United Way Guide to Managing and Accounting for Planned Gifts
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EXECUTIVE SUMMARY & ACKNOWLEDGEMENTS

New products are being devised to help non-profits meet the ever increasing demands of communities in needs. Often times these new ways of giving require new ways of accounting. Most times one need only recognize that the new product is simply a variation on an old one to understand the required accounting. The trick then is recognizing which is which.

It should be noted that when discussing resources generated there are varying levels of reporting. The following figures are reported for different purposes and according to differing sets of guidelines:

1. **Total Revenue Figure (Audited Financial Statements):** United Ways report a total revenue figure on their audit according to Generally Accepted Accounting Principles as established by the Financial Accounting Standards Board and it is these standards that this document seeks to address.

2. **Total Revenue Figure (IRS Form 990):** United Ways report a total revenue figure on the Form 990 according to the United States Tax Code and associated regulations issued by the Internal Revenue Service.

3. **Total Resources Generated Figure:** United Ways report the full scope of system-generated resources, with no double reporting, to United Way Worldwide. This is measured by the United Way Continuum on the annual UWW Database 2 survey and reporting is to be in accordance with the NPC Policy for Reporting Total Resources Generated to United Way Worldwide.

4. **Local Annual Campaign Figure:** United Ways report local annual campaign results back to their community, in the manner of their choosing. More and more the annual fundraising campaign is only one source of the revenue stream and thus may be a distinct entity from other revenues.

5. **Recognition Figure:** United Ways may generate recognition reports that satisfy the needs of major corporate and individual customers to get the public recognition they need/want within a given market.

This document is intended to be a tool that helps United Ways properly account for a variety of planned giving products in a manner that is consistent with Generally Accepted Accounting Principles (GAAP) and other United Ways. Thus, it covers reporting for levels 1 & 2 above only. By way of example, a number of different types of planned gifts are identified and then the accounting entries required under GAAP are provided that will assure consistent accounting and full transparency in financial reporting.

This document is not intended to address how United Ways properly report planned giving products for levels 3, 4, & 5 above as guidance for that reporting is already available in a document titled “NPC Policy for Reporting Resources Generated to United Way Worldwide”. While the authors may from time to time reference reporting on these levels or even provide
“tips” on how to report there, this document is not intended to be authoritative with respect to such reporting levels.

The authors acknowledge that not all United Ways will have the same mix of planned giving instruments and not all planned giving instruments are designed exactly alike. This document includes an Appendix (C) that provides a basic overview of the structure of a number of more common planned giving instruments so that users of this document will be better equipped to recognize them when they appear as part of the organization’s resource development mix.

Similarly, the examples in the main body of this document do not demonstrate every possible variation in planned giving instruments but rather demonstrate the basic principles that must be understood in order to determine proper accounting for your specific variables.
United Way Worldwide wishes to acknowledge the contributions of the following individuals who have volunteered their time and energy to serve on the sub-committee that developed this document.

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<tr>
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<th>Organization</th>
<th>Location</th>
</tr>
</thead>
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A. OVERVIEW

Throughout the Not-for-Profit sector there are many ideas on how to inspire donors to support an organization in big ways, both currently and well into the future. Some of these opportunities are time tested and ample guidance exists for understanding and recording them. Meanwhile, creative fundraising professionals are devising new “products” regularly, often without seeking input from the accountants, thus leaving them scrambling to determine how to record the donations on the books and how to provide tax documentation to the donors.

Because these types of gifts have so many different accounting, tax, and legal nuances, it is important to have a strong understanding of the basic concepts behind them. This is ultimately the goal of this guide.

B. SCOPE

This document is intended to provide guidance and information on commonly encountered planned gifts to a United Way organization. Where we do not address specific aspects of laws, regulations, etc, one should assume that definitive guidance can be obtained from other authoritative guidance referenced in the document. These documents served as the primary resource in developing this document and should always be used in concert with this document.

Where interpretations have been made of other authoritative guidance or recommended best practices, the authors have included in this document an explanation of why the position was taken which can be found in the Basis for Conclusions section.

C. ACCOUNTING FOR CONTRIBUTIONS – EXAMPLES

1. Appreciated Stock gift

On December 2nd a donor decides to gift 100 shares of XYZ common stock purchased ten years ago for $2,000. The donor accordingly instructs his/her broker to start the process of transferring the 100 shares, which are currently selling for $10 a share, and provides to United Way a pledge form for $10,000 to be paid in stock. The stock arrives in United Way’s account on December 30th and the high selling price was $10 and low selling price was $9.50 and the ultimate amount per share transferred to United Way is $9.75. On January 5th, United Way sold the stock for $9,500 and incurred a broker’s fee of $500.
Accounting treatment:
Given proper substantiation of this immediate promise and assuming there are no donor-imposed conditions or restrictions attached to the gift, the promise should be recorded as *unrestricted contribution revenue* and *contributions receivable*.

**Accounting Entry #1a:**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions receivable</td>
<td>Contribution Revenue (Unrestricted)</td>
</tr>
<tr>
<td>$10,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

When the stock is finally received in the United Way's account (assuming that this is considered full satisfaction of the pledge), the receivable must be cleared and an adjustment to record the decrease in asset value.

**Accounting Entry #1b:**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision for Uncollectible Pledges</td>
<td>Contributions receivable</td>
</tr>
<tr>
<td>$250</td>
<td>$10,000</td>
</tr>
<tr>
<td>Investments</td>
<td></td>
</tr>
<tr>
<td>$9,750</td>
<td></td>
</tr>
</tbody>
</table>

When United Way sells the stock, an entry must be recorded to represent the conversion to cash and record the brokerage fee and realized loss.

**Accounting Entry #1c:**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Investments</td>
</tr>
<tr>
<td>$9,000</td>
<td>$9,750</td>
</tr>
<tr>
<td>Investment fees</td>
<td></td>
</tr>
<tr>
<td>$500</td>
<td></td>
</tr>
<tr>
<td>Realized loss on investment</td>
<td></td>
</tr>
<tr>
<td>$250</td>
<td></td>
</tr>
</tbody>
</table>

**NOTE:** In practice some organizations will wait until the cash is received and then just record contribution revenue of $9,000. There is support for this in FAS 157 and 116 which together can be interpreted to say that the fair value of the pledge is only $9,000 and thus that is the amount to initially record. However, that is not the preferred method in terms of transparency.

2. **Charitable remainder trust**

Mary and Don Smith, aged 70 and 75, place long-term appreciated stock into a 7% unrestricted charitable remainder annuity trust valued at $1 million. They purchased the stock five years ago for $500,000. Based upon a 4.2% IRS discount rate, their tax deduction is $339,430 (see *below)*.
The Smiths are confident that the trustee will obtain annual return of 10% that will produce $1,702,433 for the local United Way on their projected date of death. A for-profit financial services company serves as trustee and facilitates all transactions.

Case One: The Smiths name the local United Way as the revocable beneficiary of the trust.

Case Two: The Smiths name the local United Way as the irrevocable beneficiary of the trust.

Accounting treatment:

A charitable remainder trust is so named because the amount remaining when the trust terminates goes to charity. To make a gift, a donor reviews the plan and various percentage payout options with his/her advisors. A legal charitable remainder trust is created and the donor makes an irrevocable gift to the trust. In return, the donor and/or named beneficiaries receive an income from the trust. The income can be paid: (1) over one life, (2) several lives, (3) a fixed number of years, (4) or one life and a number of years. When the trust terminates, the amount remaining in the trust goes to United Way.

There are two basic Types of Charitable Remainder Trusts, a Unitrust and an Annuity Trust. A Unitrust pays out an income based upon a fixed percent of the trust principal recalculated each year. As the principal goes up, so does the income. For example, a 7% unitrust would pay $7,000 on a principal of $100,000 (7% x $100,000) in year one. If the trust’s principal goes up to $140,000 the next year, the income paid would be $9,800 (7% x $140,000). The unitrust can continue to receive additional contributions.

An Annuity Trust is another form of charitable remainder trust. However, the income pay out calculated in the first year is fixed and does not change as the principal grows. For example, a 7% annuity trust would pay $7,000 on a principal of $100,000 in the first year. If the trust’s principal grew to $140,000 in year two, the annuity trust would still pay $7,000. The annuity trust does not accept additional contributions.

In our example you note that it is an Annuity Trust so:

Case one is simple. Revocable gifts should not be recorded as contributions because they are intentions rather than promises to give but it is appropriate to include a footnote in the financial statements to give recognition of the potential value of the revocable gift. However, any assets transferred to the organization under a revocable agreement should be recognized at fair value when received (non-current asset) and as a refundable advance (liability).
Case two is more complex. Assuming there are no donor-imposed conditions or restrictions, a contribution should be recorded for the difference between the fair value of assets held in trust and the liability to the beneficiary (recorded at the present value of the estimated future payments to be distributed over the beneficiaries’ expected life).

Assuming Joint & Survivor ages 70 & 75

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of asset held in trust</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less: PV of estimated payments to beneficiaries*</td>
<td>$660,570</td>
</tr>
<tr>
<td>Amount of contribution</td>
<td>$339,430</td>
</tr>
</tbody>
</table>

*PV of annuity payment of $70,000 per year using discount rate of 4.2% joint and survivor ages 70 & 75. Crescendo, Planned giving Manager or other planned giving software should provide the liability amount needed to calculate the contribution.

Transactions recorded by the local United Way at the initial contribution and measurement date are as follows:

Accounting Entry #2a:

Debit – Beneficial interest in remainder trust $339,430
Credit – Contribution Revenue (Temp Restricted*) $339,430

*Temporarily restricted due to passage of time restrictions

Each remaining year the gift must be remeasured assuming earned income, gains/losses and adjustment of the liability to reflect amortization of the discount and revaluations of future cash flows based on revisions in the donor’s life expectancy. This information is typically calculated and provided by the trustee.

For example, the trustee should provide the local United Way with the information below and necessary entries should be made to remeasure the local United Way’s interest in the trust.

Information from trustee (used to calculate the annual adjusting entry)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on assets held in trust</td>
<td>$30,000</td>
</tr>
<tr>
<td>Change in present value of liability</td>
<td>($15,950)</td>
</tr>
<tr>
<td>Net change in value of split-interest agreement</td>
<td>$14,050</td>
</tr>
</tbody>
</table>
Given this information, the local United Way should make an entry to record the change in value of split interest agreements held for them as follows:

**Accounting Entry #2b:**

- Debit – Beneficial interest in remainder trust $14,050
- Credit – Contribution Revenue (Temp Restricted) $14,050

As the annuity payments are made, the change in value of split interest gifts will begin to turn positive assuming the rate of return on invested assets does not considerably decrease.

At the end of the agreement term, the trustee forwards the remainder portion of the trust to the local United Way. Assuming the trust was accurately remeasured through its life, the balance in the beneficial interest in remainder trust account at the local United Way should be close to the remainder amount actually paid by the trustee. Assuming that the amount received is slightly different from the amount in the beneficial interest in remainder trust account, the residual should be recorded as change in value of split-interest agreements-unrestricted.

The following entry should be made to clear the balance of beneficial interest in remainder trust, assuming the local United Way receives a remainder amount of $1,690,000:

**Accounting Entry #2c:**

- Debit – Cash $1,690,000
- Debit – Change in Value of Split-Interest Agreements (Unrestricted) $10,000
- Credit – Beneficial interest in remainder trust $1,700,000

**Accounting Entry #2d:**

- Debit – Net Assets Released from Restriction – Temp restricted $1,700,000
- Credit - Net Assets Released from Restriction – Unrestricted $1,700,000

3. **Charitable Gift Annuity**

Jane Dow, age 80, establishes a $100,000 unrestricted cash gift annuity for the local United Way. The annuity pays annual payments based upon 8.9% of the initial gift. Jane's tax deduction is $60,400. It is anticipated that at her projected date of death, at least $50,000 will go to the local United Way.
Case One: The local United Way issues the charitable gift annuity.

Case Two: United Way Worldwide issues the charitable gift annuity to benefit the local United Way.

Accounting treatment:
Accounting treatment for charitable gift annuities is the similar to accounting for charitable remainder trusts. The primary difference is that the underlying trust agreement related to a remainder trust does not exist with a charitable gift annuity.

In case one, the local United Way will be managing the annuity and receiving the contribution. Therefore they will be recognizing the asset held, corresponding liability and the contribution as follows, assuming the information provided below:

Based on IRS Annuity tables the assumed life expectancy of this donor is 85 and this is used as the basis for the calculation*-

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of asset held in trust</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less: PV of estimated payments to beneficiaries*</td>
<td>$ 39,600</td>
</tr>
<tr>
<td>Amount of contribution</td>
<td>$ 60,400</td>
</tr>
</tbody>
</table>

* PV of annuity payment of $8,900 per year using discount rate of 4%** over 5 years. Crescendo, Planned Giving Manager or other planned giving software should provide the liability amount needed to calculate the contribution.

**If the organization adopts FAS 159, the interest rate used to discount the long-term portion of the receivable may change over time.

Transactions recorded at the initial contribution and measurement date.

Accounting Entry #3.1a:

Debit – Investments: Charitable Gift Annuity Assets $100,000

Credit – Liability to Annuity beneficiaries $39,600

Credit – Contribution Revenue (Unrestricted) $60,400

Each year the gift must be remeasured considering adjustment of the liability to reflect amortization of the discount. For example, if in year one the United Way makes the first annuity payment at the beginning of the year and total annual return on the remaining invested assets is 10%.
Accounting Entry #3.1b:
Debit – Liability to Annuity beneficiaries $8,900
Credit – Investments: Charitable Gift Annuity Assets $8,900
(To record payment to beneficiary)

Accounting Entry #3.1c:
Debit – Investments: Charitable Gift Annuity Assets $9,110
Credit – Realized Gain/Loss on Investments $9,110
(To record gain on assets, assuming 10% rate of return)

The PV of the annuity to the beneficiary must then be updated based on four remaining payments of $8,900 assuming the same discount rate of 4%. Holding all prior assumptions constant and assuming the recalculated present value is $32,300, the spread between the balance of the liability after the previous entries of $30,700 and the new present value of $32,300 is $1,600.

Accounting Entry #3.1d:
Debit – Realized Gain/Loss on Investments $1,600
Credit – Liability to Annuity beneficiaries $1,600
(To record change in present value)

At the end of the contract, the liability must be closed and any difference recorded to change in value of split interest agreements-unrestricted.

In case two, United Way Worldwide will recognize the asset and liability as custodian of the annuity. The designated local United Way should recognize contribution revenue (calculated based on the difference between the asset transferred to United Way Worldwide and the present value of the liability to the annuitant) and a beneficial interest in the annuity (asset).

Accounting Entry #3.2a:
Debit – Beneficial interest in annuity $60,400
Credit – Contribution Revenue (Temp Restricted)* $60,400
(To record contribution)

*Temporarily restricted due to passage of time restrictions
As the gift is remeasured each year, the local United Way should recognize changes to the value of split interest agreements-unrestricted.

**Accounting Entry 3.2b:**

Debit – Beneficial interest in annuity $7,500  
Credit – Realized & Unrealized <Gain>/Loss Beneficial Interests $7,500

*(To record subsequent valuation)*

Upon termination of the annuity, the remaining assets are transferred to the local United Way and any difference between the recorded asset and the actual amount transferred is recognized as *change in the value of split interest agreements-unrestricted.*

The following entries should be made, assuming the balance of beneficial interest in annuity is $99,000 and the amount transferred to the local United Way from United Way Worldwide is $101,000:

**Accounting Entry 3.2c:**

Debit – Cash $101,000  
Credit - Beneficial interest in annuity $99,000  
Credit – Realized & Unrealized <Gain>/Loss Beneficial Interests $2,000

**Accounting Entry 3.2d:**

Debit – Net Assets Released from Restriction – Temp restricted $ 99,000  
Credit - Net Assets Released from Restriction – Unrestricted $ 99,000

4. **Life Insurance (Purchased by the Donor)**

Robert Green, age 40, applies for a whole life insurance policy naming United Way as both irrevocable owner and beneficiary. The death benefit is $200,000 and annual premiums are $1,500. Robert contributes the $1,500 to United Way (although no formal pledge has been signed) and United Way pays the premiums. At the time of the gift the policy has no cash value.
**Accounting treatment:**

Since there is little or no cash value in a policy of this sort at the start, no contribution can be recognized (the fair value of this non-cash asset is likely zero). However, Robert’s $1,500 contribution should be recognized as a contribution, assuming the United Way has variance power over Robert’s contribution and can elect whether or not to continue paying the premiums or let the policy lapse. The $1,500 contributions should be recognized as received. When premium payments are remitted to the insurer, an asset account such as beneficial interest in insurance policy* should be debited to build the asset value as the policy’s cash value increases.

**Accounting Entry 4a:**

Debit – Cash $1,500  
Credit – Contribution Revenue (Unrestricted) $1,500  
*(To record $1,500 contribution)*

**Accounting Entry 4b:**

Debit – Beneficial interest in insurance policy $1,500  
Credit – Cash $1,500  
*(To record payments to insured)*

The policy’s cash value will eventually grow beyond the amount of premium payments, so since the policy is irrevocable and Robert cannot change the beneficiary, United Way should recognize the cash value of the policy as it increases, debiting beneficial interest in insurance policy and crediting gain or loss on insurance policies-unrestricted. Assuming an annual return of 5% on the value of the $1,500 investment above, the United Way would record a $75 gain for the year.

* For simplicity we assume here that the beneficial interest is the same as the cash paid but generally it is not exactly the same due to fees/costs addressed by the insurance company.

**Accounting Entry 4c:**

Debit – Beneficial interest in insurance policy $75  
Credit – Gain or loss on insurance policies (unrestricted) $75  
*(See Appendix B for additional examples of Life Insurance Instruments)*

5. **United Way endowment held by a community foundation**

Betty and Alvin Jones make a cash gift of $200,000 to the Community Foundation, restricted for a permanent endowment fund to benefit United Way. The corpus is to remain intact and all earnings are to be transferred to the United Way.
Accounting treatment:

United Way should recognize permanently restricted contribution revenue and beneficial interest in endowment (see Basis for Conclusions section for more information on beneficial interests) as follows:

Accounting Entry 5a:
Debit – Beneficial interest in perpetual trust $200,000
    Credit – Contribution revenue (Permanently Restricted) $200,000

As earnings from the endowment are transferred to United Way, income should be recognized as follows (assuming a 5% annual return of $10,000):
Accounting Entry 5b:
Debit – Cash $10,000
    Credit – Income from perpetual trust $10,000

(see basis of conclusions for more information on endowment funds held by Community Foundations)

6. Bequest

Nancy Adams, age 84, just had her will redone and included a provision for United Way.

Case One: She names United Way to receive $200,000

Case Two: She names United Way to receive 5% percent of her estate. She estimates United Way will receive $200,000

Case Three: She will only say that United Way is named in her will but will not say how much.

Accounting treatment:

The seemingly most complex example has the simplest solution. In all cases mentioned above, United Way should not recognize contribution revenue. According to AAG-NPO, “Such communications are not unconditional promises to give, because individuals retain the ability to modify their wills during their lifetimes. When the probate court declares the will valid, the not-for-profit organization should recognize the contribution revenue and receivable at the fair value of its interest in the estate . . . (5.51).”

However, the United Way may, if it chooses, include a footnote in its financial statement to give recognition to bequests and their estimated value. Care must be taken however to assure that the footnote clearly indicates that there is no certainty of
receiving any amount of the bequest. Also, the auditor may be averse to including in the footnotes a number that is not auditable so the organization will need to have access to reliable information that substantiates the estimated potential value of the bequest. See the example of such a footnote below.

**Bequests:** Model United Way has been named as a beneficiary in the Last Will and Testament of various living supporters of the organization. Such bequests are revocable at any time and as such can not be reported as assets of the organization under Generally Accepted Accounting Principles. However, the organization believes that recognition of the existence of the bequests is important to transparency as they are an indication of the strength of community support for the organization’s mission and represent potential contributions that may become available to fulfill that mission in future years. The estimated (unaudited) net present value of all bequests is approximately $200,000.

7. **Pledge to the endowment fund**

William Tellum, age 79, makes a $1 million five year written pledge to United Way’s permanent operating endowment fund, to be paid $200,000 a year.

**Case One:** Should William die prior to complete payment of the pledge, a provision has been made to pay the balance in his will.

**Case Two:** No provision has been made to pay the unpaid balance through his will.

**Accounting treatment:**

The accounting treatment is the same for both cases, regardless of how the pledge is to be paid. According to AAG-NPO, “Such agreements between not-for-profit organizations and potential donors should be reported as contribution revenue and receivables if such agreements are, in substance, unconditional promises to give, even if the promise is not legally enforceable (5.47).”

As a general rule, contributions recognized from unconditional promises to give paid over multiple years (pledges) increase temporarily restricted net assets because time restrictions exist. In this example the added nuance is that it is pledged to the permanently restricted endowment fund so it will be recorded as permanently restricted revenue. Also, the initial amount recognized should be discounted to present value and subsequently valued based on the duration of the pledge and a risk-free rate of return.

