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"After you." "No, after you." The Case for Simultaneous Linear Equations with Competing Deductions

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Several provisions of the Internal Revenue Code[1] require a modified computation of taxable income. Frequently, the required modification is computing taxable income[2] without regard to certain sections or certain deductions. When a taxpayer's return implicates more than one such provision, how the interaction among the different computations works is far from clear.

The issue has existed in niche areas for years.[3] However, the passage of H.R. 1,[4] which requires these modified taxable income calculations in several common contexts, gives the issue renewed significance. This article discusses two alternative

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1 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

2 "Taxable income" is defined in section 63(a) for purposes of subtitle A (sections 1-1563) as gross income minus the deductions allowed by chapter 1 (sections 1-1400Z-2).

3 For example, in Revenue Ruling 79-347, the IRS addressed the interaction between the limitation on the dividends received deduction under section 243 and the limitation on the percentage depletion deduction under section 613A. *See* Rev. Rul. 79-347, 1979-2 C.B. 122, *considered in* GCM 37648 (Aug. 23, 1978).

4 H.R. 1, an act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, was signed into law on December 22, 2017, as Public Law No. 115-97, 131 Stat. 2054 (2017) (the "Act").

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methods for dealing with the modified taxable income calculations when more than one such calculation is at play.

For illustrative purposes, this article deals primarily with one overlap, that between section 172(a)(2) and section 250(a)(2).[5] In fact, the issue can exist with respect to several additional provisions,[6] and a given taxpayer could have to balance overlaps between more than two provisions. Nevertheless, the core issues are evident in the simpler example of only two competing provisions.

The Competing Provisions Discussed in this Article[7]

Section 172(a)(2)

Prior to H.R. 1, a corporation could generally offset 100 percent of its taxable income with net operating losses for regular tax purposes.[8] H.R. 1 modified section 172(a)(2) to effectively limit the net operating loss ("NOL") deduction for losses arising in tax years beginning after December 31, 2017, to 80 percent of taxable income.[9] The mechanism the statute uses is to limit the deduction to 80 percent of taxable income computed without regard to the deduction allowable under section 172. The legislative history to section 172(a)(2) suggests that Congress imposed such a limit on the NOL deduction to ensure that every profitable taxpayer pays at least some amount of income tax, similar to the alternative minimum tax for corporations that was eliminated in H.R. 1.[10]

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[5] Additionally, even within section 250, this article focuses on a taxpayer that has only GILTI and not FDII (as those terms are defined below), and assumes that the taxpayer does not have any foreign tax credits available to offset its GILTI inclusion.

[6] *See also* sections 163(j)(8)(A), 170(b)(2)(D), 199A(e)(1), and 247(c)(1).

[7] This article does not address the conceptually distinguishable issue of whether to recompute various percentage limitations in a carryback year as a result of the carryover and deduction of NOLs generated in other years into that year. *See* section 1.172-5(a)(2)(ii).

[8] Even before H.R. 1, under the alternative minimum tax regime of sections 55-59, only 90 percent of "alternative minimum taxable income" (as defined in those sections) could be offset by NOL deductions.

[9] Section 172(a); H.R. 1, 115th Cong. § 13302(e)(1). H.R. 1 was introduced in the U.S. House of Representatives with a provision that generally would have limited the amount of the NOL deduction to 90 percent of taxable income without regard to the deduction under section 172. *See* H.R. 1, 115th Cong. § 3302(c)(1) (as introduced in House, Nov. 2, 2017). The U.S. Senate would have amended this provision to provide for a 90 percent limitation for NOLs arising in tax years beginning after December 31, 2017, and for an 80 percent limitation for tax years beginning after December 31, 2022. *See* H.R. 1, 115th Cong. § 13302 (as passed by Senate, Dec. 2, 2017). The Conference Agreement provides for a limitation on the NOL deduction equal to 80 percent of taxable income (determined without regard to the deduction) for NOLs arising in tax years beginning after December 31, 2017. *See* H.R. Conf. Rep. No. 115-466, at 70-72, 393-394 (2017) (the "Conference Report").

[10] *See* H. Rep. No. 115-409, at 252 (2017) ("The Committee also believes that taxpayers should pay some income tax in years in which the taxpayer has taxable income (determined without regard to the NOL deduction). Therefore, the Committee believes that the NOL deduction should be limited to 90 percent of taxable income (determined without regard to the deduction)"); S. Prt. No. 115-20, at 176 (2017) (the "Senate Print"). Revenue considerations also appear to have been weighed heavily by the policymakers.

