State Individual Income Tax

GO TO 2040's section "Reform State and Local Tax Policy" recommends that the efficiency and equity of the state income tax be evaluated, and potentially adjusted, to support economic efficiency and fairness. Recommendations in this area should help move metropolitan Chicago toward a system of taxation that raises revenue sufficient for public services and avoids creating undue burdens on taxpayers. Given this direction, the Regional Tax Policy Task Force should analyze the rate structure and exemptions of the state income tax.

While equity can be defined in different ways, it is generally agreed that taxes should strive for two different principles. The first, "horizontal equity," means that similar people and firms should share similar burdens. The second, "vertical equity," means that the tax system should be based on the entity's ability to pay. In the case of the state income tax, the flat rate structure imposes the same rate for all taxpayers regardless of ability to pay, and the narrow base of the tax is reflected in the exemptions granted to pensions and other retirement income. GO TO 2040 provides the following implementation action area, to be executed by the Regional Tax Policy Task Force:

Evaluate the efficiency and equity of the state income tax Lead Implementers: Task Force, CMAP Board, State	Evaluate the impacts of graduating the state income tax by applying marginal rates for different tax brackets. Also evaluate the relatively narrow nature of the state's income tax base, given its exemptions for retirement income, particularly public and private pensions. Prepare detailed recommendation.

This interim report will examine the current conditions of the income tax base and rate structure.

Background

Illinois' individual income tax (IIT) was first enacted in 1969. The rate was originally 2.5 percent, and rose to 3 percent in 1989. In 2011, a temporary increase was enacted, raising the rate to 5 percent through 2014. The rate will then drop to 3.75 percent and will drop again to 3.25 percent in 2025. Pursuant to the 1970 Illinois Constitution's requirement that "a tax on or measured by income shall be at a non-graduated rate,"[1] the income tax applies the same rate to all taxpayers of all income levels.

Base income subject to the IIT includes federal adjusted gross income, plus several additions including any interest, dividends, and capital gains that are excluded from federal adjusted gross income. Subtractions from base income include retirement and social security income. Individuals are taxed on base income minus $2,000 for each federally claimed exemption and $1,000 each for any taxpayer or spouse who is 65 years of age or older and/or legally blind.

Individual income tax revenue (along with corporate income tax revenue) is distributed as follows:

- A proportion of gross receipts are deposited into the Income Tax Refund Fund according to a statutory formula that is adjusted annually. In FY2011, 8.75 percent of IIT revenues and 17.5 percent of corporate income tax revenues went to the Refund Fund.
- Of the remainder:
  - 10 percent of the amount generated from the pre-2011 rate to municipalities and counties based on the population in proportion to the total state population;
  - 7.3 percent to the Education Assistance Fund, which funds elementary and secondary education as well as community colleges;
  - The remainder to the General Revenue Fund.

[1] Illinois State Constitution of 1970, Article IX, Section 3(a).

To clarify, municipalities and counties do not receive any additional revenue generated from the 2011 rate increase. Revenue disbursements to local governments are held at previous levels by reducing the percentage disbursed. Local governments receive 10 percent of the ratio of the current rate to the new rate (e.g. 10% of $\frac{3\%}{5\%}$ = 6%). The following table summarizes the rates and shares to local governments.

State Income Tax Rates and Local Government Share

Time Period	Individual Income Tax Rate (IIT)	Corporate Income Tax Rate (CIT)	Local Government Share of IIT	Local Government Share of CIT
Before 2011	3.00%	4.80%	10.00%	10.00%
2011-2014	5.00%	7.00%	6.00%	6.86%
2015-2024	3.75%	5.25%	8.00%	9.14%
2025 and on	3.25%	4.80%	9.23%	10.00%

