

2.008 Tax Treatment of Business Expenses (Service-Related)

This policy addresses the tax treatment of expense payments (reimbursements/allowances) made to individuals who are not employed by RCUH or UH, but who have incurred expenses with a service-related “business purpose” (i.e., business expenses).

RCUH and UH employee travel expenses and supply reimbursements are addressed in the policies under 2.600 Travel, and in [Policy 2.703 Employee Business Expense Reimbursements \(AFP Form\)](#).

I. Details of Policy

A. Overview

The Internal Revenue Code permits employers to exclude reimbursements/allowances paid to employees for business-related travel and other expenses of the employer, from an employee’s income using Internal Revenue Service (IRS) accountable plan rules. Accountable plan rules may also be used to exclude an expense (i.e., not subject to tax withholding or reporting) incurred by a service provider, such as an independent contractor, volunteer, or employed business visitor, if the expense is incurred in connection with services they have performed (i.e., a business expense). IRS accountable plan rules are only applicable to service-related relationships.

B. Accountable Plan Rules

1. Business expenses of service providers may be excluded from income (i.e., not subject to tax withholding or reporting) if all of the following IRS accountable plan rules are met:
 - a. *Business Connection/Purpose* – The expenses must be paid or incurred while the recipient is performing services for RCUH/UH (e.g., as an independent contractor, volunteer, etc.) or for his/her own employer, and the services must benefit RCUH/UH (i.e., the party that retained the individual) or his/her employer.
 - b. *Substantiation* – The expenses must be substantiated and adequately accounted for within 60 days after they are paid or incurred (e.g., the last day of travel). A meals and incidental expenses (M&IE) allowance that does not exceed the federal allowable rate by city, and a mileage rate that does not exceed the federal allowable rate, is considered substantiated.⁴ All other expenses require the submission of original receipts, invoices, or other proof of payment. See [Attachment 12 Current RCUH Travel Rates](#) for the current federal rates.

- c. *Return of Excess* – All excess advance payments or allowances must be returned within 120 days after the expense is paid or incurred.

¹Volunteers are not permitted to receive allowances, and are subject to a specific volunteer mileage rate (discussed below).

2. If any of the above rules are *not* met, the payment will be considered income to the recipient, and may need to be reported and/or withheld. Please contact RCUH Disbursing if the above rules are not met, to determine if the payment is subject to reporting and/or withholding.
3. Accountable plan rules normally only apply to payments to individuals (not entities), however, a recipient's employer may be paid directly if (a) the payment is for the recipient, (b) the recipient was specifically invited by RCUH/UH, **and** (c) the recipient requests that his/her employer be reimbursed because the employer paid the recipient's expenses. For example, a professor from the University of Stockholm is invited to present a seminar, but requests that his expenses be reimbursed to the University of Stockholm, and not to himself, because the University of Stockholm paid for his expenses. If accountable plan rules are met, the payment is excluded from income, and can be made without tax withholding or reporting.

C. Establishing a Business Purpose/Initiating the Transaction

1. Prior to making any commitments to individuals, the reason the RCUH/UH financial support is being provided should be analyzed to classify the planned expenses. The program must provide a description of tasks and expectations required of the service provider (including why the recipient's expenses are necessary for the program or for the recipient's employer) to the Fiscal Administrator. The purpose should be clear enough such that anyone unfamiliar with the program can understand the purpose and eligibility of the expense.

Note to Principal Investigators – When preparing grant proposals that include activities where services are expected from individuals, it is important to include a detailed description of those services. For example, if services are expected from conference participants, a detailed description of their proposed services should be included in the grant proposal and related promotional and registration documents. Properly documenting the service requirement is necessary to support the application of the accountable plan rules.

2. The following types of individuals are generally presumed to be serving a business purpose, and although further justification of a business purpose is not required, the PO or [Non-Employee Expense Payment Form](#) must still include a description of the activity's name, location, and date(s):
 - a. Guest speakers providing services to RCUH/UH;
 - b. Independent Contractors performing services for RCUH/UH;
 - c. Individuals invited for a RCUH/UH job interview;

- d. Employed business visitors (a visitor **must** establish that he/she is performing services for his/her employer, i.e., that the services are related to the visitor's employment); and
 - e. UH and RCUH volunteers (a justification of a business purpose is required for volunteers who are also students).
3. Purchase Order (PO) or Non-Employee Expense Payment Form – The program can choose to issue a purchase order (PO) or file a [Non-Employee Expense Payment Form](#) in the name of the recipient. The business purpose must be provided on whichever form is used, and it should include the following: (1) the recipient's name, (2) the recipient's position/title, (3) the recipient's employer's name, if any, and (4) a description of the activity (name, location, date(s)).
 4. Reimbursements/Direct Payments are Encouraged – It is recommended that expense payments be made as reimbursements to recipients after the activity has taken place, when all facts surrounding the payment are known, particularly when nonresident aliens may be involved. Without full knowledge of a recipient, there will be incomplete information to determine the proper tax treatment of the financial support. For this reason, third-party payments are discouraged.
 5. Budget Category/Object Code – In order to properly code a payment as a business expense, all facts and circumstances should be known. If a payment is erroneously made as a business expense prior to confirmation of the classification of the expense, the end result may be a failure to withhold and/or report the expense payment as income to the recipient.
 6. Documentation of Tax Residency – A UH Form WH-1 is required for direct payees when setting up a vendor record. Refer to [Policy 2.012 Requirements When Paying Foreign Persons](#) for additional information on the UH Form WH-1, and the eligibility of resident aliens and nonresident aliens to receive certain payments.
 7. Travel Advance – In general, a travel advance to a non-employee recipient should be avoided. It is recognized, however, that a travel advance may be necessary under certain circumstances. [A Request for Advance Payment and/or Deposit to a Vendor or Contractor](#) (Attachment 47) must be completed, approved, and attached to the PO to the recipient before the travel advance is approved by the Fiscal Administrator.

