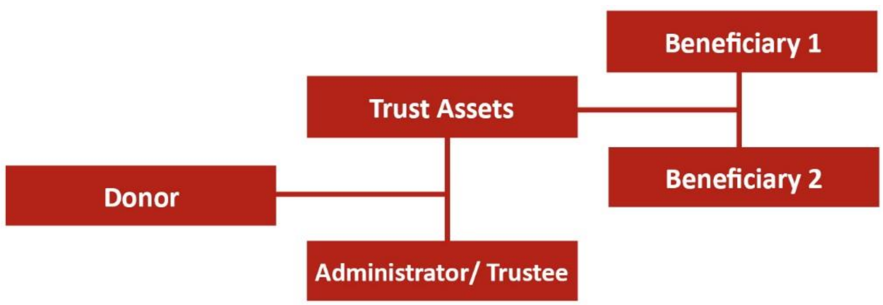
# GASB Finalizes Irrevocable Split-Interest Agreements Guidance

In late March 2016, the Governmental Accounting Standards Board (GASB) issued Statement No. 81, *Irrevocable Split-Interest Agreements*, standardizing accounting and financial reporting for these arrangements. At inception, a government would recognize an asset, a liability and a deferred inflow of resources. The guidance also covers certain irrevocable split-interest agreements administered by a third party. Public higher education institutions and health systems will likely be most affected by these amendments. Entities may see a change in timing of revenues as the new standard requires recognition when the resources become applicable to the reporting period. In some cases, this may be much later than current practice. The standard would be effective for periods beginning after December 15, 2016, with early adoption encouraged.

## Background




Split-interest agreements are a specific type of giving arrangement used by donors to provide resources to two or more beneficiaries, including governments. In general, these agreements are created through trusts or other legally enforceable agreements with characteristics equivalent to irrevocable split-interest agreements, wherein a donor irrevocably transfers resources to an intermediary to hold and administer for the benefit of the government and at least one other beneficiary. The agreement can terminate after a specified number of years, upon the occurrence of a specified event (commonly the death of the lead beneficiary or the donor) or a combination of both.

In the U.S., many individuals use these trusts to distribute all or a portion of their estate when they die for both philanthropic purposes and tax benefits. The most common example is a charitable remainder trust, which is an irrevocable structure established by a donor to provide an income stream to the income beneficiary (lead interest) with a charity or government receiving the remainder value (remainder interest) when the trust terminates. Other types of arrangements include charitable lead trusts and life interests in real estate.

Current accounting and reporting practice for irrevocable trusts varies. Many governments follow the recognition criteria in GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions;* however, some governments believe Statement No. 33's recognition criteria are not met, and recognition is not appropriate. Other governments see no substantive difference between permanent endowments received by an institution (and subsequently transferred to independent investment managers) and resources directly deposited into an irrevocable trust.

Private institutions, under the guidance of Financial Accounting Standards Board Statement No. 136, *Transfers of Assets to a Not-for Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, recognize the resources held in an irrevocable trust as assets and the contributions into the trust as revenues. Many colleges and universities engage in one or more types of split-interest agreement. However, because trusts are held by third parties or foundations that often are component units of the primary government, information about beneficial interests in assets held by others generally doesn't appear in the school's financial statements.

## Scope

This narrowly scoped standard only covers irrevocable split-interest agreements created through trusts or other legally enforceable agreements with characteristics equivalent to irrevocable split-interest agreements, *e.g.*, life interest in real estate. GASB specifically excludes some other forms of beneficial interests with similar characteristics, such as permanent endowments, pledges and perpetual trusts. In addition, irrevocable split-interest agreements aren't required to be reported partially or in their entirety in fiduciary funds. (GASB is currently deliberating fiduciary activities reporting as part of a separate project.)

## Government Is Intermediary & Beneficiary

A government that administers and benefits from an irrevocable split-interest agreement should recognize an asset for resources received or receivable, a liability for the other beneficiary's interest and a deferred inflow of resources for the government's unconditional remainder interest. Revenue should be recognized when resources become applicable to the reporting period.

Donated assets should be measured and, if applicable, remeasured according to existing standards, *e.g.*, measuring donated assets at fair value if they meet the definition of an investment. All changes in the assets, including interest, dividends and changes in fair value, should be reflected by adjusting the remainder interest, whether that remainder interest is a liability or a deferred inflow of resources.

