AcSB
Accounting Standards Board

Exposure Draft

Proposed Accounting Standards for Private Enterprises

Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement

(Proposed amendments to Sections 1591, 3251 and 3856)

September 2017

COMMENTS TO THE AcSB MUST BE RECEIVED BY January 15, 2018

Respondents are asked to email their comment letters (in a Word file) to:
info@acsbcanada.ca

Please address your comments to:

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This Exposure Draft reflects proposals made by the Accounting Standards Board (AcSB).

Individuals and organizations are invited to send written comments on the Exposure Draft proposals. Comments are requested from those who agree with the Exposure Draft as well as from those who do not.

Comments are most helpful if they relate to a specific paragraph or group of paragraphs. Any comments that express disagreement with the proposals in the Exposure Draft should clearly explain the problem and include a suggested alternative, supported by specific reasoning. All comments received by the AcSB will be available on the website shortly after the comment deadline, unless confidentiality is requested. The request for confidentiality must be stated explicitly within the response.

Highlights

The Accounting Standards Board proposes, subject to comments received following exposure, to amend FINANCIAL INSTRUMENTS, Section 3856 in Part II of the CPA Canada Handbook – Accounting, to modify the accounting for retractable or mandatorily redeemable shares issued in a tax planning arrangement.

The Board also proposes, subject to comments received following exposure, to amend:

- SUBSIDIARIES, Section 1591, to add guidance on substantive rights; and
- EQUITY, Section 3251, to present the effects of the amendments to FINANCIAL INSTRUMENTS, Section 3856, as a separate component of equity.

Background

Retractable or mandatorily redeemable shares issued in a tax planning arrangement are a liability in accordance with FINANCIAL STATEMENT CONCEPTS, paragraph 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. Issues relating to scope, measurement and reclassification of these shares have arisen in practice. As a result, the Board is re-examining this classification exception to address application issues in practice today.

Main features of the Exposure Draft

The amendments proposed in this Exposure Draft are as follows:

- The classification exception in FINANCIAL INSTRUMENTS, paragraph 3856.23, would be amended to focus on whether control of the enterprise issuing the shares is retained.
- Guidance on assessing the effect of substantive rights in the control assessment would be added to SUBSIDIARIES, Section 1591.
- The amendments would require a reassessment of the classification of the retractable or mandatorily redeemable shares issued in a tax planning arrangement classified as equity only when a subsequent event or transaction occurs that indicates one or more of the conditions for equity classification may no longer be met. Reclassification of retractable or mandatorily redeemable shares to financial liabilities would be required when the conditions for equity classification are no longer met at the reassessment date.
- Retractable or mandatorily redeemable shares issued in a tax planning arrangement initially classified as financial liabilities would be prohibited from being subsequently reclassified to equity even if conditions change.
- Retractable or mandatorily redeemable shares issued in a tax planning arrangement classified as financial liabilities would be measured at the redemption amount.
- Guidance would be added in EQUITY, Section 3251, to present as a separate component of equity the effect of classifying and measuring the retractable or mandatorily redeemable shares as financial liabilities and to disclose the nature of the separate component of equity.
- Retrospective application would be required in accordance with ACCOUNTING CHANGES, Section 1506, with an option to not restate comparative financial information.

Consequential amendments

Minor consequential amendments would be made, as required, to other standards in Part II of the Handbook.

Plans for finalizing the proposals

The Board will redeliberate the proposals in light of comments received. Part of the redeliberation process includes consultations with the Board's Private Enterprise Advisory Committee (Advisory Committee). The Advisory Committee assists the Board in maintaining and improving accounting standards for private enterprises by providing input and recommendations on potential changes to the standards. The Board will also consult stakeholders through outreach activities such as roundtables. The Board will provide updates about its redeliberations in its decision summaries and on the project page.

The Board plans to issue the final amendments in the first quarter of 2019, if no significant changes are required to the proposals after deliberating the comments received. In that case, the proposed effective date of the amendments would be for fiscal years beginning on or after January 1, 2020.

Comments requested

Comments are most helpful if they relate to a specific paragraph or group of paragraphs. Any comments that express disagreement with the proposals in the Exposure Draft should clearly explain the problem and include a suggested alternative supported by specific reasoning.

While the Board welcomes comments on all changes proposed in this Exposure Draft, it particularly welcomes comments on the following:

1. Do you agree that the shares issued in a tax planning arrangement with characteristics described in paragraphs 5-8, should be described as retractable or mandatorily redeemable shares? If not, what should these shares be called and why?

2. Do you agree that a definition of a tax planning arrangement is not necessary and that the use of judgment can be applied in practice? If not, why not?

3. Do you agree an exception to liability classification for retractable or mandatorily redeemable shares issued in a tax planning arrangement based on retention of control of an enterprise and the further two conditions, as described in paragraphs 27–54 of the Basis for Conclusions, reflects the notion that nothing of substance has changed? If not, why and what other conditions that reflect the notion that nothing of substance has changed should be considered for an exception to liability classification?

4. Do you think retractable or mandatorily redeemable shares issued in a tax planning arrangement classified as financial liabilities should be measured at the redemption amount? If not, why not?

5. In order to provide sufficient guidance to stakeholders in assessing control, the Board proposes to provide additional guidance on substantive rights in SUBSIDIAIRES, Section 1591. Do you think this additional guidance could affect control assessments beyond the scope of this project? If so, should the Board consider providing transitional relief? Please provide examples of situations where a control assessment could change as a result of this additional guidance and how commonly these situations occur.

6. Do you agree that the effect of classifying and measuring the financial liability at its redemption amount should be presented in a separate component of equity? If not, how should the adjustment be presented and why?

7. Do you agree with the proposed disclosures in EQUITY, Section 3251, about the charge resulting from classifying and measuring the liability and presented as a separate component of equity? If not, why not and what disclosures, if any, should be provided?

8. Do you agree that retractable or mandatorily redeemable shares issued in a tax planning arrangement classified as a financial liability should be separately presented on the balance sheet? If not, why not?

9. Do you agree with the proposed disclosure requirements in FINANCIAL INSTRUMENTS, Section 3856, to require a description of the arrangement that gave rise to the retractable or mandatorily redeemable shares issued in a tax planning arrangement? If not, why not?

10. Do you agree that the proposals should be applied retrospectively in accordance with ACCOUNTING CHANGES, Section 1506, with simplified transitional provisions and an option to not restate comparative financial information? If not, why not?

11. Do you agree that the proposals should not require an enterprise that chooses to retrospectively apply the amendments, to restate retractable or mandatorily redeemable shares in a tax planning arrangement that were settled or otherwise extinguished in periods prior to the date the amendments are first applied? If not, why not?

12. Do you agree that the transition options should be available on first-time adoption of accounting standards for private enterprises? If not, why not?

13. Do you agree with the proposed effective date (i.e., fiscal years beginning on or after January 1, 2020)? If not, why not?

The deadline for providing your comment letter to the Board is January 15, 2018. You may email your comments (Word format preferred) to info@acsbcanada.ca.

Basis for Conclusions

Introduction

1. This Basis includes the expected effects that were considered by the Board in developing the proposals in this Exposure Draft. The Board re-affirms its view that retractable or mandatorily redeemable shares issued in a tax planning arrangement meet the definition of a liability, as defined in FINANCIAL STATEMENT CONCEPTS, paragraph 1000.28-.30. However, the Board is considering an exception to financial liability classification for retractable or mandatorily redeemable shares issued in a tax planning arrangement when certain conditions are met.

2. In developing the proposals, the Board considered the consequences of adopting the proposals relative to the objective of financial statements and the benefit versus cost constraint, as described in FINANCIAL STATEMENT CONCEPTS, Section 1000. The purpose of financial reporting is to "communicate information that is useful to investors, creditors and other users in making their resource allocation decisions and/or assessing management stewardship." The Board thinks that the proposals will improve the relevance, understandability and comparability of financial reporting.

Applicability to not-for-profit organizations

3. In developing the proposed 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 retractable or mandatorily redeemable shares in a tax planning arrangement. Accordingly, these proposed 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

4. As the proposals result in removing the specific sections of the Income Tax Act that are currently included in the exception in FINANCIAL INSTRUMENTS, paragraph 3856.23, a reference to the types of arrangements that give rise to the shares is needed.

5. The Board considered how to refer to these shares within the guidance in the accounting standards for private enterprises and decided that the shares should be referred to as "retractable or mandatorily redeemable shares" rather than "redeemable preferred shares".

