Tax Topics®

January 17, 2013
Number 2132

RESTRICTIVE COVENANTS — THE FINAL CHAPTER (FOR NOW) — PART I

— Mark Woltersdorf CA, LL.B., Partner, Fraser Milner Casgrain LLP

This article discusses proposed legislation dealing with the taxation of restrictive covenants. Due to its length, it is divided into two parts. Part I addresses the history, basic inclusion rules, tax treatment to the purchaser, elections to avoid subsection 56.4(2), Ministerial reallocation of proceeds, and the arm's length employee exception. Part II addresses the realization of goodwill and disposition of property exceptions, special provisions, anti-avoidance rules, and transitional provisions. Part II will be published in a subsequent edition of *Tax Topics*.

History

The decisions of the Federal Court of Appeal in *Fortino*[1] and *Manrell*[2] held that payments received by a taxpayer for entering into a non-competition agreement were not income from a source and, therefore, were not taxable. The federal government was not pleased with these decisions, presumably because they did not want to see increasingly larger amounts of otherwise taxable consideration being allocated in an exempt manner. On October 7, 2003, the Department of Finance issued News Release 2003-049, advising that payments received or receivable[3] by a taxpayer after that date for agreeing not to compete would be taxable as ordinary income, subject to certain exceptions.

Nearly 10 years later, legislation implementing these proposals has not been enacted. Draft legislation has been introduced numerous times with the most current version contained in Bill C-48, *Technical Tax Amendments Act, 2012,* which includes a number of previously released provisions (see the October 24, 2012, Notice of Ways and Means Motion [CCH *Special Report* No. 068H]). Bill C-48 received first reading in the House of Commons on November 21, 2012.

It would be reasonable to expect that these provisions will become law some time in 2013. That being said, I made the same prediction in an earlier version of this article in 2007, so clearly there are no guarantees as to when (or if) the current version of the draft legislation will become law. This article summarizes the major changes contained in the proposed provisions contained in Bill C-48.

Income Inclusion — Subsection 56.4(2)

Under subsection 56.4(2),[4] the basic rule is that a taxpayer (or another taxpayer with whom the taxpayer does not deal at arm's length) must include in income the full amount of all amounts received or receivable in a taxation year in respect of a restrictive covenant ("RC") granted by him or her. However, if certain conditions apply, the amount received or receivable can be characterized as a capital gain or a gain arising from cumulative eligible capital, only half of which is included in income.

The definition of an RC[5] is very broad and will apply to most, if not all, forms of agreement not to compete. An RC is partially defined in subsection 56.4(1) as "... an agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer ... that affects, or is intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer ...". The definition is so broad that it may also apply to other agreements, such as lending agreements or non-solicitation agreements. An RC does not have to be enforceable to be subject to the proposed provisions.

Subsection 56.4(3) provides three exceptions to the income inclusion rules in subsection 56.4(2) for amounts received or receivable in respect of an RC granted by a taxpayer to a person with whom the taxpayer deals at arm's length as follows:

(1) paragraph 56.4(3)(*a*) — the amount is required to be included in the taxpayer's income (or would have been required to be included in income if it had been received in the taxation year) as income from employment (that is, the full amount of the payment is included in income under section 5 or 6);

(2) paragraph 56.4(3)(*b*) — the amount is an eligible capital amount[6] in respect of the business to which the RC relates (that is, the payment will be taken into income under section 14); or

(3) paragraph 56.4(3)(*c*) — the amount directly relates to the disposition of property that is an "eligible interest" in the partnership or corporation that carries on the business to which the RC relates (that is, if the payment relates to a sale of shares or a partnership unit that gives rise to a capital gain, then the payment is more in the nature of a capital amount than an income amount and is treated as such).

An election in prescribed form is required by the taxpayer (or jointly between the taxpayer and the purchaser if the purchaser carries on business in Canada) for the exception in paragraphs 56.4(3)(*b*) and (*c*) to apply. For information on how to file an election required under these provisions, refer to the discussion under the heading "Filing Elections" below.

Tax Treatment to the Purchaser

Subsection 56.4(4) provides rules applicable to amounts paid or payable by a purchaser in respect of an RC in certain circumstances.

