

## Illinois's March to a Graduated Income Tax

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In the inaugural installment of *Prairie State Perspectives*, Heyman and Silverman summarize Illinois Gov. J.B. Pritzker's graduated income tax proposal and discuss potential criticisms that it could face before its placement on the November 2020 ballot.

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### Introduction

Welcome to the first installment of *Prairie State Perspectives*, a quarterly column that will examine various tax issues in Illinois. The state's tax system is unique in many ways, and the state is dealing with unprecedented fiscal challenges. Addressing those challenges will likely require fundamental changes in the way the state and local governments operate — both in the way they raise revenue and in the way they spend it. In this first column, we summarize and analyze the recent graduated income tax proposal of Gov. J.B. Pritzker (D). In doing so, we will review the process for amending the Illinois Constitution, explore the history of the flat tax embedded in the constitution since 1970, and consider some of the challenges and criticisms the proposal will face leading up to November 2020, when the required amendment is expected to be on the ballot for voters to consider.

### The Governor's Plan

After pushing a graduated income tax on the campaign trail, Pritzker unveiled his tax plan on March 7.<sup>1</sup> The plan involves raising marginal income tax rates to 7.75 percent for those earning \$250,000 per year or more and ranging up to 7.95 percent for those earning \$1 million per year or more, maintaining the 4.95 percent rate for those in the \$100,000 to \$250,000 bracket, and reducing rates slightly below 4.95 percent for those making under \$100,000.<sup>2</sup> Unusually, the plan's rate of 7.95 percent for the top bracket would apply to the entirety of any such taxpayer's income, not only to the amount earned over the \$1 million threshold.<sup>3</sup>

<sup>1</sup> Office of Gov. J.B. Pritzker, "Fair Tax for Illinois" (2019).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

Together with the 1.5 percent personal property replacement tax (PPRT) on passthrough entities, this would result in a top rate on passthrough income of 9.45 percent.

The plan would also raise the state corporate income tax rate by just under a percentage point, from 7 percent to 7.95 percent.<sup>4</sup> When combined with the 2.5 percent PPRT on corporations, this would raise the total corporate tax rate to 10.45 percent, making it the third highest in the nation.<sup>5</sup> Since the Illinois Constitution mandates a “non-graduated rate” of tax,<sup>6</sup> the plan will require a constitutional amendment (which must be approved by the voters) to be enacted.

The combination of these proposed tax increases is intended to raise roughly \$3.4 billion that could be put toward Illinois’s budget deficit and drastically underfunded state pensions, though there is no explicit requirement in the proposal that the increase in revenue be spent on reducing pension liabilities,<sup>7</sup> and only \$200 million of it is slated for this purpose.<sup>8</sup> The state carries \$15 billion in debt associated with unpaid bills, with late interest penalties exceeding \$1.25 billion, and a whopping \$133.5 billion gap in funding for state employee and retiree pensions.<sup>9</sup>

In addition to its revenue-raising provisions, Pritzker’s plan would allow a \$100 child tax credit for those under specific income limits, as well as a 20 percent increase in the property tax credit (subject to the income limit of \$500,000 for couples filing jointly, which would remain in force).<sup>10</sup> Both measures are intended to further the goal of providing tax relief for those in the lower-tier

brackets while requiring larger contributions from higher earners.

### Comparison of Proposed Graduated Rates to Other States

Illinois’s roughly 38,000 millionaires will bear the brunt of Pritzker’s tax plan, with a 7.95 percent rate applied to their entire income, which would put their tax burden generally in line with or above that of their peers in the other 33 states that have already implemented a graduated income tax — and that’s before taking into account the additional 1.5 percent PPRT on passthrough income.<sup>11</sup> By way of comparison, the neighboring states of Wisconsin and Iowa have top rates of 7.65 percent and 8.53 percent, respectively.<sup>12</sup> New York taxes all income above \$1,077,550 at 8.82 percent, and California, not to be outdone, carries a marginal rate of 13.3 percent for the gilded class.<sup>13</sup> Those states, unlike Illinois, also allow many or most of the deductions from adjusted gross income allowable in computing federal taxable income; Illinois, in contrast, taxes AGI. Thus, looking at the proposed rates alone understates the total tax impact in Illinois compared with most other states. But ultimately, it is states like Indiana, with a 3.23 percent flat income tax rate, or even those with no income tax at all, such as Texas and Florida, that will look most attractive to mobile high earners and that Pritzker should be worried about if Illinois is to retain the portion of its tax base on which his plan so heavily relies.

