

Announcement 92-111 (I.R.B. 1992-32)

PURPOSE

The Internal Revenue Service has been asked whether the interest on registered warrants issued by the State of California since July 1, 1992, is excludable from gross income under section 103 of the Internal Revenue Code. The Service has also been asked whether the information reporting requirements for brokers under section 6045 of the Code apply to transactions involving the warrants.

BACKGROUND

Because of its current fiscal crisis, California is issuing obligations called "registered warrants" under applicable state law to pay employee salaries, state income tax refunds, and other general disbursements. California is complying with those information reporting requirements that normally apply to these types of payments (e.g., Form 1099-MISC for nonemployee compensation, Form 1099-G for state income tax refunds, and Form W-2 for payroll). Financial institutions in California presently are purchasing the warrants at their face amount from original holders.

Each warrant has a stated face amount that is equal to the amount initially owed to the original holder. The interest rate on the warrants is set by California's Pooled Money Investment Board, subject to a statutory cap of 5%, after considering market conditions and affording affected parties, including potential financial institution purchasers, an opportunity to comment. The warrants have a priority legal claim against unapplied funds in California's general fund, subject only to specified higher priority claims. The warrants are payable upon presentation after due call for redemption, and California must call them for redemption from these unapplied funds upon availability, without significant discretion.

California will redeem all the warrants in substantially less than one year and in most cases within one to four months from their date of issuance. On July 22, 1992, California announced that substantially all of the then outstanding warrants will be redeemed by August 6, 1992. Warrants issued on or after July 27, 1992, will contain a legend to the effect that California will redeem those warrants within one year from the date of issuance.

TAX-EXEMPT STATUS OF INTEREST ON THE WARRANTS

Section 103 of the Code provides generally that gross income does not include interest on any eligible state or local bond or obligation.

Section 149(a) of the Code provides generally that interest on any registration-required bond or other obligation is not exempt from federal income tax unless the bond is in registered form. Bonds or other obligations that have a maturity of not more than one year, however, are exempted from this requirement.

Based on these unique circumstances, the Service has determined that the warrants are "obligations" of the State of California under section 103(c)(1) of the Code, and that they qualify for the section 149(a)(2)(B) exception to the definition of a registration-required bond because they are obligations that have a maturity of not more than one year.

Accordingly, so long as the warrants satisfy the other applicable requirements for tax-exempt obligations, the interest on the warrants will be excludable from gross income under section 103 of the Code. In this regard, California must comply with the section 149(e) information reporting requirements applicable to the warrants.

INFORMATION REPORTING UNDER SECTION 6045

Section 6045(a) of the Code provides that every person doing business as a broker shall, when required by regulation, file certain information returns. Under section 1.6045-1(a)(1) of the regulations, financial institutions are brokers when they effect sales of debt instruments for others in the ordinary course of their financial trade or business. Further, section 1.6045-1(b) (Ex. 1(ii)) of the regulations provides that obligors that regularly issue and retire their own debt are generally brokers. However, sections 5f.6045-1(c)(3)(i)(B)(1) and (11) of the temporary regulations exempt payments made to corporations and financial institutions from any section 6045 reporting.

The Service has determined that the following transactions involving the warrants issued by California

will not be subject to the information reporting requirements of section 6045 of the Code:

(1) The transfer of a warrant by an original holder to a financial institution; and

(2) The retirement by California of a warrant surrendered by an original holder.

The application of the section 6045 information reporting requirements to other transactions involving the warrants is not affected by this announcement.

Accordingly, if an employee receives a warrant in payment of wages and transfers the warrant to a bank for payment, and the bank thereafter surrenders the warrant

to the state for retirement, the two transactions will be exempt from any section 6045 reporting requirements.

FURTHER INFORMATION

The principal author of this announcement is John Moriarty of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding the information reporting requirements discussed in this announcement, please contact John Moriarty on (202) 622-4950 (not a toll-free call). For further information regarding the tax-exempt status of interest on the warrants, please contact John J. Cross III on (202) 622-3900. Neither of the listed telephone numbers is a toll-free call.