

# Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement

## Foreword

In December 2018, the Accounting Standards Board (AcSB) amended SUBSIDIARIES, Section 1591, EQUITY, Section 3251 and FINANCIAL INSTRUMENTS, Section 3856 in Part II of the CPA Canada Handbook – Accounting. The AcSB has approved for publication the contents of this document setting out its rationale for the amendments.

Background Information and Basis for Conclusions documents are sources of generally accepted accounting principles, as described in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100 in Part II of the Handbook. These documents are intended to help readers understand how the AcSB reached its conclusions, but they do not include explanations of requirements or guidance on the application of the relevant Section or Accounting Guideline.

December 2018

<b>TABLE OF CONTENTS</b>	<b>Paragraph</b>
<b>Introduction</b>	1-2
<b>Background</b>	3-13
<b>Applicability to not-for-profit organizations</b>	14
<b>Retractable or mandatorily redeemable shares issued in a tax planning arrangement</b>	15-20
<b>Effects analysis</b>	21-26
<b>The conditions for a classification exception</b>	27-67
Condition 1 – Control	28-35
Joint control	36-39
Existing guidance in Part II prior to amendments	40
Substantive rights	41-46
Unit of account for related parties	47-53
Condition 2 – No consideration other than shares	54-62
Condition 3 – Redemption schedule	63-67
<b>Option for liability classification</b>	68-69
<b>Initial measurement of ROMRS that are classified as a financial liability</b>	70-72
<b>Subsequent measurement</b>	73-79
Fair value option	73-74
Reassessment	75-79
<b>Disclosure</b>	80-82
<b>Separate component of equity</b>	83-90
<b>Accrued distributions</b>	91-94
<b>Tax accounting implications</b>	95-97
<b>Transition</b>	98-106

<b>Effective date</b>	107-109A
<b>Consequential amendments</b>	110-113
<b>Exposure for comment</b>	114-115

## **INTRODUCTION**

- 1 This document summarizes the AcSB's key considerations in reaching its conclusions in developing amendments to SUBSIDIARIES, Section 1591, EQUITY, Section 3251, and FINANCIAL INSTRUMENTS, Section 3856. This document sets out the reasons the Board undertook the project to develop this material, the process of research and deliberation, the key decisions made and the principal reasons for adopting the positions taken and rejecting others. Individual Board members gave some factors greater weight than other ones.
- 2 Nothing in this document is to be taken as overriding the requirements of the Handbook. However, the discussion may help readers understand how the AcSB reached its conclusions in developing the Sections and the Board's intent with respect to interpretation and application of the amendments.

## **BACKGROUND**

- 3 Retractable or mandatorily redeemable shares issued in a tax planning arrangement ('ROMRS') are a liability in accordance with FINANCIAL STATEMENT CONCEPTS, paragraphs 1000.28-.30. FINANCIAL INSTRUMENTS, paragraph 3856.23, provides an exception from liability treatment and requires that these shares be classified as equity when issued under specific sections of the Income Tax Act. In 2013, the AcSB began to re-examine paragraph 3856.23 to address the following three application issues:
  - (a) In practice, paragraph 3856.23 was being applied to transactions for which it was not intended. These transactions included commercial financing arrangements, employee compensation plans and management buy-outs.
  - (b) Some ROMRS were outside the scope of paragraph 3856.23 because they were not issued under any of the sections of the Income Tax Act specified therein. However, the transactions that gave rise to these types of shares had the same characteristics as the transactions that were specified in paragraph 3856.23. This resulted in inconsistent treatment of ROMRS.
  - (c) There was confusion in practice with applying the existing exception in paragraph 3856.23. This confusion related to when ROMRS, presented as equity under the classification exception, should be reclassified to a financial liability. Specifically, the feedback from stakeholders was that the phrase "when redemption is demanded" in paragraph 3856.23 is challenging to apply considering the broad range of redemption features of shares from tax planning arrangements. As a result, there was confusion as to when the shares should be reclassified from equity to a financial liability.
- 4 In October 2014, the AcSB issued an Exposure Draft, "Redeemable Preferred Shares Issued in a Tax Planning Arrangement." In the Exposure Draft, the Board expressed its view that ROMRS meet the definition of a financial liability (see paragraphs 1000.28-.30) because they give the holder the right to require the issuer to redeem the shares on demand. As such, the Board proposed to remove the exception to liability classification.
- 5 In response to the 2014 Exposure Draft, the Board received 73 comment letters and heard from 90 stakeholders at roundtables from across Canada. Several stakeholders commented that the proposals were based on discussions with creditors with a high level of accounting knowledge and that additional types of users should be consulted. These respondents said that other users might not understand the results of reporting ROMRS as a financial liability.
- 6 Upon deliberating the feedback to its 2014 proposals, the Board reaffirmed its view that ROMRS meet the definition of a financial liability. However, based on the strong feedback received from its stakeholders, the Board decided to re-examine paragraph 3856.23 to assess whether an exception to liability classification might continue to be justified based on cost / benefit considerations
- 7 The Board noted that the original intent of paragraph 3856.23 was to address the accounting for retractable or mandatorily redeemable shares issued in estate freeze and asset rollover transactions. The Board reaffirmed that retractable or mandatorily redeemable shares issued in other types of transactions should not be classified as equity. The Board focused its attention on the characteristics of estate freeze and asset rollover transactions to assess the appropriateness of a classification exception and the conditions under which such an exception might continue to be permitted.
- 8 The Board directed its staff to conduct research on tax planning arrangements that exist in practice. Meetings were held with technical advisory and working groups and with assurance, tax and advisory professionals from firms across Canada who routinely engage in tax planning arrangements. The outreach focused on:
  - (a) describing the characteristics of estate freezes;
  - (b) describing the characteristics of enterprises that typically execute estate freezes;
  - (c) identifying estate freezes that are scoped out of the classification exception in paragraph 3856.23 because they are not executed under one of the specified sections of the Income Tax Act; and
  - (d) identifying types and characteristics of transactions, other than estate freezes, currently using the exception in paragraph 3856.23.

