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LEGEND

Taxpayer =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
ISSUES

(1) Taxpayer has both charitable contribution and net operating loss carryovers from multiple tax years available in the year at issue. Section 170(d)(2)(B) requires a reduction to a taxpayer’s charitable contribution carryover to the extent an excess charitable contribution reduces modified taxable income (as computed under § 172(b)(2)) and increases an NOL carryover, so as to eliminate a double tax benefit. Is Taxpayer required to calculate the charitable contribution carryover adjustment using a year-by-year or an aggregate NOL computation under § 172(b)(2)?

(2) Taxpayer has a charitable contribution carryover set to expire in the year at issue pursuant to the five-year carryover period provided in § 170(d)(2). Section 170(d)(2)(B) requires a reduction to a taxpayer’s charitable contribution carryover to the extent an excess charitable contribution reduces modified taxable income (as computed under § 172(b)(2)) and increases an NOL carryover. Is Taxpayer required to reduce its current year charitable contributions first or can it choose to reduce a prior year’s charitable contribution carryover to prevent its expiration?

CONCLUSIONS

(1) Section 172(b)(2) requires Taxpayer to use a year-by-year NOL absorption computation to determine the charitable contribution carryover adjustment under § 170(d)(2)(B).

(2) Taxpayer must first reduce its current year charitable contributions by the adjustment under § 170(d)(2)(B) before reducing its earliest year’s charitable contribution carryover.

FACTS

Taxpayer is a corporation that had several years of net operating loss carryovers (NOL carryovers) and charitable contribution carryovers (charitable carryovers) that were available to use in Year 1, the year at issue. The NOL carryovers totaled Amount 1 and the charitable carryovers totaled Amount 2. The charitable carryovers included Amount 3 from Year 2, which had not been utilized for four consecutive years and was scheduled to expire at the end of Year 1 if not utilized.

In Year 1, Taxpayer generated taxable income of Amount 4 before considering its NOL carryovers. Also in Year 1, Taxpayer made charitable contributions of Amount 5. All of Taxpayer’s Year 1 taxable income was offset by its NOL carryovers reducing its taxable
income to $0. As a result, Taxpayer was not allowed to deduct any charitable contributions in Year 1. Taxpayer had additional unused NOL and charitable carryovers available for use in the following year, Year 3.

LAW AND ANALYSIS

Section 170(a) of the Internal Revenue Code allows a deduction for charitable contributions paid within the taxable year. Section 170(b)(2) limits a corporation’s current charitable contribution deduction to ten percent of its taxable income (the 10% limit). Taxable income is computed for purposes of § 170(b)(2) without regard to the charitable contribution deduction or any NOL carryback to the taxable year. NOL carryovers are taken into account when calculating taxable income for purposes of determining the 10% limit.

Section 170(d)(2) provides for a carryover of charitable contributions a corporation makes in a taxable year that exceed the 10% limit. In determining which charitable contributions are deductible in a taxable year, current year contributions are deducted first. If current year contributions are less than the 10% limit, carryover contributions are taken into account in the order in which they arose. The maximum carryover period for charitable contributions is five taxable years.

Section 172(a) of the Internal Revenue Code allows a deduction for any NOLs carried back and carried forward to a taxable year. Section 172(b)(1) sets forth the years to which an NOL may be carried, while § 172(b)(2) specifies how to compute the amount of the NOL that is carried to those years. Section 172(b)(2) provides that an NOL shall be carried to the earliest year available. Once carried to the earliest taxable year available, all or a portion of the NOL is used up or absorbed. The amount of an NOL that is absorbed in a taxable year equals a taxpayer’s modified taxable income—taxable income for that year determined with certain modifications pursuant to § 172(b)(2). If an NOL carried to a taxable year is more than the modified taxable income for the taxable year, the excess of the NOL over the modified taxable income is carried to the next taxable year.

Under § 172(b)(2), modified taxable income is determined without taking into account the NOL to be absorbed or NOLs incurred in taxable years that are after the taxable year of the NOL to be absorbed. Treas. Reg. § 1.172-5(a)(2)(ii). However, NOLs carried from years before the taxable year of the NOL to be absorbed are considered in determining modified taxable income, as are charitable contribution deductions. Section 1.172-6 illustrates this year-by-year NOL absorption and carryover calculation. If an NOL deduction reduces a taxpayer’s taxable income to $0, no charitable contribution deduction is allowable for that taxable year.

