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.04 Taxable Income Calculation

A. Federal Income Tax Conformity

1. General Provisions

South Carolina income tax laws conform substantially to the federal income tax laws. This conformity simplifies the filing of returns by adopting federal taxable income as a starting point for South Carolina income tax purposes. With some exceptions, South Carolina income tax liability is determined in accordance with the same set of statutes and rules used in determining federal income tax liability. Federal concepts of realization, recognition, and basis as well as federal principles of accounting are used, but differences may result from South Carolina modifications,¹ allocation, and apportionment² provisions. Subject to modifications, allocation, and apportionment, South Carolina gross income and taxable income of a business is the business's gross income and taxable income as determined under the Internal Revenue Code.³

Each year South Carolina's income tax laws are amended to conform to the Internal Revenue Code of 1986 as amended through the immediately preceding December 31st.⁴ The effective date provisions contained in the Internal Revenue Code are also adopted. Therefore, when the annual South Carolina conformity amendment becomes effective,⁵ Internal Revenue Code provisions that went into effect during the preceding year are retroactively adopted and considered to have the same effective date as they had for federal income tax purposes. In addition, if Congress amended the Internal Revenue Code during the preceding year with a provision that will be effective at a future date, South Carolina also adopts that change with the same future effective date.

Note: The annual conformity amendment may result in differences in federal and South Carolina law. Usually these differences are temporary. To avoid filing a return under current law and then amending it when the conformity amendment becomes effective, some taxpayers request an extension to file their returns.⁶

¹See SC Code Title 12, Chapter 6, Article 9.

²See SC Code Title 12, Chapter 6, Article 17. See discussion in Section .05 of this portfolio.

³SC Code §§12-6-580 and 12-6-1110.

⁴See SC Code §12-6-40. The 2004 legislative session was an exception to this rule. The annual conformity usually provided in SC Code §12-6-40 was provided for in a temporary proviso. Accordingly, South Carolina's income tax laws conform to the Internal Revenue Code of 1986, as amended through December 31, 2003, for calendar year 2004 income tax returns, subject to the exceptions listed in SC Code §12-6-50. See Section .01 B. of this portfolio for more information on South Carolina's conformity and exceptions.

⁵The amendment usually becomes effective in July.

⁶See Section .07 A. of this portfolio for a discussion of extensions to file a return.

Note: The Internal Revenue Code is deemed to contain all changes necessary for the State to administer its provisions. For example, “Secretary” or “Commissioner” used in the Internal Revenue Code are deemed to mean the Director of the Department, and “Internal Revenue Service” is deemed to mean the Department.⁷

2. Internal Revenue Code Sections Not Adopted

SC Code §12-6-50 provides that the following Internal Revenue Code sections are specifically not adopted by South Carolina:

1. Sections 1(a) through 1(e), 3, 11, and 1201 relating to federal tax rates;
2. Sections 22 through 53, 515, 853, 901 through 908, and 960 relating to tax credits;
3. Sections 55 through 59 relating to minimum taxes;
4. Sections 78, 86, 87, 196, and 280C relating to certain federal tax credits and the inclusion of social security and certain railroad retirement benefits in income;
5. Sections 72(m)(5)(B), 72(f), 72(o), 72(q), and 72(t), relating to penalty taxes on certain retirement plan distributions;
6. Section 168(k) relating to bonus depreciation;
7. Section 172(b)(1) relating to net operating loss carrybacks;
8. Sections 531 through 564 relating to certain special taxes on corporations;
9. Sections 581, 582, and 585 through 596 relating to the taxation of banking institutions;
10. Sections 665 through 668 relating to taxation of certain accumulation distributions from trusts;
11. Sections 801 through 845 relating to taxation of insurance companies;
12. Sections 861 through 908, 912, 931 through 940, and 944 through 989 relating to the taxation of foreign income;
13. Sections 1401 through 1494 relating to taxes on self employment income and withholding on non-United States persons;
14. Sections 1501 through 1505 relating to consolidated tax returns; and

⁷SC Code Ann. § 12-6-40(A)(2).

