

THE RESTRICTIVE COVENANT PROPOSALS – BRAIN OVERLOAD¹

Kim G C Moody,² CA, TEP, Matt Clark,³ LL.B. and Nicolas F Baass,⁴ LL.B., LL.M. (Tax)

ABSTRACT

The restrictive covenant rules were first introduced in 2003 as a response to the *Fortino* and *Manrell* cases. Since this time the restrictive covenant rules have gone through a number of amendments which has substantially complicated the initial rules. The authors examine the rules as they were proposed in Bill C-10, dated October 29, 2007, including amendments made to other sections of the Act as a consequence of these rules. Furthermore, tax implications for non-residents and potential GST implications are examined. Illustrative examples are provided to demonstrate problems that may arise due to the complexity of these rules. The authors examine potential valuation matters that may arise in the context of restrictive covenants. The authors conclude that while the purpose of these rules may be laudable, they add great complication and administrative burden to otherwise routine commercial transactions.

INTRODUCTION

“The hardest thing in the world to understand is the income tax.” -*Albert Einstein*

The Department of Finance’s attempt to establish a legislative framework to deal with the *Manrell*⁵ decision makes for an excellent study in the complexities of balancing two essential principles of taxation: fairness and predictability of fiscal legislation versus the prevention of abusive tax planning. While the *Manrell* decision left an understandably unacceptable gap in the Act⁶ that may have been abused by taxpayers, the resulting response by the Department of Finance far exceeded anything tax practitioners could have expected. The complexity of the proposed restrictive covenant legislation reflects the Department of Finance’s desire to capture any potential and conceivable covenant, even those that have not as of yet been contemplated. The application of these new rules to specific transactions requires an excellent understanding of the rules and exceptions, otherwise undesirable tax consequences may result. This paper aims to clarify the proposed rules pertaining to restrictive covenants and will also examine certain difficulties that arise from the complexity of these rules. Be prepared for brain overload.

While many papers have already been written on the new restrictive covenant proposals⁷ (and certainly this paper will overlap on some of the analysis already completed by the eminent authors), it is hoped that this paper will further expand on some of the practical difficulties that these proposals contain for taxpayers and their advisors.

TRADITIONAL TAX TREATMENT OF RESTRICTIVE COVENANTS PRIOR TO *FORTINO* AND *MANRELL*

Given the prevalence of restrictive covenants in business and share sale transactions, it is somewhat surprising that Canadian case law has not addressed the tax treatment of restrictive covenants prior to *Fortino*⁸. Indeed, restrictive covenants are a standard element to most sales of business assets or shares, and most transactions of this nature would not be consummated without the seller agreeing to a restrictive covenant of some sort.

While Canadian case law prior to *Fortino* is mute⁹ on the tax treatment of restrictive covenants, the Canada Revenue Agency (“CRA”) has issued a number of Interpretation Bulletins and opinions to aid taxpayers and tax practitioners seeking guidance as to the tax treatment of restrictive covenants, and more specifically non-competition agreements. Indeed, prior to *Fortino* and *Manrell*, very few commercial agreements specifically allocated consideration to non-competition agreements, and allocating amounts to covenants other than non-competition covenants was largely unheard of.

The CRA's traditional approach to the taxability of restrictive covenants depends on the nature of the underlying transaction to which the restrictive covenant relates. Starting with IT-330R,¹⁰ the CRA has consistently¹¹ taken the position that an amount received as consideration for entering into a non-competition agreement relating to the disposition of business property should be treated as a disposition of eligible capital property. On the other hand, an amount received for entering into a restrictive covenant that relates to the disposition of shares will fall within the ambit of section 42 of the Act.¹²

In subsequent years, the CRA further refined its position on non-competition agreements by stating that the right to compete in business fell within the definition of property in subsection 248(1) of the Act:

Property is broadly defined in subsection 248(1) of the Act to include, "...a right of any kind whatever..." It is our view that where a taxpayer gives up his right to compete in a business under a contract that right would be a property for the purpose of the Act and any consideration received by the taxpayer for giving up such right would generally be on account of capital."¹³

In addition, as late as 2002, in a revised Interpretation Bulletin, the CRA continued to pronounce that non-competition payments may be eligible capital expenditures (although it is interesting to note the use of the word "may").¹⁴

The CRA's position prior to *Fortino* and *Manrell* seemed tenable, which may explain the lack of challenge from taxpayers. Indeed, given the very broad definition of "property" in the Act, it was conceivable and seemed probable that the CRA's position represented the state of the law at the time. As such, practitioners gave little thought to allocating amounts to a non-competition agreement entered into during a sale of business assets or shares, thereby resulting in a favourable capital gains tax treatment for the vendor.

FORTINO AND MANRELL

As alluded to earlier, the impetus to reform the taxation of non-competition agreements in Canada was provided by two significant court decisions: *Fortino* and *Manrell*. In *Fortino*, the Crown was not allowed to present its most promising arguments due to procedural constraints. Following the Crown's loss in *Fortino*, taxpayers began more aggressively entering into tax-free non-competition agreements. The CRA's test case with respect to non-competition agreements was *Manrell*. It is now well known that the CRA lost this case as well, resulting in the current proposed restrictive covenant rules.

Fortino

The Facts

In *Fortino*, shareholders of Fortino's Supermarket Ltd. ("Fortino's") sold their shares to a competing grocery store chain, ("Loblaws") for consideration of approximately \$7 million. In addition to the share sale, the shareholders entered into non-competition agreements, which provided that the shareholders would not compete (in specific areas of Ontario) with the purchaser for a 10-year period (5 years in the case of the shareholders' immediate family members). Consideration for the non-competition agreement was approximately \$1.35 million. It was noted that absent the non-competition agreement, the share sale would not have gone through.

The shareholders did not report the non-competition agreement amounts in their personal tax returns. On assessment, the Minister included the taxable portion of the non-competition agreements under subsection 14(1) of the Act. The Minister subsequently reassessed and removed the subsection 14(1) income inclusion, and recomputed the capital gain of the share sale by adding the non-competition payments to the proceeds of disposition of the shares.

The taxpayers appealed; their position being that the non-competition agreements represented consideration for personal goodwill, not income from a source, and constituted a windfall. The taxpayers

argued that there was no provision in the Act which would subject the non-competition payments to income tax.

The Minister conceded that the non-competition payments should not have been included as proceeds of disposition of the shares, but as taxable income from a source under section 3. Alternatively, the Minister argued if the non-competition payments were not found to be income from a source under section 3 they should be taxed under section 14.

The non-competition payments were found by the Tax Court to be in the nature of a non-taxable capital receipt, and therefore, not income from a source under section 3. Section 14 was found not to apply, as it does not apply to shareholders who are not operating any business themselves. The grocery business was operated by the corporation, Fortino's, and not the shareholders.

The decision of the Tax Court was affirmed by the Federal Court of Appeal ("FCA").

The Capital Property Argument

One of the positions taken by the Minister to establish a basis for the reassessments under issue was that the non-competition payments constituted disguised proceeds of disposition of the shares. However, this argument was dropped before the trial. The intended alternative position that the non-competition payments be treated as a disposition of property ("a right of any kind whatever"),¹⁵ and therefore, taxable under sections 38 and 39 was not specifically raised in the pleadings when the trial started. Therefore, for procedural reasons, the Minister was precluded from arguing that the non-competition payments should be treated as proceeds of disposition of capital property. The FCA confirmed the decision of the Tax Court with respect to the amounts not being income from a source under section 3, and confirmed that the Minister was not allowed to raise the argument with respect to proceeds of disposition of a right of some sort.

The issue with respect to whether the granting of the non-competition agreement constituted a disposition of property giving rise to a capital gain was subsequently addressed in the *Manrell* decision.

The Section 3 Argument

Paragraph 3(a) of the Act includes in a taxpayer's income all amounts which are income from a source, including but not restricted to income from an office, employment, business, or property. Therefore, in order to determine if an amount is taxable under section 3, one must first determine if the amount is income, and also, whether the amount is income from a source.

The Tax Court, after reviewing the extensive case law on this point, concluded that the non-competition payments were "more in the nature of a capital receipt and were not income from a productive source under section 3."¹⁶ Accordingly, it was found that the non-competition payments were not taxable as income from a source under section 3 of the Act.

The Section 14 Argument

The non-competition payments were made to the shareholders of the corporation. In an effort to apply section 14 to the shareholders, the Minister attempted to lift the corporate veil as if the corporation was acting as agent for the shareholders. The Tax Court concluded that the grocery business was conducted by the corporate entity (Fortino's), and not by the shareholders. Therefore, the non-competition payments could not be characterized as eligible capital amounts.

The Section 42 Argument

Section 42 of the Act deems the proceeds of disposition of property to include amounts received as consideration for warranties, covenants, or other contingent or conditional obligations given by a taxpayer in respect of the disposition of the property.

Notwithstanding the Minister did not argue that section 42 was applicable, the Tax Court also considered this issue. Warranties or covenants contemplated by section 42 must have an element of conditional or contingent obligation. The non-competition payments were not contingent obligations given with respect to the sale of the shares. There was no uncertainty as to when the non-competition payments were made or the amount payable. Therefore, the Tax Court concluded that section 42 was not applicable.

Following *Fortino*, the CRA was seeking a test case with respect to non-competition agreements. The CRA's strongest arguments with respect to non-competition agreements were to be tested in *Manrell* both at the Tax Court level and the FCA.

Manrell

While the *Fortino* case stood for the proposition that non-competition agreement receipts were not taxable, the CRA was not provided with the opportunity to fully argue its case in *Fortino*. The CRA's principal argument that a non-competition agreement was property, and thus subject to capital gains treatment, was to be tested in *Manrell*.

The Facts

In *Manrell*, the taxpayer entered into a non-competition agreement on the arm's length share sale of his manufacturing business. The payment for the non-competition agreement was included in the purchase price of the shares. The non-competition agreement was a condition to the share sale and pertained to a specific duration or term and geographic territory. The taxpayer initially included the non-competition payments in the proceeds of disposition of his shares on his 1995, 1996 and 1997 tax returns. The tax returns were assessed as filed. As the payments under the non-competition agreement were receivable in four annual installments, the taxpayer claimed the benefit of statutory reserves¹⁷ to spread the taxable capital gain over the years in which the payments were received.

Subsequent to the decision in *Fortino*, the taxpayer filed notices of objection in an attempt to recharacterize the non-competition payments as non-taxable on the basis that a non-competition agreement was not property for purposes of the Act. The Minister confirmed the original assessments, failing to recharacterize the non-competition payments as tax-free. The taxpayer appealed to the Tax Court.

The taxpayer's appeal was dismissed. The Tax Court found that the right to compete under the non-competition agreement fell within the definition of property found in subsection 248(1) in the context of the phrase "right of any kind whatever." The taxpayer disposed of a right to compete, which was found to be property for purposes of the Act.

The Tax Court decision was reversed on appeal. The FCA found that property must have or entail an exclusive right to make a claim against someone else.¹⁸ Through the execution of the non-competition agreement, the taxpayer only gave up the non-exclusive commonly held right to carry on business, and did not give up property within its ordinary meaning. The shared right to carry on business was found not to be a "right of any kind whatever," and therefore, was not "property" within the statutory definition found in subsection 248(1). As a capital gain can only be realized on the disposition of "property," the taxpayer did not realize a capital gain in respect of the non-competition payments received.

Tax Court of Canada – Definition of Property

The taxpayer's position at the Tax Court level was that the agreement to not exercise the right to compete did not constitute property for purposes of the Act. The non-competition payments were therefore, not taxable on the basis that the payments did not constitute a gain from the disposition of property.

The taxpayer argued that subsection 248(1) restricts the definition of property to the common law concept of property. Quoting jurisprudence from England and Australia, the taxpayer asserted that, at common law, the ability to compete is not considered property. The Crown responded that the taxpayer disposed of a bundle of rights, and made a promise not to do something in connection with these rights. The Crown also added that the definition of property found in subsection 248(1) is broader than that of England and Australia, and would include non-competition payments, including the right to enter into a business and the promise to do or not to do certain things.

The taxpayer argued that in the context of the Act, the phrase "a right of any kind whatever" must be understood to mean a right in the nature of property. The right to compete is simply the freedom everyone shares to carry on a business. It is a personal liberty, not a right that is exclusive or that entails any claim against anyone else. Therefore, it is not within the statutory definition of property.

The taxpayer also submitted that if the Tax Court finds that the right to compete constitutes property, he has not done anything to sell or dispose of his right to compete, but simply covenanted not to exercise his right. A disposition requires that the taxpayer actually alienate, or part with, the property in question. When an individual agrees not to compete, they do not part with that right to compete. Therefore, a disposition has not been triggered. Notwithstanding the covenant to not exercise the right to compete, it is still possible to engage in a competing business; all that has changed is that the recipient of the covenant or promise has a right to seek recourse if the covenant or promise is broken. The ability to engage in the competing business does not cease to exist by virtue of the granting of the covenant.

The Crown argued that the use of the word "includes" in the statutory definition of property in subsection 248(1) indicates that it must be given a meaning that is broader than its ordinary meaning. In particular, the phrase "a right of any kind whatever" is sufficiently broad that it includes rights that do not necessarily have the usual characteristics of property.¹⁹

The Tax Court agreed that notwithstanding that the right to compete may not be property at common law, this fact is not relevant; the language in subsection 248(1) cannot be ignored. Property is defined in subsection 248(1) as "property of any kind whatever, whether real or personal or corporeal or incorporeal and without restricting the generality of the foregoing, includes a right of any kind whatever." There is no restriction in subsection 248(1) to the common law concept of property.²⁰

Federal Court of Appeal – Definition of Property

For purposes of deciding whether a right to compete is a "right of any kind whatever," and therefore, "property" as defined by subsection 248(1), the FCA considered the ordinary meaning of the word "property," the statutory context, and the relevant jurisprudence.

Ordinary Meaning

When considering the ordinary meaning of the word "property," the FCA quoted the following from *Principles of Property Law*:²¹

Property is sometimes referred to as a bundle of rights. This simple metaphor provides one helpful way to explore the core concept. It reveals that property is not a thing, but a right, or better, a collection of rights (over things) enforceable against others. Explained another way, the term property signifies a set of relationships among people that concern claims to tangible and intangible items.²²

Subsequent to citing that passage, the FCA stated:²³

It is implicit in this notion of “property” that “property” must have or entail some exclusive right to make a claim against someone else. A general right to do something that anyone can do, or a right that belongs to everyone, is not the “property” of anyone. In this case, the only thing that Mr. Manrell had before he signed the non-competition agreement that he did not have afterward was the right he shares with everyone to carry on a business. Whatever it was that Mr. Manrell gave up when he signed that agreement, it was not “property” within the ordinary meaning of that word.

Statutory Meaning

The Crown argued that, although a right to compete was not “property” within the ordinary meaning of that word, the definition of “property” found in subsection 248(1) was broad enough to include it because the definition referred to “a right of any kind whatever.”

The taxpayer argued that, in the context of the Act, the phrase “a right of any kind whatever” must be understood to mean a right in the nature of property. At the very least, it must be a right entitling its holder to “compel someone else to pay money or do something, or the right to exclude all competing claimants to the same right.” What the Crown tried to characterize as a “right to compete” was, according to the taxpayer, simply the freedom everyone shares to carry on a business.²⁴

The FCA concluded that “property” must have or entail an exclusive right to make a claim against someone else. The phrase “right of any kind whatever” was not included in the Income Tax Act enacted in 1948 to expand the ordinary meaning of property to include a non-exclusive commonly held right to carry on business.²⁵

Jurisprudence

The FCA noted that in the history of Canadian tax jurisprudence considering the statutory definition of the word “property,” there is not a single case in which the word property was held to include a right that is not or does not entail an exclusive and legally enforceable claim.²⁶

At paragraph 54 of the decision, the FCA states:

Before signing the non-competition agreement, Mr. Manrell could carry on or invest in a plastic mould manufacturing business competing with the three operating companies that were sold. However, that gave him no claim against anyone else, and no right to stop anyone else from starting exactly the same business. By signing the non-competition agreement, Mr. Manrell became obliged not to undertake activities that he could have undertaken before. If what he gave up was a right of some kind, it was a right shared by everyone to carry on a business. I see nothing in the context of the Income Tax Act that justifies the conclusion that this was a “right of any kind whatever” that makes it “property” within the statutory definition.

The FCA did not find anything in the statutory context or the relevant jurisprudence to indicate that the meaning to be given to the word “property” should derogate from its ordinary meaning. Thus the term “property” as defined in subsection 248(1) was not intended to include non-exclusive, commonly held rights, including the right to compete.

The Impact of *Manrell*

There is no doubt that the *Manrell* case was a surprising win for taxpayers. There is even less doubt that the *Manrell* case shocked the CRA and the Department of Finance, as their position seemed to be strongly founded both in fiscal policy and in law. Judge Sharlow, writing for the FCA acknowledged that the court’s conclusions in *Manrell* may not have reflected the fiscal policy with respect to non-competition agreements:

This case presents a strong temptation to legislate in the guise of statutory interpretation. No doubt many will consider the result of this case to be unsatisfactory in terms of fiscal policy. I am sympathetic to the view that it seems unfair that the shareholder of a corporation who bargains for a non-competition payment in the context of a sale of the shares is not taxed on the payment, even though in economic terms it may represent the realization of a substantial part of the commercial value of the business of the corporation.

