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The 1% Floor on Charitable Deductions May Erode NOL Carryovers

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C corporations with NOL carryovers may see those carryovers reduced as a result of OBBBA's new 1% floor on charitable contribution deductions, write KPMG's Preston Quesenberry and Ethan Walker.

A restriction on corporate charitable contribution deductions buried in the One Big, Beautiful Bill Act, Pub. L. 119-21, may reduce net operating loss carryovers for C corporations, in addition to permanently disallowing some (or even all) of many corporations' deductions for charitable contributions — a double negative result that compounds the cost of OBBBA's 1% floor.

OBBBA amended §170(b)(2)(A) to impose a 1% floor on corporate charitable contribution deductions, effective for tax years beginning after Dec., 31, 2025. Under the new provision, a corporation may deduct charitable contributions only to the extent the aggregate of such contributions exceeds 1% of taxable income (as defined in §170(b)(2)(D)) and do not exceed 10% of taxable income (the longstanding "10% limit"). Despite its apparent simplicity, the 1% floor can, in certain instances, reduce available NOL carryovers by more than the NOL deduction actually used in computing taxable income. For many corporations, this NOL reduction will be accompanied by the permanent disallowance of charitable contribution deductions — consequences that make careful tax planning essential for affected corporations.

This article provides a brief overview of the law's 1% floor, discusses how the 1% floor interacts with the 80% limit on certain NOL carryovers, reviews the mechanical application of the NOL carryover rules of §172(b)(2), and explains how the advent of the 1% floor may cause some C corporations to observe an unanticipated reduction to an NOL carryover.

Application of the 1% floor. OBBBA amended §170(b)(2)(A) to allow corporations to take charitable contribution deductions "only to the extent that the aggregate of such contributions exceeds 1% of the taxpayer's taxable income for the taxable year and doesn't exceed 10% of the taxpayer's taxable income for the taxable year." Certain adjustments to taxable income (set forth in §170(b)(2)(D)) apply when determining the 1% floor and 10% limit. For purposes of the examples in this article, we will focus primarily on the fact that taxable income for purposes of applying the 1% floor and 10% limit excludes the charitable contribution itself, and includes the §172 NOL carryover deduction.

The Joint Committee on Taxation has interpreted the 1% floor as meaning that a corporation "may only deduct total charitable contributions of up to nine percent of" taxable income in a tax year. However, the JCT also acknowledges that a "technical correction may be needed so that the statute reflects this intent." This acknowledgment most likely reflects a competing interpretation of the amended statute under which a corporation may still deduct up to 10% of taxable income in a tax year but must contribute an additional 1% of taxable income (11% total) to reach that limit.

The modifications to the charitable contribution carryover rules are clear: Charitable contributions disallowed by the 1% floor are allowed to be carried over to each of the subsequent five years only in the event that the 10% limit is also exceeded §170(d)(2)(C).

Simultaneous application of the NOL limitation. NOLs generated in taxable years beginning after Dec. 31, 2017, ("post-2017 NOLs") and carried over to taxable years beginning after Dec. 31, 2020, are subject to a limit of 80% of taxable income without regard to any post-2017 NOL deduction (and certain other modifications specified in §172(a)(2)(B)(ii)) but with regard to charitable contribution deductions.

For corporations that face both the 80% limit on post-2017 NOLs and the 1% floor and 10% limit on charitable

contributions, neither the tax code nor any IRS guidance provides any ordering rules that taxpayers can use in taking deductions to determine taxable income for purposes of the limitations. In the absence of ordering rules, simultaneous equations are arguably the only correct way to determine the various limitations in a manner that satisfies the parameters established by Congress in each provision.

The use of simultaneous equations is best explained with an example. Assume the following:

- Corporation with charitable contributions in a tax year beginning in 2026 also has post-2017 NOL carryovers available to be used in that tax year and will be subject to the 80% limit under §172(a)(2)(B)(ii)
- x represents charitable deductions that will be permitted after application of the 1% floor
- y represents permissible post-2017 NOL deductions
- CC represents actual charitable contributions made in or carried over to the tax year potentially subject to the 1% floor
- T is the taxable income in the tax year without regard to either charitable deductions or post-2017 NOL deductions.
- None of the other differences in the definitions of taxable income in §170(b)(2)(D) and §172(a)(2)(B)(ii) apply
- No other deductions will potentially be subject to a limit based on taxable income.

