# The Post-TCJA Interplay Between NOLs and Charitable Deductions

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In this article, the authors navigate the complexities that corporations face (and the potential benefits they may enjoy) if they have charitable contributions and net operating loss carryovers available for deduction on their 2021 returns.



The interplay between charitable contribution deductions and net operating loss deductions has long bedeviled tax practitioners.[1] Unfortunately, the Tax Cuts and Jobs Act significantly increased the complexity of this relationship — an increased complexity that many taxpayers are grappling with for the first time as they prepare their returns for the 2021 tax year. After providing a brief review of the relevant rules governing charitable contributions and NOL deductions, this article will attempt to navigate the complexities taxpayers face when they have both charitable contributions and NOL carryovers available to deduct. It focuses on charitable contributions and NOL deductions available to corporations rather than individuals because the underlying principles are simpler to explain as applied to corporate taxpayers.

## The 10 Percent Limit: Charitable Deductions

Corporations may take a federal income tax deduction under section 170 for contributions or gifts to charities and other organizations described in section 170(c). A corporation's charitable deductions in any tax year are generally limited to 10 percent of its taxable income.[2] For purposes of this 10 percent limit, taxable income is computed without regard to (1) charitable deductions; (2) capital loss carrybacks to the tax year under section 1212(a)(1); and (3) deductions under sections 241 through 246A (dividends received deductions), section 249 (limit on deduction of premium on repurchase of convertible debt), and section 250 (deduction for foreign-derived intangible income and global intangible low-taxed income).[3]

If charitable contributions made by a corporation in a tax year exceed the 10 percent limit, section 170(d)(2) provides for a carryover. Charitable contributions made in the current year are deducted and applied against the 10 percent limit first. If current-year contributions are less

[1] For a review of the complexities that existed before the Tax Cuts and Jobs Act, see David Culp and Vivian Moore, "Complex Benevolence: Converting Charitable Contributions to NOLs," *Tax Notes*, June 11, 2012, p. 1381.

[2] Section 170(b)(2)(A). Section 2205(a)(2)(B)(i) of Div. A of the CARES Act, 134 Stat. at 346, as amended, temporarily increased this limitation to 25 percent of taxable income for certain "qualified contributions" made in calendar year 2020 and 2021. Congress has also temporarily lifted the limitation for certain contributions made for relief efforts in qualified disaster areas on numerous occasions. Finally, section 170 contains several higher limitations for specific kinds of contributions, such as certain food inventory contributions (15 percent) and qualified conservation contributions by certain corporate farmers and ranchers (100 percent). *See* section 170(b)(2)(B), (e)(3)(C)(ii)(II).

[3] The adjustments to taxable income for purposes of the 10 percent limit are set forth in section 170(b)(2)(D). Taxable income for purposes of the 10 percent limit is also computed without regard to any NOL carryback to the tax year. Section 170(b)(2)(D)(iii). But this adjustment should generally not be relevant for tax years beginning in 2021 except for some insurance companies (other than life insurance companies) and farming businesses. *See* section 172(b)(1)(B) and (C)(i). The passthrough deduction allowed to specified agricultural or horticultural cooperatives under section 199A(g) and the deduction for contributions made by a Native American corporation to a settlement trust (as defined in section 646(h)) are also disregarded. Section 170(b)(2)(D)(ii), (v).

than the 10 percent limit, carryover contributions from prior years are taken into account in the order in which they arose. The maximum carryover period for charitable contributions is five tax years.

Section 170(d)(2)(B) addresses the interplay between charitable contributions and NOLs, providing that a charitable contribution carryover must be reduced to the extent charitable contributions in excess of the 10 percent limit increase an NOL carryover. This interaction between charitable contributions and NOLs — commonly referred to as a "conversion" of a charitable contribution carryover into an NOL carryover — requires an explanation of how and why charitable contributions in excess of the 10 percent limit can increase an NOL carryover. But before providing that explanation, we first present some general background on the NOL deduction.

### The 80 Percent Limit: NOL Deductions

Under section 172(a), as amended by the TCJA and the Coronavirus Aid, Relief, and Economic Security Act, a taxpayer generally may deduct in any tax year beginning in and after 2021 (1) the aggregate amount of NOLs arising in tax years beginning before January 1, 2018 (pre-2018 NOLs) carried to that tax year, plus (2) the aggregate amount of NOLs arising in tax years beginning after December 31, 2017 (post-2017 NOLs) carried to that tax year, with the post-2017 NOL carryovers being subject to a limit. The limit on post-2017 NOL carryovers that may be deducted in a tax year is equal to 80 percent of the excess of (1) taxable income in the tax year, computed without regard to any NOL deduction or the deduction under section 250, over (2) the aggregate amount of post-2018 NOLs carried to the tax year (the 80 percent limit).[4]

The application of this 80 percent limit on post-2017 NOLs was temporarily suspended by the CARES Act for tax years 2018, 2019, and 2020.[5] It resumed in 2021, meaning that many taxpayers preparing their 2021 returns are now grappling with the 80 percent limit for the first time.

