
The Process for Making Tax Policy in the United States: A System Full of Friction

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INTRODUCTION

The American Revolution (1775-1783) resulted in the independence of 13 of Great Britain's North American colonies. In the 1780s, leaders of the new American nation realized that the national government, formed under the articles of confederation, was too weak. In 1787, representatives of the new states met in Philadelphia to consider ways to strengthen the national government, although many of them feared that a national government with enhanced authority had the potential to usurp power from the states and oppress the people.¹ The result of the Philadelphia convention was the US constitution. The constitution gave many additional powers to the national government. At the same time, the constitution addressed the fear of

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1 The Declaration of Independence (1776) asserted that the reason for severing ties with Great Britain was the abusive exercise of power by the British government: "The history of the present King of Great Britain is a history of repeated injuries and usurpations, all having in direct object the establishment of an absolute Tyranny over these States." A long list of alleged oppressions follows this statement, including "imposing Taxes on us without our Consent."

governmental abuse by creating a structure with checks and balances, including a bicameral legislature, an independent executive, and an independent judiciary.²

This system of checks and balances fundamentally affects the formation of policy in the United States today, including the formation of tax policy. Ultimately, federal tax legislation in the United States must be approved by both houses of Congress (the House of Representatives and the Senate) and signed by the president (or, if the president vetoes the bill, Congress must override the veto). This legislative structure creates the framework for the development and enactment of US federal tax laws. This structure is quite different from the structure in many other countries, including, for example, countries with a parliamentary system of government.

Legislation is not the only vehicle by which US federal tax policy is made. It is made in various additional ways, including

- Treasury department regulations,
- other published guidance by the Treasury department that is generally applicable to all taxpayers,³
- guidance by the Internal Revenue Service (IRS) relating to particular taxpayers,⁴
- IRS administrative initiatives⁵ and IRS internal guidance,⁶
- tax treaties and other intergovernmental agreements,⁷ and
- court opinions in litigated cases.

This paper will focus on the development of US federal tax policy through legislation, followed by a brief discussion of regulations.

2 In Federalist Paper no. 51 (1788), James Madison explained, “If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.” Consequently, it is necessary to “contriv[e] the interior structure of the government as that its several constituent parts may, by their mutual relations, be the means of keeping each other in their proper places” (James Madison, “The Structure of the Government Must Furnish the Proper Checks and Balances Between the Different Departments,” *New York Packet*, February 8, 1788). See also John M. Blum, Bruce Catton, Edmund S. Morgan, Arthur Schlesinger Jr., Kenneth M. Stampp, and C. Vann Woodward, *The National Experience: A History of the United States*, 2d ed. (New York: Harcourt Brace & World, 1968), at 131-38.

3 For example, Revenue rulings, Revenue procedures, and notices.

4 For example, a private letter ruling that can be relied upon only by the taxpayer who received the ruling.

5 For example, efforts to find offshore bank accounts.

6 For example, IRS procedures contained in the *Internal Revenue Manual*, infra note 23.

7 For example, tax information exchange agreements and agreements under the Foreign Account Tax Compliance Act (FATCA), subtitle A of title V of the Hiring Incentives To Restore Employment Act of 2010, Pub. L. no. 111-147, enacted on March 18, 2010.

As a preliminary matter, it is helpful to describe the tax function in the executive branch of the federal government. The executive branch consists of the president, the White House, and various departments (such as the Treasury department) and agencies. The tax function has two primary parts. The Treasury department's Office of Tax Policy, which has approximately 100 lawyers, economists, and accountants, advises and represents the administration regarding tax legislation. It also participates in the preparation of regulations and other generally applicable published guidance, negotiates tax treaties, represents the United States in meetings of multi-lateral organizations dealing with tax policy matters, and prepares revenue estimates for the administration. The IRS, which has more than 90,000 employees, administers the tax law and deals with all matters involving particular taxpayers, such as the filing of returns, collections, audits, and litigation. The Justice department also conducts tax litigation. The responsibilities of the Office of Tax Policy and the IRS are generally separate and distinct, but they do work together on published guidance generally applicable to all taxpayers, such as regulations.⁸

One other important observation is that during the 1600s and 1700s, the 13 American colonies developed as 13 separate sovereignties under the rule of England. The constitution was drafted by representatives of the new states and ratified by the states, which intended to retain most of their original sovereignty. The constitution grants various enumerated powers to the federal government, including the power to “lay and collect Taxes.”⁹ However, the federal government is the product of a federation of the states and, as articulated in the 10th amendment to the US constitution, the “powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.”¹⁰ Among the powers retained by the states is the power to levy taxes. Consequently, the states (and local governments) have their own tax systems and develop their own tax policy.¹¹

FEDERAL TAX LEGISLATION

Sources of Legislative Ideas

In the United States, there are many sources of legislative ideas. First and foremost, members of Congress (with the assistance of their staff) develop tax policy ideas and introduce tax legislation (in the form of bills). Tax proposals can either be broad reform proposals or focus more narrowly on particular areas or specific issues.

