PROPOSED SECTION 56.4 -- STILL DRAFT AFTER ALL THESE YEARS

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I extend my apologies to Paul Simon for using the above title. *Still Crazy after All These Years* was Paul Simon's fourth studio album. The album was recorded in 1975, which makes it older even than the proposed legislation. However, Mr. Simon actually released his album in final form in October of 1975 – amazingly, the very same year that he recorded it. Rumor has it that Mr. Simon has not changed any of the notes in the tunes that were included on the album.

Proposed section 56.4 contains proposed rules on the taxation of payments that are received (or that become receivable) in respect of non-competition agreements and other arrangements that come within the defined term "restrictive covenant".

I have to keep repeating "proposed" because section 56.4 is still not in force. As senior practitioners might recall, the proposal was first announced in a press release dated October 7, 2003.[2] As we assemble at this 2011 British Columbia Tax Conference, we are about to mark – I do not say celebrate -- the 8th anniversary of that press release. The proposal is still not law.

The draft legislation has been extensively criticized and has been revised numerous times in attempts to deal with that criticism.[3] If it is ever actually enacted, however, the proposed provision will have retroactive effect to amounts received or receivable after October 7, 2003.[4]

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2 Finance Canada News Release 2003-049, October 7, 2003.

3 For those who want the full exciting history of the draft legislation, the first version was introduced as part of February 27, 2004 draft amendments. The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants provided its comments and criticisms on the first draft. In response, the Department of Finance released an amended proposed section 56.4 on July 18, 2005. The Joint Committee again voiced its concerns, and another amended version was released on November 9, 2006. Additional, albeit minor, changes were made to the 2006 version when the legislation was included in Bill C-10 and passed first reading in the House of Commons on October 29, 2007 but died on the Order Paper when Parliament was prorogued. The most recent amendments were released on July 16, 2010.

4 The coming-into-force provision provides an exception for any amounts paid by arm's-length parties under an agreement made prior to October 7, 2003 provided that the amounts are received before the 2005

Because the proposals have been revised extensively, however, slightly different rules will apply to some restrictive covenants that were granted between October 7, 2003 but prior to various dates on which the Department of Finance announced proposed tweaks to fix problems in the proposed legislation. The relevant dates are November 9, 2006 and July 16, 2010. As well, taxpayers will be able to file a joint election in order to have slightly different rules apply to restrictive covenants granted prior to November 9, 2006 (but this election for different treatment will have to be filed before the 180th day after the proposed legislation receives Royal Assent (whenever that might be).

This paper will focus on the current edition of the proposals, given that the current edition of the proposals (if enacted) will apply to transactions occurring after the presentation of this paper. Anyone dealing with past transactions, however, will have to carefully review the coming-into-force provisions applicable in respect of the proposed legislation as the rules may be slightly different in respect of those past transactions.

All this raises serious questions about the rule of law, because practitioners are being forced to comply with an unenacted piece of draft legislation that changes form more frequently than the shapeshifter Odo (of Star Trek Deep Space Nine fame). I will not deal with the rule of law issues but merely note that this is becoming an increasing problem. Practitioners have to deal with more and more draft legislation that never seems to actually pass through the Parliamentary process.[5]

Why Section 56.4?

Senior practitioners will remember that proposed section 56.4 of the ITA was proposed as a response to the Federal Court of Appeal's decisions in *Fortino*[6] and *Manrell*[7].

In *Fortino*, the shareholder had sold shares of a corporation and had received an amount for entering a non-competition agreement. Since the shareholder was not carrying on a business (the corporation carried on the business), the shareholder took the position that the non-competition payment was not taxable. The court agreed, but noted that the federal Department of Justice had not pleaded various other arguments that could have been raised and the court did not deal with those other arguments. As a result, it was unclear whether *Fortino* meant that non-competition payments received by a shareholder on the sale of shares were tax-free or whether the shareholder in *Fortino* had merely been lucky.

In *Manrell*, the issue came before the court again and the Department of Justice made sure that it

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taxation year. It is symptomatic of the problems with this legislation that the grandfathering has expired long before the legislation has been passed.

