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Amendments to Section 3856 *Financial Instruments* for shares issued in tax planning arrangements

What you need to know!

November 2019

Table of contents

What are the key changes?

Private companies that issue redeemable preferred shares in a tax planning arrangement under certain specified sections of the Income Tax Act are currently exempt from classifying these shares as liabilities, pursuant to paragraph 23 of Section 3856, *Financial Instruments* ("S.3856") of ASPE. These shares are measured at their par, stated or assigned value. Due to concerns that the exception was being applied more broadly than originally intended, the Accounting Standards Board ("AcSB") has withdrawn the exception and replaced it with a new model.

Based on stakeholder feedback, the AcSB believed that often nothing of substance changes in the management and operations of the enterprise before and after a tax planning arrangement. Therefore, the AcSB concluded that if nothing of substance has changed, an exception to financial liability classification should be permitted. Consequently, retractable or mandatorily redeemable shares ("ROMRS") issued in a tax planning arrangement may be classified as ***equity*** only if all of the following three conditions are met:

Condition 1
Control of the enterprise is retained by the shareholder receiving the ROMRS

Condition 2
Only shares are exchanged (or no consideration is received by the enterprise issuing the ROMRS) AND

Condition 3
No other written or oral arrangement exists, such as a redemption schedule, that gives the holder the contractual right to require the enterprise to redeem the ROMRS on a fixed or determinable date (or within a fixed or determinable period).

If all three conditions ***are met***, the ROMRS may be classified as equity and measured at their par, stated or assigned value (which is generally nominal).

If any of the three conditions ***are not*** met, the ROMRS would be classified as financial liabilities and measured at their redemption amount (i.e., the amount due on demand). Enterprises can elect to classify any ROMRS as a financial liability (at their redemption amount) without performing the analysis.

The amendments are effective on a retrospective basis for fiscal years beginning on or after January 1, 2020 with earlier application permitted and transitional relief including the option to record the cumulative impact in opening retained earnings as at January 1, 2020 without restating comparatives.

What shares are "in scope" of the amendments?

The amendments refer to "retractable or mandatorily redeemable" shares issued in a "tax planning arrangement". Neither component is defined in ASPE and therefore judgment must be applied in making the assessment of which shares are in scope:

- The reference to "retractable or mandatorily redeemable" is intended to capture shares issued in a tax planning arrangement that generally have the following characteristics:
  - They are redeemable on demand
  - They have, at least, voting rights on any matter involving a modification to the attributes attached to them
  - There are no restrictions on their transfer; and
  - They have priority on distribution and liquidation over any other class of shares.
- With the removal of the reference to specified sections of the Income Tax Act, judgment will be required to determine which tax planning arrangements fall within scope. However, this term is generally well understood in practice and includes estate freezes, asset rollover transactions and capital reorganizations. Asset rollovers will not meet the conditions for equity classification. However, there is relief for asset rollovers that occurred prior to January 1, 2018 (see "Transition guidance" below).

Tell me more about the three conditions for equity classification

The discussion in this section does not consider any transitional relief, which will be discussed further below.

Condition 1

Control of the enterprise is **retained** by the shareholder receiving the ROMRS 3856.23(a)

Nature of the assessment	What to consider
• An assessment of who controls the enterprise before and after the ROMRs are issued is required. The condition will only be met when control has been retained by the shareholder receiving the ROMRs. • Control of the enterprise is assessed in the same manner as in Section 1591, *Subsidiaries* and is defined as the continuing power to determine the strategic operating, investing and financing policies without the co-operation of others.	• The control analysis starts with voting rights but should also consider substantive rights provided by other contractual arrangements as these rights can result in control. Be careful of protective rights as they do not provide control. • If the enterprise is jointly controlled by one or more parties either before or after the ROMRS are issued, this condition cannot be met because no one shareholder controlled the enterprise before or after the arrangement. • For the purposes of the control assessment, it does not matter if two or more shareholders are related or not. Related parties are defined under Section 3840, *Related Party Transactions* and includes immediately family members (spouse and those dependents). In the circumstances that ROMRS are issued to related parties, only one party in a related group can have control. The outcome may be such that the related parties may have different classification of shares depending on who retained control (i.e., the controlling shareholder's shares classified as equity and the non-controlling shareholder's shares classified as liabilities) or both will be classified as liabilities if it is concluded that neither controls (i.e., joint control between related parties such as spouses). • If the ROMRS are held by a holding company or trust, the analysis will typically involve a greater degree of judgment. The control assessment within Section 1591, *Subsidiaries* includes consideration of both direct and indirect equity interests, so it is relevant to consider indirect holdings in the control assessment. In addition, the analysis should also consider the shareholder that is <u>receiving</u> the shares, since the condition requires that such shareholder must have retained control. And finally, the assessment should consider whether something of substance has changed for the enterprise issuing the ROMRS. All of these data points should be factored into the analysis and judgment should be applied to see where the weight of evidence lies.

