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

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Introduction

This is the second part of a two-part article discussing proposed legislation dealing with the taxation of restrictive covenants ("RC").[1] Part I was published in *Tax Topics* No. 2132 on January 15, 2013, and addressed the history, basic inclusion rules, tax treatment to the purchaser, elections to avoid subsection 56.4(2),[2] Ministerial reallocation of consideration, 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 I of the article discussed the exceptions to the Ministerial reallocation provisions contained in proposed paragraph 68(*c*). These provisions are most likely to be used where there is a sale and an RC has been granted not to compete with the purchaser in the future. (It is important to understand that the draft legislation defines the vendor as the person granting the RC and the purchaser as the person receiving the RC.) Where no amount of consideration is allocated to the RC (or an inadequate amount of consideration is allocated to the RC), paragraph 68(*c*) allows the Minister to reallocate a reasonable portion of the consideration to the person who granted the RC. This reallocation can occur irrespective of the form or the legal effect of the contract or agreement providing for the sale of property relating to the RC.

There are three situations in which the Minister cannot use the reallocation provisions in paragraph 68(*c*). Part I addressed the first of these situations — the "arm's length employee" exception. Part II addresses the other two, being the "goodwill amount" and "disposition of property" exceptions.

Subsection 56.4(7) — The "Realization of Goodwill Amount" and "Disposition of Property" Exceptions

In Bill C-48, the "realization of goodwill amount" and "disposition of property" exceptions are combined into a single subsection, whereas previously they were contained in separate subsections. Subsection 56.4(7) is applicable in three situations, namely: (i) a disposition of goodwill, (ii) a disposition of property (other than goodwill or shares of a corporation), and (iii) a disposition of shares in the capital stock of a corporation.

The provisions in subsection 56.4(7) differ slightly for RCs granted to an arm's length person (subparagraph 56.4(7)(*a*)(i)) and RCs granted to an "eligible individual"[3] (subparagraph 56.4(7)(*a*)(ii)). Most notably, where the RC is granted to an eligible individual, the vendor must be a resident of Canada at the time the RC is granted and at the time the property is disposed of. Where shares of a family corporation (defined

below) are disposed of to an eligible corporation[4] of the eligible individual, the vendor cannot retain any interest in the family corporation or hold any interest in the eligible corporation (directly or indirectly in any manner whatever).

The provisions contained in subsection 56.4(7) are the most complex and difficult to understand of all of the RC provisions and, as such, warrant special care and attention when being worked with.

(A) Grant of an RC to an Arm's Length Party

Subparagraph 56.4(7)(*a*)(i) is the starting point where a taxpayer (the "vendor") grants an RC to another taxpayer with whom the vendor deals at arm's length (the "purchaser"). The RC must be an undertaking of the vendor not to provide, directly or indirectly, property or services in competition with the property or services provided or to be provided by the purchaser (or by a person related to the purchaser) in the course of carrying on the business to which the RC relates. This provision essentially restricts the application of subparagraph 56.4(7)(*a*)(i) to non-competition covenants.

(i) Goodwill Amount[5]

Where a transaction involves a "goodwill amount" (i.e., a disposition of goodwill), the amount of consideration that can reasonably be considered to be for the RC is either included by the vendor in computing the vendor's goodwill amount or is received or receivable as a goodwill amount to the vendor's eligible corporation. This exception is applicable where, for example, a vendor is selling its assets to a purchaser (or the vendor is a shareholder of a corporation that is selling its assets to the purchaser) and goodwill is one of the assets sold. (It must be noted that the vendor is the person that grants the RC and is not necessarily the person selling the assets.)

For the exception to apply, a joint election in prescribed form must be filed by the vendor (or the vendor's eligible corporation if it receives the goodwill amount) and the purchaser (or the purchaser's eligible corporation if it incurs the expenditure that is the goodwill amount to the recipient). However, no election under subsection 56.4(7) is required to be filed for RCs granted on or before October 24, 2012 (see discussion under "Transitional Provisions" below).

