

Not Paying Your Taxes? Your Board Could Be Personally Liable

By Francis J. Serbaroli

If a nonprofit fails to pay taxes, the IRS may go after individual board members and executives to repay the money. Don't fall prey to this fate.

IN THE FACE OF THE CURRENT ECONOMIC downturn, many nonprofits have found themselves in dire financial straits. Contributions have plummeted and endowments have dwindled, while the need for these charities' services has continued to grow. In the event of a cash shortage, even a charity with the best intentions may be tempted to delay tax payment or "borrow" its employees' federal withholding taxes and use that money to meet other needs.

But charitable organizations should avoid this temptation at all costs. In seeking payment of these taxes, the Internal Revenue Service (IRS) will pursue not only a charity's assets but also the personal assets of individuals who were directly or indirectly associated with a nonpayment of taxes.

Here we explore the critical lessons to be learned from cases in which nonprofit board members and executives have been held liable for a nonprofit's failure to remit taxes. If you're a board member or executive with ties to the purse strings, here's how to avoid getting into trouble.

The Law

The law concerning nonpayment of withholding taxes is clear and unambiguous. The Internal Revenue Code (or "the Code") requires employers to withhold

federal income and Social Security taxes as well as Medicare and Federal Insurance Contributions Act (FICA) taxes from employees' wages.¹ The Code classifies these funds as held by employers in trust for the United States² and specifically prohibits employers from using these funds for operational or business expenses.³

The Code provision that holds individuals personally responsible for nonpayment is broadly worded: "Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over."⁴

The Code's definition of a "person" includes any officer or employee of a corporation who has a duty to collect, account for, or pay withholding taxes.⁵

If an individual falls into one of the following categories, there is a fig leaf of protection for unpaid volunteer board members of tax-exempt organizations:

- the individual serves solely in an honorary capacity;
- the individual does not participate in day-to-day or financial operations of

an organization, and

- the individual had no knowledge of the failure on which a penalty has been imposed.⁶

Still, the provision goes on to state, "The preceding sentence shall not apply if it results in no person being liable for the penalty imposed by subsection (a)." Thus, if the IRS cannot assess against a liable party, even the fig leaf disappears.

An individual found personally liable for nonpayment of taxes must pay the IRS, but he can then take legal action to share the pain with others. "If more than 1 person is liable for the penalty," the provision states, "with respect to any tax, each person who paid such penalty shall be entitled to recover from other persons who are liable for such penalty an amount equal to the excess of the amount paid by such person over such person's proportionate share of the penalty."⁷

Real-World Cases

Last year two federal court decisions were the latest in a line of cases in which the IRS has successfully held board members and executives of charitable organizations liable for misuse of withholding taxes that should have been remitted to the government.

In *Doulgeris v. United States*, a federal district court held the president

of a charitable nonprofit hospital personally liable for the hospital's unpaid withholding taxes.⁸ James Doulgeris served as the interim president and CEO of Granada Hills Community Hospital (GHCH), a bankrupt facility in Florida. When Doulgeris arrived, GHCH was already delinquent in paying its withholding taxes, and Doulgeris was aware of the problem. The CEO had authority to write checks on the hospital's accounts, including those for "payroll" and "taxes." As interim president, he signed some 57 checks that totaled \$2.9 million and were payable to creditors, even though he knew that the hospital had been delinquent in paying withholding taxes.

When the IRS took action, Doulgeris claimed that he merely signed checks prepared by GHCH's chief financial officer and that he was not in control of whom the hospital paid. Nonetheless, the court held him personally liable for the full amount owed: more than \$1.93 million. Doulgeris then filed suit in federal court seeking relief.

The court held that Doulgeris was responsible for paying taxes owed to the government and could not shirk that responsibility by delegating it to others. The court noted that Doulgeris (1) knew that payroll taxes had not been paid to the government; (2) had the authority to make payments on behalf of the hospital; (3) signed checks to pay other creditors despite knowledge that the hospital was delinquent in tax payments; and (4) had the power to directly transfer hospital funds to the government and had previously done so. The court concluded that Doulgeris willfully failed to pay withholding taxes to the government, upheld the IRS's findings, and awarded the IRS the full amount of unpaid taxes.

In *Verret v. United States*, the IRS went beyond a charitable organization's management and reached directly into its boardroom.⁹ A federal district court

in Texas upheld the IRS's determination that the chairman of a nonprofit hospital's board of trustees was personally liable for the hospital's nonpayment of withholding taxes.

Stephen Verret had been the chairman of the board of Doctors Hospital in Groves, Texas. In 2001, as the hospital's financial condition deteriorated, Verret was informed by the hospital's executive director, David Cottey, that the hospital had failed to remit to the IRS some \$400,000 in withholding taxes. Verret immediately arranged for the hospital to satisfy this tax liability with borrowed funds. Verret and the board informed Cottey that under no circumstances should the executive director fail to pay these taxes again. Thereafter, when the board repeatedly inquired about the taxes, Cottey reassured board members that the hospital's remission of its withholding taxes was current. But Cottey ultimately informed Verret and the board that withheld income and FICA taxes for the third and fourth quarters of 2001 had not been paid to the government. In 2003 the hospital filed for bankruptcy.

