6 A TAX POLICY UPDATE *for* AMERICA'S SMALL BUSINESSES

Synopsis

Taxes are perennially listed as a significant concern of America's small business community. [1] Entrepreneurs face a complex and ever-changing web of federal, state, and local (and sometimes international) tax rules and burdens. Significant advances in data availability and econometric methods have spawned a large and growing body of literature on the effects of tax policies on small business activity. The bulk of prior research effort has been focused on tax *rates*, while public discourse is focused on nonrate tax policies such as depreciation rules, health insurance deductibility, and when state governments have the right to tax multi-state businesses.

This report is intended to shed greater light on several prominent federal, state, and local tax issues faced by small businesses today. First, a discussion of federal tax issues focuses on the individual income tax, the alternative minimum tax (AMT), the corporate income tax, and the estate tax. Policy issues at the federal level include the possible extension of the 2001 and 2003 federal income tax rate cuts, possible solutions to the burgeoning AMT filing population, and whether to change the tax treatment of small business investment (through depreciation rules), health insurance costs, and carried interest.

Turning to state and local tax issues next, the author discusses several key nonrate tax issues that are receiving increasing attention by policymakers but have not been as intensively studied by researchers:

- the small business implications of recent changes in state business taxation (namely, the taxation of variants of gross receipts instead of net business profit as a way to tax business activity),

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- efforts by state and local governments to streamline sales tax rules in order to eventually be able to tax multi-state (and especially online) commerce more efficiently,

- state efforts to "decouple" from federal tax rules, and

- key changes in the legal landscape such as recent rulings regarding the uses of tax breaks to lure business activity and the determination of nexus for multi-state tax purposes.

The context for this discussion is the latest evidence of the total state and local business tax burden, recognizing that small businesses pay much more than the income and payroll taxes that have received so much attention in the economics literature.

The report's closing section focuses on a few emerging themes that will place additional pressure on federal, state, and local tax systems and will thus have implications for small businesses. Specifically, the discussion looks at issues related to the aging of America's population, the rapidly expanding technology of tax planning through legal and illegal means, and the coming growth of environmentally conscious tax policies, as well as how those trends will couple with pre-existing pressures to force discussion of fundamental tax reform in 2009.

Throughout, the report considers the economic, demographic, and political forces that have given rise to recent tax policy changes and current tax policy debates. The nation's federal, state, and local governments all face continuing pressure on all of these fronts, and it will be important to establish the appropriate policy context for each of the specific tax issues under consideration. For the purposes of this report, the author sets aside issues with respect to the size of the tax pie and focuses instead on the issues involved in the structure of federal, state, and local tax systems. In this vein, it is critical to be able to discuss possible changes to the tax landscape without worrying as much about the revenue impacts.

Federal Tax Issues Faced by Small Businesses

Perhaps the most prominent topics in federal taxation today are whether to make the 2001 and 2003 income tax rate cuts permanent, the future of the alternative minimum tax (AMT), and the future of estate taxation. These are discussed in the sections that follow, along with several other federal tax issues that might have implications for small businesses in the coming years.

Individual Income Tax Issues

The broad reductions in marginal tax rates that were implemented in 2001 and 2003 are set to expire at the end of 2010 when the law reverts to 2001 tax law, barring new policy action. This is a particularly critical issue for small businesses, the majority of which pay federal taxes through the individual (not corporate) income tax.[2] Potentially affected firms include sole proprietorships, partnerships, S corporations, and other pass-through entities. Coupled with the increase in tax rates on regular income (and corresponding tax bracket adjustments) will be a reversion from the favorable tax rate applied to qualified dividend income to regular income tax rates. This will increase the cost of raising equity capital and distort business decisions (for example, by reducing the incentive for profits to be redistributed to shareholders and increasing the incentive to hold profits as retained earnings).

As with the tax rates on ordinary and dividend income, attractive tax provisions for certain capital gains are set to expire or be scaled back at the end of 2010. Additionally, asset classes will be modified based on holding periods, potentially necessitating additional recordkeeping and adding to overall tax code complexity or compliance costs faced by small businesses. The higher tax rates themselves could potentially reduce the returns to some small business investments and also reduce the available pool of startup capital. At the same time, the higher capital gains tax rates will provide a benefit to small businesses in the form of an increase in the marginal value of the exclusion for qualified small business stock.

