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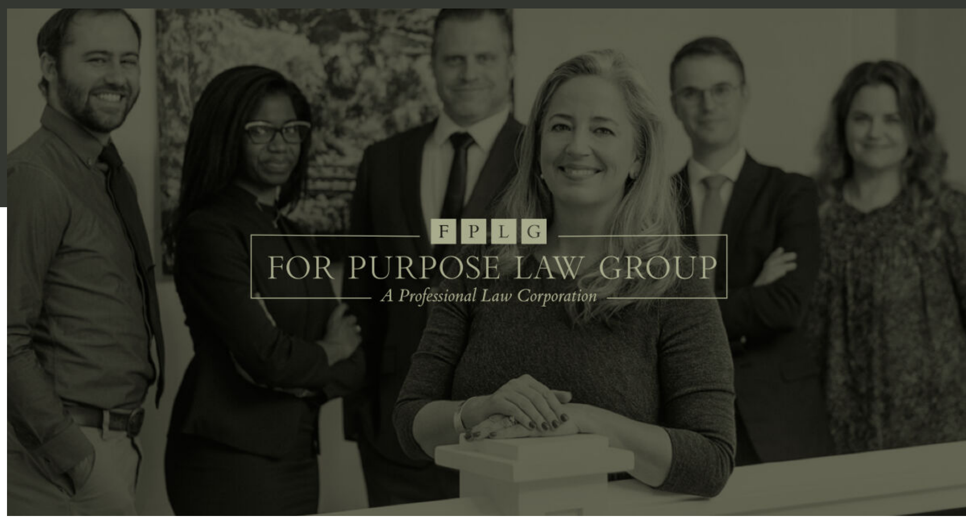
Payroll Taxes: The One Payment a Nonprofit Should NEVER Skip

05.29.15 | Linda J. Rosenthal, JD



It happened to the Alliance of AIDS Services-Carolina. The 25-year-old organization had a long-standing contract with Wade County, North Carolina. But in 2012 and 2013, the nonprofit began to have some financial difficulties.

In order to "manage" these problems, the organization did something "excruciatingly common." It missed payment on payroll taxes to juggle and pay other outstanding bills. But the Internal Revenue Service quickly acted, imposing a tax lien in April and then in July 2014. By September, the County cut off the federal Ryan White funding so crucial to the viability of the Alliance.

The organization managed to clear up its IRS problems, but by then, the County ended its contract with the Alliance, and took the program services back under government control and operation.

"Cascading Problems"

Especially during periods of economic slowdowns, contributions to nonprofits may decrease and endowments may lose value. There may be funding cutbacks as well by government sources and others. But the need for services from the nonprofit often increases at the same time. So a charity may "delay" tax payments, intending to make it up as soon as possible. But a "cascade" of irreversible consequences gets rolling fairly quickly after making this financial mistake. It "create[s] distrust among multiple groups of stakeholders in one fell swoop." Even if the organization can repay the back taxes and penalties, often the additional problems created by the payroll tax delinquency are irreversible, and can cause the organization to fail so completely it must close its doors.

Personal Liability

As we pointed out in "A Reminder to California Employers," nonprofits, though exempt from payment of federal and state income taxes, are still liable for the same duties and obligations that all employers face, including payment of payroll withholding taxes for employees.

And failure to make these withholding tax payments can have devastating results, because individual board members and executives may become personally liable for repayment of these deficiencies. The Internal Revenue Service will often go after not just the charity's revenue and assets, but also the personal assets of people who were directly or indirectly connected with the nonpayment of the taxes.

There's no ambiguity or uncertainty about the duty to withhold and pay over payroll taxes. The law concerning nonpayment of withholding taxes is clear and unambiguous. These funds are deemed to be held in trust for the United States; diversion of these funds for operational or business expenses is prohibited.

The Code provision that holds individuals personally responsible for nonpayment is broad and severe: "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."

A "person" includes any officer or employee of a corporation who has a duty to collect, account for, or pay withholding taxes.

There is a small window of protection for certain unpaid volunteer board members of exempt organizations. The exception can apply if the person:

- serves only in an honorary capacity;
- doesn't participate in day-to-day or financial operations; and
- had no knowledge of the failure to pay the taxes.

But there's a catch even to this limited protection. The exception doesn't apply "… if it results in no person being liable for the penalty imposed… "

A person who is liable must pay the amount to the IRS, but may be able to sue others who are liable for indemnity.