Source: CMAP analysis of Public Act 96-1496

Federally Taxed Retirement and Social Security Income

The largest individual income tax expenditure[2] is the deduction for federally taxed retirement and social security income. Under the federal income tax, if half of social security benefits received plus all other income fall between $25,000 and $34,000 for single filers and $32,000 and $44,000 for joint filers, then either half of all income over the threshold or half of the social security benefits (whichever is lower) are subject to the federal income tax. For taxpayers with income above these thresholds, 85 percent of benefits are subject to taxation. However, under the Illinois IIT, social security benefits, as well as income from qualified pension plans, IRAs, state and local government deferred compensation plans, and several other sources of retirement income can be fully deducted. If Illinois subjected the same social security and retirement income to the state income tax as the federal income tax, the State would have received an additional $973.4 million in revenues in FY2009 (under the 3 percent IIT rate). This is equivalent to 9.5 percent of the total revenues generated from the IIT that year. In 2011, this percentage is likely to stay level, although the amount of the tax expenditure and revenue will rise because of the rate increase from 3 percent to 5 percent. The following table shows the amount that the State would have received, or the tax expenditure, for taxing retirement and social security income.

Illinois Tax Expenditure for Federally Taxed Retirement and Social Security Deduction

Fiscal Year	Tax Expenditure	Total Individual Income Tax Revenue	Expenditure as a Percent of Total Revenue
2002	$716,940,000	$8,086,000,000	8.9%
2003	$732,055,000	$7,979,000,000	9.2%
2004	$757,659,000	$8,235,000,000	9.2%
2005	$828,265,000	$8,873,000,000	9.3%
2006	$899,174,000	$9,568,000,000	9.4%
2007	$983,015,000	$10,425,000,000	9.4%
2008	$983,892,000	$11,187,000,000	8.8%
2009	$973,416,000	$10,219,000,000	9.5%

Source: Illinois Office of the Comptroller Tax Expenditure Reports and Traditional Budgetary Financial Reports

[2] According to the Illinois Office of the Comptroller, a tax expenditure is "any exemption, exclusion, deduction, allowance, credit, preferential tax rate, abatement, or other device that reduces the amount of tax revenue that would otherwise accrue to the State."

There are 41 states[3] that impose income taxes. Of these, the majority (26) do not tax social security benefits, but most (38) do tax both public or private pensions at least partially. The following table summarizes how these states treat social security and retirement income.

Tax Treatment of Social Security and Pension Income among States, 2006

Number of states that tax social security benefits	15
Number of states that tax public pensions	31
Number of states that tax public pensions and exempt a portion of the income	26
Number of states that tax private pensions	38
Number of states that tax private pensions and exempt a portion of the income	23
Number of states that have an age limitation for pension exemptions	15
Number of states that tax pensions for taxpayers of all income levels	27

Source: AARP Public Policy Institute, "State Taxation of Social Security and Pensions in 2006"

Deductions and Exemptions

Illinois allows a $2,000 exemption for every exemption claimed on the federal tax return, but no standard deduction. Exemptions and deductions lower a taxpayer's taxable income and resulting tax liability. Moreover, lowering taxable income by a set amount provides more vertical equity in the tax system, because it reduces taxable income for lower-income taxpayers by a larger proportion than it reduces taxable income for higher-income taxpayers. According to a 2009 Institute on Taxation & Economic Policy report, Illinois's overall tax system ranked as the sixth most regressive system in the United States.[4] Illinois' income tax ranked the 39th most progressive out of the 41 states with an income tax. These rankings reflect Illinois' flat income tax, low income tax exemptions, high combined state and local sales tax rates, and the sales tax on food. Enhancing progressivity in the state income tax would increase vertical equity in Illinois' overall tax system. The following table provides a simplified example of how the personal exemption works in Illinois.

How Illinois' Personal Exemption Affects Effective Tax Rates

	Taxpayer 1	Taxpayer 2
Filing Status	Single	Single
Income	$25,000	$100,000
Exemption	-$2,000	-$2,000
Exemption as a % of Income	8%	2%
Taxable Income	$23,000	$98,000
Tax Liability at 5%	$1,150	$4,900
Effective Tax Rate	4.6%	4.9%

All but one state provides an exemption for each person in the taxpayer's family, while 34 states provide a standard deduction that varies depending on filing status. Ten states use the federal standard deduction amount and eight of those states also use the federal amounts for personal exemptions. A benefit to using the federal amount is that they adjust for inflation, so the amounts stay more consistent with taxable income. In 2010, the federal standard deduction was $5,700 for single filing status and each exemption was $3,650. Most states that do not use federal deduction and exemption amounts use amounts below those levels. The following table shows how increasing the personal exemption to the federal amount in 2010 would change the tax liability for the taxpayers in the previous example.