As pledge payments are made, the receivable is reduced and cash is increased.
Finally, discounting on the pledge should be updated each year. Using a discount rate of 3%**, the net present value of a $1,000,000 pledge, received over five years is approximately $916,000. At the time William’s pledge is made, the following entries should be recorded:

**Accounting Entry 7a:**

Debit – Contributions receivable   $1,000,000
Credit – Contribution Revenue (Permanently restricted)   $916,000
Credit – Unamortized Discount on contributions receivable   $84,000

**If the organization adopts FAS 159, the interest rate used to discount the long-term portion of the receivable may change over time.**

When William makes his payments and the net present value is updated for the four remaining years (NPV of four annual installments of $200,000, using a discount rate of 3% is $743,500), the following entries should be made:

**Accounting Entry 7b:**

Debit – Cash   $200,000
Credit – Contributions receivable   $200,000

After the payment is recorded, the balance of pledges receivable is $800,000 and the discount remains at $84,000. This results in a net receivable of $716,000 ($800,000 less a discount of $84,000). This is $27,500 less than the updated net present value of $743,500. Since the net present value is higher than the amount recorded, the discount should be reduced and additional contribution revenue recognized for the difference as follows:

**Accounting Entry 7c:**

Debit – Unamortized Discount on contributions receivable   $27,500
Credit – Contribution Revenue (Permanently restricted)   $27,500

**Result:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$200,000</td>
</tr>
<tr>
<td>Pledges receivable</td>
<td>$800,000</td>
</tr>
<tr>
<td>Less: Unamortized discount</td>
<td>$(56,500)</td>
</tr>
<tr>
<td>Net pledges receivable</td>
<td>$743,500</td>
</tr>
</tbody>
</table>

As remaining payments are made, the receivable should be recalculated and reduced in this fashion until the balance is fully paid.

8. **Donor Advised Fund (previously known as Philanthropy Fund)**

The Pension Protection Act classifies a contribution as a Donor Advised Fund (DAF) contribution if the following three tests are met:

1. Separately identified funds with reference to the donor
2. Owned and controlled by the sponsoring organization
3. The donor or someone named by the donor has or can expect to have the privilege of advising investments or distribution.

While most United Ways would argue that the Philanthropy Fund (P-Fund) gifts are not DAFs but rather simply designated gifts, the Internal Revenue Service regulations are unclear so a certain amount of caution is required in handling these types of gifts.

Current legal opinion (see appendix D) leans toward the classification of P-Funds as DAFs despite the fact that the donor maintains the option of directing any and/or all of their gift (to a qualified 501c3) at a time after making their gift and that the restricted gifts are recorded on the books as a liability (designation payable). The attorneys specifically point to the fact that IRS conducted a 30 month study of DAFs to determine the appropriate deductibility of such contributions and because the “P-Fund” operates so much like a DAF, legal advisors believe that the IRS could take the position that it is a DAF and therefore should be structured and documented accordingly.

At issue is how the IRS would classify a P-Fund contribution if it is not structured properly as a DAF. The IRS could disqualify the tax deduction for the P-Fund contribution at the time it is made, forcing the donor to wait to deduct the contribution until the funds are either distributed or they give up the right to direct where it goes.

In the case of a properly structured DAF, the donor is allowed to take a charitable contribution deduction at the time the contribution is made because the donor has given up discretionary authority over the ultimate recipient of the funds (e.g. they only have the right to recommend, not the absolute right to direct who will receive the funds). Under GAAP, this is an unrestricted contribution to the DAF sponsoring organization. The IRS has also made clear that one exception exists. This is when the donor retains the absolute right to determine the ultimate recipient organization but they only designate a single organization.

While the IRS was researching DAFs they also issued Notice 2008-16 which gave some insight into the IRS thought process. In that notice they indicated that they do not consider a contribution to be “made” (i.e. “deductible by the donor”) until the funds reach the ultimate recipient organization. They went on to indicate that if the donor retains the right to determine who the recipient organization(s) will be, the donor should be precluded from taking a deduction for the contribution until the funds were distributed to the ultimate recipient.

Given the above, the authors of this document recommend that P-Funds be properly structured as DAFs, removing the absolute right to direct where funding will go, in order to avoid jeopardizing deductibility for the donor. (See Appendix E for sample documents for properly structuring a DAF and for how to convert an improperly designed DAF into one that complies with the regulations)
The following example is based on the assumption that the contribution was made through a properly structured DAF and that while GAAP does not specifically address accounting for DAFs, it is the opinion of the authors that the recommended journal entries would conform to GAAP based on the interpretation above.

John Warbucks, age 72, makes a $50,000 contribution to United Way’s Donor Advised Fund in June. The DAF terms allow certain donors the right to recommend use of their gift throughout a calendar year. If they do not recommend the use of any or all of the contributed proceeds by the end of the year, the remaining funds roll into United Way’s Unrestricted Community Investment fund. Thus, in December, Mr. Warbucks notifies the United Way that he recommends the funds to be distributed to five organizations (one of which is the United Way) in equal proportions.

The gift would be accounted for as follows:

Accounting entry #8a:
Debit – DAF Cash $ 50,000
Debit – Unrestricted Net Assets $ 50,000
Credit – DAF Contributions (Unrestricted) $50,000
Credit – Board Designated DAF Net Assets (Unrestricted) $50,000
(to record the receipt of the pledge as a receivable for a donor Advised fund gift)

When the donor advises of his wishes for the distribution of the funds, assuming the distribution meets with the Board approved policies, the organization distributes the funds and the accounting for the distribution will be as follows:

Accounting entry #8b:
Debit – Grant Expense $40,000
Credit – Grants Payable $40,000
(to record grants awarded from Donor Advised Funds)

Accounting Entry #8c:
Debit – Grants Payable $40,000
Credit – Cash $40,000
(to record distribution to other organizations)
D. Basis for Conclusions

1. Beneficial interests in Endowments held by Community Foundations

Respondents to the exposure draft raised a question of whether or not a United Way should record an asset on its books when the United Way establishes an endowment with another organization (usually a Foundation). In response to that question, the authors looked to SFAS 136 (as amended where it states in the following paragraphs):

**Beneficiary**

15. A specified beneficiary shall recognize its rights to the assets (financial or nonfinancial) held by a recipient organization as an asset unless the recipient organization is explicitly granted variance power. Those rights are either an interest in the net assets of the recipient organization, a beneficial interest, or a receivable. If the beneficiary and the recipient organization are financially interrelated organizations, the beneficiary shall recognize its interest in the net assets of the recipient organization and adjust that interest for its share of the change in net assets of the recipient organization. If the beneficiary has an unconditional right to receive all or a portion of the specified cash flows from a charitable trust or other identifiable pool of assets, the beneficiary shall recognize that beneficial interest, measuring and subsequently remeasuring it at fair value. In all other cases, a beneficiary shall recognize its rights to the assets held by a recipient organization as a receivable and contribution revenue in accordance with the provisions of Statement 116 for unconditional promises to give.

16. If the donor explicitly grants a recipient organization variance power, the specified unaffiliated beneficiary shall not recognize its potential for future distributions from the assets held by the recipient organization.

88. The Board considered whether a beneficiary’s rights to the assets transferred to a recipient organization should be recognized as an asset of the beneficiary. The Board concluded that the beneficiary should recognize those rights as an asset if the recipient organization is not explicitly granted variance power. Clearly, unless the donor grants variance power, the recipient organization’s representation to the donor that it will transfer the assets to the specified beneficiary is evidence of a probable future benefit to that beneficiary. The donor expects that the recipient organization will deliver and that the specified beneficiary will receive the assets it transferred. In addition, the recipient organization has a social and moral obligation, and most likely a legal obligation, to deliver the assets to the beneficiary. That obligation provides the beneficiary with the ability to obtain the future benefit of the assets. (An obligation may not exist if the recipient organization and the specified beneficiary are financially interrelated organizations. Refer to paragraphs 98–104.) Finally, unless the recipient organization is explicitly
granted variance power, the event that gives rise to the beneficiary’s rights (the acceptance of the assets from the donor and the representation that they will be transferred to the specified beneficiary) has already occurred.

89. In contrast, the Board concluded that if the recipient organization is explicitly granted variance power, the specified beneficiary does not have a right that meets the criteria for recognition in financial statements. Because **variance power is defined as a unilateral power** [emphasis added], another beneficiary can be substituted without the permission of the donor, the specified beneficiary, or any other interested party. Thus, the specified beneficiary is unable to control others’ access to the future economic benefits of the assets held by the recipient organization. Further, because the recipient organization can change the beneficiary at will, no past event giving rise to a beneficiary’s right has occurred and none will occur until the recipient organization promises to give the transferred assets to the specified beneficiary. Thus, the specified beneficiary’s potential for future distributions from the assets held by the recipient organization does not meet the definition of an asset.

90. Most respondents to the Exposure Draft that commented about beneficiary reporting agreed with the Board’s conclusions. However, several of those that disagreed expressed concerns about the administrative burdens of identifying assets that are held by recipient organizations for the beneficiary. In addition, many respondents that act as recipient organizations expressed concerns about the burden of notifying beneficiaries of the amounts of assets they hold. The Board believes that in most instances recipient organizations tend to raise resources on an ongoing basis for a select group of beneficiaries. Thus, specified beneficiaries generally are aware of the efforts of recipient organizations, and the ongoing relationships between the organizations usually enable the beneficiaries to request and receive the information that they need for the preparation of their annual (or quarterly) financial statements. Although systems may need to be enhanced to gather or provide information on a more timely basis, the Board believes that the basic systems generally are in place.

---

6 Recognizing an interest in the net assets of the recipient organization and adjusting that interest for a share of the change in net assets of the recipient organization is similar to the equity method, which is described in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. If the beneficiary and the recipient organization are included in consolidated financial statements, the beneficiary’s interest in the net assets of the recipient organization would be eliminated in accordance with paragraph 6 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*.

7 For an unconditional promise to give to be recognized in financial statements, paragraph 6 of Statement 116 states, “. . . there must be sufficient evidence in the form of verifiable documentation that a promise was made and received.” Paragraph 15 of Statement 116 states, “Receipts of unconditional promises to give with payments due in future periods
shall be reported as restricted support unless explicit donor stipulations or circumstances surrounding the receipt of a promise make clear that the donor intended it to be used to support activities of the current period.” Paragraph 20 of Statement 116 states, “The present value of estimated future cash flows using a discount rate commensurate with the risks involved is an appropriate measure of fair value of unconditional promises to give cash” (footnote reference omitted).

Thus, the key to the issue is understanding the legal structure. Most often the structure is such that the Foundation “owns” the asset but the United Way is the named sole beneficiary and the United Way does not control the foundation. When that is the case, the Foundation does not have unilateral variance power (see paragraph 89 above) because the United Way has an unconditional right to receive benefits and therefore, this beneficial interest is properly recorded as an asset of the United Way.

Whether an Organization records all or a portion of the asset transferred depends on whether the transfer is reciprocal. That is, the Organization would record an interest in the transfer equal to the interest which they have received in return.

Example 9 of FAS 136 discusses a situation where a Not-For-Profit (NFP) transfers assets to a Community Foundation.

Example 9—Transfer of Assets from a Not-for-Profit Organization to a Community Foundation to Establish an Endowment for the Benefit of the Not-for-Profit Organization

53. Symphony Orchestra receives a large unrestricted gift of securities from Individual. Because it has no investment expertise, Symphony Orchestra transfers the securities to Community Foundation to establish an endowment fund. The agreement between Symphony Orchestra and Community Foundation states that the transfer is irrevocable and that the transferred assets will not be returned to Symphony Orchestra. However, Community Foundation will make annual distributions of the income earned on the endowment fund, subject to Community Foundation’s spending policy. The agreement also permits Community Foundation to substitute another beneficiary in the place of Symphony Orchestra if Symphony Orchestra ceases to exist or if the governing board of Community Foundation votes that support of Symphony Orchestra (a) is no longer necessary or (b) is inconsistent with the needs of the community. (That is, Symphony Orchestra explicitly grants variance power to Community Foundation.) The agreement does not permit either organization to appoint members to the other organization’s governing board or otherwise participate in the policymaking processes of the other.

54. Community Foundation would recognize the fair value of the transferred securities as an increase in investments and a liability to Symphony Orchestra because Symphony Orchestra transferred assets to Community Foundation and specified itself as beneficiary (paragraph 17(d)). The transfer is not an equity transaction because Community Foundation and Symphony Orchestra are not
financially interrelated organizations (paragraph 18(b)). Symphony Orchestra is unable to influence the operating or financial decisions of Community Foundation (paragraph 13(a)).

55. Symphony Orchestra would recognize the fair value of the gift of securities from Individual as contribution revenue. When it transfers the securities to Community Foundation, it would recognize the transfer as a decrease in investments and an increase in an asset, for example, as a beneficial interest in assets held by Community Foundation (paragraph 17(d)). Also, Symphony Orchestra would disclose in its financial statements the identity of Community Foundation, the terms under which Community Foundation will distribute amounts to Symphony Orchestra, a description of the variance power granted to Community Foundation, and the aggregate amount reported in the statement of financial position and how that amount is described (paragraph 19).

56. In this example, Symphony Orchestra would recognize an asset and Community Foundation would recognize a liability because the transaction is deemed to be reciprocal (paragraph 96). Symphony Orchestra transfers its securities to Community Foundation in exchange for future distributions. Community Foundation, by its acceptance of the transfer, agrees that at the time of the transfer distributions to Symphony Orchestra are capable of fulfillment and consistent with the foundation’s mission. Although the value of those future distributions may not be commensurate with the value of the securities given up (because Symphony Orchestra is at risk of cessation of the distributions), the transaction is accounted for as though those values are commensurate. In comparison, the donors to Community Foundation in Example 2 explicitly grant variance power to Community Foundation in a nonreciprocal transfer. In that example, it is clear that the donors have made a contribution because they retain no beneficial interests in the transferred assets. Because the donors in Example 2 explicitly grant variance power to Community Foundation, it, rather than City Botanical Society, is the recipient of that contribution.

In this example, the NFP retains the right for future distributions, subject to the Foundations annual spending policy. Though the Foundation retains variance power and can redirect the annual distributions, FAS 136 concluded that the NFP should record an interest equal to the full value of the assets transferred.

As the noted in the previous reference to FAS 136, the beneficiary shall recognize that beneficial interest, measuring and subsequently remeasuring it at fair value, using a valuation technique such as the present value of the estimated expected future cash flows. FAS 136 states that “If the values exchanged are not commensurate, in concept, the transfer is in part a contribution (paragraphs 3 and 51 of Statement 116).” The statement goes on to discuss that, if the entire transfer is considered reciprocal, the not-for-profit may value their interests in the transfer equal to the value of the assets transferred.
FAS 136 states generally that entity would base their value on the expected future cash flows of the asset. In January of 2010 the AICPA issued a “draft” issues paper that defines a number of best practices for valuation. That paper is included in this document as Appendix F and the reader is encouraged to follow its guidance when valuing beneficial interests.

2. **Differentiating Donor Advised Fund contributions from Designated contributions**

Some respondents to the Exposure draft raised the question of whether designated contributions that identify more than one recipient organization might need to be treated as if they were a Donor Advised Fund contribution in order to protect the donor’s charitable contribution deduction. At issue is the fact that the IRS has not to date provided a clear definition of what a “donor designated contribution” in a Federated Fundraising Campaign is and how it must be documented. Rather, in the instructions for preparing IRS Form 990, in its definition of a DAF, indicate the following:

*A donor advised fund does not include any fund or account:*

1. That makes distributions only to a single identified organization or governmental entity...
2. That the Secretary exempts from being treated as a donor advised fund because either such fund or account is advised by a committee not directly or indirectly controlled by the donor or donor advisor or such fund benefits a single identified charitable purpose.

Given this definition, a case can be made that a “donor designated contribution” that identifies more than one recipient organization would likely not qualify under this exclusion from DAF treatment and must be handled as if it were a DAF contribution in order to preserve the donor’s deductibility.

The authors considered whether the IRS intended to extend its definition of a DAF to “donor designated contributions” that are part of a Federated Fundraising Campaign and sought to find a specific reference to such gifts elsewhere in the Form 990 instructions. The authors noted only one such reference (found in the instructions for the Core Form, Part VIII), as follows:

**Line 1a.** Enter on line 1a the total amount of contributions received indirectly from the public through solicitation campaigns conducted by federated fundraising agencies and similar fundraising organizations (such as from a United Way organization). Federated fundraising agencies normally conduct fundraising campaigns within a single metropolitan area or some part of a particular state, and allocate part of the net proceeds to each participating organization on the basis of the donors’ individual designations and other factors.

The authors concluded from this specific reference to “donors’ individual designations” that the IRS considers this type of contribution to be distinctly different from a Donor Advised Fund contribution and therefore, not subject to the DAF rules (see page 12ff, section 8, “Donor Advised Funds”).
### Appendix A - Cumulative Results on Financial Statements:
#### Accounting for Contributions – “T” Account Summary of Transactions

**Statement of Financial Position (Balance Sheet) Accounts**

<table>
<thead>
<tr>
<th>Cash</th>
<th>Contributions Receivable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1c</td>
<td>$9,000</td>
</tr>
<tr>
<td>2c</td>
<td>$1,690,000</td>
</tr>
<tr>
<td>3.2c</td>
<td>$101,000</td>
</tr>
<tr>
<td>4a</td>
<td>$1,500</td>
</tr>
<tr>
<td>5b</td>
<td>$10,000</td>
</tr>
<tr>
<td>7b</td>
<td>$200,000</td>
</tr>
<tr>
<td>8a</td>
<td>$50,000</td>
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<tr>
<td></td>
<td>$2,020,000</td>
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<table>
<thead>
<tr>
<th>Investments</th>
<th>Unamortized Discount on Multi-Year Contributions Receivable</th>
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<tr>
<td>1b</td>
<td>$9,750</td>
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<td>$0</td>
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<table>
<thead>
<tr>
<th>Investments: Charitable Gift Annuity Assets</th>
<th>Beneficial Interest in Remainder Trust</th>
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<tr>
<td>3.1a</td>
<td>$100,000</td>
</tr>
<tr>
<td>3.1c</td>
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<table>
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<th>Beneficial Interest in Annuities</th>
<th>Beneficial Interest in Insurance Policies</th>
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<td>3.2a</td>
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<thead>
<tr>
<th>Liability to Charitable Gift Annuity Beneficiaries</th>
<th>Beneficial Interest in Perpetual Trusts</th>
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<tr>
<td>3.1b</td>
<td>$8,900</td>
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<td></td>
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<table>
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<tr>
<th>Custodial Assets - DAF</th>
<th>Custodial Liabilities - DAF</th>
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<tbody>
<tr>
<td>8b</td>
<td>8c</td>
</tr>
<tr>
<td>$50,000</td>
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## Statement of Activities (Income Statement) Accounts

<table>
<thead>
<tr>
<th>Contribution Revenue (Unrestricted)</th>
<th>Contribution Revenue (Temporarily Restricted)</th>
</tr>
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<tbody>
<tr>
<td>$10,000 1a</td>
<td>$339,430 2a</td>
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<tr>
<td>$60,400 3.1a</td>
<td>$14,050 2b</td>
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<tr>
<td>$1,500 4a</td>
<td>$60,400 3.2a</td>
</tr>
<tr>
<td><strong>$71,900</strong></td>
<td><strong>$50,000 8a</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$463,880</strong></td>
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<table>
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<tr>
<th>Provision for Uncollectible Pledges</th>
<th>Contribution Revenue (Permanently Restricted)</th>
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<tbody>
<tr>
<td>1b $250</td>
<td>$200,000 5a</td>
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<tr>
<td></td>
<td>$916,000 7a</td>
</tr>
<tr>
<td></td>
<td>$27,500 7c</td>
</tr>
<tr>
<td></td>
<td><strong>$1,143,500</strong></td>
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<table>
<thead>
<tr>
<th>Income from Perpetual Trusts</th>
<th>Realized &lt;Gain&gt;/Loss on Investments</th>
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<tbody>
<tr>
<td>$10,000 5b</td>
<td>$9,110 3.1c</td>
</tr>
<tr>
<td>1c $250</td>
<td>$1,600 3.1d</td>
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<tr>
<td>3.1d $1,500</td>
<td><strong>$7,260</strong></td>
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<tr>
<th>Realized &amp; Unrealized &lt;Gain&gt;/Loss Beneficial Interests</th>
<th>Realized &amp; Unrealized &lt;Gain&gt;/Loss on Insurance Policies</th>
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<tr>
<td>$7,500 3.2b</td>
<td>$75 4c</td>
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<td>$2,000 3.2c</td>
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<td><strong>$9,500</strong></td>
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<table>
<thead>
<tr>
<th>Net Assets Released from Restriction (Unrestricted)</th>
<th>Net Assets Released from Restriction (Temp Restricted)</th>
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<tbody>
<tr>
<td>$1,700,000 2d</td>
<td>$1,700,000</td>
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<tr>
<td>$99,000 3.2d</td>
<td>$99,000</td>
</tr>
<tr>
<td><strong>$50,000 8d</strong></td>
<td><strong>$50,000</strong></td>
</tr>
<tr>
<td><strong>$1,849,000</strong></td>
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<table>
<thead>
<tr>
<th>Investment Fees</th>
<th>Designations - DAF</th>
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<td>1c $500</td>
<td>8e $40,000</td>
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<table>
<thead>
<tr>
<th>Change in Value of Split Interest Agreements (Unrestricted)</th>
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</thead>
<tbody>
<tr>
<td>2c $10,000</td>
</tr>
</tbody>
</table>
 Accounting for Contributions – Financial Statement Summary of Transactions

Statement of Financial Position

Cash = $2,020,000
Contributions Receivable = $800,000
Less: Unamortized discount on Rec. = <$56,500>
Investments: Charitable Gift Annuities = $100,210
Beneficial Interest in Remainder Trust = $353,480
Beneficial Interest in Insurance Policies = $1,575
Beneficial Interest in Perpetual Trusts = $200,000
Beneficial Interest in Annuities = $67,900
Less: Liability to Annuity Beneficiaries = <$32,300>
Total Assets = $3,454,365

