

Joint Committee on Taxation Blue Book Section 68 and the 2/37ths Reduction for Trusts and Estates

JCT footnote 102, DNI haircut mechanics, daisy-chain modeling, and
fiduciary planning issues

By: Robert S. Keebler, Jonathan G. Blattmachr, and Martin M. Shenkman

Sources reflected throughout the deck: uploaded JCT excerpts and practitioner notes; uploaded Excel modeling workpapers.

Agenda

Why the JCT interpretation matters and how the deck is organized

Blue Book text: present law, operative rule, and the sequencing language for the new section 68 limitation.

Footnote 102: the Joint Committee's explanation that estates and trusts are covered and that sections 642(b), 651, and 661 are itemized deductions for this purpose.

Mechanical consequences: how a full DNI distribution can still leave trust-level taxable income.

Modeling results: one-level versus multi-tier trust structures, with and without offset assumptions.

Broader sweep: possible application to section 642(c) charitable deductions and section 691(c) IRD deductions.

Practice implications, unresolved technical questions, and discussion points.

Why This Matters

Practitioner reaction reflected in the uploaded notes

Practitioner concern

Perhaps the most controversial outcome is the definition of itemized deductions at the trust level.

Economic critique

"The JCT report means that the effects of itemized deductions at the trust level cannot automatically (if at all) be shifted to income beneficiaries, no matter what, in a non-grantor trust structure and in effect imposes a 2% penalty on the privilege of shifting the taxation of such income."

A concern is not simply classification of deductions, but whether Subchapter J distributions can still shift the income tax burden the way practitioners have historically expected.

Blue Book Text: Present Law

Section 68 background and the prior-law exception for estates and trusts

JCT excerpt (present law)

"Before 2018, the total amount of itemized deductions... was limited... This itemized deduction limitation was colloquially referred to as the 'Pease limitation.' The Pease limitation included a rule excepting estates and trusts from the limitation..."

The JCT extraction states that the former Pease regime specifically excepted estates and trusts.

That historic exception provides the immediate contrast to the new rule described in the JCT Blue Book.

This contrast is a major reason practitioners initially expected a different result under the new law.

Blue Book Text: Operative Formula

The new section 68 limitation

JCT operative language (quoted in uploaded notes)

"Under the provision, the amount of itemized deductions otherwise allowable for a taxable year is reduced by $\frac{2}{37}$ of the lesser of the amount of itemized deductions otherwise allowable for the year or so much of the taxable income for the year (determined without regard to the provision and increased by the amount of otherwise allowable itemized deductions) as exceeds the dollar amount at which the 37-percent rate bracket... begins..."

Sequencing language

"The provision's limitation on the tax benefit of itemized deduction applies after the application of any other limitation on the allowance of any itemized deduction..."

The $\frac{2}{37}$ ths fraction is approximately 5.4054%.

Sequencing matters because the limitation applies after deduction-specific limits.

That sequencing point becomes important when section 642(c) is considered.

Effective Date and Scope

Direct excerpts in the uploaded notes

Effective date

"The provision is effective for taxable years beginning after December 31, 2025."

Applicability statement

"The provision also applies to estates and trusts."

The effective date is tax years beginning after December 31, 2025.

The JCT applicability statement appears in footnote 102 to the Blue Book discussion.

The rest of the analysis turns on what counts as an 'itemized deduction' at the trust level.

A Fiscal year may offer a one-year window to avoid the new rule.

Footnote 102 (Part I)

Actual Blue Book language quoted in the uploaded notes

Footnote 102 excerpt

"See sec. 641(b) (providing that the taxable income of an estate or trust generally is computed in the same manner as in the case of an individual). Section 63(d) defines the term 'itemized deductions' to refer to all allowable deductions other than those allowable in arriving at adjusted gross income, see sec. 62, and those listed in section 63(b)."

Footnote 102 excerpt

"Therefore, the itemized deductions for an estate or trust include (without limitation) the personal exemption under section 642(b) and the deductions for beneficiary distributions under sections 651 and 661."

Footnote 102 (Part II)

Regulation under section 67(e) rejected as controlling for section 68

Footnote 102 excerpt

"Treasury Regulation section 1.67-4(a)(1)(ii) provides that these three deductions 'are not itemized deductions under section 63(d).' That regulation, however, interprets section 67(e)... Because the rule of section 67(e) is, by its terms, limited to section 67, the regulation does not exclude the deductions under section 642(b), 651, or 661, or any other deductions, from being itemized deductions for purposes of the provision."

The Joint Committee rejected reliance on section 67(e) and the regulation for section 68 purposes.

The quoted phrase 'or any other deductions' is the textual hook for arguments that the issue reaches beyond DNI.

That broader sweep is addressed later in the deck.

