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Via E-mail: rule-comments@sec.gov

Jonathan G. Katz
Committee Management Officer
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File Number 265-23; The SEC Advisory Committee on Smaller Public Companies' Request for Public Comment on its proposed Committee Agenda.

Dear Mr. Katz:

We would like to address an issue of PCAOB and SEC interpretation that has only recently come to our attention and which we believe to be within the scope of the Advisory Committee on Smaller Public Companies (the "Committee"). Specifically, our comments address Committee Agenda section 4.2, regarding the effects of auditing firm's standards and requirements on smaller public companies and section 6.4, concerning the overlay and impact of other regulatory schemes, as they pertain to limited partnerships which invest in low-income housing tax credit ("LIHTC") residential rental properties and offer limited partnership interests to the public and must, therefore, register with the Securities and Exchange Commission. We regret that we have been unable to comment earlier, but the SEC staff positions which have the greatest potential for adverse impact on the affordable rental housing industry have only recently come to our attention.

These public limited partnerships invest in affordable rental housing properties which are closely regulated both by the Internal Revenue Service and by the state housing finance agency in which each property is located. We are concerned that, if the auditors of the entities which own and operate the affordable rental properties are required to follow the additional audit requirements of the Public Company Accounting Oversight Board ("PCAOB"), the existence of this source of capital for affordable housing will be jeopardized and the additional requirements will not provide any meaningful additional protection for individual investors.

To understand why this is so, it may be useful to provide a summary of the Federal low-income housing tax credit program and the nature of the investments involved.

The Operation of Low-Income Housing Tax Credit

The Statutory Framework

The low-income housing tax credit operates as a block grant to each state, administered by the Treasury Department under section 42 of the Internal Revenue Code. The amount of credits is determined annually by reference to each state's population. Each state establishes an allocation plan pursuant to which it will allocate the tax credits. Developers compete for the tax credits by applying to build affordable rental housing that meets the needs described in the state allocation plan.

In order for an apartment complex to qualify for the LIHTC, I.R.C. section 42 requires either that a minimum of 20 percent of the residential units must have restricted rents and be set aside for renters with household income no more than 50 percent of the area median income or that 40 percent of the residential units have restricted rents and be set aside for renters with a household income no more than 60 percent of the area median income. These income and rent restrictions apply to the property for an extended period of time, from a minimum of 15 years to as many as 50 years or more. Importantly, rents cannot be raised to exceed the restricted rent limits even if required in order to cover excess operating expenses, including additional audit fees.

How the Program Works

For the tax credits to work as an economic incentive for the construction or rehabilitation of affordable rental housing, they have to find their way to taxpayers who can use them and are willing to pay for them. Thus, once a developer receives an allocation of LIHTCs, it will monetize the credits by finding an investor willing to pay cash for a ten- to twelve-year stream of tax credits. This is usually done through a limited partnership ("operating limited partnership" or "operating partnership"). The investor contributes cash to the partnership and becomes a limited partner, while the developer, or an affiliate of the developer, becomes the general partner of the limited partnership which owns the affordable housing property.

The operating limited partnership uses the cash equity from the limited partner for a portion of property acquisition/construction or rehabilitation costs. This equity allows the limited partnership to borrow less than what would otherwise be required to build or rehabilitate the apartment complex. With the lower debt service requirement, the limited partnership can offer rents at lower rates and meet the statutorily prescribed affordable rental requirements.

Often, the limited partner is a syndicated limited partnership ("syndicated fund"). A syndicated fund will often invest in several different limited partnerships which own LIHTC properties to reduce investment risk of potential noncompliance with I.R.C. section 42. The syndicator will be the general partner of the syndicated fund and the limited partners will consist of various investors.

Today, most investors in these syndicated funds are corporations which invest via private offerings in million dollar increments. Individual investor participation in an LIHTC syndicated fund is typically available only through a public offering in thousand dollar increments. It is only those syndicated funds which sell or have sold primarily to large numbers of individuals which are considered to be public and required to register with the Securities and Exchange Commission. Although the number of new publicly offered syndicated funds has dropped dramatically in recent years, over the last 15 years, hundreds of existing public funds with individual investors have invested in LIHTCs.