Unrestricted Net Assets = $1,986,975
Temporarily Restricted Net Assets = $413,880
Permanently Restricted Net Assets = $1,143,500
Total Net Assets = $3,454,365
### Income Statement:

<table>
<thead>
<tr>
<th></th>
<th>Unrestricted</th>
<th>Temp. Rest.</th>
<th>Perm. Rest.</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution Revenue</td>
<td>$121,900</td>
<td>$413,880</td>
<td>$1,143,500</td>
<td>$1,679,280</td>
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<tr>
<td>Less: Provision for</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Uncollectible Pledges</td>
<td>&lt;$250&gt;</td>
<td>$0</td>
<td>$0</td>
<td>&lt;$250&gt;</td>
</tr>
<tr>
<td>Net Contribution Revenue</td>
<td>$121,650</td>
<td>$413,880</td>
<td>$1,143,500</td>
<td>$1,679,030</td>
</tr>
<tr>
<td>Income from Perpetual Trusts</td>
<td>$10,000</td>
<td>$0</td>
<td>$0</td>
<td>$10,000</td>
</tr>
<tr>
<td>Realized Gain on Investments</td>
<td>$7,260</td>
<td>$0</td>
<td>$0</td>
<td>$7,260</td>
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<tr>
<td>Realized Gain on Beneficial Int.</td>
<td>$9,500</td>
<td>$0</td>
<td>$0</td>
<td>$9,500</td>
</tr>
<tr>
<td>Realized Gain on Life Ins Policies</td>
<td>$75</td>
<td>$0</td>
<td>$0</td>
<td>$75</td>
</tr>
<tr>
<td>Net Assets Released from Rest.</td>
<td>$1,799,000</td>
<td>&lt;$1,799,000&gt;</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Net Revenue</td>
<td>$1,947,485</td>
<td>&lt;$1,385,120&gt;</td>
<td>$1,143,500</td>
<td>$1,705,865</td>
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<tr>
<td>Grants Expense – DAF</td>
<td>&lt;$40,000&gt;</td>
<td>$0</td>
<td>$0</td>
<td>&lt;$40,000&gt;</td>
</tr>
<tr>
<td>Change in Value of Split-Interest</td>
<td>&lt;$10,000&gt;</td>
<td>$0</td>
<td>$0</td>
<td>&lt;$10,000&gt;</td>
</tr>
<tr>
<td>Investment Fee Expense</td>
<td>&lt;$500&gt;</td>
<td>$0</td>
<td>$0</td>
<td>&lt;$500&gt;</td>
</tr>
<tr>
<td>Net Surplus (Income)</td>
<td>$1,896,985</td>
<td>&lt;$1,385,120&gt;</td>
<td>$1,143,500</td>
<td>$1,655,365</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Beginning of the Year</th>
<th>End of the Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Assets -</td>
<td>$0</td>
<td>$1,799,000</td>
</tr>
<tr>
<td>Net Assets -</td>
<td>$1,896,985</td>
<td>$413,880</td>
</tr>
</tbody>
</table>
Appendix B - Donor Life Insurance Contracts (additional examples)

1. **Donor Contributes Paid Up Policy**

**Scenario:** Mr & Mrs John Smith are passionate supporters of United Way in their mid-50’s. Their children are established and have successful careers. After a discussion with United Way staff the Smiths decided that they want to make a meaningful gift to United Way. After meeting with their estate planner, the Smiths decided that giving an existing $500,000 face value paid up life insurance policy with $125,000 in cash surrender value would work best for their specific situation. Having grown children, the Smiths felt they no longer needed the “safety net” the policy was meant to provide for their family. In the next year, the cash surrender value increased $8,750 to $133,750.

**Summary:** Donor contributes a fully paid policy and designates United Way as the owner and beneficiary

- **Debit** Cash Surrender Value of Life Ins. Contracts $125,000
- **Credit** Contribution Revenue $125,000
  (to record contribution of fully paid life insurance contract*)

- **Debit** Cash Surrender Value of Life Ins. Contracts $8,750
- **Credit** Realized Gain on Life Insurance $8,750
  (to record annual increase in value of fully paid life insurance contract**)

2. **Donor Contributes Existing Policy with Remaining Premiums to be Paid by United Way**

**Scenario:** Tom and Rita Jones, both in their 70’s, have supported United Way over the past 55 years, gave at the Tocqueville level until retirement and are now giving $6,000 annually. Recently, their only son was killed in an automobile accident. Tom and Rita both want to create a meaningful gift in his memory. After consulting with their estate planner, they decided to donate an existing $1,000,000 face value insurance policy on Tom’s life to United Way with 5 annual premiums of $15,000 remaining to be paid. The policy has current cash surrender value of $45,000.

**Summary:** Donor contributes an existing policy and United Way pays remaining premiums due.

- **Debit** Cash Surrender Value of Life Ins. Contracts $45,000
- **Credit** Contribution Revenue $45,000

---

* According to FASB Technical Bulletin No. 85-4 premiums paid for a life insurance policy consist of two portions, one for insurance expense for the period applicable to the insurer’s assumption of risk and the other for cash surrender value. Additionally, FASB Interpretation No. 39 indicates that cash surrender value is usually presented under long-term investments. However, if the policy will be cashed in within the next year, the cash surrender value will be reported under current assets.

** According to FASB ASC 325-30-35-1 an asset representing an investment in a life insurance contract shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position… the death benefit shall not be realized before the actual death of the insured…
United Way has agreed to pay the five remaining premiums on the policy, and will be setting up a fund in memory of the son with the proceeds from the death benefit when it is paid. Assuming the premium is $15,000 of which the insurance company uses $5,000 for the cost of insurance, the UW makes the following entry in each of the next five years:

\[
\begin{align*}
\text{[Debit]} & \quad \text{Insurance Expense} & \quad $5,000 \\
\text{[Debit]} & \quad \text{Cash Surrender Value of Life Ins. Contracts} & \quad $10,000 \\
\text{[Credit]} & \quad \text{Cash} & \quad $15,000 \\
\end{align*}
\]

(to record subsequent payment of insurance premiums by United Way*)

In the years following the payment of the final premium, assuming the cash surrender value of the policy increases by $12,000 per year, the UW makes the following entry each year:

\[
\begin{align*}
\text{[Debit]} & \quad \text{Cash Surrender Value of Life Ins. Contracts} & \quad $12,000 \\
\text{[Credit]} & \quad \text{Realized Gain on Life Insurance} & \quad $12,000 \\
\end{align*}
\]

(to record annual increase in value of fully paid life insurance contract**)

3. **Donor Donates Policy for United Way to Cash Out**

**Scenario:** Norman Peachtree, age 48, has served on United Way allocation teams for the last 5 years. In a recent meeting with his financial adviser, Norman was advised that he may be over-insured and might not need a $100,000 policy he took out in his 20’s. His adviser recommended Norman cash out the policy and pays applicable taxes or gives the policy to charity. It currently has a cash surrender value of $25,000. Norman would like to give it to United Way and does not object to the UW cashing out the policy to create a long term funding mechanism for to a cause he cares greatly about, working with abused children.

**Summary:** Donor contributes a partially paid policy, designates United Way as the owner and beneficiary, and United Way opts to cash out policy rather than pay future premiums.

\[
\begin{align*}
\text{[Debit]} & \quad \text{Cash Surrender Value of Life Ins. Contracts} & \quad $25,000 \\
\text{[Credit]} & \quad \text{Contribution Revenue} & \quad $25,000 \\
\end{align*}
\]

(to record contribution of partially paid life insurance contract*)

\[
\begin{align*}
\text{[Debit]} & \quad \text{Cash} & \quad $25,000 \\
\text{[Credit]} & \quad \text{Cash Surrender Value of Life Ins. Contracts} & \quad $25,000 \\
\end{align*}
\]

(to record Life Insurance Contract surrendered for cash)

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* According to FASB Technical Bulletin No. 85-4 premiums paid for a life insurance policy consist of two portions, one for insurance expense for the period applicable to the insurer’s assumption of risk and the other for cash surrender value. Additionally, FASB Interpretation No. 39 indicates that cash surrender value is usually presented under long-term investments. However, if the policy will be cashed in within the next year, the cash surrender value will be reported under current assets.

** According to FASB ASC 325-30-35-1 an asset representing an investment in a life insurance contract shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position… the death benefit shall not be realized before the actual death of the insured…
[Debit] Board Designated Net Assets – Children’s Fund $  25,000  
[Credit] Investments – Children’s Fund $  25,000  
(to record board established Fund for Abused Children’s programs)

4. New life insurance policy owned by and benefitting United Way

Scenario: Betty Mahon is a high-level executive at ABC Corporation and is a Tocqueville Society member. She and her husband Tom are both in their mid-40’s. She recently was asked by a coworker accompanied by UW Major Gift staff to consider participating in United Way Life™. After receiving the quote, Betty and Tom have decided to use United Way Life. United Way will be the owners and beneficiary of the $250,000 life insurance policy with 5 annual insurance premium payments of $5,000. Betty and Tom will increase their annual $10,000 Tocqueville gift to $15,000, will be recognized in the United Way campaign at the $15,000 Tocqueville recognition level, and will become a member of the Tocqueville Legacy Circle. Their $15,000 will be credited to ABC Corporation’s annual campaign and $15,000 will be credited to United Ways annual campaign. Betty and Tom intend (but do not formally pledge) to continue to give at this higher level for at least five years, enabling United Way to have the resources to pay the 5 annual premium payments on the policy.

Summary: United Way purchases a policy on a donor’s life, names itself as beneficiary, and makes all the premium payments themselves. Assuming the insurance company uses $3,000 of the premium the first year for the cost of life insurance and fees then in the other years uses $1,500 for the cost of insurance, the UW makes the following entries:

In the first year the UW records:

[Debit] Cash $ 15,000  
[Credit] Contribution Revenue $ 15,000  
(to record annual contribution at Tocqueville Level)

[Debit] Insurance Expense $ 3,000  
[Debit] Cash Surrender Value of Life Ins. Contracts $ 2,000  
[Credit] Cash $ 5,000  
(to record purchase of insurance policy by United Way in the first year*)

In the following four years the UW records:

[Debit] Cash $ 15,000  
[Credit] Contribution Revenue $ 15,000  
(to record annual contribution at Tocqueville Level)

* According to FASB Technical Bulletin No. 85-4 premiums paid for a life insurance policy consist of two portions, one for insurance expense for the period applicable to the insurer’s assumption of risk and the other for cash surrender value. Additionally, FASB Interpretation No. 39 indicates that cash surrender value is usually presented under long-term investments. However, if the policy will be cashed in within the next year, the cash surrender value will be reported under current assets.

** According to FASB ASC 325-30-35-1 an asset representing an investment in a life insurance contract shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position… the death benefit shall not be realized before the actual death of the insured…
[Debit] Insurance Expense $ 1,500
[Debit] Cash Surrender Value of Life Ins. Contracts $ 3,500
[Credit] Cash $ 5,000
(to record subsequent payment of insurance premiums by United Way the remaining 4 years*)

In years six and following (assuming donors continue to give an ADT level and annual cash surrender value increases at a rate of $2,500 per year):

[Debit] Cash $ 15,000
[Credit] Contribution Revenue $ 15,000
(to record annual contribution at Tocqueville Level)

[Debit] Cash Surrender Value of Life Ins. Contracts $ 2,500
[Credit] Realized Gain on Life Insurance $ 2,500
(to record annual increase in value of fully paid life insurance contract**)

5. One-time Payment on a new life insurance policy owned by and benefitting United Way

Scenario: Same as Example #4, except Betty Mahon and Tom elect to transfer $22,000 in preferred company stock in one lump sum to pay for the 5 annual premiums

Summary: Same as Example #4 but in addition, donor contributes funds up front sufficient to pay all future premiums and earmarked for payment of premiums. Assuming the insurance company uses $3,000 of the premium the first year for the cost of life insurance and fees then in the other years uses $1,500 for the cost of insurance, the UW makes the following entries:

In the first year the UW records:

[Debit] Cash $ 10,000
[Debit] Investments – Preferred Stock $ 22,000
[Credit] Contribution Revenue – Temp. Restricted $ 22,000
[Credit] Contribution Revenue – Unrestricted $ 10,000
(to record contribution received, earmarked for payment of insurance premiums)

[Debit] Cash $ 5,000
[Credit] Investments – Preferred Stock $ 5,000
(to record sale of a portion of Preferred Stock to pay current year insurance premiums)

* According to FASB Technical Bulletin No. 85-4 premiums paid for a life insurance policy consist of two portions, one for insurance expense for the period applicable to the insurer’s assumption of risk and the other for cash surrender value. Additionally, FASB Interpretation No. 39 indicates that cash surrender value is usually presented under long-term investments. However, if the policy will be cashed in within the next year, the cash surrender value will be reported under current assets.

** According to FASB ASC 325-30-35-1 an asset representing an investment in a life insurance contract shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position… the death benefit shall not be realized before the actual death of the insured…
[Debit] Insurance Expense $3,000
[Debit] Cash Surrender Value of Life Ins. Contracts $2,000
[Credit] Cash $5,000
(to record purchase of insurance policy by United Way in the first year*)

[Debit] Temp. Restricted Net Assets $5,000
[Credit] Unrestricted Net Assets $5,000
(To release assets from restriction, purpose restriction has been met)

In the following four years the UW records (assuming preferred stock appreciates by $3,000 over the four years and it is recorded as an increase in Temp. Restricted Net Assets):

[Debit] Cash $10,000
[Credit] Contribution Revenue $10,000
(to record annual contribution at Tocqueville Level)

[Debit] Insurance Expense $1,500
[Debit] Cash Surrender Value of Life Ins. Contracts $3,500
[Credit] Cash $5,000
(to record subsequent payment of insurance premiums by United Way the remaining 4 years*)

[Debit] Cash $5,000
[Credit] Investments – Preferred Stock $5,000
(to record sale of a portion of Preferred Stock to pay current year insurance premiums)

[Debit] Temp. Restricted Net Assets $5,000
[Credit] Unrestricted Net Assets $5,000
(To release assets from restriction, purpose restriction has been met)

In years six and following (assuming donors continue to give an ADT level and annual cash surrender value increases at a rate of $2,500 per year):

[Debit] Cash $10,000
[Credit] Contribution Revenue $10,000
(to record annual contribution at Tocqueville Level)

[Debit] Cash Surrender Value of Life Ins. Contracts $2,500
[Credit] Realized Gain on Life Insurance $2,500
(to record annual increase in value of fully paid life insurance contract**)

* According to FASB Technical Bulletin No. 85-4 premiums paid for a life insurance policy consist of two portions, one for insurance expense for the period applicable to the insurer’s assumption of risk and the other for cash surrender value. Additionally, FASB Interpretation No. 39 indicates that cash surrender value is usually presented under long-term investments. However, if the policy will be cashed in within the next year, the cash surrender value will be reported under current assets.

** According to FASB ASC 325-30-35-1 an asset representing an investment in a life insurance contract shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position… the death benefit shall not be realized before the actual death of the insured…
6. New life insurance policy owned by and benefitting United Way with longer payment periods

Scenario: Same as Example #4, but Betty and Tom elect to pay the premiums over 10 years instead of 5 so the annual premium over 10 years will be $3,000 per year instead of $5,000 so their annual contributions will be $13,000.

Summary: Same as Example #4 but in addition donor pledges to contribute funds over time sufficient to pay all future premiums.

Assuming the insurance company uses $3,000 of the premium the first year for the cost of life insurance and fees then in the other years uses $1,500 for the cost of insurance, the UW makes the following entries:

In the first year the UW records:

[Debit] Cash $ 13,000
[Credit] Contribution Revenue – Unrestricted $ 13,000
(to record first contribution received, partially earmarked for payment of insurance premiums)

[Debit] Insurance Expense $ 3,000
[Credit] Cash $ 3,000
(to record purchase of insurance policy by United Way*)

In years two through ten:

[Debit] Cash $ 13,000
[Credit] Contribution Revenue – Unrestricted $ 13,000
(to record subsequent contributions received, earmarked for payment of insurance premiums)

[Debit] Insurance Expense $ 1,500
[Debit] Cash Surrender Value of Life Ins. Contracts $ 1,500
[Credit] Cash $ 3,000
(to record subsequent payments of insurance premiums by United Way*)

* According to FASB Technical Bulletin No. 85-4 premiums paid for a life insurance policy consist of two portions, one for insurance expense for the period applicable to the insurer's assumption of risk and the other for cash surrender value. Additionally, FASB Interpretation No. 39 indicates that cash surrender value is usually presented under long-term investments. However, if the policy will be cashed in within the next year, the cash surrender value will be reported under current assets.

** According to FASB ASC 325-30-35-1 an asset representing an investment in a life insurance contract shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position... the death benefit shall not be realized before the actual death of the insured...
In years eleven and following (assuming donors continue to give an ADT level and annual cash surrender value increases at a rate of $2,500 per year):

[Debit]  Cash       $ 13,000
[Credit] Contribution Revenue    $ 13,000
(to record annual contribution at Tocqueville Level)

[Debit]  Cash Surrender Value of Life Ins. Contracts  $ 2,500
[Credit] Realized Gain on Life Insurance $ 2,500
(to record annual increase in value of fully paid life insurance contract**)
Appendix C – Overview of Planned Giving Vehicles

Building Blocks for a Stronger Community

- Will
- IRA
- Retirement Plan
- Life Insurance Beneficiary
- Living Trust

- Outright Gift
- Pooled Income Fund
- Life Insurance
- Gift Annuity

- Annuity Trust
- Life Estate
- Unitrust
- Lead Trust
Giving Through Your Will or Living Trust

Donor

Family

WILL

Explanation

Charitable bequests are the “backbone” of planned giving programs and the most common form of planned gift. Bequests can be made for: (1) a specific amount (2) a percent of the estate (3) the residue left in the estate after completing provisions for family and others (4) or a bequest that is contingent on specific circumstances.

To make a bequest a donor meets with an attorney to draw up a will or living trust. At death, property is distributed according to the wishes of the donor. A donor can amend an existing will to include a bequest through the use of a simple document known as a codicil.
Charitable Gift Annuity

Explanation
A charitable gift annuity is a simple contract between the donor and United Way. The donor reviews the contract with his/her advisors. The donor then signs the contract, makes a gift, and United Way agrees to pay the donor and/or other income beneficiary a fixed annuity income for life. Since many states regulate charitable gift annuities, United Way should be familiar with the state laws before starting a charitable gift annuity program. (NOTE: United Way of America has established a National Charitable Gift Annuity Program which is designed to support the efforts of local United Way organizations.)
Deferred Gift Annuity

**Explanation**

A deferred charitable gift annuity is a simple contract between the donor and United Way. The donor discusses the contract with his/her advisors. The donor then signs the contract, makes a gift, and United Way agrees to pay the donor and/or other income beneficiary a fixed annuity income to commence on a "deferred" date indicated by the donor. Once started, the income is a fixed annuity over the donor and/or other beneficiary’s lifetime. Since many states regulate deferred charitable gift annuities, United Way should be familiar with state laws before starting a deferred charitable gift annuity program. (NOTE: United Way of America has established a National Charitable Gift Annuity Program which is designed to support the efforts of local United Way organizations.)
The pooled income fund is a form of charitable remainder trust involving multiple donors. A donor makes a gift to one “trust” which is then pooled with gifts from other donors. The donor and/or other named income beneficiary receives an income from the trust annually, proportional to his/her share of the pooled income fund. When the donor, or last of the named income beneficiaries dies, the donor’s share of the fund (remainder amount) is “severed” and given to United Way. The fund continues to accept gifts and distribute income for living donors.

The donor should first review the plan, the disclosure statement, and gift agreement with his/her advisors. The donor then signs the agreement and transfers the gift to the pooled income fund.

When donor “A” dies, his/her share is severed from the pooled income fund and given to United Way. The fund continues to operate for donors “B” and “C” and continues to accept additional gifts.
A charitable remainder trust is so named because the amount remaining when the trust terminates goes to charity. To make a gift, a donor reviews the plan and various percentage payout options with his/her advisors. A legal charitable remainder trust is created and the donor makes an irrevocable gift to the trust. In return, the donor and/or named beneficiaries receive an income from the trust. The income can be paid: (1) over one life, (2) several lives, (3) a fixed number of years, (4) or one life and a number of years. When the trust terminates, the amount remaining in the trust goes to United Way.

**Types of Charitable Remainder Trusts**

**Unitrust**

A Unitrust pays out an income based upon a fixed percent of the trust principal recalculated each year. As the principal goes up, so does the income. For example, a 7% unitrust would pay $7,000 on a principal of $100,000 (7% x $100,000) in year one. If the trust’s principal goes up to $140,000 the next year, the income paid would be $9,800 (7% x $140,000). The unitrust can continue to receive additional contributions.

