ASPE Section 3856 Financial Instruments

Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement

September 2020

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Introduction

In December 2018, the Accounting Standards Board (AcSB) issued amendments to ASPE 3856 *Financial Instruments* revising the requirements for classification and measurement of retractable or mandatorily redeemable shares issued in a tax planning arrangement (throughout this guide we will refer to these types of shares as "retractable shares"). The amendments are effective for annual financial statements relating to fiscal years beginning on or after January 1, 2021[1], and earlier application is permitted.

Amended ASPE 3856 provides new requirements for the accounting for retractable shares. The amendments, which are covered in more detail throughout this guide, consist of:

1) Clarification that this guidance is not limited to preferred shares issued in accordance with certain sections of the Income Tax Act.
2) Elimination of the mandatory exception for tax planning shares from classifying retractable shares as a financial liability.
3) Introduction of an election for exemption from classification as a financial liability when all three conditions outlined below are met:
    i) Control of the enterprise must be retained by the party receiving the retractable shares;
    ii) No consideration other than shares of the enterprise is involved in the transaction; and
    iii) The non-existence of a redemption schedule.
4) Guidance on reassessing the classification of the retractable shares.
5) Revised disclosure guidance pertaining to retractable shares.

[1] In December 2018, Section 3856, Financial Instruments was amended in the CPA Canada Handbook – Accounting, with the amendments effective for years beginning on or after January 1, 2020. As a result of the COVID-19 health pandemic, the Accounting Standards Board deferred the effective date of the amendments to this Section by one year to be effective for years beginning on or after January 1, 2021. Early application is permitted. Further details on this decision can be found in the AcSB's April 15, 2020 Decision Summary.

Classification of Retractable Shares

Retractable shares meet the definition of a financial liability because they give the holder the right to require the issuer to redeem or repurchase the shares on demand. Prior to these amendments, ASPE 3856 *Financial Instruments* included an exception to this classification, instead requiring preferred shares issued in a tax planning arrangement (issued under Income Tax Act Sections 51, 85, 85.1, 86, 87, or 88) to be recorded at par, stated, or assigned value and to be presented as a separate line item in the equity section of the balance sheet.

The amendments state that all retractable shares must be classified as a financial liability measured at their redemption value unless all three conditions are met which would allow management to elect to apply equity classification. Specifically, the three conditions are:

1. Control of the enterprise must be retained by the party receiving the retractable shares (e.g., the shareholder);
2. Shares of the enterprise must be the only consideration involved in the transaction; and
3. The non-existence of a share redemption schedule.

The three conditions for the exemption have a general goal of identifying transactions in which nothing of substance has changed for the enterprise issuing the retractable shares.

Some transactions can occur in a series of concurrent steps, rather than one single transaction. When assessing the conditions for the exemption, focus should be placed on the substance of the overall transaction, whether it was executed as one or more steps. For example, an enterprise may perform various share exchanges, redemptions, stock-dividends, or exchanges of non-share consideration as steps in a single plan. If these steps are executed in contemplation of each other, the enterprise needs to assess the substance of the transaction as a whole.

Condition 1: Control

The first condition to be met is that control of the enterprise issuing the retractable shares is retained by the shareholder receiving the retractable shares in the arrangement.

Note! Control of an enterprise is the continuing power to determine its strategic operating, investing, and financing policies without the co-operation of others (decisions about the relevant activities). Further guidance on control is contained in ASPE 1591 *Subsidiaries*. Generally, control is conferred by holding greater than 50% of an enterprise's voting rights or holding the right to elect a majority of an enterprise's governing body (e.g., board of directors). However, contractual arrangements can significantly impact the control assessment such as through the right to appoint key management positions, decision making power of management vs. the board, quorum for board meetings, and any decisions which may require greater than simple majority to pass.

For condition 1 to be met the shareholder receiving the retractable shares must have held control of the enterprise before the tax planning arrangement has been implemented and continues to hold control afterward, so nothing of substance has changed. If control changes, or the retractable shares are issued to a shareholder that did not have control, the exemption would not be permitted.