However, it is one thing to recognize an unsatisfactory state of affairs, and quite another to repair it. Perhaps non-competition payments should be within the tax net in some way, but in what way? The history of this case and *Fortino* illustrate several theoretical possibilities. I have no doubt that other theories could be devised.²⁷

The Department of Finance clearly took Justice Sharlow's advice to heart and repaired the lacuna in the Act. While *Manrell* dealt specifically with non-competition agreements, the principles enunciated by the court could easily be transposed to other forms of contractual covenants, not only in the course of the sale of business assets and shares, but also in the ordinary course of business. Thus, taxpayers could conceivably allocate amounts to other clauses in an agreement and argue that these amounts were tax-free based on the principles set forth by the Federal Court of Appeal. In effect, the *Manrell* decision created a complete class of rights that arguably have value to taxpayers, but that are non-taxable. This could allow a taxpayer to carve out clauses in a contract and assign them value, free of tax. For each tax-free clause carved out of the agreement, the aggregate amount of taxable consideration received would be reduced. In other words, taxpayers had the potential to greatly reduce taxes, not only during the sale of business assets and shares, but also for many other commercial agreements conceivable. The Department of Finance expressed these concerns before the Standing Senate Committee on Banking, Trade and Commerce as follows:

[...] A couple of tax cases gave us some pause, *Fortino v. Canada* and *Manrell v. Canada*. Those two cases read together stood for the proposition that an amount received by a shareholder for a covenant not to compete was tax free. We all would have liked to go to the status quo ante where one saw those covenants but did not see an amount broken out of the deal to be specifically in consideration of the covenant. These court decisions gave rise to the startling proposition of a tax-free receipt in the context of the disposition of a business. We began to see many taxpayers assigning a value to a non-compete covenant with their own corporations. That became unsustainable as part of the tax system, and as a result we had to move to implement these rules.

However, we were faced with a problem. *The court decision established the principle that a personal covenant gave rise to a tax-free receipt and brought to the limit, which means that you can have any personal covenant and achieve a tax-free amount. These rules had to be fairly comprehensive and to deal across the board with all kinds of covenants but we dealt more particularly with the covenants not to compete because they were the more common ones in place. Other covenants would have come forth in order to take advantage of the decisions.*²⁸ [Emphasis added]

Additionally, certain high-profile cases may have put further strain on the Department of Finance's tolerance regarding non-competition schemes. Needless to say, this threat could not go unanswered by the Department of Finance. The preceding comments explain why a simple amendment of the definition of "property," to include non-competition and similar agreements may have been quick and efficient, but would not have effectively countered the *Manrell* decision. For this reason, the Department of Finance has opted for a complete new set of rules to cover not only non-competition agreements but also any covenant that falls within the tax gap created by *Manrell*. As the *Manrell* decision had such potentially large tax implications, the corresponding rules resulting from this decision are both complex and far-reaching.

TAXATION OF RESTRICTIVE COVENANTS IN FOREIGN JURISDICTIONS

Before looking at Canada's response to *Fortino* and *Manrell*, the Department of Finance likely reviewed how other countries taxed restrictive covenants. While an exhaustive review is beyond the scope of this

paper, we chose (randomly) to look at the United States, New Zealand, Australia and the United Kingdom.

United States²⁹

The United States takes a very aggressive stance on taxation of various restrictive covenants as income. Any consideration received pursuant to a covenant not to compete is treated as ordinary income.³⁰ Where the consideration is paid to a former employee, new rules set out specific guidelines that must be followed, or else the consideration paid could be subject to a 20% penalty and immediate taxation.³¹

Regarding the tax treatment to the Covenantee, the consideration paid for obtaining a restrictive covenant to benefit the business is either a section 197 intangible asset or an unclassified intangible asset. Section 197 deals with covenants that are entered into in connection with the acquisition of a trade or business (or a substantial portion thereof), and require straight-line depreciation over 15 years.

New Zealand³²

Unique as compared to many Commonwealth jurisdictions, the *Income Tax Act* of New Zealand does not tax receipts from the disposition of capital. In 1995 and 1996, the New Zealand Tax Court determined that payments received for providing restrictive covenants were capital.³³ The legislative response occurred in October 2000 and the Commentary on the Bill suggests that the new provisions pertaining to services-related payments, restrictive covenants and exit inducements were based on Section 313 of the *Income and Corporation Taxes Act 1988* of the United Kingdom.³⁴

The relevant legislation is now contained in the *Income Tax Act 2007*. Regarding restrictive covenants, the Commentary summarizes that wherever a person gives an undertaking which has the effect of restricting the person's ability to perform services (whether as an employee, independent contractor or otherwise and whether legally enforceable or not), the consideration is taxable.³⁵ There is an anti-avoidance provision ensuring that attempts to re-characterize such a restrictive covenant as capital will not get such treatment.³⁶

Excepted are restrictive covenants received when selling a going concern (either in a business or share sale). These transactions are not taxable. To be excepted, the person giving the covenant must not provide any services following the sale, other than services that are incidental to the sale and temporary³⁷ and the parties agree in writing that the covenant relates to a sale of a taxable activity.³⁸

Regarding deductibility of payments made by the Covenantee, certain provisions ensure a matching of treatment. Expenditures related to restrictive covenants are deductible if the receipts are taxable in the hands of the Covenantor.³⁹

Australia⁴⁰

The Australian tax treatment is unambiguous. Firstly, there is no case law to suggest that any type of restrictive covenant is not property. Therefore, all restrictive covenants are capital property and subject to Capital Gains Tax pursuant to Section 106(5) of the *Income Tax Assessment Act 1997*. Selected types of property are subject to a 50% discount under s. 106(5), however, restrictive covenant payments are not such a type. Therefore, there is no benefit to an employer paying to enforce a restrictive covenant nor planning to segregate payments made to enter restrictive covenants in the context of asset sales. However, it may be the case that employers will not be required to make a 9% superannuation contribution in regards to payments to employees regarding restrictive covenants.

For corporate entities, there is no distinction between receiving consideration for the restrictive covenant on account of capital or income. However, when a corporation pays for the restrictive covenant, the tax treatment depends on whether Schedule 29 of the *Finance Act*⁴² applies, in which case, amortization is allowable but not required.

For individuals, capital gains tax is calculated separately from income. Until April 6, 2008 there was “taper relief” which is similar to the marginal taxation rates on income in Canada. The different rates applied depending on the duration the asset was owned and whether the asset was a business or non-business related asset. However, this taper relief was changed to a flat rate of tax, 18%, this year.⁴³

Currently, any dispositions of capital by an individual are subject to the 18% rate. There is an entrepreneurial relief provision similar to the LCGE on QSBC shares. Otherwise, there is an annual exemption of £9,600 for general capital gains. Capital treatment of a receipt of consideration relating to a restrictive covenant is preferred by the covenantor, but this classification is subject to scrutiny.

In Guidance Document CG68060, the HM Revenue & Customs states that the “tax treatment of the receipt will depend on the precise facts of the case in question and in particular the purpose for which the payment was made.” The key facts appear to be the duration of the covenant and the effect the covenant has on earning income.⁴⁴

THE DEPARTMENT OF FINANCE RESPONDS TO *MANRELL*

On October 7, 2003 then Finance Minister John Manley announced proposed amendments to the Act in response to the FCA decisions in *Fortino* and *Manrell*.⁴⁵ The proposed amendments would treat any amounts receivable in respect of a restrictive covenant as ordinary income, except in certain circumstances. Finance Minister Manley’s announcement gave birth to new section 56.4 of the Act. As declared in the announcement, “These proposals will apply to amounts received or receivable after today⁴⁶ other than to amounts received before 2005 pursuant to a written agreement made on or before today between parties dealing at arm’s length.”

On February 27, 2004 the Department of Finance released its first draft of proposed section 56.4. In response to the draft legislation released on February 27, 2004, The Joint Committee on Taxation of The Canadian Bar Association, and The Canadian Institute of Chartered Accountants (the “Joint Committee”) provided their comments on 12 concerns with the draft legislation on December 20, 2004 (the “December 2004 Comments”). The December 2004 Comments highlighted the Joint Committee’s main concern that the proposed legislation released on February 27, 2004 was “significantly broader” than the Department of Finance originally described in its Press Release. Specifically, the definition of restrictive covenant could apply to a wide range of payments received that would otherwise be included in income from a business or property under section 9 of the Act.

On July 18, 2005 the Department of Finance released a second round of amendments to the draft legislation for section 56.4 of the Act. Again, subsequent to the July 18, 2005 amendments, the Joint Committee provided its comments. In its submission dated January 30, 2006, the Joint Committee reiterated many of its concerns highlighted in the December 20, 2004 submission. In addition, the Joint Committee provided its concerns regarding new amendments included in the July 18, 2005 proposed legislation.

On November 9, 2006 the Department of Finance released a third set of amendments to the draft legislation for section 56.4 of the Act. After making some very minor changes, the proposed legislation was included in Bill C-10 and passed by the House of Commons on October 29, 2007. It is at this stage that the passage of Bill C-10 becomes an interesting saga. After receiving first reading in the Senate, the Bill was sent to The Standing Senate Committee on Banking, Trade and Commerce for debate. Bill C-10 contained numerous other controversial tax proposals such as the non-resident trust proposals, foreign investment entity proposals and film tax shelter proposals. The Senate Committee appears to have given

careful consideration to many of the proposed tax changes in Bill C-10. With the call of the election in 2008, Bill C-10 died and will need to be reintroduced to Parliament by the Department of Finance. At the time of writing, the restrictive covenant proposals have not been reintroduced to Parliament in Bill format. While the majority view is that the restrictive covenant proposals will be reintroduced to Parliament, the timing of such a decision is far from certain.

THE CURRENT RESTRICTIVE COVENANT PROPOSALS

When reading a provision, a practitioner should always be mindful of its position within the Act. The Act is structured in a logical way and examining a provision's position within the Act is an important tool for interpretation. Thus, it is interesting to note the Department of Finance's placement of the restrictive covenant rules within the Act. In this respect, it should be noted that the restrictive covenant rules have been placed in subdivision d of Division B of Part I of the Act. Subdivision d of the Act deals with sources of income other than income from office or employment (subdivision a), business or property (subdivision b) or capital gains (subdivision c). Subdivision d includes income from pension, unemployment benefits, spousal support, scholarships and other similar income that is not derived from office, employment, business or property. This approach is consistent with the *Manrell* decision, in which restrictive covenants were found not to be property.

At the very heart of the new restrictive covenant rules is the definition of restrictive covenant under proposed subsection 56.4(1). Needless to say, if an agreement does not fall within the definition of restrictive covenant, the rules at proposed section 56.4 are inapplicable and the ordinary principles of tax law must be applied. As such it is essential to delineate the definition of restrictive covenant.

The definition of restrictive covenant under proposed subsection 56.4(1), discussed in detail below, includes any exchange of property *whether legally enforceable or not*, that affects property or services.

By definition therefore, the Act includes restrictive covenants beyond the legal definition of the term. However, identifying the common law definition is still helpful to practitioners because determining whether the restrictive covenant is enforceable or not can have a significant impact on the determination of value of the restrictive covenant, as discussed under heading H – Valuation Matters - of this paper.

Restrictive Covenants and the Common Law

*Black's Law Dictionary*⁴⁷ defines "restrictive covenant" in an unusually restrictive manner. It defines a restrictive covenant as a "non-competition covenant". A "non-competition covenant" is defined as follows:

A promise, usually in a sale-of-business, partnership, or employment contract, not to engage in the same type of business for a stated time in the same market as the buyer, partner, or employer. Noncompetition covenants are valid to protect business goodwill in the sale of a company. In other contexts, they are generally disfavoured as restraints of trade: courts generally enforce them for the duration of the business relationship, but provisions that extend beyond the termination of that relationship must be reasonable in scope, time and territory.

There are certainly other restrictive covenants that meet the common law definition that are not non-competition covenants. Although this definition is unnecessarily limiting, the statement regarding the legal analysis of whether a restrictive covenant is valid is a good summary of the law in Canada.

A brief history of the common law analysis follows, explaining how Canadian courts have reached and followed the standard of reasonableness called the "*Nordenfelt* Test".

Restrictive covenants have been relevant to commercial activity in common law jurisdictions since the Church and State provided privileges and monopolies to their business connections. The courts were often the protector of individual rights in those days, and they sought ways to protect citizens from unfair treatment from monopolies. This battle of conflicting interests can be traced back in England to the

Crown's regulation of the labour force through the *Statute of Artificers* (1563) and the case of *Davenant v. Hurdis*.⁴⁸ In *Davenant*, Sir Edward Coke was afforded his first opportunity to argue that legislation that establishes monopolies are illegal. The court accepted this argument and found that any rule restricting trade to one company or one person is illegal.

The common law developed ad-hoc for almost three hundred years, resulting in several different tests depending on whether the restraint was specific or general, as well as developing many exceptions to the general rule that all restraints of trade are invalid. The law had become cumbersome, until the reasonableness test was introduced in *Nordenfelt v. Maxim Nordenfelt Guns & Ammunition Co.*⁴⁹

There are two main competing principles in determining the reasonableness of a restrictive covenant. First, there is the protection of the individual's right to work. Second, there is the requirement that individuals are entitled to freely contract as they mutually agree. When these principles directly contradict, the *Nordenfelt* test applies.

Lord Macnaghten in *Nordenfelt* described the test as follows,

"The public have an interest in every person's carrying on his trade freely: so has the individual. All interference with individual liberty of action in trading, and all restraints of trade themselves, if there is nothing more, are contrary to public policy, and therefore void. This is the general rule. But there are exceptions: restraints of trade and interference with individual liberty of action may be justified by the special circumstances of a particular case. It is a sufficient justification, and indeed it is the only justification, if the restriction is reasonable – reasonable, that is, in reference to the interests of the parties concerned and reasonable in reference to the interests of the public, so framed and so guarded as to afford adequate protection to the party in whose favour it is imposed, while at the same time it is in no way injurious to the public."⁵⁰

He continues by distinguishing sale of business cases from employment cases,

"to a certain extent, different considerations must apply in cases of apprenticeship and cases of that sort, on the one hand, and cases of the sale of business or dissolution of a partnership on the other. A man is bound as an apprentice because he wishes to learn a trade and to practice it. A man may sell because he is getting too old for the strain and worry of business, or because he wishes for some other reason to retire from business altogether. Then there is obviously more freedom of contract between buyer and seller than between master and servant or between an employer and a person seeking employment."

Since *Nordenfelt* it has been clearly established that the covenantee must demonstrate that the restrictive covenant obtained must be no broader in scope than is needed to protect the covenantee's proprietary interest. Therefore, restrictive covenants pertaining to trade secrets or other confidential information are almost universally held to be valid. This determination has often been described as the equitable test.⁵¹ The second part of the *Nordenfelt* test is a determination of the public interest. Although applied less often, a restrictive covenant is not valid in Canada if the restrictive covenant demonstrates "economic and social effects demonstrably harmful to the public interest."⁵²

Under the equitable part of the *Nordenfelt* Test, a restraint on the geographic area of competition must be confined to the area within which competition from the vendor will in all probability injure the purchaser. Also, a restrictive covenant can be invalidated where the activities restricted are beyond the range taken by the prior owner as part of the former business. A well-drafted restrictive covenant may be amended by the courts for reasonableness.⁵³ Regarding the limit on duration, although there is no guiding principle in the common law, reasonableness is required. As stated by Morden J.A. in *Bliss & Laughlin Industries Incorporated v. Doerner*:⁵⁴

"generally, the chief reason why a time restriction may be held to be unreasonably long is that it extends into a period where it may reasonably be thought that the purchaser would be on its own feet in the business and the influence of the seller diminished by his lack of contact with the trade."

However, as stated earlier, the Act will allow for exchanges that are not legally enforceable and therefore any exchange mutually agreed to will be valid for tax purposes. Accordingly, it is advisable that clients are aware that the restrictive covenants they enter into are potentially unenforceable and therefore the consideration exchanged or value ascribed may be inappropriate – particularly where an adjustment to the consideration is required as a result of a damages award following litigation.

Restrictive Covenants and the Act

Definition of Restrictive Covenant

Proposed subsection 56.4(1) contains the following definition of “restrictive covenant”:

"restrictive covenant", of a taxpayer, means an agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer (other than an agreement or undertaking for the disposition of the taxpayer's property or -- except where the obligation being satisfied is in respect of a right to property or services that the taxpayer acquired for less than its fair market value -- for the satisfaction of an obligation described in section 49.1 that is not a disposition), whether legally enforceable or not, that affects, or is intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer or by another taxpayer that does not deal at arm's length with the taxpayer.

This definition is broad and, as discussed earlier, has been the subject of criticism by the Joint Committee and many tax practitioners. In fact, the term “restrictive covenant” is a misnomer as the definition contemplates all undertakings or waivers, whether written, oral or even legally valid that affect or are intended to affect the acquisition or provision of property. The covenant need not necessarily restrict anything; it need only affect the acquisition or provision of property. While many tax practitioners equate the term “restrictive covenant” with non-competition agreements, it must be remembered that the breadth of the term is not limited to such non-competition agreements. Many covenants and clauses that are found in commercial agreements that do not usually invoke scrutiny by the tax community should now be reexamined in light of the definition of restrictive covenant. Aside from non-competition payments, which are clearly caught by the proposed definition, the following covenants may fall within the definition:

1. Agreements not to solicit employees/suppliers/customers;
2. Confidentiality agreements;
3. Take or pay contracts;
4. Exclusive distributorship agreements; and
5. Clauses restricting the payment of dividends during a due diligence audit.⁵⁵

Needless to say, due to the broadness of the definition, it is impossible to contemplate every possible restrictive covenant that is subject to the proposed definition and as such the list above is obviously non-exhaustive. These agreements are commonly found in purchase and sale transaction and employment contracts, amongst others. In the context of a sale of business assets or shares, this type of covenant will affect the transaction.