6. The Board learned through comment letter responses, discussions with stakeholders and field testing (see results of field testing below) that shares issued in a tax planning arrangement are not always preference shares. Accordingly, the Board proposes to remove reference to "preferred."

7. 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 class of shares; and

   (e) the shares are issued as part of a tax planning arrangement.

The term “retractable or mandatorily redeemable” is also currently used within FINANCIAL INSTRUMENTS, Section 3856, to describe all classes of shares with these characteristics. The Board is not aware of any issues with this term in practice.

8. The Board proposes to use the term “tax planning arrangement” to refer to the arrangements within the scope of the exception but not to define the term. The Board expects stakeholders to exercise judgment when determining what constitutes a tax planning arrangement.

Effects analysis

9. The Board acknowledges that the proposals will result in a change in practice for some stakeholders. However, the Board is of the view that retaining an exception for a limited set of circumstances would be better than removing the exception entirely.

10. Based on the proposals, enterprises would be required to reclassify some retractable or mandatorily redeemable shares issued in a tax planning arrangement from equity to a financial liability on transition. The proposals may also result in some retractable or mandatorily redeemable shares issued in a tax planning arrangement currently classified as a financial liability to be reclassified as equity on transition. The Board recognizes that reclassification from a financial liability to equity would be less common. In some circumstances, the proposals would not result in any change in classification on transition. The proposals also contain reassessment criteria to determine if a reclassification is needed subsequent to transition for shares that will be classified as equity.

11. The proposals could have varying effects on the financial statements of an enterprise depending on the nature of the transaction that resulted in the issuance of retractable or mandatorily redeemable shares in a tax planning arrangement.

12. The benefits to financial reporting from these proposals would 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.

13. There would be costs associated with the change. Based on the feedback received on the 2014 Exposure Draft, these costs may include:

    (a) costs associated with determining the redemption amount of the shares when classified as a financial liability at transition;

    (b) changing financial metrics embedded in contracts, such as debt covenant ratios; and

    (c) costs for preparers to communicate the effect of the changes on the financial statements to lenders and other users of the financial statements. However, once the user education is performed, this will lead to increased user understanding on the nature of these arrangements so that they can make educated decisions on the effects of these arrangements within an entity’s financial statements.

14. The Board acknowledges that these additional costs would be borne by stakeholders and has tried to minimize these costs by providing more guidance and transitional relief. Examples include:

    (a) providing guidance on the initial measurement of a retractable or mandatorily redeemable shares issued in a tax planning arrangement classified as a financial liability;

    (b) adding subsequent measurement guidance for retractable or mandatorily redeemable shares issued in a tax planning arrangement;

    (c) providing 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; and

    (d) providing simplified guidance on how to assess whether retractable or mandatorily redeemable shares issued in a tax planning arrangement meet equity classification at transition.

15. There were additional costs identified by stakeholders in their comment letter responses to the 2014 Exposure Draft. In accordance with FINANCIAL STATEMENT CONCEPTS, 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. The Board considers the costs associated with transition and the ongoing monitoring of the accounting proposals. The Board recognizes that classification of these shares as financial liabilities will affect the net assets, net income and equity of the enterprise and to enhance the communication of these changes to the financial statements has included presentation and disclosure requirements to ensure financial statement users have the information that they need.

16. In the Board's view, the benefits of the proposed amendments outweigh the costs in that the proposals will improve the relevance, understandability and comparability of financial reporting.

Background

Why are we doing this project?

17. The Board reiterates that retractable or mandatorily redeemable shares issued in a tax planning arrangement meet the definition of a liability (see FINANCIAL STATEMENT CONCEPTS, 1000.28-.30) because they give the holder the right to require the issuer to redeem the shares on demand. Allowing an exception for classification is based on whether the benefits of doing so outweigh the costs.

18. There are three application issues in practice today that caused the Board to re-examine paragraph 3856.23:

    (a) There are transactions in practice for which paragraph 3856.23 was not intended but is being applied. These transactions include commercial financing arrangements, transfers of individual assets, employee compensation plans and management buy-outs.

    (b) Some retractable or mandatorily redeemable shares issued in a tax planning arrangement are excluded from paragraph 3856.23 because they are not issued under any of the specified sections of the Income Tax Act listed in paragraph 3856.23. However, the transactions that gave rise to these shares have the same characteristics as the transactions that are currently specified in paragraph 3856.23 and for which the exception was intended. The result has been inconsistent treatment of retractable or mandatorily redeemable shares issued in a tax planning arrangement.

    (c) There is confusion in practice with applying the current exception in paragraph 3856.23. This confusion relates to when retractable or mandatorily redeemable shares issued in a tax planning arrangement should be reclassified to a financial liability. Specifically, the feedback from stakeholders is 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 these types of arrangements. As a result, there is confusion as to when the shares should be reclassified from equity to a financial liability.

19. When stakeholders raised these application issues, the Board decided to re-examine paragraph 3856.23. In conducting its re-examination, the Board noted that the original intent of paragraph 3856.23 was to address the accounting for retractable or mandatorily redeemable shares issued in a tax planning arrangement involving estate freeze and asset rollover transactions. The Board continues to think that retractable or mandatorily redeemable shares issued in other types of transactions should not be classified as equity. However, the Board considered whether a classification exception for estate freezes and asset rollover transactions might continue to be justified based on cost benefit considerations. The Board focused its attention on the characteristics of these tax planning arrangements to assess the appropriateness of a classification exception and the conditions under which such an exception might continue to be permitted. As described in paragraphs 27-54, the Board thinks that estate freezes that meet the required conditions should qualify for the classification exception. However, based on the results of the additional work performed, it is the Board's view that retractable or mandatorily redeemable shares issued in connection with asset rollover transactions should not be classified as equity.

Presentation as a financial liability or equity

What the Board has learned since the 2014 Exposure Draft

20. In response to the 2014 Exposure Draft, the Board received 73 comment letters and heard from 90 stakeholders at nine roundtables from across Canada. These roundtables included 79 practitioners, nine users and two academics. Stakeholders commonly 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 may not understand the results of reporting retractable or mandatorily redeemable shares issued in a tax planning arrangement as a financial liability. The Board deliberated upon the feedback and decided that additional outreach was necessary to address the concerns raised with the 2014 proposals.

21. 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 not able to use the 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.

22. The findings of this additional outreach first led the Board to explore whether a classification exception could continue to be permitted on the notion that nothing of substance has changed, by focusing on the retention of control of the enterprise issuing the shares.

23. Basing an exception on the condition of retention of control is consistent with the key message received from stakeholders that nothing of substance has changed in the management and operations of the enterprise as a result of the tax planning arrangement. The Board agreed that if nothing of substance has changed, an exception to classifying these shares as financial liabilities might be warranted based on a cost/benefit assessment.

24. 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 and large organizations. The participants were chosen for their extensive knowledge of, and broad exposure to, the various types of tax planning arrangements in practice. The field-test participants were asked to identify the full range of scenarios seen in practice and to provide a detailed description of the most common scenarios. The scenarios included asset rollovers, estate freezes, management buy-outs, stock dividends and second-generation estate freezes. For each scenario, participants assessed whether they thought that control of the enterprise was retained and described how they arrived at that conclusion. They also provided feedback regarding the challenges in performing their analyses.

25. The Board also sought input from members of its Advisory Committee. In addition, the Board conducted outreach with users including lenders, lessors and insurers actively involved with private enterprises that engage in tax planning arrangements. The focus of this outreach was to understand how these arrangements affect an enterprise's risk profile. Additionally, the lenders provided feedback on the proposals and shared concerns about retractable or mandatorily redeemable shares issued in tax planning arrangements today.

26. The Board considered the feedback from these users when developing the amendments, including how:

    (a) they are concerned with transactions or arrangements that would impact the risk profile of the enterprise. Therefore, their focus is on who controls the enterprise and the enterprise's cash flows and identifying when that changes;

    (b) they want to be able to clearly identify on the face of the financial statements retractable or mandatorily redeemable shares issued in a tax planning arrangement; and

    (c) they want to understand the nature of the arrangement that gave rise to the issuance of the shares.

The conditions for the classification exception

27. The Board decided that the basis for the proposed exception should be on the condition of retention of control of the enterprise and decided that the control of the enterprise must be retained by the party receiving the retractable or mandatorily redeemable shares issued in a tax planning arrangement. The Board further decided additional conditions were necessary, being the existence of a redemption schedule and that no consideration other than shares is exchanged. The following provides further details on how each condition in the proposed exception was developed.