The Nature of the Investment

The prospectus for a publicly offered LIHTC fund makes clear that the only anticipated return to the investor is the tax credit.[1] As a practical matter, the funds are structured

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[1] For example, the prospectus for Boston Capital Tax Credit Fund IV L.P., Series 45 and 46 (August 1, 2003) at 55 describes the investment objectives as follows:

> Boston Capital has four objectives for its investments in operating partnerships, in order of importance:
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> (1) *Generate tax credits during the first ten to twelve years of an investment in each operating partnership which investors can use to offset federal income taxes from all sources.* These tax credits include federal housing tax credits, and in limited circumstances a small amount of historic tax credits. Each apartment complex must meet continuing occupancy requirements for the initial fifteen-year period beginning once tax credits are first taken. Tax credit rules can be complicated and the failure of apartment complexes to comply with them can result in the loss and/or recapture of tax credits sometimes years after tax credits are allocated.
>
> (2) *Preserve and protect investor's capital.* Boston Capital requires the general partners of the operating partnerships to:
>
> - guarantee completion of the apartment complex;
> - fund any construction cost overruns;
> - pay operating shortfalls for a limited period;
> - guarantee a specific minimum amount of tax credits.
>
> While these safeguards provide additional protection, there can be no assurance that these measures will adequately protect investments in the respective partnerships.
>
> (3) *Provide tax benefits in the form of passive losses.* Individual investors generally may deduct any tax losses allocated to them only to the extent of your income derived from passive activities, namely income other than wages, salaries, dividends, and interest….

assuming there will be no anticipated capital gain at the end of the tax credit compliance period. The value of the property is anticipated to equal the remaining mortgage balance at the end of the compliance period which is a minimum of fifteen years. Similarly, the prospectus makes clear that the investors should not anticipate any free cash flow.

Non-SEC Regulatory Requirements

Thus, the most important factor in the success of the investment from the perspective of an investor is whether the apartment buildings owned by the operating partnerships (which are, in turn owned by a public syndicated fund) are operated in a manner consistent with the requirements of I.R.C. section 42 to qualify for the stream of low-income housing tax credits over a period of years. A rigorous compliance structure, independent of requirements imposed under the Sarbanes-Oxley Act of 2002, has been developed to assure that the statutory requirements for continuation of the stream of credits are maintained.

Of course, as with any other limited partnership, the partnership and its partners are subject to audit by the Internal Revenue Service. In addition, even though Congress explicitly drafted the low-income housing tax credit to help fund affordable rental housing, syndicated funds offered to the public are, nevertheless, considered "tax shelters" and, as such, are subject to increased scrutiny by the Internal Revenue Service. Thus, they come under audit much more frequently than many other entities.

However, I.R.C. section 42 is unique in its requirements to assure compliance. It adds the additional layer of very detailed ongoing monitoring of compliance by state housing agencies which allocate LIHTCs to individual developers for specific properties.

Recordkeeping

Treasury regulations promulgated under I.R.C. section 42 require owners of affordable rental housing to keep detailed records relating to units that are low-income units qualifying for LIHTC financing. These records include:

- the total number of units allocated to low-income tenants,
- the percentage of residential rental units in the building that are low-income units,
- the rent charged on each residential unit in the building (including any utility allowances),

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(4) *Distribute net cash, if any, from the sale or refinancing of apartment complexes.* Under certain favorable market and regulatory conditions, Boston Capital will distribute to investors part or all of their original investment when some or all of the properties are sold or refinanced. You can get money back from the sale or refinancing of an apartment complex equal to your original investment only if the net sales price is large enough to pay fees and expenses paid in this offering, estimated to be 25% of your initial investment, plus all the costs of the sale. Tax credits may be the only material benefit from the investment because the investors may not get back their capital.