**Annuity Trust**

An annuity trust is another form of charitable remainder trust. However, the income pay out calculated in the first year is fixed and does not change as the principal grows. For example, a 7% annuity trust would pay $7,000 on a principal of $100,000 in the first year. If the trust’s principal grew to $140,000 in year two, the annuity trust would still pay $7,000. The annuity trust does not accept additional contributions.
Wealth Replacement Trust

Explanation

The so called “wealth replacement trust” is used in conjunction with a charitable remainder trust to “replace” for the family what was given away to charity. By talking to his/her advisors, donors may find a gift to a unitrust produces tax savings and extra income sufficient to purchase a life insurance policy to replace what was given away (placed in the unitrust). The life insurance is owned by a life insurance trust outside the donor’s estate. When the donor dies, the amount within the charitable remainder trust is given to United Way; the death benefit from life insurance goes to family through the life insurance trust.
Charitable Lead Trust

Explanation

A lead trust works similar to a charitable remainder trust except that the income first goes to United Way and the remainder amount goes to the beneficiaries named by the donor (typically grandchildren) when the trust dissolves. The trust can be established for a fixed number of years or the life or lives of an individual(s). A lead trust can pay a fixed amount or a percentage of the trust recalculated each year.
Retained Life Estate

Explaination

A donor decides to give his/her house to United Way but retains the right to live in the house over his/her lifetime. By talking to his/her advisors, a donor may find an irrevocable retained life estate agreement has significant tax benefits over making a similar gift to United Way through a will.

The donor gets continued use of the house but must pay all maintenance costs and taxes. At his/her death, United Way receives the house to use or sell.
Life Insurance

Explanation

There are situations where donors may utilize life insurance to accomplish their philanthropy objectives. One technique enables a donor to a) create a future commitment that will endow their gift; b) leverage the gift from their current income or assets; and c) receive a charitable deduction.

This is how it works:

1. The donor applies for a policy naming United Way as the owner and beneficiary;
2. In addition to the donor’s annual gift, an additional unrestricted gift is made to United Way of sufficient size to cover the annual premiums;
3. The donor receives an income tax deduction for the total amount contributed;
4. United Way pays the annual premiums;
5. At the demise of the donor(s), United Way receives the death benefit.

NOTE: Both the donor and United Way should have qualified independent professional review to assess if the life insurance product selected is appropriate. Be cautious of life insurance programs that promise “something for nothing.” Often they produce sizable profits for promoters with minimal and/or uncertain benefits for United Way.
You have asked for guidance on the tax rules that apply to donor advised funds to assist local United Way organizations in structuring their “Philanthropic Funds” or “P-Funds.”

I. Background

As part of the United Way’s annual campaign, local United Way organizations may accept gifts that are designated for payment to another charity, such as a United Way located in another community, a United Way member agency, or a non-United Way agency. Generally, to be eligible to receive designated gifts, a non-United Way agency must be a Section 501(c)(3) organization providing health and human services. Typically, a local United Way that receives a designated gift will issue an acknowledgment letter to the donor, even though the gift is designated for payment to another charity.1 Recently, a number of local United Way organizations began offering donors the option of making contributions to funds, commonly called “Philanthropic Funds” or “P-Funds,” that permit the donors to delay designating recipient organizations for a period of time, typically up to one year. Any funds that remain undesignated at the end of the time period are transferred to the United Way’s local community fund.

II. Recent Changes in Tax Law

The Pension Protection Act of 2006 amended the Internal Revenue Code (the “Code”) to provide new rules for donor advised funds and the charities that maintain them. The Code defines a “donor advised fund” as a fund or account that is (1) owned or controlled by a sponsoring organization, (2) separately identified by reference to contributions of a donor or donors, and (3) with respect to which the donor or a person designated by the donor (donor advisor) has or reasonably expects to have advisory privileges with respect to the distribution or investment of the assets in the fund. Among other changes, the new rules provide that a donor may not claim a charitable deduction for

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a contribution to a donor advised fund unless the donor obtains an acknowledgement from the sponsoring charity confirming that the charity has exclusive legal control over the assets contributed. In addition, the new rules impose excise taxes on sponsoring charities, their managers, and/or donor advisors in the case of certain prohibited distributions. Prohibited distributions include any distribution (i) to an individual, (ii) for non-charitable purposes, (iii) to a private non-operating foundation or “disqualified supporting organization” as defined in the Code unless the sponsoring charity complies with special recordkeeping and reporting requirements, or (iv) that provides a more than incidental benefit to a donor, a donor advisor, or a related person. Finally, the new rules impose additional Form 990 reporting requirements on sponsoring charities.

III. Legal Implications for the Operation of P-Funds

Local United Ways need to be mindful of the donor advised fund rules in structuring their P-Funds. As described below, too much donor control will delay the donor’s tax deduction.

A. Donor Advised Funds. For a P-Fund to qualify as a “donor advised fund” and for a donor is to be eligible for a tax deduction at the time of a transfer to a P-Fund, the sponsoring United Way must have exclusive ownership and control of the assets in the P-Fund. A donor to a P-Fund may have only advisory privileges with regard to distributions from the P-Fund. To achieve this result, all marketing and solicitation materials and any agreements with donors should state consistently that a donor may make nonbinding recommendations as to the timing, amount, and recipient of any distributions, but has no right to direct such distributions. Such materials and agreements also should state that the United Way will approve distributions only for charitable purposes and will not approve distributions that result in a more than incidental benefit to the donor or persons related to the donor.

B. Donor Directed Funds. By contrast, if the United Way permits a donor to retain control over assets donated to a P-Fund (for example, if the donor has the right to direct future distributions), the P-Fund will not qualify as a donor advised fund. The donor will not be eligible to claim a charitable contribution deduction at the time of the initial transfer to the P-Fund because the donor has not relinquished control. Instead, the donor will be eligible to claim a deduction only when the funds ultimately are distributed from the P-Fund to the recipient charity (or transferred to the local community fund). If the initial transfer to the P-Fund and the distribution to the recipient charity (or local community fund) occur within the same calendar year, the timing of the donor’s deduction will be the same. On the other hand, if the donor transfers funds to a P-Fund in December and the funds are not actually distributed to a designated recipient until the following May, the charitable contribution for tax purposes will occur in May, not December. For some donors making year-end gifts, this may be an undesirable result.

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2 Similarly, donors should complete “grant recommendation” forms.
3 For example, a distribution from a P-Fund may not satisfy a personal pledge.
4 Examples of language that suggests that a donor retains control include the following: “distribute your funds in way you desire over the course of the calendar year” and “make disbursements quickly and easily from your account.”

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IV.  Rules Applicable to P-Funds that Qualify as Donor Advised Funds

If the P-Funds qualify as donor advised funds, then the following requirements apply to the sponsoring United Way:

   A.  **Written Acknowledgment Must Include Control Language.**  For donors to be eligible to claim a charitable contribution for a contribution to P-Funds, the sponsoring United Way must confirm in its acknowledgment letter that it has exclusive legal control over the assets contributed to the P-Fund.

   B.  **United Way Must Verify Public Charity Status of Grantees.**  Before making a grant from a P-Fund, the sponsoring United Way must verify that the grantee is a U.S. public charity (other than a disqualified supporting organization) or U.S. private operating foundation, as defined by the Code.  If not, special recordkeeping and reporting requirements will apply.

   C.  **Grant Letter Should Require Use of Funds for Charitable Purposes.**  The grant distribution letter should specify that the grant must be used for charitable purposes and may not benefit any specific individual or fulfill a personal pledge.  If the letter identifies the donor who recommended the grant, the letter should instruct the grantee not to issue a tax substantiation letter (this is to prevent the donor from deducting the same contribution twice).

   D.  **Form 990 Reporting.**  The sponsoring United Way must report on its IRS Form 990 certain information about the donor advised funds it maintains.  The Form 990 includes specific questions relating to the requirements of exclusive legal control and no impermissible private benefit.

* * *

Local United Ways that wish to offer their donors the flexibility to make an up-front, tax-deductible charitable contribution and then advise on future grants should be careful to structure their programs to comply with the new tax rules relating to donor advised funds.  By following the guidelines in Sections III.A. and IV., above, local United Ways can help protect themselves and their donors from unintended and potentially adverse tax consequences.

* * *

IRS Circular 230 Disclosure:  To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.
Appendix E – Establishing a properly designed Donor Advised Fund

Sample #1: PHILANTHROPY ACCOUNTS

Overview & Guidelines

What is a Philanthropy Account?
At United Way of ______________ (United Way) we have a special personal giving program for those individuals who make a pledge of at least $________. Your personal Philanthropy Account allows you to consolidate your overall charitable giving into one account and recommend distributions to charitable organizations over the course of the calendar year. This service is provided free of charge to our leadership donors, but we do suggest a ___% contribution to United Way’s Community Impact Fund as part of your philanthropy.

These Philanthropy Account Guidelines describe the philanthropy fund program of United Way, as well as important policies, procedures, and benefits associated with establishing and maintaining a Philanthropy Account. All activities of United Way's Philanthropy Account program are subject to the terms and conditions of this document. United Way reserves the right to modify the program at any time as IRS and regulatory changes may require or the United Way prescribes from time to time.

You may establish a Philanthropy Account by completing a Donor Advised Fund Agreement form and providing an initial contribution of a minimum of $_______. Once United Way accepts your contribution, it is irrevocable and is owned and held by United Way. Your Philanthropy Account held at United Way is classified as a Donor Advised Fund (by Internal Revenue Code) and as such, contributions to United Way, through this fund are irrevocable and are immediately tax deductible to the fullest extent under the law.

**Philanthropy Account contributions are not refundable.** Any balance remaining on the account at the end of the calendar year (December 31st) will be transferred to United Way’s Community Impact Fund. In the event of the death of a donor(s), all remaining funds will be transferred to United Way’s Community Impact Fund.

Benefits:
- Personalized service: there is a dedicated Philanthropy Account Manager, a full-time staff person, who provides the day-to-day administration of all Philanthropy Accounts at United Way.
- Ease of advising and recommending gift distributions using your personalized “PIN” number; simply by notifying the United Way by telephone, e-mail, fax, postal mail or on the United Way website.
- Quarterly statements are provided plus a complete year-end statement showing all distributions made to date for easy recordkeeping.
- Easy payment options including payroll deduction, credit cards, checks, securities and monthly billing.
- A confirmation letter for each distribution made will be sent to you. It will indicate the check number, date of the check, amount, agency name and any special instructions that you may have requested.
- A distribution package will be mailed to you every January.
Program Basics:
- Recommendations on distributions must be a minimum of $____.
- United Way verifies that the receiving organization is a qualified 501(c) 3 according to the IRS Tax Code laws.
- Within 7 -10 business days of the receipt of your recommendation (assuming the recommendation meets the legal and administrative requirements set forth below), a payment will be released to recommended organization, with notification sent to you and the recipient organization.

   Additionally, we will send you quarterly statements of your account activities in early April, July and October. In late January, you will receive a complete record of your account for the previous calendar year.

Distributions, Restrictions and Confirmation:
As a donor, you may recommend distributions from your Philanthropy Account to qualified charitable organizations. These are organizations described in Internal Revenue Code (IRC) section 501(c)(3) to which contributions are tax deductible and that qualify as public charities within IRC section 170(B)(1)(A).

Recommendations shall be submitted to United Way via United Way's online website, e-mail, fax, voicemail or mail of a completed Philanthropy Account Distribution Request Form. Once approved by the Philanthropy Account Manager, the proceeds will be disbursed to the recommended organization. In the event that a recommended distribution cannot be approved, United Way will notify you within 10 business days from the date the recommendation is received.

Below are the exceptions for which United Way can not process your recommended distribution.
1. Distributions may not be used to pay any legally binding pledge or to provide any private benefit (such as school tuition or scholarships sent directly to individuals, dues, membership fees, benefit tickets, or goods bought at charitable auctions).
2. For charitable events, distributions are not permitted to purchase goods/services or fees (i.e., purchase of tickets, fees to play golf in a tournament), only the charitable portion going to the organization is permitted (per IRS regulation).
3. Distributions may not be used for political contributions or to support political campaign activities.
4. United Way must make distribution checks payable to the recipient organization's legal name, which may be different from the common use name, and must mail each check to the organization's official address.
5. Distributions to educational organizations outside of the state of ______________ are limited to scholarship funds and educational foundations.
6. Donations to religious organizations are limited to social service agencies and general fund drives only (i.e.: Catholic Charities Fund Appeal, Jewish Federation, etc.). Gifts to individual places of worship are not eligible.

Contact Us:
For more information about the Philanthropy Account, please contact:

_______________________________________
Phone: (___) _____________
E-mail: _________________________________
Sample #2  Philanthropy Fund
Overview & Guidelines

These Philanthropy Fund Guidelines describe the philanthropy fund program of United Way of __________, as well as important policies, procedures, and benefits associated with establishing and maintaining a Philanthropy Fund. All activities of United Way’s Philanthropy Fund program are subject to the terms and conditions of this document. United Way reserves the right to modify the program at any time.

United Way of ___________ (“United Way”) is classified as a public charity under the Internal Revenue Code. The Philanthropy Fund is classified as a Donor Advised Fund and as such, contributions to United Way, through this fund are irrevocable and are immediately tax-deductible to the fullest extent under the law. United Way’s Philanthropy Fund is a charitable vehicle that offers individuals and families the flexibility to make charitable recommendations on their own timetable – now, next year, or whenever they are ready. As a member of the United Way Philanthropy fund program, you have the opportunity to:

- Make charitable contributions to the United Way of cash or securities;
- Receive an immediate federal income tax deduction up to the maximum allowed by law for contributions to public charities;
- Recommend distributions to charitable organizations anywhere in the United States, on your own timetable. (Distributions are subject to approval by United Way.)

Establishing a Philanthropy Fund

Eligible Donors
Individuals, families, trusts, and foundations are all eligible to open Philanthropy Fund accounts.

To Open an Account
You may establish a Philanthropy Fund by completing a Letter of Agreement and providing an initial irrevocable contribution of a minimum of $_________. For every contribution received for your Philanthropy Fund, a minimum of $______ (or any higher amount as instructed by the donor) will be given to United Way’s Local Community Fund to be used in making a positive and lasting impact in our community.

Contributions
You may contribute cash, mutual fund shares, stocks, bonds and other securities. Contributions of securities will be sold as soon as possible with the proceeds added to your Philanthropy fund.

Contributions are irrevocable
Once United Way accepts a contribution, it is irrevocable and is owned and held by United Way. Philanthropy fund contributions are not refundable. Any balance remaining on the account at the end of your term, which varies depending on the date your contribution is made, will be transferred to United Way’s Local Community Fund. In the event of the death of the donor(s), all remaining funds will be transferred to United Way’s Local Community Fund.

Account Communication and Updates
Once your contribution has been made, United Way staff will inform you when the term ends. All Philanthropy Fund donors receive notice at least one month prior to the end of their term. This notice will notify you of the balance in your Fund and the deadline to make recommendations prior to the funds transferring to United Way’s Local Community Fund.
Making Distributions to Charitable Organizations

Distribution recommendations by the donor(s)
As a donor, you may recommend distributions from your Philanthropy Fund account to qualified charitable organizations. These are organizations described in Internal Revenue Code (IRC) section 501(c)(3) to which contributions are tax deductible and that qualify as public charities within IRC section 170(B)(1)(A).

United Way’s Governing Board has designated ______________________________________ as the staff eligible to review and approve your distribution recommendation. Recommendations shall be submitted to United Way via email or Donor Recommendation Form, and once approved, the proceeds will be distributed to the recommended organization. In the event that a recommended distribution cannot be approved, United Way will notify you within ___ business days from the date the recommendation is received.

Timing of distributions
UNITED WAY GENERALLY REVIEWS DISTRIBUTIONS ON A ________ BASIS. UPON RECEIPT OF A DONOR’S RECOMMENDATION AND APPROVAL BY STAFF, DISTRIBUTIONS ARE PROCESSED WITHIN ______ WORKING DAYS OF RECEIPT.

Distributions to public charities
Distributions can only be made to tax-exempt public charities. Additionally, please note that the United Way of ______________ is required to comply with the USA Patriot Act. As a result every organization receiving a disbursement is required to sign a certification form prior to disbursement. This may delay disbursements from your fund during the initial certification process. We will notify you if we expect a significant delay.

Distributions to foreign charitable organizations
Federal tax law does not allow United Way to make distributions to foreign charitable organizations. However, Philanthropy Fund accounts may make distributions to IRC section 501(c)(3) charities that fund foreign charitable activities.

Distributions, Restrictions and Confirmation
a) Distributions may not be used to pay any legally binding pledge or to provide any private benefit (such as school tuition or scholarships sent directly to individuals, dues, membership fees, benefit tickets, or goods bought at charitable auctions.

b) Distributions may not be used for political contributions or to support political campaign activities.

c) Distribution recommendations for disallowed purposes will not be approved and action to correct will be taken if we discover that disallowed distributions have been made. Action may include, but is not limited to, requiring that the distribution be returned or that the donor make an additional non-deductible contribution.

d) United Way is not able to forward any enclosures with distributions. However, distribution payments are accompanied by a letter from United Way recognizing the account name, and the name of the donor unless you request anonymity. After your recommended distribution is made, you will receive a confirmation from United Way, along with the balance in your fund.

e) United Way must make distribution checks payable to the recipient organization’s legal name, which may be different from the common use name, and must mail each check to the organization’s official address.
Minimum distribution amounts
The minimum amount for distribution recommendation is $____. If the amount of a distribution recommendation exceeds the balance of a Philanthropy Fund account, the distribution will not be made. If this occurs, you will be contacted for further direction.

Number of distributions
United Way allows unlimited distributions from an account.

If you have any additional questions, please contact

______________________________
Phone: (___) _____________
E-mail: _________________________________
Sample #1 Philanthropy Account - Donor Advised Fund Agreement

This AGREEMENT, made as of the _______ day of __________, 20__, by and between
______________________________________________________________________,
(the "Donor") residing at___________________________________________________,
and United Way of __________, a state of ___________ Not-for-Profit Corporation
("United Way").

1. Establishment of Fund. The Donor hereby irrevocably assigns and transfers to
United Way the designated amount to their Philanthropy Account (as stated on the
Donor's annual pledge form), and United Way acknowledges receipt of the
designated amount.

2. Property of the Fund. A fund shall be established in the records of United Way
which shall be known as the Philanthropy Account for _____________________
(the "Fund"). The Fund shall include the designated amount received herewith;
such additional designations may from time to time be transferred to the Fund and
accepted by United Way, and all undistributed income and principal shall be under
the control of the United Way.

3. Management of the Fund. United Way shall hold the Fund as it may exist from
time to time and shall invest and reinvest all of the assets constituting the Fund.
United Way may commingle and co-invest the Fund assets with its other assets as
it has done in the past. United Way shall have ultimate authority and control over
all of the assets in the Fund, and the income derived there from, in accordance
with the Certificate of Incorporation and By-laws of United Way (as the same may
be amended from time to time), and the terms of this Agreement applied in a
manner consistent with said Certificate and By-laws.

4. Administrative Fee. The Fund currently does not charge an administrative fee.
The Donor will be informed of any fees should they need to exist in the future.

5. Donor Advice. The Donor may at least annually, or more frequently make non-
binding recommendations as to the timing, amount and recipient of distributions
from the Fund. Recommended grantees must be US charitable organizations
described in Internal Revenue Code (IRC) section 501(c) (3) that qualify as public
charities. The Donor does not retain any legal right to direct the same. Fund
assets may not be used to pay legally binding obligations of the Donor or to
otherwise benefit the Donor. The recipient of any grant from the Fund shall be
advised that the grant is to be used solely for charitable purposes.

6. Governing Law. This Agreement shall be governed by, and its terms and
conditions construed in accordance with, the General Laws of the State
___________ without regard to its conflict of law rules.
7. **Complete Agreement.** This Agreement supersedes all prior and contemporaneous understandings and agreements, whether written or oral, between the parties stated above relating to the transactions stated in this agreement. The donor agrees to abide by all rules set forth in the attached Philanthropy Account Overview & Guidelines.

IN WITNESS WHEREOF, the Donor and United Way have executed this Agreement as of the date first set forth above.

________________________________________

Donor Name(s) (please print)

________________________________________

Donor Signature(s)

UNITED WAY OF _________________________

By: ____________________________________

   Name (please print)

________________________________________

Title

________________________________________

Signature
Sample #2 Donor Advised Fund Agreement

THIS AGREEMENT, made as of the _____ day of __________, 2008, by and between _______________________________________________________________, (the “Donor”) residing at ________________________________________________, and United Way of ______________, a State of __________ Not-for-Profit Corporation ("United Way"), with its principal office located at ________________________________.

1. Establishment of Fund. The Donor hereby irrevocably assigns and transfers to United Way the property described on the contributions statement attached to this Agreement, and United Way acknowledges receipt of the property listed thereon.

2. Property of the Fund. A fund shall be established in the records of United Way which shall be known as the ____________________________________________ (the “Fund”). The Fund shall include the property received herewith, such additional property as may from time to time be transferred to the Fund and accepted by United Way, and all undistributed income and principal.

3. Management of the Fund. United Way shall hold the Fund as it may exist from time to time and shall invest and reinvest all of the assets constituting the Fund. United Way may commingle and co-invest the Fund assets with its other assets. United Way shall have ultimate authority and control over all property in the Fund, and the income derived therefrom, in accordance with the Certificate of Incorporation and By-laws of United Way (as the same may be amended from time to time), and the terms of this Agreement applied in a manner consistent with said Certificate and By-laws.

4. Administrative Fee. The Fund currently does not charge an administrative fee. Fees may be established from time to time by United Way. Donor will be informed of such fees as they occur.

5. Donor Advice. The Donor may at least annually, or more frequently make non-binding recommendations as to the timing, amount and recipient of distributions from the Fund. Recommended grantees must be US charitable organizations described in IRC section 501(c)(3) that qualify as public charities. The Donor does not retain any legal right to direct the same. Fund assets may not be used to pay legally binding obligations of the Donor or to otherwise benefit the Donor. The recipient of any grant from the Fund shall be advised that the grant is to be used solely for charitable purposes.