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Section 250(a)(2)

Under new provisions added to the Code by H.R. 1 designed to reshape taxation of U.S. multinational corporations, U.S. corporations take into account as income certain amounts of foreign derived intangible income ("FDII") and global intangible low-taxed income ("GILTI").[11] To reduce the effective tax rate on those foreign source inclusions, section 250 generally provides a deduction to a domestic corporation[12] for (1) a specified percentage of its FDII (through 2025, 37.5 percent, and 21.875 percent thereafter) and (2) a specified percentage of its GILTI (through 2025, 50 percent, and 37.5 percent thereafter). The section 250 deduction is subject to a limitation based on the taxpayer's taxable income. Section 250(a)(2) provides that if the sum of the FDII and the GILTI amounts otherwise taken into account by the domestic corporation in computing the deduction exceeds the taxable income of the domestic corporation (determined without regard to section 250), then the amounts of the FDII and the GILTI so taken into account are reduced proportionately to aggregate the amount of taxable income computed without regard to section 250.[13]

The legislative history to H.R. 1 suggests that Congress intended section 250 to reduce the effective tax rate on FDII and GILTI in order to incentivize taxpayer behavior.[14] It is, however, unclear why the taxable income limitation of section 250(a)(2) was included, because it has the effect of increasing the effective rate on FDII and GILTI by requiring a taxpayer to use deductions that could otherwise offset

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[11] For any amount of GILTI that is includible in the income of a domestic corporation, the new law provides for a deemed paid credit limited to 80 percent of the foreign taxes attributable to the GILTI inclusion. Under section 78, an amount equal to the taxes deemed paid by a corporation under section 960, including 100 percent of the amount of foreign taxes attributable to the GILTI inclusion (i.e., not subject to the 80 percent limitation for purposes of determining the amount of the foreign taxes deemed paid), is treated as a dividend received by the domestic corporation from the foreign corporation. The amount of the section 250 deduction for GILTI includes the amount treated as a dividend received under section 78. The new law creates a separate basket for deemed paid taxes attributable to the GILTI inclusion for purposes of calculating the limitation on the use of such credits. The deemed paid taxes on GILTI are not allowed to be carried back or forward to other tax years. *See* N.Y. State Bar Ass'n, Report No. 1394, Report on the GILTI Provisions of the Code (May 4, 2018).

[12] While any U.S. shareholder of a controlled foreign corporation can have a GILTI inclusion by reason of section 951A(a), only a U.S. shareholder that is a domestic corporation can claim a section 250 deduction. Section 250(a)(1). U.S. shareholders that are not domestic corporations are subject to "full U.S. tax on their GILTI." Conference Report, at 622 n.1515. The committee reports do not articulate any particular rationale for this limitation, though the Senate Print's articulation of the reasons for change exhibits a remarkably corporation-centric perspective. Senate Print, at 370-371 (discussing GILTI), 375 (discussing the section 250 deduction).

[13] There is no carryforward of the portion of any GILTI or FDII deduction that exceeds the taxable income limitation. Therefore, to the extent that the amount of GILTI and/or FDII taken into account is reduced as a result of the taxable income limitation, a deduction for such amounts is permanently lost.

[14] Senate Print, at 375:

> One of the Committee's goals in tax reform is to remove the tax incentive to locate intangible income abroad and encourage U.S. taxpayers to locate intangible income, and potentially valuable economic activity, in the United States. The Committee believes that offering similar, preferential rates for intangible income derived from serving foreign markets, whether through U.S.-based operations or through CFCs, reduces or eliminates the tax incentive to locate or move intangible income abroad, thereby limiting one margin where the Code distorts business investment decisions. . . . The Committee believes that establishing a deduction for foreign derived intangible income earned by domestic corporations helps the United States compete with countries that offer preferential rates for intellectual property.

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income taxable at a higher rate to offset FDII and GILTI.[15] Unlike section 172, where Congress chose to preserve NOL carryovers for later use when there is a limitation under section 172(a)(2), Congress essentially created a permanent disallowance of the section 250 deduction for FDII and GILTI with the section 250(a)(2) limitation.[16]

The Conflict and Potential Paradox

If the "without regard to" language in the requirement to compute modified taxable income as part of the determination of the deduction amount under each of section 172 and section 250 is interpreted to mean that the existence of the underlying section cannot be taken into account in any way when computing the respective limitation (the "Separate Calculations Approach"), some interesting and paradoxical patterns emerge. The interplay becomes interesting only when the deductions at issue are sufficiently large in relation to taxable income without regard to the other deduction. In each of the following examples, we assume the only deductions at play that are subject to limitations susceptible of this type of interaction are deductions under sections 172 and 250.[17]

Example 1: Separate equations when the magnitude of the potential deductions is small enough to present no conflict