The proposed provisions dealing with the joint election required to be filed where the RC is granted to an arm's length party (subparagraph 56.4(7)(*g*)(i)) contained in the October 24, 2012, Notice of Ways and Means Motion ("NWMM") are different than the provisions contained in Bill C-48. The NWMM makes reference to an election between the vendor and an "eligible individual", or the "eligible individual's eligible corporation", whereas Bill C-48 makes reference to an election between the vendor and the "purchaser" or the "purchaser's eligible corporation". The Department of Finance has confirmed that the NWMM was incorrect and corrections have been made in Bill C-48.

(ii) Disposition of Property (Excluding Goodwill or Shares of a Corporation)

Where the transaction is a "disposition of property" (other than goodwill or shares of a corporation), it must be reasonable to conclude that the RC is integral to a written agreement under which the vendor (or the vendor's eligible corporation) disposes of property to the purchaser (or the purchaser's eligible corporation) for consideration that is received or receivable by the vendor (or the vendor's eligible corporation). For this exception to apply, subparagraph 56.4(8)(*a*)(i) requires that the consideration that may reasonably relate to the RC be received or receivable by the vendor or the vendor's corporation for disposing of the property. This exception is applicable where, for example, a vendor is selling assets to a purchaser (such as an interest in a partnership or plant and equipment used by a division of the vendor's business).

(iii) Disposition of Shares in the Capital Stock of a Corporation

Where the property disposed of consists of shares in the capital stock of a corporation (the "target corporation"), it must be reasonable to conclude that the RC is integral to a written agreement under which the vendor (or the vendor's eligible corporation) disposes of the target corporation to the purchaser (or a person related to the purchaser and with whom the vendor deals at arm's length). While the vendor granting the RC does not have to be the taxpayer disposing of the target corporation, a clarifying rule in paragraph 56.4(12)(*b*) provides that the consideration that can reasonably be considered to be for the RC is to be added to the proceeds of disposition of each taxpayer who disposes of the target corporation to the extent of their respective shares, notwithstanding that another person may have granted the RC.

In each of the three situations described above, the vendor cannot receive or be entitled to receive proceeds for granting the RC. According to the explanatory notes prepared by the Department of Finance, in cases where proceeds are received or receivable by a vendor for granting an RC, the proceeds are taxable as ordinary income under subsection 56.4(2), unless one of the three exceptions in subsection 56.4(3) applies (discussed in Part I).

Where shares of a target corporation are disposed of, the disposition cannot be a redemption, acquisition, or cancellation of a share to which subsection 84(3) applies; otherwise the RC amount cannot be added to the proceeds of disposition.

Finally, in each of the three situations described above, the RC must reasonably be regarded to have been granted to maintain or preserve the fair market value of the goodwill amount, property (other than goodwill), or the shares of the target corporation.

(B) Grant of an RC to an Eligible Individual

Subparagraph 56.4(7)(*a*)(ii) is the starting point where a taxpayer (the "vendor") grants an RC to an eligible individual — that is, an individual that is related to the vendor and is at least 18 years of age.

The provisions applicable to the grant of an RC to an eligible individual are virtually identical to the provisions applicable where an RC is granted to an arm's length party, with the two following significant exceptions.

(i) Residency Requirement

Where a vendor grants an RC to an eligible individual, the vendor must be a resident of Canada at the time the RC is granted and at the time the property is disposed of. Presumably this additional requirement is added so that non-arm's length taxpayers are unable to take advantage of tax savings that may be realized where non-resident withholding taxes (if any) are less than the taxes otherwise payable in Canada.

(ii) "No-Interest" Requirement

Where the property disposed of consists of shares in the capital stock of a corporation that are disposed of to an eligible corporation of an eligible individual (referred to as the "family corporation"), the vendor does not, at any time after the grant of the RC, have an interest, directly or indirectly in any manner whatever, in the family corporation or in the eligible individual's eligible corporation.

Other than the two exceptions noted above, there are no other substantive differences between the provisions dealing with RCs granted to an arm's length person or to an eligible individual.

