



January 3, 2006

Via Electronic Mail

CC:PA:LPD:PR (REG-105847-05)  
Room 5203  
Internal Revenue Service  
POB 7604  
Ben Franklin Station  
Washington, DC 20044

Re: Notice of Proposed Rulemaking: Income Attributable to Domestic Production Activities (70 Fed. Reg. 67220 November 4, 2005)

Congress established the Office of Advocacy (Advocacy) to represent the views of small business before Federal agencies and Congress.<sup>1</sup> Advocacy is an independent entity within the U.S. Small Business Administration (SBA), so the views expressed by Advocacy do not necessarily reflect the views of the SBA or the Administration. Section 612 of the Regulatory Flexibility Act (RFA) requires Advocacy to monitor agency compliance with the RFA. On August 13, 2002, President Bush underscored the importance of agency compliance with the RFA and Advocacy's role in giving a voice to small businesses in the rulemaking process when he signed Executive Order 13272, titled "Proper Consideration of Small Entities in Agency Rulemaking."

Pursuant to our statutory authority, Advocacy regularly disseminates information to, and solicits comments from, small businesses regarding Federal government activities affecting them. Advocacy convenes roundtables as one effective means of gathering information from small businesses. Advocacy held a roundtable on November 30, 2005, to obtain small business comments on this NPRM. This comment letter is based on information exchanged at that roundtable and received thereafter.

The participants at the roundtable universally expressed the concern that the simplified and small business method of calculating the deduction is too difficult. The code section and proposed regulation requires taxpayers to apportion certain income and expenses to calculate qualified production activities income (QPAI). Despite the difficult calculation of QPAI presented by the code and proposed regulations, the roundtable participants believe that the group of taxpayers eligible to use the simplified and small business method should be expanded.

In the proposal, Treasury and IRS certify that the NPRM will not have a significant impact on a substantial number of small entities. The Office of Advocacy disagrees. The rulemaking will likely limit the number of entities that will take advantage of the deduction. Advocacy believes

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<sup>1</sup> Pub. L. No. 94-305 (codified as amended at 15 U.S.C. §§634a-g, 637).

that the rule should be changed to broaden small businesses' understanding of the deduction and, ultimately, their use of the deduction.

In the "Special Analyses" section of the NPRM, the Treasury and IRS certify that the NPRM will not have a significant economic impact on a substantial number of small entities. Treasury and IRS reach this conclusion by stating that "any burden on cooperatives is minimal."<sup>2</sup> As a result of the certification, the Treasury and IRS conclude that an Initial Regulatory Flexibility Analysis (IRFA) under the RFA is not required.

Section 605(b) of the RFA permits the head of an agency to certify that the rulemaking will not have a significant impact on a substantial number of small entities. However, prior to certifying a rule under Section 605(b), Advocacy recommends that an agency perform a preliminary analysis of the proposed rule's impact on small entities. The results of this analysis will likely provide the factual basis for the certification. A mere statement that there will be no effect without substantiation is not sufficient. Therefore, the agency should conduct an analysis demonstrating that it has considered the potential effects of the regulation on small entities.<sup>3</sup>

The factual basis supporting the Treasury and IRS RFA certification does not provide sufficient information for small entities to determine the impact the NPRM will have on their business. Treasury and IRS limit their certification to cooperatives; this is problematic because other types of taxpayers are permitted to avail themselves of the provisions of this rule and in doing so will incur recordkeeping responsibilities.<sup>4</sup> Specifically, taxpayers conducting their business in partnership or S-corporation form are required to provide sufficient information to their partners or shareholders so that they can calculate the deduction.

Advocacy suggests first, that if the Treasury and IRS have the factual data supporting its certification, then it should be published as a supplemental note in the *Federal Register* with a period for public comment. Second, Advocacy encourages the Treasury and IRS to review carefully the comments submitted regarding the impact of its proposed rule on small entities. Based on the comments, the Treasury and IRS should take appropriate steps to bring this rulemaking into compliance with the RFA by either publishing the factual basis for the certification or by publishing an IRFA for public comment. Finally, if Treasury and IRS determine that the RFA certification lacks a factual basis, then an IRFA should be performed and published in the *Federal Register* with a period for notice and comment.

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<sup>2</sup> 70 Fed. Reg. 67220, 67239 November 4, 2005.

<sup>3</sup> See *North Carolina Fisheries Ass'n v. Daley*, 16 F. Supp. 2d 647, 652 (E.D. Va. 1997) and *Northwest Mining Ass'n v. Babbitt* 5 F. Supp 2d 9. In both cases the courts concluded that a mere statement that a rule will not have a significant effect on a substantial number of small entities is not sufficient under Section 605(b) of the RFA. Agencies must provide an analytical basis for certification.

<sup>4</sup> Section 601(7) of the RFA defines a "collection of information" to mean: obtaining, causing to be obtained, soliciting, or requiring the disclosure to third parties or the public, of facts or opinions by or for an agency, regardless of form or format, calling for answers to identical questions posed to, or identical reporting or recordkeeping requirements imposed on, 10 or more persons, other than agencies, instrumentalities, or employees of the United States. Section 607(8) of the RFA defines "recordkeeping" as a requirement imposed by an agency on persons to maintain specified records.

Congress intended to provide an incentive to industry to manufacture a broad range of products domestically.<sup>5</sup> The incentive is not limited to large employers; it is available to all employer firms that produce products domestically and who meet the statutory requirements. Treasury and IRS need to evaluate the cost small firms will incur to obtain the deduction. After discussing the NPRM with several small employers, many stated that the difficulty in calculating the deduction would pose a serious barrier to them using the deduction. Consequently several participants in the roundtable indicated that they will not take advantage of the deduction.<sup>6</sup>

Small entities that participated in Advocacy's roundtable expressed deep concern about the usability of the proposed regulations. For that reason we encourage the Treasury and IRS to expand the universe of small entities that can use the simplified and small business method for calculating QPAI. Advocacy encourages the Treasury and IRS to carefully review the comments of affected small entities and take appropriate steps to bring this NPRM into compliance with the requirements of the RFA. Small entities need the Treasury and IRS to specify the effects this rule will have on the way they manage their affairs. In fact, government agencies aspiring to comply with best rulemaking practices should provide this type of information to ensure an equitable rulemaking process. Congress enacted the RFA to require the Treasury and IRS to provide this information to ensure small entities are not disadvantaged in the rulemaking process. On Advocacy's website ([www.sba.gov/advo](http://www.sba.gov/advo)) there is additional information about RFA compliance.

If you have any questions or require additional information, please contact Candace Ewell at 202-401-9787 or [candace.ewell@sba.gov](mailto:candace.ewell@sba.gov). Thank you for this opportunity to contribute to the rulemaking process.

Sincerely,

Thomas M. Sullivan  
Chief Counsel for Advocacy

Candace B. Ewell  
Assistant Chief Counsel for Tax

cc: The Honorable Dr. John Graham, Administrator, Office of Information and Regulatory Affairs

Eric Solomon Acting Deputy Assistant Secretary (Tax Policy)  
The Honorable Donald Korb Chief Counsel of the Internal Revenue Service

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<sup>5</sup> Section 199 of the Internal Revenue Code was enacted as part of the American Jobs Creation Act of 2004 (Pub. L. No. 108-357 section 102).

<sup>6</sup> These concerns were articulated in a comment submitted by Carl-Henry Geschwind of Cocke, Szpanka & Taylor CPAs in Reston, VA on December 14, 2005 (2005 TNT 244-22).