8 This separation of duties is a consequence, in part, of the Watergate era in the early 1970s, when the White House attempted to use the IRS to harass President Nixon's enemies.

9 US constitution, article I, section 8.

10 Tenth amendment to the US constitution (1791).

11 For example, unlike the federal government, state and local governments impose franchise taxes, sales and use taxes, and property taxes.

In the House of Representatives, primary jurisdiction over tax matters is exercised by the Ways and Means Committee. For example, since 2011, this committee and the Senate Finance Committee have held numerous hearings about many aspects of tax reform. Congressman Dave Camp, the chair of the Ways and Means Committee, has issued discussion drafts about reform of international taxation (October 2011), financial products taxation (January 2013), and small business taxation (March 2013). He has indicated that he will introduce a comprehensive tax reform package that will be considered by the full Ways and Means Committee.

In the Senate, primary jurisdiction over tax matters is exercised by the Senate Finance Committee. In 2012-13, the committee issued numerous papers listing options for reform of various areas of US tax law. In September 2012, Senator Michael Enzi, a member of the committee, introduced a bill to reform international taxation. In November 2013, Senator Max Baucus, the chair of the Senate Finance Committee, issued discussion drafts about reform of international taxation, tax administration, and cost recovery and accounting.

In addition, members of Congress who are not on the House Ways and Means Committee or the Senate Finance Committee develop tax policy ideas and introduce legislation. For example, Senator Carl Levin has introduced the Stop Tax Haven Abuse Act to address concerns about the use of offshore entities to avoid or evade US tax.¹² He has also chaired hearings of the Senate Permanent Subcommittee on Investigations examining offshore profit shifting by US corporations.

An important office serving Congress in tax matters is the Joint Committee on Taxation. The staff of this committee consists of lawyers, economists, and accountants who assist committees and members of the House and Senate on tax legislative matters. The staff publish numerous documents on all aspects of federal tax law, and prepare the official congressional revenue estimates for tax legislation.

The president and his administration also play an important role in the development of tax policy. Every year, normally in early February, the administration issues its proposal for the government's budget for the coming fiscal year (starting on October 1). Included in the budget proposal are tax legislative proposals prepared by the Treasury's Office of Tax Policy, with input from White House staff, such as the National Economic Council. The administration puts forth other tax policy documents as well. For example, in February 2012, the Obama administration issued "The President's Framework for Business Tax Reform," a joint report by the White House and the Treasury department that set forth five principal elements for business tax reform. The administration also creates commissions. President George W. Bush created the President's Advisory Panel on Federal Tax Reform, which in November 2005 put forth two different reform proposals. One proposal would have reformed the income tax system; the other would have blended elements of both an income tax and a consumption tax. In December 2010, a majority of President

12 S. 1533, introduced on September 19, 2013.

Obama's National Commission on Fiscal Responsibility and Reform recommended substantial federal spending reductions coupled with tax reform that would eliminate many deductions, reduce tax rates, and reduce budget deficits.

The IRS, which administers the tax law, also contributes ideas to improve tax administration. These ideas are often reflected in the administration's annual proposal for the government's budget. In addition, the IRS Taxpayer Advocate, an independent organization within the IRS that helps taxpayers resolve problems arising from their interactions with the federal tax authority, recommends law changes to prevent future taxpayer difficulties, including changes to protect taxpayer rights.

Other governments and governmental organizations contribute to the development of US federal tax policy. For example, formalized groups of countries, such as the Group of Eight (G8) and the Group of Twenty (G20), both of which include the United States, meet periodically about common issues. The G8 and the G20 have focused on tax issues, including exchange of information among countries, tax avoidance and tax evasion, and base erosion and profit shifting. Both groups have also expressed their support for the work of the Organisation for Economic Co-operation and Development (OECD) in the area of base erosion and profit shifting. The OECD (of which the United States is a member, along with 33 other countries) has undertaken a project on this subject. In February 2013, it published a report on the issue, including discussion of possible solutions, which was followed by the publication of an action plan in July 2013.¹³ Although the findings and recommendations of the OECD are not binding on the United States, they do influence the US debate on tax policy and may lead to US actions, such as actions within the authority of the executive branch or proposed legislation.