The extent to which these tax cuts will be allowed to expire is certain to be a matter of significant public discussion in the coming years. Fiscal pressures suggest that the odds of all of the tax cuts being made permanent are quickly falling. With this in mind, it is important to consider the implications of a pending tax rate increase. While earlier research tended to find a positive correlation between tax rates and entrepreneurial activity, the most recent work suggests that higher tax rates reduce entrepreneurial activity. Indeed, results from the study by Bruce and Gurley (2005) suggest that tax rate increases on

2 Bruce and Gurley-Calvez (2008) show that corporate entities have filed a smaller share of all business tax returns over time, with the corporate share falling to only about 8 percent by 2002.

the order of what might happen at the end of 2010 could have very large negative impacts on the level of entrepreneurial activity in the economy.

Another individual tax issue faced by small businesses is the deductibility of health insurance costs. While full deductibility is now possible under the individual income tax, full deductibility under the payroll tax is not permitted. This differential treatment drives a wedge between the cost of health insurance faced by small businesses and that faced by wage workers, who enjoy full deductibility under both taxes. Recent research has found that greater deductibility of health insurance premiums can enhance small business survival (Gurley-Calvez, 2006).

Among the potentially expiring tax provisions of interest to small businesses is the tax credit for pension plan startup costs. This credit, which equals half of the first $1,000 of eligible costs associated with starting and administering a qualified pension plan for the plan's first three years, is available to firms with fewer than 100 employees that received at least $5,000 in compensation in the prior year. Further, the credit is available to all qualifying small firms regardless of whether they file individual or corporate income tax returns. The expiration of this credit at the end of 2010 will reduce the incentive for small businesses to establish retirement plans for their employees, and will thus reduce those firms' ability to attract high-quality workers.

The tax treatment of carried interest is an issue that has received attention in recent years. Carried interest is a claim that the general partner of a private investment fund has on a share of the fund's returns above some minimum rate of return. These returns, along with annual management fees, are paid to the general partner and distributed to individual managers in return for managing the fund's assets and for contributing a small portion of the fund's initial capital.

On average, management fees and carried interest constitute two-thirds and one-third, respectively, of total payments to the general partner. Per current federal code, the individual partners of the general partner are taxed on these payments rather than the general partner itself. The fees are treated as wage-and-salary income and are subject to ordinary income tax rates (up to a current maximum rate of 35 percent). The carried interest is treated as investment income, however, and subject to long-term capital gains rates (up to a current maximum of 15 percent).

The debate surrounding carried interest involves whether this tax differential is warranted. The most extensive proposals call for taxing carried interest as regular income. Changing the way in which carried interest is taxed could affect businesses in a few key ways. First, it could alter effective corporate income tax rates. Since corporate profits are taxed at the firm and individual level, higher rates on carried interest will increase the degree of double taxation on a fund's profits that are from businesses that pay corporate income taxes. Raising rates (through the expiration of the 2001 and 2003 tax cuts or some other reform) will raise effective corporate income tax rates, increasing the degree of double taxation. Second, it may decrease productive small business activity to the extent that private equity firms are involved in their creation and funding.

Alternative Minimum Tax

The AMT was established in 1969 when it became known that a small number of very wealthy individuals were not paying any federal income taxes. If a taxpayer's tax liability is found to be too low relative to their income, they might incur AMT liability now in addition to any regular income tax liability. Unfortunately, the income threshold for AMT liability is not indexed for inflation. Combined with the 2001 and 2003 tax cuts (which reduced most individuals' tax liabilities relative to their income), this nonindexation has caused growth in the number of taxpayers potentially subject to the AMT. Researchers at the Tax Policy Center estimate that more than 23 million taxpayers will have been affected by the AMT in 2007.[3]

Since 2001, Congress has regularly raised the AMT exemption amount on a temporary basis in an effort to stave off this growing problem. The cost of this annual "patch" rises each year, suggesting that a permanent solution will eventually become necessary. Outright repeal of the AMT will be a very expensive proposition, so it is more likely that an AMT reform will preserve its basic structure and intent, while possibly indexing for inflation. Small businesses will want to keep track of AMT reform discussions, as any change in AMT policy can lead to higher or lower overall marginal tax rates.