Analyzing each element of the definition is critical to applying proposed section 56.4. The definition pertains to any “agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer”. This definition contemplates all contracts between parties, oral or written. It also contemplates an “undertaking made”, which is a positive or negative covenant to act or not act and in the vast majority of situations will involve a contract. Finally, the term “waiver of an advantage or right” is used. A waiver is a formal acknowledgement that something possessed by the taxpayer (in this case an advantage or right possessed) is formally released from possession.

Affect, or is Intended to Affect, in any way Whatever, the Acquisition or Provision of Property or Services

The contract, undertaking or waiver must “affect, or is intended to affect, in any way whatever, the acquisition or provision of property or services.” This describes, essentially, any commercial context. Arguably, the focus on *acquisition* of property suggests that a restrictive covenant provided on the *disposition* of property (as in, for example, the disposition of a business) is excluded. However, this argument is untenable because it would therefore exclude all non-competition agreements provided when disposing of a business, and the better interpretation is that when disposing of a business one also acquires another form of property, typically cash.

The words “affects, or is intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer...” are open to further interpretation. Firstly, it must be noted that the taxpayer mentioned in this passage is the taxpayer granting the covenant. Secondly, the wording is broad enough to capture at least two different sets of circumstances:

1. The “acquisition or provision of property or services” by the taxpayer relates to the acquisition or provision of property or services by the taxpayer granting the covenant to the taxpayer who has been granted the covenant. For example, in the context of the sale of shares, the vendor (the “taxpayer”) will enter into a non-competition agreement in order to induce the purchaser to purchase the shares. In this way, the covenant is an agreement that affects the provision of the taxpayer’s shares to the purchaser.

Alternatively, this wording can be interpreted as follows:

2. The “acquisition or provision of property or services” by the taxpayer relates to an acquisition or provision of property or services by the taxpayer granting the covenant to a third party uninvolved with the covenant. For example, if the taxpayer enters into a non-competition agreement not to publish a newspaper within a certain geographic location, such a covenant will affect the taxpayer’s provision of property (i.e. the newspapers) to third parties unrelated to the covenant.

Presumably, the wording is sufficiently wide that it captures both of the above-described situations.

The Exceptions to the Definition of Restrictive Covenant

The definition specifically excludes two items, described in the bracketed portion of the definition. The simpler and more specific item excluded is section 49.1 obligations. An obligation is subject to section 49.1 when property is acquired as a result of an absolute or contingent obligation to provide the property pursuant to a contract or “other arrangement one of the main objectives of which was to establish a right [...] and that right was not under the terms of a trust, partnership agreement, share or debt obligation.” Essentially, section 49.1 is a contingent interest in property, so the property has not vested in the taxpayer yet. The exclusion further provides that a section 49.1 obligation is only excluded where the taxpayer has obtained the property relevant to the section 49.1 obligation for less than fair market value.

The second and significantly broader exception is more difficult to ascertain. The words used are “other than an agreement or undertaking for the disposition of the taxpayer’s property”. On its face, this exception seems to exclude any restrictive covenant entered into that relates to the disposition of property. If true, proposed section 56.4 would only apply to employment relationships or other service relationships. This interpretation would of course result in the exclusion of non-competition agreements provided in the context of a sale of a business. Considering the provision was drafted seemingly with the intention of changing the law following the *Manrell* decision, this interpretation is not likely to be the one intended by the legislative drafters.

An example is useful to illustrate the complication in interpreting the wording of this exception. Let us suppose that a taxpayer disposes of his shares of an operating corporation for consideration that includes shares in the purchaser. Furthermore, supposing that as part of the disposition, the vendor covenants not to dispose of the shares received as consideration for a period of 2 years. While it is likely that the covenant fits within the definition of “restrictive covenant,” would the parenthesized exception apply? Two interpretations are conceivable:

1. It could be argued that the words “agreement or undertaking for the disposition of the taxpayer’s property” apply to any covenant that relates to or is in respect of the disposition of property. In the above example, since the covenant not to dispose of the shares received as consideration relates to the disposition of the shares by the taxpayer, the exception would apply to exclude the covenant from the definition of “restrictive covenant.”
2. It could also be argued that the words “agreement or undertaking for the disposition of the taxpayer’s property” should be interpreted as meaning an agreement that provides for the sale of the taxpayer’s property. The use of the word “for” in the exception should be read as saying that the agreement must be for the sale of property and not just related to or in respect of the sale of property. In the above example, the covenant is entered into to prevent the taxpayer from disposing of the shares. It is not a covenant to sell the property of the taxpayer, and as such would not fit within the parenthesized exception.

As previously stated, this second interpretation should be privileged, as applying the first interpretation would result in the exclusion of every covenant that simply relates to the sale of property. Thus, in the above example, the covenant would fit within the definition of “restrictive covenant” as the exception would not apply.

This exception is further complicated by the fact that the rights expressed in an agreement could fit within the broad definition of property. It should be remembered that the CRA had originally argued that the right to compete was property under the Act. While the court rejected this argument, it is conceivable that certain other rights may fall within the definition of property. Thus, the disposition of these rights in an agreement may also fall within the exception, as they would be the disposition of property. If this interpretation is retained, the first part of the definition and the exception should ultimately be read as “any agreement/undertaking/waiver except when such agreement/undertaking/waiver is property to the taxpayer”. All agreements, undertakings and waivers that are property appear to be excluded from the definition.

While it is difficult to conclude that the interpretation provided above is the correct one based on the words in the proposed definition, if correct the exception is logical and fits within the context of the legislation being a response to *Manrell*. As discussed more fully above, the court in *Manrell* found that the restrictive covenant exchanged was not property and was therefore not taxable. Therefore, section 56.4 applies where the restrictive covenant is similarly not property, and based on this interpretation of the exception, section 56.4 does not apply in most commercial contexts where the restrictive covenant is property.

It is critical, therefore, to determine whether the restrictive covenant is property. This issue has been addressed following *Manrell* in the recent case *RCI Environnement Inc. v. The Queen*.⁵⁶ In *RCI*, the taxpayer and Centres De Transbordement et de Valorization Nord-Sud Inc. (“CTVNS”) released WMI Waste Management of Canada Inc. (“WMI”) and its related parties of restrictive covenants entered into by Canadian Waste Services Inc., which was subsequently amalgamated into a larger group of companies including WMI. The amalgamation resulted in WMI becoming subject to the conditions of the restrictive covenants, which was an unacceptable commercial result and therefore WMI agreed to pay RCI and CTVNS a sum of \$12 million to be released from the obligations of the restrictive covenants.

Like *Manrell*, the primary issue was whether the sum received was on account of capital, income, or as the taxpayer first reported it, a non-taxable windfall. To be on account of capital, which the Court ultimately found as the result, the payment to be released from the restrictive covenants must be classified as a disposition of property. Therefore, the definition of “property” formed a critical part of Justice Archambault’s analysis.

In *RCI*, the Court continued to accept the definition proposed by Professor Ziff as a good starting point for the definition of “property” in the Act:

“Professor Ziff, in *Principles of Property Law*, 3rd ed (Scarborough: Carswell, 2000), says this about property (emphasis added) (at page 2):

Property is sometimes referred to as a bundle of rights. This simple metaphor provides one helpful way to explore the core concept. It reveals that property is not a thing, but a right, or better, a collection of rights (over things) enforceable against others. Explained another way, the term property signifies a set of relationships among people that concern claims to tangible and intangible items.⁵⁷

This definition is helpful as it focuses on rights enforceable against others, which provides insight into the definition described in the definition of “property” in subsection 248(1).

Regarding the definition, Justice Archambault states,

“Because the English version says “property’ means”, this is clearly, in my opinion, an exhaustive definition. What is important to take from the definition is the fact that the concept includes both corporeal and incorporeal property, including a right of any kind. It is not necessary here to determine the precise scope of the concept of “right”, which is not defined in the Act. In the usual sense of the word, “droit” (right) includes, according to *Le Petit Robert*: “[TRANSLATION] ... Something that is required or permitted under a precise, express rule (law, regulation)”. A contract could have been included in that list of the sources of rights.”⁵⁸

Although this definition is not particularly instructive, taken with an earlier part of his decision, Justice Archambault does in fact provide strong guidance on where an agreement creates property. He states that a non-competition agreement confers an advantage of an enduring nature because it protects goodwill, citing two British cases and one Canadian case for this precedent.⁵⁹ Therefore, it can be concluded that where an agreement creates a right to demand that the other party to the agreement do or not do anything, and that right has the effect of protecting the goodwill of a party, property is obtained.

As could be expected, counsel for the taxpayer argued that non-competition agreements are not objects of commerce and cannot be considered as property pursuant to *Manrell*. The court disagreed with this opinion, and distinguishes *Manrell* by stating that when the object of the obligation was not to do something, it was evident that such an obligation was not property. However, when one is the beneficiary of another’s undertaking not to do something, this right, of which the taxpayer is beneficiary, is property to the beneficiary. Thus, while the non-competition agreement may not be property to the taxpayer granting it, it is property for the beneficiary who disposes of it.

The Court found that *RCI* and *CTVNS* had received property when *WMI* entered into the restrictive covenants and therefore disposed of said property when they released *WMI* from the restrictive covenants⁶⁰.

As mentioned earlier, the restrictive covenant proposals have undergone significant change with each subsequent revision. The rules have become more opaque as the Department of Finance seeks to rectify the lacuna of each prior version by grafting on further subsections to the rules. We shall now examine the most recent set of draft legislation, as it is certainly difficult to understand on a simple reading of the legislation.

The Income Inclusion Rules

Proposed Subsection 56.4(2) of the Act

Besides the definition of “restrictive covenant”, the heart of the restrictive covenant rules is found at proposed subsection 56.4(2). This subsection serves to overrule the *Manrell* decision and include into income all amounts in respect of a restrictive covenant. Pursuant to subsection 56.4(2) a taxpayer must include in computing income for a taxation year all amounts in respect of a restrictive covenant when the following criteria are met:

1. The amount is in respect of a restrictive covenant of the taxpayer;
2. The amount was received or receivable in the taxation year;
3. The amount must be received or receivable by the taxpayer or a taxpayer with whom the taxpayer does not deal at arm’s length; and
4. The amount was not included in the taxpayer’s income because of subsection 56.4(2) in a previous taxation year (or in the taxpayer’s eligible corporation’s income because of subsection 56.4(2) during the year or a previous taxation year).

The general rule regarding restrictive covenants is one of full income inclusion, not of capital gains treatment. At first blush, this full income inclusion is somewhat surprising in light of the Department of Finance’s avowed objective of restoring the taxability of restrictive covenants to the pre-*Manrell status quo*.⁶¹ Indeed, as we have previously seen, the CRA’s initial positions, both pre-*Manrell* and as part of the *Manrell* case, were that amounts received for entering into a non-competition agreement were to be given capital treatment. However, when one considers that a “restrictive covenant” is much more than just a non-competition agreement, the full income treatment might make more sense. Indeed, barring any application of the principles enunciated in *Manrell*, many restrictive covenants would normally find their way into income through section 9 of the Act.

By the operation of these rules, the taxpayer liable for income inclusion of amounts received for restrictive covenants will usually be the taxpayer granting the covenant. In the event that a non-arm’s length taxpayer is the recipient of the amounts, the taxpayer entering into the covenant will nevertheless be liable to include the amount into income. For example, if a shareholder enters into a restrictive covenant but the amount in respect of the covenant is paid out to the corporation with whom the shareholder does not deal at arm’s length, the shareholder will be have to include the amount into income (assuming no exceptions to the rules as discussed later). Seemingly, this rule exists to prevent tax avoidance by the person granting the covenant by redirecting payment in respect of the covenant to a non-arm’s length taxpayer. It is questionable whether this rule is necessary, as this behaviour would likely be caught by subsection 56(2) of the Act, regarding indirect payments. In order to avoid this mismatch of income receipts and liability, the taxpayer granting the covenant should also be the recipient of the amounts in most cases. It has also been noted by tax commentators that subsection 56.4(2) of the Act captures into income both amounts that are received and amounts that are receivable. This creates a potential disparity between the inclusion into income of the amount and the actual moment at which the amount is received. Presently, the restrictive covenant rules do not provide any relief by way of deferral. Thus, cash flow problems may exist for taxpayers who are entitled to future amounts relating to restrictive covenants.

In order to illustrate the income inclusion provision under proposed subsection 56.4(2) of the Act, let us suppose that Company A has a new technology which Company B wishes to use on a world-wide and exclusive basis for the benefit of Company B’s business. Company A and Company B deal at arm’s length. Company B agrees to pay Company A \$2M in year 1 and \$8M in year 2 for the exclusive use of Company A’s new technology. In addition, Company B will pay Company A royalties for the ongoing use of Company A’s technology. The exclusivity agreement will likely be a restrictive covenant pursuant to proposed subsection 56.4(1) of the Act as it is an agreement that affects the provision of property by

Company A. Company A must report the complete \$10,000,000 with respect to the exclusivity payment in the year of signing, despite receiving \$2M in the first year and \$8M in the second year. There is no reserve possible for the \$8M received in the second year.

Tax practitioners may question whether the exclusivity covenant may fall within the parenthesized exception to the definition of restrictive covenant. In other words, could the exclusivity covenant be “an agreement or undertaking for the disposition of the taxpayer’s property”? Firstly, while the exclusivity agreement relates to the disposition of the new technology held by Company A, it is not in itself an agreement for the sale of the new technology. It is an agreement to sell the technology only to Company B. Secondly, it could be questioned whether entering into an exclusivity agreement is not the disposition of Company A’s rights to do business with others? Thus, the question is, is the right to do business with others property pursuant to the Act? If Manrell is to be followed, then such a right should not be property under the Act, and consequently the parenthesized exception to the definition should not apply.

Avoidance of Double Taxation

One could question the tax treatment of the recipient of the amounts received in respect of a restrictive covenant entered into by another taxpayer. As explained above, the person granting the covenant will include the full amount in income, but what of the recipient? Proposed subsection 56.4(12) of the Act provides clarity in this respect. Amounts that are received by one taxpayer but included in the income of another taxpayer pursuant to subsection 56.4(2) of the Act, will not be included in income of the recipient. This provision is essential to clarify and prevent any possible occurrence of double taxation when the person granting the covenant is not the recipient of the amounts in respect of the covenant. While proposed subsection 56.4(12) of the Act offers some relief from double taxation, amounts that are received by a corporation for a restrictive covenant entered into by the shareholder will not increase the capital dividend account. As a result, the amounts received by the corporation will be “trapped” within the corporation and distributions of these amounts to the shareholder will attract further taxation.

As mentioned, proposed subsection 56.4(2) of the Act does afford relief from full income inclusion when amounts have been received in respect of a restrictive covenant but the amount has already been included in income pursuant to subsection 56.4(2) of the Act. Strangely, this exclusion also applies to amounts that were included in a taxpayer’s eligible corporation’s income for the taxation year or preceding taxation year under subsection 56.4(2) of the Act. However, given that subsection 56.4(2) of the Act operates in such a fashion as to always include the amount in the income of the taxpayer granting the covenant, it is difficult to imagine how any amounts could be included in the income of the taxpayer’s eligible corporation in the first place. In other words, this exclusion will likely never apply and appears to have no purpose in subsection 56.4(2). Thus, if a shareholder enters into a restrictive covenant but the amount in respect of the covenant is received or receivable by the corporation, only the shareholder will include the amount in income. Without this clarification the rules could be interpreted in a fashion that would lead to double taxation. However, as noted by the Joint Committee,⁶² a form of double taxation will continue to exist when the amount is paid to a corporation, as the amount must then be taxed a second time when it is distributed to the shareholders.

New proposed subparagraph 12(1)(x)(v.1) of the Act also provides for relief from potential double taxation. Paragraph 12(1)(x) states that certain inducements, reimbursements, contributions, allowances and assistance must be included in a taxpayer’s business income. Subparagraph 12(1)(x)(v.1) of the Act provides that when there is an income inclusion pursuant to the restrictive covenant rules, the amount must not be included under paragraph 12(1)(x).

Relief from double taxation is also afforded by new subsection 14(5.1) of the Act. This subsection provides that when an amount is included in income pursuant to subsection 56.4(2), no amount is to be included in the description of E in the definition of cumulative eligible capital (“CEC”) under subsection 14(5) of the Act. Thus if a goodwill amount is to be included in income pursuant to the restrictive covenant rules it will not also be taken into account for the purposes of section 14. If the Department of Finance thought it necessary to include proposed subsection 14(5.1) of the Act it is questionable why the Department did not include a similar exception at section 9 and paragraph 12(1)(a) of the Act.

In addition to the core restrictive covenant rules, certain other sections of the Act have been introduced so as to integrate the restrictive covenant rules within the Act. One of these rules is paragraph 60(f) of the Act dealing with bad debts. Paragraph 60(f) provides that there may be deducted from a taxpayer's income amounts owing to the taxpayer that have become bad debts in the taxation year and that were included in income pursuant to proposed subsections 56.4(2) or 6(3.1) of the Act.

Pursuant to the restrictive covenant rules, an amount may be receivable by one taxpayer but included in the income of another taxpayer. The taxpayer who must include the amount in income should be the one that benefits from the bad debt rules at paragraph 60(f) of the Act. However, paragraph 60(f) of the Act benefits the taxpayer to whom the amounts are owing. Thus, if a debt with respect to a restrictive covenant should become a bad debt and the amount was owing to a taxpayer that was not the taxpayer required pursuant to subsection 56.4(2) to include the amount in income, there will be a mismatch between the taxpayer who is entitled to the deduction and the taxpayer who shall include the amount in income. The same comments are applicable to new paragraph 56(1)(m) which requires a taxpayer who has received an amount in respect of a restrictive covenant that had previously been deducted as a bad debt.

Exceptions to Proposed Subsection 56.4(2) of the Act

As we have seen, the CRA originally envisioned amounts received for restrictive covenants as being either included in the proceeds of disposition of whichever property they relate to or, as eligible capital property. The exceptions to proposed subsection 56.4(2) of the Act mirror this traditional treatment to the extent that they allow for such treatment.