The two simultaneous equations would be as follows:

- $x = CC - 0.01(T - y)$
- $y = 0.8(T - x)$

One can reduce the first equation to one variable by substituting the definition of the second variable in the second equation for the same variable in the first equation, as follows:

- $x = CC - 0.01(T - y)$
- $x = CC - 0.01(T - 0.8(T - x))$
- $x = CC - 0.01(T - 0.8T + 0.8x)$
- $x = CC - 0.01T + 0.008T - 0.008x$
- $1.008x = CC - 0.002T$
- $x = (CC - 0.002T)/1.008$

Accordingly,

- Permissible charitable contribution deduction above the 1% floor in the tax year is going to equal $(CC - 0.002T)/1.008$
- If $(CC - 0.002T)/1.008$ is zero or less than zero, no charitable contribution deduction would be permitted.

Employing the same simultaneous equation approach (and assuming the 10% limit actually limits deductions to 9% of taxable income as suggested by the JCT), one can also determine that:

- Charitable contribution deductions would be subject to a ceiling of $(0.018/0.928) * T$
- Permissible charitable contribution deductions would then equal the lesser of $(CC - 0.002T)/1.008$ (if not less than zero) or $(0.018/0.928) * T$
- Corporation could then subtract the permissible charitable deductions from T and take 80% of that to figure out the 80% limit on post-2017 NOL deductions.

NOL carryover rules. When an NOL carryover is deducted in a taxable year, §172(b)(2) prescribes rules for determining the remaining amount of the NOL that can be carried over to the subsequent year. Generally, the amount of an NOL able to be carried over to the subsequent year is computed by subtracting a modified version of taxable income, or MTI from the NOL itself. The excess of the NOL carried into the tax year over MTI for that tax year is the amount of NOL able to be carried over to the next year.

MTI is taxable income computed "without regard to the net operating loss for the loss year or for any taxable year thereafter" and reduced by 20% of taxable income as defined for purposes of the 80% limit on post-2017 NOLs. *See* §172(b)(2) (which also notes certain other modifications by cross-reference to section §172(d)). MTI can't be less than zero. §172(b)(2)(B). The calculation of MTI is governed by the tax rules that are effective for the year in which the loss is carried. §172(e).

The regulations governing the computation of MTI make clear that "any deduction which is limited in amount to a percentage of the taxpayer's taxable income or adjusted gross income shall be recomputed upon the basis of the modifications" in computing MTI. Treas. Reg. §1.172-5(a)(2)(ii).

This recomputation can be well illustrated in the context of the 10% limit, which is specifically mentioned in Treas.

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Reg. §1.172-5(a)(2)(ii). Even though the 1% floor and 10% limit are based on a measure of taxable income that takes into account the NOL carryover deduction, MTI is taxable income computed "without regard to the net operating loss for the loss year or for any taxable year thereafter."

By disregarding the NOL carryover deduction, the 10% limit under MTI is based on a measure of taxable income that is higher than actual taxable income, resulting in a higher 10% limit for purposes of MTI. When a higher 10% limit results in more charitable deductions being taken against MTI than are taken against taxable income, a corporation benefits from a larger NOL carryover to the subsequent year than would be the case if the corporation simply subtracted the NOL absorbed in computing taxable income from the total NOL available to be deducted during the tax year.

Example 1:

- Corporation has 2025 taxable income (before charitable contribution and NOL deductions) of $1,000
  o NOL carryover from 2017 (not subject to the 80% limit) of $2,000
  o No NOLs from earlier years
- The 10% limit is determined with regard to NOL deductions, and 10% of $0 ($1,000 minus $1,000 of the 2017 NOL) is $0
- For purposes of MTI, the 10% limit would be 10% of taxable income without regard to the 2017 NOL deduction, which would be 10% of $1,000, or $100
- If the corporation donated $100 or more in 2025, MTI would be $1,000 - $100, or $900
- Amount of the 2017 NOL carried over to 2026 would then be $2,000 minus $900, or $1,100 — which is $100 more than one would expect based on the $1,000 of the NOL deducted against actual taxable income.