- 9 The Board also sought input from members of its Private Enterprise Advisory Committee ("Advisory Committee") and conducted research with users including lenders, lessors and insurers actively involved with private enterprises that engage in tax planning arrangements. The Board further conducted field testing with a smaller group of tax and assurance practitioners from small to large organizations using common tax planning scenarios.
- 10 Based on the results of the additional work performed subsequent to the 2014 Exposure Draft, the Board concluded that ROMRS that meet certain conditions should qualify for a classification exception.
- 11 In September 2017, the Board issued the Exposure Draft "Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement (Proposed amendments to Sections 1591, 3251 and 3856)." The Exposure Draft proposed a classification exception on the basis that control of the enterprise must be retained by the party receiving the ROMRS. The Exposure Draft further proposed additional conditions were necessary: no consideration other than shares is exchanged and no redemption schedule exists.
- 12 The Board received 23 comment letters and heard from 112 stakeholders at roundtables from across Canada. Respondents, including roundtable participants, generally supported the Board's proposals to base a classification exception on certain conditions being met. However, respondents provided additional comments suggesting changes to some of the proposals. The specific issues addressed in this project, including the comments received on the Exposure Draft and any changes made in response to those comments, are highlighted in the subsequent sections.
- 13 In October 2017, the AcSB issued the Exposure Draft "Accounting for Related Party Financial Instruments and Significant Risk Disclosures." The Board considered the two Exposure Drafts together when finalizing the amendments to Section 3856.

#### **APPLICABILITY TO NOT-FOR-PROFIT ORGANIZATIONS**

- 14 In developing the amendments, the Board also considered the effect on not-for-profit organizations (NFPOs) applying accounting standards set out in Part III of the Handbook. The Not-for-Profit Advisory Committee confirmed the Board's understanding that NFPOs do not issue ROMRS. Accordingly, these amendments do not apply to NFPOs applying accounting standards set out in Part III of the Handbook.

#### **RETRACTABLE OR MANDATORILY REDEEMABLE SHARES ISSUED IN A TAX PLANNING ARRANGEMENT**

- 15 The amendments remove reference to specific sections of the Income Tax Act that were previously in the classification exception in paragraph 3856.23. Therefore, a reference to the types and features of arrangements that give rise to the shares to which the classification exception was applicable was needed.
- 16 Reference to "retractable or mandatorily redeemable" 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.
- 17 Through its consultation process, the Board learned that not all shares issued in tax planning arrangements are preferred shares. Therefore, the Board decided to refer to these shares as "retractable or mandatorily redeemable shares issued in a tax planning arrangement".
- 18 Respondents recommended including a definition in the guidance of "retractable or mandatorily redeemable shares" with the characteristics noted above. Some respondents also questioned the length of the phrase "retractable or mandatorily redeemable shares issued in a tax planning arrangement" appearing on the face of the balance sheet.
- 19 The Board considered this feedback and noted that the term "retractable or mandatorily redeemable" is already used within Section 3856. The Board also sought its Advisory Committee's input, which was that there were no issues with the term in practice. As such, the Board concluded that the term "retractable or mandatorily redeemable" is well understood in practice. The Board expects stakeholders to continue to exercise judgment when determining what shares are ROMRS and how to refer to these shares on the balance sheet.
- 20 Some respondents also advised the Board to define "tax planning arrangement" to eliminate possible confusion as to what types of transactions are subject to the classification exception in paragraph 3856.23. The Board considered this feedback and input from its Advisory Committee and concluded that this term is also well understood in practice. The Board expects stakeholders to exercise judgment to determine what constitutes a tax planning arrangement.

#### **EFFECTS ANALYSIS**

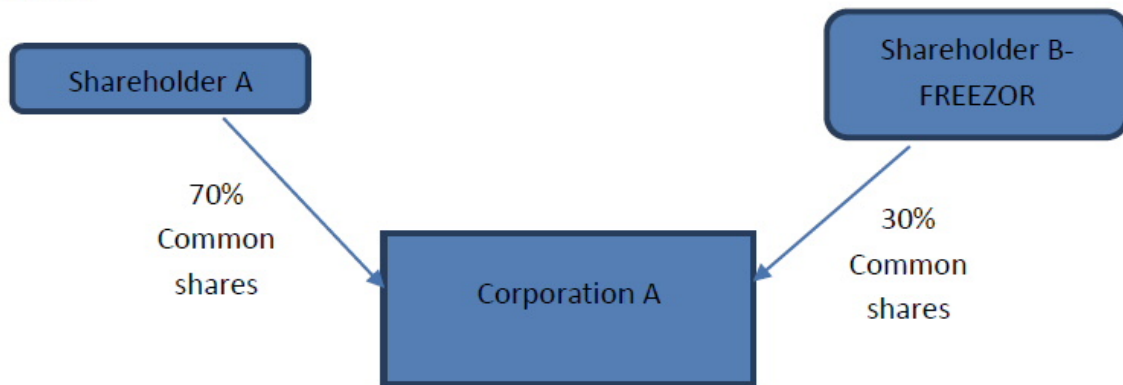
- 21 In developing these amendments, the AcSB considered the consequences of adopting them relative to the objective of financial statements and the benefit versus cost constraint. As described in paragraph 1000.12, the "objective of financial statements is to communicate information that is useful to investors, creditors and other users ('users') in making their resource allocation decisions and/or assessing management stewardship."