6. Governing Law. This Agreement shall be governed by, and its terms and conditions construed in accordance with, the laws of the State of __________ without regard to its conflict of law rules.
7. **Complete Agreement.** This Agreement supercedes all prior and contemporaneous understandings and agreements, whether written or oral, between the parties stated above relating to the transactions stated in this agreement. Donor agrees to abide by all rules set forth in the attached Philanthropy Fund Overview & Guidelines.

IN WITNESS WHEREOF, the Donor and United Way have executed this Agreement as of the date first set forth above.

_________________________________________________
Donor Name(s) (please print)

_________________________________________________
Donor Signature(s)

UNITED WAY OF _____________________

By: _________________________________________
Name (please print)

____________________________________________
Title

____________________________________________
Signature
Sample #1 Memo to convert improperly designed P-Fund to a properly designed Donor Advised Fund

To: Philanthropy Account Contributors
From: _________________Chief Financial Officer
Date: ______________

Subject: IRS Update - Charitable Contribution Deduction for Philanthropy Accounts

The Internal Revenue Service (IRS) has recently introduced changes to the IRS code regarding donor advised funds.

In order to ensure that you continue to receive the full tax deduction credit from the IRS for your contributions to your Philanthropy Account (P-Fund) at the United Way of _______________, it is important that you complete and sign the attached Donor Advised Fund Agreement and return it to us by _______________. For your convenience, we have provided a prepaid envelop for you to return this document to us.

This is a one-time request by United Way in order to ensure that your P-Fund is administered in compliance with the new Internal Revenue Code (IRC) regarding "donor advised funds".

United Way is required to comply with this new IRS regulation to ensure that the donor's designation transfer to their P-Fund will continue to be eligible for a tax deduction.

Please find attached the following documents pertaining to yourPhilanthropy Account which are explained in this document.

1. Philanthropy Fund Overview and Guidelines.
2. Donor Advised Fund Agreement for your signature.

If you have any questions about this letter and/or the attached materials, please do not hesitate to contact ________________________________.

We appreciate your support of United Way of ________________.

OVERVIEW

With the recent changes to the Internal Revenue Code (IRC) regarding "donor advised funds", it has been determined that your P-Fund account (administered by United Way of _______________) is considered a donor advised fund. For a donor to be eligible for a tax deduction at the time of a transfer to a P-Fund, technically United Way must have exclusive ownership and control of the assets in the P-Fund. A donor to a P-Fund may only have advisory privileges over any distributions so that the ownership transfer of the assets to the United Way is complete.

In order to protect our donors and United Way, we obtained a legal opinion on the impact of the new IRS Regulations on the administration of the United Way P-Fund to ensure that our P-Fund account holders continue to be eligible to claim a tax deduction for their funds contributed to
United Way P-Fund Account. We value your P-Fund contributions and with the exception of the requirements below, intend to operate your P-Fund account as we have in the past.

**RECENT CHANGES IN TAX LAW**

**Donor Advised Fund**

The Pension Protection Act of 2006 amended the Internal Revenue Code (IRC) to provide new rules for donor advised funds and the charities that maintain them. The IRC defines a "donor advised fund" as a fund or account that is:

1. Owned or controlled by a sponsoring organization (like United Way);
2. Separately identified by reference to contributions of a donor or donors; and
3. Advised by the donor or a person designated by the donor (donor advisor) who reasonably expects to have advisory privileges with respect to the distribution or investment of the assets in the fund.

**Form 990 Reporting Requirement**

The IRS extensively revised the Form 990 (which is the Annual Return for Tax-Exempt Organizations) in 2008 and now requires United Way to report information pertaining to Donor Advised Funds. The Form 990 must include the total number of Donor Advised Funds held by United Way and the total contributions to and distributions from such Funds, as well as the aggregate value of those Funds at the end of the fiscal year. In addition, United Way must indicate whether we have informed our donors and donor advisors in writing that the assets held in a donor advised fund are the organization’s property and that such assets may only be used for charitable purposes and not for the benefit of the donor or donor advisor in anyway.

**ADMINISTRATIVE CHANGES TO P-FUND ACCOUNT**

Effective ______________ the following administrative changes will be in effect for all P-Fund accounts held by United Way of ____________.

1. A Donor Advised Fund Agreement must be completed and signed by both the Donor and United Way. Once completed, a signed copy will be mailed to the Donor for their records and the original will be kept on file at United Way. This agreement stays in effect until the Donor no longer wishes to maintain a P-Fund Account.

2. Donor funds that are transferred to a P-Fund Account become irrevocable and are owned by United Way. Contributions are not refundable for any reason.

3. The donor maintains advisory privileges (gift distribution recommendations) with regard to distributions from their P-Fund Account. The Internal Revenue Code does not allow the donor to maintain control over the assets donated to the P-Fund. Only United Way can approve distributions for charitable purposes.

With the exception of the changes above, we intend to honor your gift recommendations to those charities that you continue to support. Your contributions and participation in the United Way Philanthropy Account service is greatly appreciated.
Appendix F Draft Issues Paper

FASB Accounting Standards Codification Section 820, Fair Value Measurements and Disclosures, for Certain Issues Pertaining to Not-for-Profit Entities - January 2010

Prepared by the AICPA Accounting Standards Executive Committee and the Not-for-Profit Entity Fair Value Task Force. (This draft issues paper is not a source of established accounting principles as described in FASB Statement No. 168, The Hierarchy ofGenerally Accepted Accounting Principles.)

Introduction

This draft issues paper discusses fair value measurement for certain issues pertaining to not-for-profit entities. Specifically, this draft issues paper discusses fair value measurement pertaining to the following:

- Unconditional promises to give cash
- Beneficial interests in perpetual trusts
- Split interest agreements

Not-for-profit entities (NFPs) face various challenges in applying the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820 (which codifies FASB Statement No. 157, Fair Value Measurements.) Many of these challenges result from the fact that markets don't exist for these assets and liabilities. This draft issues paper discusses the provisions of FASB ASC 820 as they pertain to the issues listed above, and provides the Accounting Standards Executive Committee’s (AcSEC’s) nonauthoritative views on applying the provisions of FASB ASC 820 to those issues.

UNCONDITIONAL PROMISES TO GIVE CASH

1. FASB ASC section 958-605 (FASB Statement No. 116),1 in discussing measurement principles for contributions, requires NFPs to generally measure at fair value recognized contributions of cash or other assets (for example, marketable securities, land, buildings, use of facilities or utilities, materials and supplies, other goods or services) and unconditional promises to give those items in the future.2

2. The discussion of fair value measurements in FASB ASC 820-10-35 (FASB Statement No. 157) includes an exit price approach, that is, the price that would be received for a promise to give (asset) in an exchange involving market participants, determined under current market conditions. FASB ASC 820-10-35 (FASB Statement No. 157) (and its interpretive guidance) emphasizes that because fair value is a market-based (not an entity-specific) measurement, the exit price is determined without regard to whether an entity intends to sell or hold an asset or liability that is measured at fair value.

3. This issues paper addresses the application of FASB ASC 820-10-35 (FASB Statement No. 157) in determining the fair value of a promise to give cash.

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1 Pursuant to Financial Accounting Standards Board (FASB) Statement No. 168, The FASB Accounting Standards Codification TM and the Hierarchy of Generally Accepted Accounting Principles, the FASB Accounting Standards Codification (ASC) generally is effective for financial statements issued for interim and annual periods ending after September 15, 2009. To aid readers in using this issues paper, as a drafting convention in referencing to sources of authoritative generally accepted accounting principles, this issues paper sometimes references pronouncements that were issued prior to the effective date of FASB ASC, and from which the FASB ASC paragraphs are derived.

2 FASB ASC 958-605 (FASB Statement No. 116) allows practical expedients in certain circumstances. Unconditional promises to give that are expected to be collected or paid in less than one year may be measured at net realizable value (net settlement value) pursuant to FASB ASC 958-605-30-6 (FASB Statement No. 116, paragraph 21).

3 In practice, some NFPs have pooled unconditional promises to give with certain similar attributes. The Accounting Standards Executive Committee (AcSEC) believes such pooling is permissible in circumstances in
which the results would not be materially different than reporting with each unconditional promise to give as the unit of account.

**What is the Unit of Account for a Promise to Give That is Expected to Be Collected in One Year or More?**

4. For an unconditional promise to give that is expected to be collected in one year or more, the unit of account specified in FASB ASC 958-605 (FASB Statement No. 116) is the individual (stand alone) promise to give. That means that the focus of the fair value measurement is on the individual (stand alone) promise to give, where the exit price represents the amount a market participant would pay to acquire the right to receive from the donor the cash flows inherent in the promise to pay the NFP. AcSEC believes the fair value measurement assumes that the cash flows paid by the donor to the NFP (donee) would transfer to the market participant, but the donor and the NFP (donee) would remain unchanged. In other words, for purposes of determining the fair value of an unconditional promise to give that is expected to be collected in one year or more, NFPs should assume that a market participant steps into the shoes of the NFP, retaining the entity-specific characteristics of the NFP, and that the relationship between the donor and the market participant therefore is the same as the relationship between the donor and the NFP.

**Valuation Technique(s) Should an NFP Use to Measure the Fair Value of an Unconditional Promise to Give that is Expected to be Collected in One Year or More?**

5. FASB ASC 820-10-35-28 (FASB Statement No. 157) provides that valuation techniques consistent with the market approach, income approach, and cost approach, or all three, should be used to measure fair value. FASB ASC 820-10-35-29 to 820-10-35-35 (Paragraph 18 of FASB Statement No. 157) explain those valuation techniques as follows:

- **Market Approach**
  - The market approach is defined in this [s]ubtopic as a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business).
  - For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative).
  - Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities’ relationship to other benchmark quoted securities.

- **Income Approach**
  - The income approach is defined in this [s]ubtopic as an approach that uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts.
  - Those valuation techniques include the following:
    - Present value techniques
    - Option-pricing models (which incorporate present value techniques), such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model)
    - The multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets.

- **Cost Approach**
  - The cost approach is defined in this [s]ubtopic as a valuation technique based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost).
  - From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

6. FASB ASC 820-10-35-24 (Paragraph 19 of FASB Statement No. 157) clarifies that, “[v]aluation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value.” For an unconditional promise to give that is expected to be collected in one year or more, AcSEC believes that in evaluating
valuing techniques, a present value (PV) technique (an application of the income approach) will be the most prevalent valuation technique to measure fair value. In reaching that conclusion, AcSEC observes that the market approach typically would not be operational for measuring the fair value of unconditional promises to give cash, and the cost approach is not used for valuing financial assets such as promises to give.

PV Techniques

7. FASB ASC 820-10-55-4 to 820-10-55-20, discuss present value techniques. FASB ASC 820-10-55-5 states:

A fair value measurement of an asset or liability, using present value should capture all of the following elements from the perspective of market participants as of the measurement date:

- An estimate of future cash flows for the asset or liability being measured.
- Expectations about possible variations in the amount and/or timing of the cash flows representing the uncertainty inherent in the cash flows.
- The time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows (risk-free interest rate). For present value computations denominated in nominal U.S. dollars, the yield curve for U.S. Treasury securities determines the appropriate risk-free interest rate. U.S. Treasury securities are deemed (default) risk free because they pose neither uncertainty in timing nor risk of default to the holder.
- The price for bearing the uncertainty inherent in the cash flows risk premium).
- Other case-specific factors that would be considered by market participants.

4 The FASB ASC glossary term promise to give (paragraph 87 of FASB Statement No. 116) notes that, “the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer.” As noted in paragraph 108 of FASB Statement No. 116, in developing FASB Statement No. 116, the board found that although legal remedies are available, they are seldom necessary because “promises generally are kept.” AcSEC believes, however, in many (if not most) cases, uncertainty will exist. Therefore, it will be necessary to consider risk in a fair value measurement.

In the case of a liability, the nonperformance risk relating to that liability, including the reporting entity’s (obligor’s) own credit risk.

8. Risk and uncertainty associated with the amount, timing, or both, of cash flows of an asset (or liability) are key considerations when measuring fair value because risk-averse market participants would demand compensation for bearing the uncertainty inherent in the cash flows (the risk premium).4 FASB ASC 820-10-55-7 and 820-10-55-8 explain:

- 55-7 A fair value measurement, using present value, is made under conditions of uncertainty because the cash flows used are estimates rather than known amounts. In many cases, both the amount and timing of the cash flows will be uncertain. Even contractually fixed amounts, like the payments on a loan, will be uncertain if there is risk of default.
- 55-8 A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment.

9. AcSEC observes that the requisite risk assessment requires judgments, and that those judgments are significant in some cases. In making that assessment, consistent with FASB ASC 820-10-35-55 (paragraph 30 of FASB Statement No. 157), AcSEC believes an NFP need not undertake all possible efforts for any and all information from or about the donor. Rather, the NFP would assess the risk associated with the promise to give using information that is reasonably available without undue cost and effort in the circumstances, considering factors specific to the donor and the promise to give. AcSEC believes those factors may include, but are not limited to, the following:

- The ability of the donor to pay (credit risk), which may be indicated by published credit ratings (for example, a credit rating might be available for an enterprise that is a donor or that is comparable to the donor); financial analysis (for example, cash flow and ratio analysis); or credit reports for an individual donor.
- Factors specific to the donor that might be relevant in assessing the donor’s commitment to honor its promise, such as the extent to which the donor is vested or otherwise involved in the activities of the NFP (for
example, whether the donor is a member of the governing board), the donor’s history of charitable giving and involvement with charitable organizations, including but not limited to the NFP, the donor’s financial circumstances and history (past bankruptcies or defaults), financial condition (including other debt), current employment (including its stability), current economic conditions, earnings potential over the term of the promise, and personal circumstances (including family situation, age, and health).

- The NFP’s prior experience in collecting similar types of promises to give, including the extent to which the NFP has enforced the promises.
- Whether the underlying asset is held in an irrevocable trust or escrow; in that case, default risk will be reduced because delivery is certain.

10. FASB ASC 820-10-55 (Derived in part from appendix B to FASB Statement No. 157) discusses two PV techniques, the (a) traditional or discount rate adjustment (DRA) technique and (b) expected present value (EPV) technique, which may be applied using one of two methods. Those PV techniques differ in how they adjust for risk. Key differences are summarized in the following table.

<table>
<thead>
<tr>
<th></th>
<th>EPV Method 1</th>
<th>EPV Method 2</th>
<th>DRA</th>
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<tbody>
<tr>
<td><strong>Cash Flows</strong></td>
<td>Expected (probability-weighted) cash flows (or expected value),</td>
<td>Expected (probability-weighted) cash flows (or expected value).</td>
<td>Single set of cash flows (contractual, promised, most likely).</td>
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<td>adjusted for general market (systematic) risk by subtracting the</td>
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<td>cash risk premium. The risk-adjusted expected cash flows</td>
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<td>represent a certainty-equivalent cash flow.</td>
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<td></td>
<td>The risk-adjusted expected cash flows are not conditional cash</td>
<td>The expected cash flows are not conditional cash flows because</td>
<td>The single set of cash flows are conditional cash flows (in other</td>
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<td>flows because they are probability-weighted.</td>
<td>they are probability-weighted.</td>
<td>words, contractual or promised cash flows for a bond are conditional</td>
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<td>on the event of no default by the debtor).</td>
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<tr>
<td><strong>Discount Rate</strong></td>
<td>Risk-free interest rate (for example, yield-to-maturity on U.S.</td>
<td>Risk-free interest rate (for example, yield-to-maturity on U.S.</td>
<td>Risk-adjusted discount rate derived from observed rates of return</td>
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<td>Treasuries).</td>
<td>Treasuries), adjusted for general market (systematic) risk by</td>
<td>for comparable assets or liabilities that are traded in the market,</td>
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<td>adding risk premium. The risk-adjusted discount rate represents</td>
<td>that is, a market rate of return that corresponds to an observed</td>
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<td>the expected rate of return that corresponds to an expected</td>
<td>market rate associated with such conditional cash flows and,</td>
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<td>rate associated with such probability-weighted cash flows. Can</td>
<td>therefore, represents the amount market participants would demand</td>
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<td></td>
<td>be derived using models for pricing risky assets, such as the</td>
<td>for bearing the uncertainty inherent in such cash flows.</td>
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<tr>
<td></td>
<td></td>
<td>capital asset pricing model.</td>
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</tbody>
</table>

Because the risk-adjusted discount rate (expected rate of return) relates to expected (probability-weighted) cash flows, which are not conditional cash flows, it likely will be lower than the risk-adjusted discount rate used in DRA technique.

Because the risk-adjusted discount rate relates to conditional cash flows, it likely will be higher than the risk-adjusted discount rate used in EPV method 2.
11. FASB ASC 820-10-55-10 (paragraph B7 of FASB Statement No. 157) discusses the DRA technique as follows: The discount rate adjustment technique uses a single set of cash flows from the range of possible estimated amounts, whether contractual or promised (as is the case for a bond) or most likely cash flows. In all cases, those cash flows are conditional upon the occurrence of specified events (for example, contractual or promised cash flows for a bond are conditional on the event of no default by the debtor). The discount rate used in the discount rate adjustment technique is derived from observed rates of return for comparable assets or liabilities that are traded in the market. Accordingly, the contractual, promised, or most likely cash flows are discounted at a rate that corresponds to an observed market rate associated with such conditional cash flows (market rate of return).

5 For example, FASB ASC 410 (FAS 143, Accounting for Asset Retirement Obligations), discusses the use of different present value techniques for asset retirement obligations, which are long-term obligations with a high degree of uncertainty associated with the future cash flows. FASB ASC 410-20-30-1 (footnote 6a to paragraph 8 of FAS 143) states

12. FASB ASC 820-10-55-13 (Paragraph B12 of FASB Statement No. 157) discusses the EPV technique as follows: The [EPV] technique uses as a starting point a set of cash flows that, in theory, represents the probability-weighted average of all possible cash flows (expected cash flows). The resulting estimate is identical to expected value, which, in statistical terms, is the weighted average of a discrete random variable’s possible values where the respective probabilities are used as weights. Because all possible cash flows are probability-weighted, the resulting expected cash flow is not conditional upon the occurrence of any specified event (as are the cash flows used in the discount rate adjustment technique).

What are Some of the Key Issues an NFP Should Consider in Determining Which PV technique to Use to Measure the Fair Value of an Unconditional Promise to Give that is Expected to be Collected in One Year or More?

13. FASB ASC 820-10-55-4 (Paragraph B1 of FASB Statement No. 157) states that, “the present value technique used to measure fair value will depend on facts and circumstances specific to the asset or liability being measured (for example, whether comparable assets or liabilities can be observed in the market) and the availability of sufficient data.”

14. Conceptually, the 3 PV methods discussed in the chart in paragraph 10 of this issues paper should give the same results. AcSEC observes that in practice, however, certain techniques may be easier, more practical, or more appropriate to apply to certain facts and circumstances. For example, a DRA technique might be more appropriate than an EPV technique in circumstances in which market data about comparable assets is available. An EPV technique might be more appropriate than a DRA technique in circumstances in which little (or no) market data about comparable assets is available; and EPV proper application of a [DRA] technique entails analysis of at least two liabilities—the liability that exists in the marketplace and has an observable interest rate and the liability being measured. The appropriate rate of interest for the cash flows being measured shall be inferred from the observable rate of interest of some other liability, and to draw that inference the characteristics of the cash flows shall be similar to those of the liability being measured. Rarely, if ever, would there be an observable rate of interest for a liability that has cash flows similar to an asset retirement obligation being measured. In addition, an asset retirement obligation usually will have uncertainties in both timing and amount. In that circumstance, employing a discount rate adjustment technique, where uncertainty is incorporated into the rate, will be difficult, if not impossible.

Method 2 may be more appropriate than EPV method 1 because EPV method 1 requires determining a certainty equivalent cash flow, which typically would be impracticable for unconditional promises to give. As discussed in FASB ASC 820-10-35-53 and 820-10-35-55 (paragraph 30 of FASB Statement No. 157), in considering the availability of market data about comparable assets and the effect on determining the risk premium

- in circumstances in which little (or no) market data about comparable assets is available, the NFP should nevertheless consider market inputs, if available, in determining the risk premium.
- in circumstances in which market inputs are unavailable in determining the risk premium, management should consider unobservable inputs that reflect its own assumptions about the assumptions market participants would use in pricing the asset developed based on the best information available in the circumstances.
15. AcSEC observes that the DRA technique eliminates the need to probability weight the cash flows and use pricing models or otherwise estimate the systematic risk premium, as required by the EPV technique. The DRA technique may therefore be easier and more practical to apply at initial recognition in certain circumstances. AcSEC observes, however, using the DRA technique at initial recognition may introduce challenges in periods subsequent to initial recognition (day 2 accounting) for NFPs that do not elect to report contributions receivable at fair value pursuant to an election under FASB ASC 825 (FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities). For example, in determining the day 2 allowance for doubtful accounts, the NFP would have to determine (a) the amount of uncollectible cash flows that market participants estimated on day 1 in determining (b) the observed rate of return demanded by those market participants for comparable assets. In addition, the benefit of avoiding estimating probability weighted cash flows on day 1 (if using the DRA technique) would be substantially negated by the fact that on day 2, the NFP would nevertheless have to estimate cash flows in determining the day 2 allowance for doubtful accounts. AcSEC believes, therefore, that use of the DRA technique (using contractual cash flows) would be impracticable for NFPs that do not elect to report contributions receivable at fair value pursuant to an election under FASB ASC 825 (FASB Statement No. 159).

