debt remains deductible.

Imputed Interest

Interest you are considered to have earned - and therefore owe tax on - if you make a below-market-rate loan. The term is also used to refer to the interest income you must report on taxable zero-coupon bonds. Although the bonds pay no interest until maturity, you must report and pay tax on the interest as it accrues.

Indexing

To prevent inflation from eroding certain tax benefits - including standard *deductions* and exemption amounts and the beginning and end of each *tax bracket* - they are automatically adjusted for increases in the consumer price index.

Individual 401(k) Plan

Changes in the 401(k) rules effective in 2005 allow a self-employed person with no employees to use a 401(k) plan to sock away -- and deduct -- far more for his or her retirement than in the past or in other retirement plans used by the self-employed, such as SEP and Keogh plans.

Individual Retirement Account (IRA)

A reference to an IRA without the moniker "Roth" in front of it is a reference to a traditional IRA, a tax-favored account designed to encourage saving for retirement. If your income is below a certain level or you are not covered by a retirement plan at work, deposits into a traditional IRA can be deducted. The maximum annual contribution for 2005 through 2007 is \$4,000 or 100% of the compensation earned during the year, whichever is less. (A husband or wife can, however, contribute part of his or her compensation to an IRA for a non-working spouse.) The tax on all earnings inside the IRA is postponed until you withdraw the funds. In most cases there is a penalty for withdrawing funds before you reach age 59 1/2. You can also contribute a catch up amount of \$500 if you are over the age of 50.

Innocent Spouse Rules

Tax rules designed to protect married taxpayers who file joint returns from being held responsible for taxes due to erroneous actions by their spouses -- such as failing to report income or claiming unsubstantiated deductions. Basically, if you can show that you didn't know and didn't have reason to know about error that resulted in the underpayment of tax on the joint return, you can be relieved of responsibility for that underpayment. You have two years from the time the IRS begins trying to collect the underpayment to petition for innocent spouse relief.

Installment Sale

With an installment sale you agree to have the purchaser pay you over a number of years, and you report the profit on the sale as you receive the money instead of all at once in the year of the sale. If you made an installment sale before May 7, 1997 - the effective date for the latest capital gains tax cut approved by Congress - the part of payments received on or after that date that represent long-term gain qualifies for the lower rate.

Investment Interest

Interest paid on loans used for investment purposes, such as to buy stock on margin. You can deduct this interest on Schedule A if you itemize, up to the amount of investment income (not including capital gains) you report.

Itemized Deductions

See *Deductions*.

Keogh Plan

Also known as an H.R. 10 plan, this is a retirement plan for the self-employed. As much as 25% of self-employment income (or \$41,000...whichever is less) can be deposited in a Keogh, and contributions can be deducted. There is no tax on the earnings until the money is withdrawn, and there are restrictions on tapping the account before age 59 1/2.

Kiddie Cards

A reference to the Social Security cards needed by any child you claim as a *dependent* on your tax return. The nine-digit identifying number shown on the card must be reported on the tax return of the parent who claims the child as a dependent. What if a child is born late in the year and you haven't received a social security number by the time you're ready to file? The IRS says you must delay filing, even if it means getting an extension to file past the April 15 deadline. If you claim a dependent and fail to include the number, the exemption will be rejected and your tax bill hiked accordingly.

Kiddie Tax

The tax - at the parents' tax rate - imposed on *unearned income* of children who are under age 14 at the end of the year. The kiddie tax applies to the child's unearned income between \$800 and \$8000.

Lifetime Learning Credit

See *College credits*.

Like-Kind Exchange

The tax-free exchange of similar assets, such as real estate for real estate. The tax on profit accrued in the first property is deferred until the subsequent property is sold.

Limited Partnerships

Investments - in real estate and oil and gas, for example - that pass both profits and losses on to investors. By definition, limited partnerships are passive investments, subject to the *passive-loss rules*.

