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NON-COMPETITION AGREEMENTS: RESTRICTIVE COVENANT RULES

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on important tax changes regarding non-competition agreements and restrictive covenant rules. Alpert Law Firm is experienced in providing legal services to its clients in tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions and estate administration.

A. BACKGROUND

When negotiating an asset or share sale, parties commonly include a non-competition clause which prevents the vendor from competing with the purchaser of the acquired business for a specified period of time and in a particular area. Other restrictive covenants might also be included in a sale agreement, including non-solicitation clauses such as arrangements not to solicit existing customers of the business or not to induce existing employees to leave the business.

Such covenants have a real value to the purchaser, since the consideration payable for a newly-acquired business could be materially affected by competitive actions undertaken by the vendor after the sale. Prior to 2013, however, the tax treatment of sums received in respect of such restrictive covenants was uncertain due to case law which left open the possibility that payments for non-competition agreements were non-taxable receipts.

The Department of Finance responded directly to these cases by proposing changes to the Income Tax Act (the “Act”) with regard to payments for restrictive covenants. These amendments are found primarily in section 56.4 of the Act, which has been in force as of June 26, 2013. Section 56.4 of the Act also applies retroactively to amounts received or receivable by a taxpayer after October 7, 2003, other than amounts received before January 1, 2005, under a written grant of a restrictive covenant made on or before October 7, 2003.

B. GENERAL RULES RELATING TO RESTRICTIVE COVENANTS

Subsection 56.4(2) of the Act provides that all amounts with respect to a restrictive covenant that are received or receivable in a taxation year by a taxpayer or a person not dealing at arm's length with the taxpayer will be fully taxable as ordinary

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income. Pursuant to paragraph 212(1)(i) of the Act, where the taxpayer is a non-resident, a 25% withholding tax applies.

A "restrictive covenant" is defined in subsection 56.4(1) of 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, 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, other than an agreement or undertaking that disposes of the taxpayer's property."

The definition given to "restrictive covenant" is a broad one and includes non-competition agreements, non-solicitation agreements, and other types of restrictive covenants, including covenants attached to land. Likewise, it is not limited in scope to promises to refrain from certain conduct or actions, but also applies to positive promises to undertake certain courses of action. The definition is broad enough that in addition to non-competition and non-solicitation agreements it could possibly include non-disclosure agreements, exclusivity clauses, signing bonuses, and break fees.

Due to the nature of the general charging provision contained in subsection 56.4(2) of the Act, and the broad definition given to the term "restrictive covenant", parties must use care when drafting a restrictive covenant in a sales agreement in order to avoid having unintended amounts treated and taxed as income.

C. RELIEF FROM THE GENERAL RULES

Subsection 56.4(3) of the Act provides some relief from the general rule that payments in respect of restrictive covenants are to be treated as income. These exceptions apply only when the parties to the agreement deal with each other at arm's length. Pursuant to subsection 56.4(4) of the Act, where these exceptions apply, the tax treatment for the purchaser should mirror that of the vendor.

(a) COVENANTS GRANTED BY EMPLOYEES

Paragraph 56.4(3)(a) of the Act provides that if the amount in respect of the restrictive covenant is included in income received from an office or employment under section 5 or 6 of the Act, it need not be included under section 56.4 of the Act. This exception ensures that the same amount will not be taxed under more than one section, but it does not prevent the payment from being treated as income. The amount will be

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taxed to the employee as income; for the employer it will be considered to be wages paid or payable by the purchaser to the employee.

The amount will also be subject to source deductions in the same manner as other employee wages. Special tax treatment for such amounts is available under subsection 6(3.1) of the Act, which allows employees a maximum 36-month deferral in the event that the payments occur over more than one taxation year.

(b) ASSET SALES

In certain circumstances, parties to an asset sale in which intangible assets are sold can avoid having the value of a restrictive covenant treated as income by filing an election. Under paragraph 56.4(3)(b) of the Act, if an amount in respect of the restrictive covenant is included in the proceeds of disposition of a Class 14.1 property of the business to which the restrictive covenant relates, then subsection 56.4(2) will not apply to the amount if the parties jointly file an election. Class 14.1 property generally includes intangible assets such as goodwill, trademarks, customer lists, etc.

Details regarding how to make the paragraph 56.4(3)(b) election are set out in section F of this memorandum.

(c) SHARE SALES

In certain circumstances, parties to a share sale can avoid having the value of a restrictive covenant treated as income by filing an election. Paragraph 56.4(3)(c) applies to restrictive covenants granted with respect to sales of “eligible interests”. These are defined to be capital properties of the taxpayer that are either: (i) partnership interests in a partnership that carries on a business; (ii) shares of the capital stock of a corporation that carries on a business; or (iii) shares in a holding corporation if 90% or more of the fair market value (the “FMV”) of that holding corporation is attributable to the eligible interests of one other corporation that is carrying on business.

