

## **M. Net Economic Loss Carry-Over (G.S. 105-130.8)**

### **1. Preliminary Statement**

In order that some measure of relief may be granted to corporations which have incurred economic misfortune or which are otherwise materially affected by strict adherence to the annual accounting rule in determining taxable income, the statute provides for the carrying forward of a net economic loss for a period of fifteen (15) years. A net economic loss carried forward from any year shall first be applied to, or offset by, any income taxable or nontaxable of the next succeeding year before any portion of the loss may be carried forward to a succeeding year.

Note: The fifteen-year carryforward period applies only to losses incurred in tax years beginning on or after January 1, 1993. Losses incurred in tax years beginning before January 1, 1993 could be carried forward for only five years.

### **2. Differences Between North Carolina and Federal Provisions**

The loss deduction allowed for North Carolina income tax purposes differs from the loss deduction permitted for Federal income tax purposes in two principal ways:

- For North Carolina tax purposes, the loss must be a net *economic* loss rather than a net *operating* loss.
- For North Carolina tax purposes, a loss can *only be carried forward*, whereas under the Federal law a loss may also be carried back to years preceding the loss year.

### **3. Definition of Net Economic Loss**

A net economic loss is the amount by which allowable deductions, other than prior years' losses, exceed income from all sources in the year including any *income not taxable*. *Dayco Corporation v. Clayton, Commissioner of Revenue (1967), 269 N.C. 490, 153 S.E. 2d 28.*

### **4. Income Not Taxable**

Income not taxable includes any income item that has been deducted in computing State net income under G.S. 105-130.5, any nonbusiness income that has been allocated directly to another state under G.S. 105-130.4, and any other income that is not taxable under State law. (See *Dayco Corporation v. Clayton*.) The amount of the income item considered income not taxable for corporate income tax is determined after subtracting related expenses for which a deduction was allowed for corporate income tax.

### **5. Procedure for Deducting a Net Economic Loss**

A net economic loss is carried forward from the loss year and deducted from income in the next succeeding year. However, any such loss carried forward must be reduced or offset by any *income not taxable* received in the succeeding year in determining the amount of net economic loss deduction in such succeeding year. Any unused portion of a net economic loss remaining may be carried forward to the next succeeding year. (See *Dayco Corporation v. Clayton*)

### **6. Corporations Allocating Their Net Income (17 NCAC 05C.1506)**

A corporation required to allocate and apportion its net income or net loss under G.S. 105-130.4 may carry forward only a portion of its net economic loss. After the required adjustments for income not taxable in the next succeeding year have been made, the allocable portion of

such determined net economic loss deduction is deducted from the total amount of income allocated to this State. For example, a corporation allocating 50% of its net income or loss to North Carolina in a particular year in which it sustains a total net economic loss of \$1,000 may carry forward only \$500 to a subsequent year.

Where the allocating corporation earns nonapportionable income subject to direct allocation outside North Carolina in a year succeeding the loss-year, the portion of the directly allocated income used to offset the loss brought forward is determined by applying to such income the allocation percentage applicable to the succeeding year.

**7. Corporation Sustaining Loss Entitled to Deduction (17 NCAC 05C.1507)**

In the case of a merger of a loss corporation and a profit corporation, pre-merger losses may be offset against post-merger profits only to the extent that the group of assets that was previously operated at a loss is operated at a profit after the merger. Accounting records must show clearly the income and expenses attributable to such groups of assets. See *Good Will Distributors (Northern) Inc. v. Currie*, Commissioner of Revenue (1959) 251 N.C. 120, 110 S. E. 2<sup>nd</sup> 880; *Holly Farms Poultry Industries, Inc. v. Clayton*, Commissioner of Revenue (1970) 9 N.C. App. 345, 176 S.E. 2<sup>nd</sup> 367; *Fieldcrest Mills, Inc. v. Coble*, (1976), 290 N.C. 504, 135 S.E. 2<sup>nd</sup> 205.

**8. Examples**

The following examples show the proper method of computing net economic losses and the correct procedure for carrying them forward as deductions.