Corporate Income Tax Issues

The small business implications of corporate income tax policies are much more significant at the state level, as discussed below. Some important fed-

3 See Burman, Gale, Leiserson, and Rohaly (2007).

eral issues are worth mentioning here. These are particularly important for incorporated small businesses that pay federal corporate income taxes. First, changes in expensing rules for business investment are in constant flux given policymakers' taste for using depreciation rules as a primary vehicle for economic stimulus. While a certain dollar amount of qualified business assets may be expensed, that amount has changed over time, and short-term increases in it have been greatly reduced. Indeed, small businesses paying their taxes through the individual income tax face a similar set of confusing and ever-changing depreciation rules.

Increases in expensing allowances and bonus depreciation allow businesses, and especially small businesses whose investment falls below the phase-out amounts, to either make new investments or to make investments earlier. It is not clear from the available research, however, whether the changing depreciation rules have meaningful impacts on the overall level of business investment or on the distribution of investment among small and large businesses, rather than just on the timing of investment. This will be a particularly important topic for future empirical analysis of business decisions.

Like the individual income tax, the federal corporate income tax has a corresponding alternative minimum tax. Unlike the individual AMT, the corporate AMT has not been adjusted for inflation in recent years. This is perhaps because of the starkly different public perception of a rising corporate AMT-filing population.[4] As the corporate AMT-filing population grows over time, small and mid-sized corporations may be most affected since they are most likely to be just below the filing threshold now. This only increases the overall effective marginal tax rate on corporate income, and carries the usual effects on the cost of raising capital. It also potentially reduces the incentive to incorporate among noncorporate entities. This boils down to a tradeoff between the individual income tax and the AMT and corporate equivalents.

Estate Tax Issues

The gradual repeal of the federal estate tax that was set in motion in 2001 received prominent attention and support from the small business community. Opponents of estate taxation pointed to its effects on family businesses,

4 Following the first year of operation, during which all corporations are exempt from the corporate AMT, firms may face AMT liability if their average annual gross receipts exceed $5 million over the first three tax years and $7.5 million for the next three tax years.

recounting stories of firms that were dissolved, rather than passed down to heirs, in order to pay the estate tax. It is well known that the full repeal of the estate tax in 2010 will be fully reversed in 2011 unless the law is changed to make the repeal permanent (or to preserve some elements of the repeal).

The qualified family-owned business interest (QFOBI) exemption will come back into play with the reversion to 2001 law in 2011, assuming no policy changes. Those with eligible business assets will enjoy lower estate taxes on the same amount of wealth than those without eligible assets. This may have several important effects on small business activity. First, it might encourage taxpayers to shift assets into business form, or to avoid liquidating existing businesses, when possible. It might also encourage the overvaluation of business assets, the removal of nonbusiness assets from the estate, or the use of costly additional estate planning resources. This tax differential between asset types might lead to a misallocation of capital and employment of heirs by requiring businesses to stay in the family.

State and Local Tax Issues Faced by Small Businesses

Before discussing the details of current and pending state and local tax issues faced by small businesses, it is important to establish the context within which the tax changes are taking place. State and local governments have experienced tremendous pressures in recent years for many reasons, some obvious and some less so. The largest component of state and local government spending is education. Recent court cases in many states and federal requirements to track student performance have placed restrictions on the size and structure of education finance systems.[5] Several states have had to turn away from the property tax as the primary vehicle for funding public schools. In some states, a turning away from the property tax has been the result of tax revolts rather than legal mandates.

A second key source of state and local fiscal pressure is health care inflation. It is well known that growing health care costs have burdened state and local governments responsible for providing health benefits to government

5 The National Access Network reports that 43 states plus the District of Columbia have faced some form of legal challenge of their school funding systems, and states have lost the majority of those challenges (http://www.schoolfunding.info/states/state_by_state.php3).

employees in addition to individuals who qualify for low-income health care assistance programs (notably Medicaid). Policymakers have limited options when faced with rising health care costs, so other discretionary spending is typically cut or taxes are increased.

