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INFLATION ADJUSTMENTS AFFECTING INDIVIDUAL TAXPAYERS IN 2006: ANALYSIS AND COMMENTARY

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Without inflation adjustments to key portions of the tax system, individuals would be faced with an erosion of their purchasing power. Beginning in 1985, Congress implemented an indexation procedure to adjust various income tax components, including the tax rate schedules, standard deduction, and personal and dependency exemptions. Although suspended by the Tax Reform Act of 1986, indexation resumed in 1989 and now applies to many items in the tax system.

In this article, Young discusses 2006 inflation adjustments to specific portions of the individual tax system that are tied to a "consumer price index year" ending in August. Items adjusted by that indexation procedure include the tax rate schedules, standard deductions, exemptions (and related phaseout), the overall limit on itemized deductions, the annual gift tax exclusion, and some computational elements related to the unearned income of minor children, child credit, earned income tax credit, adoption expenses, educational savings bonds, education credits, education loan interest, qualified transportation fringe benefits, medical savings arrangements (Archer MSAs), health savings accounts, long-term care insurance premiums, and the section 179 expense election.

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Introduction

Some provisions of the Internal Revenue Code are structured to reflect the impact of inflation. Those provisions require reference to noncode information (that is, a cost-of-living index) to make the computations. Indexation and taxation generally became intertwined in the Economic Recovery Tax Act of 1981 (P.L. 97-34). Because inflation erodes the value of the various fixed dollar amounts specified in the code to determine tax liability, Congress enacted inflation adjustment mechanisms for several provisions. The number of code provisions subject to inflation adjustment continues to expand. Also, the manner in which calculations are made often differs across the code provisions. This article provides information related to inflation adjustments based on a "consumer price index year" ending in August.

The measure used most often for making adjustments to amounts specified in the code is the Consumer Price Index for All-Urban Consumers (CPI-U). The index, issued monthly by the Bureau of Labor Statistics, is intended to reflect changes in a market basket of goods and services purchased by consumers and the weighting factors for items in the market basket. The Consumer Price Index reports changes in prices for a fixed group of items rather than the amount of money spent. It is based on the assumption that the same items in the market basket are purchased in the same proportions (or weight) month after month. Technically, it is a price index rather than a cost-of-living index.

2006 Inflation Adjustments

The annual inflation adjustments are determined by examining the increase in the CPI-U (section 1(f)(5)). The increase in CPI is determined by comparing the *average* CPI for any 12-month period ending August 31 with the *average* CPI for the appropriate base period specified by statute. The following table summarizes the various base periods and their related CPIs:

Item	Base Period Is the 12-Month Period Ending	Base Period CPI	Adjustment First Occurs in Calendar Year
Standard deduction	August 31, 1987	111.9833333	1989
Unearned income of minor child (base amount)	August 31, 1987	111.9833333	1989
Exemptions	August 31, 1988	116.6166667	1990
Educational savings bonds	August 31, 1989	122.1500000	1991
Exemption phaseout	August 31, 1990	128.0583333	1992
Itemized deduction limitation (3% of AGI)	August 31, 1990	128.0583333	1992
Tax rate schedules:			
10% bracket	August 31, 2002	178.6750000	2004
15%/25%/28% brackets	August 31, 1992	138.9250000	1994
33%/35% brackets	August 31, 1993	143.1750000	1995
Earned income credit	August 31, 1995	151.0750000	1997
Standard deduction for employed dependents	August 31, 1997	159.4916667	1999
Medical savings accounts	August 31, 1997	159.4916667	1999
Annual gift tax exclusion	August 31, 1997	159.4916667	1999
Qualified transportation fringe benefits:			
Categories 1 and 2	August 31, 2001	175.8750000	2003
Category 3	August 31, 1998	162.1833333	2000
HOPE, lifetime learning, and child tax credits	August 31, 2000	170.3083333	2002
Education loan interest	August 31, 2001	175.8750000	2003
Adoption expenses/credit	August 31, 2001	175.8750000	2003
Section 179 expense amounts	August 31, 2002	178.6750000	2004

2006 inflation factors. For the 12-month period ended August 31, 2005, the average CPI for all-urban consumers is 192.7666667. As a result, the 2006 inflation factors are as follows:

Item	CPI Difference	Inflation Adjustment Factor (1 + (CPI Difference/ Base Period CPI))
Standard deduction	192.7666667 - 111.9833333 = 80.7833334	1.7213871
Unearned income of minor child (base amount)	192.7666667 - 111.9833333 = 80.7833334	1.7213871
Exemptions	192.7666667 - 116.6166667 = 76.1500000	1.6529941
Educational savings bonds	192.7666667 - 122.1500000 = 70.6166667	1.5781143
Exemption phaseout	192.7666667 - 128.0583333 = 64.7083334	1.5053036
Itemized deduction limitation (3% of AGI)	192.7666667 - 128.0583333 = 64.7083334	1.5053036
Tax rate schedules:		
10% rate bracket	192.7666667 - 178.6750000 = 14.0916667	1.0788676
15%/25%/28% brackets	192.7666667 - 138.9250000 = 53.8416667	1.3875592
33%/35% brackets	192.7666667 - 143.1750000 = 49.5916667	1.3463710
Earned income credit	192.7666667 - 151.0750000 = 41.6916667	1.2759667
Standard deduction for employed dependents	192.7666667 - 159.4916667 = 33.2750000	1.2086316
Medical savings accounts	192.7666667 - 159.4916667 = 33.2750000	1.2086316
Annual gift tax exclusion	192.7666667 - 159.4916667 = 33.2750000	1.2086316
Qualified transportation fringe benefits:		
Categories 1 and 2	192.7666667 - 175.8750000 = 16.8916667	1.0960436
Category 3	192.7666667 - 162.1833333 = 30.5833334	1.1885726
HOPE, lifetime learning, and child tax credits	192.7666667 - 170.3083333 = 22.4583334	1.1318687
Education loan interest	192.7666667 - 175.8750000 = 16.8916667	1.0960436
Adoption expenses/credit	192.7666667 - 175.8750000 = 16.8916667	1.0960436
Section 179 expense amounts	192.7666667 - 178.6750000 = 14.0916667	1.0788676

Those factors are applied to specified dollar amounts in the appropriate code provision. Rounding conventions differ and are specified by statute.

Standard Deduction and Exemption Amounts

According to section 1(f) (and sections 63(c)(4) and 151(d)(3)), the standard deduction and exemption amounts are to be adjusted by the appropriate CPI increase (section 1(f)(5)). Any increases computed for those items are rounded down to the nearest $50 multiple ($25 for married, filing separately) (section 1(f)(6)). Similar adjustments are made to the adjusted gross income amounts used to phase out exemptions.

Standard deduction amounts. The standard deduction amounts specified by section 63(c) are adjusted annually for inflation. The standard deduction for married taxpayers filing a joint return is specified by law to be twice the standard deduction for single taxpayers (section 63(c)(2)). After adjustment, the 2006 standard deduction amounts will be as follows (2005 amounts for comparison):

	2006	2005
Single individual	$5,150	$5,000
Married, filing jointly and surviving spouse	10,300	10,000
Head of household	7,550	7,300
Married, filing separately	5,150	5,000

Additional standard deductions for elderly and blind. For a taxpayer (and spouse) who is elderly (age 65 or over) or blind, the following applies (section 63(f)):

1. *Unmarried taxpayer:* An additional $1,250 (unchanged from 2005) standard deduction is allowed ($2,500 for a taxpayer who is both elderly and blind).

2. *Married taxpayer:* An additional $1,000 (unchanged from 2005) standard deduction is allowed ($2,000 for a taxpayer who is both elderly and blind).

Limitation for dependents. If an individual may be claimed as a dependent on another taxpayer's return, the basic standard deduction is limited (section 63(c)(5)). For dependents with earned income (but total income less than the basic standard deduction), a slightly increased standard deduction (of up to $250) is available. Both the limited standard deduction ($500) and the additional earned income standard deduction ($250) are indexed annually for inflation. In 2006 a dependent's basic standard deduction is limited to the *lesser* of:

1. The basic standard deduction for single taxpayers ($5,150); or
2. The *greater* of:
   a. $850 (up from $800 in 2005); or
   b. The dependent's earned income plus $300 (up from $250 in 2005).

In 2005 a dependent's basic standard deduction is limited to the *lesser* of:

1. The basic standard deduction for single taxpayers ($5,000); or
2. The *greater* of:
   a. $800; or
   b. The dependent's earned income plus $250.

Exemption amount. After adjustment for inflation, the 2006 exemption amount will be $3,300 (up from $3,200 in 2005). The 1989 exemption amount of $2,000 is used as the base.

Exemption phaseout. Exemption amounts claimed on a tax return are subject to a phaseout as the taxpayer's AGI exceeds a threshold amount (section 151(d)(3)). Specifically, *all* exemption amounts claimed on a return are reduced by 2 percent for each $2,500 (or fraction thereof) of AGI in excess of the appropriate threshold amount ($1,250 for a married individual filing separately). As a result, exemption deductions are completely eliminated when AGI exceeds the AGI threshold amount by more than $122,500 ($61,250 for a married individual filing separately). The table below shows the AGI threshold amounts for 2006 (2005 amounts for comparison).

