

January 22, 2015

by email: ed.accounting@cpacanada.ca

Ms. Rebecca Villmann, Director, Accounting Standards
Accounting Standards Board
277 Wellington Street West
Toronto, ON M5V 3H2

Dear Ms. Villmann:

Re: Invitation to Comment on Exposure Draft – Redeemable Preferred Shares Issued in a Tax Planning Arrangement.

We appreciate the opportunity to respond to the Accounting Standards Board (“AcSB”) Exposure Draft (“ED”) on Redeemable Preferred Shares Issued in a Tax Planning Arrangement issued in October, 2014.

We agree with the conclusion that the AcSB reached that these instruments are liabilities. The fundamental question that we believe needs to be addressed, is whether there are transactions or circumstances where it is appropriate to provide an exception to liability treatment for certain types of redeemable equity instruments. We note that other major accounting frameworks, including IFRS, IFRS for SMEs and US GAAP, all provide exemptions from liability treatment for certain classes of puttable or redeemable equity (i.e. instruments redeemable at the option of the holder) which meet specified criteria. We believe it is appropriate for the AcSB to re-consider the cost/benefit analysis supporting the conclusions in the Exposure Draft requiring all redeemable equity instruments to be presented as financial liabilities as we believe that the benefits to continue to present redeemable equity instruments issued as part of estate freeze transactions as equity instruments outweigh the costs. In fact, our preliminary analysis has identified certain potential costs associated with presenting redeemable equity instruments associated with estate freeze transactions as financial liabilities that may not have been considered by the AcSB.

We do believe that 3865.23 requires redrafting and that not all redeemable instruments eligible to be classified as equity under 3865.23 as currently drafted should be eligible for equity classification. The current wording in 3865.23 in our experience can be applied to a broad range of transactions, including certain financing transactions which were effected through the use of the referenced Income Tax Act sections and therefore we propose that instead of deleting 3865.23, the AcSB should amend 3865.23 to further limit the scope only to estate freeze transactions, rather than eliminating the paragraph in its entirety.

Please find attached our comments to the specific questions raised in the Exposure Draft. If you require any further information, please contact Jon Kligman at 416-874-3638 or Brian Devereux at 604-640-4994.

Yours truly,

A handwritten signature in cursive script, appearing to read "Julie Corden".

Julie Corden
National Professional Practice Director
Private Companies, Public Sector and Not-for-Profit Organizations
Deloitte LLP

1. Do you agree that the preferred shares described in FINANCIAL INSTRUMENTS, paragraph 3856.23 are liabilities and that paragraph 3856.23 should be deleted in accordance with the cost/benefit assessment set out in the Basis for Conclusions in this Exposure Draft in order to improve financial reporting? If not, why not? What aspect of the cost/benefit assessment do you disagree with?

We agree that the preferred shares described in FINANCIAL INSTRUMENTS, paragraph 3856.23 are financial liabilities.

However, we believe that paragraph 3856.23 is an important and relevant concept for transactions such as estate freezes and instead of deleting the paragraph in its entirety, the scope of the paragraph should be limited.

We believe that there are additional factors to consider which support the amendment of 3856.23 to limit the scope rather than deletion of the paragraph in its entirety. These factors include the following:

a. Estate freeze transactions are different from commercial, arms-length transactions

In a typical estate freeze transaction, the current owners will exchange their common shares in a business for redeemable preferred shares whose value is fixed at the value of the business at the date of the estate freeze. In order that the preferred shares qualify for tax-free roll-over treatment, they are generally issued as redeemable on demand at the option of the holder. The beneficiaries (e.g. adult children) generally subscribe for common shares in the company at a nominal amount in order to benefit from its future growth. Because the objective of the transaction is to ensure that the private company survives within the family in the long-term, in most cases, the shareholders of the preference shares do not have an intention to redeem the shares in the short-term and these shares will only be redeemed when the company has sufficient cash resources to fund both the redemption and its long-term operating requirements, including the payment of financing obligations. As a result, the redeemable preferred shares function similar to equity until redemption is demanded by the holder. Paragraph 3856.23 permitted such shares to be classified as equity at their stated, par or assigned value until redemption was demanded, at which point they were re-classified as liabilities and re-measured at their redemption amount. Absent this exception, these shares would have appropriately been classified as financial liabilities and measured at their fair value on the date of issuance. However, this would have resulted in a significant increase in liabilities and a corresponding "debit" to equity, to reflect the imbalance created by recognizing the fair value of the business in the redeemable preferred share liability without recognizing the fair value of the assets which contributed to this.

