**8507. Why are many tax provisions indexed for inflation each year?**

Many tax provisions are indexed annually for inflation so that increases in a taxpayer’s income that result solely from inflation does not push them in a higher tax bracket or over thresholds that would reduce or eliminate certain tax benefits.

For example, Asher a single taxpayer earns $89,350 as the manager of a computer superstore. Assume at that income level, Asher is at the very end of the 25% tax bracket. At the end of the year, he receives a cost of living adjustment (another term for an adjustment for inflation) that increases his salary to $92,000. If tax brackets were not indexed for inflation, Asher’s cost of living raise of $2,650 ($92,000 minus $89,350) would be taxed at 28%. Yet, based on inflation, $92,000 of today’s dollars is the equivalent of $89,350 of yesterday’s dollars. Thus, without indexing, Asher would experience a tax hike. However, by adjusting the tax brackets by inflation, i.e., increasing the 25% bracket to $92,000, Asher’s tax liability essentially remains unchanged.

The following are examples of tax sensitive items indexed for inflation:

* Individual income tax brackets
* Basic standard deduction
* Additional standard deduction (taxpayers 65 or older)
* Exemptions
* Alternative minimum tax exemption amount
* Maximum earned income credit
* Overall limitation on itemized deductions
* Education credits (Hope Scholarship, American Opportunity and Lifetime Learning Credits)
* Adoption credit
* Child tax credit
* Low income housing credit
* Phase out of exemptions
* Deductibility of interest on education loans[[1]](#endnote-1)

**8507.02 What indexing factor does the IRS use to make the adjustments for inflation?**

The indexing factor (referred to in the IRC as the cost-of-living adjustment) is the percentage by which the Consumer Price Index (CPI) for the prior calendar year exceeds the CPI for a year designated as a reference point in each respective IRC Section. In all cases, the CPI is the average Consumer Price Index as of the close of the 12-month period ending on August 31 of the calendar year.[[2]](#endnote-2) Thus, for example, in calculating the new tax rate schedules, the minimum and maximum dollar amounts for each rate bracket (except as described below) are increased by the applicable cost-of-living adjustment. The rates (percentages) themselves are not adjusted automatically for inflation. This method of increase explained above, however, does not apply to the phase out of the marriage penalty in the 15 percent bracket.[[3]](#endnote-3)

The Secretary of the Treasury has until December 15 of each calendar year to publish new tax rate schedules (for joint returns, separate returns, single returns, head of household returns and for returns by estates and trusts) that will be effective for taxable years beginning in the subsequent calendar year.[[4]](#endnote-4) As a practical matter the new numbers for the following tax year are often available as early as October of the preceding year. For a schedule of current tax rates, see Q 8506.

1. Rev. Proc. 2013-35, 2013-47 IRB 537, [↑](#endnote-ref-1)
2. IRC Secs. 1(f)(3), 1(f)(4). [↑](#endnote-ref-2)
3. IRC Sec. 1(f)(2). [↑](#endnote-ref-3)
4. IRC Sec. 1(f)(1). [↑](#endnote-ref-4)