That phaseout will be gradually eliminated beginning in 2006. The phaseout will be reduced by one-third in 2006 and 2007, two-thirds in 2008 and 2009, and completely eliminated in 2010.

Tax Rate Schedules

The minimum and maximum dollar amounts for each rate bracket (sections 1(a) through (e)) are adjusted annually for inflation (section 1(f)(6)). Any increases computed for those items are rounded down to the nearest $50 multiple ($25 for married, filing separately). The 2006 tax rate schedules appear in Table 1; the 2005 tax rate schedules are presented in Table 2.

Overall Limitation on Itemized Deductions

Total itemized deductions otherwise allowable are reduced by 3 percent of a taxpayer's AGI in excess of specified threshold amounts (section 68). That overall limitation

Exemption Phaseout	2006		2005	
	Phaseout Begins When AGI Exceeds	Phaseout Completed When AGI Exceeds	Phaseout Begins When AGI Exceeds	Phaseout Completed When AGI Exceeds
Single individual	$150,500	$273,000	$145,950	$268,450
Married, filing jointly and surviving spouse	225,750	348,250	218,950	341,450
Head of household	188,150	310,650	182,450	304,950
Married, filing separately	112,875	174,125	109,475	170,725

Table 1
2006 Tax Rate Schedules

Single (section 1(c)):	
If taxable income is:	The tax is:
Not over $7,550	10% of taxable income.
Over $7,550 but not over $30,650	$755.00, plus 15% of the excess over $7,550.
Over $30,650 but not over $74,200	$4,220.00, plus 25% of the excess over $30,650.
Over $74,200 but not over $154,800	$15,107.50, plus 28% of the excess over $74,200.
Over $154,800 but not over $336,550	$37,675.50, plus 33% of the excess over $154,800.
Over $336,550	$97,653.00, plus 35% of the excess over $336,550.
Head of Household (section 1(b)):	
If taxable income is:	The tax is:
Not over $10,750	10% of taxable income.
Over $10,750 but not over $41,050	$1,075.00, plus 15% of the excess over $10,750.
Over $41,050 but not over $106,000	$5,620.00, plus 25% of the excess over $41,050.
Over $106,000 but not over $171,650	$21,857.50, plus 28% of the excess over $106,000.
Over $171,650 but not over $336,550	$40,239.50, plus 33% of the excess over $171,650.
Over $336,550	$94,656.50, plus 35% of the excess over $336,550.
Married, Filing Jointly and Surviving Spouse (section 1(a)):	
If taxable income is:	The tax is:
Not over $15,100	10% of taxable income.
Over $15,100 but not over $61,300	$1,510.00, plus 15% of the excess over $15,100.
Over $61,300 but not over $123,700	$8,440.00, plus 25% of the excess over $61,300.
Over $123,700 but not over $188,450	$24,040.00, plus 28% of the excess over $123,700.
Over $188,450 but not over $336,550	$42,170.00, plus 33% of the excess over $188,450.
Over $336,550	$91,043.00, plus 35% of the excess over $336,550.
Married, Filing Separately (section 1(d)):	
If taxable income is:	The tax is:
Not over $7,550	10% of taxable income.
Over $7,550 but not over $30,650	$755.00, plus 15% of the excess over $7,550.
Over $30,650 but not over $61,850	$4,220.00, plus 25% of the excess over $30,650.
Over $61,850 but not over $94,225	$12,020.00, plus 28% of the excess over $61,850.
Over $94,225 but not over $168,275	$21,085.00, plus 33% of the excess over $94,225.
Over $168,275	$45,521.50, plus 35% of the excess over $168,275.
Estates and Trusts (section 1(e)):	
If taxable income is:	The tax is:
Not over $2,050	15% of taxable income.
Over $2,050 but not over $4,850	$307.50, plus 25% of the excess over $2,050.
Over $4,850 but not over $7,400	$1,007.50, plus 28% of the excess over $4,850.
Over $7,400 but not over $10,050	$1,721.50, plus 33% of the excess over $7,400.
Over $10,050	$2,596.00, plus 35% of the excess over $10,050.

applies to itemized deductions after all other floors have been applied. After application of the 3 percent floor, the "net itemized deductions" remain.

Threshold amount. For 2006 the threshold amount is $150,500 for *all taxpayers* except a married individual filing separately, in which the threshold is $75,250. For 2005 the threshold amount is $145,950 for *all taxpayers* except a married individual filing separately, in which the threshold is $72,975.