Condition 2

Only shares are exchanged (or no consideration is received by the enterprise issuing the ROMRS) 3856.23(b)

Nature of the assessment	What to consider
• This condition requires that the only consideration exchanged in the transaction is shares. The AcSB believes that consideration other than shares exchanged for ROMRS are in effect financing transactions. • The introduction of other consideration such as assets that the enterprise did not previously own will violate the condition because these other assets or liabilities fundamentally change the enterprise's future cash flow expectations and would not meet the underlying premise that nothing of substance has changed.	• Asset rollovers will not qualify for equity treatment. However, there is relief for asset rollovers that occurred prior to January 1, 2018 (see "Transition guidance" below). • Other assets that could taint the arrangement include cash and notes receivable received for the ROMRS. • If a nominal amount of consideration has been included in the transaction either specifically for the ROMRS or for new common shares, it is again important to consider if something of substance has changed for the enterprise issuing the ROMRS. For example, if $1 or $10 was required to be paid for the ROMRS to legally affect the transaction, the nominal consideration is non-substantive to the transaction and the condition could be considered to be met. This is contrasted with a transaction that included tens of thousands of dollars of consideration for the ROMRS or including some other assets in the transaction, in which case, there is a substantive change as a result of the transaction and the condition would not be met. • Arrangements executed in one or more steps are considered holistically if the transactions were executed in contemplation of one another. For example, an enterprise may first exchange common shares for ROMRS, followed by an exchange of a building for cash from the same shareholder. If these steps are executed in contemplation of each other, the second condition would not be met as a result of the assets exchanged as part of the tax planning arrangement. Factors that should be considered in the analysis would include the time lag between the transactions. For example, if the steps occurred months or years apart instead of one after another. Whether these transactions should be considered one tax planning arrangement would depend on the facts and circumstances and judgment should be applied. Time difference alone does not mean you have two separate tax planning arrangements.

Condition 3

No other written or oral arrangement exists, such as a redemption schedule, that gives the holder the contractual right to require the enterprise to redeem the ROMRS on a fixed or determinable date (or within a fixed or determinable period) 3856.23(c)