### How We Got to Now

Fundamentally, it is the well-publicized pension crisis that is driving the urgent need for a way to satisfy the state’s revenue gap, whether in the form of Pritzker’s plan or through some other alternative. So how did the land of Lincoln end up with a \$100 billion albatross around its neck? There is no one party to blame — a pension crisis of this size requires the participation of a long line of statesmen from both parties over multiple decades.

<sup>4</sup> *Id.*

<sup>5</sup> Janelle Cammenga, “State Corporate Income Tax Rates and Brackets for 2019,” Tax Foundation (Feb. 27, 2019).

<sup>6</sup> Ill. Const. Art. IX, section 3(a).

<sup>7</sup> See “Fair Tax for Illinois,” *supra* note 1.

<sup>8</sup> Office of Gov. J.B. Pritzker, “Illinois State Budget: Fiscal Year 2020” (2019).

<sup>9</sup> Commission on Government Forecasting and Accountability, “Monthly Briefing for the Month Ended: November 2018” (2018). Apart from this tremendous funding gap carried by the state, the Chicago pension funds carry unfunded liabilities of \$41.8 billion (fiscal 2017), and the downstate fire and police pension funds carry \$9.9 billion (fiscal 2016). Commission on Government Forecasting and Accountability, “A Report on the Financial Condition of the Illinois Municipal, Chicago and Cook County Pension Funds of Illinois” (2019); and “Fiscal Analysis of the Downstate Police & Downstate Fire Pension Funds in Illinois” (2017).

<sup>10</sup> See “Fair Tax for Illinois,” *supra* note 1.

<sup>11</sup> Ben Winck, “How the Proposed Tax on Illinois Millionaires Compares to Other States,” *Crain’s Chicago Business*, Mar. 8, 2019.

<sup>12</sup> Wis. Stat. section 71.06; and Iowa Code section 422.5A.

<sup>13</sup> N.Y. Tax Law section 601; Cal. Const. Art. XIII, section 36(f)(2)-(3); and Cal. Rev. & Tax. Code section 17043.

The Commission on Government Forecasting and Accountability concluded that the single largest factor in the pension shortfall was inadequate contributions by the state, with \$41.2 billion in underpayments between 1985 and 2012.<sup>14</sup> The first major step toward the abyss can be traced back to 1994, when then-Gov. Jim Edgar implemented the idea of allowing lower state contributions to the pension fund for the first 15 years after its implementation, with larger contributions in later years (the so-called Ramp) in order to ultimately get to 90 percent funding by 2045. Under the plan, Illinois contributed just \$614 million in 1996 (equivalent to roughly 2 percent of the general funds budget at the time), and by 2017 it was slated to add \$7.6 billion (roughly a quarter of the general funds budget at that point in time).<sup>15</sup> But in 2002 then-Gov. George Ryan and Speaker Michael Madigan backed a plan to let workers retire early in an attempt to reduce an overburdened state payroll. The resulting cost to the pension system ended up at \$2.3 billion — quadruple what was originally estimated.<sup>16</sup> Just a few years later in 2006 and 2007, this time under the administration of Rod Blagojevich, the governor signed off on a deal that allowed the state to sidestep half its pension obligations for the two years.<sup>17</sup> Finally, the two major recessions that roiled the global economy and bookended the aughts — the bursting of the dot-com bubble and the subprime mortgage crisis — clobbered the state's investments, with an estimated \$15.9 billion in investment losses suffered by the pension fund between the two downturns.<sup>18</sup>

### Constitutional Impediment

Article IX, section 3 of the Illinois Constitution provides that “[a] tax on or measured by income shall be at a non-graduated rate.”<sup>19</sup> Consequently, implementation of Pritzker's plan would require

amending the constitution to remove this limitation on the state's taxing power. The earliest a progressive tax could be implemented would be 2021.

Amending the constitution requires that each house of the Illinois General Assembly approve the proposed amendment by a three-fifths vote at least six months before a general election.<sup>20</sup> The next general election is in November 2020. In that election, the amendment would be placed on the ballot as a referendum. At least 60 percent of those voting on the amendment or 50 percent of those voting in the election in general must vote for the amendment in order for it to become effective.<sup>21</sup> Democrats control the requisite three-fifths of the votes in each house,<sup>22</sup> and therefore an amendment is widely expected to garner the requisite supermajorities in the General Assembly<sup>23</sup> (although it should be noted that a similar constitutional amendment failed by three votes when it was put to a vote in both 2015<sup>24</sup> and 2016,<sup>25</sup> when several Democrats broke ranks and voted against the amendment).

