ASPE Briefing: Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement

MARCH 2019

ASPE Briefing: Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement

MARCH 2019

Table of Contents

Introduction

Retractable or mandatorily redeemable shares (ROMRS) meet the definition of a liability in accordance with Section 1000, *Financial Statement Concepts*.[1] However, when the Accounting Standards for Private Enterprises (ASPE) were issued in 2011, Section 3856, *Financial Instruments*,[2] provided an exception for redeemable preferred shares issued under specified Sections of the *Income Tax Act*. An entity that issued such shares classified them as equity rather than as a liability.

In December 2018, the Accounting Standards Board (AcSB) amended Section 3856. The amendments provide new conditions that must be met in order for ROMRS issued in a tax planning arrangement to be classified as equity, as well as some changes to measurement, presentation and disclosure requirements.

These amendments apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020, with earlier application permitted.

This Briefing will describe the new accounting for ROMRS issued in a tax planning arrangement, including how to determine whether they should be classified as a financial liability or as equity, initial and subsequent measurement, presentation and disclosure requirements and transition provisions. Other amendments to Section 3856 made at the same time to related party financial instruments and significant risk disclosures are not addressed in this Briefing.

The amendments to Section 3856 will result in some redeemable preferred shares classified as equity being reclassified as a financial liability. Less commonly, the amendments may result in reclassifications from liabilities to equity. Such changes will affect financial metrics (e.g., debt-equity ratios and interest coverage ratios) often embedded in debt covenants and sometimes in other contracts. Companies may need to discuss the effects of the changes with lenders and other users.

1 Paragraphs 1000.28-.30

2 Paragraph 3856.23

Why the Changes?

The AcSB noted the following concerns with the existing accounting requirements in Section 3856:

- Liability accounting was being applied to transactions such as commercial financing agreements, employee compensation plans and management buyouts. This was not the intent of Section 3856.
- Section 3856 only permitted equity accounting for ROMRS issued under specified sections of the *Income Tax Act*. ROMRS issued under other sections of the *Income Tax Act* did not qualify for equity treatment, even though they might be substantively similar.
- Section 3856 required ROMRS classified as equity to be reclassified as liabilities "when redemption is demanded." Given the broad range of redemption features occurring in practice, there was diversity in practice over when to reclassify ROMRS from equity to liabilities.

What Are Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement?

The term “retractable or mandatorily redeemable shares” is not defined in Section 3856. When considering the amendments, the AcSB deliberated whether to provide a definition. The term already existed in Section 3856 and the Board concluded it is well understood in practice. However, the **Basis for Conclusions** notes the term “is intended to capture shares issued in a tax planning arrangement that generally have the following characteristics:

a. the holder of the shares has the right to require their redemption on demand at a redemption price equal to the fair market value of the common shares exchanged;

b. the shares have, at least, voting rights on any matter involving a modification to the attributes attached to them;

c. there are no restrictions on their transfer;

d. the shares have priority on distribution and liquidation over any other type of shares; and

e. the shares are issued as part of a tax planning arrangement.”[3]

The AcSB decided that ROMRS eligible for equity classification should not be limited to preferred shares since not all shares issued in tax planning arrangements are preferred shares. Another significant difference introduced by the amendments to Section 3856 is that there are no references to specific sections of the *Income Tax Act*. Instead, the revised Section 3856 refers more generically to “a tax planning arrangement.”

It is important to recognize a tax planning arrangement as not limited to a single transaction; a series of transactions made in contemplation of each other is viewed as a single tax planning arrangement when determining the classification of ROMRS.

3 Paragraph BC 16

When Can ROMRS Issued in a Tax Planning Arrangement Be Classified as Equity?

As noted earlier, ROMRS meet the definition of a financial liability. Liability classification can have a significant effect on the balance sheet. For example, in a typical estate freeze, a shareholder exchanges common shares for ROMRS. If the ROMRS are classified as a financial liability, the result is a decrease in equity and an increase in liabilities. This will affect the debt-equity ratio. Since dividends on shares classified as a financial liability are reported as interest rather than dividends, there is also an impact on the interest coverage ratio. The effect can be heightened by the requirement to measure the financial liability based on the redemption amount of the ROMRS, which is generally significantly greater than the amount at which the enterprise previously recorded the shares. For example, assume Company A issues ROMRS in a tax planning arrangement in exchange for common shares held by Mr. X recorded in Company A's financial statements at $500,000. The redemption amount of the ROMRS is $1,500,000. The ROMRS financial liability will be recorded at $1,500,000 and equity will be reduced by a similar amount. This reduction to equity could potentially result in minimal or even negative equity.

Conditions for Classification as Equity

Often nothing of substance changes in the management and operations of the enterprise before and after a tax planning arrangement. The AcSB thought that, if nothing of substance has changed, an exception to financial liability classification should be permitted. Consequently, ROMRS issued in a tax planning arrangement may be classified as equity provided **all** the following three conditions are met:

1. Shareholder receiving the ROMRS retains control of the enterprise
2. No consideration other than shares
3. No redemption arrangement

These conditions are discussed in more detail below.