Example 1: Corporation X, a North Carolina corporation, conducts its entire business in this State. The corporation had a net loss of (\$10,000) in 2004 and net income of \$20,000 in 2005. In each year, the corporation received \$500 from U.S. government obligations and \$500 from State of North Carolina bonds. Interest on North Carolina bonds and interest on U.S. obligations were deducted in computing State net income and net loss.

**Determination of Net Economic Loss**

Net loss for 2004		(\$10,000)
Reduced by income not taxable:		
U. S. Government interest	\$ 500	
N.C. bond interest	<u>500</u>	
		<u>1,000</u>
Net economic loss for 2004		(\$ 9,000)

### Computation of Net Economic Loss Deduction

Net loss brought forward from 2004	(\$ 9,000)
Reduced by income not taxable received in 2005:	
U. S. Government interest	\$500
N.C. bond interest	<u>500</u>
	<u>1,000</u>
Net economic loss deduction in 2005	(\$ 8,000)

### Computation of 2005 Net Taxable Income

Net income for 2005	\$20,000
Less: Net economic loss deduction (from above)	( 8,000)
Net taxable income	\$12,000

Example 2: Corporation Y is a North Carolina corporation engaged in the business of manufacturing and selling chemicals and related products within and without this State. Its business is directed or managed from its North Carolina offices; therefore its commercial domicile is in this State. The corporation had a net loss of (\$22,500) in 2004 and net income of \$21,500 in 2005.

The arithmetical average of the apportionment factors of property, payroll and sales was 60% in 2004 and 70% in 2005.

The corporation received nontaxable interest of \$800 in 2004 and \$600 in 2005 on U.S. government bonds.

In determining net loss and net income in the above years, the corporation included the following income and deduction items:

- a. Contributions of \$1,000 to North Carolina donees were deducted in each year. Included in this deduction for each year were fully deductible contributions of \$500 to qualified educational institutions in North Carolina.
- b. Nonapportionable rental income, less related expenses, of \$2,000 was received in each year on a building located outside North Carolina. (Note: Since the rental income was received on nonapportionable real property, it is allocated directly to the state in which the property was located.)
- c. A gain of \$500 in 2004 and a loss of (\$500) in 2005 were realized on the sale of U.S. government bonds. (Note: Since the commercial domicile of Corporation Y is in North Carolina, such nonapportionable gains or losses on intangible property are allocated directly to this State.)
- d. Nonapportionable dividend income of \$1,000 (net nonapportionable dividend income) was received in each year. (Note: Since the commercial domicile of Corporation Y is in North Carolina, such net nonapportionable dividend income is allocated directly to this State.)

### Computation of Net Economic Loss

Net loss for 2004	(\$22,500)
Add: Contributions	<u>1,000</u>
Total	(\$21,500)

Less total nonapportionable income:

Net rental income	\$2,000
Gain on bonds sold	500
Net nonapportionable dividends	<u>1,000</u>
	<u>\$ 3,500</u>

Total apportionable income (loss) (\$25,000)

Apportionable to North Carolina — 60% (\$15,000)

Add nonapportionable income allocated directly to N C:

Gain on bonds sold	\$ 500
Net nonapportionable dividends	<u>1,000</u>
	<u>\$ 1,500</u>

Total (\$13,500)

Less: Contributions to educational

institutions located in N. C \$ 500

Total (\$14,000)

Less income not taxable in North Carolina:

U.S. Government interest (60% of \$800)	\$ 480
Net rental income (60% of \$2,000)	<u>1,200</u>
	<u>\$ 1,680</u>

Net economic loss for 2004 (\$12,320)

### Computation of Net Economic Loss Deduction

Net economic loss brought forward from 2004 (\$12,320)

Reduced by nontaxable income received in 2005:

U.S. Government interest (70% of \$600)	\$ 420
Net rental income (70% of \$2,000)	<u>1,400</u>
	<u>\$ 1,820</u>

Net economic loss deduction in 2005 (\$10,500)