Non-governmental organizations also contribute significantly to the development of tax policy in the United States. There are numerous policy organizations across the entire political spectrum, including think tanks such as the Urban Institute, the Center on Budget and Policy Priorities, the Tax Foundation, and the Heritage Foundation. These organizations employ public-policy experts who publish papers, make proposals, and otherwise play an active role in the tax policy debate.

In addition, professional organizations make an important contribution to the US tax policy discussion. For example, the American Bar Association Section of Taxation has prepared papers discussing options for tax reform in various areas of the tax law. As another example, the New York State Bar Association Tax Section has submitted technical comments on Chairman Camp's international tax reform discussion draft.

Finally, constituents, including businesses, organizations, and individuals, contribute to the development of tax policy. Discussions with members of Congress, the administration, and the White House are a common and accepted part of the

13 Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013) and *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013).

US policy-making process. A substantial industry has developed, particularly in Washington, DC, in which lobbyists provide information and advocate on behalf of their clients to members of Congress and the administration.¹⁴

The Federal Tax Legislative Process

The US federal tax legislative process starts with the introduction of a bill by a member of Congress. The constitution requires that all bills for raising revenue shall originate in the House of Representatives.¹⁵ Tax bills introduced in the House are referred to the House Ways and Means Committee. The House Ways and Means Committee considers the bill and can process it, often in a public setting called a “markup.” If the Ways and Means and Committee approves the bill (by majority vote), the bill is sent to the full House (the House floor) for consideration. The House can then approve the bill by majority vote.

In the Senate, tax legislation is referred to the Senate Finance Committee. The Senate Finance Committee considers the bill and can process it, again often in a markup. Sometimes the Senate Finance Committee has a conceptual markup, in which it does not have specific statutory language before it. If the Senate Finance Committee approves the bill (by majority vote), the bill is sent to the full Senate (the Senate floor) for consideration. The rules of the Senate allow filibusters, a parliamentary tactic used to delay or prevent a bill’s passage.¹⁶ Under Senate rules, a filibuster can be stopped only by invoking “cloture” and obtaining the vote of 60 of the 100 senators to proceed. Thus, in practice, in the Senate a bill needs 60 votes to be approved. Because filibusters can have the effect of preventing Senate action on many matters, there have been recent debates about changing the rules to prevent filibusters in certain situations.¹⁷ Nevertheless, today the ability to filibuster legislation continues. If there is no filibuster on a bill or the filibuster is overcome, the entire Senate can approve a bill by majority vote, with the vice-president breaking a tie.

The bills passed by the House and Senate might not be identical. In fact, as the result of negotiations and amendments in the House and Senate proceedings, the bills passed by the two houses of Congress might be quite different. Consequently, if the bills are different, a conference committee made up of leading members of the House Ways and Means Committee and the Senate Finance Committee negotiate

14 There is a legend that the term “lobbyist” was first used by President Grant (1869-1877) to describe people who approached him for favours while he was enjoying brandy and a cigar in the lobby of the Willard Hotel in Washington, DC, although in fact the word originated before Grant’s time in office.

15 US constitution, article I, section 7.

16 The Senate rules do not allow filibusters on reconciliation bills, which deal with budget issues.

17 On November 21, 2013, in a highly controversial action, the Senate voted to end the ability to filibuster presidential nominations for executive-branch and most judicial positions.

to achieve a compromise bill. If the negotiations are successful, the compromise bill is sent back to the House and Senate for passage.

Finally, an identical bill passed by the House of Representatives and the Senate is then sent to the president for his signature. If the president signs the bill, it becomes law. However, if the president vetoes it, it is sent back to Congress and does not become law unless both the House and the Senate override the veto by a two-thirds majority vote in both houses.