The exceptions found at proposed subsection 56.4(3) of the Act apply to exclude the application of proposed subsection 56.4(2) of the Act. The preamble of proposed subsection 56.4(2) of the Act sets out the following criteria for the exceptions to apply:

1. A taxpayer must have granted a restrictive covenant;
2. The restrictive covenant must have been granted by the taxpayer to another taxpayer with whom the taxpayer granting the covenant deals at arm's length;⁶³ and
3. The amount must be received or receivable by the person granting the covenant.

It should be noted that the preamble of proposed subsection 56.4(3) of the Act does not allow for the exceptions to apply if the person granting the restrictive covenant is not the one receiving the amounts in respect of the restrictive covenant. Furthermore, the exceptions are limited to restrictive covenants granted to taxpayers dealing at arm's length with the person granting the covenant. This restriction aims at preventing abusive tax planning between non-arm's length parties. For example, the sole shareholder of two sister corporations (ACo and BCo) could enter into a business asset sale agreement wherein ACo would sell its assets to BCo. In the course of the sale, the shareholder would grant a non-competition agreement to BCo for consideration. If the exceptions under proposed subsection 56.4(3) applied between non-arm's length parties, the amounts received as consideration of the non-competition agreement could benefit from preferential tax treatment. Thus a shareholder could manufacture notional transactions to convert distributions from a corporation into capital gains if the exception under proposed subsection 56.4(3) of the Act were otherwise met. However necessary the non-arm's length exception may be, it could be very problematic in legitimate non-arm's length transfers of businesses involving a restrictive covenant. This fact was pointed out before the Standing Senate Committee on Banking, Trade and Commerce. The Department of Finance addressed these concerns as follows:

In designing those rules, it became apparent that there was a great willingness on the part of non-arm's length taxpayers to enter into transactions to create tax-free receipts in order to achieve the benefit before and, with these rules in place, to achieve whatever benefits could be obtained by recharacterizing the receipts from an amount on income account to amount on capital account. Accordingly, their rules are different for non-arm's length transactions than they are for arm's-length transactions.

[...]

That is not unique in the Income Tax Act. We have stop-loss rules for non-arm's-length transactions and a variety of rules that apply in the case of non-arm's length transactions that are more stringent than in the case of arm's length standard.⁶⁴

We shall now examine each exception in turn.

Proposed Paragraph 56.4(3)(a) of the Act – Employment Income (The First Exception)

The first exception to the proposed income inclusion under proposed subsection 56.4(2) of the Act relates to employment income. In essence, amounts received or receivable for entering into a restrictive covenant will not be included in income under proposed subsection 56.4(2) of the Act if they are included or would have been included in employment income under sections 5 and 6 of the Act. This exception targets payments made by employers to employees for entering into restrictive covenants. It is likely that such payments are caught by sections 5 or 6 of the Act.⁶⁵ Thus, this exception is necessary to prevent potential double taxation when amounts could be included in income under both sections 5 and 6 and subsection 56.4(2) of the Act.

This exception may suffer from certain problems with respect to the interpretation of statutes. Rules of statutory interpretation dictate that specific provisions will prevail over general provisions.⁶⁶ As the rules governing section 5 and 6 are general in nature, and the rules with respect to restrictive covenants are specific, any payments made as consideration for restrictive covenants should always be governed by the proposed restrictive covenant rules in preference to the rules under sections 5 and 6. In other words, because proposed section 56.4 should have precedence over sections 5 and 6, amounts paid for restrictive covenants should logically never be included in sections 5 and 6 of the Act. Sections 5 or 6 and proposed section 56.4 of the Act could not both operate to include income twice due to the saving provision at subsection 248(28) of the Act, which prevents a single amount from being included into income twice. Despite this potential interpretative issue, the policy intent behind the proposed paragraph 56.4(3)(a) exception appears to be that when sections 5 and 6 could apply, they should apply in preference to proposed subsection 56.4(2) of the Act.

Employees are habitually taxable on amounts received, not on amounts receivable. The employment income exception applies to exclude an income inclusion under proposed subsection 56.4(2) of the Act even if the amount is only receivable, not received. Thus, the employee will only be taxable pursuant to sections 5 or 6 of the Act on amounts received only, even if the amount in respect of the restrictive covenant is receivable in a prior year and thus would be taxable under subsection 56.4(2) of the Act if it were not for this exception.

In addition, the new proposals add new subsection 6(3.1) of the Act. This new subsection ties in with the exception under paragraph 56.4(3)(a) of the Act and the new restrictive covenant rules. As employment income is only included in income in the year it is received, the Department of Finance drafted subsection 6(3.1) of the Act to limit the deferral of income that could be obtained by delaying the payment of the consideration for a restrictive covenant to an employee. Subsection 6(3.1) of the Act applies when all the following criteria are met:

1. An amount is receivable by a taxpayer in respect of a covenant;
2. The taxpayer agreed to the covenant more than 36 months before the end of the taxation year;
3. The covenant is in reference to what the taxpayer is or is not to do; and
4. The amount would be included in the taxpayer's income under subdivision a – Income or Loss from an Office or Employment, if the amount was received in the year.

When the above-mentioned criteria are met, the amount will be deemed to have been included in the taxpayer's income for the year as employment income and will be deemed not to have been received at any other time. Proposed subsection 6(3.1) of the Act does not apply to amounts that are included in paragraph 6(1)(a) of the Act by virtue of subsection 6(11) of the Act. Subsection 6(11) of the Act deals with salary deferral arrangements.

By way of example, let us suppose that EmployerCo hires Employee A pursuant to an employment agreement that specifically restricts Employee A's abilities to earn additional employment or business income outside of Employee A's employment with EmployerCo. Employee A is paid \$100,000 annually for services rendered. It could be said that the restrictive clause in the employment agreement is an agreement entered into that affects, or is intended to affect, in any way whatever, the provision of services by Employee A. Thus, the restrictive clause within the employment contract would likely qualify as a restrictive covenant pursuant to subsection 56.4(1) of the Act. EmployerCo and Employee A have not assigned value to the restrictive covenant and no amounts were paid to Employee A as consideration for this restrictive covenant. Presumably, this restrictive covenant has some value for EmployerCo as it forces Employee A to dedicate his full attention to his employment with EmployerCo. It is conceivable that section 68 of the Act, as discussed below, will apply to reallocate a portion of Employee A's salary to the restrictive covenant. However, as such amounts would be included in calculating Employee A's income under section 5, the proposed exception at paragraph 56.4(3)(a) of the Act would apply to exclude these amounts from income inclusion under proposed subsection 56.4(2) of the Act. At first blush an income inclusion under section 5 or proposed subsection 56.4(2) of the Act does not appear to make a difference for the taxpayer as both are complete income inclusions. However, an income inclusion under proposed subsection 56.4(2) would have a negative impact on the employee's calculation of RRSP contribution limits⁶⁷ and the ability for the employee to claim certain deductions under section 8 of the Act.

Paragraph 56.4(3)(b) of the Act – Cumulative Eligible Capital (The Second Exception)

Were it not for the new restrictive covenant provisions, amounts received in respect of a restrictive covenant entered into on the sale of business assets would likely result in an income inclusion as CEC due to the description of E in the definition of CEC at subsection 14(5) of the Act. The opening words of the description of E in the definition of CEC at subsection 14(5) of the Act read as follows:

E is the total of all amounts each of which is $\frac{3}{4}$ of the amount, if any, by which

(a) an amount that the taxpayer has or may become entitled to receive, after the taxpayer's adjustment time and before that time, on account of capital in respect of the business carried on or formerly carried on by the taxpayer, other than an amount that

(i) is included in computing the taxpayer's income, or deducted in computing, for the purposes of this Act, any balance of undeducted outlays, expenses or other amounts for the year or a preceding taxation year,

(ii) reduces the cost or capital cost of a property or the amount of an outlay or expense, or

(iii) is included in computing any gain or loss of the taxpayer from a disposition of a capital property. [emphasis added]

The exception under proposed paragraph 56.4(3)(b) of the Act applies to allow a taxpayer to treat the amounts received or receivable in respect of a restrictive covenant as CEC rather than full income inclusion, when the following criteria are met:

1. The amount would be required to be included in the description of element E in the definition of CEC at subsection 14(5) of the Act for the taxpayer granting the covenant, if the Act were read without reference to the restrictive covenant rules. Thus, pursuant to subsection 14(5) of the Act the following further criteria must also be met:

- a. The amount received was on account of capital; and
 - b. The amount was received in respect of a business carried on by the taxpayer.
2. The restrictive covenant must relate to the business referred to at subsection 14(5) of the Act;
 3. The person granting the covenant must elect in prescribed form to apply proposed paragraph 56.4(3)(b) of the Act, or if the amount is payable by the purchaser in respect of a business carried on in Canada by the purchaser, the taxpayer and the purchaser must jointly elect.

As previously mentioned, this exception seems to target restrictive covenants entered into in the course of business asset sales transactions. However, due to the restrictiveness of the exception, it may rarely apply to afford relief to a taxpayer. The main issue with this exception is that the taxpayer who grants the restrictive covenant (usually a shareholder) will not be the one carrying on the business (usually the corporation). As subsection 14(5) of the Act requires that the amount received must be received in respect of a business carried on by the taxpayer, this exception will usually not apply when the business assets of a corporation are sold and the shareholder is granting the covenant. The disparity between the person granting the restrictive covenant and the taxpayer carrying on business will often be fatal to the application of proposed paragraph 56.4(3)(b) of the Act.

It is somewhat surprising that the Department of Finance did not anticipate this difficulty in light of the fact that a very similar argument had been used to counter the CRA in *Fortino*. As it will be remembered, the Tax Court had rejected the CRA's contention that the amounts received in respect of a restrictive covenant should be included as CEC:

If the taxpayer does not carry on the business that was the object of the transaction, then 14(1) does not come into play.

In the present case, the NCA payments were made to the appellants who were the shareholders of *Fortino's* which was carrying on the business.⁶⁸

The Court further notes that it is a well established principle of corporate law that the holding of shares by a shareholder does not lead to the conclusion that the shareholder is carrying on the business of the corporation.⁶⁹ If this is indeed the interpretation that must be given to paragraph 56.4(3)(b) of the Act, then its use to taxpayers who operate a businesses through a corporation is greatly reduced. If the exception under proposed subsection 56.4(3) is not available, the exception under proposed subsection 56.4(7), as discussed below, may nevertheless be available. Indeed, proposed subparagraph 56.4(7)(e)(ii) specifically provides for the situation where a taxpayer operates his business through a corporation. While subsection 56.4(7) may offer relief where subsection 56.4(3) does not apply, the criteria for subsection 56.4(7) to apply is more restrictive than the criteria at subsection 56.4(3). As shall be discussed below, proposed subsection 56.4(8) of the Act may also offer relief for asset sales.

Proposed Paragraph 56.4(3)(c) of the Act – Capital Gains (The Third Exception)

The exception under proposed paragraph 56.4(3)(c) of the Act to the full income inclusion of restrictive covenants relates to the sale of shares or partnership units. This exception suffers of numerous and at times seemingly arbitrary criteria that diminish its effectiveness significantly. Proposed paragraph 56.4(3)(c) is subject to the anti-avoidance rule at proposed subsection 56.4(10), as discussed below. Paragraph 56.4(3)(c) of the Act will apply when the following criteria are met:

1. The amount received or receivable in respect of the restrictive covenant relates directly to the person granting the covenant's disposition of an "eligible interest";
2. The "eligible interest," described further below, must be in a partnership or corporation that carries on the business to which the restrictive covenant relates, or the capital stock of a

corporation that derives 90% of its fair market value from the shares of a corporation that carries on the business to which the restrictive covenant relates;

3. The shares or partnership interests that are eligible interest(s) are disposed to a taxpayer that has been granted the restrictive covenant or a person related to that taxpayer;
4. The amount is consideration for a non-competition agreement;⁷⁰
5. The restrictive covenant may reasonably be considered to have been granted to maintain or preserve the value of the eligible interest disposed of to the purchaser;
6. If the restrictive covenant is granted on or after July 18, 2005, subsection 84(3) does not apply to the disposition;
7. Neither of the rollover provisions of section 85 or subsection 97(2) of the Act applies to the disposition;⁷¹
8. The amount received or receivable in respect of the restrictive covenant is added to the proceeds of disposition of the eligible interest for capital gains purposes; and
9. Both the person granting the covenant and the purchaser of the eligible interest elect in prescribed form to have proposed paragraph 56.4(3)(c) apply.

An “eligible interest” of a taxpayer is defined in proposed subsection 56.4(1) as being capital property of the taxpayer that is either a partnership interest, or the capital stock of a corporation that carries on business, or capital stock of a corporation 90% or more of the fair market value is derived from shares of one other corporation that carries on business. The fact that the definition of eligible interest specifically limits itself to capital stock of a corporation 90% or more of the fair market value is derived from shares of one other corporation, will limit the applicability of the exception found at paragraph 56.4(3)(c). Indeed, a corporate group consisting of several operating corporate entities held by a single holding company will not be entitled to benefit from the exception under paragraph 56.4(3)(c) on the sale of an eligible interest as the fair market value of the holding company’s shares is not derived from a single other corporation.

Proposed Subsection 56.4(4) of the Act – Treatment for the Purchaser

Proposed subsection 56.4(4) of the Act sets out rules for the purchaser’s treatment of amounts paid for a restrictive covenant. These rules closely mirror the exceptions found under proposed subsection 56.4(3) of the Act. Under proposed paragraph 56.4(4)(a) an amount paid by the purchaser of a restrictive covenant that is included in the income of an employee of the purchaser is considered as wages to the employee, and thus presumably deductible.⁷²

Under proposed paragraph 56.4(4)(b), if the election under proposed paragraph 56.4(3)(b) of the Act has been made, the amount is to be considered incurred on account of capital for the purposes of applying the definition of “eligible capital expenditure” (“ECE”) under subsection 14(5) of the Act, and not to be an amount paid for any other purpose.

Under proposed paragraph 56.4(4)(c), if the election has been made under proposed paragraph 56.4(3)(c) of the Act, the amount paid must be included in computing the cost to the purchaser of the shares or units acquired, and is considered not to be an amount paid for any other purpose of the Act.

In the event that none of the exceptions under proposed subsection 56.4(3) of the Act applies, and thus none of the treatments provided for at proposed subsection 56.4(4) of the Act applies, the payment of an amount in respect to a restrictive covenant will depend on the general principles of the Act. As the definition of “restrictive covenant” is so broad and can cover many different types of agreements, it is impossible to generalize about the tax treatment for the purchase of every conceivable restrictive

covenant. However, it is likely that most restrictive covenants will be paid out on account of capital and will thus likely benefit from ECE treatment.

Section 68 and Restrictive Covenants

Following the *Manrell* decision, it was desirable for a taxpayer to allocate substantial amounts to restrictive covenants in the context of a share sale as these amounts would be tax-free. Under the new restrictive covenant rules, it is undesirable to do so, as the total amount will be included in income. It is much preferable, in the context of a sale of shares or business property, to simply allocate the entire purchase price to the assets or shares and none to the restrictive covenant. This would result in the entirety of the consideration for the covenant being subsumed into the proceeds of disposition of the shares or business property, resulting in an advantageous capital treatment. To prevent taxpayers from evading the restrictive covenant rules in such a fashion, the Department of Finance has proposed amendments to section 68 of the Act, to take into consideration restrictive covenants.

Existing section 68 of the Act requires a taxpayer to reasonably allocate an amount received or receivable between property and services. This section prevents a taxpayer from allocating amounts received in the most tax advantageous way possible. Section 68 of the Act is to be amended so as to require a taxpayer to allocate a reasonable amount to restrictive covenants.

New proposed section 68 of the Act deems the amount that can reasonably be regarded as being consideration for a restrictive covenant to be an amount received or receivable in respect of a restrictive covenant. This allocation disregards any legal agreement that may allocate the amount received in a different manner. Consequently, a taxpayer may not evade the application of the restrictive covenant rules by formulating a legal agreement so that no amount is allocated to a restrictive covenant. The question as to what a reasonable allocation will be is a question of fact that will depend on many factors, including the nature of the restrictive covenant granted. Such valuation matters are discussed later in this paper.

It is interesting to note that in a recent Tax Court decision, *Robert Glegg Investment Inc. v. The Queen*,⁷³ a taxpayer attempted to invoke section 68 to reallocate consideration received from the disposition of shares to a non-competition agreement. In that decision, the taxpayer had disposed of shares in his company and entered into a non-competition agreement with respect to the business carried on by the company. No consideration was allocated to the non-competition agreement. The taxpayer wished to reallocate consideration for the shares to the non-competition agreement in order to benefit from the tax-free treatment of non-competition agreements prior to the introduction of the proposed restrictive covenant rules. The court accepted the proposition that pursuant to section 68 of the Act, only the amount that can reasonably be regarded as consideration for the shares can be attributed to the shares. On the assumption that the non-competition agreement has some value in the total amount paid, the reasonable amount paid for the shares should be carved out of the total amount paid, with the residue of the total amount logically being attributable to the non-competition agreement. In the end the taxpayer was not successful, as the shares in the company were held by a holding company, which resulted in a mismatch between the entity receiving the amounts and the person granting the covenant. However, it is interesting to note that section 68 of the Act could be applied as to carve out amounts for a non-competition agreement even prior to the proposed addition of paragraph 68(c) of the Act. In the recent appeal decision of this case,⁷⁴ the FCA dismissed the appeal but appears to reverse the Tax Court's analysis of section 68 of the Act. The FCA laconically states that when the entire amount of consideration received by a taxpayer can reasonably be considered for the disposition of a particular property, then paragraph 68(a) does not apply. Presumably, the FCA is expressing the opinion that when only one particular property is disposed, section 68 cannot apply as there is no other property to which the amount may be reallocated.