- 22 The amendments would require some enterprises to reclassify ROMRS from equity to a financial liability on transition. The amendments may also result in some instances of ROMRS currently classified as a financial liability to be reclassified as equity. In some circumstances, the amendments would not result in any change in classification.
- 23 The benefits to financial reporting from these amendments include:
- (a) removal of the unintended use of paragraph 3856.23 that is occurring in practice for arrangements that were not intended to be within scope of the exception;
  - (b) consistent accounting for the same type of tax planning arrangement, regardless of the section of the Income Tax Act that is used to affect the transaction, which would address users' needs by enhancing comparability; and
  - (c) reduced diversity in practice on when reclassification from equity to a financial liability is required based on the lack of understanding of "when redemption is demanded" in the current exception.
- 24 There would be costs associated with applying the amendments. Based on the feedback received from respondents, these costs may include:
- (a) changing financial metrics embedded in contracts, such as debt covenant ratios if the shares are reclassified as a financial liability; and
  - (b) communicating the effects of the changes on the financial statements to lenders and other users.
- 25 The Board acknowledges that stakeholders would bear these additional costs and therefore, the Board has tried to minimize these costs by providing more guidance and transitional relief. Examples include:
- (a) transitional relief in respect of the timing of when conditions for equity classification are assessed;
  - (b) an enterprise is not required to meet the condition specified in paragraph 3856.23(b) on transition;
  - (c) simplified guidance to initially and subsequently measure ROMRS classified as a financial liability at redemption amount;
  - (d) an option to classify ROMRS as financial liabilities; and
  - (e) an option to not restate comparative information on transition. This relief will be helpful for enterprises that have rolling covenant calculations and are concerned that adjustments made to the prior period amounts will affect banking covenants.
- 26 In accordance with paragraph 1000.13, in developing accounting standards, the Board weighs the anticipated costs and benefits of its proposals in general terms to assess whether they are justified on cost / benefit grounds. Some respondents to the Exposure Drafts disagreed with the Board's conclusion that the benefits of these amendments outweigh the financial reporting costs. These respondents highlighted the costs to renegotiate existing debt agreements with lenders outweigh the benefits of improved financial reporting as lenders are familiar with the nature of ROMRS. The Board discussed this feedback, acknowledged the concerns of stakeholders and will develop a plan to undertake user education for the amendments. As such, the Board thinks that the benefits of the proposed amendments outweigh the costs in that the proposals will improve the relevance, understandability and comparability of financial reporting.
- The conditions for the classification exception**
- 27 The Board decided that the exception should be conditional on retention of control of the enterprise. Specifically, the Board decided that control of the enterprise must be retained by the party receiving the ROMRS. The Board further decided additional conditions were necessary, being the non-existence of a redemption schedule and that no consideration other than shares is involved in the transaction. The following provides further details on how each condition in the proposed exception was developed.
- Condition 1 – Control**
- 28 The AcSB frequently heard during its outreach activities following the 2014 Exposure Draft that an exception to liability classification should be permitted because nothing of substance has changed in the management and operations of the enterprise before and after a tax planning arrangement. The Board agreed that if nothing of substance has changed, an exception to liability classification should be permitted. Therefore, the Board began exploring the notion of nothing of substance has changed, by focusing on whether control of an enterprise issuing ROMRS is held before and after the tax planning arrangement.
- 29 To test the viability of applying the condition that control of an enterprise has been retained, the Board conducted field testing with a smaller group of tax and assurance practitioners from small to large organizations. The participants analyzed whether control of an enterprise was retained before and after a tax planning arrangement for scenarios such as first and second generation estate freezes, asset rollovers, management buy-outs and stock dividends. The participants provided feedback on how they reached their conclusions and what challenges they faced.
- 30 Some field-test participants assessed control from the perspective of the enterprise issuing the shares whereas others assessed it from the perspective of the shareholder receiving the shares. Users were concerned with both perspectives as changes in control could affect their assessment of an enterprise's risk profile. Users were also concerned about who controls the strategic operating, investing and financing activities of an enterprise.
- 31 Considering the collective feedback from field-test participants and users, the Board decided to articulate both perspectives in one condition as "control of the enterprise issuing the retractable or mandatorily redeemable shares in a tax planning arrangement is retained by the shareholder receiving the shares in the arrangement". The Board, with

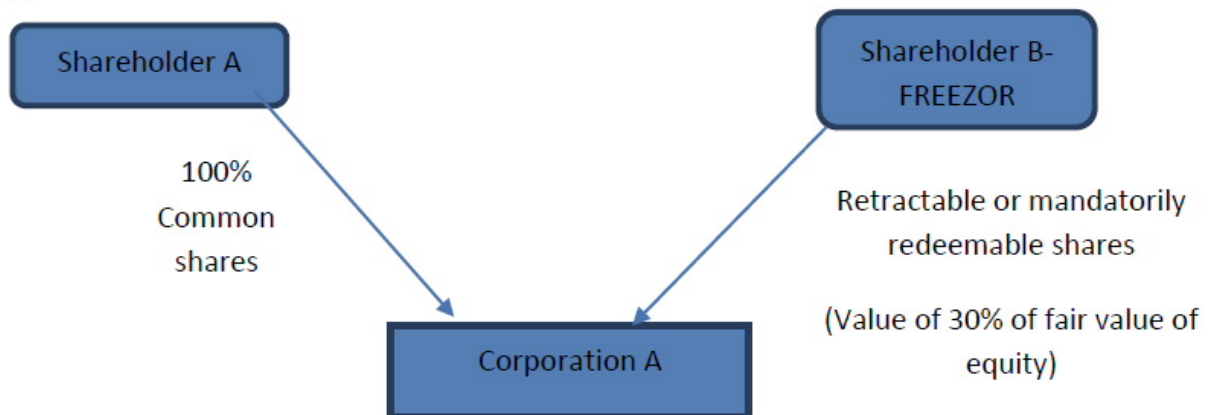
advice from its Advisory Committee, deliberated the articulation of this condition in multiple meetings as this condition would be the foundation for the classification exception. The Board wanted to make sure the control condition was not confusing or onerous.

- 32 To demonstrate the control condition, the Board considered an example whereby Shareholder B, who currently owns 30% of the voting shares of the enterprise issuing the ROMRS, executes an estate freeze. As a result, Shareholder B exchanges their voting common shares for retractable or mandatorily redeemable shares.
- 33 This arrangement would not meet the control condition and the ROMRS would be classified as a financial liability. The rationale is that the shareholder receiving the ROMRS (Shareholder B) did not retain control of the enterprise issuing those shares, as the shareholder did not have control prior to the tax planning arrangement.
- 34 The Board concluded this arrangement should not meet the classification exception because Shareholder B did not have the ability to control the strategic operating, investing and financing policies of the enterprise before the estate freeze. Therefore, Shareholder B could not unilaterally declare a dividend on his or her shares. However, after the estate freeze, Shareholder B has the ability to redeem his or her shares on demand. As such, something of substance has changed and liability classification is required.