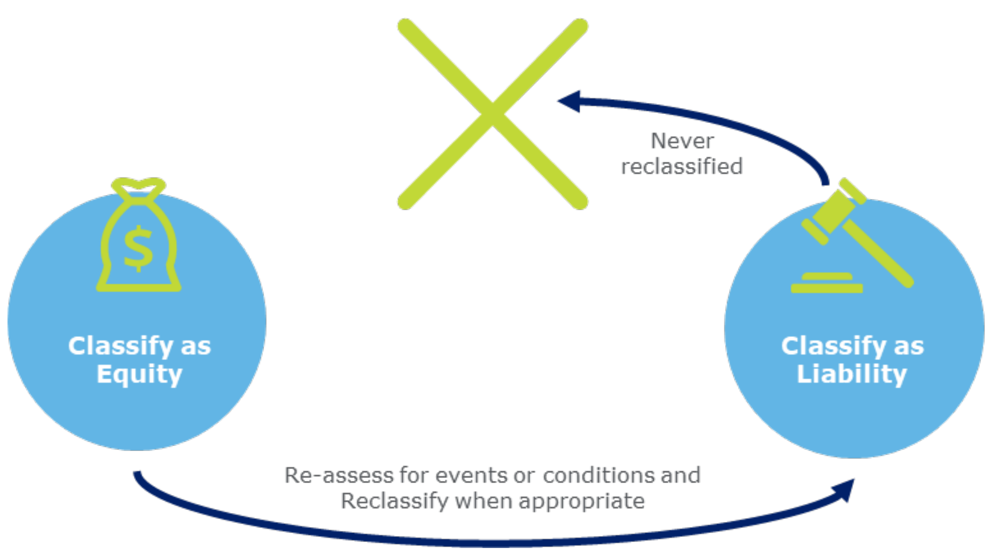
Nature of the assessment	What to consider
• For shares to receive preferential tax treatment, they are required to be due on demand. Without the exception, the shares would meet the definition of a financial liability because they give the holder the right to redeem the shares on demand. However, an exception to liability accounting was permitted unless there is a redemption schedule that specifies timing of redemption of the ROMRS. If a redemption schedule exists, the ROMRS would require liability treatment because the enterprise will be required to pay cash on fixed or determinable dates. • If a redemption schedule existed for only some, but not all, of the ROMRS, only the shares for which there is a redemption schedule should be classified as a financial liability and the remaining shares are equity assuming the other conditions are also met. However, if there are consistent patterns of redemption schedules being created for some of the shares after initial recognition, judgment should be applied to determine if all the shares should be classified as liabilities based on the company's practice of introducing redemption schedules.	• Any contractual arrangement, oral or written should be considered. Examples include Shareholders' Agreements, Articles of Incorporation, minutes of Board meetings and any other contracts that govern the ownership and operation of the enterprise including relevant purchase and sales agreements. • Redemption of the ROMRS based on contingent events (i.e., repayment of debt, meeting EBITDA targets) should be considered in the analysis. • Section 1510, *Current Assets and Current Liabilities*, was amended as these shares are due on demand and would typically be classified as a current liability unless there is an arrangement to indicate otherwise. For example, if the enterprise obtained a waiver from the holder of the ROMRS such that the holder will not demand repayment within one year from the balance sheet date, then long- term presentation would be acceptable. However, the tax consequences of obtaining a waiver should be discussed with the enterprise's tax specialists to determine if the preferential tax treatment for the ROMRS would be negated if the enterprise is party to a waiver-type agreement. • Judgment has to be applied to determining what constitutes a "redemption schedule" and the enforceability of such a schedule needs to be considered. • Enterprises will need to holistically assess any arrangements that may exist which requires the enterprise to redeem the shares on a fixed or determinable date or within a fixed or determinable period when determining whether this condition has been met.

Can the ROMRS be reclassified after the initial classification?

If the ROMRS are classified as ***equity***, the ROMRS need to be monitored for any events or changes in circumstances which indicate that one or more of the conditions are no longer met. When the conditions are no longer met, the ROMRS must be reclassified as a financial liability.

Examples of events that may indicate one or more of the conditions are no longer met include: the death of the holder of the ROMRS; a change in the ownership of the enterprise; a change in the shareholders' agreement; or a redemption of some or all of the ROMRS.

If the ROMRS are classified as a ***financial liability***, either initially or after a change in circumstances, they are prohibited from being reclassified to equity, even if circumstances change.



In a nutshell

Are all three conditions met[1]?

Yes	No
Shares are classified as **equity**	Shares are classified as a ***financial liability***
Measured at par, stated or assigned value[2]	Measured at their redemption amount (i.e., the amount due on demand)
Monitor for events that could threaten any of the three conditions required for equity classification	Prohibited from being reclassified to equity, even if circumstances change
Dividends recorded in equity	Dividends paid presented as interest expense

Any ***resulting adjustment*** if reclassification from equity to liability is required is recognized in either retained earnings or a separate component of equity (policy choice).

A Decision Tree of how to apply the new model has been included in Appendix A.

[1] Enterprises can elect to classify any ROMRS as a financial liability (at their redemption amount) without performing the analysis.
[2] In practice, this would have been the accounting value recorded for the shares (i.e., nominal amount paid to subscribe for the shares).

Transition guidance

The amendments are effective for fiscal years beginning on or after January 1, 2020; earlier application is permitted.

There has been some transitional relief provided, as outlined below.

There are two key determinations that an enterprise will have to make upon transition:

1. First, the date at which they will apply the amendments, and
2. Second, the date at which the shares were issued, specifically whether they were issued before or after January 1, 2018.

