More on the AICPA Whitepaper on Fair Value Measures

To assist organizations in measuring items unique to the nonprofit sector, in October 2011, the AICPA issued a whitepaper, *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities* (the Whitepaper). The Whitepaper provides the nonauthoritative views of the AICPA Financial Reporting Executive Committee (FinREC) for applying the provisions of FASB ASC 820, *Fair Value Measurements*, to unconditional promises to give, beneficial interests in trusts, and split-interest agreements. Our March 2012 issue discussed measurement of unconditional promises to give and present value techniques. This article discusses measurement of beneficial interests in trusts and split-interest gifts.

**Beneficial Interests in Trusts Held by Third Parties**

If a donor transfers cash or other assets to an independent trustee (such as a bank, trust company, foundation, or private individual) and the donor specifies that the nonprofit organization will receive distributions from the trust assets, the organization has a beneficial interest in the trust. If that beneficial interest is an *irrevocable* right to the distributions, the organization recognizes this right as its asset, even if the trustee controls the investment decisions and timing of distributions and the organization cannot transfer its beneficial interest. (However, if the trustee has variance power to redirect the benefits to another entity, or if the organization’s right is otherwise conditional, recognition of the contribution is delayed until the distribution is received or the organization receives an unconditional right to distributions under the trust agreement.)

**Unit of Account.** The Whitepaper explains that because the organization’s asset (the beneficial interest) is the right to receive cash flows from the trust, *and not the assets of the trust itself*, the fair value of a beneficial interest in a trust must be determined by assuming a hypothetical transaction at the measurement date. Currently there is no market in which beneficial interests in charitable trusts trade and, therefore, there are no observable exit prices for those beneficial interests.
interests. Although the trust assets themselves may be investments for which quoted prices in an active market are available, those individual investments are not the organization’s assets and are not the unit of account for the measurement. Since quoted market prices are not available, the Whitepaper discusses other methods for estimating the fair value of beneficial interests.

Types of Beneficial Interests. The Whitepaper discusses measurement of two types of beneficial interests in charitable trusts held by third parties: nonperpetual and perpetual. In a nonperpetual trust, the organization receives one or more distributions, and at some point (e.g., after a specified number of years or upon the death of the donor), the distributions cease. Interests in charitable lead trusts or charitable remainder trusts that are held by third parties are examples of nonperpetual beneficial interests in trusts. In contrast, the distributions from a perpetual trust never end. The organization has the irrevocable right to receive the income earned by trust assets in perpetuity, but no one, including the organization, will ever receive the assets held in the trust.

Fair Value of an Interest in a Nonperpetual Trust. According to the Whitepaper, the income approach (i.e., a present value technique) is likely to be the most practical method for measuring the beneficial interest in a nonperpetual trust. The beneficial interest is measured as the present value of the future distributions projected to be received over the expected term of the agreement, discounted at an appropriate rate. When determining the appropriate discount rate, the Whitepaper states that it is important to remember that the expected cash flows from the trust to the organization are at least as risky as the cash flows within the trust itself. In other words, the discount rate should always be greater than or equal to the assumed rate of the return on the investments of the trust. Risks that change the pattern of the cash flows can cause the discount rate to be higher, but it should never be lower. Because of that relationship, an estimate of the fair value of the beneficial interest in a trust would never exceed the fair value of the trust assets. The Whitepaper provides an example of using one present value technique, the discount rate adjustment technique, to measure the interest in a nonperpetual trust.

Because a nonprofit organization is required to remeasure the fair value of a beneficial interest in a trust at each reporting date, it should apply the same technique that it used for the initial fair value measurement, updating all of the assumptions including the discount rate, to reflect current market conditions.

Fair Value of an Interest in a Perpetual Trust. The Whitepaper states that the fair value of the assets in a perpetual trust can be used when measuring a beneficial interest in a perpetual trust, generally without further adjustment. However, the Whitepaper discusses situations in which adjustments may be necessary and states that if facts and circumstances indicate that the fair value of the beneficial interest differs from the fair value of the assets contributed to the trust, the income approach (i.e., a present value technique) might be used for the fair value measurement.

Practical Consideration:
The Whitepaper states that, by analogy to FASB ASC 820-10-35-54B, the measurement for a beneficial interest in a perpetual trust should be a level 3 fair value measurement because the organization will never receive the trust’s assets.

Split-interest Gifts Held by Nonprofits
A split-interest agreement (sometimes referred to as deferred giving) is an agreement in which a donor makes an initial transfer of assets to a trust or directly to an organization and directs that the assets be shared between the organization and another beneficiary that is not a charity (usually the donor or a family member of the donor). One beneficiary receives distributions during the term of the agreement (the lead interest); the other beneficiary receives a distribution at the end of the agreement (the remainder interest). GAAP generally requires the asset, liability, and contribution associated with a split-interest gift to be initially measured at fair value. The Whitepaper addresses questions about these fair value measurements that have arisen in practice.