On the basis of the discussion in the Exposure Draft, it does not appear that the accounting for redeemable preferred shares in an estate freeze transaction is at issue; rather the issue is in the inappropriate extension of paragraph 3856.23 to commercial exchange transactions with arm's length parties (e.g. redeemable preferred shares issued to a venture capitalist for cash in a financing transaction). We agree that preferred shares which are issued in these types of commercial transactions and are redeemable at the option of the holder should be accounted for as financial liabilities and measured at fair value, consistent with the accounting for the consideration received in the exchange. As a result, one possible option would be to amend paragraph 3856.23 to restrict the equity treatment permitted by paragraph 3856.23 to estate freeze transactions and, therefore, prevent entities which issue redeemable preferred shares in other transactions from applying this exception (this is elaborated on further in the response to question 2).

b. Adverse tax consequences

Our understanding is that there may be adverse tax consequences for private companies with business operations in Quebec. Under the Quebec Income Tax Act, a corporation must calculate its taxable capital. The amount of the taxable capital is increased by the amount of the paid-up capital stock and by any debt in existence for more than 6 months. Therefore, the proposed amendment will result in an increase in the taxable capital equal to the amount of the preferred shares that is recognized as debt in the financial statements. However, the separate charge that would be recognized in equity would not reduce the taxable capital of the corporation for Quebec purposes. The Quebec Income Tax Act provides for specific amounts to be deducted and, unlike the federal Income Tax Act, it does not contain a specific provision to allow for the deduction of the amount that would be recognized in a separate component in the equity of the corporation.

While this impact could seem irrelevant for a corporation since Quebec has not imposed a capital tax since 2010, the resulting increase in the taxable capital due to the proposed change could have a negative impact on the amount of income tax that a corporation would have to pay. This negative impact can come from a reduction of the amount of income that could be eligible for the small business deduction and/or a reduction in the level of investment tax credit that the private company could receive. More specifically, the level of taxable capital is still taken into consideration in the following:

- To determine the amount of active business income that is eligible for the small business deduction. In Quebec, the first \$ 500,000 of active business income is eligible for a reduction of income taxes for the small business deduction. However, the \$ 500,000 is reduced proportionately for every dollar of taxable capital that exceeds \$ 10,000,000. Once a Canadian controlled private company reaches \$ 15,000,000 of taxable capital, it is not eligible to the small business deduction. The proposed amendment could increase the tax cost of a private company (up to 7.9% increase in tax payable for small to medium manufacturing enterprises, 3.9% for the other Canadian controlled private corporations).
- A private corporation that meets certain conditions, one of which is to have a taxable capital that is less than \$ 10,000,000, can make instalments on a quarterly basis instead on a monthly basis. The proposed change could have a negative impact on the cash flows of such corporation and potentially increase its interest costs.
- The Quebec Income Tax Act allows an investment tax credit for certain investment in manufacturing and processing equipment. The taxable capital is used in the determination of the eligibility of a corporation to have access to an increase in the basic investment tax credit rate and on the calculation of the refundable portion. Again the proposed changes could have a negative impact by reducing the amount of the investment tax credit that could be refunded.

The Accounting Standards Board (AcSB) staff have noted in the Exposure Draft that based on input they have received from several tax experts that liability classification would not impact the Small Business Deduction. (pg. vii-viii) Given that the foregoing observations, we would recommend that further research and/or consideration be given to assessing the potential tax consequences which could be triggered if redeemable preferred shares issued in certain tax planning arrangements are reclassified as liabilities.

c. Potential adverse financing implications

The Exposure Draft notes that the AcSB staff have consulted with lenders from a range of financial institutions in different parts of Canada and have concluded that such users would be able to identify and understand the nature of redeemable preferred shares issued in a tax planning arrangement and would not interpret an entity having negative equity for this reason as meaning the entity is in immediate financial trouble. (pg. v).