Before



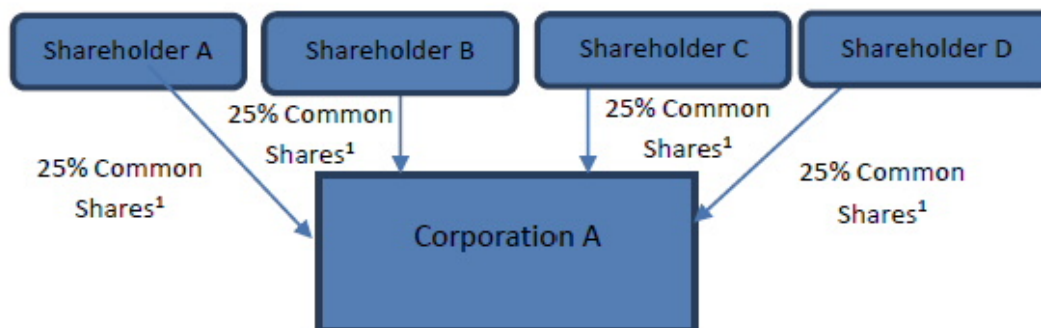
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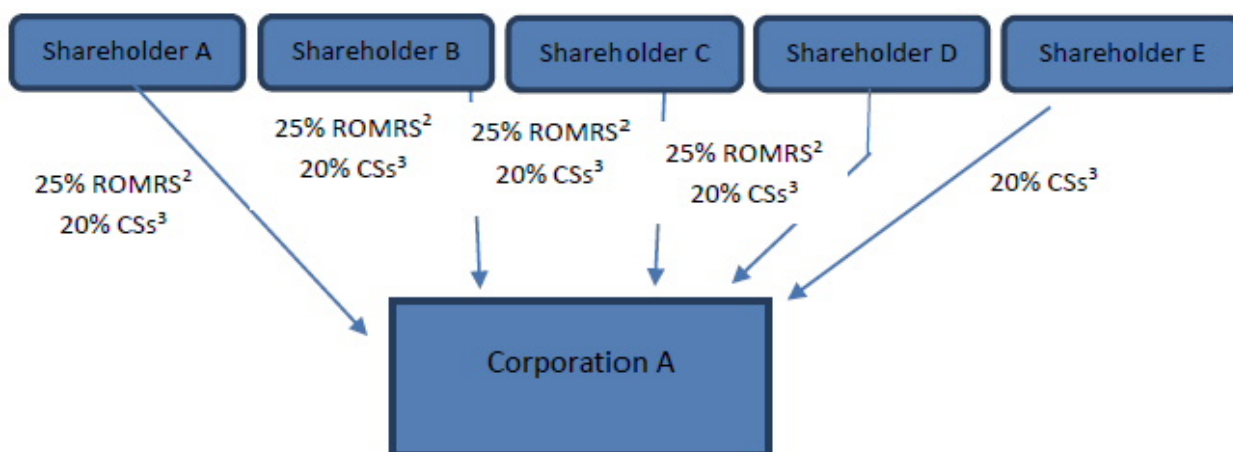
- 35 Respondents to the Exposure Draft expressed some concern with the complexity of applying control as a condition for the exception. Some respondents also suggested the Board include the above example in the guidance. The Board deliberated the feedback and concluded that control as a condition for the exception remains an appropriate condition. However, the Board has planned for educational activities to assist stakeholders with implementation. The Board also concluded that the above example would be helpful guidance and included it as Illustrative Example 5 in Section 3856.
- Joint control

- 36 The Board and the Advisory Committee also discussed the notion of joint control. The issue was raised because a field-test participant presented a scenario that involved executing an estate freeze of an enterprise jointly controlled by investors.
- 37 The scenario is illustrated as follows:

### Before



### After



1. Common shares – representing voting interest of 25% in Corporation A. Decisions on the strategic operating, investing and financing policies require the consensus of all shareholders.
2. Retractable or mandatorily redeemable shares (non-voting).
3. Common shares – representing voting interest of 20% in Corporation A. Decisions on the strategic operating, investing and financing policies require the consensus of all shareholders.

- 38 When this scenario was analyzed by the field-test participants, they thought that the ROMRS would require liability classification as the control condition was not met: no individual controlled the enterprise on his or her own before or after the transaction. Some respondents to the Exposure Draft disagreed with this conclusion as they viewed joint control as an extension of control. These respondents thought that ROMRS issued in joint control situations should also be in the scope of the exception.
- 39 The Board considered the feedback from the field-test participants and the respondents to the Exposure Draft. The Board agreed that the field-test participant's conclusion that no individual controlled the enterprise was reasonable because prior to the transaction, no individual shareholder can make unilateral decisions regarding the management and operations of the enterprise (e.g., to declare a dividend). After the transaction, each of the four shareholders has the ability to demand cash repayment through redemption of their own ROMRS.
- Existing guidance in Part II prior to the amendments
- 40 During the field test, participants were asked if they thought the guidance provided in Section 1591 was sufficient to assess whether control of the enterprise was retained. While for most scenarios, the participants thought guidance was

sufficient, they recommended additional guidance in two areas. The Board considered the following two areas for additional guidance:

- (a) substantive rights; and
- (b) unit of account for related parties.