This exception to financial liability classification is **optional**. ROMRS issued in a tax planning arrangement that meet these three conditions may be classified as equity, but financial liability classification is also permissible. However, if ROMRS are classified as financial liabilities, they cannot subsequently be reclassified as equity. If all three conditions are not met, then the ROMRS must be classified as financial liabilities.

Reasons to classify ROMRS as financial liabilities include:

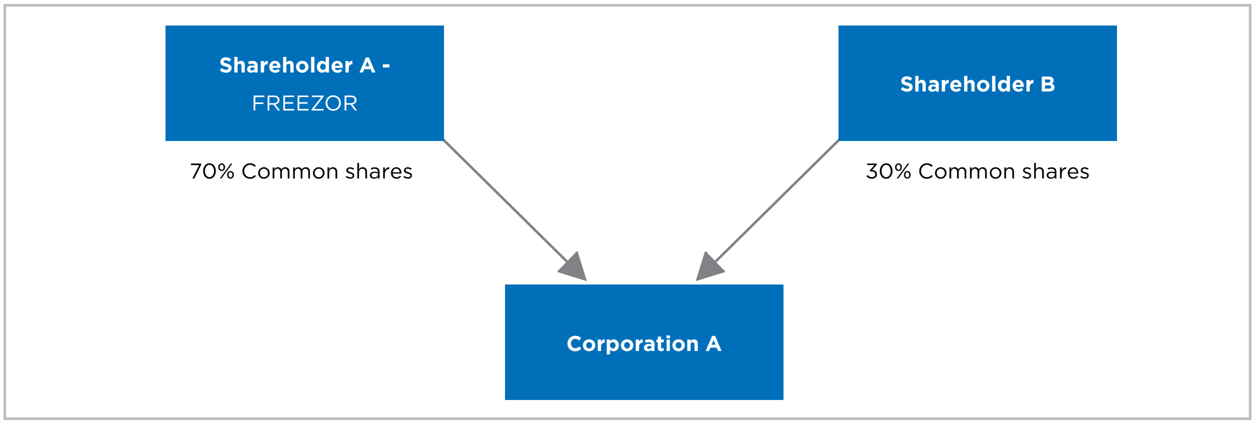
- Users of the financial statements may prefer this classification.
- The cost and effort of determining whether the conditions are met on initial recognition and in subsequent periods may be avoided.

1. **Shareholder receiving the ROMRS retains control of the enterprise**
   The first condition required for ROMRS issued in a tax planning arrangement to be classified as equity is that the shareholder of the enterprise issuing the ROMRS retains control. Identifying whether a party has control of an enterprise can be straightforward or complicated depending on the circumstances. Control is addressed in Section 1591, *Subsidiaries*. Section 3856 refers to that Section for guidance on control.[4]

   The following examples demonstrate the control condition.

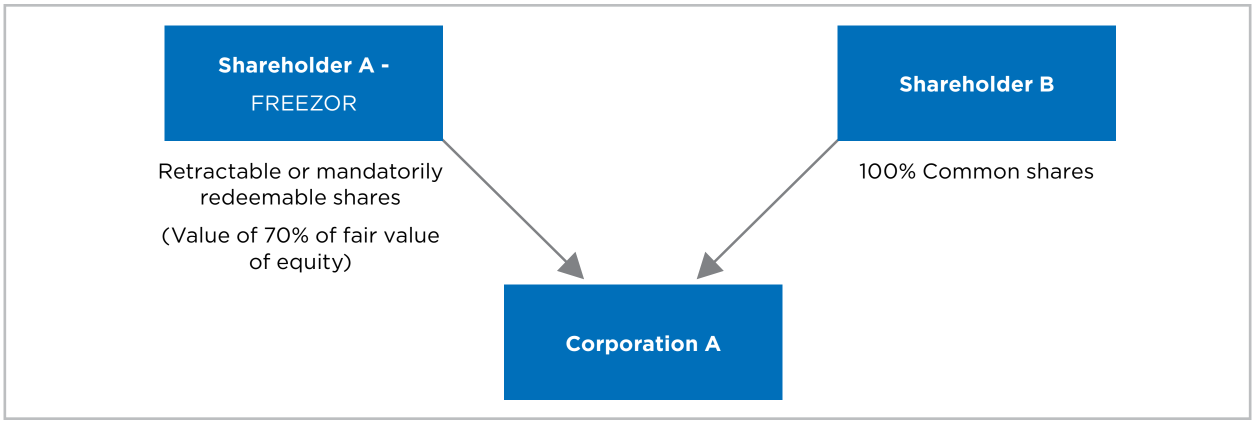
   In the first scenario, Shareholder A currently owns 70% of the voting common shares of Corporation A. Shareholder A executes an estate freeze by exchanging voting common shares for ROMRS that carry the same voting rights as the common shares. No new common shares or ROMRS were issued to Shareholder B (holder of the remaining 30% of the voting common shares) in the tax planning arrangement.

Before the estate freeze



4 See *CPA Canada ASPE Briefing: A New Light on Accounting for Investments* for a discussion on control as defined in Section 1591.