Condition 1–Control

28. The field-test participants were asked to determine whether they thought that control of the enterprise was retained in each of the scenarios presented. In some cases, different responses were received from the participants.

29. Some of the field-test participants assessed control from the perspective of the enterprise issuing the retractable or mandatorily redeemable shares in a tax planning arrangement. In contrast, other participants assessed control from the perspective of the shareholder receiving the shares. Users thought both perspectives were important to address their concerns.

30. The Board decided that both aspects of the control condition were necessary:

    (a) Is control of the enterprise retained? The enterprise issuing the retractable or mandatorily redeemable shares in a tax planning arrangement is the reporting enterprise. Users have noted that they look for changes in control of the enterprise that can affect the risk profile of the enterprise. The issuance of retractable or mandatorily redeemable shares in a tax planning arrangement that results in a change in control of the reporting enterprise should be reflected as a financial liability in the financial statements of the enterprise.

(b) Is control of the enterprise retained by the shareholder receiving the retractable or mandatorily redeemable shares issued in a tax planning arrangement (the freezor)? The freezor should have the ability to control the strategic operating, investing and financing policies of the enterprise before and after the freeze (for example, the freezor should have the ability to control the dividend policy of the enterprise).

31. The Board considered the description of the control 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 while retaining its meaning. After reflecting on the Advisory Committee's advice, the Board decided that the second step of the control condition was sufficient, and the first step was removed. Members of the Advisory Committee and the Board could not identify any scenarios that would fail the first step of the control condition and not fail the second step.

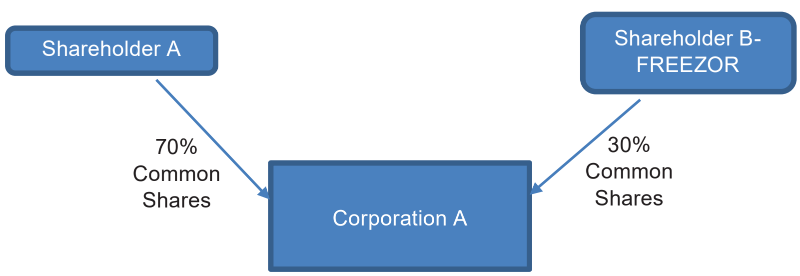
32. To demonstrate the control condition, the following example was considered. As illustrated below, Shareholder B, who currently owns 30% of the voting shares of the enterprise issuing the retractable or mandatorily redeemable shares in a tax planning arrangement, executes an estate freeze. As a result, Shareholder B exchanges his/her voting common shares for retractable or mandatorily redeemable shares.

33. This arrangement would not meet the proposed control condition and the retractable or mandatorily redeemable shares issued in a tax planning arrangement would be classified as a financial liability. The rationale is that the shareholder receiving the retractable or mandatorily redeemable shares issued in a tax planning arrangement (Shareholder B) did not retain control of the enterprise issuing those shares as the shareholder did not have control prior to effecting the tax planning arrangement.

34. The Board thinks 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. Thus, the shareholder could not unilaterally declare a dividend on his/her shares. However, after the freeze, Shareholder B has the ability to redeem his/her shares on demand.

35. Therefore, something of substance has changed and liability classification is required.

Before



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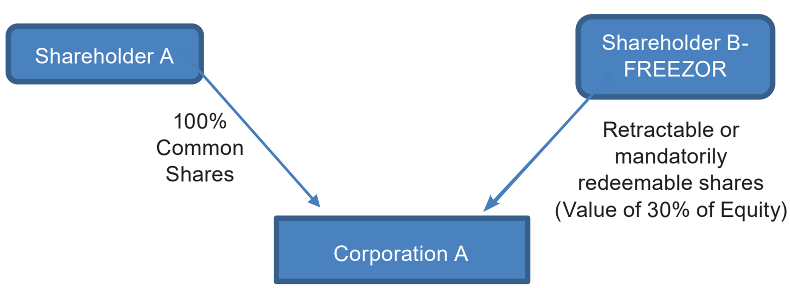
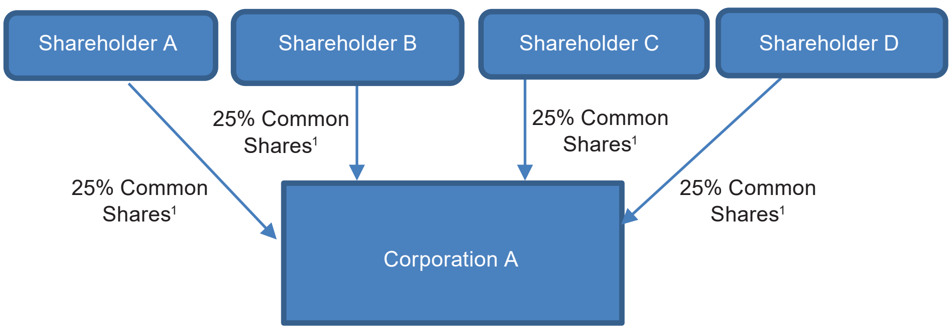


Joint control

36. The Board and the Advisory Committee also discussed the notion of joint control. The issue was raised as a result of one of the scenarios presented by the field-test participants involved in the execution of an estate freeze of an enterprise jointly controlled by investors.

37. The scenario is illustrated as follows:

Before



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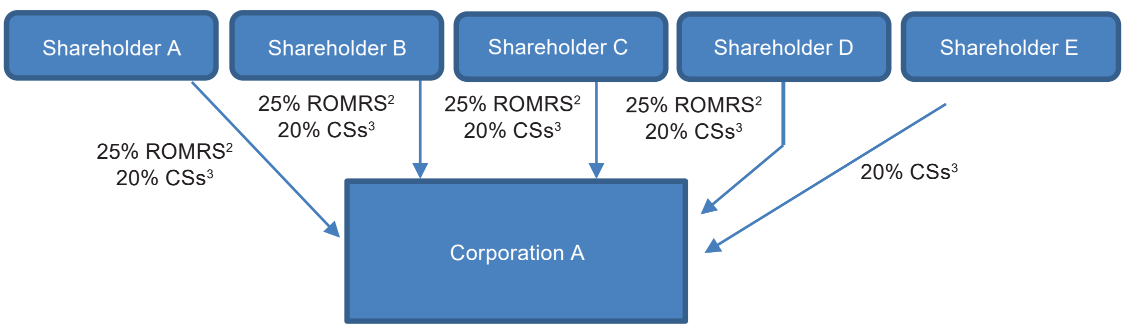


1 Common shares – representing voting interest of 25% in Corporation A. Decisions on the strategic operating, investing and financing policies generally require the consensus of all shareholders.
2 Retractable or mandatorily redeemable shares (non-voting)
3 Common shares – representing voting interest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

38. When this scenario was analyzed by the field-test participants, they thought that the retractable or mandatorily redeemable shares issued in a tax planning arrangement would require liability classification as the control of the enterprise condition was not met: no individual controlled the enterprise on his or her own before or after the transaction.

39. The Board is of the view that this is a reasonable conclusion. Prior to the transaction, an individual shareholder is unable to make unilateral decisions regarding the management and operations of the enterprise (for example, to declare a dividend). After the estate freeze, each of the four shareholders has the ability to demand cash repayment through redemption of their own retractable or mandatorily redeemable shares.

Existing guidance in Part II

40. The field-test instructions asked participants if they thought the guidance provided in SUBSIDIARIES, Section 1591, was sufficient to assess whether control of the enterprise was retained. While for most of the scenarios the participants thought that the guidance was sufficient, additional guidance in some areas was thought to be helpful. The Board considered the following two areas as to whether additional guidance should be provided:

    (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 foreseeable 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 very helpful in assessing control.

42. When developing SUBSIDIARES, Section 1591,[4] 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, *Consolidated Financial Statements*.

43. The rationale for proposing to add guidance on substantive rights at this time is the relevance of that guidance to the accounting for retractable or mandatorily redeemable shares issued in a tax planning arrangement. Additionally, Advisory Committee members thought that the guidance could be helpful for all control assessments, as some stakeholders currently look to the guidance in IFRS 10, *Consolidated Financial Statements* on substantive rights. The Advisory Committee members were of the view that 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 is asking the question in this Exposure Draft regarding the broader implications of adding guidance on substantive rights at this time.

