Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel
(Area 4, Chicago, Group 1)
Small Business/Self-Employed

from: Senior Technician Reviewer, Branch 3
(Procedure & Administration)

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subject: Deposit Loan Superpriority

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

Year 1 =
Year 2 =
Year 3 =

ISSUE

Does the superpriority provided by IRC § 6323(b)(10) apply to a loan that is secured by the taxpayer's business checking account?

CONCLUSION

The section 6323(b)(10) superpriority extends to a loan secured by "a savings account, share or other account." Accordingly, the superpriority could apply to a secured interest in a checking account, since a checking account constitutes an "other account." Accordingly, the taxpayer's business checking account in this case can secure the bank's interest for purposes of section 6323(b)(10).

BACKGROUND

Your case addresses a situation involving an Illinois bank and a business taxpayer presumably incorporated in Illinois.

In your case, the taxpayer incurred multiple periods of liability for employment taxes. The Internal Revenue Service (the Service) assessed taxes, totaling approximately $90,000, in Year 2. In Year 3, the Service filed notices of federal tax lien (NFTLs) based on the assessments.

The taxpayer maintained a business checking account with the bank. Before the federal taxes were assessed, the bank loaned $100,000 to the taxpayer and received a promissory note in exchange. The promissory note provides in part:

> RIGHT OF SETOFF. To the extent permitted by applicable law, Lender reserves a right of setoff in all Borrower's accounts with Lender (whether checking, savings, or some other account) …. Borrower authorizes Lender, to the extent permitted by applicable law, to charge or setoff all sums owing on the indebtedness against any and all such accounts, and, at the Lender's option, to administratively freeze all such accounts ….
>
> * * * * *
>
> SECURITY INTEREST IN DEPOSIT ACCOUNTS. The undersigned further grants Bank a security interest in all of the Undersigned's deposit accounts maintained by the Bank ….

The note matured in full in Year 1. As of July Year 3, the bank claimed that almost none of the loan's principal had been repaid.

In July of Year 3, the Service served a notice of levy on the bank, based on the Year 2 assessments. The bank declined to comply with the levy because it had perfected a security interest in the taxpayer's "deposit accounts" maintained with the bank, including the taxpayer's business checking account. Thus, the bank argued, it was entitled to set off the funds in the account against the taxpayer's debt, regardless of the fact that the NFTL was filed before the setoff occurred, pursuant to the "superpriority" afforded by IRC § 6323(b)(10).

You ask whether section 6323(b)(10) was intended to apply to loans secured by accounts other than passbook-type savings accounts, such as the type of account, a business checking account, held by the taxpayer in this case. In addition, you ask whether section 6323(b)(10), even if applicable to a business checking account, can apply to the account at issue in this case under Illinois law.

We have informally notified your office that the bank is entitled to the superpriority, and the levy was accordingly released. This memorandum formally conveys the analysis and conclusions we previously communicated informally

ANALYSIS

The bank in this case took the position that because its interest in the taxpayer's business checking account had priority over the federal tax lien, it was not required to comply with the Service's levy. Specifically, the bank argued that its right to set off the amount in the taxpayer's account against the taxpayer's liability under the promissory note justified the bank's noncompliance with the levy.

A bank's right of setoff does not, in itself, excuse the bank from honoring the Service's levy. Rather, the bank's remedy is to comply with the levy and then file a wrongful levy claim or suit under IRC § 7426(a)(1). However, when a bank contacts the Service in response to the levy and shows that it has met the criteria for establishing a superpriority under IRC § 6323(b)(10), the Service will release the levy. Rev. Rul. 2006-42, 2006-35 I.R.B. 337. In this case, the bank properly responded to the levy by demonstrating its entitlement to the section 6323(b)(10) superpriority.

Section 6323 of the Internal Revenue Code governs the relative priority of the federal tax lien and other liens against a taxpayer's property. Section 6323(a) provides that a federal tax lien shall not be valid as against certain specified interests until proper notice thereof has been filed. Section 6323(b) provides that, even after a notice of federal tax lien has been filed, the federal tax lien shall not be valid against certain interests; these interests are referred to as "superpriorities" because they take priority over the federal tax lien even though they arise after the federal tax lien is perfected by the filing of a NFTL. One such superpriority is afforded to:

> a savings deposit, share, or other account, with an institution described in section 581 or 591, to the extent of any loan made by such institution without actual notice or knowledge of the existence of such lien, as against such institution, if such loan is secured by such account.

