Office of Chief Counsel
Internal Revenue Service
memorandum
CC:PA:04:TWCurteman
POSTN-129251-10

UILC: 6331.00-00, 6323.00-00

date: October 4, 2010

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subject: Levy upon Credit Card Processor and Bank Reserve or Charge-Back Accounts

ISSUE

(1) Whether the Service may levy on "reserve accounts" or "charge-back accounts" controlled by an electronic transaction processor or bank and which are dictated by merchant agreements where the merchant/taxpayer has no control over the funds within these accounts.

(2) If the Service may levy on funds in these "reserve accounts" or "charge-back accounts," whether the electronic transaction processor or bank may have priority over the Service with respect to any portion of the funds in these accounts.

(3) If the Service may levy on funds in these "reserve accounts" or "charge-back accounts," whether the processor or bank must surrender the funds upon demand as set forth in I.R.C. § 6332, or may wait for the expiration of the time period dictated by the merchant agreements.

CONCLUSION

(1) The Service may levy on the contents of a "reserve account" or "charge-back account" because the funds within the account are the property or rights to property of the merchant taxpayer under I.R.C. § 6331.

(2) The processor or bank may have priority over the Service with respect to the funds in the reserve account if the processor has executed a setoff before receiving notice of an administrative levy, if the processor has a security interest earlier in time than the Service's notice of federal tax lien under I.R.C. § 6323(a), or if the processor has a super priority under I.R.C. § 6323(b)(10).

(3) The Service must wait for the time period dictated by the merchant agreement to obtain the funds.

BACKGROUND

In today's economy, an electronic transaction is often the preferred manner by which a customer purchases goods or services from a merchant. A majority of businesses nationwide accept electronic forms of payment (*e.g.*, credit or debit cards) in order to meet consumer expectations. Unlike the more traditional cash and check payments which a merchant can physically deposit in its bank of choice, the internal and legal complexity of electronic transactions typically requires a merchant to contract with a "processor" (also called an acquirer) and the processor's related or affiliated bank.

The contract between the merchant and the processor is called a "merchant agreement," and governs the rights and obligations of both parties. Although a merchant agreement does not preclude a merchant from maintaining a traditional account with its bank of choice, the legal and financial obligations set forth in a merchant agreement are often very different from and more comprehensive than a traditional banking relationship. A standard merchant agreement may set forth the expected transaction time period, the initial discount rate, fees, transaction clearance and settlement procedures, and the affiliated card associations (*e.g.*, Visa and MasterCard). More extensive merchant agreements may include electronic check services, ACH (Automated Clearing House) collection services, or gift card services. For the purposes of this memorandum, we will concentrate on one component of these merchant agreements: the requirement for the merchant to have a primary account[1] and a reserve account[2] with the processor or its affiliated banks.

The primary account is an account by which the merchant obtains payment for the electronic transaction. While most primary accounts are established at the bank affiliated with the processor, some merchant agreements authorize the merchant to establish a primary account at another bank, provided that this other bank is approved by the processor and its affiliated bank. The merchant generally promises to maintain sufficient funds in the primary account to satisfy all obligations contemplated by the merchant agreement, including any fees, chargebacks, or the discount rate if not

[1] Some merchant agreements alternatively identify a primary account as a "designated account" or a "collection account."

[2] Some merchant agreements alternatively identify a reserve account as a "chargeback account," a "secondary account," or a "security account."

automatically applied. Most merchant agreements also entitle the processor or its affiliated bank to a right of setoff on the primary account.

