Where Not to Look for Short-Term Cash Flow Needs

Dipping into employee taxes may lead to personal responsibility for directors, officers

by Kathryn M. Vanden Berk

There is an urban legend in the Illinois nonprofit world about a Chicago-based nonprofit organization that was notified by the state department of revenue of a withholding tax delinquency. The executive director and board chair drove to the capitol city of Springfield to look into the matter. However, the interview did not go as they had expected. As the story goes, the state impounded the car they came in and they were forced to return home by train.

This sounds humorous, but it isn't.

This is budget and cash flow crunch time in the human services field. Numerous providers that rely on state or federal payments for operating funds are wondering how they will make ends meet. Here in Illinois, it is widely reported that the state is six months in arrears.

When receivables swell and an organization taps out its available funds, where can it find quick cash when payroll comes due?

One place *not* to take money is from the account that holds employee withholding taxes.

Personal Responsibility for Employee Taxes

It may seem unlikely that any Alliance for Children and Families members would think of not paying these taxes as a way to meet short-term cash needs; however, I've recently heard several mentions of other organizations doing this as a method of survival when funds are tight. I've also had some client experiences with this issue (see the sidebar on the following page).

I cannot emphasize this too well: Employee withholding taxes are funds the organization holds in trust for employees; these funds are not the organization's money![1]

In fact, corporate officers, executive leaders, and board directors are *personally* responsible for the payment of those taxes. Let me repeat that: Corporate officers, executive leaders, and board directors are personally responsible to the government for paying employee taxes.

The two-part test for determining responsibility is straight forward and provides a relatively low threshold. An individual merely needs to be:

1. an officer who has the duty and power to collect, account, and pay these taxes; and
2. aware, or should be aware, that employee withholding taxes are due.

As far as the federal or state governments are concerned, using these funds to pay other creditors is enough to prove the second part of the test.[2] Moreover, the government does not need to show there was intent to never pay, nor must it prove evil intent or malicious motives. (More information about the two-part test is available online at magazine.alliance1.org.)

Social Utility Helps—to a Point

To a certain degree, the fact that a nonprofit organization is engaged in socially useful activities will protect individuals to a certain degree.

For example, in a Pennsylvania case, the bankruptcy court relieved the board

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Six Factors in Deciding Personal Responsibility of a Director or Officer

In my own practice, I received a call last year from a woman in Minneapolis who asked me if I could help her with an Internal Revenue Service (IRS) problem. Several years before, she had served as executive director of an agency in the Chicago area that, when faced by tough financial constraints, coped by not paying its employee taxes.

When she left to take a new position, the board assured her that they would pay this money back. They didn't. Subsequently, the IRS had taken $65,000 from her personal bank account.

Responsibility is a matter of "status, duty, or authority, not knowledge."[1] The following factors are considered by courts when deciding whether to impose personal responsibility on a nonprofit's board directors or officers:

1. descriptions of authority in the bylaws;
2. ability to sign checks on the company's bank account;
3. signature on the employer's federal quarterly and other tax returns;
4. payment of other creditors in lieu of the United States government;
5. involvement in hiring and discharging employees; and
6. involvement in the organization's financial affairs.

ENDNOTES:

1. *See In re Treacy,* 255 BR 656 (ED PA 2000).

president of a nonprofit organization of responsibility for unpaid employee withholding taxes totaling $48,265. While the bylaws of the organization gave him financial authority, his position was an unpaid one, his control over the payment of bills was limited, and he had little involvement in the day-to-day operations.[3] (See the online version of this column at magazine.alliance1.org for a second example.)

In cases that have relieved a nonprofit's leaders of personal responsibility, the courts give heed to a 1983 case in which a judge berated the IRS for its insistence on imposing liability when the facts clearly showed that volunteers were doing their best under difficult circumstances.[4]

However, the nonprofit sector is not entirely exempt. Organizations must be aware of complications that can change the outlook from friendly to unfriendly.

When a Texas hospital filed for bankruptcy protection in 2003, the Internal Revenue Service assessed a tax and penalty liability of more than $400,000 against Board Chair Stephen K. Verret. Verret paid the assessment in full but later requested a refund. The IRS refused, and a federal court upheld the denial, finding it inconceivable that Verret was unaware of the fact that the hospital was using employee trust funds to pay its bills.

What complicated this case was the fact that Verret was not a volunteer, but received $26,000 for serving as a corporate officer. Also, his wife was employed as the hospital's COO.[5] (A second example can be found at magazine.alliance1.org.)

Immediate Benefits Don't Outweigh Risks

The simple rule is this: if your organization is so desperate for funds that dipping into employee taxes seems to be the only option, the board needs to seriously consider closing down operations. If the organization can't afford to send in the taxes this quarter, it most likely won't be able to send in a double payment next quarter.

Board directors shouldn't put themselves at risk.

ENDNOTES:

1. When net wages are paid to an employee, the taxes that were, or should have been, withheld are credited in full to the employee even if they are never remitted to the government. "Thus, unless the government can collect these taxes from the employer … the revenues are forever lost to the Government." *Verret v. United States*, 542 F. Supp. 2d 526, 533 (E.D. Tex. 2008).
2. See Section 6672 of the Internal Revenue Code, 26 U.S.C. 6672.
3. See *In re E. Harry Lartz, Debtor* (2003-1 USTC 50,339; U.S. Bankruptcy Court, Mid. Dist. Pa.).
4. See *Hildebrand v. United States*, 563 F. Supp. 1259, 1260 (U.S. Dist. Ct. N.Jer. 1983).
5. See *Verret v. U.S.* 542 F. Supp. 2d 526 (E.D. Tex. 2008).

Kathryn Vanden Berk practiced law for nine years before serving as the president of two residential treatment centers for children. Now practicing in Chicago, she focuses on nonprofit start-ups, corporate and tax law, and employment issues. She serves as adjunct faculty at several Chicago universities, and is a member of the Advisory Board of the Axelson Center for Nonprofit Management at North Park University. She authored a handbook on starting nonprofits that is available from the Nonprofit Financial Center, Chicago, and a chapter in the Illinois attorney's handbook Not-for-Profit Corporations, *2004 Ed., Illinois Institute of Continuing Legal Education. In 2004 she authored* Retooling Employment Standards for the Future, *a publication of the First Nonprofit Educational Foundation, Chicago. She can be reached at 312-442-9076 or at info@beavandenberk.com.*