Where the amount is treated as employment income of an employee of the purchaser, the purchaser will treat the amount paid or payable as wages paid to the employee. The purchaser should comply with the applicable withholding tax obligations contained in paragraph 153(1)(*a*) at the time the payment is made or deemed to have been made.

If an election has been made pursuant to paragraph 56.4(3)(*b*), the amount subject to the election is considered to be an outlay incurred by the purchaser on account of capital for the purpose of applying the definition "eligible capital expenditure" in subsection 14(5). In these circumstances, the purchaser should be able to amortize a portion of the outlay incurred as a deduction in computing income from a business.

If an election has been made pursuant to paragraph 56.4(3)(*c*), the amount subject to the election is included in computing the cost to the purchaser of an eligible interest acquired by the purchaser. While no immediate deduction is available in these circumstances, the purchaser will be able to deduct the outlay if there is a disposition of the eligible interest in the future.

Other than above, the proposed provisions are silent as to the income tax treatment to the purchaser of amounts paid or payable in respect of an RC. As such, where the above provisions are not applicable, the purchaser will need to apply general income tax principles in determining the appropriate income tax treatment. For example, where a purchaser acquires all of the shares in the capital stock of a target corporation from a third party, but an election is not made pursuant to paragraph 56.4(3)(*c*), it would seem appropriate for the purchaser to add to the purchase price of the shares the amount paid in respect of the RC. However, if the vendor is required to include the amount received or receivable in income pursuant to subsection 56.4(2), perhaps it is also appropriate (or more fair) for the purchaser to be able to report the amount paid or payable in respect of the RC as a current expenditure — or as an outlay that is amortized over the period of time covered by the RC.

Proposed paragraph 212(1)(*i*) imposes a 25% withholding tax obligation in respect of amounts paid or payable to a non-resident person that are subject to subsection 56.4(2). The 25% withholding requirement may be reduced under an applicable treaty. This paragraph is applicable to amounts paid or credited after October 7, 2003.

Where a joint election pursuant to paragraph 56.4(3)(*b*) or (*c*) is made, the vendor is deemed to have disposed of cumulative eligible capital or an eligible interest in a partnership or shares of a corporation. Where the vendor is a non-resident person, the purchaser should ensure that the compliance requirements contained in subsection 116(3) in respect of "taxable Canadian property" are addressed to avoid the 25% withholding tax requirement.

Paragraph 56.4(3)(c)

The election available under paragraph 56.4(3)(*c*) will likely be one of the most sought-after escapes from the full income inclusion requirement of subsection 56.4(2).

Paragraph 56.4(3)(*c*) applies only if all of the following conditions are met:

(1) the disposition of the eligible interest is to a purchaser or to a person related to the purchaser;

(2) the amount in issue is consideration for an undertaking by the taxpayer not to compete (note that not all RCs will be an undertaking not to compete, and therefore, not all RC payments can qualify for this election, even if they are paid in connection with the sale of an eligible interest);

(3) the RC can reasonably be considered to have been granted to preserve the value of the eligible interest disposed of to the purchaser;

(4) if the covenant not to compete is granted after July 17, 2005, subsection 84(3) does not apply to the transaction;

(5) the amount received or receivable is added to the particular taxpayer's proceeds of disposition in respect of the eligible interest; and

(6) the taxpayer and the purchaser make a joint election in prescribed form.

An "eligible interest" is a capital property of a taxpayer that is an interest in a partnership that carries on a business, shares in the capital stock of a corporation that carries on a business, or shares of a corporation 90% or more of the fair market value of which is attributable to eligible interests in one other corporation.[7]

It is uncertain why the above definition excludes shares of a corporation where, for example, that corporation owns all of the shares in the capital stock of two or more subsidiary corporations. For example, assume the only property of Holdco consists of all of the shares of Subco1 and Subco2. The fair market value of Subco1 is roughly equal to that of Subco2. Subco1 owns the land and building used exclusively by Subco2 to carry on its business. In these circumstances, the Holdco shares would not be an eligible interest. To avoid this, Subco1 and Subco2 could amalgamate as a pre-closing transaction so that shares in the capital stock of Holdco would qualify as an eligible interest.

