

Trusts and the Charitable Deduction Limit

Take-Away: The One Big Beautiful Bill Act (OB3) restricts the 'unlimited' charitable deduction that was previously available to non-grantor trusts and estates. This change will force fiduciaries to revisit their investment strategies and communicate with beneficiaries the forced changes to investments and how the trust or estate is administered.

Background: Some non-grantor trusts direct that each year the trustee distribute an amount that is equal to the trust's taxable income to a charitable beneficiary to reduce the trust's taxable income to zero (0) under the unlimited charitable deduction for trusts and estates. With the One Big Beautiful Bill Act (OB3) that income tax minimization strategy will no longer work. Not only is the settlor's intent frustrated by this OB3 change but the trustee will end up paying income taxes.

IRC 642(c)(1): Under this Tax Code section trusts and estates may deduct charitable contributions only to the extent that they are paid from the trust's gross income. Because gross income generally exceeds taxable income, a trust or estate can contribute amounts greater than taxable income to optimize deductions.

OB3: Under IRC 641(b), non-grantor trusts and estates are taxed in the same manner as individuals, except as otherwise provided by statute. The OB3 revised IRC 68 to remove a previous 'exception' for trusts and estates, thus making trusts and estates subject to the same tax deduction rules as individuals. Accordingly, starting in 2026, trusts and estates will be subject to the 'new' overall itemized deduction limitation that apply to individual taxpayers. The OB3 reduces the allowable itemized deductions by about **5.4%** of the lesser of (i) the total itemized deductions or (ii) the amount by which taxable income (increased by itemized deductions) exceeds the 37% marginal federal income tax bracket.

\$16,001 Taxable Income: Most non-grantor trusts and estates will have taxable income that exceeds the 37% marginal federal income tax bracket once their taxable income exceeds \$16,001 in 2026.

IRC 642(c): The OB3 change thus affects the previous ‘unlimited’ charitable income tax deduction that was available to non-grantor trusts and estates under IRC 642(c). As a result of this OB3 change, starting in 2026, trusts and estates will no longer receive a full tax deduction for charitable contributions made by the trustee.

Example: In 2025, a non-grantor trust with taxable income and gross income of \$1.0 million can distribute \$1.0 million of its income to a charitable beneficiary and eliminate any income tax liability. In 2026, the same tax deduction will be reduced by \$50,000 under IRC 68. If the trust’s gross income exceeds \$1,050,000, the trustee could make a distribution to the charitable beneficiary of \$1,050,000 to fully offset the 2026 taxable income.

Fiduciary Planning: The upshot of the OB3 change is that a trustee or personal representative must now evaluate whether to increase charitable giving to reduce the exposure to federal income taxes, or reserve liquidity for the resulting ‘new’ income tax burden.

Gift Gross Income: As noted in the prior example, one way to circumvent this new income tax deduction limitation is to exploit the cumulative gross income rule of IRC 642(c)(1), which permits the trust or estate to deduct distributions of gross income to a charity. Accordingly, by making larger charitable gifts using gross income, that might be used to offset the ‘new’ tax deduction limitation.

Plan for Liquidity: Even with a trust or estate’s gross income management, many trusts and estates will still face residual taxable income exposure due to the IRC 68 income tax deduction limitation. In these situations, the fiduciary will have to plan to have enough liquidity to cover the income tax liability. This could entail revisiting existing investment strategies or reevaluating distributions, in addition to intentionally setting aside reserves specifically for the ‘new’ income tax liability, to avoid ‘forced sales’ of assets create the needed liquidity.

Transparency: With this new income tax liability faced by trusts and estates due to the ‘new’ limit on available income tax deductions, a trustee or personal representative will

need to alert beneficiaries of this change and the resulting income tax liability exposure, and how the fiduciary plans to address this change to preserve charitable goals and to minimize income tax exposure under IRC 68.

Conclusion: The OB3's new rule that limits the overall itemized deductions indirectly affects the otherwise 'unlimited' charitable income tax deduction that is available to trusts and estates. Fiduciaries will now be required to reassess both planned charitable distributions and investments needed to generate liquidity to deal with the resulting income tax liability that many trusts and estates will face in 2026.

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