



Grant Thornton LLP  
The US Member Firm of  
Grant Thornton International

666 Third Avenue  
New York, NY 10017  
(212) 599-0100 Direct  
(212) 370-4520 Fax  
www.grantthornton.com

#### Memorandum

*To:* Rev. Paul S. Manning— The Roman Catholic Diocese of Paterson, Vicar for Education,  
777 Valley Road, Clifton, NJ 07013

*From:* Daniel Romano, *Partner-in-Charge, National NFP Tax Practice*

*Cc:* Frank Kurre, *National Managing Partner, Not-for-Profit and Higher Education Practice*  
Adam Lambert, *Executive Director*

*Date:* February 8, 2011

*Re:* Taxability of Host Family Payments

#### SCOPE

This memorandum addresses the taxability of stipends paid to volunteer host families in the Pope John XXIII High School exchange student program. It addresses the tax treatment of these monthly payments as well as the reporting of them.

#### FACTS

Pope John XXIII High School (the School), which is part of the Roman Catholic Diocese of Paterson (the Diocese), participates with an outside vendor in an international student program that enables students to come from China to the United States. As part of the program the School arranges with host families to house the students. The host families sign a Homestay Parent Agreement which sets forth the expectations of the family. This agreement also entitles the host to a monthly stipend of \$1,000 which is paid directly or applied to their personal tuition bills.

#### ISSUE

Are the stipend payments made to host families as part of the exchange student program taxable and/or reportable to them?

## CONCLUSION

The payment of a stipend to the host families is not excluded from taxable income under the Internal Revenue Code. Since no exclusion exists for this type of payment, in order for it to be nontaxable to the host family it would have to qualify as an expense reimbursement and receipts would need to be provided by the family to the School as support for the reimbursement. We caution, however, that reimbursing the expenses of the host family, even if partial, may prevent the family from taking a charitable deduction on their personal income tax returns for the remainder of their qualified expenses. Absent the reimbursement method, the payment is considered taxable and should be reported to the host family on Form 1099-MISC in Box 3 – Other Income.

Since it would be difficult to determine if the host families would benefit more from a reimbursement (and disallowance of a charitable deduction for expenses above the stipend amount) or from treating the stipends as taxable and deducting their expenses (as a charitable or potentially a business expense) we recommend the Diocese treat the payments as taxable and issue Form 1099. We also recommend that the Diocese provide the host families with a letter explaining that they could take a deduction for their expenses and should discuss with an advisor the most beneficial approach to doing so. Should the Diocese choose to treat the payments as nontaxable expense reimbursements you will need to create a policy and procedure to obtain original receipts for such expenses and a review of such to make sure that the stipend does not exceed the substantiated amounts (which would be taxable if they were).

## DISCUSSION

Internal Revenue Code Section 61 and the Regulations thereunder provide that “gross income” includes all income from whatever source derived, with certain exceptions. Code Sections 101 through 140 contain specific exclusions from “gross income”. Further, Code Sections 161-199 and 211-224 provide for additional specific deductions from income that an individual may take. There may be items which are included as income under Section 61 where a similar deduction would be available under one of the other above referenced Sections (potentially up to a specified limit).

In order for an item to be excluded from gross income, it must be specifically referenced in Code Sections 101 through 140. Payment to a host family involved in a student exchange program is not one of the exclusions. There is however, a specific charitable contribution allowed for expenses paid by a host family in relation to hosting such a student. Section 170 of the Code provides for charitable deductions for contributions made to qualified organizations. In addition, IRS Publication 526 highlights the rules for taking charitable deductions and has a section dealing specifically with these programs. {Since the qualifications of the students or the sponsor are not in question we will not discuss those in this memo.} One of the qualifications spelled out in this publication is that in order to obtain a charitable deduction for these expenses the host family can't be reimbursed for ANY of the expenses unless the reimbursement is for an extraordinary event. As such, even a partial reimbursement will disallow any charitable deduction on the host family's personal income tax return.

### Accountable Plan Rules for Expenses

The rules surrounding non-taxable business and travel expenses are mandated by Treasury Regulation (T.R.) §1.62-2, *Reimbursements And Other Expenses Allowance Arrangements*. Non-taxable expenses or reimbursements, must meet the requirements as specified under T. R. §1.62-2 (d) business connection, §1.62-2 (e) substantiation, and §1.62-2 (f) returning amounts in excess of expenses. Expenses and reimbursements that meet the requirements of these above mentioned paragraphs will be amounts considered paid under an “accountable plan.” §1.62-2 (c)(4) provides for the treatment of payments under

Accountable Plans: “Amounts treated as paid under an accountable plan are excluded from the employee’s gross income, are not reported as wages or other compensation on the employee’s Form W-2, and are exempt from the withholding and payment of employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), Railroad Retirement Tax Act (RRTA), Railroad Unemployment Repayment Tax (RURT), and income tax.)”