It should be noted that section 68 applies to all restrictive covenants, whereas the exception under paragraph 56.4(3)(c) and subsections 56.4(6), (7) and (8) of the Act (as discussed below) apply only to non-competition agreements.

Proposed Subsection 56.4(5) of the Act – Non-Application of Section 68

The proposals provide relief from the application of section 68 in very specific circumstances. Proposed subsection 56.4(5) of the Act states that when that subsection applies, section 68 of the Act will not apply to reallocate an amount to the restrictive covenant. Presumably, when subsection 56.4(5) of the Act applies, the taxpayer may decide to allocate no amount to the restrictive covenant and thus escape the application of the restrictive covenant rules. In the event that the taxpayer allocates a certain amount to the restrictive covenant, the exception under subsection 56.4(5) of the Act will not benefit the taxpayer in respect of the amount allocated to the restrictive covenant. Thus, if the taxpayer wishes to benefit from capital gains or ECE treatment, no value should be assigned to the restrictive covenant and the exception under subsection 56.4(5) of the Act should be sought. As a result, capital gains or ECE treatment may be obtained without relying on the elections under proposed subsection 56.4(3) of the Act.

Proposed Subsection 56.4(6) of the Act – Employee Provided Covenants

The exception under proposed subsection 56.4(6) of the Act targets employees who have entered into restrictive covenants in the course of the acquisition of the employee's employer by an arm's length party. Subsection 56.4(6) of the Act provides that subsection 56.4(5) of the Act will apply when all the following conditions are met:

1. The restrictive covenant is granted by an individual to another taxpayer with whom the individual is dealing at arm's length;
2. The restrictive covenant directly relates to the acquisition by the arm's length party of an interest in the individual's employer, in a corporation related to the employer or in a business carried on by the employer;
3. The individual granting the restrictive covenant deals at arm's length with the employer and the vendors of the interest in the employer;
4. The restrictive covenant is a non-competition agreement;⁷⁵
5. No consideration is received or receivable for granting the restrictive covenant; and
6. The amount that can reasonably be regarded as consideration for the restrictive covenant is received or receivable only by the vendor.

In essence, the exception at proposed subsection 56.4(6) of the Act applies when an employee grants a restrictive covenant but the vendor, who is disposing of the employer, is obtaining the consideration for the restrictive covenant. This exception has presumably been included to provide relief to key employees of a business.

Proposed paragraph 56.4(13)(a) of the Act provides for further clarification as to amounts that must be included in income by the vendors. If subsections 56.4(5) and (6) of the Act applies then the amount of consideration received in respect of the covenant by the vendor must be included in their computation of the proceeds of disposition of the interest in the employer.

Proposed Subsection 56.4(7) of the Act – Goodwill Amounts

Proposed subsection 56.4(7) of the Act provides for a further exception to the applicability of section 68. As with all the exceptions found in the restrictive covenant rules, this exception is both complicated and designed to address a very specific situation. This exception applies to a vendor of goodwill who grants a restrictive covenant that relates to the disposition of goodwill. To the extent that the amount received is included in the vendor's goodwill amount (discussed below) section 68 will not apply. This exception is

subject to the anti-avoidance rule found at subsection 56.4(11), as discussed below. The exception will apply when all the following criteria are met:

1. A restrictive covenant is granted by a taxpayer to another taxpayer dealing at arm's length;
2. The restrictive covenant is a non-competition agreement;⁷⁶
3. No consideration is given to the person granting the covenant;⁷⁷
4. The amount that can reasonably be regarded as being the consideration for the restrictive covenant is included by the person granting the covenant in computing a goodwill amount (discussed below) or is received or receivable by an eligible corporation (discussed below) of the person granting the covenant and included as a goodwill amount in respect of the business to which the restrictive covenant relates;
5. The restrictive covenant may reasonably be considered to have been granted to maintain or preserve the value of the goodwill disposed;
6. Neither section 85 nor subsection 97(2) of the Act applies to the disposition;
7. No amount of consideration that can be regarded as being consideration for the restrictive covenant is received or receivable directly or indirectly by an individual not dealing at arm's length with the person granting the covenant; and
8. The person granting the covenant and the purchaser jointly elect in prescribed form to apply proposed subsection 56.4(5) of the Act, or when the consideration is received or receivable by an eligible corporation of the taxpayer, the taxpayer, the eligible corporation and the purchaser must jointly elect in prescribed form.

Both the terms "eligible corporation" and "goodwill amount" are defined at proposed subsection 56.4(1) of the Act. An eligible corporation is a taxable Canadian corporation of which the taxpayer holds, directly or indirectly, shares of the capital stock and individuals with whom the taxpayer does not deal at arm's length⁷⁸ hold, in aggregate directly or indirectly, less than 10% of the issued and outstanding shares worth less than 10% of the aggregate fair market value of the shares of the corporation. A "goodwill amount" is an amount received or receivable by the taxpayer as consideration for the disposition of goodwill that is required by the description of E to be included in calculating CEC under subsection 14(5) of the Act.⁷⁹

As can be surmised from the foregoing, this exception is not only complicated to understand, but possibly very rarely applicable due to the numerous criteria for its application.

Proposed paragraph 56.4(13)(b) of the Act provides for further clarification as to amounts that must be included in income. If subsections 56.4(5) and (7) of the Act applies then the amount of consideration that can reasonably be regarded as being the consideration for the restrictive covenant must be added to the amount described at E of the definition of CEC in subsection 14(5) of the Act. This clarification, while always useful for practitioners, appears duplicative as the wording of paragraphs 56.4(7)(d) already states this inclusion.

Proposed Subsection 56.4(8) of the Act – Disposition of Property

Proposed subsection 56.4(8) of the Act provides for the final exception to the application of section 68 to restrictive covenants. This exception relates to the disposition of share and property other than shares and is subject to the anti-avoidance rule at subsection 56.4(11) of the Act, as discussed below.

The exception will apply when the following criteria are met:

1. The restrictive covenant is granted by the taxpayer (“vendor”) to a purchaser with whom he is dealing at arm’s length;⁸⁰
2. The restrictive covenant is a non-competition agreement;⁸¹
3. The restrictive covenant is integral to an agreement in writing under which the vendor disposes of property for consideration that is received or receivable by the vendor or the restrictive covenant is integral to an agreement in writing under which shares of a corporation are disposed of to the purchaser;
4. Where property other than shares is being disposed of, consideration that can reasonably be regarded as being in part of the restrictive covenant is received or receivable by the vendor as consideration for the disposition of the property;
5. Where the property is shares of a corporation, no portion of the amount of consideration that can reasonably be regarded as being part of the consideration for the restrictive covenant can be received or receivable directly or indirectly by an individual not dealing at arm’s length with the vendor;
6. Subsection 84(3) of the Act does not apply to the disposition;
7. Neither section 85 nor subsection 97(2) of the Act applies to the disposition; and
8. The restrictive covenant can reasonably be regarded as being granted to maintain or preserve the fair market value of the property disposed of.

Proposed subsection 56.4(8) of the Act was introduced in the latest round of draft legislation. This provision is highly useful for taxpayers granting non-competition agreements in the course of shares sale and closely mirrors the exception at proposed paragraph 56.4(3)(c) of the Act. Its usefulness for share sales is twofold: firstly, pursuant to proposed subparagraph 56.4(8)(c)(ii) of the Act, and unlike the exception at proposed paragraph 56.4(3)(c) of the Act, the taxpayer granting the covenant need not be the taxpayer disposing of the shares. This is highly useful for tiered structures that are frequently found in corporate groups. Secondly, the exception under proposed subsection 56.4(8) is useful as it does not require an election to be effective. This exception is not as practical for business asset sales, as the vendor of the assets must be the one granting the covenant. Thus, if a shareholder is granting the covenant, and the corporation is selling the business assets, the criteria at proposed subparagraph 56.4(8)(c)(i) would not be met and a reallocation of proceeds under section 68 would be possible.

Proposed subsection 56.4(8) of the Act appears to mirror the exceptions found at proposed subsection 56.4(3)(c) of the Act. It appears that this duplication of exceptions arises from the fact that proposed subsection 56.4(8) of the Act was introduced only in a later round of draft legislation and that certain taxpayers had structured transactions based on the requirements found at proposed paragraph 56.4(3)(c) of the Act. Thus, while proposed subsection 56.4(8) is arguably more useful than proposed paragraph 56.4(3)(c) of the Act, the Department of Finance appears to have kept this later provision for the benefit of taxpayers who had planned their affairs pursuant to proposed paragraph 56.4(3)(c) of the Act.

Proposed paragraph 56.4(13)(c) of the Act provides for further clarification as to amounts that must be included in income. If subsections 56.4(5) and (8) of the Act applies, the amount of consideration that can reasonably be regarded as being the consideration for the restrictive covenant must be added to the proceeds of disposition of the property or shares as the case may be.

Proposed Subsection 56.4(9) of the Act – Capital Gains Election

Proposed subsection 56.4(9) of the Act applies to offer some relief to a taxpayer that does not qualify for the exceptions under proposed subsections 56.4(7) and (8) of the Act solely because a portion of the

consideration that was reasonably regarded as consideration for the restrictive covenant was received by an individual not dealing at arm's length with the vendor.

To the extent that proposed subsections 56.4(7) and (8) qualify, but for the portion of the consideration that is received or receivable by the non-arm's length party, then proposed paragraph 56.4(9)(a) of the Act will restrict the application of section 68 only to the portion of the consideration received by the arm's length party.

Proposed paragraph 56.4(9)(b) offers further relief by allowing the taxpayer and each non-arm's length taxpayer to jointly elect to have the portion of the consideration subject to section 68 to be received by the taxpayer as a goodwill amount in the case of proposed subsection 56.4(7) or as proceeds of disposition in the case of proposed subsection 56.4(8). If the election is made, the non-arm's length taxpayer will be deemed not to have received the consideration.⁸² Furthermore, if the election is made, and the amount was received by a corporation, partnership or trust, the amount is deemed to have been received by the corporation, partnership or trust as agent of the taxpayer, if the consideration is transferred to the taxpayer within 180 days of being received.⁸³ This deemed agency rule is most useful, as it allows the distribution of the amount in the corporation, partnership or trust without any tax consequence for the entity acting as agent.⁸⁴ For example, if the amount that can reasonably be regarded as consideration for the restrictive covenant is paid to a corporation and the election under paragraph 56.4(9)(b) of the Act is made, the amount may be distributed to the shareholder granting the covenant without further tax consequences. In the absence of this rule, the amount would have to be distributed from the corporation as a dividend, thereby creating further tax consequences for the taxpayer granting the covenant.

Anti-Avoidance Rules

As with all complex rules in the Act, the restrictive covenant rules include certain anti-avoidance provisions. Proposed subsection 56.4(10) of the Act states that proposed paragraph 56.4(3)(c), which allows for capital gains treatment in respect of restrictive covenants on the sale of shares, will not apply if the amount would otherwise be included in employment, business or property income. The purpose of this anti-avoidance rule is to prevent the conversion of fully taxable income into gains that benefit from preferential tax treatment.

Proposed subsection 56.4(11) also restricts the application of the exceptions under proposed subsections 56.4(7), (8) and (9) if the result of not applying section 68 would be that the amount normally included in computing a taxpayer's income from employment, business or property were not to be included under paragraph 3(a).

Joint Elections – Practical Implications

Proposed subsection 56.4(14) sets out the rules as to how the elections under proposed paragraphs 56.4(3)(b) and (c), 56.4(7)(h) and 56.4(9)(b) are to be filed. If the person who granted the covenant was resident in Canada then such election must be filed on or before the person's filing due date⁸⁵ for the taxation year that includes the day on which the restrictive covenant was granted. In any other case, the election must be filed by the non-resident on or before the day that is 6 months after the day on which the restrictive covenant was granted. However, as the restrictive covenant legislation is only in draft form and has not yet been enacted, an election will be deemed to be filed on a timely basis when it is filed on or before the day that is 180 days after the day the restrictive covenant rules are given Royal Assent.

The CRA has provided its version of the proposed elections (prior to officially releasing a prescribed form after Royal Assent of the proposals) at <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/lf-vnts/sllng/rstrctv/Ltr-eng.pdf>.

The proposed elections reflect earlier versions of the draft legislation and have not been updated to reflect later versions of the draft legislation. It is the Department of Finance's intention to include the elections

under the restrictive covenant rules in regulation 600, thereby allowing for late filings for the purposes of paragraphs 220(3.2)(a) and (b) of the Act.

There are several practical implications with respect to the requirement to file joint elections for capital treatment. Firstly, as the Joint Committee noted in its December 2004 Comments, “it would be consistent with good tax policy” to allow for capital gains treatment to be the default, rather than the elective treatment.

Second, the joint election seems to ask for significant information that may be burdensome, resulting in higher transaction costs. Further, it is unknown whether gathering such information will provide any additional value in monitoring the application of the restrictive covenant provisions. Such transactional information is typically available to tax auditors as part of an audit. Perhaps the CRA is intent on gathering information about the value of restrictive covenant transactions taking place.

Third, non-residents that are party to transactions involving restrictive covenants will incur additional transaction costs to understand the nature and requirement for joint elections relating to restrictive covenants. Further, non-residents who do not have Canadian tax filing requirements may be hesitant to sign joint elections that expose them to compliance risk.

Finally, in most cases, both parties must file the election, which may create certain difficulties as the purchaser of the restrictive covenant may not have any incentive to file the election on a timely basis. As such, the person granting the restrictive covenant should be sure to provide for mechanisms in the agreement to compel the purchaser to file the election when required. Failing this, the election may not be valid and may result in an income inclusion pursuant to proposed subsection 56.4(2) of the Act.

Certain Trends in the Draft Legislation

The motivation of the Department of Finance in proposing the new restrictive covenant legislation may be gleaned from certain reoccurring trends in the draft legislation. Some of the trends are as follows:

1. Tiered companies: the draft legislation appears to be hostile to schemes that involve tiered corporations. The exceptions to full income inclusion, as discussed above, will not be available in a structure that involves multiple tiered corporations and a shareholder granting the covenant. In other words, the Department of Finance has restricted the application of the exceptions to scenarios that involve one majority shareholder, a holding corporation, and one operating corporation. If restrictive covenants involve multiple holding companies, or sister companies, many of the exceptions will not be available. The intention behind this hostility towards tiered structures appears to be a desire to limit planning wherein one taxpayer may grant a covenant and one or more other taxpayers receive the consideration for the covenant.
2. Arm’s length transactions: the draft legislation allows for certain exceptions to the income inclusion only in non-arm’s length scenarios. The intention behind this restriction appears to be a desire to restrict abusive non-arm’s length planning wherein non-arm’s length parties create “artificial transactions” so as to convert otherwise fully taxable income into capital gains like treatment under the exceptions.
3. Non-competition agreements: Due to the multitude of potential restrictive covenants that could be imagined, the definition of restrictive covenant has purposely been drafted in a broad fashion. Certain exceptions only apply when the restrictive covenant entered into is a non-competition agreement. Presumably, this restriction aims at preventing taxpayers from assigning values to covenants (other than non-competition covenants) that would otherwise be included income, but that could benefit from preferential tax treatment if the exception otherwise applies. This penalizes restrictive covenants that should be considered on account of capital, but that are not non-competition agreements.

4. Broad definition of restrictive covenant: As we have seen, the term restrictive covenant is misleading, as it can include covenants that are not restrictive. The Department of Finance clearly intended the definition to be as broad as possible so as to prevent possible abuses of the principles enunciated in *Manrell*. The aim of drafting such a broad definition appears to have been to prevent taxpayers from assigning value to a covenant in a transaction that would be exempt from tax pursuant to the principles in *Manrell*, and thereby erode the taxable portion of the transaction.

As may be surmised from the above, the Department of Finance appears to have two main preoccupations with the new rules. First, the rules are restrictive to prevent a taxpayer who enters into a restrictive covenant from shifting the consideration for the restrictive covenant to other taxpayers. Second, the rules appear to aim at preventing the conversion of full income into preferential capital gains or ECE treatment. While all of these objectives are laudable, the execution of these principles is far too complex and convoluted. Indeed, it is arguable that perhaps one main taxing provision, one large and liberal exception and one anti-avoidance provision would have been sufficient to get the job done.

IMPLICATION OF NEW SECTION 56.4 TO BUSINESS DEALINGS

Non-Resident Implications

In the situation where a non-resident sells its Canadian business, either by way of a share sale or asset sale, and grants a restrictive covenant, the restrictive covenant rules do not exclude its application to the non-resident vendor. Section 3 of the Act provides for non-resident persons to be subject to Canadian tax in the following circumstances:

1. Was employed in Canada;
2. Carried on a business in Canada, or
3. Disposed of a taxable Canadian property.⁸⁶

As discussed in detail above, the ambit of the restrictive covenant rules deems various tax consequences with respect to amounts received as restrictive covenants as follows (summarized):

1. Ordinary income (subsection 56.4(2));
2. Employment income (section (5) or (6));
3. Disposition of goodwill (section 14); or
4. Capital gains treatment on disposition of eligible interest in a corporation or partnership.