15. Except as provided below, sections 2001 through 7655, 7801 through 7871, and 8001 through 9602, generally related to taxes other than income taxes, procedural matters and criminal matters, and certain other purely federal matters. Internal Revenue Code §6015, innocent spouse relief from joint and several liability on joint returns, is specifically adopted. Sections 6654 and 6655, additions to tax for failure to pay estimated income taxes, are adopted with certain modifications provided in SC Code §12-6-3910. Internal Revenue Code §7518, Tax Incentives Relating to Merchant Marine Capital Construction Funds apply for South Carolina income tax purposes to any taxpayer for taxable years beginning after 1986.⁸

3. Elections, Tax Year, and Accounting Method

Elections made for federal income tax purposes in connection with Internal Revenue Code Sections adopted by South Carolina automatically apply for South Carolina income tax purposes.⁹ There is one exception to this rule. If a South Carolina corporation had a valid S election in effect for federal tax purposes before January 1, 1985, it may, at its option, continue to be taxed as a C corporation; *i.e.*, subject to the 5% corporate tax provided in SC Code §12-6-530, or it may elect South Carolina S corporation status.¹⁰

A taxpayer may not make an election solely for South Carolina income tax purposes, except for elections not applicable for federal purposes, *e.g.*, filing South Carolina’s version of a “consolidated” return or a composite return as provided in SC Code §§12-6-5020 and 12-6-5030, respectively.¹¹

A taxpayer’s South Carolina taxable year¹² and method of accounting¹³ must be the same as the taxpayer’s taxable year and method of accounting for federal income tax purposes.¹⁴

⁸SC Code §12-6-1120(9).

⁹SC Code §12-6-40(B).

¹⁰See SC Code 12-6-1210(F) and Section .03 C. 2. of this portfolio.

¹¹SC Code §12-6-40(B). See Section .07 B. of this portfolio for a discussion of “consolidated” and composite returns.

¹²If a taxpayer’s taxable year is changed for federal income tax purposes, then the taxable year for South Carolina income tax purposes is changed. The taxpayer must provide the Department with a copy of any permission to change received from the Internal Revenue Service. If a change in taxable year results in a taxable year of less than twelve months, South Carolina income tax must be computed in the manner provided in Internal Revenue Code §443(b) (Computation of Tax on Change of Annual Accounting Period). SC Code §12-6-4410.

¹³If a taxpayer’s method of accounting is changed for federal income tax purposes, the method of accounting for South Carolina income tax purposes is changed. The taxpayer must provide the Department with a copy of any written permission received from the Internal Revenue Service. When written permission is not required to change a method of accounting, the taxpayer must provide the Department with a copy of the election or statement provided to the Internal Revenue Service. Additional

Note: A taxpayer planning to cease doing business in this State by the incorporation of an existing business or, in the case of a corporate taxpayer other than a subsidiary corporation, by the dissolution or surrender of its charter, must make a complete accounting of all items of income and expense not previously taken into account because the accounting method used by the taxpayer did not require the reporting of the items. A corporate taxpayer must report all items of such income in its final return.¹⁵

B. Gross Income Modifications

South Carolina gross income of a business is the business's gross income as determined under the Internal Revenue Code¹⁶ subject to certain modifications,¹⁷ and allocation and apportionment.¹⁸

Modifications which must be made to a corporation's federal gross income to arrive at South Carolina gross income include:¹⁹

1. South Carolina taxable income does not include amounts excluded from federal income tax by reason of a treaty of the United States.²⁰
2. A business incorporated in a foreign country may elect to apportion only United States source income as determined for federal purposes on Form 1120F. No change in the election may be made without permission of the Department.²¹

South Carolina income or deductions which result from adjustments that are necessary because of a change in the method of accounting are included in or deducted from income as provided in the Internal Revenue Code. SC Code §12-6-4420.

¹⁴SC Code §§12-6-4410 and 12-6-4420, respectively.

¹⁵SC Reg. §117-670.

¹⁶SC Code §§12-6-580 and 12-6-1110.

¹⁷See SC Code Title 12, Chapter 6, Article 9.

¹⁸See SC Code Title 12, Chapter 6, Article 17. See discussion at Section .05 of this portfolio.

¹⁹There are additional modifications for individuals, estates, and trusts which are not discussed in this portfolio.

²⁰SC Code §12-6-1200.

²¹SC Code §12-6-2300.

