

INTERNAL REVENUE SERVICE  
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MEMORANDUM FOR NORTHERN CALIFORNIA DISTRICT COUNSEL

FROM: Alan C. Levine  
Chief, Branch1 (General Litigation)

SUBJECT: Notice of Levy - Stock/Mutual Funds

We are responding to your September 25, 1998, inquiry. This document is not to be cited as precedent.

LEGEND

Taxpayer A  
Brokerage Firm A  
Amount A  
Court A  
Trust A

Date A  
Date B

ISSUE

Whether a levy on a brokerage firm reaches stock and mutual fund shares if the firm was not in possession of any certificates representing the shares of stock but was managing them electronically.

FACTS

The underlying liability in this case is an I.R.C. § 6700 penalty of amount A, which was assessed against Taxpayer A for selling and promoting abusive trusts. There is currently pending, in Court A, a suit brought by the United

States under § 7408 to enjoin Taxpayer A and others from engaging in § 6700 activities. The court granted preliminary injunctions. The suit also seeks to reduce the § 6700 penalty to judgment.

[REDACTED] Taxpayer A holds an account at Brokerage Firm A that consists of stocks in various corporations, shares in mutual funds and a market value cash account with check-writing privileges.<sup>1/</sup> The account is held in the name of Trust A. A notice of levy was served on Brokerage Firm A on Date A to collect the penalty owed by Taxpayer A. Final demand was made on Date B. To this date, Brokerage Firm A has not complied with the levy.

[REDACTED] You requested advice on whether the levy was sufficient to reach the stock and the mutual funds shares in the account because Brokerage Firm A was not in possession of the certificates representing the shares of stock and mutual funds.

LAW AND ANALYSIS

Section 6332 of the Internal Revenue Code provides that upon demand of the Service, a person in possession of property, upon which a levy is made, is required to surrender the property to the Service. There are two defenses for the failure to honor a levy: (1) the party did not possess any property or rights to property of the taxpayer, or (2) the property was subject to a prior attachment or execution. See § 6332 (a). [REDACTED] is considered not to be in possession of the taxpayer’s property or rights to property because it did not actually possess the stock certificates, Brokerage Firm A would have a proper defense for not honoring the levy.

Stock

A stock certificate, as a certified security, is a negotiable instrument that is freely transferable without notice to the issuing corporation. UCC § 8-102(1)(a); UCC § 8-105(1). Since a certified security is negotiable, it follows that the stock certificate that represents the certified security is crucial, and transfer of the security can only occur when the purchaser receives actual physical possession of the certificate. UCC § 8-313(1)(a), (c) and (d). Therefore, a seizure of the stock certificate itself is necessary for an effective levy. Under UCC § 8-317(1), a creditor may not attach or levy upon a certified security without actually seizing the

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1/ [REDACTED]

certificate.<sup>2/</sup> However, where a creditor did not actually seize the stock certificate but garnished the debtor's account, the Eighth Circuit recognized this as a valid seizure because there were no physical stock certificates representing the stock owned by the debtor. Enterprise Bank v. Magna Bank of Missouri, 92 F.3d 743, 748 (8<sup>th</sup> Cir. 1996). There are no cases that distinguish or approvingly cite Enterprise for the proposition that a creditor can attach or levy a certified security without seizing the actual stock certificates where there are no actual stock certificates. Furthermore, the UCC does not expressly provide for the situation where there are no actual stock certificates.

The reason for this rule is that because a certified security is freely negotiable, a levy without possession may result in a corporation being subject to double liability to the creditor and to a bona fide purchaser who presents a properly endorsed certificate. UCC § 8-405(3).

Therefore, if the Government is desirous of selling stock certificates, there must be physical possession by the revenue officer of the stock certificates before a seizure is accomplished. Service of a notice of levy on a corporate transfer agent, the corporation, or a securities dealer is ineffective unless at the time of service, the party served has actual physical possession of the taxpayer's property interest. IRM 35(19).

