

SC REVENUE RULING #08-2

- SUBJECT:** Tax Rate Reduction on Active Trade or Business Income from a Pass Through Business (Income Tax)
- EFFECTIVE DATE:** Tax Years Beginning in 2006
- SUPERSEDES:** SC Revenue Ruling #06-12 and all previous advisory opinions and any oral directives in conflict herewith.
- REFERENCES:** S. C. Code Ann. Section 12-6-545 (As Amended by Act No. 110, Section 10 of 2007)
- AUTHORITY:** S. C. Code Ann. Section 12-4-320 (Supp. 2000)
S. C. Code Ann. Section 1-23-10(4) (Supp. 2000)
SC Revenue Procedure #05-2
- SCOPE:** The purpose of a Revenue Ruling is to provide guidance to the public and to Department personnel. 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 It is the Department's position until superseded or modified by a change in statute, regulation, court decision, or another Departmental advisory opinion.

INTRODUCTION:

South Carolina Code Section 12-6-510 imposes an income tax rate upon South Carolina taxable income of individuals, estates, and trusts at graduated rates ranging from 3%¹ to a maximum rate of 7%.

Effective for tax years beginning in 2006, South Carolina Code Section 12-6-545 permits 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 income tax rate applicable to active trade or business income is 6.5% in 2006 and is reduced annually by .5% until it reaches a 5% tax rate in 2009. Note: For simplicity and illustration purposes, the "optional" income tax rate is referred to in this document as the "reduced tax rate" or the "5% rate," i.e., the final phased-in amount in 2009.

¹ In 2007, the 2.5% tax bracket was reduced to 0%. Accordingly, beginning in 2007, the lowest tax rate where tax is due is 3%.

The purpose of this advisory opinion is to address some common questions that have arisen from persons that may be eligible for the reduced tax rate. For reference purposes, the most recent version of the forms used to compute the reduced tax rate are attached. As the forms are revised, the line number references may change, however, the concepts discussed in this advisory opinion continue to apply. The forms may be obtained from the Department's website at www.sctax.org.

LAW:

Code Section 12-6-545 states:

(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” mean 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
after 2008	5 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 applies against taxes imposed by this section.

QUESTIONS AND ANSWERS:

General Provisions:

1. Q. Who qualifies for the reduced income tax rate in Code Section 12-6-545 on active trade or business income?

A. A person who meets the following criteria is eligible to use the reduced tax rate:

1. Is an individual, a trust, or an estate taxed at the regular graduated tax rate of 3% to 7% under Code Section 12-6-510²;
2. Has an interest in a “pass through business”; and
3. Receives “active trade or business income” from the pass through business.

Entities listed in Code Sections 12-6-530, 12-6-540, and 12-6-550 do not qualify for the reduced income tax rate since they are currently taxed at a rate of 5% or are exempt from South Carolina income tax. For example, a corporation (including a limited liability company or professional or other association taxed for South Carolina income tax purposes as a corporation), bank, building and loan association, insurance company, or tax exempt organization under Internal Revenue Code Sections 501 through 528 do not qualify for the reduced tax rate.

2. Q. What is a “pass through business”?

A. A “pass through business” is defined as:

1. a sole proprietorship;
2. a partnership;
3. an S corporation; or
4. a limited liability company taxed as a sole proprietorship, partnership, or S corporation.

² In 2007, the 2.5% tax bracket was reduced to 0%.

3. Q. What income qualifies for the reduced tax rate?

A. Only the South Carolina “active trade or business income” of a pass through business that is received by the owner of an interest in a partnership or S corporation, or received by a sole proprietor is eligible for the reduced tax rate. If a pass through business is involved in both an active trade or business activity and a passive investment, then only the active trade or business income or loss portion received is eligible for the reduced tax rate. See Questions 8, 9, and 14 for income that does not qualify for the reduced rate computation, including passive investment income and amounts reasonably related to personal services.

Note: Whether an activity is an “active trade or business” or a “passive investment” is determined at the entity level for purposes of the reduced tax rate in Code Section 12-6-545.

4. Q. Is the reduced tax rate optional?

A. Yes. A taxpayer may decide annually to have eligible “active trade or business income” taxed at the reduced rate under Code Section 12-6-545 or continue to use the standard graduated 3% to 7% rates under Code Section 12-6-510 to compute South Carolina tax. For taxpayers filing a joint return, the election to use the reduced rate in Code Section 12-6-545 is effective for both taxpayers. There is no formal election to be made by the taxpayer; the reduced tax rate and/or the standard tax rate are simply a mathematical computation made on the tax return when filed. South Carolina Form I-335, “Active Trade or Business Income – Reduced Rate Computation,” and applicable Worksheet 1 (Form I-335A) and Worksheet 2 (Form I-335B), are used to calculate the reduced tax.

A taxpayer with an overall active trade or business loss from pass through businesses will receive no tax benefit from the reduced rate in Code Section 12-6-545, therefore, there is no need to do the active trade or business income calculations discussed in this document; the standard graduated rates in Code Section 12-6-510 should be used in computing South Carolina taxable income.

Further, a taxpayer would want to continue to use the standard rate instead of the reduced rate if he has taxable income from a pass through business, but overall has South Carolina taxable income subject to tax at a marginal rate less than the “reduced” rate. See Question 5 for the reduced rate amount.

5. Q. When does the reduced tax rate begin and what is the reduced rate amount?

A. The reduced tax rate is phased in over a 4 year period and the first reduction is available for tax years of the individual, estate, or trust beginning in 2006.