Areas of Concern

Concern was expressed with previous versions of the draft legislation that subsection 56.4(5) may not be applicable in certain situations if related persons received a portion of the consideration in respect of an RC, thereby disqualifying the transaction from this important protection.

Let us assume that two spouses own all the shares of a private corporation. One spouse is active in the business and the other is not. On a purchase of the shares for $1 million, the purchaser would likely seek an RC from the other spouse, who will not receive any consideration for granting the RC. The fair market values of the RC and shares are $40,000 and $960,000, respectively.

In the above example, the non-active spouse would receive a portion of the consideration in respect of the RC in the form of increased proceeds of disposition for the shares. Under previous versions of the draft legislation, it was believed that the spouses would have been unable to rely on subsection 56.4(5) on the basis that a non-arm's length individual received consideration for the RC and the Minister would be entitled to reallocate a portion of the proceeds to the active spouse.

Other than as discussed above, the most recent version of the draft legislation does not preclude subsection 56.4(5) from applying where a non-arm's length individual receives consideration for an RC granted by another. In fact, paragraph 56.4(12)(*b*) has been added to clarify that the portion of the consideration that reasonably relates to the RC is to be added in computing the consideration that is received or receivable by each of the taxpayers disposing of shares, to the extent of the portion of consideration received or receivable by them. The limitation ensures that a taxpayer is not required to report consideration that is greater than the amount received or receivable. In the above example, each spouse would report $500,000 as proceeds of disposition for the shares sold, even though a portion of this amount ($20,000 each) relates to the RC granted by the spouse that is active in the business.

Discussions with the Department of Finance indicate that the intent of paragraph 56.4(12)(*b*) is to prevent a taxpayer from arguing that an amount received or receivable by that taxpayer that reasonably relates to an RC granted by another taxpayer should not be included in that taxpayer's income because paragraph 68(*c*) prevents the Minister from allocating any portion of the RC to them. However, the Department of Finance did acknowledge that this

provision might result in the shifting of capital gains between taxpayers in some non-arm's length situations.

Paragraphs 56.4(6)(*e*) (arm's length employee exception) and 56.4(7)(*d*) ("goodwill amount" and "disposition of property" exceptions) provide that no proceeds can be received or receivable by the individual granting the RC. Under common law, a contract is not valid unless consideration is given, even where the amount of consideration is nominal (for example, many commercial agreements refer to consideration of $1 paid between the parties, "the receipt and sufficiency of which is hereby acknowledged"). As such, where consideration of any amount is paid, it is uncertain if a vendor will ever be able to utilize subsection 56.4(5) to prevent the application of paragraph 68(*c*) unless the contract relating to the RC is executed under seal (i.e., a contract without consideration). The explanatory notes accompanying the draft legislation state that where proceeds are received or receivable by a vendor for granting an RC, the proceeds are taxable as ordinary income under subsection 56.4(2) unless one of the three exceptions in subsection 56.4(3) applies. This suggests that only the proceeds actually received would be taxable and that the exception would still be applicable. However, the legislation can be interpreted to mean that the exceptions contained in paragraphs 56.4(6)(*e*) and 56.4(7)(*d*) are not applicable if proceeds of any amount are received. Until the legislation is revised or a comfort letter is issued, advisers should be wary of this issue and plan accordingly.

Special Provisions

Subsection 6(3.1)

Proposed subsection 6(3.1) deems an amount receivable by an employee (that is not part of a salary deferral arrangement) in respect of an RC granted more than 36 months before the end of a particular year to have been received by that employee in the taxation year. This would apply where, for example, an employee granted an RC in December 2010 that is payable to the employee five years later in December 2015. The amount receivable would be required to be included in income from employment in 2013. It is important to note that the amount must be "receivable" by the employee to be caught by subsection 6(3.1). In the above example, if the amount had not vested in the employee by the end of 2012, then it is not receivable and is not caught by subsection 6(3.1). This could occur where, for example, no amount was payable unless the employee could demonstrate that the conditions contained in the RC had been met continuously throughout the five-year period.

