Moodys Gartner Tax Law responds to Accounting Standards Board on proposed accounting treatment of redeemable preferred shares issued in tax planning arrangements

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Our firm has long believed that accountants and lawyers should work together in the delivery of tax services. Both professions bring different skill sets and perspectives to the table when crafting client solutions. To that end, we purposely employ both professions in our tax law firm. It is common when dealing with tax matters that an issue will arise that requires input from both accountants and lawyers, and the subject of this article is a great example. In October 2014, the Accounting Standards Board ("AcSB") released an Exposure Draft that, if implemented, will have great consequences for many private enterprises when reporting certain common tax planning arrangements, as discussed in more detail below.

Background to the proposals

For private enterprises in Canada, redeemable preferred shares have long been a tool of choice when it comes to tax and estate planning. Redeemable preferred shares are often issued to fully or partially "freeze" the value of an owner's equity interest in a private corporation, or to allow a contribution of assets by the owner into the corporation on a tax-deferred ("rollover") basis.

Under section 3856 of the Accounting Standards for Private Enterprises ("ASPE"), financial instruments are required to be classified as a liability or as equity, or a combination of both, in accordance with the substance of the contractual arrangement. Since preferred shares that are redeemable at the option of the holder represent an obligation of the issuer to repay an amount in the future, these would normally be initially recognized as a financial liability at fair value. However, paragraph 3856.23 of the current ASPE provides an exception to this general rule. Under such paragraph, preferred shares issued in a tax planning arrangement under Sections 51, 85, 85.1, 86, 87, or 88 of the Income Tax Act (the "Act") shall be presented as equity at par, stated or assigned value, with a description indicating that they are redeemable at the option of the holder.

While such redeemable preferred shares may have a high redemption value (equal to the value "frozen" or the value of the assets contributed), they are usually assigned a low stated capital in order to achieve the desired tax results. Hence, these preferred shares are sometimes referred to by practitioners as "high-low shares." Because of paragraph 3856.23, issuing these high-low shares as part of a tax plan usually causes little impact to a private company's financial statements since these shares would be reported as equity and measured at their nominal stated capital amounts.

Paragraph 3856.23 was introduced more than 10 years ago and most practitioners and clients we work with agree that it is the correct accounting policy. The redeemable preferred shares issued in freeze and rollover transactions are legally equity and thus the current accounting treatment is consistent with its legal form. While it is true that, by issuing such shares, the enterprise has entered into a binding commitment to redeem the preferred shares in the future, most believe that characterizing this commitment as a liability is not consistent with the economic, business, and legal realities. In most cases, the business owner will retain these redeemable preferred shares, gradually redeem them over

time, and allow the next generation to "buy-in" by subscribing for reasonably priced common shares. Typically, such freeze transactions involve an exchange of the owner's common shares into redeemable preferred shares. If the redeemable preferred shares were to be reported as a liability at the redemption amount, a misleading "lopsided" financial statement would result: a liability equal to a portion or the entirety of the fair value of the net assets, but assets that remain at historical costs with no recognition for off-balance-sheet assets such as goodwill and other intangibles.

The AcSB proposals

As mentioned above, in October 2014, the AcSB released an Exposure Draft titled "Redeemable Preferred Shares Issued in a Tax Planning Arrangement that proposes changes. In the Exposure Draft, the AcSB reflected upon the treatment of preferred shares under paragraph 3856.23, and identified two issues with the current treatment. Firstly, the AcSB thought that the sections of the Act referred to in paragraph 3856.23 were overly narrow, such that redeemable preferred shares issued in some circumstances (such as on a stock dividend) fall outside of the paragraph, leading to inconsistent treatment merely because one tax plan relied on sections referred to in paragraph 3856.23 and the other does not. Secondly, the AcSB noted the usage of paragraph 3856.23 to avoid classifying redeemable preferred shares as liabilities in the context of transactions such as commercial financing arrangements, business combinations, or employee incentive programs, but paragraph 3856.23 was not intended to be applicable to those types of transactions.

As a result, the AcSB has proposed that the exception in paragraph 3856.23 be deleted so that all redeemable preferred shares be presented as a liability at its fair value, consistent with other liabilities, regardless of the context they were issued under. To record this liability, the offsetting side of the entry (in accounting speak, the debit side) would be recorded as a separate component of equity. The AcSB recognizes that the treatment results in a lopsided balance sheet since liabilities would be measured at fair value while assets remain at historical cost, but decided against requiring the revaluation of assets so as to prevent this lopsided result (in accounting speak, this is referred to as "push-down accounting"). In its cost-benefit analysis, the AcSB stated its view that most financial statement users today are sophisticated enough to understand the true impact of the redemption feature of preferred shares on an enterprises' resource. As such, users will adapt accordingly and the cost of implementation will not be significant. Also, since the fair value of a preferred share is usually its redemption amount, the initial recognition process would not, in its opinion, be onerous. The proposed change would apply retrospectively, and is proposed to be effective 2016.

