

## **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:

1. For North Carolina tax purposes, the loss must be a net economic loss rather than a net operating loss.
2. 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 nonapportionable 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 fifty percent (50%) of its net income or loss to North Carolina in a particular year in which it sustains a total net economic loss of one thousand dollars (\$1,000) may carry forward only five hundred dollars (\$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 if the following three tests are met:

1. The “but-for” test, which allows the deduction if, but for the merger, the corporation suffering the loss would have been able to utilize the deduction;
2. The “assets” test, which allows the deduction 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; and
3. The “substantially the same business” test, which allows the deduction if the business of the acquired corporation which sustained the loss has not been materially altered or enlarged by the merger.

See *Good Will Distributors (Northern) Inc. v. Currie, Commissioner of Revenue* (1959) 251 N.C. 120, 110 S. E. 2nd 880; *Holly Farms Poultry Industries, Inc. v. Clayton, Commissioner of Revenue* (1970) 9 N.C. App. 345, 176 S.E. 2nd 367; *Fieldcrest Mills, Inc. v. Coble*, (1976), 290 N.C. 504, 135 S.E. 2nd 205; *Bellsouth Telecommunications, Inc., d/b/a Southern Bell Telephone and Telegraph Company v. Department of Revenue* (1997), 485 SE2d 333.

## 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 ten thousand dollars (-\$10,000) in 2006 and net income of twenty thousand dollars (\$20,000) in 2007. In each year, the corporation received five hundred dollars (\$500) from U.S. government obligations and five hundred dollars (\$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 2006		(\$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 2006		(\$ 9,000)

### Computation of Net Economic Loss Deduction

Net loss brought forward from 2006		(\$ 9,000)
Reduced by income not taxable received in 2007:		
U. S. Government interest	\$500	
N.C. bond interest	<u>500</u>	
		<u>1,000</u>
Net economic loss deduction in 2007		(\$ 8,000)

### Computation of 2007 Net Taxable Income

Net income for 2007	\$20,000
Less: Net economic loss deduction (from above)	<u>( 8,000)</u>
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 twenty-two thousand five hundred dollars (-\$22,500) in 2006 and net income of twenty-one thousand five hundred dollars (\$21,500) in 2007.

The arithmetical average of the apportionment factors of property, payroll and sales was sixty percent (60%) in 2006 and seventy percent (70%) in 2007.

The corporation received nontaxable interest of eight hundred dollars (\$800) in 2006 and six hundred dollars (\$600) in 2007 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 one thousand dollars (\$1,000) to North Carolina donees were deducted in each year. Included in this deduction for each year were fully deductible contributions of five hundred dollars (\$500) to qualified educational institutions in North Carolina.
- b. Nonapportionable rental income, less related expenses, of two thousand dollars (\$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 five hundred dollars (\$500) in 2006 and a loss of five hundred dollars (-\$500) in 2007 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 one thousand dollars (\$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 2006	(\$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	\$ <u>500</u>
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 2006	(\$12,320)

### Computation of Net Economic Loss Deduction

Net economic loss brought forward from 2006	(\$12,320)
Reduced by nontaxable income received in 2007:	
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 2007	(\$10,500)

### Computation of 2007 Net Taxable Income

Net income for 2007	\$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 2007	 \$ 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 fifty-two thousand five hundred dollars (-\$52,500) in 2006 and net income of ninety-one thousand one hundred dollars (\$91,100) in 2007.

The arithmetical average of the apportionment factors of property, payrolls and sales was twenty percent (20%) in 2006 and twenty-five percent (25%) in 2007.

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

- a. In each year, contributions of one thousand dollars (\$1,000) to donees outside North Carolina were deducted. In 2007 contributions of two hundred dollars (\$200) to North Carolina donees were also deducted.
- b. A loss of five hundred dollars (-\$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 two thousand dollars (\$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 ten thousand dollars (\$10,000) (net nonapportionable dividend income) were received in each year from Corporation A. (Note: Although Corporation Z included the ten thousand dollars (\$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 2006	(\$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 2006	\$10,200)

### Computation of Net Economic Loss Deduction

Net economic loss brought forward from 2006	\$10,200)
Reduced by nontaxable income received in 2007:	
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 2007	(\$ 7,200)

### Computation of 2007 Net Taxable Income

Net income for 2007	\$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 2007	\$12,550