



STATE OF SOUTH CAROLINA
DEPARTMENT OF REVENUE

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SC REVENUE RULING #21-15

SUBJECT: Active Trade or Business Income – Annual Election by Pass-Through Entity to Pay Tax at Entity Level (Income Tax)

EFFECTIVE DATE: Tax Years Beginning 2021 and Thereafter

MODIFIES: SC Revenue Ruling #08-2

SUPERSEDES: All previous advisory opinions and any oral directives in conflict herewith.

REFERENCES: S.C. Code Ann. Section 12-6-545(A) through (F) (2014)
S.C. Code Ann. Section 12-6-545(G) (As Added by 2021 S.C. Act No. 61)

AUTHORITY: S.C. Code Ann. Section 12-4-320 (2014)
S.C. Code Ann. Section 1-23-10(4) (2005)
S.C. Revenue Procedure #09-3

SCOPE: The purpose of a Revenue Ruling is to provide guidance to the public. It is an advisory opinion issued to apply principles of tax law to a set of facts or general category of taxpayers. It is the Department's position until superseded or modified by a change in statute, regulation, court decision, or another Department advisory opinion.

PURPOSE

Effective for tax years beginning 2021, Act No. 61 of 2021 added Code Section 12-6-545(G) to provide an optional election for certain pass-through entities to report "active trade or business income" (as defined in Code Section 12-6-545(A)(1)) directly on the entity's tax return and pay an entity level income tax on it at 3%. For these electing entities, recent Internal Revenue Service guidance clarifies that state income taxes imposed on and paid by a partnership or S corporation in computing its taxable income or loss are allowed under Internal Revenue Code Section 164 as a federal income tax deduction by the pass-through entity for the tax year within which paid or

accrued. Code Section 12-6-1130(2), however, requires the electing entity to “add back” the federal deduction for state taxes.¹

For owners of electing entities, active trade or business income taxed at the entity level is not included in the owners’ South Carolina income. As a result of the payment and deduction of the state taxes by the entity, these state taxes are not passed through to the owners and are not taken into account in determining the federal \$10,000 state and local tax deduction limitation for individuals who itemize.² If a pass-through entity does not make the election to have its income taxed at the entity level for the tax year, then Code Section 12-6-545(B)(1) continues to provide that an owner of a pass-through business may decide annually (“owner’s election”)³ to have his active trade or business income taxed at the reduced rate of 3% or the standard rate of up to 7% for any one or more pass-through entities he owns. This calculation continues to be made by the electing owner on SC Form I-335, “Active Trade or Business Income Reduced Rate Computation.”

The purpose of this advisory opinion is to provide a brief summary of recent IRS guidance regarding a pass-through entity’s deduction of certain state and local income taxes, provide a brief review of guidance on Code Section 12-6-545(A) through (F), and address general technical and compliance questions regarding the new election in Code Section 12-6-545(G) by a qualified entity to report and pay tax on active trade or business income at the entity level.

OVERVIEW OF IRS NOTICE 2020-75 – DEDUCTION OF “SPECIFIED INCOME TAX PAYMENTS” BY PASS-THROUGH ENTITIES UNDER IRC SECTION 164

Internal Revenue Code Section 164 provides a deduction of certain taxes, paid or accrued for federal income tax purposes. Pursuant to Code Section 12-6-1130(2), South Carolina adopts IRC Section 164 with modifications, and reads, in part:

(2) The deduction for taxes permitted by Internal Revenue Code Section 164 is computed in the same manner as provided in Section 164 except there is no deduction for state and local income taxes, state and local franchise taxes measured by net income, other income taxes, or taxes measured with respect to net income.

Generally, an entity treated as a partnership for federal income tax purposes is not subject to South Carolina income tax. Each partner includes its share of South Carolina partnership income on the partner’s tax return.⁴ An S corporation having a valid “S” election under IRC Subchapter

¹ Because South Carolina taxable income is computed by starting with federal income, a qualified electing partnership or S corporation deducting state income taxes on their federal Form 1065 or Form 1120S must “add back” the state income taxes in computing South Carolina income.

² See SC Revenue Ruling #19-1, “State Tax Deduction for Individuals who Itemize Deductions,” for more information on how the state tax addback should be calculated for South Carolina income tax purposes.

³ There is no formal “owner election” for the owner to make. The 3% reduced rate or the standard tax rate are simply mathematical computations made on the tax return when filed. See SC Revenue Ruling #08-2, “Tax Rate Reduction on Active Trade or Business Income from a Pass Through Business” and SC Form I-335, “Active Trade or Business Income Reduced Rate Computation.”

⁴ SC Code Section 12-6-600. See IRC Section 701.

S is not subject to South Carolina income tax to the extent it would be exempt from federal corporate income tax. Each shareholder includes its share of the South Carolina S corporation's income on the shareholder's tax return.⁵ As such, a pass-through entity deduction for income taxes was not allowed under IRC 164⁶ or South Carolina Code Section 12-6-1130.

In November 2020, the IRS issued Notice 2020-75⁷ regarding proposed regulations that will clarify that state and local income taxes (i.e., "specified income tax payments") imposed on and paid by a partnership or S corporation are allowed as a deduction by the pass-through entity in computing its non-separately stated taxable income or loss for the taxable year of payment. The Notice provides that a state's pass-through entity tax must be a direct income tax imposed on and paid by the entity, and defines these taxes as "specified income tax payments."

OVERVIEW OF CODE SECTION 12-6-545(A) through (F) – RATE REDUCTION ON ACTIVE TRADE OR BUSINESS INCOME TO AN OWNER

Note: Code Section 12-6-545, allowing a tax rate reduction on South Carolina active trade or business income from a pass-through business, is different from IRC Section 199A, a deduction for non-corporate taxpayers with qualified business income from pass-through entities. South Carolina specifically does not adopt IRC Section 199A.⁸

Since tax year 2006, Code Section 12-6-545(A) through (F) has allowed individuals, estates, or trusts to use an "optional" income tax rate to compute the tax on "active trade or business income or loss" received from a pass-through business in lieu of the "standard" income tax rate under Code Section 12-6-510. The reduced rate was phased-in and has been 3% for tax years beginning in 2014 and thereafter. Code Section 12-6-510 imposes an income tax rate upon South Carolina taxable income of individuals, estates, and trusts at graduated rates up to 7%. For purposes of the 3% tax rate available to an owner, a "pass-through business" is a sole proprietorship, partnership, S corporation, and limited liability companies taxed as one of these.

Code Section 12-6-545(A)(1) defines "active trade or business income or loss" as:

"Active trade or business income or loss" means income or loss of an individual, estate, trust, or any other entity except those taxed or exempted from tax pursuant to Sections 12-6-530 through 12-6-550 resulting from the ownership of an interest in a pass-through business. Active trade or business income or loss does not include:

(a) (i) passive investment income as defined in Internal Revenue Code Section 1362(d) generated by a pass-through business and income of the same type regardless of the type of pass-through business generating it; and

(ii) expenses related to passive investment;

⁵ SC Code Section 12-6-590. See IRC Section 1363(b).

⁶ IRC Sections 703(a)(2)(B) and 1363(b)(2).

⁷ 2020-49 IRB 1453.

⁸ Code Section 12-6-50(19).

(b) capital gains and losses;

(c) payments for services referred to in Internal Revenue Code Section 707(c);

(d) amounts reasonably related to personal services. All amounts paid as compensation and all guaranteed payments for services, but not for the use of capital, as defined in Internal Revenue Code Section 707(c) are deemed to be reasonably related to personal services. In addition, if an owner of a pass-through entity who performs personal services for the entity is not paid a reasonable amount for those personal services as compensation or payments referred to in Internal Revenue Code Section 707(c), all of the owner's income from the entity is presumed to be amounts reasonably related to personal services. For purposes of this section, amounts reasonably related to personal services include amounts reasonably related to the personal services of the owner, the owner's spouse, and any person claimed as a dependent on the owner's income tax return.

South Carolina Revenue Ruling #08-2, “Tax Rate Reduction on Active Trade or Business Income from a Pass Through Business” provides guidance to persons eligible for the reduced tax rate under Code Section 12-6-545(A) through (F).

NEW LAW – CODE SECTION 12-6-545(G)⁹

Code Section 12-6-545(G) permits a “qualified” pass-through entity to elect and pay an entity level income tax on “active trade or business income” apportioned to South Carolina. To the extent such an election is made, and tax is paid on the active trade or business income at the entity level, that income is excluded from the entity owners’ South Carolina taxable income.

Code Section 12-6-545(G) reads:

(1)(a) ‘Qualified entity’ means a partnership or ‘S’ Corporation including a limited liability company taxed as a partnership or ‘S’ Corporation, where all of its owners are qualified owners or partnerships, and, where those partnerships are owned directly or through other partnerships by qualified owners.

(b) ‘Qualified owner’ means a partner or shareholder of a qualified entity that is an individual, estate, trust, or any other entity except those taxed or exempted from tax pursuant to Sections 12-6-530 through 12-6-540 and 12-6-550 and except for any other entity exempt from South Carolina income tax.

⁹ While Act No. 61 was enacted on May 17, 2021, Code Section 12-6-545(G) first applies to tax years beginning after 2020. The federal individual itemized tax deduction limitation of \$10,000 enacted in the Tax Cuts and Jobs Act of 2017 (Public Law 115-97) contained a sunset provision for tax years beginning on or after January 1, 2026. **However, new Code Section 12-6-545(G), providing for the entity level active trade or business income tax, does not have a sunset provision.**

- (2) A qualified entity may elect annually under this subsection to have its income taxed on its active trade or business income at the rate provided in subsection (B)(2) imposed on the qualified entity itself. Such elections must be made no later than the due date for filing the applicable income tax return, including any extensions.
- (3) In computing South Carolina taxable income, a qualified owner shall exclude active trade or business income from an electing qualified entity provided that the qualified entity properly filed an income tax return and paid the taxes pursuant to this subsection that included the active trade or business income or loss.
- (4) Active trade or business losses of the qualified owner from other pass-through entities that are reported directly by such owner may not reduce tax at a rate higher than the rate provided in subsection (B)(2).
- (5) Active trade or business income for which this subsection is elected shall be apportioned by the pass-through entity pursuant to Section 12-6-2240, and none of it shall be treated as income from personal services that is allocated pursuant to Section 12-6-2220(6).
- (6) Section 12-8-590, dealing with tax withholding on distributions to nonresident shareholders of 'S' Corporations and nonresident partners, does not apply to electing qualified entities to the extent of the tax the electing entities pay on their active trade or business income.
- (7) For tax years beginning after 2021, an electing qualified entity shall submit estimated tax payments pursuant to Section 12-6-3910.
- (8) If the electing entity fails to pay the amount owed to the department with respect to income as a result of the election, the department may collect the amount from the electing entity or its direct or indirect owners based upon their proportionate share of the income, or both.
- (9) The basis of both resident and nonresident shareholders of a qualified 'S' Corporation in their stock of the qualified 'S' Corporation shall be determined as if the election under subsection (G)(2) had not been made and each of the shareholders of the qualified 'S' Corporation had properly taken into account each shareholder's pro rata share of the qualified 'S' Corporation's items of income, loss, and deduction in the manner required with respect to an 'S' Corporation for which no such election is in effect. The basis of a qualified partnership, including a limited liability company taxed as a partnership, shall be determined in the same manner.

