

MAC Capital Reserve Funds Allocation

MEMOS 1991-1992

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M E M O R A N D U M

January 8, 1992

TO: Lynnette Kelly  
Fran Higgins Jacobs

FROM: Richard Chirls

RE: Revised Draft Memorandum Regarding Allocation of  
Capital Reserve Funds

Attached is a blacklined revised memorandum incorporating comments and questions raised by Fran, as well as some additional thoughts. The substance of the memorandum is not significantly changed.

Please call me with any questions or comments.

Draft  
1/7/92

M E M O R A N D U M

January , 1992

TO:

FROM: Richard Chirls

RE: MAC Rebate Calculation for Capital Reserve

The purpose of this memorandum is to set forth the procedure to be utilized in determining the amount of proceeds and allocable investments held in the capital reserve funds relating to the bonds issued by The Municipal Assistance Corporation of the City of New York (the "Corporation") for purposes of compliance with federal arbitrage rebate requirements.

Background. The Corporation has issued its several series of bonds under three bond resolutions (referred to herein as the "First Resolution," the "Second Resolution" and the "1991 Resolution"). The source of payment for the bonds and the lien on revenues of the Corporation with respect to its bonds differs under each bond resolution.

Under each of the bond resolutions there is established a separate Capital Reserve Fund or, in the case of the 1991 Resolution, a Bond Reserve Fund which are intended to operate as reasonably required reserve funds within the meaning of Section 148(d) of the Internal Revenue Code of 1986 (the "Code") and Section 103(c)(2) of the Internal Revenue Code of 1954, as amended. The Capital Reserve Funds established under the First Resolution and Second Resolution (the "First Capital Reserve Fund" and the "Second Capital Reserve Fund," respectively) are required to be maintained in an amount not less than the amount of principal and interest maturing or otherwise becoming due in the succeeding calendar year on all bonds issued pursuant to the respective resolution. Notwithstanding this requirement, however, with respect to the First Capital Reserve Fund and the Second Capital Reserve Fund, each Fund need only have been funded at zero percent of the required amount for 1975 and 1976, 25 percent of the required amount in 1977, 50 percent of the required amount in 1978, 75 percent of the required amount in 1979 and 100 percent of the required amount in 1980 and thereafter. The requirement with respect to the 1991 Resolution Bond Reserve Fund is an amount not less than one-half of the maximum debt service due in any

calendar year on all bonds outstanding under the 1991 Resolution.

As a consequence of the permitted delayed funding of the Capital Reserve Funds to meet the required amounts, at the time of issuance of many of the early series of bonds by the Corporation, no deposit was made to the Capital Reserve Funds. However, with respect to several subsequent series of bonds, substantial amounts of the proceeds of the bond issues were deposited to the Capital Reserve Funds. Additional amounts deposited or held in the Capital Reserve Funds consisted of revenues of the Corporation or accumulated investment earnings derived from amounts held in such Funds. At the time of issuance of the bonds pursuant to the 1991 Resolution, proceeds of such bonds were deposited to the Bond Reserve Fund equal to the required amount.

The Corporation has issued several series of bonds under the Second Resolution with respect to which more than 15 percent of the proceeds of the issue have been deposited in the First Capital Reserve Fund or the Second Capital Reserve Fund. Treasury Regulation Section 1.103-14(d)(1) provides in part that an obligation shall not be an arbitrage bond solely by reason of the fact that a portion of the proceeds of the issue may be invested in materially higher yield acquired obligations that are part of a reasonably required reserve or replacement fund. Generally, a reserve or replacement fund will be considered reasonably required only if the amount so invested does not exceed 15 percent of the amount of the issue. However, Section 1.103-14(d)(2) of the Treasury Regulations provides that an amount in excess of 15 percent may be invested at a materially higher yield if the Internal Revenue Service (the "Service") issues a ruling to the effect that such excess will be considered to be invested in a reasonably required reserve fund.

Accordingly, the Corporation filed certain requests for rulings from the Service to such effect with respect to the proceeds of certain issues of its bonds. The Corporation received a letter ruling from the Service issued on July 10, 1984, supplementing letter rulings issued on April 29, 1980 (as supplemented and clarified by letters of April 30, 1980 and August 28, 1980) and March 23, 1981. Copies of such letter rulings are attached hereto as Exhibit A. Although each of the letter rulings differed slightly, they are virtually identical in all substantive respects.

Apparently vital to the Service's analysis was the Corporation's representation that the total amount on deposit in each separate Capital Reserve Fund will never exceed the lesser of (i) 1.25 times the average annual debt service or

(ii) the maximum annual debt service on all bonds issued under each resolution, respectively. Further, the Corporation represented that the amount on deposit in each Capital Reserve Fund will never exceed 15 percent of all bonds issued under each resolution, respectively (taking into account adjustments for bond issues the original issue price of which are less than 98 percent of the original face amount thereof, as required by Treasury Regulation Section 1.103-13(b)(1)(ii)). Further, all refunding issues of the Corporation will be taken into account in determining whether the 15 percent limit is met. However, no amounts in the Capital Reserve Funds that are allocable to a refunding issue will be invested at a materially higher yield than the yield on the refunding issue until the adjusted maturity dates of the prior issues. The Corporation also represented that it does not intend to maintain in either Capital Reserve Fund an amount substantially in excess of the required deposit (including any increase or decrease in such amounts reasonably expected within the then current or succeeding fiscal years), but rather intends to transfer any excess to the appropriate bona fide debt service funds with respect to the bonds to pay debt service on all bonds issued under the applicable resolution.

The Service noted that the Corporation argued that each Capital Reserve Fund must be considered to be a debt service reserve fund for all bonds issued under each respective resolution on a parity basis and should be treated as a reserve for a single issue. Therefore, the Corporation contended that the amount constituting a "reasonably required reserve fund" should be determined, at any particular time, on the basis of 15 percent with respect to all bonds issued under the respective resolution.

On the basis of the foregoing, the Service issued its rulings to the effect that all amounts deposited in each Capital Reserve Fund established under the First Resolution and the Second Resolution, respectively, which are allocable to a particular issue of bonds, including any such amounts consisting of investment proceeds to be deposited in the future, to the extent required to meet such Fund's peak requirement for all bonds issued under the particular resolution (as such requirement may change from time to time), may be invested without restriction as to yield.

Following the receipt of the Service's rulings the Corporation has been able to invest all amounts held in the Capital Reserve Funds at an unrestricted yield. Pursuant to the terms of such rulings and then applicable Treasury Regulations, there was no need for the Corporation to separately account for the amounts deposited to the Capital Reserve Funds or to allocate such amounts to particular bond

issues. Thus, regardless of whether the amounts deposited to the Capital Reserve Funds consisted of original proceeds of bonds, investment earnings thereon or revenues of the Corporation and regardless of the amount that might be allocable to a bond issue, all amounts were eligible for investment at an unrestricted yield.

The Tax Reform Act of 1986 added Section 148(f) to the Code which imposed an arbitrage rebate requirement on the Corporation with respect to all bonds issued after August 31, 1986. Accordingly, although the Corporation may continue to be permitted to invest all amounts in the Capital Reserve Funds at an unrestricted yield, any arbitrage profits derived from the investment of gross proceeds allocable to post-August 1986 bond issues are required to be rebated to the federal government.

^The Tax Reform Act of 1986 also added Section 148(d)(1) to the Code which provides that the amount of proceeds of a bond issue that may be invested at an unrestricted yield in a reserve or replacement fund may not exceed 10 percent of the proceeds of such issue, unless the Treasury Department determines that a larger amount is necessary with respect to the issue. However, the General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Tax Committee on Taxation (the "Bluebook"), at page 1204, explains that Congress intended that a reserve or replacement fund in excess of 10 percent will be allowed without the necessity of a Treasury determination if the master legal document authorizing the particular bonds was adopted before August 16, 1986 and (1) requires a reserve or replacement fund in excess of 10 percent of proceeds, but not more than maximum annual debt service; (2) is not amended after August 31, 1986; and (3) provides that bonds having a parity of security may not be issued without satisfying such reserve fund requirement. The Capital Reserve Funds and the bonds of the Corporation issued under the First Resolution and Second Resolution satisfy each of these requirements. Accordingly, in reliance upon this statement in the Bluebook, the 10 percent limitation has been determined to not be applicable to the deposits to the Capital Reserve Funds.^

Since August 31, 1986, the Corporation has issued several series of bonds pursuant to the Second Resolution (i.e., Series 60 through Series 68). Each such series of bonds has been issued for the purpose of refunding outstanding series of bonds previously issued under the Second Resolution and to pay a portion of the costs of issuance of the bonds. Since each of these series of bonds is subject to the arbitrage rebate requirement it is necessary to determine (i) the amount of gross proceeds which are allocable to the bonds deposited in the Capital Reserve Funds, if any, (ii) the yield on

investments acquired with such gross proceeds and (iii) the amount of any arbitrage profits attributable to such investments.

