North Carolina Department of Revenue

Beverly Eaves Perdue
Governor

David W. Hoyle
Secretary

August 8, 2011

[redacted]

Re: Net Economic Loss – Ruling Request

Dear [redacted]:

This is in response to your letter dated [redacted] in which you requested clarification on the Department's letter dated [redacted], which was provided to you to address your concerns regarding the availability of a net economic loss presented in your written request for a ruling dated [redacted] and [redacted].

Your [redacted] letter requested clarification of the facts for consideration:

Background:
[redacted] and [redacted] are subsidiaries of [redacted], owned indirectly through, [redacted], a holding company incorporated in [redacted]. [redacted] is a [redacted] corporation conducting business in [redacted] as well as North Carolina. [redacted] is also a [redacted] corporation conducting business only in North Carolina. Both of these entities build and sell homes in North Carolina. Both of these subsidiaries file separate North Carolina tax returns in accordance with N.C. Gen. Stat. Sec. 105-130.14.

Anticipated Transaction:
[redacted], the smaller entity, plans to merge with and into [redacted], with [redacted] being the surviving entity. The anticipated transaction is referred to herein as the "Merger". The Merger is expected to occur on or before [redacted]. After the Merger, [redacted] will have all the assets of [redacted] and assume all its rights and obligations under its existing contracts. [redacted] will conduct business in North Carolina and [redacted].

For federal income tax purposes, the Merger will be a tax free merger under IRC Sec. 368.

Clarification of the Requested Ruling:
We respectfully request that you clarify that the pre-merger losses [redacted] generated from selling homes can be used to offset income generated from [redacted]'s post-merger sale of future homes, taking into consideration the fact that the assets that generated the pre-merger losses may no longer exist in [redacted]'s post-merger inventory.

This distinction is important since the assets merged by [redacted] are primarily realty and its net economic losses. Unlike other industries that may merge tangible assets, [redacted]'s homes that generated the losses for the most part have been sold. As home are built and sold by the merged entity, new land acquisitions will be made to continue the process of building homes on acquired land and selling those homes to third parties.

Also, from your letter request dated [redacted], you wrote, "After the Merger the asset test will be met since [redacted]'s assets that generated the losses will be tracked and will only be allowed to offset the gain associated with these loss assets."

Applicable North Carolina Law:
Under N.C. Gen. Stat. Sec. 105-130.8(a), economic losses may be carried over for fifteen years. North Carolina law also provides for a post-apportionment net economic loss deduction, which includes state adjustments to the federal taxable loss.

For income tax purposes, if a loss corporation and a profit corporation merge, premerger losses may be offset against postmerger profits only to the extent that the group of assets which was previously operated at a loss is operated at a profit after the merger. However, accounting records must show the income and expenses attributable to such groups of assets. (Sec. 17:05C.1507, N.C. Adm. Code).

In a more recent case, BellSouth Telecommunication, Inc., dba Southern Bell Telephone Telegraph v. NC Department of Revenue (1997), the North Carolina Appeals court discussed three tests, enunciated by the Court in Fieldcrest, that need to be met in order for the pre-merger loss to be allowed. The first is the "but-for" test, which allows the deduction, if but for the merger, the corporation with the loss would have been able to utilize the deduction. The "assets" test requires that the pre-merger assets that generated the loss may only be deducted against the income from the pre-merger assets, if they are producing income after the merger. Finally, the "substantially the same business" test allows the deduction if the business of the merged corporation which generated the loss has not been materially altered or enlarged by the merger.

For the asset test in *Fieldcrest*, the North Carolina Supreme Court concluded that "where a loss corporation and a gain corporation are merged, pre-merger losses may be offset against post-merger gains only to the extent that the *business* [or group of assets] which was previously operating at a loss is now operating at a profit." *227 S.E.2d at 574*.

Department's Response:

The Department in determining whether a successor corporation may claim a net economic loss suffered by a predecessor corporation, must find that the two corporations are the "same" by applying the continuity of business enterprise test in the Fieldcrest Mills, Inc. v. Coble case. The continuity of business enterprise means that when a loss corporation and a gain corporation are merged, pre-merger losses may be offset against post-merger profits only to the extent that the business [or group of assets] which was previously operating at a loss is now operating at a profit. Thus, the Department's policy, following the guidance of Fieldcrest, is that, "…pre-merger losses may be offset against post-merger gains only to the extent that the *business* [or group of assets] which was previously operating at a loss is now operating at a profit." *227 S.E.2d at 574.* (Net Economic Losses are subject to the provisions and limitations of G.S. 105-130.8, the court cases addressing Net Economic Losses, such as Fieldcrest Mills, Inc. v. Coble, and Sec. 17:05C.1507 of the N.C. Adm. Code).

Based on our longstanding position and our review of the information provided in your letters of [redacted], [redacted], and [redacted], [redacted] would be able to utilize the net economic loss generated by [redacted] only if separate accounting records are maintained and [redacted]'s business [or group of assets] (formally operating at a loss) are now operating at a profit.

This ruling is based solely on the facts submitted to the Department of Revenue for consideration of the transactions described. If the facts and circumstances given are not accurate, or if there are other facts that were not disclosed that might cause the Department to reach a different conclusion, then the taxpayer requesting this ruling may not rely on it. A letter ruling is not equivalent to a Technical Advice Directive that generally affects a large number of taxpayers. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material aspect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that this document is not to be cited as precedent and that a change in statute, a regulation, or case law could void this ruling.

Very truly yours,

[redacted]