South Carolina's highest standard graduated tax rate of 7% is reduced by .5% each year until a reduced tax rate of 5% is reached. The reduced tax rate phase in is as follows:

<u>Individual, Estate, or Trust Tax Year Beginning in</u>	<u>Reduced Tax Rate</u>
2006	6.5 %
2007	6.0 %
2008	5.5 %
2009 and after	5.0 %

6. Q. How are credit amounts computed when a taxpayer uses both the standard rate and the reduced tax rate?
- A. The type of tax (*e.g.*, individual income, corporate, license fee, etc.) a credit may be used against and the amount of the credit available for use depends on the particular tax credit. For example, the jobs tax credit in Code Section 12-6-3360 states that it may be used only against taxes imposed under Code Section 12-6-510 (individual income tax at the standard rate), Code Section 12-6-530 (corporate income tax), insurance premium tax, or bank tax, and it states that the credit is limited to 50% of the taxpayer's South Carolina income tax liability.

Code Section 12-6-545, however, provides that an income tax credit available to offset taxes due under Code Section 12-6-510 also may be used to offset taxes due under Code Section 12-6-545. In this example, a taxpayer who uses the standard tax rate and/or the reduced tax rate would use the job tax credit to offset "total taxes" due, without regard to the any separate income or tax rate computations resulting from the application of Code Section 12-6-545.

7. Q. Can the reduced tax rate be used on composite returns?
- A. Yes. Code Section 12-6-5030 allows S corporations and partnerships to separately compute South Carolina income and tax attributable to each participating nonresident shareholder or partner and report the total tax due on a single return. The pass through business is not required to withhold income tax pursuant to Code Section 12-8-590 on behalf of any nonresident shareholder or partner whose income is reported on the composite return.

If the participant provides an affidavit (see Form I-338) stating that he has no other South Carolina income (other than from the pass through business), then the pass through business may determine each eligible participant's tax due by one of the following methods:

1. Compute the pro rata share of the standard deduction or itemized deduction and personal exemption amount for each participant pursuant to Code Section 12-6-1720(2) in the same manner as if it was being separately reported, or
2. Compute each participant's share of South Carolina income without regard to any deductions or exemptions.

The reduced tax rate may then be used to compute the tax on “active trade or business income” received from the pass through business and the standard tax rate is used to compute the tax on other income received from the pass through business.

Code Section 12-6-5030(B)(1)(b) provides that if a participant does not provide an affidavit (see Form I-338) stating he has no South Carolina income other than from the pass through business, then this participant’s South Carolina income tax is computed on active trade or business income using the reduced tax rate under Code Section 12-6-545 and on other income using the 7% standard tax rate, without regard to the standard or itemized deductions and personal exemptions. (See Questions 16 - 18 for information on a safe harbor provision applicable to eligible participants of a composite return.)

Active Trade or Business Income Determination:

8. Q. What is “active trade or business income or loss” of a pass through business?
- A. “Active trade or business income or loss” is gross income from the pass through business minus the specifically listed items excluded from the reduced rate computation (see excluded items discussed below) and minus deductions related to the active trade or business.

The items listed below are not “active trade or business income or loss” and are excluded from the reduced rate computation:

1. “Passive investment income” generated by a pass through business and expenses related to passive investment.

For purposes of Code Section 12-6-545, the definition of “passive investment income” has the same meaning as used in the S corporation provisions in Internal Revenue Code Section 1362(d).³ The definition of “passive investment income” contained in the S corporation provisions of Internal Revenue Code Section 1362(d) is also applicable to income generated by a sole proprietorship or partnership, and applicable to expenses related to those passive investments.

In general, “passive investment income” is gross receipts derived from: (1) royalties, (2) rents, (3) dividends, (4) interest, (5) annuities, and (6) sales or exchanges of stock or securities to the extent of gains. (See Question 9 below for more information.)

³ Internal Revenue Code Section 1362(d) is applied at the S corporation level and is also applied at the “pass through business” level for purposes of Code Section 12-6-545.

Note: “Passive investment income” defined in Internal Revenue Code Section 1362(d) should not be confused with a “passive activity” defined in Internal Revenue Code Section 469. Internal Revenue Code Section 469 passive activity provisions are not applicable for purposes of Code Section 12-6-545; an owner, partner, shareholder, or member can use the reduced tax rate even if he does not materially participate in the pass through business. For example, a limited partner in a partnership that generates “active trade or business income” under Internal Revenue Code Section 1362(d) is not disqualified from using the reduced tax rate in Code Section 12-6-545 even though the partner is considered passive under Internal Revenue Code Section 469 with regard to the activity of the partnership.

2. Capital gains and losses, including Internal Revenue Code Section 1231 gains and losses from property used in the trade or business that receive capital gain and loss treatment;
 3. Guaranteed payments for services as defined in Internal Revenue Code Section 707(c); and
 4. Amounts reasonably related to personal services.
9. Q. What is passive investment income?
- A. **Note:** Internal Revenue Code Section 1362(d) defines passive investment income and provides exceptions. The regulations under Internal Revenue Code Section 1362, and other guidance such as federal rulings and cases, should be consulted in determining whether income is “passive investment income.”

The following are examples of the six types of “passive investment income” that do not qualify for the reduced tax rate:

1. Royalties. Royalties mean all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, and franchises.

Passive investment income does not include royalties derived in the ordinary course of a trade or business of franchising or licensing property or active business computer software royalties. Accordingly, such royalties are active trade or business income eligible for the reduced rate.