[4] Section 1591 was developed by modifying Section 1590 to incorporate additional guidance on accounting for subsidiaries controlled through rights other than equity interests and necessary consequential changes.

Unit of account for related parties

44. The field-test participants raised the issue of whether two related parties should be considered as one or two units when assessing a field-test scenario. The Board discussed whether to provide guidance on defining the unit of account for related party transactions in the context of this project. The Board decided against providing unit of account guidance for related parties as it could affect a broader range of transactions that are outside of the scope of this project. The Board is of the view that adding guidance on the unit of account for related parties would have a more substantive impact on stakeholders than substantive rights as there is diversity in practice.

45. 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.

Condition 2—Redemption schedule

46. The Board decided that the second condition for the proposed classification exception to equity should be that no other arrangement exists that requires redemption of the retractable or mandatorily redeemable shares issued in a tax planning arrangement in a fixed or determinable period by the enterprise.

47. 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 by the issuer should require liability classification of those shares.

48. The Board had extensive discussions on what constitutes a redemption schedule. Through outreach, the Board learned that the term redemption schedule had varying 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 and expect stakeholders to holistically assess any arrangement that exists that requires redemption of the shares in a fixed or determinable date or period by the enterprise.

Condition 3—No consideration other than shares exchanged

49. The Board decided that the third condition for the proposed classification exception to equity 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.

50. The Board consulted its Advisory Committee and other users who shared the same view that consideration other than shares exchanged for retractable or mandatorily redeemable shares in lieu of debt are financing arrangements. They advised that following these transactions, the introduction of other consideration (for example, 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.

51. 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.

52. This condition would scope out retractable or mandatorily redeemable shares issued in an asset rollover transaction from meeting the classification exception. Asset rollovers are a type of financing arrangement in which the freezor is providing an asset (or group of assets) in exchange for retractable or mandatorily redeemable shares issued in a tax planning arrangement. The stakeholder receiving 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 crystalizing the value of the enterprise at a point in time through the use of retractable or mandatorily redeemable shares such that nothing of substance has changed. As well, the addition of an asset or group of assets into the enterprise will change the cash flows of that enterprise and thus constitutes a substantive change.

53. The Board considered the effect of requiring liability classification for the shares in asset rollovers. The Board noted that the issuance of shares measured at the redemption amount is accompanied by an inflow of assets. An illustration of this requirement's effect is shown in the proposed amendments to RELATED PARTY TRANSACTIONS, Section 3840, Illustrative Example 4.

54. 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 proposals, the Board focused on the substance of the overall transaction, whether it was executed as one or more transactions. The Board views the series of steps entered into in contemplation of each other as one transaction that results in the issuance of retractable or mandatorily redeemable shares in exchange, in this scenario, for an asset (or a group of assets). For example, an enterprise may first exchange common shares for retractable or mandatorily redeemable shares followed by an exchange of a building for cash. If these transactions are executed in contemplation of each other, the enterprise needs to assess the substance of the transaction holistically.

Initial measurement of the retractable or mandatorily redeemable shares issued in a tax planning arrangement that require liability classification

55. FINANCIAL INSTRUMENTS, Section 3856, requires initial measurement of a financial instrument to be at fair value when a transaction is between unrelated parties. Paragraph 3856.08 requires initial measurement of a financial instrument between related parties to be determined in accordance with RELATED PARTY TRANSACTIONS, Section 3840, which requires such a transaction to be recorded at carrying amount, or in some circumstances, exchange amount.

56. For the initial measurement of retractable or mandatorily redeemable shares issued to unrelated parties that are classified as a financial liability, the Board proposes to require measurement at the redemption amount. Typically, the redemption amount would be fair value given that they are due on demand due to the requirements of the Income Tax Act. The Board considered providing guidance to allow the shares to be discounted at a risk-free rate. However, the Board decided 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 should not be permitted. Since the amount at which the shares are measured cannot be less than the amount that is due on demand, FINANCIAL INSTRUMENTS, paragraph 3856.A12 does not apply to retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as financial liability measured at the redemption amount.

57. In addition, the Board is proposing that the redemption amount also be used for the initial measurement of retractable or mandatorily redeemable shares that are classified as a financial liability when issued to related parties. A project is currently underway by the Board to address the broader concerns with the initial measurement of related party financial instruments. An exposure draft on that topic is scheduled to be issued later this year. However, for stakeholders to understand and evaluate the effect these proposals would have in practice, that measurement guidance is included in this project's Exposure Draft.

58. The Board is of the view that redemption amount is appropriate for initial measurement of the retractable or mandatorily redeemable shares that are classified as a financial liability as they are due on demand (i.e., liability should not be measured as less than 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.

59. The consequential amendments of these proposals include revising RELATED PARTY TRANSACTIONS, Section 3840, Illustrative Example 4. This example is an asset rollover transaction and the revisions provide an example to stakeholders on the determination of the redemption amount.

Subsequent measurement

Fair value option

60. The proposals require initial measurement of the retractable or mandatorily redeemable shares issued in a tax planning arrangement at the redemption amount when classified as financial liabilities. The Board considered whether fair value for subsequent measurement should be allowed and decided that it should not be permitted.

61. As previously mentioned in this document, retractable or mandatorily redeemable shares issued in a tax planning arrangement are due on demand. As such, even if the shares are subordinated to other debt or a redemption schedule specifying repayment terms exist, discounting of cash outflows to reflect expected timing of redemption and credit risk is not permitted.

Reassessment

62. The Board thinks that if the shareholder loses control of the enterprise, or if the other two conditions required for equity classification are no longer met, something of substance has changed. In that case, reclassification of the shares from equity to a financial liability would be required.

63. The Board considered the effect of subsequent transactions or events that would 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 redeemable or mandatorily retractable shares. 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.

64. The proposals state that an enterprise should reassess the equity classification of the redeemable or mandatorily retractable shares upon the occurrence of a transaction or event. Guidance of this nature would be similar to the current guidance in INVESTMENTS, Section 3051, in determining whether indicators of impairment of an investment exist. As such, examples of transactions or events that might give rise to the need to reassess equity classification are provided in the guidance to assist stakeholders in understanding circumstances that would require reassessment. Reassessment would not automatically lead to a reclassification change from equity to liability classification. 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.

65. The Board considered whether the reassessment criteria should be applicable to shares that are classified as a financial liability on initial recognition as well as shares that are classified as equity. The Board decided that to do so would introduce a level of complexity in the proposals for which the costs would outweigh the benefits and would lead to more confusion for stakeholders.

66. As such, the Board concluded that if the conditions for equity classification are not met on initial recognition, the enterprise is not permitted to classify the redeemable or mandatorily retractable shares as equity at a subsequent date.

Disclosure

67. The Board considered whether the existing disclosure requirements in FINANCIAL INSTRUMENTS, Section 3856, provide sufficient information in respect of retractable or mandatorily redeemable shares issued in a tax planning arrangement. The Board considered the disclosure requirements for retractable or mandatorily redeemable shares that qualify for the exception of paragraph 3856.23, therefore requiring equity classification, and those that require liability classification. Users thought that the current disclosure requirements applicable to financial liabilities and to equity instruments are appropriate for retractable or mandatorily redeemable shares that are classified as liabilities and equity, respectively. However, users also suggested an additional disclosure that describes the arrangement that gave rise to the shares would be helpful. The Board thinks that this additional disclosure would not be onerous for enterprises as the information required is readily available.

Separate component of equity

68. In the 2014 Exposure Draft, the Board proposed that the effect of liability classification should be included in a separate component of equity. 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 retractable or mandatorily redeemable shares issued in a tax planning arrangement and the balance of retained earnings. Most of the 2014 Exposure Draft respondents agreed with this proposal. As well, the additional outreach supported presenting the effect of liability classification in a separate component of equity.

69. Recognition of a financial liability for retractable or mandatorily redeemable shares issued in a tax planning arrangement 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.

70. The Board noted that EQUITY, Section 3251, requires an entity to present a separate category of equity for each category that is of a different nature. Based on input from users, the Board thinks that separate presentation would provide useful information. Accordingly, this Exposure Draft proposes to amend Section 3251 to clarify that:

    (a) the effect of classifying retractable or mandatorily redeemable shares issued in a tax planning arrangement as a financial liability should be shown as a separate component of equity; and

    (b) the amount presented in this separate category of equity would be reclassified to retained earnings as the retractable or mandatorily redeemable shares are called for redemption.

