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## SC information letter #22-4

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STATE OF SOUTH CAROLINA  
DEPARTMENT OF REVENUE

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SC INFORMATION LETTER #22-4

SUBJECT: Active Trade or Business Income – SC Tax Forms and Reporting Issues for  
Tax Year 2021  
(Income Tax)

DATE: March 11, 2022

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

SCOPE: An Information Letter is a written statement issued to the public to announce  
general information useful in complying with the laws administered by the  
Department. An Information Letter has no precedential value.

**NOTICE TO PASS-THROUGH ENTITIES ELECTING TO PAY ACTIVE  
TRADE OR BUSINESS INCOME AT THE ENTITY LEVEL, ENTITY  
OWNERS, TAX PREPARERS, AND TAX SOFTWARE COMPANIES**

**TAX YEAR 2021 ACTIVE TRADE OR BUSINESS INCOME (ATBI) ELECTION –  
SC INCOME TAX FORM ISSUES (SC 1120S, SC 1040, I-435, and I-335)**

Background and Guidance

New South Carolina ATBI Entity Election – Reporting Tax at Entity Level. Effective for tax years beginning 2021, Code Section 12-6-545(G) provides 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%. This calculation is made by the electing entity on SC Form I-435, “Active Trade or Business Income for Electing Partnerships and S Corporations.” For owners of electing entities, active trade or business income taxed at the entity level is not included in the owners’ South Carolina income.

ATBI Entity Election Not Made – Reporting Tax at Owner Level. 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”)<sup>1</sup> 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.”

Guidance. SC Revenue Ruling #21-15, “Active Trade or Business Income – Annual Election by Pass-Through Entity to Pay Tax at Entity Level,” addresses 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. A copy is available on the Department’s Law and Policy page at [dor.sc.gov/policy](http://dor.sc.gov/policy).

Purpose. The purpose of this Information Letter is to provide guidance and clarification with respect to several important South Carolina income tax form reporting or tax software issues identified on South Carolina Forms 1120S, 1040, I-435, I-335, credit forms, and instructions for this filing season.

### **Issue 1: Section 179 Expense Deduction - Reporting Issue on SC Form 1120S for S Corporations<sup>2</sup>**

Current Reporting Issue. The mechanics of Form SC 1120S, as described below, are creating a tax reporting question for Internal Revenue Code Section 179 amounts reported by an S corporation making the new ATBI entity election. Specifically, SC 1120S, Line 1, does not include the Section 179 deduction since the starting point of SC Form 1120S (Line 1) is Federal 1120S Schedule K, “Shareholders’ Pro Rata Share Items” Lines 1 – 10. Federal 1120S Schedule K, Line 11, is used by an S corporation to report the federal Section 179 amount.

Further, SC Form 1120S, page 1, does not contain a necessary line to make the computation to allow the Section 179 deduction from income reported on the federal Schedule K. However, Form I-435, “Active Trade or Business Income for Electing Partnerships and S Corporations,” is used by the electing entity to compute the South Carolina active trade or business income and entity tax. The computation of the active trade or business income on the I-435 contains a separate line (Line 12) that allows for the Section 179 deduction. After computation on the I-435, the entity’s active trade or business income is then entered on SC 1120S, Line 5, and the tax is entered on SC 1120S, Line 6.

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<sup>1</sup> 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 (SC 1040) when filed. See SC Revenue Ruling #08-2, “Tax Rate Reduction on Active Trade or Business Income from a Pass Through Business” for guidance to persons eligible for the 3% reduced tax rate under Code Section 12-6-545(A) through (F).

<sup>2</sup> The form design of the SC 1065 is different enough from the SC 1120S that it does not appear to have this Section 179 reporting issue.

The 2021 Form SC 1120S, “S Corporation Income Tax Return” Lines 1 – 10 read:  
 (\* The bold portion in Line 7 below has been added for purposes of this Information Letter)

1. Total of line 1 through 10, Schedule K of the federal 1120S.....	▶	1. 00
3. Total net income as reconciled (add line 1 and line 2).....		3. 00
4. If multi-state corporation, enter amount from Schedule G, line 6; otherwise, enter amount from line 3. ....		4. 00
5. Active Trade or Business Income (from I-435, line 22).....		5. 00
6. Active Trade or Business Tax (from I-435, line 25).....		6. 00
7. Income taxed to shareholders (*See Section 179 expense workaround described below) .		7. 00
8. South Carolina net taxable income (subtract line 5 and line 7 from line 4).....	▶	8. 00
10.Total Income Tax (add line 6 and line 9).....		10. 00

**Advised Reporting Workaround for 2021 SC Form 1120S – Use of Line 7, “Income taxed to shareholders.”** In order for the electing entity to arrive at the correct South Carolina net taxable income amount on Line 8, the Department’s Income Tax Services Section is instructing tax return preparers and tax preparation software companies to enter the Section 179 deduction amount on SC Form 1120S, Line 7, “Income taxed to shareholders.” This workaround will create an amount on Line 7 that is not “income taxed to shareholder,” and should be disregarded as such, but will create an amount on Line 7 that will prevent the electing entity from erroneously reporting taxable income on Line 7 equal to the South Carolina Section 179 deduction amount. **Caution:** The South Carolina Section 179 expense deducted by the entity should not also be reported separately to the shareholder.