Immediate Consequence for DNI

The uploaded notes identify sections 651 and 661 as the distribution deduction at issue

Uploaded note summarizing footnote 102

"So the DNI deduction is treated as an itemized deduction subject to the 2/37ths haircut."

Practitioner illustration in the uploaded notes

"QTIP example \$1M income pay out as DNI so if pay out \$1M tax is on -0-. After this \$1M – 54,000 (2/37s) so have \$54,000 income at trust level that trust would pay..."

If the section 651 or 661 deduction is reduced, a trust can distribute all of its accounting income yet still retain federal taxable income.

The QTIP example in the uploaded notes uses a \$1,000,000 distribution as the intuitive illustration.

The uploaded Excel workpapers then quantify the effect.

Potential Broader Sweep Beyond DNI

Actual language in the uploaded practitioner notes

The Blue Book's logic

"This interpretation would also capture other deductions such as the deduction for charitable income applied by an estate or trust for charitable purposes under IRC Section 642(c), and the deduction for federal estate tax attributable to income in respect of a decedent under IRC Section 691(c)."

The quoted sentence expressly identifies section 642(c) and section 691(c) as possible deductions drawn into the same framework.

Section 642(c) charitable deductions would suffer a haircut.

Statement drawn from the uploaded comments document discussing the broader implications of the Blue Book approach.

Step-by-Step Mechanical Illustration

\$1,000,000 distribution; one trust; no offset assumption

Item	Amount
Gross income	\$1,000,000
Income distribution deduction before limitation	(\$1,000,000)
2/37 add-back from uploaded model	\$54,054.05
Exemption (estate model)	(\$600)
Taxable income after add-back	\$53,454.05
Federal income tax in workpaper	\$17,708

How the workpaper presents the result

In Scenario 1 (No Offsetting), \$54,054.05405 as the section 68 add-back for a \$1,000,000 distribution and \$17,708 of resulting federal income tax at the estate level.

The 2/37ths fraction of \$1,000,000 is approximately \$54,054.05.

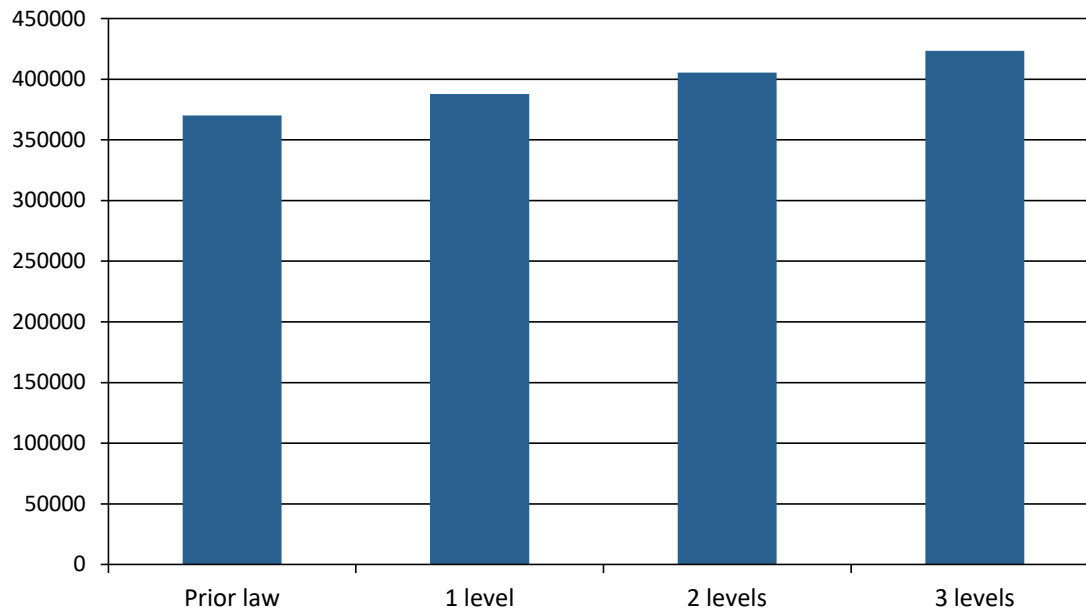
Once the deduction is reduced by that amount, taxable income reappears at the trust or estate level.

The resulting tax even though the full \$1,000,000 was distributed.