QUESTIONS AND ANSWERS

The remainder of this document addresses general technical and compliance questions regarding the new election in Code Section 12-6-545(G).¹⁰ This Q and A Section is divided into the following parts:

Part 1 – Entity Election Questions. Questions 1 – 10.

Part 2 – Entity Administrative and Compliance Questions (including questions about Schedule K-1 and other information to provide to owners, entity estimated payment due dates and payment procedure, and nonresident withholding). Questions 11 – 18.

Part 3 – Entity Level Tax on Active Trade or Business Income – General Entity Computation Questions (including tax rate, state tax deduction, active trade or business loss treatment, and use of tax credits at entity level). Questions 19 – 24 and Examples 1 through 3 – Entity Level Tax Computation Worksheet and Information Reported to the Owners.

Part 4 – Owner Compliance and Reporting Questions (including owner tax reporting, use of tax credits, South Carolina basis impact, “owner election” for non-electing entities, and treatment of losses when a qualified owner owns an interest in both electing and non-electing entities). Questions 25 – 28.

PART 1 - ENTITY ELECTION QUESTIONS

1. Q. What tax years does the entity election apply?

A. The election for a qualified entity to report and pay tax on active trade or business income at the entity level under Code Section 12-6-545(G) is available for tax years beginning in 2021 and thereafter. The “entity” election is an annual election and applies for the elected tax year only. It is an optional election and may be revoked under certain circumstances.

Note: A qualifying entity may elect to pay the active trade or business income at the entity level in one year and may choose to not make the election the following year. The entity does not need to obtain approval from the Department to make or not make the election.

See Questions 7, 8, and 9 for how and when to make or revoke the annual entity election and Question 10 for a discussion of a fiscal year entity election.

2. Q. Does the entity election apply to all income of the electing pass-through entity?

A. No. The entity election does not apply to all income; it only applies to active trade or business income and deductions (such as the IRC Section 179 expense deduction) related to the active trade or business income. Income that is not active trade or business income of an electing entity and deductions not related to the active trade or business income must be passed through to the owners for the owners to report on their own tax returns.

¹⁰ Code Section 12-6-545(A) through (F) is provided in the Appendix for reference.

Consistent with tax rules in years prior to the enactment of Act. No. 61, separately stated items (e.g., charitable contributions, retirement contributions, certain royalty income,¹¹ etc.) not considered part of the active trade or business income calculation will continue to be passed through to the shareholder or partner.

3. Q. Can a qualified entity that has a loss for the tax year make the entity election?
 - A. Code Section 12-6-545(G)(2) provides that a qualified entity may elect annually to have its income taxed on its active trade or business income at 3% imposed on the qualified entity itself. If an entity knows it has a loss for the year, then technically the election should not be made. If, however, the election is made in a tax year the qualified entity had a tax loss, the election will have no effect. As such, the loss would not remain at the entity level, but would pass through to the owners, as if the election had not been made.
4. Q. Who makes the election for a qualified entity to report and pay tax on active trade or business income at the entity level under Code Section 12-6-545(G)?
 - A. The annual election to report and pay tax on active trade or business income at the entity level is made by the “qualified entity” (i.e., the partnership or S corporation) for each tax year (including any short tax year) to the Department. The entity election is not reported by the owners to the Department.

Note: A separate election is not made for each division or separate lines of the business.

5. Q. Does the election apply to all owners?
 - A. An election made by the qualified entity for the tax year applies to all entity owners with respect to the active trade or business income of that qualified entity for that tax year. An owner does not have the option to “opt out” of an entity’s election with the Department.

In addition, an owner that is a qualified entity with its own active trade or business income may make an election for its own active trade or business income. Also, see Question 6 – Example 2 where an entity ineligible to make the election does not disqualify another qualified entity in the ownership structure from making the election for its active trade or business income to be taxed at the entity level.

6. Q. What is a “qualified entity” eligible to make the election to report and pay tax on active trade or business income at the entity level?
 - A. Only a “qualified entity,” all of whose owners are “qualified owners,” is eligible to make the election each year to report and pay tax on active trade or business income at the

¹¹ For example, royalties from mineral, oil, and gas are generally passive investment income, however royalty income derived in the ordinary course of business of franchising or licensing property is active trade or business income.

entity level. Code Section 12-6-545(G)(1) defines “qualified entity” and “qualified owner” as:

(a) ‘Qualified entity’ means a partnership or ‘S’ Corporation including a limited liability company taxed as a partnership or ‘S’ Corporation, where all of its owners are qualified owners or partnerships, and, where those partnerships are owned directly or through other partnerships by qualified owners.

(b) ‘Qualified owner’ means a partner or shareholder of a qualified entity that is an individual, estate, trust, or any other entity except those taxed or exempted from tax pursuant to Sections 12-6-530 through 12-6-540 and 12-6-550 and except for any other entity exempt from South Carolina income tax.

Below are illustrations of S corporations and partnerships that meet the definition of qualified entity and, therefore, are eligible to make the election under Code Section 12-6-545(G) and illustrations of those that do not meet the definition and, therefore, are not eligible to make the election.

General Rule – Qualified Entity and Qualified Owner.

Based upon Code Section 12-6-545(G), the election is limited to only partnerships, S corporations, or limited liability companies taxed as a partnership or S corporation that only have qualified owners.¹²

Based upon Code Section 12-6-545(G)(1), a “qualified owner” is not an entity listed in:

- Code Section 12-6-530 (corporations and other entities taxed at the same tax rate as corporations for federal income tax purposes);
- Code Section 12-6-535 (electing small business trust or ESBT);
- Code Section 12-6-540 (unrelated business income of exempt organizations, homeowner’s associations, and cooperatives);
- Code Section 12-6-550 (corporations exempt from income tax, i.e., banks, savings and loans, insurance companies); and
- Other tax exempt organizations, such as an organization under IRC 501 through 528.

To the extent these entities are subject to tax in South Carolina, they are taxed at a rate above 3%. The existence of one of these entities in the ownership structure of an S corporation or partnership will disqualify a pass-through entity from meeting the definition of “qualified entity.”¹³

¹² A sole proprietorship is not a qualified entity for purposes of the new election in Code Section 12-6-545(G). A sole proprietorship, however, continues to meet the definition of “pass through business” for purposes of the “owner” optional 3% rate reduction election in Code Section 12-6-545(B)(1).

¹³ The existence of one of these entities may also invalidate the S corporation’s “S” election.

S Corporation - Qualified Entity and Qualified Owner Requirements.

An S corporation is permitted under federal and South Carolina income tax rules to only have shareholders who are an: (1) individual, (2) trust (including an ESBT), (3) estate, (4) certain exempt organizations, or (5) qualified subchapter S subsidiary.¹⁴ A partnership is not permitted to be a shareholder in an S corporation.¹⁵ An S corporation will meet the definition of “qualified entity” eligible to make the election in Code Section 12-6-545(G), unless it has a “non-qualified owner” described above.

Partnership¹⁶ - Qualified Entity and Qualified Owner Requirements.

Generally, a partnership is permitted to have partners that include: (1) individuals, (2) trusts, (3) partnerships, (4) S corporations, and (5) C corporations.¹⁷ However, a partnership will not meet the definition of “qualified entity” eligible to make the election in Code Section 12-6-545(G) if the partnership has a C corporation, S corporation, or other “non-qualified owner” in its ownership structure. A partnership is a “qualified entity” if it has an individual, trust (not subject to corporate tax), or partnership (with only “qualified owners”) in its ownership structure.

Examples best illustrate who is eligible to make the election.

Example 1 – Entity Eligible to Make Election. Assume S corporation Z has three shareholders – an individual, a trust not subject to corporate tax, and an estate. Since S corporation Z meets the definition of “qualified entity” and each of its shareholders are “qualified owners,” S corporation Z is eligible to make the election to have its active trade or business income taxed at the entity level. Any income that is not active trade or business income and any deductions not related to S corporation Z’s active trade or business income must be passed through to the owners for the owners to report on their own tax returns.

Example 2 – Entity Not Eligible to Make Election; Owner Eligible to Make Election. Assume Partnership A has three partners - two partners are individuals and one partner is a partnership (Partnership B). Partnership B is owned by an individual and an S corporation (S corporation 1 with all individual shareholders). Partnership A’s income is all active trade or business income.

Partnership A is **not eligible** to make the election. Since Partnership A has an S corporation in its ownership structure, Partnership A does not meet the definition of “qualified entity,” (because of Partnership B’s S corporation owner), and therefore is not eligible to make the election to have its active trade or business income taxed at the entity level. The income is passed through to the owners of Partnership A.

¹⁴ Code Section 12-2-25(B). A “qualified subchapter S subsidiary,” as defined in IRC Section 1361(b)(3)(B) is not regarded as an entity separate from the S corporation that owns the stock of the qualified entity. A single member limited liability company, which is not taxed for South Carolina income tax purposes as a corporation, is not regarded as an entity separate from its owner.

¹⁵ IRC Section 1361(b)(1)(B).

¹⁶ Code Section 12-2-25(A)(1) provides that a partnership includes a limited liability company taxed for South Carolina purposes as a partnership.

¹⁷ Code Section 12-2-25(A)(3) provides that a corporation includes a limited liability company taxed for South Carolina purposes as a corporation.

Partnership B is **not eligible** to make the election. Likewise, Partnership B does not meet the definition of “qualified entity” since it has an S corporation in its ownership structure, and therefore is not eligible to make the election to have its active trade or business income taxed at the entity level as provided in Code Section 12-6-545(G). The income is passed through to the owners of Partnership B.