Substantive rights

- 41 Paragraph 1591.14(b) refers to how exercise and conversion of options can only be considered when the economic cost is not so high as to make the exercise / conversion unlikely in the near future. IFRS 10, *Consolidated Financial Statements* refers to economic or other barriers that would prevent the holder from exercising their conversion rights. IFRS 10 includes additional guidance on substantive rights that field-test participants thought would be helpful in assessing control.
- 42 When developing Section 1591, 3 the Board considered adding guidance on substantive rights at that time. However, the decision was that the guidance might have an effect on voting interest subsidiaries and was beyond the scope of that project. That guidance was discussed along with other guidance from IFRS 10.
- 43 The rationale for adding guidance on substantive rights now is the relevance of that guidance to the accounting for ROMRS. Additionally, Advisory Committee members thought the guidance could be helpful for all control assessments, as some stakeholders currently look to the guidance in IFRS 10 on substantive rights. The Advisory Committee members thought guidance on substantive rights would not substantially change current control assessments. Reflecting on this feedback, and the fact that control is typically obtained through equity interests, the Board decided that guidance on substantive rights warranted further consideration. As such, the Board asked a question in the Exposure Draft regarding the broader implications of adding guidance on substantive rights at this time.
- 44 Most respondents to the Exposure Draft thought that the guidance on substantive rights was unlikely to affect existing control assessments. These respondents cited the following reasons for their conclusion:
- (a) Some preparers might already look to IFRS 10, per the GAAP hierarchy, for guidance on substantive rights.
  - (b) When assessing control, an enterprise should have considered guidance within Section 1591 on protective rights. As a result, substantive rights would likely have implicitly been considered in conjunction with protective rights at the time the control assessment was performed.
  - (c) The substantive rights guidance is consistent with the current guidance regarding factors to be considered in determining whether control exists under paragraphs 1591.11-.23.
- 45 However, some respondents noted that if substantive rights guidance did result in a change in the control assessment, this change would have significant financial reporting implications. As such, respondents recommended that enterprises should be afforded some transitional relief.
- 46 None of the respondents to the Exposure Draft who raised the transition concerns provided specific examples of when an enterprise's assessment of control over its subsidiaries may change. However, the Advisory Committee identified a scenario involving a partnership where one partner has the ability to remove another partner from the partnership. In that scenario, substantive rights guidance could affect the control conclusion. In such a scenario, however, the Advisory Committee advised that substantive rights would likely have been considered. Therefore, the likelihood of a change in control assessment would be limited. The Board collectively considered this feedback and determined that no additional transition relief is necessary for applying the guidance on substantive rights.

Unit of account for related parties

- 47 The field-test participants raised the issue of whether two related parties should be considered as one unit when assessing control. When developing the Exposure Draft, the Board decided against providing unit of account guidance for related parties as it could affect a broader range of transactions outside of the scope of this project.
- 48 Lenders also expressed no concerns about this issue since a primary factor in their lending decisions is the collateral and cross guarantees that are given between the enterprises, whether between related or unrelated parties.
- 49 Most respondents to the Exposure Draft and participants at the roundtables expressed concern with the absence of guidance on the unit of account between related parties. For example, there were differing views on whether spouses (related parties, as defined in RELATED PARTY TRANSACTIONS, Section 3840) would be considered one unit of account or two.
- 50 Some stakeholders also raised concerns about determining the unit of account between parties who are related as defined in the Income Tax Act, but are not related in accordance with Section 3840 (e.g., adult siblings and parents and their adult children). The concern raised was two-fold: expanding the notion of unit of account to include a broader group and the need for consistency between accounting and tax definitions.
- 51 Several stakeholders also questioned how to determine the unit of account when a unanimous shareholders' agreement is present. For example, consider an enterprise that is equally owned by four siblings and a unanimous shareholders' agreement exists, which governs the rights of the shareholders. If the siblings executed an estate freeze and the agreement was considered the unit of account, would the ROMRS issued to all the siblings meet the control condition for equity classification?

52 The Board deliberated this feedback and the extent of diversity that could result from a lack of guidance on determining the unit of account. Therefore, to address the potential diversity, the Board decided to provide guidance in the standard that clarifies that only one party in any related group can have control when assessing the control condition for the purpose of classifying ROMRS.

53 During its deliberations, the Board continued to be concerned that providing unit of account guidance could affect a broader range of transactions outside of the scope of this project. Therefore, the Board decided that the guidance on unit of account is to be applied only to determine whether the control condition is met for ROMRS. The Board may consider unit of account guidance overall in a broader project for related party transactions.

**Condition 2 – No consideration other than shares**

54 The Board decided that the second condition for the classification exception should be that the only consideration exchanged in the transaction is shares. The decision to add this condition was based on feedback received from some respondents to the 2014 Exposure Draft and the additional user outreach. These stakeholders thought that transactions in which other consideration is exchanged for shares are in effect financing transactions.

55 The Board consulted its Advisory Committee and other users who also thought that consideration other than shares exchanged for ROMRS in lieu of debt are financing arrangements. They further advised that the introduction of other consideration (e.g., an asset or a group of assets) that the enterprise did not previously own fundamentally changes 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 should not qualify for equity classification.

56 The Board also noted from stakeholders that retractable or mandatorily redeemable shares issued in asset rollover transactions are often redeemed within a relatively short period of time.

57 This condition would scope out ROMRS issued in an asset rollover transaction from meeting the classification exception. An asset rollover is an arrangement in which the freezor is giving up an asset (or group of assets) in exchange for receiving ROMRS. The recipient of the shares is not freezing the value of the entity but transferring asset(s) into an enterprise on a tax-deferred basis. This transaction differs from an estate freeze that is crystallizing the value of the enterprise at a point in time through the use of ROMRS whereby nothing of substance has changed. As well, 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.

58 Respondents to the Exposure Draft and participants at the roundtables disagreed that asset rollover transactions are financing transactions. These stakeholders noted that asset rollover transactions are often performed by related parties without the characteristics of a financing arrangement. The Board considered this feedback but reaffirmed its view that asset rollovers, while not always a financing transaction, do result in a substantive change for the reporting enterprise. As such, ROMRS issued in asset rollover transactions should not qualify for equity classification.

59 Some respondents to the Exposure Draft also raised concerns with the articulation of the condition in the proposals. The Board proposed the condition to read "the only consideration exchanged in the arrangement is one class of shares for another class of shares of the enterprise issuing the shares." Stakeholders advised the Board that:

- (a) "one class of shares for another class" would result in transactions where two classes of shares are exchanged for one class, or vice versa, failing the condition; and
- (b) stock dividends, which are a form of an estate freeze transaction, would not qualify for equity classification as no shares are "exchanged."