Under paragraph 56.4(3)(c), the vendor and purchaser may jointly file an election to opt out of the general charging provision and elect to treat a portion of the amount payable for the restrictive covenant as proceeds of disposition of the eligible interest, to the extent that the amount increases the FMV of the grantor’s eligible interest. This portion of the proceeds will then be taxed as proceeds of disposition of a capital property, resulting in either a capital gain or capital loss. Any portion of the amount paid

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for the non-competition agreement in excess of the portion elected to be treated as proceeds of disposition of the eligible interest will be taxable as ordinary income.

This optional joint election is subject to the following additional restrictions:

(i) If less than 90% of the FMV of a holding corporation is attributable to shares of a corporation that carries on business, the parties will not be able to file the joint election. This 90% requirement is a point-in-time test and may be overcome by redistributing assets prior to a sale in order to satisfy it;

(ii) Shares of additional tiers of holding companies that do not have direct interests in the operating company will not meet the criteria for the joint election and such tiers would have to be merged before an acquisition if the parties wish to take advantage of the joint election;

(iii) The joint election only applies to non-competition agreements whereby the grantor agrees to not provide, directly or indirectly, property or services in competition with those provided or to be provided by the purchaser. Any other type of restrictive covenant will not be eligible for this treatment;

(iv) The restrictive covenant must be granted to the purchaser of the eligible interest or to a person related to the purchaser of the eligible interest;

(v) The restrictive covenant must reasonably be considered to have been granted to maintain or preserve the value of the eligible interest disposed of to the purchaser;

(vi) The deemed dividend rules in subsection 84(3) of the Act cannot apply to the disposition of the eligible interest, meaning there cannot be a redemption, acquisition or cancellation of any shares in the capital stock of a corporation that are the eligible interest being disposed of; and

(vii) The amount elected must be added to the vendor’s proceeds of disposition of the eligible interest.

These provisions do not seem to contemplate a situation where a holding company sells the shares of a target and the restrictive covenant is granted by a shareholder of the holding company. In such a situation this election would be unavailable.

Details regarding how to make the paragraph 56.4(3)(c) election are set out in section F of this memorandum.

(d) ANTI-AVOIDANCE PROVISION

The exception with respect to sales of eligible interests provided for in paragraph 56.4(3)(c) of the Act is subject to an anti-avoidance rule set out in subsection 56.4(9) of the Act. In the event that the portion of the proceeds that relate to the restrictive covenant would otherwise be treated as income from an office or employment or a business or property, the exception is not applicable and the amount will be treated as income and not a capital gain.

D. ALLOCATION PROVISIONS

Section 68 of the Act allows the Canada Revenue Agency (the “CRA”) to reassess any allocation of the purchase price for shares or assets that relates to the grant of a restrictive covenant and does not appear to be reasonable in the circumstances.

Section 68 of the Act allows the CRA to allocate a value to a restrictive covenant (even if the vendor and purchaser have not included such a clause in the purchase and sale agreement) if it can reasonably be regarded that a portion of the sale proceeds are consideration for the grant of a restrictive covenant. This reallocation will apply to both parties to the agreement.

As a result, it is open to the CRA to question: (i) why a restrictive covenant was omitted from a purchase and sale agreement; (ii) why a restrictive covenant was required without increasing the sale price; and (iii) whether the amount allocated by the vendor and purchaser in a purchase and sale agreement accurately represents the value of the restrictive covenant.

Pursuant to the provisions of subsection 56.4(5) of the Act, there are three specific situations in which the provisions of section 68 of the Act will not apply.

(a) COVENANTS GRANTED BY EMPLOYEES

Pursuant to subsection 56.4(6) of the Act, the CRA is not entitled to use the provisions of section 68 of the Act to reallocate the consideration for a non-competition agreement in the case of an individual employee granting a restrictive covenant to an

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arm's length purchaser of the employer's business, where the following conditions are met:

(i) the restrictive covenant must relate directly to the acquisition by the purchaser from one or more vendors of an interest in the individual's employer, in a corporation related to the employer or in a business carried on by the employer;

(ii) the employee must deal at arm's length with both the purchaser and the vendor(s);

(iii) the restrictive covenant must be an undertaking to not provide, directly or indirectly, property or services in competition with those provided or to be provided by the purchaser;

(iv) the taxpayer must not have received, or be entitled to receive, any consideration for granting the restrictive covenant; and

(v) the amount that can be reasonably regarded as consideration for the restrictive covenant must have been received or receivable only by the vendor(s).