Example of a change in control

William is the sole shareholder of Ice Drill Corp. (Ice Drill). In order to transition the business to his son James, William initiated an estate freeze in which he exchanged his common shares for mandatorily redeemable preferred shares. As part of this tax planning arrangement, Ice Drill then issued a new class of common shares, with James receiving 90% and William receiving 10%. Decisions about the relevant activities of Ice Drill are made by a simple majority vote of the common shareholders.

Assessment: In this situation William had control of Ice Drill prior to the transaction because he held 100% of the voting common shares so was able to control the strategic operating, investing, and financing policies of Ice Drill prior to the estate freeze. However, after the estate freeze, William has the ability to redeem his preferred shares on demand but can no longer unilaterally make strategic decisions. Therefore, something of substance has changed and liability classification is required.

Example of retention of control

Betty is sole shareholder of XYZ Corp. (XYZ). Betty has executed an estate freeze, exchanging her voting common shares for mandatorily redeemable shares. As part of this tax planning arrangement, common shares are issued to Betty's daughter, Peggy, with the intent to eventually pass ownership of XYZ to Peggy once Betty is ready to retire. Per the terms of the shareholders' agreement, Peggy's common shares are non-voting with no board representation, while Betty's new shares are voting with the ability to appoint the board of directors.

Assessment: In this situation Betty had control of XYZ prior to the transaction because she held 100% of the shares. Betty had the ability to control the strategic operating, investing, and financing policies of XYZ prior to the estate freeze. Therefore, Betty could unilaterally declare a dividend on her shares. After the estate freeze, Betty has the ability to redeem her shares on demand and the ability to control the strategic operating, investing, and financing policies of XYZ through her voting shares and ability to appoint the board of directors. Peggy does not have control over XYZ, as her shares have no votes. Therefore, nothing of substance has changed and condition 1 for the exemption is met.

Note! In scenarios of joint control, no individual controls the enterprise on their own before the implementation of a tax planning arrangement. No shareholder can make unilateral decisions regarding the management and operations of the enterprise. After the implementation of a tax planning arrangement, such as an estate freeze, each shareholder would have the ability to redeem their own retractable shares on demand. Therefore, something of substance has changed, the retention of control condition would not be met, and classification of the retractable shares as a financial liability would be required.

The amendment also provides guidance on the consideration of substantive rights which have been added to ASPE 1591 *Subsidiaries*. When assessing control, only substantive rights relating to the enterprise are considered. For a right to be substantive, the shareholder must have the practical ability to exercise that right over the enterprise.

In the case of an enterprise being controlled by a related group of people, control is assessed on an individual shareholder basis and not assessed as a group.

Condition 2: No consideration other than shares of the enterprise

The second condition for the classification exemption is that either no consideration is received by the enterprise issuing the retractable shares, or only shares of the issuing enterprise are exchanged. In arrangements where there is other consideration received, such as an asset or group of assets, there will be a change in the enterprise's future cash flow expectations. Therefore, the shares in these transactions do not meet the underlying premise that nothing of substance has changed and would not qualify for equity classification.

Note! In cases where only shares of the enterprise issuing the retractable shares are exchanged this condition is met. For example, shares from stock dividends meet this condition. Furthermore, the condition can still be met when more than one class of shares is exchanged.

Retractable shares issued in asset rollover transactions (Section 85 of the Income Tax Act) would not meet condition 2. This is because in these arrangements the recipient of the shares is giving up an asset (or group of assets) in exchange for retractable shares. The receipt of an asset or group of assets by the enterprise will change the cash flows of that enterprise and thus constitutes a substantive change.

Condition 3: Non-existence of a redemption schedule

The third condition for the classification exemption is that no other arrangement exists that requires the enterprise to redeem the retractable shares in a fixed or determinable period. In most cases, for the shares to receive preferential tax treatment, they are required to be due on demand, similar to a demand loan. However, redemption schedules often exist in addition to the demand feature, and lenders often refer to these schedules for when cash is expected to leave the business. The existence of these schedules suggests the holder has declared their intentions concerning the redemption of the shares and the timing of the cash outflows for their redemption is now determinable. The existence of a redemption schedule specifying timing of redemption of the shares therefore requires liability classification of those shares.