Listed Property

"Listed property" is the term used for depreciable assets that Congress has put on a special list for special scrutiny by the IRS. Basically, this includes things Congress worries you might use for personal as well as business purposes - a car, computer, cellular telephone, boat, airplane and photographic and video equipment. (If a computer or photographic or video equipment is used exclusively at your regular place of business, however, it is not considered listed property.) There are special restrictions on the depreciation of listed property if business use does not exceed 50%.

Long-Term Gain or Loss

See *capital gain* or *capital loss*.

Lump-Sum Distribution

The payment within one year of the full amount of your interest in a pension or profit-sharing plan. To qualify as a lump-sum distribution - and for favorable *ten-year averaging* - other requirements must be met.

Marginal Tax Rate

The share of each extra dollar of income that will go to the IRS. It's not necessarily the same as the rate in your top *tax bracket* because in many cases rising income squeezes the value of tax breaks, so that the extra income is effectively taxed more harshly than advertised. Knowing your marginal rate tells you how much of each additional dollar you make will go to the IRS and how much you'll save for every dollar of *deductions* you claim.

Marital Deduction

The deduction that allows any amount of property to go from one spouse to the other - via lifetime gifts or bequests - free of federal gift or estate taxes.

Market Discount

The difference between what you pay for a bond and its higher face value. The tax treatment varies depending on whether the bond is taxable or tax-free and whether you redeem it at maturity or sell it before that time.

Master Limited Partnerships

Similar to regular *limited partnerships*, but MLPs shares are traded on the major exchanges, making for a much more liquid investment. Although limited-partnership losses are considered passive, income from an MLP is considered investment income rather than passive income. That means passive losses can't be used to shelter MLP income.

Material Participation

The test used to determine whether you are involved enough in a business to avoid the *passive-loss rules*. To be considered a material participant, you must be involved on a "regular, continuous and substantial basis." One way to pass the test is to participate in the business for more than 500 hours during the year.

Medicare Tax

The portion of the Social Security tax – 2.9% for employees and self-employed taxpayers - that pays for Medicare. Although the part of the tax that pays for retirement benefits stops at \$87,900 in 2005, the Medicare portion applies to all wages and self-employment income. In 2005, Kiplinger estimates that the limit for the Social Security portion of the tax will be \$87,900.

Midmonth Convention

The rule that treats certain kinds of depreciable property, including real estate, as though it were placed in service in the middle of the month it was first used.

Midquarter Convention

In general, business property is depreciated under a midyear rule that allows half a year's *depreciation* for the first year, whether you buy property in January or December. However, if you buy more than 40% of the business property you put into service for the year during the fourth quarter, the midquarter convention takes over. With it, you depreciate each piece of property as though it were placed into service in the middle of

the calendar quarter in which it was purchased. You claim just six weeks' worth of depreciation for property put in service during the final quarter, for example.

Mortgage Interest

A term often used to refer to deductible interest paid on debt that qualifies as *acquisition indebtedness* or home-equity debt.

Multiple-Support Agreement

An agreement under which two or more taxpayers, who together provide more than half the support for someone else, agree that one will claim that person as a *dependent* and the others will not.

Original Issue Discount (OID)

The amount by which the face value of a bond exceeds its issue price. Part of the discount on taxable bonds must be reported as taxable interest income each year that you own the securities.

Passive-Loss Rules

Passive activities are investments in which you do not materially participate. Losses from such investments can be used only to offset income from similarly passive investments. Passive losses generally can't be deducted against other kinds of income, such as salary or income from interest, dividends or capital gains. Generally, all real estate and limited-partnership investments are considered passive activities, but there is a limited exception for rental real estate in which you actively participate. Losses you can't use because you have no passive income to offset can be carried over to future years.

Personal Exemption

See *Exemptions*.

Personal Interest

Basically, this is interest that doesn't qualify as mortgage, business, student loan or *investment interest*. Included is interest you pay on credit cards, car loans, life insurance loans and any other personal borrowing not secured by your home. Personal interest cannot be deducted.