### Government Is Remainder-Interest Beneficiary

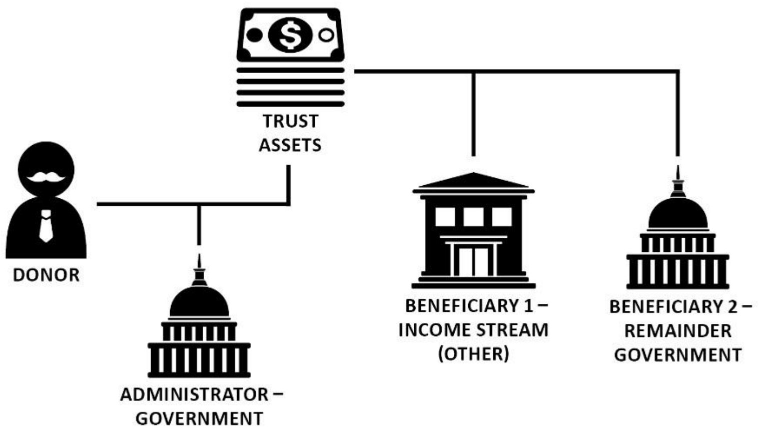
A remainder interest is the right to receive all or a portion of the resources remaining at the end of the split-interest agreement's term. When a government is the remainder-interest beneficiary, it should recognize assets for resources received or receivable, a liability for the lead interest assigned to other beneficiaries and a deferred inflow of resources for the government's unconditional interest.

The lead-interest valuation is subject to the specific terms of the split-interest arrangements. The lead-interest benefit can be defined as an annuity (a specific percentage of the fair value of the assets at the time of the donation) or as a unitrust (a specific percentage of the fair value remeasured every year). Other terms can limit disbursement to the income earned by the trust assets during a specific period or create makeup provisions. Some arrangements terminate after a specified period or could be contingent upon the beneficiaries' lives. Due to the variability in lead-interest terms, GASB declined to provide a specific measurement technique; rather, the liability for the stream of payments to other beneficiaries should initially be measured at settlement amount. Measurement of the liability should be based on an established valuation technique that takes into account the specific provisions of the agreements as well as agreement's implied risks. Assumptions to be considered when measuring the liability include:

- Agreement's payment provisions
- Assets' estimated rate of return
- Mortality rate, if the term is life-contingent
- Discount rate, if a present value technique is used

Remeasurement is required for the lead-interest liability at each reporting period, with any changes recognized as an increase or decrease in the related deferred inflow of resources.

The remainder interest due to the government (deferred inflow of resources) should be measured as a residual amount of the value of the assets, less the value of the liability for the lead interest. Upon the agreement's termination, a government should recognize a gain (revenue in governmental funds) for any liability eliminated. Governments also should recognize the remaining deferred inflow of resources as revenue.




| Asset – Donation | Liability – **Lead Interest** – Other Beneficiaries | Deferred Inflow Resources – **Remainder Interest** Government |
|---|---|---|
| Measure using existing standards for asset type, *e.g.*, investments, Statement No. 72 Fair Value<br>All changes including fair value interest & dividends are reflected in the remainder interest | Settlement amount<br>Remeasured at each reporting date | Asset – Liability = Deferred Inflow |

## Government Is Lead-Interest Beneficiary

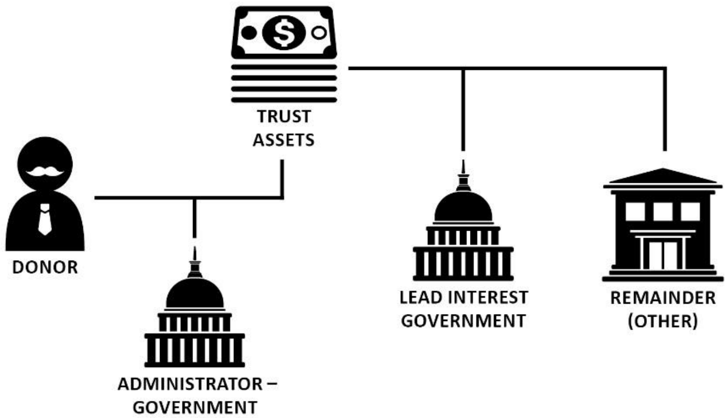
A lead interest is the right to all or a portion of the benefits of resources during the term of a split-interest agreement. When a government is the lead-interest beneficiary, it should recognize an asset for resources received or receivable, a liability for the other beneficiary's remainder interest and a deferred inflow of resources for the government's unconditional lead interest.