16. AcSEC observes that in estimating fair value, FASB ASC 820-35 (FASB Statement No. 157) does not preclude the use of fair value estimates provided by third parties, such as valuation specialists, in circumstances in which a reporting entity has determined that the estimates provided by those parties are determined in accordance with FASB ASC 820-35 (FASB Statement No. 157). For example, in using an EPV technique, valuation specialists may be helpful in determining the risk premium to add to the risk-free rate (EPV method 2).

**What are the key pricing inputs when using a PV Technique?**

17. Key pricing inputs should reflect the factors that market participants would consider in setting a price for the promise to give. The FASB ASC 820-10-35 (FASB Statement No. 157) fair value hierarchy prioritizes market observable inputs, but also allows for the use of unobservable (internally-derived) inputs when relevant market observable inputs are unavailable. When using a PV technique, a key pricing input is the discount rate. The discount rate differs depending on the PV technique used, as discussed in the following sections.

**EPV Method 1**

18. When using EPV method 1, the risk-adjusted expected cash flows are discounted by the risk-free interest rate, which may be indicated by the yield-to-maturity on U.S. Treasuries. In EPV method 1, the risk-free interest rate is appropriate because all risk is built into the expected cash flows (which therefore represents a certainty equivalent cash flow). (As discussed in FASB ASC 820-10-55-15 [paragraph B14 of FASB Statement No. 157], EPV method 1 adjusts the expected cash flows for the systematic [market] risk by subtracting a cash risk premium in arriving at risk-adjusted expected cash flows.) As noted in paragraph 14 of this issues paper, however, determining a certainty equivalent cash flow typically would be impracticable for unconditional promises to give.

6 The systemic risk of an asset (or liability) refers to the amount by which the asset (or liability) increases the variance of a diversified portfolio when it is added to that portfolio. Portfolio theory holds that in a market in equilibrium, market participants will be compensated only for bearing the systemic or nondiversifiable risk inherent in the cash flows. Or (in markets that are inefficient or out of equilibrium, other forms of return or compensation might be available.)

**EPV Method 2**

19. When using EPV method 2, the expected cash flows are discounted by the risk-adjusted rate, which is determined based on the risk-free interest rate, adjusted for general market (systematic) risk by adding a risk premium.

20. In EPV method 2, some, but not all, risk is built into the expected cash flows. The expected cash flows are probability-weighted and, therefore, are adjusted for the likelihood of possible outcomes affecting the timing and amount of the cash flows. However, probability-weighting is not enough. It also is necessary to adjust for general market (systematic risk). FASB ASC 820-10-55-14 (Paragraph B13 of FASB Statement No. 157) explains: In making an investment decision, risk-averse market participants would consider the risk inherent in the expected cash flows. Portfolio theory distinguishes between two types of risk:
• Unsystemic (diversifiable) risk (The risk specific to a particular asset or liability, also referred to as diversifiable risk.)
• The second is general market risk, also referred to as systemic (nondiversifiable) risk.

21. In EPV method 2, the adjustment for systematic (or market) risk is built into the discount rate. The risk-adjusted discount rate represents an expected rate of return that corresponds to an expected rate associated with such probability-weighted cash flows. The expected rate of return may be derived using models for pricing risky assets, such as the capital asset pricing model.

DRA

22. When using the DRA technique, the estimated cash flows are discounted by a risk-adjusted rate. As discussed in FASB ASC 820-10-55-10 (paragraph B7 of FASB Statement No. 157): the [DRA] technique uses a single set of cash flows from the range of possible estimated amounts, whether contractual or promised (as is the case for a bond) or most likely cash flows. In all cases, those cash flows are conditional upon the occurrence of specified events (for example, contractual or promised cash flows for a bond are conditional on the event of no default by the debtor).

7 AcSEC believes a promise to give is different from a trade receivable. A promise to give arises from a donative intent. It is not an exchange transaction where each of the parties to the exchange receives equivalent value and generally will be expected to exercise rights created by the exchange to enforce the terms of the transaction. AcSEC believes information derived from a trade receivable might be relevant in determining the discount rate used in the discount rate adjustment technique. However, adjustments to that information might be needed to incorporate the risk inherent in the cash flows in situations in which the NFP does not have a practice of enforcing its rights to receive promises to pay.

A single set of estimated cash flows is appropriate because all risk is built into the discount rate.

23. The risk-adjusted discount rate used in the DRA technique is derived from observed rates of return for comparable assets or liabilities that are traded in the market. That rate represents a market rate of return that corresponds to an observed market rate associated with such conditional cash flows and, therefore, represents the amount market participants would demand for bearing the uncertainty inherent in such cash flows. In circumstances in which the estimated cash flows reflect the elimination or significant reduction of credit risk, NFPs should apply a discount rate that reflects that reduced risk, in order to avoid double counting that credit risk, as discussed in FASB ASC 820-10-55-6 (paragraph B3 of FASB Statement No. 157).

24. Determining the observed rate of return for comparable assets that are traded in the market requires an analysis of market data for comparable assets. FASB ASC 820-10-55-11 (paragraph B8 of FASB Statement No. 157) explains, “comparability is established by considering the nature of the cash flows (for example, whether the cash flows are contractual or noncontractual and are likely to respond similarly to changes in economic conditions), as well as other factors (for example, credit standing, collateral, duration, restrictive covenants, and liquidity.)” As a basis for assessing comparability, AcSEC believes best practice is for the NFP to assess the likelihood that the donor will not honor its promise to give (default risk), as well as the risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows.

25. Market comparable data that might be relevant in determining the risk-adjusted discount rate used in the DRA technique will differ depending on the donor (for example, whether the donor is an individual, a corporation, or a foundation). Some examples follow.

7 In considering the yield on debt issued by a foundation or other NFP, AcSEC believes the relevant input is the taxable yield, not the tax-exempt yield.

26. If the donor is an individual, AcSEC believes that the risk-adjusted discount rate might be determined using unsecured consumer lending rates that are generally available from published sources (major financial institutions). AcSEC believes best practice is to use those unsecured consumer lending rates in circumstances in which the credit characteristics of the donor are similar to the credit characteristics of those with unsecured debt. A promise to give a single fixed contribution might be more similar to unsecured debt than a promise to give multi-year contributions.
27. AcSEC believes, in applying the DRA technique to promises from individuals, an unsecured consumer lending rate might be a starting point for determining an observable market interest rate. The NFP, however, may need to make adjustments to that rate, as discussed in paragraph 30 of this issues paper, including but not limited to adjustments based on differences in the credit characteristics of the donor compared to the credit characteristics of borrowers of unsecured debt. (AcSEC believes such adjustments might be made based on the average credit characteristics of a homogeneous group of donors in circumstances in which the results would not be materially different than making such adjustments based on the specific credit characteristics of an individual donor.)

28. If the donor is a corporation, AcSEC believes that the risk-adjusted discount rate might be determined using the yield on publicly-traded debt, whether issued by the corporation itself or by a comparable corporation. AcSEC believes best practice is to use that yield on publicly-traded debt in circumstances in which the promise to give is similar to the publicly-traded debt. If the donor is a private foundation, AcSEC believes that the risk-adjusted discount rate might be similarly determined using the yield on publicly-traded debt, whether issued by the foundation itself, by a comparable foundation, or by a comparable corporation.

For publicly-traded zero coupon debt, comparability should be established based on its remaining term to maturity. For a debt instrument that periodically pays interest and/or principal, AcSEC believes comparability should be established based on its duration, not its remaining term to maturity. Duration refers to the weighted average term over which the debt cash flows will be received.

9 For publicly-traded zero coupon debt, comparability should be established based on its remaining term to maturity. For a debt instrument that periodically pays interest and/or principal, AcSEC believes comparability should be established based on its duration, not its remaining term to maturity. Duration refers to the weighted average term over which the debt cash flows will be received.

10 References are to the 2008 edition of the AICPA Audit and Accounting Guide Not-for-Profit Organizations, unless otherwise noted.

29. In either case (whether the donor is a corporation or a foundation), the NFP would consider factors specific to the promise, including its terms and risk, in assessing the extent to which the promise to give is similar to publicly-traded debt. For example, AcSEC believes a promise to give a single fixed contribution at a future date likely would be more similar to publicly-traded zero coupon debt that pays a single amount at a future date than a debt instrument that periodically pays interest or principal, or both.

30. In all cases, the NFP would evaluate comparability and adjust available market data for differences so that the risk-adjusted discount rate used to measure fair value (unsecured lending rates, yield on publicly-traded debt) is reasonable when considered in the context of the donor.

INTERESTS IN PERPETUAL TRUSTS

31. An NFP may have a beneficial interest in a perpetual trust that is reported at fair value pursuant to FASB ASC 958-605-30-14 (paragraph 15 of FASB Statement No. 136). Such beneficial interests typically exist because the NFP has the irrevocable right to receive the income earned on trust assets in perpetuity, but never receives the assets held in trust. In such circumstances, the NFP’s asset is the right to the stream of cash flows (the interest in the cash flows). Further, in such circumstances, typically the trustee controls the investment decisions and timing of distributions to the NFP, and the NFP cannot transfer its interest.

32. FASB ASC 958-605-30-14, (footnote 17 to paragraph 6.29 of the AICPA Audit and Accounting Guide Not-for-Profit Organizations), discusses circumstances in which an NFP has the irrevocable right to receive the income earned on trust assets in perpetuity, but never receives the assets held in trust. It provides as follows: The fair value of a perpetual trust held by a third party generally can be measured using the fair value of the assets contributed to the trust rather than the fair value of the income earned on those assets.

33. FASB ASC 820-10-55-5 (paragraph 10 of FASB Statement No. 157) discusses the fair value measurement of an asset or liability, using present value, from the perspective of market participants. FASB ASC 820-10-55-5d (FASB Statement No. 157 paragraph B2d) provides that such measurements should capture, among other elements, the price for bearing the uncertainty inherent in the cash flows (risk premium).

34. FASB ASC 825-10-50-10 (paragraph 10 of FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments), in discussing disclosures about the fair value of financial instruments, provides as follows:
An entity shall disclose all of the following:

- Either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value
- The method(s) and significant assumptions used to estimate the fair value of financial instruments
- A description of the changes in the method(s) and significant assumptions used to estimate the fair value of financial instruments, if any, during the period.

For financial instruments recognized at fair value in the statement of financial position, the disclosure requirements of [FASB ASC] 820 also apply.

**How Should NFPs Estimate the Fair Value of Interests in Perpetual Trusts?**

35. AcSEC believes that the guidance in FASB ASC 958-605-30-14 (and footnote 17 of chapter 6 in *Not-for-Profit Organizations* guide) continues to be relevant in measuring an NFP’s interest in a perpetual trust in accordance with FASB ASC 820 (FASB Statement No. 157)—that is, “the fair value of a perpetual trust held by a third party generally can be measured using the fair value of the assets contributed to the trust, unless facts and circumstances indicate that the fair value of the beneficial interest differs from the fair value of the assets contributed to the trust.” AcSEC believes that in practice, beneficial interests in perpetual trusts generally can be measured using the fair value of the assets contributed to the trust, without further adjustment. Facts and circumstances may exist, however, in which the fair value of the beneficial interest differs from the fair value of the assets contributed to the trust. For example, if at initial recognition, the trustee has been instructed not to distribute assets from the trust for a period of years or to distribute only a minor portion of the trust’s income as that income is received by the trust, the fair value of the beneficial interest may differ from the fair value of the assets contributed to the trust. Similarly, for purposes of subsequent measurement at fair value, in circumstances in which the trustee does not distribute assets from the trust or distributes only a minor portion of the trust’s income as that income is received by the trust, the fair value of the beneficial interest may differ from the fair value of the assets in the trust.

36. Further, in making the disclosures required by 825-10-50-10 (paragraph 10 of FASB Statement No. 107), as discussed in paragraph 34 of this issues paper, AcSEC believes that in circumstances in which the fair value of the contribution (or asset at subsequent measurement) is measured using the fair value of the assets contributed to (or in) the trust, best practice is for entities to disclose (a) that they have used the fair value of the assets contributed to (or in) the trust to determine fair value and (b) the terms and practice of the trust pertaining to distributions.

37. AcSEC considered whether the fact that the trustee controls the investment decisions should affect the estimated fair value of the NFP’s interest in the trust. AcSEC believes the fact that the trustee controls the investment decisions typically has no effect on the estimated fair value of the asset (interest in the trust). Assuming the trustee exercises its fiduciary responsibilities, AcSEC believes NFPs should assume that the trustee stands in the shoes of the NFP in making investment decisions, and therefore the trustee’s control over such investment decisions is neither an enhancement nor a diminishment of the NFP’s interest in the trust.

38. AcSEC considered whether the risk premium related to the individual investments held in the trust should be considered in estimating the fair value of the asset (interest in the trust). AcSEC believes that the risk premium related to the individual investments held in the trust should not be separately considered in estimating the fair value of the asset (interest in the trust), because that risk premium is already built into the price of each individual investment held in the trust.

**SPLIT-INTEREST AGREEMENTS**

39. Split-interest agreements (sometimes referred to as deferred giving) are agreements in which a donor makes an initial gift to a trust or directly to an NFP in which the NFP has a beneficial interest but is not the sole beneficiary. The time period covered by the agreement is expressed either as a specific number of years or as the remaining life of an individual or individuals designated by the donor. The assets are invested and administered by the NFP, a trustee, or a fiscal agent. Under some kinds of agreements, referred to as lead interests, the NFP receives any distributions or income during the agreement's term and the donor (or other individuals or entities designated by the donor) receives all or a portion of the assets remaining at the end of the agreement's term. In other kinds of agreements, referred to as remainder interests, the donor (or other individuals or entities designated by the donor) receives the distributions
during the term and the NFP receives all or a portion of the assets remaining at the end of the agreement's term. Split-interest agreements, therefore, are typically a combination of a contribution and an exchange transaction.

**Remainder Interests**

40. Three primary types of remainder agreements exist: Charitable remainder trusts, charitable gift annuities, and pooled income funds.

**Charitable Remainder Trusts**

41. Under charitable remainder trusts, as described in the glossary of FASB ASC and paragraph 6.30 of *Not-for-Profit Organizations*, the donor establishes and funds a trust with specified distributions to be made to a designated beneficiary or beneficiaries over the trust's term. The distributions to the beneficiaries may be for a specified dollar amount, an arrangement called a *charitable remainder annuity trust*, or for a specified percentage of the trust's fair market value as determined annually, an arrangement called a *charitable remainder unitrust*. Some charitable remainder unitrusts limit the annual payout to the lesser of the stated percentage or the actual income earned. Obligations to the beneficiaries are limited to the trust's assets.

**Charitable Gift Annuities**

42. Charitable gift annuities are similar to charitable remainder trusts except that, as described in FASB ASC 958-30-05-11 (paragraph 6.35 of *Not-for-Profit Organizations*), no trust exists, the assets received are held as general assets of the NFP, and the annuity liability is a general obligation of the NFP. Under charitable gift annuities, the NFP agrees to pay a fixed amount for a specified period of time to the donor or to individuals or entities designated by the donor.

**Pooled Income Funds**

43. The third type of remainder agreement, described in the FASB ASC glossary and paragraph 6.39 of *Not-for-Profit Organizations*, is a pooled income fund. A pooled income fund is a trust for which the NFP is trustee. The trust pools the contributions of many donors and invests those gifts as a group. Donors are assigned a specific number of units in the pooled income fund based on the proportion of the fair value of their contributions to the total fair value of the pooled income fund on the date of the donor's entry to the pooled fund. Until a donor's death, the donor (or the donor's designated beneficiary or beneficiaries) is paid the actual income (as defined under the arrangement) earned on the donor's assigned units. Upon the donor's death, the value of the assigned units reverts to the NFP.

**Lead Interests**

44. The most common type of lead interest is an arrangement in which a donor establishes and funds a trust with specific distributions to be made to a designated NFP over a specified period. The distributions may be for a fixed dollar amount, an arrangement called a *charitable lead annuity trust*, or for a fixed percentage of the trust's fair market value as determined annually, a *charitable lead unitrust*. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to the beneficiaries designated by the donor.

**Recognition of Split-Interest Agreements**

45. As noted in FASB ASC 958-30-30 (chapter 6 of *Not-for-Profit Organizations*), recognition of split-interest agreements generally requires the assets, liabilities, and contribution to be initially measured at fair value. FASB ASC 958-30 provides guidance for determining the fair value of the contribution, either a lead or remainder interest. The following are sources of that guidance:

- Example 2 of appendix C of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*
- Paragraph 15 of FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*
- Chapter 6 of *Not-for-Profit Organizations.*
46. Prior to FASB Statement No. 157, which is reflected in FASB ASC 820, the fair value of the contribution inherent in a split-interest agreement was estimated using the income approach (present value techniques) as follows:

- For agreements in which independent trustees hold the transferred assets, paragraph 15 of FASB Statement No. 136 stated that the beneficial interest should be measured and subsequently remeasured at fair value, using a valuation technique such as the present value of the estimated expected future cash flows.
- For lead interests in agreements in which the transferred assets are held by the NFP (either in trust with the NFP as trustee or as general assets of the NFP), paragraph 6.07 of Not-for-Profit Organizations stated that the fair value of the contribution can be estimated directly based on the present value of the future distributions to be received by the NFP as a beneficiary.
- For remainder interests in agreements in which the transferred assets are held by the NFP (either in trust with the NFP as trustee or as general assets of the NFP), paragraph 6.07 of Not-for-Profit Organizations stated that the fair value of the contribution may be estimated based on the fair value of the assets transferred by the donor less the present value of the payments to be made to the other beneficiaries. That guidance is consistent with paragraph 178 of FASB Statement No. 116 (example 2 in appendix C), which stated that the amount of the contribution received by Organization B is the fair value of the trust assets less the fair value of the estimated annuity payments (the present value of $X to be paid annually over the expected life of the annuitant.) For remainder interests in which the assets are held by the NFP (either in trust with the NFP as trustee or as general assets of the NFP), therefore, the contribution is a function of the liability to the beneficiary.

11 With the 2009 edition, the name of this guide changed from Not-for-Profit Organizations to Not-for-Profit Entities.

47. Prevalent practice is to measure the fair value of the contribution and liability using commercially available software aimed at determining the amount of the donor’s tax deduction. The objective of that software is to measure the tax deductibility of the gift rather than to determine the fair value of the gift in accordance with generally accepted accounting principles.

48. The 2007 edition of Not-for-Profit Organizations was conformed to FASB Statement No. 157, and Not-for-Profit Organizations (and FASB ASC) indicates that present value techniques are one valuation technique for measuring the fair value of the contribution and liability; other valuation techniques are also available, as described in FASB Statement No. 157. Paragraphs 6.10 and 6.11 of Not-for-Profit Entities (2009 edition, which has been conformed to FASB ASC), in discussing initial measurement of lead and remainder agreements (other than pooled income funds or net income unit trusts), provide as follows:

6.10 Per FASB ASC 958-30-30-7, under a lead interest agreement, the fair value of the contribution can be estimated directly based on the present value of the future distributions to be received by the NFP as a beneficiary. Under lead interest agreements, the future payments to be made to other beneficiaries will be made by the NFP only after the NFP receives its benefits. In those situations, the present value of the future payments to be made to other beneficiaries may be estimated by the fair value of the assets contributed by the donor under the agreement less the fair value of the benefits to be received by the NFP. If present value techniques are used, the fair value of the benefits to be received by the NFP should be measured at the present value of the benefits to be received over the expected term of the agreement.

6.11 Per FASB ASC 958-30-30-8, under remainder interest agreements, the present value of the future payments to be made to other beneficiaries can be estimated directly based on the terms of the agreement. Future distributions will be received by the NFP only after obligations to other beneficiaries are satisfied. In those cases, the fair value of the contribution may be estimated based on the fair value of the assets contributed by the donor less the fair value of the payments to be made to other beneficiaries.

49. Questions have arisen about how the fair value of the liability in remainder interest agreements should be estimated and whether the inherent assumption that the fair value of the contribution is equal to the fair value of the assets less the fair value of the liability is a correct assumption. For example, questions have arisen about the following:

- Whether the market approach should be used to value the liability.
• How discount rates should be determined if the income approach is used, including how to incorporate any risk premium that hypothetical market participants would demand for bearing the uncertainties inherent in the cash flows (such as uncertainties associated with the lifespan of the beneficiary).

**Market Approach**

50. In some respects, assets and liabilities related to split-interest agreements are similar to assets and liabilities related to fixed and variable rate annuity contracts that are sold by insurance companies. However, certain differences exist between annuities offered by insurance companies and annuities offered by NFPs. The following are the most significant differences:

- For most types of agreements, a donor who enters into a split-interest agreement is able to take a charitable contribution deduction on his or her tax return in the year the agreement is signed and funded. Split-interest agreements that do not result in an initial charitable contribution deduction have other tax benefits. Insurance company contracts are investment vehicles, some of which offer tax-deferral opportunities.
- Annuities offered by insurance companies generally pay out at a higher rate of return than annuities offered by NFPs. Because of the individual’s intention to make a tax-deductible contribution, an individual generally is willing to accept a lower payout rate from an NFP than he or she would accept from an insurance company.
- The insurance industry is highly regulated, and states have insurance guarantee associations that provide the purchasers of insurance company products with varying degrees of limited protection against the inability of the insurance company to pay its obligations under the agreements. (As of September 2009, 40 of the 50 states provided protection for the present value of an annuity contract to a maximum of $100,000. The other 10 states provided varying degrees of protection. Most states however, restrict insurance agents and companies from advertising the existence of that protection.) Some states do not regulate split-interest agreements; other states regulate them, but not to the extent that insurance companies are regulated. For example, a state may require the NFP to do 1, 2, or all of the following: (a) maintain minimum reserves, (b) create a segregated trust, (c) limit its investment options to those perceived to be conservative. Those NFP requirements, however, are not as pervasive or extensive as requirements for insurance companies; and reserves, when required, typically are held by the NFP rather than a third party.