Points

In connection with getting a home mortgage, each point is equal to 1% of the mortgage amount. Points paid on a mortgage to buy or improve your principal residence are generally fully deductible in the year you pay them. You even get to deduct points paid for you by the seller of the home. Points paid to refinance the mortgage on a principal home or to buy any other property must be deducted over the life of the loan.

Preference Items

Tax breaks allowed under the regular income tax but not under the alternative minimum tax. One that is becoming more and more important to more and more taxpayers is the "spread" between the exercise price and the value of stock purchased with incentive stock options. Although that amount is not taxed under the regular tax, it is a preference item subject to tax if you're hit by the AMT.

Premature Distributions

Withdrawals from company retirement plans subject to a 10% penalty if you're under age 55 (in the year you leave the job) or under age 59 1/2 (if you're still employed).

Qualified Plan

An employee benefit plan - such as a pension or profit-sharing plan - that meets IRS requirements designed to protect employees' interests.

Reimbursement Account

A fringe benefit, sometimes called a flexible spending account or salary reduction plan, which allows an employee to divert some of his or her salary to a special account that is used to reimburse the employee for medical or child-care expenses. Funds channeled through the account escape federal income and Social Security taxes and, in almost all states, state income taxes as well.

Rollover

The tax-free transfer of funds from one individual retirement account to another. If you take possession of the funds, the money must be deposited in the new *IRA* within 60 days. You can only use the rollover method only once in any one year period to move money from one IRA to another. The once-a-year rule applies to each IRA you own so, for example, if you own two different IRAs -- accounts A and B -- you may use the rollover to transfer the money from account A to account C and, during the same year, use a rollover to move money from account B to account D.

You can also use a rollover to transfer funds from a company plan - when you receive a *lump-sum distribution* at retirement, for example - to an IRA. The tax bill is delayed until you withdraw funds from the IRA. (Beware that when the rollover method is used to move money from a company plan to an IRA, 20% of the amount will be withheld for the IRS, even though the rollover is tax-free if the money is in the IRA within 60 days. To avoid this automatic withholding, use the direct transfer method to move money from a company plan to an IRA.).

Roth IRA

The backloaded IRA named after a chief supporter - Sen. William Roth of Delaware. It's called backloaded because the tax benefits come at the end of the line. Contributions are not deductible but all withdrawals are tax-free, as long as they come after you reach age 59 1/2 and at least four calendar years after the year in which the account was opened. Up to \$4,000 can be contributed to a Roth IRA in 2005, \$5,000 in 2006 and as long as your adjusted gross income is under \$150,000. For taxpayers' age 50 and older, the annual catch up provision is \$4,000 in 2005 and \$5,000 year in 2006. You can roll over funds

from an old IRA to a Roth IRA - so that all future earnings would be tax-free rather than simply tax deferred. But to do so, you have to pay tax on the money you move from the old IRA to the Roth.

S Corporation

Named after the subchapter of the tax law that authorizes it, an S corporation generally pays no tax because profits and losses are passed on and taxed to the shareholders.

Salary Reduction Plan

Whenever you have deductions such as a 401(k) or health insurance savings account, you will be reducing your taxable income.

Self-Employment Tax

The tax due on self-employment income to pay for Social Security retirement and Medicare benefits. For 2005, the rate is 15.30% on the first \$87,900 of earnings and 2.9% on all amounts over that amount.

Short-Term Gains and Losses

See *Capital gain* or *Capital loss*.

SIMPLE

The Savings Incentive Match Plan for Employees (SIMPLE) is a retirement plan that can be offered by firms with 100 or fewer employees. A key is that the employer generally must match employee contributions up to 3% or contribute 2% of pay for each employee, whether or not they contribute on their own. The rules are simpler than for other tax-qualified retirement plan, and Congress hopes that this will encourage smaller employers

to establish plans. For 2005, a self-employed person with no employees could open a SIMPLE and contribute up to \$10,000 of self-employment earnings (\$12,000 if age 50 or older).