Having studied the AcSB's Exposure Draft, we strongly felt that AcSB's proposals were misguided. The AcSB invited comments on the proposals and, accordingly, we have submitted a letter to the AcSB outlining our views on this matter. You can read a copy of our full submission here.

Below are the highlights of the points we raised in our letter:

- The underlying rationale behind paragraph 3856.23 still holds true today. It is difficult to imagine how a lopsided balance sheet and the decoupling of the logical relationship between assets and liabilities/equity would improve the relevance and understandability of the balance sheet. Such an accounting treatment would reflect an "accounting fiction" and not respect legal realities;

- Classifying the entire redemption amount of a preferred share issued on a freeze or rollover transaction as a liability is inconsistent with the economic, business, and legal realities. Redemption of those shares typically occurs over a lengthy period of time because the holder of such shares is usually an owner-manager who is interested in not jeopardizing the viability of the

enterprise. Also, provincial corporate statutes generally limit the extent of redemption allowed. Further, these preferred shares often have tax basis below redemption value. In order to manage the tax liability upon redemption, these shares are often redeemed gradually, or not redeemed at all until the holder's death;

- If an enterprise's value decreases after a freeze or rollover transaction, the redemption amount shown as a liability may be nonsensical since a full redemption would be impossible, but there would be no way to "write-down" this liability amount;

- Recording the redemption values as a liability will significantly weaken financial ratios of affected private enterprises, and will cause many to violate their loan covenants;

- The users of financial statements of private enterprises are usually front-line loan officers, credit department of suppliers and vendors, and potential acquirers of the business. It would be naïve to think that none of them would dismiss outright a private enterprise from its loan/credit/acquisition consideration after seeing the negative equity and exaggerated liability on the enterprise's balance sheet that arose from a freeze or rollover transaction;

- The initial recognition of the redeemable preferred share at their fair value may not be as straightforward as AcSB contemplates. These shares are usually issued with price adjustment clauses so that the redemption amount automatically adjusts in the event the fair value at the time of the transaction was subsequently determined to be different. When triggered, this adjustment applies retroactively to the date of the transaction. This problem is compounded for shares that were issued years ago but that would also have to be valued at fair value under the proposal due to retrospective application;

- A preferred share issued on a freeze transaction may be redeemable for an amount that is a significant portion or the entirety of the value of an enterprise. If such preferred shares are classified as a liability, the enterprise may potentially be prevented from paying a dividend since provincial corporate statute usually imposes liquidity and solvency requirements; and

- We highlighted that the proposal may affect the application of interest deductibility rules such as the "thin-capitalization" rule under subsection 18(4) of the Act or the "fill the hole" test developed by the courts because these rules operate based on accounting concepts of debt and equity. The Canada Revenue Agency ("CRA") has previously commented that preferred shares would be treated as equity irrespective of their accounting classification when applying the thin-capitalization rule.[1] However, it is uncertain whether taxpayers can still rely on this administration position given it was issued in 1996, and accounting standards have changed tremendously since then.

In our letter, we recommended an alternative approach of amending ASPE section 3856 to address AcSB's stated concerns. Under our recommended approach, paragraph 3856.23 would be retained, but its wording would be amended to clarify that it would only apply in a related party context, the main purpose of which is to facilitate an inter-generational transfer of ownership, or to facilitate the tax deferred transfer of assets. The paragraph may also specifically exclude transactions where fixed value redeemable preferred shares are issued as part of a commercial financing arrangement, a business combination, or a key employee incentive program. Additionally, we recommended enhancing the disclosure of redeemable preferred shares by requiring the disclosure of the aggregate redemption value on the face of the balance sheet. We believe that our recommended alternatives will improve the relevance and understandability of financial statements involving redeemable preferred shares, while

minimizing the cost involved in implementation.

We hope the AcSB will heed our comments, as well as those of numerous other practitioners who have responded to the Exposure Draft. If the AcSB proceeds with the proposal, enterprises that have undertaken freeze and rollover transactions, both of which are longstanding and well-accepted tax planning techniques, will be subject to immense cost. It will also mark a major shift in the tax planning landscape going forward for practitioners.

[1] CRA Views document number 9619120 – "CICA 3860 shares reclassified as debt"