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INSIDE THIS ISSUE

Illinois' PPRT: The Challenge of "Replacing" a Tax

By Mike Klemens

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Among the least understood of Illinois taxes are a group known as the Personal Property Replacement Taxes – enacted, as their name suggests, to replace a tax imposed on personal property owned by businesses in Illinois. When enacted the concept was simple: find a way to get the same taxpayers to pay what they had paid in personal property taxes, but under a less onerous scheme. Over time the notion of replacement faded as people forgot the old personal property tax, flaws created other problems, and Illinois kept distributing taxes as if nothing had changed in 40 years.

Background

The property tax is older than Illinois, having first been imposed before statehood when what is now Illinois was part of the Northwest Territory. The first property taxes taxed both real property and personal property. An Illinois farmer would have paid tax on his land, his house, his barn, his horse, mules, wagon, cows, and chickens. In a time of cheap land and rustic buildings, the horse, mules and wagon (personal property) may well have been worth more than the land and buildings (real property).

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NOTES FROM THE INSIDE. . .

By Carol S. Portman

In this edition of *Tax Facts* we focus on the Personal Property Replacement Tax, or more accurately, Taxes. The PPRT is a series of taxes that are generally not well understood. The Taxpayers' Federation was at the table in the late 1970s when the compromise creating the structure was hammered out and again later when it was revised. One of the pens Gov. Jim Thompson used to sign that bill into law graces TFI's office wall.

Several things stick out in my mind after reading Mike Klemens' history and overview of the PPRT:

First: Replacing one tax with another is difficult. Perhaps such replacements should be temporary and phased out after a while. At this point, the tax-paying "capacity" freed up by elimination of the personal property tax has surely been taken up by the tax on real property. And distributing taxes based on the way the world was 40 years is problematic. As Mike notes, the world has changed, but PPRT remains the same.

Second: It has always been hard to impose new taxes. The Illinois Constitution required the replacement of a much-despised tax within ten years, but the issue still went down to the wire and was enacted only after an attempt to amend the Constitution failed.

Third: Illinois doesn't always get enough credit for not taxing personal property. Colleagues in other states recount horror stories about personal property taxes. While PPRT is certainly imperfect, we need to remember that taxes on personal property can be even more troublesome.

We also take a brief look at the debate over whether the PPRT is an income tax. To me, it comes down to this: your view on the issue depends on where you stand.

As time progressed personal property taxation became more of a hassle. Property owners had to file a form listing and valuing their personal property, an ugly form even by the low standards we use to judge tax forms. There are stories of companies putting stocks and bonds on trains so they would not be in Illinois on the taxable status day and of farmers taking their livestock to the slaughterhouse before tax day to avoid taxation. Besides that, personal property was far more difficult to value than land and buildings where one can look at comparable sales, and the tax saw high rates of non-compliance.

In about 1950 Cook County stopped imposing the tax on individuals and taxed only business personal property. Small businesses called the tax the "sue and settle" system or the "pay and pray" system. By 1970 the tax fell heavily on utilities and retailers.

The personal property tax on individuals was eliminated statewide in 1969 as part of the tradeoffs involved in creating Illinois' first income tax. A year later delegates to the new Illinois Constitution included a requirement that:

> *(c) On or before January 1, 1979, the General Assembly by law shall abolish all ad valorem personal property taxes and concurrently therewith and thereafter shall replace all revenue lost by units of local government and school districts as a result of the abolition of ad valorem personal property taxes subsequent to January 2, 1971. Such revenue shall be replaced by imposing statewide taxes,*

other than ad valorem taxes on real estate, solely on those classes relieved of the burden of paying ad valorem personal property taxes because of the abolition of such taxes subsequent to January 2, 1971. If any taxes imposed for such replacement purposes are taxes on or measured by income, such replacement taxes shall not be considered for purposes of the limitations of one tax and the ratio of 8 to 5 set forth in Section 3 (a) of this Article.

Replacement Taxes

After struggling to come up with the constitutionally required replacement, including a failed attempt to amend the Constitution to remove the requirement that personal property taxes be abolished, the General Assembly eventually settled on a package of taxes (the Personal Property Replacement Taxes) to meet the constitutional requirement, specifically:

- A 2.5 percent surcharge on the corporate income tax (it was slightly higher the first year),
- A 1.5 percent tax on the net income of partnerships, Subchapter S corporations and trusts, and
- A 0.8 percent tax on the invested capital of public utilities.