The IRS commenced an action against Verret, Cottey, and the hospital's chief financial officer, Angela Massey, and held them as "responsible parties" for the hospital's failure to pay withholding taxes. The IRS settled with Cottey and claimed that Massey owed \$182,000. The IRS assessed a penalty of more than \$407,000 plus \$1,821 of interest against Verret, who paid the assessment and then filed suit in federal district court to obtain a refund.

The court noted that for personal liability purposes, the crucial inquiry in determining a responsible party is whether an individual has the power to pay the withholding taxes: that is, whether an individual "actually could have ensured the satisfaction of the tax obligations." According to the court, factors that determine whether an individual is a

responsible party include the following:

- Is the individual an officer or member of the board of directors?
- Does the individual own a substantial amount of stock in the company?
- Does the individual manage a business's day-to-day operations?
- Does the individual have authority to hire and fire employees?
- Does the individual make decisions on the disbursement of funds and payment of creditors?
- Does the individual have the authority to sign company checks?

Although Verret claimed that the board lacked the authority to dictate which bills should be paid, the court observed that the hospital's corporate bylaws gave the board final authority over numerous matters, including reviewing the performance of the executive director, who had misled the board about the payment of taxes. Another crucial consideration was Verret's intimate involvement with the hospital,¹⁰ which included the following activities:

- Verret's 26-year-tenure as a board member and his position as board chairman at the time the taxes were not paid;
- his involvement in the development of new cash-flow strategies for the hospital;
- his frequent presence at the hospital;
- his daily discussions with the executive director;
- his authority to sign checks on hospital accounts;
- his action to ensure payment of delinquent withholding taxes on a prior occasion;
- his signature on the hospital's IRS Form 990; and
- his authority, along with the board's, to hire and fire the executive director.

The court rejected Verret's arguments that he exercised no power, authority, or control over the actual payment of the

Nonprofit Case Study: From Financial Crisis to Resolution

by Shelly Chamberlain

The following story details how a small nonprofit arts organization survived a potentially deadly financial crisis and successfully negotiated a payment plan with the IRS concerning unpaid payroll taxes and filing penalties.

An eight-year-old arts organization had a budget of slightly less than \$200,000 annually, six volunteer board members, and five paid staff members, all of whom were artistic, with the exception of the organization's managing director.

The managing director intentionally misled the board about the organization's financial condition. When it came to managing the organization's finances, the managing director was well meaning but out of her depth.

With the organization already facing a cash-flow challenge, a project that involved a national touring artist went well over budget. To resolve the situation, the artistic director gave the organization a personal loan of approximately \$25,000. The organization continued to thrive artistically but struggled to rise above what was perceived as moderately challenging financial circumstances.

At each board meeting, the board received Excel spreadsheets containing financial reports, which the managing director had created. The board treasurer position was vacant, and no additional financial oversight had been put into place.

Then the financial crisis hit.

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The Time Line of a Crisis

JULY 2000: The organization's managing director announces her resignation, citing that she has "outgrown" the organization.

1

FALL 2000: All artistic members are assigned administrative duties, in addition to their artistic duties. These combined roles continue to this day.

3

OCTOBER 2000: The organization receives \$20,000 from its largest grant funder to fund a part-time financial consultant for one year. The consultant presents a plan to untangle the financial mess, manage the organization's finances, and develop best practices. The plan includes developing financial procedures, securing a line of credit, improving quality and frequency of financial reporting, and training administrative staff on financial management.

5

The board and staff also develop a fundraising plan, including a strategy to approach the organization's major grant supporters to candidly explain the situation and outline the steps for resolution and prevention. Board members are charged with securing emergency funds from potential major donors.

DECEMBER 2000: Filings to the state attorney general's office are now up to date.

7

JUNE 2001: The organization sends a letter to the IRS documenting the events that led to the crisis. The organization also provides minutes that document the board's lack of knowledge about the organization's financial crisis.

9

AUGUST 2001: The IRS demands a second meeting. Despite making payments, the organization is informed that the IRS will begin a "trust-fund penalty case" of approximately \$30,000 against parties that it deems responsible for unpaid payroll taxes. The board chair contacts a consultant to act as the intermediary in negotiations with the IRS. The intermediary forestalls trust-fund penalty action and helps the IRS to understand that the organization is taking action to repay the outstanding principal in full.

11

APRIL 2002: The lender accepts the loan, and the organization makes an offer to the IRS via the consultant for repayment in full of back taxes, penalties, and interest owed.

13

2

AUGUST 2000: The organization hires a contract financial consultant to handle the organization's financial management. Three days after the consultant begins work, the crisis emerges. The consultant discovers unfiled tax returns and unpaid payroll taxes, unopened notices from the IRS, unopened bills, and accumulated credit card debt.

4

SEPTEMBER 2000: A full financial picture emerges. It is determined that the organization owes approximately \$72,000 to its creditors, including \$35,000 in unpaid payroll taxes to the state and federal governments; \$17,000 in accumulated credit card debt; and \$20,000 in preexisting long-term debt. The two previous Internal Revenue Service Form 990s had been filed six and nine months late, respectively, and the required filings with the attorney general's office had not been filed. The board agrees to meet monthly until further notice.