2. Rents. In general, rents are amounts received for the use of, or right to use, real or personal property of the pass through business. An example of rent that is “passive investment income” is the net lease of a building.

Passive investment income does not include rents derived in the active trade or business of renting property if, based on all the facts and circumstances, the pass through business (1) provides significant services or (2) incurs substantial

costs in the rental business. Accordingly, such rents are active trade or business income eligible for the reduced rate. This determination is based, in part, on the number of persons employed to provide the services and the types and amounts of costs and expenses incurred, other than depreciation. Examples of rents that are “active trade or business” include operating a hotel or a short term car rental business.

3. Dividends. Dividends include dividends as defined in Internal Revenue Code Section 316 and personal holding company consent dividends described in Internal Revenue Code Section 565.
4. Interest. Interest is any amount received for the use of money, including tax exempt interest, amounts treated as imputed interest under Internal Revenue Code Sections 483 (“Interest on Certain Deferred Payments”) or 7872 (“Treatment of Loans with Below-Market Interest Rates”), and original issue discount.

Passive investment income does not include interest on any obligation (1) acquired from the sale of property described in Internal Revenue Code Section 1221(a)(1) or (2) from the performance of services in the ordinary course of a trade or business of selling the property or performing the services. Accordingly, such interest is active trade or business income eligible for the reduced rate.

5. Annuities. Annuities means the entire amount received as an annuity under an annuity, endowment, or life insurance contract, if any part of the amount would be includable in gross income under Internal Revenue Code Section 72.
6. Gross Receipts from Sales or Exchanges of Stock or Securities (to the extent of gains.) Stock or securities include shares or certificates of stock, stock rights or warrants, bonds, debentures, certificates of indebtedness, notes, municipal bonds, and an interest as a limited partner in a partnership.

Passive investment income does not include gross receipts that are directly derived in the ordinary course of a trade or business of: (1) lending or financing; (2) dealing in property; (3) purchasing or discounting accounts receivable, notes, or installment obligations; or (4) servicing mortgages. Accordingly, such gross receipts are active trade or business income eligible for the reduced rate.

10. Q. What expenses reduce active trade or business income?

- A. Code Section 12-6-545(D) states the Department may issue guidance as to what expenses reduce active trade or business income subject to the 5% reduced rate. In general, business related expenses, including those listed on the federal Schedule C, “Profit or Loss from Business,” Schedule F, “Profit or Loss from Farming,” or Schedule E, “Supplemental Income and Loss,” are expenses that reduce “active trade or business income.”

Examples include ordinary and necessary business expenses, interest expense on funds used to acquire business assets, one-half of self employment tax (*i.e.*, the equivalent of FICA tax borne by the employer,) depreciation deductions, and Internal Revenue Code Section 179 expense deductions.

However, expenses of a personal nature are used to reduce income subject to the regular graduated tax rate of up to 7%. Examples include itemized deductions for charitable contributions, home mortgage interest, and medical expenses; and certain deductions allowed from “total income” in arriving at “adjusted gross income” such as alimony paid, IRA’s, self employed health insurance, and self employed SEP or qualified retirement plans.

11. Q. Is an adjustment to “active trade or business income or loss” from a pass through business made for current year losses, prior year suspended losses, or net operating loss carryforwards?

A. Yes, depending on the taxpayer’s particular circumstances, an adjustment to “active trade or business income or loss” may be required in determining the amount subject to the reduced rate. The adjustment may be positive (*i.e.*, increase active trade or business income subject to the reduced rate) or negative (*i.e.*, reduce active trade or business income subject to the reduced rate.) For example, a current year South Carolina loss resulting from the ownership of a partnership or S corporation interest that the taxpayer is not allowed to use because: (1) the taxpayer does not have basis, (2) the taxpayer does not have sufficient “at risk” amounts, or (3) the loss is a passive activity loss under Internal Revenue Code Section 469⁴ will increase South Carolina active trade or business income subject to the reduced rate by the amount of the suspended loss (*i.e.*, it is a positive adjustment.)

However, previously suspended losses resulting from the ownership of an interest in a partnership or S corporation that the taxpayer is now allowed to use because (1) he now has basis, (2) he now has “at risk” basis, or (3) he may now use a net operating loss carryforward will decrease active trade or business income subject to the reduced rate, to the extent they are South Carolina “active trade or business losses.”

12. Q. How are Internal Revenue Code Section 1231 gains and losses used in the computation of “active trade or business income or loss”?

A. Internal Revenue Code Section 1231 gains and losses that receive capital gain treatment do not qualify for the reduced tax rate and are excluded from the “active

⁴ “Passive investment income” defined in Internal Revenue Code Section 1362(d) should not be confused with a “passive activity” defined in Internal Revenue Code Section 469. Internal Revenue Code Section 469 passive activity provisions are not applicable for purposes of Code Section 12-6-545; an owner, partner, shareholder, or member can use the reduced tax rate even if he does not materially participate in the pass through business.

trade or business income” computation. (A gain used in the computation of the 44% net capital gain deduction in Code Section 12-6-1150 is not eligible for the 5% reduced tax rate.)

Internal Revenue Code Section 1231 gains that are treated as ordinary gains qualify for the reduced tax rate and are included in “active trade or business income,” unless otherwise disqualified, *e.g.*, passive investment income.