When telecommunications and electric utilities were deregulated, the electric excise tax and telecommunications infrastructure maintenance fees replaced the invested capital tax for those industries.

The law provided that the taxes would be collected by the Department of Revenue which, based upon historic collections, would put 51.65 percent in a pot for Cook county and 48.35 percent in a pot for the other 101 counties. Eight times a year funds would be distributed to local governments based on their shares of total personal property tax collections in 1976 for Cook County and 1977 for the rest of the state.

Replacement Taxes Today

The Personal Property Replacement Taxes are distributed broadly to each unit of local government that imposed a tax on personal property in 1979. For Fiscal Year 2017 the Department of Revenue distributed $1.47 billion to 6,525 local governments and project they will distribute $1.12 billion in FY 2018. Total receipts ranged from $299 million for Chicago Public Schools to $55.32 for the Oak Ridge Sanitary District in Woodford County. The average annual payments were $225,000 per taxing district in FY 2017.

By type of district the statewide distributions go:

- 52 percent – K-12 schools
- 20 percent – municipalities
- 9 percent – county
- 5 percent – park districts
- 4 percent – sanitary districts
- 4 percent – community colleges
- 6 percent – all other districts

By region the payments go 52 percent to Cook County, 12 percent to the five collar counties, and 36 percent to the other 96 counties.

What one thinks of the PPRT depends on where one sits:

1) From the perspective of Illinois citizens, few have an understanding of PPRT. If they are aware of it at all, it is from the attention that the tax has gotten from business interests arguing that the 2.5 percent surcharge on the corporate income tax contributes to making the state's business climate non-competitive.

2) From the perspective of local governments, few officials were around 40 years ago when the program was created and, in my personal experience, almost none understand the concept. Their concern is understandably more with the larger revenue generators: their shares of income tax, sales tax, motor fuel tax and various locally imposed taxes.

One exception is in school districts where the PPRT receipts are factored into the school aid formula. Historically PPRT was considered part of local resources when determining how much state school aid a district was entitled to receive. (State aid = Total funding requirement – local resources.) Only when it is understood that PPRT replaced a local tax can one understand how a tax imposed and collected by the state is counted as a local tax. As an aside, had it been characterized instead as a state tax, the gap between the state and local shares of school funding would have narrowed, by about 5 percent. Over the life of the tax, PPRT's contribution to total school funding has dropped from 3.7 percent to 2.4 percent. The new "evidence based" model for school funding passed into law earlier this year will continue to take how much money a district receives in PPRT (the new law calls it CPPRT (Corporate Personal Property Replacement Tax) into account when calculating the amount of school aid to which a district is entitled.

3) From the perspective of the Department of Revenue, the statutory scheme requires them to distribute money as much as two years before they receive the relevant tax return. As a result, they must make estimates at the time of distribution and adjustments after the fact.

<u>What does "replacement" mean? – part 1</u>

The Department of Revenue closely tracked PPRT collections when the transition was made to assure that the replacement tax fully covered the lost taxes. Personal property tax collections for 1978 (payable in 1979) were $456 million; replacement tax payments in 1980 were $553 million. If "replace" means cover the $456 million in actual dollars, that standard has been met.

However, if "replace" in the Constitution means the new tax source should grow with the original tax base, then the old business personal property tax receipts have likely not been replaced. In 1978 personal property tax collections were 11.7 percent of real property tax collections. If you apply that percentage to the most recent year's collections (2015 payable in 2016) replacement tax collections would have to be $3.4 billion, more than twice what they actually were. There has been a significant increase in the value of residential properties since 1979, so if you used the same percentage of commercial and

TABLE 1. PPRT VS PROPERTY TAXES BILLED ($ BILLIONS)								
	1980	1985	1990	1995	2000	2005	2010	2015
Total PTAX Billings	4.836	6.281	9.668	12.905	15.968	21.139	25.915	28.746
Com/Ind PTAX Billings	1.949*	2.716	4.253	5.367	6.031	7.175	7.899	8.983
PPRT	0.519	0.646	0.597	0.881	0.979	1.202	1.329	1.421
*Projected Source: Illinois Comptroller and Illinois Department of Revenue								

industrial extensions instead, replacement taxes would have to be $2.8 billion, still considerably more than the PPRT brought in.

