~~Indicates Matter Stricken~~

Indicates New Matter

COMMITTEE REPORT

March 17, 2021

**S. 627**

Introduced by Senators Bennett, Adams, Kimbrell, M. Johnson, Davis, Turner, Campsen, Hembree, Alexander, Williams, Cromer, McElveen, Loftis, Climer, Talley, Rice, Garrett, Rankin and Leatherman

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Read the first time March 2, 2021.

**THE COMMITTEE ON FINANCE**

To whom was referred a Bill (S. 627) to amend Section 12‑6‑545, Code of Laws of South Carolina, 1976, relating to income tax rates for pass‑through trade and business income, so, etc., respectfully

**REPORT:**

That they have duly and carefully considered the same and recommend that the same do pass with amendment:

Amend the bill, as and if amended, by striking SECTION 1 and inserting:

/ SECTION 1. Section 12‑6‑545 of the 1976 Code is amended by adding a new subsection at the end to read:

“(G)(1) Notwithstanding Section 12‑6‑510 and any other provision of this section, a partnership or ‘S’ corporation, including a limited liability company taxed as a partnership or ‘S’ corporation, may elect annually under this subsection to have income tax on its active trade or business income at the rate provided in subsection (B)(2) imposed on the pass‑through business entity itself. Such elections must be made no later than the due date for filing the applicable income tax return, including any extensions.

(2) Also notwithstanding Section 12‑6‑510, in computing South Carolina taxable income, an individual shall exclude net income or losses from an electing entity of which the individual is a shareholder, partner, or member provided that the entity properly filed an income tax return and paid the taxes pursuant to this subsection that included the net income or loss.

(3) A pass‑through business entity making an election under this subsection shall report to each of its owners the owner’s pro rata or distributive share of the trade or business income on which the pass‑through business entity paid tax under this subsection. To the extent of the share, the net active trade or business losses of the 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).

(4) An owner of a pass‑through business entity making an election under this subsection is not allowed a credit under Section 12‑6‑3400 for taxes paid to another state on the entity’s active trade or business income taxed to the entity pursuant to the election, but the entity itself is allowed a credit under Section 12‑6‑3400 for the taxes that would otherwise be creditable to its owners under the section in the absence of such election, subject to the limitation contained in that section applied at the entity level.

(5) Section 12‑8‑590, dealing with tax withholding on distributions to nonresident shareholders of ‘S’ corporations and nonresident partners, does not apply to electing entities regarding their active trade or business income.

(6) For tax years beginning after 2021, an electing entity shall submit estimated tax payments pursuant to Section 12‑6‑3910.

(7) 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 the shareholders, partners, or members based upon their proportionate share of the income, or both.” /

Renumber sections to conform.

Amend title to conform.

HUGH K. LEATHERMAN, SR. for Committee.

**STATEMENT OF ESTIMATED FISCAL IMPACT**

**Explanation of Fiscal Impact**

**State Expenditure**

This bill amends §12-6-545 relating to income taxes for pass-through businesses to allow taxpayers to elect to file and pay taxes on active trade or business income at the entity level. DOR anticipates that the changes required in the bill can be accomplished with existing staff and resources. However, the agency noted that as the bill is effective for tax year 2021, this may present a challenge in providing guidance for taxpayers and implementing the necessary programming changes.

**State Revenue**

This bill allows pass-through businesses to elect to file and pay taxes on active trade or business income at the entity level beginning in tax year 2021 as opposed to the current process of passing through income to each individual partner or shareholder. This election is available to a partnership or ‘S’ corporation, including a limited liability company taxed as a partnership or ‘S’ corporation. The entity may make the election annually, and the election only applies to active trade or business income as outlined in §12-6-545.

Currently, individuals with active trade or business income from a pass-through business may choose to pay taxes on this income at the flat 3 percent rate pursuant to §12-6-545 as opposed to the marginal individual income tax rates that range from 0 percent to 7 percent in §12-6-510. Under this bill, the partnership or ‘S’ corporation may elect to have this income taxed at the entity level at the 3 percent flat rate. The election must be made no later than the due date for filing the applicable income tax return, including any extensions.

By allowing taxpayers to elect to pay income taxes at the entity level, this bill would permit these entities to claim a deduction for the full amount of state and local taxes paid in determining federal taxable income. Under the federal Tax Cuts and Jobs Act of 2017, individual taxpayers are limited to claiming only $10,000 of state and local taxes, frequently referenced as the SALT limitation. This limitation does not apply to corporations. The Internal Revenue Service has specified that if a state allows for taxation of pass-through businesses at the entity level, the taxpayers may also file an entity-level federal return and will not be subject to the SALT limitation, thus reducing the federal income taxes for these entities. Because South Carolina does not allow a deduction for state income taxes paid, this change is not expected to impact South Carolina income taxes as a result of this deduction for federal income taxes. Based upon discussions with DOR, there may be some change in income tax revenue as a result of a change from taxation at the individual level to the entity level in how credits are taken and the losses that may be deducted and at which level of taxation, but these changes are not expected to substantively change total tax revenue.