S corporation 1 **is eligible** to make the election. The fact that Partnership A is not eligible to make the election, does not disqualify another qualified entity in the ownership structure to make an election for its active trade or business income to be taxed at the entity level. Since S corporation 1 (an owner of Partnership B) is a “qualified entity,” S corporation 1 can make an election to have its active trade or business income taxed at the entity level, including any pass through income from Partnership A and B. If S corporation 1 also had its own active trade or business income, the election would also apply to its active trade or business income.

7. Q. How is the “entity election” made each year?

- A. There is not a formal, separate South Carolina election form to use to make the entity election. An annual election for a qualified entity to report and pay tax on active trade or business income directly at the entity level for the tax year is made on the qualified entity’s SC Form 1065, “Partnership Return” or SC Form 1120S, “S Corporation Income Tax Return” by marking the election “check box” on the first page of the tax return. The election is made by (or revoked by) the qualified entity and can be made on the entity’s original return or an entity’s amended return. See Questions 8 and 9 for guidance on the time period in which the election or revocation must be made.

Note: A qualifying entity may elect to pay tax on the active trade or business income at the entity level in one year and may choose not to make the election in a subsequent year. The entity does not need to obtain prior consent or approval from the Department to make or revoke the entity election. Further, an entity can make a tax payment prior to the annual election since the “entity election” is not required to be made until the due date of the return, including extensions. The entity extension form and entity estimated payment vouchers do not have an election check box. See Question 14 for information on making tax payments prior to the election being made.

8. Q. When is the election required to be made each year?

- A. Code Section 12-6-545(G)(2) provides that a qualified entity must make the election no later than the due date for filing the applicable income tax return (SC Form 1065 or SC Form 1120S), including any extensions. To be valid, the annual election must be made during the following times:

For an Electing Entity that Does Not File an Extension of Time to File. If the electing entity does not have a valid extension of time to file for the tax year, then the election must be made by the original due date¹⁸ of the electing partnership’s or S corporation’s income tax return (e.g., March 15 for calendar year entities).

¹⁸ Code Section 12-6-4970 provides for the time to file returns.

For an Electing Entity With a Valid Extension of Time to File. If the electing entity filed an extension of time for the tax year, then the election must be made by the extended due date of the electing partnership's or S corporation's extended income tax return (e.g., September 15 for calendar year entities).

General Extension Rules and Acceptance of Federal Extension.¹⁹ Code Section 12-54-70 provides for an extension of time for filing returns and paying tax. Code Section 12-6-4980 allows for a six-month extension of time for filing partnership and S corporation returns. If a qualified entity files an extension with the IRS, the Department will accept the federal extension and will grant an automatic extension of time to file the South Carolina return for six months, unless the taxpayer is required to make a South Carolina tax payment with the extension.²⁰ If a payment is required, a separate South Carolina extension needs to be filed with the payment. A copy of a South Carolina extension or a copy of the federal extension form does not need to be attached to the South Carolina paper or electronic return when filed. When the return is filed, the electing entity should "check the box" on the South Carolina return which indicates an extension was filed.

Caution – An Extension (SC or Federal) is Needed to Make or Change Election After Original Due Date of Entity Return: A partnership or S corporation that has doubts if it wants to make the entity election when filing its return on or before the original due date should consider paper filing a South Carolina extension on or before the original due date to ensure that the election can later be made or revoked on the entity's amended (or superseding) return filed on or before the extended due date. South Carolina Form SC 8736, "Request for Extension to File Return for Fiduciary and Partnership," can be used to extend a partnership return. South Carolina Form SC 1120-T, "Application for Automatic Extension of Time to File Corporate Tax Return," can be used to extend an S corporation return.

9. Q. Can the election be made or revoked by the qualified entity for the tax year after timely filing its SC Form 1065 or SC Form 1120S?
- A. Code Section 12-6-545(G)(2) provides that a qualified entity must make the election no later than the due date for filing the applicable income tax return (SC Form 1065 or SC Form 1120S), including any extensions. Accordingly, the making of the election or the revocation of the election is permitted by the later of: (1) the due date of the return, or (2) the extended due date of the return if a proper federal or South Carolina extension is filed. Once the election is final (i.e., either on the original due date of the return or the extended due date of the return, as applicable), the election (or lack of making the election) must be adhered to by the entity and its owners for that tax year.²¹ Although the annual election can be made or revoked prior to the due date or extended due date of the

¹⁹ See SC Revenue Procedure #17-1, "Return Due Dates and Extensions of Time to File – Revised Dates."

²⁰ Code Sections 12-54-25 and 12-54-43(D) impose interest on, and penalties for, late payment. The election under Code Section 12-6-545(G), however, will not be invalidated solely as a result of late payment.

²¹ There is no relief for a late election in a specific tax year, unless the return due dates are changed by the Governor or General Assembly or under Code Section 12-4-320(6) for damage caused by natural disasters and similar acts.

entity return, as applicable, an annual entity election cannot be changed after the due date or extended due date, as applicable, of the entity return for that tax year (e.g., the election cannot be changed on an amended return filed two years later).

For an Electing Entity Without an Extension of Time to File – Entity Retroactively Makes the Election. The election can be made or can be revoked at any time prior to the due date of the electing partnership's or S corporation's income tax return (March 15 for calendar year entities),²² when the entity did not request an extension of time to file for the tax year.

For example, a calendar year partnership files its SC Form 1065 for tax year 2021 on March 1, 2022 and does not make the election to report and pay tax on active trade or business income at the entity level. The partnership did not file a federal or South Carolina extension of time. The partnership files an amended return on March 14, 2022, and makes the election. The election made on the amended return is timely. The election may not be further changed after the final due date of the entity return, March 15, 2022, since a request for an extension of time to file the entity return was not made.

Note: In this example, if the entity had filed a proper extension of time after filing the return (March 1, 2022) but before the due date of the return (March 15, 2022), then the election could be made (or changed) by filing an amended return by the due date of the extended return (September 15, 2022). The election may not be further changed after the extended due date of the entity return.

For an Electing Entity With a Valid Extension of Time to File²³ – Entity Retroactively Revokes the Election. The election can be made or can be revoked at any time prior to the extended due date of the electing partnership's or S corporation's extended income tax return (September 15 for calendar year entities) when the entity has filed a proper extension of time. For example, a calendar year S corporation files an extension of time to file its SC Form 1120S for tax year 2021 on March 15, 2022. On April 1, 2022, the S corporation files its original SC Form 1120S and makes the election to report and pay tax on active trade or business income at the entity level. The S corporation files an amended (superseding) return on September 15, 2022, and revokes the election. The revocation of the election by the qualified entity on its amended return is timely. The revocation is applicable to all owners and as a result of the election revocation, the active trade or business income will pass through to the owners who will report and pay the tax for the current tax year (e.g., tax year 2021).

10. Q. What is the first year a fiscal year entity can make the election?

A. The election in Code Section 12-6-545(G) is first available for tax years beginning 2021. For a fiscal year taxpayer, the first tax year the election can be made is for its fiscal year

²² Code Section 12-6-4970(B)(1) provides that returns of partnerships and S corporations must be filed on or before the 15th day of the third month following the tax year.

²³ See Question 8.

beginning in 2021 and thereafter.²⁴ For example, assume a qualified partnership has a June 30 year end and has active trade or business income and income that does not qualify as active trade or business income. The partnership has two partners, both of whom are individuals. Since the partnership's fiscal year July 1, 2020 through June 30, 2021 begins in 2020 and does not begin after 2020, the partnership cannot make the election for its 2020 tax year. The partnership can first make the election for its fiscal year July 1, 2021 through June 30, 2022; the original partnership return would be filed on a 2021 SC Form 1065 due September 15, 2022, (in the absence of filing an extension). The SC 1065 K-1 information reflecting the income that does not qualify for (or is not included in) the partnership's active trade or business election is passed through to the individual owners and included on the owners' 2022 SC Form 1040, "South Carolina Individual Income Tax Return," since the partnership's tax year ends in 2022, which is within the tax year reported on the partners' 2022 SC Form 1040.

PART 2 - ENTITY ADMINISTRATIVE AND COMPLIANCE QUESTIONS

11. Q. How does the entity notify owners that the election was made or revoked for the current tax year?
- A. The electing pass-through entity must provide Form SC 1120S K-1, "Shareholder's Share of South Carolina Income, Deductions, Credits, Etc.," or Form SC 1065 K-1, "Partner's Share of South Carolina Income, Deduction, Credits, Etc.," to each owner reporting the amount of the owner's share of the active trade or business income taxed at the entity level, along with the other information required to be reported on the SC K-1. Further disclosure could be made in the SC K-1 footnotes or as an attachment to the SC K-1.

For tax year beginning 2021, these SC K-1's will have a "check box" to indicate whether the election is made for the current tax year. If an amended return is filed to revoke the election previously made for the tax year, the election "check box" should be left blank. The SC K-1 "checkbox" will alert the owner, or tax professional preparing the owner's income tax return, whether an "entity election" to directly pay the tax on South Carolina active trade or business at the entity level was or was not made by the entity for the tax year.

12. Q. What tax information should an electing qualified entity provide to the owners on or with their Schedule SC K-1?
- A. An electing entity must notify its owners that the election has been made²⁵ and provide its owners the non-active trade or business income and related deductions and credits passed through to the owner so the owner can complete their own South Carolina tax return. The entity should provide a statement identifying the owner's distributive share of income that was subject to tax at the entity level (so the owner can reconcile the Federal K-1 and SC K-1 information in computing his own South Carolina taxable income). If the election

²⁴ A taxpayer with a 52-53 week tax year can first make the election on its 2021 tax return even though its tax year began the last week of December 2020. See IRC Section 441 and IRS Publication 538.

²⁵ SC Form 1065 and SC Form 1120S K-1's have a "check box" for the qualified entity to indicate that the entity election was made (or not made) for the tax year.

is later revoked for the tax year, the entity must notify each owner by providing an amended Schedule SC K-1.

In addition, the electing entity should provide the owners with their share of state income taxes paid at the entity level so the owners can determine their South Carolina tax basis in their partnership interest or S corporation stock. Code Section 12-6-545(G)(9) provides that the South Carolina basis of nonresident and resident shareholders and partners is determined as if the election in Code Section 12-6-545(G) had not been made and each owner had taken into account their pro rata share of the entity's income, loss, and deductions. This treatment may result in higher owner basis upon disposition of the interest or stock, and a lower South Carolina gain or higher loss.