Increasingly mobile tax bases have increased the importance of tax competition for state and local governments. Thanks to technological advances and relatively cheaper transportation options, individuals and businesses are better able to "vote with their feet" to reduce their tax burdens. This relates to the common criticism that state and local tax systems were designed for an economic structure that no longer exists. Indeed, the increasing mobility of taxable activities has paralleled strong growth in hard-to-tax elements of the economy, such as services, electronic commerce, and intangibles.

In the face of these pressures, state and local governments have turned toward higher taxes on businesses and outsiders, neither of whom vote (directly, at least) for or against state and local policymakers. In some cases, as discussed in greater detail below, small businesses might end up bearing a disproportionate share of an increased burden.

Recent Developments in State Corporate Income Tax Policy

Adding to the pressure on state business tax revenues has been a gradual decline in the base for the major business tax in most states: taxable corporate profits. Of course, some of this base erosion has been the result of state and local efforts to provide tax incentives to presumably important businesses that were recruited into an area. Other forces in the base erosion have been aggressive corporate tax planning activities (either to physically move to lower-tax jurisdictions or to use accounting and other methods to reduce the share of profits that are taxable in a particular state), and federal tax changes (such as bonus depreciation) that reduce tax bases for states where the state tax code is linked to federal rules.[6]

The flagging performance of state corporate income taxes in recent years has led states to revisit their business tax systems. For most states, this process has involved making changes to existing corporate income taxes in order to shore up falling bases. In a small number of other states, business tax systems

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6 See Fox (forthcoming) for more on the fiscal pressures facing state business taxes, Bruce, Deskins, and Fox (2007) for more detail on corporate tax planning, and Luna and Watts (2007) for more discussion of the issue of state-federal corporate tax linkages.

have been fundamentally changed in such a way as to expand the taxable base while lowering the tax rate. Each of these changes has potentially important implications for small businesses.

Efforts to shore up existing corporate income tax systems include such things as the assertion of economic nexus (rather than physical presence), the adoption of combined reporting requirements, changes in apportionment formulas, and decoupling from key federal tax changes. States have attempted many other things to save their corporate tax systems, but the focus here is first on these four major approaches, then on more fundamental state business tax changes.

Economic Nexus. For a state to collect business income taxes, the business involved has to have what is called nexus, or some attachment to the state. Traditionally, nexus for corporate income tax purposes has been defined by Public Law 86-272, which essentially requires the business to have some form of physical presence in the state that wishes to collect the tax. However, two recent court cases have called this into question. In both the *Lanco* and *MBNA* cases, states asserted that the businesses in question had sufficient nexus as a result of substantial economic presence, either by license agreements with affiliates or by efforts to generate sales in the states.[7] These cases were not reviewed by the U.S. Supreme Court, so some states have taken this to imply tacit acceptance of economic nexus.

While this issue is perhaps more relevant in the few states that have fundamentally changed their business tax systems (see below), the general trend away from physical presence nexus toward economic presence has broad implications for virtually every state and local tax system and certainly for small businesses operating or selling goods or services in multiple states. This issue will be revisited in the discussion of sales tax challenges below.

In simplest terms, a small business in one state that generates sufficient sales in another state may end up generating a new state tax burden if those sales satisfy the second state's definition of economic nexus. This is consistent with the general trend in state business tax systems to expand the tax to a broader set of businesses, especially those operating in multiple states that might not have had sufficient nexus under P.L. 86-272.

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7 *Lanco, Inc. v. Director, Div. of Taxation,* Docket No. A-89-05 (N.J. October 12, 2006), and *Tax Comm'r of the State of W. Va. v. MBNA America Bank N.A.*, Docket No. 33049 (W.Va. November 21, 2006).