Early polling of the electorate is inconclusive.<sup>26</sup> In any case, it is clear that both sides of the aisle are gearing up for a protracted fight, with millions of dollars pouring into Think Big Illinois and the Coalition for Jobs, Growth and Prosperity, the respective 501(c)(4) organizations of the proponents and opponents of Pritzker's plan.<sup>27</sup>

### Genesis of the Graduated Income Tax — The Sixth Illinois Constitutional Convention

The procedures for amending the Illinois Constitution are simple enough, but the question

<sup>20</sup> Ill. Const. Art. XIV, section 2(a).

<sup>21</sup> Ill. Const. Art. XIV, section 2(b).

<sup>22</sup> See “Current House Members,” Illinois General Assembly; and “Current Senate Members,” Illinois General Assembly.

<sup>23</sup> Senate Joint Resolution 1, proposing to amend the Illinois Constitution to permit a graduated income tax, has already been introduced and sponsored by Assistant Majority Leader Don Harmon (D) as of the date of this article. S.J. Res. 1, 101st Gen. Assemb. (Ill. 2019).

<sup>24</sup> Monique Garcia and Kim Geiger, “Madigan's ‘Millionaire Tax’ Question Fails in House,” *Chicago Tribune*, May 21, 2015.

<sup>25</sup> Tina Sfondeles, “Déjà Vote: Madigan Millionaire Tax Fails Once Again,” *Chicago Sun-Times*, Apr. 21, 2016.

<sup>26</sup> Rich Miller, “Poll: Graduated Income Tax Might Be a Squeaker,” *Capitol Fax*, Mar. 18, 2019.

<sup>27</sup> Miller, “Dark Money-Funded Groups Plan Fight Over Illinois Progressive Income Tax,” *Chicago Sun-Times*, Feb. 8, 2019.

<sup>14</sup> Commission on Government Forecasting and Accountability, “Analysis of Change in State Pension Unfunded Liability — 1985 Through 2012.”

<sup>15</sup> Dave McKinney, “The Illinois Pension Disaster: What Went Wrong?” *Crain's Chicago Business*, Aug. 10, 2015.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> Commission on Government Forecasting and Accountability, “Briefing on Causes of State Pension Unfunded Liability” (2013).

<sup>19</sup> Ill. Const. Art. IX, section 3(a).

whether the removal of the flat tax requirement is prudent in the first place is another one entirely. The Illinois Constitution of 1970 was drafted and debated during the Sixth Illinois Constitutional Convention, which lasted from December 8, 1969, to September 3, 1970. The delegates to the convention proposed a wide range of income tax provisions, including ones calling for a graduated tax,<sup>28</sup> a flat tax with a maximum rate,<sup>29</sup> and a tax with no specifications at all.<sup>30</sup> The last option was discussed at length, with proponents arguing that restricting the legislature to a specific tax policy did not have a logical place in a constitutional document.<sup>31</sup> As a visiting speaker to the convention, U.S. Sen. Ralph Smith advised the delegates that a revenue article “is one of the areas in which detail would be hurtful rather than helpful in providing an equitable overall revenue structure in the state of Illinois.”<sup>32</sup> The proponents of the nonspecific option also believed that granting the legislature the flexibility to implement a graduated income tax would allow the state to decrease any reliance on property and sales taxes if it so chose.<sup>33</sup>

The arguments for the provision that ultimately ended up in the ratified constitution centered on a desire to avoid the perceived failings of the progressive federal income tax. Critics of graduated rates feared that high marginal rates imposed on those in the top brackets would create strong incentives to lobby for loopholes and carveouts that would push down the real tax burden to those in the middle.<sup>34</sup> Delegate Wendell Durr expressed this sentiment in the strongest possible terms, stating that “a graduated tax is absolutely the worst thing that you can visit on the taxpayers of this state, particularly those in the lower to middle brackets

up to perhaps \$25,000 or \$30,000, because the absolutely unavoidable effect of graduated rates is to grant the inducement and the equitable strength of position to create the loopholes that benefit no one but the \$153,000 to \$208,000 people.”<sup>35</sup> While the top rates under the Pritzker plan are an order of magnitude away from the highest federal rates at the time of the Sixth Constitutional Convention, the delegates’ arguments continue to be anticipated by opponents of graduated income taxes.