The reserve account, on the other hand, is a second account established pursuant to the merchant agreement for the benefit of the processor or its affiliated bank as a guaranty of payment. The merchant agreement typically authorizes the processor or bank to open the reserve account in the name of the merchant, or requires the merchant to open the reserve account and give the processor or the affiliated bank deposit and withdrawal rights to the account. In some cases, several merchants' funds may be deposited and comingled together by a processer in a single reserve account. Generally, the funds that the processor or bank deposit into the reserve account on behalf of the merchant are that merchant's funds, and consist of a sufficient sum to serve as a security against any costs, losses, or expenses incurred or anticipated.[3] Most merchant agreements explicitly provide that the merchant has no right to withdraw funds from the reserve account. Furthermore, most merchant agreements provide that the reserve account cannot be closed and the funds in the account cannot be returned to the merchant until a prescribed period of days has passed (*e.g.*, 270 days) after termination of the merchant agreement.[4] Depending on the merchant, the merchant agreement, and the nature of the merchant's business, the size of a particular merchant's reserve account may vary greatly from a couple hundred dollars to several thousand.

We must note that the internal organization of processors varies and may affect the applicability of this memorandum's contents. Some processors are separate companies that merely have a business agreement with a bank or set of banks, and some are agents of or otherwise controlled by a bank. The important distinction is whether the processor actually possesses or controls a merchant's funds by nature of its relationship with the bank, or whether the processor simply processes the transaction information and forwards that information to the affiliated bank. For the purposes of this memorandum, we will assume that the processor and the bank are the same entity and that it therefore possesses and controls the funds in the merchant accounts. To the extent that the processor does not possess or control the funds, the processor will likely inform the Service about which bank actually does possess or control those funds. In such a case, this memorandum would apply to the bank instead of the processor.

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[3] This is a result of the lengthy settlement process for electronic transactions. While a full description of this process is outside the scope of this memorandum, it is important to note that because of a credit cardholder's right to contest an electronic transaction, the period of time between the initial transaction date and the ultimate clearance date may take several weeks. During that time, the processor may have credited the merchant with funds that the merchant may later owe the processor due to a charge successfully contested by a consumer.

[4] In the case of a comingled reserve account consisting of funds from many merchants, the reserve account may not be closed but instead the particular merchant's contributions to the reserve account may be isolated and distributed to the merchant at the end of the prescribed time period.

LAW AND ANALYSIS

(1) The Service's levy attaches to the funds in a reserve account.

I.R.C. § 6321 provides that a tax lien attaches to "all property and rights to property, whether real or personal, belonging to [the person with a tax liability]." I.R.C. § 6331(a) provides that within 10 days after notice and demand for payment of a tax liability, the Service may "levy upon all property or rights to property (except for such property as is exempt under section 6334) belonging to such person or on which there is a lien provided in this chapter for the payment of a tax."

Federal tax liens may attach to – and the Service may levy upon unless excluded under I.R.C. § 6334 – a then-existing, fixed and determinable right to receive property in the future. When a levy is served, the Service acquires whatever rights the taxpayer possessed. United States v. National Bank of Commerce, 472 U.S. 713, 725 (1985). For example, a vested pension plan is generally subject to lien and levy, even if it may not be immediately available for withdrawal by the taxpayer or the Service. See In re Anderson, 250 B.R. 707 (Bankr. D. Mont. 2000); In re Dinatale, 235 B.R. 569 (Bankr. D. Md. 1999); In re Wesche, 193 B.R. 76 (Bankr. B.D. Fla. 1996); see also IRM 5.11.6.1 (Jan. 22, 2010).

The contents of the reserve account are similar to the vested pension example. Depending on the pension agreement, a taxpayer with a vested pension may be entitled to future payments, but unable to currently withdraw from that pension fund. Similarly, the funds in the reserve account are the merchant's, although the merchant may be contractually precluded from withdrawing any funds from the reserve account until the mandatory time period has expired. Although there may be a question regarding the priority of interest in some or all of the funds within the reserve account and the timing of turnover of the funds, this issue does not affect the gateway determination that the levy may attach to the reserve account funds directly.

(2) The processor may have priority over the Service with respect to the funds in the reserve account if the processor has executed a setoff before receiving notice of an administrative levy, if the processor has a security interest under I.R.C. § 6323(a) earlier in time than the Service's notice of federal tax lien, or if the processor has a super priority under I.R.C. § 6323(b)(10).