[3] Two states, Tennessee and New Hampshire, are not included in this count, but impose an income tax on dividends and interest income.
[4] Institute on Taxation & Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," November 2009, http://www.itepnet.org/whopays3.pdf.

How Increasing Illinois' Personal Exemption Would Affect Effective Tax Rates

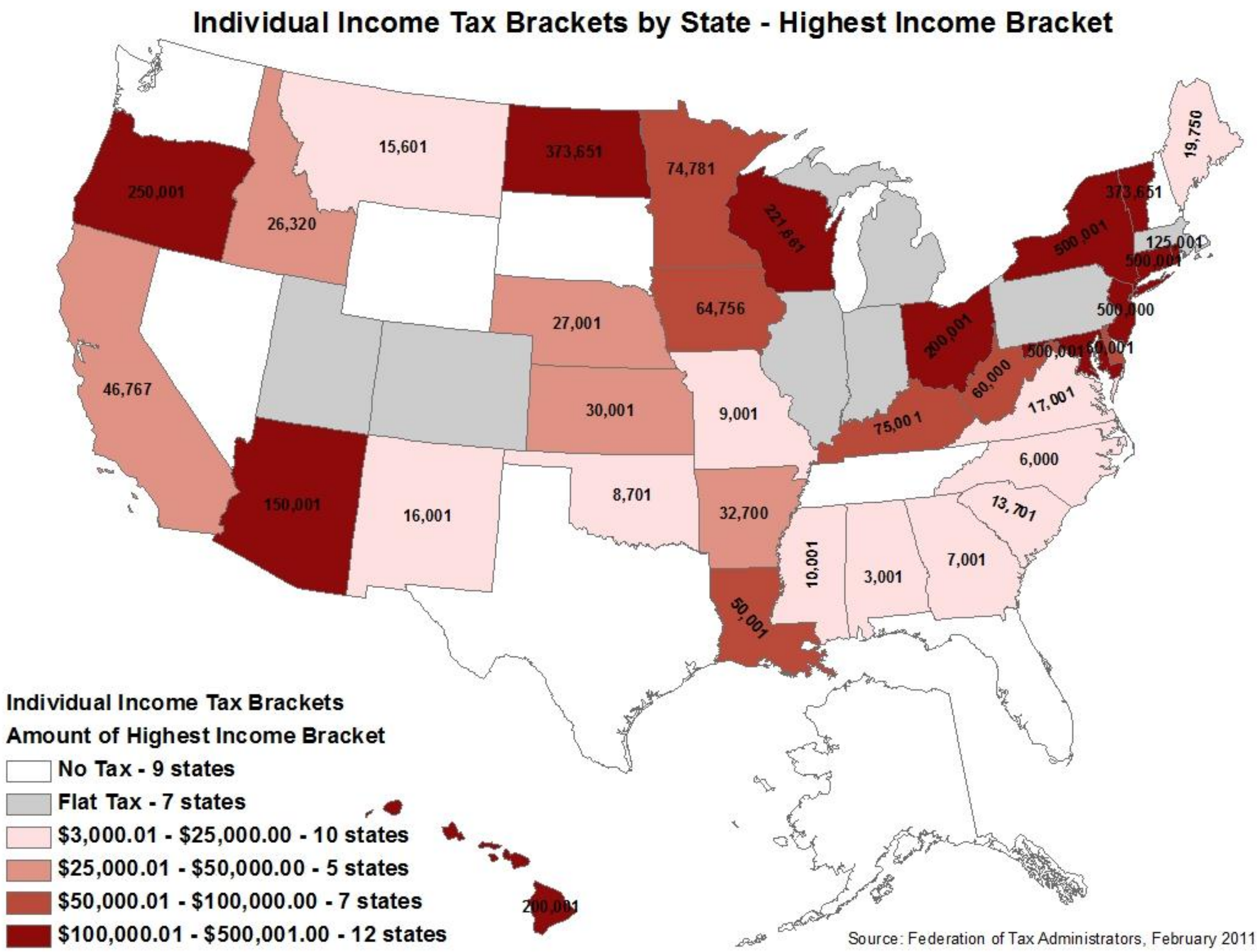
	Taxpayer 1	Taxpayer 2
Filing Status	Single	Single
Income	$25,000	$100,000
Exemption	-$3,650	-$3,650
Exemption as a % of Income	14.6%	3.65%
Taxable Income	$21,350	$96,350
Tax Liability at 5%	$1,068	$4,818
Effective Tax Rate	4.3%	4.8%