In sum, post-2017 NOLs are subject to the 80 percent limit, while pre-2018 NOLs are not. Pre-2018 NOLs and post-2017 NOLs are also different in that pre-2018 NOLs generally may be carried forward 20 years, while post-2017 NOLs may generally be carried forward indefinitely.[6] Also, pre-2018 NOLs could be carried back two years as well as carried forward, while post-2017 NOLs may now generally only be carried forward (with limited exceptions for some insurance companies and farming businesses).[7]

### Ordering the 10 Percent and 80 Percent Limits

A corporation's 10 percent limit on its charitable deductions is computed on a measure of taxable income that includes the deduction of post-2017 NOL carryovers (as well as pre-2018 NOL carryovers) but not charitable deductions. Conversely, a corporation's 80 percent limit on its deduction of post-2017 NOLs is computed on a measure of taxable income that includes the charitable deduction but not the deduction of post-2017 NOLs. But there is no statutory ordering rule that specifies which deduction should be taken against which version of taxable income first. Given these competing definitions of taxable income and the lack of any ordering rules, how does a corporation compute both limitations and determine how much in post-2017 NOL carryovers and charitable deductions it may take?

These ordering-rule and tiebreaker questions come up from time to time in situations in which taxpayers must balance or order the application of two overlapping provisions of the code. These questions have a fresh urgency given important

[4] Section 172(a)(2)(B). Taxable income for these purposes is also computed without regard to the qualified business income deduction under section 199A, but this rule generally is not relevant for corporate taxpayers.

[5] Section 172(a)(1) and (2), as amended by section 2303(a)(1) of Div. A of the CARES Act, 134 Stat. at 352.

[6] Section 172(b)(1)(A)(ii). NOLs generated by insurance companies (other than life insurance companies) continue to be carried forward 20 years. Section 172(b)(1)(C)(ii).

[7] For the exception for insurance companies (other than life insurance companies) and farming businesses, see section 172(b)(1)(B) and (C)(i). Also, under a provision added by the CARES Act, NOLs arising in tax years beginning in 2017, 2018, and 2019 could generally be carried back five years. Section 172(b)(1)(D).

deductions that, as a result of amendments to the code made by the TCJA, now feed into — and partially depend on — the calculation of taxable income.[8]

Sometimes the text of a statute provides explicit or implicit ordering rules.[9] Sometimes Treasury and the IRS issue regulations setting them out.[10] In other situations, courts effectively fashion ordering rules based on principles of statutory construction to find that one code section trumps another in a given context.[11] Finally, a few authorities employ simultaneous equations to balance the application of competing provisions.[12] While some may recoil at the thought of having to recall middle school algebra lessons,[13] simultaneous equations enjoy vocal support in some quarters.[14] Indeed, the IRS has recently embraced the use of simultaneous equations in the preambles to final regulations under sections 163(j)[15] and 250.[16]

The IRS also suggested simultaneous equations as an option for computing limits on charitable deductions and NOLs in IRS chief counsel advice released in 2012.[17] This memorandum addressed alternative minimum tax NOLs (AMT NOLs), which are subject to a limitation equal to 90 percent of alternative minimum taxable income, determined without regard to the AMT NOL deduction but considering the charitable deduction.[18] The interplay between the 90 percent limit on AMT NOL deductions and the 10 percent limit on charitable deductions presents the same quandary as that raised by the 80 percent limit on post-2017 NOLs. And, in facing this quandary in the 2012 chief counsel advice, the IRS concluded that "simultaneous linear equations may be used to determine the proper amount of each deduction." In other words, the 80 percent and 10 percent limits presented the corporate taxpayer at issue with two equations with two unknown variables — one variable being permissible charitable deductions and the other being permissible post-2017 NOL deductions — and the taxpayer was permitted to use basic algebra to reduce one of the equations to one variable.

The use of simultaneous equations is best explained with an example. Suppose x represents permissible charitable deductions, y represents permissible post-2017 NOL deductions, and T is the taxable income of a corporation without regard to either charitable deductions or post-2017 NOL deductions. Further, assume that none of the other differences between taxable income used to compute the 80 percent and 10 percent limits apply. In that case, the two simultaneous equations would be as follows:

$$x = 0.1(T - y)$$

$$y = 0.8(T - x)$$

One can reduce the first equation to one variable by substituting the definition of the

[8] *See, e.g.*, sections 163(j), 172(a), and 250.

[9] For explicit ordering rules, see, *e.g.*, section 172(d)(5) and section 246(b)(1). For implicit ordering rules, see, *e.g.*, section 213 (providing a deduction for personal medical expenses to the extent they exceed 10 percent of adjusted gross income) and section 262 ("*Except as otherwise expressly provided in this chapter*, no deduction shall be allowed for personal, living, or family expenses" (emphasis added).).

