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Discussions

Flash – ASPE

Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement

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Flash bulletins provide a summary of the most recent news and publications from standard setters on accounting standards for private enterprises (ASPE), not-for-profit organizations and pension plans. However, they cannot deal with all topics. Where applicable, readers are encouraged to refer to the original publications mentioned in the articles before making any decisions.

Overview

Section 3856, Financial Instruments, currently provides an exception in paragraph 23 that requires retractable preferred shares issued in a tax planning arrangement under specific sections of the Canadian Income Tax Act (ITA) to be presented as equity and measured at par, stated or assigned value.

Following publication of two Exposure Drafts in 2014 and 2017 and various discussions on the comments received, in December 2018, the Accounting Standards Board of Canada (AcSB) published the definitive amendments to Sections 3856 and 3251, Equity, to amend the balance sheet classification of retractable preferred shares issued in a tax planning arrangement. These amendments will result in significant changes in the accounting for these shares. Accordingly, some of the preferred shares now classified as equity under the previously described liability classification exception will remain classified as equity if they meet certain conditions. However, we expect many preferred shares will be reclassified as liabilities and measured at their redemption amount.

These amendments are relevant to private enterprises that report under Part II of the *CPA Canada Handbook – Accounting* and apply ASPE.

Why the change?

The AcSB is of the view that retractable or mandatorily redeemable shares are contractual obligations that meet the definition of a financial liability under ASPE because they give the holder the right to require the issuer to redeem the shares on demand. As such, they would normally be reported as liabilities on the balance sheet. Despite this point of view, the AcSB had nevertheless included in Section 3856 a classification exception that requires retractable preferred shares issued in a tax planning arrangement under specific sections of the ITA to be presented as equity (hereafter the “classification exception”) and measured at their par, stated or assigned value.

The practical application issues due to the classification exception caused the AcSB to re-examine the classification exception in Section 3856:

- There are transactions for which the classification exception was not intended, but was being applied. These transactions include commercial financing arrangements, transfers of individual assets, employee compensation plans and management buy-outs. The AcSB wanted the exception to only apply to estate freezes (which generally happen when the value in the enterprise is frozen for the benefit of the owner while the future growth will accrue to the next generation).

- Some retractable or mandatorily redeemable shares issued in a tax planning arrangement were excluded from the scope of the classification exception because they were not issued under any of the specified sections of the ITA listed in Section 3856. However, these shares had the same characteristics as shares that currently meet the classification exception, which was inconsistent.

- There was confusion as to when retractable or mandatorily redeemable shares issued in a tax planning arrangement should be reclassified as liabilities.

In creating the new requirements, the AcSB analyzed their benefits and the costs to stakeholders and considered feedback received from users of financial statements and other stakeholders in roundtables and outreach activities throughout Canada. The AcSB acknowledges that the definitive amendments result in a change in practice; however, it was considered that retaining a classification exception for a limited set of circumstances was better than removing the classification exception entirely.

Amendments to Sections 3856 and 3251

The Section 3856 classification exception has been amended and is now based on the principle that nothing of substance has changed in the management and operations of the enterprise as a result of the tax planning arrangements in which retractable or mandatorily redeemable shares (hereafter "redeemable shares") are issued. They are of the view that if nothing of substance has changed, such as the retention of control by the shareholder holding the redeemable shares, an exception from liability classification is still warranted. Accordingly, the following significant amendments were made to Section 3856:

- The current classification exception in Section 3856 is replaced with a new classification exception. Under the new exception, an enterprise that issues redeemable shares in a tax planning arrangement (a concept that is not defined in Section 3856) may choose to present these shares at their par, stated or assigned value as a separate component of equity on the balance sheet if the following conditions are met:

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

  Consideration – In the arrangement, either no consideration is received by the enterprise issuing the redeemable shares or only shares of the enterprise issuing the redeemable shares are exchanged; and

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

- If any of the above conditions are not met for any or all of the shares issued, the issuer shall classify those shares as a financial liability, present them separately on the balance sheet and measure them at their redemption amount. Any resulting adjustment must be recognized either in retained earnings or in a separate component of equity.

- An enterprise may however choose to present the shares as a financial liability on issuance without undertaking the analysis of the conditions described above to determine whether the shares could otherwise have qualified for presentation in equity.