### The Civic Committee Plan

The plan is not the only major state tax reform proposal to come out this year. On February 5 the Civic Committee of the Commercial Club of Chicago issued its Restore Illinois plan, which called for a combination of tax hikes and spending cuts that would put the state on track to pay off its more than \$130 billion in pension debt.<sup>36</sup> Instead of graduated rates, the plan sticks to the constitutionally mandated flat rate structure already in place, in no small part because of a strong belief that the state does not have the luxury of waiting until the constitutional amendment process takes its course before a graduated tax can be implemented in 2021.<sup>37</sup>

Under the civic committee’s plan, personal and corporate income tax rates would each be increased by 1 percentage point across the board to raise a combined \$4 billion.<sup>38</sup> Expanding the tax base to include retirement income and increasing the 65 and over exemption from \$1,000 to \$15,000 would yield an additional \$1.9 billion while protecting low-income retirees.<sup>39</sup> The plan would also widen the sales tax base to include some consumer services, which is estimated to generate an additional \$500 million.<sup>40</sup> Finally, the committee would cut \$1 billion from general

<sup>28</sup> E.g., Sixth Illinois Constitutional Convention, “Record of Proceedings,” at 50, 116, 120 (1970) (including proposals to fund education entirely through a graduated income tax and to remove local property taxes as a source of funding for that purpose).

<sup>29</sup> E.g., *id.* at 51, 124.

<sup>30</sup> E.g., *id.* at 1881-83 (discussing Minority Proposal 2B).

<sup>31</sup> *Id.* at 1881.

<sup>32</sup> *Id.* at 388.

<sup>33</sup> *Id.* at 1881-82.

<sup>34</sup> Similar criticisms against progressive taxation have been levied in the most recent decades as well. See “The Case for Flat Taxes,” *The Economist*, Apr. 14, 2005.

<sup>35</sup> “Record of Proceedings,” *supra* note 28, at 1877.

<sup>36</sup> Civic Committee of the Commercial Club of Chicago, “Restore Illinois: A Foundation for Growth” (2019). In the interest of full disclosure, the authors note that their partner, Larry Barden, is a member of the Civic Committee and served on the Tax Reform Tax Force that issued the report.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* Illinois is one of the few states to exempt retirement income.

<sup>40</sup> *Id.*

spending and \$1 billion in health insurance benefits to state workers and retirees, putting the state's health insurance plans more in line with what is offered in the private sector.<sup>41</sup> All of the above would free up \$2 billion per year to be contributed to closing the pension funding gap, which would result in a 93 percent funding level by 2045, thereby saving the state \$46 billion in interest costs in the intervening years.<sup>42</sup>

### Arguments Expected From Proponents

Supporters of Pritzker's proposal emphasize arguments centered on fairness and equity. For example, an analysis of Department of Revenue data by Robert Bruno, director, Labor Education Program, Project for Middle Class Renewal, University of Illinois Urbana-Champaign; and Frank Manzo, policy director, Illinois Economic Policy Institute, alleges that a progressive income tax could accomplish five potential policy goals: Illinois could cut income taxes for at least two-thirds of taxpayers; Illinois could cut residential property taxes by about 10 percent; Illinois could protect small businesses; Illinois could balance the budget and restore investor confidence; and Illinois could grow the economy by increasing investments and boosting consumer demand.<sup>43</sup> The authors conclude that moving to a graduated-rate structure could make the state's tax code fairer, cut income taxes for working-class and middle-income families, provide opportunities for property tax relief, help balance the budget, and provide revenue to fund essential public services that contribute to the growth of the Illinois economy.<sup>44</sup>

Similarly, the Center for Tax and Budget Accountability, a leading proponent of the graduated income tax, alleges that the top 10 percent of U.S. families captured all the growth in real family income between 1979 and 2015, and the bottom 90 percent experienced a decline in real income during the same period. Thus, a progressive system of taxation would distribute

tax burdens proportionately with the economic benefits received across the income spectrum and would better match taxpayers' ability to pay.<sup>45</sup> When combined with other state and local taxes, the center alleges, Illinois taxpayers actually share the tax burden regressively — the bottom 20 percent pay an effective combined tax rate of 13.2 percent on their income (the second highest in the nation for this income segment), and the top 1 percent end up with an effective combined rate of 4.6 percent (34th highest in the nation for this income segment).<sup>46</sup> When compared with its peers, Illinois is amongst only seven other states in the country imposing a flat tax on its residents.<sup>47</sup>