> Taxpayer has $20 of NOL carryover from 2018 and no prior year NOL carryovers. In 2019, Taxpayer has $100 of taxable income without regard to section 172 or section 250. In 2019, Taxpayer has $30 of GILTI, which is included in the $100 of overall income.
>
> To calculate its deduction under section 172(a), Taxpayer computes its modified taxable income, taking into account all deductions other than the NOL deduction. Taxpayer's deduction under section 250, without regard to the existence of any potential deduction under section 172, is $15 (50 percent of $30 of GILTI, all of which hypothetically would be allowed as $30 of GILTI is less than the $100 of taxable income without regard to section 172). Accordingly, Taxpayer's modified taxable income is $85, and so Taxpayer can offset up to $68 (80 percent of $85) of income with post-2018 NOL carryovers. Since Taxpayer has only $20 of post-2018 carryovers, it can fully use its carryover.
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> To calculate its deduction under section 250, Taxpayer computes its modified taxable income, taking into account all deductions other than its deduction under section 250. Taxpayer's modified taxable income, taking into account its deduction under section 172, is $80. Since

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[15] Perhaps revenue considerations might provide an explanation for this limitation.

[16] *See also* section 163(j)(2) (as modified by section 13301(a) of the Act) (unlimited carryovers of disallowed interest deductions); sections 53(d)(2) and 53(e) (as added by § 12002(a) of the Act) (enhanced ability to utilize prior minimum tax credits, which were also made refundable).

[17] We assume that the taxpayer is a domestic, standalone, calendar-year corporation. Also, to simplify, we assume the absence of potential foreign tax credits and correlative gross-up under section 78. Moreover, the calculations and analysis in this article reflect a taxpayer with no pre-2018 NOL carryovers. The reason for this is that there are some complexities to the calculation of the section 172(a)(2) limitation when both pre- and post-2018 carryovers are present that are beyond the scope of this article.

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Taxpayer's total GILTI of $30 is less than its modified taxable income, Taxpayer can take the full amount into account in computing its deduction under section 250. Taxpayer's deduction is $15 (50 percent of $30).

Taxpayer's taxable income taking into account both deductions is $65.

As the above example demonstrates, there is no conflict between the two calculations when each deduction is sufficiently small. However, when the deductions become larger in comparison to the overall taxable income, the interplay becomes interesting, as the following two examples demonstrate.

Example 2: Separate equations when the magnitude of the potential deductions is great enough to present a conflict

Taxpayer has $200 of NOL carryover from 2018 and no prior year NOL carryovers. In 2019, Taxpayer has $100 of taxable income without regard to section 172 or section 250. In 2019, Taxpayer has $70 of GILTI, which is included in the $100 of overall income.

To calculate its deduction under section 172(a), Taxpayer computes its modified taxable income, taking into account all deductions other than the NOL deduction. Taxpayer's deduction under section 250, without regard to the existence of any potential deduction under section 172, is $35 (50 percent of $70 of GILTI, all of which hypothetically would be allowed as $70 of GILTI is less than the $100 of taxable income without regard to section 172). Accordingly, Taxpayer's modified taxable income is $65, and so Taxpayer can offset up to $52 (80 percent of $65) of income with post-2018 NOL carryovers.

To calculate its deduction under section 250, Taxpayer computes its modified taxable income, taking into account all deductions other than its deduction under section 250. Taxpayer's modified taxable income, taking into account what its deduction under section 172 would be if there were no section 250 deduction, is $20 (section 172 would allow a deduction of $80, or 80 percent of the $100 of taxable income Taxpayer would have without regard to section 250). Accordingly, Taxpayer can only take into account $20 of its GILTI in computing its deduction under section 250, and Taxpayer's total deduction is $10.[18]

Taxpayer's taxable income taking into account both deductions is $38.

[18] The application of the Separate Calculations Approach resulted in $25 of forgone deductions under section 250. Taxpayer would have had a $35 section 250 deduction if it had zero NOL carryovers and Taxpayer's section 250 deduction would be $10 under the Separate Calculations Approach. Taxpayer would have been able to deduct $80 of NOL carryovers if it had zero of GILTI, and was allowed to deduct only $52 under the Separate Calculation Approach. Taxpayer may continue to carryover the $28 of NOL carryovers that were subject to limitation under the Separate Calculations Approach, in contrast to the $25 of forgone deductions under section 250 that are permanently disallowed.

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Example 3: Same as example 2, with higher GILTI

Taxpayer has $200 of NOL carryover from 2018 and no prior year NOL carryovers. In 2019, Taxpayer has $100 of taxable income without regard to section 172 or section 250. In 2019, Taxpayer has $90 of GILTI, which is included in the $100 of overall income.

To calculate its deduction under section 172(a), Taxpayer computes its modified taxable income, taking into account all deductions other than the NOL deduction. Taxpayer’s deduction under section 250, without regard to the existence of any potential deduction under section 172, is $45 (50 percent of $90 of GILTI, all of which hypothetically would be allowed as $90 of GILTI is less than the $100 of taxable income without regard to section 172). Accordingly, Taxpayer’s modified taxable income is $55, and so Taxpayer can offset up to $44 (80 percent of $55) of income with post-2018 NOL carryovers.