60 The Board deliberated this feedback and affirmed that ROMRS issued in a tax planning arrangement involving only shares should qualify for equity classification, assuming the other conditions are also met. This conclusion reflects the notion that a tax planning arrangement involving only shares does not result in a substantive change in the enterprise. Therefore, the Board revised the condition in paragraph 3856.23(b):

- (b) In the arrangement, either:
  - (i) no consideration is received by the enterprise issuing the retractable or mandatorily redeemable shares; or
  - (ii) only shares of the enterprise issuing the retractable or mandatorily redeemable shares are exchanged.

61 The Board also noted from its field testing that asset rollover transactions can occur in a series of concurrent steps rather than one single transaction. In developing the Exposure Draft, the Board focused on the substance of the overall transaction, whether it was executed as one or more steps. The Board views the series of steps entered into in contemplation of each other as one transaction that results in the issuance of ROMRS. 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 substance of the transaction holistically.

62 In its Exposure Draft, the Board did not propose guidance requiring an assessment of a series of steps as one tax planning arrangement. However, some respondents to the Exposure Draft raised concerns about how an absence of guidance on interpreting a series of steps could lead to diversity in practice. The Board considered this feedback and decided to add guidance in the standard requiring an assessment of whether a series of steps is undertaken in contemplation of one another. The Board's view is that such transactions in a series of steps should be considered as one tax planning arrangement when determining whether the conditions for equity classification are met.

**Condition 3 – Redemption schedule**



- 63 The Board decided that the third condition for the classification exception should be that no other arrangement exists that requires the enterprise to redeem the ROMRS in a fixed or determinable period.
- 64 For shares to receive the preferential tax treatment, they are required to be due on demand, similar to a demand loan. However, feedback received from lenders indicated that redemption schedules often exist and they look to the schedules for when cash is expected to leave the business. These users added that the existence of a redemption schedule points to who ultimately controls the cash outflows relating to the shares. Therefore, the existence of a redemption schedule specifying timing of redemption of the shares should require liability classification of those shares.
- 65 The Board had extensive discussions on what constitutes a redemption schedule. Through outreach, the Board learned that the term "redemption schedule" had various meanings in practice and decided that defining the term could be prescriptive and lead to unintended consequences. The Board also learned that redemption rights can exist in various forms including written and oral.
- 66 In its Exposure Draft, the Board proposed the condition to read "no other explicit or implicit arrangements exist ...." Respondents to the Exposure Draft and roundtable participants raised questions about how to interpret an "implicit arrangement". For example, would a forecast of the controlling shareholder's future cash flow needs into retirement as part of an estate plan be considered an implicit arrangement to redeem shares?
- 67 The Board deliberated this feedback and concluded that any ROMRS that are subject to a contractual arrangement requiring redemption within a fixed or determinable period should not qualify for equity classification. Therefore, the Board replaced "explicit or implicit arrangement" with "written or oral arrangement" to clarify the condition. The Board, however, expects stakeholders to assess holistically any arrangement that may exist that 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.

#### **Option for liability classification**

- 68 Some respondents to the Exposure Draft advised the Board that an option to classify ROMRS as a financial liability should be permitted. The purpose of this option would be to:
- (a) provide preparers the flexibility to present ROMRS as a financial liability if that was the preferred presentation of its financial statement users; and
  - (b) allow stakeholders to choose whether to undertake the cost of determining if the ROMRS meet the conditions for equity classification.
- 69 The Board discussed this feedback and noted that ROMRS meet the definition of a financial liability. Therefore, if enterprises prefer to present ROMRS as a financial liability, such an option should be available. However, shares classified as a financial liability cannot be reclassified as equity even if all conditions for equity classification are met.

#### **Initial measurement of ROMRS that are classified as a financial liability**

- 70 Section 3856 requires initial measurement of a financial instrument to be at fair value when a transaction is between unrelated parties. However, for initial measurement of ROMRS issued to unrelated parties that are classified as a financial liability, the Board decided to require measurement at the redemption amount. Typically, the redemption amount would be fair value as the Income Tax Act requires that ROMRS be due on demand. The Board considered permitting the shares to be discounted at a risk-free rate as recommended by respondents to the Exposure Draft. However, the Board decided even if the shares are subordinated to other debt or a redemption schedule specifying repayment terms, discounting of cash outflows to reflect expected timing of redemption and credit risk should not be permitted. Since the amount at which the shares are measured cannot be less than the amount that is due on demand, paragraph 3856.A12 does not apply to ROMRS that are classified as a financial liability measured at the redemption amount.
- 71 The Board also decided that the redemption amount be used for the initial measurement of ROMRS that are classified as a financial liability when issued to related parties. The Board thinks that redemption amount is appropriate for initial measurement of ROMRS that are classified as a financial liability as they are due on demand (i.e., the liability should not be measured as less than the amount payable on demand). Users have also communicated to the Board the importance of the redemption amount of the shares in the tax planning arrangement when assessing the future cash flows of the enterprise.
- 72 The consequential amendment in Section 3840, Illustrative Example 4 provides an example of determining the redemption amount of ROMRS in an asset rollover transaction.

#### **Subsequent measurement**

##### **Fair value option**

- 73 The amendments require initial measurement of the ROMRS at the redemption amount when classified as a financial liability. The Board considered whether fair value for subsequent measurement should be allowed and decided that it should not be permitted.
- 74 As previously noted, ROMRS are due on demand. As such, even if the shares are subordinated to other debt or a redemption schedule specifying repayment terms exists, discounting of cash outflows to reflect expected timing of redemption and credit risk is not permitted.