- An insurance company typically includes fees and a profit margin or both in its contracts, whereas an NFP that enters into an annuity or unitrust agreement typically does not build any fees (or only very low fees to cover costs) into the agreement because the NFP will receive its benefits via the contribution portion of the agreement.

- The marketplace for annuities with variable payments offered by insurance companies is significantly more diverse than the marketplace for annuities with fixed payments. Variable annuities offered by insurance companies include a plethora of investment returns, tax deferral strategies, and payout terms. In addition, variable annuities offered by insurance companies are structured differently than variable annuities offered by NFPs. Variable annuities offered by NFPs hold the assets funding the annuity in trust. Further, variable annuities offered by NFPs pay an agreed-upon rate that is applied to the fair value of the trust assets on the annual measurement date. In comparison, variable annuities offered by insurance companies generally have a guaranteed lifetime income component that results in a liquidation of the assets. The variable component of such annuities offered by insurance companies generally increases in circumstances in which the total return on the assets exceeds a defined value.

51. When using a market approach, FASB ASC 820-10-35-50 (paragraph 28 of FASB Statement No. 157) requires the entity to adjust the observed market prices for the differences between the item being measured and the item for which the price was observed. It is unclear whether and how the NFP should adjust for the tax deductibility, adjust for the protection provided by the guarantee association, and remove the profit and fee components from the observed market prices for the insurance company contracts.

**Discount Rate**

52. In discussing discount rates used in PV measurements, 958-30-30-6 (paragraph 6.09 of *Not-for-Profit Entities* [2009 edition]) specifies that a discount rate commensurate with the risks involved should be used if present value techniques are used to measure the fair value split-interest obligations. In practice, some NFPs have used surrogates for a discount rate commensurate with the risks involved, such as average rate of return on the investment portfolio or
average interest rate on outstanding borrowings, asserting that those surrogates generally did not result in measures that resulted in material misstatements in the financial statements.

53. As noted in paragraph 7 of this issues paper, FASB ASC 820-10-55-5 (paragraph B2 of FASB Statement No. 157) states that a fair value measurement of an asset or liability, using present value should capture all of the following elements from the perspective of market participants as of the measurement date:

- An estimate of future cash flows for the asset or liability being measured.
- Expectations about possible variations in the amount or timing, or both, of the cash flows representing the uncertainty inherent in the cash flows.
- The time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows (risk-free interest rate). For present value computations denominated in nominal U.S. dollars, the yield curve for U.S. Treasury securities determines the appropriate risk-free interest rate. U.S. Treasury securities are deemed (default) risk free because they pose neither uncertainty in timing nor risk of default to the holder.
- The price for bearing the uncertainty inherent in the cash flows (risk premium).
- Other case-specific factors that would be considered by market participants.
- In the case of a liability, the nonperformance risk relating to that liability, including the reporting entity’s (obligor’s) own credit risk.

54. As discussed in paragraph 8 of this issues paper, FASB ASC 820-10-55-7 and 820-10-55-8 discuss price (or compensation) that market participants would demand for bearing the uncertainty inherent in the cash flows (the risk premium):

- 55-7 A fair value measurement, using present value, is made under conditions of uncertainty because the cash flows used are estimates rather than known amounts. In many cases, both the amount and timing of the cash flows will be uncertain. Even contractually fixed amounts, like the payments on a loan, will be uncertain if there is risk of default.
- 55-8 A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment.

55. In determining PV, therefore, entities should consider the risk that actual cash flows (in both timing and amount) may differ from the cash flows used in the PV calculation. All other factors being equal, therefore, the higher the risk that actual cash flows may differ from the cash flows used in the PV calculation, the higher the discount rate or rate of return. Questions have arisen about how the risk premium should be determined in estimating the fair value of the liability in remainder interest agreements.

56. When a split-interest gift is to be funded from a trust, the obligation to make payment to the donor rests with the trust. In using an income approach, questions arise regarding whether the nonperformance risk relating to the liability should include the reporting entity’s (NFP’s) credit risk or the trust’s (obligor’s) credit risk. Questions have also arisen regarding whether, if the nonperformance risk is the risk of the trust’s nonperformance, is a risk-free discount rate the appropriate rate because the obligation is satisfied only from the assets in the trust. If it is determined that the risk-free rate is inappropriate, what types of adjustments to a risk-free rate might be necessary?

**How Should NFPs Estimate the Fair Value of Liabilities Under Split-Interest Remainder Agreements with Fixed Payments?**

57. For liabilities under split-interest remainder agreements with fixed payments, AcSEC believes that one of two approaches will be the best valuation technique for measuring fair value. In the circumstances described in paragraph 64 of this issues paper, AcSEC believes that a market approach, using level 2 inputs, as described in FASB ASC 820-10-35-29 to 820-10-35-31 (paragraph 18 of FASB Statement No. 157), will provide the best measure. In other circumstances, described in paragraph 66 of this issues paper, AcSEC believes the income approach, in the form of present value techniques using level 2 inputs for interest rates, yield curves, and life expectancy tables, will provide the best measure. NFPs could, of course, use other valuation techniques to measure the fair value of liabilities under split-interest remainder agreements with fixed payments.
58. AcSEC believes that other than the protection provided by the guarantee association for insurance company annuities, the differences between annuities offered by (a) insurance companies, and (b) NFPs discussed in paragraph 50 of this issues paper, are irrelevant in determining the fair value of the liabilities under split-interest remainder agreements with fixed payments in conformity with FASB ASC 820 (FASB Statement No. 157). The obligation to make fixed payments to the beneficiary is the same, regardless of the charitable or for-profit nature of the payment vehicle. AcSEC believes the fair value of a liability for a series of fixed payments would be the same, assuming similar risk profiles (credit standing), regardless of whether the liability originated as part of a split-interest agreement or as part of an annuity with an insurance company.

59. AcSEC notes that observable prices are readily available from the Web sites of insurance companies and brokers for annuities with fixed payments and terms that are similar to split-interest liabilities with fixed payments. AcSEC believes that for split-interest agreements with fixed payments, those quoted prices are level 2 inputs pursuant to the FASB ASC glossary definition of level 2 inputs and FASB ASC 820-10-35-48 (paragraph 28 of FASB Statement No. 157) because they are an observable quoted price for a similar liability and are in an active market.

60. AcSEC considered whether NFPs should make adjustments to market prices of annuities offered by insurance companies (level 2 inputs) in estimating the fair value of liabilities under split-interest remainder agreements with fixed payments to reflect difference in credit risk. AcSEC does not know how much emphasis market participants place on the credit standing of the payer of a fixed annuity, but AcSEC presumes that some market participants place some emphasis on that credit standing.

61. Historically and in the current market, AcSEC notes that few defaults are observed on annuities from either (a) NFPs or (b) insurance companies. Perhaps because of such a low incidence of default, market participants may place little to no emphasis on the credit standing of the payer of the annuity. (In fact, an anomaly exists in that in some circumstances, annuities from insurance companies with better credit standing pay more than do annuities from insurance companies with worse credit standing.)

62. Market participants, however, may have reasons other than the low incidence of defaults for placing little or no emphasis on the credit standing of the payer. If an NFP is the payer, market participants may place a little or no emphasis on the credit risk of the payer because of their affinity for the NFP and their donative intent. As another example, if an insurance company is the payer, market participants may place little or no emphasis on the credit risk of the payer because of the high degree of regulation of the insurance industry, including the protection provided by state guarantee associations that assume some or all of the liability to the annuitant if the insurance company defaults.

63. Even though market participants may place little or no emphasis on the credit standing of the payer, annuity obligations of an NFP may have a different risk profile than annuities offered by insurance companies because of differences in credit standing, the existence and extent of insurance company regulation, including protection provided by state guarantee associations, whether the NFP annuity obligation is adequately funded through a trust, and the existence and extent of minimum reserve requirements related to NFP annuity obligations. Therefore, market quotes for fixed payment annuities offered by insurance companies may need to be adjusted for credit quality or credit enhancement features.

64. FASB ASC 820-10-35-50 (paragraph 28 of FASB Statement No. 157) requires that observed market prices be adjusted if they are for liabilities that are similar to, rather than the same as, the liability being measured (level 2 measures). AcSEC observes that the insurance industry is highly regulated, which results in annuities being offered by insurance companies that have (a) a strong, superior, or excellent capacity to meet their financial commitments (credit worthiness) or (b) a somewhat lesser creditworthiness but that market participants may view as equally creditworthy because of protection provided by a state guarantee association. Thus, AcSEC believes best practice is to limit the use of market quotes for fixed payment annuities offered by insurance companies in measuring split-interest obligations with fixed payments to situations for which credit risk associated with the split-interest obligation is similarly low. Specifically, AcSEC believes that the use of market quotes for fixed payment annuities offered by insurance companies for measuring split-interest obligations is the best practice in any of the following situations:

- The annuity obligation is adequately funded from assets held in an irrevocable trust and the NFP is observing its fiduciary responsibilities as trustee.
- The NFP has a credit standing similar to that of the insurance companies whose quotes are observed in the market place. That is, the NFP has a credit standing reflecting strong, superior, or excellent capacity to meet...
financial commitments; in other words, “investment grade.” (Note that the NFP’s credit standing may be based on the NFP’s own assessment, rather than a rating by a third-party rating agency.)

- The NFP holds a commercially available annuity that provides cash flows to the beneficiary in the amount of and for the entire term of the agreement.

65. In those three situations, AcSEC expects that NFPs generally would make no adjustment for credit risk to the market prices of annuities offered by insurance companies when estimating the fair value of liabilities under split-interest remainder agreements with fixed payments, unless facts and circumstances indicate that such adjustments should be made.

66. In situations other than those described in paragraph 64 of this issues paper, AcSEC believes that the income approach, in the form of present value techniques that maximize the use of observable inputs for interest rates, yield curves, and life expectancy tables, will be the best valuation technique for split-interest agreements with fixed payments. (The income approach, including considerations for determining the discount rate, is discussed further in paragraphs 75–89 of this issues paper.)

67. When using present value techniques to determine the fair value of a split-interest agreement’s obligation to make fixed payments, AcSEC believes NFPs should consider the risk premium that hypothetical market participants would demand for bearing the uncertainty inherent in the cash flows of the obligation. For example, a market participant would likely demand a premium to be compensated for uncertainties associated with the lifespan of an annuitant. Market quotes for annuities of insurance companies already include this risk premium.

68. Some have used tables provided by the IRS or tables in planned giving software based on those IRS tables to estimate fair value of liabilities under split-interest remainder agreements with fixed payments. AcSEC believes that tables provided by the IRS or tables in planned giving software based on those IRS tables may be inappropriate for estimating fair value of liabilities under split-interest remainder agreements with fixed payments. For example, life expectancy statistics are updated annually, yet the IRS tables are updated only every 10 years. The updates to the tables issued in May 2009 were based on the 2000 census and likely will not be replaced until 2019, at which time the mortality statistics will be 19 years old. The tables updated by the May 2009 publications were based on mortality statistics from 1989-1991. Further, actuarial assumptions and the resulting actuarial tables used in IRS tables and software based on those tables may be based on the population at large, rather than the population likely to buy an annuity or enter into a split-interest agreement. AcSEC believes evidence exists that the population likely to buy an annuity or enter into a split-interest agreement has a greater life expectancy than the general population, because of the demonstrated relationship between wealth, health, and expected life. AcSEC believes that quoted market prices for fixed-payment annuities in active markets appropriately consider the estimated life of the relevant pool of annuitants.

**How Should NFPs Account for the Changes in the Liabilities Under Split-Interest Agreements with Fixed Payments in Subsequent Periods?**

69. FASB ASC 958-30-35 (Chapter 6 of Not-for-Profit Organizations) discusses recognition and measurement during the term of a split-interest agreement. The NFP has two options available for reporting the liabilities under split-interest agreements with fixed payments: it can (a) elect the fair value option pursuant to FASB ASC 825-10-35 (FASB Statement No. 159) or (b) amortize the discount associated with the obligation (remainder trust) or contribution (lead interest) and adjust for changes in life expectancies (if payments are life-dependent).

70. FASB ASC 820-10-35-25 (paragraph 20 of FASB Statement No. 157) requires that valuation techniques be consistently applied unless a change in valuation techniques results in a measurement that is equally or more representative of fair value in the circumstances. If the NFP elects to report the annuity payment liability at fair value in subsequent periods, it therefore should use the same method to determine fair value as it did at initial recognition (unless a change in valuation techniques results in a measurement that is equally or more representative of fair value in the circumstances). That is, if at initial recognition the NFP used market quotations gathered from the internet for commercially available annuity products with similar terms, it should repeat that process (unless a change in valuation techniques results in a measurement that is equally or more representative of fair value in the circumstances) and the liability would be adjusted upward or downward to reflect the new market quote. If at initial recognition the NFP used present value techniques to estimate the fair value, it should update all the elements described in paragraph 53 of this issues paper, including the discount rate assumptions, in arriving at the current fair value estimate.
71. If the NFP does not elect to report the annuity liability at fair value, it should not adjust the discount rate assumptions. It should update only the actuarial assumptions, including life expectancy. AcSEC observes that if the NFP initially measured the liability using market quotes, it would determine the imputed discount rate to be used in amortizing the liability. To do so, the NFP might use a calculator with finance functions to solve for the discount rate using the fixed payment amount, the life expectancies at the inception of the contract (obtained from a reliable published source such as National Center for Health Statistics), and the market quote (the present value at initial measurement). That imputed discount rate would be used in the subsequent periods’ remeasurements over the life of the agreement.

How Should NFPs Estimate the Fair Value of Split-Interest Liabilities with Variable Payments?

72. For liabilities under split-interest agreements with variable payments (sometimes referred to as charitable unitrusts), AcSEC believes an income approach, using present value techniques and level 2 inputs for interest rates, as described in the FASB ASC glossary and 820-10-35-32 and 820-10-35-33 (paragraph 18 of FASB Statement No. 157), often will be the best valuation technique for measuring fair value. This issues paper, therefore, discusses various techniques under an income approach for measuring the fair value of liabilities under split-interest remainder agreements with variable payments.

73. AcSEC believes the market approach is not feasible for split-interest agreements with variable payments. The marketplace for annuities with variable payments offered by insurance companies is significantly more diverse than the marketplace for annuities with fixed payments. Variable annuities offered by insurance companies include a plethora of investment returns, tax deferral strategies, and payout terms. In addition, variable annuities offered by insurance companies are structured differently than variable annuities offered by NFPs. Further, variable annuities offered by NFPs pay an agreed-upon rate that is applied to the fair value of the trust assets on the annual measurement date. In comparison, variable annuities offered by insurance companies generally have a guaranteed lifetime income component that results in a liquidation of the assets. The variable component of such annuities offered by insurance companies generally increases in circumstances in which the total return on the assets exceeds a defined value. The market approach therefore is not feasible for split-interest agreements with variable payments because prices in an active market for obligations similar to split-interest agreements with variable payments cannot be observed with a reasonable cost and effort.

74. AcSEC observes that the cost approach is not feasible because it is not used for valuing financial liabilities, such as split interest obligations.

75. All variable payment split-interest agreements hold the assets in trust. In circumstances in which the assets are held in trust, the trust is the obligor, and not the NFP that serves as trustee. Further, holding the assets in trust provides significant protection (similar to collateral) against risk of default because
   - the variable payments are computed as a percentage of the trust assets, and thus the payments decrease if investment losses cause a decrease in the trust assets.
   - split-interest remainder agreements that result in tax deductions must have a remainder interest equal to or greater than 10 percent of the fair value of the assets initially transferred to the trust, which provides additional protection against default.

76. To use the income approach to measure the fair value of the contribution and obligation of a split-interest agreement with variable payments, an NFP must make assumptions about the following inputs to the present value techniques:
   - Expected rate of return on the investments in the trust.
   - Discount rate for the obligation.
   - The expected mortality of the individual on which termination of the agreement depends, if the agreement is life dependent.

77. In circumstances in which cash is invested, the investor is subject to various types of risk, including market risk, credit risk, inflation risk, and so forth. AcSEC observes that because the payments to the beneficiary depend upon the assets in the trust, the cash flows from the trust are at least as risky as the cash flows of the trust investments. That is, if
the trustee expects, for example, a rate of return on the trust investments of 6 percent (due to the risk of investing the trust assets), then the beneficiary of the cash flows from the trust also bears at least that same risk. AcSEC believes that because the beneficiary also bears that risk, best practice is for the discount rate to also reflect those risks, and therefore the discount rate in this example would be at a minimum 6 percent.

12 This mortality table can be adjusted to reflect the fact that mortality rates improve over time. For example, projection scale G is used to adjust annual rates of mortality in individual annuity tables.

78. AcSEC observes that defaults rarely occur on split-interest agreements with variable payments because they are collateralized obligations and NFPs generally perform their trust duties as assigned. Therefore, AcSEC believes if the NFP is complying with all of its fiduciary duties as trustee, best practice is to use the same rate for the expected rate of return on the investments and the discount rate. The NFP can use either the risk-neutral rate or the expected earnings rate on the trust assets.

79. Life expectancy information can be obtained from various sources, such as recent annuity tables published by the Society of Actuaries, including The Annuity 2000 Mortality Table (adopted by the National Association of Insurance Commissioners in 1996) or the National Center for Health Statistics (National Vital Statistics Reports: United States Life Tables). The Annuity 2000 Mortality Tables reflect the fact that individuals who purchase annuities tend to be wealthier, and thus healthier, than the general public.12 The tables published by the National Center for Health Statistics are based on the general public. Some sources suggest that a minimum of two years and a maximum of six years would be added to the life expectancies in mortality tables based upon the general public to reflect annuitants expected longer lives.

80. An example of an income approach calculation for a charitable remainder unitrust appears in exhibit 1.13 The Treasury yield curve rates published by the U.S. Treasury are an alternative set of risk-free rates.

81. FACT SET

James Joyce establishes a charitable remainder unitrust with assets valued at $100,000, naming ABC Charity as the remainder beneficiary and trustee. The unitrust agreement specifies that Mr. Joyce will receive 6 percent of the value of the trust assets annually, based on the fair value of the trust assets on the measurement date. Mr. Joyce is 75 years old when the agreement is signed. Payments are made at the end of the year.

82. The following table provides information for determining a risk-neutral rate, which is measured as the risk-free rate adjusted for the credit swap spread rate.13 (The credit swap spread measures a more liquid market in which AA banks lend to each other.) The credit swap spread rate is measured as the difference between LIBOR and the T-bill rate. The boxes indicate observable market returns.