To calculate its deduction under section 250, Taxpayer computes its modified taxable income, taking into account all deductions other than its deduction under section 250. Taxpayer’s modified taxable income, taking into account what its deduction under section 172 would be if there were no section 250 deduction, is $20 (section 172 would allow a deduction of $80, or 80 percent of the $100 of taxable income Taxpayer would have without regard to section 250). Accordingly, Taxpayer can only take into account $20 of its GILTI in computing its deduction under section 250, and Taxpayer’s total deduction is $10.

Taxpayer’s taxable income taking into account both deductions is $46.[19]

As these two examples demonstrate, Taxpayer’s overall tax due (using this methodology) goes *up* as the portion of its income that is generated by GILTI increases. Since the intent of section 250 is to provide preferential treatment to GILTI (and FDII), this result is paradoxical. Moreover, Taxpayer would have had a better overall tax result in both situations had it simply generated domestic income in lieu of GILTI, indicating that the effective marginal tax rate on the GILTI can *exceed* the 21 percent statutory rate.[20] A similar result would be obtained for FDII. This result is difficult to reconcile with Congress’s apparent intent in enacting section 250.

Example 4 will demonstrate that reducing Taxpayer’s NOL carryovers to 2019 will similarly improve Taxpayer’s overall tax result.

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[19] Consider the same example in which Taxpayer has $200 of GILTI. Taxpayer’s section 172(a) deduction would be $40 because the section 250 deduction taken into account in computing the section 172(a) deduction under the Separate Calculations Approach would be $50. Taxpayer’s GILTI deduction would be $10 because Taxpayer’s section 172(a) deduction taken into account in computing the section 250 deduction under the Separate Calculations Approach would be $80. Taxpayer’s taxable income taking into account both deductions is $50.

[20] The application of the Separate Calculations Approach resulted in $35 of forgone deductions under section 250. Taxpayer would have had a $45 section 250 deduction if it had zero NOL carryovers and Taxpayer’s section 250 deduction would be $10 under the Separate Calculations Approach.

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Example 4: Same as example 3 with lower NOL carryover

Taxpayer has $30 of NOL carryover from 2018 and no prior year NOL carryovers. In 2019, Taxpayer has $100 of taxable income without regard to section 172 or section 250. In 2019, Taxpayer has $90 of GILTI, which is included in the $100 of overall income.

To calculate its deduction under section 172(a), Taxpayer computes its modified taxable income, taking into account all deductions other than the NOL deduction. Taxpayer's deduction under section 250, without regard to the existence of any potential deduction under section 172, is $45 (50 percent of $90 of GILTI, all of which hypothetically would be allowed as $90 of GILTI is less than the $100 of taxable income without regard to section 172). Accordingly, Taxpayer's modified taxable income is $55, and so Taxpayer can offset up to $44 (80 percent of $55) of income with post-2018 NOL carryovers. Since Taxpayer only has $30 of NOL carryover, Taxpayer can use the full carryover.

To calculate its deduction under section 250, Taxpayer computes its modified taxable income, taking into account all deductions other than its deduction under section 250. Taxpayer's modified taxable income, taking into account what its deduction under section 172 would be if there were no section 250 deduction, is $70 (because Taxpayer only has $30 of NOL carryover, the higher potential limitation when the section 172(a)(2) limit is calculated without regard to section 250 does not come into play). Accordingly, Taxpayer can only take into account $70 of its GILTI in computing its deduction under section 250, and Taxpayer's total deduction is $35.

Taxpayer's taxable income taking into account both deductions is $35.

The interplay between these limitations, demonstrated by the above examples, seems inconsistent with the purpose of either section. The purpose for section 250, as expressed by the legislative history, is to provide a preferential rate for GILTI and FDII over the rate for regular taxable income. As examples 2 and 3 show, when the taxpayer also has a large NOL carryover, a higher proportion of GILTI or FDII income results in a *higher* effective tax rate under the Separate Calculations Approach. Similarly, the purpose of the NOL limitation is presumably to allow a taxpayer to balance lean years with the flush, while ensuring that the taxpayer continues to pay some amount of tax in profitable years, even when it has loss carryovers. When there is a substantial amount of GILTI or FDII, however, under the Separate Calculations Approach, the amount of tax due actually decreases when the taxpayer has a smaller loss carryover.[21]

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[21] The application of the Separate Calculations Approach resulted in $10 of forgone deductions under section 250. Taxpayer would have had a $45 section 250 deduction if it had zero NOL carryovers and Taxpayer's section 250 deduction would be $35 under the Separate Calculations Approach.