Table 1 shows in five-year increments tax collections deposited into the Personal Property Tax Fund compared to total property taxes billed (the technical term is extended) and property taxes billed for only commercial and industrial properties, since the "replacement." Commercial and industrial billings are shown because those are the types of property upon which the abolished personal property tax on business fell most heavily.

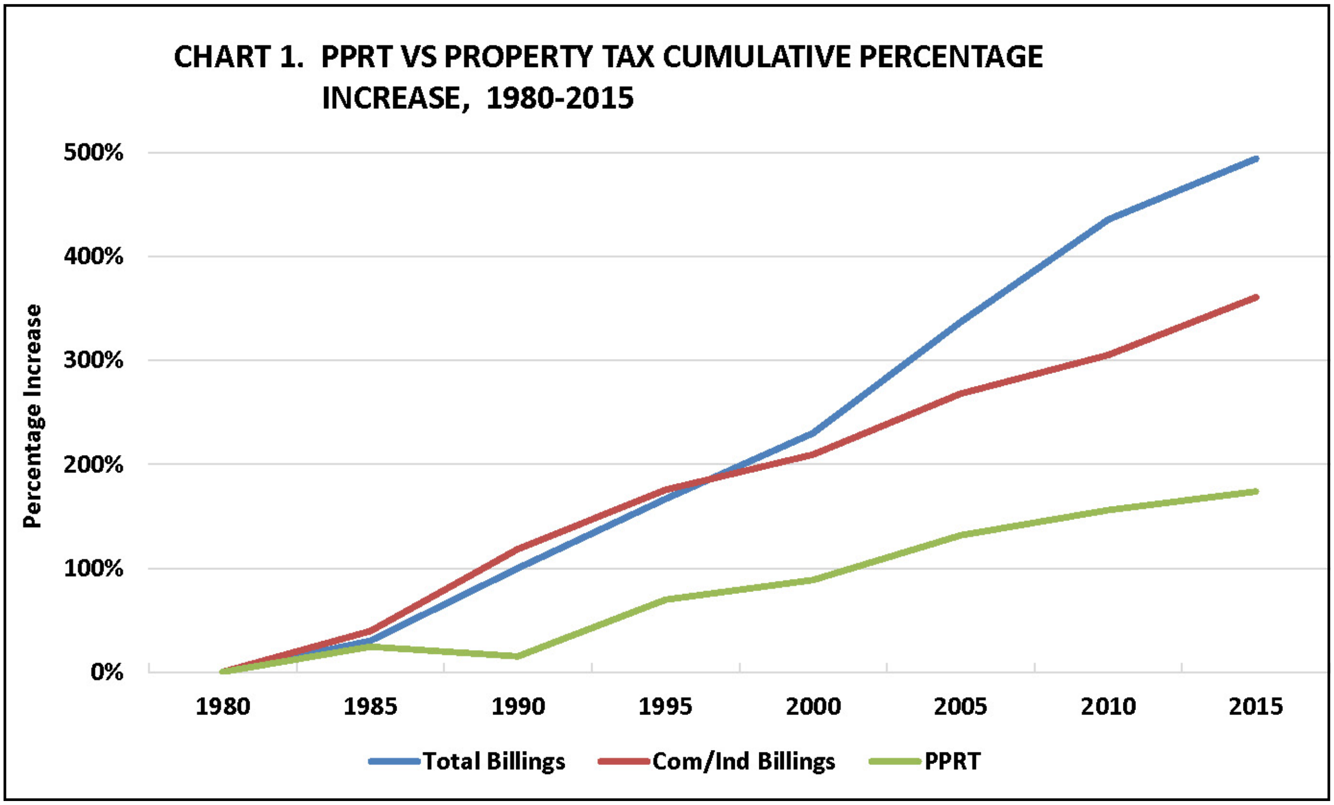
Chart 1 on page 6 displays the same data but looks at the cumulative percentage increase in PPRT, total taxes billed, and commercial/industrial taxes billed. Chart 1 and Table 1 both illustrate that total property taxes have grown fastest, followed by commercial/industrial property taxes and that PPRT has lagged both.