Lien priority is not a defense against administrative levy by the Service. National Bank of Commerce, 472 U.S. at 721-22. There are only two defenses to levy: (1) the levied-upon party is neither in possession of nor obligated with respect to the taxpayer's property or rights to property, and (2) the taxpayer's property is subject to a prior judicial attachment or execution. Id. However, if a levied-upon party can establish that it had a priority interest under I.R.C. § 6323, the Service may exercise its administrative discretion and release some or all of a levy. Rev. Rul. 2006-42.

If neither defense to levy exits, the key question becomes whether the processor has priority over the Service with respect to some or all of the funds held in the reserve account upon receiving the Notice of Levy. State law dictates the rights to property that a party may have, but the priority of a property interest in relation to a federal interest is a federal question. Drye v. United States, 528 U.S. 49, 58 (1999). As explained more below, under federal law the processor may have priority over the Service with respect to the funds in the reserve account (a) if the processor has executed a setoff before receiving notice of an administrative levy, (b) if the processor holds a security interest earlier in time than the Service's notice of federal tax lien, or (c) if the processor has a super priority under I.R.C. § 6323(b)(10).

(a) The processor may have executed a setoff.

The processor may have a priority interest in the contents of a reserve account to the extent that it has timely exercised a right of setoff. The right of setoff is a state right that most – if not all – merchant agreements afford the processor. Generally, a bank's right of setoff is not affected by another party's security interest. See U.C.C. § 9-340(b). Similar to the super priority under section 6323(b)(10) discussed below, the right of setoff may not apply to processors that are not also banks, so it is important to identify the processor in each case.

The processor's right of setoff is subject to the federal requirement that the claim be exercised and not "contingent upon taking subsequent steps for enforcing it." United States v. Security Trust & Savings Bank, 340 U.S. 47, 51 (1950); accord, United States v. Pioneer American Ins. Co., 374 U.S. 84, 90-91 (1961). In other words, the processor cannot use the mere right of setoff to claim priority in the reserve account; it must also have demonstrated "an obvious decision to exercise the setoff right." United States v. Central Bank of Denver, 843 F.2d 1300, 1310 (10th Cir. 1988). Generally, three steps are necessary to exercise the setoff right: "(1) the decision to exercise the right; (2) some action that accomplishes setoff; and (3) some record which evidences that the right of setoff has been exercised." Id. (citations omitted). Therefore, unless the processor has actually exercised the right of setoff by an affirmative act and has evidence that it was done before notice of the levy, funds in the reserve account still belong to the merchant and the Service's levy – and priority – will attach.

(b) The processor may have a security interest earlier in time than the notice of federal tax lien.

I.R.C. § 6322 provides that the federal tax lien described in section 6321 "shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed (or a judgment against the taxpayer arising out of such liability) is satisfied or becomes unenforceable by reason of lapse of time." For the purposes of section 6322, "arise" is synonymous with "attach." United States v. Taylor, 338 F.3d 947, 950 (8th Cir. 2003); Redondo Const. Corp v. United States, 157 F.3d 1060, 1062 (6th Cir. 1998); Central Bank of Denver, 843 F.2d at 1307 n. 6. In the absence of a statutory priority,

the priority of an interest with respect to a federal tax lien is generally established by the rule of "first in time is first in right." United States v. City of New Britain, Connecticut, 347 U.S. 81, 85-86 (1954). Congress, however, has provided the statutory priority of a federal tax lien against competing creditors' interests by enacting I.R.C. § 6323. Section 6323(a) provides that certain creditors will have priority over a federal tax lien unless the Service has filed a notice of federal tax lien before certain creditors' lien's arise. One such creditor that is afforded this extra protection by section 6323(a) is the holder of a security interest.

For the purposes of section 6323(a), a security interest is "any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability." I.R.C. § 6323(h)(1). A security interest is valid only "(A) if, at such time the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth."[5] Id.