Internal Revenue Code Section 1231 losses treated as ordinary losses are “active trade or business losses” and reduce “active trade or business income” subject to the reduced tax rate.

13. Q. Are guaranteed payments for the use of capital eligible for the reduced tax rate?

A. Yes. Guaranteed payments for the use of capital are “active trade or business income” and are eligible for the reduced tax rate, unless otherwise disqualified, *e.g.*, as passive investment income. In order to assist in the computation of amounts eligible for the reduced tax rate, a pass through business should indicate on the K-1 the guaranteed payment amount for the use of capital.

14. Q. How is the “amount reasonably related to personal services” and “paid a reasonable amount for those personal services as compensation” determined for a person performing personal services for a pass through business?

A. The statute provides that active trade or business income does not include amounts reasonably related to personal services. All compensation (*e.g.*, wages, salaries, bonuses, etc.) and guaranteed payments for services are income related to personal services. These amounts have been deducted by the pass through business in arriving at taxable income and do not require an additional adjustment on SC Form I-335. However, the taxpayer may have “additional personal service income” that must be subtracted from “pre-adjusted active trade or business income” reflected on SC Form I-335 and Worksheets 1 and 2.

Definitions. For purposes of this advisory opinion, the following terms have the meaning provided below:

Pre-Adjusted Active Trade or Business Income – A taxpayer’s active trade or business income from a pass through business⁵ after all deductions related to the active trade or business (including any deductions for compensation, *e.g.*, wages, salaries, bonuses, and guaranteed payments for services) except the deduction for additional personal service income. See SC Form I-335 Worksheet 1, Line 3 and Worksheet 2, Line 22.

⁵ This amount also includes amounts for personal services of the taxpayer’s spouse if a joint return is filed.

Additional Personal Service Income – The total amount of a taxpayer’s income⁶ related to personal services for a pass through business less the taxpayer’s compensation⁷ and guaranteed payments for services deducted by the pass through business. See SC Form I-335, Line 4.

General Personal Service Rule. Accordingly, a taxpayer performing personal services for a pass through business who chooses to use the reduced tax rate may have to decrease pre-adjusted active trade or business income eligible for the reduced rate by additional personal service income. There are two methods to determine additional personal service income on SC Form I-335, Line 4 in arriving at the amount eligible for the reduced rate:

1. The “actual” method. The taxpayer must determine the actual amount of additional personal service income for each applicable pass through business in which he performs personal services.⁸ In determining this amount, the following process is used:

Step 1. Determine Pre-adjusted Active Trade or Business Income.

This amount is derived from SC Form I-335 Worksheet 1, Line 3, or Worksheet 2, Line 22.⁹ See definition above.

Step 2. Determine Additional Personal Service Income. This amount, if positive, is reflected on SC Form I-335, Line 4 to reduce pre-adjusted active trade or business income eligible for the reduced tax rate.

Part A. The taxpayer (*i.e.*, owner) must determine the total fair market value of all his personal services performed for the pass through business, including those performed by his spouse and dependents. Subtract any amount reported on a W-2 to the taxpayer, spouse, and dependents, or guaranteed payment for services to the taxpayer, spouse, or dependents. Compare the resulting amount to the pre-adjusted active trade or business income determined in Step 1 above; the lesser amount is used in Step 2 – Part B below.

Part B. If the amount in Part A is greater than \$0, this amount is the “additional personal service income” entered on SC Form I-335, Line 4, and used to reduce pre-adjusted active trade or business income to determine the amount eligible for the reduced rate (SC Form I-335, Line 5).

⁶ This amount also includes amounts for personal services of the taxpayer’s spouse and his dependents.

⁷ This amount also includes amounts for personal services of the taxpayer’s spouse and his dependents.

⁸ A pass through business for which the taxpayer does not perform personal services or for which the taxpayer has a taxable loss are ignored.

⁹ This amount also includes amounts from the taxpayer’s spouse if a joint return is filed.

If the amount in Part A is \$0 or less than \$0 (*e.g.*, the shareholder/partner received a W-2 or guaranteed payment in excess of the amount reasonably related to personal services), then there is no “additional personal service income” to enter on SC Form I-335, Line 4. As a result, the pre-adjusted active trade or business income amount determined in Step 1 is the amount of active trade or business income eligible for the reduced tax rate.

2. The “safe harbor” method. The taxpayer, if eligible, may choose to treat 50% of his pre-adjusted active trade or business income as additional personal service income. See Questions 15 and 16 for more information on the safe harbor method and to determine if a taxpayer is eligible to use the safe harbor based upon the SC taxable income dollar limitation test.

Actual Method. For most taxpayers who perform personal services for the pass through business and do not use the safe harbor method there is generally no single factor decisive in determining additional personal service income. Each situation must be considered as a whole and consideration must be given to all the facts and circumstances of the pass through business activity. Further, the amount determined may change each year based on the facts and circumstances.

Facts and circumstances to use in making this determination include, but are not limited to, the following:

1. Amounts that would be paid to obtain comparable services from a person not having an ownership interest in the pass through business;
2. Prevailing rates of compensation paid for comparable positions in comparable businesses;
3. Salary policy of the pass through business as to all employees;
4. Size and complexity of the business;
5. Employee’s/owner’s qualifications and skills;
6. Managerial responsibilities; or
7. Amounts related to personal services that can reasonably be identified from the pass through business’s books and records kept in the regular course of business, *e.g.*, payments related to hours worked, quantity or quality of services performed, number of items sold, or collections for services.