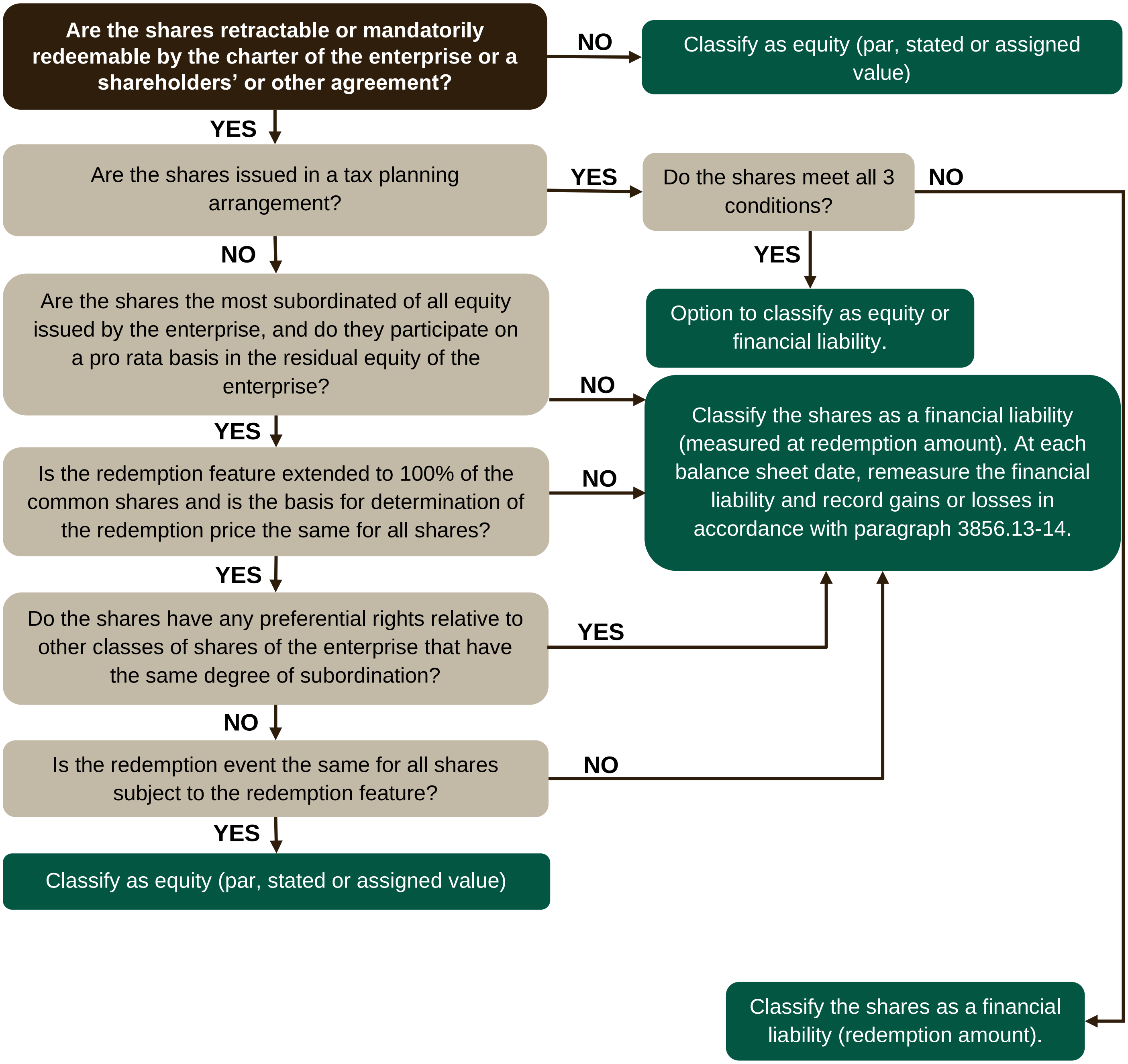
The amendment clarifies this condition by stating that "*no other written or oral arrangement exists*"; therefore, retractable shares that are subject to any contractual arrangement requiring redemption within a fixed determinable period would not qualify for equity classification.