The Whitepaper describes how, in practice, some organizations use software to measure the fair value of the contribution and liability. However, that software’s objective is to compute the donor’s tax deduction, which the Whitepaper points out is not necessarily a fair value measurement for GAAP. To use commercially available software, the Whitepaper states an organization would need to consider whether the assumptions that are inherent in the software’s calculations (such as interest rates and mortality) are market participant assumptions that are appropriate for the measurement of fair value. If the assumptions are inappropriate, it should be determined whether the output from the software can be adjusted to reflect fair value measurements that comply with GAAP. The Whitepaper suggests one method to test whether the software can be used is to select a sample of split-interest agreements and compare the measurements arrived at using the methods described in the Whitepaper to the measurements from...
the software. The next paragraphs describe the methods recommended in the Whitepaper.

**Split-interest Agreements with Fixed Payments.** A charitable gift annuity or a charitable annuity trust makes payments of a fixed amount to the lead beneficiary during the term of the agreement (the lead interest); at the end of the agreement the remaining assets belong to the remainder beneficiary (the remainder interest). The lead interest is measured at fair value, as are the assets transferred by the donor. If the organization holds the remainder interest, the difference between the two measures is the liability to the remainder beneficiary. The Whitepaper states that the split interest agreement’s obligation to make fixed payments (the lead interest) can be measured using market quotes for fixed payment annuities offered by insurance companies in any of the following situations:

- The annuity obligation is adequately funded from assets held in an irrevocable trust, and the organization, as trustee, is observing its fiduciary responsibilities.
- The organization has a credit standing similar to that of the insurance companies whose quotes are observed in the marketplace. The Whitepaper says that the organization should have a credit standing similar to “investment grade,” reflecting strong, superior, or excellent capacity to meet financial commitments. (This assessment may be made by the organization itself rather than by a third-party rating agency.)
- The organization holds a commercially available annuity that provides cash flows to the beneficiary in the amount of and for the entire agreement term.

In other situations, the Whitepaper states an income approach that uses interest rates, yield curves, and life expectancy tables as observable inputs to a present value calculation will be the best valuation technique for split-interest agreements with fixed payments.

In subsequent periods, the organization should update the actuarial assumptions, including life expectancy. Unless the organization elects to report the lead interest annuity at fair value in subsequent periods, it should not adjust the discount rate assumptions. If the organization initially measured the fixed payment annuity using market quotes from insurance companies, it needs to determine the imputed discount rate to amortize the lead interest liability. Presumably, it would do so using the market quote, the cash flows during the life-expectancy period, and present value techniques.

**Split-interest Agreements with Variable Payments.** A charitable lead unitrust or a charitable remainder unitrust makes payments of a variable amount to the lead beneficiary during the term of the agreement (the lead interest); at the end of the agreement the remaining assets belong to the remainder beneficiary (the remainder interest). The lead interest is measured at fair value, as are the assets transferred by the donor. If the organization holds the remainder interest, the difference between the two measures is the contribution to the organization. If the organization holds the lead interest, the difference between the two measures is the liability to the remainder beneficiary.

The Whitepaper states that it would be difficult to find market quotes for variable annuities that are similar to the unitrusts offered by nonprofit organizations. The variable annuities offered by insurance companies are structured differently and include a plethora of investment returns, tax deferral strategies, and payout terms. Therefore, the Whitepaper concludes that an income approach, using present value techniques and observable interest rates, often will be the best valuation technique for measuring the obligation to make variable payments to the lead beneficiary.

The Whitepaper contains three exhibits that illustrate the calculations. The organization begins by estimating the payments to the lead beneficiary. If the payments are life dependent, the organization would use life expectancy information to determine the duration. Because unitrusts are collateralized obligations, if an organization is complying with all of its fiduciary duties as trustee, the Whitepaper states best practice is to use the same rate for the projected rate of return on the investments when estimating payments as it uses for the discount rate when using present value techniques. The Whitepaper states that the organization can use either the risk-neutral rate or the projected earnings rate on the trust assets.

In subsequent periods, the nonprofit organization should update the actuarial assumptions, including life expectancy. Unless the organization elects to report the unitrust liability at fair value in subsequent periods, it should not adjust the discount rate assumptions and the projected rate of return on the investments.