Note: This provision only relates to the computation of an owner's South Carolina tax basis in the partner's/owner's interest. Federal income tax rules control the owner's federal basis. South Carolina law does not amend IRC Section 705 for a partnership or IRC Section 1367 for an S corporation and the related provisions of federal income tax law regarding computation of the owner's federal tax basis in the partner's/owner's interest. See also Question 26.

13. Q. What are the due dates for estimated payments required to be made by the electing entity?
- A. Code Section 12-6-545(G)(7) provides that for tax years 2022 and thereafter, an electing qualifying entity must make estimated tax payments pursuant to Code Section 12-6-3910.

Code Section 12-6-3910(A)(1) and (2) provides that South Carolina estimated tax payments are made in accordance with Internal Revenue Code Sections 6654 and 6655 except that the small amount provisions in Internal Revenue Code Sections 6654(E)(1) and 6655(f) are \$100 and income for the first installment for corporations is annualized using the first three months in the tax year.

For purposes of the Code Section 12-6-545(G) election, a partnership will pay estimated tax on the due dates for "taxpayers other than corporations" and S corporations will pay estimated tax on the due date for "corporations" as prescribed in Code Section 12-6-3910(A)(3).

Partnership Estimated Tax Payments. The due dates of the estimated tax payments for calendar year partnerships are:

First quarter:	April 15
Second quarter:	June 15
Third quarter:	September 15
Fourth quarter:	January 15 of the following tax year

S Corporation Estimated Tax Payments. The due dates of the estimated tax payments for calendar year S corporations are:

First quarter:	April 15
Second quarter:	June 15

Third quarter: September 15
Fourth quarter: December 15

Fiscal Year Pass-through Entity. For a pass-through entity with a fiscal tax year, the month that corresponds to the months specified above for the partnership or S corporation must be substituted.

14. Q. Can a calendar year cash basis qualified entity make an estimated payment of its 2021 taxes (due March 15, 2022) in December 2021 before the “election” is made on the SC Form 1065 or SC Form 1120S?
- A. Yes. A partnership or S corporation can make a payment in December 2021 for the 2021 tax year taxes; no election notification to the Department is needed at that time. The taxpayer (qualified entity) can make the tax payment through MyDORWAY or by paper form on SC Form 1065V, “Partnership Tax Payment Voucher,” or SC Form 1120V, “Corporate Income Tax Payment Voucher.”

Note 1 – 2021 Tax Year Payment Methods: An entity who makes any payment due under Code Section 12-6-545(G) for tax year 2021 by check will not be assessed a penalty for failure to make such payment or payments with immediately available funds as prescribed in Code Section 12-54-250.

Note 2 – Estimated Payments for Tax Years 2022 and Thereafter: For years 2022 and thereafter, a partnership or S corporation can make estimated tax payments through MyDORWAY or by paper SC Form 1065ES, “Partnership Declaration of Estimated Income Tax,” or SC Form 1120CDP, “Corporation Declaration of Estimated Income Tax,” for a tax year before the “election” is made on the SC Form 1065 or SC Form 1120S.

15. Q. For tax year 2021, the first year the election is available, will the electing entity be subject to estimated tax underpayment penalties since the new statute does not require estimated tax payments be made for tax years beginning before 2022?
- A. No. Code Section 12-6-545(G)(7) provides that for tax years beginning in 2022 and thereafter, an electing qualified entity shall submit estimated tax payments pursuant to Code Section 12-6-3910. Since there is no requirement for the electing entity to make estimated payments in the 2021 tax year, there can be no assessment of a penalty for underpayment of estimated tax²⁶ on an electing qualified entity for its tax year that begins in 2021.
16. Q. Does a penalty for underpayment of estimated tax in Code Section 12-54-55 apply to an S corporation or partnership making the election for tax years after 2021?
- A. Code Section 12-54-55 imposes a penalty on “an individual taxpayer, estate, trust, or corporate taxpayer,” in lieu of all other penalties, for the underpayment of estimated tax. Accordingly, this penalty may be assessed on an S corporation making the election under Code Section 12-6-545(G) in the same manner as the penalty in IRC Section 6665 and

²⁶ Code Section 12-54-55.

applicable regulations, except the small amount provisions are \$100. However, at this time, absent a legislative amendment, this penalty may not be assessed on a partnership making the election under Code Section 12-6-545(G).

17. Q. Can any estimated tax payment amount paid by the entity be refunded or moved to another account or taxpayer if the payments exceed the tax due?
- A. To the extent the estimated tax payments are in excess of the electing partnership's income tax liability or electing S corporation's income tax and license fee liability, the pass-through entity may claim (1) a refund or (2) credit for estimated tax for the next tax year.

Code Section 12-60-470(C)(2) further provides for a written assignment of right to a refund to another person. The taxpayer legally liable for the tax may assign a refund to another person only after the taxpayer's claim is allowed, the amount of the refund is finally decided, and the Department has approved the refund.

18. Q. Is an electing qualified entity relieved of the nonresident withholding requirements in Code Section 12-8-590?
- A. Code Section 12-8-590 requires S corporations and partnerships to withhold income tax at the rate of 5% on nonresident S corporation shareholders' and nonresident partners' share of South Carolina taxable income, whether distributed or undistributed. Code Section 12-6-545(G)(6) provides that Code Section 12-8-590 does not apply to electing qualified entities to the extent of the tax the electing entities pay on their active trade or business income. However, nonresident withholding may be required to the extent the entity has non-active trade or business income or other income subject to nonresident withholding.

There are exceptions to the withholding requirements in Code Section 12-8-590. For example, an S corporation or partnership is not required to withhold income taxes with respect to any shareholder or partner:

1. Who submits an affidavit stating the nonresident shareholder or partner is subject to the personal jurisdiction of South Carolina or
2. For which the entity reports the nonresident shareholder's or partner's income on a composite tax return.²⁷

See SC Revenue Procedure #17-2, "Withholding on South Carolina Income of Nonresident Shareholders and Partners," for guidance, including SC Form I-309, "Nonresident Shareholder or Partner Affidavit and Agreement – Income Tax Withholding;" and guidance on filing composite individual income tax returns on behalf of the nonresident shareholders or partners, and how the nonresident withholding amount is computed and remitted.

²⁷ See Code Section 12-6-5030 regarding a composite return. Form SC 1040, "Individual Income Tax Return," is modified and used by the S corporation or partnership to file a composite return on behalf of eligible nonresident shareholders and partners.

PART 3 - ENTITY LEVEL TAX ON ACTIVE TRADE OR BUSINESS INCOME – GENERAL ENTITY COMPUTATION QUESTIONS

19. Q. What is the tax rate on active trade or business income taxed to an entity making the election under Code Section 12-6-545(G)?

- A. A 3% tax rate applies to the active trade or business income apportioned to South Carolina of a qualified entity making the election under Code Section 12-6-545(G)(2).

Note: If an election was made in a tax year the qualified entity had a tax loss or does not have “active trade or business income” for South Carolina tax purposes (after working through the statutory subtractions in Code Section 12-6-545(A)(1), such as passive investment income and capital gains), the loss does not remain at the entity level; the loss passes through to the owners (as a distributive share or pro rata item), as if the election had not been made. See also Question 3.

20. Q. How is income earned by the entity that is not active trade or business income taxed?

- A. Code Section 12-6-545(G) did not change South Carolina law on this issue. Income of the entity that is not active trade or business income is passed through to the owners and the tax due on this income is paid by the partner or shareholder at a rate up to 7% as provided in Code Section 12-6-510. Other items of portfolio income, gain, loss, or deductions are generally required to be separately stated on the SC K-1 provided to the owner.²⁸ Income listed in Code Section 12-6-545(A)(1) that is not active trade or business income includes: amounts reasonably related to personal service income; capital gains and losses (which include IRC Section 1231 gains); and passive investment income²⁹ and expenses related to passive investments.

Note: Whether an activity is an “active trade or business” or a “passive investment” is determined at the entity level for purposes of the 3% rate. See Code Section 12-6-545 and SC Revenue Ruling #08-2, “Tax Rate Reduction on Active Trade or Business Income from a Pass Through Business,” for guidance.

21. Q. Are state and local taxes deducted under Internal Revenue Code Section 164 by the electing entity allowed as a deduction for South Carolina income tax purposes?

- A. IRS Notice 2020-75 clarifies that state and local income taxes imposed on and paid by the pass-through entity are allowed as a federal income tax deduction in the year of payment.³⁰ However, Code Section 12-6-1130(2) provides that the deduction for taxes

²⁸ See Code Sections 12-6-590 and 12-6-600 and IRC Sections 1366(a) and 702(a).

²⁹ IRC Section 1362(d) defines passive investment income and provides exceptions. The regulations under IRC Section 1362, and other guidance such as federal rulings and cases, should be considered in determining whether income is “passive investment income.” See SC Revenue Ruling #08-2 for examples of passive investment income, including royalties, rents, dividends, and interest, and exceptions of when these items may not be passive investment income.

³⁰ The deductibility of taxes paid or accrued under IRC Section 164 is a federal question. IRS Notice 2020-75 is not clear if state and local taxes accrued by partnerships and S corporations are included as a “specified tax payment.” Until superseded by an IRS announcement, proposed regulation, change in statute, court decision, or another

permitted under IRC Section 164 is computed in the same manner as provided in IRC Section 164 except there is no deduction for state and local income tax. Accordingly, the qualified electing partnership or S corporation deducting state income taxes on their federal Form 1065 or federal Form 1120S must “add back” the state income taxes deducted in computing South Carolina taxable income reported on their SC Form 1065 or SC Form 1120S.

Note: South Carolina does not allow a state tax credit for an owner on his individual income tax return for his pro rata share of state income taxes paid by the entity on active trade or business income. See also Questions 25 and 26.

22. Q. Is personal service income considered “active trade or business income” eligible for the 3% tax rate?

A. Code Section 12-6-545(A)(1)(d) states that active trade or business income does not include amounts “reasonably related to personal services.” Amounts related to personal services include all compensation (e.g., wages, salaries, bonuses, etc.) and guaranteed payments for services.

Caution: If an owner of a pass-through entity who performs personal services for the entity is not paid a reasonable amount for those personal services as compensation or payments referred to in IRC Section 707(c), all of the owner’s income from the entity is presumed to be amounts reasonably related to personal services.

See SC Revenue Ruling #08-2, “Tax Rate Reduction on Active Trade or Business Income from a Pass Through Business” for additional guidance.

