Report No. 1517
December 1, 2025

The Honorable Scott Bessent
Secretary
Department of the Treasury
and
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Kenneth Kies
Assistant Secretary (Tax Policy)
Department of the Treasury
and
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: NYSBA Tax Section Report No. 1517 - Report on the Impact of Revised Section 68 on Trusts, Estates and their Beneficiaries

Dear Secretary Bessent and Assistant Secretary Kies:

Please find attached Report No. 1517 of the Tax Section of the New York State Bar Association. The Report discusses consequences to estates, trusts and their beneficiaries of the revisions to Section 68 that were recently enacted by P.L. 119-21, informally known as One Big Beautiful Bill Act (the "**Act**"). Under the Act, Section 68, for tax years beginning after 2025, will generally limit the tax savings from itemized deductions to the savings that would be achieved by an individual taxed at the 35% marginal income tax bracket.

It is unclear, at least in some cases, to what extent revised Section 68 was intended to apply to itemized deductions that are only available to trusts and estates. Examples include distribution deductions under Sections 651 and 661, charitable income tax deductions under Section 642(c), and administration expense deductions described in Section

67(e)(1). The Report discussed whether, and to what extent, as a policy matter, it makes sense to limit the foregoing deductions under section 68, as revised. The Report also makes certain recommendations, including as to regulatory or other guidance that the Treasury and the Internal Revenue Service could consider providing to clarify this if they determine they have the authority to do so.

We appreciate your consideration of this Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Andrew Walker
Chair

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Report No. 1517

New York State Bar Association

Tax Section

Report on the Impact of Revised Section 68 on Trusts, Estates and Their Beneficiaries

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Contents

New York State Bar Association
Tax Section

Report on the Impact of Revised Section 68 on Trusts, Estates and Their Beneficiaries

This report (the "**Report**")[1] addresses the possible consequences to estates, trusts and their beneficiaries of the revisions to Section 68[2] that were recently enacted by P.L. 119-21, informally known as One Big Beautiful Bill Act (the "**Act**"). Under the Act, Section 68, for tax years beginning after 2025, will generally limit the tax savings from itemized deductions to the savings that would be achieved by an individual taxed at the 35% marginal income tax bracket.[3] It is unclear, at least in some cases, to what extent the revamped version of Section 68 is intended to apply to itemized deductions that are only available to trusts and estates. Examples include distribution deductions under Sections 651 and 661, charitable income tax deductions under Section 642(c), and administration expense deductions described in Section 67(e)(1). This Report identifies issues for the Treasury Department and the Internal Revenue Service (the "**Service**") to consider and makes recommendations relating to the application of the new Section 68 limitation to trusts, estates and their beneficiaries.

This Report is organized into four sections. Section I lists our principal recommendations. Section II provides an overview of the taxation of trusts and estates. Section III describes how Section 68 potentially affects the taxation of trusts, estates, and their beneficiaries. Finally, Section IV describes our recommendations.

I. SUMMARY OF PRINCIPAL RECOMMENDATIONS

Our recommendations are as follows:

1. The Treasury Department and Service should determine whether they have the authority to treat the Section 651 and 661 distribution deductions as non-itemized deductions for

[1] The principal author of this Report is Austin Bramwell. Significant contributions were made by Amy Albert, Alan Halperin, Benjamin Held, Carlyn McCaffrey, Yeshim O'Donnell, and Leah Socash. Helpful comments were received from Andrew Motten, Michael Schler, Andrew Walker, and Libin Zhang.

[2] IRC § 68. All Section (or §) references are to the Internal Revenue Code of 1986, as amended (the "**Code**" or "**IRC**") or the Treasury regulations, unless otherwise specified.

[3] *See* Senate Finance Committee Section-by-Section (prepared by Republican staff) at 9, available at https://www.finance.senate.gov/imo/media/doc/finance_committee_section-by-section_title_vii5.pdf ("For a taxpayer with taxable income that, before reduction for itemized deductions, exceeds the dollar amount at which the 37- percent tax rate bracket begins, this provision generally caps the tax-reducing value of each dollar of otherwise allowable itemized deductions at 35 cents.").

purposes of Section 68.

2. The Treasury Department and Service should also determine whether they have the authority to treat the charitable deductions available to estates as non-itemized deductions for purposes of Section 68, to the extent that the application of Section 68 would otherwise cause charitable beneficiaries to bear the burden of a tax on income that, if received directly by the charitable beneficiaries, would be exempt from tax.

3. The Treasury Department and Service should not incorporate the Section 67(e)(1) definition of adjusted gross income into Section 68.

4. The Treasury Department and the Service should clarify that in computing the Section 68 limitation, a hypothetical computation of distributable net income, determined without regard to Section 68, is required.

II. OVERVIEW OF SUBCHAPTER J

A. Allocation of Taxable Income

Subchapter J of Chapter 1 of subtitle A of the Code spans Sections 641 to 692 ("**Subchapter J**"). Broadly, Subchapter J creates a system to allocate taxable income between an estate or trust, on the one hand, and its beneficiaries or deemed owners (in the case of a grantor trust), on the other hand. As a general matter, Subchapter J provides rules for allocating income; it does not generally create or reduce income.[4] For estates and non-grantor trusts, [5] Subchapter J does so by initially computing taxable income under Section 641 in the same manner as an individual, as if the estate or trust were a separate entity, then providing modifications to that baseline in later sections of Part I of the subchapter.[6]

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[4] Estates and trusts, however, in lieu of a personal exemption, are entitled to a deduction of $600 for an estate, $300 for a simple trust, and $100 for other trusts generally. IRC § 642(b).

[5] Subchapter J categorizes trusts primarily as either grantor trusts, or non-grantor trusts. Compare Subpart E of Subchapter J to Subparts A, B, C and F of Subchapter J. Non-grantor trusts further are categorized as either simple trusts or complex trusts. Compare IRC §§ 651 and 661 to IRC §§ 652 and 662. The separate treatment of simple and complex trusts primarily facilitates the calculation of taxable income for non-grantor trusts. IRC § 651(a)(1)-(2). Under Section 671, grantor trusts are disregarded as a separate entity from their deemed owners. Other types of trusts dealt with in Subchapter J include electing small business trusts (IRC § 641(c) and charitable remainder trusts (IRC § 664) do not provide distribution deductions. Accordingly, references to trusts throughout this Report are to non-grantor trusts, unless otherwise specified.

[6] IRC § 641.

B. Distribution Deductions and Income Inclusion

One central modification, found in Sections 651 and 661, is a special deduction, known as a distribution deduction, allowed for amounts paid, credited or required to be distributed by estates and trusts to beneficiaries.[7] Sections 652 and 662 impose a corresponding income inclusion on beneficiaries to whom those amounts are paid, credited or required to be distributed.[8] Trusts and estates, in short, act as conduits or, more accurately, as quasi-conduits, given that they are generally treated as separate taxpayers.

As the architects of Subchapter J explained:

> [A] trust or an estate is regarded as a separate taxable entity which computes its tax in essentially the same manner as does an individual taxpayer, except that in addition to the deductions which may be taken by an individual taxpayer the trust is granted a deduction for certain amounts distributed or distributable to beneficiaries. The beneficiaries, in turn, include in their income the amount deductible by the trust. [9]

If there is no distribution (actual or required) from the estate or trust in a given tax year, there is neither a distribution deduction against the trust's taxable income nor a gross income inclusion for the beneficiaries. The estate or trust is instead taxed on its retained taxable income. Generally, for domestic trusts and estates, retained taxable income is taxed at the estate or trust level and is not taxed in subsequent years when later distributed from the estate or trust.

C. Distributable Net Income

Distributable net income ("**DNI**") determines the extent to which a distribution from an estate or trust carries out income to beneficiaries.[10] DNI serves both qualitative and quantitative purposes. Qualitatively, DNI generally determines the character of items of income, with the character of income (as received by the estate or trust) passing through to the beneficiaries who receive distributions.[11] Quantitatively, DNI limits both the allowable distribution deductions that

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[7] IRC § 651; § 661.

[8] IRC § 652; § 662.

[9] Kamin, Surrey, and Warren, "The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries," 54 Colum. L. Review 1237, 1240 (1954).

[10] IRC § 643.

[11] Treas. Reg. § 1.643(a)-0. Classes of income that are specifically allocated by the terms of the trust or estate to different beneficiaries, however, are allocated to those beneficiaries. IRC § 652(b); § 662(b); *see generally* Treas. Reg. § 1.652(b)-2.

an estate or trust may take and the total amount of gross income included by the estate or trust beneficiaries.[12]

DNI is calculated by first determining taxable income (without regard to the distribution deductions under Sections 651 and 661 or personal exemption equivalent under Section 642(b)), then generally subtracting net capital gains,[13] and then adding net tax-exempt income under Section 103.[14] Items that are excluded from DNI, because such items are not deducted as part of the distribution deduction, are taxed to the estate or trust.