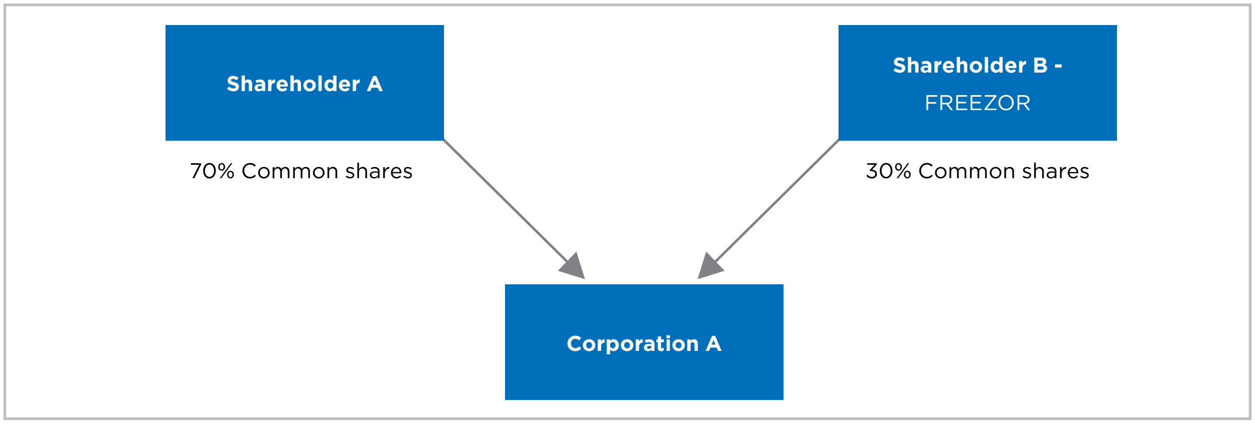
After the estate freeze



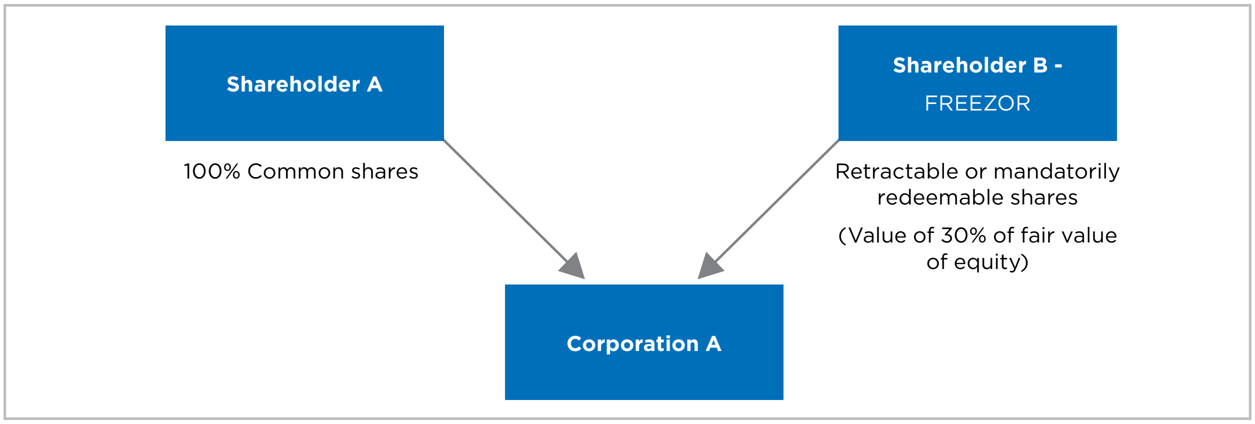
Since the ROMRS have the same voting rights as the common shares, Shareholder A has retained control of Corporation A. (This is a simplified example. In practice, other factors may affect control. Refer to the guidance in Section 1591 to determine whether Shareholder A has retained control.)

However, the result is different if Shareholder B executes the estate freeze.

Before the estate freeze



After the estate freeze



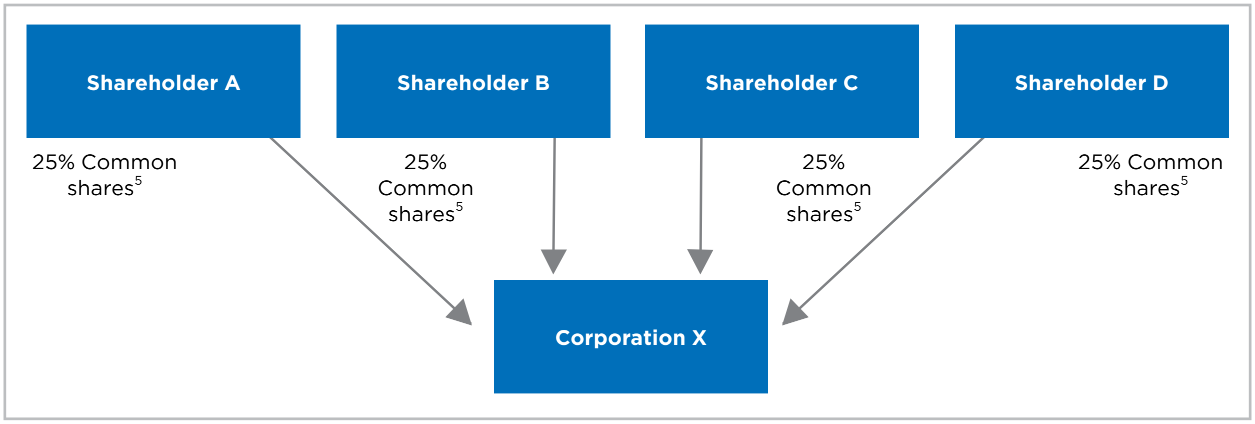
This arrangement does not meet the control condition. Shareholder B did not control Corporation A prior to the tax planning arrangement and therefore could not "retain control." Further, this transaction is not consistent with the overriding principle for equity classification that there must be no change of substance. Prior to the estate freeze, it was not within the power of shareholder B to choose unilaterally whether to receive cash flow from Corporation A either through the declaration of a dividend or the redemption of the shares. After the estate freeze, however, Shareholder B is able to demand cash from Corporation A by redeeming the ROMRS. Corporation A therefore must classify the ROMRS as a financial liability.