Subparagraph 12(1)(*x*)(v.1)

Paragraph 12(1)(*x*) requires a wide range of receipts, including government assistance, to be included in computing the income of a taxpayer. Proposed subparagraph 12(1)(*x*)(v.1) provides that these income inclusion provisions do not apply to the extent the amount in respect of an RC was included under subsection 56.4(2) in computing the income of a person related to the taxpayer. In other words, to the extent that a taxpayer receives an amount in respect of an RC that a person related to the taxpayer is required to include in income under subsection 56.4(2), paragraph 12(1)(*x*) will not apply to also include the amount in income of the taxpayer.

Subsection 14(5.1)

Proposed subsection 14(5.1) provides that the description E of the definition of "cumulative eligible capital" in subsection 14(5) does not apply to an amount required to be included in income under subsection 56.4(2). Subsection 56.4(2) is not applicable where a joint election pursuant to paragraph 56.4(3)(*c*) is made, in which case the amount may be a cumulative eligible capital receipt.

Subsection 56.4(8)

Special rules contained in subsection 56.4(8) are applicable when applying the exceptions to paragraph 68(*c*) contained in subsection 56.4(7). Where property is disposed of (other than goodwill or shares of a corporation) as described in either clause (*b*)(ii)(A) (RC granted to an arm's length person) or subclause (*c*)(i)(B)(I) (RC granted to an eligible individual), these provisions will only be applicable if the consideration reasonably regarded as part of the consideration for the RC is received or receivable by the vendor or the vendor's eligible corporation as consideration for the disposition of the property.

If all or part of the consideration is reasonably regarded as a goodwill amount, section 56.4(2), paragraph (3)(*b*), subparagraph 7(*b*)(i), or clause (7)(*c*)(i)(A) applies to the consideration reasonably regarded as being for a goodwill amount.

Paragraph 56.4(8)(*b*) provides that, for the purpose of determining if the conditions in paragraph 56.4(7)(*c*) are met (RC

granted to an eligible individual), and for the purpose of applying section 69, the fair market value of a property is the amount that can reasonably be regarded as being the fair market value of the property as if the RC were part of the property.

Subsection 56.4(14)

Subsection 56.4(14) states that section 42 is not applicable to amounts received or receivable in respect of an RC. Section 42 deals with proceeds of disposition in respect of warranties, contingencies, covenants, etc.

Paragraph 60(*f*)

Proposed paragraph 60(*f*) provides a deduction in respect of debts that are established to have become bad debts in respect of a receivable arising because of the application of subsection 6(3.1) or 56.4(2).

Anti-Avoidance Provisions

Subsection 56.4(9) contains an anti-avoidance provision that denies an election under paragraph 56.4(3)(*c*) that would have allowed a taxpayer to treat certain amounts as proceeds of disposition in respect of an eligible interest. Subsection 56.4(9) applies where the amount in respect of the RC is otherwise required to be included in income from an office or employment or from a business or property.

Subsection 56.4(10) contains an anti-avoidance provision that overrides the exception to the application of section 68 contained in subsection 56.4(7). Subsection 56.4(10) is applicable where the amount in respect of the RC is otherwise required to be included in income from an office or employment or from a business or property.

These provisions could prevent an income amount from being treated as a capital gain.

Transitional Provisions

Legislation enacting these rules is effective, for the most part, to amounts received or receivable in respect of an RC granted after October 7, 2003, other than amounts received before 2005 under an RC granted in writing on or before October 7, 2003.

For RCs granted by a taxpayer on or before the Announcement Date (October 24, 2012), subsection 56.4(7) is read without reference to paragraph (*g*). Essentially, this means that the taxpayer does not need to file the prescribed form otherwise required by subsection 56.4(7) provided that the RC was granted on or before October 24, 2012. In all other cases, the prescribed form required under this subsection is deemed to be filed on a timely basis if it is filed before the day that is 180 days after the provisions receive Royal Assent.

In the case of an election filed pursuant to subsection 56.4(3), it will be deemed to be filed on a timely basis if it is filed before the day that is 180 days after the provisions receive Royal Assent.