D. Charitable Distribution and Set-Aside Deductions

Estates and trusts are permitted a charitable distribution deduction under Section 642(c)(1). The charitable distribution deduction is in lieu of the Section 170 charitable deduction allowed for individuals. Under Section 642(c)(1), an estate or trust may deduct the amount of any gross income paid pursuant to the terms of the governing instrument for a charitable purpose as specified in Section 170(c).[15] The Section 642(c)(1) deduction has no percentage limitation, in contrast to an individual's charitable distribution deduction, which is limited to a percentage of such individual's adjusted gross income ("**AGI**"). The Section 642(c)(1) deduction may not be carried over to later years, but may be carried backwards to the prior year.[16]

Charitable distribution deductions are not taken into account when computing the income inclusions for estate and trust beneficiaries. For simple trusts, under Sections 651 and 652, the Section 642(c) distribution deductions are simply excluded by definition.[17] For estates and complex trusts, Section 663(a)(2) expressly excludes Section 642(c) deductions from the both the distribution deduction under Section 661 and the beneficiaries' corresponding income

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[12] Treas. Reg. § 1.643(a)-0.

[13] The general rule is that capital gains are excluded from DNI, but there are exceptions under IRC § 643 and Treas. Reg. § 1.643(a)-3. Capital losses do not reduce DNI unless capital gains are included in DNI, and even then only in certain cases. *See* Treas. Reg. § 1.643(a)-3(d).

[14] IRC § 643(a)(5); Treas. Reg. § 1.643(a)-5. In addition, simple trusts exclude extraordinary dividends and taxable stock dividends from DNI in certain cases; foreign trusts include capital gains and losses in DNI. IRC § 643(a)(4), (6).

[15] IRC § 642(c)(1).

[16] Treas. Reg. § 1.642(d)-1(b). The Section 170 charitable contribution deduction for individuals, by contrast, generally may be carried forward up to five years. *See* IRC § 170(b)(1)(D)(ii); IRS § 170(d); Treas. Reg. § 1.170A-10.

[17] IRC § 651(a)(2) defines a simple trust as one that by its terms does not provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in Section 642(c).

inclusion under Section 662. Treas. Reg. § 1.662(b)-2 further provides that income required to be distributed from an estate or trust is considered as distributed first to the noncharitable beneficiaries (at which point the distribution deductions and income inclusions apply), and then, from the balance of income, distributed to charities (at which point the charitable deductions apply).[18] In the case, however, of income that may be, but is not required to be, distributed to noncharitable beneficiaries, the Section 642(c) deduction reduces the DNI taxable to the beneficiaries.

Under Section 642(c)(2), estates, but not trusts, also are permitted to deduct any amounts that, during the taxable year, are permanently set aside by the will for a designated charitable purpose, also known as the charitable set-aside deduction.[19] This deduction prevents income that is earmarked for later distribution to charity from being taxed during the period of estate administration. This provision ensures that income destined for charity is treated in the same manner as if it were received directly by the charities (that is, bearing no tax burden), and is not subject to tax simply as a result of being held in the estate for some period of time prior to distribution.

E. Other Deductions

Under Section 212, a trust or estate is generally allowed to deduct reasonable amounts paid or incurred as expenses of administration.[20] Section 67(e)(1), as discussed in further detail in Section III of this report, classifies certain of those amounts, for Section 67 purposes, as allowed in determining AGI and therefore not subject to disallowance as miscellaneous itemized deductions. An expense satisfies the Section 67(e)(1) test if it not have been incurred if the property were not held in such trust or estate (essentially, expenses that are unique to the estate or trust). Examples include probate fees, the costs of preparing fiduciary income tax returns, and the expenses of maintaining fiduciary accounts. Fiduciary commissions are also deductible to the extent they are not charged for investment management or relate to other expenses that an

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[18] *See* Treas. Reg. § 1.662(b)-2 Example 1. Treas. Reg. § 1.662(b)-2 states that "for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently."

[19] IRC § 642(c)(2); Treas. Reg. § 1.642(c)-2(d).

[20] Treas. Reg. § 1.212-1(i); Treas. Reg. § 1.67-4(b). Fiduciary administration expenses, though often incurred neither for the production of income nor the management, conservation, or maintenance of property held for the production of income, are deductible under Section 212. *Bingham's Trust v. Comm'r*, 325 U.S. 365 (1945) (holding such expenses are deductible under Section 212's predecessor).

individual holding the same property would otherwise commonly or customarily incur, such as costs associated with mere ownership of property or preparing tax returns other than for fiduciaries, the decedent, or relating to estate or generation-skipping taxes. The impact of Section 67 is discussed in further detail below.

III. Overview of Revised Section 68 And Its Impact on Trusts, Estates and Their Beneficiaries

A. New Section 68 Limitation on Itemized Deductions

Prior to its suspension by the Tax Cuts and Jobs Act, Section 68 limited the benefit of an individual's itemized deductions.[21] Under the original version of Section 68, often referred to as the "Pease limitation," an individual's itemized deductions were generally[22] reduced by 3% of the excess of AGI over certain thresholds, or, if less, 80% of the itemized deductions otherwise allowable. The Act replaces the former Pease limitation with a new limitation (the "**2/37ths Limitation**"), effective for tax years beginning on or after January 1, 2026. The 2/37ths Limitation is designed to limit the benefit of itemized deductions to the savings that a taxpayer would enjoy if the taxpayer's taxable income were taxed at a marginal rate no higher than 35%.[23]

Under the 2/37ths Limitation, itemized deductions will be reduced by 2/37ths of the lesser of two amounts. The first amount, which this Report refers to as the "**First Limitation Amount**," is simply the amount of the taxpayer's itemized deductions. The second amount, referred to in this Report as the "**Second Limitation Amount**," is equal to the taxpayer's taxable income, *plus* the amount of his, her or its itemized deductions determined without regard to Section 68, *less* the amount at which the 37% tax rate begins to apply for that taxpayer. In other words, the Second Limitation Amount is the excess of the taxpayer's taxable income, before itemized deductions, over the 37% bracket threshold. If any of the taxpayer's income is taxed at the 37% bracket (the First Limitation) or would be taxed at that rate but for the itemized

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[21] Originally enacted in 1990, P.L. 101-508, Sec. 11103(a), Section 68 was suspended under the Tax Cuts and Jobs Act for tax years beginning on or after January 1, 2018, through tax years beginning before January 1, 2026. IRC § 68(f) (as in effect for tax years beginning before 2026). The Act revives and, as discussed in this Report, overhauls Section 68 for tax years beginning after 2025.

[22] Certain itemized deductions (namely, for medical expenses, investment interest expense, and casualty and theft loss) were not subject to the Pease limitation. Under the Act's revisions, Section 68 does not include any similar exceptions.

[23] Senate Finance Committee Section-by-Section (prepared by Republican staff) at 9 (Section 68 "generally caps the tax-reducing value of each dollar of otherwise allowable itemized deductions at 35 cents"), available at https://www.finance.senate.gov/imo/media/doc/finance_committee_section-by-section_title_vii5.pdf.

deductions (the Second Limitation), the 2/37ths Limitation applies and reduces the overall amount of the taxpayer's itemized deductions.[24]

The effect of the 2/37ths Limitation can be illustrated by contrasting the following two examples:

> Example 1: A single individual has $600,000 of gross income, all of which is from wages, in a year when the marginal 37% tax rate applies to ordinary income in excess of $620,000. The taxpayer also has $40,000 of deductions, all of which are itemized deductions. The 2/37ths Limitation does not apply and the $40,000 of itemized deductions reduces the individual's taxable income by $40,000. The tax saved by the itemized deductions is 35% x $40,000 = $14,000.[25]
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> Example 2: A single individual has $900,000 of gross income, all of which is from wages, in a year when the marginal 37% tax rate applies to ordinary income in excess of $620,000. The taxpayer also has $40,000 of deductions, all of which are itemized deductions. In a year when the 2/37ths Limitation does not apply, the $40,000 of itemized deductions reduces the individual's taxable income by $40,000, and the tax saved is 37% x $40,000 = $14,800. In a year when the 2/37ths Limitation does apply, the $40,000 is reduced by 2/37ths of itemized deductions (i.e., the First Limitation Amount), or $2,162. Thus, only $37,838 of the itemized deductions are deductible. The tax saved by the itemized deductions is 37% x $37,838 = $14,000. The taxpayer in Example 2, who is in the 37% bracket, saves the same amount of tax as the taxpayer in Example 1, who is in the 35% bracket.[26]

B. Application of Section 68 to Trusts and Estates

Prior to its amendment by the Act, Section 68(e) expressly provided that the Pease

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[24] That said, the 2/37ths Limitation also applies in some cases even if no portion of the taxpayer's income is taxed at the 37% rate. If a taxpayer has income, such as long-term capital gain, unrecaptured Section 1250 gain, or qualified dividend income, Section 1(h) causes the tax on that income to be taxed separately; the tax on items of income that are taxed at lower rates is then added to the tax on the ordinary income. Thus, a taxpayer's total taxable income, including income taxed at rates lower than 37%, can exceed the 37% bracket threshold, yet none of it may be taxed at that rate because (1) Section 1(h) imposes lower maximum rates on certain categories of income and (2) once those categories are subtracted, the remaining ordinary income may be less than the 37% bracket threshold. The Section 2/37th Limitation, because it applies based on taxable income rather than just ordinary income, nevertheless applies.