### Computation of 2005 Net Taxable Income

Net income for 2005		\$21,500
Add: Contributions		<u>1,000</u>
 Total		 \$22,500
 Less total nonapportionable income:		
Net rental income	\$2,000	
Loss on bonds sold	( 500)	
Net nonapportionable dividends	<u>1,000</u>	
		<u>\$ 2,500</u>
 Total apportionable income		 \$20,000
 Apportionable to North Carolina – 70%		 \$14,000
Add nonapportionable income allocated directly to N. C.:		
Loss on bonds sold	(\$ 500)	
Net nonapportionable dividends	<u>1,000</u>	
		<u>\$ 500</u>
 Total allocated to North Carolina		 \$14,500
 Less: Net economic loss deduction from above		 ( <u>10,500</u> )
 Total		 \$ 4,000
 Less contributions to North Carolina donees:		
Amount subject to 5% limitation (5% of \$4,000)	\$ 200	
Amount given to N. C. educational institution	<u>500</u>	
		<u>\$ 700</u>
 Net taxable income in 2005		 \$ 3,300

Example 3: Corporation Z, a Delaware corporation domesticated in North Carolina, is engaged in the business of manufacturing machinery within and without this State. Its commercial domicile is in New York. The corporation had a net loss of (\$52,500) in 2004 and net income of \$91,100 in 2005.

The arithmetical average of the apportionment factors of property, payrolls and sales was 20% in 2004 and 25% in 2005.

Listed below are income and deduction items included in the computation of net loss and net income.

- a. In each year, contributions of \$1,000 to donees outside North Carolina were deducted. In 2005 contributions of \$200 to North Carolina donees were also deducted.

- b. A loss of (\$500) was realized in each year on the sale of corporate bonds acquired and held as an investment. (Note: Since the losses were nonapportionable losses they are not included in apportionable income.)
- c. Nonapportionable interest of \$2,000 was received in each year on bonds acquired and held as an investment. (Note: Since this interest is nonapportionable income, it is not included in apportionable income.)
- d. Nonapportionable dividends of \$10,000 (net nonapportionable dividend income) were received in each year from Corporation A. (Note: Although Corporation Z included the \$10,000 in gross income, these dividends are nonapportionable income and as such are not included in apportionable income.)

### Computation of Net Economic Loss

Net loss for 2004	(\$52,000)
Add: Contributions	<u>1,000</u>
Total	(\$51,500)
Less total nonapportionable income:	
Loss on bonds sold	(\$ 500)
Interest	2 000
Net nonapportionable dividends	<u>10,000</u>
	<u>\$11,500</u>
Total apportionable income (loss)	(\$63,000)
Apportionable to North Carolina – 20%	(\$12,600)
Reduced by income not taxable:	
Interest (20% of \$2,000)	\$ 400
Net dividends (20% of \$10,000)	<u>2,000</u>
	<u>\$2,400</u>
Net economic loss for 2004	(\$10,200)

### Computation of Net Economic Loss Deduction

Net economic loss brought forward from 2004	(\$10,200)
Reduced by nontaxable income received in 2005:	
Nonapportionable interest (25% of \$2,000)	\$ 500
Net nonapportionable dividends (25% of \$10,000)	<u>2,500</u>
	<u>\$ 3,000</u>
Net economic loss for 2005	(\$ 7,200)

### Computation of 2005 Net Taxable Income

Net income for 2005	\$91,100
Add: Contributions to donees located in N C	<u>200</u>
Total	\$91,300
Less total nonapportionable income:	
Loss on bonds sold	(\$ 500)
Interest	2,000
Net nonapportionable dividends	<u>10,000</u>
	<u>\$11,500</u>
Total apportionable income	\$79,800
Apportionable to North Carolina – 25%	\$19,950
Less: Net economic loss deduction from above	<u>( 7,200)</u>
Total allocated to North Carolina	\$12,750
Less: Contributions to donees located in North Carolina	<u>200</u>
Net taxable income for 2005	\$12,550