(b) REALIZATION OF GOODWILL OR DISPOSITION OF PROPERTY

Pursuant to subsection 56.4(7) of the Act, in certain circumstances, the CRA is not entitled to use the provisions of section 68 of the Act to reallocate the consideration for a non-competition agreement to transactions involving a disposition of goodwill, a disposition of shares in the capital stock of a corporation, or a disposition of property, other than goodwill or shares of a corporation.

1. Disposition of goodwill

The following conditions must be met in order for subsection 56.4(7) of the Act to apply to a transaction involving a disposition of goodwill:

(i) the restrictive covenant is granted by the vendor to either a purchaser with whom the vendor deals at arm’s length or an eligible individual in respect of the vendor (“eligible individual” is defined in subsection 56.4(1) of the Act as “an individual (other than a trust) who is related to the vendor and who has attained the age of 18 years”);

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(ii) the restrictive covenant is an undertaking of the vendor not to provide, directly or indirectly, property or services in competition with the property or services provided or to be provided by the purchaser or a person related to the purchaser;

(iii) the amount that can reasonably be regarded as consideration for the restrictive covenant is:

(a) included by the vendor in computing its proceeds of disposition of a Class 14.1 property; or

(b) received or receivable by an eligible corporation of the vendor and included in the eligible corporation's computation of its proceeds of disposition of a Class 14.1 property ("eligible corporation" is defined in subsection 56.4(1) of the Act as "a taxable Canadian corporation of which the taxpayer holds, directly or indirectly, shares of the capital stock").

(iv) where the restrictive covenant is granted to an eligible individual, the vendor must be a resident of Canada at the time the restrictive covenant was granted;

(v) no consideration may be received or receivable by the vendor for granting the restrictive covenant;

(vi) the restrictive covenant can reasonably be regarded to have been granted to maintain or preserve the FMV of the benefit of the expenditure derived from the goodwill amount; and

(vii) the parties must file a joint election as prescribed by paragraph 56.4(7)(g) of the Act.

2. **Disposition of shares and disposition of property, other than goodwill or shares of a corporation**

The following conditions must be met in order for subsection 56.4(7) of the Act to apply to a transaction involving a disposition of shares, or a disposition of property other than goodwill or shares of a corporation:

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(i) the restrictive covenant is granted by the vendor to either a purchaser with whom the vendor deals at arm's length or an eligible individual in respect of the vendor ("eligible individual" is defined in subsection 56.4(1) of the Act as "an individual, other than a trust, who is related to the vendor and who has attained the age of 18 years");

(ii) the restrictive covenant is an undertaking of the vendor not to provide, directly or indirectly, property or services in competition with the property or services provided or to be provided by the purchaser or a person related to the purchaser;

(iii) it is reasonable to conclude that the restrictive covenant is integral to a written agreement under which the vendor or the vendor's eligible corporation disposes of property for consideration that is received or receivable by the vendor or the vendor's eligible corporation;

(iv) where the restrictive covenant is granted to an eligible individual:

  (a) the vendor must be a resident of Canada at the time the restrictive covenant was granted; and

  (b) the vendor may not at any time after granting the restrictive covenant have an interest, directly or indirectly in any manner whatever, in the eligible corporation of the eligible individual;

(v) no consideration may be received or receivable by the vendor for granting the restrictive covenant;

(vi) if the property being disposed of consists of shares of the capital stock of a corporation, subsection 84(3) of the Act cannot apply (i.e. there cannot be a redemption, acquisition or cancellation of the shares of the corporation); and

(vii) the restrictive covenant can reasonably be regarded to have been granted to maintain or preserve the FMV of the property or shares being sold.

(c) ANTI-AVOIDANCE PROVISION

The exception provided for in subsection 56.4(7) of the Act is subject to an anti-avoidance rule. Pursuant to subsection 56.4(10) of the Act, in the event that the portion of the proceeds that relate to the restrictive covenant would otherwise be treated as

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income from an office or employment or a business or property, then subsection 56.4(7) of the Act is not applicable. According to the Department of Finance, the purpose of this anti-avoidance rule is to prevent the conversion of ordinary income into a capital gain.

E. CONSIDERATION

The exceptions contained in subsections 56.4(6) and (7) of the Act, which prevent the CRA from reallocating the consideration for a non-competition agreement, both require that no consideration be received or receivable by the taxpayer in respect of granting the restrictive covenant.

To ensure that the contract is legally binding, non-competition agreements commonly assign nominal consideration to the restrictive covenant by using language such as “for $1 dollar and other good and valuable consideration”. However, a technical reading of subsections 56.4(6) and (7) of the Act would mean that taxpayers, who signed contracts containing such nominal allocations of consideration, are unable to take advantage of the exceptions contained in these subsections.