5 For example, the proposed amendment to section 94 of the ITA dealing with non-resident trusts was first put forward in the 1999 federal budget. The first proposed version was released on August 2, 2001. These proposed amendments are still not in force and have been amended numerous times.

6 97 DTC 55 (TCC); affirmed [2000] 1 CTC 349 (FCA).

7 [2003] CTC 50 (FCA).

raised the other arguments that it had not raised in *Fortino*. However, the Federal Court of Appeal rejected those other arguments and ruled that non-competition payments received by a vendor in a share sale was not received on a disposition of property and therefore was not taxable.

Not surprisingly, business owners and tax advisors started to allocate amounts in a sale of shares to the non-competition agreements with the shareholders. The Department of Finance thus began its arduous journey towards developing legislation to respond to the *Manrell* decision.

A Way Through the Maze

Proposed section 56.4 is very complicated. The schedule to this paper contains a flow chart that is meant to assist the reader in navigating through the provision. The flow chart may also help the reader to navigate through this paper.

At the risk of over-simplification, the text under this subheading attempts to summarize the proposed legislation.

The general rule requires that the grantor of a restrictive covenant must include in income any amount that is "received or receivable" if the amount can be regarded as relating to the granting of that covenant. The amount is included as ordinary income (not as a capital amount). The grantor of the covenant is the one who includes the amount in income (even if the amount is not paid to the grantor).

This general rule is subject to two different sets of exceptions. The first set of exceptions is set out in subsection 56.4(3). The second set of exceptions is contained in subsections 56.4(6) to (8.1). The presence of two separate sets of exceptions is confusing, especially given that the sets seem to overlap. This confusing state of affairs seems to be due in part to the long incubation period involved. Given that many transactions were structured on the basis of the first set of exceptions, the Department of Finance was reluctant to tweak the first set of exceptions. Accordingly, they tacked on a second set of "improved exceptions". As a result, one has to work through the exceptions one by one in order to see if the taxpayer can avoid an income inclusion.

As noted, the Department of Finance has made various "tweaks' to the proposals in an attempt to deal with inherent problems. This repeated "tweaking" has a lot to do with the complicated structure of the provision, as the Department tends to just add another exception to the general rule. Besides adding to the complication of the legislation, however, these attempts to fix inherent problems often result in making the waters even murkier. It is rather like new versions of computer software: the new version fixes one glitch but ends up creating other glitches and generally makes the central processing unit run more slowly because of all the extra software code that is tacked onto the existing software code.

Restrictive Covenant Definition: Taxed if You Do, Taxed if You Don't

Real estate practitioners will be familiar with the term "restrictive covenant" as referring to a covenant that applies to a piece of real estate for the benefit of some other piece of real estate. That sense of the term has no application in the context of the proposed new rules.

The ordinary person might be puzzled that the Department of Finance would choose a real estate term to describe non-competition agreements. However, the tem "restrictive covenant" has a non-real estate meaning. *Black's Law Dictionary* defines the term "restrictive covenant" as a "noncompetition covenant". *Black's Law Dictionary* then goes on to define "noncompetition covenant" 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.

Contrast the above definition with the current version of section 56.4, which defines restrictive covenant as follows.[8]

> "restrictive covenant", of a taxpayer, means 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
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> (a) that disposes of the taxpayer's property;[9] or
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> (b) in satisfaction of an obligation described in section 49.1 that is not a disposition 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.[10]

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8 Definition of "restrictive covenant", as set out in proposed subsection 56.4(1).

9 The exception in paragraph (a) refers to the agreement to dispose of the property itself. This exception is fairly clear, as any proceeds from that agreement will be taxed in the normal manner as proceeds of disposition of property. Some might consider that this paragraph renders the definition self-nugatory, but *Manrell* decided that a right to engage in an activity that anyone can engage in is not property. Based on *Manrell*, a payment for a non-competition covenant would not result in a disposition of any property (my right to engage in the prohibited activity not being property). Accordingly, the granting of the restrictive covenant itself would not come within the paragraph (a) exception.