We are unable to say conclusively how the reclassification of redeemable preferred shares from equity to liabilities will impact lending practices. It is possible however that lenders outside of the group consulted by the AcSB may not have as thorough an understanding of the implications if the redeemable preferred shares were reclassified from equity to liabilities. As a result, this creates the risk that some lending institutions could potentially adjust the credit or risk rating of entities leading to reduced lending facilities, increase collateral or personal guarantee requirements and/or result in companies incurring additional fees to revise existing lending agreements.

d. Potential adverse business implications

We understand that private entities which rely on working capital or equity as a key metric in their business may be adversely affected. For example, construction and other companies which tender bids with the Ministry of Transportation of Ontario (MTO) are given a financial rating based on several metrics, one of which is “net current assets”. If the classification of the redeemable preferred shares resulted in presentation of these instruments as current liabilities, such classification would appear to reduce such metric and, therefore, may restrict a company’s ability to bid on certain contracts.

We further understand that entities, such as construction companies, which are required to obtain performance bonds may be adversely affected as a result of such reclassification.

Some companies also provide their financial statements to suppliers as a means of assisting them in evaluating the company’s creditworthiness and establishing credit limits. As all suppliers may not be as knowledgeable as to the nature of such shares, they may not fully appreciate the implications of presenting such shares as liabilities to their own supply decisions.

e. Potential measurement challenges

Given that the preferred shares issued in such arrangements are redeemable on demand at the option of the holder, they would be presented on the balance sheet as current liabilities (unless a waiver is obtained from the holder agreeing to waive redemption for a period of at least 12 months from the balance sheet date). If a waiver is obtained that provides that the holder will not demand repayment for a period greater than 12 months from the balance sheet date (e.g. for 2 years), the liability would be discounted over that period. However, if on the expiry of the waiver, the entity subsequently agrees to defer its option to redeem payment for a longer period (e.g. 5 years), then a question arises as to whether the change represents a modification of the liability or a settlement. In line with the intentions of the holder of many of these instruments, there is a possibility that the redemption date may become a “moving target”. This may cause complexities when measuring the liability – specifically, in determining whether changes to the period over which redemption will be made constitute a modification or extinguishment of the liability. Many private companies may also have difficulty determining the appropriate discount rate to use to perform the calculations if they do not obtain third-party, arms-length financing and thus would not have ready access to a “market discount rate”.

2. If you think there are sufficient cost/benefit arguments to justify retention of the equity classification, how should paragraph 3856.23 be amended to address the issues with that paragraph noted in the Basis for Conclusions?

Due to the potential incremental costs for entities reporting under ASPE, we believe the wording of paragraph 3856.23 may be revised to provide for equity treatment of certain preferred shares in line with the original intention and reduce any abuse of the current wording. As noted in the Exposure Draft, the original intention of paragraph 3856.23 was to provide private companies with an exception from recording redeemable preferred shares issued in estate freeze transactions as liabilities. Therefore, one potential way to prevent abuse would be to restrict the application of paragraph 3856.23 only to estate freeze transactions effected by the issuance of redeemable preferred shares where those transactions are (1) non reciprocal in nature or (2) the only consideration is the exchange of the company's common shares or preferred shares classified as equity that had been held by a common shareholder.

An estate freeze transaction refers to a transaction where the current owner (i.e. the parent) transfers the future growth in the value of a business or assets into the hands of the subsequent generation. An estate freeze can be accomplished by the current owner (i.e. the parent) exchanging his or her common shares in the family business for preferred shares whose value is fixed equal to the fair value of the business on the date of the estate freeze and which are redeemable on demand at the option of the holder. The subsequent generation (i.e. the children) may then subscribe for common shares for nominal consideration in order to be able to participate in the future growth of the business. The current owner often maintains control over the business for the foreseeable future (which may be accomplished by making the redeemable preferred shares voting shares with sufficient voting rights to outvote the beneficiary at least until the preferred shares have been substantially redeemed). Often, the holders of the preferred shares do not have an incentive to redeem these shares in the short-term as doing so could threaten the survival of the company and, as a result, they remain outstanding similar to equity financing until redemption is demanded.