3. The exclusion from gross income authorized by Internal Revenue Code §103 (Interest on State and Local Bonds) is modified to exempt only interest on obligations issued by South Carolina or any of its political subdivisions, and to exempt interest from obligations of the United States. This modification applies to all Internal Revenue Code Sections referencing §103.²² If only a portion of the funds of a regulated investment company is invested in obligations²³ producing tax exempt interest, the portion of dividends received which is attributable to those obligations is exempt for South Carolina income tax purposes. The fund need not be invested 50% or more in exempt obligations in order for the taxpayer to receive pass-through exempt treatment for the dividends received.²⁴
4. South Carolina gross income does not include any state income tax refund included in federal gross income.²⁵ This modification is consistent with the tax benefit rule since no deduction is permitted for state income taxes.²⁶
5. South Carolina gross income is determined without application of Internal Revenue Code §§78 (Gross-up of Dividends Received from Certain Foreign Corporations) and 87 (Alcohol Fuel Credit).²⁷
6. A beneficiary of a trust excludes from South Carolina income any excess distributions by trusts included in the beneficiary's federal taxable income by reason of Internal Revenue Code §§665 through 668 (throwback rules) or any comparable provisions.²⁸
7. A partner in the Palmetto Seed Capital Fund Limited Partnership²⁹ excludes 75% of the partner's proportionate share of income from South Carolina gross income the fund derives from a South Carolina business which is either:

²²SC Code §12-6-1120(1). See SC Rev. Rul. #91-15 for the rules used to determine if an obligation generates tax-exempt interest and a list of obligations which generate tax-exempt interest.

²³Generally obligations which generate tax exempt interest for South Carolina income tax purposes are those obligations which Congress has designated as nontaxable, obligations of the United States, and obligations of South Carolina and its political subdivisions to the extent they are nontaxable for federal income tax purposes. SC Rev. Rul. #91-15.

²⁴SC Rev. Rul. #91-15.

²⁵SC Code §12-6-1120(2).

²⁶SC Code §12-6-1130(2).

²⁷SC Code §12-6-1120(4).

²⁸SC Code §12-6-1120(6).

²⁹See SC Code §41-44-60. The Palmetto Seed Capital Fund Limited Partnership is a partnership formed pursuant to SC Code Title 41, Chapter 44. Its purpose is to raise funds to provide financing to businesses which are expected to experience significant sales growth over the next 5 years.

- a. Established and operated in a “least developed county;”³⁰ or
 - b. Invested in agriculture, aquaculture, or a related business or in a business created by a socially or economically disadvantaged individual as defined in 13 Code of Federal Regulations §§124.105(A) and 124.106.³¹
8. Internal Revenue Code §7518, Tax Incentives Relating to Merchant Marine Capital Construction Funds, applies to any taxpayer for taxable years beginning after 1986.³²

C. Taxable Income Modifications

Modifications which must be made to federal taxable income to arrive at South Carolina taxable income include:³³

1. The disallowance of deductions relating to tax exempt income required by Internal Revenue Code §265 applies if the related income is exempt for South Carolina income tax purposes, whether or not the income is exempt for federal purposes. If an expense or interest is disallowed under Internal Revenue Code §265 for federal purposes, but is related to income taxed in South Carolina, that expense or interest may be deducted for South Carolina income tax purposes.³⁴
2. The deduction for taxes permitted by Internal Revenue Code §164 is computed in the same manner as §164 except there is no deduction for state and local income taxes, or any other taxes measured by, or with respect to, net income.³⁵

³⁰See SC Code §12-6-3360 and Section .06 B. 2. d. in this portfolio for the method of determining least developed counties.

³¹SC Code §12-6-1120(8).

³²SC Code §12-6-1120(9).

³³There are additional modifications for individuals, estates, and trusts which are not discussed in this portfolio.

³⁴SC Code §12-6-1130(1).

³⁵SC Code §12-6-1130(2). This modification is limited for individual taxpayers to the excess of itemized deductions over the standard deduction that would be allowed if the taxpayer had used the standard deduction for federal income tax purposes.

SC Revenue Ruling #03-6 provides a summary of selected taxes which are allowed or disallowed as deductions under SC Code §12-6-1130(2) in arriving at South Carolina's taxable income, assuming they are allowed as a deduction under Internal Revenue Code §164. Below is the summary.