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Alternative: Simultaneous Limitations

An alternative method of computing the competing limitations is to take a more relaxed approach to the injunction that modified taxable income be computed “without regard to” the section or deduction being tested (the “Simultaneous Limitation Approach”). Under this approach, modified taxable income is still calculated without taking into account the amount of the actual deduction under the relevant section, but the approach takes into account the impact the existence of that deduction would have on the amount of deduction available under the other section.

The long-form way of calculating the amounts under this approach would be to use an iterative methodology. First, the taxable income limitation would be calculated under one section (the “first section”). Next, the output (i.e., the amount of the deduction subject to the limitation) from the first section would be used to calculate the taxable income limitation under that other section. Then, the output from the other section would be used to recalculate the amount of the taxable income limitation under the first section, and the process would repeat.

A more practical way to accomplish this result (though computer technology can be leveraged to do the long-form computations fairly painlessly) requires the use of simultaneous equations, an exercise in mathematics more complex than what the average tax practitioner sees on a daily basis. The calculation of taxable income can be abstracted into a system of linear equations in two variables: F and N.

Example 5: Simultaneous Limitations Approach when the magnitude of the potential deductions is large enough to present a conflict

Taxpayer has $200 of NOL carryover from 2018 and no prior year NOL carryovers. In 2019, Taxpayer has $100 of taxable income without regard to section 172 or section 250. In 2019, Taxpayer has $70 of GILTI, which is included in the $100 of overall income.

The system of equations to solve for this problem is as follows:[22]

$$Taxable\ income = 100 - F - N$$

$$Section\ 250\ deduction: F = (100 - N) * 0.5$$

$$NOL\ deduction: N = (100 - F) * 0.8$$

[22] If, instead, the taxpayer had both GILTI and FDII income, the formula would be a little more complicated. Instead of multiplying by 0.5, the formula for the section 250 deduction would be F = (100-N)*Y, with Y being a blend of 0.5 and 0.35. For example, if the taxpayer had $70 of GILTI and $30 of FDII, Y would be 0.455, reflecting that 70 percent of the deduction would be computed by reference to the GILTI rate of 0.5 and 30 percent by reference to the FDII rate of 0.35.

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Since the equation for each variable can be solved if the other variable is known, the section 250 deduction equation can be substituted where the Section 250 variable appears in the NOL deduction equation, and the equation can be solved.

$$N = (100 - (100 - N) * 0.5) * 0.8$$

$$N = (100 - 50 + 0.5N) * 0.8$$

$$N = (50 + 0.5N) * 0.8$$

$$N = 50(0.8) + 0.5N(0.8)$$

$$N = 40 + 0.4N$$

$$0.6N = 40$$

$$N = 66\frac{2}{3}$$

Having computed the amount of the NOL deduction to be $66.67, we can substitute this amount into the Section 250 deduction equation and solve for F, and then use both N and F to calculate taxable income.

$$F = \left(100 - 66\tfrac{2}{3}\right) * 0.5 = 16\tfrac{2}{3}$$

Taxpayer's taxable income taking into account both deductions is $16.67 ($100 minus $66.67 of NOL and $16.67 of section 250 deduction).

Note that this methodology assumes that the taxpayer does, in fact, have at least $66.67 of NOLs and $33.33 of GILTI. If, in fact, one of the two deductions is less than the limit computed under this methodology, then the Separate Calculations Approach may be more appropriate.[23]

Comparing the Methodologies

Compare Examples 2 and 5. They use the same inputs, but the Simultaneous Limitations Approach of Example 5 results in a substantially more taxpayer favorable result than the Separate Calculations Approach of Example 2. The Example 5 result also seems more in line with the legislative intent underlying both section 172 and section 250 (and the taxable income limitations in those sections), though it arguably still fails to capture the full benefit intended under section 250.

The primary concern with the Simultaneous Limitations Approach (apart from the question of whether Congress could possibly have intended to build regimes that require taxpayers to utilize multi-variable linear equations) is whether the language of the underlying provisions can be interpreted in a manner that provides, or at least allows, for its application.

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[23] In a multi-variate example, a combined approach may be warranted. That is beyond the scope of this article.

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For example, section 172(a)(2) mandates that the limitation be computed “without regard to the deduction allowable under this section.” Once the taxpayer runs the simultaneous equations, the taxpayer is left with a number for the section 172 deduction that is less than or equal to 80 percent of taxable income taking into account all items except for the actual section 172 deduction itself. However, the determination of the amount of section 250 deduction to take into account does require cognizance of the section 172 deduction. Does “without regard to the deduction allowable under this section” mean that all subordinate computations involved in arriving at taxable income need be done without regard to the existence of a potential deduction under section 172, or is it sufficient that the amount of the actual deduction under section 172 not enter into the immediate equation?