For RCs granted on or before the Announcement Date, subparagraph 56.4(7)(*f*)(i) is to be read as follows:

> (i) the benefit of the expenditure *made by the taxpayer* derived from the goodwill amount referred to in subparagraph (*b*)(i) or clause (*c*)(i)(A). (emphasis added)

Statute-Barred Taxation Years

It is worth noting that transactions entered into in 2009 or earlier that are affected by these proposed provisions may already be statute-barred. It is uncertain if the Minister is able to open a statute-barred year of a taxpayer that fails to make an election under subsection 56.4(13) within the 180-day time period referred to in Bill C-48. Many advisers are of the view that the Minister cannot (and perhaps *should not* even if able to) open statute-barred taxation years in these circumstances.

Out of caution, some taxpayers are filing a letter with their tax return advising the Canada Revenue Agency (the "CRA") of their desire to make an election in respect of an RC. While this does demonstrate the taxpayer's intent to make an election, such a letter does not technically meet the requirements imposed by the ITA. One would assume that the CRA will apply administrative discretion in these circumstances, but until a written administrative policy is published, taxpayers should consider filing the prescribed form within 180 days of Bill C-48 receiving Royal Assent, even if the taxpayers previously filed a letter advising of the election.

November 9, 2006

For RCs granted by a taxpayer prior to November 9, 2006, the definition of RC found in subsection 56.4(1) is to be read as follows:

(*b*) that is in satisfaction of an obligation described in section 49.1 that is not a disposition . . .

The proposed version of paragraph (*b*) if enacted in its current form makes reference to an obligation that is satisfied in respect of a right to property or services that the taxpayer acquired for less than its fair market value.

Paragraph 56.4(3)(*c*) is to be read subject to modified wording if the taxpayer elects within 180 days of Royal Assent.

Section 56.4 is to be read without reference to subsection (9) or (10), which means that amounts otherwise included in income from an office or employment may, in certain circumstances, be included as consideration for property sold and be subject to more favourable tax treatment.

July 17, 2010

For RCs granted before July 17, 2010, the provisions in paragraphs 56.4(7)(*d*) and 8(*a*) are subject to a modified wording that should be reviewed on a case-by-case basis.

Conclusion

The proposed provisions discussed above are complex. There are a number of transitional provisions and exceptions to the general operation of the provisions that are also complicated. Although some elections are permitted to be late-filed, amended, or revoked, there is a financial penalty for doing so.

To minimize the risk of reporting the income effects related to an RC incorrectly, taxpayers and their advisers must direct a significant amount of attention to the effect of granting an RC in any transaction. The greatest benefit will be realized where these issues are addressed at the early stages of the transaction, rather than later in the process.

Notwithstanding the foregoing, the valuation of an RC will pose one of the more significant challenges to taxpayers and their advisers. Arguably, refusing to sign the RC is a "deal-breaker" and therefore a significant portion of the consideration should be allocated to the RC. The counter-argument is that when one looks at the volume of documents in a commercial transaction (agreements, representations and warranties, consents, assignments, transfers, elections, approvals, indemnities, etc.), the refusal or inability to provide any of the foregoing could also be a "deal-breaker". Therefore, the RC is just one of the many components in the transaction and is of no material value by itself. Only time will tell which of these arguments (or variations thereof) will prevail.

Regardless of the uncertainty associated with several issues identified in this article, it would appear that the Department of Finance has achieved its most significant goal, which was to ensure that amounts received in respect of an RC are no longer tax-free. When the CRA begins to consider its response to the issues identified herein, hopefully it will adopt reasonable administrative positions.

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.

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Notes:

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

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

[3] An "eligible individual" in respect of a vendor is defined in subsection 56.4(1) to be an individual (other than a trust) who is related to the vendor and has attained the age of 18 at or before that time.

[4] An "eligible corporation" of a taxpayer is defined in subsection 56.4(1) to be a taxable Canadian corporation of which the taxpayer holds, directly or indirectly, shares of the capital stock.

[5] 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