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Amendments to the accounting for *Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement* under ASPE

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Overview

In December 2018, the Canadian Accounting Standards Board (AcSB) issued amendments to Section 3856 *Financial Instruments* in Part II of the CPA Canada Handbook – Accounting – Accounting Standards for Private Enterprises ("ASPE") pertaining to the classification and measurement of retractable or mandatorily redeemable shares issued in a tax planning arrangement. The amendments have the potential to significantly impact the financial statements of many privately-held enterprises in Canada because these types of shares are regularly issued as a part of tax planning arrangements. This publication provides some background on the project, outlines the key changes and provides some examples of how privately held enterprises may be impacted.

Background and current treatment

Privately-held businesses in Canada regularly undertake tax planning arrangements. Although the term 'tax planning arrangement' is not defined in ASPE, from a tax perspective a tax planning arrangement is generally considered to be any transaction performed with the goal of tax deferral, minimization and / or crystallization. Some of the most common examples of tax planning arrangements include: wind-ups or amalgamations of entities, asset transfers or roll-overs, and estate freezes (i.e., intergenerational transfers of businesses).

A tax planning arrangement usually involves the issuance of shares (most often, preferred shares) that are retractable or mandatorily redeemable at the option of the holder in exchange for cash or other financial assets. Based on the current guidance in ASPE, these instruments meet the definition of a financial liability and would be initially recognized at fair value and presented as a liability rather than equity. However, ASPE currently contains an exception that requires redeemable shares issued in a tax planning arrangement under specific sections[1] of the Canadian Income Tax Act (ITA) to be presented as equity and measured at their par, stated or assigned value.

In October 2014, the AcSB issued an Exposure Draft (the "2014 ED") which proposed the elimination of the exception to liability classification. Stakeholders raised significant concerns. In response to these concerns, the AcSB reconsidered its initial proposals and issued a revised Exposure Draft in September 2017 entitled *Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement (Proposed amendments to Sections 1591, 3251, and 3856)* (the "2017 ED"). In response to the stakeholder comments received regarding the 2017 ED, the AcSB made some adjustments to their proposed amendments and released the final amendments into ASPE in December 2018. The amendments are effective for fiscal periods beginning on or after January 1, 2020, but may be adopted earlier.

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1 The exception provided in paragraph 3856.23 was available for tax planning arrangements completed under *Sections 51, 85, 85.1, 86, 87 or 88 of the Canadian Income Tax Act.*

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Practical insights

Originally, the exception to liability classification for preferred shares issued in a tax planning arrangement was introduced because, at that time, presenting retractable or mandatorily redeemable shares issued in a tax planning arrangement as liabilities at fair value was considered controversial (particularly for estate freeze transactions that provide for an intergenerational transfer of a business). In an estate freeze transaction, the shares issued usually have a redemption amount equal to the fair value of the business; however, the issuance of the shares is not accompanied by an inflow of assets. As a result, if the shares were recorded as a liability and measured at their redemption amount, there would have been a charge to equity which may have resulted in an enterprise reporting a sizeable deficit. The exception to liability classification was designed to address the concern that financial statement users would interpret that sizeable deficit to mean that the enterprise was in immediate financial trouble and that a great deal of explanation would have been required to convince users otherwise.

The AcSB became aware that the exception was being applied in unexpected situations (such as management buyouts); thus, it revisited the exception with the goal of improving financial reporting.

Amendment highlights

Initial recognition and measurement

Under the amendments, an enterprise that issues retractable or mandatorily redeemable shares in a tax planning arrangement **may** present the shares in equity at their par, stated or assigned value **only** when **all** of the following criteria are met at the time of issuance:

Control test – Control of the enterprise issuing the shares is retained by the shareholder receiving the shares in the arrangement;

Consideration test – No consideration other than shares of the enterprise issuing the retractable or mandatorily redeemable shares is exchanged; and

Redemption schedule test – There is no written or oral arrangement, such as a redemption schedule, that gives the holder of the shares the contractual right to require the enterprise to redeem the shares on or within a fixed or determinable date or period.

Our thoughts – Applying the exception

It is important to note that using the exception to present these types of shares in equity is now a choice; therefore, an enterprise that meets the criteria above can present the shares as a financial liability if it chooses to do so. We believe that an enterprise is afforded the choice each time it issues retractable or mandatorily redeemable shares in a tax planning arrangement.

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If one or more of the criteria are not met, then the shares must classified as a financial liability and are generally measured at the redemption amount. Any resulting difference between the amounts exchanged is recorded either in a separate component of equity or in retained earnings (with accompanying note disclosures). Any dividends declared on shares classified as a liability are recorded as an expense in net income.

Practical insights – Stock dividends

Due to the manner in which the former exception was structured, shares issued in a tax planning arrangement by way of stock dividend did not qualify for the exception to liability classification. This issue was rectified in the amendments.