Standard Deduction

A no-questions-asked write-off that reduces *taxable income*, the amount of which varies depending on your *filing status*. For 2004, for example, the standard deduction is \$9,700 on a joint return, \$4,850 on a single return and \$7,150 on a *head of household* return. Taxpayers age 65 and older get larger standard *deductions*. Unlike taxpayers who itemize deductions, you need no records to prove you deserve this deduction. Even if you somehow made it through the year without incurring any deductible expenses, you may still claim the full standard deduction. About two-thirds of all taxpayers use the standard deduction rather than itemize.

Standard Mileage Rate

The deductible amount you can claim for each mile you use your car for business, charitable, job-related moving or medical purposes without having to keep track of the actual cost. For 2004, the standard rate for business travel was 37.5 cents a mile; for charitable use of your car, it is 14 cents a mile; for job-related moving or medical purposes, it's 13 cents a mile. In any case, you add the cost of parking and tolls.

Stepped-up Basis

The basis of inherited property is stepped-up to its value on the date of death of the owner, or a slightly later date if chosen by the executor of a taxable estate. In other words, tax on any appreciation during his or her lifetime is forgiven. The heir uses the higher basis to figure his or her gain when the property is ultimately sold.

Taxable Income

This can mean different things. It can refer to income that is taxable (such as wages, interest and dividends) rather than tax-exempt (such as the interest on municipal bonds).

On tax returns, "taxable income" is your income after subtracting all adjustments, *deductions* and *exemptions* - that is, the amount on which your tax bill is computed.

Tax Bracket

Each tax bracket encompasses a certain amount of income to be taxed at a set rate. For 2004, the brackets are: 10%, 15%, 25% 28%, 33% or 35%. Some of your income -- such as the amounts protected by your personal and any dependent exemptions and your standard or itemized deductions -- is tax-free.

Tax-Exempt Interest

Interest paid on bonds issued by states or municipalities that is tax-free for federal income tax purposes. Although you must report this income on your return, it is not taxed.

Tax-Free Income

Tax-free vehicles can be either state tax free, federal tax-free or both. Check with your advisor to see which would be the most advantageous to you.

Taxpayer Advocate

The official inside the IRS who is charged with helping individuals resolve their problems with the IRS, as well as identifying changes in IRS procedures that could make the agency more taxpayer-friendly. This official oversees IRS Problem Resolution Officers (PRO) around the country. You should go to a PRO, or ultimately the Advocate, if you are getting the run-around - or worse - from regular IRS channels.

Ten-Year Averaging

Even though five-year averaging has been abolished, this special tax-computation method for lump-sum distributions from pension and profit-sharing plans is still available, but only to taxpayers born before January 1, 1936. If you qualify, it could save you a substantial amount.

Tuition Credit

In 2004 and 2005, you can deduct up to \$2,000 you spend for college tuition and other qualifying expenses within the first two years of college (Hope Credit). This deduction is an adjustment to income, so you can get the benefit even if you don't itemize deduction. This credit is eliminated if your AGI is greater than \$52,000 if you are single or \$105,000 if you are filing a joint return. You can claim the deduction in future years (Lifetime Learning Credit) of up to \$2,000 per year with the same phase out rules as the Hope Credit.

Unearned Income

Income from investments, such as interest, dividends and capital gains.

Voluntary Withholding

You can now ask the Social Security Administration to withhold taxes from your social security benefits. This could make sense if withholding allows you to avoid making quarterly estimated tax payments. To request voluntary withholding, file a W-4V form with Social Security.

Wage Base

The level of earnings to which the full Social Security tax applies. For 2005, the full 15.30% tax applies to the first \$87,900 of wages or self-employment income and the 2.9% Medicare portion applies to all income over that level. (Employees pay half the tax -- 7.65% up to the wage base limit and 1.45% after that -- and their employers pay the other half. Self-employed taxpayers have to pay it all.)

Wash Sale

The sale of stocks, bonds or mutual fund shares for a loss when, within 30 days before or after that sale, you buy the same or substantially identical securities. The law forbids the deduction of the loss.

Withholding

The amount held back from your wages each payday to pay your income and social security taxes for the year. The amount withheld is based on the size of your salary and the form W-4 from your employer