In the situation where a non-resident receives a restrictive covenant amount, the Canadian domestic rules will apply to tax such amounts received by the non-resident vendor. A general summary of the possible tax consequences follows:

Canadian Classification of Income	Tax implications
Ordinary income pursuant to proposed subsection 56.4(2)	Subject to a 25% withholding tax under proposed 212(1)(i) of the Act for amounts that are received or receivable.
Employment income under subsection 5 or 6.	Subject to source deductions. ⁸⁷ Must ensure that such an arrangement is not considered a

	salary deferral arrangement.
Disposition of CEC (i.e. goodwill)	Considered a disposition of “taxable Canadian property” pursuant to the definition in subsection 248(1) and subject to a 25% withholding tax under subsection 116(3) of the Act.
Considered to directly relate to the disposition of an eligible interest in the partnership or corporation capital gains.	Considered a disposition of “taxable Canadian Property” pursuant to the definition in subsection 248(1) and subject to a 25% withholding tax under subsection 116(3) of the Act. However may be considered “excluded property” pursuant to subsection 116(6) of the Act.

Notwithstanding the above-noted Canadian tax implications, the respective Tax Convention, if any, between Canada and the resident country of the non-resident vendor must be reviewed to determine if there are any Treaty provisions available to the non-resident vendor that will provide relief from the application of the restrictive covenant rules.

Non-resident withholding tax under proposed paragraph 212(1)(i) of the Act should not apply when the payer of the amount in respect of a restrictive covenant is a non-resident. However, proposed paragraph 212(13)(g) may deem a non-resident payer to be a resident for the purposes of paragraph 212(1)(i) if the amount paid is intended to affect, in any way whatever, the acquisition or provision of property or services in Canada, the acquisition or provision of property or services outside Canada by a person resident in Canada or the acquisition or provision outside Canada of a taxable Canadian property. Thus, withholding tax will be imposed by one non-resident on payments made to another non-resident. By way of example, let us suppose the Non-Resident A (“NR-A”) enters into a non-competition agreement with Non-Resident B (“NR-B”) by which NR-A agrees not to compete with NR-B in Canada. As consideration, NR-B pays NR-A a certain cash amount. As the amount is in respect of a restrictive covenant which affects NR-A’s acquisition and provision of property and services in Canada, NR-B, the payer, will be deemed resident of Canada pursuant to proposed paragraph 212(13)(g) and withholding taxes will apply on the payment pursuant to paragraph 212(1)(i) of the Act.

While the above discussion with respect to the application of proposed paragraph 212(13)(g) of the Act reflects the probable policy intent behind the provision, a close reading of this provision reveals that proposed paragraph 212(13)(g) of the Act is ineffective and will never apply. On a careful reading of paragraph 212(13)(g) of the Act, the following criteria must be met in order for this paragraph to apply:

1. A non-resident person pays or credit and amount;
2. Paragraph 212(1)(i) applies to the amount;
3. The amount is intended to affect, in any way whatever:
 - a. The acquisition or provision of property or services in Canada;
 - b. The acquisition or provision of property or services outside Canada by a person resident in Canada, or
 - c. The acquisition or provision outside Canada of a taxable Canadian property.

In the event that the above-enumerated criteria are satisfied, proposed paragraph 212(13)(g) of the Act will operate to deem the non-resident to be resident in Canada with respect to the payment. It is important to note that the non-resident will be deemed to be a resident only once the criteria are met. The criterion which renders proposed paragraph 212(13)(g) of the Act inoperative in every circumstance is the criterion that requires paragraph 212(1)(i) of the Act to apply to the amount. Indeed, a close analysis of paragraph 212(1)(i) of the Act reveals that this paragraph will never apply in the envisioned circumstances, and thus paragraph 212(13)(g) of the Act will likewise never apply. Proposed paragraph 212(1)(i) of the Act applies when the following criteria is met:

1. A person resident in Canada pays or credits and amount;
2. The amount is paid or credited to a non-resident;
3. The amount would be included in income pursuant to subsection 56.4(2) of the Act, if the non-resident were a resident of Canada

The disparity that must be noted is that paragraph 212(13)(g) of the Act requires the payer to be a non-resident, while paragraph 212(1)(i) of the Act requires the payer to be a resident of Canada. Thus, if the payer is resident of Canada, paragraph 212(1)(i) could apply, but paragraph 212(13)(g) could not apply. However, if the payer is not resident of Canada, paragraph 212(1)(i) of the Act cannot apply and therefore paragraph 212(13)(g) of the Act cannot apply as one of the criteria for paragraph 212(13)(g)'s application is the application of paragraph 212(1)(i) of the Act. At this point it should be remembered that the non-resident is deemed to be a resident of Canada only once all of the criteria enumerated at paragraph 212(13)(g) of the Act is satisfied. Thus paragraph 212(13)(g) of the Act may not be relied upon to deem the non-resident payer to be a resident for the purposes of paragraph 212(1)(i). There appears to be a significant circular logic error in proposed paragraph 212(13)(g) that cannot be resolved by means of statutory interpretation. While legislation should be interpreted in a fashion that will give it effect, (the so-called "presumption of coherence")⁸⁸ the text of paragraph 212(13)(g) of the Act is clear and unequivocal. Thus, giving effect to paragraph 212(13)(g) of the Act would require a substantial straining of legislative interpretation, especially in light of the fact that when the text of a provision is clear and unambiguous, the purpose of the provision should be of significantly lesser interpretative force.⁸⁹

Situation 1 – Non-resident grants a restrictive covenant⁹⁰

Consider the case where a U.S. corporate vendor (that does not have a permanent establishment in Canada) sells the shares of its Canadian subsidiary to a Canadian or U.S. corporate purchaser. The U.S. vendor grants to the purchaser a restrictive covenant not to compete. The parties either do not specifically allocate any portion of the share purchase price to the covenant, or allocate a nominal amount to the covenant.

The following Canadian income tax consequences could apply. That portion of the purchase price that can reasonably be regarded as consideration for the restrictive covenant could be deemed to be received by the non-resident pursuant to proposed paragraph 68(c) of the Act. The deemed receipt rule would apply even though the parties did not allocate any amount (or perhaps a nominal amount) to the covenant. The U.S. vendor could be subject to Canadian withholding tax equal to 25% of the amount reasonably allocable to the restrictive covenant. This would be the case even where the U.S. vendor might otherwise be exempt from Canadian income tax on the capital gain on the share sale under the Canada-US Tax Convention.⁹¹

The U.S. vendor may have arguments to obtain relief from the imposition of Canadian withholding tax on any deemed restrictive covenant payment under the Treaty. However, there is no certainty if such positions will hold. For example, if a restrictive covenant payment is treated as Business Profits under Article VII of the Treaty (and assuming that the U.S. vendor has no permanent establishment in Canada), the vendor would obtain relief from Canadian withholding tax. Alternatively, if a restrictive covenant payment is treated as Other Income under Article XXII of the Treaty, it may be argued that the restrictive

covenant payment should not be considered to arise in Canada as it relates to activities originating with the U.S. vendor in its country of residence, and so the U.S. vendor would obtain relief from Canadian withholding tax.

Situation 2 – Canadian Disposes of a Foreign Subsidiary and Grants a Restrictive Covenant ⁹²

In the situation where a Canadian corporate vendor sells the shares of its foreign subsidiary to a Canadian or other non-resident purchaser, and allocates a nominal amount to the granting of a restrictive covenant, the application of proposed paragraph 68(c) (assuming no other exceptions apply) could be problematic. If the deemed receipt rule under paragraph 68(c) applies, the vendor would be required to include in income, as ordinary income, an amount reasonably allocable to the restrictive covenant notwithstanding that the proceeds were allocated to a share sale which is only half taxable.

If proposed paragraph 68(c) of the Act applies, the Canadian vendor would not be able to elect under subsection 93(1) of the Act to convert the “proceeds” on the disposition of the shares of a foreign affiliate to a deemed dividend. Very generally, this election allows a Canadian vendor to take advantage of the exempt surplus rules, which generally allows for the tax free distribution of the proceeds of disposition to the extent that exempt surplus exists.

As such the potential application of proposed 68(c) of the Act should always be considered, and that a reasonable attempt is made to determine if there is any value to the granting of any restrictive covenant.

GST and Restrictive Covenants

While income tax considerations may attract the lion’s shares of the tax community’s interest, GST considerations should not be neglected as they have the potential to seriously impact a transaction.

GST is levied, pursuant to the Excise Tax Act (“ETA”),⁹³ on supplies of property or services made to a recipient within Canada.⁹⁴ The supply will only attract GST to the extent that it is a “taxable supply.” Taxable supplies are supplies made in the course of commercial activity.⁹⁵ Thus, very loosely, at least two essential criteria are necessary for a supply to be subject to GST: (1) there must be a supply of property or services and (2) the supply must be made in the course of commercial activities.

In two separate rulings, both published on March 27, 2000,⁹⁶ (prior to the *Manrell* decision) the CRA was called upon to opine as to the GST treatment of non-competition agreements on the sale of the shares of a corporation. It was the CRA’s opinion that non-competition agreements were to be considered as a supply in light of the definition at subsection 123(1) of the ETA. A supply is broadly defined as “the provision of property or a service in any manner.” The CRA simply states that a non-competition agreement is a supply without further analysis. As the definition of supply targets both property and services, it is likely that a non-competition agreement will fall within one or the other of these categories. Indeed, the definition of property is as broad and similar to the one found in the Income Tax Act. Given the similitude with the Income Tax Act’s definition it is likely that a non-competition agreement is not property in light of the FCA’s decision in *Manrell*. The definition of services includes anything other than property, money, or anything supplied by an employee to an employer, and thus catches anything that may have not been captured by the definition of property. While non-competition agreements are likely not property in light of *Manrell*, it is very likely that a non-competition agreement is caught within the definition of a service, given its broad reach.

Despite a non-competition agreement likely being a service, GST will not be applicable unless the supply of such a non-competition agreement is done in the course of commercial activity. The shareholder of a corporation being sold does not carry on business. It is the corporation itself that carries on the business. As a result, the shareholder’s granting of a restrictive covenant is usually not done in the course of carrying on commercial activity and will thus not fulfill the requirement for taxability under the ETA. It is also the CRA’s opinion that the supply of a non-competition agreement is not an adventure or concern in the nature of trade.

The CRA is careful to state that a non-competition agreement may nevertheless be taxable in certain situations when the person granting the non-competition agreement is the one carrying on commercial activities. Such an analysis is to be made on a case-by-case basis. The rulings state that GST may be applicable when the payment is made directly to a corporation or to the sole proprietor involved in commercial activities.

When advising a client as to the taxability of non-competition agreements, tax practitioners should bear in mind the above, and ascertain that the person granting the non-competition agreement is not granting the agreement in the course of commercial activity.

CRA's Application of the Restrictive Covenant Rules

At a recent Round Table on Federal Taxation,⁹⁷ the CRA entertained a question with respect to the tax treatment of an exclusivity payment. Despite the restrictive covenant rules not yet being enacted into law, the CRA opined on the applicability of subsection 56.4(2) of the Act to an exclusivity payment.

A corporation ("BCo") retained the services of a second arm's length corporation ("ACo"). Mr. X is the sole owner of ACo. Pursuant to the terms of their agreement, ACo and Mr. X were to offer their management services exclusively to BCo for a 5 year period. As consideration for this exclusivity, BCo paid the sum of \$1.5M directly to ACo at the time of the signature of the agreement.

The CRA is of the opinion that the definition of restrictive covenant is sufficiently broad so as to include the exclusivity agreement between Mr. X, ACo and BCo. Based on this premise, the CRA finds that ACo has to include the \$1.5M amount in income pursuant to subsection 56.4(2) of the Act.

The CRA goes on to mention that since Mr. X is personally committed to the exclusivity agreement, amounts added to Mr. X's income under section 5 or 6 would be excluded under paragraph 56.4(3)(a). However, it is difficult to understand the CRA's application of this exception in light of the fact that Mr. X did not receive and was not entitled to receive amounts under the exclusivity payment, and as such the opening words of proposed paragraph 56.4(3)(a) of the Act would not be met. The payment was made entirely to ACo. Thus no amounts could be included in Mr. X's income pursuant to sections 5 and 6, and consequently the exception under paragraph 56.4(3)(a) of the Act could not apply. The CRA then goes on to state that the CEC exception under proposed paragraph 56.4(3)(b) does not apply as the payment does not result from the disposition of eligible capital property. Finally, the CRA notes that section 68 could apply to reallocate the value attributed to the restrictive covenant. It is interesting to note that in this first CRA document dealing with the new rules the restrictive covenant in question is not a non-competition agreement, but an exclusivity agreement. This helps to justify the Department of Finance's adoption of a broad definition of restrictive covenant.

Illustrative Examples

As the proposed restrictive covenant rules are complicated, it is useful to illustrate their application through certain examples:

Example #1 – Non-Arm's Length Transactions

OpCo's shares are wholly owned by Dad. He sells his OpCo shares to his son for \$1M, payable by a promissory note over 10 years. Subsection 40(1.1) of the Act would normally enable Dad to claim a capital gains reserve over 10 years. As part of the disposition Dad grants a non-competition agreement for the benefit of the son, but no value is allocated to the agreement. It is evident that the non-competition agreement will be a restrictive covenant pursuant to the proposed rules. Furthermore, section 68 of the Act will apply to reallocate some of the consideration for the shares to the restrictive covenant. The exceptions to the income inclusion under proposed subsections 56.4(3) and (8) of the Act will not apply as Dad does not deal at arm's length with his son. Finally, any consideration reallocated pursuant to

section 68 will be included in the Father's income under proposed subsection 56.4(2) of the Act, which will in turn reduce the reserve available under subsection 40(1.1) of the Act.

This example illustrates the difficulties that the proposed rules present for legitimate non-arm's length transactions. This example also illustrates that the rules lack any reserve mechanism for payments that overlap taxation years.

Example #2 – Supply Contracts

Consider the situation where Farmer A grows and sells bananas to a wholesaler. A wholesaler, FruitCo, wishes to guarantee its supply of bananas. Farmer A and FruitCo enter into a contract by which FruitCo has to purchase a certain amount of bananas at a guaranteed price for a fixed period of time. The agreement is not an exclusivity agreement, as Farmer A may sell his excess bananas elsewhere. However, FruitCo must take delivery of the bananas or be liable for a significant penalty. FruitCo pays Farmer A \$100,000 as consideration for signing the contract in addition to any consideration for the bananas.

Farmer A will have entered into a restrictive covenant as the "supply contract is an agreement that affects, in any way whatever, the provision of bananas by Farmer A to FruitCo. At first blush, it could be argued that the agreement to sell bananas at a guaranteed price would likely fall within the parenthesized exception in the definition of restrictive covenant, which excludes agreements for the disposition of the taxpayers property, as discussed in section F of this paper. Indeed, setting the purchase price of a sale seems to be integral to the disposition of property. However, it could be more convincingly argued that this exception does not apply, as the covenant is a covenant that fixes the price at which the bananas are sold and thus not an agreement for the disposition of property. This conclusion can be arrived at from the fact that Farmer A is being paid for the bananas in addition to being paid for entering into the contract. In other words, the \$100,000 payment is not for the purchase of the actual bananas, it is for the purchase of the right to buy the bananas at a given price. Thus, the \$100,000 would likely have to be included in income pursuant to proposed subsection 56.4(2) of the Act. This result is arguably correct, as the \$100,000 should likely be considered as business income absent the restrictive covenant rules.

This example clearly illustrates a practical complication that arises from the exception to the definition of restrictive covenants which excludes agreements for the disposition of property. Indeed, in the above example, is the covenant a covenant to guarantee a fixed price or is the covenant an agreement to dispose of Farmer A's bananas? If the former interpretation is preferred, the exception would not apply. If the latter interpretation is preferred, the exception would apply and the restrictive covenant rules would not apply. If the latter interpretation is preferred, what is the tax treatment of the \$100,000 received? Can a taxpayer argue the principles in *Manrell* and receive this amount on a tax-free basis? In essence the problem can be described as follows: when will a covenant be for the disposition of property and when will a covenant be in respect of or relating to the disposition of property? The answer to this question may make the difference between the application and non-application of the proposed restrictive covenant rules. However, this question is perhaps best left to commercial lawyers who have a better grasp of the intricacies of contract law.

Example # 3 – Escrow Shares

Mr. A sells his shares of OpCo to PubCo. As consideration, Mr. A receives shares of PubCo with a fair market value of \$7M and \$5M in cash. Mr. A enters into an agreement by which he may not sell the PubCo shares for a period of two years following the transaction. The fair market value of the OpCo shares is \$10M. However since the sale of the PubCo shares is restricted for two years, PubCo is willing to pay an aggregate amount of \$12M (\$7M PubCo shares and \$5M cash) for the OpCo shares. Finally, let us suppose that a section 85 election applied to the transaction such that Mr. A chose to treat the \$7M of PubCo share consideration on a tax deferred basis.

The agreement not to sell the PubCo shares is an agreement that affects, in any way whatever, the provision of the PubCo shares by Mr. A. The parenthesized exception to restrictive covenants excludes agreements for the disposition of a taxpayer's property. The question is, is the agreement not to sell the PubCo shares an agreement for the disposition of Mr. A's property? The answer should be that it is not. While the agreement relates to the disposition of the Pubco shares (by restricting their disposition), it is not in itself an agreement for the disposition of the shares. Thus, the agreement not to dispose of the shares is likely a restrictive covenant pursuant to proposed subsection 56.4(1) of the Act. Likewise, pursuant to the principles enunciated in *Manrell*, it is unlikely that the right to sell the shares is property in itself, and consequently will not fall within the application of the parenthesized exception to the definition of restrictive covenant.

As no value was assigned to the restrictive covenant, section 68 could apply to allocate consideration to the restrictive covenant. The value of this covenant is a question to be answered by valuers. However, the \$2M of difference between the aggregate consideration (\$7M of PubCo shares and \$5M cash) and the FMV of the OpCo shares could reasonably be attributable to the restrictive covenant. Thus, in this example, Mr. A would have an income inclusion of \$2M in the year in which the agreement was signed. Furthermore, no relief is provided by the exceptions under proposed subsection 56.4(3) and (8) of the Act as section 85 applied to the transaction. In this case, the result appears to be highly inequitable as the amount should arguably be on account of capital, not on account of income. There appears to be no exception that would cure this problem.