That limitation will be phased out beginning in 2006. The limitation will be reduced by one-third in 2006 and 2007, two-thirds in 2008 and 2009, and completely eliminated in 2010.

Annual Gift Tax Exclusion

Since 1999 the annual gift tax exclusion is subject to an inflation adjustment, with any increase rounded down to the nearest $1,000 multiple (section 2503(b)). The 1998 exclusion amount of $10,000 is used as the base. For 2006 the annual gift tax exclusion will be $12,000 (up from $11,000 in 2005).

Unearned Income of Minor Children

The federal tax liability of a minor child having gross income is computed in the same manner as any other taxpayer. However, intrafamily transfers of income-producing property will not reduce the family's overall income tax liability by shifting income from the parents'

Table 2
2005 Tax Rate Schedules

Single (section 1(c)):	
If taxable income is:	The tax is:
Not over $7,300	10% of taxable income.
Over $7,300 but not over $29,700	$730.00, plus 15% of the excess over $7,300.
Over $29,700 but not over $71,950	$4,090.00, plus 25% of the excess over $29,700.
Over $71,950 but not over $150,150	$14,652.50, plus 28% of the excess over $71,950.
Over $150,150 but not over $326,450	$36,548.50, plus 33% of the excess over $150,150.
Over $326,450	$94,727.50, plus 35% of the excess over $326,450.
Head of Household (section 1(b)):	
If taxable income is:	The tax is:
Not over $10,450	10% of taxable income.
Over $10,450 but not over $39,800	$1,045.00, plus 15% of the excess over $10,450.
Over $39,800 but not over $102,800	$5,447.50, plus 25% of the excess over $39,800.
Over $102,800 but not over $166,450	$21,197.50, plus 28% of the excess over $102,800.
Over $166,450 but not over $326,450	$39,019.50, plus 33% of the excess over $166,450.
Over $326,450	$91,819.50, plus 35% of the excess over $326,450.
Married, Filing Jointly and Surviving Spouse (section 1(a)):	
If taxable income is:	The tax is:
Not over $14,600	10% of taxable income.
Over $14,600 but not over $59,400	$1,460.00, plus 15% of the excess over $14,600.
Over $59,400 but not over $119,950	$8,180.00, plus 25% of the excess over $59,400.
Over $119,950 but not over $182,800	$23,317.50, plus 28% of the excess over $119,950.
Over $182,800 but not over $326,450	$40,915.50, plus 33% of the excess over $182,800.
Over $326,450	$88,320.00, plus 35% of the excess over $326,450.
Married, Filing Separately (section 1(d)):	
If taxable income is:	The tax is:
Not over $7,300	10% of taxable income.
Over $7,300 but not over $29,700	$730.00, plus 15% of the excess over $7,300.
Over $29,700 but not over $59,975	$4,090.00, plus 25% of the excess over $29,700.
Over $59,975 but not over $91,400	$11,658.75, plus 28% of the excess over $59,975.
Over $91,400 but not over $163,225	$20,457.75, plus 33% of the excess over $91,400.
Over $163,225	$44,160.00, plus 35% of the excess over $163,225.
Estates and Trusts (section 1(e)):	
If taxable income is:	The tax is:
Not over $2,000	15% of taxable income.
Over $2,000 but not over $4,700	$300.00, plus 25% of the excess over $2,000.
Over $4,700 but not over $7,150	$975.00, plus 28% of the excess over $4,700.
Over $7,150 but not over $9,750	$1,661.00, plus 33% of the excess over $7,150.
Over $9,750	$2,519.00, plus 35% of the excess over $9,750.

(generally higher) marginal tax rate to a child's (generally lower) tax bracket. Instead, the "net unearned income" of a minor child (section 1(g)(2)) is taxed at the parents' marginal tax rate (section 1(g) and reg. section 1.1(i)-1T).

Net unearned income. The net unearned income computation contains a base amount that is subject to an inflation adjustment each year. Also, the computation allows a subtraction for a portion (or all) of the child's standard deduction, which also is subject to an inflation adjustment (discussed previously). For 2006 net unearned income is computed as follows (section 1(g)(4)):

	Unearned Income
Less:	$850 (up from $800 in 2005)
Less:	The *greater* of:
	(1) $850 of the standard deduction (or $850 of itemized deductions) (up from $800 in 2005);
	OR
	(2) The amount of allowable deductions that are directly connected with the production of the unearned income.
Equals:	Net Unearned Income