A primary purpose of this discussion summarizing the US federal tax legislative process is to emphasize the diffusion of responsibility for tax policy and the effect of the checks and balances created by the constitution, requiring passage by both houses of the legislative branch and approval by the executive branch. The US federal system is quite different from the systems in many other countries, including, for example, the parliamentary systems in the United Kingdom, Australia, Canada, and New Zealand, where the ruling party can achieve the enactment of tax legislation in a much quicker and more efficient manner. Some would argue that the checks and balances of the US federal tax system are an obstacle to action. Others would argue that the system operates as the framers of the constitution intended, to promote debate and ensure consensus. The Tax Reform Act of 1986¹⁸ is cited as an example where, despite challenges along the way, the system ultimately produced a successful outcome.

Government Officials Involved in the Tax Legislative Process

Consistent with the diffusion of responsibility described above, there are numerous government officials involved in the development and enactment of US federal tax policy. Of course, members of Congress, in particular members of the House Ways and Means Committee and the Senate Finance Committee, are primary participants. Because members of Congress have so many responsibilities besides tax, and because the tax law is so complicated, staff members play a critical role, especially the staffs for the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation.

In the executive branch, the Treasury's Office of Tax Policy and White House staff play a role in the tax legislative process. Their participation varies depending on the bill and the political environment. For example, during the period leading up to the enactment of the Tax Reform Act of 1986, President Reagan was a vocal supporter of tax reform and the Treasury department played a critical role in the process, by (among other things) issuing two comprehensive studies with legislative proposals. In contrast, more recently, the role of the administration in tax legislation has varied, in part because of increased political partisanship. The level of the administration's involvement can depend on which party controls the houses of Congress and the presidency.

18 Pub. L. no. 99-514, enacted on October 22, 1986.

There are many people, both inside and outside the US federal government, who have extensive experience in tax policy issues. Leaders of the House Ways and Means Committee and the Senate Finance Committee have worked on tax matters for many years. Various other government participants, such as congressional staff members and employees of the Treasury's Office of Tax Policy, usually have extensive private-sector business, legal, or academic experience. After their government experience, they generally return to the private sector and often interact with current government officials. Some even return to the government at a later time. This interchange between the public and private sectors is beneficial because it enables government policy makers to understand current trends and issues. On the other hand, it contributes to the perception of a revolving door, whereby former government officials have special access to current government officials and personally profit from this access.

Some Observations About the Current Legislative Scene

As previously discussed, in the US system there is a diffusion of responsibility that has a profound effect on the formation of tax policy. The checks and balances created by the constitution, combined with the existence of two distinct political parties, have created many points of friction, including, for example, Democrats versus Republicans, the House of Representatives versus the Senate, and Congress versus the administration. These frictions make it difficult to reach agreement. Adding to the difficulty is intense political partisanship, which has created an environment of mistrust with standoffs and brinkmanship. For example, Congress and the Obama administration faced a "fiscal cliff" at the end of 2012 when 2001/2003 tax relief was scheduled to expire. The United States faced other crises when the federal debt limit was reached in the summer of 2011 and the fall of 2013.

In the current environment, it is difficult to reach political compromises. Contributing to the challenging atmosphere is the role of the media and electronic communications. The media, through television, radio, and the Internet, heavily influence public opinion and the views of members of Congress, the administration, and other government officials. Instant electronic communication, whether by the media or by interested organizations and individuals, provides helpful transparency, but at the same time concerns about disclosure can discourage politicians and other government officials from engaging in sensitive discussions that can be helpful in finding a middle ground.

The inability to resolve problems results in continuing uncertainty, which hampers planning for individuals and businesses. In the near term, it will be difficult for Congress and the administration to reach agreement on two of the most pressing domestic issues, spending and taxes, including tax reform. Some have expressed the fear that only as a result of a crisis can the obstacles to compromise be overcome.

The US federal budget deficits also have a substantial impact on the tax legislative process. The annual US federal budget deficit has exceeded US\$1 trillion in several recent years. Because of concerns about revenue impact, revenue estimates prepared by the staff of the Joint Committee on Taxation play a major role in all tax

legislation. Furthermore, to minimize the revenue impact of revenue-losing provisions, such as tax incentives, Congress has enacted dozens of temporary provisions that expire after a year or two. Upon expiration, Congress is compelled to revisit the provisions, which are usually reenacted for another temporary period. In addition, sometimes Congress enacts tax increases to offset the costs of non-tax programs. For example, in 2010, Congress included various taxes in the Patient Protection and Affordable Care Act¹⁹ and the Health Care and Education Reconciliation Act²⁰ (“the health-care acts”) to offset the cost of health-care measures.