- the number of occupants in each low-income unit if rent is determined by the number of occupants in each unit,
- the low-income unit vacancies in the building and information that shows when, and to whom, the next available units were rented,
- the annual income certification of each low-income tenant per unit, and
- documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal tax return, Forms W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation.[2]

Annual Certification

The Treasury regulations then require that the owner of the property certify to the applicable state housing agency, under penalties of perjury, at least annually for a minimum of fifteen years, a long list of items. These include that, for the preceding twelve-month period,

- the project met the statutory requirements as to percentage of units occupied by tenants who met the statutory maximum income tests,
- there was no change in the applicable fraction of any building in the project allocated to low-income tenants or, if there was a change, a detailed description,
- the owner received an annual income certification from each low-income tenant, and documentation to support that certification; or, in the case of a tenant receiving Section 8 housing assistance payments, a statement from a public housing authority,
- each low-income unit in the project was rent restricted under I.R.C. section 42(g)(2),
- all the units were for use by the general public and that no finding of discrimination under the Fair Housing Act occurred for the project,
- the buildings and low-income units in the project were suitable for occupancy, taking into account local health, safety, and building codes,
- if a low-income unit became vacant during the year, that reasonable efforts were or are being made to rent that unit of the next available unit of comparable or smaller size to tenants having qualifying income before any units in the project were or will be rented to tenants not having a qualifying income, and
- if the income of tenants of a low-income unit in the project increased above the limit allowed under section 42, the next available unit of comparable or smaller size in the project was or will be rented to tenants having a qualifying income.[3]

State Housing Agency Compliance Monitoring

The Treasury regulations promulgated under section 42 require the applicable state housing agency to review at *least annually* all certifications provided by owners of

[2] Treas. Reg. Sec. 1.42-5(b).
[3] Treas. Reg. Sec. 1.42-5(c)(1).

properties which have been allocated credits. In addition, the applicable state housing agency must:

- conduct on-site inspections of all buildings in a low-income housing project by the end of the second calendar year following the year the last building in the project is placed in service and, for at least 20 percent of the project's low-income units, inspect the units and review the low-income certifications, the documentation supporting the certifications, and the rent records for the tenants in those units.
- after the first inspection, at least once every three years, the state housing agency must conduct on-site inspections of all buildings in the project and, for at least 20 percent of the project's low-income units, inspect the units and review the low-income certifications, the documentation supporting the certifications, and the rent records for the tenants in those units.[4]

If the state housing agency finds any noncompliance, it must provide prompt written notice to the owner and must file a Low-Income Housing Credit Agencies Report of Noncompliance (Form 8823) with the Internal Revenue Service.[5]

GAAS Audit Procedures

In addition to these requirements, independent auditors of public LIHTC funds, in accordance with Generally Accepted Auditing Standards, have been able to rely on the annual financial statements of the operating limited partnerships performed by the local auditors of the operating partnerships. The audits, and reports thereon, of these private entities, typically owned 99 percent by a public low-income housing tax credit fund have been performed in accordance with Generally Accepted Auditing Standards.

The partnership agreements of existing operating limited partnerships require GAAS audits and not PCAOB audits, since these agreements were negotiated prior to the guidance issued by the PCAOB. These audits, even before enactment of the Sarbanes-Oxley Act, address the following points:

- Fraud & Risk Assessment under SAS 99 – determine where key risk areas are and design audit procedures accordingly.
- Obtain an understanding of internal controls and document the controls over cash receipts and disbursements.
- Confirm cash balances with banks.
- Confirm cash escrow, reserve, and mortgage balances with lenders as well as current status of loan balances and terms.
- Audit tenant receivables and determine collectibility.
- Confirm all other loans with lenders, as well as current status of loan.

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[4] Treas. Reg. Sec. 1.42-5(c)(2).
[5] Treas. Reg. Sec. 1.42-5(e).

- Obtain a listing of accounts payable and compare material amounts to invoices and subsequent payment.
- Compare tenant security deposit liability to rent roll and trace a sample to the leases.
- Perform a search for unrecorded liabilities.
- Compare material fixed asset additions to invoices and evaluate the building for impairment.
- Audited cost certifications are required to obtain forms 8609, therefore the initial land, building costs, and intangibles (i.e., mortgage financing fees) are compared to the audited cost certification.
- Re-compute revenue based on the rent roll for reasonableness and compare charges for a sample of leases to the tenant rent rolls and bank deposits.
- Housing authority or HUD rent payments are compared to signed agreements.
- Auditing of expenses focuses on obtaining third party invoices or other third party documentation for material items, such as:
  - Interest expense
  - Real estate taxes
  - Insurance & repair
  - Maintenance costs (also reviewed for possible capitalization)
  - Utilities
- Management fees are audited by recalculating the expense based on management agreement and rent collections.
- Depreciation and amortization are recalculated.
- Salaries are audited by testing the payroll system.
- Analytical review is performed on all revenue and expense accounts by comparing current year to prior year balances and investigating material variances.
- Legal invoices are reviewed to ascertain if litigation exists or is pending. Legal letters are sent to lawyers to validate client assertions regarding status of litigation.
- Review correspondence with regulatory agencies (HUD, state or local housing agencies) for indications of noncompliance (physical inspection reports, form 8823 for I.R.C. sec. 42 purposes).
- Obtain representation from management regarding compliance with I.R.C. section 42 regulations.
- Review insurance policy to assess adequacy of coverage.