"Like Kind" and permanent inconsistency, by statute

During the period between the adoption of the Constitution of 1970 and the 1979 date for eliminating the remaining personal property tax on business, there was significant doubt as to whether the replacement tax required under the new Constitution would be enacted. In fact, replacement proved so difficult that in 1978 the General Assembly had submitted a Constitutional amendment to voters that would have eliminated the requirement to end the personal property tax, but it failed to get the required votes. Sparked by that doubt, some assessors began reclassifying property from personal to real to protect their tax base.

When that reclassification continued after enactment of the new Replacement Tax, businesses complained that they were effectively being taxed twice: first, they were paying property tax on what used to be personal property; and second, they were paying the new replacement tax on their incomes and invested capital. CILCO won a Supreme Court case that reclassifying property had subjected it to double taxation, but the case left open the question of new property added after 1979. The solution, passed in 1982, is called the like kind provision and prevented reclassifying property personal to real, and vice versa:

> *(35 ILCS 200/24-5) Sec. 24-5. Tax on personal property....No property lawfully assessed and taxed as personal property*



prior to January 1, 1979, or property of like kind acquired or placed in use after January 1, 1979, shall be classified as real property subject to assessment and taxation. No property lawfully assessed and taxed as real property prior to January 1, 1979, or property of like kind acquired or placed in use after January 1, 1979, shall be classified as personal property.

The legislation solved the problem with reclassifying property, but it created others. First, although the property tax is supposed to be imposed uniformly by value, what is personal and what is real property varies by county, and cannot be changed. A walk-in cooler that was classified in 1979 as personal property in one county can never be taxed. An identical walk-in cooler in the next county classified in 1979 as real property will always be taxed. And, who is going to remember nearly 40 years later how a particular type of property was taxed.

It took a number of lawsuits, several years, and an Illinois Supreme Court ruling to resolve what was real and what was personal in nuclear power plants. And then along came technology that wasn't around before 1979, for example when cell phone towers began to dot the landscape. Later, when developers wanted to build wind farms in Illinois, the General Assembly enacted a different tax scheme to avoid court battles and issues where wind farms crossed county lines and were taxable in one county but not in the second.

The world changes but not PPRT distributions

As you can see in **Table 2 on page 7**, the shares of PPRT collections allocated to particular local governments have barely changed since 1980. The law provides that they would change only with collection of delinquent taxes from 1976 or

1977. The exception is Heartland Community College, a community college district in Bloomington-Normal that wasn't established until 1990. For 1996, a legislative change added Heartland to the pool, so it receives replacement tax money even though the taxing district did not exist when business-owned personal property was taxed.

While the distributions have not changed, the composition of the state has. Looking at property taxes extended (billed) by class of property in 1981 (the oldest readily available data and only reported at the county level) commercial and industrial extensions in Cook County accounted for 70.1 percent of all commercial and industrial extensions statewide. (We are once again using commercial and industrial taxes billed as a way to roughly estimate personal property taxes.) For the most recent year, 2015 taxes payable in 2016, Cook's share of statewide commercial and industrial extensions had fallen to 55.4 percent. Nevertheless, Cook County taxing districts have consistently received 51.65 percent of PPRT collected.

Cook County's decline in share of statewide commercial and industrial property has been offset by increases primarily in the collar counties. Lake County's share of statewide commercial and industrial property increased from 3.0 to 5.4 percent between 1981 and 2015. DuPage County's share grew even more, from 4.09 to 8.0 percent. Downstate McLean County followed the same trend, with its share increasing from 0.6 to 1.0 percent and Williamson County's grew at the highest rate, from 0.1 to 0.3. However, Macon County followed Cook's lead, trending downward from 0.6 to 0.5 percent. And again, each of these counties has received roughly the same share of PPRT year over year, despite these dramatic changes in share of statewide business real property collections.