Caution: If a taxpayer has additional personal service income from a pass through business and does not treat that amount as reasonably related to personal services, then all income from the pass through business is subject to tax at the regular graduated tax rate.

Examples. The following examples illustrate the computation of pre-adjusted active trade or business income, additional personal service income, and the active trade or business income eligible for the reduced rate. Each example assumes that the taxpayer has an interest only in the pass through business illustrated, has \$60,000 pre-adjusted active trade or business income, and is based on the stated facts.

Example 1 illustrates the computation for a taxpayer who does not perform personal services for the pass through business.

Examples 2 and 4 illustrate the actual method for computing additional personal service income. In Example 2 the taxpayer has determined, based on the facts and circumstances, the fair market value of his personal services for the pass through business is \$45,000 and includes \$20,000 of W-2 wages. Whereas, in Example 4 the taxpayer has determined the fair market value of his personal services for the pass through business is \$20,000 and \$20,000 is reflected on his W-2 as wages.

Example 3 illustrates the safe harbor method for computing additional personal service income.

	Example 1 - <u>No</u> Personal Services Performed by Taxpayer <u>No</u> additional personal service income computation <u>necessary</u>	Example 2 - Personal Services Performed by Taxpayer <u>“Actual Method”</u> Used to Compute Additional Personal Service Income	Example 3 - Personal Services Performed by Taxpayer <u>“Safe Harbor Method”</u> Used to Compute Additional Personal Service Income	Example 4 - Personal Services Performed by Taxpayer <u>“Actual Method”</u> Used to Compute Additional Personal Service Income
Pre-adjusted Active Trade or Business Income (See Form I-335, Worksheet 1 or Worksheet 2)	\$60,000	\$60,000	\$60,000	\$60,000
Less: Additional Personal Service Income (See Form I-335, Line 4)	\$0 N/A - No personal services performed	(\$25,000) *	(\$30,000) 50% x pre-adjusted active trade or business income	\$0 **
Active Trade or Business Income (See Form I-335, Line 5)	\$60,000	\$35,000	\$30,000	\$60,000

* \$45,000 actual fair market value of all personal services performed for the pass through business - \$20,000 W-2 wages = \$25,000 additional personal service income

** \$20,000 actual fair market value of all personal services performed for the pass through business - \$20,000 W-2 wages = \$0. Note: The answer would be the same if the actual fair market value of the personal services was \$15,000 and the W-2 wages were \$20,000.

Safe Harbor:

15. Q. What is the “safe harbor” calculation to determine “amounts reasonably related to personal services”?

A. A qualifying taxpayer may choose one of the following methods to determine additional personal service income:

1. The actual method. See Question 14 above and Example B below or
2. The “safe harbor” method. See Example A below. This method may be used only if certain conditions discussed in Question 16 are met. The safe harbor allows a taxpayer to determine additional personal service income by simply treating 50% of his pre-adjusted active trade or business income¹⁰ received from each pass through business in which he performs personal services and has income as “additional personal service income.” This amount would be reflected on SC Form I-335, Line 4, and used to reduce active trade or business income eligible for the reduced tax rate.

¹⁰ Pre-adjusted active trade or business income means a taxpayer’s active trade or business income from a pass through business after all deductions related to the active trade or business (including any deductions for compensation, *e.g.*, wages, salaries, bonuses, and guaranteed payments for services) except the deduction for additional personal service income. This amount also includes amounts for personal services of the taxpayer’s spouse if a joint return is filed. See SC Form I-335 Worksheet 1, Line 3, and Worksheet 2, Line 22.

Example A – Safe Harbor Method. The following example is provided to illustrate the computation to use by taxpayers filing a joint individual income tax return who opt to use the “safe harbor” method for determining amounts related to personal services. This example assumes the husband and wife each have several interests in South Carolina pass through businesses and perform personal services for the businesses noted. It also assumes the safe harbor dollar limitation explained in Question 16 has been met.

Column 1 SC Pre-adjusted active trade or business income (From information on Taxpayers Worksheet 1 and all Worksheets 2)	Column 2 “Total Relevant” SC active trade or business income¹¹	Column 3 Safe Harbor Method Used	Column 4 Additional Personal Service Income
(\$25)* Partnership #1	N/A – Loss K-1		
\$200* Partnership #2	N/A – No personal services performed		
\$100* Schedule C	\$100 – personal services performed		
\$ 50* Partnership #3	\$50 - personal services performed		
(\$15)* S Corporation K-1	N/A – Loss K-1		
\$310 Total Column 1	\$150 Total Column 2	50% of “Relevant” SC active trade or business income \$150 x 50% = \$75	\$75 (To Form I-335, Line 4)

* The SC pre-adjusted active trade or business income or loss amount is obtained from SC Form I-335 Worksheet 1, “Pass Through Income from a Sole Proprietorship” or Worksheet 2, “Pass Through Income from a Partnership or S Corporation” and is a taxpayer’s active trade or business income from the pass through business after all deductions (including any deductions for compensation or guaranteed payments for services), except the deduction for additional personal service income.

Note: If a taxpayer uses the safe harbor method of determining the “amount related to personal services,” the following guidelines are important to remember:

1. Pass through businesses for which the taxpayer does not perform personal services are ignored. (See Partnership #2 K-1 in the example above.)
2. Pass through businesses for which the taxpayer has a pre-adjusted trade or business loss are ignored. (See Partnership #1 K-1 and S Corporation K-1 in the example above.)
3. Compensation or guaranteed payments for services that are deducted by the pass through business do not require an additional adjustment on SC Form I-335.