Thus, it is clear that the most important factors determining success of an LIHTC investment – compliance with I.R.C. section 42 requirements for the income level of the tenants, the amount of rent charged and maintenance of the property are either not addressed in a GAAS or PCAOB audit or are monitored more extensively by state housing agencies and the Internal Revenue Service. Since at this point the only material difference between a GAAS and PCAOB audit is a completion memo, it would seem that modifying the audit standard is of little or no practical value.

Current PCAOB/SEC Position

Unfortunately, the PCAOB and the SEC have nevertheless increased the expense involved in the audit of LIHTC limited partnerships in which public funds hold limited partnership interests without improving investor protection and more recently have put in jeopardy the ability to perform audits in a timely manner.

2005

The first problem arose last year. In response to a question at a PCAOB Forum on Auditing held in Atlanta, GA, Board Member Kayla J. Gillan forwarded a question and answer marked "draft" and dated 5/6/05 which stated, in pertinent part:

> Q: A portion of an issuer's investments that are accounted for under the equity method and are material to the issuer's consolidated financial statements is audited by a firm other than the principal auditor. Does the audit of the investments need to be performed according to PCAOB standards?
>
> A: Yes. *Whether the firm is registered or unregistered*, it would need to perform the audit according to PCAOB standards. (Emphasis added.)

The average fees for a Section 42 audit under GAAS are approximately $7,000. The fees for a Section 42 audit with a PCAOB standards opinion range from $8,500 - $9,500, depending on the CPA firm issuing the audit opinion. Since many of the public syndicated funds may invest in as many as a hundred operating limited partnerships, the additional cost is material, especially when the only source of income to pay for this increased cost -- rent from lower-income tenants – is limited by the statutory requirements imposed under section 42 for availability of the low-income housing tax credit and, in many cases even more strict income and rent limitations imposed by the state housing agency which originally allocated the tax credits to an individual property. In addition, as a limited partner in the operating partnership, the registrant public fund in many cases does not have the legal authority to force the general partner to obtain an audit to PCAOB standards.

Under the PCAOB position as expressed in the 5/6/05 draft Q & A, if the principal auditor of a registrant public fund refers to the audit reports of the lower-tier operating limited partnerships, the audit of those operating partnerships must be performed in accordance with, and the operating partnerships auditor's audit opinion must refer to, the standards of the PCAOB.

Alternatively, if the principal auditor of the public fund is unable to obtain PCAOB opinions from the operating partnerships' auditors, the principal auditor must assume responsibility for the operating partnerships' auditors' work. In assuming such responsibility over, in many cases, hundreds of operating partnership's annual financial statements, under existing professional standards and interpretations, the principal auditor must obtain and retain in its work papers sufficient audit evidence to demonstrate that the audits of the operating partnerships, performed by the operating partnerships' local auditors, were performed in accordance with the standards of the PCAOB. To emphasize, this involves annual audits of every property built under the LIHTC program that is included in a public fund. To date, there have been over 22,500 affordable housing properties built under the LIHTC program.

If the principal auditor assumes responsibility for the operating partnership auditor's work under PCAOB standards, it will still require the operating partnership auditors to do more work in order for their work papers to comply with the PCAOB standards. This will increase operating partnership audit fees and create more work and expenses for the principal auditor and the public fund. Of course, since the syndicator is a limited partner in the operating partnerships, it has limited ability to assure that principal auditors obtain access to the operating partnership auditors' work papers, which is necessary in order to take them under the principal auditors opinion.