While we largely anticipate that total revenue will remain the same, this change is expected to shift revenue from individual income tax to corporate income tax for entities that are ‘S’ corporations. For tax year 2018, there were approximately 90,731 ‘S’ corporations that filed a corporate income tax return. For tax year 2019, 108,955 individual income tax returns reported a total of $8,689,507,433 in active trade or business income equating to $260,685,223 in individual income tax at the 3 percent tax rate. Data are not available to estimate the portion of the $260,685,223 that may shift from individual income tax to corporate income tax.

Further, DOR noted several concerns with implementation of the bill. The bill is effective for tax year 2021, which has already begun, and may present a challenge in providing timely guidance for taxpayers and implementing the necessary programming changes in time for tax filing. Because the election may be made annually, there may be issues with taxpayers paying as an individual prior to the election by an entity to pay at the entity level, which would significantly complicate administration of the taxes and potentially affect timing of revenue collections.

Frank A. Rainwater, Executive Director

Revenue and Fiscal Affairs Office

**A** **BILL**

TO AMEND SECTION 12‑6‑545, CODE OF LAWS OF SOUTH CAROLINA, 1976, RELATING TO INCOME TAX RATES FOR PASS‑THROUGH TRADE AND BUSINESS INCOME, SO AS TO CREATE AN ELECTION TO TAX PARTNERSHIPS AND “S” CORPORATIONS AT THE ENTITY LEVEL; AND TO AMEND SECTION 12‑6‑3400, RELATING TO CREDIT FOR INCOME TAX PAID BY SOUTH CAROLINA RESIDENTS TO ANOTHER STATE, SO AS TO PROVIDE THAT AN ELECTING PASS‑THROUGH BUSINESS ENTITY IS ELIGIBLE FOR THE CREDIT.

Be it enacted by the General Assembly of the State of South Carolina:

SECTION 1. Section 12‑6‑545 of the 1976 Code is amended by adding a new subsection at the end to read:

“(G)(1) Notwithstanding Section 12‑6‑510 and any other provision of this section, a partnership or ‘S’ corporation, including a limited liability company taxed as a partnership or ‘S’ corporation, may elect annually under this subsection to have income tax on its active trade or business income at the rate provided in subsection (B)(2) imposed on the pass‑through business entity itself. Such elections must be made no later than the due date for filing the applicable income tax return, including any extensions.

(2) Also notwithstanding Section 12‑6‑510, in computing South Carolina taxable income, an individual shall exclude net income or losses received from an electing entity of which the individual is a shareholder, partner, or member provided that the entity properly filed an income tax return and paid the taxes pursuant to this subsection that included the net income or loss.

(3) A pass‑through business entity making an election under this subsection shall report to each of its owners the owner’s pro rata or distributive share of the trade or business income on which the pass‑through business entity paid tax under this subsection. To the extent of the share, the net active trade or business losses of the 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).

(4) Elections under this subsection have no impact on the determination of the basis of pass‑through business entity owners in their ownership interests and indebtedness of entities making the elections for purposes of determining their South Carolina gross income, except that their pro rata or distributive share of the tax paid or accrued by the entities pursuant to such elections must be taken into account in determining such basis.

(5) An owner of a pass‑through business entity making an election under this subsection is not allowed a credit under Section 12‑6‑3400 for taxes paid to another state on the entity’s active trade or business income taxed to the entity pursuant to the election, but the entity itself is allowed a credit under Section 12‑6‑3400 for the taxes that would otherwise be creditable to its owners under the section in the absence of such election, subject to the limitation contained in that section applied at the entity level.

(6) Section 12‑8‑590, dealing with tax withholding on distributions to non‑resident shareholders of ‘S’ corporations and non‑resident partners, does not apply to electing entities regarding their active trade or business income.

(7) The provisions of Article 25 apply to electing entities, such that an ‘S’ corporation or limited liability company, taxed as a partnership or partnership that qualifies for a credit pursuant to Article 25, may pass‑through the credit earned to each shareholder of the ‘S’ corporation, member of the limited liability company, or partner of the partnership.

(8) For tax years beginning after 2021, an electing entity shall submit estimated tax payments pursuant to Section 12‑6‑3910.

(9) 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 shareholders, partners, or members based upon their proportionate share of the income.”

SECTION 2. Section 12‑6‑3400(A)(2)(b) of the 1976 Code is amended to read:

“(b) the income tax actually paid to the other state, either directly by the individual or by a pass‑through business entity and passed through by the entity to the individual, on income taxed under this chapter.”

SECTION 3. This act takes effect upon approval by the Governor and first applies to tax years beginning after 2020.

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