[25] This assumes, as is realistic, that the 35% bracket threshold is less than $540,000.

[26] In a scenario where the Second Limitation Amount applies, such as if the taxpayer in this example had $650,000 of income, the results are comparable, in that the savings from itemized deductions would again be approximately $14,000, although the proof of that outcome is more complex.

limitation did not apply to estates and trusts.[27] The Act eliminates that exception for tax years beginning on or after January 1, 2026.[28] Although, by its terms, the new 2/37ths Limitation applies only "in the case of an individual," the Act does not modify Section 641(b). That Section continues to provide that "the taxable income of an estate or trust shall be computed in the same manner as in the case of an individual," except as provided in part I of subchapter J of chapter 1 of the Code. In other words, the rules that determine the computation of an individual's taxable income generally also determine the computation of the taxable income of an estate or trust. Given the repeal of Section 68(e) and the conformity principle of Section 641(b), the new 2/37ths Limitation clearly applies to any deductions of a trust or estate that are properly classified as itemized deductions.

C. General Definition of Itemized Deductions

Section 63(d) defines "itemized deductions" as deductions other than (1) those allowed in determining AGI and (2) the deductions referred to in Section 63(b), namely, the standard deduction, the personal exemption, and certain other deductions listed in Section 63(b).[29] The Section 63(d) definition applies for all income tax purposes, including for purposes of determining the taxable income of a trust or estate.[30] Thus, unless a special rule applies, a deduction allowed to a trust or estate that is neither allowed in computing AGI nor enumerated in Section 63(b) is subject to the 2/37ths Limitation.

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[27] Technically, Section 68(e) was inconsistent with Section 641(b), which directs a trust and estate to compute taxable income in the same manner as an individual, subject only to exceptions set forth in Sections 641-685 (not an exception found elsewhere, such as in Section 68).

[28] By Section 68(f), prior to its replacement beginning for tax years after 2025, the Tax Cuts and Jobs Act temporarily suspended the Pease limitation entirely for tax years beginning after December 31, 2017, and before January 1, 2026. Thus, the Pease limitation has not affected any taxpayer, whether an individual, estate or a trust, since tax years beginning before 2018.

[29] The Tax Cuts and Jobs Act and the Act have expanded the Section 63(b) list of deductions allowed to taxpayers claiming the standard deduction. Those deductions now include the Section 199A deduction for qualified business income, the revived Section 170(p) charitable deduction for itemizers, the new Section 224 deduction for certain tips, the new Section 225 deduction for certain overtime pay, and the new Section 163(h)(4) deduction for qualified passenger vehicle loan interest.

[30] Congress and the Treasury Department, consistent with the Section 63(d) definition, have from time to time expressly referred to certain deductions of a trust or estate as "itemized." *See* Section 67(b)(4) (defining the Section 642(c) charitable deductions available exclusively to trusts and estates as non-miscellaneous itemized deductions); Treas. Reg. § 1.642(h)-2(b)(1)(classifying excess deductions on termination of a trust or estate, which are carried to beneficiaries in the year of termination, as allowed in AGI, as a miscellaneous itemized deduction, and/or as a non-miscellaneous itemized deduction, depending on the nature of the expense).

D. Varying Definitions of AGI in the Case of Trusts and Estates

Historically, the distinction between nonitemized, "above-the-line"[31] deductions and itemized, "below-the-line" deductions had little or no application to trusts and estates. For an individual, the significance of itemized deductions is that they are allowed in lieu of the standard deduction defined in Section 63(c). Yet Section 63(c) and its predecessors have always denied the standard deduction to trusts and estates.[32] Trusts and estates, in contrast to individuals, do not compute taxable income by first computing AGI and then choosing whether to claim the standard deduction or itemized deductions. Instead, they simply apply the default rule that taxable income is equal to gross income less deductions.[33]

That said, since the standard deduction was first introduced, Congress has from time to time chosen to define the AGI of a trust or estate for certain purposes. An important example is found in Section 67. Under that Section, certain itemized deductions are classified as "miscellaneous itemized deductions" ("**MIDs**"). MIDs include, for example, most Section 212 investment management expenses[34] and the expenses of being in the trade or business of being an employee, as well as certain other itemized deductions.[35] As originally enacted, Section 67 only allowed MIDs to the extent that they exceeded 2% of AGI. Under the Tax Cuts and Jobs Act and now the Act, MIDs are disallowed altogether.[36]

To apply the former 2%-of-AGI floor to trusts and estates under Section 67, Congress added a definition of AGI in the case of an estate or trust. Under that definition, which by its terms only applies for purposes of Section 67, a trust or estate computes AGI in the same manner as an individual (i.e., by subtracting the deductions listed in Section 62), but then goes on to subtract certain additional deductions described in Section 67(e)(1)-(2). Under Section 67(e)(1),

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[31] The metaphors "above the line" and "below the line" refer to older versions of Form 1040 (U.S. Individual Income Tax Return), which drew a line across the page (or, in later years, added a page break) after the computation of AGI. See Treas. Reg. § 1.67 – T2(a)(1) (referring to deductions allowed in AGI as "above the line" deductions.)

[32] IRC § 63(c)(6)(D).

[33] IRC § 63(a).

[34] Section 212 expenses attributable to property held for the production of rents or royalties, however, are allowed in determining AGI and therefore are not itemized deductions or miscellaneous itemized deductions. IRC § 62(a)(4).

[35] Section 62(a)(1) provides that trade or business expenses are allowed in computing AGI only if they do not consist of the performance of services by the taxpayer as an employee. Thus, such expenses are itemized, and, by Section 67(b), they are also MIDs. For other examples of MIDs, see IRS Publication 529.

[36] IRC § 67(h). Prior to the Act, Section 67(g) denied MIDs for tax years beginning after December 31, 2017, and before January 1, 2026.

a trust or estate may subtract administration expenses, assuming they are deductible under Section 212, that would not have been incurred if the property were not held by the trust or estate;[37] under Section 67(e)(2), a trust or estate may also subtract the Section 651 or Section 661 deductions for distributions and the Section 642(b) personal exemption equivalent. By treating those deductions as allowed in determining AGI, Section 67(e) causes them to escape the definition of itemized deductions altogether.[38] In consequence, the deductions described in Section 67(e) are not subject to the former 2%-of-AGI floor or the complete denial of MIDs now in effect under the Tax Cuts and Jobs Act and the Act.

Section 67(e) is not the only example where federal tax law provides a definition of AGI in the case of a trust or estate. Other examples are as follows:

- Treas. Reg. §1.30D-2(B)(31) incorporates the Section 67(e) definition by reference, for purposes of determining a Section 30D clean vehicle credit.[39]
- Section 165(h)(4)(C) defines a trust's or estate's AGI for purposes of determining the AGI-based floor on net casualty loss.[40]
- Section 641(c)(2)(E)(ii) defines AGI for purposes of determining the charitable deduction allowed to electing small business trusts.[41]
- Section 642(b)(2)(C)(i)(II) incorporates the Section 67(e) definition by reference when defining a qualified disability trust's AGI for purposes of determining its personal exemption deduction.
- Section 1411(a)(2)(B)(i) incorporates the Section 67(e) definition by reference for purposes of determining the amount of net investment income that is subject to the Section 1411 net investment income tax.

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[37] The last category was construed by the Supreme Court in *Knight v. Comm'r,* 552 U.S. 181 (2008). *See also* Treas. Reg. § 1.67-4(b).

[38] IRC § 63(d)(1); *see also* Treas. Reg. § 1-67-4(a)(ii).

[39] Under Section 30D(f)(10), the credit is disallowed if a taxpayer's AGI, as modified by Section 30D(f)(10)(C), exceeds certain thresholds. The incorporation of Section 67(e) by reference in the regulations (though not in the statute) is favorable to taxpayers, insofar as Section 67(e) permits reductions in a trust's or estate's AGI, including for distributions to individuals who may themselves exceed the thresholds.

[40] A deduction for net casualty loss is only allowed to the extent that it exceeds 10% of AGI (plus the amount of any casualty gain). For purposes of this floor, a trust's or estate's AGI is determined in the same manner as an individual, except that deductions for costs paid or incurred in connection with administration are allowed. Unlike Section 67(e), AGI for purposes of casualty loss deduction does not include the Section 651 or 661 distribution deductions. Denying a distribution deduction makes sense in the context of an AGI-based deduction floor, for otherwise trusts and estates could artificially reduce AGI and minimize the impact of the floor simply by making distributions to beneficiaries. *But see* Treas. Reg. §1.30D-2(b)(31) (adopting a different approach for purposes of AGI-based limits on the clean vehicle credit).

[41] Under that definition, an electing small business trust computes AGI in the same manner as an individual, but is allowed, similar to Section 67(e)(1), deductions for costs which would not have been incurred if the property were not held in trust.

