

Ready for Equitable Adjustments by your Trustee?

Take-Away: We are only now beginning to appreciate the changes made to the Tax Code a year ago. That includes the limit on the ability to claim itemized income tax deductions for those taxpayers in the highest marginal federal income tax bracket.

Background: The One Big Beautiful Bill Act (OB3) created the limitation on itemized deductions. [IRC 68(a).] This section is the 2/37th limitation on claiming itemized deductions, particularly those taxpayers in the highest marginal 37% federal income tax bracket. In 2026 an irrevocable trust reaches this highest marginal income tax bracket when its taxable income is over \$16,000. As previous missives have pointed out, this limitation on claiming itemized deductions applies to trusts and estates which will have an impact on many estate administration expenses and fiduciary elections. The Blue Book released by the Joint Committee on Taxation released on May 28, 2026, is sweeping in its application to estates and to trusts. Critical is the Blue Book's footnote 102 which expressly addresses its application to estates and to trusts.

IRC 68: OB3 created a new itemized deduction limitation under IRC 68 that reduces otherwise allowable itemized income tax deductions by 2/37th of the lesser of (i) the total itemized deductions, or (ii) the amount by which taxable income exceeds the threshold for the 37% federal income tax bracket. As such, an irrevocable trust will face this itemized deduction limitation once its income exceeds \$16,000.

Footnote 102: This footnote in the Blue Book addresses the application of the IRC 68 to IRC 642(b), IRC 651, and IRC 661. It concludes that those authorized income tax deductions are *"not excluded from the scope of IRC 68 or any other deductions from being itemized deductions for purposes of the provision."*

Estates: What Section 68 means, for estate administration purposes, is that the expenses that usually are incurred in estate administration, such as attorney's fees, accounting fees, and fiduciary fees, will all be subject to this 2/37th itemized deduction limitation.

Trusts: Not only will deductible attorney, accounting, and fiduciary fees will be limited by Section 68, so will the itemized deduction that a trust claims from its income for distributable net income (DNI) that is distributed to trust beneficiaries.

Example: Assume that a marital deduction trust is funded for a surviving spouse. That marital trust generates \$1.0 million of taxable income for the year. To claim the marital deduction, the trust instrument requires that all income must be distributed to the surviving spouse beneficiary each year. Accordingly, the trustee distributes the entire \$1.0 million to the spouse-beneficiary, per the trust's mandate. But only 35/37th of that income distribution to the surviving spouse will be deductible by the marital trust. [IRC 651 or IRC 661.] That means that while the trust has no income because all of it was distributed to the surviving spouse, the trust will be denied an itemized deduction for about \$54,000 which it paid to the surviving spouse. Due to IRC 68(a), the trust will have to pay federal income taxes on \$54,000 but it will have no income with which to pay that tax.

- Consider, as well, the common situation where a revocable trust directs that on the settlor's death the revocable trust assets are to be transferred to a marital trust and to a bypass trust. Each of these trust, the revocable trust, and the marital trust and the bypass trust, will be limited in its itemized deductions due to IRC 68.
- **Charitable Distributions:** Not mentioned in footnote 102 is IRC 642(c). This Tax Code section permits qualifying charitable distributions from a trust's income to be deducted "*without limitation*." The question is whether a trust that distributes its income to a qualified charity is subject to the same 2/37th limitation imposed by IRC 68(a)? Perhaps footnote 102 does not directly apply to IRC 642(c) because unlike these other sections, distributions under IRC 642(c) are never treated as deductions that are used in arriving at adjusted gross income under IRC 67(a). In any event, there is still some question due to the use of the words *without limitation* in IRC 642(c) whether the 2/37th itemized deduction limitation applies to charitable distributions of income from a trust.

Equitable Adjustment: With this new limitation on the amount that an estate or trust can claim as an itemized income tax deduction, fiduciaries will have to become more familiar with the terms of the Uniform Principal and Act (UPIA.) [MCL 555.504(1).] The UPIA provides a mechanism that allows a fiduciary to equitably reallocate funds between a trust's income and principal. The trustee often uses this power to fulfill its duty of

impartiality, balancing the competing financial interests of current income beneficiaries and future remainder beneficiaries. As such, the trustee can transfer principal to income, or transfer income to principal. Due to the possible loss of future itemized deductions by the trust (see the example above) a trustee may again turn to its equitable adjustment power to address some other hardships caused by IRC 68(a). Regarding an estate administration, a trustee or fiduciary can elect to take administration expenses on either the income tax return or the federal estate tax return, which may now be yet another consideration that a fiduciary will have to take into account. A fiduciary's equitable adjustment power applies unless the governing instrument, like the trust instrument, explicitly forbids it. Nor can the fiduciary make an equitable adjustment if it would compromise specific benefits intended by the trust, e.g., qualify for the marital deduction.

Conclusion: As we learn more about the OB3, or how the IRS intends to interpret the OB3 and its provisions, the more surprises can be expected.

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