Scenario 1: No Offsetting

Total federal income tax rises as trust layers increase

Total federal income tax

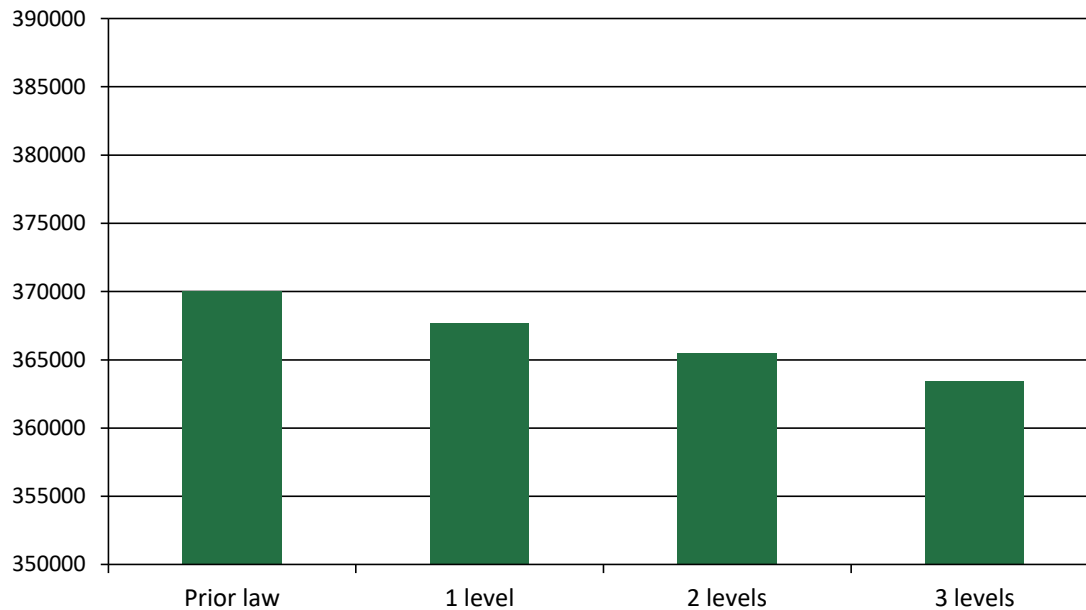


Levels	Total tax	Effective rate
Prior law	\$370,000	37.0000%
1 level	\$387,708	38.7708%
2 levels	\$405,527	40.5527%
3 levels	\$423,420	42.3420%

Scenario 2 from Uploaded Workpaper: Offsetting of Limitation Against DNI

Alternative assumptions reduce total tax as distributions decrease

Total federal income tax



Levels	Total tax	Effective rate
Prior law	\$370,000	37.0000%
1 level	\$367,708	36.7708%
2 levels	\$365,527	36.5527%
3 levels	\$363,420	36.3420%

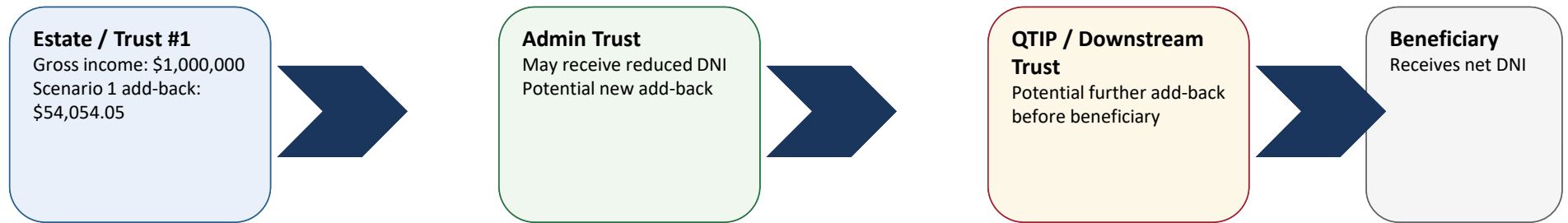
Assumes offsetting of the limitation against DNI.

Under that assumption, lower distributions at each level reduce beneficiary-side tax more than the added trust-level tax

This illustrates the range of possible outcomes depending on the operative assumption.

Daisy-Chain Illustration

How stacked trust structures can compound the issue



Uploaded email note

"Attached is the OBBBA DNI analysis which factors in the 'daisy chaining' issue when income passes from an estate/trust to another trust and to the beneficiary."

Structure and terminology drawn from the uploaded notes and the Excel workpaper organizing results by one, two, and three levels.

Equitable Adjustment / Holdback Mathematics

Uploaded worksheet iterating to a near-zero net trust cash flow

Iteration snapshot	Adjusted DNI / distribution	Taxable income	Trust tax	Net trust cash flow
Initial full distribution	(\$1,000,000)	\$54,054.05	\$20,000.00	(\$20,000.00)
Intermediate example	(\$970,550.00)	\$81,912.16	\$30,307.50	(\$857.50)
Near-equilibrium example	(\$969,233.19)	\$83,157.79	\$30,768.38	(\$1.58)
Final workpaper line	(\$969,231.07)	\$83,159.80	\$30,769.13	(\$0.19)

The 'Holdback Required' and shows 3.0768 as the final output line immediately before 'As Percent of Total Distribution.'