Finally, some Code provisions refer to AGI without providing a unique definition that applies to estates and trusts. For example, under new Section 163(h)(4), a deduction is allowed in tax years beginning before 2029 for qualified passenger vehicle loan interest. The deduction is phased out based on the extent to which a modified version of AGI exceeds certain thresholds.[42] No separate definition of AGI for trusts and estates is provided for purposes of Section 163(h)(4); thus, by Section 641(b), a trust or estate presumably computes AGI, for purposes of the qualified passenger vehicle loan interest deduction, in the same manner as an individual. Another example is the AGI-based phaseout of the temporarily increased deduction for state and local taxes under Section 164(a)(6). Once again, no definition of a trust's or estate's AGI is provided. Thus, a trust or estate determines the amount of the available deduction using the same Section 62(a) definition of AGI that applies to individuals.

In summary, there is no one definition of AGI that generally applies to trusts and estates. Rather, as the foregoing reveals, Congress (and sometimes the Treasury Department, by regulation) has defined a trust's or estate's AGI differently for different purposes.

E. Deductions Unique to Trusts and Estates

Section 68 does not contain its own definition of AGI. Thus, trusts and estates, to determine which deductions are itemized for purposes of the 2/37ths Limitation, must apply the same Section 62(a) definition of AGI as individuals. Although certain deductions are unique to trusts and estates, none of those unique deductions is included on the Section 62(a) list of deductions allowed in determining AGI or the Section 63(b) list of additional nonitemized deductions. Thus, all of them are potentially subject to the 2/37ths Limitation.[43] As discussed below, the 2/37ths Limitation, to the extent it applies to trusts and estates, would have different and, in some cases, perhaps unintended effects, depending on the deduction in question.

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[42] IRC § 163(h)(4)(C)(ii).

[43] Some may suggest that the legislative history is inconsistent with a plain reading of the statute. In particular, the Senate Finance Committee Section-by-Section (prepared by Republican staff) states that the 2/37ths Limitation is a "new overall limitation on the tax benefit of itemized deductions*, applicable to individuals, estates, and trusts*." (Emphasis added.) The phrase "applicable to individuals, estates, and trusts" could be interpreted to modify "itemized deductions," so that the 2/37ths Limitation only applies to deductions that can be claimed by all three categories of taxpayers – namely, individuals, estates, and trusts – and not, by contrast, to deductions that can only be claimed by estates and trusts. That reading, however, is not supported by the statutory text. Although the placement of the phrase "applicable to individuals, estates, and trusts" does create ambiguity, the comma that precedes the phrase and consistency with the statute both imply that the authors of the Section-by-Section intended for the phrase to modify "new overall limitation" rather than "itemized deductions."

1. Distribution Deductions

As discussed above in Section II of this Report, under either Section 651 or 661,[44] a trust or an estate is entitled to a deduction for amounts that are properly paid, credited or required to be distributed to beneficiaries to the extent those amounts do not exceed the trust's or estate's DNI. These deductions, known as distribution deductions, do not reduce the combined taxable incomes of trusts, estates and their beneficiaries. Rather, the purpose of Sections 661 and 662 is to allocate taxable income among them. By the companion Sections 652 and 662, beneficiaries of a trust or an estate to whom an amount is properly paid, credited or required to be distributed must include in their gross incomes the amounts properly paid, credited or required to be distributed, again to the extent that they do not exceed the trust's or estate's DNI.[45] In this way, the Section 651 and 661 distribution deductions, together with the corresponding Section 652 and 662 gross income inclusions, cause taxable income to be carried out from a trust or estate to the beneficiaries. Trusts and estates, in short, act as quasi-conduits, as discussed above in Section II of this Report.

Not surprisingly, given the purpose of the distribution deductions, Section 68, if it applied to trusts and estates, would artificially increase the combined taxable incomes of a trust or estate and its beneficiaries. An example is as follows:

> Example 3: A trust (T) has $100,000 of gross income for the taxable year and distributes $50,000 to a beneficiary, B. T has no other expenses or deductions. T claims a distribution deduction under Section 651, while B includes $50,000 of gross income under Section 662. For tax years beginning before January 1, 2026, T would claim a distribution deduction of $50,000 and have taxable income of $50,000.[46] A total $100,000 of gross income is thereby allocated between T and B.
>
> For tax years beginning on or after that date, if Section 68 applies, T's distribution deduction would, after applying the First Limitation, be reduced by 2/37 x $50,000 = $2,702.70. Only $47,297.30 would be deductible under Section 661, which would

[44] Section 651 applies only to trusts, known as "simple" trusts, which are required to pay all income currently, do not make principal distributions during the year, and do not pay or permanently set aside amounts for charitable purposes. IRC § 651(a). Section 661 applies to all other trusts, as well as to estates. IRC § 661(a).

[45] Logically enough, however, a trust or estate may not claim a deduction for an amount of tax-exempt income that is paid, credited or required to be distributed, even though it is included in the items carried out to a beneficiary. IRC § 651(b); 661(c).

[46] Technically, taxable income would be $49,900, thanks to the Section 641(b)(2)(A) personal exemption equivalent, which has not been increased since 1954 and we ignore for the sake of simplicity.

leave T with taxable income of $52,702.70. Yet B would still have $50,000 of gross income included under Section 662. The combined amounts taxed to T and B would be artificially increased by $2,702.70 to $102,702.70. That is, $50,000 would be taxed to B and $52,702.70 would be taxed to T, for a combined amount of $102,702.50.[47]

2. <u>Charitable set-aside deduction</u>

Under Section 642(c)(2), as discussed in Section II of this Report, estates of decedents may claim a deduction for any amount of gross income that pursuant to the will is set aside for charitable purposes.[48] The effect of Section 642(c)(2), known as the charitable set-aside deduction, is to prevent income that is destined to be distributed to charity from being taxed during the period of estate administration. For example, suppose that a decedent leaves his or her entire estate to a tax-exempt charity organized and operated exclusively for charitable purposes. Any income received[49] by the executor during the period of administration qualifies for a 100% charitable set aside deduction, even if the income is not distributed during the taxable year. The estate effectively functions as a tax-exempt entity, so that the charitable beneficiary does not bear the burden of taxes that would not apply if the income of the estate were received directly by the charity.

If Section 68 applied to the Section 642(c)(2) charitable set-aside deduction, tax-exempt charitable beneficiaries of estates would, in many cases, indirectly pay taxes on income that is accumulated for their benefit. The most obvious example is an estate that is directed to be paid entirely to charity. The following is an illustration:

<u>Example 4</u>: An individual (D) dies and leaves D's entire estate to a tax-exempt charity organized and operated exclusively for charitable purposes. D's estate receives $500,000 of interest income. For tax years beginning before January 1, 2026, the $500,000 of gross income is fully offset by a 100% charitable set-aside deduction, even if no distributions are made during the year to the charity. For tax years beginning on or after that date, if Section 68 applies, only a portion of the gross

[47] Note also that B's gross income inclusion may cause B's taxable income, before itemized deductions, to exceed the 37% bracket threshold so that Section 68 applies independently to B.

[48] The charitable set-aside deduction is also available to certain trusts created before October 10, 1969, or under wills executed before that date and to qualified revocable trusts that elect under Section 645 to be treated as part of the estate of its settlor.

[49] Courts have denied a Section 642(c)(2) charitable set-aside deduction for passthrough income that is not actually received and set aside by the fiduciary. *Sid W. Richardson Foundation v. U.S.,* 430 F.2d 710 (5th Cir. 1970), *cert. denied,* 401 U.S. 1009 (1971).

income would be offset. Assuming no other deductions[50] and a 37% bracket threshold of $15,000, the Second Limitation applies, and the Section 642(c)(2) deduction would be reduced by 2/37th x ($500,000 - $15,000) = $26,216.22. That amount would be subject to tax, despite that the same income, if received directly by the charitable beneficiary, would be exempt from tax.[51]

The same effect – that is, charitable beneficiaries bearing the burden of tax on income that is accumulated for their benefit – also may arise in the case of an estate, a fixed fraction of which is directed to be paid to charity. The effect of Section 68 in that case depends on how the executor accounts for the payment of income taxes. The following is a relatively simple example:

Example 5: An individual (D) dies and leaves 50% of D's estate to an individual (B) and the other 50% to a tax-exempt charity (C) organized and operated exclusively for charitable purposes. D's estate receives $1,000,000 of interest income, half of which the executor sets aside for B and other half of which the executor sets aside for C. The $500,000 of income set aside for C qualifies for the charitable set aside deduction. Assume for simplicity that the first $15,000 of taxable income is taxed at a flat 35% rate and the balance is taxed at a 37% rate. For tax years beginning before January 1, 2026 , the amount of taxable income for the year is $500,000, assuming no other deductions.[52] The total amount of tax is $184,700, i.e., ($15,000 x 35%) + ($485,000 x 37%). For fiduciary accounting purposes, the executor charges the tax entirely against B's share of the estate's income.[53] C will receive its $500,000 share of income without reduction for taxes – which is the same result as in Example 4, where 100% of the estate was directed to be paid to charity but there was only $500,000 of interest income.

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[50] An estate is entitled to a $600 deduction in lieu of a personal exemption. IRC § 642(b). We ignore the personal exemption equivalent for simplicity, although we note that the Section 642(b) personal exemption amounts are, like the other deductions discussed in this report, unique to trusts and estates.