71. 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 RELATED PARTY TRANSACTIONS, paragraph 3840.17 and the proposed EQUITY, paragraph 3251.06A. Paragraph 3840.17 requires any adjustments to equity as a result of a related party transaction to be recognized either as retained earnings or contributed surplus.

72. The Board proposes to clarify that the balance of this separate category of equity should be charged to retained earnings and not contributed surplus. The balance in equity would be charged to retained earnings as the retractable or mandatorily redeemable shares issued in a tax planning arrangement are called for redemption.

73. 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 proposes that the enterprise disclose the amount of the separate component of equity that is to be reclassified to retained earnings as the retractable or mandatorily redeemable shares issued in a tax planning arrangement are called for redemption.

74. 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 retractable or mandatorily redeemable shares issued in a tax planning arrangement to the total equity balance. The Board noted that the decision model used to develop the disclosures in accounting standards for private enterprises suggests that disclosure be provided in respect of rare or unusual transactions and, accordingly, added these disclosures to the proposals.

Accrued distributions

75. Currently, there are retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as financial liabilities as they do not meet the exception in FINANCIAL INSTRUMENTS, paragraph 3856.23. Any dividends that are paid on those shares are recorded as interest expense in the income statement as any return relating to liabilities is treated as interest expense. Dividends on retractable or mandatorily redeemable shares issued in a tax planning arrangement that currently meet the exception in paragraph 3856.23 are presented as dividends. In both situations, a financial liability is recorded once the dividend is declared until such time as it is paid.

76. Based on the proposals, on transition there may be retractable or mandatorily redeemable shares issued in a tax planning arrangement that would be reclassified from equity to a financial liability and others that would be reclassified from a financial liability to equity. Reclassification of the shares presented as equity could also be reclassified to a financial liability subsequently when a reassessment leads to reclassification.

77. Whether the retractable or mandatorily redeemable shares are classified as a financial liability or equity, a liability arises when a dividend is declared. Therefore, an enterprise records a dividend payable in earnings or retained earnings, depending on the classification of the shares. If the shares are reclassified prior to the payment of the dividends, the enterprise could have an interest payable on shares that they had previously charged to retained earnings, or a dividend payable that they had expensed for shares that are classified as a financial liability.

78. The Board discussed whether guidance was needed relating to whether reclassification of the previously recognized charge was required on transition or at reassessment. The Board thinks the guidance is clear in FINANCIAL INSTRUMENTS, 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

79. Enterprises applying the future income taxes method may need to adjust for the effects when retractable or mandatorily redeemable shares issued in a tax planning arrangement are remeasured from a nominal amount within equity to the redemption amount when reclassified to a financial liability.

80. The Board considered whether additional guidance or illustrative examples are necessary to assist preparers and practitioners with the accounting for the future income tax implications of a change in the accounting basis for the retractable or mandatorily redeemable shares issued in a tax planning arrangement.

81. The proposals include a revised RELATED PARTY TRANSACTIONS, Section 3840, Illustrative Example 4, which highlights the future tax implications of measuring retractable or mandatorily redeemable shares issued in a tax planning arrangement at the redemption amount. The Board thinks this example will provide sufficient guidance for stakeholders.

Transition

82. Respondents to the 2014 Exposure Draft noted that retrospective application would not be onerous as the information necessary to record the shares at their redemption amount is readily available.

83. However, one area of concern raised by stakeholders was that requiring retrospective application could lead to non-compliance with some rolling covenant calculations. As such, the Board is proposing to provide an option for enterprises to not restate comparative information. This would alleviate the need for stakeholders to renegotiate covenants that might contain prior year amounts.

84. In addition, the proposals do not require an enterprise to assess whether the retractable or mandatorily redeemable shares issued in a tax planning arrangement meet the conditions for equity classification when they were redeemed prior to the date the amendments were first applied.

85. For example, consider the amendments are effective for fiscal years beginning on or after January 1, 2020. An enterprise has retractable or mandatorily redeemable shares issued in a tax planning arrangement currently classified as equity that are redeemed in May 2019. Assume these shares would not meet the classification exception under the proposals in this Exposure Draft. When the enterprise chooses to apply the proposals at January 1, 2020, and is preparing its financial statements for the year ending December 31, 2020, the enterprise would not be required to apply the proposals in the prior period financial statements for the change in classification for those redeemed shares.

86. The proposals require the 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 acknowledges that some retractable or mandatorily redeemable shares 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 conditions for equity classification are assessed as though the tax planning arrangement occurred on the date that the enterprise applies the amendments for the first time. As such, control of the enterprise that issued the retractable or mandatorily redeemable shares must be held by the shareholder who owns the shares. This condition would look at control as at the date of transition and determine if the shareholder who holds the retractable or mandatorily redeemable shares has control of the enterprise. If control is held by another party or if the retractable or mandatorily redeemable shares are owned by another party, this condition will not be met. Additionally, on the date the amendments are first applied, no other arrangement can exist that requires redemption of the retractable or mandatorily redeemable shares issued in a tax planning arrangement in a fixed or determinable period by an enterprise. Lastly, the only consideration exchanged in the transaction was shares of the enterprise.

87. The Exposure Draft is asking stakeholders if this additional transitional relief is helpful. The Board thinks that in most situations an enterprise would only have one arrangement that gave rise to retractable or mandatorily redeemable shares issued in a tax planning arrangement. As such, if the shares are redeemed in the prior year, the enterprise could choose to not restate comparatives. However, if the enterprise has more than one arrangement that gave rise to these types of shares, this transitional relief might be beneficial.

88. The Board acknowledges that allowing this transitional relief may result in lack of comparability in the year of transition, as some enterprises would chose 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 retractable or mandatorily redeemable shares issued in a tax planning arrangement 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 retractable or mandatorily redeemable shares issued in a tax planning arrangement would appear in the current year's opening retained earnings. As such, after the year of transition, comparability across enterprises would be obtained.

Effective date

89. The Board understands that the proposals would result in some retractable or mandatorily redeemable shares issued in a tax planning arrangement no longer receiving equity treatment and vice versa. This classification change could affect financial metrics and may result in the need to renegotiate loan covenants or other contractual agreements. The Board's view is that the proposed effective date, being fiscal years beginning on or after January 1, 2020, would allow sufficient time to revise loan agreements or other contractual agreements. In addition, the Board thinks that this should be sufficient time to educate users on the nature of the arrangements.

Consequential amendments

90. The proposed changes would have an effect on other Sections. The rationale for some of the more significant amendments are described throughout the Basis as well as below.

CURRENT ASSETS AND CURRENT LIABILITIES, Section 1510, and BALANCE SHEET, Section 1521

91. Some of the users consulted thought that retractable or mandatorily redeemable shares issued in a tax planning arrangement should be presented separately on the face of the financial statements from other liabilities. Providing a separate line item would help explain the potential differences between these arrangements and other liabilities.

92. The consequential amendment to CURRENT ASSETS AND CURRENT LIABILITES, Section 1510, is also being proposed as these shares are due on demand. Therefore, they are typically current liabilities unless there is an arrangement to indicate otherwise.

FIRST TIME ADOPTION, Section 1500

93. The Board reviewed the transitional provisions that would be made 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 choose to 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 arising from classification issues as enterprises currently applying the framework.

Conclusion

94. Having considered the effects of the proposed changes discussed above, the Board's view is that the benefits of the proposals will outweigh any costs and that the proposals will result in significant improvements to financial reporting for private enterprises.

Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement

PROPOSAL

The following Sections would be amended as indicated below. Additional text is denoted by underlining and deleted text by strikethrough.

SUBSIDIARIES, Section 1591

DEFINITIONS

.14 The continuing power to determine the strategic operating, investing and financing policies of an enterprise without the co-operation of others may be obtained through statute, contractual arrangements, or ownership of financial instruments that, if converted or exercised, either individually or through a combination thereof, would give the other enterprise control. The following are examples of such situations:

(a) Ownership of less than the majority of voting shares combined with an irrevocable arrangement with other owners to exercise voting interests collectively may result in majority voting power and, therefore, may confer control. Control is not conferred solely by the holding of proxies or participation in a limited voting arrangement that is temporary in nature, provides for joint control or is cancellable by other parties to the arrangement. In the absence of other factors, such limited voting arrangements force an enterprise to rely on the continuing co-operation of other owners.