The calculation iteratively reduces the distribution until the trust's remaining cash shortfall is nearly zero.

That exercise models the amount a fiduciary would need to hold back if the trust, rather than the beneficiary, bears the section 68 tax cost.

Economic Incidence and Fiduciary Accounting Considerations

Comments in the uploaded notes

"Issue on all income trust is fairness to remainder beneficiaries."

"Income can be charged with certain items and that may reduce income that has to be distributed. If state income tax is imposed on FAI then FAI is reduced for federal income tax purposes."

Consider the fairness between income and remainder interests.

Consider the possibility that accounting and tax charging rules may affect how much fiduciary accounting income is distributed.

These are administration and drafting questions layered on top of the federal income tax issue.

Is there a gift if the remainder interest does not insist on an equitable adjustment?

Dedicated Section 642(c) Slide

Why charitable deductions may also be exposed under the same logic

"JCT no relief on 642(c) reduction"

There is no mention of a technical correction to fix the problem. 642(c) is not mentioned, so must we assume it's a itemized deduction for sure."

Broader-implications

"This interpretation would also capture other deductions such as the deduction for charitable income applied by an estate or trust for charitable purposes under IRC Section 642(c)..."

Section 642(c) as a likely collateral issue under the same reasoning.

There is no separate statutory carve-out for section 642(c).

This is a technical risk rather than as an enacted clarification.

Practice Questions for CPAs and Tax Attorneys

Presenter synthesis based on the uploaded materials

Should fiduciaries hold back cash to fund the section 68 tax cost rather than distribute all DNI?

If there are multiple non-grantor trust layers, which entity or class of beneficiaries bears the friction cost in administration?

Do drafting provisions need to address tax apportionment, income/principal charging, or distribution formulas to absorb the haircut?

How should preparers disclose assumptions when modeling DNI, offsetting, or equitable adjustment approaches?

If section 642(c) or section 691(c) is affected under the same logic, which planning techniques require immediate reevaluation?

Unresolved Technical Questions

Where the uploaded materials indicate uncertainty

Will courts and/or Treasury ultimately embrace the Blue Book's reading of section 63(d), section 67(e), and the regulation in this context.

Might there be a Loper Bright challenge to this?

Whether and how the limitation should alter DNI mechanically when distributions move through multiple trusts.

How will fiduciary accounting and state-law charging rules interact with the trust-level tax?

Whether charitable and IRD-related deductions are exposed because the logic states itemized deductions include those listed 'without limitation.'

Whether future technical corrections or guidance will address the issues?

This slide synthesizes the uncertainties identified in the uploaded notes and the divergent assumptions in the workpapers.

CLE Takeaways

Condensed summary for the professional audience

The uploaded JCT excerpts state that the new section 68 limitation applies to estates and trusts.

Footnote 102, as reproduced in the uploaded notes, says sections 642(b), 651, and 661 are itemized deductions for this purpose.

That classification can leave trust-level taxable income after a full distribution and can compound in multi-tier trust structures.

Consider possible collateral exposure for section 642(c) and section 691(c).

For practice, the issue is both doctrinal and economic: classification of deductions, cash-flow holdback, and incidence among trust stakeholders all matter.

Appendix: Selected Source Excerpts

Quick reference quotations for the presenter

Blue Book / uploaded JCT extraction

"The provision also applies to estates and trusts."

"...include (without limitation) the personal exemption under section 642(b) and the deductions for beneficiary distributions under sections 651 and 661."

"...the regulation does not exclude the deductions under section 642(b), 651, or 661, or any other deductions, from being itemized deductions for purposes of the provision."

Notes / comments

"So the DNI deduction is treated as an itemized deduction subject to the 2/3rds haircut."

"This interpretation would also capture other deductions such as... section 642(c)... and section 691(c)."

"Attached is the OBBBA DNI analysis which factors in the 'daisy chaining' issue..."

Appendix: Workpaper Metrics

Key numerical outputs used in the deck

Source	Metric	Value
Scenario 1 – No Offsetting	Add-back on \$1,000,000	\$54,054.05
Scenario 1 – No Offsetting	Total federal tax, 3 levels	\$423,420
Scenario 1 – No Offsetting	Effective rate, 3 levels	42.3420%
Scenario 2 – Offsetting	Beneficiary taxable income at 3 levels	\$846,445.42
Scenario 2 – Offsetting	Total federal tax, 3 levels	\$363,420
Equitable Adjustment Worksheet	Final near-zero shortfall	(\$0.19309)

Metrics copied from the two uploaded Excel workpapers and used in the tables and charts above.