6

NOVEMBER 2000: Quarterly payroll tax filings that had not been filed previously are filed, and the IRS promises to contact the organization about repayment. A payment plan is arranged with the state Department of Revenue.

8

MAY 2001: The IRS demands a meeting with staff. The organization is encouraged to begin to make payments, regardless of the status of the IRS's action. It is later determined that these payments have been applied only to interest and penalties owed, not to the principal.

10

JULY 2001: The organization makes a formal request to the IRS for abatement of penalties for late filings of both Form 990 for the prior two fiscal years and unfiled Form 941s.

12

SEPTEMBER 2001: The organization applies for a loan to cover repayment of all outstanding payroll taxes owed to the IRS.

14

MAY 2002: The IRS accepts the organization's offer for repayment of payroll taxes in full, and the trust fund penalty case is dropped.

15

2010: Today the organization is thriving artistically and structurally. The organization is well respected locally and nationally and has seven paid staff (including a new managing director), has instituted financial accountability procedures, and has grown its budget to \$450,000 annually. All the original debt has been paid off.

hospital's accounts and held that he had personal liability if he merely possessed the effective power to pay the taxes. The court found that when a responsible person clearly should have known and was in a position to find out easily that there was a grave risk that withholding taxes were not being paid, that person acts with reckless disregard and, thus, *willfully* for purposes of liability. It also explained that the Code's imposition of personal responsibility is intended to have a prophylactic effect and to encourage multiple responsible persons, including officers, directors, and high-level employees, to stay informed of the timely payment of all withholding taxes to the government.

Lessons to Be Learned

There are several lessons to be learned from cases where individuals have been held personally liable for a charity's unpaid withholding taxes.

Lesson one. The IRS has repeatedly demonstrated that it will aggressively seek to tag board members, executives, and employees as "responsible persons" and hold them personally liable for unpaid withholding taxes. Absent strong evidence to the contrary, federal courts usually agree. The IRS has also repeatedly demonstrated that it will treat charitable organizations and nonprofits no differently than their for-profit counterparts. Nonprofit executives should heed this warning: courts are prepared to mete out harsh punishment to individuals regardless of the 501(c)(3) status of the organizations they oversee.

Lesson two. Virtually any alternative—including taking on additional debt, restructuring, downsizing, and filing for bankruptcy—is better than failing to remit withholding taxes to the government.

Lesson three. Board members, executives, and employees who fall within the Code's definition of a responsible person

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should actively ensure that their nonprofit has remitted all withholding taxes to the government on time.

Lesson four. If you are in a position to do something about unpaid withholding taxes, the fact that you are a voluntary, uncompensated board member of a charitable organization affords you little protection. Because the definition of a responsible person is so broadly worded, the IRS can hold any of the following personally responsible:

- a chairman of the board;
- board officers and board committee chairs (e.g., the finance committee);
- a president or CEO;
- a CFO;
- a controller; and
- other officers or employees responsible for payment of withholding taxes.

In determining a responsible person, job titles matter less to the IRS than do the duties and authority of a given position.

Lesson five. Pointing the finger at other board members, executives, and employees doesn't shift responsibility. The IRS wants its money and will attempt to recover it from those it identifies as responsible persons. As noted previously, once the IRS has been paid in full by one or more responsible persons, the law leaves it to these individuals to fight it out among themselves.

Lesson six. Corporate bylaws should carefully delineate the responsibilities of a governing body versus those of management. These cases underscore the importance for nonprofit board members and executives to know their proper roles and responsibilities. In the Verret case, for example, had the board chairman not been so intimately involved in day-to-day operations—even to the point of signing hospital checks—the outcome might have been different.

Lesson seven. Directors' and officers' liability insurance coverage should include indemnification of individual

board members and senior executives for liabilities incurred by a charitable corporation.

The bottom line is this: The IRS doesn't want to discourage service on the boards of charitable organizations. But the IRS wants its money and will get it any way it can and from whomever it can prove was a responsible person. Board members and senior executives of any charitable organization should be vigilant in ensuring that an organization is current in all its payment obligations to taxing authorities.

ENDNOTES

1. 26 U.S. Code Sections 3102(a); 3402(a).
2. 26 U.S.C. Sections 7501(a).
3. 26 U.S.C. Sections 3102(b), 3403, 7501(a).
4. IRC Sec. 6672(a).
5. IRC Sec. 6671(b).
6. IRC Sec. 6672(e).
7. IRC Sec. 6672(d).
8. *Doulgeris v. United States*, Case No. 8:08-cr-282-T-24-MAP (M.D. Fla. August 3, 2009).
9. 542 F. Supp. 2d 526 (E.D. Texas February 14, 2008); affirmed, 312 Fed. Appx. 615, 2009 WL 483962 (5th Cir., February 26, 2009).
10. Verret's relationship with the hospital was not entirely voluntary. He was also paid by the hospital for consulting services; his company was a providing vendor to the hospital, and his wife was employed for several months as the chief operating officer of the hospital.

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