<table>
<thead>
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<th>Portfolio return and discount rate:</th>
<th>Libor</th>
<th>T-bill</th>
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</thead>
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<td>1 Year Treasury</td>
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<tr>
<td>Linear interpolation between</td>
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<td>years 3 and 5</td>
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<td>5 Year Treasury</td>
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<td>Linear interpolation between</td>
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<td>years 5 and 10</td>
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<td>8 Year Treasury</td>
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<td>9 Year Treasury</td>
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<td>10 year Treasury</td>
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Linear interpolation between years 10 and 30

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<th>Trust assets at the beginning of the year</th>
<th>Trust return/discount rate</th>
<th>Payout</th>
<th>Expected Payment</th>
<th>Discount Factor</th>
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<td>2,817</td>
<td>0.77186</td>
<td>2,174</td>
</tr>
<tr>
<td>11</td>
<td>0.064614 0.605424</td>
<td>70,926</td>
<td>3.838</td>
<td>4,256</td>
<td>2,576</td>
<td>0.76637</td>
<td>1,974</td>
</tr>
<tr>
<td>12</td>
<td>0.069729 0.563208</td>
<td>69,393</td>
<td>3.885</td>
<td>4,164</td>
<td>2,345</td>
<td>0.76055</td>
<td>1,783</td>
</tr>
<tr>
<td>13</td>
<td>0.075129 0.520895</td>
<td>67,925</td>
<td>3.933</td>
<td>4,076</td>
<td>2,123</td>
<td>0.75442</td>
<td>1,602</td>
</tr>
<tr>
<td>14</td>
<td>0.081346 0.478522</td>
<td>66,521</td>
<td>3.980</td>
<td>3,991</td>
<td>1,910</td>
<td>0.74799</td>
<td>1,429</td>
</tr>
<tr>
<td>15</td>
<td>0.087988 0.436418</td>
<td>65,177</td>
<td>4.028</td>
<td>3,911</td>
<td>1,707</td>
<td>0.74126</td>
<td>1,265</td>
</tr>
<tr>
<td>16</td>
<td>0.095054 0.394935</td>
<td>63,891</td>
<td>4.075</td>
<td>3,833</td>
<td>1,514</td>
<td>0.73425</td>
<td>1,112</td>
</tr>
<tr>
<td>17</td>
<td>0.102537 0.354440</td>
<td>62,661</td>
<td>4.123</td>
<td>3,760</td>
<td>1,333</td>
<td>0.72696</td>
<td>969</td>
</tr>
<tr>
<td>18</td>
<td>0.110440 0.315295</td>
<td>61,485</td>
<td>4.170</td>
<td>3,689</td>
<td>1,163</td>
<td>0.71940</td>
<td>837</td>
</tr>
<tr>
<td>19</td>
<td>0.117691 0.278188</td>
<td>60,360</td>
<td>4.218</td>
<td>3,622</td>
<td>1,007</td>
<td>0.71159</td>
<td>717</td>
</tr>
<tr>
<td>20</td>
<td>0.125100 0.243386</td>
<td>59,284</td>
<td>4.265</td>
<td>3,557</td>
<td>866</td>
<td>0.70354</td>
<td>609</td>
</tr>
<tr>
<td>21</td>
<td>0.132647 0.211102</td>
<td>58,255</td>
<td>4.313</td>
<td>3,495</td>
<td>738</td>
<td>0.69525</td>
<td>513</td>
</tr>
<tr>
<td>22</td>
<td>0.140309 0.181482</td>
<td>57,272</td>
<td>4.360</td>
<td>3,436</td>
<td>624</td>
<td>0.68673</td>
<td>428</td>
</tr>
<tr>
<td>23</td>
<td>0.148066 0.154611</td>
<td>56,333</td>
<td>4.408</td>
<td>3,380</td>
<td>523</td>
<td>0.67800</td>
<td>354</td>
</tr>
<tr>
<td>24</td>
<td>0.163725 0.129297</td>
<td>55,436</td>
<td>4.455</td>
<td>3,326</td>
<td>430</td>
<td>0.66907</td>
<td>288</td>
</tr>
<tr>
<td>25</td>
<td>0.182176 0.105742</td>
<td>54,579</td>
<td>4.503</td>
<td>3,275</td>
<td>346</td>
<td>0.65995</td>
<td>229</td>
</tr>
<tr>
<td>26</td>
<td>0.204277 0.084142</td>
<td>53,762</td>
<td>4.550</td>
<td>3,226</td>
<td>271</td>
<td>0.65064</td>
<td>177</td>
</tr>
<tr>
<td>27</td>
<td>0.231053 0.064701</td>
<td>52,983</td>
<td>4.598</td>
<td>3,179</td>
<td>206</td>
<td>0.64117</td>
<td>132</td>
</tr>
<tr>
<td>28</td>
<td>0.263745 0.047636</td>
<td>52,239</td>
<td>4.645</td>
<td>3,134</td>
<td>149</td>
<td>0.63154</td>
<td>94</td>
</tr>
<tr>
<td>29</td>
<td>0.287334 0.033949</td>
<td>51,532</td>
<td>4.693</td>
<td>3,092</td>
<td>105</td>
<td>0.62176</td>
<td>65</td>
</tr>
</tbody>
</table>
83. The calculation in exhibit 1 incorporates a yield curve and mortality probabilities. AcSEC believes a shortcut method would provide an adequate estimate of fair value in circumstances in which the results would not be materially different than the more precise method illustrated in exhibit 1. Exhibit 2 presents a shortcut calculation for the same fact set as exhibit 1.

### Exhibit 2

84. Instead of using annual mortality statistics, the beneficiary’s life expectancy is used, and 13.44 years (exhibit 1) is rounded to 14 years. Instead of using the yield curve used in exhibit 1, the average return over the life of the beneficiary is estimated. The boxes indicate observable market returns. As is done in exhibit 1, the return on Treasuries after year 10 is imputed using a linear interpolation of the 10-year and 30-year rates. Thus, the average return is computed as follows:

<table>
<thead>
<tr>
<th>Treasury Maturity</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Year Treasury</td>
<td>0.47%</td>
</tr>
<tr>
<td>2 Year Treasury</td>
<td>0.86%</td>
</tr>
<tr>
<td>3 Year Treasury</td>
<td>1.29%</td>
</tr>
<tr>
<td>4 Year Treasury</td>
<td>1.64%</td>
</tr>
<tr>
<td>5 Year Treasury</td>
<td>1.98%</td>
</tr>
<tr>
<td>6 Year Treasury</td>
<td>2.21%</td>
</tr>
<tr>
<td>7 Year Treasury</td>
<td>2.44%</td>
</tr>
<tr>
<td>8 Year Treasury</td>
<td>2.67%</td>
</tr>
<tr>
<td>9 Year Treasury</td>
<td>2.90%</td>
</tr>
<tr>
<td>10 year Treasury</td>
<td>3.12%</td>
</tr>
<tr>
<td>11 year Treasury</td>
<td>3.17%</td>
</tr>
<tr>
<td>12 year Treasury</td>
<td>3.22%</td>
</tr>
<tr>
<td>13 year Treasury</td>
<td>3.26%</td>
</tr>
<tr>
<td>14 year Treasury</td>
<td>3.31%</td>
</tr>
</tbody>
</table>

Average Treasury: 2.32%
Swap spread: 0.67%
Average return: 2.99%

The average return is used to compute the return on the investments in the portfolio, for purposes of estimating the trust assets at the beginning of the year. It is also used as the discount rate, which is computed using the formula \(1/(1+\text{interest rate})^n\) in which \(n\) is the number of years. The estimate of the obligation to the beneficiary and ABC Charity’s contribution is as follows using the shortcut method:

\[
\text{Total FV of Donor's Interest} = 52,543 \\
\text{Total FV of ABC Charity’s Interest} = 47,457
\]
### Estimate of Fair Value of Obligation to the Beneficiary and ABC Charity’s Contribution

#### Projected Trust Balance:

<table>
<thead>
<tr>
<th>Beginning of Year</th>
<th>Projected Trust Income</th>
<th>Projected Trust Payout</th>
<th>Present Value Factor</th>
<th>Present Value of Payout</th>
</tr>
</thead>
<tbody>
<tr>
<td>A = Aprev+Bprev -Cprev</td>
<td>B = A X 2.993%</td>
<td>C = A X 6%</td>
<td>D</td>
<td>E = C * D</td>
</tr>
<tr>
<td>Year 1</td>
<td>100,000</td>
<td>2,993</td>
<td>6,000</td>
<td>0.9709</td>
</tr>
<tr>
<td>Year 2</td>
<td>96,993</td>
<td>2,903</td>
<td>5,820</td>
<td>0.9427</td>
</tr>
<tr>
<td>Year 3</td>
<td>94,077</td>
<td>2,816</td>
<td>5,645</td>
<td>0.9153</td>
</tr>
<tr>
<td>Year 4</td>
<td>91,249</td>
<td>2,731</td>
<td>5,475</td>
<td>0.8887</td>
</tr>
<tr>
<td>Year 5</td>
<td>88,505</td>
<td>2,649</td>
<td>5,310</td>
<td>0.8629</td>
</tr>
<tr>
<td>Year 6</td>
<td>85,844</td>
<td>2,570</td>
<td>5,151</td>
<td>0.8378</td>
</tr>
<tr>
<td>Year 7</td>
<td>83,263</td>
<td>2,492</td>
<td>4,996</td>
<td>0.8135</td>
</tr>
<tr>
<td>Year 8</td>
<td>80,760</td>
<td>2,417</td>
<td>4,846</td>
<td>0.7898</td>
</tr>
<tr>
<td>Year 9</td>
<td>78,331</td>
<td>2,345</td>
<td>4,700</td>
<td>0.7669</td>
</tr>
<tr>
<td>Year 10</td>
<td>75,976</td>
<td>2,274</td>
<td>4,559</td>
<td>0.7446</td>
</tr>
<tr>
<td>Year 11</td>
<td>73,692</td>
<td>2,206</td>
<td>4,422</td>
<td>0.7229</td>
</tr>
<tr>
<td>Year 12</td>
<td>71,476</td>
<td>2,140</td>
<td>4,289</td>
<td>0.7019</td>
</tr>
<tr>
<td>Year 13</td>
<td>69,327</td>
<td>2,075</td>
<td>4,160</td>
<td>0.6815</td>
</tr>
<tr>
<td>Year 14</td>
<td>67,243</td>
<td>2,013</td>
<td>4,035</td>
<td>0.6617</td>
</tr>
</tbody>
</table>

#### Total FV of Donor’s Interest $56,842

#### Total FV of ABC Charity’s Interest $43,158

85. The shortcut method in exhibit 2 results in an obligation to the beneficiary of $56,842 as compared to $52,543 in the more exact method in exhibit 1, which is a difference of $4,299 or 8 percent. The primary reason for the difference is the use of the average return over the life expectancy of the beneficiary instead of the yield curve. In circumstances in which the average return is used and the yield curve is upward sloping (as it typically is), the trust assets are not depleted as rapidly and the estimated payments to the beneficiary are larger.

86. Exhibit 1 and exhibit 2 used a risk-neutral rate adjusted by the swap rate as the estimated return on the trust assets and the discount rate. As discussed in paragraph 78 of this issues paper, if an NFP uses the expected earnings rate on the trust assets in the present value calculation and the NFP is complying with all of its fiduciary duties as trustee, best practice is to use that expected earnings rate as the discount rate. Exhibit 3 presents a shortcut calculation for the same fact set as exhibits 1 and 2, but uses the expected earning rate on the trust assets as the discount rate, rather than the risk-neutral rate.

#### EXHIBIT 3

87. The beneficiary’s life expectancy from exhibit 2 (13.44 years) is rounded to 14 years. Instead of using the yield curve used in exhibit 1 or the average return over the life of the beneficiary used in exhibit 2, the expected return on the portfolio of 4 percent is used as the discount rate and rate of return on the trust assets.

### Estimate of Fair Value of Obligation to the Beneficiary and ABC Charity’s Contribution

<table>
<thead>
<tr>
<th>Projected Trust Balance: Beginning of Year</th>
<th>Projected Trust Income</th>
<th>Projected Trust Payout</th>
<th>Present Value Factor</th>
<th>Present Value of Payout</th>
</tr>
</thead>
<tbody>
<tr>
<td>A = Aprev+Bprev -Cprev</td>
<td>B = A X 4%</td>
<td>C = A X 6%</td>
<td>D</td>
<td>E = C * D</td>
</tr>
<tr>
<td>Year 1</td>
<td>100,000</td>
<td>4,000</td>
<td>6,000</td>
<td>0.9615</td>
</tr>
<tr>
<td>Year 2</td>
<td>98,000</td>
<td>3,920</td>
<td>5,880</td>
<td>0.9246</td>
</tr>
</tbody>
</table>
The shortcut method in exhibit 3 results in an obligation to the beneficiary of $56,479 as compared to $52,543 in the more exact method in exhibit 1, a difference from Exhibit 1 of $3,936 or 7.5 percent. The primary reason for the difference is the use of the average return on trust investments over the life expectancy of the beneficiary instead of the yield curve. In circumstances in which the average return is used and the yield curve is upward sloping (as it typically is), the trust assets are not depleted as rapidly and the estimated payments to the beneficiary are larger. The difference from the shortcut method using the risk-neutral rate is negligible ($56,842 compared to $56,479).

89. To determine how sensitive the fair value measurements are to changes in the rate used for the investment return, an NFP or its auditors can do a sensitivity analysis by substituting different rates of return and discount rates into the spreadsheet used to compute the fair value estimates. Doing so results in the following values of the obligation using the shortcut method and the following rates. Readers are reminded that the discount rate would equal the expected rate of return on the investments if the NFP is complying with all of its fiduciary duties as trustee.

<table>
<thead>
<tr>
<th>Portfolio return</th>
<th>Discount Rate</th>
<th>Obligation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.99%</td>
<td>2.99%</td>
<td>$56,842</td>
</tr>
<tr>
<td>1.00</td>
<td>1.00</td>
<td>57,574</td>
</tr>
<tr>
<td>2.00</td>
<td>2.00</td>
<td>57,205</td>
</tr>
<tr>
<td>4.00</td>
<td>4.00</td>
<td>56,479</td>
</tr>
<tr>
<td>5.00</td>
<td>5.00</td>
<td>56,122</td>
</tr>
</tbody>
</table>

APPENDIX A
FASB ASC 820-10-55-4 to 820-10-55-20 (Appendix B. of FASB Statement No. 157), Present Value Techniques

55-4 FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, provides guidance for using present value techniques to measure fair value. That guidance focuses on a traditional or discount rate adjustment technique and an expected cash flow (expected present value) technique. This section clarifies that guidance. (That guidance is included or otherwise referred to principally in paragraphs 39–46, 51, 62–71, 114, and 115 of Concepts Statement 7.) This section neither prescribes the use of one specific present value technique nor limits the use of present value techniques to measure fair value to the techniques discussed herein. The present value technique used to measure fair value will depend on facts and circumstances specific to the asset or liability being measured (for example, whether comparable assets or liabilities can be observed in the market) and the availability of sufficient data.
The Components of a Present Value Measurement

55-5 A fair value measurement of an asset or liability, using present value should capture all of the following elements from the perspective of market participants as of the measurement date:

a. An estimate of future cash flows for the asset or liability being measured.

b. Expectations about possible variations in the amount and/or timing of the cash flows representing the uncertainty inherent in the cash flows.

c. The time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows (risk-free interest rate). For present value computations denominated in nominal U.S. dollars, the yield curve for U.S. Treasury securities determines the appropriate risk-free interest rate. U.S. Treasury securities are deemed (default) risk free because they pose neither uncertainty in timing nor risk of default to the holder.

d. The price for bearing the uncertainty inherent in the cash flows (risk premium-- compensation generally sought by risk-averse market participants for bearing the uncertainty inherent in the cash flows of an asset or liability).

e. Other case-specific factors that would be considered by market participants.

f. In the case of a liability, the nonperformance risk relating to that liability, including the reporting entity’s (obligor’s) own credit risk. (Nonperformance risk refers to the risk that the obligation would not be fulfilled and affects the value at which the liability is transferred. Nonperformance risk includes but may not be limited to the reporting entity's own credit risk.)

General Principles

55-6 Present value techniques differ in how they capture those elements. However, all of the following general principles govern the application of any present value technique:

a. Cash flows and discount rates should reflect assumptions that market participants would use in pricing the asset or liability.

b. Cash flows and discount rates should consider only factors attributed to the asset (or liability) being measured.

c. To avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects expectations about future defaults is appropriate if using contractual cash flows of a loan (discount rate adjustment technique). That same rate would not be used if using expected (probability-weighted) cash flows (expected present value technique) because the expected cash flows already reflect assumptions about future defaults; instead, a discount rate that is commensurate with the risk inherent in the expected cash flows should be used.

d. Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows (that include the effect of inflation) should be discounted at a rate that includes the effect of inflation. The nominal risk-free interest rate includes the effect of inflation. Real cash flows (that exclude the effect of inflation) should be discounted at a rate that excludes the effect of inflation. Similarly, after-tax cash flows should be discounted using an after-tax discount rate. Pretax cash flows should be discounted at a rate consistent with those cash flows (for example, a U.S. Treasury rate is quoted on a pretax basis, as is a London Interbank Offered Rate [LIBOR] or a prevailing term loan rate).

e. Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.
Risk and Uncertainty

55-7 A fair value measurement, using present value, is made under conditions of uncertainty because the cash flows used are estimates rather than known amounts. In many cases, both the amount and timing of the cash flows will be uncertain. Even contractually fixed amounts, like the payments on a loan, will be uncertain if there is risk of default.

55-8 A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment.

55-9 Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example:
   a. The discount rate adjustment technique uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows.
   b. Method 1 of the expected present value technique uses a risk-free rate and risk-adjusted expected cash flows.
   c. Method 2 of the expected present value technique uses a risk-adjusted discount rate (which is different from the rate used in the discount rate adjustment technique) and expected cash flows.

Discount Rate Adjustment Technique

55-10 The discount rate adjustment technique uses a single set of cash flows from the range of possible estimated amounts, whether contractual or promised (as is the case for a bond) or most likely cash flows. In all cases, those cash flows are conditional upon the occurrence of specified events (for example, contractual or promised cash flows for a bond are conditional on the event of no default by the debtor). The discount rate used in the discount rate adjustment technique is derived from observed rates of return for comparable assets or liabilities that are traded in the market. Accordingly, the contractual, promised, or most likely cash flows are discounted at a rate that corresponds to an observed market rate associated with such conditional cash flows (market rate of return).

55-11 The application of the discount rate adjustment technique requires an analysis of market data for comparable assets or liabilities. Comparability is established by considering the nature of the cash flows (for example, whether the cash flows are contractual or noncontractual and are likely to respond similarly to changes in economic conditions), as well as other factors (for example, credit standing, collateral, duration, restrictive covenants, and liquidity). Alternatively, if a single comparable asset or liability does not fairly reflect the risk inherent in the cash flows of the asset or liability being measured, it may be possible to derive a discount rate using data for several comparable assets or liabilities in conjunction with the risk-free yield curve (a build-up approach). Example 2 (see paragraph 820-10-55-33) illustrates the build-up approach.

55-12 In applying the discount rate adjustment technique to fixed claims, the adjustment for risk inherent in the cash flows of the asset or liability being measured is included in the discount rate. In some applications of the discount rate adjustment technique to cash flows that are other than fixed claims, an adjustment to the cash flows also may be necessary to achieve comparability with the observed asset or liability from which the discount rate is derived.

Expected Present Value Technique

55-13 The expected present value technique uses as a starting point a set of cash flows that, in theory, represents the probability-weighted average of all possible cash flows (expected cash flows). The resulting estimate is identical to expected value, which, in statistical terms, is the weighted average of a discrete random variable’s possible values where the respective probabilities are used as weights. Because all possible cash flows are probability-weighted, the resulting expected cash flow is not conditional upon the occurrence of any specified event (as are the cash flows used in the discount rate adjustment technique).
In making an investment decision, risk-averse market participants would consider the risk inherent in the expected cash flows. Portfolio theory distinguishes between two types of risk:

a. Unsystermic (diversifiable) risk (The risk specific to a particular asset or liability, also referred to as diversifiable risk.)

b. The second is general market risk, also referred to as systemic (nondiversifiable) risk.

Method 1 of the expected present value technique adjusts the expected cash flows for the systematic (market) risk by subtracting a cash risk premium (risk-adjusted expected cash flows). These risk-adjusted expected cash flows represent a certainty equivalent cash flow, which is discounted at a risk-free interest rate. A certainty equivalent cash flow refers to an expected cash flow adjusted for risk such that one is indifferent to trading a certain cash flow for an expected cash flow. For example, if one were willing to trade an expected cash flow of $1,200 for a certain cash flow of $1,000, the $1,000 is the certainty equivalent of the $1,200 (the $200 would represent the cash risk premium). In that case, one would be indifferent regarding the asset held.

In contrast, Method 2 of the expected present value technique adjusts for systematic (market) risk by adding a risk premium to the risk-free interest rate. Accordingly, the expected cash flows are discounted at a rate that corresponds to an expected rate associated with probability-weighted cash flows (expected rate of return). Models used for pricing risky assets, such as the capital asset pricing model, can be used to estimate the expected rate of return. Because the discount rate used in the discount rate adjustment technique is a rate of return relating to conditional cash flows, it will likely be higher than the discount rate used in Method 2 of the expected present value technique, which is an expected rate of return relating to expected or probability-weighted cash flows.

To illustrate Methods 1 and 2, assume that an asset has expected cash flows of $780 in 1 year based on the possible cash flows and probabilities shown below. The applicable risk-free interest rate for cash flows with a 1-year horizon is 5 percent, and the systemic risk premium is 3 percent.

<table>
<thead>
<tr>
<th>Possible Cash Flows</th>
<th>Probability</th>
<th>Probability-Weighted Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>$500</td>
<td>15%</td>
<td>$75</td>
</tr>
<tr>
<td>$800</td>
<td>60%</td>
<td>$480</td>
</tr>
<tr>
<td>$900</td>
<td>25%</td>
<td>$225</td>
</tr>
</tbody>
</table>

Expected cash flows $780

In this simple illustration, the expected cash flows ($780) represent the probability-weighted average of the 3 possible outcomes. In more realistic situations, there could be many possible outcomes. However, it is not always necessary to consider distributions of literally all possible cash flows using complex models and techniques to apply the expected present value technique. Rather, it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows. For example, a reporting entity might use realized cash flows for some relevant past period, adjusted for changes in circumstances occurring subsequently (for example, changes in external factors, including economic or market conditions, industry trends, and competition as well as changes in internal factors impacting the entity more specifically), considering the assumptions of market participants.

In theory, the present value (fair value) of the asset’s cash flows is the same ($722) whether determined under Method 1 or Method 2, as indicated below. Specifically:

a. Under Method 1, the expected cash flows are adjusted for systematic (market) risk. In the absence of market data directly indicating the amount of the risk adjustment, such adjustment could be derived from an asset pricing model using the concept of certainty equivalents. For example, the risk adjustment (cash risk premium of $22) could be determined based on the systematic risk premium of 3 percent ($780 – [$780 × (1.05/1.08)]), which results in risk-adjusted expected cash flows of $758 ($780 – $22). The $758 is the certainty equivalent.
of $780 and is discounted at the risk-free interest rate (5 percent). The present value (fair value) of the asset is $722 ($758/1.05).

b. Under [m]ethod 2, the expected cash flows are not adjusted for systematic (market) risk. Rather, the adjustment for that risk is included in the discount rate. Thus, the expected cash flows are discounted at an expected rate of return of 8 percent (the 5 percent risk-free interest rate plus the 3 percent systematic risk premium). The present value (fair value) of the asset is $722 ($780/1.08).

55-20 When using an expected present value technique to measure fair value, either [m]ethod 1 or [m]ethod 2 could be used. The selection of [m]ethod 1 or [m]ethod 2 will depend on facts and circumstances specific to the asset or liability being measured, the extent to which sufficient data are available, and the judgments applied.

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