

The 2/37th Debate

Quick-Take: A debate currently rages among commentators whether estates and non-grantor trusts are subject to the new 2/37th limitation on itemized deductions starting in 2026.

Background: Some legal commentators have too much time on their hands these days as they start to ‘nit-pick’ the One Big Beautiful Bill (OB3) provisions. Or, maybe it’s their way of saying that Congress, in order to curry favor of our sitting President, rushed to pass tax legislation without carefully reading the proposed tax bill before voting in its favor. Whatever the reason, there is an ongoing debate with regard to the OB3’s repeal of IRC 68(e) and its impact on non-grantor trusts and estates. In the past week I have read 5 separate articles on this topic alone, each expressing a slightly different viewpoint on what Congress intended with the repeal of IRC 68(e). [Searching for any Congressional ‘intent’ seems to be overly generous these days, other than its obvious pandering to the President-but I digress.]

Taxation of Estates and Trusts: An estate or trust needs to determine which of its additional deductions are adjustments to gross income, not limited by IRC 68. IRC 67(e) provides that an estate or trust’s adjusted gross income is the same as an individual’s, subject to various exceptions. IRC 67(e) allows the IRC 651 or 661 distribution deductions and the IRC 642(b) personal exemption (\$100-\$600) in computing adjusted gross income of the estate or trust. Rather than obtain an IRC 661 deduction for income that is paid to charities, trusts and/or estates receive an IRC 642(c) deduction for gross income that is paid to charity. If, and to the extent a trust has unrelated business income, which includes S corporation K-1 items regardless of nature, IRC 681 requires the trust to use instead IRC 170 to deduct charitable distributions. IRC 67(b)(4) specifies that IRC 642(c) or IRC 170 deductions are itemized deductions, and IRC 679(e) does not protect these deductions. [This is like reading Leviticus in the Old Testament! I get exhausted moving my lips just reading these interconnected rules.]

Repeal: The 2017 Tax Act replaced the ‘Pease Limitation’ which was designed to curtail itemized deductions for wealthy taxpayers, with IRC 68(a). It placed limits on the amount of itemized deductions a taxpayer could claim (a 3% limitation on itemized deductions.) However, an exception was added to this 3% limitation on itemized deductions for non-

grantor trusts and estates. [IRC 68(e).] Accordingly, under the 2017 Tax Act, non-grantor trusts and estates did not face this 3% limitation on their itemized deductions like individual taxpayers. Now, IRC 68(e) is eliminated in OB3 come 2026.

Question: This repeal raises the question of whether non-grantor trusts and estates are now subject to the 2/37th limitation on itemized deductions for taxpayers in the 37% marginal federal income tax bracket? Are trusts and estates treated like individual taxpayers? Recall that non-grantor trusts and estates reach the highest marginal income tax bracket at \$16,000 income starting in 2026. Accordingly, the commentators (who apparently have plenty of time on their hands to dig into the dark corners of the Tax Code) have something to passionately debate about, despite the reality that soon the IRS will come up with proposed Regulations that will answer, at least temporarily, this question of whether the 2/37 ‘haircut’ to itemized deductions applies to non-grantor trusts and estates.

Yes: These commentators believe that new IRC 68(g) impacts the charitable deduction for estates and non-grantor trusts [IRC 642(c)] along with the IRC 691(c) deduction [this is the income tax deduction for estate taxes paid on income in respect of a decedent, e.g., an IRA paid to the trust]. However, they do not believe the income tax deductions under IRC 651 and IRC 661 for distributions from an estate or trust, the trust or estate’s personal exemption [IRC 642(b)] nor ‘deductions’ for unique expenses associated with the administration of an estate or trust, are covered by the 2/37 deduction limitation, based on the conclusion that IRC 67(e) defines adjusted gross income for an estate or trust for all purposes so as to include the distribution deduction [either IRC 651 or IRC 661] and that expenses unique to an estate or trust are not really ‘itemized deductions.’ As a result, these commentators believe that deductions by estates and non-grantor trusts must now deal with the 2/37th ‘haircut’ on itemized deductions under IRC 68(a).

No: The basis for this position comes from statutory language used in IRC 642(c) which says that an estate or trust’s deductions under IRC 642(c)(1) are available from “any amount of gross income, **without limitation.**” IRC 68(e) had previously exempted estates and trusts from the 2017 Tax Act’s ‘haircut’ limitation to itemized deductions, making the words **without limitation** largely academic. The phrase ‘without limitation’ was inserted in IRC 642(c) to distinguish fiduciary deductions from those deductions available to individuals and corporations under IRC 170; for individuals and corporations, IRC 170

imposes percentage ceilings on the deductibility of charitable gifts against income. By contrast, trusts and estates were given broader latitude: they could deduct charitable distributions out of gross income 'without limitation' of those IRC 170 percentage caps. Historically, courts have long recognized this distinction, but the courts have also refused to extend the 'without limitation' language to override other structural provisions of the Tax Code.

With that exemption gone, does "without limitation" reflect a decision to make inapplicable the percentage limitations applicable under IRC 170, or does it also extend to shield 'without limitation' deductions from the new 2/37th 'haircut' under IRC 68(a)? Some commentators claim that the 'without limitation' language extends to protect estates and trusts from IRC 68(a) yet other commentators say the 'without limitation' language only applies to protect estates and trusts from the charitable deduction percentage limitations of IRC 170.

Conclusion: The 2/37th disallowance of some deductions will cause a trust or estate entirely payable to charity to pay income tax. Until the IRS tells us what exactly OB3 does to itemized deductions for estates and non-grantor trusts, and the scope of the 'without limitation' words used in IRC 642(c), fiduciaries will need to consider the possible loss of these tax deductions and it will be necessary for them to maintain a cash reserve to pay income taxes that in prior years were not due from the estate or non-grantor trust.

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