While tax liability for both taxpayers was reduced, the taxpayer with $25,000 experienced an effective rate reduction from 4.6% under the current system to 4.3% under the federal exemption amount. The taxpayer with $100,000 experienced a more modest effective rate reduction – 4.9% to 4.8%. If either taxpayer had additional dependents to apply additional exemptions, the rate would decrease more. Increasing the exemption amount would enhance the progressiveness of Illinois' income tax system. In addition, allowing a standard deduction would have a similar effect on rates, but would not be affected by family size.

Rate structure

Among the 41 states that impose income taxes, Illinois is one of seven that imposes a flat rate on taxpayers of all income levels. The remaining 34 states impose graduated rates that increase as taxpayers' income levels rise. Under a graduated tax system, the tax rate for a particular income range or bracket only applies to income falling within the bracket. For example if all income less than $2,000 were taxed at a 2 percent rate and all income above $2,000 were taxed at a 4 percent rate, a taxpayer with an income level of $8,000 would pay 2 percent on the first $2,000 and 4 percent on the remaining $6,000. The average tax rate for this taxpayer would be 3.5 percent.

Under graduated rather than flat rates, vertical equity is improved because tax burdens reflect taxpayers' ability to pay. The following chart summarizes the use of graduated income tax rates among states and the income levels of states' highest tax brackets.



Of the 34 states that impose a graduated income tax, ten states do not have brackets that start above $25,000. This means that while the rates vary for income under $25,000, all income over $25,000 is taxed at the same rate. In these states, more than 80 percent of the households fall into the top bracket.[5] In five cases, the top bracket starts at less than $10,000, and more than 90 percent of households have income above the top bracket. In seven of the ten states with low top income brackets, it is possible that the low amounts are the result of not indexing brackets to inflation. Thirteen of the 34 states with graduated rates index brackets for inflation, which means taxpayers will not be pushed into a higher tax bracket over time as long as their income keeps up with inflation. A benefit of indexing brackets to inflation is that new legislation does not need to be enacted in order to keep brackets up-to-date. The federal government indexes brackets to inflation and, like North Dakota and Vermont, had a top tax bracket of $373,651 in 2010.