(b) Control may exist when an enterprise does not own the majority voting interest if it has the continuing ability to elect the majority of the members of the board of directors through ownership of rights, options, warrants, convertible debt, convertible non-voting equity such as preferred shares, or other similar instruments that, if converted or exercised, would give the enterprise the majority voting interest. In such circumstances, the enterprise takes into account its ability to maintain control by exercising rights, options or warrants or converting securities and the ability of others to dilute its voting interest through such exercises or conversions. Exercises and conversions are only taken into account when the economic barriers or other costs ~~is~~ are not so high as to make them unlikely for the foreseeable future. In the absence of an existing majority voting interest, an existing right to acquire such an interest or an arrangement or statute that confers a majority voting interest, an enterprise's ability to elect the majority of the members of the board of directors of another enterprise is usually dependent on the co-operation of others and would, therefore, not constitute control.

.14A When assessing the continuing power to determine the enterprise's strategic operating, investing and financing policies, only substantive rights relating to another enterprise are considered. For a right to be substantive, the enterprise (the holder) must have the practical ability to exercise that right over the other enterprise.

.14B Determining whether rights are substantive requires judgment, taking into account all facts and circumstances. Factors to consider in making that determination include but are not limited to:

(a) Whether there are any barriers (economic or other) that prevent the holder (or holders) from exercising the rights. Examples of such barriers include but are not limited to:

(i) financial penalties and incentives that would prevent (or deter) the holder from exercising its rights;

(ii) an exercise or conversion price that creates a financial barrier that would prevent (or deter) the holder from exercising its rights;

(iii) terms and conditions that make it unlikely that the rights would be exercised, for example, conditions that narrowly limit the timing of their exercise;

(iv) the absence of an explicit, reasonable mechanism in the founding documents of a subsidiary or in applicable laws or regulations that would allow the holder to exercise its rights;

(v) the inability of the holder of the rights to obtain the information necessary to exercise its rights;

(vi) operational barriers or incentives that would prevent (or deter) the holder from exercising its rights (e.g., the absence of other managers willing or able to provide specialized services or provide the services and take on other interests held by the incumbent manager); or

(vii) legal or regulatory requirements that prevent the holder from exercising its rights.

(b) When the exercise of rights requires the agreement of more than one party, or when the rights are held by more than one party, whether a mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so. The lack of such a mechanism is an indicator that the rights may not be substantive. The more parties that are required to agree to exercise the rights, the less likely it is that those rights are substantive.

.14C To be substantive, rights also need to be exercisable when decisions about the direction of the strategic operating, investing or financing policies need to be made. Generally, to be substantive, the rights need to be currently exercisable. However, sometimes rights can be substantive, even though the rights are not currently exercisable.

.14D Substantive rights exercisable by other parties can prevent a party from controlling another party to which those rights relate. Such substantive rights do not require the holders to have the ability to initiate decisions. As long as the rights are not merely protective (see paragraph 1591.21), substantive rights held by others may prevent one party from controlling the other party even if the rights give the holders only the current ability to approve or block decisions that relate to the relevant activities.

…

EFFECTIVE DATE AND TRANSITION

.39 Except as specified in paragraphs 1591.39A-.39B and 1591.48, this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2016. An enterprise applies this Section retrospectively, in accordance with ACCOUNTING CHANGES, Section 1506, except as specified in paragraphs 1591.40-.47. Earlier application is permitted.

…

.48 The amendments to paragraph 1591.14 and the new paragraphs 1591.14A-.14D apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. Earlier application is permitted.

EQUITY, Section 3251

.06A A charge to equity is reported for retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as financial liabilities (see FINANCIAL INSTRUMENTS, paragraph 3856.23 and 3856.23C). Any such charges are treated as a capital transaction, are excluded from the determination of net income in accordance with CAPITAL TRANSACTIONS, Section 3610, and are presented as a separate component of equity.

.06B For example, if retractable or mandatorily redeemable shares issued by an enterprise in a tax planning arrangement are issued in exchange for common shares of the same enterprise, and the retractable or mandatorily redeemable shares are classified as financial liabilities, the amount of the excess of the redemption amount of the shares over the carrying value of the common shares exchanged is recognized as a charge to equity.

.06C When some or all of the retractable or mandatorily redeemable shares issued in a tax planning arrangement are called for redemption, the appropriate proportion of the amount recognized in the separate component of equity is charged to retained earnings at the date redemption is requested.

.06D For transactions between related parties that are within the scope of RELATED PARTY TRANSACTIONS, paragraph 3840.17, the excess in the separate component of equity from issuing retractable or mandatorily redeemable shares in a tax planning arrangement is charged to retained earnings, not contributed surplus.

…

.12A *When a separate component of equity is presented as a result of the issuance of retractable or mandatorily redeemable shares in a tax planning arrangement (see paragraph 3251.06A), an entity shall disclose that the balance of the separate component of equity will be charged to retained earnings as the shares issued are called for redemption.*

…

EFFECTIVE DATE AND TRANSITION

.13 Except as specified in paragraph 3251.14, ~~T~~this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted.

.14 The new paragraphs 3251.06A-.06D and 3251.12A apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. Earlier application is permitted.

RELATED PARTY TRANSACTIONS, Section 3840

MEASUREMENT

.17 When a related party transaction is measured at the carrying amount, any difference between the carrying amounts of the items exchanged, together with any tax amounts related to the item transferred, is a contribution of capital to, or a distribution of equity of, the enterprise. A net credit is a capital contribution and is credited to contributed surplus. A net debit is an equity distribution and is charged against any existing credit balance in contributed surplus arising from previous related party transactions, except as specified in accordance with EQUITY, paragraph 3251.06D, with any excess charged against retained earnings.

…

EFFECTIVE DATE AND TRANSITION

…

.61 Except as specified in paragraphs 3840.62-.6~~3~~4, this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted.

…

.64 Amendments to paragraph 3840.17 apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. Earlier application is permitted.

FINANCIAL INSTRUMENTS, Section 3856

MEASUREMENT

Initial measurement

.07 *Except as specified in paragraph 3856.08A, ~~W~~when a financial asset is originated or acquired or a financial liability is issued or assumed in an arm's length transaction, an ~~entity~~ enterprise shall measure it at its fair value adjusted by, in the case of a financial asset or financial liability that will not be measured subsequently at fair value, financing fees and transaction costs that are directly attributable to its origination, acquisition, issuance or assumption. (Paragraphs 3856.A8-.A13 provide related application guidance.)*

.08 *Except as specified in paragraph 3856.08A, ~~W~~when a financial asset is originated or acquired or a financial liability is issued or assumed in a related party transaction, an entity enterprise shall measure it in accordance with RELATED PARTY TRANSACTIONS, Section 3840.*

.08A *For retractable or mandatorily redeemable shares issued in a tax planning arrangement classified as a financial liability in accordance with paragraph 3856.23, an enterprise shall measure the financial liability at its redemption amount.*

…

Subsequent measurement and income recognition

…

.13 *Except for a financial instrument to which paragraph 3856.08A applies, ~~A~~an enterprise may elect to measure any financial asset or financial liability at fair value by designating that fair value measurement shall apply:*

(a) *when the asset or liability is first recognized in accordance with this Section; or*

(b) *for an investment in an equity instrument that was previously measured at fair value in accordance with paragraph 3856.12(a), when the instrument ceases to be quoted in an active market.*

Any designation in accordance with this paragraph is irrevocable.

…

PRESENTATION

Liabilities and equity

…

.23 An ~~entity~~ enterprise that issues ~~preferred~~ retractable or mandatorily redeemable shares in a tax planning arrangement ~~under Sections 51, 85, 85.1, 86, 87 or 88 of the Income Tax Act (Canada)~~ shall present the shares at par, stated or assigned value as a separate line item in the equity section of the balance sheet ~~with a suitable description indicating that they are redeemable at the option of the holder~~ only when all of the following conditions are met:

(a) control (see SUBSIDIARIES, Section 1591) 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;

(b) the only consideration exchanged in the arrangement is one class of shares for another class of shares of the enterprise issuing the shares; and

(c) no other explicit or implicit arrangement exists, such as a redemption schedule, that gives the holder of the shares the contractual right to require the enterprise to redeem the shares on a fixed or determinable date or within a fixed or determinable period.

~~When redemption is demanded,~~ If any of the above conditions are not met, the issuer shall ~~re~~classify the shares as financial liabilities, present them separately on the balance sheet and measure them ~~at the redemption amount~~ in accordance with paragraph 3856.08A. Any adjustment shall be recognized ~~in retained earnings~~ in a separate component of equity in accordance with EQUITY, Section 3251.