Liability classification

The amended equity criteria in ASPE 3856 are an elective exemption, providing the option to classify qualifying retractable shares as equity if that is the preferred presentation of its financial statement users. Stakeholders may prefer to accept the default classification as a financial liability rather than undertake the cost of determining if the retractable shares meet the three conditions for equity classification.

Note! Once shares have been classified as a financial liability they cannot subsequently be reclassified as equity even if all three conditions for equity classification are met.

Classification and Measurement of Retractable Shares Decision Tree



Source: CPA Handbook ASPE 3856.A29

Initial Measurement

Retractable shares that are classified as a financial liability are measured at the redemption amount with any resulting adjustment recognized either in retained earnings or as a separate component of equity. Retractable shares classified as a financial liability are due on demand and cannot be measured at less than the amount payable on demand.

Retractable shares classified as equity are measured at par, stated, or assigned value.

Example of initial recognition classified as financial liability

John, the sole shareholder of Venmar Communications Corp. (Venmar), was issued 100 mandatorily redeemable preferred shares at their par amount, $100. There is a redemption schedule that states the shares must be redeemed on January 1st of every year for 5 years, at $50,000 per year. When preparing the year-end financial statements, Venmar must assess the classification of its preferred shares.

The following information is extracted from Venmar's draft financial statements:

	Venmar
Liabilities	
Current	
Trade and other payables	$250,000
Income taxes payable	11,500
	$261,500
Shareholder's Equity	
Share capital	$100
Preferred shares	100
	$200
Retained earnings	488,000
	$488,200
	$749,700

Example of initial recognition classified as financial liability

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Assessment: Venmar meets the first condition for equity classification because John is the sole shareholder before and after the tax planning arrangement. Condition two has also been met because only shares of the enterprise issuing the retractable shares are exchanged. Condition three however, has not been met because there is the presence of a clear redemption schedule that requires redemptions to occur on January 1st each year for five years.

Based on the above analysis, the retractable shares should be classified as a financial liability and measured at the redemption amount. Therefore, the following correcting journal entry is required:

Purpose	Account Name	Debit	Credit
To record the classification of retractable shares as a financial liability.	Retractable shares equity offset	$249,900	
	Preferred Shares	$100	
	Retractable shares liability		$250,000

Based on the above analysis, Venmar's statements are presented as follows:

	Before	After
Liabilities		
Current		
Trade and other payables	$250,000	$250,000
Income taxes payable	11,500	11,500
Retractable shares liability	-	250,000
	$261,500	$511,500
Shareholder's Equity		
Share capital	$100	$100
Preferred shares	100	-
	$200	$100
Retained earnings	488,000	488,000
Retractable shares equity offset*	-	(249,900)
	$488,200	$238,200
	$749,700	$749,700

**Rather than being shown as a separate line within equity on the balance sheet, the adjustment resulting from the initial measurement of the retractable shares could alternatively be presented as a current year adjustment to retained earnings on the statement of retained earnings.*

Impact on Covenants and Other Financial Information

Key financial ratios will be affected by the classification of retractable shares as a financial liability. Enterprises with covenants in place, particularly those based on debt-to-equity, will need to discuss the impact on those covenants with their lenders. Covenants would be impacted by the enterprises being more debt leveraged. Other financial ratios, such as the current or quick ratios, may be negatively impacted due to the increase in current liabilities resulting from the classification of retractable shares as a current financial liability.

Example of a covenant violation resulting from the classification of retractable shares as a financial liability

Below is an excerpt of the balance sheet for Premier Accommodations Ltd. (Premier), a private enterprise that operates in the hospitality industry and runs several hotels. The statement illustrates the difference between retractable shares classified as equity or as a financial liability. Premier's preferred shares, initially issued at par, are retractable for $600,000. Premier has mortgaged one of its properties, and part of the mortgage agreement is a covenant that states Premier will not exceed a debt-to-equity ratio of 2.5:1. The impact of the classification of retractable shares as either equity or a financial liability on this covenant is illustrated below.