[51] If there were no funds other than the set-aside income with which to pay the tax caused by the application of Section 68, in theory the amount of the deduction should be further reduced by the amount needed to pay the income tax, because that amount would not be available to set aside for charity. The calculation of the amount of that further reduction would require an interrelated computation. A 1986 decision by the Second Circuit, however, rejected this approach. It concluded that the charitable set-aside deduction should not be further reduced by the amount of tax paid, even if a tax payment means that less gross income can actually be set aside for charity. *Hartwick College v. U.S.*, 801 F.2d 608 (2nd Cir. 1986).

[52] Once again, we ignore for simplicity the personal exemption equivalent under Section 642(b).

[53] *See* New York's Estates, Powers and Trusts Law ("**EPTL**") 11-A-2.2(a) (providing that any amount allowed as a tax deduction to an estate for income payable to a charitable organization shall ultimately be paid to that charitable organization "without diminution for taxes"). Note that if the executor could not, consistent with claiming a charitable set aside deduction for 50% of the interest income, subtract the tax payment equally from B's and C's shares of income. If the executor did so, then the executor would have failed to have set aside 50% of the income for charity.

> For tax years beginning on or after January 1, 2026, if Section 68 applies, only a portion of the gross income set aside for C be deductible. In accordance with the First Limitation, the Section 642(c)(2) deduction would be reduced by 2/37th x $500,000 = $27,027.03. Thus, taxable income would increase to $527,027.03 and the total tax would be $194,700. Assume that for fiduciary accounting purposes, the executor charges $184,700 of tax against B's share of the estate's income; the $10,000 balance, which represents the tax generated by the 2/37ths Limitation, is charged against C's share of income.[54] C indirectly pays a 2% tax on the $500,000 of income set aside for C, despite that the same income, if received directly by C, would be exempt from tax.[55] In other words, by limiting the benefit of the charitable set aside deduction to the savings derived by a 35% taxpayer, Section 68 effectively imposes the additional 2% tax on charity.

Finally, it is possible that the additional tax generated by the application of Section 68 to the charitable set aside deduction would be paid not by charitable estate beneficiaries but, as it should be, by noncharitable beneficiaries. The following is an example:

> <u>Example 6</u>: A decedent (D) directs that all income of an estate be paid, upon windup of the estate, to a tax-exempt charity (C) organized and operated exclusively for charitable purposes. D further directs that the corpus of the estate be paid over to an individual (B); finally, D directs that all income taxes be charged to corpus.[56] D's estate receives $500,000 of interest income. For tax years beginning before January 1, 2026, the $500,000 of gross income is fully offset by a 100% charitable set-aside deduction, even if no distributions are made during the year to C. B indirectly enjoys a 100% income tax charitable deduction on the income generated by the corpus passing to B.
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> For tax years beginning on or after that date, if Section 68 applies, only a portion of the gross income would be offset. Assuming no other deductions[57] and a 37% bracket threshold of $15,000, the Second Limitation applies, and the Section 642(c)(2) deduction would be reduced by 2/37th x ($500,000 - $15,000) = $26,216.22. That amount would be subject to tax and, as a result of D's direction to

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[54] *See* EPTL 11-A-2.2(a).

[55] If there were no funds other than the set-aside income with which to pay the tax caused by the application of Section 68, in theory the amount of the deduction should be further reduced by the amount needed to pay the income tax, because that amount would not be available to set aside for charity. The calculation of the amount of that further reduction would require an interrelated computation. A 1986 decision by the Second Circuit, however, rejected this approach. It concluded that the charitable set-aside deduction should not be further reduced by the amount of tax paid, even if a tax payment means that less gross income can actually be set aside for charity. *Hartwick College v. U.S.*, 801 F.2d 608 (2nd Cir. 1986).

[56] In other words, D overrides default rules of state law that that would reduce the net income of the estate by the taxes charged to income. *See* EPTL 11-A-5.5(a).

[57] Once again, the Section 642(b) personal exemption equivalent is ignored here for simplicity.

pay the tax out of corpus, would reduce the amount of corpus passing to B.

Finally, it is worth noting that, while charitable beneficiaries of an estate would be adversely affected by the application of Section 68, many charitable remainder beneficiaries of trusts will be indifferent to Section 68. The reason is that, in the case of trusts, the Tax Reform Act of 1969 replaced the charitable set-aside deduction, which was formerly available to trusts, with Section 664(c), which entirely exempts charitable remainder trusts from income tax, provided that they meet a number of technical requirements.[58] Thus, a charitable set-aside deduction is not needed in order to exempt amounts of income set aside for charity by a charitable remainder trust. By contrast, the deduction is needed and still applies to estates, in order to effectively exempt charitable estates from tax.

3. Charitable distribution deduction

Related to the charitable set-aside deduction, though serving a different function, is the charitable distribution deduction allowed to trusts and estates by Section 642(c)(1). Under that Section, as discussed in Part II of this Report, a trust or estate may claim a deduction for any amount of gross income that pursuant to the terms of the governing instrument is paid for charitable purposes. Unlike the charitable set-aside deduction of Section 642(c)(2), which. in many cases, as discussed above, protects charitable beneficiaries of estates from bearing the burden of income tax, the Section 642(c)(1) charitable distribution deduction reduces the tax burden of noncharitable beneficiaries.

An example is as follows:

> Example 7. A trust (T) directs that $500,000 be paid annually to a tax-exempt charity for a 10-period period; at the end of the period, the remaining property of the trust is paid over to an individual beneficiary (B). T receives $500,000 of interest income annually, all of which is paid over to the charitable beneficiary. For tax years beginning before January 1, 2026, the $500,000 of gross income is fully offset by a 100% charitable distribution deduction.[59]

For tax years beginning on or after that date, if Section 68 applies, only a portion of

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[58] Unrelated business taxable income, however, is taxed at a confiscatory rate of 100%. IRC § 664(c)(2)(A).

[59] In cases where charities and individuals are both beneficiaries eligible for distributions (but not, in the case of an individual, entitled to distributions of income), the individual beneficiaries benefit from the Section 642(c)(1) charitable distribution deduction, even when distributions are made both to charities and individual beneficiaries in the same year. This is accomplished by Section 662(b), which subtracts the charitable distribution deduction from distributable net income (DNI), which in turn limits the amount of DNI carried out to the individual beneficiary.

the gross income will be offset. Assuming no other deductions[60] and a 37% bracket threshold of $15,000, the Second Limitation applies, and the Section 642(c)(1) deduction will be reduced by 2/37ths x ($500,000 - $15,000) = $26,216.21. That amount will be subject to tax. Note that if the same income were contributed directly by an individual to a charity, the individual would potentially also be subject to the 2/37ths Limitation.

4. Administration Expense Deductions

Trusts and estates have historically been allowed deductions under Section 212 for reasonable amounts paid or incurred as expenses of administration, such as fiduciary commissions.[61] Under the Tax Cuts and Jobs Act and the Act, most Section 212 deductions, such as most investment management expenses, are classified as MIDs and are now disallowed under Section 67(h).[62] However, Section 67(e)(1) treats administration expenses that "would not have been incurred if the property were not held in such trust or estate" as allowed, for purposes of Section 67, in determining AGI.[63] Thus, such expenses escape classification as MIDs for purposes of Section 67 and remain deductible. Examples include probate fees, the costs of preparing fiduciary income tax returns, the expenses of maintaining fiduciary accounts, as well as fiduciary commissions to the extent not allocable to investment management or other nondeductible expenses that an individual holding the same property would incur.[64]

Section 67(e) only defines a trust's or estate's AGI for purposes of Section 67. Outside of Section 67, the administration expenses of a trust or estate are generally[65] classified as itemized deductions, because they are not allowed in determining AGI under the general Section 62(a) definition of AGI and are not among the other non-itemized deductions listed in Section 63(b). Thus, Section 68 applies to the administration expenses of a trust or estate that are

[60] Trusts are generally entitled to a $100 personal exemption equivalent, which we ignore for the sake of simplicity. IRC § 642(b).

[61] Treas. Reg. § 1.212-1(i); Treas. Reg. § 1.67-4(b). As noted, *supra* note 20, in *Bingham's Trust v. Comm'r*, 325 U.S. 365 (1945), the Supreme Court held that trust and estate administration expenses are deductible under Section 212's predecessor.

[62] MIDs are defined apophatically in Section 67(b) to exclude most Section 212 deductions. However, expenses of managing property held for rent are allowed in computing AGI and therefore are not itemized deductions or MIDs. IRC § 62(a)(4).

[63] *See Knight v. Comm'r*, 551 U.S. 181 (2008).

[64] Treas. Reg. § 1.67-4(b)-(c).

[65] As noted, however, administration expenses are sometimes allowed in computing a trust's or estate's AGI for certain other purposes.

deductible under Section 212 and Section 67(e)(1). An example is as follows:

> Example 8. A trust (T) receives $500,000 of interest income annually and incurs $5,000 of expense preparing fiduciary income tax returns. For tax years beginning before January 1, 2026, the tax return preparation expense is fully deductible and saves, at the marginal rate of 37%, $1,850 of tax. For tax years beginning on or after that date, if Section 68 applies, then, assuming no other deductions, 2/37ths or $270.27 of the $5,000 expense is nondeductible, in accordance with the First Limitation. The tax savings from the $4,729.73 of deduction is $1,750, or 35% of the total $5,000 expense.