This position is consistent with the principle that a Service levy can only reach property or an interest in property belonging to the taxpayer. See United States v. General Motors Corp., 929 F.2d 249 (6<sup>th</sup> Cir. 1991) (Service steps into the shoes of the taxpayer). As you informed us, the investor's stockholdings at Brokerage Firm A are electronic only. Therefore, when the levy was served on Brokerage Firm A, Brokerage Firm A did not have actual physical possession of the stock certificates representing the taxpayer's securities holdings. However, as you informed us, at the request of the account holder, Brokerage Firm A can obtain the actual certificates from the companies whose stock is held.<sup>3/</sup> Because actual certificates exist it is essential for the Service to obtain the certificate. UCC § 8-317(1). After the Service seizes the certificates, the Service

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<sup>2/</sup> The official comment to UCC § 8-317 states: "In dealing with certified securities the instrument is the vital thing, and, therefore, a valid levy cannot be made unless all possibility of the security wrongfully finding its way into a transferee's hands has been removed."

<sup>3/</sup> While it is Brokerage Firm A's policy that there is a monetary cost for the account holder to obtain actual stock certificates from the issuing corporation, this monetary cost is not a defense for Brokerage Firm A to not honor the levy. See § 6332(a).

would be required to sell them and then apply the proceeds to the taxpayer's account.

I.R.C. § 6335 describes the procedures governing the sale of seized property. The sale must be conducted by public auction or by public sale under sealed bids. § 6335(e)(2)(A). There is no language in the statute indicating that the Service has the option of selling seized stock on a stock exchange. Consequently, since the Service is not permitted to sell seized stock on the stock exchange, it was our past position that it does not have the authority to direct a broker to sell such stock on the stock exchange. See Memorandum to Director, Collection Division, GL-5561, dated September 22, 1972, Memorandum to Regional Counsel, Dallas, GL-4422, dated March 26, 1970, Memorandum to District Counsel, San Francisco, GL-546-81, dated April 22, 1982. In other words, the Service cannot do indirectly what it is forbidden to do directly. [REDACTED]

[REDACTED] Nevertheless, this issue is out of the scope of this memorandum which solely answers the question of whether a levy is sufficient to reach stock and mutual fund shares held in a brokerage account.

Once the levy was served on Brokerage Firm A [REDACTED], the Service effectively seized the taxpayer's property and rights to property held by the firm. Accordingly, after the levy is served, the Service steps into the shoes of the taxpayer and can request the broker to obtain physical stock certificates, representing the taxpayer's stock holdings held by the broker.

[REDACTED]

#### Mutual Funds

The investor who puts money into a mutual fund gets shares in return and in effect becomes a part owner of the fund. As is the reasoning in certified stocks, if the Service levies on a mutual fund the levy allows the Service to request the broker to obtain certificates representing the taxpayer's mutual fund shares.

Some managers of mutual fund accounts redeem the taxpayer's interest in the stock and give the Service cash upon levy. Some managers of these accounts decline to pay over the cash value of the levied-upon accounts to the Service. Instead, these agents issue certificates representing the total number of shares in

each of the accounts belonging to the taxpayer, claiming that since the Service does not have the right to redeem the taxpayer's interest in the account, the levy only requires that shares, representing the taxpayer's interest in the account, be given to the Service. In most cases, the Service is given cash. However, while the Service is considering to revise its position, Memorandum to District Counsel, Honolulu, GL-0298-93 dated June 9, 1993, we currently follow the policy not to demand cash. See, Memorandum to District Counsel, San Francisco, GL-762-84, dated January 10, 1985.

The Internal Revenue Service June 1998 Report on Notices of Federal Tax Lien and Notices of Levy, Review of Current Procedures, recognized that under the Service's current treatment of mutual funds the taxpayer may suffer in at least two ways. One, no one will buy the shares at the Service's sale for full market value, so the taxpayer gets less than if they are converted into cash. Two, the expenses of the sale reduce the amount that is credited toward the outstanding tax liability. Support for this Legislative Recommendation is found in a recent case where the Tenth Circuit held that a trust company was not liable to the holder of an individual retirement account where the company liquidated the mutual fund shares in the account and remitted the proceeds to the Service in response to a notice of levy served on the company. Kane v. Capital Guardian Trust Company, 145 F.3d 1218, 1222 (10<sup>th</sup> Cir. 1998). The Report makes the Legislative Recommendation to enact legislation which would permit the Service to levy mutual funds and get a check for the value of the shares in the fund.

#### CONCLUSION

Upon levy the Service secures the property rights of the taxpayer. Accordingly, the Service can direct a broker, who is managing stock in corporations and mutual funds electronically, to obtain the actual stock certificates and certificates representing the taxpayer's mutual fund shares. [REDACTED]

If you have any further questions please call (202)622-3610.

cc: Assistant Regional Counsel (GL), Western