As a result of these provisions, more charitable contributions may be allowable in computing modified taxable income under § 172(b)(2) than are allowable in computing taxable income under § 170(b)(2). 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.

The additional charitable contributions that are allowed in computing modified taxable income are not actually deducted when a taxpayer computes taxable income. If these additional amounts were allowed as charitable carryovers, then the contributions would produce a double tax benefit by reducing the amount of the NOL absorbed (which increases the NOL carryover) and also remaining available in a subsequent taxable year as a charitable contribution deduction. Section 170(d)(2)(B) exists to prevent this result and provides that charitable carryovers must be reduced to the extent that an excess charitable contribution reduces modified taxable income in the absorption calculation of § 172(b)(2) and increases an NOL carryover to a succeeding year under § 172 (the § 170(d)(2)(B) adjustment). The effect of these provisions is that some charitable contributions with a five-year carryover period are converted into an NOL with a twenty-year carryover period.

Issue 1

Exam asserts that the § 170(d)(2)(B) adjustment must be calculated for each taxable year an NOL carryover is absorbed, beginning with the earliest NOL available for use in the taxable year. Thus, Exam applied the 10% limit to Amount 6 (Amount 4 less Amount 7). Ten percent of Amount 6 equals Amount 8.

Taxpayer’s position is that the § 170(d)(2)(B) adjustment should be calculated on an aggregate basis. As a result, Taxpayer did not apply a year-by-year analysis of the § 170(d)(2)(B) adjustment. Taxpayer applied the 10% limit to the Year 1 taxable income of Amount 4, which equals Amount 9. Amount 9 is greater than Amount 8, and under Taxpayer’s method, Taxpayer would be entitled to a larger § 170(d)(2)(B) adjustment than allowed by Exam.

Section 172(b)(2) requires a chronological, year-by-year, NOL absorption computation. Section 1.172-6 illustrates the year-by-year NOL absorption and carryover calculation. Applying an aggregate basis standard is incorrect. In determining modified taxable income, Taxpayer was required to take into account the Year 4 NOL carryover of Amount 7. The NOL to be absorbed (part of the Year 5 NOL carryover) is not taken into account in determining modified taxable income. Accordingly, the § 170(d)(2)(B) adjustment is Amount 8.

Issue 2

Taxpayer and Exam disagree on which charitable contributions must be reduced pursuant to the § 170(d)(2)(B) adjustment. Exam asserts that Taxpayer must first reduce the Year 1 charitable contributions by the § 170(d)(2)(B) adjustment. If a
§ 170(d)(2)(B) adjustment remained after reducing the Year 1 charitable contributions to $0, then Taxpayer would reduce its charitable carryovers starting with the earliest year. In this case, the Year 1 charitable contributions of Amount 5 are greater than the § 170(d)(2)(B) adjustment, so no charitable carryovers are taken into account in computing the § 170(d)(2)(B) adjustment.

Taxpayer contends that § 170(d)(2)(B) does not address which charitable contributions must be reduced first so it should be able to use any reasonable method. Thus, in computing the § 170(d)(2)(B) adjustment, Taxpayer reduced its expiring charitable carryovers from Year 2 rather than the charitable contributions made in Year 1.

As described above, the Year 1 charitable contributions must be reduced first. The rules of §§ 170 and 172 and the regulations thereunder, which must be read in conjunction, dictate that current year charitable contributions rather than charitable carryovers are taken into account in the § 172(b)(2) calculation that reduces modified taxable income and increases the NOL carryover. As a result, it is the current year charitable contributions that trigger the § 170(d)(2)(B) adjustment and must therefore be reduced.

Taxpayer cites Revenue Ruling 76-145 for the proposition that current year charitable contributions and all charitable carryovers are co-equal, fungible elements of “excess contributions,” and each is an equally viable option to be reduced first or last.