If the redeemable preferred shares issued in an estate freeze are recognized as liabilities and measured at their fair value this would cause an "imbalance" in the financial statements because the increase in the value of the business would be captured in the redeemable preferred shares with no increase in the value of the assets which contributed to this. Such imbalance would not exist where redeemable preferred shares are issued to a third party in a commercial transaction as the preferred shares would be exchanged for incoming cash or other assets (e.g. cash received from a venture capitalist in the case of a financing). This "imbalance" could be addressed by allowing paragraph 3856.23 to be applied only to estate freeze transactions where the transactions are: (1) non-reciprocal in nature or (2) the only consideration is the exchange of the company's common shares or preferred shares classified as equity that had been held by the common shareholder. These conditions are described further below:

(1) Non-reciprocal

An estate freeze transaction could be accomplished through a stock dividend. In a simple scenario, the current owner holds all of the common shares of a company. The company issues a stock dividend to the current owner in the form of redeemable preferred shares whose value is equal to the fair value of the business and which are redeemable on demand by the current owner. The current owner would then cancel his or her common shares. The beneficiaries would then subscribe for common shares in the business for nominal consideration. This transaction is "non reciprocal" in that the current owner does not exchange any consideration for the receipt of the redeemable preferred shares. Therefore, estate

freeze transactions which are non-reciprocal would fall within the scope of paragraph 3856.23 and the redeemable preferred shares would be recorded in equity at their par, stated or assigned value.

(2) Only consideration exchanged is the company's common or preferred shares classified as equity that had been held by the common shareholder

An estate freeze could also be accomplished where the current owner exchanges his or her common shares and any preferred shares held which are classified as equity in the business for redeemable preferred shares in that business. The preferred shares would have a redemption amount fixed at the value of the business at the date of the estate freeze and would be redeemable on demand by the current owner. The beneficiaries would then subscribe for new common shares for nominal consideration. In this case, the only consideration being exchanged by the current owner would be one form of equity in the business for another. Therefore, estate freeze transactions where the only consideration exchanged is common shares and/or preferred shares classified as equity in the business for redeemable preferred shares in the business would qualify for the exception in paragraph 3856.23. Therefore, an estate freeze transaction whereby the parent receives cash, a promissory note or other consideration in addition to redeemable preferred shares would not be eligible for the exception.

(3) Use of a holding company

This is a variation on point (2) above. In some circumstances, an estate freeze may be accomplished through the use of a holding company. For example, the current owner may establish a holding company and transfer his or her common shares and any preferred shares classified as equity in the business into such holding company. The holding company would then issue redeemable preferred shares to the current owner equal to the fair value of the business and the beneficiaries would subscribe for common shares for nominal consideration. Often, the transfer by an individual of an asset into a wholly-owned holding company will result in the transaction falling in the scope of Section 3840. From the holding company's perspective, the next consideration is whether there has been a substantive change in the ownership interest of the business transferred. We note that paragraph 3840.38 provides that non-voting participating shares issued to unrelated parties (e.g. adult children) as part of an estate freeze generally do not give rise to a substantive change in ownership interests. Therefore, in the holding company's financial statements, if there is no substantive change in the ownership of the business transferred, the business would be recorded at its carrying value in the balance sheet of the transferred business. Consideration may be given to applying the proposed exception in paragraph 3856.23 to the measurement of the redeemable preferred shares issued by the holding company where there is no substantive change in the ownership of the business transferred, the holding company holds no other assets or liabilities, and the only consideration exchanged for the redeemable preferred shares is the common shares and preferred shares classified as equity held by the common shareholder.

As the objective of the amendment to paragraph 3856.23 would be to capture estate freeze transactions only, it would be appropriate to remove references to the Income Tax Act sections which could be used to accomplish estate freezes as well as other commercial transactions. A secondary issue is how to account for redeemable preferred shares when they are required to be redeemed in accordance with a repayment schedule from the date of issuance. In our view, in those circumstances, those redeemable preferred shares would qualify as financial liabilities as their redemption in cash is, in effect, pre-programmed. The proposed wording in **Appendix A** illustrates how paragraph 3856.23 might be modified to address these issues.