[10] *E.g.*, reg. section 1.482-2(a)(3) (setting out ordering rules when a stated rate of interest is subject to adjustment under multiple code sections); prop. reg. section 1.163(j)-1(b)(37)(ii) (proposed ordering rules to coordinate the taxable income limitations in sections 163(j) and 250), published in REG-106089-18, 83 F.R. 67490, 67541 (Dec. 28, 2018); prop. reg. section 1.250(a)-1(c)(4) (proposing ordering rules to coordinate the section 250(a)(2) amount with sections 163(j) and 172(a)) and reg. section 1.250(a)-2(f) Example 2, published in REG-104464-18, 84 F.R. 8188, 8211-8212 (Mar. 6, 2019).

[11] *E.g.*, *St. Charles Investment Co. v. Commissioner*, 232 F.3d 773 (10th Cir. 2000), *rev'g* 110 T.C. 46 (1998) (considering interplay between sections 469(b) and 1371(b)(1)).

[12] *E.g.*, *Shell Oil Company v. Commissioner*, 89 T.C. 371, 419-420 (1987) *rev'd in part and remanded in part*, 952 F.2d 885 (5th Cir. 1992); Rev. Rul. 79-347, 1979-2 C.B. 122.

[13] Those who would rather not use simultaneous equations may cite *Edwards v. Slocum*, 264 U.S. 61, 62 (1924) (noting that "algebraic formulae are not lightly to be imputed to legislators").

[14] *See, e.g.*, Libin Zhang, "Simultaneous Equations: The Statute Strikes Back," *Tax Notes Federal*, Sept. 21, 2020, p. 2211; Zhang, "Simultaneous Equations for Simpler Tax Analysis," *Tax Notes*, Oct. 29, 2018, p. 571; Chris Pollock, Bela Unell, and Maury Passman, "'After you.' 'No, after you.' The Case for Simultaneous Linear Equations With Competing Deductions," KPMG, June 18, 2018. *See also* American Institute of CPAs, "AICPA Recommendations for the 2021-2022 Guidance Priority List," May 27, 2021 ("Allow any reasonable method, including simultaneous equations, for purposes of determining deductions that are limited by taxable income (*e.g.*, deductions under sections 163(j), 250, and 172).").

[15] T.D. 9905, 85 F.R. 56686, 56703 (Sept. 14, 2020).

[16] T.D. 9901, 85 F.R. 43042, 43044-43045 (July 15, 2020).

[17] ILM 201226021.

[18] Section 56(d)(1)(A)(i)(II). For tax years beginning after December 31, 2017, the AMT is no longer imposed on corporations. For more information on AMT NOLs, see Amy Chapman and Alexander Dobyan, "ATNOL Carrybacks Under the CARES Act," *Tax Notes Federal*, May 18, 2020, p. 1185; and Passman et al., "CARES Act Refund Claims and ATNOL Guidance: Another Fly in the Ointment," *Tax Notes Federal*, Sept. 7, 2020, p. 1823.

second variable in the second equation for the same variable in the first equation, as follows:

$$x = 0.1(T - y)$$

$$x = 0.1(T - 0.8(T - x))$$

$$x = 0.1(T - 0.8T + 0.8x)$$

$$x = 0.1T - 0.08T + 0.08x$$

$$0.92x = 0.02T$$

$$x = 0.02/0.92 * T$$

Thus, permissible charitable deductions equal 0.02/0.92 (about 2.174 percent) of taxable income before any post-2017 NOL or charitable deductions. Taxpayers can also use algebra to solve for the y variable, in which case the result would show that permissible post-2017 NOL deductions equal 0.72/0.92 (about 78.261 percent) of taxable income before any post-2017 NOL or charitable deductions.

The computation may get slightly more complicated if deductions are available that may be taken into account in computing taxable income for purposes of one limitation but not the other (for example, under sections 241 through 246A or section 249 or capital loss carrybacks). But given that those deduction amounts will be known variables, the taxpayer will still have two equations with only two unknown variables. Therefore, the taxpayer can still apply the same simultaneous equations to compute the permissible deductions.

To take a simple numerical example, suppose a corporation has taxable income of $2,000 in 2021 before considering NOL carryovers or charitable deductions and without regard to any deductions under section 250. The corporation has total NOL carryovers of $2,600 available to use in 2021, which includes $1,000 from 2017, $710 from 2019, and $890 from 2020. The corporation also made $200 in charitable contributions during 2021.[19] The corporation has no deductions available that are disregarded in computing taxable income for purposes of the 10 percent limit but regarded in computing taxable income for purposes of the 80 percent limit. Finally, the corporation has no other deductions limited by taxable income (for example, under section 163(j)).

After reducing taxable income by the $1,000 pre-2018 NOL, the corporation is left with $1,000 of taxable income without regard to either charitable deductions or post-2017 NOL deductions. Based on the percentages computed by using simultaneous equations, permissible charitable deductions are 2.174 percent of this amount, or $21.74. Permissible post-2017 NOL deductions are 78.261 percent of this amount, or $782.61.

