The New 2/37th Itemized Deduction Limitation

Take-Away: For wealthy individuals, and non-grantor trusts and estates, we are going to have to learn how to deal with the new 2/37th limitation on claiming itemized deductions under the One Big Beautiful Bill.

Background: The One Big Beautiful Bill Act made changes to IRC 68 by imposing a 2/37th limitation on non-miscellaneous itemized deductions. This limitation applies not only to individuals but also to non-grantor trusts and estates. The OBBBA repealed the so-called Pease Limitation and replaced it with a new 2/37ths limitation on itemized income tax deductions applicable to taxpayers with income in excess of the highest marginal rate bracket. This new limitation is effective in 2026.

Basic Math: How this itemized deduction limitation applies is outlined below.

- 2 divided by 37 = **5.41%.** This percentage represents the reduction imposed on otherwise allowable itemized deductions.
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- 5.41% times 37% = **2.0017%**. This percentage represents the actual tax benefit lost due to the reduction in allowable itemized deductions.
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- **Example:** John reports income of $1.0 million. This new 'cut-back' in john's itemized deductions will cost him $20,017.

Operation of the Deduction Limitation: The itemized deduction limitation operates as follows:

- ***Lesser of:*** Allowable itemized deductions are reduced by the **lesser** of: (i) 2/37th of the total itemized deductions; or (ii) 2/37ths of the amount of taxable income in excess of the income level at which the highest rate bracket applies of 37%. For individuals, the highest rate bracket applies to income in excess of **$751,600** for married couples filing jointly and **$626,350** for single taxpayers (these are 2025 income thresholds, which are expected to increase in 2026.)
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- **Example:** Fred and Wilma have income of $1,751,600, which is $1.0 million in excess of the 37% income tax bracket. Fred and Wilma give $100,000 to charity, and they have $100,000 of other itemized deductions. The itemized deduction limitation can be calculated by multiplying $1 million by 2/37ths, which equals $54,100, and by multiplying the total itemized deductions of $200,000 by 2/37ths, which equals $10,811. The statute calls for the *lesser* of the two amounts to be used, which results in Fred and Wilma's itemized deduction being reduced by $10,811.

Three Rules: To determine who is impacted by this new 2/37th rules, three basic rules should be followed:

1. If the individual makes less taxable income than the 37% federal income tax bracket threshold, the 2/37th limitation simply does not apply.
2. If the individual has taxable income slightly over the 37% federal income tax bracket threshold, the individual's itemized deductions will be reduced by about 5.41% of the amount in excess of the 37% tax bracket threshold.
3. If the individual has taxable income well above the 37% tax bracket threshold, then the federal income tax limitation cannot exceed 5.41% of the individual's total itemized tax deductions.

Trusts and Estates: Under the prior law, the Pease Limitation did not apply to trusts and estates. [IRC 68(e).] That is not the case with the 2/37th itemized deduction limitation, which is intended (sort of) to replace the Pease Limitation. It is estimated that a trust or an estate will reach the highest marginal income tax bracket in 2026 with income of **$16,000.** As a result, trustees will have to be mindful of the itemized deduction limitation starting next year as IRC 641(b) (unchanged after the OBBBA) provides that the taxable income of an estate or non-grantor trust must be computed in the same manner as an individual.

- **However:** There is still much confusion whether this new itemized deduction limitation applies to deductions that are allowed for distributions of income from a non-grantor trust or an estate under IRC 642(c), i.e., income distributions to a charity. Hopefully that question will be answered when the IRS issued Proposed Regulations under IRC 68.

Conclusion: The Pease Limitation is gone and soon will be forgotten. In its place we now have the limitation imposed on itemized tax deductions for high earners and non-grantor trusts and estates. We may soon see steps taken by individuals to keep their income below the highest marginal federal income tax bracket, e.g., aggressive non-qualified deferred compensation arrangements with employers, increased contributions to retirement plans like defined benefit plans, to preserve their full access to claim itemized income tax deductions. Similarly, non-grantor trusts may be more inclined to make distributions of income to stay below the $16,000 retained income level. In short, tax planning could become a lot more complicated in the years to come.

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