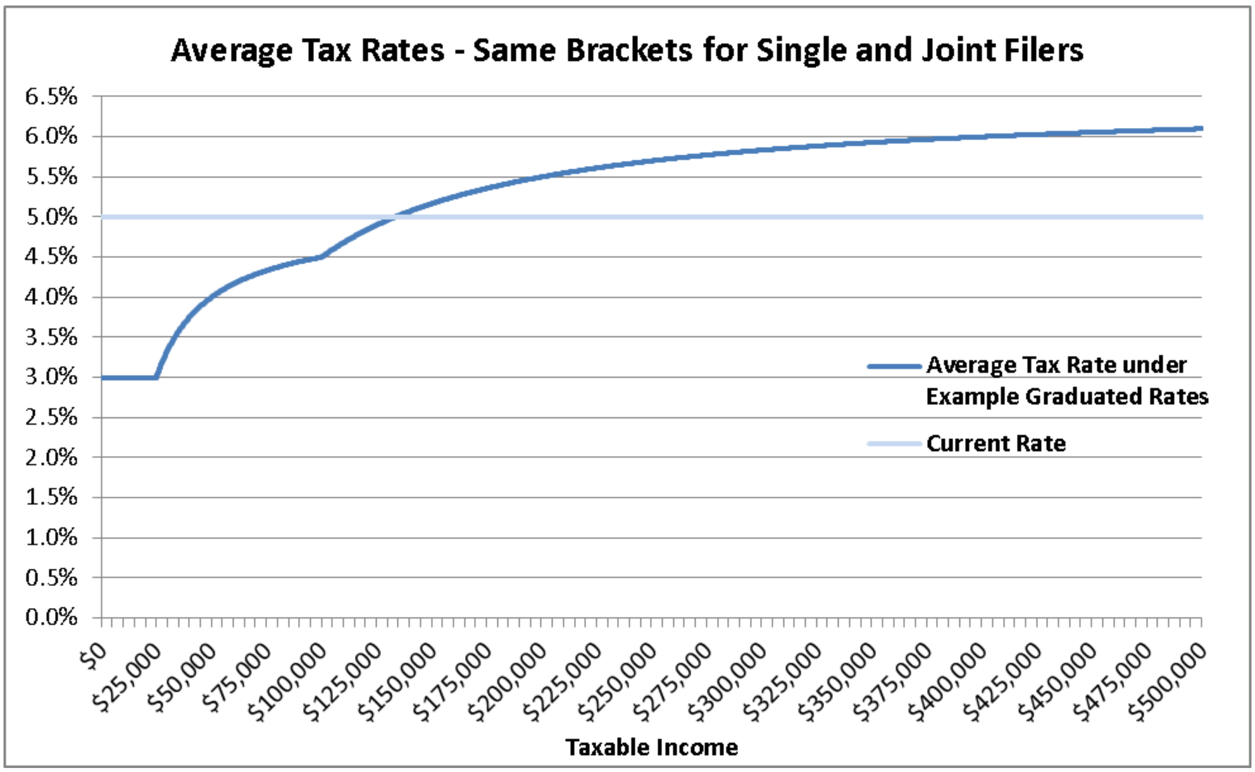
The federal income tax has six tax brackets, while the number of brackets employed by states ranges from three to 12. The following is an example of how Illinois might use three tax brackets at graduated rates while keeping revenues neutral. This analysis includes taxable income after any exemptions, deductions, or credits.

[5] Households falling into the top bracket do not use taxable income and are approximate. These estimates use household income data from the U.S. Census Bureau, American Community Survey 5-year Estimates, 2005-2009.

Example of Graduated Income Tax Rates – Same Brackets for Single and Joint Filers

Tax Bracket	Marginal Rate on Income in Bracket	Average Rate for Taxpayers with Income Falling Inside Bracket
$0-$25,000	3%	3%
$25,000-$100,000	5%	3%-4.5%
Above $100,000	6.5%	4.5%-6.5%

Under this example, the marginal tax rates result in average tax rates ranging from 3 percent to 6.5 percent. However, for most taxpayers, the average tax rate, or the actual percentage of all income paid in taxes $\left(\frac{\text{income tax owed}}{\text{taxable income}}\right)$ is significantly lower than 6.5 percent. A 6.5 percent average tax rate is not approached until income reaches about $4 million. The following chart displays average tax rates for taxable income up to $500,000. Under this system, taxpayers with total taxable income under $133,340 would experience a rate reduction.



Fifteen states and the federal government use different brackets for married taxpayers who file jointly. Frequently the brackets are twice the amount of the brackets for single or married filing separately. The following is a revenue neutral example of how Illinois could create different brackets for taxpayers who file jointly.

Example of Graduated Income Tax Rates – Different Brackets for Single and Joint Filers

Tax Bracket – Single or Married Filing Separately	Tax Bracket – Married Filing Jointly	Marginal Rate on Income in Bracket	Average Rate for Taxpayers with Income Falling Inside Bracket
$0-$25,000	$0-$50,000	3%	3%
$25,000-$50,000	$50,000-$100,000	5%	3%-4%
Above $50,000	Above $100,000	6.5%	4%-6.5%

Under this system, single taxpayers with total taxable income under $83,330 and joint filers with total taxable income under $166,660 would experience a rate reduction. The following chart displays average tax rates for taxpayers under this bracket system.