If we apply these permissible deductions in computing each of the 10 percent and 80 percent limits, we can prove that the simultaneous linear equations worked. If one takes 10 percent of $1,000 minus post-2017 NOL deductions of $782.61, the result is 10 percent of $217.39, or $21.74. Conversely, if one takes 80 percent of $1,000 minus charitable deductions of $21.74, the result is 80 percent of $978.26, or $782.61.

Thus, the corporation may deduct $21.74 of the $200 in charitable contributions made in 2021, leaving a total of $178.26 to potentially carry over to 2022 (although, as discussed below, that carryover will have to be reduced under section 170(d)(2)(B)). As for the $782.61 in permitted post-2017 NOL deductions, because one generally must deduct NOL carryovers beginning with the loss arising in the earliest tax year,[20] all of the $710 NOL carryover from 2019 would be deducted, and $72.61 of the NOL carryover from 2020 would be deducted. One might assume that this would result in $0 of the 2019 NOL being carried over to 2022 and $817.39 ($890 less $72.61) of the 2020 NOL being carried over to 2022. However, as we'll see, the result is not quite that simple because of the role of charitable contributions in computing NOL carryovers.

Before we move to the computation of NOL carryovers, it is important to note that the 2012 chief counsel advice described above states only that "simultaneous linear equations *may* be used

[19]For the sake of simplicity, we assume that none of these were "qualified contributions" within the meaning of section 2205 of the CARES Act or other kinds of contributions that would qualify for a higher percentage limitation.

[20]Section 172(b)(2); reg. section 1.172-4(a)(3). Section 382 and the separate return loss year rules set out in reg. section 1.1502-21(c)(1)(i), when they apply, can further complicate this analysis.

to determine the proper amount of each deduction" (emphasis added).[21] It does not say that simultaneous equations are required. Indeed, in preambles to several recent sets of final regulations, Treasury and the IRS have concluded that "further study is required to determine the appropriate rule for coordinating section 250(a)(2), 163(j), 172, and other code provisions (including, for example, sections 170(b)(2), 246(b), 613A(d), and 1503(d)) that limit the availability of deductions based, directly or indirectly, upon a taxpayer's taxable income."[22] Treasury and the IRS have also indicated that they "are considering a separate guidance project to address the interaction of sections 163(j), 172, 250(a)(2), and other code sections that refer to taxable income"[23] and that "until such additional guidance is effective, taxpayers may choose any reasonable approach (which could include an ordering rule or the use of simultaneous equations) for coordinating taxable income-based provisions as long as such approach is applied consistently for all relevant taxable years."[24] Accordingly, taxpayers may consider reasonable approaches other than simultaneous equations in coordinating the 80 percent limit on post-2017 NOLs and the 10 percent limit on charitable deductions, such as a consistently applied ordering rule.

### Charitable Deductions and NOL Carryovers

In contrast to the flexibility discussed above when generally considering overlapping deductions, a specific method to determine the amount of an NOL carryover is set forth in section 172(b)(2) and the regulations.[25] Section 172(b)(2) provides that the entire amount of an NOL arising in any tax year (referred to in the statute and regulations as the loss year) is carried to the earliest of the tax years to which it may be carried, and the portion of the loss that is carried to a subsequent year is the excess, if any, of the amount of that loss over the sum of the taxable income for each of the prior tax years to which that loss may be carried. For purposes of section 172(b)(2), taxable income is subject to specific modifications (described further below) and is commonly referred to as modified taxable income (MTI).[26] So when an NOL is not fully absorbed by MTI in the first (earliest) tax year to which it is carried, the NOL available to be carried to the second or any succeeding tax year is the excess of the NOL over the sum of the MTI of all prior intervening years.[27] For example, assuming no carrybacks are available, if a $1,000 NOL arises in 2021 (the loss year), and MTI in 2022 and 2023 is $500 and $300, respectively, the amount of the 2021 NOL carried over to 2024 is $1,000 minus $500 minus $300, or $200.

For purposes of section 172(b)(2), MTI is computed "by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter."[28] In other words, MTI takes into account NOL carryovers to the tax year that arose only in years before the loss year.[29] (As a reminder, the loss year is the year in which the NOL at issue arose.) Also, MTI is computed without regard to the deduction under section 250[30] and cannot be considered less than zero.[31] Finally, for tax years beginning after December 31,

[21] ILM 201226021.

[22] T.D. 9901 (setting forth final regs that address determining the amount of deduction for FDII and GILTI and that coordinate FDII and GILTI deduction with other tax provisions). *See also* T.D. 9905 (drawing the same conclusion in the context of the final regulations under section 163(j)).

[23] T.D. 9901. That guidance is not among the 193 projects set forth in the 2021-2022 priority guidance plan released by Treasury and the IRS on September 9, 2021 (and updated February 22, 2022), so the current "any reasonable approach" standard may be with us for a while.

[24] T.D. 9905.

[25] The same provision also contains the rules for determining the amount of NOL carryback, in the limited instances in which carrybacks continue to be applicable.