For example, a calendar year end enterprise that presents one year of comparatives and is not early adopting the amendments would have to assess the following:

1. Select the application date

The first decision is at what point in time does the enterprise want to apply the amendments:

- At the beginning of the current period (i.e., January 1, 2020) or
- At the beginning of the prior period (i.e., January 1, 2019)

This determination is important because this is the date that will establish the population of shares to be assessed under the amendments. For example, if the enterprise wants to apply the amendments on January 1, 2020, then it is the shares that exist on this date that they will make the assessment for. This policy choice is also intended to provide an option not to restate comparatives. This choice will impact when the cumulative effect of applying the amendments is recorded and whether prior periods need to be restated.

So, if an enterprise chooses to apply the amendments at the beginning of the current period, January 1, 2020 (the fiscal year in which the amendments are first applied), the cumulative effect is recorded in opening retained earnings or a separate component of equity on January 1, 2020. The comparative period is not restated. If, instead, an enterprise chooses to apply the amendments at the beginning of the prior period, January 1, 2019, the cumulative effect is recorded in opening retained earnings or a separate component of equity on January 1, 2019 and the 2019 comparative period is restated.

2. Determine the population of shares and if the enterprise does not elect liability classification, assess if the shares were issued before or after January 1, 2018

After selecting the application date, the enterprise has to then determine the population of shares that exist at that date. [Note, there is transitional relief available if the application date selected is the beginning of the prior period (i.e., January 1, 2019) and the shares were redeemed prior to January 1, 2020 – in this case, the 2019 comparative period is not restated for those shares.]

If the enterprise has not elected liability classification and chooses to assess the ROMRS for equity classification, they must determine when the ROMRS were issued since transitional relief has been provided for ROMRS issued before January 1, 2018 (this date is independent from the enterprise's selected application date).

If the ROMRS were issued on or after January 1, 2018, all three conditions discussed previously have to be met.

However, if the ROMRS were issued before January 1, 2018, the enterprise only has to apply Conditions 1 and 3 to determine if the ROMRS can be classified as equity as follows:

Condition 1 – ***Control of the enterprise that issued the ROMRS is held*** by the party that owns the ROMRS in the arrangement at the date of initial application. The enterprise need not assess if control has been ***retained*** from the date of the initial transaction that gave rise to the shares.

Condition 3 – No other written or oral arrangement exists, such as a redemption schedule, that gives the holder of the ROMRS the contractual right to require the enterprise to redeem the ROMRS within a fixed or determinable period.

Transitional relief is provided for ROMRS issued before January 1, 2018 – no assessment of condition 2 "consideration exchanged" in the arrangement is required. This transitional relief will result in shares issued in asset rollovers prior to January 1, 2018 to qualify for equity classification on transition; however, shares issued in asset rollovers on or after January 1, 2018 will not quality for equity classification.

A Decision Tree of how to apply the transition requirements has been included in Appendix B.

Practical example of how to apply the transition requirements

Let's look at an example of how to apply the transition requirements and how this impacts the balance sheet if there is a change in classification from equity to liability.

Assume that we have a calendar year end enterprise that is not early adopting the amendments. The enterprise performs the following steps:

1. **Select the application date** – The enterprise has selected an application date to apply the amendments as of the beginning of the current period (i.e., January 1, 2020).

2. **Determine the population of shares and if the enterprise does not elect liability classification, assess if the shares were issued before or after January 1, 2018** – in determining the population of shares that exist on January 1, 2020, the enterprise has identified preferred shares that are in scope that were issued prior to January 1, 2018 in a tax planning arrangement. Prior to applying the amendments, these shares were eligible for equity classification and recorded at their par value of $100. The redemption amount of $500,000 was disclosed. The enterprise has not elected liability classification.

As the shares were issued prior to January 1, 2018, the enterprise assesses if the ROMRS meet the two conditions for equity classification. Assume that the enterprise concludes that the conditions were not met. Accordingly, the ROMRS are reclassified as financial liabilities and measured at their redemption amount of $500,000. The ROMRS are classified as current liabilities (as they are due on demand).

The enterprise uses the taxes payable method so future income taxes have not been considered.