Filing Elections

Subsection 56.4(13) provides details on how the joint elections required by paragraphs 56.4(3)(*b*) and (*c*) and subsection 56.4(7) (discussed in Part II) are to be filed. There are two rules, depending on whether the taxpayer is a resident or non-resident:

(1) if the person who granted the RC is resident in Canada at the time it was granted, the election must be filed with the Minister on or before the taxpayer's filing due date for the taxation year that includes the day that the RC was granted; or

(2) in any other case, the election must be filed with the Minister on or before the day that is six months after the day on which the RC was granted.

A copy of the RC is required to be filed with the prescribed form. No form for making the above election has been prescribed yet. See the discussion under the heading "Transitional Provisions" (discussed in Part II) for elections made pursuant to subsection 56.4(7) on or before October 24, 2012.

Regulation 600 will be amended to include elections required under subsection 56.4(13). This will permit elections in respect of an RC to be late-filed, amended, or revoked. This could be of significant benefit where, for example, the Minister has revised the amount of proceeds allocated to an RC, or if a determination has been made to reallocate some of the consideration from one taxpayer to another (see the discussion below under heading "Paragraph 68(c) — Ministerial Reallocation").

Paragraph 68(c) — Ministerial Reallocation[8]

The necessity to escape subsection 56.4(2) using subsection 56.4(3) presupposes that an amount is received or receivable in respect of an RC.[9] If the parties to a contract agree that no portion of the purchase price is to be allocated to the RC, then the above exceptions would not be required because the taxpayer does not receive an amount in respect of an RC. However, proposed paragraph 68(*c*) will allow the Minister to reallocate a reasonable portion of the payment as an amount paid or payable to the taxpayer by the person the RC is granted to.

It is important to note that the reallocation can occur irrespective of the form or the legal effect of the contract or agreement that the RC relates to. Moreover, the Minister can allocate an amount to be included in a taxpayer's income notwithstanding another taxpayer actually received the amount to which the income inclusion relates.

For example, assume two taxpayers are spouses and each owned 50% of the common shares of a corporation. They sell their shares to an arm's length purchaser for a total of $1 million. They each grant an RC to the purchaser, who pays $50,000 to each of them as consideration for granting the RC. One shareholder is actively involved in the business and the other is not. The Minister may view the value of the RC granted by the active shareholder to be greater than $50,000 and reallocate some, or all, of the amount received by the inactive shareholder to the active shareholder. In the alternative, the Minister may be of the view that the RCs should be valued at more than $100,000 and reallocate a portion of the $1 million share consideration to them.

Where a reallocation has occurred, and an amount in respect of an RC is received or receivable by one taxpayer but is required to be included in the income of another taxpayer, subsection 56.4(11) confirms that the amount received or receivable by the first taxpayer is not to be included in computing his or her income. Only the taxpayer that is deemed to have received the amount in respect of the RC is required to include that amount in income.

Exception to Paragraph 68(c) — Subsection 56.4(5)

The Minister cannot use the reallocation available under paragraph 68(*c*) where subsection 56.4(5) is applicable. Subsection 56.4(5) applies in three situations:

(1) subsection 56.4(6) — an arm's length employee grants the RC;

(2) subsection 56.4(7) — the amount in respect of the RC is included in computing the "goodwill amount"[10] of the vendor; or

(3) subsection 56.4(7) — the payment relates to a disposition of property where the vendor receives consideration in respect of the RC (e.g., a corporate sale of goodwill) or, in the case of a sale of shares, the amount in respect of the RC is otherwise included in the vendor's income.

A number of conditions must be met for each of the above exceptions to apply.

Subsection 56.4(6) — The Arm's Length Employee Exception

The intent of this exception is to prevent an employee from being subject to an income inclusion where an RC is granted, but the employee does not receive consideration for doing so. Assume, for example, that the employee is a key employee who could erode the goodwill being purchased by the purchaser if he or she started his or her own competing business after the sale. The purchaser wishes to prevent this and requests an RC from the employee. The employee is willing to grant the RC for no consideration to ensure that the sale occurs and that he or she retains his or her position after the sale.