Since stock dividends are, in effect, issued for no consideration (shares or otherwise), they will pass the consideration test. Therefore, as long as the other two criteria are met, shares issued in a tax planning arrangement by way of a stock dividend will now qualify to be presented as equity at their par, stated or assigned value.

Performing the control test when related parties are involved

If the enterprise issuing the retractable or mandatorily redeemable shares in the tax planning arrangement is controlled by two or more related parties, the enterprise issuing the shares must perform an analysis to identify whether a single party within the related party group has control over of the enterprise. The control assessment must be based on the guidance in Section 1591 *Subsidiaries*. If the enterprise cannot identify one party within the related party group that has control both before and after the tax planning arrangement, then the shares would not pass the control test.

Practical examples

Example #1

Mr. X and Mrs. X (who are husband and wife) each own 50% of the common shares of Company A. Their tax advisor recommends that they perform an estate freeze to pass the future growth of the company onto their daughter. This arrangement would result in Mr. and Mrs. X each receiving preferred shares in exchange for their common shares. The preferred shares are voting and redeemable, on demand, at the option of Mr. and Mrs. X. As a result of the estate freeze, Mr. and Mrs. X would continue to have shared control (i.e., 50% each) of Company A.

While Mr. and Mrs. X control Company A as a related party group both before and after the estate freeze, neither Mr. X or Mrs. X individually has control of Company A both before and after the estate freeze; as a result, the shares would not pass the control test. Therefore, the preferred shares issued to both Mr. and Mrs. X in the estate freeze would be presented as liabilities at their redemption amount.

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Example #2

Mr. Y owns 51% of the common shares of Company B. His wife, Mrs. Y, owns the remaining 49% of the common shares of Company B. Their tax advisor recommends that they perform an estate freeze which would result in Mr. and Mrs. Y each receiving preferred shares in exchange for their common shares. The preferred shares are voting and redeemable on demand at the option of Mr. and Mrs. X. As a result of the estate freeze, Mr. and Mrs. Y retain the same proportion of voting interests in Company B (i.e., 51%/49%).

Assuming that share ownership determines control in this case, Mr. Y would be considered to have the continuing power to determine the strategic operating, investing and financing policies pertaining to Company B and, thus, control of Company B both before and after the estate freeze under Section 1591 *Subsidiaries*. Therefore, the shares issued to Mr. Y in the estate freeze would pass the control test. Assuming the redemption schedule test was passed, the shares issued to Mr. Y would qualify to be presented as equity at their par, stated or assigned value. On the other hand, if the shares issued to Mrs. Y did not pass the control test, they would be presented as liabilities at their redemption amount.

Subsequent classification and measurement

Shares initially classified as equity

If the retractable or mandatorily redeemable shares issued in a tax planning arrangement were initially classified as equity, they are only subsequently reclassified if an event or transaction occurs that causes one or more of the three criteria to no longer be met. As a result, enterprises will need to continually reassess whether the criteria to apply the exception are met.

Practical examples

Some examples of events or transactions that may require reclassification of the shares from equity to a liability include:

- The death of the holder of the retractable or mandatorily redeemable shares issued in a tax planning arrangement
- A change in the ownership of the enterprise or a shareholders' agreement that may affect the assessment of control of the enterprise that issued the retractable or mandatorily redeemable shares in a tax planning arrangement
- Redemption of some or all of the retractable or mandatorily redeemable shares issued in a tax planning arrangement
- The creation of an arrangement that gives the holder of the retractable or mandatorily redeemable shares issued in a tax planning arrangement the right to require the enterprise to redeem the shares within a fixed or determinable period
- Modifications to the attributes of the retractable or mandatorily redeemable shares issued in a tax planning arrangement

When an event or transaction gives rise to a reclassification of the shares from equity to a financial liability, the enterprise measures the shares at the redemption amount and presents them as a liability separately on the balance sheet. Any resulting difference would be recorded either in a separate component of equity or retained earnings (with accompanying note disclosures). Once reclassified, the shares cannot return to equity classification.

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Shares classified as a financial liability

When the shares are classified as a financial liability, they cannot be reclassified to equity and must be measured at the redemption amount until the shares are redeemed. This requirement applies regardless of whether the shares:

- were initially classified as liabilities because one or more of the criteria were not met (even if the criteria were subsequently met);
- could have been classified as equity (i.e., the criteria were met), but the enterprise chose to present them as liabilities initially; or
- were initially classified as equity, but were subsequently reclassified to liabilities due to the occurrence of an event that required reclassification.