In the context of the relative priority of an interest in reserve accounts, the merchant agreement serves as the contract and security agreement with respect to money owed to the processor. The Service should determine whether the interest has been adequately protected under local law by referring to the state's adoption of the applicable parts of the Uniform Commercial Code.[6] More importantly, however, the processor's priority interest in the contents of the reserve account is only valid to the extent that it has parted with "money or money's worth."[7] For example, a processor may not have priority over those funds in the reserve account that relate to transactions made after the Service files a notice of federal tax lien because the processor has not yet parted with money or money's worth by affording the merchant access to payment from the electronic transaction.

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[5] In effect, this is a restatement of the principle that the state-law security interest must be choate in order to have priority over a federal interest. See United States v. Pioneer American Ins. Co., 374 U.S. 84, 88 (1963) (holding only choate state-created liens take priority over later federal tax liens); Central Bank of Denver, 843 F.2d at 1307-09 (restating principles of choateness). The traditional requirements for a state-lien to be choate are the existence of: (1) the lienor's identity, (2) the property subject to the lien, and the (3) amount of the lien. Pioneer, 374 U.S. at 89. In other words, a state-lien is perfected when there is nothing more to be done to have a choate lien. Id.

[6] For example, under U.C.C. § 9-312(b)(1) a security interest in a deposit account is perfected by control of the account. See U.C.C. § 9-314; U.C.C. § 9-104(a)(1) ("A secured party has control of a deposit account if the secured party is the bank with which the deposit account is maintained[.]").

[7] This is analogous to the third prong of the choateness analysis, namely whether the amount of the lien is readily ascertainable. See, e.g., Central Bank of Denver, 843 F.2d at 1308-09 (bank did not have a priority interest in certain contents of an account because, *inter alia*, the amount of the liability was not identifiable at the time the IRS filed its notice of federal tax lien). This is also equivalent to the U.C.C. concept that a security interest will not have "attached" and is therefore unenforceable unless "value" has been given. See U.C.C. § 9-203(b)(1) (enforceability requires given value) and § 1-204 (defining value).

(c) The processor may hold a super priority under I.R.C. § 6323(b)(10).

The super priority afforded certain deposit accounts under section 6323(b)(10) provides yet another avenue by which a processor may claim priority over the government's interest in funds within a reserve account. Section 6323(b)(10) provides that regardless of whether the Service has filed a notice of federal tax lien, a bank may hold a priority interest in an account "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 actually secured by such account."[8]

The section 6323(b)(10) super priority only applies to a bank and similar institutions defined under I.R.C. §§ 581 or 591. Because not all processors are banks or agents of banks, it is important to identify the organization of the processor and determine whether the processor meets the definition under sections 581 or 591.

Likewise, the term "loan" as defined in the same subchapter is any debt as used in I.R.C. § 166. See I.R.C. § 593(d)(3). Per section 166, a "debt" is "a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money."[9] Treas. Reg. § 1.166-1(c). Under state law, the merchant agreement generally serves as a contract and an "enforceable obligation to pay," but the *obligation* is only fixed and determinable when the *amount* is fixed and determinable. The requirement that the debt be a "fixed and determinable sum" echoes the similar requirement under the security interest priority of section 6323(a) that a holder of a security interest has parted with "money or money's worth." See I.R.C. § 6323(h)(1).