A final observation about the US federal legislative process is that the Internal Revenue Code²¹ is used for purposes besides raising revenue to fund the government. In particular, it is used to achieve social and economic policy objectives. For example, the health-care acts impose taxes on employers who decline to provide, and employees who decline to obtain, health-care coverage. Tax provisions can also serve as an alternative to direct spending. For example, there are numerous tax incentives to effectuate energy policy and refundable tax credits to assist disadvantaged individuals and families. Because of the use of the Internal Revenue Code for social and economic policy purposes, it is very complex and a political battleground.

REGULATIONS

The Internal Revenue Code is the foundation of the US federal tax system. However, it does not answer all the tax questions that arise in a complex society and economy. Accordingly, in section 7805 of the Code, Congress has given general authority to the secretary of the treasury (or his delegate) to “prescribe all needful rules and regulations for the enforcement of [the tax laws].” Furthermore, various sections of the Code give additional authority to the Treasury department to issue regulations in particular areas.²²

Because there are so many unanswered questions in the Internal Revenue Code, the Treasury department has issued thousands of pages of regulations. Consequently, in addition to the enactment of legislation included in the Internal Revenue Code, the promulgation of regulations is a fundamental part of the articulation of tax policy in the United States. For this reason, a brief discussion of the regulatory process is appropriate.

19 Pub. L. no. 111-148, enacted on March 23, 2010.

20 Pub. L. no. 111-152, enacted on March 30, 2010.

21 Internal Revenue Code of 1986, as amended (herein referred to as “the Code”).

22 For example, section 1502 of the Code states that the “Secretary [of the treasury (or his delegate)] shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group . . . may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability [of the group and its members], and in order to prevent avoidance of such tax liability.”

The preparation and issuance of regulations is a joint effort of the Treasury's Office of Tax Policy and the IRS. Participants in the process generally include lawyers (and sometimes economists on projects such as transfer pricing) in the Office of Tax Policy and lawyers in the IRS Office of Chief Counsel. The development and drafting of regulations is a lengthy process, which usually begins with an announcement that the government intends to undertake a particular project. Every year, the assistant secretary for tax policy (who heads the Office of Tax Policy and reports to the secretary of the treasury), the IRS commissioner, and the IRS chief counsel jointly publish a priority guidance plan that lists the regulations and other published guidance projects that the Office of Tax Policy and the IRS will work on in the coming year. The process for issuing regulations normally involves internal memorandums, drafts, meetings, and briefings.

In preparing and issuing regulations, the Office of Tax Policy and the IRS follow the *Internal Revenue Manual* (an internal IRS document)²³ and the Administrative Procedure Act.²⁴ Accordingly, there is generally formal notice and the opportunity for comment by the public. In addition to formal procedures for comment, there is informal interaction between the government and the private sector about issues being considered in regulatory projects. In these informal discussions, government employees are careful not to divulge confidential or otherwise sensitive information, such as the specific content of the regulations or their effective date.

Regulations are first issued in proposed form. A notice and comment period follows. If requested, a public hearing is held. Regulations are finalized after receipt and consideration of the public comments. Most regulations have an effective date as of the date of finalization. Some regulations are both proposed and temporary (that is, immediately effective) in order to provide currently needed guidance or to prevent abuse.

Regulations have the force of law. Their validity can be challenged, but a challenger must satisfy a relatively high standard in order to prevail. In *Mayo Foundation v. United States*,²⁵ the US Supreme Court applied a two-part analysis in upholding the validity of a regulation. Under this analysis, a challenge will be successful only if the regulation is contrary to a statute that is unambiguous or if the regulation is an unreasonable interpretation of the statute.

23 See Internal Revenue Service, *Internal Revenue Manual* (Washington, DC: IRS), at part 32.1 regarding regulations.

24 See 5 USC section 553.

25 131 S. Ct. 704 (2011).

CONCLUSION

The US constitution established a system of checks and balances that underlies the structure of the US federal legislative process, including the process for enacting tax legislation. The system of checks and balances is intended to promote debate and ensure consensus. The tax policy debate in the United States is extensive, with substantial interaction within the government and between government officials and the public. The level of the debate is enhanced by the participation of numerous tax policy experts, both inside and outside the government.

Although the system of checks and balances has certain advantages, it operates today in an environment of intense partisanship and a pervasive concern about budget deficits. This combination of factors has made it difficult for Congress and the president to achieve the agreement necessary to resolve pressing fiscal issues, including the need for tax reform.