Presentation and disclosure

The classification of retractable or mandatorily redeemable shares issued in a tax planning arrangement will affect the liabilities, net income and equity of the enterprise. To ensure that financial statement users have the information that they need to understand the effects of the shares, an enterprise is required to:

- present any shares classified as liabilities separately on the balance sheet (as current or non-current, depending on the agreement with the shareholder);
- recognize the effects of recording the shares as a liability in either a separate component of equity or in retained earnings, with accompanying note disclosure;
- present any shares classified as equity separately on the balance sheet along with:
  - the total redemption amount for all classes of such shares outstanding on the face of the balance sheet
  - disclosure of the aggregate redemption amount for each class of shares;
- describe the arrangement that gave rise to the shares.

Practical insights – Current or non-current presentation

Retractable or mandatorily redeemable shares that are presented as a liability, are generally classified as a current liability when the shareholder has the ability to redeem the shares on demand. If the holder of the retractable or mandatorily redeemable shares provides written confirmation to the entity's other shareholders indicating that they waive their right to demand redemption for more than one year from the balance sheet date, then it would be appropriate for the entity to classify the retractable or mandatorily redeemable shares as a non-current liability. This waiver may be included a clause of a shareholders' agreement between the shareholders.

Implications

The amendments will result in significant changes to the accounting for retractable or mandatorily redeemable shares issued in a tax planning arrangement; however, the exception permitting these shares to be classified as equity instruments will still apply in certain limited circumstances. In particular, the exception would continue to apply to retractable or mandatorily redeemable shares issued in estate freeze transactions, where control of the enterprise is retained and no redemption schedule exists. In situations where the retractable or mandatorily redeemable shares issued in previous tax planning arrangements no longer qualify to be presented as equity and measured at their par, stated or assigned value, the reclassification to liabilities could have a significant impact on the entity's balance sheet, and could impact whether the enterprise is in compliance with its debt covenants.

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Retractable or mandatorily redeemable shares issued in the following types of tax planning arrangements will no longer qualify for the exemption:

- Transfers of an asset into the enterprise (i.e., asset rollovers) because these transactions involve the exchange of assets and do not meet the 'consideration test';
- Some management buyouts if the 'control test' is not met because control of the enterprise issuing the shares is transferred to management
- Estate freezes for minority shareholders or shareholder groups where no single party has control.

Practical insights

The classification exception that allows equity presentation is based on the principle that nothing of substance changed in the management and operation of the enterprise as a result of the tax planning arrangement in which the retractable or mandatorily redeemable shares were issued. The AcSB is of the view that if nothing of substance changed (e.g., control of the enterprise issuing the shares), an exception from liability classification is warranted; however, if something of substance did change then liability classification is appropriate.

Practical examples – A comprehensive look at the new amendments

As part of a tax planning arrangement, in exchange for common shares with a carrying amount of $100, an enterprise issues preferred shares that are redeemable at the option of the holder for $500,000 and have an assigned value for tax purposes of $100. The tables below demonstrate the difference in the presentation of the shares as equity versus a liability on the balance sheet. Comparing the total liabilities and total equity in each scenario, it is clear that the manner in which the shares are presented and measured can have a significant impact on an enterprise's balance sheet.

When shares are presented in **equity** and measured at their **par, stated or assigned value**:

Balance sheet	
Total assets	**$1,050,000**
Accounts payable	$ 20,000
Other current liabilities	300,000
Total liabilities	**320,000**
Common shares	100
Preferred shares (redeemable at $500,000)	100
Retained earnings	729,800
Other equity	-
Total equity	**730,000**
Total liabilities and equity	**$1,050,000**

When shares are presented as a **financial liability** and measured at their **redemption amount**:

Balance sheet	
Total assets	**$1,050,000**
Accounts payable	$ 20,000
Preferred shares	500,000
Other current liabilities	300,000
Total liabilities	**820,000**
Common shares	100
Retained earnings	729,800
Other equity*	(499,900)
Total equity	**230,000**
Total liabilities and equity	**$1,050,000**

**Option to present difference between carrying amount of shares exchanged and redemption amount of issued shares in retained earnings with note disclosure*

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Disclosure requirements

When an enterprise issues retractable or mandatorily redeemable shares in a tax planning arrangement and the shares are classified as equity, the enterprise must disclose the following in its annual financial statements:

- on the face of the balance sheet, the total redemption amount for all classes of the shares outstanding;
- the aggregate redemption amount for each class of the shares; and
- a description of the arrangement that gave rise to the shares.

If the retractable or mandatorily redeemable shares issued in a tax planning arrangement are classified a financial liability, in addition to the general disclosure requirements for all financial liabilities, the enterprise must provide a description of the arrangement that gave rise to the shares. In addition, if the effect of classifying the shares is recorded in retained earnings, the enterprise must disclose, on the face of the balance sheet, the amount charged to retained earnings for all classes of shares.

Transition and next steps

The amendments are effective for fiscal periods beginning on or after January 1, 2020. Early adoption is permitted. The amendments must be applied as if this policy has always been applied (i.e., retrospective application) although there are choices as to whether to restate the comparative information which are described below.