Tax Year	Number of Qualifying Children	Earned Income Base Amount	Credit Percentage	Maximum Credit	Phaseout Base	Phaseout Percentage	Phaseout Ends at Income of:
2006	*Married, Filing Jointly:*						
	No children	$5,380	7.65	$412	$8,740	7.65	$14,120
	One child	8,080	34.00	2,747	16,810	15.98	34,001
	Two or more children	11,340	40.00	4,536	16,810	21.06	38,348
	Other Taxpayers:						
	No children	$5,380	7.65	$412	$6,740	7.65	$12,120
	One child	8,080	34.00	2,747	14,810	15.98	32,001
	Two or more children	11,340	40.00	4,536	14,810	21.06	36,348
2005	*Married, Filing Jointly:*						
	No children	$5,220	7.65	$399	$8,530	7.65	$13,750
	One child	7,830	34.00	2,662	16,370	15.98	33,030
	Two or more children	11,000	40.00	4,400	16,370	21.06	37,263
	Other Taxpayers:						
	No children	$5,220	7.65	$399	$6,530	7.65	$11,750
	One child	7,830	34.00	2,662	14,370	15.98	31,030
	Two or more children	11,000	40.00	4,400	14,370	21.06	35,263

If net unearned income is $0 (or negative), the child's tax is computed without regard to that provision.

Election to place unearned income on parent's return. If some requirements are met (section 1(g)(7)(A)), a parent may elect to include the unearned income of a minor child on his or her return (section 1(g)(7)). Form 8814 is used to make the election. Making the election eliminates the need for the child to file a tax return. The section 1(g)(7) election amounts are linked to the inflation-adjusted amounts used in computing net unearned income (section 1(g)(4)).

In 2006 the section 1(g)(7) election can be made if a child has gross income (exclusively from interest and dividends) between $850 and $8,500 (up from between $800 and $8,000 in 2005) and the other requirements of section 1(g)(7)(A) are met. In 2006 the tax on a child's first $1,700 of unearned income will be the lesser of $85 ($850 x 10%) or 10 percent of unearned income exceeding $850. If the child has unearned income in excess of $1,700, it will be taxed at the parent's highest marginal tax rate.

Alternative minimum tax exemption. Minor children with unearned income face a reduced AMT exemption amount (section 59(j)). In general, the AMT exemption is limited to the child's earned income plus $5,000 (but no more than the AMT exemption for single taxpayers). The $5,000 amount is subject to an annual inflation adjustment and rounded to the nearest $50 multiple. In 2006 the addition to earned income will be $6,050 (up from $5,850 in 2005).

Child Tax Credit

The child tax credit provisions allow taxpayers to take a tax credit based on the number of eligible dependent children (section 24). The child tax credit is $1,000 per child. For higher-income taxpayers, the available credit begins to phase out when AGI reaches $110,000 for married couples filing a joint return, $55,000 for married couples filing separately, and $75,000 for all other taxpayers. Those threshold amounts are *not* indexed for inflation. For lower-income taxpayers, the child tax credit is refundable to the extent of 15 percent (10 percent in years before 2005) of the taxpayer's earned income in excess of $10,000 (section 24(d)). The $10,000 earned income floor is adjusted for inflation each year and rounded to the nearest $50 multiple. For 2006 the earned income floor is $11,300 (up from $11,000 in 2005).

Earned Income Tax Credit

The EITC authorized by section 32 is determined by multiplying an inflation-adjusted maximum amount of earned income by a specified credit percentage (based on the number of qualifying children). The credit is reduced by a specified percentage of income over an inflation-adjusted phaseout amount. For married taxpayers filing a joint return, the phaseout base amount is increased by $2,000 in 2005 through 2007, and $3,000 in 2008. The $3,000 base amount increase will be adjusted for inflation beginning in 2009. The income used for that phaseout is the greater of a taxpayer's AGI or earned income. Finally, "investment" income in excess of a specified inflation-adjusted target disqualifies an individual from the EITC (section 32(i)(1) and (2)).

The maximum earned income and phaseout base amounts (which are to be used for inflation adjustment purposes) are specified in section 32(b)(2). Base amounts determined in the inflation calculations are then rounded to the nearest $10 multiple. The inflation-adjusted disqualified income amount is rounded down to the nearest $50 multiple.

The EITC percentages and phaseout percentages are specified in section 32(b)(1). The table above shows the earned income base amounts and phaseout information for 2006 and 2005. In 2006 the section 32(i) disqualified income amount will be $2,800 (up from $2,700 in 2005).