With respect to the first condition, Section 3856 states that control must be assessed in accordance with the guidance in Section 1591, Subsidiaries, and may only be held by one party in a related party group. Accordingly, any tax planning arrangement transactions involving shareholders, whether or not related, with joint control or significant influence will lead to the classification of any redeemable shares as liabilities.

The second condition aims to limit the classification exception to estate freezes that meet the required conditions. This, therefore, means that redeemable shares issued in asset tax rollover transactions cannot be classified as equity.

For the third condition, the AcSB decided that the existence of a redemption schedule specifying the timing of redemption of the shares by the issuer requires liability classification of those shares.

In the following table, we provide examples of transactions that qualify or do not qualify for equity classification under the new classification exception, assuming there is no redemption schedule in place:

Classification as equity	Classification as liabilities
▪ Estate freezes where the controlling shareholder continues to control the enterprise afterwards; ▪ Dividends of redeemable shares paid to the controlling shareholder.	▪ Asset tax rollovers – i.e., the transfer of assets between related parties (no matter the nature of the relationship); ▪ Transfers of businesses under common control; ▪ Estate freezes for shareholders who do not have control (e.g., significant influence or joint control); ▪ Business combinations; ▪ A series of transactions where the substance of the overall transaction is to transfer assets in exchange for redeemable shares.

Reassessment of classification

An enterprise is required to reassess the classification of the redeemable shares classified as equity when a subsequent event or transaction occurs that could indicate that one or more of the conditions for equity classification may no longer be met. Section 3856 provides a non-exhaustive list of examples of events or transactions in this regard, in particular the death of the holder of the redeemable shares or a change in the shareholders' agreement that may affect the assessment of control of the enterprise that issued the shares. It should be noted that the reassessment process will not automatically result in a reclassification of the shares as a financial liability, but will require enterprises to reassess the conditions for classification as equity to determine whether they are still met despite the event or transaction that occurred. Therefore, enterprises will need to continually reassess whether the conditions to apply the exception are met.

If the reassessment gives rise to a reclassification of the shares as a financial liability, the reclassification must be on the date the event or transaction giving rise to the reclassification occurs and the shares shall be measured at their redemption amount. Any resulting adjustment must be recorded either in retained earnings or in a separate component of equity.

Once redeemable shares issued in a tax planning arrangement are classified as financial liabilities, Section 3856 prohibits their subsequent reclassification in equity.

Presentation and disclosure

Classification of redeemable shares issued in a tax planning arrangement as financial liabilities will affect the enterprise's balance sheet presentation. The following is an example illustrating the impact on the balance sheet:

Example

An enterprise issues preferred shares that are retractable for $500,000 and have an assigned value for tax purposes of $100 in exchange for common shares with a carrying amount of $100. The tables below show the difference in the classification of the shares as equity versus as liability on the balance sheet.

When the shares are classified in **equity at 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		100
Retained earnings		729 800
Other equity		-
Total equity		**730 000**
Total liabilities and equity	**$**	**1 050 000**

When the shares are classified as **financial liabilities** measured at **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**

A comparison of the total liabilities and the total equity in each scenario clearly shows that the share presentation and measurement have a material impact on the entity's balance sheet, which could also have an impact on the loan covenants.

* The difference between the carrying amount of the exchanged shares and the redemption amount of the issued shares can also be recognized in retained earnings, provided the disclosure of information on the face of the balance sheet. The AcSB decided to offer the choice to recognize the impact of the classification as liabilities either as a separate component of equity or in retained earnings because some respondents to the 2017 Exposure Draft stated that presentation as a separate component of equity could have an adverse effect on the small business deduction. Do not hesitate to contact your Raymond Chabot Grant Thornton adviser for assistance in making the appropriate choice in your situation.

To mitigate the effects of the change and to ensure that financial statement users have the information that they need, the following amendments to Sections 3856 and 3251 have been made:

- The redeemable shares classified as liabilities must be presented separately on the balance sheet, either as current or noncurrent depending on the agreement with the shareholder(s). Presentation of a callable debt as provided in Section 1510, Current Assets and Current Liabilities, is not permitted for these shares.

- When the redeemable shares are classified as liabilities and the effect of this classification is recorded in retained earnings, an enterprise shall disclose, on the face of the balance sheet, the amount charged to retained earnings for all classes of such shares.