ROMRS may be issued to two or more related parties as part of a tax planning arrangement. Only one party in any related group can have control when assessing the control condition. For example, each of two spouses receives 50% of the ROMRS issued. Application of the guidance on control in Section 1591 to the specific facts and circumstances may result in the determination that following the transaction:

- If one of the spouses controls the enterprise (i.e., the shares held by that spouse meet the control condition for classification as equity), the shares held by the other spouse will be classified as a financial liability because the control condition is not met.
- If joint control exists (i.e., neither spouse controls the enterprise), all the shares will be classified as a financial liability.

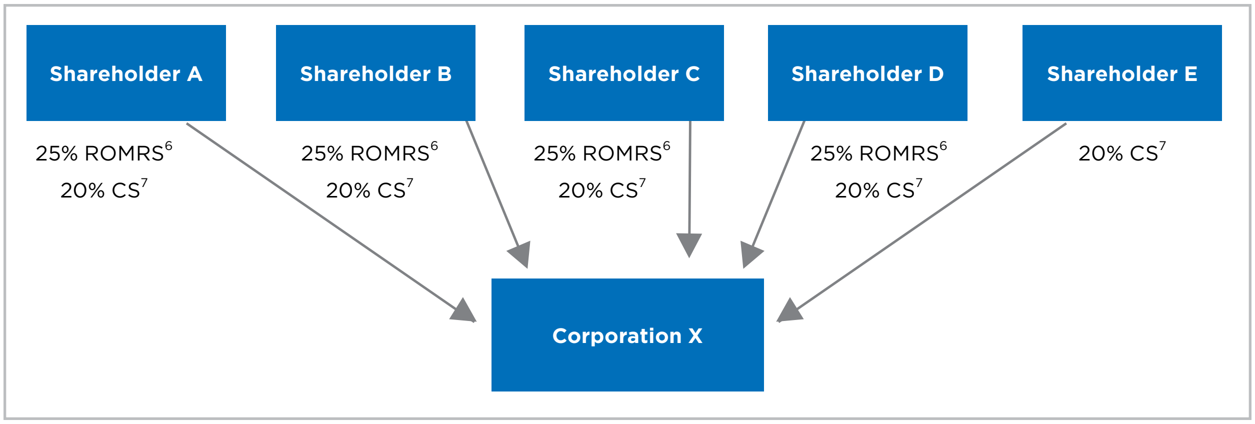
The following example considers the issuance of ROMRS by Corporation X in an estate freeze when four shareholders have joint control.

Before



5 Common shares (CS) representing voting interest of 25% in Corporation X. Decisions on the strategic operating, investing and financing policies require the consensus of all shareholders.

After



In this example, since the ROMRS do not meet the control condition for equity classification, they must be classified as financial liabilities. Prior to the issuance of the ROMRS, no individual shareholder could make unilateral decisions regarding the management and operations of the enterprise (e.g., declare a dividend). Following the transaction, each shareholder can demand cash from Corporation X through redemption of their ROMRS.

The control condition is the foundation for the exception to equity classification. If control is not retained after the transaction, the shares will automatically be classified as a financial liability. Therefore, all freezes of minority positions and joint control scenarios will not qualify for equity classification.

2. No consideration other than shares

The second condition required for ROMRS to be classified as equity is that the only consideration exchanged in the transaction should be shares. This is consistent with the AcSB's view that only ROMRS issued in a tax planning arrangement that do not result in a substantive change in the enterprise should qualify for equity classification. Consideration other than shares (e.g., cash, notes receivable, property and equipment or other) will generally change the cash flows of the enterprise and thus constitute a substantive change.

The condition covers two scenarios:

1. No consideration is received by the enterprise issuing the ROMRS. This includes estate freezes effected by stock dividends.
2. Only shares of the enterprise issuing the ROMRS are exchanged (e.g., an estate freeze effected by the shareholder exchanging common shares for ROMRS).

6 Retractable or mandatorily redeemable shares (non-voting).

7 Common shares representing voting interest of 20% in Corporation X. Decisions on the strategic operating, investing and financing policies require the consensus of all shareholders.

Asset rollover transactions do not meet this condition. ROMRS issued as part of an asset rollover transaction cannot be classified as equity. Some asset rollover transactions involve multiple steps. For example, an enterprise may first exchange common shares for ROMRS, followed by an exchange of a building for cash. If these steps are executed in contemplation of each other, the enterprise needs to assess the transaction holistically.