¹¹ Total relevant South Carolina active trade or business income means the pre-adjusted active trade or business income without regard to income from a pass through business in which the taxpayer, his spouse, or his dependents did not perform personal services and without regard to a pass through business for which the taxpayer had a pre-adjusted active trade or business loss.

Example B – Actual Method. The following example is provided to illustrate the computation for determining amounts related to personal services when taxpayers filing a joint individual income tax return use the “actual” method. This example assumes the husband and wife each have several interests in South Carolina pass through businesses and perform personal services for the businesses noted. Example A illustrates the safe harbor method results in a \$75 additional personal service income adjustment whereas Example B illustrates the actual method results in a \$30 additional personal service income adjustment.

Column 1 SC Pre-adjusted active trade or business income (From information on taxpayers Worksheet 1 and all Worksheets 2)	Column 2 “Total Relevant” SC active trade or business income (<i>i.e.</i> “Pre-adjusted Active Trade or Business Income” disregarding any pass through businesses with no personal services or losses)	Column 3 - Actual Method Used Fair Market Value (FMV) – Compensation (e.g., W-2 or guaranteed payments for services)			Column 4 Additional Personal Service Income *Compare column 2 and result in column 3 – use lesser number; if negative, no adjustment is made, enter 0 (See Question 14 for details)
(\$25) Partnership #1	N/A – Loss K-1	N/A			
\$200 Partnership #2	N/A – No personal services	N/A			
\$100 Schedule C	\$100 – personal services	FMV \$30 -	\$0 comp	\$30*	\$30
\$ 50 Partnership #3	\$50 – personal services	FMV \$15 -	Guaranteed Payment \$20	(\$5)*	\$ 0 Negative = No adjustment
(\$15) S Corporation K-1	N/A – Loss K-1	N/A			
Total \$310	Total \$150				\$30 (To Form I-335, Line 4)

16. Q. Who is a qualifying taxpayer that may use the “safe harbor”?

- A. The safe harbor is available to a taxpayer if total South Carolina taxable income from all pass through businesses in which the taxpayer performs personal services is \$100,000 or less, excluding capital gains and losses. **Note:** For purposes of the safe harbor, including the taxable income dollar limitation, the “taxpayer” is both taxpayers who file a joint return.

The limitation test only determines if a taxpayer is eligible to use the safe harbor method to compute additional personal service income. The limitation test does not compute the amount of personal service income under the safe harbor method or the actual method. See Question 14 above for guidance and examples that illustrate the calculation of the amount of additional personal service income.

Safe Harbor Income Limitation Test and Examples. Pursuant to Code Section 12-6-545(E)(2), the Department has approved a method to compute the safe harbor income limitation.

This method to determine the total South Carolina taxable income from all pass through businesses for which he performs personal services, excluding capital gains and losses, is computed as follows:

1. include all types of income items from the pass through business, *e.g.*, W-2 income, guaranteed payments for services or for the use of capital, active trade or business income, portfolio income, passive income, ordinary losses, Section 1231 gains and losses treated as ordinary gains and losses, etc., unless otherwise listed below as disregarded,
2. include all types of deductions from the pass through business, such as Section 179 deductions,
3. disregard all capital gains and capital losses, and
4. disregard Section 1231 gains and losses treated as capital gains and capital losses.

Examples 1, 2, and 3 below use this method.

Caveat: The examples are simplified to illustrate the basic concepts used in computing the safe harbor income limitation, *e.g.*, they do not show all items of income or deduction that may exist on a K-1, they show different types of income and deductions, etc. They are intended to illustrate the mechanics of the safe harbor limitation test method approved by the Department. See Question 14 above for guidance and examples that illustrate the calculation of the amount of “additional personal service income”, if any, that must be subtracted from “pre-adjusted active trade or business income” reflected on SC Form I-335 and Worksheets 1 and 2 in determining the amount eligible for the reduced rate.

Example 1: This example illustrates the following:

- a. only amounts from a pass through business in which the taxpayer performs personal services are included when determining if a taxpayer qualifies to use the safe harbor method, even if compensation (*e.g.*, wages, salaries, bonuses, guaranteed payments, etc.) is not received. Therefore, the amounts from Partnership 2 below are included in the safe harbor limit test even though the taxpayer did not receive a guaranteed payment for his personal services. Further, all items from S corporation 1 below are disregarded in this computation since the taxpayer did not perform personal services with respect to S corporation 1;
- b. the guaranteed payment is included in the safe harbor income computation test to determine the taxpayer’s SC taxable income from Partnership 1 since the partnership deducted this amount in arriving at its ordinary income; and
- c. all capital losses are disregarded from the safe harbor income computation test.