Adoption Expenses Credit and Exclusion

If a taxpayer incurs expenses related to the adoption of a qualified child (for example, adoption fees, attorney and court costs, social service review costs, and transportation costs), an adoption expenses credit is available (section 23). The tax credit covers the first $10,000 of adoption expenses paid by a taxpayer. The available credit is phased out ratably over a range of $40,000 for taxpayers whose modified AGI (section 23(b)(2)(B)) exceeds $150,000. Both the $10,000 ceiling on qualified expenses and the $150,000 modified AGI phaseout target are adjusted annually for inflation (and rounded to the nearest $10 multiple). In 2006 the first $10,960 of adoption expenses will qualify for the credit (up from $10,630 in 2005) and the credit will begin to phase out when a taxpayer's AGI exceeds $164,410 (up from $159,450 in 2005).

If employers provide adoption assistance, an income exclusion is available to the employee. In 2006 the total income exclusion available is $10,960 per child (up from $10,630 in 2005).

Educational Savings Bonds

Interest income earned on a qualified U.S. Series EE savings bond used to finance the higher education of the taxpayer, spouse, or dependents is excluded from gross income (section 135). The exclusion (reported on Form 8815) applies to savings bonds purchased and redeemed in tax years beginning after December 31, 1989. No exclusion is allowed to married individuals filing separate returns.

If the principal and interest amounts received do not exceed the qualified higher education expenses, all interest is excludable subject to an inflation-adjusted modified AGI phaseout. If the principal and interest amounts received exceed the qualified higher education expenses, only a pro rata portion of the interest will qualify for the exclusion (the ratio of qualified higher education expenses to total principal and interest received).

Phaseout of benefit. The tax exclusion is subject to a phaseout that is tied to the taxpayer's modified AGI (section 135(c)(4)). The excludable interest is reduced (but not below zero) by applying the following formula:

$$\text{Excludable Interest} \times \frac{\text{Modified AGI - AGI Base}}{\$15{,}000 \text{ (\$30,000 for married, filing jointly)}}$$

When modified AGI exceeds the AGI base, the exclusion is completely phased out. The AGI bases (section 135(b)(2)(A); $60,000 for married, filing jointly; $40,000 for single and head of household) are adjusted for inflation, with the adjusted amounts rounded to the nearest $50 multiple. The AGI base amounts for 2006 and 2005 are:

	2006	2005
Married, filing jointly	$94,700	$91,850
Single (including head of household)	$63,100	$61,200

HOPE Scholarship and Lifetime Learning Credits

The HOPE scholarship credit and the lifetime learning credit are available to help qualifying individuals defray the cost of higher education (section 25A). Those nonrefundable credits are available for qualifying expenses (tuition and related expenses; not room, board, or books) for eligible students (section 25A(b)(3)) pursuing undergraduate or graduate degrees or vocational training.

The HOPE scholarship credit is available during an eligible student's first two years of postsecondary education. The $1,000 qualifying expense base (section 25A(b)(1)) that is part of the credit is adjusted for inflation and rounded down to the nearest $100 multiple. For 2006 the base increases to $1,100 (up from $1,000 in 2005). As a result, the maximum HOPE scholarship credit in 2006 is $1,650 (100 percent of the first $1,100 of qualifying expenses and 50 percent of the next $1,100); the maximum HOPE scholarship credit in 2005 is $1,500.

The lifetime learning credit is available to eligible students when the HOPE credit is not available. In 2006 the lifetime learning credit is 20 percent of the first $10,000 of qualifying expenses. The qualifying expense limit is not subject to an annual inflation adjustment.

Phaseout of credits. Both education credits are subject to a phaseout that is tied to the taxpayer's modified AGI (section 25A(d)(3)). The combined education credits are reduced by applying the following formula:

$$\text{Education Credits} \times \frac{\text{Modified AGI - AGI Base}}{\$10{,}000 \text{ (\$20,000 for married, filing jointly)}}$$

The AGI bases (section 25A(d)(2); $80,000 for married taxpayers filing jointly; $40,000 for all other taxpayers) are adjusted for inflation and rounded down to the nearest $1,000 multiple. The AGI base amounts for 2006 and 2005 are:

	2006	2005
Married, filing jointly	$90,000	$87,000
All other taxpayers	$45,000	$43,000

Education Interest Expense

Up to $2,500 of interest expense paid on qualified education loans (as defined in section 221(d)(1)) may be deducted *for* AGI. The deduction is subject to a phaseout for taxpayers whose modified AGI (section 221(b)(2)(C)) exceeds specified targets. The interest expense deduction is reduced by applying the following formula:

$$\text{Education Interest Expense} \times \frac{\text{Modified AGI - AGI Base}}{\$15{,}000 \text{ (\$30,000 for married, filing jointly)}}$$