Combined Reporting Requirements. A similar issue involves business actions to spin off certain segments of their operations, or to create passive investment companies or other affiliates, to escape business tax liability in certain states. States have attempted to counter this trend by adopting so-called combined (or unitary) reporting requirements, under which all related entities in a unitary system must file their business tax returns together. This practice has become especially important in recent years, with nearly half of all states enacting combined reporting requirements.[8]

Combined reporting requirements have the obvious effect of pulling certain out-of-state entities into (or back into) state business tax systems. It is not clear how this might affect small businesses, however. On the surface, small businesses that were created for the purpose of avoiding state business taxes in other states might be folded back into corporate structures, leading to a false conclusion that small business activity has suffered. Alternatively, combined reporting rules might encourage some corporate entities to reclassify themselves as noncorporate entities.

These two possible responses represent a change not in the level of business activity, but only in the organization of it into various types of businesses. Yet another outcome from combined reporting requirements might be an increase in small business activity, as the tax playing field is at least partially leveled between larger multi-state corporations and smaller single-state firms. Indeed, this possibility is borne out in research by Bruce and Deskins (2006), who find that states with combined reporting rules tend to have more small business activity.

Apportionment Formulas. Income earned by businesses that operate in multiple states (and have nexus in those states) is apportioned among the taxing states for corporate income tax purposes. Historically, most states placed equal weight on business payroll, plant and equipment, and sales in determining the share of the corporation's total profits that can be taxed by any single state. Over time, however, many states have elected to place more weight on the sales factor. Cline and Neubig (2007) report that only 11 states now use equal weights on all three factors, with 18 states using a 100 percent weight on sales and the others using at least a double weight on the sales factor.

Increasing the sales factor weight effectively takes some of the tax burden off mostly in-state firms with significant amounts of payroll or plant and equip-

8 See Cline and Neubig (2007) for more information on the spread of combined reporting.

ment and places it on firms with less physical presence (in terms of those two factors) but more sales in a state. As with the policy actions noted above, this is intended at least in part to spread a state's corporate tax system to a larger number of taxpayers. From the state's perspective, this action can also serve as an economic development tool since it can reduce the tax burdens borne by many in-state firms. It is not clear which, if either, of these possibilities is most relevant for small businesses.

Decoupling from Federal Provisions. It has become increasingly popular for the federal government to enact stimulative policies through the corporate and individual income tax codes. Unfortunately for states that are linked closely to the federal corporate income tax structure, any federal tax break directly becomes a state tax break unless the states act to break that link (i.e., to "decouple" from the federal provision). This has become more and more common in recent years as states have been reluctant to follow the federal provisions, which often would otherwise result in a loss of state tax revenues.[9]

Fundamental State Business Tax Changes

In some states, the problems with corporate income tax systems combined with other state budget pressures have led to a fundamental change in the way those states attempt to tax business activity. The most extreme cases have been seen in Ohio, Michigan, and Texas, where business taxes now resemble gross receipts taxes in one way or another. While the more incremental changes to existing corporate income taxes might affect small businesses on the margin, the shift toward gross receipts taxation could have more dramatic and far-reaching effects.

One significant feature of the business taxes in these three states is that they now apply to virtually any business entity, not just corporations. Sole proprietorships, partnerships, and other noncorporate entities now find themselves facing state business tax liability in those states in addition to any individual (or sales, property, or other) tax liability. Further, the base for these new taxes is some variant of gross receipts rather than net income. One potential advantage from the states' perspective is that gross receipts taxes are not necessarily subject to P.L. 86-272 nexus, which—by the assertion of those states—

9 See Luna and Watts (2007) for an interesting discussion of the extent to which states have decoupled from federal tax provisions in recent years.

applies only to business income taxes. This further expands the reach of state gross receipts taxes to a broader set of largely out-of-state firms.

In the extreme, the new systems can also create tax liabilities for firms with net operating losses.[10] Further, recent research by Rork and Wheeler (2008) shows that shifting from a corporate income tax to a gross receipts tax can create winners and losers, raising the usual sorts of horizontal and vertical equity concerns. Additionally, the fact that states focusing on gross receipts taxation are not "playing well with others" in the sense that their business taxes are not well aligned with the federal system or those in other states makes the overall business tax environment potentially more complex, especially for smaller businesses.