**Conclusion**

The measurement approach in the Whitepaper is also illustrated in PPC’s Guide to Nonprofit Contributions. The Guide, available at (800) 431-9025 or ppc.thomsonreuters.com, has examples for both annuity and unitrust obligations at initial measurement, during the life of the agreement, and at termination.
The 2011 Form 990—What’s New

The 2011 Form 990 instructions include many welcome clarifications along with some burdensome changes, plus, the glossary revises certain definitions that will affect Form 990 reporting. Some of the more significant changes are highlighted here.

Glossary

Understanding the definitions contained in the glossary located in the Form 990 instructions is essential to the preparation of an accurate return. The following definitions were clarified in the 2011 glossary.

Control. To determine if control of a partnership (or limited liability company) exists for reporting related organizations, a managing partner is a partner designated as such under the partnership agreement, or regularly engaged in the management of the partnership even though not so designated.

 Significant disposition of net assets. Several examples of situations not considered to be significant dispositions of net assets were added. See the Schedule N discussion later in this article for guidance.

Term endowment is renamed temporarily restricted endowment and includes both endowment funds established by donor-restricted gifts for a specified period and all other temporarily restricted net assets held in a donor-restricted endowment (including certain income from permanent endowments).

At the Core

The 2011 core Form 990 contains several note-worthy changes.

Heading. An organization required to file an annual information return (Form 990 or 990-EZ) or an annual electronic notice (Form 990-N) for a tax year must do so even if it has not yet filed a Form 1023 or 1024 with the IRS, if it claims tax-exempt status. Also, the name and address of the principal officer and the website address should be current as of the filing date.

Part II, Signature Block. The instructions clarify that the return is to be signed by a current (as of the date the return is filed) officer who is authorized to sign. In addition, paid preparers must enter their preparer’s taxpayer identification number (PTIN) instead of his or her social security number but may sign returns by rubber stamp, mechanical device, or computer software program.

Part VI, Governance, Management, and Disclosure. A governing body includes a group of one or more persons authorized under state law to make governance decisions on behalf of the organization and its shareholders or members, if applicable. In addition, the governing body can sometimes include a committee or other persons to which the governing body has delegated authority. The instructions contain several new examples for determining when a board chair’s compensation is considered officer/employee compensation instead of director compensation. Finally, the instructions clarify that merely informing governing body members that a copy of the organization’s Form 990 is available upon request is not considered providing a copy.

Part VII, Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors. For a short year return in which no calendar year ends, columns (D) and (E) of Section A should be blank unless the return is a final return. In addition, amounts deferred from the tax year to a date that is no more that 2 ½ months after the tax year end should not be reported as deferred compensation in column (F). Because the transition rule expired, beginning in 2011 non-Section 501(c)(3) organizations are required to report any former highest compensated employee compensation in Section A.

Part VIII, Statement of Revenue. The instructions clarify that net losses from uncollectible pledges, refunds of contributions and service revenue, or reversal of grant expenses should not be reported on line 1 of Part VIII. These items are reported as “Other changes in net assets or fund balances” on line 5 of Part XI and explained in Schedule O.

The instructions also clarify that contributions of conservation easements and other qualified conservation contributions must be reported consistently with the organization’s books, records, and financial statements. This also affects the reporting on Schedules A, B, D, and M.

Form 990 Schedules

The 2011 Form 990 schedules also contain some noteworthy changes and clarifications.

Schedule A. If any of the five years included in the public support computation period (current and four prior tax years) were short years, explain in Part IV. While donated services or use of materials, equipment, or facilities are not reported as gifts, grants, or contributions in Part II or III; certain donated services and facilities from a governmental unit are reported (on a
The change in composition of publicly traded securities.

**Schedule C.** Section 501(c)(3) organizations that made the Section 501(h) election and are part of an affiliated group must list in Part IV each affiliated group member’s name, address, EIN, expenses, and share of excess lobbying expenditures. Also, Section 501(c)(3) organizations that did not make the Section 501(h) election must provide in Part IV a detailed description of the lobbying activity for each affirmative response to lines 1a through 1i.

**Schedule D.** As discussed earlier in this article, term endowment is renamed to temporarily restricted endowment and the definition clarified. In addition, the instructions provide examples of when a conservation easement is modified, transferred, released, extinguished, or terminated by the organization.

**Schedule F.** Organizations with foreign investments valued at $100,000 or more during the tax year must complete Part I. However, funds transferred into non-interest bearing foreign accounts to be used for program services are not reportable as investments in Part I, but are reportable as expenditures once they are used for program services outside the U.S. Expenses for certain services provided in the U.S. that include recipients both inside and outside the U.S. (e.g., telemedicine and services provided over the internet) should not be reported in Part I. In addition, Parts II and III should reflect grants and other assistance to U.S. organizations or individuals for the understood purpose of engaging directly or indirectly in foreign activity.