23. Q. Can an electing entity use the safe harbor provision in Code Section 12-6-545(E)(1) allowing an owner to treat 50% of active trade or business income as not related to personal services in certain circumstances?

A. No. The safe harbor provision in Code Section 12-6-545(E)(1) is not applicable to the entity in determining amounts reasonably related to personal services that are not included in active trade or business income.

24. Q. How are tax credits related to active trade or business income treated when an entity makes the election to directly pay the income tax on its active trade or business income?

A. Some South Carolina income tax credits may only be earned by a certain type of entity (e.g., earned only by a C corporation). Most credits, however, may be earned by C corporations, S corporations, partnerships, sole proprietorships, and limited liability companies taxed as one of these entities. Each specific credit statute has detailed requirements that should be reviewed to determine eligibility. The use of South Carolina tax credits to reduce an electing entity’s tax depends, in part, on whether the credit was

Department advisory opinion, it is the Department’s position that such taxes imposed on, and accrued by, the qualified entity, and subsequently paid by the due date of the return, including extensions, are allowed as a federal income tax deduction by the qualified entity.

earned by an S corporation or a partnership and whether it is related to active trade or business income. Code Section 12-6-3310(B)³¹ provides for the use and pass through of tax credits earned by pass-through entities, and reads, in part:

(B)(1) Unless specifically prohibited, an “S” corporation, limited liability company taxed as a partnership, or partnership that qualifies for a credit pursuant to this article may pass through the credit earned to each shareholder of the “S” corporation, member of the limited liability company, or partner of the partnership.

(2) A credit earned by an “S” corporation owing corporate level income tax must first be used at the entity level. Only the remaining credit passes through to the shareholders of the “S” corporation.

Electing S Corporation Use of Credits. Based upon Code Section 12-6-3310(B)(2), a qualified S corporation that makes the election provided in Code Section 12-6-545(G) to directly pay the income tax (i.e., a corporate entity level tax) on its active trade or business income must first use a credit earned by the S corporation that is related to active trade or business income at the entity level, unless prohibited by the specific credit provision. The remaining credit passes through to the shareholders of the S corporation to be applied against the shareholder’s income tax liability.

Example – An S corporation engaged in manufacturing earns a \$15,000 job tax credit. The credit is related to its active trade or business. The S corporation has one individual shareholder and elects to pay tax at the entity level under Code Section 12-6-545(G). The job tax credit statute provides that the credit can be claimed against taxes imposed by Code Sections 12-6-510 and 12-6-530 and that an S corporation owing corporate level income tax must first use the credit at the entity level, and pass the remaining credit through to its shareholders.³²

SC income tax liability on SC Form 1120S before the job tax credit		\$10,000
Job tax credit earned by S corporation	\$15,000	
Job tax credit used by S corporation (limited to 50% of the entity tax liability) ³³		\$5,000
Job tax credit passed through to shareholder	\$10,000	
SC individual income tax liability of the shareholder on SC Form 1040 before the job tax credit		\$6,000
Credit limited to use by shareholder (limited to 50% of the tax liability)		\$3,000
Credit carryforward by shareholder	\$7,000	

³¹ Code Section 12-6-3310(B) was enacted in 2003.

³² Code Section 12-6-3360(K).

³³ Code Section 12-6-3360, the job tax credit statute, permits the job tax credit to be used against 50% of a taxpayer’s tax liability. See SC Revenue Rulings #19-11 and #99-5 for further guidance.

This example illustrates that an S corporation must first use the job tax credit against the entity income tax under Code Section 12-6-545(G) after computing the entity's 50% income tax limitation and then must pass through the remaining credit to the shareholder who will also apply his 50% income tax limitation at the shareholder level. Once the credit is passed through to the shareholder, it may not be later used by the S corporation.

If the S corporation had a \$10,000 loss and no South Carolina income tax liability, the answer would change. The loss would pass through to the shareholder and the entire \$15,000 job tax credit would pass through to the shareholder.

Electing Partnership Use of Credits. There is no statutory requirement for a credit earned by a partnership owing entity level income tax to be used first at the entity level. Based upon Code Section 12-6-3310(B)(1), a qualified partnership who makes the election provided in Code Section 12-6-545(G) to directly pay the income tax (i.e., an entity level tax) on its active trade or business income may pass through the credit earned related to active trade or business income to the partners. Accordingly, an electing partnership may choose to apply a credit first at the entity level or may choose to pass the credit through to the partners. The partnership may make this choice on a credit by credit basis. The choice may be changed with each annual election under Code Section 12-6-545(G).

Example – A partnership is engaged in the business of providing professional architecture design and consulting services in South Carolina. The partnership, owned by four individual architects, earns a \$500,000 abandoned building credit when its newly renovated architecture office building is placed into service. The partnership elects to pay tax on its active trade or business income directly at the entity level under Code Section 12-6-545(G). The abandoned building credit statute provides that the income tax credit is taken in equal installments over three years (\$166,667 for each installment in this example). The income tax credit can be used against taxes imposed under Chapter 6 (income tax) and can offset the taxpayer's entire income tax liability. For the current tax year, the partnership chooses to not use the credit installment at the entity level and passes through the specially allocated credit installment to one partner.³⁴

SC income tax liability on SC Form 1065		\$100,000
Abandoned building credit ³⁵ earned by partnership	\$166,667	
Abandoned building credit passed through to one partner	\$166,667	
SC individual income tax liability of the partner on SC Form 1040 before the abandoned building credit		\$60,000
Credit used by partner (offsets 100% of the tax liability)		\$60,000
Credit carryforward by partner	\$106,667	

³⁴ Code Section 12-67-140(B)(6) provides for the allocation of the abandoned building credit and unused carryforward. It provides that the credit may be allocated among any of its partners, including an allocation of the entire credit to any partner, without regard to the Internal Revenue Code.

³⁵ Chapter 67 of Title 12 contains the Abandoned Building Revitalization Credit. See SC Revenue Ruling #15-7 for further guidance.

This example illustrates that a partnership has the choice to first use the abandoned building credit against the entity income tax and then must pass through the remaining credit to the partner or partners as permitted under the specific credit provision. Once the credit installment is passed through to the partner, it may not be later used by the partnership.

Other Credit Rules Applicable to Electing Entities and Owners. Other important general rules (but not all inclusive rules) to remember regarding South Carolina income tax credits used by electing S corporations and partnerships and by shareholders and partners to whom the credits are passed through include:

1. The type of tax a credit may be used against depends upon the particular credit. A credit may provide the taxes it can offset, including individual income tax under Code Section 12-6-510; corporate income tax under Code Section 12-6-530; taxes under Chapter 6; or any other taxes or combination of them. However, a credit that can be used at the entity level is also subject to restrictions in Code Section 12-6-3310 and 12-6-545.
2. While the statutory language of each credit may limit the credit to certain entities subject to tax under a specific South Carolina code section, Code Section 12-6-545(F) states that an income tax credit available to offset taxes due pursuant to Code Section 12-6-510 also apply against taxes imposed by Code Section 12-6-545.

For example, the job tax credit in Code Section 12-6-3360 states the credit “may be claimed against income taxes imposed by Section 12-6-510 or 12-6-530, bank taxes imposed pursuant to Chapter 11 of this title, and insurance premium taxes imposed pursuant to Chapter 7, Title 38.” Code Section 12-6-545(F) allows the individual partner or shareholder to use the job tax credit to offset his active trade or business income taxed under Code Section 12-6-545 as well as other income reported on his individual income tax return that is taxed under Code Section 12-6-510.

However, Code Section 12-6-545 does not authorize income tax credits available to offset taxes due pursuant to Code Section 12-6-530 to reduce the tax under Code Section 12-6-545. Accordingly, credits allowed only against corporate income tax due under Code Section 12-6-530 cannot be claimed against the S corporation entity tax due under Code Section 12-6-545(G).

For example, credits currently available for use only against the corporate income tax under Code Section 12-6-530 are: the corporate headquarters credit under Code Section 12-6-3410; the infrastructure credit in Code Section 12-6-3420; the recycling credits in Code Sections 12-6-3460 and 12-6-3465; and the effluent toxicity testing credit in Code Section 12-6-3589. To the extent an S corporation making the election under Code Section 12-6-545(G) earns one of the above credits, the entity can only use the credit against tax due under Code Section 12-6-530, if any; the entity cannot use the credit to offset any tax due under Code Section 12-6-545(G). Further, a shareholder may not use any of these credits against individual income tax due under Code Section 12-6-510. Code Section 12-6-3310(B)(3) provides that the credit allowed is against the type of tax or taxes specifically provided by the credit.

3. Each taxpayer (entity and owner) may apply credits in any order, unless otherwise specifically provided.³⁶
4. Any limitations on the total amount of liability for taxes or license fees that can be reduced by the use of a credit are computed separately for each credit by the entity before applying any other credit in the order it chooses to apply the credits (unless otherwise provided in the credit statute). A credit passed through to a partner or shareholder is not affected by the generating entity's income and is not limited to a percentage of the generating entity's income tax.
5. Most credits can be used against all South Carolina income tax reported by the partner, shareholder, or member. A credit may be limited to a percentage of the partner's, shareholder's, or member's income tax liability or married couple's income tax liability. Any limitations on the total amount of liability for taxes that can be reduced by the use of a credit must be computed by the partner or shareholder separately for each credit before applying any other credit in the order he chooses to apply the credits (unless otherwise provided in the credit statute).
6. Unless otherwise provided by law, a tax credit administered by the Department must be used in the year generated and must not be refunded. Code Sections 12-2-100, 12-6-3310(A), and 12-6-3480(4).
7. Notwithstanding the general rules, the use and carryforward of credits may be subject to special rules contained in certain credits, such as the rehabilitation credit in Code Section 12-6-3535, the South Carolina housing tax credit in Code Section 12-6-3795, the textile mill credit in Code Section 12-65-10, and the abandoned building credit in Chapter 67, Title 12. See Code Sections 12-2-100(B) and 12-67-140(B)(6).

Examples of Computing the Entity's Active Trade or Business Income and Tax and Reporting Items Passed Through to the Owner

On the following nine pages, three comprehensive examples illustrate the concepts and consequences when a qualified entity considers making an entity election under Code Section 12-6-545. The three examples, along with explanations, provide additional guidance regarding the entity election, computing the entity level tax, and reporting the information to the owner.

Example 1 – A partnership files an extension of time to file with the intent to make the entity election under Code Section 12-6-545(G). After preparing the entity tax returns, all federal income reported is from personal services. Since amounts reasonably related to personal services are NOT active trade or business income for South Carolina purposes, the partnership has no active trade or business income to tax at the entity level. Although a “qualified entity,” any election by the partnership has no effect. See complete Example 1 on page 24.