Moving Beyond Business Income Taxation

Of course, it is important to note that income taxes (either on businesses themselves or on individuals) represent a small share of the total state and local business tax burden. In the latest of a series of regular reports on the total tax burden borne by businesses, Phillips, Cline, and Neubig (2008) estimate that property taxes on business property and general sales taxes on business inputs are the two most important state and local taxes paid by businesses. These two taxes represent 35.1 percent and 22.9 percent, respectively, of the total state and local business tax burden. A major sales tax issue could have important implications for small businesses.

The Streamlined Sales Tax Project. As with the corporate income tax, state and local governments have witnessed significant erosion of the base of a relatively more important tax, the general sales tax. Shifts in consumption away from generally taxable goods toward generally tax-exempt services, the continuing process of legislated sales tax exemptions, and the rapid growth of remote (and especially electronic) commerce have all played a role in the gradual decline of the state and local sales tax base (Bruce and Fox, 2000).

States have typically responded by continually raising their sales tax rates rather than expanding sales tax bases, as expanding the sales tax base to include more services has proven to be politically very difficult in some states. In the case of remote commerce, in-state shoppers who buy something out of state are legally obligated to remit use tax in an amount equivalent to what the

10 See Pogue (2007) and Testa and Mattoon (2007) for much more on the pros and cons of state gross receipts taxation.

sales tax would have been had the sale taken place in the state. It comes as no surprise that use tax compliance has historically been very low, at least among individuals, because of low enforcement.

The recent explosion of catalog and Internet sales has cast greater light on the use tax issue, and has even led the states to begin working together to seriously consider simplification of state and local sales tax systems. States' ability to enforce collection of sales (or use) taxes by an out-of-state seller on purchases by in-state consumers is limited, as with the corporate income tax, to situations in which the seller has nexus. Interestingly, nexus for sales and use tax purposes has been gradually refined through a series of court cases to mean physical presence in much the same way as P.L. 86-272.[11] The courts have left the issue open, however, calling on Congress to reevaluate the appropriateness of a physical presence requirement. The states would like to apply an economic presence version of nexus, but have been challenged by Congress to simplify their sales and use tax systems in exchange for a hearing on this issue.

Answering this challenge, a large number of states have formed the Streamlined Sales Tax Project (SSTP). To date, 18 states are in full compliance with the various provisions included in the resulting Streamlined Sales Tax Agreement and another four states are reasonably close to achieving full compliance.[12] The odds of eventual policy change in the states' favor are significant enough that many large multi-state retailers have begun voluntarily collecting and remitting sales taxes on remote sales by residents of participating SSTP states.

On net, this development is probably a positive one for small business. First, local small businesses have been at a competitive disadvantage relative to larger out-of-state businesses since sales taxes are almost always due on local purchases but can easily be evaded or avoided on many remote purchases. If states are successful in leveling the sales tax playing field between in-state and remote retailers, that competitive disadvantage will largely disappear. Second, the broader tax base that would result from such changes might allow state and local governments to lower their sales tax rates. This is especially important considering that businesses end up paying up to 40 percent of all state and local sales taxes (Ring, 1999).

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11 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

12 Those provisions include such things as uniform definitions of potentially taxable items and rate simplification within states, among many others.

State and Local Individual Income Tax Developments

State taxes on individual income continue to play a prominent role in the tax portfolios of small businesses, certainly for noncorporate pass-through entities. While the practice has not become widespread, some states are following on trends to expand the reach of corporate income taxes to expand individual income taxes to those who earn a substantial share of their income by crossing state lines. Professional athletes and performing artists have been prominent targets of these efforts, but more recent activity suggests that lower-profile individuals such as traveling business people might also be targeted.

In terms of policy developments, perhaps the most important discussion involves possible federally mandated standards regarding the number of days one physically works in a state before that state can impose income taxation. Those standards vary from state to state, with some imposing tax after a single day of work and others requiring a minimum of up to 60 days of work before tax would be due. While it is unlikely that the environment for individual taxation will resemble business taxation to the extent that individual income will be apportioned among states in which it is earned, small businesses—especially those whose owners or employees cross state lines in the pursuit of income—will certainly want to monitor these proceedings.