In these circumstances, the Minister should not be able to allocate a portion of the vendor's consideration to the employee, who is not really receiving any benefit from granting the RC other than ensuring that his or her position is preserved after the sale.

To apply, the person granting the RC is an employee and:

(1) the RC is granted by the individual to an arm's length taxpayer;

(2) the RC directly relates to the acquisition from one or more other persons by the purchaser of an interest in the individual's employer, a corporation related to the employer, or in a business carried on by that employer;

(3) the individual deals at arm's length with the employer and with the vendors;

(4) the RC is an undertaking by the individual not to compete with the purchaser or a person related to the purchaser in a business to which the RC relates;

(5) no proceeds are received or receivable by the employee for granting the RC; and

(6) the amount reasonably regarded as consideration for the RC is only received or receivable by the vendors.

The above exception will apply to the arm's length employee who provides an RC and receives no consideration for doing so. The arm's length condition ensures that the exception will not apply where, for example, the employee is the spouse or a child of the vendor. Alternatively, this exception is not applicable where a majority shareholder of the corporation is also an employee.

Note that the definition of RC for purposes of this exception is narrowed significantly by virtue of the requirements that the RC relate to the acquisition of an interest in the individual's employer and that the individual undertakes not to compete with the business to be carried on by the purchaser.

In Part II of this article, I will discuss the "realization of goodwill" and "disposition of property" exceptions to Ministerial reallocation. These provisions are the most complex and difficult to understand of the draft legislation and are contained in Part II so that they can be addressed thoroughly.

Mark Woltersdorf is a Partner in the Tax Department of the Edmonton office of Fraser Milner Casgrain LLP. A number of tax lawyers from Fraser Milner Casgrain LLP write commentary for CCH's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for CCH's Canadian* Income Tax Act with Regulations, Annotated. *Fraser Milner Casgrain lawyers also write the commentary for CCH's* Federal Tax Practice *reporter and the summaries for CCH's* Window on Canadian Tax. *Fraser Milner Casgrain lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by CCH:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy Under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Fraser Milner Casgrain LLP, and a member of the Editorial Board of CCH's* Canadian Tax Reporter*, is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

For more insight from the tax practitioners at Fraser Milner Casgrain LLP on the latest developments in tax litigation, visit the firm's Tax Litigation blog at http://www.canadiantaxlitigation.com/.

Notes:

[1] 2000 DTC 6060 (F.C.A.). It is worth noting that the Crown failed to plead that the payment gave rise to a capital gain, an issue that was not resolved until the *Manrell* case where it was decided that an agreement not to compete is not "property".

[2] 2003 DTC 5225 (F.C.A.).

[3] It was proposed also that payments received before 2005 pursuant to a written agreement made on or before October 7, 2003, between parties dealing at arm's length, would be excluded.

[4] Unless otherwise indicated, all statutory references are to the *Income Tax Act* (the "ITA").

[5] Restrictive covenant is defined in subsection 56.4(1).

[6] Specifically, an amount that is required by the description of E in the definition of "cumulative eligible capital" in subsection 14(5) to be included in computing the taxpayer's cumulative eligible capital in respect of the business to which the RC relates.

[7] An "eligible interest" is defined in subsection 56.4(1).

[8] The proposed revisions to section 68 are deemed to have come into force February 27, 2004, but exclude RCs granted by a taxpayer to an arm's length person in writing before February 27, 2004.

[9] See, for example, *Robert Glegg Investment Inc. v. The Queen*, 2008 TCC 20, where the Court held that no portion of the purchase price was allocable to the covenant not to compete.

[10] A "goodwill amount" is defined in subsection 56.4(1) to mean an amount received or receivable by the taxpayer as consideration for the disposition by the taxpayer of goodwill, and that is required by the description of E in the definition "cumulative eligible capital" in subsection 14(5) to be included in computing the cumulative eligible capital of a business carried on by the taxpayer through a permanent establishment located in Canada. Permanent establishment means a permanent establishment defined for the purpose of subsection 16.1(1).