	Deduction Allowed (no add-back required)	Deduction Disallowed (add-back required)
1. State income-based taxes imposed by South Carolina	<input type="checkbox"/>	<input checked="" type="checkbox"/>
2. State income-based taxes imposed by other states	<input type="checkbox"/>	<input checked="" type="checkbox"/>
3. Local income-based taxes imposed by South Carolina local governments	<input type="checkbox"/>	<input checked="" type="checkbox"/>
4. Local income-based taxes imposed by out-of state local governments	<input type="checkbox"/>	<input checked="" type="checkbox"/>
5. Foreign taxes (other countries) Note: No response; it depends on facts not provided.	<input type="checkbox"/>	<input type="checkbox"/>
6. State franchise taxes based on capital stock or net worth	<input checked="" type="checkbox"/>	<input type="checkbox"/>
7. State gross receipts taxes	<input checked="" type="checkbox"/>	<input type="checkbox"/>
8. Indiana Gross Receipts Tax	<input checked="" type="checkbox"/>	<input type="checkbox"/>
9. Kentucky License Tax	<input checked="" type="checkbox"/>	<input type="checkbox"/>
10. Michigan Single Business Tax	<input checked="" type="checkbox"/>	<input type="checkbox"/>
11. New Hampshire Business Profits Tax	<input type="checkbox"/>	<input checked="" type="checkbox"/>
12. Ohio Franchise Tax - net worth portion	<input checked="" type="checkbox"/>	<input type="checkbox"/>
13. Ohio Franchise Tax - income-based portion	<input type="checkbox"/>	<input checked="" type="checkbox"/>
14. Texas Franchise Tax - net worth portion	<input checked="" type="checkbox"/>	<input type="checkbox"/>
15. Texas Franchise Tax - income-based portion	<input type="checkbox"/>	<input checked="" type="checkbox"/>
16. Washington Business and Occupation Tax	<input checked="" type="checkbox"/>	<input type="checkbox"/>
17. West Virginia Business and Occupation Tax	<input checked="" type="checkbox"/>	<input type="checkbox"/>

3. For purposes of computing the deduction for estate taxes allowed by Internal Revenue Code §691(c), "estate tax" means the South Carolina estate tax including any South Carolina generation-skipping transfer tax.³⁶

³⁶SC Code §12-6-1130(3).

4. A net operating loss (NOL) deduction is computed in accordance with the Internal Revenue Code except that:
 - a. All items of income and deductions used in computing the NOL deduction are subject to modification.³⁷
 - b. No carrybacks are allowed. A federal election to carryback an NOL deduction does not affect the computation of this deduction for South Carolina income tax purposes.
 - c. An NOL is subject to allocation and apportionment under SC Code Article 17 of Chapter 6 of Title 12 in the year the loss is incurred.³⁸

Note: A federal NOL is never automatically used for South Carolina income tax purposes. The South Carolina NOL is computed for each applicable year. The federal loss is modified by any applicable South Carolina adjustments.³⁹

Note on NOL limitations: South Carolina has adopted §§269, 381, and 382 of the Internal Revenue Code.⁴⁰ In the context of NOLs, §269 limits certain NOL deductions obtained through the acquisition of stock or property where the taxpayer's principal purpose was tax avoidance. Sections 381 and 382 limit the use of NOL carryovers where there has been a substantial change in the corporation's ownership. South Carolina has not, however, adopted the Internal Revenue Code consolidated return sections or regulations.⁴¹ Therefore the "separate return limitation year" or "SRLY" rules and the rules with respect to the application of Internal Revenue Code §382 to consolidated groups do not apply to limit NOL deductions.⁴²

³⁷See the discussion in this Section of this portfolio and SC Code Title 12, Chapter 6, Article 9.

³⁸SC Code §12-6-1130(4). See Section .05 of this portfolio.

³⁹See ¶7.12[1][b] of Hellerstein & Hellerstein, *State Taxation* (3rd ed. 2000) which refers to this method of calculating the state NOL as "manner conformity."

⁴⁰SC Code §§12-6-40 and 12-6-50.

⁴¹Internal Revenue Code §§1501 through 1505 and the regulations thereunder. See SC Code §12-6-50(13).

⁴²Treas. Reg. §1.1502-21 and 1.1502-90 through 1.1502-99.

In an Administrative Law Court decision,⁴³ where the facts made the Tax Reform Act of 1986 amendments to §382 inapplicable, the Judge determined that §382 did not apply, but that the anti-abuse cases which preceded §§381 and 382, *Libson Shops*⁴⁴ and *Woolford Realty*,⁴⁵ applied to deny the use of the NOLs.