Clearly, during this period there was significant growth in the collar counties, including expansions of the types of businesses that would have been subject to personal property taxation. The statutorily-mandated 1976 and 1977 base

TABLE 2. ALLOCATION FACTOR CHANGES, SELECTED DISTRICTS*, 1980-2017

	1980	2017
Chicago Public School District 299		
Cook County Portion	27.0407562	27.1040198
DuPage County Portion	.0097970	0.0098880
Williamson County	0.0595432	0.0594742
Decatur	0.2079261	0.2076087
Heartland Community College		
DeWitt County Portion	0	0.0077267
Ford County Portion	0	0.0039894
Livingston County Portion	0	0.0123005
Logan County Portion	0	0.0092893
McLean County Portion	0	0.0789229
Tazewell County Portion	0	0.0108018
Addison	0.0337305	0.0346553

*Percentage shares of respective Cook County's (51.65 percent) or rest of state's (48.35) allocations for each district years prevent that change from being reflected in PPRT receipts.

What does "replacement" mean? – part 2

The Personal Property Replacement Tax was supposedly enacted to replace revenue lost when the personal property tax on businesses was abolished in 1979. Most recently it has increasingly been used to "replace" state revenue sources, at the expense of local governments. Through Fiscal Year 2009, Department of Revenue expenses for administering and distributing PPRT were paid from PPRT receipts, and the balance was distributed to taxing districts based on the 1976 or 1977 shares.

In FY 2009 total diversions were the $21.6 million for IDOR expenses. Since then the fund has been used to pay the salaries of state's attorneys and public defenders' salaries, stipends to a number of other county officials, along with expenses for the Property Tax Appeal Board, Regional Offices of Education, State Board of Elections, Illinois Education Labor Relations Board, Court Reporters, State Appellate Prosecutor, local health department grants and community colleges. While these expenses are arguably related to local governments, they traditionally were funded by the state, with other revenue. For FY 2018, total diversions are set at $297 million, meaning one dollar in five is being diverted from local governments. **Table 3 on page 9** illustrates the recent pattern in new diversions.

Other states

It is worth remembering that as we tick off the "deficiencies" with the Replacement Tax, the old corporate personal property tax was no gem, and that – while one hears few boasts that Illinois is a good place to do business because it lacks a personal property tax – in many states personal property is still taxed, and the frustrations and deficiencies of those taxes are legendary. The personal property tax is not widely studied, because data on it is hard to get. The Tax Foundation wrestled with the lack of data in a 2012 study entitled *States Moving Away from Taxes on Tangible Personal Property*, in which researchers were forced by lack of data to estimate personal property taxation in many states.

The report found that Illinois was one of only seven states that did not impose a tax on personal property. The break is significant. Had Illinois collected tax at the $100 per capita rate the Tax Foundation calculated for Indiana, Illinois would have generated $1.2 billion. At the $333

Illinois Tax Facts

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TABLE 3. PERSONAL PROPERTY REPLACEMENT TAX DIVERSION BY THE STATE BASED ON THE STATE FISCAL YEAR ($ IN THOUSANDS)

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018
Dept of Revenue Admin/Enforcement	21,643	23,683	24,773	27,121	26,257	26,751	28,412	30,151	30,984	32,836
Local Government Officials' salaries, stipends, and bonuses (state's attorneys, public defenders, supervisors of assessment, sheriffs, etc.)	-	-	-	14,425	27,909	25,290	27,089	27,385	27,498	27,348
Property Tax Appeal Board		2,791	3,367	4,482	4,778	4,577	5,034	5,321	5,321	5,587
Regional Offices of Education	-	-	-	13,032	16,975	13,636	17,670	15,720	17,740	17,840
State Board of Elections					159	2,571	5,843	3,100	5,800	3,100
Illinois Education Labor Relations Board						1,559	1,698	1,577	1,571	1,760
Court Reporters							34,114	34,114	34,114	85,830
Appellate Prosecutor								450	675	880
Illinois Community Colleges								-	97,100	103,500
Grants to Local Health Depts.										18,099
TOTAL PPRT DIVERSION	21,643	26,474	28,148	59,059	76,078	74,385	119,860	117,818	220,803	296,779

Source: Compiled from Budget Bills

per capita rate calculated for Missouri, Illinois would have generated nearly $4 billion.