The deferred inflow of resources should be measured based on the government's expected payment, *i.e.*, the settlement amount. Such measurement should be based on an established valuation technique that takes into account specific provisions in the agreement as well as the risks implied in the agreement. Assumptions to be considered include:

- Agreement's payment terms
- Assets' estimated rate of return
- Mortality rate, if the term is life-contingent
- Discount rate, if a present value technique is used

The amount reported as a deferred inflow of resources should be remeasured at each financial reporting date, based on changes in the assumptions used to determine the settlement amount. Remeasurement changes to the deferred inflow of resources should be recognized as an increase or decrease in the related liability. The amount of the governmental benefit for the period should be recognized as revenue with a corresponding decrease in the deferred inflow of resources. The liability for the remainder interest should initially be measured as the difference between the donated assets and related deferred inflow of resources.

Upon the agreement's termination, when the assets are transferred to the remainder-interest beneficiaries, the liability and any remaining deferred inflow of resources should be eliminated.




| Asset – Donation | Deferred Inflow Resources – **Lead Interest** Government | Liability – **Remainder** – Other Beneficiaries |
|---|---|---|
| Measure using existing standards for asset type, *e.g.*, investments, Statement No. 72 Fair Value<br>All changes including fair value interest & dividends are reflected in the remainder interest | Settlement amount<br>Remeasured at each reporting date | Asset - Deferred Inflow = Liability |

## A Third Party Is the Intermediary

In some irrevocable split-interest agreements where the government is a beneficiary, the donated assets are transferred to a third-party intermediary, rather than directly to the government's control. Previously, no authoritative guidance existed as to whether these arrangements met the definition of an asset. This standard sets forth criteria for asset recognition when a government becomes aware of such an agreement and has sufficient information to measure the beneficial interest. Donated resources held and administered by a third party outside the reporting entity would be beyond the donor's control, granting the government control over beneficial interests, when **all** the following criteria are met:

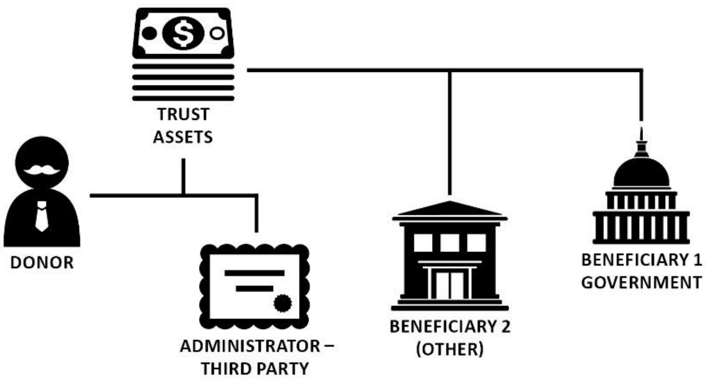
- The government is specified by name as beneficiary in the legal document underlying the donation.
- The donation agreement is irrevocable.
- The donor has not granted variance power to the intermediary.
- The intermediary is not under the donor's control (in the case of agency relationships).
- The government has an unconditional beneficial interest.

If the criteria are met, a government would recognize an asset, initially measured at fair value, for its beneficial interest held and administered by a third party. A deferred inflow of resources would be recorded in the same amount as the asset, which would be remeasured at fair value at each reporting period. The fair value changes would be reflected as an increase or decrease in the related deferred inflow of resources.

For lead interests, revenue should be recognized and the related deferred inflow of resources reduced as stipulated in the irrevocable split-interest agreement. If a government is the remainder-interest beneficiary, the government should recognize revenue for the beneficial interest at the agreement's termination. At the agreement's termination, the beneficial interest asset and the related deferred inflow of resources should be eliminated.