Comment: In the authors' view South Carolina follows the conclusion that *Libson Shops* and other similar cases have no application where §§381 and 382 apply to limit the use of the NOL.⁴⁶ If §§381 and 382 do not limit the use of the NOL, the authors' believe that, consistent with the Administrative Law Court decision, *Libson Shops*, etc., apply, but should only be applied in a situation which could be seen as an abuse, and that is most likely when it is a case, where under the Internal Revenue Code, the SRLY rules would apply.

A loss incurred during a separate return year by a member of a group that would meet the South Carolina requirements to file a consolidated return⁴⁷ during the separate return loss year, may, if the group elects to file consolidated returns in a future year, be used as an NOL to offset the income of other consolidated members.⁴⁸

5. A corporation may not carry back a net capital loss as permitted by Internal Revenue Code §1212(a). A net capital loss may be carried forward to future years to the extent provided in Internal Revenue Code §1212(a).⁴⁹
6. In computing the depletion deduction pursuant to Internal Revenue Code §§611 through 613, a taxpayer that allocates or apportions income under the provisions of SC Code Article 17 of Chapter 6 of Title 12 has the option of:
 - a. Apportioning the deduction according to the appropriate South Carolina apportionment percentage provided in SC Code §§12-6-2250 through 12-6-2310;⁵⁰ or

⁴³*Anonymous v. SC Dept. of Revenue*, Docket No. 95-ALJ-17-0228-CC (January 17, 1996).

⁴⁴*Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957).

⁴⁵*Woolford Realty Co., Inc. v. Rose*, 286 U.S. 319 (1932).

⁴⁶This is the "more widely accepted" view; see ¶14.46[2] Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* (7th ed. 2000).

⁴⁷See Section .07 B. of this portfolio. In South Carolina the taxable income and loss of each corporation is determined separately and then combined.

⁴⁸SC Tech. Adv. Memo. #89-22.

⁴⁹SC Code §12-6-1130(5).

⁵⁰See Section .05 E. of this portfolio.

- b. Allocating the deduction to South Carolina with respect to mines, oil and gas wells, and other natural deposits located in this State. The amount allocated to South Carolina may not exceed 50% of the net income apportioned to South Carolina by SC Code §§12-6-2250 through 12-6-2310.⁵¹
7. The provisions of Internal Revenue Code §280C limiting the deduction of certain expenses for which federal credits are allowable do not apply.⁵²
8. Taxable income is computed without the deductions for certain unused business credits authorized by Internal Revenue Code §196.⁵³
9. If, for federal income tax purposes, a taxpayer claims a credit which requires a reduction of basis to §38 property under Internal Revenue Code §50(c), the taxpayer may deduct the amount of the basis reduction for South Carolina income tax purposes by the amount of the basis reduction in the tax year in which basis is reduced for federal income tax purposes.⁵⁴
10. A dividend from a foreign corporation is treated as a dividend from a domestic corporation for the purposes of the dividends received deduction under Internal Revenue Code §243.⁵⁵

D. Modifications Initiated by the Department or Taxpayer

1. Internal Revenue Code §§482 and 7872

South Carolina has adopted Internal Revenue Code §482, allowing the allocation of income, deductions, and credits among taxpayers under common control in order to clearly reflect income, and Internal Revenue Code §7872 imputing interest payments on certain below-market interest rate loans.

The Department has not used Internal Revenue Code §482 often. Although §482 has been used in audits, the only reported decision in the last ten years to consider it⁵⁶ ultimately relied upon Internal Revenue Code §7872.

⁵¹SC Code §12-6-1130(6).

⁵²SC Code §12-6-1130(7).

⁵³SC Code §12-6-1130(8).

⁵⁴SC Code §12-6-1130(9).

⁵⁵SC Code §12-6-1130(11).

⁵⁶Commission Decision #94-44 (1994).

Note: It has been argued that states that have adopted Internal Revenue Code §482 do not have discretionary authority to use it because §482 grants that discretion to the Secretary of the Treasury.⁵⁷ South Carolina law, however, provides that for South Carolina income tax purposes, “Secretary,” as used in the Internal Revenue Code, is deemed to mean the Director of the Department.⁵⁸

The audit involved parent and subsidiary corporations. The parent was an active management company that provided services to all of its subsidiaries. The parent did not file income tax returns with South Carolina and the Department did not attempt to assert nexus over it. The taxpayer was a subsidiary corporation engaged in the business of manufacturing and distributing products throughout the United States. The subsidiary conducted business in South Carolina and filed income tax returns with South Carolina.

