

Illinois Considers an 11.25 Percent Tax on Small Businesses

By Jared Walczak & Joseph Henchman

Policy Analyst

Vice President,
Legal & State Projects

Key Findings

- A proposal under consideration in Illinois would convert the state's single-rate individual income tax into a four-bracket tax with a top rate of 9.75 percent on individuals and 11.25 percent on small businesses.
- The proposal is contingent on ratification of a constitutional amendment authorizing a graduated-rate income tax, which could also permit alternative graduated-rate income tax rates and brackets in the future.
- Under the proposal, Illinois would impose the second-highest state rate in the country on pass-through businesses, after only California. Illinois would be third after the state of California and New York City when local income taxes are also taken into account.
- By changing one of the most competitive elements of the Illinois tax code, the state would fall from 23rd to 48th on the Tax Foundation's *State Business Tax Climate Index*.

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Designer, Dan Carvajal

Tax Foundation
1325 G Street, NW, Suite 950
Washington, DC 20005

202.464.6200

taxfoundation.org

Small businesses in Illinois could soon face state income taxes as high as 11.25 percent, one of the highest rates on small businesses anywhere in the nation, and significantly above the rate the state imposes on traditional C corporations.

Under legislation sponsored by House Deputy Majority Leader Lou Lang (D),¹ the Illinois individual income tax, currently levied at a flat rate of 3.75 percent, would be converted into a graduated rate tax with a top rate of 9.75 percent. Because pass-through businesses fall under the individual, and not the corporate, income tax schedule, and because they must also pay a 1.5 percent “personal property replacement tax”—in fact, a second income tax—their new top marginal income tax rate would be 11.25 percent.

By way of comparison, four of Illinois’ six neighboring states impose top marginal rates of 6 percent or less on small businesses, and a fifth (Iowa) adopts a deduction for federal taxes paid which dramatically reduces individual income tax liability. Additionally, traditional C corporations in Illinois would continue to face a 7.75 percent corporate income tax rate,² meaning that many of the state’s small businesses would face substantially higher income tax rates than their much larger corporate competitors.

Illinois would fall substantially on the Tax Foundation’s *State Business Tax Climate Index* with the adoption of this proposal, which both raises rates and introduces new structural flaws into the state’s system of taxation. Currently, Illinois ranks below average on four of the *Index*’s five subcomponents (corporate, sales, unemployment insurance, and property taxes), with a highly competitive individual income tax functioning as the tax system’s saving grace. Transitioning to one of the least competitive individual income tax structures in the country would eliminate this one remaining support, with Illinois’s overall rank falling from 23rd to 48th overall.

Background

In 2011, confronted with mounting debt and unpaid bills, Illinois legislators approved a temporary tax increase which, among other things, increased the individual income tax from 3.0 to 5.0 percent. A partial expiration was permitted to take effect in 2015, with the individual income tax rate falling back to 3.75 percent. Absent additional legislative action, a further reduction to 3.25 percent is scheduled for 2025.³

1 House Bill 689, Illinois General Assembly, 99th Session, 2016, <http://www.ilga.gov/legislation/billstatus.asp?DocNum=689&GAID=13&GA=99&DocTypeID=HB&LegID=85163&SessionID=88>.

2 Including both the 5.25 percent corporate income tax rate and a 2.5 percent personal property replacement tax on corporate income.

3 35 Ill. Comp. Stat. § 5/201.

Despite the more than \$30 billion raised by the temporary tax increases, Illinois still has over \$7.2 billion in unpaid bills,⁴ and Governor Bruce Rauner (R) and legislative Democrats continue to deliberate over the adoption of a state budget for the 2016 fiscal year. Since the partial expiration of the state's temporary tax increases, many in the legislature have clamored for permanently higher taxes, and in particular for the introduction of a graduated-rate individual income tax. For his part, Governor Rauner has insisted on a range of structural reforms as a prerequisite to considering any tax changes.⁵

Graduated-Rate Income Tax Proposal

House Bill 689, sponsored by Representative Lang, would give Illinois the fourth highest top marginal individual income tax rate in the country, after those in California, Oregon, and Minnesota. Because the proposed rate schedule does not double bracket widths for joint filers, the bill would also introduce a marriage penalty, meaning that married couples could pay more filing jointly than they would as single filers. Pass-through businesses, including S corporations, partnerships, and trusts, would continue to pay an additional 1.5 percent tax on income that is already embedded in the state's tax code.⁶ The proposed rates and brackets under HB 689 are as follows.