Example 2 – An S corporation makes the entity election under Code Section 12-6-545(G) for the current tax year. All income of the S corporation is South Carolina active trade or business income. See complete Example 2 on page 25.

³⁶ Code Section 12-6-3480(3).

Example 3 – A partnership makes the entity election under Code Section 12-6-545(G) for the current tax year. The partnership has both South Carolina active trade or business income and other income. See complete Example 3 on page 27.

Important Points to Remember in Computing Active Trade or Business Income and Example Caveats

- Federal “ordinary business income” may not be the same as South Carolina “active trade or business income.” Income not included in federal ordinary business income is reported separately on the Schedule K-1, such as net rental real estate income, other net rental income, interest income, net section 1231 gains, etc.
- Federal income after state modifications is subject to allocation and apportionment of an entity engaged in multi-state business activities.
- South Carolina active trade or business income is income from the pass-through business, minus the specifically listed items excluded from active trade or business income, and minus deductions related to the active trade or business. See Code Section 12-6-545(A).
- Items listed below are not active trade or business income and are excluded from the entity level tax computation:
 - a. Passive investment income³⁷ generated by a pass through business and expenses related to passive investment. In general, passive investment income includes: (1) dividend income, (2) interest income, (3) rental real estate income, and (4) sales of stock to the extent of gains;
 - b. Capital gains and losses, including IRC Section 1231 gains from property used in the trade or business;
 - c. Guaranteed payments for services defined in IRC Section 707(c); and
 - d. Amounts reasonably related to personal services.
- Examples of deductions related to active trade or business income include, but are not limited to: ordinary and necessary business expenses, interest on funds used to acquire business assets, depreciation deductions including specially allocated adjustments under IRC Section 754, and IRC Section 179 expense deduction.
- The following examples are intended to illustrate a sample worksheet prepared by the qualified entity to determine the impact of the election under Code Section 12-6-545(G). The examples are simplified to illustrate the basic concepts used in computing the entity level tax on South Carolina active trade or business income, e.g., they do not show all items of income or deduction that may exist on a Schedule K-1. The treatment of certain items, such as IRC Section 1231 gains, are based on the specific facts presented in each example.

³⁷ For purposes of Code Section 12-6-545(G) applicable to S corporations and partnerships, the definition of “passive investment income” has the same meaning as used in IRC Section 1362(d). Passive investment income defined in IRC Section 1362(d) should not be confused with a “passive activity” defined in IRC Section 469.

- **CAVEAT – Federal Guidance and Forms:** For reference purposes, the following examples are based on federal guidance available as of the date of this advisory opinion and on line number references from tax year 2020, the most recent version of the federal forms available. If the forms are revised, the line number references may change, however, the concepts discussed in this advisory opinion continue to apply. Any future IRS guidance will be controlling to the extent it alters the federal reporting illustrated in the examples.
- **CAVEAT – SC Forms:** As of the date of this advisory opinion, the referenced South Carolina forms and instructions have not been finalized. While the South Carolina form mechanics may differ, the electing entity and qualified owners should arrive at the same result as illustrated in this advisory opinion.

EXAMPLE 1 – Qualified Entity – Ordinary Business Income is NOT Active Trade or Business Income – No Valid Election

Facts: The taxpayer, a South Carolina partnership, is owned by two individuals who started a law practice this year. The partnership is a “qualified entity.” Partner A owns a 30% share and Partner B owns a 70% share. The partnership compensates the partners via an allocation of partnership profits or income, and not by guaranteed payments. The partnership has no employees and pays no wages. The partnership’s ordinary business income is \$300,000, and is derived entirely from personal services. The partnership has no other separately stated items of income, deduction, or credit. Neither individual is an owner of any other pass-through entities.

Purpose: Below is a **sample worksheet prepared by the entity** to determine if the entity is eligible to make the election to pay tax on its active trade or business income at the entity level.

Partnership Items of Income and Deduction	Federal Sch. K Information of Partnership (As listed on the federal Schedules K and K-1)	Adjusted SC Amounts from Federal K-1 (after apportionment)	SC Active Trade or Business Income and Related Deductions of Electing Partnership	Total SC Non-Active Trade or Business Income and Related Deductions (30% or 70% is Reported on Appropriate Partners SC K-1)
Ordinary Business Income	\$300,000 ³⁸	\$300,000	None	\$300,000
Active Trade or Business Income			None	
SC Tax Paid Directly by Electing Partnership			N/A	
Amounts Passed Through to Partners				\$300,000

Entity Level Income and Tax Computation. The partnership has no South Carolina active trade or business income as all of the income is related to personal services. In this example, the partnership’s ordinary business income computed for federal income tax purposes (\$300,000) is

³⁸ All compensation paid to the partners is income related to personal services.

not the same as South Carolina active trade or business income (\$0) as defined in Code Section 12-6-545. Therefore, the qualified entity does not pay any South Carolina entity level tax.

Information Reported to the Partners on their Schedule SC K-1. The entity reports to each partner their share of the entity's total net federal taxable income of \$300,000 (\$90,000 to Partner A and \$210,000 to Partner B) so that each individual can complete his SC Form 1040. Partner A qualifies to use the safe harbor provision to treat 50% of active trade or business income as not related to personal service income since his total taxable income from the partnership is \$100,000 or less. Partner B does not qualify for the safe harbor and his \$210,000 is subject to tax at the individual income tax rates up to 7%.³⁹ See Code Section 12-6-545(E).

EXAMPLE 2 – S Corporation Makes Entity Election – All Income is Active Trade or Business Income

Summary of Reporting Ordinary Business Income and Separately Stated Items: Federal Form 1120S is used to report the income, gains, losses, deductions, credits, and other information from the operation of an S corporation. An S corporation generally does not pay federal income tax, but passes through any profits or losses to its shareholders. The S corporation computes "ordinary business income" (i.e. income from an activity other than a rental activity) that involves the conduct of a trade or business under the Internal Revenue Code and federal precedent and reports it on Federal Form 1120S, page 1. This amount is also reported on Federal Schedule K, line 1, as ordinary business income. Schedule K, "Shareholder's Share of Income, Deductions, Credits, etc.," is also used to report other types of income, loss, and deductions required by IRS regulations to be separately stated in order for the shareholder to compute taxable income on his income tax return. These amounts are not included in the computation of the ordinary business income amount reported on Form 1120S, page 1. These separately stated amounts include net rental real estate income, net rental income from non-real estate activities, portfolio income, royalties, capital gains and losses, IRC Section 1231 gains and losses, other separately stated items of income, IRC Section 179 expense deduction, and charitable contributions. In addition, other items of deduction may be separately reported to the shareholder on a Schedule K-1. The Schedule K-1 shows each shareholder's distributive share of each item.

Facts: The taxpayer, an S corporation, is a South Carolina heavy equipment retailer that also engages in the rental of heavy equipment. The S corporation is a "qualified entity" and makes the election to tax its active trade or business income at the entity level. The calendar year entity will pay \$4,500 in South Carolina entity level tax on \$150,000 of South Carolina active trade or business income. The S corporation's ordinary business income is from the selling and maintenance of heavy equipment (\$500,000) and from equipment rental (\$50,000). The IRC Section 179 expense (\$400,000) is from the purchase of maintenance trucks. The S corporation's only shareholder received reasonable compensation for his personal services (W-2 wage income of \$300,000); the combined \$550,000 of income is active trade or business income. In this example, net South Carolina active trade or business income is \$150,000. The S corporation did not earn any South Carolina tax credits this tax year. The S corporation correctly determined its South Carolina active trade or business income, as reported below, for its specific business activities as provided in Chapter 6 of Title 12, Code Section 12-6-545, and SC Revenue Ruling #08-2.

³⁹ See rates provided in Code Section 12-6-510.

Purpose: Below is **a sample worksheet prepared by the entity** to determine: (1) the entity's active trade or business income and related deductions; (2) the entity level tax, (3) shareholder items reported on the Schedule SC K-1, and (4) that no income or deductions passed through to the individual shareholder for South Carolina income tax purposes.

S Corporation Items of Income and Deduction	Federal Sch. K Information of S Corporation (As listed on the federal Schedules K and K-1)	Adjusted SC Amounts from Federal K-1 (after apportionment)	SC Active Trade or Business Income and Related Deductions of Electing S Corporation	Total SC Non-Active Trade or Business Income and Related Deductions (Reported on Shareholder SC K-1)
Ordinary Business Income	\$495,500 (after state tax deduction of \$4,500) ⁴⁰	\$500,000 (after state tax addback of \$4,500)	\$500,000	\$0
Net Rental Income⁴¹	\$ 50,000	\$ 50,000	\$ 50,000	\$0
IRC Section 179 Deduction⁴²	(\$400,000)	(\$400,000)	(\$400,000)	\$0
Active Trade or Business Income			\$ 150,000	\$0
Entity Tax Credits				
3% Rate on Active Trade or Business Income			x 3%	
SC Tax Paid Directly by Electing S Corporation			\$4,500	
Amounts Passed Through to the Shareholder				\$0

Entity Level Active Trade or Business Income. The electing qualified entity will pay South Carolina active trade or business income tax on its net active trade or business income. In this example, the entity's net SC active trade or business income of \$150,000 is the sum of SC ordinary business income and separately stated net rental (non-real estate) income on the

⁴⁰ See IRS Notice 2020-75 providing that "specified income tax payments" are not separately taken into account. These entity tax payments will be reflected in a partner's or shareholder's distributive share or pro-rata share of non-separately stated income or loss reported on a Schedule K-1 (or similar form).

⁴¹ Based on the facts in this example, the rental of heavy equipment by the S corporation is a trade or business rental activity. Net rental income is taxed as ordinary income, but is not included in ordinary business income reported on line 1 of the federal Schedules K and K-1 since the IRS requires it to be separately stated for purposes of IRC Section 469 for the shareholder's computation of federal taxable income.

⁴² The IRC Section 179 expense deduction was not deducted in arriving at ordinary business income. It is separately stated for the owner to use in computing his taxable income. See IRS Form 4562.

Schedule K-1 (\$550,000 total) less the IRC Section 179 deduction (\$400,000). Since there is no deduction for state income taxes under Code Section 12-6-1130(2), the entity must add back the \$4,500 state taxes deducted for federal purposes in arriving at South Carolina taxable on the SC Form 1120S. Note: The shareholder reports a net of \$145,500 of S corporation income on his Federal 1040, as computed on Schedule E.