**Schedule H.** Organizations may use any reasonable method (e.g., total revenue per facility or number of patients served) to determine size for Sections A and C of Part V. In addition, Section B of Part V applies to charges to individuals eligible for assistance under the facility’s financial assistance policy. Organizations that use criteria other than Federal Poverty Guidelines to determine eligibility for free or discounted care must explain the criteria used in Part VI.

**Schedule J.** The value of housing provided by the employer does not have to be reported as compensation to the extent that such value is a working condition fringe benefit. In addition, cell phones provided to employees primarily for business purposes are a working condition fringe benefit and not reportable as compensation.

**Schedule K.** An organization must indicate if it routinely engages outside counsel to review any management or service contracts or research agreements that may result in private business use of bond-financed property. In addition, an organization must indicate if it has established written procedures to ensure timely identification and correction of any federal tax regulation violations.

**Schedule L.** A business transaction between the organization and an entity more than 35% owned by current or former trustees, directors, officers or key employees (TDOKEs) is not reportable in Part IV if the entity is a Section 501(c)(3) organization, a 501(c) organization of the same subsection as the filing organization, or a governmental unit. Additionally, the 2011 instructions eliminate the requirement that a business transaction between the organization and another entity be reported simply because a current or former TDOKE of the organization was a key employee of the other entity.

**Schedule N.** A significant disposition of net assets has been clarified to exclude the following situations:

- The change in composition of publicly traded securities held in an exempt organization’s passive investment portfolio.
- Asset sales made in the ordinary course of the organization’s exempt activities to accomplish the organization's exempt purpose (e.g., gross sales of inventory).
- Grants or other assistance made in the ordinary course of the organization’s exempt activities to accomplish the organization’s exempt purpose (e.g., the regular charitable distributions of a United Way or other federated fundraising organization).
- A decrease in the value of net assets due to market fluctuation in the value of assets held by the organization.
- Transfers to a disregarded entity of which the organization is the sole member.

**Schedule R.** The instructions clarify the reporting of a related foreign organization that is recognized as a charity by the foreign country. Regarding UBI reported in box 20 of Form 1065, Schedule K-1, if an organization has reason to believe that the amount is incorrect, it should consult with the partnership. The stated amount in box 20 is not controlling for UBI reporting.

In addition, the instructions provide that the organization should report related split-interest trusts in Part IV by type (e.g., charitable remainder trust, charitable lead trust, or pooled income fund), but do not need to report such trust’s specific name, address, or EIN or complete certain columns.
Partnerships and Joint Ventures

One of the most significant changes in the 2011 instructions requires a change in partnership reporting on Form 990 and the related schedules. Previously, partnership activity was reported based on the books and records method. The 2011 instructions require reporting the organization’s distributive share of the partnership’s total income and assets using the amounts reported by the partnership on the organization’s Schedule K-1 (Form 1065) for the tax year ending with or within the filing organization’s tax year.

The IRS has indicated that the change was meant to boost accuracy and uniformity and to capture suspected unreported income. However, they received many comments arguing that the change was overly burdensome and would not necessarily increase accuracy. The IRS responded by making the change optional for 2011 returns, see www.irs.gov/charities/article/0,,id=255841,00.html for more information.

The IRS has indicated that the incremental Form 990 redesign is near completion and that fewer significant changes are expected for 2012. However, exempt organization examination activity is on the rise, so it is important to carefully prepare and review Forms 990.

Practical Consideration:

While the IRS backed down on the issue of partnership reporting for 2011, organizations will likely be required to report distributive share of activity from their Schedules K-1 (Form 1065) in 2012.

Tax Briefs

PUBLIC INSPECTION FINAL REGULATIONS ISSUED.

Final regulations effective February 29, 2012, were recently published that affect organizations that were tax-exempt but are no longer exempt and organizations that were denied tax-exempt status. Letter rulings denying or revoking tax-exempt status must be made available for public inspection [Reg. 301.6104(a)-1].

SOME GROUP EXEMPTION HOLDERS WILL RECEIVE AN IRS QUESTIONNAIRE.

Many organizations have lost their tax-exempt status for failure to file a Form 990 as part of the automatic revocation process. The IRS has received a number of requests for retroactive reinstatement from large organizations. The relief program was expected to primarily assist smaller exempt organizations. Many of the automatic reinstatement requests involve subordinate organizations leading the IRS to believe that there is a need for education and training on subordinate organizations’ responsibilities. The IRS will question the methods subordinate organizations are using to satisfy their filing requirements as well as practices used by central organizations in the upcoming questionnaire.

Practical Consideration:

While the IRS backed down on the issue of partnership reporting for 2011, organizations will likely be required to report distributive share of activity from their Schedules K-1 (Form 1065) in 2012.