D. Processing Payments of Business Expenses Paid Directly to a Recipient

1. The Principal Investigator (PI) is responsible for adequately explaining the business purpose of the expense, and the Fiscal Administrator's approval of a PO payment or [Non-Employee Expense Payment Form](#) constitutes an acknowledgement that the cost qualifies as a business expense.
2. U.S. Citizens and Permanent Resident Aliens

- a. If the business purpose criteria *and* all accountable plan rules are met, the PO payment or [Non-Employee Expense Payment Form](#) may be approved online. The payment is not income to the recipient and no tax reporting is required.
- b. If the business purpose criteria *or* accountable plan rules are **not** met, the payment is income, and may need to be reported to the IRS. The expenditure code must be changed to reflect a change in the tax treatment before the payment is approved. Contact RCUH Disbursing if you have questions regarding the proper reclassification of the expense, or reporting of the expense.

3. Resident Aliens and Nonresident Aliens

- a. All payments to resident aliens and nonresident aliens must be submitted to RCUH Disbursing. Payments to resident aliens will be treated in the same manner (for tax purposes) as payments to U.S. citizens and permanent resident aliens, as described above, except that the payment will be processed by RCUH Disbursing.
 - i. If the business purpose criteria *and* all accountable plan rules are met, the payment is not income to the recipient, and no tax reporting or withholding is required.
 - ii. If the business purpose criteria *or* accountable plan rules are **not** met for nonresident aliens, the payment is income, and tax reporting and/or withholding may be required. The expenditure code must be changed to reflect a change in the tax treatment before the payment will be approved by RCUH Disbursing. Contact RCUH Disbursing if you have questions regarding the proper reclassification of the expense, or reporting of the expense.

4. Additional Requirements/Considerations for Expenses Paid to Volunteers

- a. Volunteers are not permitted to receive allowances for their expenses. Volunteers can only be reimbursed for their service-related expenses if accountable plan rules are met, *and* an original receipt, invoice, or other proof of payment is submitted for all incurred expenses.
- b. Mileage for volunteers is reimbursed at a specific rate. See [Attachment 12 Current RCUH Travel Rates](#).
- c. Nonresident alien volunteers must be work-eligible despite the fact that they are not paid wages. Refer to [Policy 2.012 Requirements When Paying Foreign Persons](#).
- d. It is the program's responsibility to determine (by consulting with UH or RCUH Human Resources) whether an individual who provides services to UH or RCUH is properly classified as a volunteer, is eligible to be a volunteer, or is required to be hired as an employee. It is recommended that UH programs process volunteers through UH if possible.

- i. A bona fide UH program volunteer must be registered in accordance with [UH AP 9.041 Utilization of Volunteer Services at the University of Hawai'i](#), and Chapter 90 of the Hawaii Revised Statutes. Any volunteer activity that requires an overnight absence “away from home” should also be reviewed by the UH Office of Risk Management, as UH volunteers are covered by workers’ compensation insurance.
- ii. Refer to [Policy 3.220 RCUH Volunteers](#) for all requirements regarding the registration of RCUH volunteers.

E. Utilizing Third-Party Vendors

1. Individuals may not claim reimbursements for other individuals – Employee cash advances for a third-party payment of a recipient’s business expenses are not permitted. Employees must also not use their personal funds and later request a reimbursement for another individual’s business expenses.
2. A third-party vendor payment is any payment that is *not paid directly* to the individual (i.e., the recipient) incurring the business expense. For example, when a program pays another vendor to provide services/goods (such as airline tickets, accommodations, food, etc.) to the recipient. In the event a third-party vendor payment is unavoidable, the procedure in this section should be followed.
3. On the third-party vendor PO, provide the recipient’s country of residency and visa status, along with an explanation of the business purpose as described in Section I.C, ESTABLISHING A BUSINESS PURPOSE/INITIATING THE TRANSACTION, above. It is important that the recipient’s name (or if there are multiple recipients, a list of names and the amount attributed to each recipient) be included, as the recipient’s name will not be linked to the PO in the RCUH financial system (due to the likelihood that there is no RCUH vendor record for the recipient).
4. Use the object code that describes what is being purchased, rather than who the item is being purchased for. Improper expenditure coding may result in a failure to report a payment (made to the third-party vendor) to the IRS.
5. The issuance of third-party vendor POs for recipients who are likely to be nonresident aliens requires careful consideration, because much of the required immigration documentation (such as the visa status of the nonresident alien when entering the U.S.) will likely be unknown prior to the visit. Refer to [Policy 2.012 Requirements When Paying Foreign Persons](#) for information regarding immigration requirements and payment eligibility for nonresident aliens based on their visa status.