Entity Level Tax Computation. The entity will pay \$4,500 of South Carolina income tax on its net \$150,000 of active trade or business income. The entity has no income or deductions to pass through to the shareholder to be reported on his South Carolina individual income tax return.

Information Reported to the Shareholder on, or with, his Schedule SC K-1:

- The entity reports to the shareholder that \$150,000 of the entity's federal taxable income (before SC income tax deduction) has been subject to the active trade or business income tax at the entity level, and that the shareholder has no income to report from the S corporation for South Carolina income tax purposes. Therefore, \$150,000 should be subtracted on SC Form 1040 from the shareholder's South Carolina income since federal taxable income (\$145,500) is the starting point to determine an individual's South Carolina taxable income and it includes the net \$150,000 in South Carolina active trade or business income after the modification for the \$4,500 of state entity tax paid discussed below. The shareholder does **not** pay SC tax on active trade or business income when the tax is paid at the entity level.
- The entity reports to the shareholder (on or attached to the SC 1120S Schedule K-1) that \$4,500 state taxes were deducted at the entity level for federal purposes. Note: This \$4,500 is an addition to federal taxable income on the SC Form 1040 by the 100% shareholder. This amount is not deductible by the shareholder on his Federal 1040, Schedule A. See Question 25.
- The entity reports the shareholder's share of state income tax paid at the entity level (\$4,500) so the owner can determine his South Carolina tax basis in the S corporation stock. See Question 25.

EXAMPLE 3 – Partnership Makes Entity Election – Both Active Trade or Business Income and Other Income

Summary of Reporting Ordinary Business Income and Separately Stated Items: Federal Form 1065 is an information return used to report the income, gains, losses, deductions, credits, and other information from the operation of a partnership. A partnership does not pay federal income tax, but passes through any profits or losses to its partners. The partnership computes "ordinary business income" (i.e. income from an activity other than a rental activity) that involves the conduct of a trade or business under the Internal Revenue Code and federal precedent and reports it on Federal Form 1065, page 1. This amount is also reported on Schedule K, line 1, as ordinary business income. Schedule K is also used to report other types of income, loss, and deductions required by IRS regulations to be separately stated in order for the partner to compute taxable income on their income tax return. These amounts are not combined with the ordinary business income amount reported on Form 1065, page 1. These separately stated amounts include net rental real estate income, net rental income from non-real estate activities, guaranteed payments to a partner in lieu of a W-2 or 1099, portfolio income, royalties, capital gains and losses, IRC Section 1231 gains and losses, other separately stated items of income, IRC Section 179 expense deduction, and charitable contributions. In addition, other items of deduction may be separately reported to the partner on a Schedule K-1. The Schedule K-1 shows each partner's distributive share of each item.

Facts: The taxpayer is a South Carolina professional service partnership providing services in South Carolina owned by two equal individual partners. The partnership compensates the partners for their services via guaranteed payments of \$250,000 each. The partnership is a “qualified entity” and makes the election to tax its active trade or business income at the entity level. The calendar year entity will pay \$1,740 in South Carolina entity level tax on \$58,000 of South Carolina active trade or business income. The partnership compensates partners for services via a guaranteed payment for services which is a deduction in arriving at the partnership’s federal ordinary business income. For federal tax purposes, all guaranteed payments are separately reflected on Schedules K and K-1. The partnership sold an old office building that results in an IRC Section 1231 gain, sold stock held for investment that results in a capital gain, and purchased office equipment eligible for the IRC Section 179 deduction. The partnership did not earn any South Carolina tax credits this tax year. The partnership correctly determined its South Carolina active trade or business income, as reported below, for its specific business activities as provided in Chapter 6 of Title 12, Code Section 12-6-545, and SC Revenue Ruling #08-2.

Purpose: Below is a **sample worksheet prepared by the entity** to determine: (1) the entity’s active trade or business income and related deductions; (2) the entity level tax; and (3) the remaining income and deductions passed through to the partners for South Carolina income tax purposes.

Partnership Items of Income and Deduction	Federal Sch. K Information of Partnership (As listed on the federal Schedules K and K-1)	Adjusted SC Amounts from Federal K-1 (after apportionment)	SC Active Trade or Business Income and Related Deductions of Electing Partnership	Total SC Non-Active Trade or Business Income and Related Deductions (One-Half Reported on Each Partner’s SC K-1)
Ordinary Business Income	\$98,260 (after state tax deduction of \$1,740) ⁴³	\$100,000 (after state tax addback of \$1,740) ⁴⁴	\$100,000	\$0
Rental Real Estate Income⁴⁵	\$ 30,000	\$ 30,000		\$ 30,000

⁴³ See IRS Notice 2020-75 providing that “specified income tax payments” are not separately taken into account. These entity tax payments will be reflected in a partner’s or shareholder’s distributive share or pro-rata share of non-separately stated income or loss reported on a Schedule K-1 (or similar form).

⁴⁴ The partnership deducting state income taxes on its Federal Form 1065 must “addback” the state income taxes when computing South Carolina taxable income since South Carolina income is computed starting with federal income.

⁴⁵ Rental real estate income is taxed as ordinary income, but is not included in ordinary business income reported on line 1 of the federal Schedules K and K-1 since the IRS requires it to be separately stated for purposes of IRC Section 469 passive loss rules. See Federal Form 1065, Schedule K, line 2 and Form 8825. In this example, the rental real estate income is passive income for South Carolina purposes, and therefore, it is not active trade or business income computed under Code Section 12-6-545(A)(1)(a)(i).

Guaranteed Payments for Services⁴⁶	\$500,000	\$500,000		\$500,000
Long-Term Capital Gain⁴⁷	\$ 2,000	\$ 2,000		\$ 2,000
Section 1231 Gain (capital gain)⁴⁸	\$ 2,000	\$ 2,000		\$ 2,000
Section 179 Deduction⁴⁹	(\$35,000)	(\$35,000)	(\$35,000)	\$0
Other Deductions Related to Active Trade or Business Income⁵⁰	(\$ 7,000)	(\$ 7,000)	(\$ 7,000)	\$0
Profit Sharing Plan Contribution⁵¹	(\$110,000)	(\$110,000)		(\$110,000)
Active Trade or Business Income			\$58,000	
Entity Tax Credits				
3% Rate on Active Trade or Business Income			x 3%	
SC Tax Paid Directly by Electing Partnership			\$1,740	
Amounts Passed Through to Partners				\$424,000

Entity Level Active Trade or Business Income. The electing qualified entity will pay SC active trade or business income tax on its net active trade or business income. In this example, the entity's net active trade or business income of \$58,000 (\$100,000 ordinary income less IRC Section 179 and other deductions). While rental real estate income is ordinary income, it is passive income and is excluded from active trade or business income under Code Section 12-6-545.

Entity Level Tax Computation. The entity paid \$1,740 of South Carolina income tax on its net \$58,000 of South Carolina active trade or business income (\$98,260 of ordinary income, plus \$1,740 SC entity tax which equals \$100,000, less \$35,000 of IRC Section 179 deduction, less \$7,000 of other deductions). Since there is no deduction for state income taxes under Code Section 12-6-1130(2), the entity must add back the \$1,740 state taxes deducted for federal purposes in arriving at South Carolina taxable income on the SC Form 1065. The entity passes

⁴⁶ Guaranteed payments for services were deducted in arriving at ordinary business income. However, the entity must separately report on the federal Schedules K and K-1 each partner's guaranteed payments received for the partner to use in computing his taxable income. Note: Guaranteed payments for the use of capital are treated differently for South Carolina purposes – guaranteed payments for the use of capital are active trade or business income eligible for the 3% tax rate to be paid at the entity level. See SC Revenue Ruling #08-2, Question 13.

⁴⁷ The long term capital gain was not included in ordinary business income reported on line 1 of the federal Schedules K and K-1. See IRS Form Schedule D. It is separately stated for the owner to use in computing his taxable income. See IRS Form Schedule D.

⁴⁸ Based on the specific facts in this example, the IRC Section 1231 gain was not included in ordinary business income reported on line 1 of the federal Schedules K and K-1. See IRS Form 4797. It is separately stated for the owner to use in computing his taxable income.

⁴⁹ The IRC Section 179 expense deduction was not deducted in arriving at ordinary business income. See IRS Form 4562. It is separately stated for the owner to use in computing his taxable income.

⁵⁰ In this example, the other deductions were not deducted in arriving at ordinary business income reported on line 1 of the federal Schedules K and K-1. The amount is not both deducted and separately reported.

⁵¹ The profit sharing plan contribution was not deducted in arriving at ordinary business income reported on line 1 of the federal Schedules K and K-1. It is separately stated for the owner to use in computing his taxable income.

through \$424,000 of other income and deductions to be reported by the owners (one-half each) on their South Carolina individual income tax returns.

Information Reported to the Partners on, or with, their Schedule SC K-1:

- The entity reports to the partners that their share of the \$58,000 entity's federal taxable income has been subject to the active trade or business income tax at the entity level. Therefore, \$29,000 should be subtracted on the SC Form 1040 from each partner's South Carolina income since federal taxable income is the starting point to determine an individual's South Carolina taxable income and it includes the \$29,000 allocated to each partner in active trade or business income. The partners do **not** pay South Carolina tax on active trade or business income when the tax is paid at the entity level.
- The entity reports to each partner \$212,000 (one-half of the total net \$424,000 other income and related deductions) so that each individual can complete his SC Form 1040.
- The entity reports to each partner (on the SC 1065 Schedule K-1) that \$870 SC income tax (\$1,740 total) was deducted at the entity level for federal purposes for each partner. Note: This \$870 is an addition to federal taxable income on each equal partner's SC Form 1040. This amount is not deductible by the partners on their Federal Form 1040, Schedule A. See Question 25.
- The entity reports each partner's share of state income tax paid at the entity level (\$870) so the partner can determine his South Carolina tax basis in his partnership interest. See Question 25.

PART 4 - OWNER COMPLIANCE AND REPORTING QUESTIONS

25. Q. How does the "qualified entity election" to pay tax on active trade or business income at the entity level impact the owner for South Carolina income tax purposes?

A. If a qualified entity makes an election under Code Section 12-6-545(G) to report active trade or business income directly on the entity return and pay a South Carolina entity level tax, the impact to the owner includes:

- Taxable Income and Tax Rate. Code Section 12-6-545(G)(3) provides that when the tax is paid on the active trade or business income at the entity level, that income is excluded from the entity owners' South Carolina taxable income.