10 The exception in paragraph (b) refers to ITA section 49.1, which avoids a doubling-up of dispositions if one were to consider that the right to acquire an item is disposed of on the acquisition of the item. It is a technical provision that can be ignored for purposes of this paper. For covenants that were granted prior to November 9, 2006, however, paragraph (b) ends with the words "that is not a disposition".

The ITA definition captures much more than non-competition clauses. The definition potentially includes contractual provisions that are not in fact restrictive or even covenants. It not only encapsulates the promise to abstain from certain actions, it also includes a positive promise to do a particular action. For example, a covenant to resign as a director or an officer would fall under this definition of restrictive covenant, as would an agreement to provide assistance in transitioning customers to a new owner. Any consulting or confidentiality agreement would also quite arguably fit under this definition as an agreement that affects the provision of services by the taxpayer. For example, a party to a confidentiality agreement usually agrees to not use certain confidential information when providing his services to third parties or agrees to use that information only in specific ways.

Confidentiality agreements are particularly interesting. At the start of negotiations for the merger of two businesses, the potential suitors will often enter into mutual confidentiality agreements restricting the use of information that is exchanged during the courtship. The parties are effectively waiving their right to gossip. Usually, no cash is exchanged (not even the $1 that is so often referred to in the recitals). However, the agreement is binding because there is an exchange of mutual promises. Presumably, those mutual promises have a value. That value is potentially greater if the proposed merger falls apart, as the jilted party can then comfort itself in the knowledge that its secrets are still safe and cannot be used by the party who walked out on the new relationship. Does this value have to be taxed under section 56.4? Strictly speaking, it would appear so. However, is it good tax policy to require taxpayers to pay tax in order to enter into negotiations that might lead to a business combination?

As a practical matter, the only answer seems to be to assume that the value of mutual confidentiality agreements is nominal (so that no amount is considered to have been received in respect of the restrictive covenant). This is probably not a valid assumption, but might develop into one of those fictions that have to be generally accepted in order to avoid having a complicated set of rules collapse under its own weight.

Based on the proposed definition, an agreement can be a restrictive covenant even if the agreement is not enforceable. Presumably, this was inserted because overly-broad non-competition agreements are not enforceable in the courts. While a non-enforceable agreement would presumably have little value, it could involve considerable expense to determine that a court will not enforce the agreement. Consequently, even a non-enforceable agreement might have some value if the grantor is reluctant to take on the costs of litigating the matter.

To illustrate the breadth of the definition, consider the following example. My wife has read about over-stressed lawyers suffering strokes because they spend too much time working. Not wanting that to happen to me, she insists that I leave the office when the staff leave and that I do not bring work home. If I agree, is that a restrictive covenant? My wife certainly intends to affect the way in which I provide my legal services. Indeed, that is the whole point of her request. One might argue that there is no consideration for my agreement to come home at quitting time, but what if my wife is extra nice to me if I agree to her request? For example, she always has a good hot meal waiting for me when I arrive home, whereas it was always dried-out warmed-up leftovers when I came home late. There is certainly value to that. The ITA

definition contains no requirement that a payment for a restrictive covenant be in cash or that the covenant be given as part of a sale of a business.[11] As well, it is irrelevant whether the covenant is enforceable at law.[12]

Non-Competition Covenant as a Subset of the Restrictive Covenant Concept

As noted, the definition of restrictive covenant is very broad.

The proposed legislation also has a more limited concept that I will refer to as a "non-competition covenant". However, this is not a term used in the draft legislation. As well, the concept is relevant only for purposes of some of the exceptions to the income inclusion rule.

There is no single definition of the non-competition covenant concept (as noted, the proposed legislation does not even use the term). The concept is described in the exception to which it relates. With one difference, however, the description of the concept is quite consistent throughout the exceptions.[13]

As used in the eligible interest exception from the first set of exceptions, a non-competition covenant is described as follows.[14]

> an undertaking given by a taxpayer not to provide, directly or indirectly, property or services in competition with the property or services provided or to be provided by the purchaser (or by a person related to the purchaser).

The concept also appears in the second set of exceptions. For purposes of the second set of exceptions, the description is substantially as set out above except that the description specifies that the undertaking must relate to the property or services to be provided by the purchaser (or the person related to the purchaser) "in the course of carrying on the business to which the restrictive covenant [being the non-competition covenant] relates".