F. Processing Payments of Business Expenses Made Through a Third-Party Vendor

1. The Principal Investigator (PI) is responsible for adequately explaining the business purpose of the expense, and the Fiscal Administrator’s approval of a third-party PO payment constitutes an acknowledgement that the cost qualifies as a business expense for the recipient(s).

2. Third-Party Payments for U.S. Citizens and Permanent Resident Aliens

- a. If the business purpose criteria *and* all accountable plan rules are met, the third-party PO payment may be approved online. The payment is not income to the recipient and no tax reporting is required.
- b. If the business purpose criteria *or* accountable plan rules are **not** met, the payment may need to be reported to the IRS. Contact RCUH Disbursing if you have questions regarding the proper reclassification of the expense. When the expense is reclassified, provide the recipient's UH Form WH-1, and the amount he/she received to RCUH Accounting at the time the recipient receives his/her payment via the third-party vendor.

3. Third-Party Payments for Resident Aliens and Nonresident Aliens (When Their Tax Residency Status is Known)

- a. All payments for resident aliens and nonresident alien recipients must be submitted to RCUH Disbursing, regardless if the third-party vendor is a U.S. entity.
 - i. If the business purpose criteria *and* all accountable plan rules are met, expenses paid through a third-party vendor are not income to the recipient. No tax withholding or reporting is required.
 - ii. If the business purpose criteria *or* accountable plan rules are **not** met, the expenses paid through the third-party vendor is income to the recipient, and the expense will need to be reclassified. Tax reporting and/or grossing-up of the vendor payment may be required.
 - (1) Gross-Up Example: If a PO was issued to Hawaiian Airlines to pay for a \$1,500 ticket for a recipient that is subject to 30% tax withholding, the \$1,500 payment amount must be grossed up to \$2,142.86 for Hawaiian Airlines to be paid the \$1,500 due. The program account will be charged \$2,142.86 for the ticket.
$$\$1,500 / 70\% (.70) = \$2,142.86 \text{ [\$1,500 grossed up]}$$

\$1,500 is paid to Hawaiian Airlines

\$642.86 is paid to the IRS
 - (2) The program must initiate an Authorization for Payment (AFP) to pay the IRS for the \$642.86 tax due. In the AFP description, reference the date, payment request number, and check number of the initial vendor payment, and provide the recipient's name and the formula used to determine the amount of the tax. A copy of the vendor payment document should also be attached and sent to RCUH Disbursing for processing. Contact RCUH Disbursing if assistance is required.
- b. If the PO was used for both U.S. individuals (U.S. citizens or permanent resident aliens) AND foreign nationals (nonresident aliens and resident aliens) only the

portion of the payment for foreign nationals is required to be submitted to RCUH Disbursing.

- c. If the vendor payment is required prior to confirmation of the recipients' tax residency or establishment of a business purpose, follow the procedures described in Section I.F.4, below.

4. Third-Party Payments When Facts Are Unknown

- a. If at the time of payment, the business purpose criteria or tax residency status of the recipients (i.e., U.S. or foreign) is unknown, process the payment online as if it were an advance. This allows RCUH Disbursing to track the payment, and permits the program to provide the information at a later date.
- b. If the payment is being made after goods or services are received, or qualifies as a pre-approved advance payment exception, an Attachment 47 is not required.
- c. When all required information to substantiate the payment as having a business purpose is complete and the advance can be cleared, provide (1) the recipient's name, (2) the recipient's position/title, (3) the recipient's employer's name, if any, (4) a description of the activity (name, location, date(s), and (5) the recipient's country of residency and visa status, to RCUH Disbursing.
- d. If, when all facts are known, the business purpose criteria *or* accountable plan rules are **not** met, tax reporting and/or withholding or grossing-up may be required. See the gross-up example in the Section I.F.3.a.ii.(1), above.

II. Relevant Documents

[Tax Treatment of Business Expenses \(Service-Related\) Decision Tree](#)

[Attachment 12 Current RCUH Travel Rates](#)

[Attachment 47 Request for Advance Payment and/or Deposit to a Vendor or Contractor](#)

[Non-Employee Expense Payment Form](#)

[Policy 2.012 Requirements When Paying Foreign Persons](#)

[Policy 2.601 RCUH Employee Travel](#)

[Policy 2.703 Employee Business Expense Reimbursements \(AFP Form\)](#)

[Policy 3.220 RCUH Volunteers](#)

[UH AP 9.041 Utilization of Volunteer Services at the University of Hawai'i](#)

[UH Form WH-1](#)

Date Revised: 2/02/2017