Example #4 – Dividend Payments During a Due Diligence Period

Suppose that Company A pays regular dividends pursuant to a dividend policy that has been in place for 30 years, during which time Company A has not missed any dividend payments. Company B initiates a takeover bid to acquire all of Company A's shares, subject to a limited due diligence period. Company A enters into an agreement with Company B not to pay any dividends during the due diligence period. This example was raised before the Standing Senate Committee on Banking, Trade and Commerce.⁹⁸ As no amount was paid as consideration for the restrictive covenant, there will be no income inclusion pursuant to proposed subsection 56.4(2) of the Act. Furthermore, as no amount was paid, section 68 of the Act will not apply to reallocate an amount to the restrictive covenant. Indeed, section 68 only applies when an amount is received or receivable by a taxpayer. However, what will happen in the event that the acquisition occurs? Will a certain amount of the consideration received for the shares be allocated to the restrictive covenant pursuant to section 68 of the Act? Section 68 of the Act applies when it is reasonable to consider that the amount paid is part consideration for property and part consideration for a restrictive covenant. It is arguable that the restrictive covenant has some value, or else why would the parties enter into such an agreement? As such it could be argued that part of the consideration for the shares could reasonably be considered as being paid for the restrictive covenant, resulting in a reallocation pursuant to section 68 of the Act.

An unforeseen problem that is illustrated with this example is the lack of contemporaneousness between the entering into the restrictive covenant and the payment of amounts in respect to a transaction to which the restrictive covenant relates. Let us suppose that a share sale transaction occurs but that a non-competition agreement is signed for no consideration several weeks or months after the transaction. Could section 68 of the Act apply to reallocate some of the consideration paid during the transaction to the restrictive covenant that was entered into months following the transaction? Section 68 of the Act applies when it is reasonable to consider that some of the amount paid relates to the restrictive covenant. While this may be relatively simple to admit in the example of the non-competition agreement, it is more difficult to characterize what is "reasonable" in the example of the restriction of dividend payments.

In addition to the above, certain valuation questions may arise when considering an agreement to suspend dividend payments. Presumably, such a covenant will have certain value for the purchaser. However, it could be argued that nothing of value is surrendered by the business when it agrees to the covenant. The cash that was otherwise available to pay for the dividend still exists within the business, and should the acquisition not proceed, the dividend will be paid to the shareholder. Should the acquisition proceed, it is

likely that the purchase price for the business would be adjusted to a pre-determined working capital balance in any event.⁹⁹

Example #5 – Confidentiality Agreement

OpCo is wholly owned by Mr. A. Mr. A sells OpCo's shares to Mr. B for \$1M of cash. As part of the sale transaction Mr. A signs a confidentiality agreement with OpCo and Mr. B not to divulge any trade secrets or other proprietary information to outside parties. This set of facts is quite common in asset or share sale transactions. The non-divulgence agreement is an agreement that affects or is intended to affect the acquisition of property by Mr. A (i.e. the acquisition of cash by Mr. A). Both the exceptions under proposed subsection 56.4(3) and (8) of the Act would not apply as the restrictive covenant is not a non-competition agreement as provided by subparagraph 56.4(3)(c)(ii) and paragraph 56.4(8)(b) of the Act. As no consideration is assigned to the restrictive covenant, section 68 of the Act could apply to assign a reasonable value to the restrictive covenant and thus include the amount into Mr. A's income pursuant to proposed subsection 56.4(2) of the Act. Thus, the question is, what value does such a non-divulgence have? This is a question that must be answered by professional valuers. However, the CRA could always argue that the restrictive covenant has some value or else the parties would not have entered into the covenant in the first place. Furthermore, by entering into the agreement, Mr. A is giving up his future right to reveal or use certain trade secrets.

Example #6 – Trust Structures

Let us suppose that a trust (the "Family Trust") owns all the issued and outstanding shares of OpCo. The beneficiaries of the Family Trust are the members of Family A, which include a father, mother and children. The father operates and manages OpCo's affairs, while the remainder of the family is passive with respect to OpCo. The Family Trust disposes of the OpCo shares to an arm's length taxpayer. In the course of the transaction, the father enters into a non-competition agreement with the purchaser for \$500,000 of consideration. The \$500,000 is paid directly to the father. This amount would likely be on account of capital according to the CRA's pre-*Fortino* treatment of non-competition agreements.

It is evident that the non-competition agreement is a restrictive covenant. Furthermore, proposed subsection 56.4(2) of the Act applies to include the \$500,000 in the father's income. Thus, the question is, do any exceptions apply to provide relief to the full income inclusion?

Proposed paragraph 56.4(3)(c) of the Act would offer no relief in the present case, as that paragraph requires the disposition of the shares to be made by the taxpayer who has granted the restrictive covenant.¹⁰⁰ As value has been assigned to the restrictive covenant, the exceptions to section 68 of the Act would be useless. Thus, the father would be forced to include the \$500,000 into income.

The following plan could be undertaken in an effort to circumvent the full income inclusion. No value should be assigned to the restrictive covenant, resulting in greater proceeds of disposition of the shares. Proposed subsection 56.4(8) of the Act would apply to prevent reallocation of the value of the restrictive covenant to the father pursuant to section 68 of the Act. Indeed, proposed subparagraph 56.4(8)(c)(ii) of the Act does not require that the taxpayer granting the covenant be the taxpayer disposing of the property. Subsection 56.4(13) of the Act states that when subsection 56.4(8) of the Act applies, the amount that is received in respect of the restrictive covenant is to be added to the proceeds of disposition of the shares.

However, this plan is not without problems, as proposed paragraph 56.4(8)(e) of the Act must be considered. That paragraph states that when subparagraph 56.4(8)(c)(ii) of the Act applies for the disposition of shares, no amount that can reasonably be regarded as consideration for the restrictive covenant may be received by a person not dealing at arm's length with the taxpayer who has granted the covenant. In the present example, the Family Trust which has received the amounts for the disposition of the shares does not deal at arm's length with the father who has granted the restrictive covenant.¹⁰¹ Thus, the conditions at subsection 56.4(8) of the Act would not be met. Nevertheless, the saving provision at proposed subsection 56.4(9) of the Act could apply to grant capital gains treatment.

Proposed subsection 56.4(9) of the Act states that if proposed subsection 56.4(8) of the Act does not apply to a share sale solely because the amount that could reasonably be considered as being part consideration for a restrictive covenant (the “amount”) was received by a person not dealing at arm’s length with the person granting the restrictive covenant, section 68 of the Act will only apply to that amount. Furthermore, an election may be filed under paragraph 56.4(9)(b) which allows the taxpayer granting the covenant to deem the amount as being proceeds of disposition of capital property for the taxpayer granting the covenant. Thus, if the election is made by the father and the trust, the amounts in respect of the non-competition agreement will be included as capital gains in the father’s income. Proposed paragraphs 56.4(9)(c) and (c.1) of the Act further states that the amounts will be deemed not to be included in the income of the trust and that the trust has received the amounts as agent for the father.

Thus, by not assigning any value to the restrictive covenant and by applying the mechanisms in proposed subsections 56.4(8) and (9) of the Act, the father may obtain capital gains treatment for the amounts received in respect of the non-competition agreement.

VALUATION MATTERS¹⁰²

Introduction

When a business is sold, a prudent purchaser will make all reasonable efforts to protect the value of the tangible and intangible assets that have been paid for. Some protection is accomplished through due diligence procedures, where the purchaser ensures that potential write-downs of tangible assets have been identified or that the legal protection afforded to intangible assets such as patents and trademarks is clear and beyond dispute.

Some intangible assets cannot be owned in a legal sense, but they exist, and they have tremendous value and create shareholder wealth. These “soft” intangibles include relationships with customers and suppliers and the skills and knowledge of the key employees and the management team. Soft intangibles cannot be easily replicated, and that may be why the purchaser made the decision to acquire a business as opposed to building from within.

Soft intangibles are also vulnerable to loss should the original owners of the company (the “competing seller”) or unhappy key employees decide to leave the business and start-up on their own. Reducing this risk exposure can be done in one of two ways. The first approach could be through an incentive-laden purchase price where the price paid for the business would be dependent on the subsequent performance of the seller’s business. Paying for a portion of the acquired business through shares held in trust or escrowed stock (for public company acquirers) also shifts risk to the seller.

Another way to protect value is through the use of restrictive covenants. Restrictive covenants are widely defined in the proposed income tax legislation and would include non-competition agreements. As we have previously seen in this paper, proposed income tax legislation will require an identification of restrictive covenants separate from the purchase transaction and additional tax liabilities may result. This section of the paper will discuss the valuation of restrictive covenants and focus on non-competition agreements, since these agreements would be the most common restrictive covenant of relevance in most acquisitions.

For many companies, the valuation of non-competition agreements is already being done. Financial statement reporting requirements outlined in Section 1581 of the CICA Handbook requires an allocation of the purchase price when accounting for business combinations. Now, with the proposed income tax legislation, the allocation of value to restrictive covenants like non-competition agreements has income tax implications for all taxpayers, including many private companies and individuals who were relatively unconcerned about purchase price allocation in the past.

This legislation may have particular relevance to smaller companies. The value of a small company can often rest on the shoulders of one or a couple of key individuals within that organization. Any acquirer of

that type of business will depend on non-competition agreements to prevent competition in the future from these individuals and to protect their investment.

Valuing a Non-Competition Agreement – The Methodology

A common method for valuing non-competition agreements is to use a discounted income or cash flow approach that compares fair market value with and without the non-competition agreement in place. Business valuers are familiar with the methodology and its application. The approach seems simple, but it requires astute business judgment that does not begin and end with number crunching in isolation. There are many wrinkles, and we will identify some of them later in this section of the paper. But first, we will proceed with a general discussion of the methodology used for valuing non-competition agreements.

The valuation methodology consists of three major steps. To begin, the expected net income from a business with a non-competition agreement should be compared to the expected net income of the same business as if the non-competition agreement did not exist (an “incremental” analysis).

Quantifying changes in revenue due to the hypothetical competing seller would require the valuator to consider, amongst other items:

- the vulnerability of the firm to competition;
- revenue lost from existing customers leaving the business;
- the inability to attract revenue from new customers; and
- the need to discount prices to attract and maintain the customers that are at risk.

An expense analysis would consider, amongst other items:

- new advertising and promotion expenses to compete against the competing seller and attract new customers;
- additional unit costs that result from lower volumes and reduced plant efficiencies;
- increased wages and other concessions to retain key employees and prevent their defection;
- increased training costs for new employees hired as replacements; and
- increased management effort and time to work with existing customers.

The second step in the valuation process is calculating the incremental effect of competition on the firm’s capital assets, inventory, and working capital needs. Capital asset acquisitions may be cancelled as reduced business will not justify the expenditures that otherwise would have been prudent. One may initially believe that working capital requirements may lessen with the reduced business, however this may not be the case. Instead, credit terms to customers may have to be relaxed in order to maintain the existing customers and attract new customers. Inventory may have to expand to ensure back orders are minimized and newer marginal products are offered for immediate delivery to keep customers from seeking alternative suppliers.

The third step in the valuation process is calculating the appropriate discount rate and applying that rate against the incremental cash flows. The original purchase price for the business could be used to calculate the internal rate of return that was expected by the purchaser. There would be uncertainty and risk associated with a non-competition agreement, and typically, the valuation of the non-competition agreement is done by risk-adjusting the incremental cash flows (related to non-competition agreements) and applying probabilities. The discount rate applied against the cash flows would be the same present value discount rate used to support the original purchase price for the business.^{103 104}

In the end, the discount rate would be applied against the income or cash flow to arrive at the present value of the business, first with the non-competition agreement in place, and then with the non-competition agreement excluded. The difference in value between the two scenarios would be a measurement of the value of the non-competition agreement.

Determining the Probability of Competition and the Potential Loss in Value had the Non-Competition Agreement Never Existed

In assessing potential losses from the breach of a non-competition agreement, the valuator is usually involved after the breach of the non-competition agreement has already happened. The losses that were suffered or are continuing to be suffered can be calculated based on the specific events in the past. The probability that the breach occurred and how that breach happened is known or assumed based on the facts at hand. The effect on the plaintiff's net income may be in dispute, but losses in value can be quantified.

Under the proposed tax legislation, the valuator now has to determine the incremental value of a non-competition agreement, without knowing the probability of competition had the non-competition agreement never existed and without knowing how the competing seller would have gone after the business of his former company.

Hindsight is 20/20, and there is the danger that subsequent events, such as a breach of the non-competition agreement, will be used by CRA to justify a change in value originally assigned to the restrictive covenant. In another circumstance, delaying the value calculation of a non-competition agreement may result in judgment being applied in the light of subsequent economic events. In general, the valuation of assets should be at a specific point in time, encompassing the existing economic circumstances and uncertainties at that date. Undertaking the valuation of restrictive covenants immediately after the relevant transaction will also be an important plus in the taxpayer's favour should the income tax authorities choose to challenge the allocation of value to the non-competition agreement.

The difficulties of assigning a value to the non-competition agreement are best laid out in a simple example. Mr. A sells products in a designated territory. He sells the shares of his operating company to Company B, and as part of the transaction, he signs a non-competition agreement for a three year period.

Determining the value of the business with the non-competition agreement in place has been done as part of the analysis undertaken prior to the completed acquisition. However, the difficulty for the valuator is to identify the value of the business assuming that the non-competition agreement had not been signed. The valuator would need to assess the most viable and likely way that Mr. A would have chosen to compete. Competition comes in many forms: direct and indirect; through a new business venture or as an employee with a competing company; for certain products or all products; in the territory surrendered or an adjacent territory; and with a full product line or a limited product line.

The valuator then needs to determine the probability of Mr. A competing without a non-competition agreement. Probability assessment requires a clear understanding of the industry and the situation at hand. A comprehensive analysis is your best protection against reassessment. In our example, would Mr. A find it difficult to reproduce the business structure that he had in the past? What are the key success factors to obtaining new business and maintaining business from current customers? Is customer loyalty important? Would financing be difficult to obtain for a new venture? Are there a limited number of sale representatives for certain product lines allowed in a territory? What are Mr. A's personal circumstances (age, health, experience, etc.)?

In summary, allocating value to the non-competition agreement is not an impossible task, but one that requires a thorough understanding of the acquired business, the seller's personal circumstances, and how the buyer perceived value. A valuator's analysis is enhanced through comprehensive discussions with top management of both the seller and purchaser¹⁰⁵, a detailed analysis of company's operating results and industry performance, and performing sensitivity and risk analysis under different scenarios.

Other Valuation Issues Related to Non-Competition Agreements

Non-competition agreements are generally signed for a limited period of time (the “restricted period”), after which it is assumed that the damages from the competing seller will be minimized. However, if the non-competition agreement is breached during the restricted period or no non-competition agreement was ever signed and competition came about, then the losses suffered by the purchaser may not be limited to that restricted period. As an example, losses resulting from the poaching of customers or the defection of key employees to the competing seller would normally continue beyond the restricted period and have a permanent negative effect on the value of the business. This permanent loss of value would have to be considered in the incremental valuation analysis.

The original purchase price of the business represents the total value assigned to all of the net assets. Tangible asset value is more easily determined. Value for intangibles such as trademarks, patents, customer lists, non-competition agreements, and goodwill require seasoned professional judgment. Ultimately, in the end, the value assigned to the individual assets and liabilities (including restrictive covenants) should reconcile to the purchase price paid for the business. The value assigned to any one intangible asset or restrictive covenant cannot be looked at in isolation from the other assets.

If much of the value of a business has been built up with readily identifiable intangible assets (such as brands, trademarks, patents, rights to the company name, phone numbers, etc.), it may be difficult for an unhappy seller to later go back into business. The intangibles that were given up in the original purchase transaction may be difficult to reproduce or replace. Therefore, the likelihood of significant damages resulting from the inability to sign a non-competition agreement could be minor, but every case is unique.

Often, the seller with a non-competition agreement will also have signed a management services agreement with the purchaser to ensure a smooth transition from the seller to the purchaser. The management services to be provided would include introduction to key clients and suppliers, training of new people and working with experienced staff to ensure minimum turnover. The seller would normally receive an attractive compensation for their services. As time goes on and the transition steps are completed, it is less likely that the non-competition agreement would be breached.

Finally, there are terms and conditions normally found in a purchase-sale agreement that would discourage competition, even if a non-competition agreement was not present. For example, a portion of the purchase price may be incentive laden based on subsequent performance or consideration given was shares of the purchasing company. It may not be sensible for an unhappy seller to compete if their purchase price was going to be clawed back in any event. Therefore, the value of a non-competition agreement would be diminished.

Valuing Other Restrictive Covenants

The incremental approach used to value non-competition agreements may also be useful for other restrictive covenants. What would the value of the business have been either with or without the restrictive covenant? Remember however that restrictive covenants are so individual and applied in so many different situations that any generalizations or a rules-of-thumb are not possible. For example, a purchase-sale agreement is full of legal covenants and restrictions, but it would be unfair to value each individual restriction or covenant by saying “what would be the change in value if this covenant was not present or honored”. The package of conditions and restrictions in a purchase-sale agreement ensure a smooth transition will happen, but they do not create value in and of themselves.

Some restrictive covenants are transacted for at market value. For example, entering a futures contract for a commodity could be a restrictive covenant to the acquirer, but that contract would have been acquired at a price that was determined by knowledgeable, arm’s length parties to be fair. Value would be determined at the point in time that the futures contract was entered into, and not based on the subsequent results (i.e. was a profit achieved from the futures contract at a later date).