For purposes of many of the exceptions, it will be necessary to distinguish between restrictive covenants that are non-competition covenants and restrictive covenants that do not fit within this subset. Most non-solicitation covenants should qualify as a form of non-competition covenant, as the granter is undertaking not to compete in respect of existing customers (but is reserving the ability to compete for other customers). However, a covenant to run a franchised business in

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[11] The draft legislation habitually uses the term "vendor" to refer to the person who grants the restrictive covenant. However, this is a defined term in each case and is used only in the exception provisions. The term "vendor" is not used in proposed subsection 56.4(2).

[12] This comment is not meant to imply that the law is more significant that my wife's wishes.

[13] One wonders why the legislative drafters did not add a defined term in this regard, as the lack of a defined term adds to the wordiness and complexity of the overall provision.

[14] See paragraph 56.4(3)(c)(ii).

accordance with specific procedures would not. While the purpose of many franchise covenants is to protect the goodwill of the franchise itself, they do so by ensuring that franchise standards are maintained (not by reducing competition).

General Rule: Ordinary Income Treatment

The basic rule for the tax treatment of restrictive covenants can be found in proposed subsection 56.4(2). This provision includes in income all restrictive covenant amounts that are received or receivable in a taxation year by a taxpayer (or by a person who is non-arm's length to the taxpayer). The amount is included in income and is included without any right to claim a reserve for amounts that are merely receivable.

In order to get capital (as opposed to income treatment), the grantor of the restrictive covenant has to fit into specific exceptions to the general rule.

General Rule: Received or Receivable

Proposed section 56.4(2) refers to amounts that are "received or receivable". As this paper is already long enough, and given that there is no reserve for receivable amounts, this paper will use "received" to include both received and receivable.

If a restrictive covenant amount is included in income because it is receivable in the year, it does not have to be included in income again when it is actually received.[15]

General Rule: Grantor Pays the Tax Whether or Not the Grantor Receives the Cash

If proposed subsection 56.4(2) requires an income inclusion, the income inclusion is not necessarily for the person who receives the restrictive covenant amount (as opposed to the person who provides the restrictive covenant). While the latest edition of the proposal provides a rule against double taxation of the same amount, the person who is taxed is the person who provides the restrictive covenant (not necessarily the person who receives the amount).

One has to skip over to proposed subparagraph 68(c) to confirm this result under the general rule. If an amount received from a person can reasonably be regarded as being in part for a restrictive covenant granted by a taxpayer (the grantor of the covenant), that part of the amount is deemed to be both

(a) a restrictive covenant amount received by the taxpayer (meaning the grantor of the covenant); and

(b) an amount paid to the taxpayer (meaning the grantor of the covenant) by the person to whom the covenant was granted.

Proposed paragraph 68(c) deems the grantor to have received the restrictive covenant amount

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[15] See the parenthetical exclusion found in the last half of proposed subsection 56.4(2).

"irrespective of the form or legal effect of the contract or agreement". Since the grantor is deemed to have received the amount, the income inclusion rule in subsection 56.4(2) applies to the grantor of the covenant (even if the grantor receives nothing).

While the grantor is deemed to have received the restrictive covenant amount, there is no provision that deems the recipient of the cash not to have received an amount. This could lead to double taxation. The latest edition of section 56.4 addresses this double taxation issue by adding proposed subsection 56.4(12). This new proposal provides that the restrictive covenant amount is to be included in the income of the person who is taxed under section 56.4(2). If some other person actually receives the amount, that other person does not include the amount in income.

For example, assume that the principal of a corporation provides a non-competition agreement as part of a sale of corporate assets but does not personally receive any amount for giving that covenant (letting all the sale proceeds be paid to the corporation). Unless a special rule applies as discussed below, the principal has to include the restrictive covenant amount in income (even though the corporation actually receives the amount).

Proposed subsection 56.4(12) does not avoid all double taxation in the above situation. It provides that the corporation does not have to pay tax on the restrictive covenant amount. However, the corporation still receives the amount and could distribute that amount as a dividend down the road. Proposed subsection 56.4(12) does not avoid taxation of that subsequent dividend (even if the amount has been taxed as ordinary income of the principal).