3. **No redemption arrangement**
   The third condition required for equity classification is the absence of any arrangement requiring redemption of the ROMRS within a fixed or determinable period. This includes both written and oral arrangements and includes, but is not limited to, a formal redemption schedule. "Redemption schedule" is not defined in Section 3856. Because it has varying meanings in practice, the AcSB decided that defining the term could be viewed as prescriptive and lead to unintended consequences.

   A redemption arrangement may be in written form (e.g., a formal redemption schedule) and may be included in a shareholders' agreement, articles of association, a board or shareholders' meeting minutes, purchase and sale agreements or elsewhere. A redemption agreement may also be an oral agreement. Stakeholders must assess holistically any existing arrangement that requires redemption of the shares on a fixed or determinable date or within a period by the enterprise.

   For shares to receive the preferential tax treatment that drives tax planning arrangements, they must be due on demand. This feature, in itself, does not disqualify ROMRS from being classified as equity.

Reclassification

ROMRS issued in a tax planning arrangement may initially meet all three of the conditions discussed above required for equity classification. However, a future event or transaction may prevent one or more conditions from being met. If all the conditions for equity classification are no longer met, ROMRS classified as equity must be reclassified as a financial liability.

There is no requirement to continuously reassess whether all three conditions are being met. The classification should only be reassessed when an event or transaction occurs that may indicate all three conditions for equity classification are no longer being met. Examples of such events or transactions include, but are not restricted to:

- the death of the holder of the ROMRS
- a change in the ownership of the enterprise that may affect the assessment of control of the enterprise that issued the ROMRS

- a change in the shareholders' agreement that may affect the assessment of control of the enterprise that issued the ROMRS
- redemption of some or all of the ROMRS
- the creation of a written or oral arrangement that gives the holder of the ROMRS the right to require the enterprise to redeem the shares within a fixed or determinable period
- modifications to the ROMRS.

Reassessment of ROMRS classified as equity does not automatically lead to reclassification of the ROMRS as a financial liability. Such reclassification will depend on whether, after considering the effects of the transaction or event, the ROMRS continue to meet all three conditions for classification as equity.

ROMRS classified as a financial liability cannot be reclassified. This is so even if they met the criteria for equity classification on initial recognition, but the enterprise chose to classify them as a financial liability.

How Should ROMRS Classified as a Financial Liability Be Measured?

ROMRS classified as a financial liability are measured at the redemption amount.

In many cases, the redemption amount is also the fair value because the *Income Tax Act* requires that the ROMRS be due on demand. However, ROMRS may be subordinated to other debt or have a redemption schedule specifying repayment terms and therefore be unlikely to be redeemed in the near term. The fair value of such ROMRS is the redemption amount discounted from the first date the amount could be required to be paid.[8] However, the AcSB has decided not to permit discounting of the redemption amount of ROMRS to reflect expected timing of redemption and credit risk.

The above discussion on measurement applies whether the shares are issued to unrelated or to related parties.

If ROMRS issued in a tax planning arrangement are reclassified from equity to financial liabilities, the reclassified shares are measured at the redemption amount on the date the event or transaction causing the reclassification occurs.

The amount recorded as a financial liability may be different from the amount at which the shares were recorded in equity;[9] the difference is recorded in retained earnings[10] or in a separate component of equity in accordance with Section 3251, *Equity.* If the difference is recorded in a separate component of equity, this amount should be charged to retained earnings as the ROMRS are called for redemption. Enterprises applying the future income taxes method should consider the tax accounting effects.[11]

8 See 3856.A12

9 If the ROMRS are:
  a. classified as a financial liability when issued, "the amount recorded in equity" is the carrying amount in the enterprise's financial statements of the shares given up by the shareholder in exchange for the ROMRS.
  b. initially classified as equity and subsequently reclassified as a financial liability, "the amount recorded in equity" is the carrying amount of the ROMRS in equity immediately prior to the reclassification.

10 The option to record the difference in retained earnings addresses a concern that recording it as a separate component of equity could have an adverse effect on the small business deduction for Quebec enterprises. Disclosure requirements were included to ensure transparency when the difference is recorded in retained earnings.

11 Illustrative Example 4 in Section 3840, *Related Parties*, highlights the future income tax implications of measuring ROMRS at the redemption amount.

Example 1: ROMRS classified as a financial liability

Company A issues ROMRS in a tax planning arrangement in exchange for common shares held by Mr. X which are recorded in Company A's financial statements at $500,000. The redemption amount of the ROMRS is $1,500,000. The ROMRS either (a) do not meet the conditions to be classified as equity or (b) do meet those conditions but Company A decides to classify them as a financial liability.

The journal entry on the issuance of the ROMRS would be:

Dr Common shares	500,000	
Dr Retained earnings	1,000,000	
Cr Liability (ROMRS)		1,500,000

The debit to retained earnings could, alternatively, be made to a separate component of equity.[12] The debit is a capital transaction and cannot be recorded in net income. Assume the debit was recorded as a separate component of equity and the following year, 20% of the ROMRS were redeemed. The journal entries would be:

Dr Liability (ROMRS)	300,000	
Cr Cash		300,000
Dr Retained earnings	200,000	
Cr Equity (special component)		200,000

Example 2: ROMRS initially classified as equity

In this example, the ROMRS meet the three conditions necessary to be classified as equity and the enterprise elects to classify them as equity.