	Equity	Liability
Liabilities		
Current		
Trade and other payables	$820,000	$820,000
Income taxes payable	132,000	132,000
Current portion of long-term debt	500,000	500,000
Retractable shares liability	-	600,000
	1,452,000	2,052,000
Long-term liabilities		
Long-term debt	5,000,000	5,000,000
Total Liabilities	6,452,000	7,052,000
Shareholder's Equity		
Share capital	100	100
Preferred shares	100	-
	200	100
Retained earnings	3,396,000	3,396,000
Retractable shares equity offset*	-	(599,900)
	3,396,200	2,796,200
	9,848,200	9,848,200
Debt-to-equity ratio	1.90	2.52

** Rather than being shown as a separate line within equity on the balance sheet, the adjustment resulting from the initial measurement of the retractable shares could alternatively be presented as a current year adjustment to retained earnings on the statement of retained earnings.*

Example of a covenant violation resulting from the classification of retractable shares as a financial liability
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Assessment: The debt-to-equity ratio increased from 1.90 to 2.52 due to the classification of the retractable shares as a financial liability. If these shares are required to be presented as a financial liability, Premier is in violation of its covenant. Therefore, it is important that private enterprises assess the required classification of any retractable shares and discuss the impact on any covenants with their lenders prior to adoption of the amendments to ASPE 3856, and thereafter, prior to the issuance of any retractable shares.

Subsequent Re-classification and Measurement

Retractable shares initially classified as a financial liability (or subsequently reclassified as a financial liability) cannot be subsequently reclassified to equity. That is, shares will never be reclassified from a liability to equity.

For retractable shares initially recognized as equity, the enterprise must reassess the equity classification if a transaction or event occurs that could indicate that one of the conditions for equity classification may no longer be met. Reassessment would be on the same basis as the three conditions for the classification exemption on initial recognition. The transaction or event that triggers reassessment would require financial statement preparers to consider whether the conditions for equity classification continue to be met or whether reclassification of the shares is required.

Examples of events or transactions that may indicate the conditions for equity classification are no longer met may include, but are not restricted to:

- The death of the holder of the retractable shares;
- A change in the ownership of the enterprise that may affect the assessment of control of the enterprise that issued the retractable shares;
- A change in the shareholders' agreement that may affect the assessment of control of the enterprise that issued the retractable shares;
- Redemption of some, or all, of the retractable shares;
- The creation of a written or oral arrangement that specifies a fixed or determinable period during which the shares will be redeemed; or
- Modification of the retractable shares.

In the event that a transaction gives rise to reclassification from equity to a financial liability, the enterprise shall measure the reclassified shares at the redemption amount on the date the event or transaction occurs and present them separately on the balance sheet. The valuation adjustment from par or stated value to redemption value shall be recorded in retained earnings or as a separate component of equity.

Example of re-classification

Tim is sole shareholder of Fast Fluid Hauling Inc. (Fast Fluid). Tim has executed an estate freeze, resulting in Tim exchanging his voting common shares for non-voting mandatorily redeemable shares. As part of this tax planning arrangement, new common voting shares are issued: 60 to Tim, 20 to his son Jake and 20 to his son Jon. Decisions on relevant activities of Fast Fluid occur by majority vote of the shareholders. Tim has no intention of redeeming his shares and as such does not establish any redemption schedule.

Example of reclassification
(continued from previous page)

10 years later, nearing retirement age, Tim is stepping away from the business. A second estate freeze occurs, with all common shares exchanged for non-voting mandatorily redeemable shares. Jake and Jon are each issued 50 new common voting shares. No redemption schedule is established for any of the mandatorily redeemable shares.

Assessment - Estate Freeze #1: In this situation Tim has control of Fast Fluid before and after the transaction, only shares of Fast Fluid were exchanged as consideration, and no redemption schedule exists. As the mandatorily redeemable shares issued to Tim meet all three conditions, Fast Fluid can elect to classify the shares as equity.