***Community Foundations***

*It's common for a community foundation to be the administrator for split-interest agreements. In general, community foundations hold variance power as an entity over the resources they administer. Some community foundations also can administer resources for which the board of the foundation doesn't have variance power. The standard's language in the variance power criteria is specific to the donated resources and not the entity administering the resources. A government must determine whether the community foundation has the ability to redirect the governmental benefit at will. No other specific guidance is proposed for community foundations in this project.*




| Asset – Donation | Deferred Inflow Resources |
|---|---|
| Measure at fair value<br>Remeasure each reporting period, with changes recognized as an increase/decrease in deferred inflows | Asset = Deferred Inflow |

## Life Interests in Real Estate

A life interest in real estate is a specific type of irrevocable split-interest agreement where the donor (or other named party) retains the right to use the donated asset—usually a residence. Real estate assets donated pursuant to life interests in real estate should be recognized as capital assets or investments, depending on donor-imposed restrictions and management's intent at the time of the donation.

*For example, a restriction that donated farm land only can be used for agricultural research after the donor's right to use expires would be considered a capital asset. If no donor restrictions exist, a government may decide to sell the donated asset when the donor's right to use expires and would, therefore, be considered an investment.*

If the donation is considered a capital asset, it should be measured at acquisition value and be subject to existing requirements for deprecation, impairment and disclosure. A systematic and rational allocation of the asset's initial acquisition value should reduce the carrying value of the asset and the deferred inflow of resources throughout the life of the agreement.

If the donation were considered an investment, it would be measured at fair value, in accordance with GASB [Statement No. 72](). Changes in the fair value of the investment should be recognized as an increase or decrease in the related deferred inflow of resources.

A liability should be recognized for any contractual obligations assumed by the government, *e.g.*, improvements, maintenance or insurance. The liability should be reduced as the government satisfies its contractual obligations.

A deferred inflow of resources should be recognized for the residual interest in the real estate and should be measured as the difference between the donated asset and related liability, if one is recognized.

At the agreement's termination, revenue should be recognized for the deferred inflow of resources and for any remaining portion of the liability.

| Asset – Real Estate | Liability – Any legal Obligations | Deferred Inflow of Resources |
|---|---|---|
| If capital asset, measure at acquisition value<br>Amortize using systematic & rational approach, reduce deferred inflows<br>If investment, measure at fair value<br>Changes to fair value offset in deferred inflows | Legally assumed expenses, *e.g.*, insurance, maintenance, repairs | Asset - Liability (if any) = Deferred Inflow |

## Disclosures

There are no new disclosure requirements; GASB concluded disclosure requirements in existing standards provide adequate information to financial statement users.

## Effective Date & Transition

The GASB 81 requirements are effective for periods beginning after December 15, 2016, though early application is encouraged. Changes should be retroactively applied. In the adoption period, changes made to comply with the statement should be treated as an adjustment to prior periods, and financial statements presented for the periods affected should be restated.

If restatement of the financial statements for prior periods isn't practical, the cumulative effect of applying the statement should be reported as a restatement of beginning net position (or fund net position or fund balance, as appropriate) for the earliest period restated. In the first period the statement is applied, governments should disclose the nature of and reason for the restatement or the reason for not restating prior periods presented.

*Universities and health systems that currently account for split-interest arrangements as voluntary nonexchange transactions under Statement No. 33 could see a delay in the timing of revenue recognition. Under Statement No. 33, assets received in voluntary nonexchange transactions—and the related revenue—are recognized when eligibility requirements have been met. In general, time requirements are considered met during the period in which the resources are required to be used or when use is first permitted.*

*Under the new guidance, a government is required to recognize revenue when the resources become applicable to the reporting period. The majority of revenue related to split-interest arrangements only will be recognized at the agreement's termination. Today, a significant portion is recognized at inception, and a remaining portion (which could be significant depending on the actual versus expected term of the agreement), is recognized at termination. When Statement No. 81 is adopted, these entities would need to derecognize revenue and recognize it in a future period.*

*The new standard creates additional differences between higher education institutions that follow FASB and those that follow GASB. The guidance also creates different results between public institutions and their affiliated foundations (FASB entities) for the same gift agreements.*

For more information, contact your BKD advisor.

## Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com