Although the CRA initially took the position that the technical interpretation was correct, the CRA has since stated that it has reconsidered its position during the CRA Round Table at the 2014 Canadian Tax Foundation’s Annual Conference. The CRA is now prepared to accept that a contract granting a restrictive covenant that uses nominal consideration language such as “$1 and other good and valuable consideration” only to ensure that the restrictive covenant is legally binding, will not, in and of itself, constitute proceeds received or receivable by the grantor of the restrictive covenant for the purposes of subsections 56.4(6) and (7) of the Act.

Alternatively, parties may wish to avoid the use of nominal consideration language altogether and instead sign the restrictive covenant agreement under seal to ensure enforceability.

F. SECTION 56.4 ELECTIONS

Subsection 56.4(13) of the Act states that an election under paragraphs 56.4(3)(b) or (c) or subsection 56.4(7) of the Act must include a copy of the restrictive covenant and must be filed in prescribed form. The deadline for filing the election depends on whether the grantor (i.e. seller) of the restrictive covenant was a resident or non-resident of Canada at the time that the restrictive covenant was granted. If the taxpayer who granted the restrictive covenant was a resident of Canada, the election must be filed with the CRA on or before the taxpayer’s filing-due date for the taxation year during which the restrictive covenant was granted. If the taxpayer who granted the

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restrictive covenant was a non-resident of Canada, the election must be filed with the CRA within six months of the date on which the restrictive covenant was granted. If any party required to file the election fails to do so, none of the parties will be able to take advantage of the election.

The CRA has not yet released a prescribed form for making elections under section 56.4 of the Act. In the meantime, the CRA has published guidelines on its website which recommends parties to a restrictive covenant to make such an election by filing a jointly-signed letter.

The letter must include the following information for both the grantor and purchaser: (i) full name; (ii) social insurance or business number; (iii) address; and (iv) taxation year in which the transaction occurred. The letter must also include the following information about the restrictive covenant: (i) description of the restrictive covenant; (ii) name of the taxpayer granting the restrictive covenant; (iii) name of the taxpayer receiving consideration for the restrictive covenant; (iv) confirmation that the parties deal at arm's length; and (v) the provision of the Act under which the election is being made by the parties.

G. <u>CASE LAW</u>

1. <u>Pangaea One Acquisition Holdings XII S.A.R.L. v. The Queen, 2018 TCC 158</u>

The taxpayer, Pangaea One Acquisition Holdings XII S.A.R.L. ("Pangaea"), was incorporated in Luxembourg and was a non-resident of Canada for income tax purposes. Pangaea, Thomvest Seed Capital Inc. ("Thomvest"), and a third shareholder owned all the issued and outstanding shares of Public Mobile Holdings Inc. ("Public Mobile"). The three shareholders signed a unanimous shareholder agreement which provided that the Public Mobile shares could not be transferred without the prior written consent of the other shareholders.

In 2013, Pangaea and Thomvest entered into an agreement (the "Contract") wherein Thomvest agreed to pay $3,000,000 as consideration for Pangaea's agreement to waive its veto right and execute a share purchase agreement in connection with the sale of Public Mobile shares to Telus Communications Inc. ("Telus"). Thomvest, which was a corporation resident in Canada, withheld 25% of the agreed payment amount (i.e. $750,000) and remitted this sum to the CRA pursuant to Part XIII of the Act.

In 2014, Pangaea made an application to the CRA for a refund of the withholding tax on the basis that the $3,000,000 payment falls under the business profits exemption

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under the Canada-Luxembourg tax treaty. CRA denied the refund on the basis that the Contract was a restrictive covenant, which "does not benefit from any treaty relief". The sole issue in this case was whether the Contract should be characterized as a "restrictive covenant" pursuant to section 56.4 of the Act.

The Tax Court of Canada stated that a "restrictive covenant", as defined by subsection 56.4(1) of the Act, can be characterized as follows:

(i) an agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer, whether legally enforceable or not;

(ii) 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; and

(iii) excluding an agreement or undertaking that disposes of the taxpayer's property.

The Tax Court held that the requirement set out in (i) above was satisfied since the Contract can be viewed as either "an agreement" or "a waiver of an advantage or right". The Tax Court held that the requirement set out in (ii) was also satisfied since there was an obvious nexus between the Contract and the disposition of Public Mobile shares by Pangaea to Telus.

The remaining issue was whether the Contract falls under the exception set out in (iii) above. Pangaea attempted to argue that the Contract falls under this exception because the it dealt with the disposition of Pangaea's veto right to Thomvest, and the veto right can be characterized as "property". The Tax Court rejected Pangaea's argument and held that even if the veto right can be characterized as "property", the right was merely waived by Pangaea, and there was no evidence of an actual disposition (i.e. transfer or assignment) of the right to Thomvest

The Tax Court concluded that the Contract was a "restrictive covenant" as defined in subsection 56.4(1) of the Act. As a result, Pangaea was not entitled to a refund of the withholding tax and its appeal was dismissed.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

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