

Substantive Tax Relief for Pass-Through Stakeholders



In the last days of the 2021 South Carolina legislative session, the General Assembly passed one of the most substantive tax relief bills for small businesses operating as pass-through entities in this state. The most intriguing aspect of this state legislation is that it saves federal taxes rather than state taxes by saving significant federal taxes for individuals who own and operate pass-through entities in South Carolina and who are subject to the \$10,000 individual itemized deduction state and local tax (SALT) cap.

New Code Section 12-6-545 (G) allows qualified pass-through entities and their stakeholders (individual partners and S corporation shareholders) to elect annually, beginning in 2021, to have their Active Trade or Business Income (ATBI) taxed at the entity level rather than on their Form SC1040 as reported on the SC K-1. Stakeholders reporting ATBI will still report that income on their federal Form 1040 via schedule E. However, that federal income will be reduced by the SC taxes at the 3% ATBI rate that would have normally been reported on a federal and SC K-1 at a gross number. On the stakeholders SC1040, a deduction will be taken from federal income for the ATBI taxed at the entity level in arriving at SC taxable income. Thus, an individual itemized deduction (state taxes paid on ATBI) is converted to a corporate deduction which reduces federal income passed out on the federal K-1 and taxpayer AGI. Generally, a qualified pass-through entity is one owned by individuals, estates, or trusts without a C corporation or tax-exempt entity being included in the ownership chain. Stakeholders can be both SC residents and non-residents.

It is important to note that this provision only applies to entity level ATBI. Passive investment income (interest, dividends, royalties, capital gain), rental income, guaranteed payments for services, and any amount for personal services reported as ordinary income on a partnership return are not eligible for this treatment and will remain separately stated on the stakeholder's schedule SC K-1 and subject to tax at a marginal rate up to 7% on form SC1040.

For most businesses operating as partnerships, the problematic piece of this legislation remains in the difficulty in determining the amount of allocable ordinary income reasonably related to personal services. Presumably entities operating as S corporations are adequately compensating their shareholder employees for their personal services; however, one questions why any rational shareholder would pay compensation to himself above the FICA cap, thus depriving that marginal income of being subject to the reduced SC ATBI entity tax, additional Medicare tax, and the litany of related negative tax consequences. It should be noted SC ATBI differs from federal QBI and IRC Sec. 199 which SC does not follow and should not be confused with it.

This bill places this provision under the active trade or business provision (Sec 12-6-545) limiting it solely to ATBI. Perhaps in the upcoming legislative session, a two-tier entity level tax could be elective thus making the entire entity income subject to a deductible entity level tax of 3% on ATBI and 7% on all other income. Thereby, entirely bypassing the SALT cap for such taxpayers which would prove to be a real advantage to the SC small business taxpayer.

When the original ATBI legislation became effective in 2006, the Department issued guidance and safe harbors for low-income taxpayers. The SC Department of Revenue will need to provide both forms and guidance to implement this change and the devil may well prove to be in those details. The election for this treatment is annual and at least for 2021 appears to be able to be made on a timely filed return (but preferably by the due date without extension, otherwise penalties and interest will probably attach). Any entity/stakeholders looking to make the election may wish to alter their 2021 SC individual estimates plans, but for the 2022 tax year, entity level estimated payments are required by section 12-6-545(G)(7).



Bill West, CPA
Member - Tax & Advisory Services

To learn more about this tax benefit and other tax savings strategies for your business, please contact Bill West:

(803) 753-5230
bwest@scottandco.com