Therefore, just as when determining the priority of a federal tax lien compared to a security interest under section 6323(a), it is important in the context of the section 6323(b)(10) super priority for the Service to determine whether the processor bank's claimed interest is fixed and determinable sum, i.e., it has parted with money or money's worth, as of the date that the processor bank is served with the levy and learns of the federal tax lien. For example, because typically all of a merchant's credit card transactions for a single day are batched and settled at a certain time at the end of the

[8] The section 6323(b)(10) super priority is currently more inclusive than it was before Congress amended it on July 22, 1998. Prior to that date, the super priority applied only to passbook accounts, *i.e.* accounts which are characterized by the bank's continuous and exclusive possession and which restricts withdrawal by the depositor. See Treas. Reg. § 301.6323(b)-1(j) (not yet amended since section 6323(b)(10) was amended). The current section 6323(b)(10) has deleted all references to exclusive control and continuous possession, bringing the protection in line with the modified U.C.C. § 9-104(a)(1) ("A secured party has control of a deposit account if the secured party is the bank with which the deposit account is maintained[.]").

[9] Similarly, the Service may only levy on property which is an obligation owed to a taxpayer if that obligation is fixed and determinable. See Treas. Reg. § 301.6331-1(a) ("Except as provided in § 301.6331-1(b)(1) with respect to a levy on salary or wages, a levy extends only to property possessed and obligations which exist at the time of levy. Obligations exist when the liability of the obligor are fixed and determinable although the right to receive payment thereof may be deferred until a later date.").

business day, the processor has a right to funds in the reserve account relating to those transactions at the end of that business day. To the extent that the processor has credited the merchant with the transaction proceeds before the transactions are ultimately reconciled through the transaction clearing process, the processor may have parted with a fixed and determinable sum and the merchant has acquired an enforceable obligation to pay the processor. However, as soon as the processor has actual knowledge of the federal tax lien by being served with the levy, that super priority under section 6323(b)(10) will no longer extend to future transactions if the Service levies again on that account.

(3) The Service must wait for the time period dictated by the merchant agreement to obtain the funds.

When the Service administratively levies, it only acquires whatever rights the taxpayer possesses to the levied property or rights to property. National Bank of Commerce, 472 U.S. at 725; United States v. Rodgers, 461 U.S. 677, 690 (1983). Conversely, if the taxpayer lacked a right with respect to the property levied upon, the Service cannot suddenly obtain that right merely by serving its levy. For example, "if the Commissioner levies on a taxpayer's pension, he will receive property from the levy only if the pension is already in payout status or the taxpayer has the right to demand a lump-sum distribution of his pension interest." Wadleigh v. Comm'r, 134 T.C. No. 14, 2010 WL 2465531, at *9 (June 15, 2010) (citing United States v. Novak, 476 F.3d 1041, 1062 (9th Cir. 2007) and IRS v. Snyder, 343 F.3d 1171, 1175 (9th Cir. 2003)).

In most merchant agreements, while the reserve account holds the merchant's funds, the merchant lacks the right to withdraw those funds until a certain number of days after the merchant agreement is terminated. Because the merchant has no right to force the processor to pay over those funds any earlier than the time period prescribed in the merchant agreement, the Service similarly lacks a right to force the funds to be paid over immediately even though the Service steps into the merchant's shoes in claiming an interest and right to those funds. This is because while the Service has a right to the funds as property of the taxpayer under section 6321, the federal tax lien does not afford the Service the right to unilaterally cancel the merchant agreement on behalf of the taxpayer.

FINAL CONSIDERATIONS FOR LEVYING ON A RESERVE ACCOUNT

Because the rights and obligations of the taxpayer with respect to the reserve account are addressed in the merchant agreement and may differ among several such agreements, it is important that the revenue officer obtain and review the applicable merchant agreement before serving a levy on a processor or its affiliated bank. Because processors may have additional rights to the extent that they are banks or agents of banks, it is important for a revenue officer to fully identify the nature of the processor and determine whether it is a bank or a separate entity. To the extent that the processor either does not control the funds or the processor is not a bank, the revenue officer may need to tailor the levy or serve an additional levy to the affiliated

bank. Finally, because the processor's potential security interest is a product of state law, it is important for the revenue officer to be familiar with the state law provisions governing the processor's property right and security interest in reserve account funds in order to determine the relative priority in these funds between the processor and the Service.

Please call (202) 622-3630 if you have any further questions.