Under the business connection condition, the employer’s arrangement for the reimbursement or payment of expenses meets the requirements if it “provides advances, allowance (including per diem allowances, allowances only for meals and incidental expenses, and mileage allowances), or reimbursements only for business expenses that are allowed as deductions by Part VI (section 161 and the following), subchapter B, chapter 1 of the code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer

The substantiation criterion requires that each business expense be substantiated to the payor (employer, its agent, or third party) within a reasonable period of time.

The third qualification for an expense or reimbursement to be considered as paid under an accountable plan and therefore considered non-taxable to the employee is the return of amounts in excess of expenses. The employer’s arrangement must require the employee to return any amounts in excess of an expense to the payor within a reasonable period of time. “Money [...] advanced to an employee to defray expenses will be treated as satisfying the requirements of this paragraph (f) only if the amount of money advanced is reasonably calculated not to exceed the amount of anticipated expenditures, the advance is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, and any amounts in excess of the expenses substantiated in accordance with paragraph (e) of this section are required to be returned to the payor within a reasonable period of time after the advance is received.”

It should be noted that the above relates to expense reimbursements from an employee to the employer. With respect to nonemployees, The Form 1099-MISC instructions for Box 7 items indicate that “travel expenses for which the nonemployee did not account to the payer” are specifically included in the 1099 reporting requirements. Therefore, it appears that certain expenses reimbursed to nonemployees, if properly accounted for, would be excluded from 1099.

IRS Publication 15-B, *Employer’s Tax Guide for Fringe Benefits*, also discusses taxable fringe benefits for nonemployees being reported on a 1099-MISC. Therefore, it would also appear that a nontaxable fringe benefit to a nonemployee wouldn’t be included on Form 1099-MISC. While this is not exactly on point, this guidance allows certain items to be excluded from 1099 reporting and avoiding the nonemployee from having to report/deduct the items on their own income tax return.

*Richard Clarke Randall v. Commissioner.*, U.S. Tax Court, CCH Dec. 57,448(M), T.C. Memo. 2008-138, 95 T.C.M. 1546, (May 20, 2008) discusses the disallowance of certain business expenses incurred by a nonemployee, which were included on a Form 1099-MISC because they were not properly accounted for (emphasis added):

*Some portion of the monies received were reimbursements for expenses”, specifically \$11,033 of the \$38,358 he received from Lab Test Int’l, and \$10,800 of the \$12,231 he received from Network Courier Services, Inc. Petitioner also claimed that he incurred \$8,285 in “occupation-related expenses”. **Petitioner did not present any evidence to substantiate these expenses other than his vague testimony, and he admitted at trial that he had not provided any documentation to the Internal Revenue Service regarding his alleged expenses. Petitioner’s uncorroborated testimony cannot serve to establish that he incurred expenses.***

Accordingly, although there isn’t much specific guidance to excluding properly accounted for expense reimbursements to nonemployees (other than travel expenses) from Form 1099-MISC reporting, there appears to be guidance that alludes to the ability to do so as long as proper substantiation and accounting for such expenses is provided.

## Information Reporting Requirements

Internal Revenue Code Section 6041 provides guidance with respect to information reporting on items of income paid in the course of a trade or business. Specifically, Section 6041 indicates the following:

*“all persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income...of \$600 or more in any taxable year...shall render a true and accurate return to the Secretary, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.*

Additionally, the instructions for Form 1099-MISC, *Miscellaneous Income*, indicate that payments of “other income” which do not relate to nonemployee services are generally reported in Box 3 of Form 1099-MISC.

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The advice expressed in this memorandum is not an opinion as to the tax consequences of the transaction or set of facts. This memorandum is provided solely for the use as guidance with respect to previous research done on these specific issues, and all conclusions and authorities should be verified as they apply to each client’s specific set of facts. Questions regarding the facts and issues discussed in this memorandum should be directed to those listed as the contacts for this memorandum, a specific subject matter expert, and/or SALT-NTO.

The issues and conclusions expressed in this memorandum are based on facts, assumptions, documents and representations received from the client from whom Grant Thornton LLP has directly or indirectly received facts, assumptions, documents and representations, and on any assumptions stated within the memorandum. Grant Thornton LLP has neither independently investigated nor verified these facts, representations, and assumptions, although the reasonableness of such facts, representations and assumptions has been considered. The conclusions expressed in this memorandum may be adversely affected if any of the facts, representations or assumptions reflected in this memorandum is inaccurate. The discussion in the memorandum is based on the Internal Revenue Code, as amended, specific state tax codes, as amended, the regulations promulgated thereunder and other relevant authorities. These authorities are all subject to change, and such change could have retroactive effect. Any such changes could thus have an effect on the validity of the conclusions reached in the memorandum.