[26] The term "modified taxable income" is not used in section 172 or the accompanying regulations, but it is employed in IRS Publication 536, "Net Operating Losses (NOLs) for Individuals, Estates, and Trusts" (Jan. 29, 2020), for convenience in referring to the taxable income computed with the modifications required by section 172(b)(2), *i.e.*, without regard to the NOL for the loss year or for any year thereafter and without regard to section 250 (accomplished by the cross-reference to section 172(d)(9)).

[27] *See* reg. section 1.172-4(b)(2).

[28] Section 172(b)(2)(A).

[29] Reg. section 1.172-5(a)(2)(i).

[30] Section 172(b)(2)(A) (cross-referencing section 172(d)(9)). MTI is also computed without regard to deductions under section 199A, but that should not generally be relevant for corporate taxpayers. Section 172(d)(8). Finally, some modifications that can apply in computing MTI for real estate investment trusts are beyond the scope of this article. *See* section 172(d)(6).

[31] Section 172(b)(2)(B).

2020, section 172(b)(2) (as amended by the TCJA and CARES Act) provides that MTI is reduced by the amount of total post-2017 NOL deductions potentially disallowed by the 80 percent limit. In other words, MTI is reduced by an amount equal to the remaining 20 percent of taxable income used as the measure of the 80 percent limit (referred to hereinafter as the "20 percent disallowance"). Reducing MTI by the 20 percent disallowance ensures that taxpayers may carry over the portion of any NOL that could not be deducted because of the 80 percent limit. (This new provision concerning the 20 percent disallowance raises even more questions, which will be discussed below.)

The regulations make clear that "any deduction which is limited in amount to a percentage of the taxpayer's taxable income . . . shall be recomputed upon the basis of the modifications" in computing MTI.[32] More specifically, the regulations state that the deduction for charitable contributions is determined "with regard to any . . . modifications" prescribed in the computation of MTI.[33] This rule can often result in the amount of charitable deductions permitted to be taken against MTI being greater than the amount permitted to be taken against actual taxable income. This is because all deductible NOL carryovers are potentially taken into account in computing the 10 percent limit for purposes of actual taxable income, while only NOL carryovers arising in tax years preceding the loss year are taken into account in computing the 10 percent limit for purposes of MTI.[34]

To take a simple example, if a corporation has $1,000 in taxable income in 2021 and a $1,000 NOL carryover from 2017 available to be deducted in 2021 (and no other NOL carryovers), actual taxable income is $0, meaning no charitable deduction may be taken against actual taxable income as a result of the 10 percent limit (since 10 percent of $0 is $0). But in determining the 10 percent limit for purposes of MTI, the $1,000 NOL carryover from 2017 is disregarded. Thus, for purposes of MTI, up to 10 percent of $1,000 — or $100 — in charitable contributions may be deducted. Thus, if the corporation had $100 in charitable contributions to deduct, MTI would be $1,000 minus $100, or $900, and the carryover of the 2017 NOL to 2022 would be $1,000 minus $900, or $100. In sum, the NOL carryover to 2022 is $100 higher than it would be if only charitable deductions against actual taxable income ($0) were taken into account.

This is precisely how and when section 172(d)(2)(B) and the "conversion" of a corporate charitable contribution carryover into an NOL carryover come into play. Because $100 in charitable contributions deducted from MTI increased the 2017 NOL carryover by $100, section 170(d)(2)(B) reduces the charitable contribution carryover by $100 — from $100 to $0. In this manner, section 172(d)(2)(B) prevents the corporation from getting a double carryover benefit from the same $100 charitable contribution. Rather than both a $100 charitable contribution carryover and a $100 NOL carryover, the corporation gets only a $100 NOL carryover. While the net number of attributes carried over remains $100, a carryover of an NOL is generally preferable to a charitable contribution carryover because it has either a 20-year or a perpetual carryover period instead of a five-year carryover period and is subject to no limit or an 80 percent limit rather than a 10 percent limit.

While the aspects of determining an NOL carryover discussed above are relatively uncontroversial, at least two questions regarding the computation remain outstanding — one long-standing and the other resulting from recent amendments made by the CARES Act. The next two subsections will examine each of these questions.

### 1. When a corporation has NOLs carried over from multiple loss years, is the 10 percent limit on charitable deductions for purposes of MTI computed separately for each 'loss year'?

One question that practitioners have considered for decades is, when a tax year is preceded by two or more loss years with NOL carryforwards potentially available, should the 10

[32] Reg. section 1.172-5(a)(2)(ii). This regulation was promulgated before the TCJA and CARES Act amendments to section 172, meaning that disregarding "the net operating loss for the loss year or any taxable year thereafter" was the only modification that applied in computing MTI for corporate taxpayers when the regulation was issued. Reg. section 1.172-5(a)(2)(i).

