A RECAP OF THE NEW RESTRICTIVE COVENANT RULES

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After nearly a decade of review and revision, the restrictive covenant rules initially proposed by the Minister of Finance ("Finance") on October 7, 2003 finally became law in 2013.

New section 56.4 and the income inclusion rule

New section 56.4 of Canada's Income Tax Act (the "Act"), in force as of June 26, 2013, applies to payments received in respect of non-competition agreements and other arrangements caught under the defined term "restrictive covenant". This new section provides that such payments are taxable as ordinary income in the year received or receivable unless certain limited exceptions apply. For a period of time prior to the introduction of the restrictive covenant rules, generally speaking, such payments were not subject to taxation at all.

By way of background, the restrictive covenant rules were introduced by Finance in response to two Federal Court of Appeal decisions, *Fortino v Canada*, [2000] 1 CTC 349 and *Manrell v Canada*, [2003] 3 CTC 50, which generally found that non-competition payments received by a vendor in a share sale were not taxable. In light of these decisions, it became typical in a share sale to allocate a portion of the purchase price to non-competition agreements so that the vendor could receive such portion tax-free. Not surprisingly, Finance retaliated with rules to ensure that payments so allocated would be taxable, and would be treated as income rather than as capital receipts. The income classification precludes vendors from taking advantage of the tax benefits associated with capital property, such as the 50% income inclusion rate for capital gains and the lifetime capital gains exemption (at $800,000 in 2014). Capital gains treatment (and its benefits) normally applies to the majority, if not the whole, of a purchase price on a share sale.

Exceptions to the income inclusion rule

Because an amount received in respect of a restrictive covenant is treated as income, 100% of such amount must be included in the vendor's income in the year of receipt and taxed accordingly. There are, however, limited exceptions whereby an amount may be afforded more favourable tax treatment. The exceptions only apply where parties to the restrictive covenant deal at arm's length. The exceptions generally pertain to: (i) employment income; (ii) elective cumulative eligible capital; and (iii) elective eligible interest.

With regard to the first exception, the income inclusion rule will generally not apply if the amount received under the restrictive covenant is required to be included in the calculation of a vendor's employment income. Under the elective cumulative eligible capital exception, the income inclusion rule will similarly not apply if the amount is classified as proceeds of disposition of eligible capital property and the vendor and purchaser file a joint election.

The eligible interest exception is a bit more complex. If the amount received under the restrictive covenant directly relates to the vendor's disposition of an eligible interest (generally being capital property that is a partnership interest in or a share of the capital stock of the vendor, which must carry on a business) and if the vendor and purchaser file a joint election, then, subject to certain specific additional requirements codified under subparagraphs 56.4(3)(c)(i) through (v) of the Act, a portion of the amount may be treated as proceeds of disposition of the vendor's eligible interest to the extent that the restrictive covenant increases the fair market value of the eligible interest. A capital gains tax rate would apply to such portion, with any excess amount being taxable as ordinary income.

Reasonable allocation of purchase price

Where a restrictive covenant is included in an asset or share sale, parties to the sale are required to allocate a "reasonable" amount of the purchase price to the restrictive covenant given. If the parties fail to allocate

an amount considered reasonable by Canada Revenue Agency ("CRA"), CRA may make such allocation itself in accordance with paragraph 68(c) of the Act. Despite the vagueness of the term "reasonable" and the onerous effects of failing to make a reasonable allocation, CRA has indicated that it does not intend to publish guidelines to assist taxpayers in valuing restrictive covenants. (Note there are exceptions to CRA's ability to reallocate a greater portion of a purchase price to the restrictive covenant where certain specific conditions are met.)

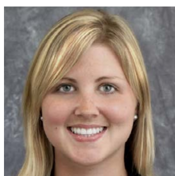
Broad definition of "restrictive covenant"

The new rules in section 56.4 of the Act do not only address non-competition agreements or other covenants granted in the course of carrying on a business. A "restrictive covenant" is broadly defined in the Act as an "agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer, whether legally enforceable or not." The definition's scope encompasses more than simply an agreement not to compete. In fact, CRA has acknowledged the possibility that the scope may be broad enough to include break fees and signing bonuses in certain situations.

Applicability of rules

The new restrictive covenant rules apply retroactively to amounts received or receivable by a taxpayer **after** October 7, 2003, **other than** amounts received before 2005 pursuant to a restrictive covenant made in writing **on or before** October 7, 2003 between arm's length parties. In light of this retroactive application, some completed restrictive covenant arrangements may require a revisit.

It is important that taxpayers obtain proper legal and tax advice before engaging in any restrictive covenant arrangement.



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