In order to establish a procedure for making such determinations the Corporation has delivered its Arbitrage and Use of Proceeds Certificate (the "Arbitrage Certificate") with respect to each series of such bonds, including, attached as an exhibit thereto, its Accounting Memorandum. Each Arbitrage Certificate with respect to post-August 1986 bonds provides a description of the refunding and refunded bonds, the use of the proceeds of the refunding and refunded bonds and the procedure for accounting for the deposits held in the Capital Reserve Funds.

Specifically, in Section 6.3 of each Arbitrage Certificate, the Corporation describes that each of the subject bonds are secured by the Second Capital Reserve Fund and that moneys in such Fund have been derived from revenues and bond proceeds of the Corporation. However, as described in the Arbitrage Certificates, the Corporation has applied a first-in, first-out method of accounting for purposes of establishing that the amounts presently held in the Second Capital Reserve Fund consist solely of bond proceeds and investment earnings thereon. The basis for this analysis is apparently that the Corporation's revenues which were the initial deposits to such Fund can be regarded as the first amounts withdrawn from the Fund at certain times when the required deposit was reduced.

The Arbitrage Certificates further provide that the Corporation will establish special sub-accounts within the Second Capital Reserve Fund, which are denominated as the "Series [60 through 68] Capital Reserve Account." Each such sub-account in the Second Capital Reserve Fund is stated to be attributable to the particular series of bonds and equal to the aggregate debt service requirement for that series of bonds for the calendar year in which the bonds are issued. Although it would seem appropriate that the amount deposited to each sub-account will be increased or decreased to reflect the current annual debt service requirement for each series of bonds, it is not clear from the terms of the Arbitrage Certificates whether the amount in each sub-account is required to be changed each year to reflect current debt service requirements. The Arbitrage Certificates may be read to merely require an initial funding amount for the sub-account with no provision for subsequent changes in the debt service requirement. Accordingly, the Corporation's practice to date has been to not change the amount deposited to the sub-accounts to reflect current annual debt service. However, as discussed below, it would seem to be inappropriate to not make annual changes to the sub-account amounts to reflect current annual

service. <sup>^</sup> On this basis, such requirement for each series of bonds will vary each year based on scheduled debt service (from a high of approximately \$632 million in 1993 in the aggregate for all such bonds to a low of \$514 million in 1994, rising again to \$604 million in 2000 and back down to approximately \$540 million each year from 2001 until the final maturity of the bonds in 2009). Although the amounts deposited to each sub-account are unrestricted as to yield on the investment thereof, the Arbitrage Certificates provide that, as the amounts in the Second Capital Reserve Fund attributable to the issues of refunded bonds becomes "transferred proceeds" of the series of refunding bonds, a pro-rata portion of the amounts in the particular series sub-account shall become subject to the terms of the Accounting Memorandum and, thereby, subject to the arbitrage rebate requirement.

The Arbitrage Certificates also describe the amounts that are released from the Second Capital Reserve Fund and transferred to the Bond Service Fund as a result of the reduction in the debt service requirement due to the issuance of the refunding bonds and that will be used to pay a portion of the debt service on bonds issued pursuant to the Second Resolution.

In the case of the Series 66 and 68 bonds, Section 6.3 of the Arbitrage Certificates also establishes a Series [66 or 68] Capital Reserve Account within the First Capital Reserve Fund. In the case of these particular series of bonds, the bonds which were refunded thereby had provided for a deposit of proceeds to the First Capital Reserve Fund. Accordingly, the Corporation treated the proportionate amount of original proceeds of the refunded bonds deposited to the First Capital Reserve Fund as attributable to the Series 66 and 68 bonds. (The proportion was based on the principal of bonds refunded compared to the original principal amount of the refunded bond issue. In this calculation the Series 11, 12 and 13 bonds and the Series 16, 17 and 18 bonds were treated as single issues. Arguably, the Series 10 bonds and Series 15 bonds should also be treated as part of each such issue of bonds, respectively. However, it appears to be more appropriate to determine the proportionate amount based on the principal of the refunded bonds that is outstanding at the time the refunding bonds are issued.) The amount so determined to be allocable to the Series 66 and 68 bonds was deposited to a sub-account in the First Capital Reserve Fund. The Arbitrage Certificates provide that as the proceeds of the refunded bonds become "transferred proceeds" of the refunding bonds, a pro-rata portion of the amounts in the particular series sub-account shall become subject to the terms of the Accounting Memorandum and, thereby, subject to the arbitrage rebate requirement.

Exhibit B attached hereto sets forth for each issue of bonds, Series 60 through 68, the following: (i) the amount of the direct or indirect deposit of proceeds of the bonds refunded by such refunding bonds to the First Capital Reserve Fund and Second Capital Reserve Fund, if any, (ii) the amount of the initial deposit to the series sub-account of the First Capital Reserve Fund and Second Capital Reserve Fund, (iii) the current or future maximum annual debt service requirement and year for each such series of bonds and (iv) the amount withdrawn from the Second Capital Reserve Fund at the time of issuance of the refunding bonds.

Attached hereto as Exhibit C are certain provisions excerpted from the Arbitrage Certificate relating to the Series 68 bonds as an example of the provisions of the Arbitrage Certificates.

Analysis. As shown on Exhibit B, the amount deposited to the particular series sub-account in the Capital Reserve Funds differs substantially from the amount of proceeds of the refunded bonds deposited to the Capital Reserve Funds. (See Exhibit B, columns C-1 and C-2, and B-1 and B-2, respectively.) Following in this memorandum is an analysis of whether the amount held in such sub-accounts should properly be the amount treated as gross proceeds of bonds subject to the arbitrage rebate requirement or whether a different amount should be taken into account for such purposes and, if so, the procedure for determining such amount.

The procedure for determining the amount of proceeds subject to the rebate requirement as set forth in the Arbitrage Certificates was originally adopted by the Corporation with respect to the Series 60 bonds. The rationale supporting this procedure seems to be based on several factors. First, although the Corporation has determined that, using a first-in, first-out method of accounting, the deposits to the Second Capital Reserve Fund consists solely of original proceeds and investment proceeds, the Corporation has not maintained records which specifically allocate investment proceeds to any particular series of bonds from which was made a deposit of original proceeds to the Fund. Second, the Service's rulings treat the First Capital Reserve Fund and Second Capital Reserve Fund as allocable to all issues secured thereby and eligible for unrestricted investment as long as the total deposit thereto does not exceed 15 percent of the aggregate amount of bonds issued under each resolution. This may be viewed as effectively treating all bonds under a resolution as a single issue for purposes of analyzing the allocation of the Capital Reserve Funds. Finally, there do not exist any Treasury Regulations or rulings by the Service which provide a specific procedure for allocating proceeds deposited in a reserve fund

securing several bond issues among the bonds. Most of the rules governing the allocation of gross proceeds were reserved by the Treasury Department in the regulations which have been promulgated regarding the rebate requirement. <sup>^</sup>(Treasury Regulations Section 1.103-13(g)(6) provides for an allocation of a sinking fund for two or more issues between the issues either (i) in proportion to the original face amounts of the issues, or (ii) according to the total amount of debt service of the issues that will actually be paid from the sinking fund. This provision is not directly applicable to the rebate requirement and has generally been criticized as not reflecting an appropriate method of allocation for a reserve fund which is established on the basis of the maximum annual debt service requirement for each issue secured thereby.)<sub>^</sub>

As a consequence of the foregoing analysis, the amounts deposited to the Second Capital Reserve Fund have been allocated to the sub-accounts relating to the Series 60 through 68 bonds on the basis of the annual debt service requirements for such bonds without regard to whether such amounts are attributable to proceeds of the bonds that are refunded by such series of bonds. However, the amounts allocated to such sub-accounts are not treated as gross proceeds of the bonds and subject to the rebate requirement until, and in proportion to, the retirement of the principal of the refunded bonds.