In Revenue Ruling 76-145, the current year charitable contributions were $2, but the applicable percentage limit was $5. Thus, the current year charitable contributions of $2 plus the charitable carryover of $3, together, had to be taken into account in calculating the § 170(d)(2)(B) adjustment because the $2 and the $3, together, reduced modified taxable income in the absorption calculation of § 172(b)(2) and increased the NOL carryover to a succeeding year under § 172. If the current year charitable contributions were also $3, then the current year charitable contributions would be reduced first by operation of § 170(d)(2)(B), and there would be $1 left of the charitable carryover.

In Taxpayer’s case, the Year 1 charitable contributions of Amount 5 are greater than the 10% limit of Amount 8. Thus, only the Year 1 charitable contributions of Amount 5 are taken into account in calculating the § 170(d)(2)(B) adjustment because Amount 5 alone reduced modified taxable income in the § 172(b)(2) absorption calculation thereby increasing the NOL carryover to a succeeding year. Accordingly, the result in Revenue Ruling 76-145 and the result in this case are not inconsistent; rather, the facts merely dictate a different result. If the facts of this case were such that the 10% limit was greater than the current year charitable contributions, then Taxpayer would add the amount of the earliest year’s charitable carryover to the current year charitable contributions to the extent the charitable carryover also reduced modified taxable income in the absorption calculation of § 172(b)(2) and increased the NOL carryover to a succeeding year under § 172.
Here, to the extent the charitable contributions in Year 1 reduced modified taxable income in the absorption calculation of § 172(b)(2) and increased the NOL carryover to Year 3, the charitable carryover must be reduced by the amount of the Year 1 charitable contributions that increased the NOL carryover. Amount 8 of the Year 1 charitable contributions reduced modified taxable income and, thus, increased the NOL carryover so that the remainder should be carried over to Year 3.

Moreover, because the Year 2 charitable carryover expires in Year 1, it is not an excess contribution under § 170(d)(2)(A). The charitable carryover from Year 2 may not be used because of the expiration of the five-year statute of limitations period.

The rules and analysis can be explained by this simplified example. X Corp had $1,000 of taxable income in 2017 before considering its NOL carryovers or charitable contribution deduction. X Corp had NOL carryovers of $5,000 available to use in 2017, which included $100 from 2012 and $1,500 from 2013. X Corp also had charitable carryovers available to use in 2017 of $300, which included $150 from 2012. In 2017, X Corp made charitable contributions of $120.

In this example, like in Taxpayer’s case, X Corp cannot deduct any charitable contributions in 2017 because the NOL carryovers reduce taxable income for 2017 to $0. But, like Taxpayer, X Corp still must compute the 10% limit for purposes of determining modified taxable income and the amount of the NOL carryovers that are absorbed.

First, X Corp must subtract its 2012 NOL from its 2017 taxable income to determine the § 170 taxable income ($1,000-$100=$900). X Corp must then multiply its § 170 taxable income by the 10% limitation ($900x.10=$90). The $90 represents the amount of the 2017 charitable contribution that is allowed for purposes of calculating modified taxable income under § 172(b)(2).

Second, because X Corp cannot deduct any charitable contributions in 2017 and it has NOL and charitable carryovers, it must determine how much of the 2017 charitable contributions it can carry over to 2018 after applying the § 170(d)(2)(B) adjustment. X Corp must reduce its 2017 charitable contributions by $90 because that amount was allowed in the modified taxable income calculation ($900-$90=$810), resulting in an increased NOL carryover to 2018 and the charitable contributions not actually being deducted. The result is that only $30 ($120-$90) of the 2017 charitable contributions is allowed to be carried over to 2018.

Lastly, X Corp must calculate the amount of the 2013 NOL carryover that is absorbed under § 172(b)(2) and the amount carried over to 2018. The 2013 NOL carryover is reduced by the amount absorbed, which is the 2017 modified taxable income, and the remainder is carried over to 2018 ($1,500-$810=$690).
In this example, like in Taxpayer's case, only the current year charitable contributions are taken into account in calculating the § 170(d)(2)(B) adjustment because the current year charitable contributions alone reduced modified taxable income in the absorption calculation of § 172(b)(2) and increased the NOL carryover to a succeeding year under § 172. Accordingly, X Corp loses the ability to use any charitable carryovers from 2012 as a result of the expiration of the five-year statute of limitations period.

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Please call (202) 317-7003 if you have any further questions.