The language in section 250(a)(2) is less forgiving than the language in section 172(a)(2). Section 250(a)(2) requires that the limitation be computed “without regard to this section,” arguably broader than the “without regard to the deduction allowable under this section” of section 172(a)(2). The language in section 172(a)(2) is more easily finessed to permit an input in the calculation that is based on the section 172 deduction if the deduction itself does not enter the calculation. It requires more creativity to argue that such a calculation is truly “without regard” to section 250 at all. In *Litchfield Securities Corp. v. United States*,[24] the Second Circuit exhibited this creativity, with the aid of legislative history, in interpreting a provision governing the computation of the amount of adjustments to personal holding company income under section 545(b).[25]

On the other hand, it is not clear that the Separate Calculations Approach is entirely consistent with the requirements of the limiting language either. For example, when testing the section 172(a)(2) limitation under the Separate Calculations Approach, the taxpayer computes modified taxable income taking into account a deduction under section 250 that bears no relationship to the amount of deduction that will actually be allowed under that section. Is that distortion truly consistent with the injunction to compute taxable income with only one adjustment?

Furthermore, the phrase “taxable income of the domestic corporation (determined without regard to [section 250])” in section 250(a)(2)(A)(ii), and the similar language in section 172(a), suggests an implicit ordering rule because the limitation language requires the deduction to be computed after the application of all other allowable deductions—a simple, deduction-exclusive method. The Separate

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[24] Litchfield Securities Corp. v. United States, 325 F.2d 667 (2d Cir. 1963).

[25] Under section 545(b)(5) in effect for the tax years in question, a deduction was allowed for the excess of the net long-term capital gain for the tax year over the net short-term capital loss for such year, minus the taxes attributable to such excess. The statute provided that “the taxes attributable to such excess shall be an amount equal to the difference between—(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and (B) such taxes computed for such year without including such excess in taxable income.” The Second Circuit found the injunction to compute taxes without including the excess in taxable income to be satisfied by simply subtracting the excess from the taxable income numbers already calculated rather than requiring taxable income to be computed ab initio as though the excess were not an includible amount. Because of the limitation on the dividends received deduction based on taxable income, a fresh computation of taxable income entirely disregarding the excess of the net long term capital gains over the short term capital loss would have resulted in a greater amount of tax attributable such excess, and, as a result, a greater reduction to the amount of personal holding company income.

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Calculations Approach does not accomplish that because each calculation depends on an interim tentative computation of the other deduction rather than taking into account the actual deductions. By contrast, the Simultaneous Equations approach maintains the implicit ordering of deductions by computing both actual deductions together as the last step in calculating taxable income.

Analogous Authority

Obviously, no court has yet ruled on the interpretation of the limiting provisions in section 172(a)(2) or section 250(a)(2). However, the general considerations presented by provisions that require circular computations are not new to U.S. federal tax law. As discussed above, there are several pre-H.R. 1 provisions with taxable income restrictions similar to sections 172(a)(2) and 250(a)(2). Below we discuss how the IRS and the courts have dealt with a few of these situations.

Shell Oil

In *Shell Oil Co. v. Commissioner*,[26] the Tax Court analyzed the use of simultaneous equations to resolve the circularity caused by the inclusion of the windfall profit tax in an allocation base used to calculate the windfall profits tax. In support of its conclusion that simultaneous equations were appropriate in that case, the Tax Court noted that computations requiring the use of simultaneous equations are required elsewhere by U.S. federal tax law: [27]

> [Simultaneous equations] are required for a determination of the correct estate tax liability when property left to charity or to a surviving spouse is burdened by the payment of estate taxes. . . Similarly, the determination of the correct gift tax liability requires the use of simultaneous equations where the donee is required to pay the gift tax. When a self-employed person makes contributions to a defined contribution plan, there is an interaction between the person's compensation (the base upon which the deduction for the contribution to the plan is computed) and the deduction itself, which may require the use of simultaneous equations. Under section 338 the interplay of the deemed sales price of the assets following a transfer of control of a corporation to achieve a step-up in tax basis for the corporation's assets and recapture taxes requires complex simultaneous equations. . . The deductions for dividends received and percentage depletion are both subject to limitations based upon a percentage of the taxable income of the taxpayer. . . The interplay of these two limitations may require the use of simultaneous equations. See Rev. Rul. 79-347, 1979-2 C.B. 122.

The Tax Court did not accept the IRS's assertion that any benefits derived from including the windfall profits tax in the allocation base was outweighed by the costs of performing the allocation. The Tax Court also stated that a method of allocation was chosen not only because it provided a sound matching of overhead to the cost objectives, but also because the clerical costs and effort necessary to implement the allocation base were not excessive.[28]

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[26] Shell Oil Co. v. Commissioner, 89 T.C. 371, 419-420 (1987), *rev'd in part and remanded in part*, 952 F.2d 885 (5th Cir. 1992).