On the other hand, the allocation of the amounts deposited to the First Capital Reserve Fund is based on a distinctly different approach. In this case the allocation to the sub-accounts relating to the Series 66 and 68 bonds was based on the amount of original proceeds of refunded bonds that were deposited to the First Capital Reserve Fund, with further provision for treating such amounts as gross proceeds of the Series 66 and 68 bonds upon the payment of principal of the refunded bonds.

Although there exist no regulations or rulings providing precise guidance regarding the appropriate method for allocating the amounts deposited to the Capital Reserve Funds among the bonds, the methods described in the Arbitrage Certificates are inconsistent in its application of certain provisions of applicable regulations. Specifically, such methodology appears to treat the amounts deposited to the Second Capital Reserve Fund as revenues of the Corporation rather than as proceeds attributable to particular series of refunded bonds. This is inconsistent with the statement in the Arbitrage Certificates to the effect that, under the first-in, first-out method of accounting, the deposits to the Second Capital Reserve Fund consist solely of bond proceeds and investment earnings thereon. Further, this allocation method is inconsistent with treating the amounts deposited to the

series sub-accounts as becoming transferred proceeds of the refunding bonds and subject to the rebate requirement upon the payment of principal of the refunding bonds. Such a transferred proceeds analysis is only appropriate with respect to amounts which are original or investment proceeds of the refunded bonds. Other amounts, including amounts treated as revenues of the Corporation are not subject to becoming transferred proceeds of the refunding bonds. See, Treas. Reg. Section 1.103-14(e)(2)(ii). In fact, amounts treated as revenues which are held in a reserve fund allocable to a series of bonds are gross proceeds of such bonds immediately upon the deposit to such reserve fund and are, at such time, subject to the arbitrage rebate requirement determined with respect to such bonds. (Note, if amounts deposited to sub-accounts are not varied each year as annual debt service changes, such approach would also be inconsistent with treating all deposits to the Second Capital Reserve Fund, as revenues for purposes of allocations.) Further, as noted above, the allocation of the amounts in the First Capital Reserve Fund among sub-accounts was based on a tracing of original proceeds of refunded bonds, rather than the above analysis with respect to the Second Capital Reserve Fund.

In light of this inconsistency in the method set forth in the Arbitrage Certificates, it is appropriate to evaluate whether an alternative procedure is more appropriate for allocating the amounts deposited to the Capital Reserve Funds among the bonds for purposes of determining the arbitrage rebate requirement.

In particular, it may be more appropriate to start the analysis by recognizing that certain amounts deposited to the Capital Reserve Funds are directly traceable to the original proceeds of bonds and that the remainder of the deposits consist of investment earnings on such bond proceeds and, in the case of the First Capital Reserve Fund, revenues of the Corporation. This characterization of all deposits to the Second Capital Reserve Fund, as bond proceeds (original and investment proceeds) differs markedly from the allocation method whereby the deposits to the Second Capital Reserve Fund were allocated among bonds on the basis of the debt service requirements for the bonds as if the deposits consisted of revenues of the Corporation. Further, the allocation of the deposits among bonds as proceeds of the bonds is not inconsistent with the Service's rulings. These rulings stated that Capital Reserve Funds deposits which are allocable to a particular issue of bonds may be invested at an unrestricted yield. Accordingly, the Service recognized that the deposits are to be allocated to particular bonds, but it did not give any guidance as to the proper method for making the allocation. Further, in reaching the conclusion that the

deposits in the Capital Reserve Funds could be invested without restriction as to yield, the Service did not necessarily treat the deposits as if they were Corporation revenues which would be allocated among all bonds issued under their respective resolutions so that the allocated amounts would be less than 15 percent of the amount of such series of bonds. Rather, the Service's ruling was based on the determination under Treasury Regulation Section 1.103-14(d)(2) that an amount of bond proceeds in excess of 15 percent of the bonds may be invested at an unrestricted yield in the Capital Reserve Funds as a reasonably required reserve fund.

By recognizing that all deposits to the Second Capital Reserve Fund consist of original or investment proceeds of particular series of bonds, such proceeds will be treated as gross proceeds of the Series 60 through 68 refunding bonds by application of the transferred proceeds rules of Treasury Regulation Section 1.103-14(e)(2)(ii). <sup>^</sup>(The transferred proceeds rules of Proposed Treasury Regulation Section 1.148-4T(e)(2) are not applicable to the Series 60 through 68 bonds by virtue of the effective date of such regulation.) Accordingly, upon the payment of the principal of the refunded bonds by the proceeds of the refunding bonds, the proceeds deposited in the Second Capital Reserve Fund which are allocable to the refunded bonds would become gross proceeds of the particular Series 60 through 68 refunding bonds on a pro-rata basis and, thereby, subject to the arbitrage rebate requirement.

The same analysis may be applied with respect to the portion of the First Capital Reserve Fund that is attributable to original or investment proceeds of bonds issued under the Second Resolution and which were refunded by the Series 66 and 68 bonds and, therefore, will become gross proceeds of such bonds upon payment of the principal of the refunded bonds. Amounts in the First Capital Reserve Fund which are derived from revenues of the Corporation will not be treated as gross proceeds of the Series 60 through 68 bonds since such revenues are not subject to the transferred proceeds rules of the arbitrage regulations.

The proportionate amounts of the proceeds of the refunded bonds that become transferred to the refunding bonds is set forth in Exhibit C attached hereto.

Therefore, in order to determine the amount of gross proceeds of the refunding bonds, it is necessary to first determine the amount of proceeds of the refunded bonds which are on deposit in the Capital Reserve Funds. First, the amount of original proceeds of the refunded bonds deposited to the Capital Reserve Funds may be determined from the books and

records of the Corporation. (See Exhibit B, columns B-1 and B-2.) In certain instances proceeds of certain earlier issuances of bonds were deposited to the Capital Reserve Funds and have become transferred proceeds of the refunded bonds which, in turn, refunded such earlier bonds. Second, the investment earnings must be allocated to the refunded bonds, as described below. Third, withdrawals from the Capital Reserve Funds must be allocated to the bonds. (See Exhibit B, column F.) It is appropriate to treat any such withdrawal which is attributable to the reduction in the annual debt service requirement as a consequence of the issuance of refunding bonds as derived initially from proceeds of the particular refunded bonds. This allocation procedure is also set forth in the Arbitrage Certificate for the Series 65 and 66 bonds. Any additional withdrawals are allocated on a proportionate basis from the allocable portion of the Capital Reserve Fund attributable to all bonds secured thereby.

The allocation of investment earnings to particular bonds requires the use of certain accounting conventions since the Corporation has not maintained any records by which it has attributed investment earnings to any particular sources of proceeds or investments. This will be a fairly complicated procedure and requires a review of account records for many prior years. Nevertheless, once the accounting conventions are established and the records are gathered, the procedure is a mechanical one and has been undertaken by Orrick, Herrington's Financial Services Group on several prior occasions for other issuers of bonds involving similar circumstances. The basic concept of the allocation of investments is to assume that proceeds from different sources are invested proportionately in different investment securities (rather than attempting to trace particular proceeds to specific investments). Thus, the process involves determining the sources of the Capital Reserve Funds balances at a particular date and allocating investment earnings proportionately to the different sources. The proportion will change each time there is an additional deposit or withdrawal from the Capital Reserve Funds from any source other than investment earnings.

As described above, once the deposits in the Capital Reserve Funds have been allocated among any refunded bonds, such proceeds will become transferred proceeds of refunding bonds as described above. (See also Exhibit B, column H for principal payment dates of refunded bonds and Exhibit C for the proportionate amounts of transferred proceeds.)

The amounts which are treated as gross proceeds of the bonds must be allocated to the investments held from time to time in the Capital Reserve Funds. For simplicity, it is most appropriate to allocate investment securities among the gross

proceeds of different series of bonds on a proportionate basis. Other methods of allocation may also be permissible, although, likely with greater complication and little practical financial impact. The allocation of investments to gross proceeds must be determined on the basis of the fair market value of each investment on the date that amounts in the Capital Reserve Funds become treated as gross proceeds of a series of bonds.