#### **Reassessment**

- 75 The Board thinks that if the controlling party loses control of the enterprise, or any of the other two conditions required for equity classification is no longer met, something of substance has changed. In that case, reclassification of the shares from equity to a financial liability should be required.
- 76 The Board considered the effect of subsequent transactions or events that may result in the criteria for equity classification no longer being met. For example, an event could occur that would result in control no longer being retained by the holder of the ROMRS. The Board decided to create reassessment criteria that:
- (a) would not require a continuous assessment by financial statement preparers; and
  - (b) would be on the same basis as the criteria for the classification exception on initial recognition.
- 77 The amendments require that an enterprise should reassess the equity classification of the ROMRS if a transaction or event occurs that could indicate that one of the conditions for equity classification may no longer be met. Examples of transactions or events that might give rise to the need to reassess equity classification are provided in the standard to assist stakeholders in understanding circumstances that may require reassessment.
- 78 Reassessment would not automatically lead to reclassification of ROMRS from equity to liability. The transaction or event would require financial statement preparers to reassess whether the conditions for equity classification continue to be met or whether reclassification of the shares is required.
- 79 The Board discussed whether the reassessment criteria should only apply to shares that are classified as equity or whether it should also apply to shares classified as a financial liability. The Board decided that reassessing shares that are classified as a financial liability to determine if the shares subsequently meet the conditions for equity classification added a level of complexity in the amendments for which the costs would outweigh the benefits. As such, the Board concluded that if:
- (a) the conditions for equity classification are not met on initial recognition;
  - (b) the conditions for equity classification are not met at a subsequent date (i.e., the shares are reclassified to a financial liability); or
  - (c) an enterprise chooses to classify the shares as a financial liability on initial recognition,
- the enterprise is not permitted to classify the ROMRS as equity at a subsequent date.

#### **Disclosure**

- 80 The Board considered whether the disclosure requirements in Section 3856 provided sufficient information for ROMRS classified as equity or as a financial liability. Users thought that the disclosure requirements applicable to financial liabilities and to equity instruments were appropriate. However, users also recommended an additional disclosure that described the arrangement that gave rise to the shares. The Board agreed with the users' recommendation and added guidance requiring this disclosure. The Board thinks this additional disclosure would not be onerous for enterprises as the information required is readily available.
- 81 Some respondents to the Exposure Draft and participants at the roundtable discussions raised concerns with the potential length of the disclosures for ROMRS as the disclosures would remain in the notes to the financial statements as long as the ROMRS exist. These stakeholders recommended that the description of the arrangement should be required disclosure only in the year a tax planning arrangement occurs. The rationale for this recommendation was that users of private enterprise financial statements can request additional information as needed.
- 82 The Board discussed this feedback and concluded that the disclosure requirements should remain as proposed. The Board notes that users of private enterprise statements continue to grow beyond lending institutions. As such, users may have differing access to additional information and therefore, a recurring disclosure describing the arrangements that resulted in ROMRS would benefit these users.

#### **Separate component of equity**

- 83 Recognition of a financial liability for ROMRS would result in a charge to equity. The Board noted that if this effect is recorded directly in retained earnings, the effect on retained earnings would not be directly observable in future periods. Users thought that it would be helpful to show the effect of liability classification on the total amount of equity separately as this would illustrate the relationship between the ROMRS and the balance of retained earnings.
- 84 The Board noted that Section 3251 required an enterprise to present a separate component of equity for each component that is of a different nature. Based on input from users, the Board thinks that separate presentation would provide useful information. Accordingly, the Board proposed to amend Section 3251 to clarify that:
- (a) the effect of classifying ROMRS as a financial liability should be shown as a separate component of equity; and
  - (b) the amount presented in this separate component of equity would be reclassified to retained earnings as the ROMRS are called for redemption.
- 85 Some respondents to the 2014 Exposure Draft who agreed with the separate component of equity were concerned there may be transactions that are within the scope of both paragraph 3840.17 and the new paragraph 3251.06A. Paragraph 3840.17 requires any adjustments to equity as a result of a related party transaction to be recognized either in retained earnings or contributed surplus.

- 86 Therefore, the Board clarified that the balance of this separate component of equity should not be offset with an existing balance in contributed surplus. The adjustment in equity should be charged to retained earnings as the ROMRS are called for redemption.
- 87 The Board also considered what information should be disclosed with respect to the proposed presentation of the effects of liability classification in a separate component of equity. The Board proposed in the Exposure Draft that the enterprise disclose the amount of the separate component of equity that is to be reclassified to retained earnings as the ROMRS are called for redemption. Users noted that this information would be beneficial because presentation of a separate component of equity is unusual in nature, and that this information would clearly illustrate the link between the ROMRS to the total equity balance.
- 88 Most respondents to the Exposure Draft supported presentation of a separate component of equity. However, some respondents advised the Board that a separate component of equity could have an adverse effect on the small business deduction for Quebec enterprises.
- 89 To address this unintended consequence, the Board decided to provide an option to record the effect of liability classification in either a separate component of equity or retained earnings.
- 90 If an enterprise records the effect of liability classification in retained earnings, the amendments require disclosure of the amount charged to retained earnings on the face of the balance sheet. As a result, the relationship between the ROMRS and the balance of retained earnings would be illustrated for the users of the financial statements.

#### **Accrued distributions**

- 91 Dividends paid on ROMRS 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 ROMRS classified as equity are presented as dividends. In both situations, a financial liability is recorded once the dividend is declared until such time as it is paid.
- 92 On transition, there may be ROMRS that would be reclassified from equity to a financial liability and others that would be reclassified from a financial liability to equity. Reclassification of shares from equity to liability could also occur when a reassessment leads to reclassification or if an enterprise elects to present the shares as a financial liability.
- 93 Whether the ROMRS are classified as a financial liability or equity, a liability arises when a dividend is declared. Therefore, an enterprise records a dividend payable in net income or retained earnings, depending on the classification of the shares.
- 94 The Board discussed whether guidance was needed relating to whether reclassification of the previously recognized charge was required on transition or at reclassification. The Board thinks the guidance is clear in paragraph 3856.15 and the subsequent application guidance in paragraphs 3856.A39-A40. As such, additional guidance was not considered necessary on this issue.