Impact

Due to the selection of the application date of January 1, 2020, the adjustment of $499,900[3] is recorded in opening retained earnings as at January 1, 2020 with disclosure on the face of the balance sheet of the amount charged to retained earnings. Alternatively, a separate component of equity can be used. The enterprise does not restate prior periods.

The balance sheet before and after the amendments are applied will be presented as follows as at January 1, 2020:

Before (qualify for equity)		**After (conditions not met; financial liability)**	
Assets		**Assets**	
Total assets	**$ 750,000**	Total assets	**$ 750,000**
Liabilities		**Liabilities**	
Accounts Payable	$ 400,000	Accounts payable	$ 400,000
		Mandatorily redeemable shares	500,000
			$ 900,000
Equity		**Equity**	
Common shares	$10,000	Common shares	$10,000
Preferred shares	**100**	**Deficit (amount related to mandatorily redeemable shares: $499,900)[3]**	(160,000)
Retained earnings	$ 339,900		
Total Equity	$ 350,000	Total Equity	$ (150,000)
	$ 750,000		**$ 750,000**

The reclassification of the ROMRS may adversely impact financial ratios, such as the current ratio and debt to equity ratio, which may require renegotiation of banking covenants going forward.

[3] Dr. Retained earnings $499,900 Dr. Equity $100 and Cr. ROMRS $500,000

Transition checklist

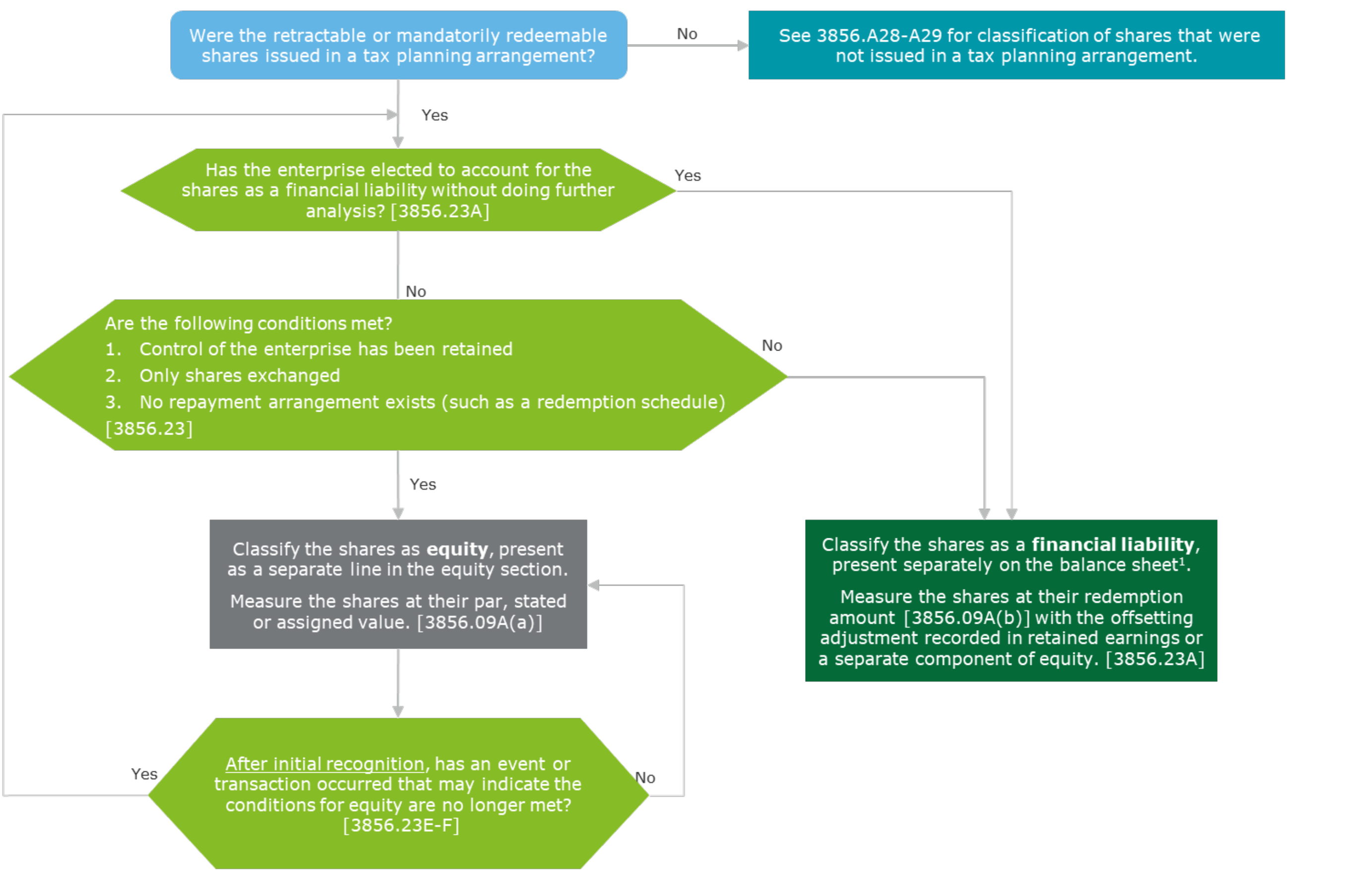
To assist enterprises in working through the transition, we have included a checklist of the things to consider in the analysis:

1	Inventory the population – Does the enterprise have any outstanding retractable or mandatorily redeemable shares issued in a tax planning arrangement? If yes, the following steps should be performed.
2	Understand the nature of the tax planning arrangement and the terms attached to the ROMRS issued in the arrangement.
3	Will the enterprise elect to classify these ROMRS as financial liabilities? If the enterprise will not be making the election, an analysis of the conditions for equity classification will be required in Step 5.
4	Determine the date of when the enterprise wants to apply the amendments i.e., beginning of current period or beginning of prior period?
5	Assess if the conditions for equity classification have been met and if any adjustment is required on transition (see "Transition guidance" section). a. If the shares were issued prior to January 1, 2018 – assess **two** conditions b. If the shares were issued on or after January 1, 2018 – assess **three** conditions
6	Assess the impact on the financial statements.
7	Assess impact to bank covenants and key performance indicators (i.e., current ratio, debt to equity ratio).
8	Gather the information required for the new disclosure requirements.

Appendix A: Decision Tree for new transactions (post-transition)

S. 3856 Retractable or mandatorily redeemable shares issued in a tax planning arrangement (ROMRS)
On-going classification and measurement

The following flowchart applies to the assessment of retractable or mandatorily redeemable shares issued in a tax planning arrangement issued after the effective date of the S. 3856 amendments (i.e. for fiscal years beginning on or after January 1, 2020 with earlier application permitted).