The PCAOB is justifiably proud of the number of accounting firms which have registered. There are, however, a large number of small accounting firms, many with only one auditing partner and one tax partner, serving a clientele consisting of small private companies and individuals, not public companies. While these firms operate under GAAS, they have no incentive to undertake the time and cost to become PCAOB registered, they are not as familiar with the PCAOB standards as registered firms are, and they may not have sufficient personnel to meet PCAOB audit review requirements even if they wanted to register.

Although the size and limited scope of practice of many auditors of operating partnerships would make it difficult for principal auditors to review the work of the operating partnerships' auditors and take their GAAS audits under the principal auditor's opinion, it would be most likely that, under the requirements described in the 5/6/05 Q & A, that would be the procedure that would have to be followed.

The number of accounting firms the registrant public fund's auditing firm will need to take under its opinion and the additional cost associated with this work is estimated to cost a minimum of $500 per operating subsidiary. Since public funds can have as many as a hundred lower tier operating partnerships and the registrant, as a limited partner in the operating partnerships cannot force the general partner to change auditors to a firm that will be able to perform an audit in accordance with PCAOB standards, the new PCAOB standards as described in the Q & A would add an extraordinary financial burden on registrants without providing any additional meaningful protection for investors.

January 2006

A far greater problem has come to our attention within the last few weeks. We have been informed that the SEC is now taking the position that any opinion that is included in a registrant's filing, even if the actual financial statement is not being presented (e.g., the opinion of an operating limited partnership's auditor), will be treated as an opinion of the registrant. As a result, in order for the principal auditor of a public fund to refer to the opinion of a lower-tier operating partnership's auditor, the operating partnership's auditor must issue a full PCAOB standards opinion and follow all of the associated rules and standards in conducting their audit.

There also is an unresolved issue relating to CPA independence. The SEC/PCAOB independence rules, unlike the rule under GAAS, prohibit an auditor from preparing or assisting in the preparation of the financial statements. In the LIHTC industry, the operating partnership auditors in almost every case prepare the financials. The SEC/PCAOB independence rule may call into question whether the operating partnership auditors will be able to issue a PCAOB standards opinion as they may be deemed to lack independence.

In addition, if the principal auditor of an LIHTC public fund knows the operating partnership's auditor prepared the operating partnership's financial statements and is therefore not deemed independent by the SEC and PCAOB, can the principal auditor take the operating partnership's audit under its own opinion? Can the principal auditor take responsibility for the work of an auditor who is viewed to lack independence? If not, unless the general partner of an operating partnership prepares its own financials or has someone else prepare the financials, its auditors will only be able to issue GAAS opinions.

Of course, these issues pose significant problems on a prospective basis. However, for existing funds the problems are very immediate, calling into question how any LIHTC public fund will be able to file with the SEC, especially for 2004 and 2005.

Conclusion

We hope that the Board will agree that investments in LIHTC public funds are fundamentally different from other investments registered with the SEC. Unlike other investments, they are designed to provide a vehicle for the delivery of tax credits, and not sold to investors with an expectation of appreciation. These investments are already subject to strict regulation by both the Internal Revenue Service and state housing agencies with federal statutory guidelines which provide substantial safeguards for investors.

The investments themselves are very simple. They consist solely of apartment buildings which, with the assistance of a Federal tax credit, can be built at less cost than otherwise would be possible. In return, a significant percentage of the tenants must be of modest income and rent charged must be limited. The state housing agency/IRS regulatory structure assures that the apartments are operated in compliance with the statutory goals and that the apartments are maintained for a period even beyond that for which investors will receive the tax credits in which they have invested.

We also hope that the Board will agree that these regulatory requirements, combined with a GAAS opinion from an auditor of lower-tier operating partnerships in which an LIHTC public fund invests as a limited partner, provide sufficient safeguards to allow the principal auditor of such a public fund to refer to an operating partnership GAAS audit opinion as part of its PCAOB opinion for the public fund or, at a minimum, allow the auditor of such a public fund to take an audit of an operating partnership under its own opinion even though the audit of the operating partnership was performed under GAAS.

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We appreciate this opportunity to comment, and would be pleased to discuss our comments with you in further detail. If you have any questions or would like to discuss our comments further, please do not hesitate to contact me at (202) 347-2251 or rbelas@davis-harman.com.

Respectfully submitted,

Richard S. Belas