3. Do you agree that the adjustment to equity as a result of recognizing and measuring the liability should be presented in a separate component of equity? If not, how should the adjustment be presented?

Yes, we agree that in the event that paragraph 3856.23 is deleted, the adjustment to reflect the change in carrying value to fair value of the preferred shares should be presented as a separate component of equity.

4. Do you think that COMPREHENSIVE REVALUATION, Section 1625, should be amended to clarify when the conditions to apply push-down accounting are met for some of the transactions covered by paragraph 3856.23? If so, what aspects of Section 1625 should be clarified? In your view, to what extent would entities apply push-down accounting?

We believe that in the event that paragraph 3856.23 is deleted, it would be beneficial to amend Section 1625 to provide an accounting policy choice to allow entities to apply Section 1625 to capture the fair value of assets and liabilities which are directly correlated with the issuance of redeemable preferred shares in an estate freeze. This accounting policy choice would allow entities to mitigate the potential significant reduction in equity as a result of only recording a fair value adjustment to preferred shares upon elimination of paragraph 3856.23.

An entity may choose to apply comprehensive revaluation depending on the cost/benefit of obtaining sufficient support for the valuation and the resulting costs of an audit or review, if subject to audit or review.

5. Do you agree that the current disclosure requirements in Section 3856 are appropriate for redeemable preferred shares currently accounted for under paragraph 3856.23? If not, why not and how should the disclosures in Section 3856 be amended?

We agree that the current disclosure requirements in Section 3856 are appropriate for redeemable preferred shares currently accounted for under paragraph 3856.23.

6. Do you agree with the proposed disclosures in EQUITY, Section 3251, in respect of the presentation of the effect of liability recognition as a separate component of equity? If not, why not and what disclosures, if any, should be provided?

Yes

7. Do you agree that the proposals should be applied retrospectively in accordance with ACCOUNTING CHANGES, Section 1506? If not, why not?

Yes

8. Do you agree with the proposed effective date (i.e., fiscal years beginning on or after January 1, 2016)? If not, why not?

Yes, provided that a final standard is issued on or before June 30, 2015 to provide entities with sufficient time to meet with the users of their financial statements to renegotiate and revise existing agreements prior to the proposed effective date.

Appendix A

.23

An entity that issues preferred shares that are redeemable at the option of the holder in an estate freeze transaction would classify the preferred shares as equity, except as otherwise indicated. Estate freeze transactions represent an inter-generational transfer of a business or other assets where the value retained by the current owner is frozen at the date of the transfer.¹ Estate freeze transactions within the scope of this paragraph are non-reciprocal transactions and transactions where the only consideration is the exchange of the company's common shares or preferred shares classified as equity that have been held by the current owner. This transaction can also be accomplished through the establishment of a holding company that acquires the parent's shares in exchange for redeemable preferred shares, where such holding company does not hold other assets or have other liabilities, there is no substantive change in ownership in the business or assets transferred, and the only consideration for the redeemable preferred shares would be the common shares or preferred shares classified as equity that have been held by the current owner. This explicitly excludes transactions where redeemable preferred shares are issued to third parties in exchange for financing and any other transactions where the redeemable preferred shares are issued for consideration other than the company's own shares.

23A

The redeemable preferred shares issued in an estate freeze transaction described in paragraph 23 shall be presented at their 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. When redemption is demanded, the issuer shall reclassify the shares as liabilities and measure them at the redemption amount. Any adjustment between the carrying amount of the shares and their redemption amount shall be recognized in retained earnings. When the terms of such preferred shares issued require redemption by the holder for cash or other financial assets over a scheduled period of time, they shall be classified as financial liabilities upon their issuance, or where such scheduled redemption is imposed subsequent to issuance, at the date of such event.

¹ An estate freeze with the above described objective can also be accomplished between an individual and his or her brother or sister.