North Carolina Department of Revenue

Beverly Eaves Perdue
Governor

David W. Hoyle
Secretary

February 4, 2011

[redacted]

Re: Net Economic Loss – Ruling Request

Dear [redacted]:

This is in response to your letters dated [redacted] and [redacted] in which you requested a ruling regarding the availability of a net economic loss of which consideration is given to the facts you presented in your letters.

Your letters you presented these facts for consideration:

> We respectfully request confirmation that the North Carolina Department of Revenue, will allow [redacted], and [redacted] to utilize their pre-merger net economic losses to offset anticipated future post-merger taxable income. [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. These two subsidiaries reported net economic losses in FYE 11/30/08 and 11/30/09. As of 11/30/09, [redacted] and [redacted]'s respective net economic losses were approximately [redacted] and [redacted].
>
> **Anticipated Transaction:**
> [redacted] 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.

**Business Purpose of Transaction:**
Considering our current economy, [redacted] (parent company of [redacted] and [redacted]), has undertaken the necessary steps across the nation to reduce duplication of efforts and overhead in order to move our entire organization towards profitability.

The business purpose of this Merger in particular, is to reduce the significant direct and indirect costs of maintaining two separate entity offices that buy land and build homes primarily in North Carolina as we strive to streamline processes in order to obtain profitability.

**Assumptions Regarding the Post-Merger Operations:**
After the Merger, [redacted] will continue to build and sell homes in North Carolina.

**Requested Ruling:**
After the Merger, the net economic losses sustained by [redacted] in the pre-Merger years will be allowed to offset the income generated by these assets formally owned by [redacted] which are now owned by [redacted].

**Applicable 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.

When a loss corporation and a profit corporation merger, pre-merger losses may be offset against post-merger profits only to the extent that the group of assets previously operated at a loss generates a profit after the merger (Sec. l7:0SC.IS07, N.C. Adm. Code). In order to take the post-merger losses, accounting records need to ref1ect the yearly income and expenses attributable to such groups of assets (Benton Woods, Inc.).

Where corporations have merged, the court will look to the substance of the merger to determine if the net economic loss may be carried forward. If the resulting merged corporation is substantially the same corporation that incurred the losses, the deduction will be allowed. If the post-merger corporation has been altered, enlarged or materially affected by the merger, the deduction will be denied (Good Will Distributors (Northern) Inc. v. Currie).

In Fieldcrest Mills, Inc. v. Coble (N. C 1976), North Carolina affirmed that the continuity of enterprise is required to take the pre-merger losses against the post-merger income. In this court case a corporation engaged in the business of textile manufacturing could not use the net economic loss carryover of a former subsidiary which was engaged in textile printing. The court held this merger results in a new enterprise, materially different from either predecessor.

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 deduct the loss against the income from these assets. Finally, the "substantially the same business" test allows the deduction if the business of the acquired corporation which generated the loss has not been materially altered or enlarged by the merger.

**Argument In Support of Requested Ruling:**
The Merger will satisfy the continuity of business enterprise and meet all three of the Fieldcrest tests. In particular, the Merger will satisfy the "but for" test, since [redacted] would have been able to claim the net economic loss carryover if it had remained a separate entity. 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. The substantially same business test will be met since both of these subsidiaries build and sell homes and will continue the same business after the Merger. In addition the business of selling homes will not be materially altered or enlarged by the Merger.

**Conclusion:**
Based on the support provided, we respectfully request confirmation that the Department, will allow [redacted] and [redacted] to utilize, if merged, their respective pre-merger net economic losses to offset anticipated future post-merger taxable income.

**Ruling Requested:**
After the Merger, the net economic losses sustained by [redacted] in the pre-Merger years will be allowed to offset the income generated by these assets formally owned by [redacted] which are now owned by [redacted].

**Department's Response:**
According to the information provided in your letters, we agree that after the merger, [redacted] will retain the NEL's from [redacted] that were generated prior to the merger. Further, [redacted] can utilize the NEL to offset income generated after the merger, subject to the provisions and limitations of G.S. 105-130.8 and the case law you cited.

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]