F. Definition of AGI in Section 67(e) and Section 642(h) Regulations

As noted, the Code has multiple different definitions of AGI in the case of an estate or trust, each of which applies for a different purpose. The Section 67(e) definition of AGI, for example, applies for purposes of Section 67, i.e., for purposes of determining whether a deduction is subject to the former 2%-of-AGI floor or the complete disallowance of MIDs under Section 67(h). Other definitions of AGI, however, apply for other purposes. There is no universal definition of AGI for trusts and estates apart from the default Section 62(a) definition.

Nevertheless, Treas. Reg. § 1.67-4 does not by its terms limit the application of its definition of AGI. On the contrary, the regulation states flatly that "[a]n estate or trust . . . must compute its adjusted gross income in the same manner as an individual," but with the deductions described in Section 67(e)(1)-(2) subtracted. Read literally, the regulation would apply the Section 67(e) definition wherever it is necessary for a trust or estate to determine AGI, including Section 68. That said, in other pronouncements, including the preamble to the final version of Treas. Reg. § 1.67-4, the Treasury Department and the Service have correctly stated that the Section 67(e) definition of AGI applies only for purpose of Section 67.[66]

Treas. Reg. § 1.642(h)-2(b) likewise takes an expansive view of the Section 67(e) definition of AGI. That regulation implements Section 642(h)(2), which allows beneficiaries to claim deductions in the amount of the excess, if any, of a trust's or estate's deductions in the year of termination (other than the personal exemption under Section 642(b) or the Section 642(c) charitable deductions) over gross income. A Section 642(h)(2) excess-deductions-on-termination or "**EDOT**" deduction is not allowed in determining AGI under Section 62(a). Nor is it

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[66] *See* Notice 2018-61; T.D. 9918, 85 FR 66219 ("Section 67(e) provides that*, for purposes of section 67,* an estate or trust computes its adjusted gross income in the same manner as that of an individual," except for the deductions described in Section 67(e)(1)-(2))(emphasis added).

otherwise allowed by Section 63(b) to individuals claiming the standard deduction. Thus, the Code apparently defines the EDOT deduction as a nondeductible MID under Section 67(b).

Nevertheless, Treas. Reg. § 1.642(h)-2(b) provides that EDOT deductions, in the hands of the beneficiaries, are classified as itemized, MID, or allowed in AGI, depending on the operation of Section 67(e). In other words, Section 67(e) has the effect of determining the treatment of an administration expense deduction in the hands of a beneficiary, despite that Section 67(e) by its terms has no effect on individuals. As the Treasury Department and the Service asserted in the preamble to the final registration:

> The characterization of these excess deductions as a single miscellaneous itemized deduction in the current regulations was made before the enactment of section 67(g) and served as an administrative convenience. Making a change to that characterization is now appropriate to reflect the temporary disallowance of miscellaneous itemized deductions under section 67(g) since the regulations were written and is a proper exercise of the Secretary's specific grant of regulatory authority in section 642(h).[67]

In other words, for purposes of Section 642(h), the Treasury Department has the power to determine to what extent an EDOT deduction is itemized or not. The Treasury Department, furthermore, applies Section 67(e) to determine whether a deduction is allowed, not just for purposes of Section 67, but also for purposes of determining an individual's AGI under Section 62.

G. "Without Limitation" Language in Section 642(c)

As discussed, among the deductions that are unique to trusts and estates is the charitable distribution deduction of Section 642(c)(1). That Section provides that the deduction is allowed, "without limitation," for any amount of gross income distributed for charitable purposes. The phrase "without limitation" means that the Section 642(c) charitable deductions, unlike the Section 170(a) deduction allowed for charitable contributions by individuals and corporations, are not limited to a percentage of the taxpayer's income.[68] The phrase was necessary to include because Section 642(c) states that the charitable distribution deduction is allowed "in lieu of the deduction allowed by section 170(a), relating to deduction for charitable, etc., contributions and

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[67] T.D. 9918, 85 FR 66219.

[68] *U.S. v. Benedict*, 338 U.S. 692 at fn. 8 (1950)("When the words 'without limitation' are read in connection with [the predecessor to Section 170(b)], their effect is only to make inapplicable" the then percentage-of-income limitation).

gifts." That cross-reference to Section 170, and nothing more, could imply that, to the extent that Section 642(c) is not specific, the Section 170(b) limitations, which limit an individual's or corporation's charitable contribution deductions to a percentage of the taxpayer's contribution base (i.e., a modified version of AGI), apply to trusts and estates. The phrase "without limitation" negates that inference and makes clear that the Section 170(b) percentage-of-income limitations do not apply to Section 642(c).[69]

Despite the limited purpose of the phrase "without limitation," taxpayers have from time to time sought a more expansive and favorable construction.[70] For example, in *U.S. v. Benedict*,[71] trustees unsuccessfully attempted to claim a deduction, under the predecessor to Section 642(c), for all capital gains for the year, despite that only one-half the capital gains were included in gross income under the law at the time. The effect of the trustees' position would have been to offset with a charitable deduction amounts of income that were set aside not for charity but for individuals. Not surprisingly, the Court rejected the trustees' position and, in a footnote, stated that "without limitation" in Section 642(c) means nothing more than that the percentage-of-income limitations do not apply.[72]

IV. RECOMMENDATIONS

A. Clarification of Section 68 Effect on Distribution Deductions

We recommend that the Treasury Department and Service determine whether they have the authority to treat the distribution deductions of Sections 651 and 661 as non-itemized deductions for purposes of Section 68. At a minimum, if Section 68 does apply to distribution deductions, then the Form 1041 (U.S. Income Tax Return for Estates and Trusts) for tax years

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[69] *See* Treas. Reg. § 1.642(c)-1(a)(describing the Section 170(a) deduction as a "limited" deduction, in contrast to the Section 642(c) deductions).

[70] In *U.S. v. Green*, 880 F.3d 519 (10th Cir. 2018), a trustee unsuccessfully argued that the phrase "without limitation" permitted a Section 642(c)(1) deduction for the entire value of donated property, including appreciation, despite that the appreciation did not constitute gross income as required by Section 642(c). The Court, citing *Benedict*, held on the contrary that "the phrase 'without limitation' . . . was intended only to make clear that the percentage limits outlined in § 170 that apply to charitable deductions made by individuals and corporations do not apply to charitable deductions made by estates and trusts." 880 F.3d at 531.

[71] 338 U.S. 692 at fn. 8 (1950).

[72] The Court further stated that the phrase would negate "any other statutory limitation which otherwise might apply to charitable contributions made out of the gross income of an estate or trust." We caution against making inferences from the Court's speculative *dictum* regarding a hypothetical future statute. As discussed below, later courts, ruling on the meaning of "without limitation" prior to the Act, have concluded that under *Benedict*, the phrase "without limitation" merely negates the percentage-of-income limitations of Section 170. *U.S. v. Green*, 880 F.3d 519, 531 (10th Cir. 2018).

beginning on or after January 1, 2026, will need to be revised. Alternatively, if the Treasury Department concludes that it does not have the authority to treat distribution deductions as excluded from the 2/37ths Limitation, it could seek a technical correction from Congress to provide that the Section 651 and 661 deductions are not treated as itemized deductions for purposes of Section 68.

We believe that there are compelling reasons to conclude that Section 68 should not apply to distribution deductions.[73] For one thing, if Section 68 did apply, then the total amount of income taxed to the trust or estate and its beneficiaries would be artificially inflated whenever amounts are distributed or required to be distributed. As Example 3 above illustrates, an amount carried out as gross income to the beneficiaries under Section 652 or 662 would only be partially offset, if Section 68 applied, by a corresponding distribution deduction to the trust or estate. The total amount of income that is taxed to trusts, estates and their beneficiaries would, in consequence, exceed the amount of income that is actually available to be allocated.[74] By contrast, if no amount is paid, credited or required to be distributed for the year, so that there is no distribution deduction and corresponding gross income inclusion, then Section 68 has no effect and there is no artificial increase in the amount subject to tax. Whether Section 68 causes the combined taxable incomes of an estate or trust and its beneficiaries to be inflated depends on whether an amount of income is allocated, in accordance with Subchapter J rules, to the beneficiaries rather than to the estate or trust.

More broadly, Sections 651 and 661 are not standalone provisions but work in tandem with their companion gross income inclusion provisions, Sections 652 and 662. Given that the distribution deductions represent but one part of an integrated mechanism for carrying out taxable income from the entity to beneficiaries, they are better conceived not as deductions but as devices for allocation.[75] The Treasury Department and the Service, absent legislation from Congress making a technical correction, could consider issuing guidance that the distribution

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[73] As discussed below, we do not recommend relying on the theory that the Section 67(e) definition of AGI applies for purposes of Section 68.