Note: If there is any income that is not active trade or business income from the qualified entity, then the owner must include that income in South Carolina taxable income. Since it is non-active trade or business income, it is not eligible for the 3% reduced rate in Code Section 12-6-545.

- No Owner Tax Credit for Entity Tax Paid. A shareholder or partner is not allowed a South Carolina credit for entity level taxes paid to South Carolina or another state on its active trade or business income by qualified entities making the election under Code Section 12-6-545(G). See Question 26 and Code Section 12-6-3400.
- SC State Tax Addback. Since the entity taxes were used to reduce federal taxable income (i.e., the income from the entity is net of state taxes) reported on the owner's Federal 1040, a shareholder or partner is required to make a federal to state

“adjustment” on his SC Form 1040 to “addback” his share of entity level taxes paid directly by a partnership or S corporation making the election under Code Section 12-6-545. Also note that the entity level state tax is not deductible by the partner or shareholder on his Federal Form 1040, Schedule A.

- SC Income Tax Credits Earned by Entity. To the extent the qualifying entity passes through a South Carolina tax credit generated by the entity to the owner (e.g., job tax credit), the credit may be applied against the owner’s income tax liability, as though the entity level election had not been made. The passed-through credit is not limited to use against the electing partnership’s or S corporation’s income. Further, if the partner or shareholder files a joint return, the credit may be used to offset the income of both spouses, even if only one spouse is the partner or shareholder. See Question 24.
- SC Basis Adjustment. Code Section 12-6-545(G)(9) provides that a shareholder’s or partner’s South Carolina basis is determined as if the entity election had not been made and each owner had taken into account his pro rata share of the entity’s income, loss, and deductions. This treatment may result in higher owner South Carolina basis upon disposition of the interest or stock, and a lower South Carolina gain or higher loss. Note: Federal income tax rules control the owner’s federal basis. Code Section 12-6-545(G)(9). See Question 12.
- Tax Losses of Other Entities Not Making the Election Offset Income at Rate Up to 3%. Code Section 12-6-545(G)(4) provides that losses from other entities reported directly by the owner reduce an owner’s tax by up to 3%. See Question 28 for a computation illustrating the tax impact to the owner who owns an entity that makes the entity election under Code Section 12-6-545(G) and also owns another entity that passes losses through to the owner.
- Liability for Unpaid Entity Taxes. Code Section 12-6-545(G)(8) provides that if the electing entity fails to pay the amount owed to the Department with respect to income as a result of the election, the Department may collect the amount from the electing entity or its direct or indirect owners based upon their proportionate share of the income, or both.

26. Q. Does Code Section 12-6-3400 allow an individual a credit for taxes paid to other states for pass-through income tax paid by a partnership or S corporation electing to pay tax on its active trade or business income at the entity level under Code Section 12-6-545?

A. No. Code Section 12-6-3400 does not apply to entity level taxes paid by qualified entities under Code Section 12-6-545(G).

Code Section 12-6-3400 provides a resident individual a credit against South Carolina income taxes imposed by Chapter 6 of Title 12 for taxes he or she pays to another state on income from sources within that state which is taxed both under this chapter and the laws of that state regardless of the taxpayer’s state of residence. Note: Code Section 12-6-3400 does not apply to nonresidents.

Unlike most other states, South Carolina taxes residents on worldwide personal service income, but not on out-of-state business (non-personal service) income.⁵² As a result, a credit for entity taxes paid to other states for South Carolina residents is not needed.

27. Q. If a qualified entity does not make the election under Code Section 12-6-545(G), can an owner of a pass-through entity still apply the provisions in Code Section 12-6-545(A) through (F) and make an “owner election” and elect the 3% rate reduction on active trade or business income or losses?
- A. Yes. Code Section 12-6-545(A) through (F) continues to allow an optional election for an owner to use a reduced individual income tax rate of 3% on active trade or business income of a pass-through business (i.e., a sole proprietorship, partnership, S corporation, or limited liability company taxed as one of these type entities). Note: Whether or not income is “active trade or business” income is determined at the entity level for purposes of the 3% rate. See Code Section 12-6-545 and SC Revenue Ruling #08-2.
28. Q. How does the owner of a qualified entity that makes the election to pay income tax at the entity level treat active trade or business losses passed through to him by other pass-through entities?
- A. Code Section 12-6-545(G)(4) provides that active trade or business losses of the qualified owner from other pass-through entities that are reported directly by such owner may not reduce tax at a rate higher than 3%.

For example, assume an individual has an ownership interest in three entities – Partnerships, A, B, and C. Partnership A only has active trade or business income and makes the election to have its income taxed directly at the entity level, so the owner has no income from Partnership A to report on his own return. Partnership B does not make the election, and the owner’s share of non-active trade or business income is \$300. Partnership C has a loss and the owner’s share of the active trade or business loss is \$100.

Due to the entity election by Partnership A, the rate limitation in Code Section 12-6-545(G)(4) is triggered for the owner. Accordingly, any active trade or business loss from other pass-through entities that are reported directly by the owner cannot reduce tax at higher than 3%, the rate in Code Section 12-6-545(B)(2). The following computation illustrates the tax impact to the owner in this example.

⁵² See *Seward v South Carolina Tax Commission*, 236 S.E. 2d 198 (1977) and *Ellis v South Carolina Tax Commission*, 309 S.E. 2d 761 (1983).

Individual Taxpayer's Partnership Interests	Entity Method of Reporting SC Income or Loss	Entity SC Income or Loss Not Subject to Entity Level Tax Under Code Section 12-6-545(G)	Individual's Tax Rates and Tax Amounts
Partnership A	Entity Election Made – Triggers Code Section 12-6-545(G)(4) loss rule	All income is active trade or business. Entity reports and pays tax.	
Partnership B	Entity Election Not Made	\$300 ordinary income (e.g., personal service income) - Reported directly to owner	$\$300 \times 7\% = \21
Partnership C	Entity has Loss - therefore, no election can be made. Since Code Section 12-6-545(G)(4) applies because of electing Partnership A, Code Section 12-6-545(C) does not apply to this loss.	(\$100) active trade or business loss - Reported directly to owner	$(100) \times 3\% = (\$3)$
Net Tax Impact for the Individual Taxpayer			\$18 (\$21 of income tax offset by \$3 from the \$100 of active trade or business loss)

Note: Code Section 12-6-545(C) provides that active trade or business loss must first be deducted, dollar for dollar, against active trade or business income. Any remaining loss is deductible from income tax under Code Section 12-6-510 if otherwise allowable. If a taxpayer has an interest in a pass-through entity that makes the election as well as an interest in other pass-through entities that do not make the election, then Code Section 12-6-545(C) does not apply; Code Section 12-6-545(G)(4), as illustrated above, applies to all losses.

Caution: To correctly compute South Carolina income tax as illustrated in the above example, a taxpayer may have to make this adjustment manually to their SC Form 1040.

SOUTH CAROLINA DEPARTMENT OF REVENUE

s/W. Hartley Powell

 W. Hartley Powell, Director

December 2 _____, 2021
 Columbia, South Carolina

APPENDIX
Code Section 12-6-545(A) through (F)

Code Section 12-6-545. Income tax rates for pass-through trade and business income; determination of income related to personal services.

(A) As used in this section:

(1) "Active trade or business income or loss" means income or loss of an individual, estate, trust, or any other entity except those taxed or exempted from tax pursuant to Sections 12-6-530 through 12-6-550 resulting from the ownership of an interest in a pass-through business. Active trade or business income or loss does not include:

(a)(i) passive investment income as defined in Internal Revenue Code Section 1362(d) generated by a pass-through business and income of the same type regardless of the type of pass-through business generating it; and

(ii) expenses related to passive investment;

(b) capital gains and losses;

(c) payments for services referred to in Internal Revenue Code Section 707(c);

(d) amounts reasonably related to personal services. All amounts paid as compensation and all guaranteed payments for services, but not for the use of capital, as defined in Internal Revenue Code Section 707(c) are deemed to be reasonably related to personal services. In addition, if an owner of a pass-through entity who performs personal services for the entity is not paid a reasonable amount for those personal services as compensation or payments referred to in Internal Revenue Code Section 707(c), all of the owner's income from the entity is presumed to be amounts reasonably related to personal services. For purposes of this section, amounts reasonably related to personal services include amounts reasonably related to the personal services of the owner, the owner's spouse, and any person claimed as a dependent on the owner's income tax return.

(2) "Pass-through businesses" means sole proprietorships, partnerships, and "S" corporations, including limited liability companies taxed as sole proprietorships, partnerships, or "S" corporations.

(B)(1) Notwithstanding Section 12-6-510, a taxpayer may elect annually to have the income tax at the rate provided in item (2) of this subsection imposed annually on the active trade or business income received by the owner of a pass-through business. For joint returns, the election is effective for both spouses. The amount subject to tax pursuant to this section is not subject to tax pursuant to Section 12-6-510.

(2) The rate of the income tax imposed pursuant to this subsection is:

Taxable Year Beginning in	Rate of Tax
2006	6.5 percent
2007	6 percent
2008	5.5 percent
2008 through 2011	5 percent
2012	4.33 percent
2013	3.67 percent
after 2013	3 percent

(C) Notwithstanding any other provision of this chapter, active trade or business loss must first be deducted, dollar for dollar against active trade or business income. Any remaining active trade or business loss is deductible from income taxed under Section 12-6-510 if otherwise allowable.

(D) The department may issue guidance as to what expenses reduce active trade or business income.

(E)(1) Notwithstanding item (A)(1)(d) of this section, if a taxpayer owns an interest in one or more pass-through businesses and his total South Carolina taxable income from pass-through entities for which he performs personal services is one hundred thousand dollars or less, excluding capital gains and losses, then the taxpayer may elect, instead of determining the actual amount of active trade or business income related to his personal services, to treat fifty percent of his active trade or business income as not related

to his personal services. For purposes of this item, the term "taxpayer" includes both taxpayers who file a joint return.

(2) The department may provide other methods that may be used to determine an amount that is considered to be unrelated to the owner's personal services if it determines that the benefits to the State of taxing income from personal services at a higher rate are insufficient to justify the burdens imposed on the taxpayer.

(F) An income tax credit available to offset taxes due pursuant to Section 12-6-510 also apply against taxes imposed by this section.

NOTE: New Code Section 12-6-545(G) is reproduced on page 4 of this advisory opinion.