Amend the Definition of “Liability” in the Alberta Business Corporations Act

Issue

Recent accounting changes implemented by the Chartered Professional Accountants of Canada, effective for fiscal years beginning on or after January 1, 2021, require retractable or mandatorily redeemable shares **("ROMRS")** issued in a tax planning arrangement be classified in the issuer corporation's financial statements as liabilities, rather than outstanding equity shares. These changes are wholly inconsistent with long-standing tax policy under the *Alberta Corporate Tax Act* as well as the *Income Tax Act* (Canada) and will seriously impede a wide range of tax planning transactions commonly undertaken by Alberta entrepreneurs.

Background

Recent changes implemented by CPA Canada will affect holders of preferred shares of a private corporation that carry a right to require the redemption on demand of those shares if they were issued as part of a “tax planning arrangement”[i]. The amendments (which presently are in effect) "provide new conditions that must be met in order for ROMRS issued in a tax planning arrangement to be classified as equity…”. In reality, in our view, these "new conditions" will rarely be able to be met - with the result that retractable preferred shares that are issued by many private corporations in Alberta to achieve legitimate tax planning objectives (including estate freezes and non-arm's length tax-deferred transfers of property in which taxable gain has accrued) that have long existed in Canada and are broadly accepted by both provincial and federal taxing authorities as constituting legitimate tax planning could be seriously jeopardized. Equally damaging, and the focus of the issue for business owners, is the fact that the balance sheets of a wide range of private corporations that historically have been highly solvent will suddenly appear to be far less solvent, which will seriously and adversely impede their ability to borrow much needed additional capital or attract new equity investors.

Prior to these changes, preferred shares issued in the course of a tax planning arrangement were reported on the balance sheet of the issuing corporation at their stated capital (as equity), irrespective of the redemption amount of the preferred shares. This had a very nominal impact upon the solvency of the balance sheet and served to appropriately reflect the true business-based net equity of the corporation subsequent to the implementation of the tax planning arrangement. With the adoption of the accounting changes, these preferred shares can only be reported as equity if:

- The shareholder receiving the ROMRS retains control of the enterprise after the issuance of the shares;
- The shareholder does not receive any other form of consideration other than the shares; and,
- There is no pre-determined or pre-set redemption schedule or arrangement for the shares.

Quite frankly, these conditions for "equity treatment" will be extremely difficult to meet in the course of any tax planning arrangement.

Where these conditions cannot be met, the preferred shares must be reported as a current liability on the issuing corporation's balance sheet at the redemption amount of the corporation with the off-setting entries to share capital (for the nominal stated capital of the shares) and to equity as a balancing amount.

The implications for private corporations who rely on financing from financial institutions in Alberta could be devastating. Where a corporation is required to report ROMRS as a lability, the immediate impact will be the erosion of the corporation's debt-to-equity ratio as well as the corporation's current ratio – two key ratio indicators for the purposes of debt covenants and financing in Alberta. Both of these ratios consider the impact of the corporation's liabilities in the determination of the ratio and, on a broader scale, the corporation's compliance with their debt covenants.

This anomalous result could be easily avoided if the financial institutions were precluded from including the redemption amount associated with ROMRS in the definition of a "liability" in lending agreements. As these agreements are governed by the terms and provisions of the Alberta Business Corporations Act (**ABCA**), we believe that a simple and elegant fix to this problem can be found in an amendment to the definition of the term "liability" as it is found in paragraph 1(u) of the ABCA and, specifically, in subsection 35(4) of the ABCA to specifically exclude ROMRS.

The Alberta Chambers of Commerce recommends the Government of Alberta:

1. Amends the definition of "liabilities" currently set forth in subsection 35(4) of the ABCA to add the following wording at the end of the current definition:

"…and for the purposes of this Act, a validly issued and outstanding share in the capital of a corporation shall constitute equity, and not a liability, of that corporation notwithstanding the enactment or establishment by any non-governmental body, including one that governs or regulates any profession, of any rule or provision to the effect that any such share shall constitute a liability of the corporation".