Table 1.
Proposed Rates and Brackets

Single Filer			Joint Filers		
Personal Rate	Pass-Through Entity Rate	Bracket	Personal Rate	Pass-Through Entity Rate	Bracket
3.50%	5.0%	> \$0	3.50%	5.0%	> \$0
3.75%	5.25%	> \$100,000	3.75%	5.25%	> \$200,000
8.75%	10.25%	> \$500,000	8.75%	10.25%	> \$750,000
9.75%	11.25%	> \$1,000,000	9.75%	11.25%	> \$1,500,000

Because the state constitution currently prohibits the imposition of a graduated-rate income tax,⁷ the legislation is contingent on voter ratification of a constitutional amendment (SJRCA 1) lifting the restriction. While most individual Illinoisans would not be exposed to higher rates under HB 689, it is important to bear in mind that many small businesses are subject to the individual income tax. In fact, while most pass-through businesses lack sufficient adjusted gross income (AGI) to be exposed to the new higher tax brackets, those businesses that would experience a tax increase under HB 689 account for nearly 72 percent of all pass-through income.

4 "Bill Backlog," Illinois Comptroller, April 21, 2016, <http://ledger.illinoiscomptroller.com/fiscal-condition/>.

5 "With No Budget, Rauner Repeats Call for Pro-Business Reform," *Associated Press*, Jan. 27, 2016, <http://www.chicagotribune.com/news/sns-bc-il--state-of-the-state-illinois-20160127-story.html>.

6 *Illinois Tax Handbook for Legislators*, 30th ed., Illinois General Assembly Legislative Research Unit, May 2014, <http://www.ilga.gov/commission/lru/2014taxhandbook.pdf>, 89.

7 Ill. Const. 1970, art. IX, § 3.

Of particular note, the companies responsible for over half of all small business income would be subject to a top marginal rate of 11.25 percent, which is significantly higher than Illinois corporate income tax rate of 7.75 percent. Even businesses with income above \$500,000 but not more than \$1 million would pay more as pass-through entities than they would under the corporate income tax were this plan adopted. The table below gives a sense of how many Illinois small businesses would be adversely affected by the tax increase, and the percentage of total pass-through AGI they represent.

Table 2.
Pass-Through Businesses with AGI above \$500,000 (2013)

Pass-Through Range	Number	% of Total	AGI	% of Total
\$500,000 - \$999,999	19,150	5.05%	\$4.47 billion	19.71%
\$1,000,000 +	12,330	3.25%	\$11.79 billion	51.94%
<i>Total Above \$500,000</i>	31,480	8.31%	<i>\$16.26 billion</i>	71.46%

Source: IRS Statistics of Income

At an 11.25 percent top rate for pass-through businesses, Illinois would expose pass-through businesses to the second-highest top rate in the nation, behind only California's 13.3 percent. At its current pass-through rate of 5.0 percent (including the personal property replacement tax), Illinois ties in imposing the 29th highest pass-through rate among states with individual income taxes on pass-through income.⁸

Table 3.
**Table 3. Top Rates on Pass-Through
 Businesses by State**

State	Top Rate
California	13.30%
Illinois (proposed)	11.25%
Oregon	9.90%
Minnesota	9.85%
Iowa	8.98%
New Jersey	8.97%
District of Columbia	8.95%
Vermont	8.95%
New York	8.82%
Hawaii	8.25%
Wisconsin	7.65%
Idaho	7.40%
Maine	7.15%
South Carolina	7.00%
Connecticut	6.99%
Arkansas	6.90%
Montana	6.90%
Nebraska	6.84%
Delaware	6.60%
West Virginia	6.50%
Georgia	6.00%
Kentucky	6.00%
Louisiana	6.00%
Missouri	6.00%
Tennessee	6.00%
Rhode Island	5.99%
Maryland	5.75%
North Carolina	5.75%
Virginia	5.75%
Illinois (current)	5.25%
Massachusetts	5.10%
Alabama	5.00%
Mississippi	5.00%
New Hampshire	5.00%
Utah	5.00%
Ohio	4.997%
New Mexico	4.90%
Colorado	4.63%
Arizona	4.54%
Michigan	4.25%
Indiana	3.30%
Pennsylvania	3.07%
North Dakota	2.90%

The adverse impact of this tax increase on the state's small businesses, which employ nearly half of the state's workforce,¹⁰ would harm many working Illinoisans, even if they would personally receive a modest reduction in their individual income tax liability under the proposal.