- When the redeemable shares are classified as liabilities and the effect of this classification is recorded in a separate component of equity, the enterprise shall disclose that the balance of the separate component of equity will be charged to retained earnings as the shares issued are called for redemption.

- Redeemable shares classified as equity continue to be presented on a separate line item on the balance sheet, with presentation of the total redemption amount for all classes of such shares outstanding. The aggregate redemption amount for each class of such shares must also be provided, but does not have to presented on the face of the balance sheet.

- A description of the arrangement that gave rise to the issuance of the redeemable shares must be provided, regardless of whether the shares are classified as equity or liabilities, as long as the shares are outstanding.

Effective date and transition

The new requirements apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. Earlier adoption is permitted.

Except as specified below, the enterprise can elect to apply the amendments at:

- The beginning of the earliest period presented (i.e., comparative restated); or

- The beginning of the fiscal year in which the amendments are first applied (comparatives are not restated).

Depending on the enterprise's choice, the cumulative effect of applying the amendments is recognized in opening retained earnings or a separate component of equity of the earliest period presented or of the fiscal year in which the amendments are first applied.

Upon initial application of the amendments, an enterprise that has issued redeemable shares as part of a tax planning arrangement can first elect to present them as financial liabilities, without analyzing the conditions for determining if the shares could have otherwise qualified for presentation in equity on the date of initial application. The enterprise may also elect to analyze the conditions below to present the shares as a separate component of equity on the balance sheet, if applicable.

To qualify for classification in equity on the date of initial application:

- All of the conditions for classification in equity provided in the new requirements must be met for redeemable shares issued on or after January 1, 2018;

- The following conditions must be met for redeemable shares issued before January 1, 2018:

    - The party that owns the shares has control of the enterprise as at the date of initial application of the amendments (i.e., January 1, 2020 for enterprises with a December 31 year-end). The enterprise, therefore, does not need to assess whether the party that owns the shares at the date of initial application has retained control of the enterprise since the date of the initial transaction;

    - No other written or oral arrangement exists, such as a redemption schedule, on the date of initial application.

  This means that, for redeemable shares issued prior to January 1, 2018, the enterprise is not required to meet the condition which requires that no consideration shall be received or that only shares of the enterprise issuing the redeemable shares were exchanged to be eligible to classify these shares as equity at the date of initial application.

If these conditions are not met for some or all of the shares, the shares must be classified as financial liabilities on the date of initial application.

Practical insights

- Note that January 1, 2018 is a set date that cannot be adjusted for each enterprise's year-end date. Accordingly, an enterprise with a non-December 31 year-end date must ensure that it clearly identifies redeemable shares issued on or after January 1, 2018, even if they were issued in the same fiscal period, since the conditions to be analyzed for their classification in equity will be different.

- Because enterprises are not required to meet the same conditions for the classification of redeemable shares issued before and on or after January 1, 2018, enterprises may find themselves presenting redeemable shares issued in tax planning arrangements other than estate freezes in equity as at January 1, 2020. For example, shares classified in equity as at January 1, 2020 could include retractable preferred shares issued in connection with an asset tax rollover that occurred before January 1, 2018.

If the enterprise elects to apply the amendments to the comparative period, the enterprise does not have to make retrospective adjustments for redeemable shares issued in a tax planning arrangement that were extinguished prior to the beginning of the year in which the amendments are first applied.

Revisions to other standards

The only other significant amendments made to other standards concern Section 1591. Guidance on substantive rights has been added to help enterprises assess whether they have control over an investee. Essentially, substantive rights are rights that are exercisable when decisions about the direction of the strategic operating, investing or financing policies need to be made.

Our thoughts

Now that the definitive amendments have been published, even though they only apply as of January 1, 2020, enterprises should start preparing for their application as soon as possible. Here are a few things that enterprises can start doing now in order to prepare:

- Identify any shares outstanding that may be affected and determine whether they would qualify for the exception. During transition to the new requirements, 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 could impact the enterprise's ASPE financial statements and the resulting impact on its covenants and debt agreements. If the enterprise may be affected, consider talking to the creditors and other stakeholders early to review the contractual agreements and avoid last minute surprises.

Contact your Raymond Chabot Grant Thornton adviser if you have any questions about the new requirements and how to identify the potential impact of their application.

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