IRC § 6323(b)(10).

The current version of section 6323(b)(10) was enacted as part of the IRS Restructuring and Reform Act of 1998 (RRA 1998). Prior to RRA 1998, section 6323(b)(10) applied to:

> a savings deposit, share, or other account, *evidenced by a passbook*, with an institution described in section 581 or 91, to the extent of any loan made by such institution without actual knowledge of the existence of such lien, as against such institution, if such loan is secured by such account *and if such institution has been continuously in possession of such passbook from the time the loan is made*.

IRC § 6323(b)(10)(1997)(italics added).[1]

In amending section 6323(b)(10) in 1998, Congress left the statute's language intact other than deleting the language in italics above. The legislative history indicates that the language pertaining to passbooks was removed to update the statute in accordance with modern-day banking practices. The Senate Report states that the amendment "clarifies section 6323(b)(10) to reflect present banking practices, where a passbook-type loan may be made even though an actual passbook is not used." S. Rep. 105-174, *as reprinted in* 1998 U.S.C.C.A.N. 288.

The references in the legislative history to modern banking practices pertain to two developments in the banking industry. One is that customers' savings accounts are no longer managed through the use of passbooks; instead, they are managed principally through electronic means. The other is that the Uniform Commercial Code (UCC) was, at around the time of the amendment of section 6323(b)(10), amended to allow a bank to possess a security interest in a customer's "deposit account" merely by being the banking institution with which the account is maintained, regardless of whether the depositor has the right to withdraw funds from the deposit account. *See, e.g.*, 810 Ill. Comp. Stat. 5/9-104(a)(2008).

You ask the question of whether the current version of section 6323(b)(10) should be interpreted as applying to accounts other than those for which a passbook traditionally would have been issued. The language of section 6323(b)(10) applies to any "savings deposit, share, or other account." Nothing in the current version of section 6323(b)(10) can be interpreted as limiting the scope of the provision to only accounts formerly evidenced by passbooks. Accordingly, section 6323(b)(10) should be interpreted as applying to other types of accounts, including business checking accounts.

The remaining question presented is whether the terms of the promissory note, granting a security interest in "deposit accounts," apply to the taxpayer's business checking account. The UCC, as adopted by Illinois, states:

> "Deposit account" means a demand, time, savings, passbook, or similar account maintained with a bank. The term does not include investment property or accounts evidenced by an instrument.

810 Ill. Comp. Stat. 5/9-102(a)(29)(2008). [2]

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[1] The regulations promulgated pursuant to section 6323(b)(10) mirror the language of the pre-RRA 1998 version of section 6323(b)(10). Treas. Reg. §301.6323(b)-1(j). The Service recently issued a notice of proposed rulemaking in which, *inter alia*, the language pertaining to passbooks is removed. *See* 73 FR 20877-01 (April 17, 2008).

[2] The language excluding accounts evidenced by an instrument refers to certain types of certificates of deposit. *See* 68 Am. Jur. 2d Secured Transactions § 40 (2008)

Moreover, a checking account is a "demand" account. *See* 11 Am. Jur. 2d Bills and Notes § 190 (2008). Demand accounts are encompassed in the definition of "deposit accounts" set forth above. Accordingly, the interest of the bank in this case in the taxpayer's business checking account, a demand account, constitutes an interest in a deposit account under Illinois law. Thus, the bank's interest is secured under Illinois law so as to entitle the bank to the section 6323(b)(10) superpriority.

In summary, section 6323(b)(10) as it currently exists is properly interpreted as applying to bank accounts other than those traditionally evidenced by a passbook. In this case, the bank's interest in the taxpayer's business checking account constitutes an interest in a deposit account under the UCC as adopted in Illinois. Accordingly, the bank established its entitlement to the superpriority afforded by section 6323(b)(10), and the Service appropriately decided not to pursue its levy.

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Please call if you have any further questions.

cc:

(referencing Comment 12 to the 2000 revision of UCC 9-102). Thus, the exclusion within the definition of deposit accounts does not apply to the type of account involved here, a checking account.