A complete allocation of amounts held in the Capital Reserve Funds must also take into account that the required balance in any particular year may not be reduced as a result of the retirement of the last maturity of a particular series of bonds. Of course, when refunded bonds are retired, proceeds in the Capital Reserve Funds attributable thereto will become transferred proceeds of related refunding bonds. However, when bonds which have not been refunded are retired, allocable proceeds in the Capital Reserve Funds are no longer treated as proceeds of such retired series of bonds and must then be reallocated to other outstanding bonds. In fact, it would seem appropriate that when the outstanding principal amount of a bond issue is reduced to a point where the amount of proceeds in the Capital Reserve Funds allocable to such issue exceeds such outstanding principal, the excess amount is no longer treated as proceeds of the bonds and must be reallocated to other bonds. Such an allocation among the remaining outstanding bonds may be made on a variety of methods, including, perhaps most appropriately, the proportionate annual debt service for each series of bonds. This procedure of reallocating proceeds may be more of a theoretical matter than of any practical concern. This is because, with one exception, all series of bonds of the Corporation which have not yet been refunded and to which gross proceeds are allocable as described herein mature on the same date, July 1, 2008. (The Series 57 bonds mature on July 1, 2006.) Further, this reallocation does not apply with respect to the First Capital Reserve Fund since upon full retirement of the Series 66 and Series 68 bonds, the First Capital Reserve Fund will no longer exist.

Conclusion. It should be noted that there is very little guidance in existing Treasury regulations and Service rulings for establishing a specific method for allocating proceeds and investments in the Capital Reserve Funds for purposes of compliance with federal arbitrage rebate requirements. Therefore, the analysis described herein may not ultimately be exactly the method that is approved by the Treasury in future regulations or by the Service in its rulings or, possibly, as a result of a review of the Corporation's arbitrage rebate liability.

It is expected that the Treasury will be releasing proposed regulations regarding the allocation of proceeds and investments in the near future. These regulations, when adopted, may provide additional guidance that may affect the analysis above. Accordingly, the matters covered in this memorandum should be reviewed when the Treasury promulgates additional regulations.

In light of the foregoing, it is not possible to advise the Corporation with certainty as to the proper method of allocating proceeds and investments in the Capital Reserve Funds. Similarly, it cannot be said that any particular method described herein is absolutely correct or absolutely wrong.

Nevertheless, even in the absence of precise guidance from the Treasury or the Service, the Corporation must undertake to determine and pay its rebate liability in compliance with its covenants to maintain the tax-exempt status of its bonds as set forth in the Corporation's bond resolutions and its representations set forth in the Arbitrage Certificates. Furthermore, the Corporation's obligation to pay arbitrage rebate amounts and its liability for the payment of incorrect amounts may be mitigated or, possibly, increased by the rebate penalty provisions set forth in Treasury regulations. These penalty provisions vary from a stated interest on a late rebate payment due to innocent failures to a 50% penalty plus stated interest amount for improper payments that, although not innocent, are not due to willful neglect.

Exhibit B

| (A)             | (B-1)<br>Refunded Bonds<br>Proceeds Deposit | (B-2)<br>Refunded Bonds<br>Second Capital Reserve | (C-1)<br>Series Sub-Account<br>Dist. per Arb. Cert. | (C-2)<br>Series Sub-Account<br>Second Capital Reserve | (D)<br>Max. Ann. Debt Serv. Require. | (E)<br>Max. Debt Serv. Year | (F)<br>Second Cap. Res. Withdraw | (G)<br>Original Principal | (H)<br>Issue or Call Date | (I)<br>Refunded Principal |
|-----------------|---|---|---|---|--------------------------------------|-----------------------------|----------------------------------|---------------------------|---------------------------|---------------------------|
| Series 60       | --  | --  | --  | \$29.86   | \$ 55.41                             | 2004                        | \$14.80                          | \$449.12                  | 11/26/86                  | \$175.00                  |
| Ser. 40(41)     | --  | \$15.84   | --  | --  | --                                   | --                          | --                               | 175.00                    | 07/01/93                  | 185.00                    |
| Ser. 52         | --  | --  | --  | 45.27   | 84.45                                | 2000                        | 34.20                            | 684.20                    | 02/18/87<br>(s:88-94)     | 100.00                    |
| Series 61       | --  | --  | --  | --  | --                                   | --                          | --                               | 100.00                    | 07/01/93                  | 94.05                     |
| Ser. 41(40)     | --  | --  | --  | --  | --                                   | --                          | --                               | 100.00                    | 07/01/94<br>(s:87-93)     | 206.26                    |
| Ser. 46         | --  | --  | --  | --  | --                                   | --                          | --                               | 206.26                    | 07/01/94<br>(s:87-93)     | 206.26                    |
| Ser. 48         | --  | --  | --  | --  | --                                   | --                          | --                               | 175.00                    | 07/01/95<br>(s:88-94)     | 175.00                    |
| Ser. 51         | 11.54                                       | 11.54   | --  | --  | --                                   | --                          | --                               | 175.00                    | 07/01/95<br>(s:88-94)     | 175.00                    |
| Series 62       | --  | --  | --  | 44.80   | 84.15                                | 2004                        | 11.30                            | 684.24                    | 03/31/87                  | 226.88                    |
| Ser. 50         | --  | 14.70   | --  | --  | --                                   | --                          | --                               | 226.88                    | 07/01/94<br>(s:93)        | 160.54                    |
| Ser. 53         | --  | 30.20   | --  | --  | --                                   | --                          | --                               | 160.54                    | 07/01/95<br>(s:93-94)     | 201.77                    |
| Ser. 54         | --  | 14.40   | --  | --  | --                                   | --                          | --                               | 201.77                    | 07/01/95<br>(s:94)        | 201.77                    |
| Series 63       | --  | --  | --  | 5.86  | 10.70                                | 2008                        | 8.70                             | 79.50                     | 05/18/87                  | 60.00                     |
| Ser. 24         | --  | 14.82   | --  | --  | --                                   | --                          | --                               | 100.00                    | 07/01/90<br>(s:88-89)     | 16.81                     |
| Ser. 42         | --  | --  | --  | --  | --                                   | --                          | --                               | 19.91                     | 07/01/93<br>(s:88-92)     | 125.00                    |
| Series 64       | --  | --  | --  | 9.95  | 19.10                                | 2008                        | 1.00                             | 134.49                    | 02/11/88                  | 125.00                    |
| Ser. 23         | --  | --  | --  | --  | --                                   | --                          | --                               | 125.00                    | 07/01/90                  | 125.00                    |
| Series 65       | --  | --  | --  | 7.05  | 13.50                                | 2008                        | 1.00                             | 96.90                     | 03/17/88                  | 90.00                     |
| Ser. 19(20)     | --  | 16.00   | --  | --  | --                                   | --                          | --                               | 90.00                     | 07/01/89                  | 90.00                     |
| Series 66       | --  | --  | \$36.91   | 98.19   | 147.20                               | 1995                        | 3.00                             | 700.60                    | 07/07/88                  | 314.96                    |
| Ser. 11, 12, 13 | \$47.00                                     | 13.15   | --  | --  | --                                   | --                          | --                               | 401.00                    | 08/15/88                  | 64.27                     |
| Ser. 20(19)     | --  | --  | --  | --  | --                                   | --                          | --                               | 64.27                     | 07/01/89                  | 293.11                    |
| Ser. 21, 22     | --  | 32.00   | --  | --  | --                                   | --                          | --                               | 273.95                    | 07/01/89                  | 250.00                    |
| Series 67       | --  | --  | --  | 36.98   | 66.60                                | 1999                        | 0.00                             | 396.45                    | 10/06/88                  | 125.00                    |
| Ser. 10         | --  | 16.85   | --  | --  | --                                   | --                          | --                               | 250.00                    | 11/15/88                  | 125.00                    |
| Ser. 14         | --  | 16.50   | --  | --  | --                                   | --                          | --                               | 125.00                    | 07/01/89                  | 125.00                    |
| Series 68       | --  | --  | 32.03   | 32.78   | 69.30                                | 1993                        | 0.00                             | 411.25                    | 11/21/88                  | 125.00                    |
| Ser. 15         | 9.20  | 27.30   | --  | --  | --                                   | --                          | --                               | 125.00                    | 07/01/89                  | 132.24                    |
| Ser. 16         | --  | --  | --  | --  | --                                   | --                          | --                               | 132.24                    | 07/01/89                  | 128.05                    |
| Ser. 17, 18     | 26.90                                       | 4.00  | --  | --  | --                                   | --                          | --                               | 177.00                    | 07/01/89                  | 128.05                    |

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**M E M O R A N D U M**

December 23, 1991

TO: Lynnette Kelly  
Fran Higgins Jacobs

FROM: Richard Chirls

RE: Draft Memorandum Regarding Allocation of Capital  
Reserve Funds

Attached is a draft memorandum describing a proposed methodology for the allocation of the Capital Reserve Funds among post-86 tax act bond issues for purposes of calculating the Corporation's rebate liability.