[74] To the extent that the application of Section 68 to distribution deductions is treated as an effective increase in the tax rate that applies to income held in a trust or estate, it would likely be constitutional. But if the effect of Section 68 is to cause trusts and estates to be taxed on income that does not exist, then it could face constitutional challenge. Taxpayers considering challenging the application of Section 68 might find support in in *Hoeper v. Tax Commission of Wisconsin*, 284 U.S. 206 (1931) and its declaration that “That which is not in fact the taxpayer's income cannot be made such by calling it income.”

[75] Indeed, trusts and estates report beneficiaries’ shares of taxable income on a Schedule K-1, similar to the Schedules K-1 received by partners of partnerships and shareholders of subchapter S corporations.

deductions are treated, for Section 68 purposes, not as deductions but as allocations. In that way, Section 651 and Section 661, though technically styled as deductions, would not be subject to Section 68.

B. Clarification of Section 68 Effect on Charitable Deductions Available to Estates

We further recommend that the Treasury Department and the Service determine whether they have the authority, in cases where the burden of tax generated by Section 68 would otherwise be borne by charity, to treat the charitable deductions available to estates as non-itemized deductions for purposes of Section 68. Alternatively, as with the distribution deductions, if the Treasury Department concludes that it does not have that authority, it could seek a technical correction from Congress. The charitable deductions available to the estates, like the charitable distribution deduction available to trusts, meets the Section 63(d) definition of itemized deduction. Indeed, in Section 67(b)(4), Congress has expressly defined all Section 642(c) deductions as non-miscellaneous itemized deductions.

That said, at least as a policy matter, it is not clear that Section 68 should apply in all cases to the charitable deductions available to estates. As discussed above, the charitable set-aside deduction often functions to prevent an income tax from being indirectly imposed on tax-exempt charities during the period of estate administration. Including the charitable set-aside deduction among the itemized deductions subject to Section 68, as Example 4 and 5 above illustrate, could, in some cases, cause tax-exempt charities to bear the burden of tax on income that would not be paid if the income were received directly by the charities. Not only would charities be indirectly taxed, but executors, as a result, would come under pressure to distribute estates earlier than otherwise appropriate. The application of Section 68 would also cause a disparity between charitable beneficiaries of estates, which would be indirectly taxed on estate income, and charitable beneficiaries of charitable remainder trusts, which would remain unaffected given that Section 664(c) will continue to exempt income set aside for charities.

By contrast, in other cases, as Example 7 illustrates, the effect of Section 68 would be to increase the tax burden of noncharitable estate beneficiaries. Failure to apply Section 68 to those cases would give noncharitable beneficiaries the equivalent of an indirect deduction not subject to the 2/37ths Limitation. An unlimited deduction would, in our view, not be appropriate in those cases, because it would provide a method of avoiding Section 68 that is not otherwise available to individuals and other noncharitable taxpayers.

To avoid inappropriate results, the Treasury Department and the Service, absent a technical correction from Congress, could consider issuing guidance treating the charitable set-aside deduction, solely for Section 68 purposes and only in some cases, not as a deduction but as a mechanism for protecting the exemption that charitable beneficiaries enjoy. Any relief provided by the guidance should only apply in cases where the tax generated by Section 68 would otherwise be paid indirectly by charity. As Examples 4 and 5 illustrate, those cases arise when charity is entitled to a fixed share (such as 100%) of an estate's principal and income and the charity's share of the estate is required to be paid without diminution for taxes. To achieve parity in treatment in such cases when gross income is not set aside for charity but is actually distributed, the Section 642(c)(1) charitable distribution deduction would also, under this approach, not be treated as a deduction for Section 68 purposes. In that way, the Section 642(c) charitable deductions available to estates would not be subject to Section 68, again, only where Section 68 would otherwise cause a direct or indirect tax on charity.

C. Clarification of Section 68 Effect on Charitable Distribution Deduction Available to Trusts

The Treasury Department and the Service, for completeness, should also clarify whether the Section 642(c)(1) charitable distribution deduction available to trusts is treated as an itemized deduction for purposes of Section 68. On this question, the case for issuing guidance favorable to taxpayers is weaker in the case of trusts than in the case of estates. The charitable deductions available to estates, as discussed above, often effectively preserve the tax exemption enjoyed by charities, whereas the charitable distribution deduction available to trusts reduces the tax burden of individual and other non-charitable beneficiaries.[76] The comparable Section 170 charitable deduction available to individuals and corporations, meanwhile, clearly is subject to Section 68. For those reasons, we do not see a basis – including, as discussed below, the phrase "without limitation" in Section 642(c)(1) – for excluding trusts' charitable distribution deductions from Section 68.[77]

[76] In addition, if the trustee who would have distributed gross income to charity prior to the effective date of Section 68 decides to hold back enough gross income from the distribution to meet its income tax obligation, the charity would receive less than the full amount that it would have otherwise received. Thus, it is possible that the burden of the tax generated by Section 68 would be borne at least in part by charities, even in the case of a trust's charitable distribution deduction.

[77] Some may assert that any interpretation that limits a charitable deduction is contrary to the public policy of encouraging charitable donations. *Cf. Helvering v. Bliss*, 293 U.S. 144, 150–51 (1934)("The exemption of income devoted to charity and the reduction of the rate of tax on capital gains were liberalizations of the law in the taxpayer's favor, were begotten from motives of public policy, and are not to be narrowly construed.") That

D. "Without Limitation" Not an Override of Section 68

As discussed, Section 642(c)(1) provides a charitable deduction for any amounts of gross income, "without limitation," that are paid for charitable purposes pursuant to the terms of the governing instrument. The effect of the phrase "without limitation," as the Supreme Court has held,[78] is to confirm that the percentage-of-income limitations of Section 170(b), which apply to charitable contribution deductions of individuals and corporations, do not apply to Section 642(c). Nevertheless, some have argued that the phrase, "without limitation," can be read to override the 2/37ths Limitation.[79]

We think that interpretation is aggressive. Prior to the Act, the courts construed the phrase, "without limitation," to mean only that the Section 170 percentage-of-income limitations do not apply to Section 642(c).[80] Nothing in the Act suggests that Congress intended to overturn that interpretation. Thus, because Section 68 is a limitation on the amount of overall itemized deductions, and not a percentage-of-income limitation on a charitable deduction amount, the phrase "without limitation" does not exclude Section 642(c)(1) itemized deductions from the reach of Section 68.

Moreover, Congress itself has rejected an expansive construction of the phrase. In particular, Section 67(b)(4), enacted in 1990,[81] expressly excludes the Section 642(c) deductions, as a well as the Section 170 charitable contribution deduction available to individual and corporations, from the definition of MIDs. If Section 642(c) were sufficient on its own to override the Section 67 limitation on MIDs, then it would not have been necessary for Congress to define the Section 642(c) deductions as non-miscellaneous itemized deductions. That Congress did so indicates that Congress thought that Section 67 limitation would apply, absent express language excluding Section 642(c) from the class of MIDs. Congress presumably reached the same conclusion when it overhauled the separate Section 68 limitation, namely, that

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argument proves too much, as it would constrain the Treasury Department's ability to enforce any clear statutory limitation on charitable deductions, whether on individuals, trusts, or other taxpayers.

[78] *U.S. v. Benedict*, 338 U.S. 692 at fn. 8 (1950).

[79] *See* Gespass, "Pease Pease Me: The OBBBA's Revised Limitation on Itemized Deductions," Tax Notes (August 26, 2025).

[80] *U.S. v. Green*, 880 F.3d 519, 531 (10th Cir. 2018) ("In *United States v. Benedict*, 338 U.S. 692, 697 n.8 (1950), the Supreme Court held that the phrase "without limitation," as used in the predecessor statute to § 642(c)(1), was intended only to make clear that the percentage limits outlined in § 170 that apply to charitable deductions made by individuals and corporations do not apply to charitable deductions made by estates and trusts.")

[81] P.L. 101-508, Sec. 11103(a).

absent an exception, a limitation that applies to itemized deductions generally also applies to Section 642(c).

Finally, Section 68 by its own terms is not a limitation on any charitable deduction. It is, rather, a limitation on the overall amount of itemized deductions otherwise allowable. It is one thing to say that "without limitation" protects the amounts deductible under Section 642(c) from being limited; it is another to say that it exempts those amounts, once determined, from any overall limitation that Congress might impose on deductions generally. The second conclusion does not follow from the first.[82]

E. Clarification of Section 68 Effect on Administration Expense Deductions

The case for excluding deductions unique to trusts and estates from the application Section 68 is perhaps weakest in the case of administration expenses deductible under Section 212 and Section 67(e). The plain language of Section 67(e), which applies only for purposes of Section 67, Section 63(d) and Section 68 dictate that administration expenses, if deductible at all, are itemized deductions subjection to the 2/37ths Limitation. The one possible argument to the contrary is that the Section 67(e) definition of AGI, though it applies by its terms only for purposes of Section 67, should be incorporated into Section 68. We address that argument below, together with its broader implications.