	Partnership 1	Partnership 2	S Corporation 1	Total SC Amounts Used in Safe Harbor Limit Test from All Pass Through Businesses in Which Taxpayer Performs Personal Services
	Personal Services Performed	Personal Services Performed (see item a above)	No Personal Services Performed (see item a above)	
W-2	N/A	N/A	N/A	\$0
Guaranteed Payment	\$15,000 (see item b above)	\$0	N/A	\$15,000
Ordinary Income	\$25,000	\$0	N/A	\$25,000
Interest Income	\$15,000	\$0	N/A	\$15,000
Rental Income	\$0	\$80,000	N/A	\$80,000
Capital Gain and Loss, including §1231 gains and losses treated as capital gains and losses	\$0	(\$30,000) Disregard in safe harbor income limit test (see item c above)	N/A	N/A
§179 Deduction and Other Deductions	(\$5,000)			(\$5,000)
Net SC amount used in safe harbor income limit test	\$50,000	\$80,000	N/A	\$130,000
Is Safe Harbor Available to the Taxpayer?			N/A	No \$130,000 net SC amount used in safe harbor income limit test > \$100,000 limit

Example 2: This example illustrates the following:

- a. although the taxpayer did not receive a guaranteed payment from the Partnership 1 below, since he performs personal services for the partnership he must determine the amount, if any, reasonably related to personal services;
- b. the “netting” principles used to obtain a total SC amount from all pass through businesses in which the taxpayer performs personal services, *i.e.*, pass through businesses in which the taxpayer has a loss are not ignored for purposes of safe harbor limit test;
- c. the applicability of the safe harbor option for an individual who has ownership interests in several pass through businesses, with one having taxable income over the \$100,000 limit;
- d. the W-2 amount is included in the safe harbor income computation test since the wage amount was deducted by the S corporation in arriving at its ordinary income; and
- e. all capital gains, including Section 1231 gains and losses treated as capital gains and capital losses are disregarded from the safe harbor income computation test.

	Partnership 1	S Corporation 2	Total SC Amounts Used in Safe Harbor Limit Test from All Pass Through Businesses in Which Taxpayer Performs Personal Services
	Personal Services Performed	Personal Services Performed	
W-2	N/A	\$25,000 (see note d)	\$25,000
Guaranteed Payment	\$0 (see note a)	N/A	\$0
Ordinary Income	\$110,000	(\$60,000)	\$50,000
Interest Income	\$12,000	\$0	\$12,000
Rental Income	\$10,000	\$0	\$10,000
Capital Gain and Loss, including §1231 gains and losses treated as capital gains and losses	\$90,000 Disregard in safe harbor income limit test (see note e)		N/A
§179 Deduction and Other Deductions	(\$2,000)		(\$2,000)
Net SC amount used in safe harbor income limit test	\$130,000 (see note c)	(\$35,000)	\$95,000 (see note b)
Is Safe Harbor Available to the Taxpayer?			Yes \$95,000 net SC amount used in safe harbor income limit test ≤ \$100,000 limit

Example 3: This example illustrates the following:

- a. although the taxpayer did not receive a guaranteed payment from the partnership, since he performs personal services for the partnership he must determine the amount, if any, reasonably related to personal services and
- b. all capital gains, including Section 1231 gains treated as capital gains are disregarded from the safe harbor income computation test.

	Partnership 1	Total SC Amounts Used in Safe Harbor Limit Test from All Pass Through Businesses in Which Taxpayer Performs Personal Services
	Personal Services Performed	
W-2	N/A	N/A
Guaranteed Payment	\$0 (see note a)	\$0
Ordinary Income	\$75,000	\$75,000
Interest Income	\$75,000	\$75,000
Rental Income	\$0	\$0
Capital Gain and Loss, including §1231 gains and losses treated as capital gains and losses	\$2,000 Disregard in safe harbor income limit test (see note b)	N/A
§179 Deduction and Other Deductions	(\$50,000)	(\$50,000)
Net SC amount used in safe harbor income limit test	\$100,000	\$100,000
Is Safe Harbor Available to the Taxpayer?		Yes \$100,000 net SC amount used in safe harbor income limit test ≤ \$100,000 limit

17. Q. Is the use of the safe harbor optional?

A. Yes. The decision to use the safe harbor may be made each year. For taxpayers filing a joint return, the decision to use the safe harbor is effective for both taxpayers.

18. Q. Does the safe harbor apply to participants in a composite return?

A. The decision to use or not use the safe harbor provided in Code Section 12-6-545 is made by a qualifying partner, shareholder, or member; it is not an entity level election. The safe harbor applies to composite return participants as follows:

1. No other South Carolina income by the partner, shareholder, or member and an affidavit is provided. The safe harbor can be used by the individual participant if he informs the pass through business of his safe harbor election. The participant must provide the pass through business an affidavit that he has no other South Carolina income. (See SC Form I-338.)
2. Other South Carolina income by the partner, shareholder, or member. The safe harbor cannot be used as a basis for determining the tax on the composite return by any person who has South Carolina income from sources other than the pass through business filing the composite return.

Note: The shareholder, partner, or member may, however, choose to participate in the composite return, report the income on his individual income tax return (where he may elect the safe harbor) and take credit for any tax paid on his behalf on the composite return.

3. No other South Carolina income by the partner, shareholder, or member but affidavit is not provided. Same as item 2 above.