.23A Retractable or mandatorily redeemable shares in a tax planning arrangement classified as equity in accordance with paragraph 3856.23 are not subsequently reclassified unless an event or transaction occurs that may indicate the conditions for equity classification in paragraph 3856.23 are no longer met. Retractable or mandatorily redeemable shares in a tax planning arrangement classified as financial liabilities in accordance with paragraph 3856.23 are not subsequently reclassified.

.23B Examples of events or transactions that may indicate the conditions for equity classification in paragraph 3856.23 are no longer met include, but are not restricted to:

(a) the death of the holder of the retractable or mandatorily redeemable shares issued in a tax planning arrangement;

(b) a change in the ownership of the enterprise that may affect the assessment of control of the enterprise that issued the retractable or mandatorily redeemable shares in a tax planning arrangement;

(c) a change in the shareholders' agreement that may affect the assessment of control of the enterprise that issued the retractable or mandatorily redeemable shares in a tax planning arrangement;

(d) redemption of some or all of the retractable or mandatorily redeemable shares issued in a tax planning arrangement;

(e) the creation of an arrangement that gives the holder of the retractable or mandatorily redeemable shares issued in a tax planning arrangement the implicit or explicit right to require the enterprise to redeem the shares within a fixed or determinable period; or

(f) modifications to the retractable or mandatorily redeemable shares issued in a tax planning arrangement.

.23C If the event or transaction gives rise to a reclassification of the retractable or mandatorily redeemable shares issued in a tax planning arrangement from equity to a financial liability, the enterprise shall measure the reclassified shares at the redemption amount and present them separately on the balance sheet. Any resulting adjustment shall be recorded in a separate component of equity in accordance with EQUITY, *Section 3251.*

…

DISCLOSURE

Financial liabilities

…

.47 An entity that issues any of the following financial liabilities or equity instruments shall disclose information to enable users of the financial statements to understand the effects of features of the instrument, as follows:

(a) For a financial liability that contains both a liability and an equity element (see paragraph 3856.21), an entity shall disclose the following information about the equity element including, when relevant:

(i) the exercise date or dates of the conversion option;

(ii) the maturity or expiry date of the option;

(iii) the conversion ratio or the strike price;

(iv) conditions precedent to exercising the option; and

(v) any other terms that could affect the exercise of the option, such as the existence of covenants that, if contravened, would alter the timing or price of the option.

(b) For a financial instrument that is indexed to the entity's equity or an identified factor, as described in paragraph 3856.14, an entity shall disclose information that enables users of the financial statements to understand the nature, terms and effects of the indexing feature, the conditions under which a payment will be made and the expected timing of any payment.

(c) For ~~a preferred~~ retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as equity as specified in paragraph 3856.23, an enterprise shall disclose:

(i) on the face of the balance sheet, the total redemption amount for all classes of such shares outstanding;

(ii) the aggregate redemption amount for each class of such shares; and

(iii) ~~the aggregate amount of any scheduled redemptions required in each of the next five years.~~ a description of the arrangement that gave rise to the shares.

(d) In addition to the disclosure required for financial liabilities, for retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as financial liabilities, as specified in paragraph 3856.23, an enterprise shall disclose a description of the arrangement that gave rise to the shares.

EFFECTIVE DATE AND TRANSITION

.55 Except as specified in paragraphs 3856.56-~~.61~~62, this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted.

…

.62 The amendments to paragraphs 3856.07-.08, 3856.13, 3856.23, 3856.47 and new paragraphs 3856.08A and 3856.23A-.23C apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. An enterprise applies these amendments as specified in paragraph 3856.63. Earlier application is permitted.

.63 Except as specified in paragraphs 3856.64-.65, an enterprise may choose to apply the amendments specified in paragraph 3856.62 retrospectively, as defined in ACCOUNTING CHANGES, Section 1506, either:

(a) at the beginning of the earliest period presented; or

(b) at the beginning of the fiscal year in which the amendments are first applied.

.64 When the amendments are applied for the first time, an enterprise that issued retractable or mandatorily redeemable shares in a tax planning arrangement presents the shares as a separate line in the equity section of the balance sheet when all of the following conditions are met:

(a) Control (see SUBSIDIARIES, Section 1591) of the enterprise that issued the retractable or mandatorily redeemable shares in a tax planning arrangement is held by the party that owns the shares in the arrangement. The enterprise need not assess if control has been retained from the date of the initial transaction that gave rise to the shares.

(b) The only consideration that had been exchanged in the arrangement that gave rise to the shares is one class of shares for another class of shares in the enterprise issuing the shares.

(c) No other explicit or implicit arrangement exists such as a redemption schedule, that gives the holder of the shares the contractual right to require the enterprise to redeem the shares within a fixed or determinable period.

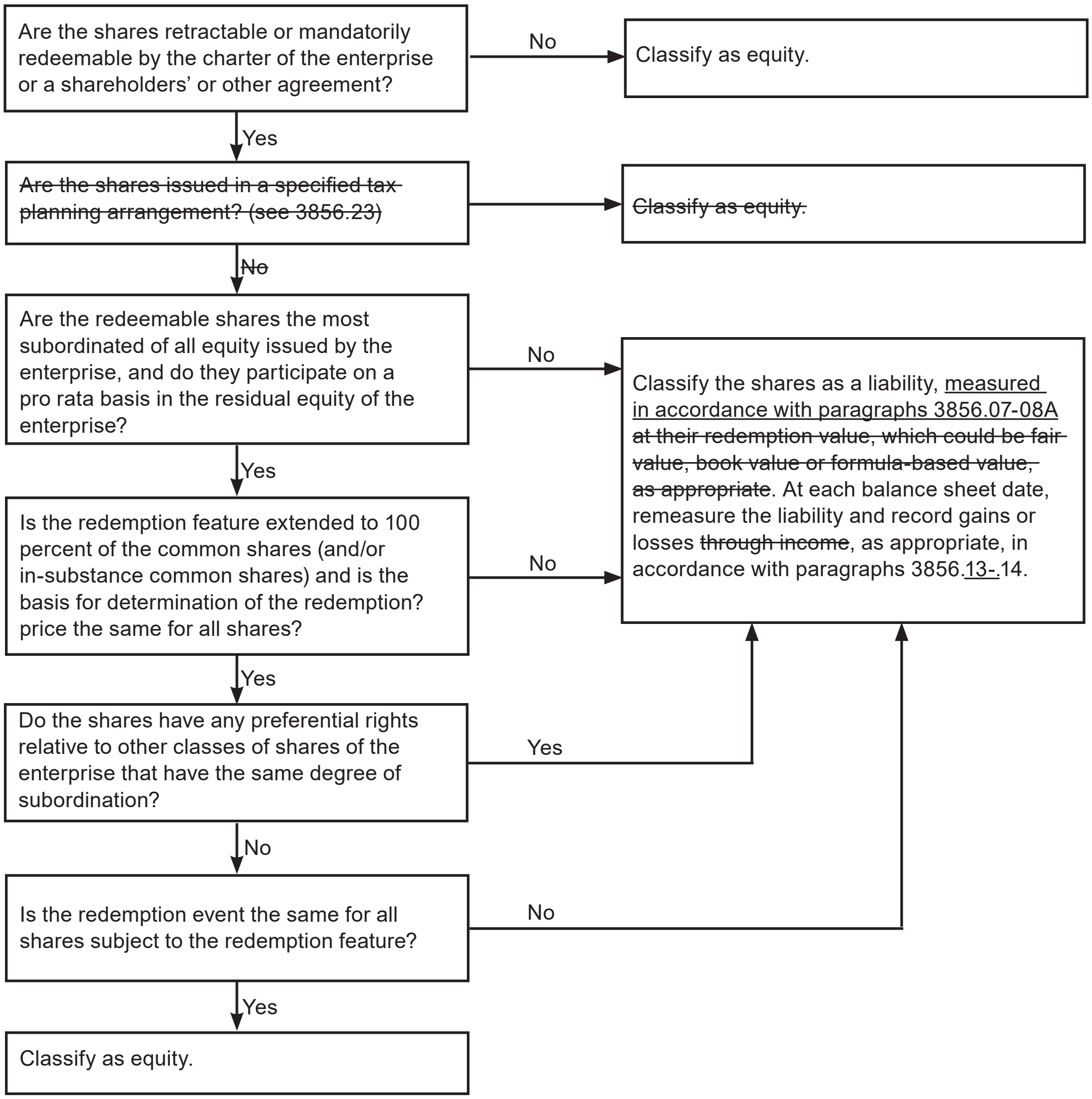
If any of these conditions are not met at the date the amendments are applied for the first time, the retractable or mandatorily redeemable shares issued in a tax planning arrangement shall be classified as a financial liability, in accordance with paragraph 3856.08A.

