OBBBA’s New 2/37th Rule

Quick-Take: The new limit on itemized deductions for those in high income tax brackets applies to estates and trusts.

Background: Section 70111 of the One Big Beautiful Bill Act (OBBBA) places a limit on itemized deductions for taxpayers in the highest marginal income tax bracket. The limit applies to individuals, estates, and trusts. The limitation is 2/37th of the itemized deduction. For example, a trust with $370,000 of itemized deductions would lose $20,000 of itemized deductions. This applies to legal, accounting, trustee fees, charitable deductions, interest deductions and the IRC 691(c) deduction for charitable gifts using trust income.

Effective Date: This new limit on itemized deductions starts in 2026.

Example: In 2026, a non-grantor trust has $500,000 of taxable income. The trust has legal, accounting, and trustee fees of $370,000 in the aggregate. The trust can only deduct $350,000 of those fees.

Example: In 2026, a decedent's estate is 100% payable to a charity, e.g., a university endowment fund. The only estate asset is an IRA worth $3.7 million, that is made payable to the decedent's estate. Accordingly, the decedent's estate will realize $3.7 million of taxable income. However, the decedent's estate will be able to a charitable deduction of $3.5 million. Assume that the estate's income is taxed at the 37% federal income tax bracket. This leads to a 'circular' computation, since the estate will have to use its cash to pay the income tax which, in turn, will reduce the cash paid to the endowment fund as a deductible distribution.

Practical Considerations: Considering this limitation, more thought needs to go into when and how expenses are paid. Consider-

- **IRC 645:** Assume that a trust is treated as part of the decedent's estate under IRC 645. The decedent's estate might consider adopting a November 30, 2025, fiscal year. Since this new limit applies starting in 2026, with an 11/30/25 fiscal year end, this new limit will not apply to either the 2025 or the 2026 period of estate/trust administration.

- **Pay Expenses in 2024:** A fiduciary should consider paying expenses, if possible, in 2025 before the new limitation becomes effective.
- **Avoid IRAs Paid to Estate or Trust:** Looking at the second example above with a large IRA paid to the decedent's estate, that situation could have been avoided if the decedent had named the university endowment directly as the beneficiary of his/her IRA.
- **Apply Expenses to Estate Taxes:** The Tax Code gives the fiduciary the option of applying deductible expenses, e.g., legal, accounting, trustee fees on the decedent's estate tax return in some situations. That would provide a more effective use of those deductible expenses applied to federal estate taxes than income taxes.

Conclusion: While a 2/37th reduction in deductible expenses does not seem like it is too big an impediment, when the expenses are large enough, especially with estate administration expenses, the loss of itemized deductions can be punitive.

If you would like to read additional missives, click here.