The parent performed the majority of cash management functions for its subsidiaries. The cash management system was composed of centralized collections and disbursements, centralized financing, and centralized administration and accounting responsibility. On a daily basis, cash was transferred from the taxpayer’s depository account to the parent’s depository account. The funds that were transferred by the taxpayer to the parent were generated by the taxpayer in the course of its manufacturing operations. On the taxpayer’s pro forma federal income tax returns, the taxpayer listed these intercompany transfers of cash as an asset called “Due from Affiliates.” On the parent’s federal income tax returns, the amount was recorded as a liability called “Payable to Subsidiaries.” The “Due from Affiliates” and “Payable to Subsidiaries” accounts fluctuated as cash was distributed by the taxpayer to the parent and returned by the parent to the taxpayer to meet the taxpayer’s day-to-day needs, including equipment purchases, utilities, payroll, and other ordinary expenses. The taxpayer paid one dividend to the parent in 1990. No other distributions from earnings and profits were recorded on the taxpayer’s returns for the three year audit period.

The first issue was whether the transfers of money from the taxpayer to the parent should be characterized as loans or constructive dividends. If the transfers were characterized as loans, the second issue was whether interest should be imputed on those loans.⁵⁹ The Commission held that the transfers from the taxpayer to the parent were loans, not constructive dividends.

The Commission first reasoned that South Carolina recognized even related corporations as distinct entities and taxpayers. Therefore, when the taxpayer transferred funds to its parent, the transaction must be recorded in a manner for accounting and tax purposes which would be appropriate if the taxpayer were dealing with an independent third party. In this case either as a loan or a dividend.

⁵⁷See *e.g.*, *Comptroller of the Treasury v. Gannett Co., Inc.*, 356 Md. 699, 741 A.2d 1130 (1999).

⁵⁸SC Code Ann. § 12-6-40(A)(2).

⁵⁹The third issue was whether that interest should be apportioned in part to South Carolina or allocated to the taxpayer's principal place of business. That issue is discussed at Section .05 F. 4. b. of this portfolio. This case also involved safe harbor leases and that issue is discussed at Section .05 F. 4. c. of this portfolio.

Relying on opinions from the U.S. Tax Court and other states, the Commission reasoned that taxpayers were entitled to attack the form of their transactions only when their tax reporting and other actions had shown an honest and consistent respect for what they argue is the substance of the transactions. It then found that the taxpayer's books and records supported the characterization of the transactions as loans.

The Commission next considered whether interest should have been imputed on the loans. The Commission held that Internal Revenue Code §§482 and 7872 both provide authority to impute interest on loans between related parties which bear no interest or a below-market interest rate. Relying on Treasury Prop. Reg. 1.7872-2(a)(2)(iii) and Bittker & Eustice,⁶⁰ it found that loans between parent-subsidary corporations on interest terms below a prescribed rate are considered covered by Internal Revenue Code §7872 rather than Internal Revenue Code §482.

Finally the Commission held that the imputed interest income should be apportioned and not allocated to the commercial domicile of the subsidiary.⁶¹

2. Allocation and Apportionment and Matching

There are four provisions which may result in apportionment formulas tailored to a particular corporation. The first, which may be initiated by the taxpayer or the Department, is used if the regular allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in South Carolina.⁶² The other three are economic development incentives which may be initiated by the taxpayer.⁶³

Expenses incurred in earning allocable income are matched and offset against the income they generated. They are not available for use against apportionable income. Income generated by prior apportioned deductions, *e.g.*, depreciation recapture, will generally be apportioned.⁶⁴

E. 1985 Transition Provisions

In 1985, South Carolina substantially conformed its income tax laws with the Internal Revenue Code. This process involved a number of provisions to make the transition smoother

⁶⁰*Federal Income Taxation of Corporations and Shareholders*, ¶ 15.04 (3d Ed. 1971).

⁶¹See Section .05 F. 4. b. of this portfolio.

⁶²SC Code §12-6-2320(A). See Section .05 E. 6. a. in this portfolio.

⁶³SC Code §§12-6-2320(B) and (C) and 12-15-40. See Section .05 E. 6. b. c, and d. in this portfolio.