The journal entry on the issuance of the ROMRS would be:

Dr Common shares	500,000	
Cr Equity (ROMRS)		500,000

In a subsequent period, a transaction or event occurs that results in one of the three conditions not being met. The ROMRS are therefore reclassified as a financial liability. The redemption amount is $1,500,000.

12 Section 3856 does not provide any guidance on how to label this separate component of equity. The separate component should refer to the required disclosures about the ROMRS, including a description of the arrangement that gave rise to the ROMRS.

The journal entry to record the reclassification would be:

Dr Equity (ROMRS)	500,000	
Dr Retained earnings	1,000,000	
Cr Liability (ROMRS)		1,500,000

The debit to retained earnings could, alternatively, be made to a separate component of equity. The subsequent accounting would be consistent with Example 1 above.

Presentation and Disclosure

ROMRS Classified As Equity

For ROMRS classified as equity, it is important to ensure transparency for users of the financial statements of the potential future cash outflows associated with the ROMRS. Such ROMRS are presented at par, stated or assigned value as a separate component of equity in accordance with Section 3251, *Equity*.[13]

The following disclosures are required:

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

ROMRS Classified As a Financial Liability

ROMRS classified as a financial liability are presented separately on the balance sheet (i.e., not combined with other liabilities).

ROMRS are generally classified as current financial liabilities since, in order to receive the preferential tax treatment under the *Income Tax Act*, they are required to be redeemable on demand. However, there may be an arrangement that indicates the ROMRS should be classified as long-term financial liabilities (e.g., if there is a redemption schedule or the holder otherwise agrees not to redeem the ROMRS within the next 12 months). The callable debt presentation included as an Illustrative Example in Section 1510, *Current Assets and Current Liabilities* cannot be used for ROMRS issued in a tax planning arrangement.

The excess of the amount at which the ROMRS financial liability is recorded over the carrying amount of the shares exchanged is a capital transaction and is recorded either in a separate component of equity or in retained earnings. It is not included in the determination of net income and is not charged against any existing balance in contributed surplus.

13 3251.05

The liability disclosures in Section 3856 apply to ROMRS classified as a financial liability. The following additional disclosures are required for ROMRS issued in a tax planning arrangement classified as a financial liability:

- a description of the arrangement that gave rise to the ROMRS
- when the effect of classifying the ROMRS as a financial liability is recorded as a separate component of equity, the fact that the balance of the separate component of equity will be charged to retained earnings as the shares issued are called for redemption
- when the effect of classifying the ROMRS as a financial liability is recorded in retained earnings, the amount charged to retained earnings for all classes of such shares is disclosed on the face of the balance sheet.

Effective Date and Transition

The amendments to the accounting for ROMRS issued in a tax planning arrangement are applicable to annual financial statements for fiscal years beginning on or after January 1, 2020. Earlier application is permitted. Early application may be attractive to enterprises that:

- have issued ROMRS that did not qualify for equity treatment under the previous accounting but meet the conditions for equity accounting in amended Section 3856
- are planning to issue ROMRS prior to a fiscal year beginning on or after January 1, 2020 and these ROMRS qualify for equity treatment under the previous accounting but will need to be reclassified as a financial liability upon transition.

For calendar year enterprises, the new accounting could be applied as early as the 2018 financial statements.

The amendments to Section 3856 issued by the AcSB in December 2018 include other changes as well as those concerning ROMRS issued in a tax planning arrangement. These other changes are also applicable to annual financial statements for fiscal years beginning on or after January 1, 2020 (earlier application is permitted). However, the changes related to ROMRS issued in a tax planning arrangement do not have to be applied at the same time as the other changes. For example, an enterprise could apply the changes related to ROMRS issued in a tax planning arrangement for the year ended December 31, 2018, and the other changes in the year ended December 31, 2020.

An enterprise may choose to apply the new accounting for ROMRS using either of the following methods:

1. **Apply at the beginning of the earliest period presented**
   In this case, the cumulative effect of applying the amendments is recorded in opening retained earnings or in a separate component of equity of the earliest period presented. For example, if the amendments are applied in the fiscal year ending December 31, 2020, and the statements also show comparatives for 2019, the cumulative adjustment is recorded as of January 1, 2019.

   Retrospective adjustment is not required for ROMRS issued in a tax planning arrangement that were extinguished prior to the beginning of the fiscal year in which the amendments are first applied. For example, assume ROMRS classified as equity are redeemed in May 2019 and the amendments are adopted for the year beginning

January 1, 2020. If those shares do not meet the classification exception, the enterprise will not be required to apply the new accounting to those redeemed shares in the prior period financial statements.

2. **Apply at the beginning of the fiscal year in which the amendments are first applied**
In this case, the cumulative effect of applying the amendments is recorded in opening retained earnings or a separate component of equity for the fiscal year in which the amendments are first applied. Using the example directly above, the cumulative adjustment will be recorded as of January 1, 2020.