The AGI bases (section 221(b)(2)(B); $100,000 for married taxpayers filing jointly; $50,000 for all other taxpayers) are adjusted for inflation and rounded down to the nearest $5,000 multiple. The AGI base amounts for 2006 and 2005 are:

	2006	2005
Married, filing jointly	$105,000	$105,000
Single (including head of household)	$50,000	$50,000

Qualified Transportation Fringe Benefits

To encourage the use of mass transit for commuting to and from work, some employee benefits, called qualified transportation fringe benefits, are excluded from income (section 132(f)(2) and (6)). Those benefits consist of expenses related to:

1. Transportation from the employee's residence to work in a commuter highway vehicle;
2. A transit pass; and
3. Qualified parking.

Categories 1 and 2 above are combined and limited to a maximum of $100 per month. Category 3 has a separate limit of $175 per month. Both amounts are adjusted annually for inflation and rounded down to the nearest $5 multiple. The 2006 and 2005 limitations are:

	2006	2005
Commuter vehicle/transit pass	$105	$105
Qualified parking	$205	$200

Medical Savings Accounts

Medical Savings Accounts (Archer MSAs) were established by the Health Insurance Act of 1996 and are available to a limited number of eligible individuals. Currently, an individual is eligible for an Archer MSA if he or she is self-employed or elects to be covered under a "high-deductible" plan of a small employer (an employer who, on average, employs 50 or fewer workers). The high-deductible plan definition includes amounts that are adjusted for inflation (section 220(c)(2)).

For 2006 a high-deductible plan is a health plan with the following deductibles and limitations on out-of-pocket expenses:

1. **Individual coverage.** An annual deductible not less than $1,800 and $2,700 (up from between $1,750 and $2,650 in 2005) and maximum out-of-pocket expenses for covered benefits not exceeding $3,650 (up from $3,500 in 2005).

2. **Family coverage.** An annual deductible not less than $3,650 and $5,450 for family coverage (up from between $3,500 and $5,250 in 2005) and maximum out-of-pocket expenses for covered benefits not exceeding $6,650 (up from $6,450 in 2005).

Contribution limitations. The amount that can be contributed to an MSA is a function of the "deductible" of the high-deductible health plan. For individual coverage, the annual contribution limit is 65 percent of the deductible; for family coverage, contributions are limited to 75 percent of the deductible. As a result, the contribution ranges for 2006 and 2005 are as follows:

	2006	2005
Individual coverage	$1,170 - $1,755	$1,138 - $1,723
Family coverage	$2,738 - $4,088	$2,625 - $3,938

Health Savings Accounts

Health savings accounts can be established by individuals who are covered by a high-deductible health plan and not covered under any other health plan that is not a high-deductible health plan (section 223(c)). In 2006 a high-deductible health plan is one with an annual deductible of at least $1,050 for individual coverage ($2,100 for family coverage) and maximum out-of-pocket expenses of $5,250 for individual coverage ($10,500 for family coverage). The 2005 amounts are $1,000, $2,000, $5,100, and $10,200, respectively.

The maximum annual contribution to a health savings account is the sum of the limits determined separately for each month, based on status, eligibility, and health plan coverage as of the first day of the month. For 2006 the maximum monthly contribution for eligible individuals with self-only coverage under a high-deductible health plan is one-twelth of the lesser of (1) the annual deductible under the high-deductible health plan ($1,050, up from $1,000 in 2005) or (2) $2,700 (up from $2,650 in 2005). For eligible individuals with family coverage under a high-deductible health plan, the maximum monthly contribution is one-twelth of the lesser of (1) the annual deductible under the high deductible health plan ($2,100, up from $2,050 in 2005), or (2) $5,450 (up from $5,250 in 2005).

Long-Term Care Insurance Premiums

Long-term care insurance premiums that do not exceed specified dollar limits based on the insured's age qualify as a medical expense (section 213(d)(10)). The dollar limits are adjusted for inflation by comparing the medical care component of each August's CPI-U to the August 1996 CPI-U medical care component. Any increase is rounded to the nearest $10 multiple. After adjustment for inflation, the 2006 limitations will be as follows (2005 amounts for comparison):

Insured's Age Before Close of Tax Year	2006	2005
40 or less	$280	$270
41 to 50	$530	$510
51 to 60	$1,060	$1,020
61 to 70	$2,830	$2,720
More than 70	$3,530	$3,400

Section 179 Expensing

Section 179 allows taxpayers to expense business property that normally would be capitalized and depreciated. The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the maximum amount that can be expensed to $100,000 (from $25,000) and increased the acquisition cost ceiling (above which the expense amount is phased out) to $400,000 (from $200,000). Intended to expire in 2006, the increases were extended through 2008 by the American Jobs Creation Act of 2004 (P.L. 108-357). Absent a legislative change, those amounts will return to their pre-2003 levels in 2009. Those amounts are to be adjusted for inflation (with the expense limit rounded to the nearest $1,000 multiple and the phaseout amount rounded to the nearest $10,000 multiple). In 2006 the maximum section 179 expense election will be $108,000 (up from $105,000 in 2005) and that amount will be subject to a phaseout once property placed in service exceeds $430,000 (up from $420,000 in 2005).