As you will see, this is a fairly complicated subject. I don't think any of us could have imagined that it would have been otherwise. The lack of regulatory guidance, the complexity associated with the Corporation's many bond issues and the absence of existing records allocating proceeds lends to this complexity.

I welcome your comments with respect to all aspects of the memorandum including factual descriptions and assumptions, legal theories and conclusions and practical consequences. This is truly a discussion draft.

You may want to start your review by reading the last few paragraphs first. It points out that there is no correct answer and that, as is the case with many rebate problems, ultimately the issuer of the bonds has the responsibility to do the best it can to fairly compute its rebate liability.

The Corporation has to pay a rebate with respect to the Series 60 bonds on or before January 25, 1992. Accordingly, it is necessary to resolve the allocation methodology within the next few days and begin the computation

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process promptly. This schedule may also affect the allocation methodology that is adopted as well. (The Corporation will also have to make rebate payments on or before April 18, 1992, May 30, 1992 and July 17, 1992 with respect to the Series 61, 62 and 63 bonds, respectively.)

Please call me with your questions or comments.

cc: J. Keohane  
P. Israel  
G. Majors

Draft  
12/23/91

M E M O R A N D U M

December \_\_, 1991

TO:

FROM: Richard Chirls

RE: MAC Rebate Calculation for Capital Reserve

The purpose of this memorandum is to set forth the procedure to be utilized in determining the amount of proceeds and allocable investments held in the capital reserve funds relating to the bonds issued by The Municipal Assistance Corporation of the City of New York (the "Corporation") for purposes of compliance with federal arbitrage rebate requirements.

Background. The Corporation has issued its several series of bonds under three bond resolutions (referred to herein as the "First Resolution," the "Second Resolution" and the "1991 Resolution"). The source of payment for the bonds and the lien on revenues of the Corporation with respect to its bonds differs under each bond resolution.

Under each of the bond resolutions there is established a separate Capital Reserve Fund or, in the case of the 1991 Resolution, a Bond Reserve Fund which are intended to operate as reasonably required reserve funds within the meaning of Section 148(d) of the Internal Revenue Code of 1986 (the "Code") and Section 103(c)(2) of the Internal Revenue Code of 1954, as amended. The Capital Reserve Funds established under the First Resolution and Second Resolution (the "First Capital Reserve Fund" and the "Second Capital Reserve Fund," respectively) are required to be maintained in an amount not less than the amount of principal and interest maturing or otherwise becoming due in the succeeding calendar year on all bonds issued pursuant to the respective resolution. Notwithstanding this requirement, however, with respect to the First Capital Reserve Fund and the Second Capital Reserve Fund, each Fund need only have been funded at zero percent of the required amount for 1975 and 1976, 25 percent of the required amount in 1977, 50 percent of the required amount in 1978, 75 percent of the required amount in 1979 and 100 percent of the required amount in 1980 and thereafter. The requirement with respect to the 1991 Resolution Bond Reserve Fund is an amount not less than one-half of the maximum debt service due in any

calendar year on all bonds outstanding under the 1991 Resolution.

As a consequence of the permitted delayed funding of the Capital Reserve Funds to meet the required amounts, at the time of issuance of many of the early series of bonds by the Corporation, no deposit was made to the Capital Reserve Funds. However, with respect to several subsequent series of bonds, substantial amounts of the proceeds of the bond issues were deposited to the Capital Reserve Funds. Additional amounts deposited or held in the Capital Reserve Funds consisted of revenues of the Corporation or accumulated investment earnings derived from amounts held in such Funds. At the time of issuance of the bonds pursuant to the 1991 Resolution, proceeds of such bonds were deposited to the Bond Reserve Fund equal to the required amount.

The Corporation has issued several series of bonds under the Second Resolution with respect to which more than 15 percent of the proceeds of the issue have been deposited in the First Capital Reserve Fund or the Second Capital Reserve Fund. Treasury Regulation Section 1.103-14(d)(1) provides in part that an obligation shall not be an arbitrage bond solely by reason of the fact that a portion of the proceeds of the issue may be invested in materially higher yield acquired obligations that are part of a reasonably required reserve or replacement fund. Generally, a reserve or replacement fund will be considered reasonably required only if the amount so invested does not exceed 15 percent of the amount of the issue. However, Section 1.103-14(d)(2) of the Treasury Regulations provides that an amount in excess of 15 percent may be invested at a materially higher yield if the Internal Revenue Service (the "Service") issues a ruling to the effect that such excess will be considered to be invested in a reasonably required reserve fund.

Accordingly, the Corporation filed certain requests for rulings from the Service to such effect with respect to the proceeds of certain issues of its bonds. The Corporation received a letter ruling from the Service issued on July 10, 1984, supplementing letter rulings issued on April 29, 1980 (as supplemented and clarified by letters of April 30, 1980 and August 28, 1980) and March 23, 1981. Copies of such letter rulings are attached hereto as Exhibit A. Although each of the letter rulings differed slightly, they are virtually identical in all substantive respects.

Apparently vital to the Service's analysis was the Corporation's representation that the total amount on deposit in each separate Capital Reserve Fund will never exceed the lesser of (i) 1.25 times the average annual debt service or

(ii) the maximum annual debt service on all bonds issued under each resolution, respectively. Further, the Corporation represented that the amount on deposit in each Capital Reserve Fund will never exceed 15 percent of all bonds issued under each resolution, respectively (taking into account adjustments for bond issues the original issue price of which are less than 98 percent of the original face amount thereof, as required by Treasury Regulation Section 1.103-13(b)(1)(ii)). Further, all refunding issues of the Corporation will be taken into account in determining whether the 15 percent limit is met. However, no amounts in the Capital Reserve Funds that are allocable to a refunding issue will be invested at a materially higher yield than the yield on the refunding issue until the adjusted maturity dates of the prior issues. The Corporation also represented that it does not intend to maintain in either Capital Reserve Fund an amount substantially in excess of the required deposit (including any increase or decrease in such amounts reasonably expected within the then current or succeeding fiscal years), but rather intends to transfer any excess to the appropriate bona fide debt service funds with respect to the bonds to pay debt service on all bonds issued under the applicable resolution.

The Service noted that the Corporation argued that each Capital Reserve Fund must be considered to be a debt service reserve fund for all bonds issued under each respective resolution on a parity basis and should be treated as a reserve for a single issue. Therefore, the Corporation contended that the amount constituting a "reasonably required reserve fund" should be determined, at any particular time, on the basis of 15 percent with respect to all bonds issued under the respective resolution.

On the basis of the foregoing, the Service issued its rulings to the effect that all amounts deposited in each Capital Reserve Fund established under the First Resolution and the Second Resolution, respectively, which are allocable to a particular issue of bonds, including any such amounts consisting of investment proceeds to be deposited in the future, to the extent required to meet such Fund's peak requirement for all bonds issued under the particular resolution (as such requirement may change from time to time), may be invested without restriction as to yield.

Following the receipt of the Service's rulings the Corporation has been able to invest all amounts held in the Capital Reserve Funds at an unrestricted yield. Pursuant to the terms of such rulings and then applicable Treasury Regulations, there was no need for the Corporation to separately account for the amounts deposited to the Capital Reserve Funds or to allocate such amounts to particular bond

issues. Thus, regardless of whether the amounts deposited to the Capital Reserve Funds consisted of original proceeds of bonds, investment earnings thereon or revenues of the Corporation and regardless of the amount that might be allocable to a bond issue, all amounts were eligible for investment at an unrestricted yield.

The Tax Reform Act of 1986 added Section 148(f) to the Code which imposed an arbitrage rebate requirement on the Corporation with respect to all bonds issued after August 31, 1986. Accordingly, although the Corporation may continue to be permitted to invest all amounts in the Capital Reserve Funds at an unrestricted yield, any arbitrage profits derived from the investment of gross proceeds allocable to post-August 1986 bond issues are required to be rebated to the federal government.