From a pragmatic perspective, proponents of Pritzker's plan are likely to point to a progressive tax's alleged benefits for supporting the local economy and raising revenue. Since low- and middle-income taxpayers spend a higher percentage of their income on consumer goods and services and tend to do so locally, the argument has been made that reducing the relative tax burden on this part of the income spectrum will help spur local economic growth through increased consumer spending.<sup>48</sup> Progressive taxation proponents also argue that the current tax system is structurally predisposed to suffer from revenue deficits in this economic environment because a flat tax fails to increase revenues in line with economic growth when such growth is disproportionately captured by the top income brackets.<sup>49</sup> Regarding the concern for the out-migration of high earners from the state, those in favor of progressive taxation have previously cited research showing a lack of a statistically significant relationship between an increase in top income tax rates and the probability of taxpayers subject to those rates moving out of state.<sup>50</sup>

<sup>45</sup> Center for Tax and Budget Accountability, "Cutting Taxes for the Middle Class and Shrinking the Deficit: Moving to a Graduated State Income Tax in Illinois" (2018).

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> Center for Tax and Budget Accountability, "The Millionaire Migration Myth: Why a Fair, Graduated Rate Income Tax Won't Drive Away Millionaires" (2014).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Robert Bruno and Frank Manzo IV, "The Impact of Enacting a Progressive Income Tax in Illinois," at i (2019).

<sup>44</sup> *Id.*

### Arguments Expected From Opponents

One criticism that is anticipated to be made against Pritzker's plan is that it does not require the proposed tax increase to be used to pay down the state's pension liability. The governor has dedicated only \$200 million of the \$3.4 billion that the tax plan intends to raise to paying down pensions,<sup>51</sup> despite the pension crisis being the supposed impetus for the tax increase in the first place. A similar scenario played out when the Illinois income tax rate was temporarily increased from 3 percent to 5 percent for tax years 2011 through 2014 with the ostensible purpose of paying down pension debt; little was used for that purpose.<sup>52</sup> When the rates reverted to 3.75 percent in 2015, the pension situation remained critically underfunded to much the same degree as it had been before the tax hike.<sup>53</sup>

Also, the Civic Federation, a nonpartisan research organization, has pointed out some flaws in the governor's revenue estimates.<sup>54</sup> The plan relies on a sustained growth in the total income of top-bracket earners that will match the growth seen between 2011 and 2016 (though the governor's office does assume that 10 percent of those in the \$1 million to \$2 million income bracket will drop down to below \$1 million in earnings in response to the tax increase).<sup>55</sup> Because the governor's tax plan depends so heavily on revenue from these top brackets, the Civic Federation deems this approach particularly problematic, not only because of its excessive optimism regarding income growth, but also because it fails to account for the high volatility seen in top incomes due to their strong correlation with market fluctuations as a whole (because of a disproportionate amount of income derived from investment income and capital gains).<sup>56</sup>

Finally, raising rates to nearly 9.5 percent on the top bracket (when factoring in the PPRT) could accelerate the departure of high-income individuals from the state, and New Jersey's experience suggests that if even a few of the highest earners leave, the increased revenue from the higher rates could be ephemeral.<sup>57</sup>

### Closing Thoughts

Because Pritzker proposed his tax plan so far in advance of its potential approval and implementation, the citizens of the Prairie State will have ample time to analyze, debate, and, hopefully, come to some degree of consensus over the advisability of the plan. We hope that this article has been helpful to that end. But regardless of the ultimate fate of Pritzker's plan, one thing is for certain — one way or another, this state must resolve its pension funding crisis, or else risk being gradually but inexorably crushed under its weight. ■

<sup>51</sup> "Illinois State Budget," *supra* note 8.

<sup>52</sup> See Benjamin VanMetre, "Illinois's \$31 Billion Tax Hike: Where Did the Money Go?" *Illinois Policy*, Mar. 21, 2014.

<sup>53</sup> *Id.*

<sup>54</sup> "Governor Offers More Details on Graduated Income Tax Plan," *The Civic Federation*, Mar. 21, 2019.

<sup>55</sup> *Id.*

<sup>56</sup> For example, the year-over-year net income of the \$500,000+ taxpayer band jumped 39 percent in 2012 but dropped sharply by 18 percent in 2013. *Id.*

<sup>57</sup> See Robert Frank, "One Top Taxpayer Moved, and New Jersey Shuddered," *The New York Times*, Apr. 30, 2016.