⁹ Seven states do not impose broad-based individual income taxes, and Kansas exempts pass-through income from its individual income tax. Liability under the Alabama, Iowa, and Louisiana individual income taxes is reduced substantially by a deduction for federal income taxes paid. Louisiana also taxes some pass-through entities at the higher corporate income tax rate.

¹⁰ Small firms were responsible for 47.2 percent of all state employment in 2012, though not all small businesses are pass-through entities. See U.S. Small Business Administration, "Small Business Profiles for the States and Territories," Feb. 2015, https://www.sba.gov/sites/default/files/advocacy/SB%20Profiles%202014-15_0.pdf, 57-60.

Should the state abandon its current constitutional prohibition of graduated-rate income taxation, moreover, there are no guarantees that rates would not increase on low- and middle-income taxpayers in the future. Proponents of the pending legislation project that it represents a \$1.9 billion tax increase.¹¹

Resulting Rank on *State Business Tax Climate Index* Ranking

The proposed tax increase's substantial impact on small businesses drives the state's precipitous drop, should the proposal be adopted, in our *State Business Tax Climate Index*. The *Index* has five components, and at present, Illinois' best—and only above-average—performance is on the individual income tax component, where it ranks 10th in the nation. Illinois currently ranks 23rd overall, driven in large part by its competitive individual income tax. Under the proposal, the state would fall to 48th both on the individual income tax component and on the *Index* overall.

Currently, Illinois ranks better than several of its regional competitors. Should HB 689 be adopted, however, the state's rank would be the worst in the region, and better only than New Jersey and New York nationwide.¹²

Table 4.
***State Business Tax Climate Index* Ranks for Illinois and Regional Competitors**

State	Overall	Corporate	Individual	Sales	Unemployment Insurance	Property
Illinois (projected)	48th	36th	48th	33rd	39th	45th
Illinois (current)	23rd	36th	10th	33rd	39th	45th
Indiana	8th	20th	11th	11th	14th	5th
Iowa	40th	49th	32nd	24th	34th	40th
Kentucky	28th	29th	30th	9th	46th	23rd
Missouri	17th	3rd	28th	23rd	12th	8th
Wisconsin	43rd	32nd	43rd	13th	36th	33rd

House Bill 689 represents a stark departure from the current system. Not only does it entail a shift from a low, flat-rate income tax to a high, graduated-rate tax, but it also introduces a marriage penalty and fails to adopt inflation indexing of brackets, meaning that a greater percentage of state income will be exposed to higher rates over time due to inflation. The projected *Index* rank of 48th reflects the following changes:

- Shifting from a flat to a graduated rate income tax;
- Imposing a top marginal rate of 9.75 percent;
- Introducing a marriage penalty by failing to double bracket width in a graduated tax; and
- Permitting “bracket creep” by failing to index the proposed brackets for inflation.

¹¹ Rich Miller, “Graduated Income Tax Plan Introduced,” *Capitol Fax*, Apr. 15, 2016, <http://capitolfax.com/2016/04/15/this-just-in-graduated-income-tax-plan-introduced/>.

¹² Jared Walczak, Scott Drenkard, and Joseph Henchman, *2016 State Business Tax Climate Index*, Tax Foundation, Oct. 2016, <http://taxfoundation.org/article/2016-state-business-tax-climate-index>.

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All of these factors are taken into consideration in our *Index*, and merit careful reflection by state policymakers, as they would result in a poorly-structured tax with one of the highest top rates in the nation.

Some proponents of the legislation insist that the proposal is consistent with the goal of shoring up the state's business climate. While our *Index* only measures one aspect of the business climate (tax structure), uncompetitive tax systems can have a deleterious effect on economic growth.¹³ Billed as a tax increase on only the richest Illinoisans, HB 689 would dramatically increase tax burdens on the state's job creators and entrepreneurs.

¹³ See, e.g., William McBride, "What is the Evidence on Taxes and Growth?" Tax Foundation Special Report No. 207, Dec. 18, 2012, <http://taxfoundation.org/article/what-evidence-taxes-and-growth>.