Comparative information

Although retrospective application is required, enterprises are provided with a choice regarding whether to restate their comparative information.

- If an enterprise chooses to restate its comparative information, it records the cumulative effect of applying the amendments in opening retained earnings or a separate component of equity at the beginning of the earliest period presented. For an enterprise with a calendar year end that does not early adopt the amendments, the equity adjustment would be recognized as at January 1, 2019.
- If the enterprise chooses not to restate its comparative information, it records the cumulative effect of applying the amendments in opening retained earnings or a separate component of equity at the beginning of the fiscal year in which the amendments are applied for the first time. For an enterprise with a calendar year end that does not early adopt the amendments, the equity adjustment would be recognized as at January 1, 2020.

If an enterprise chooses to restate its comparative information, is not required to make retrospective adjustments for retractable or mandatorily redeemable shares issued in a tax planning arrangement that were extinguished prior to the date of initial application.

Date of initial application

The date of initial application of the amendments will be the beginning of fiscal period in which the amendments are first applied (i.e., for an enterprise with a calendar year end that does not early adopt the amendments, the date of initial application will be January 1, 2020).

Transition provisions

There are transition provisions available to reduce the burden of adopting the amendments.

In situations where the enterprise completed a tax planning arrangement on or after January 1, 2018, the enterprise is not afforded any relief from retrospective application. In such situations, the enterprise must assess whether, at the date of the tax planning arrangement, all of the criteria were met to obtain equity presentation. If all of the criteria were met, at the date of initial application the enterprise can elect to present the shares as equity at their par, stated or assigned value. Otherwise, the shares are presented as a liability at the redemption amount.

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If the enterprise completed the tax planning arrangement before January 1, 2018, it is afforded some relief. In these situations, the enterprise is only required to determine whether two criteria are met as at the date of initial application, rather than the date of the original transaction. In particular, the enterprise will consider whether, at the date of initial application:

- the holder of the retractable or mandatorily redeemable shares controls the enterprise; and
- there are any written or oral arrangements in place which give the shareholder the right to redeem the shares on a fixed or determinable date or within a fixed or determinable period.

If both these criteria are met at the date of initial application, the enterprise may present the shares as equity at their par, stated or assigned value.

Regardless of when the tax planning arrangement occurred, at the date of transition, entities are afforded the choice to present the shares as liabilities even when all of the criteria for equity presentation are met.

Practical examples – Transition

Facts

On October 1, 2016, Company C issued mandatorily redeemable shares to Mr. C in a tax planning arrangement. Company C's fiscal year end is December 31; therefore, it must adopt the amendments to ASPE related to these types of shares on January 1, 2020. Company C decides to retrospectively restate its comparative figures for the amendments and would like to elect to present the shares as equity, if possible.

Example #1

Company C determines that:

- as at January 1, 2020, Mr. C controls Company C; and
- there has never been a redemption schedule related to the shares.

As a result of these facts, Company C would conclude that, as at January 1, 2020, the shares pass the control test and the redemption schedule test. Company C would not need to perform the consideration test because the shares were issued before January 1, 2018. Company C would present the shares as equity at both January 1, 2019 (the beginning of the earliest period presented) and January 1, 2020 (the date of initial application).

Example #2

Company C determines that:

- as at January 1, 2020, Mr. C does not control Company C; and
- there has never been a redemption schedule related to the shares.

As a result of these facts, Company C would conclude that, as at January 1, 2020, the shares do not pass the control test and do not meet the requirements to be presented as equity. Consequently, Company C would present the shares as liabilities at both January 1, 2019 (the beginning of the earliest period presented) and January 1, 2020 (the date of initial application).

Transition Disclosures

In its first financial statements where it applies the amendments, an enterprise discloses:

- that the amendments in Section 3856 *Financial Instruments* pertaining to Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement were applied for the first time;
- the nature of the change in accounting policy and that the change was made in accordance with the applicable transitional provisions;
- a description of the transitional provisions applied, if any; and
- for each prior period presented, the amount of the adjustment for each financial statement line item affected, including the amount of the adjustment relating to prior periods before those presented.

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Our thoughts – Next steps

Despite the fact that the amendments are not yet effective, there are a few things that enterprises can start doing now in order to prepare for the impending changes:

Identify any shares outstanding that may be affected and determine whether they qualify for the exception from liability classification. On transition to the new guidance, some enterprises may end up reclassifying shares issued in a previous tax planning arrangement from equity to a financial liability (or vice versa).

Consider how the amendments will impact the enterprise's ASPE financial statements and its financial covenants, debt agreements or other key metrics. If the enterprise will be affected, consider talking to the users of the financial statements early to avoid last minute surprises. Some banking agreements may need to be revised or waivers need to be obtained if the amendments will create violations.

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