[27] *Id.*

[28] *Id.*

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Revenue Ruling 79-347

In Revenue Ruling 79-347, the taxpayer claimed both a section 243 dividends received deduction and a section 613A percentage depletion deduction. The primary issue addressed in the ruling related to the interplay between calculating the taxable income limitations for purposes of the dividends received deduction and the percentage depletion deduction.[29]

Under section 243(a)(1) in effect at that time, a corporate taxpayer was allowed a deduction equal to 85 percent of the amount of dividends received from a domestic corporation subject to U.S. income taxation. The amount of this deduction, provided the taxpayer did not have an NOL for the year, was limited under section 246(b)(1) to 85 percent of taxable income determined without regard to certain deductions, including the deduction under section 243(a).

Under section 613A in effect at that time, a percentage depletion deduction was allowed with respect to oil and gas wells of independent producers and royalty owners. Under section 613A(d)(1), the amount of the percentage depletion deduction was limited to 65 percent of the taxable income determined "without regard to any depletion subject to the deduction computed under section 613A(c)."

These two provisions set up the same sort of conflict as the one discussed above with regard to section 172(a)(2) and section 250(a)(2). The limiting language in section 613A(d)(1), requiring a computation of modified taxable income "without regard to any depletion subject to the deduction computed under section 613A(c)" is closely analogous to the troubling language in section 250(a)(2), requiring a computation of modified taxable income "without regard to this section."

Without any discussion of the linguistic nuances, the revenue ruling declares that the computations may be made simultaneously by the use of linear equations. In other words, the revenue ruling endorses the Simultaneous Limitations Approach. The General Counsel Memorandum[30] ("GCM") underlying the revenue ruling provides additional insight into the IRS's rationale supporting the use of simultaneous linear equations. GCM 37648 states: "We do not believe that it is necessary to apply either limitation first. Rather, we believe Congress has mandated that each limitation be applied in a manner that takes into account the deductions allowed after application of the other section." GCM 37648, however, does not support its interpretation of congressional intent by parsing the statutory language, nor does the memorandum cite to any legislative history.

This approach was blessed, albeit in *dictum*, by the U.S. Court of Appeals for the Fifth Circuit, when it reviewed a Tax Court determination apparently with respect to the same taxpayer at issue in the revenue ruling.[31] At issue in the litigation was whether the taxpayer had an overall net operating loss for the year, a threshold which would determine the applicability of the percentage limitations of section 246(b)(1). The IRS assumed in Revenue Ruling 79-347 that the taxpayer did not otherwise have a net

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[29] The second issue related to the ordering of the claw-back of the limitation under section 243(b)(2), which provided that the section 243(b)(1) limitation on the amount of the dividends received deduction does not apply for a tax year in which the taxpayer has a NOL.

[30] GCM 37648 (Aug. 23, 1978).

[31] Lastarmco Inc. v. Commissioner, 737 F.2d 1440 (5th Cir. 1984), *aff'g* 79 T.C. 810 (1982).

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operating loss, which the Tax Court and Fifth Circuit concluded was not correct. However, the Fifth Circuit stated: "If the Commissioner had correctly determined that no net operating loss had occurred, we would have had little difficulty in according weight to the Commissioner's expertise and administrative function by which he had concluded that the most reasonable interpretation was that Congress had intended—if there was no net operating loss—that the percentage limitations on both deductions should be simultaneously applied, for which purpose the Commissioner had devised a linear equation, as set forth in Rev. Rul. 79-347."[32]

Chief Counsel Advice 201226021[33]

Chief Counsel Advice ("CCA") 201226021 addressed the interplay between the deduction for alternative minimum tax NOL ("ATNOL") carryovers and charitable contribution deductions against alternative minimum taxable income ("AMTI"), and the extent to which a taxpayer was entitled to take charitable contribution deductions into account in determining the amount of its ATNOL absorbed in a particular year.

Under section 56(d)(1)(A), the ATNOL deduction is generally subject to a limitation of 90 percent of AMTI determined without regard to the ATNOL deduction or the section 199 deduction.[34] Section 56(d)(1)(A) does not specify how charitable deductions are to be taken into account in computing the ATNOL limitation. In addition, section 170(b)(2) generally limits the deduction for charitable contributions to no more than 10 percent of the taxable income of the corporation, determined without regard to section 170 (and other specified deductions not relevant to this discussion). Section 170(b)(2) does not specify how ATNOL deductions are to be taken into account in computing the charitable deduction limitation.

The IRS held that in the absence of a statutory ordering rule specifying which deduction takes priority, simultaneous linear equations may be used to determine the proper amount of each deduction. Accordingly, the CCA endorses the Simultaneous Limitations Approach. Note that the section 170(b)(2) limitation mirrors the troubling language in section 250, by referencing the entire section as the item be excluded from the computation rather than simply the deduction allowed under the section.