[33] *Id.*

[34] Reg. section 1.172-5(a)(2)(i).

percent limit on charitable deductions for purposes of MTI be computed separately for each loss year (a year-by-year method) or rather may it be calculated on an aggregate basis (the aggregate method)?[35] Using the aggregate method tends to increase NOL carryovers by resulting in a higher 10 percent limit and permitting more charitable deductions to be taken against MTI. By contrast, under a year-by-year approach, a corporation with multiple loss years must separately determine the 10 percent limit on the charitable deductions permitted to be taken against MTI for each loss year. This method tends to conserve charitable contribution carryforwards at the expense of consuming NOL carryforwards. (This effect of the year-by-year method can be best demonstrated with an example, which is provided at the end of this article.)

In 2019 the IRS weighed in on this question, coming down in favor of the year-by-year approach. In ILM 201928014, the IRS concluded that determining the carryover of NOLs to subsequent years "requires a chronological, year-by-year, NOL absorption computation."[36] Under this method, taxpayers must separately compute MTI for each NOL carryover arising in a particular loss year, deducting only those available NOL carryovers that arose in years preceding that loss year. Taxpayers may then deduct charitable contributions up to a limit equal to 10 percent of MTI as computed in that manner.

The year-by-year MTI computation conclusion is supported by ample authority (even though most of that authority was not discussed in ILM 201928014) and by the structure of the NOL rules. The text of section 172(b)(2)(A) — referring to "loss year" in the singular, rather than "loss years" in the plural — supports a year-by-year approach, and the regulations set out a year-by-year method of determining the portion of an NOL that carries over.[37] The modifications in the regulations for determining MTI call for (1) deducting NOL carryovers from tax years preceding the loss year[38] and (2) computing the 10 percent limit on charitable deductions "with regard to" these modifications.[39] Courts have held that the NOL carryover ordering and calculation rules provided in section 172(b) and its regulations are mandatory, deferring to the government's interpretations and rejecting taxpayer appeals based on fairness and conservation of maximum tax attributes.[40] All these authorities provide support for the IRS position that the 10 percent limit on charitable deductions for purposes of MTI is separately computed for each loss year, taking into account NOL carryovers from prior years.

Proponents of the aggregate method for MTI calculations cite Rev. Rul. 76-145, 1976-1 C.B. 68, a section 170 carryover ruling, for support.[41] In that ruling, the IRS held that both current-year charitable contributions and charitable contribution carryovers had to be taken into account, up to the 10 percent limit, in reducing MTI. Section 170(d)(2)(A) dictates this result when computing actual taxable income; that is, it provides that both current-year charitable contributions and charitable contribution carryovers are deducted against taxable income up to the 10 percent limit (starting with the current-year contribution and then taking into account carryover contributions in the order in which they arose). Accordingly, it is not surprising that the IRS would conclude in Rev. Rul. 76-145 that this same approach should be taken when computing MTI. Rev. Rul. 76-145 did not, however, address the question of whether the 10 percent limit on charitable deductions for purposes of MTI should be computed separately for each loss year when a taxpayer has NOL carryovers from multiple loss years. Indeed, the fact pattern considered in Rev. Rul. 76-145 involved an NOL carryover from only one loss year, so the question of whether one must separately compute MTI, and the 10 percent limit

[35] *See, e.g.*, Eversheds Sutherland letter to Treasury Assistant Secretary David Kautter (Oct. 23, 2019).

[36] ILM 201928014. In support of this conclusion, the IRS notes that "section 1.172-6 illustrates the year-by-year NOL absorption and carryover calculation."

[37] Reg. section 1.172-4(b)(1), (2).

[38] Reg. section 1.172-5(a)(2)(i).

[39] Reg. section 1.172-5(a)(2)(ii).

[40] *See, e.g.*, *Messina v. United States*, 202 Ct. Cl. 155 (1973); *Hall v. United States*, 99 Fed. Cl. 617 (2011); *United States v. Foster Lumber Co.*, 429 U.S. 32 (1976) (noting that "Congress may, of course, be lavish or miserly in remedying perceived inequities in the tax structure").

[41] *See, e.g.*, Eversheds Sutherland letter, *supra* note 34.

for MTI, for each loss year would not have been at issue.

### 2. Should the 10 percent limit on charitable deductions be based on MTI before or after the 20 percent disallowance is deducted?

While the question regarding the year-by-year versus aggregate method has existed for decades, a new question has emerged as a result of the 20 percent disallowance that is now subtracted from MTI: Is the 10 percent limit on charitable deductions for purposes of MTI computed before or after the 20 percent disallowance is deducted from MTI? To be sure, the current section 172 regulations generally require the 10 percent limit for purposes of MTI to be computed "with regard" to the modifications made to arrive at MTI,[42] and the 20 percent disallowance is now a "modification" made in the calculation of MTI. But the current section 172 regulations on MTI have not been updated since 1986, well before the TCJA and CARES Act were enacted, so they could not have considered this question. Also, one could reasonably argue that the 20 percent disallowance is simply a mechanism to increase NOL carryovers to account for the 80 percent limit, not a modification that should affect taxable income for purposes of computing limitations on other deductions. The 20 percent disallowance is also computed based on actual taxable income, taking into account charitable deductions actually taken against taxable income; as a result, it would be incongruous to consider the 20 percent disallowance when determining a different amount in charitable deductions that may be taken against MTI.