[The Tax Reform Act of 1986 also added Section 148(d)(1) to the Code which provides that the amount of proceeds of a bond issue that may be invested at an unrestricted yield in a reserve or replacement fund may not exceed 10 percent of the proceeds of such issue, unless the Treasury Department determines that a larger amount is necessary with respect to the issue. However, the General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Tax Committee on Taxation (the "Bluebook"), at page 1204, explains that Congress intended that a reserve or replacement fund in excess of 10 percent will be allowed without the necessity of a Treasury determination if the master legal document authorizing the particular bonds was adopted before August 16, 1986 and (1) requires a reserve or replacement fund in excess of 10 percent of proceeds, but not more than maximum annual debt service; (2) is not amended after August 31, 1986; and (3) provides that bonds having a parity of security may not be issued without satisfying such reserve fund requirement. The Capital Reserve Funds and the bonds of the Corporation issued under the First Resolution and Second Resolution satisfy each of these requirements. Accordingly, in reliance upon this statement in the Bluebook, the 10 percent limitation has been determined to not be applicable to the deposits to the Capital Reserve Funds.]

Since August 31, 1986, the Corporation has issued several series of bonds pursuant to the Second Resolution (i.e., Series 60 through Series 68). Each such series of bonds has been issued for the purpose of refunding outstanding series of bonds previously issued under the Second Resolution and to pay a portion of the costs of issuance of the bonds. Since each of these series of bonds is subject to the arbitrage rebate requirement it is necessary to determine (i) the amount of gross proceeds which are allocable to the bonds deposited in the Capital Reserve Funds, if any, (ii) the yield on

investments acquired with such gross proceeds and (iii) the amount of any arbitrage profits attributable to such investments.

In order to establish a procedure for making such determinations the Corporation has delivered its Arbitrage and Use of Proceeds Certificate (the "Arbitrage Certificate") with respect to each series of such bonds, including, attached as an exhibit thereto, its Accounting Memorandum. Each Arbitrage Certificate with respect to post-August 1986 bonds provides a description of the refunding and refunded bonds, the use of the proceeds of the refunding and refunded bonds and the procedure for accounting for the deposits held in the Capital Reserve Funds.

Specifically, in Section 6.3 of each Arbitrage Certificate, the Corporation describes that each of the subject bonds are secured by the Second Capital Reserve Fund and that moneys in such Fund have been derived from revenues and bond proceeds of the Corporation. However, as described in the Arbitrage Certificates, the Corporation has applied a first-in, first-out method of accounting for purposes of establishing that the amounts presently held in the Second Capital Reserve Fund consist solely of bond proceeds and investment earnings thereon. The basis for this analysis is apparently that the Corporation's revenues which were the initial deposits to such Fund can be regarded as the first amounts withdrawn from the Fund at certain times when the required deposit was reduced.

The Arbitrage Certificates further provide that the Corporation will establish special sub-accounts within the Second Capital Reserve Fund, which are denominated as the "Series [60 through 68] Capital Reserve Account." Each such sub-account in the Second Capital Reserve Fund is stated to be attributable to the particular series of bonds and equal to the aggregate debt service requirement for that series of bonds for the calendar year in which the bonds are issued. The intent is that the amount deposited to each sub-account will be increased or decreased to reflect the current annual debt service requirement for each series of bonds. [Note that it is not clear from the Arbitrage Certificates whether the amount in each sub-account is required to be changed each year to reflect current debt service requirements. In fact, it may be that the Arbitrage Certificates merely require an initial funding amount for the sub-account with no provision for subsequent changes in the debt service requirement. I am not certain what the Corporation's practice has been to date. It would seem to be inappropriate to not make annual changes to the sub-account amounts to reflect current annual service.] Such requirement for each series of bonds will vary each year based on scheduled debt service (from a high of approximately \$632 million in 1993

in the aggregate for all such bonds to a low of \$514 million in 1994, rising again to \$604 million in 2000 and back down to approximately \$540 million each year from 2001 until the final maturity of the bonds in 2009). Although the amounts deposited to each sub-account are unrestricted as to yield on the investment thereof, the Arbitrage Certificates provide that, as the amounts in the Second Capital Reserve Fund attributable to the issues of refunded bonds becomes "transferred proceeds" of the series of refunding bonds, a pro-rata portion of the amounts in the particular series sub-account shall become subject to the terms of the Accounting Memorandum and, thereby, subject to the arbitrage rebate requirement.

The Arbitrage Certificates also describe the amounts that are released from the Second Capital Reserve Fund and transferred to the Bond Service Fund as a result of the reduction in the debt service requirement due to the issuance of the refunding bonds and that will be used to pay a portion of the debt service on bonds issued pursuant to the Second Resolution.

In the case of the Series 66 and 68 bonds, Section 6.3 of the Arbitrage Certificates also establishes a Series [66 or 68] Capital Reserve Account within the First Capital Reserve Fund. In the case of these particular series of bonds, the bonds which were refunded thereby had provided for a deposit of proceeds to the First Capital Reserve Fund. Accordingly, the Corporation treated \_\_\_\_\_

[explain method for determining deposit to sub-accounts in First Capital Reserve Fund; Arbitrage Certificates are silent as to methodology] of the amount held in the First Capital Reserve Fund as allocable to the refunding bonds. The Arbitrage Certificates provide that as the proceeds of the refunded bonds become "transferred proceeds" of the refunding bonds, a pro-rata portion of the amounts in the particular series sub-account shall become subject to the terms of the Accounting Memorandum and, thereby, subject to the arbitrage rebate requirement.

Exhibit B attached hereto sets forth for each issue of bonds, Series 60 through 68, the following: (i) the amount of the direct or indirect deposit of proceeds of the bonds refunded by such refunding bonds to the First Capital Reserve Fund and Second Capital Reserve Fund, if any, (ii) the amount of the initial deposit to the series sub-account of the First Capital Reserve Fund and Second Capital Reserve Fund, (iii) the current or future maximum annual debt service requirement and year for each such series of bonds and (iv) the amount withdrawn from the Second Capital Reserve Fund at the time of issuance of the refunding bonds.

Attached hereto as Exhibit C are certain provisions excerpted from the Arbitrage Certificate relating to the Series 68 bonds as an example of the provisions of the Arbitrage Certificates.

Analysis. As shown on Exhibit B, the amount deposited to the particular series sub-account in the Capital Reserve Funds differs substantially from the amount of proceeds of the refunded bonds deposited to the Capital Reserve Funds. (See Exhibit B, columns C-1 and C-2, and B-1 and B-2, respectively.) Following in this memorandum is an analysis of whether the amount held in such sub-accounts should properly be the amount treated as gross proceeds of bonds subject to the arbitrage rebate requirement or whether a different amount should be taken into account for such purposes and, if so, the procedure for determining such amount.

The procedure for determining the amount of proceeds subject to the rebate requirement as set forth in the Arbitrage Certificates was originally adopted by the Corporation with respect to the Series 60 bonds. The rationale supporting this procedure seems to be based on several factors. First, although the Corporation has determined that, using a first-in, first-out method of accounting, the deposits to the Second Capital Reserve Fund consists solely of original proceeds and investment proceeds, the Corporation has not maintained records which specifically allocate investment proceeds to any particular series of bonds from which was made a deposit of original proceeds to the Fund. Second, the Service's rulings treat the First Capital Reserve Fund and Second Capital Reserve Fund as allocable to all issues secured thereby and eligible for unrestricted investment as long as the total deposit thereto does not exceed 15 percent of the aggregate amount of bonds issued under each resolution. This may be viewed as effectively treating all bonds under a resolution as a single issue for purposes of analyzing the allocation of the Capital Reserve Funds. Finally, there do not exist any Treasury Regulations or rulings by the Service which provide a specific procedure for allocating proceeds deposited in a reserve fund securing several bond issues among the bonds. Most of the rules governing the allocation of gross proceeds were reserved by the Treasury Department in the regulations which have been promulgated regarding the rebate requirement. [Treasury Regulations Section 1.103-13(g)(6) provides for an allocation of a sinking fund for two or more issues between the issues either (i) in proportion to the original face amounts of the issues, or (ii) according to the total amount of debt service of the issues that will actually be paid from the sinking fund. This provision is not directly applicable to the rebate requirement and has generally been criticized as not reflecting an appropriate method of allocation for a reserve fund which is

established on the basis of the maximum annual debt service requirement for each issue secured thereby.]