.65 When an enterprise chooses to apply the amendments at the beginning of the earliest period presented, in accordance with paragraph 3856.63(a), the enterprise is not required to make retrospective adjustments in respect of retractable or mandatorily redeemable shares issued in a tax planning arrangement that were extinguished prior to the beginning of the fiscal year in which the amendments are first applied.

APPENDIX A

LIABILITIES AND EQUITY

A29 Decision tree — Classification of retractable or mandatorily redeemable shares



CONSEQUENTIAL AMENDMENTS

The following significant consequential amendments have been identified. Additional text is denoted by underlining and deleted text by strikethrough.

FIRST-TIME ADOPTION, Section 1500

.21A When an enterprise is applying the amendments for classification of retractable or mandatorily redeemable shares issued in a tax planning arrangement in FINANCIAL INSTRUMENTS, paragraph 3856.23, it may apply the transitional guidance in paragraphs 3856.63-.64.

CURRENT ASSETS AND CURRENT LIABILITIES, Section 1510

.11 *Current liabilities shall be segregated as between the main classes, such as bank loans, trade creditors and accrued liabilities, loans payable, taxes payable, dividends payable, deferred revenues, current payments on long-term debt, retractable or mandatorily redeemable shares issued in a tax planning arrangement and future income tax liabilities. Amounts owing on loans from directors, officers and shareholders, and amounts owing to parent and other affiliated companies, whether on account of a loan or otherwise, shall be shown separately.*

BALANCE SHEET, Section 1521

.05 The following liabilities shall be separately presented on the face of the balance sheet:

(a) main classes of current liabilities in accordance with CURRENT ASSETS AND CURRENT LIABILITIES, paragraph 1510.11;

(aa) retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as a liability (see FINANCIAL INSTRUMENTS, Section 3856);

(b) liabilities for future income taxes 2 (see INCOME TAXES, Section 3465)*;*

(c) liabilities of disposal groups classified as held for sale (see DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS, Section 3475)*;*

(d) (deleted)

(e) (deleted)

(f) long-term debt (see FINANCIAL INSTRUMENTS, Section 3856).

(g) (deleted)

(h) (deleted)

SHARE CAPITAL, Section 3240

.19 ~~Preferred~~ Retractable or mandatorily redeemable shares issued in ~~certain~~ a tax planning arrangement~~s~~ that are classified as equity in accordance with FINANCIAL INSTRUMENTS, Section 3856, are presented in accordance with the requirements of ~~that Section~~ EQUITY, Section 3251.

INCOME TAXES, Section 3465

.72 Any taxes refundable on payment of amounts related to an item classified as a liability represent an advance payment in respect of an expense and are recorded as an asset.

Examples

(a) An enterprise pays refundable tax of $100 related to investment income earned. The tax will be refundable at a rate of $1 for every $3 of dividends paid on instruments that are shares under corporate law.

When preferred shares are included in liabilities on the basis of a mandatory dividend requirement, it is presumed that dividends will be paid in future. When such dividends would give rise to a recovery of all or part of the refundable taxes paid, the refundable portion is recorded as an asset.

When the only way to recover the tax is by payment of a dividend on an amount included in equity, the tax is charged to retained earnings unless there is no expectation of paying dividends in the future.

When there is no reasonable expectation of paying dividends in the foreseeable future, the amount of the tax paid is included in income tax expense in the income statement.

(b) For retractable <u>or mandatorily redeemable</u> ~~preferred~~ shares <u>issued in a tax planning arrangement</u> classified as a liability in accordance with FINANCIAL INSTRUMENTS, Section 3856, payment of the amount of the liability might give rise to a deemed dividend for tax purposes. When such a deemed dividend will give rise to a refund of taxes previously paid, the amount of the refundable taxes is included in future income tax assets.

RELATED PARTY TRANSACTIONS, Section 3840

Example 4 — Sale of building with a Section 85 rollover election

Assume the same facts as those presented in Example 3, except that in this example, Company A sells the building to Company B using a rollover election, in accordance with Section 85 of the ITA.

The consideration received is equal to the arm's length equivalent value of the building of $1,000 and is composed of cash (equal to the elected transfer price of $800) and <u>retractable or mandatorily redeemable</u> shares (equal to the arm's length equivalent value of the building of $1,000 less the elected transfer price of $800).

Entries by Company A (Seller)

Transaction measured at exchange amount (elected transfer price = $800)	Transaction measured at carrying amount (elected transfer price = $800)
Dr. Cash 800 Dr. Investment in Co. B 200 Cr. Building 700 Cr. Gain 300 To record sale of building	Dr. Cash 800 Dr. Investment in Co. B ~~1~~ 200[5] Cr. Building 700 Cr. Contributed surplus ~~101~~ 300 To record sale of building
Dr. Future income tax expense 40 Cr. Future income tax liability 40 To record future income taxes related to the sale of the building	Dr. Contributed surplus 40 Cr. Future income tax liability 40 To record future income taxes related to the sale of the building
Dr. Future income tax expense ~~60~~ 40 Cr. Future income tax liability ~~60~~ 40 To record future income taxes as a result of the difference between the tax basis of the shares received [$0] and the amount for financial statement purposes [$200 x ~~.75~~.50[6]x .40] (Note that this entry would not be recorded when Company B is a subsidiary or joint arrangement of Company A and it is apparent that the temporary difference will not reverse in the foreseeable future.)	Dr. Contributed Surplus 40 Cr. Future income tax liability 40 To record future income taxes as a result of the difference between the tax basis of the shares received [$0] and the amount for financial statement purposes [$200 x .50[6] x .40] (Note that this entry would not be recorded when Company B is a subsidiary or joint arrangement of Company A and it is apparent that the temporary difference will not reverse in the foreseeable future.)

~~The first two entries are identical to the journal entries in Example 3. In the transaction measured at the exchange amount, the future income tax effects of the share transfer are recognized for the temporary difference created on the acquisition of the shares in Company B. No equivalent entry is required in the transaction measured at the carrying amount since the shares are measured at a nominal amount for accounting purposes. (The explanation for, and calculation of, the two entries in each column is contained in Example 3.)~~

5 The investment is valued at $200 as the consideration exchanged is retractable or mandatorily redeemable shares measured at the redemption amount.

6 The inclusion rate for taxable capital gains is revised to 50%.

Entries by Company B (Buyer)

Transaction measured at exchange amount (elected transfer price = $800)	Transaction measured at carrying amount (elected transfer price = $800)
Dr. Building 1,000 Cr. Cash 800 Cr. Share capital 200 To record purchase of building	Dr. Building 700 Dr. ~~Retained earnings~~ Other equity[7] ~~101~~ 300 Cr. Cash 800 Cr. ~~Share capital~~ Retractable or mandatorily redeemable shares issued in a tax planning arrangement ~~1~~ 200 To record purchase of building
Dr. Building 133 Cr. Future income tax liability 133 To record future income taxes on purchase of building	Dr. Future income tax asset 40 Cr. Retained earnings 40 To record future income taxes on purchase of building
The difference between the carrying amount of the building of $1,000 and its tax basis of $800 is a taxable temporary difference. In accordance with paragraph 3465.41, the cost of future income tax is added to the carrying amount of the asset. The cost of future income taxes is determined as $200 x (.40)/ (1 – .40) = $133.	The difference between the carrying amount of the building of $700 and its tax basis of $800 is a deductible temporary difference. In accordance with paragraph 3465.59, since the difference between the carrying value of the asset acquired and the exchange amount is charged to retained earnings, the future income tax benefit of $40 ($100 x .40) related to the transaction is credited to retained earnings.

The main difference between Example 4 and Example 3 is that, in the transaction measured at the carrying amount without a rollover election, in Example 3, there is a tax cost to the seller and a related increased amount of potential recovery for the buyer. In Example 4, a portion of the tax liability is transferred to the buyer, which reduces the future income tax benefit to the buyer by $60.

[7] In accordance with EQUITY, paragraph 3251.06A and FINANCIAL INSTRUMENTS, paragraph 3856.23.