How the 1% floor reduces NOL carryovers. For the same reason that the 10% limit is often higher when calculated based on MTI rather than actual taxable income, the 1% floor will also be higher under MTI — meaning a higher threshold must be cleared before any contributions become deductible. In certain cases, this produces the opposite effect of the higher 10% limit: Rather than yielding more charitable deductions against MTI, the 1% floor may cause a taxpayer to deduct fewer charitable contributions against MTI than against actual taxable income. This can leave a corporation with a smaller NOL carryover to the subsequent year than it would have if it simply subtracted the NOL absorbed in computing taxable income from the total NOL available for the tax year.

An example will help demonstrate this undesirable result.

Example 2:

- Suppose that, in its tax year beginning in 2026, a corporation has $10,000 of taxable income before charitable contribution and NOL deductions,
- $200 in current-year charitable contributions (with no carryovers from prior years),
- $9,000 NOL carryover from 2021 that is available to be used (with no carryovers from earlier years).

Applying the simultaneous equations noted in the prior section to compute its taxable income, the corporation would deduct $179 of charitable contributions (with the remaining $21 disallowed by the 1% floor) and $7,857 in NOL carryovers, leaving it with $1,964 in taxable income (an amount equal to 20% of taxable income as defined for purposes of the 80% limit on post-2017 NOLs).

Because $7,857 of its 2021 NOL carryover was used in 2026, the corporation might expect to carry over $1,143 ($9,000 minus $7,857) to 2027. But the rules for computing NOL carryovers under §172(b)(2) aren't that simple. Rather than simply subtracting the amount of the 2021 NOL used from total 2021 NOL available in 2026, the statute and regulations would require the corporation to subtract MTI from the total 2021 NOL. And in computing MTI, the 1% floor for charitable contributions must be determined "with regard to any modifications" required in the computation of MTI.

The relevant modification in this scenario is that MTI is computed without regard to any deduction of the 2021 NOL carryover. Accordingly, the 1% floor for MTI purposes wouldn't be $21 (1% of $10,000 minus the NOL carryover deduction of $7,857); rather, it would be $100 (1% of 10,000). In computing MTI, the corporation would only deduct $100 in charitable contributions (the amount of 2026 charitable contributions in excess of a $100 floor) rather than $179 (the amount of 2026 charitable contributions in excess of a $21 floor). As a result, MTI would equal $10,000 minus $100 minus $1,964 (20% of taxable income as defined for purposes of the 80% limit on post-2017 NOLs), which equals $7,936.

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The corporation would then compute the carryover of the 2021 NOL to 2027 by subtracting $7,936 from $9,000, which equals $1,064. That carryover of $1,064 is $79 less ($1,143 minus $1,064) than the carryover the corporation would expect based on its use of the 2021 NOL carryover in 2026. This is because the corporation had to deduct $79 less in charitable contributions against MTI than it could deduct against actual taxable income.

As bad as this $79 reduction to the NOL carryover may seem on its own, the corporation would also face a permanent disallowance of the $21 in charitable contributions disallowed by the 1% floor — because the $200 in total contributions doesn't exceed the 10% limit.

Key takeaways. The introduction of the 1% floor is an unfortunate change for corporations in its own right; it can result in a permanent disallowance of charitable contribution deductions that would otherwise have been fully deductible under prior law. The analysis above reveals a less obvious consequence: The 1% floor can sometimes have the undesirable "knock on" effect that permanently reduces a second tax attribute — the NOL carryover — by an amount exceeding what one would expect based on the NOL deduction actually used. Unless the Treasury Department and the IRS determine that this effect is unintended and amend the applicable Treasury Regulations accordingly, C corporations with NOL carryovers face a double-negative outcome that demands careful planning before making charitable contribution decisions for tax years beginning after Dec. 31, 2025.

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