Redeemable preferred shares issued in a tax planning arrangement (Exposure Draft issued)

November 2014

Flash

Overview

On October 1, 2014, the Canadian Accounting Standards Board (AcSB) issued an Exposure Draft pertaining to Accounting Standards for Private Enterprises (ASPE) which proposes significant revisions to the accounting for redeemable preferred shares issued in a tax planning arrangement under specific sections of the Canadian Income Tax Act (ITA). The proposed amendments would result in the presentation of preferred shares redeemable at the option of the holder as financial liabilities in the financial statements. The entities that will be the most significantly impacted by the proposals are those that previously issued redeemable preferred shares under specific types of tax planning arrangements (such as estate freeze transactions, asset rollovers or amalgamations) as these shares are currently presented as equity at their par, stated or assigned value. The comment period ends on January 15, 2015.

Background and current treatment

Preferred shares that are redeemable at the option of the holder are contractual obligations that will generally be repaid in the future with cash or other financial assets; therefore, these instruments meet the definition of a financial liability under ASPE and as such, these would normally be initially recognized at fair value. However, Section 3856, Financial Instruments, currently provides an exception in paragraph 23 that requires redeemable preferred shares issued in a tax planning arrangement under specific sections of the ITA[1] to be presented as equity and measured at their par, stated or assigned value.

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[1] The exception provided in paragraph 3856.23 is available for tax planning arrangements completed under Sections 51, 85, 85.1, 86, 87 and 88 of the ITA.

The exception was introduced over 10 years ago (in pre-changeover accounting standards) because, at that time, presenting and measuring these redeemable preferred shares as liabilities at their fair value was considered to be controversial (in particular for estate freeze transactions that provide for an intergenerational transfer of a business). When redeemable preferred shares are issued in an estate freeze transaction, the redemption amount at the date that the shares are issued is usually the fair value of the business; however, the issuance of the redeemable preferred shares is not accompanied by an inflow of assets. As a result, if the shares are recorded as a liability and measured initially at fair value, there would be a charge to retained earnings which would often result in an entity showing a sizeable deficit. The main consideration in developing the exception to liability treatment in paragraph 3856.23 was the concern that financial statement users would interpret that sizeable deficit to mean that the entity was in immediate financial trouble, and a great deal of explanation would be required to convince lenders and regulators that this was not the case.

Proposed amendments

Following a cost-benefit analysis, the AcSB has concluded that:

- users of private enterprise financial statements (such as lenders) now have a better understanding of the nature of the liabilities for redeemable preferred shares and will understand the related effects on equity; and

- the costs associated with communicating with financial statement users is no longer onerous.

Furthermore, the AcSB has stated a view that financial statement users will benefit from liability presentation for redeemable preferred shares issued in a tax planning arrangement because such presentation would reflect the economic nature of the shares, thereby improving financial reporting.

As a result, the AcSB proposes the following significant amendments:

- The exception in paragraph 3856.23 would be deleted. As a result, all preferred shares redeemable at the option of the holder would be accounted for on a consistent basis as financial liabilities, regardless of the purpose for which they were issued;

- The effect of recognizing the liability (i.e., the debit side of the entry) would be presented as a separate component of equity and not as a charge to retained earnings;

- Information regarding the nature of the separate component of equity would be disclosed.

An example

To demonstrate the impact of the amendments proposed in the Exposure Draft, consider the following example. Mr. Smith, the sole shareholder of Company A, enters into an estate freeze transaction, under Section 86 of the ITA, to transfer ownership of Company A and its operations to his grown daughter, Sally Smith.[2]

As part of the tax planning arrangement, Mr. Smith exchanges all of his common shares in Company A for redeemable preferred shares which are due on demand, have a legally stated capital amount of $100 and have a redemption amount equal to the fair value of Company A at the time of the estate freeze transaction ($800,000 which is supported by a valuation report). Sally then subscribes for 1,000 common shares of Company A for $100.

The effects of the estate freeze transaction on Company A's balance sheet would be as follows under current and proposed requirements:

- Under the current guidance, the redeemable preferred shares issued to Mr. Smith are in the scope of paragraph 3856.23, so they are presented as equity at their stated value ($100 in this case);
- If the amendments proposed in the Exposure Draft are approved and paragraph 3856.23 is deleted, the preferred shares issued to Mr. Smith would be measured at $800,000 and presented as a liability. This would result in an increase in liabilities by $800,000 and the effect of recognizing the liability for the preferred shares would be presented as a separate negative component of equity (see "Other" line in the equity section of the balance sheet below). This proposed approach would result in negative total equity of $399,900. Disclosure would be required to explain the nature of this separate component of equity;
- The following is an extract of the balance sheet under current and proposed requirements:

Balance sheet extract	Before the estate freeze $	Current requirements $	Proposed requirements $
Total assets	**500 000**	**500 100**	**500 100**
Preferred shares liability[3]	-	-	800 000
Other current liabilities	100 000	100 000	100 000
Total liabilities	**100 000**	**100 000**	**900 000**
Preferred shares, redeemable at $800,000	-	100	-
Common shares	100	100	100
Other (note X)	-	-	(799 900)
Retained earnings	399 900	399 900	399 900
Total equity	**400 000**	**400 100**	**(399 900)**
Total liabilities and equity	**500 000**	**500 100**	**500 100**

2 Assume Mr. Smith and Sally are not considered related parties in accordance with the guidance in Section 3840, Related Party Transactions, and Mr. Smith is related to Company A prior to the estate freeze as its controlling shareholder.

3 The preferred shares liability will be presented as a current liability unless the shareholder has formally waived the right to redeem the shares for at more than one year from the balance sheet date.

Transition and effective date

The proposed effective date for the amendments is for fiscal years beginning on or after January 1, 2016. The AcSB believes that this will provide sufficient time for entities to advise users of their financial statements of the changes and revise loan agreements and other contractual agreements, if necessary, as the proposed changes may affect loan covenants.

The proposals would require the retrospective restatement of prior periods in accordance with Section 1506, Accounting Changes. As a result, redeemable preferred shares issued as part of past tax planning arrangements which were in the scope of paragraph 3856.23 would be retrospectively presented as liabilities and measured initially at fair value (unless the shares were issued as part of a related party transaction[4]) and, generally, subsequently at amortized cost.

Next steps

In our view, these proposals will have a significant impact on the financial statements of privately held businesses that report in accordance with ASPE and may require discussions with stakeholders who look at these financial statements (lenders, government agencies etc.) to ensure they understand the changes. Raymond Chabot Grant Thornton plans to respond to the Exposure Draft with our concerns related to these proposals. We strongly encourage preparers and users of ASPE financial statements to respond and express their views as well. A response form can be accessed from the first page of the Exposure Draft. If you have any questions about these proposals please contact your Raymond Chabot Grant Thornton advisor.

[4] Preferred shares issued in a tax planning arrangement between related parties would initially be accounted for in accordance with Section 3840.