SOUTH CAROLINA DEPARTMENT OF REVENUE

s/Ray N. Stevens

Ray N. Stevens, Director

January 11 _____, 2008
Columbia, South Carolina



STATE OF SOUTH CAROLINA
DEPARTMENT OF REVENUE
**ACTIVE TRADE OR BUSINESS INCOME
REDUCED RATE COMPUTATION**

(Attach I-335 and all supporting Worksheets to SC1040 or SC 1041)

For the year January 1 - December 31, 2007, or fiscal tax year beginning 2007 and ending 2008

Print your name

Spouse's first name

Your Social Security number

Spouse's Social Security number

- 1a. Enter amount from Worksheet 1, line 3 1a. \$ _____ .00
- 1b. Enter total of amounts from Worksheets 2, line 22, Column C 1b. \$ _____ .00
- 1c. Add lines 1a and 1b 1c. \$ _____ .00
- 2a. Enter any adjustments necessary because of at-risk rules, South Carolina net operating losses, and/or passive activity losses. <Enter in brackets if the adjustment is negative.> Enter -0- if no adjustments are necessary 2a. \$ _____ .00
- 2b. Enter the amount of one half of self-employment tax on partnership income related to South Carolina. Do not include the amount on line 2 of Worksheet 1. 2b. \$ _____ .00
- 2c. Line 2a minus line 2b. <Enter in brackets if negative.> 2c. \$ _____ .00
- 3. Add lines 1c and 2c. If zero or negative, STOP – DO NOT PROCEED... 3. \$ Pre-adjusted .00
active trade or business income
- 4. Enter amounts reasonably related to personal services of the taxpayer, the taxpayer's spouse, or any person claimed as dependent on the taxpayer's income tax return (see Rules for Using Safe Harbor below). Do not include amounts from W-2s or 1099s or guaranteed payments for personal services 4. \$ Additional .00
personal service income
 Check here if using Safe Harbor
- 5. Subtract line 4 from line 3. If greater than zero, enter on SC1040, line 44; Schedule NR, line 39; or SC1041, Part I, line 2d. If zero or negative, STOP – DO NOT PROCEED 5. \$ Active trade or business .00
income
- 6. Tax Year 2007 rate on qualifying active trade or business income 6. 6% (.06)
- 7. Multiply line 5 by line 6 (enter here and on SC1040, line 8; or on SC1041, line 9) 7. \$ Reduced tax .00
on active trade or business income



STATE OF SOUTH CAROLINA
DEPARTMENT OF REVENUE
WORKSHEET 1
PASS-THROUGH INCOME FROM
A SOLE PROPRIETORSHIP

(Complete one Worksheet 1 for all Schedules C, C-EZ and F)
(Attach Worksheet 1 to your return)

For the year January 1 - December 31, 2007, or fiscal tax year beginning 2007 and ending 2008

Print your name

Spouse's first name

Your Social Security number

Spouse's Social Security number

In order to use the flat tax rate on active trade or business income, an individual, estate or trust with pass-through income from one or more sole proprietorships or single-member LLCs not taxed as corporations must complete Worksheet 1.

A taxpayer needs to complete only one Worksheet 1 for all federal Schedules C, C-EZ and F.

1. South Carolina net profit (loss) all federal Schedules C, C-EZ and F 1. \$_____00
2. One half of the self-employment tax related to line 1 (enter the amount from line 27 of federal Form 1040 if all business income is taxable to South Carolina) 2. \$_____00
3. Subtract line 2 from line 1 and enter here and on I-335, line 1a 3. \$_____00

Instructions to Worksheet 1

Line 1 Enter total of South Carolina amounts from federal Schedule C, line 31; Schedule C-EZ line 3; and Schedule F, line 36.

Line 2 Enter the amount from Form 1040, line 27 that applies to line 1. The entire amount applies unless one or more of the Schedules C and F are from a multi-state business or business not taxable to South Carolina.

Line 3 Subtract line 2 from line 1. Enter this amount on I-335, line 1a.



**WORKSHEET 2
PASS THROUGH INCOME FROM A PARTNERSHIP
OR S CORPORATION**

(Complete a separate Worksheet 2 for each SCK-1)
(Attach each Worksheet 2 to your return)

I-335B

(Rev. 9/28/07)

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For the year January 1 - December 31, 2007, or fiscal tax year beginning 2007 and ending 2008

Print your name

Spouse's first name

Your Social Security number

Spouse's Social Security number

In order to use the flat rate on active trade or business income, an individual, estate or trust with pass-through income from one or more partnerships, S corporations, or LLCs taxed as partnerships or S corporations must complete a separate Worksheet 2 for each partnership, S corporation or LLC.

Complete a separate Worksheet 2 for each SCK-1.

Name of business:	Column A Federal K-1 amounts	Column B SCK-1 amounts	Column C SC active trade or business amounts
1. Ordinary business income (loss)			1.
2. Net rental real estate income (loss)			2.
3. Other net rental income (loss)			3.
4. Guaranteed payments *			4.
5. Interest income			5.
6. Ordinary/qualified dividends			
7. Royalties			7.
8. Net short-term capital gain (loss)			
9a. Net long-term capital gain (loss)			
9b. Collectibles (28%) gain (loss)			
9c. Unrecaptured section 1250 gain			
10. Net section 1231 gain (loss)			10.
11. Other income (loss)			11.
12. Section 179 deduction			12. ()
13. Other deductions			
14. Self-employment earnings (loss) *			
15. Credits			
16. Foreign transactions			16.
17. Alternative minimum tax (AMT) items			17.
18. Tax exempt income and nondeductible expenses *			
19. Distributions *			
20. Items affecting shareholder basis **			
21. Other information			
22. Total of Column C			22.

Note: Worksheet 2 combines elements of federal K-1s for Forms 1065 and 1120-S.

* identifies items on Form 1065, Schedule K-1 but not on Form 1120-S, Schedule K-1.

** identifies items on Form 1120-S, Schedule K-1 but not on Form 1065, Schedule K-1.

Ownership Interest: _____%