The AcSB was aware that some ROMRS may have been issued many years ago and that complete information about the transactions may not be available at the transition date. Also, because multiple tax planning arrangements could be pooled together on the financial statements, determining which transaction resulted in which shares could be challenging. The transitional provisions therefore consider control at the date the enterprise first applies the amendments to Section 3856 rather then at the time of the original transaction. Also, the transitional provisions for ROMRS issued prior to January 1, 2018 do not include the condition that no consideration other than shares was included in the transaction. ROMRS issued in a tax planning arrangement prior to January 1, 2018 and for which there was other consideration besides shares (e.g., an asset rollover) will qualify for equity classification provided the other two conditions are met.

Therefore, when the amendments are applied for the first time, an enterprise that has outstanding ROMRS issued in a tax planning arrangement may choose to present the shares as:

- a financial liability
- in a separate line in the equity section of the balance sheet:
  - if the ROMRS were issued on or after January 1, 2018, and all three conditions required for equity classification are met
  - if the ROMRS were issued prior to January 1, 2018, and both the following conditions are met:
    - Control of the enterprise that issued the ROMRS is held by the party that owns the shares in the arrangement at the date of initial application. The enterprise need not assess whether control has been retained from the date of the initial transaction that gave rise to the shares.
    - No other written or oral arrangement exists (e.g., a redemption schedule) that gives the holder of the shares the contractual right to require the enterprise to redeem the shares within a fixed or determinable period.

ROMRS that do not meet the above conditions for classification as equity are classified as a financial liability.

Potential Impacts of This Change

For entities affected by a reclassification of the redeemable shares as a financial liability, this change could have significant implications:

- significant changes to liabilities, equity and interest expense as a result of changes to the classification of ROMRS
- changes to key financial ratios, including those specified in debt covenants and other contracts as well as those required by regulators. In some cases, debt covenants or other contractual terms affected may need to be renegotiated.

Given the above potential impacts, if your enterprise or your clients have ROMRS, it would be wise to start your analysis of the new amendments early.

Other Resources

CPA Canada

[Webinar – Amendments to Section 3856, Financial Instruments]

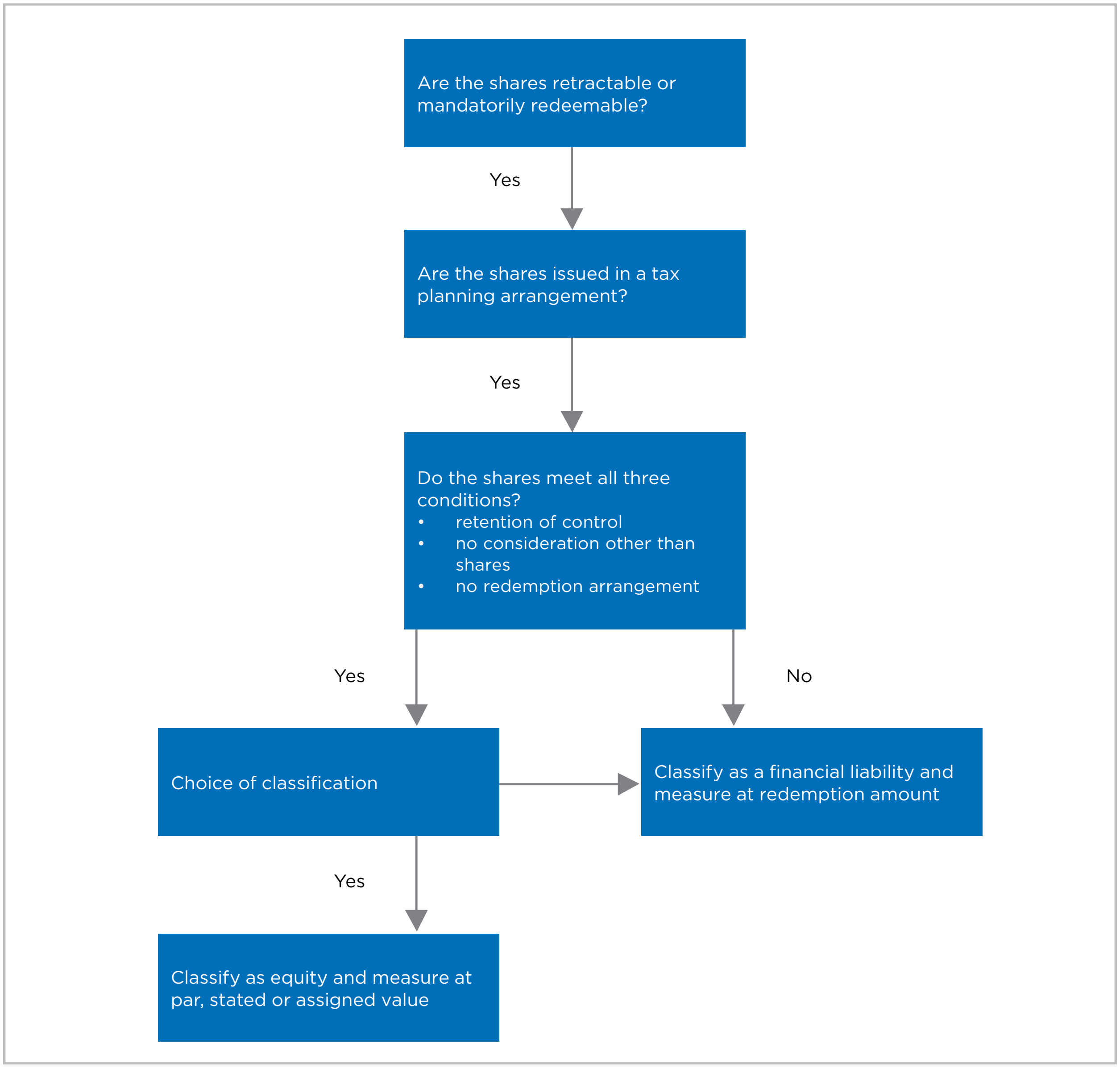
Comments

Comments on this Briefing, or suggestions for future Briefings should be sent to:

Dina Georgious, CPA, CA
Principal, External Reporting
Research, Guidance and Support
Chartered Professional Accountants of Canada
277 Wellington Street West
Toronto ON M5V 3H2
Email: dgeorgious@cpacanada.ca

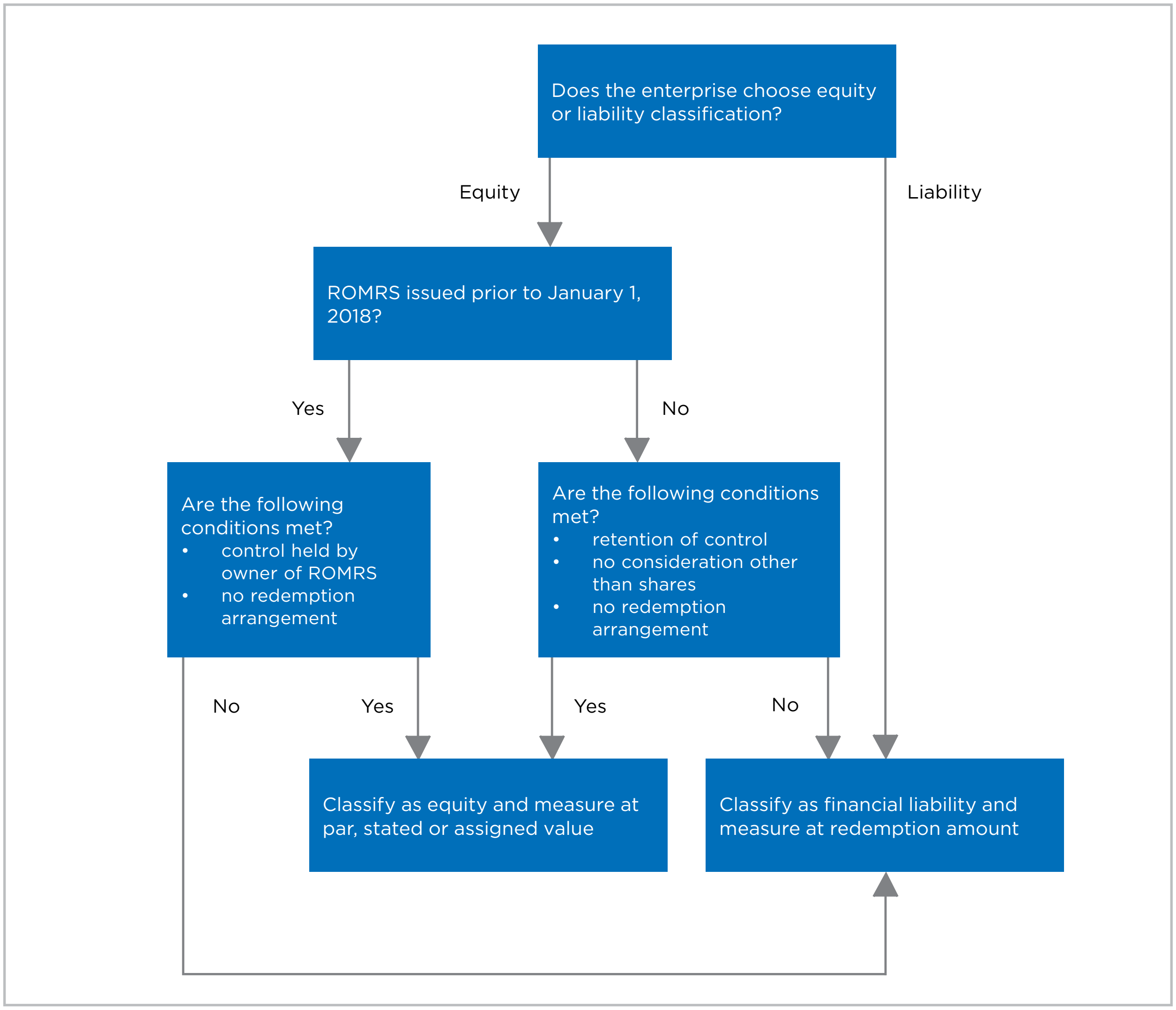
APPENDIX 1

Decision Tree — Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement



APPENDIX 2

Decision Tree — Transition



CHARTERED
PROFESSIONAL
ACCOUNTANTS
CANADA

277 WELLINGTON STREET WEST
TORONTO, ON CANADA M5V 3H2
T. 416 977.3222 F. 416 977.8585
WWW.CPACANADA.CA