

GALLAGHER  
EVELIUS & JONES LLP

January 8, 2007

Mr. Eric Solomon  
Deputy Assistant Secretary for Tax Policy  
Department of the Treasury  
1500 Pennsylvania Avenue, N.W.  
Room 3120  
Washington, DC 20220

Re: Section 42(i)(2)(D) of the Internal Revenue Code of 1986, as amended (the "Code"), and CDBG Funds for Areas Impacted by Hurricanes Katrina, Rita and Wilma ("Katrina CDBG Funds")

Dear Mr. Solomon:

Code Section 42 dealing with the low-income housing tax credit ("LIHTC") provides for a "9 percent" credit for LIHTC projects that are financed using CDBG loans with below-market interest rates. Generally, federally sourced financing with below-market interest rates causes a reduction in the LIHTC percentage to the "4 percent" credit rate, or the costs incurred by such financing may be excluded from being LIHTC eligible. Because of certain waivers and alternative requirements allowed in the legislation authorizing Katrina CDBG Funds, there is a concern that these funds, although generally CDBG funds, will be treated under Code Section 42 as federally sourced financing and not covered by the CDBG financing exception. If these funds are not treated in the same manner as existing CDBG financing under Code Section 42, the result will be serious underwriting problems for many housing projects using LIHTCs and Katrina CDBG Funds. As discussed in more detail below, we request that the treatment of Katrina CDBG Funds used in LIHTC transactions be clarified so that developers and investors in projects so financed will be able to use these CDBG sources effectively. Treating Katrina CDBG Funds in the same manner as general CDBG funds for LIHTC purposes will help achieve the intended public policy result of supplying maximum new affordable housing to the disaster-stricken areas intended to benefit from Katrina CDBG Funds.

Pursuant to Code Section 42(b)(1)(A), certain rental housing qualifies for a "9 percent" annual tax credit for ten years if such rental housing is not "federally subsidized." A "federally subsidized" project qualifies for only a "4 percent" annual credit. Code Section 42(i)(2)(A) provides that a "below-market federal loan" causes a project to be "federally subsidized." In Code Section 42(i)(2)(D), a "below-market federal loan" does not include financing funded with assistance provided under Sections 106, 107 or 108 of the Housing and Community Development Act of 1974 "(as in effect on the date of enactment of this provision)." (Emphasis added). These funds are generally referred to as CDBG Funds.

The "Emergency Supplemental Appropriations Act for Defense, the Global War on Terror and Hurricane Recovery, 2006" (the "Emergency Supplemental Appropriations Act") and the Department of Defense Appropriations Act, 2006 (the "Defense Appropriations Act") (together, the "Authorizing Acts") appropriated the Katrina CDBG Funds. The Authorizing Acts, and various HUD notices issued thereunder, allow for various waivers and alternative requirements from the general CDBG statutes and regulations. Because these Authorizing Acts allow for waivers and alternative requirements that differ from the statutes that provide for the CDBG program in general, there is a concern that the Internal Revenue Service might not view the Katrina CDBG Funds as CDBG funds qualifying for non-federally sourced financing treatment.

As described below, we believe that the Katrina CDBG Funds should be treated no differently than any other CDBG funds for LIHTC purposes. First, both the Authorizing Acts and the HUD notices state that any waivers or alternative requirements require a finding by the Secretary of HUD that such changes are not inconsistent with the overall purpose of the original CDBG statutes. The HUD notices all state that the variations from the original CDBG statutes meet this standard. Therefore, all public policy purposes of the original CDBG statutes have remained untouched by the Authorizing Acts and HUD notices. A review of the HUD notices indicates that the waivers and alternative requirements are almost exclusively related to procedural and reporting requirements, and not material provisions in the CDBG program itself. To the extent that there are waivers from substantive provisions, these waivers relate to adding flexibility in the use of CDBG funds and have no impact on the use of the funds for LIHTC projects. Allowing funds to be used for additional purposes than the original statute encompasses almost all of the substantive waivers. There is the ability to charge rent in excess of general CDBG restrictions, but this change would not apply to LIHTC projects. The LIHTC program would require maintaining strict limits on rents. In summary, the waivers and alternative requirements currently proposed, by statute and in practice, are consistent with the original substantive requirements of the CDBG program.

If the CDBG funds provided under the Authorizing Acts are treated as federally sourced financing, the result will be fewer LIHTC units available to areas intended to benefit from the additional resources. Either the Katrina CDBG Funds will be removed from tax credit-eligible costs or the funds will have to be loaned at substantially higher interest rates to qualify funded costs for tax credits. The first alternative will cause many projects to lose substantial LIHTC equity, resulting in a shortfall of necessary funding to complete the project. The second alternative would cause major underwriting and tax concerns, causing many projects to be unable to meet financial and tax requirements for attracting LIHTC equity.

As stated above, we request clarification that Katrina CDBG Funds are treated as CDBG funds under Code Section 42(i)(2)(D), resulting in such funds not being classified as below-market federally sourced financing. This interpretation is consistent with the policy reasons for both the Code Section 42(i)(2)(D) carveout of CDBG funds and the Authorizing Acts. This treatment of Katrina CDBG Funds as CDBG funds under the provisions of Code Section 42(i)(2)(D) is also a correct interpretation of Code Section

42(i)(2)(D). The Authorizing Acts specifically allow waivers and alternative requirements only if such provisions are not inconsistent with the overall purpose of the general CDBG statutes. Any waivers or alternatives should not be treated as material for purposes of Code Section 42(i)(2)(D). This matter needs immediate consideration because transactions using both Katrina CDBG Funds and the LIHTC program are required to be completed quickly to receive the benefits of recent Go Zone legislation.

Please contact me with any questions or comments.

Sincerely yours,

David E. Raderman  
DER:Imf

cc: Susan Reaman, Internal Revenue Service  
Paul Handelman, Internal Revenue Service  
Christopher Wilson, Internal Revenue Service