As a consequence of the foregoing analysis, the amounts deposited to the Second Capital Reserve Fund have been allocated to the sub-accounts relating to the Series 60 through 68 bonds on the basis of the annual debt service requirements for such bonds without regard to whether such amounts are attributable to proceeds of the bonds that are refunded by such series of bonds. However, the amounts allocated to such sub-accounts are not treated as gross proceeds of the bonds and subject to the rebate requirement until, and in proportion to, the retirement of the principal of the refunded bonds.

[Describe allocation of First Capital Reserve Fund.]

Although there exist no regulations or rulings providing precise guidance regarding the appropriate method for allocating the amounts deposited to the Capital Reserve Funds among the bonds, the method described in the Arbitrage Certificates is inconsistent in its application of certain provisions of applicable regulations. Specifically, such method appears to treat the amounts deposited to the Capital Reserve Funds as revenues of the Corporation rather than as proceeds attributable to particular series of refunded bonds. This is inconsistent with the statement in the Arbitrage Certificates to the effect that, under the first-in, first-out method of accounting, the deposits to the Second Capital Reserve Fund consist solely of bond proceeds and investment earnings thereon. Further, this allocation method is inconsistent with treating the amounts deposited to the series sub-accounts as becoming transferred proceeds of the refunding bonds and subject to the rebate requirement upon the payment of principal of the refunding bonds. Such a transferred proceeds analysis is only appropriate with respect to amounts which are original or investment proceeds of the refunded bonds. Other amounts, including amounts treated as revenues of the Corporation are not subject to becoming transferred proceeds of the refunding bonds. See, Treas. Reg. Section 1.103-14(e)(2)(ii). In fact, amounts treated as revenues which are held in a reserve fund allocable to a series of bonds are gross proceeds of such bonds immediately upon the deposit to such reserve fund and are, at such time, subject to the arbitrage rebate requirement determined with respect to such bonds. [Note, if amounts deposited to sub-accounts are not varied each year as annual debt service changes, such approach would also be inconsistent with treating all deposits to Capital Reserve Funds as revenues for purposes of allocations.]

In light of this inconsistency in the method set forth in the Arbitrage Certificates, it is appropriate to evaluate

whether an alternative procedure is more appropriate for allocating the amounts deposited to the Capital Reserve Funds among the bonds for purposes of determining the arbitrage rebate requirement.

In particular, it may be more appropriate to start the analysis by recognizing that certain amounts deposited to the Capital Reserve Funds are directly traceable to the original proceeds of bonds and that the remainder of the deposits consist of investment earnings on such bond proceeds. This characterization of all deposits to the Capital Reserve Funds as bond proceeds (original and investment proceeds) differs markedly from the allocation method whereby the deposits to the Capital Reserve Funds are allocated among bonds on the basis of the debt service requirements for the bonds as if the deposits consisted of revenues of the Corporation. Further, the allocation of the deposits among bonds as proceeds of the bonds is not inconsistent with the Service's rulings. These rulings stated that Capital Reserve Funds deposits which are allocable to a particular issue of bonds may be invested at an unrestricted yield. Accordingly, the Service recognized that the deposits are to be allocated to particular bonds, but it did not give any guidance as to the proper method for making the allocation. Further, in reaching the conclusion that the deposits in the Capital Reserve Funds could be invested without restriction as to yield, the Service did not necessarily treat the deposits as if they were Corporation revenues which would be allocated among all bonds issued under their respective resolutions so that the allocated amounts would be less than 15 percent of the amount of such series of bonds. Rather, the Service's ruling was based on the determination under Treasury Regulation Section 1.103-14(d)(2) that an amount of bond proceeds in excess of 15 percent of the bonds may be invested at an unrestricted yield in the Capital Reserve Funds as a reasonably required reserve fund.

By recognizing that all deposits to the Capital Reserve Funds consist of original or investment proceeds of particular series of bonds, such proceeds will be treated as gross proceeds of the Series 60 through 68 refunding bonds by application of the transferred proceeds rules of Treasury Regulation Section 1.103-14(e)(2)(ii). [The transferred proceeds rules of Proposed Treasury Regulation Section 1.148-4T(e)(2) are not applicable to the Series 60 through 68 bonds by virtue of the effective date of such regulation.] Accordingly, upon the payment of the principal of the refunded bonds by the proceeds of the refunding bonds, the proceeds deposited in the Capital Reserve Funds which are allocable to the refunded bonds would become gross proceeds of the particular Series 60 through 68 refunding bonds on a pro-rata basis and, thereby, subject to the arbitrage rebate requirement.

The proportionate amounts of the proceeds of the refunded bonds that become transferred to the refunding bonds is set forth in Exhibit C attached hereto.

Therefore, in order to determine the amount of gross proceeds of the refunding bonds, it is necessary to first determine the amount of proceeds of the refunded bonds which are on deposit in the Capital Reserve Funds. First, the amount of original proceeds of the refunded bonds deposited to the Capital Reserve Funds may be determined from the books and records of the Corporation. (See Exhibit B, columns B-1 and B-2.) In certain instances proceeds of certain earlier issuances of bonds were deposited to the Capital Reserve Funds and have become transferred proceeds of the refunded bonds which, in turn, refunded such earlier bonds. Second, the investment earnings must be allocated to the refunded bonds, as described below. Third, withdrawals from the Capital Reserve Funds must be allocated to the bonds. (See Exhibit B, column F.) It is appropriate to treat any such withdrawal which is attributable to the reduction in the annual debt service requirement as a consequence of the issuance of refunding bonds as derived initially from proceeds of the particular refunded bonds. This allocation procedure is also set forth in the Arbitrage Certificate for the Series 65 and 66 bonds. Any additional withdrawals are allocated on a proportionate basis from the allocable portion of the Capital Reserve Fund attributable to all bonds secured thereby.

The allocation of investment earnings to particular bonds requires the use of certain accounting conventions since the Corporation has not maintained any records by which it has attributed investment earnings to any particular sources of proceeds or investments. This will be a fairly complicated procedure and requires a review of account records for many prior years. Nevertheless, once the accounting conventions are established and the records are gathered, the procedure is a mechanical one and has been undertaken by Orrick, Herrington's Financial Services Group on several prior occasions for other issuers of bonds involving similar circumstances. The basic concept of the allocation of investments is to assume that proceeds from different sources are invested proportionately in different investment securities (rather than attempting to trace particular proceeds to specific investments). Thus, the process involves determining the sources of the Capital Reserve Funds balances at a particular date and allocating investment earnings proportionately to the different sources. The proportion will change each time there is an additional deposit or withdrawal from the Capital Reserve Funds from any source other than investment earnings.

As described above, once the deposits in the Capital Reserve Funds have been allocated among any refunded bonds, such proceeds will become transferred proceeds of refunding bonds as described above. (See also Exhibit B, column H for principal payment dates of refunded bonds.)

The amounts which are treated as gross proceeds of the bonds must be allocated to the investments held from time to time in the Capital Reserve Funds. For simplicity, it is most appropriate to allocate investment securities among the gross proceeds of different series of bonds on a proportionate basis. Other methods of allocation may also be permissible, although, likely with greater complication and little practical financial impact.

A complete allocation of amounts held in the Capital Reserve Funds must also take into account that the required balance in any particular year may not be reduced as a result of the retirement of the last maturity of a particular series of bonds. Of course, when refunded bonds are retired, proceeds in the Capital Reserve Funds attributable thereto will become transferred proceeds of related refunding bonds. However, when bonds which have not been refunded are finally retired, allocable proceeds in the Capital Reserve Funds are no longer treated as proceeds of such retired series of bonds and must then be reallocated to other outstanding bonds. Such an allocation among the remaining outstanding bonds may be made on a variety of methods, including, perhaps most appropriately, the proportionate annual debt service for each series of bonds. This procedure of reallocating proceeds may be more of a theoretical matter than of any practical concern. This is because, with one exception, all series of bonds of the Corporation which have not yet been refunded and to which gross proceeds are allocable as described herein mature on the same date, July 1, 2008. (The Series 57 bonds mature on July 1, 2006.)

Conclusion. It should be noted that there is very little guidance in existing Treasury regulations and Service rulings for establishing a specific method for allocating proceeds and investments in the Capital Reserve Funds for purposes of compliance with federal arbitrage rebate requirements. Therefore, the analysis described herein may not ultimately be exactly the method that is approved by the Treasury in future regulations or by the Service in its rulings or, possibly, as a result of a review of the Corporation's arbitrage rebate liability.