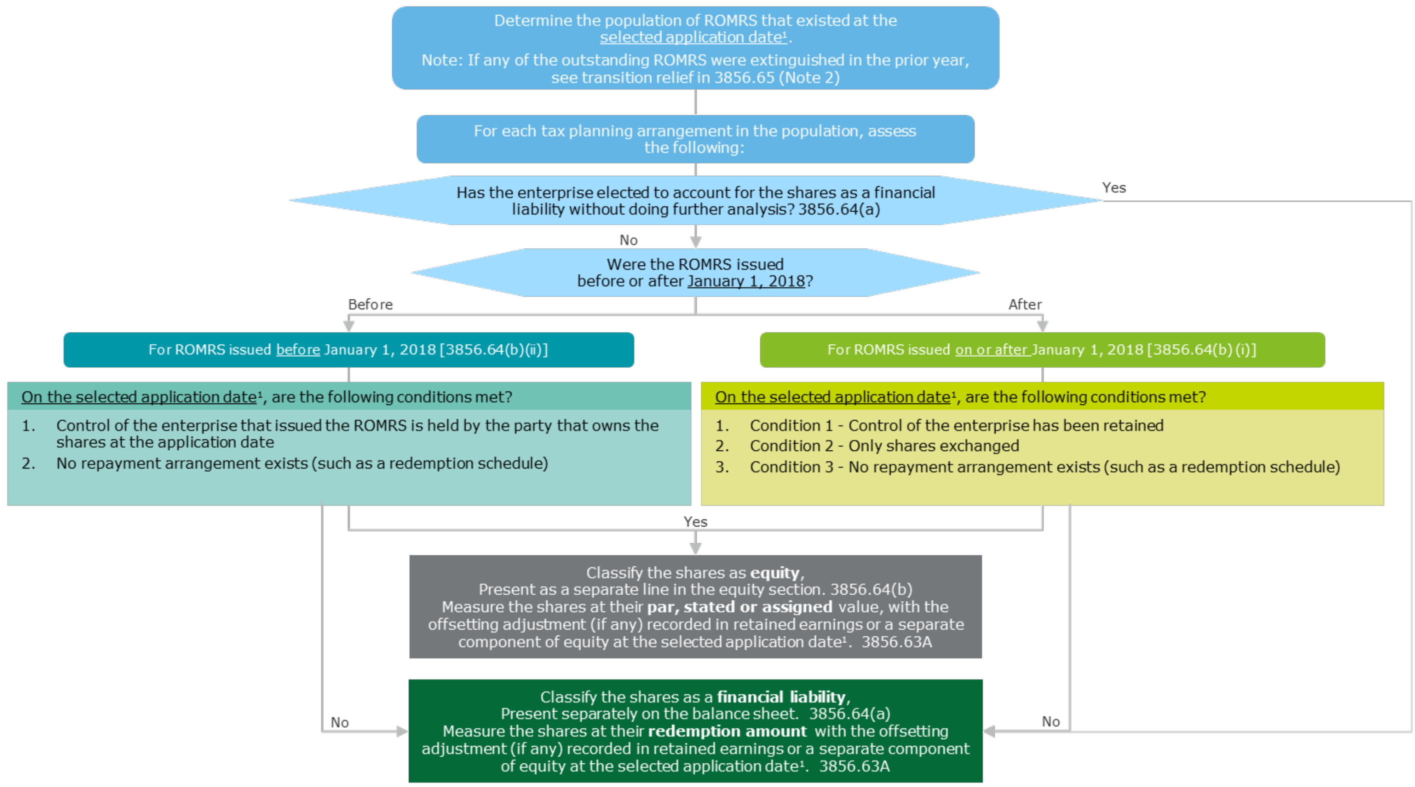


Note 1. The shares are typically presented as a current liability unless there is an arrangement to indicate otherwise [Basis for Conclusion Section 3856 – paragraph 112].

Appendix B: Decision tree at Transition

S. 3856 Retractable or mandatorily redeemable shares issued in a tax planning arrangement (ROMRS) **Transition**

The following flowchart assists engagement teams in assessing the transitional impact on adoption of the amendments to S.3856 for retractable or mandatorily redeemable shares issued in a tax planning arrangement ('ROMRS').



Notes:

1. Selected **application date** – 3856.63 provides enterprises with an **option** to apply the amendments either:
   a. at the beginning of the earliest period presented; or
   b. at the beginning of the fiscal year in which the amendments are first applied.

For example, enterprises applying the amendments for the first time in its fiscal year beginning January 1, 2020, with one year of comparatives presented, these options are:
   a. an application date of January 1, 2019 with any accumulated adjustment to opening retained earnings on January 1, 2019. Comparatives are restated.
   b. an application date of January 1, 2020 with any accumulated adjustment to opening retained earnings on January 1, 2020. Comparatives are not restated.

2. **ROMRS extinguished during the prior year** – when an enterprise chooses application date "*(a) - to apply the amendments at the beginning of the earliest period presented*" (i.e. January 1, 2019), there is relief provided for ROMRS that were extinguished prior to the beginning of the fiscal year in which the amendments are first applied (i.e. prior to January 1, 2020). Paragraph 3856.65 permits the enterprise not to make retrospective adjustments in respect of those extinguished shares. For example, if ROMRS classified as equity are redeemed in May 2019 and those shares did not meet the conditions for equity classification, the enterprise would not be required to apply the amendments in the 2019 prior period financial statements for those redeemed shares. (S.3856.65 and Basis for Conclusions paragraph 100).

Resources

- AcSB In Brief Podcasts: Retractable or Mandatorily Redeemable Shares (September 2019)
- CPA Canada – ASPE Briefing Retractable or Mandatorily Redeemable Shares (March 2019)
- CPA Quebec – Significant changes published in December 2018 (April 2019)
- Accounting Standards Board webinar (December 2018)

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