State and Local Property Tax Developments

A key component of recent state business tax changes has been a general reduction in taxes on business property, accompanied by extensive limitations on the scope and/or growth of property taxes in virtually every state. Indeed, most states now have some form of statutory limitation on property taxation.[13] On the surface, this means lower tax burdens for businesses of all sizes. Digging more deeply, however, limitations on one source of tax revenue are easily circumvented by increasing taxes on other sources, namely on one or another form of business taxation.

Another issue related to property tax limitations is that property taxes are the most important source of local tax revenue. Limits on local property tax systems, often set in place in the pursuit of more adequate or fair school funding systems, implicitly place more importance on state-level revenue instruments. Of course, the state revenue portfolio includes more taxes on business

13 National Conference of State Legislatures (2002).

activity than are present in local revenue systems, so this trend could lead to greater overall business tax burdens at the state and local level.

On another property tax issue, state and local governments have been famous for offering generous property (and other) tax breaks to lure mobile business activity. However, a recent court case has called the legality of these sorts of tax incentives into question.[14] Perhaps seeing the writing on the wall, states seem to be gravitating toward non-tax-incentive programs. The extent to which this might affect small businesses is difficult to determine. Targeted tax breaks inevitably result in higher taxes elsewhere, so a turn away from these practices could provide benefits in the form of lower overall taxes for all firms.

Looking Ahead: Tax Issues on the Horizon

The current wave of federal, state, and local fiscal pressures, which is likely to continue for some time, is also likely to be exacerbated by several emerging trends, including the effects of an aging population, expanding technology for tax planning, and the expansion of so-called green taxation.

Consequences of an Aging Population

The gradual aging of the American population poses a familiar set of problems for federal, state, and local budgets, and governmental responses to the problems could have important effects on small businesses. An older population will mean more demands on the Social Security and Medicare budgets at the federal level. Unless policymakers want to reduce benefits for those programs, payroll taxes will have to be raised. Similarly, the aging population will continue to place upward pressure on health care costs, thereby increasing the costs of running a small business.

At the state and local levels, the aging of the population will have decidedly different impacts. Older voters may fight harder for tax limitations, especially for the property tax, and tax burdens may be shifted further onto businesses. States with more balanced tax systems, especially those with stable sales taxes, will be able to weather the storm better than states that rely more heavily on individual income taxes, because individuals continue to spend money on sales-taxable items even as their incomes fall in retirement.

14 *Cuno v. DaimlerChrysler, Inc.*, No. 3:00 CV 7247 (N.D.Ohio 10/11/2006).

The Expanding Technology of Tax Planning

The increasing mobility of tax bases, both domestically across state lines and internationally into other countries, will contribute to the ongoing proliferation of methods for reducing individual and business taxes. Confronted by this increasing mobility, federal, state, and local governments will have to face the tradeoff between competing for mobile bases by lowering tax rates on one hand, and raising enough revenue to fund public service obligations on the other. Local, less mobile tax bases will be asked to bear a larger share of the total tax burden unless major changes are made in how multi-jurisdictional activities are taxed. This has especially important ramifications for local small businesses that are not as easily able to relocate to a lower-tax jurisdiction or engage in costly yet sophisticated tax planning.

The Growth of Green Taxation

As oil prices continue to climb and Americans work harder to minimize their individual and collective impacts on the environment, it is likely that governments will join in by enacting new earth-friendly tax systems. Under discussion are cap-and-trade systems for pollution permits, carbon taxes that would penalize the largest emitters, tax incentives for alternative-fuel vehicles, and tax credits for "clean" production, among many others. Policymakers will certainly be creative as they think about using various tax systems to carry out environmental policies. Small businesses involved in the green wave will likely benefit from the new direction in public policy, while others will be left holding the bill.

The nation is approaching an important period in tax policy history. The significant pressures posed by an aging population, increasingly mobile tax bases, and an ever-expanding dialogue on the impact of human activity on the environment will combine with the pending expiration of a significant number of important tax rates and policies to force a discussion of fundamental tax reform in 2009. It remains to be seen how that dialogue will affect small businesses, but current and potential business owners will certainly want to participate in the discussion.

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