Finally, in the draft legislation, the proposed definition of restrictive covenant includes the phrase “whether legally enforceable or not”. As a valuator, if any restrictive covenant or condition has no legal weight, then the effect of such a covenant or condition on value is significantly impaired, if not completely.

Valuation Conclusions

Restrictive covenants are unique and individual to the purchase transaction. There are no rules of thumb, and every situation has different income, risk, and probability factors at play.

The valuation of non-competition agreements requires a real understanding of the business and the industry that the business competes in. Should the seller of a business later come back to compete, the nature of this competition may be direct or indirect, on all products and services or just some, to all customers or a limited number, and cover all territories or just a portion. The probability of such an event is specific to the case at hand. An encompassing approach that identifies all realistic possibilities and offers a reasoned and sensible conclusion is the goal.

CONCLUSION

As hopefully is evident, the new restrictive covenant proposals are horrifically complex. While it is understandable that the Department of Finance was not amused with the *Manrell* decision and the subsequent mischief by taxpayers, one queries why the Department adopted such an apparently heavy handed response. The proposed rules are so complex that taxpayers and their advisors will likely have difficulty in their interpretation and application. While tax advisors have for years complained about the complexity of tax legislation, the restrictive covenant proposals appear to be part of the recent trend of complex drafting from the Department of Finance. Could there not have been a simpler approach to achieve the tax policy objective of taxing restrictive covenant proceeds? We think so. The new proposals create unnecessary additional complications and administrative burdens for otherwise routine commercial transactions. Assuming the proposals eventually receive Royal Assent, taxpayers and their advisors will need to be aware of such rules and deal with them accordingly.

¹ The authors wish to thank Adam Hoffman, LL.B., Dennis Nerland, LL.B., Faizal Valli, CA and Roberto Domagas, CA (all of whom practice with either Moodys LLP Tax Advisors or Shea Nerland Calnan LLP Barristers & Solicitors) for their very significant contributions to the writing and research of this paper. All errors remain those of the authors. The valuation section of the paper was written by Doug Welsh, CA, CBV of Clark Valuation Services Ltd. and the authors thank him for his tremendous work.

² Kim G C Moody is a partner at Moodys LLP Tax Advisors in Calgary, Alberta.

³ Matt Clark is an associate at Shea Nerland Calnan LLP Barristers and Solicitors in Calgary, Alberta.

⁴ Nicolas Baass is an associate at Moodys LLP Tax Advisors in Calgary, Alberta.

⁵ *Tod T. Manrell v. Her Majesty The Queen*, 2003 DTC 5225.

⁶ The *Income Tax Act*, RSC 1985, c.1 (5th Supp.), as amended and proposed to be amended, and including the regulations promulgated thereunder (the “Act”). Unless otherwise stated, statutory references in this paper are to the Act. No assurance can be given that proposed amendments to the Act will be enacted in the form proposed or at all.

⁷ See, for example:

- a) David G. Weekes, “Restrictive Covenants – Proposed Section 56.4,” *2005 Prairie Provinces Tax Conference*, (Toronto: Canadian Tax Foundation, 2005), 2:1-7.
- b) Hugh Woolley, CA, TEP, “Valuation & Allocation Issues in Canadian Income Tax,” *2006 British Columbia Tax Conference*, (Vancouver: Canadian Tax Foundation, 2006), 13:1-42.
- c) Glen London and Dennis Amirault, “The Sale of a Business - Some Practical Tips and Avoidable Traps”, *2007 British Columbia Tax Conference*, (Vancouver: Canadian Tax Foundation, 2007), 6:1-31.
- d) Crystal Taylor and Clint Gifford, “Bill C-33: Part 2 Technical Amendments,” *2007 Prairie Provinces Tax Conference*, (Toronto: Canadian Tax Foundation, 2007), 15:1-31.
- e) Clifford M. Goldlist, “Implications of Recent Tax Changes on Business Purchases and Sales,” *2007 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 2007), 11:1-24.
- f) Manon Thivierge, “Planning for the Purchase or Sale of a Business,” *Report of Proceedings of Ffifty-Seventh Tax Conference*, 2005 Tax Conference (Toronto: Canadian Tax Foundation, 2006), 10:1-30.

⁸ *Fortino v. Her Majesty The Queen*, 97 DTC 55 (TCC) and *Her Majesty The Queen v. Fortino*, 2000 DTC 6060 (FCA).

⁹ The word ‘mute’ is used here given that the jurisprudence prior to *Fortino* and *Manrell* is almost non-existent. There are many cases that deal with the deductibility of client lists and the related restrictive covenant acquired. One case, *Richstone v. MNR* 74 DTC 6129, dealt with payments ascribed to a restrictive covenant following the departure of a former employee that was found to be employment income.

¹⁰ *Interpretation Bulletin* IT-330R, “Dispositions of Capital Property Subject to Warranty, Covenant or other Conditional or Contingent Obligations,” September 7, 1990. IT-330R was archived by the CRA in 2004. Paragraph 5 of IT-330R states “Where capital properties of a business are sold, a non-competition covenant, given by the vendor not to carry on a competitive business, is considered to be in respect of the disposition of the goodwill of the business and is therefore not subject to section 42.”

¹¹ See, for example:

- a) CRA Document No. 1991-201, February 1991, “Non-Competition Payments”;
- b) CRA Document No. 9313690, May 6, 1993, “Non-Competition Payment”;
- c) CRA Document No. 9525077, November 8, 1995, “Non-Competition Payment”.

¹² See paragraph 6 of IT-330R that states: “In this regard, any amount received for a non-competition covenant referred to in paragraph 5 that is in respect of the disposition of shares comes within the provisions of section 42 as part of proceeds of disposition of the shares.”

¹³ *Supra*, note 11(c).

¹⁴ See *Interpretation Bulletin* IT-143R3, “Meaning of Eligible Capital Expenditure,” August 29, 2002. Paragraph 32 of IT-143R3 states: “An amount paid by a taxpayer to another person with whom the taxpayer deals at arm’s length,

to obtain that other person's covenant not to engage in any business within a designated geographical area during a specified period of time, that is the same as or is similar to the business carried on by the taxpayer, may qualify as an eligible capital expenditure." [emphasis added].

¹⁵ See the definition of property found in subsection 248(1).

¹⁶ Tax Court of Canada decision in *Fortino*, supra, note 8, at paragraph 54.

¹⁷ See subparagraph 40(1)(a)(iii).

¹⁸ Supra, note 5, at paragraph 25.

¹⁹ Ibid. at paragraphs 14 and 23.

²⁰ *Manrell v. Her Majesty The Queen*, 2002 DTC 1222 at paragraph 15.

²¹ Ziff, Bruce H., *Principles of Property Law*, 3rd ed. (Scarborough: Carswell, 2000).

²² Supra, note 5, at paragraph 14.

²³ Ibid., at paragraph 25.

²⁴ Ibid., at paragraph 20.

²⁵ Ibid., at paragraph 41.

²⁶ Ibid., at paragraph 53.

²⁷ Ibid., at paragraphs 60-61.

²⁸ Transcripts to the Proceedings of the Standing Senate Committee on Banking, Trade and Commerce, Issue 22 Evidence – Meeting of June 12, 2008.

²⁹ This part was reviewed by Tom Nelson of Hodgson Russ LLP, a US law firm based in Buffalo N.Y. The authors thank him for his efforts.

³⁰ *F.W. Steffens*, CA-11,83-1, USTC at paragraph. 9425.

³¹ Internal Revenue Code Section 409A – post-employment compensation (is set to commence Jan. 1, 2009). There are very specific planning requirements to comply but generally the post-employment contract must be in written form, specify the term and the amount must be clearly defined.

³² This part has been reviewed by John W. Hart of John W. Hart Limited Tax and Trust Law Specialist in Auckland, New Zealand. The authors thank him for his efforts.

³³ *Henwood v. Commissioner of Inland Revenue* (1995) 17 NZTC 12, 271 and *Commissioner of Inland Revenue v. Fraser* (1996) 17 NZTC 12, 607.

³⁴ <http://www.taxpolicy.ird.govt.nz/publications/files/html/octoberbill2000/index.html> Hon Dr. Michael Cullen, Policy Advice Division of Inland Revenue Department, October 2000.

³⁵ CE 9 (1 and 2).

³⁶ GB 30.

³⁷ CE 9 (3(d)).

³⁸ CE 9(3(b)).

³⁹ DC 9.

⁴⁰ This part was reviewed by Rick Krever, professor, Department of Business Law and Taxation, Monash University, Australia. The authors thank him for his efforts.

⁴¹ This part was reviewed by Hamilton Forrest, partner at Fladgate LLP, London, England. The authors thank him for his efforts.

⁴² *Finance Act* 2008, 2002, c. 23, Schedule 29.

⁴³ *Finance Act* 2008, c. 9, Schedule 2, ss. 22 – 56.

⁴⁴ In addition, if a restrictive covenant is for less than 5 years it is more likely to be on account of income, and if the agreement restricts completely the ability to engage in a certain trade it is more likely capital. All restrictive covenants resulting from a current or future office or employment or ceasing to hold an office or employment are considered income.

⁴⁵ Canada, Department of Finance, “Minister Manley Proposes Amendments to the Tax Treatment of Restrictive Covenants,” *Release* no.2003-049, October 7, 2003.

⁴⁶ “Today” was October 7, 2003.

⁴⁷ Bryan A. Garner, ed., *Black’s Law Dictionary*, 8th ed., (St-Paul: Thomson West, 2004)

⁴⁸ (1598), Moore (K.B.) 576 (“*Davenant*”).

⁴⁹ [1894] A.C. 535 (H.L.) (“*Nordenfelt*”).

⁵⁰ *Ibid.*, at p. 565.

⁵¹ *Mason v. Provident Clothing & Supply Co.* [1913] A.C. 724 (H.L.)

⁵² *Tank Lining Corporation v. Dunlop Industrial Ltd.*, (1982), 40 OR (2d) 219 at 233 (Ont. C.A.).

⁵³ This has been called the blue pencil rules and was first described in *Attwood v. Lamont*, [1920] 2 K.B. 146 (Div.Ct.), [1920] 3 K.B. 571 (C.A.).

⁵⁴ (1978) 42 C.P.R. (2d) 74 (Ont. C.A.)

⁵⁵ Transcripts from The Standing Senate Committee on Banking, Trade and Commerce, May 15, 2008 – Patrick Marley.

⁵⁶ 2007 TCC 647 (“*RCP*”)

⁵⁷ *Ibid.*, at paragraph 61.

⁵⁸ *Ibid.*, at paragraph 56.

⁵⁹ *Associated Newspapers Ltd. v. F.C. of T.*; *Sun Newspapers Ltd. v. F.C. of T.*, (1938) 5 A.T.D. 87, 61 C.L.R. 337, *Associated Portland Cement Manufacturers, Ltd. v. C.I.R.*, [1946] 1 All E.R. 68, 27 T.C. 103, 118, 120, cited in Canada: *No. 481 v. M.N.R.*, 58 DTC 41, 44.

⁶⁰ On December 29, 2008, the FCA released its decision in *RCI Environment Inc. c. Canada*, 2008 CAF 419. In that decision the FCA endorses the TCC’s judgment in its entirety. At the time of the writing of this paper the decision was only available in French, however, the FCA makes an interesting comment at paragraph 40, which, very loosely translated, amounts to this: the principle that arises from *Manrell* is that only a right which confers a cause of action against someone will constitute “property.”

⁶¹ *Supra*, note 28.

-
- ⁶² The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, December 20, 2004, “Issues for Consideration – February 27, 2004 Technical Amendments” at paragraph A.3.
- ⁶³ The determination of arm’s length is done without reference to paragraph 251(5)(b) of the Act.
- ⁶⁴ *Supra*, note 28.
- ⁶⁵ See *Richstone v. MNR* 74 DTC 6129.
- ⁶⁶ Ruth Sullivan, *Sullivan and Driedger on the Construction of Statutes*, 4th ed., (Markham: Butterworths Canada Ltd., 2002), at page 273.
- ⁶⁷ Pursuant to the definition of “earned income” under subsection 146(1) of the Act, restrictive covenant amounts would not be captured into such a definition.
- ⁶⁸ Tax Court of Canada decision in *Fortino*, *supra*, note 8, paragraphs 68 and 69.
- ⁶⁹ *Ibid.*, paragraph 70.
- ⁷⁰ The wording in proposed subparagraph 56.4(3)(c)(ii) states: “the amount is consideration for an undertaking by the particular taxpayer not to provide, directly or indirectly, property or services in competition with the property or services provided or to be provided by the purchase (or by a person related to the purchaser)”. Accordingly, this significantly narrows the definition of restrictive covenant for purposes of the Third Exception.
- ⁷¹ This condition was not present in the draft legislation prior to November, 2006. As such, for restrictive covenants granted before November 9, 2006, the taxpayer may elect with the Minister of National Revenue, no later than 180 days after Royal Assent filed with the Minister of National Revenue, to have the former draft of proposed paragraph 56.4(3)(c) of the Act apply. The former version of proposed paragraph 56.4(3)(c) of the Act did not have the limiting criteria respecting section 85 and subsection 97(2).
- ⁷² If the exception under proposed paragraph 56.4(3)(a) applies, consider the source deduction withholding requirement that would likely apply under paragraph 153(1)(a) of the Act.
- ⁷³ 2008 DTC 2466.
- ⁷⁴ 2008 FCA 332
- ⁷⁵ *Supra*, note 70.
- ⁷⁶ *Ibid.*
- ⁷⁷ Pursuant to general principles of the common law of contracts, a contract must be entered into for consideration. Thus, *prima facie* it is impossible to respect this condition in a common law jurisdiction. While it is possible to enter into a contract under seal, it is debatable whether this constitutes consideration or not.
- ⁷⁸ *Supra*, note 63.
- ⁷⁹ However, in order to meet this definition, the amount included as E in the computation of CEC must be in respect of a business carried on by the taxpayer through a permanent establishment in Canada.
- ⁸⁰ *Supra*, note 63.
- ⁸¹ *Supra*, note 70.
- ⁸² See proposed paragraph 56.4(9)(c).
- ⁸³ See proposed paragraph 56.4(9)(c.1).
- ⁸⁴ An agent is usually a disregarded entity for tax purposes.

⁸⁵ As defined under subsection 248(1) “filing due date” of the Act.

⁸⁶ As defined under subsection 248(1) “taxable Canadian property” of the Act.

⁸⁷ Pursuant to subsection 153(1) of the Act.

⁸⁸ *Supra*, note 66, at page 168 : “The presumption of coherence is also expressed as a presumption against internal conflict. It is presumed that the body of legislation enacted by a legislature does not contain contradictions or inconsistencies, that each provision is capable of operating without coming into conflict with any other.”

⁸⁹ *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, [2006] 1 S.C.R. 715, at paragraph 23.

⁹⁰ Cassels Brock Lawyers – Tax and Trusts Group E-Communique, February 2006.

⁹¹ Perhaps, for example, by virtue of Article XIII of the Canada-US Tax Convention (the “Treaty”).

⁹² *Supra*, note 90.

⁹³ The Excise Tax Act, RSC 1985, Chapter E-15, Parts VIII and IX enacted by S.C. 1990, c.45, as amended and proposed to be amended, and including the regulations promulgated there under (the “ETA”).

⁹⁴ Pursuant to section 165 of the ETA.

⁹⁵ As defined by subsection 123(1) of the ETA.

⁹⁶ GST Headquarters Letters, 11735-1B, 11735-15C, March 27, 2000, “Non-Competition Payments.” and GST Headquarters Letters, 11735-1, 11735-15D, March 27, 2000, “Non-Competition Agreement.”

⁹⁷ CRA document No. 2007-0243411C6, October 5, 2007, “APFF – 2007 Conference Round Table on the Federal Tax” question 31.

⁹⁸ *Supra*, note 55.

⁹⁹ Many thanks to Doug Welsh CA, CBV for the valuation comments in this example.

¹⁰⁰ Certain practitioners may question whether subsection 104(21) of the Act could not deem the father to have disposed of the shares directly in light of the wording of this section which states “[...] shall [...] be deemed [...] to be a taxable capital gain for the year of the particular beneficiary from the disposition by that beneficiary of capital property.” We believe that subsection 104(21) of the Act only deems the capital gain to be that of the beneficiary. We do not believe that that subsection deems the beneficiary to have disposed of the actual property that was disposed of by the trust. We arrive at this conclusion from the fact that subsection 104(21.2) of the Act is necessary to deem the beneficiary to have disposed of shares that are shares of a small business corporation, or disposed of qualified farm property or qualified fishing property. If subsection 104(21) of the Act deemed the beneficiary to have disposed of the property disposed of by the trust, then subsection 104(21.2) of the Act would arguably be redundant.

¹⁰¹ By virtue of paragraph 251(1)(b) of the Act.

¹⁰² This section was written by Doug Welsh CA, CBV of Clark Valuation Services Ltd.

¹⁰³ In these calculations, you would be double-counting the effects of risk if you were to adjust the cash flows for risk related to non-competition agreements, then increase the risk adjusted discount rate to account for non-competition agreements. As well, in matching cash flow to risk, the valuator should be careful to ensure that the incremental cash flows (whether pre-tax or after-tax) should be matched to the related discount rate determined on a pre-tax or after-tax basis.

¹⁰⁴ This general conclusion assumes that the risk related to the potential lost business without the non-competition agreement is a reasonable measure of the risk for the overall business being acquired

¹⁰⁵ Of course, the seller will say that the valuation exercise is mute because he already signed the non-competition agreement and does not intend to break it. It could be that discussions with the purchaser will be more fruitful for it is their assessment of the risks and benefits that resulted in the determination of an appropriate purchase price to begin with. The seller, however, would likely have the best knowledge about the business and the industry in general.