In states that tax personal property, the Tax Foundation estimated that the tax accounted for 2.25 percent of state and local tax collections. In Illinois that would, using Census Bureau data, yield about $1.6 billion.

One last thing

The PPRT takes one more bad rap, being accused of adding to the proliferation of local governments in Illinois because no local official wants to give up the PPRT that flows to it just for being in existence. The story goes that there are numerous units of local government that resist consolidation or elimination because of the PPRT.

Not so. The State Revenue Sharing Act (30 ILCS 115/12) provides that if a taxing district discontinues operations or ceases to exist, the taxing district that assumes its duties and obligations shall receive the discontinued district's share of PPRT. The law also specifically provides for adding together PPRT receipts when two taxing districts merge, and has a provision for splitting the PPRT when there is annexation on disconnection of property to or from a taxing district. There are many reasons we have so many taxing districts in Illinois, but the PPRT should not be one of them.

Conclusion

Here are some things to remember about PPRT:

1. Creation of the PPRT was extremely difficult almost 40 years ago, even though it replaced an inefficient and unpopular tax. It was enacted largely because of the Constitutional mandate.

2. The PPRT was initially tracked carefully to assure it "replaced" the abolished tax on business personal property. It has not kept pace with our estimated growth in the original tax base.

3. PPRT is distributed to local governments based on the way the world was 40 years ago, a world that has changed as industries have opened and closed and populations have shifted.

4. The PPRT is broadly distributed to 6,525 units of local government.

5. Few, including recipient local governments, understand the PPRT and without strong defenders, receipts are increasingly being siphoned off to prop up state spending.

6. Illinois is in the minority of states that do not tax personal property in some fashion, a positive factor in our tax climate that gets little attention.

Perhaps it is time to revisit the PPRT.

IS THE PPRT AN INCOME TAX?

By Carol Portman

The question comes up from time to time, particularly when referring to Illinois' overall corporate income tax rate: does the PPRT "count" as an income tax? If so, then our corporate income tax rate is now 9.5 percent (the Corporate Income Tax after 7/1/2017 is 7 percent, plus the PPRT of 2.5 percent), one of the highest state rates in the country. If not, then at 7 percent the corporate rate is still above average but no longer top ten.

The full name of the largest tax under the PPRT umbrella is the "Personal Property Tax Replacement Income Tax." For many, the argument starts and ends right there. It is imposed at Section 201(c) of the Illinois Income Tax Act (35 ILCS 5/201). The tax is paid using Form IL-1120, the corporate income tax return, and the tax base is identical to that for the corporate income tax. (This piece of the PPRT also applies to partnerships, subchapter S corporations, and trusts, although at a lower rate and using the appropriate returns for these entities.) As is the case with an income tax, no PPRT is due if a taxpayer has no taxable income, even if they still have personal property. No wonder, then, that the taxpayer community considers the PPRT an income tax—with all these attributes of an income tax, if it is not an income tax, what else could it be?

Interestingly, the framers of Illinois' Constitution anticipated that the PPRT could be, at least in part, an income tax. As Mike Klemens' primary article in this issue points out, the PPRT was enacted in 1979 pursuant to a mandate in the 1970 Constitution. (Article IX, Section 5(c)) The Constitution explicitly carves out any replacement tax based on income from counting as a corporate income tax in calculating the 8-to-5 ratio. (The corporate income tax rate can't exceed the individual income tax rate by more than an 8-to-5 ratio—Article IX, Section 3(a).) Such a carve-out would not have been necessary if a replacement tax based on income was not going to be considered an income tax.

On the other hand, the tax was not enacted with the usual income tax purpose—to raise revenue for general State government purposes. Instead, it was enacted specifically to replace the personal property tax. Similarly, the funds raised by the tax do not go to the State (with the exception of the ever-growing diversions discussed in our main article). Instead, the money goes to local governments—the same locals that had been imposing a personal property tax. So, from the perspective of the governmental units involved, the PPRT is the equivalent of the old personal property tax.

Perhaps it doesn't really matter—a tax that is based on income but allocated as if it were a 1976 property tax is certainly an odd duck, and one that warrants a thorough re-examination, no matter how it is classified.

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