Conclusion

This article outlines two potential approaches to the question of how to handle multiple provisions requiring modified determinations of taxable income when the computations for each provision require some cognizance of the other provisions. While the Separate Calculations Approach arguably is closer to a technical reading of the statutory language, its results are often at odds with the stated purpose of

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[32] *Lastarmco*, 737 F.2d at 1442.

[33] CCA 201226021 (Mar. 13, 2012).

[34] During prior years, the limitation was in some cases waived if taxpayers had ATNOLs with certain characteristics or for ATNOLs for certain tax years. The new law repealed section 199 as well as the corporate alternative minimum tax, both effective for tax years beginning after December 31, 2017, although section 56(d)(1)(A)(i)(II) and section 56(d)(1)(A)(ii)(II) continue to apply with respect to non-corporate taxpayers and to reference section 199.

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the legislation. In contrast, the Simultaneous Limitations Approach is more appealing because (1) its results are more in line with the underlying policies, and (2) it reflects a methodology that has been supported by the IRS in analogous contexts to harmonize potentially conflicting statutory provisions, even though it is arguably inconsistent with a narrow, technical reading of the statutory language.

A taxpayer seeking to adopt the Simultaneous Limitations Approach should consider the extent to which it can rely on Revenue Ruling 79-347 to prevent the IRS from challenging the taxpayer's use of simultaneous equations to determine the amount of each limitation. The IRS's procedural regulations state that a revenue ruling is an official interpretation by the IRS that has been published in the *Internal Revenue Bulletin* for the information and guidance of taxpayers, IRS officials, and others concerned.[35] Taxpayers generally may rely upon revenue rulings in determining the tax treatment of their own transactions if the facts and circumstances of the transaction are substantially the same as those in the revenue ruling and if the revenue ruling has not been superseded.[36] Although the IRS is bound by its interpretation of tax law published in a revenue ruling, a court is not so bound, and the level of deference given to the revenue ruling by a court varies.[37] Given that this issue is solely a matter of statutory interpretation (due to the absence of published guidance), the taxpayer's underlying set of facts should be relevant only to the extent the underlying facts implicate Code sections that contain two or more taxable income limitations. In this case, consideration should be given to the policies underlying the taxable income limitations of the Code sections in Revenue Ruling 79-347, and whether those underlying policies are consistent with sections 172 and 250, in order to analyze whether a taxpayer should rely on Revenue Ruling 79-347 to support the use of the Simultaneous Limitations Approach.

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[35] Sections 601.201(a)(6), 601.601(d)(2)(i)(a). Revenue Rulings are a form of sub-regulatory guidance published "to promote correct and uniform application of the tax laws by the IRS employees and to assist taxpayers in attaining maximum voluntary compliance by informing IRS personnel and the public of National Office interpretations of the internal revenue laws…" Section 601.601(d)(2)(iii). They are "published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose." Section 601.601(d)(2)(v)(d); *see also* I.R.M. ¶ 32.2.2.10(1), Force and Effect of Revenue Rulings, Revenue Procedures, Notices, Announcements, and News Releases (Aug. 11, 2004).

[36] Section 601.601(d)(2)(v)(E). *See also* Dover v. Commissioner; 122 T.C. 324 (2004) (IRS not allowed to argue the legal principles of opinions against the principles and public guidance articulated in outstanding Revenue Rulings); Rauenhorst v. Commissioner, 119 T.C. 157 (2002) (same); Chief Counsel Notice CC-2003-14 (May 8, 2003); I.R.M. ¶ 32.2.2.10(2) (2004).

[37] *See* Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner, 149 T.C. No. 3 (2017) (internal citations omitted):

> Our level of deference to agency interpretations of law varies. Where the interpretation construes an agency's own ambiguous regulation, that interpretation is accorded deference. On the other hand, where a revenue ruling improperly interprets the text of relevant statutes and has inadequate reasoning, we afford it no deference at all. Between these poles, we follow revenue rulings to the extent that they have the "power to persuade".

See also Saltzman & Book, IRS Practice and Procedure ¶ 3.03[1][b], Legal Effect of Revenue Rulings (Thomson Reuters/Tax & Accounting, Rev. 2d ed. 2002 and supp. 2018-1) (online version accessed on Checkpoint (www.checkpoint.riag.com) [April 16, 2018]. *See also* Barnes Group, Inc. v. Commissioner, T.C. Memo. 2013-109, *aff'd*, 593 Fed. Appx. 7 (2d Cir. 2014) (unpublished opinion) (reading the "facts and circumstances" of a revenue ruling narrowly and thus finding it inapposite to the facts presented in that case).

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