#### **Tax accounting implications**

- 95 Enterprises applying the future income taxes method may need to adjust for the effects when ROMRS are remeasured from a nominal amount within equity to the redemption amount when reclassified to a financial liability.
- 96 The Board considered whether additional guidance or illustrative examples are necessary to assist stakeholders with the accounting for the future income tax implications of a change in the accounting basis for the ROMRS.
- 97 The amendments include a revised Section 3840, Illustrative Example 4, which highlights the future income tax implications of measuring ROMRS at the redemption amount. The Board thinks this example will provide sufficient guidance for stakeholders.

#### **Transition**

- 98 The Board proposed to provide an option for enterprises to not restate comparative information. This would provide relief for stakeholders from renegotiating covenants that are calculated on a rolling year-end basis.
- 99 In addition, the Board proposed to not require an enterprise to assess whether the ROMRS met the conditions for equity classification when they were redeemed prior to the date the amendments were first applied.
- 100 For example, if ROMRS classified as equity are redeemed in May 2019 and those shares would not meet the classification exception, the enterprise would not be required to apply the proposals in the prior period financial statements for those redeemed shares.
- 101 The Board acknowledged that allowing this transitional relief may result in lack of comparability in the year of transition, as some enterprises would choose to restate comparatives while others would not. However, the lack of comparability would only exist in the year of transition. For enterprises that choose to restate comparatives, any adjustment due to reclassification of the ROMRS would appear in the prior year's opening retained earnings. For enterprises that choose not to restate comparatives, any adjustment due to reclassification of the ROMRS would appear in the current year's opening retained earnings. As such, after the year of transition, comparability across enterprises would be achieved.
- 102 The Exposure Draft also proposed requiring an enterprise to assess whether the conditions for equity classification are met at the date the enterprise applies the amendments for the first time. The Board noted that some ROMRS may have been issued many years ago and that assessing retention of control of the enterprise on the transaction date may be difficult in those circumstances. Therefore, the Board proposed assessing the control condition as though the tax planning

arrangement occurred on the date that the enterprise applies the amendments for the first time. Additionally, on the date the amendments are first applied, the enterprise assesses whether the remaining conditions in paragraphs 3856.23(b) and (c) are met.

- 103 Respondents to the Exposure Draft and participants at round table discussions commented that many of these tax planning transactions were done several years ago and complete information about these transactions may not be available at the transition date. Some respondents also commented that multiple tax planning arrangements could be pooled together on the financial statements and determining which transaction resulted in which shares could be challenging.
- 104 The Board considered this feedback from stakeholders and decided on a cost / benefit basis to provide additional transitional relief. The Board decided that if ROMRS were issued on or after January 1, 2018, all the conditions in paragraph 3856.23 should be met to classify the shares in equity.
- 105 For ROMRS issued prior to January 1, 2018, control of the enterprise must be held by the party that holds the shares and no other arrangement can exist that requires redemption of the ROMRS in a fixed or determinable period. An enterprise is not required to meet the condition specified in paragraph 3856.23(b) in respect of these shares.
- 106 The Board acknowledges this transitional relief will result in ROMRS issued in asset rollovers prior to January 1, 2018 to qualify for equity classification on transition; however, ROMRS issued in asset rollovers on or after January 1, 2018 will not qualify for equity classification. However, the Board agreed to provide such relief on an exception basis to reduce the potential cost of enterprises implementing the amendments.

#### **EFFECTIVE DATE**

- 107 The Exposure Draft proposed the amendments be effective for annual financial statements beginning on or after January 1, 2020, with earlier application permitted. The Board also communicated its intent to issue final amendments no later than December 1, 2018. This would allow stakeholders a full year to adopt the revised standard.
- 108 The Board heard from some respondents to the Exposure Draft that this would still be insufficient time to renegotiate loan covenants with lenders or other contractual agreements because of the complexity of some of these agreements. Respondents also highlighted that determining control could be complex for some enterprises and may require additional education for stakeholders.
- 109 The Board considered this feedback and concluded that the effective date remains appropriate. The Board also thinks this is sufficient time to educate financial statement users on the nature of these arrangements to better transition to the amended standard and renegotiation of loan covenants, if necessary.
- 109A In August 2020 the AcSB deferred the effective date of these amendments by one year to alleviate pressure on stakeholders as they navigate challenges and uncertainty created by the COVID-19 pandemic. The amendments are now effective for annual financial statements beginning on or after January 1, 2021. Earlier application is permitted and therefore, the deferral of the effective date does not prohibit stakeholders from applying the amendments in an earlier fiscal year.

#### **CONSEQUENTIAL AMENDMENTS**

- 110 The amendments would affect other Sections. The rationale for some of the more significant amendments is described throughout the Basis, as well as below.
- CURRENT ASSETS AND CURRENT LIABILITIES, Section 1510, and BALANCE SHEET, Section 1521
- 111 Some of the users consulted thought that ROMRS should be presented separately on the face of the balance sheet from other liabilities. Providing a separate line item would help explain the potential differences between these arrangements and other liabilities.
- 112 Section 1510 has been amended as these shares are due on demand. Therefore, they are typically current liabilities unless there is an arrangement to indicate otherwise. Further, the Board decided to clarify that callable debt presentation is not permitted for ROMRS.
- FIRST TIME ADOPTION, Section 1500
- 113 The Board considered the transitional provisions that are available to enterprises currently applying the accounting standards for private enterprises. The Board decided that the same transitional provisions should be afforded to enterprises that apply the accounting standards for private enterprises for the first time at a later date. The rationale is that first-time adopters could have similar covenant issues.

#### **EXPOSURE FOR COMMENT**

- 114 After resolving the issues arising from the exposure draft process, the AcSB considered, as part of its due process, whether the revisions to the proposals should be exposed for comment.
- 115 The revisions have been highlighted in the relevant sections throughout the Basis. These revisions are clarifications based on feedback received from stakeholders. Other than clarifications already highlighted in the Basis, only minor drafting changes were made. Therefore, the Board decided that there was no need for re-exposure.
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# Footnotes

3. Section 1591 was developed by modifying SUBSIDIARIES, Section 1590, to incorporate additional guidance on accounting for subsidiaries controlled through rights other than equity. Note that Section 1591 superseded Section 1590.

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