F. Section 67(e) Not a Universal Definition of AGI

We caution against incorporating the Section 67(e) definition of AGI into Section 68. To be sure, Treas. Reg. § 1.67-4 is written as if the Section 67(e) definition applies for all income tax purposes. Some may argue that Congress, in enacting Section 68, intended to incorporate that regulation into the interpretation of Section 68. If that argument is adopted, then all deductions described in Section 67(e)(1)-(2) – including both distribution deductions and administration expenses meeting the requirements of Section 67(e)(1) – would escape classification as itemized deductions. The 2/37ths Limitation, therefore, would not apply to them.

While we support guidance, as discussed above, that would exclude the Section 651 and

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[82] Nor is it clear how the Section 68 limitation is allocated among itemized deductions. It is logically possible that the limitation first reduces the amount of non-charitable itemized deductions. If that is the case, then Section 68 would not even have the effect, mathematically, of limiting the Section 642(c) deductions and the argument based on "without limitation" would be fruitless, unless there are no other itemized deductions for the year.

661 distribution deductions from the application of Section 68, we think it would be a mistake, for several reasons, to rely on the Section 67(e) definition of AGI in order to achieve that result. First, although Treas. Reg. § 1.67-4 does not expressly limit its application to Section 67, it also does not expressly claim that it applies for purposes beyond Section 67. Indeed, the limitations of Section 67(e) are noted in the preamble to the final regulation.[83] Thus, it is not clear that Treas. Reg. § 1.67-4 is indeed intended to apply beyond Section 67. In addition, as discussed above, Treas. Reg. § 1.642(h)-2(b) looks to Section 67(e) in order to determine whether a beneficiary's EDOT deduction is allowed in determining the beneficiary's AGI. That rule, however, is based on the express rule-making authority of Section 642(h), not Section 67(e). There is no similar authority that would allow the Section 67(e) definition of AGI to apply for purposes other than Section 67.

Second, the statutory language of Section 67(e) is clear that it applies solely for purposes of Section 67. If Congress meant to incorporate the broader apparent approach of Treas. Reg. § 1.67-4, it would have revised the express statutory limitation found in Section 67(e) itself. Congress having failed to do so, the Act, if anything, reaffirms the limits of Section 67(e).

Third, it is not clear that all the deductions described in Section 67(e) should avoid the 2/37ths Limitation. In particular, there is not an obvious policy reason to exclude the administration expenses described in Section 67(e)(1) from the reach of Section 68. Those expenses, in the case of a trust, are simply a cost of choosing to hold property in trust rather than outright. In the case of an estate, they are a cost of exercising the privilege of passing on property at death. Congress could and, apparently, did choose not to make those costs fully deductible, just as it could choose not to make them deductible at all and to treat instead them as nondeductible personal expenses. Historically, Congress has acquiesced in allowing administration expenses to be deducted,[84] but that is a matter of legislative grace. Congress may also choose to limit administration expense deductions.

Fourth, as discussed above, the Code defines the AGI of a trust or estate differently for different purposes. It is not clear that the Section 67(e) definition of AGI should prevail over another in the context of applying Section 68. On the contrary, the only universal definition of AGI is the default definition of Section 62(a), which, by Section 641(b), generally applies to

[83] T.D. 9918, 85 FR 66219.

[84] As noted, *Bingham's Trust v. Comm'r*, 325 U.S. 365 (1945), held that trust and estate administration expenses are deductible as costs of managing property held for the production of income, even though such expenses are often unrelated to investment.

estates and trusts. An express exception is needed in order to deviate from the Section 62(a) default.[85]

Finally, applying Section 67(e) more broadly would risk undermining Congress's policy objectives in other areas. For example, Section 164(b)(6) temporarily increases the cap on deductions for state and local income taxes, but the increased cap is phased out for taxpayers whose modified AGI exceeds certain thresholds.[86] If the Section 67(e) definition of AGI applied to trusts and estates for purposes of Section 164(b)(6), then fiduciaries could avoid the phaseout by making distributions, including to individuals whose income already well exceeds the phaseout thresholds. In that manner, a fiduciary could artificially exploit the temporarily increased cap, despite that neither the trust, estate, nor the beneficiaries would otherwise be able to benefit.

In summary, while we do recommend, as discussed above, that the Treasury Department and the Service clarify to what extent Section 68 applies to trusts and estates, we caution against incorporating the Section 67(e) definition of AGI into Section 68. We recommend instead taking a case-by-case approach, such as the one suggested by this Report.

G. Computation of DNI for Purposes of 2/37ths Limitation

The starting point in determining the Second Limitation Amount is the taxpayer's taxable income, computed without regard to Section 68. Itemized deductions, again determined without regard to Section 68, are then added to taxable income. Those first two steps potentially create confusion in the case of a trust or estate, because the taxable income of a trust or estate is reduced by a distribution deduction, under either Section 651 or Section 661, for amounts properly paid, credited or required to be distributed during the taxable year. The distribution deduction, in turn, is limited by a measure, known as "distributable net income" or "**DNI**," that is unique to the taxation of trusts and estates. DNI, finally, is defined as taxable income, subject to certain modifications.[87] Although the Second Limitation Amount is determined without regard to Section 68, it is not clear that DNI, for purposes of the 2/37ths limitation, is likewise determined without regard to Section 68.

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[85] *See* Treas. Reg. §1.30D-2(B)(31)(incorporating the Section 67(e) definition by reference for the limited purpose of determining a clean vehicle credit).

[86] IRC § 164(b)(7)(B).

[87] IRC § 643(a).

We recommend that the Treasury Department clarify that in computing the 2/37ths Limitation, a hypothetical computation of DNI, determined without regard to Section 68, is required. This hypothetical DNI would differ from the actual amount of DNI that is used to determine the amount of the Section 651 or Section 661 distribution deduction. An illustration showing the effect of computing DNI without regard to Section 68 is set forth in Annex 1. Although the need to compute a separate measure of DNI does add complexity, it is far less complex than the computations that would be required if actual DNI were used to compute the 2/37ths Limitations.[88] Further, the separate computation is consistent with the statutory mandate to determine the Second Limitation Amount without regard to the Section 68 limitation. That is, if taxable income is determined without regard to Section 68, then so should DNI, which is just a modification of taxable income.

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[88] If actual DNI were used, a circular computation would be required, because to compute taxable income, a trust or estate would need to know the distribution deduction, but to compute the distribution deduction, the trust or estate would need to know DNI, but to compute DNI the trust or estate would need to compute its taxable income, which in turn includes deductions, including itemized deductions reduced by Section 68.

Annex 1

Example of Separate Section 68 DNI Computation

Suppose a complex, discretionary trust has $1 million of ordinary income, pays $100,000 of administration expenses deductible under section 67(e)(1), and makes a $950,000 distribution to a beneficiary.

In 2025 and in earlier years, the trust's taxable income and the beneficiary's gross income inclusion would be determined as follows (ignoring, for simplicity, the small $100 personal exemption equivalent available under Section 642(b)):

1. Gross income of trust = $1,000,000

2. Tentative taxable income (i.e., taxable income of the trust before the distribution deduction) = gross income – administration expense deduction = $1,000,000 - $100,000 = $900,000

3. DNI = tentative taxable income with modifications, none of which applies in this case = $900,000

4. Distribution deduction = lesser of DNI and $950,000 distributed = $900,000.

5. Taxable income of trust = tentative taxable income – distribution deduction = $900,000 - $900,000 = $0

6. Gross income of beneficiary = lesser of DNI and $950,000 distributed = $900,000

In 2026, the trust's taxable income and the beneficiary's gross income are determined as follows, assuming for simplicity that (i) the 37% bracket begins at $15,000, (ii) the Section 661 distribution deduction is not subject to Section 68,[89] but (iii) Section 68 does apply to the $100,000 of administration expense:

1. Gross income of trust = $1,000,000

2. Tentative taxable income = $1,000,000 – administration expense deduction = $1,000,000 - $96,405 = $904,595

    a. Itemized deductions = administration expense deduction – Section 68 limitation = $100,000 - $4,595 = $96,405

        i. Section 68 limitation = 2/37 x [(taxable income of trust determined without regard to Section 68 + itemized deductions determined without

[89] If distribution deductions are subject to Section 68, a further technical problem arises, which is how to allocate the 2/37ths Limitation between the distribution deduction, which is excluded from the determination of DNI by Section 643(a)(1), and other itemized deductions, which do factor into the determination of DNI.

regard to Section 68) - $15,000]

ii. Taxable income of trust determined without regard to Section 68 = $0

- Taxable income determined without regard to Section 68 is the same as the computation above, as if Section 68 was not in effect. Note that DNI is determined as if Section 68 does not apply.

iii. Itemized deductions determined without regard to Section 68 = $100,000

iv. Section 68 limitation = 3/27 x [($0 + $100,000) - $15,000] = $4,595

3. DNI = tentative taxable income with modifications, none of which applies in this case = $904,595

   - Note that actual DNI in this example is higher than the hypothetical DNI used to determine the 2/37ths Limitation.

4. Distribution deduction = lesser of DNI and $950,000 distributed = $904,595

5. Taxable income of trust = tentative taxable income – distribution deduction = $904,595 - $904,595 = $0

6. Gross income of beneficiary = lesser of DNI and $950,000 distributed = $904,595