Moreover, as we show in an example further below, computing the 10 percent limit based on MTI after the deduction of the 20 percent disallowance can lead to illogical results in some scenarios. Specifically, computing the 10 percent limit based on MTI after the 20 percent disallowance is deducted can result in fewer charitable deductions being taken against MTI than were taken against actual taxable income, resulting in fewer total NOL carryovers than one would compute based on actual taxable income without any corresponding increase in charitable contribution carryovers. Given these illogical results, the lack of guidance to the contrary, and the IRS's flexible approach to permitting taxpayers to "choose any reasonable approach . . . for coordinating taxable income-based provisions," it is reasonable for taxpayers to compute the 10 percent limit based on MTI before the 20 percent disallowance is deducted rather than after.

## Bringing It All Together: An Example

These computational issues are difficult to discuss in the abstract, so an example bringing together the principles discussed may help clarify the underlying concepts. To return to an earlier example, suppose a corporation has taxable income of $2,000 in 2021 before considering any NOL carryovers or charitable deductions. The corporation has $2,600 of NOLs that are carried to 2021, which include $1,000 from 2017, $710 from 2019, and $890 from 2020. The corporation made $200 in charitable contributions in 2021. Applying simultaneous equations to this fact pattern, we previously computed permissible charitable deductions of $21.74 and permissible post-2017 deductions of $782.61. The 20 percent disallowance would be $195.65: 20 percent of $978.26 ($2,000 in taxable income less $1,000 in pre-2018 NOLs less $21.74 in charitable deductions). Taxable income would also be $195.65: $2,000 less $1,000 less $21.74 less $782.61.

Applying the year-by-year approach and the conclusion that the 10 percent limit on charitable deductions should be computed based on MTI before the 20 percent disallowance is deducted, NOL carryovers to 2022 would be determined as reflected in Table 1.

Because 2017 is the earliest loss year, the corporation would start its year-by-year computation with this loss year. No NOL carryovers from earlier years are available, and thus no NOL deductions are taken against MTI. Because we concluded that the 10 percent limit may (in the absence of any guidance to the contrary) reasonably be computed based on MTI before the 20 percent disallowance is deducted, the 10 percent limit is 10 percent of $2,000, or $200. This $200 charitable deduction against MTI is significantly higher than the $21.74 in charitable deductions that the corporation was permitted to deduct against actual taxable income in 2021. But even with the

[42] Reg. section 1.172-5(a)(2)(ii).

**Table 1.**

| Loss Year (Year in Which NOL Arose) | 2017 | 2019 | 2020 |
|---|---|---|---|
| NOL carried over from loss year and (ultimately) into 2021 | $1,000 | $710 | $890 |
| Current-year (2021) taxable income before charitable and NOL carryover deduction | $2,000 | $2,000 | $2,000 |
| Less NOL carryovers from years before loss year | $- | $(1,000) | $(1,710) |
| **2021 MTI before charitable deduction and 20% disallowance** | **$2,000** | **$1,000** | **$290** |
| Less charitable deductions permitted under the 10% limit | $(200) | $(100) | $(29) |
| Less 20% disallowance: | $(195.65) | $(195.65) | $(195.65) |
| MTI | $1,604.35 | $704.35 | $65.35 |
| NOL carryover to 2022 (NOL carryover from the loss year less MTI for the loss year) | $- | $5.65 | $824.65 |

larger charitable deduction of $200 and even after deducting the 20 percent disallowance, MTI is high enough — $1,604.35 — to fully absorb the $1,000 NOL carryover from 2017, meaning there is no carryover of the 2017 NOL to 2022.

Next, the corporation would move to the $710 NOL carryover from 2019. For purposes of determining any carryover of this 2019 NOL to 2022, MTI must be computed by deducting any NOL carryovers from earlier years — namely the $1,000 NOL carryover from 2017 that has already been absorbed. Accordingly, MTI before charitable deductions and the 20 percent disallowance is $2,000 minus $1,000, or $1,000. The limit on charitable deductions is 10 percent of $1,000, or $100. Thus, MTI is $1,000 minus $100 in charitable deductions minus the 20 percent disallowance of $195.65, or $704.35. The carryover of the 2019 NOL to 2022 is the NOL carryover of $710 minus MTI of $704.35, or $5.65. Even though the $100 charitable deduction taken against MTI exceeds the $21.74 charitable deduction taken against actual taxable income by $78.26, only $5.65 of that excess increases the 2019 NOL carryover, so the charitable contribution carryover must be reduced by $5.65 under section 170(d)(2)(B).