The Department acknowledges that as a result of this directed workaround on the 2021 SC 1120S, that page 1, line 7, of the SC 1120S will not correctly state the “Income taxed to shareholders” and may not match the I-335 or SC 1040 of the shareholder. This line will be disregarded by the Department for audit and compliance purposes in this context. A preparer using this workaround is not required to make a disclosure statement with the return regarding this “mislabeled” amount reported on Line 7 as a result of this workaround. Any applicable penalty will not be imposed as a result of this workaround.

**Note:** Line 7 may be used to report any non-ATBI income items (e.g., dividends, portfolio interest, capital gains, etc.). In the event the entity has non-ATBI income items taxed to the shareholders (e.g., dividends) reflected on the SC 1120S K-1, the sum of the non-ATBI items should equal SC 1120S, Line 7, after reducing Line 7 for the South Carolina Section 179 amount, if any, included on Line 7.

**Issue 2: Clarification of Determination of ATBI or Passive Investment Income for Form I-435, Column C, South Carolina ATBI amounts**

Distributive share items reflected on the I-435, “Active Trade or Business Income for Electing Partnerships and S Corporations,” contain elements of the federal Schedule K’s for Forms 1120S and 1065. Portions of these federal Schedule K lines do not impact South Carolina ATBI and are shaded on the I-435. However, several lines that are not shaded will often be passive investment income as defined in IRC Section 1362(d) and will not meet the definition of South Carolina

ATBI. For example, electing entities will generally not have a value on Form I-435, Column C, line 2 rental real estate, line 5 interest, line 7 royalties, or line 10 Section 1231 gain, unless one of the exceptions in IRC Section 1362(d) is met. See the guidance in SC Revenue Ruling #21-15, Question 20, and SC Revenue Ruling #08-2, Question 9, particularly for when rental real estate qualifies as ATBI under Code Section 12-6-545.

### **Issue 3: Active Trade or Business Losses From Other Non-electing Entities – Manual Tax Calculation Issue on SC 1040 for Owners**

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%.

It is the Department's understanding that this computation may not currently be performed by tax software. A manual override in the tax software may be required to correctly compute South Carolina income tax on the 2021 SC Form 1040 for taxpayers with this situation.

See SC Revenue Ruling #21-15, Question 28, for a complete discussion of this issue and an example that illustrates the tax impact to the owner of a qualified entity that makes the election to pay income tax at the entity level and the owner also has active trade or business losses passed through to him by other pass-through entities.

### **Issue 4: State Tax Credits – Proper SC K-1 Disclosure to Prevent Credit used by Entity from also Being used by Owner**

The use of South Carolina tax credits to reduce an electing entity's tax depends, in part, on whether the credit was earned by an S corporation or a partnership and whether it is related to active trade or business income.

See SC Revenue Ruling #21-15, Question 24, for a complete discussion of the use of credits by electing S corporations or partnerships and SC Revenue Ruling #21-15, Question 25, for guidance on the application of a credit against the owner's income tax liability to the extent a qualifying entity passes through a South Carolina unused tax credit.

**Caution:** South Carolina's tax credit forms and tax software may not be reflecting the pass through credit amounts correctly. A South Carolina tax credit amount used by the qualifying entity must be properly disclosed to the owner in order to prevent the owner from claiming a credit amount already claimed by the electing pass-through entity.

### **Issue 5: SC State Tax Addback – Tax Reporting Issue on SC 1040 for Owners**

If the electing entity taxes were deducted in computing federal taxable income that is reported on the owner's federal 1040, a shareholder or partner is required to make a federal to state adjustment on his Form SC 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. The electing entity will report to each owner the South Carolina income tax that was deducted at the entity level.

Form SC 1040 does not, however, contain a specific line item addback for South Carolina ATBI income taxes by the owner that are deducted by the the electing entity. This addback should be reported as an “other addition” on page 2 of the SC 1040 and clearly labeled, for example, “SC ATBI entity tax.” **Note:** This entity level state tax is not deductible by the partner or shareholder on his federal Form 1040, Schedule A. See SC Revenue Ruling #21-15, Question 25, for more information on owner compliance and reporting.

### **QUESTIONS AND TECHNICAL GUIDANCE**

Forms questions regarding the ATBI calculation and reporting should be directed to the Department’s Income Tax Services Section at [Partnerships@dor.sc.gov](mailto:Partnerships@dor.sc.gov).

The guidance published in SC Revenue Ruling #21-15 and in this Information Letter is controlling over the tax form mechanics and instructions. While the applicable South Carolina form mechanics may differ from the illustrations provided in the Revenue Ruling, the electing entity and qualified owners should arrive at the result as illustrated in the examples in SC Revenue Ruling #21-15.