Five-Year Summary of Key Information

Table 3 presents a five-year summary of key inflation-adjusted information (tax rate schedules, standard deduction amounts, exemption amounts and related AGI phaseout thresholds, and the AGI phaseout thresholds related to the overall limitation on itemized deductions).

Conclusion

The number of Internal Revenue Code provisions that include annual inflation adjustments continues to expand. Identifying the provisions affected by the inflation adjustment process and communicating the adjusted amounts will assist taxpayers and tax practitioners in the tax planning process.

Table 3
Tax Rate Schedules

	Indicated Rate* Applies to Taxable Income in Excess of Specified Amounts									
	Single					Head of Household				
Year	15%	25%	28%	33%	35%	15%	25%	28%	33%	35%
2006	$7,550	$30,650	$74,200	$154,800	$336,550	$10,750	$41,050	$106,000	$171,650	$336,550
2005	$7,300	$29,700	$71,950	$150,150	$326,450	$10,450	$39,800	$102,800	$166,450	$326,450
2004	$7,150	$29,050	$70,350	$146,750	$319,100	$10,200	$38,900	$100,500	$162,700	$319,100
2003	$7,000	$28,400	$68,800	$143,500	$311,950	$10,000	$38,050	$98,250	$159,100	$311,950
2002	$6,000	$27,950	$67,700	$141,250	$307,050	$10,000	$37,450	$96,700	$156,600	$307,050
	Indicated Rate* Applies to Taxable Income in Excess of Specified Amounts									
	Married, Filing Jointly					Married, Filing Separately				
Year	15%	25%	28%	33%	35%	15%	25%	28%	33%	35%
2006	$15,100	$61,300	$123,700	$188,450	$336,550	$7,550	$30,650	$61,850	$94,225	$168,275
2005	$14,600	$59,400	$119,950	$182,800	$326,450	$7,300	$29,700	$59,975	$91,400	$163,225
2004	$14,300	$58,100	$117,250	$178,650	$319,100	$7,150	$29,050	$58,625	$89,325	$159,550
2003	$14,000	$56,800	$114,650	$174,700	$311,950	$7,000	$28,400	$57,325	$87,350	$155,975
2002	$12,000	$46,700	$112,850	$171,950	$307,050	$6,000	$23,350	$56,425	$85,975	$153,525

*Rates displayed apply to 2006, 2005, 2004, and 2003 tax years; 2002 rates: 15 percent, 27 percent, 30 percent, 35 percent, and 38.6 percent.

Standard Deduction Amounts

	Basic Standard Deduction				Additional Standard Deduction (Elderly/Blind)	
Year	Single	Head of Household	Married, Jointly	Married, Separately	Married	Unmarried
2006	$5,150	$7,550	$10,300	$5,150	$1,000	$1,250
2005	$5,000	$7,300	$10,000	$5,000	$1,000	$1,250
2004	$4,850	$7,150	$9,700	$4,850	$950	$1,200
2003	$4,750	$7,000	$9,500	$4,750	$950	$1,150
2002	$4,700	$6,900	$7,850	$3,925	$900	$1,150

Exemption Amounts and Related AGI Phaseout Thresholds

		Exemption Phaseout Threshold Amounts			
Year	Exemption Amount	Single	Head of Household	Married, Jointly	Married, Separately
2006	$3,300	$150,500	$188,150	$225,750	$112,875
2005	$3,200	$145,950	$182,450	$218,950	$109,475
2004	$3,100	$142,700	$178,350	$214,050	$107,025
2003	$3,050	$139,500	$174,400	$209,250	$104,625
2002	$3,000	$137,300	$171,650	$206,000	$103,000

Overall Limitation on Itemized Deduction (AGI Phaseout Thresholds)

Year	Married, Separately	All Other Taxpayers
2006	$75,250	$150,500
2005	$72,975	$145,950
2004	$71,350	$142,700
2003	$69,750	$139,500
2002	$68,650	$137,300