If an individual is providing a restrictive covenant, it is essential that the individual actually receive the restrictive covenant amount -- unless the situation clearly falls into one of the exceptions dealt with later in this paper.

Subsection 56.4(3): First Set of Exceptions to the General Rule

Proposed subsection 56.4(3) provides three exceptions to the income inclusion requirement in subsection 56.4(2). If a taxpayer qualifies under any one of these exceptions, the taxpayer does not have to include any amount in income under subsection 56.4(2). If one of these exceptions applies, the restrictive covenant amount will be taxed in the hands of the recipient of the amount (whether or not the recipient is the grantor).

For all these exceptions, the grantor of the covenant and the "purchaser" of the covenant – namely, the person to whom the covenant is granted -- must deal at arm's length with each other.[16] As well, the grantor of the covenant is usually the one engaging in the transaction or receiving the restrictive covenant amount.[17] The exceptions are as follows.

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[16] In determining whether the grantor of the covenant and the purchaser of the covenant deal at arm's length, one ignores any rights that might exist under paragraph 251(5)(b).

[17] This is not the case for the employee exception, however. In the case of the employee exception, the arm's-length employee is merely receiving an amount for granting the covenant. The main purpose of the employee exception is to have modified employment income rules apply to the compensation received by the employee.

(a) Employment income exception

(b) Elective cumulative eligible capital exception

(c) Eligible interest exception

The last two exceptions are significant. If a restrictive covenant can fit within the confines of one of these two exceptions, the amount received will be treated as a capital amount rather than an income amount. If drafting an agreement that contains a restrictive covenant, a practitioner would want to take extra care to ensure that the restrictive covenant fits within one of those two exceptions.

Still Income Treatment: Employment income exception

The first exception is in respect of employment income. If the amount received is already taxed as employment income under sections 5 or 6 of the ITA, proposed subsection 56.4(2) rule does not apply. The amount received would be taxed as ordinary employment income under those other provisions.

Subsection 6(3) of the ITA states as follows.

> (3) An amount received by one person from another
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> (a) during a period while the payee was an officer of, or in the employment of, the payer, or
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> (b) on account, in lieu of payment or in satisfaction of an obligation arising out of an agreement made by the payer with the payee immediately prior to, during or immediately after a period that the payee was an officer of, or in the employment of, the payer,
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> shall be deemed, for the purposes of section 5, to be remuneration for the payee's services rendered as an officer or during the period of employment, unless it is established that, irrespective of when the agreement, if any, under which the amount was received was made or the form or legal effect thereof, it cannot reasonably be regarded as having been received
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> (c) as consideration or partial consideration for accepting the office or entering into the contract of employment,
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> (d) as remuneration or partial remuneration for services as an officer or under the contract of employment, or

> (e) in consideration or partial consideration for a covenant with reference to what the officer or employee is, or is not, to do before or after the termination of the employment.

Therefore, for the amount received from the restrictive covenant to be included in the taxpayer's income under section 5 or 6 of the ITA, the taxpayer must have been in the employment of the payer. In the context of the sale of a business, there are many situations in which the purchaser would have never employed the taxpayer. Therefore, the amount received for the restrictive covenant would not fit within this exception and would be taxed pursuant to proposed subsection 56.4(2).

If the payment is employment income of the employee under this provision, the purchaser is to treat the amount as wages paid or payable.[18]

Employment income is generally taxed on a cash (i.e. received) rather than on an accrual (i.e. receivable) basis. Proposed subsection 6(3.1) will change this treatment in respect of some unpaid restrictive covenant amounts. A restrictive covenant amount that is merely receivable by an employee will be deemed to have been received by the employee at the end of the taxation year if the following two conditions exist.[19]

1. The covenant was agreed to by the taxpayer more than 36 months before the end of the taxation year.

2. The amount would be included in the taxpayer's income if it had been received in the year.

This deemed receipt provision will not apply if the employee receives the full restrictive covenant amount over three years. Any portion that is paid over a longer time frame will be subject to a deemed inclusion at the end of the third year.