Assessment – Estate Freeze #2: In the second situation, while only shares were exchanged, and no redemption schedule exists, Tim controlled Fast Fluid before the transaction, and Jake and Jon have joint control after the transaction. Therefore, the shares issued in Estate Freeze #2 do not meet all three conditions and must be classified as financial liabilities. Further, given the change in control Tim's shares from Estate Freeze #1 must be reassessed. As Tim no longer controls Fast Fluid, Tim's shares from Estate Freeze #1 also fail to meet all three conditions and must be re-classified to a financial liability.

Financial Statement Presentation and Disclosure

Presentation of Retractable Shares

Retractable shares classified as equity must be presented as a separate line item in equity.

Retractable shares classified as a financial liability must be presented as a separate line item in liabilities.

Note! Callable debt presentation is not permitted for retractable shares classified as a financial liability. To receive the preferential tax treatment under the Income Tax Act, these shares are typically required to be due on demand. Therefore, they would typically be current liabilities unless there is an arrangement to indicate otherwise.

Impact of Liability Classification on Equity

Recognition of a financial liability for retractable shares results in a charge to equity. An entity has a choice to present this charge either in retained earnings or as a separate component of equity. Presentation as a separate component of equity will allow the financial statement users to compare the impact of the recognition of a financial liability directly on the balance sheet.

If the effect of classifying retractable shares as a financial liability is shown as a separate component of equity, this separate component of equity would be reclassified to retained earnings as the retractable shares are called for redemption. The entity must also disclose that this adjustment will occur in the future.

Note! ASPE 3251.06D *Equity* clarifies that the excess of the redemption amount of retractable shares over the carrying value of the common shares exchanged should not be offset with an existing balance in contributed surplus.

Alternatively, an enterprise can choose to record the effect of liability classification in retained earnings but is required to disclose the amount charged to retained earnings in the description of retained earnings on the face of the balance sheet.

Accrued Distributions

Dividends paid on retractable shares classified as a financial liability are recorded as interest expense in the income statement, as any return on financial liabilities is treated as interest expense. Dividends on retractable shares classified as equity are presented as dividends. In both situations, a financial liability (dividend payable) is recorded once the dividend is declared until such time as it is paid.

Disclosure

For retractable shares that are classified as equity, an enterprise must disclose:

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

In addition to the disclosure required for financial liabilities, for retractable shares that are classified as a financial liability, an enterprise shall disclose a description of the arrangement that gave rise to the shares.

For retractable shares that are classified as a financial liability, when the effect of classifying these shares 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.

Note! Note disclosures would remain in the notes to the financial statements as long as the retractable shares exist.

Effective Date and Transition

This Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2021. Earlier application is permitted. There is an option for enterprises to not restate comparative information which would provide stakeholders relief from renegotiating covenants that are calculated on a rolling year-end basis.

- For enterprises that choose to restate comparatives, any adjustment due to reclassification of the retractable shares would appear in the prior year's opening retained earnings or a separate component of equity.
    - Retrospective adjustment is not required for any retractable shares that were extinguished prior to the beginning of the fiscal year in which the amendments are first applied.
- For enterprises that choose not to restate comparatives, any adjustment due to reclassification of the retractable shares would appear in the current year's opening retained earnings or a separate component of equity.

On initial application an entity can choose to recognize retractable shares as a financial liability, or to apply the exemption and classify retractable shares as equity if the conditions are met as follows:

- If retractable shares were issued on or after January 1, 2018, all three conditions must be met to classify the shares in equity.
- For retractable shares issued prior to January 1, 2018, in order to classify the shares as equity control of the enterprise must be held by the party that holds the shares at the date of initial application and no other arrangement can exist that requires redemption of the retractable shares in a fixed or determinable period.
    - An enterprise is not required to meet the second condition (not required to assess whether consideration was received other than shares of the enterprise issuing the retractable shares) in respect of these shares.
- If the conditions to apply the exemption are not met for some or all of the retractable shares, those shares are classified as a financial liability, and measured at the redemption value.

Resources

External Resources

- ASPE 3856 in Part II of the CPA Canada Handbook - Accounting
- AcSB Basis for Conclusions – Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement (December 2018)
- AcSB Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement (May 2017)
- AcSB Decision Summary – April 15, 2020

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