⁶⁴See the cases discussed below in Section .05 D. of this portfolio, especially the Hercules case discussed in Section .05 D. 4.

and to answer questions about items that had tax consequences beginning prior to, and ending after, South Carolina conformity.⁶⁵

The transition rules include:

1. A taxpayer amortizing a capital expense prior to 1985 was, beginning with 1985, allowed to deduct for South Carolina income tax purposes the amount amortized and deducted for federal income tax purposes. At the expiration of the amortization for federal income tax purposes, the taxpayer may continue to amortize, for South Carolina income tax purposes, the balance of the capital expense, if any, using the same rate of amortization until the cost of the item has been fully amortized.⁶⁶
2. A taxpayer depreciating the cost of personal property or improvements to real estate placed in service before 1985, is allowed for South Carolina income tax purposes the same annual deduction as allowed for federal tax purposes. Beginning with the year following the expiration of the deductions for federal tax purposes, the balance of the deductible cost, if any, may be deducted at the rate of 50% a year for personal property and 20% a year for real property improvements, until the entire deductible cost has been deducted for South Carolina income tax purposes. The deduction may not exceed the taxpayer's depreciable basis.⁶⁷ But, if a taxpayer has a higher basis in assets for South Carolina income tax purposes, the taxpayer may continue to depreciate the assets, to the extent depreciable, in the manner in which the assets were being depreciated before 1985, if the higher basis is the result of (a) a taxable corporate liquidation, or (b) a like-kind exchange of property that qualified for deferral of gain for federal, but not South Carolina, income tax purposes.⁶⁸
3. A taxpayer reporting income from a corporate liquidation distribution under Internal Revenue Code §337 using the installment method of reporting or from an installment sale under Internal Revenue Code §453, who has previously reported all the gain for South Carolina income tax purposes must reduce his South Carolina taxable income by the amount of the installment gain. If prior to 1985, a taxpayer elected installment sale reporting for South Carolina purposes and not federal purposes, the taxpayer continues to report gain on his South Carolina tax return in addition to income otherwise taxable.⁶⁹

⁶⁵SC Code §12-6-1210. See *South Carolina Income Taxation* by F. Ladson Boyle and John von Lehe (3rd ed. 1987), for a discussion of the changes necessary for South Carolina to adopt the Internal Revenue Code.

⁶⁶SC Code §12-6-1210(A).

⁶⁷SC Code §12-6-1210(B).

⁶⁸SC Code §12-6-1210(C).

⁶⁹SC Code §12-6-1210(D).

4. If a South Carolina taxpayer had a valid S election in effect for federal tax purposes before 1985, but has not elected that treatment for South Carolina income tax purposes, the taxpayer may at its option continue to be subject to the corporate income tax provided in SC Code §12-6-530 or the taxpayer may affirmatively elect South Carolina S corporation status.⁷⁰

Comment: It is the Department's longstanding position that a foreign corporation with a valid federal S election that first comes into South Carolina on or after January 1, 1985 must file as an S corporation. An S election made on or after January 1, 1985 automatically applies for South Carolina.

5. A taxpayer receiving an annuity before January 1, 1985, that is subject to tax pursuant to Internal Revenue Code §72 must continue to report income from the annuity in the manner provided in SC Code §12-7-560(2) in effect on December 31, 1984.⁷¹ Under this method, payments that represent return of premiums are excluded from income. This section allowed the annuitant to recover his entire cost basis in the contract before reporting any income.⁷²
6. If a taxpayer is subject to the provisions of Internal Revenue Code §§483 (Interest on Certain Deferred Payments) or 1271 through 1288 (Special Rules for Bonds and Other Debt Instruments) as a result of a contract entered into before 1985, then no recomputation of principal and income is required.⁷³
7. For a taxable year beginning after 1984, to the extent gross income or taxable income of any taxpayer is affected by a provision of federal law enacted before 1985, which provision is not contained in the Internal Revenue Code, the provision is applicable in determining the South Carolina gross and taxable income of the taxpayer in the appropriate taxable year.⁷⁴

⁷⁰SC Code §12-6-1210(F). See Section .03 C. 2. of this portfolio for a discussion of making an S election.

⁷¹SC Code §12-6-1210(K).

⁷²See *A Comparison between Internal Revenue Code 1954 and South Carolina Code 1976* published by the SC Tax Commission.

⁷³SC Code §12-6-1210(L).

⁷⁴SC Code §12-6-1210(M).