Finally, we arrive at the $890 NOL carryover from 2020. After deducting the $1,000 and $710 NOL carryovers from 2017 and 2019, respectively, MTI before charitable deductions and the 20 percent disallowance is $290. This results in a limitation on charitable deductions of 10 percent of $290, or $29. After deducting the $29 in charitable deductions and the 20 percent disallowance of $195.65, MTI is $65.35.

The carryover of the 2020 NOL to 2022 is $824.65: The $890 NOL from 2020 minus the MTI of $65.35. The $29 in charitable deductions the corporation took against MTI is $7.26 more than the $21.74 in charitable deductions taken against actual taxable income on the 2021 return. This results in the carryover of the 2020 NOL to 2022 being $7.26 higher than it would have been if only $21.74 were deducted.[43] Accordingly, the charitable contribution carryover must be further reduced by $7.26 under section 170(d)(2)(B).

The result is that the charitable contribution carryover must be reduced by a total of $12.91 under section 170(d)(2)(B) — $5.65 of which is the result of an increase in the 2019 NOL carryover and $7.26 of which is the result of an increase in the 2020 NOL carryover.[44] Accordingly, the

[43] This amount of $7.26 is also the difference between the $824.65 carryover of the 2020 NOL based on MTI and the $817.39 carryover one would compute based on the $72.61 of the 2020 NOL carryover that would be absorbed in a straightforward computation of actual taxable income.

[44] In other words, in 2021 all $710 of the NOL carryovers from 2019 is deducted against actual taxable income, but $5.65 of these 2019 NOLs is carried into 2022. Similarly, $72.61 of the $890 in NOL carryovers from 2020 is deducted against actual taxable income, but $824.65 of these 2020 NOLs is carried into 2022, $7.26 more than what the $72.61 deduction would suggest. As stated in ILM 201928014, "By reducing modified taxable income, these charitable contributions result in less NOL being absorbed than the actual amount of NOL used to reduce taxable income. Thus, the additional charitable contributions allowed in determining modified taxable income increase the amount of NOL carryovers to a subsequent taxable year."

**Table 2.**

| Loss Year (Year in Which NOL Arose) | 2017 | 2019 | 2020 |
|---|---|---|---|
| NOL carried over from loss year and (ultimately) into 2021 | $1,000 | $710 | $890 |
| Current-year (2021) taxable income before charitable and NOL carryover deduction | $2,000 | $2,000 | $2,000 |
| Less NOL carryovers from years before loss year | $- | $(1,000) | $(1,710) |
| Less 20% disallowance: | $(195.65) | $(195.65) | $(195.65) |
| **2021 MTI before charitable deduction** | **$1,804.35** | **$804.35** | **$94.35** |
| Less charitable deductions permitted under the 10% limit | $(180.43) | $(80.43) | $(9.43) |
| MTI | $1,623.91 | $723.91 | $84.91 |
| NOL carryover to 2022 (NOL carryover from the loss year less MTI for the loss year) | $- | $- | $805.09 |

charitable contribution carryover is $165.35: $200 minus the $21.74 deducted against actual taxable income minus the $12.91 in excess charitable deductions that increased NOL carryovers.[45]

This same example can also be used to demonstrate the distortions that would result if the 10 percent limit on charitable deductions were based on MTI after the 20 percent disallowance is deducted rather than before. The results of this alternative method are reflected in Table 2.

Under this approach, the $9.44 in charitable deductions taken against MTI for the 2020 loss year is lower than the $21.74 deducted against actual taxable income, which *decreases* the 2020 NOL carryover by $12.30. Nothing in the code contemplates a decrease in NOL carryovers caused by a decrease in charitable deductions taken against MTI, and, accordingly, no provision in the code provides for a corresponding increase in charitable contribution carryovers when this happens. Given that no provision in the code envisions this result, it appears reasonable to compute the 10 percent limit based on MTI before the 20 percent disallowance is deducted. Otherwise, tax attributes would vanish.

## Conclusion

The changes to the NOL rules made by the TCJA further complicated the interplay between NOL carryovers and charitable deductions. Treasury and the IRS have committed to allowing any reasonable method, including simultaneous equations, to account for overlapping deductions such as NOLs and charitable contributions in any given tax year. In contrast, history and ILM 201928014 suggest that the IRS will maintain its position on a strict year-by-year approach to MTI calculations, even in the face of taxpayers who take the aggregate approach. In any event, this article has attempted to suggest reasonable approaches to these difficult issues as practitioners tackle them on 2021 tax returns. We welcome comments and reactions.[46] ■

[45] By contrast, under an aggregate method, a full $200 (10 percent of $2,000) in charitable contributions would be deducted for each loss year, resulting in a 2019 NOL carryover of $105.65 and an increase in the 2020 NOL carryover of $72.61 (from $817.39 to the full $890 available), which would result in a reduction in the charitable contribution carryover of $178.26. This reduction of $178.26 is equal to the $200 charitable contribution less the $21.74 actually deducted, which means that none of the $200 charitable contribution in 2021 would be carried over after applying section 170(d)(2)(B).

[46] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of PwC or KPMG LLP.