It is expected that the Treasury will be releasing proposed regulations regarding the allocation of proceeds and investments in the near future. These regulations, when

adopted, may provide additional guidance that may affect the analysis above. Accordingly, the matters covered in this memorandum should be reviewed when the Treasury promulgates additional regulations.

In light of the foregoing, it is not possible to advise the Corporation with certainty as to the proper method of allocating proceeds and investments in the Capital Reserve Funds. Similarly, it cannot be said that any particular method described herein is absolutely correct or absolutely wrong.

Nevertheless, even in the absence of precise guidance from the Treasury or the Service, the Corporation must undertake to determine and pay its rebate liability in compliance with its covenants to maintain the tax-exempt status of its bonds as set forth in the Corporation's bond resolutions and its representations set forth in the Arbitrage Certificates. Furthermore, the Corporation's obligation to pay arbitrage rebate amounts and its liability for the payment of incorrect amounts may be mitigated or, possibly, increased by the rebate penalty provisions set forth in Treasury regulations. These penalty provisions vary from a stated interest on a late rebate payment due to innocent failures to a 50% penalty plus stated interest amount for improper payments that, although not innocent, are not due to willful neglect.

Exhibit B

| (A)<br>Refunding<br>Bonds/<br>Refunded<br>Bonds | (B-1)<br>Refunded<br>Bonds<br>Proceeds<br>Deposit | (B-2)<br>Second<br>Capital<br>Reserve | (C-1)<br>Series Sub-Account<br>Dpst. per Arb. Cert.<br>First<br>Capital<br>Reserve | (C-2)<br>Second<br>Capital<br>Reserve | (D)<br>Max. Ann.<br>Debt Serv.<br>Require. | (E)<br>Max.<br>Debt Serv.<br>Year | (F)<br>Second<br>Cap. Res.<br>Withdraw | (G)<br>Original<br>Principal | (H)<br>Issue or<br>Call Date | (I)<br>Refunded<br>Principal |
|---|---|---------------------------------------|--|---------------------------------------|--|-----------------------------------|--|------------------------------|------------------------------|------------------------------|
| Series 60                                       |   |                                       |  |                                       |  |                                   |  |                              |                              |                              |
| Ser. 40(41)                                     | --  | (?)                                   | --   | \$29.86                               | \$ 55.41                                   | 2004                              | \$14.80                                | \$449.12                     | 11/26/86                     | \$175.00                     |
| Ser. 52   | --  | \$15.84                               | --   |                                       |  |                                   |  | 175.00                       | 07/01/93                     | 185.00                       |
|   |   |                                       |  |                                       |  |                                   |  | 185.00                       | 07/01/95                     |                              |
|   |   |                                       |  |                                       |  |                                   |  |                              | (s:88-94)                    |                              |
| Series 61                                       |   |                                       |  |                                       |  |                                   |  |                              |                              |                              |
| Ser. 41(40)                                     | --  | (?)                                   | --   | 45.27                                 | 84.45                                      | 2000                              | 34.20                                  | 684.20                       | 02/18/87                     | 100.00                       |
| Ser. 46   | --  | --                                    | --   |                                       |  |                                   |  | 100.00                       | 07/01/93                     | 94.05                        |
|   |   |                                       |  |                                       |  |                                   |  | 100.00                       | 07/01/94                     |                              |
|   |   |                                       |  |                                       |  |                                   |  |                              | (s:87-93)                    |                              |
| Ser. 48   | --  | --                                    | --   |                                       | 206.26                                     |                                   |  | 206.26                       | 07/01/94                     | 206.26                       |
|   |   |                                       |  |                                       |  |                                   |  |                              | (s:87-93)                    |                              |
| Ser. 51   | --  | 11.54                                 | --   |                                       | 175.00                                     |                                   |  | 175.00                       | 07/01/95                     | 175.00                       |
|   |   |                                       |  |                                       |  |                                   |  |                              | (s:88-94)                    |                              |
| Series 62                                       |   |                                       |  |                                       |  |                                   |  |                              |                              |                              |
| Ser. 50   | --  | 14.70                                 | --   | 44.80                                 | 84.15                                      | 2004                              | 11.30                                  | 684.24                       | 03/31/87                     | 226.88                       |
|   |   |                                       |  |                                       |  |                                   |  | 226.88                       | 07/01/94                     |                              |
|   |   |                                       |  |                                       |  |                                   |  |                              | (s:93)                       |                              |
| Ser. 53   | --  | 50.00                                 | --   |                                       |  |                                   |  | 160.54                       | 07/01/95                     | 160.54                       |
|   |   |                                       |  |                                       |  |                                   |  |                              | (s:93-94)                    |                              |
| Ser. 54   | --  | 14.40                                 | --   |                                       | 201.77                                     |                                   |  | 201.77                       | 07/01/95                     | 201.77                       |
|   |   |                                       |  |                                       |  |                                   |  |                              | (s:94)                       |                              |
| Series 63                                       |   |                                       |  |                                       |  |                                   |  |                              |                              |                              |
| Ser. 24   | --  | 14.82                                 | --   | 5.86                                  | 10.70                                      | 2008                              | 8.70                                   | 79.50                        | 05/18/87                     | 60.00                        |
|   |   |                                       |  |                                       |  |                                   |  | 100.00                       | 07/01/90                     |                              |
|   |   |                                       |  |                                       |  |                                   |  |                              | (s:88-89)                    |                              |
| Ser. 42   | --  | --                                    | --   |                                       | 19.91                                      |                                   |  | 19.91                        | 07/01/93                     | 16.81                        |
|   |   |                                       |  |                                       |  |                                   |  |                              | (s:88-92)                    |                              |
| Series 64                                       |   |                                       |  |                                       |  |                                   |  |                              |                              |                              |
| Ser. 23   | --  | --                                    | --   | 9.95                                  | 19.10                                      | 2008                              | 1.00                                   | 134.49                       | 02/11/88                     | 125.00                       |
|   |   |                                       |  |                                       |  |                                   |  | 125.00                       | 07/01/90                     |                              |
| Series 65                                       |   |                                       |  |                                       |  |                                   |  |                              |                              |                              |
| Ser. 19(20)                                     | --  | 16.00                                 | --   | 7.05                                  | 13.50                                      | 2008                              | 1.00                                   | 96.90                        | 03/17/88                     | 90.00                        |
|   |   |                                       |  |                                       |  |                                   |  | 90.00                        | 07/01/89                     |                              |
| Series 66                                       |   |                                       |  |                                       |  |                                   |  |                              |                              |                              |
| Ser. 11,  |   |                                       | \$36.91  | 98.19                                 | 147.20                                     | 1995                              | 3.00                                   | 700.60                       | 07/07/88                     |                              |
| Ser. 12, 13                                     | \$47.00   | 13.15                                 |  |                                       |  |                                   |  | 401.00                       | 08/15/88                     | 314.96                       |
| Ser. 20(19)                                     | --  | --                                    |  |                                       |  |                                   |  | 64.27                        | 07/01/89                     | 64.27                        |
| Ser. 21, 22                                     | --  | 32.00                                 |  |                                       |  |                                   |  | 273.95                       | 07/01/89                     | 293.11                       |
| Series 67                                       |   |                                       |  |                                       |  |                                   |  |                              |                              |                              |
| Ser. 10   | --  | 16.85                                 |  | 36.98                                 | 66.60                                      | 1999                              | 0.00                                   | 396.45                       | 10/06/88                     | 250.00                       |
| Ser. 14   | --  | 16.50                                 |  |                                       |  |                                   |  | 250.00                       | 11/15/88                     | 125.00                       |
|   |   |                                       |  |                                       |  |                                   |  | 125.00                       | 07/01/89                     |                              |
| Series 68                                       |   |                                       |  |                                       |  |                                   |  |                              |                              |                              |
| Ser. 15   | 9.20  | 27.30                                 | 32.03  | 32.78                                 | 69.30                                      | 1993                              | 0.00                                   | 411.25                       | 11/21/88                     | 125.00                       |
| Ser. 16   | --  | --                                    |  |                                       |  |                                   |  | 125.00                       | 07/01/89                     | 132.24                       |
| Ser. 17, 18                                     | 26.90   | 4.00                                  |  |                                       |  |                                   |  | 132.24                       | 07/01/89                     | 128.05                       |
|   |   |                                       |  |                                       |  |                                   |  | 177.00                       | 07/01/89                     |                              |