Capital Treatment: Elective cumulative eligible capital exception

Proposed subsection 56.4(3)(b) provides the elective cumulative eligible capital ("**CEC**") exception. This exception applies only if the taxpayer is carrying on a business and the amount would have been proceeds of disposition of eligible capital property had it not been for this proposed subsection. However, the exception is not applicable if the taxpayer is an employee of a corporation, or is not carrying on the business that is being sold. The draft rules do not state whether the exception would apply if the taxpayer is a partner or limited partner of the business being sold.

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[18] Proposed subsection 56.4(4)(a).

[19] Proposed subsection 6(3.1) does not apply if the amount is a deferred amount under a salary deferral arrangement. Such an amount, however, would be included in income in any event under paragraph 6(1)(a) and subsection 6(11).

This exception provides no relief to a taxpayer who is a shareholder selling the business assets of the corporation.

To a large extent, this exception merely brings one back to the situation that applied to the sale of a sole proprietorship prior to the *Fortino* and *Manrell* decisions. As the sole proprietor was carrying on the business, the sole proprietor was the owner of any goodwill associated with the business. If the sole proprietor agreed not to compete with the new owner of the business, that was seen as part of the sale of the associated goodwill and was treated as proceeds of disposition of the goodwill. This would usually result in a disposition of eligible capital property and an eligible capital receipt. Assuming that the sole proprietor had created the goodwill (i.e. had not purchased and amortized the goodwill), the proceeds of sale of the goodwill would be taxed as a capital receipt.

In order to get back to this "good old days" treatment under the proposed legislation, however, the sole proprietor now has to file an election.[20]

If the purchaser does not carry on a business in Canada, the grantor can elect alone.

If the purchaser files the joint election, the purchaser is deemed to have paid the amount for the restrictive covenant as an "eligible capital expenditure".[21] As a result, the purchaser will have to amortize the amount as if it were part of the purchase price of goodwill. In the absence of these draft rules, that likely would have been the result in any event.

What if the purchaser does not make the election? Presumably, the purchaser would be able to deduct the amount as a non-capital expenditure in the year of the purchase. If so, this will be the genesis of lots of hard bargaining between the vendor and the purchaser as to whether an election is made.

Capital Treatment: Eligible interest exception

The third exception – the eligible interest exception -- addresses the situation that was litigated in *Manrell*. The eligible interest exception will be the relevant exception for most purchases and sales, given that most businesses are carried on by corporations. If the corporation is carrying on the business, any shareholder who grants a restrictive covenant will have to fit into this exception in order to avoid an income inclusion for the restrictive covenant payment.

This exception applies only to the more narrow concept of a non-competition covenant.[22] If the restrictive covenant is a confidentiality agreement or some other form of restrictive covenant, the exception does not apply.

Prior to examining this exception in detail, one must first turn to the definition of "eligible

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[20] Proposed subsection 56.4(14).

[21] Proposed subsection 56.4(4)(b).

[22] Proposed subsection 56.4(3)(c)(ii).

interest".[23]

> "eligible interest", of a taxpayer, means capital property of the taxpayer that is
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> (a) a partnership interest in a partnership that carries on a business;
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> (b) a share of the capital stock of a corporation that carries on a business; or
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> (c) a share of the capital stock of a corporation 90% or more of the fair market value of which is attributable to eligible interests in one other corporation.

A few comments need to be made in respect of this definition. Not every interest in a partnership or corporation will be an eligible interest.

In virtually all Canadian provinces, a partnership is defined as two or more persons carrying on a business in common. Can one assume that any capital property that is a partnership interest must qualify as an eligible interest under this definition? Or does the concept of "business" for purposes of the law of partnership differ from the concept of "business" for ITA purposes? If there is no difference in the concepts of "business" between the two pieces of legislation, the definition of "eligible interest" is being redundant by referring to "partnership that carries on a business". Under general principles, one is not to assume that legislative wording is redundant. However, the definition of "eligible interest" is silent as to what any distinction might be.

The definition refers to "a share of the capital stock of a corporation that carries on a business". This does not state that the corporation must carry on an active business or even carry on a business in Canada. However, the corporation must carry on some form of business. Does holding investments qualify, given that the income from those investments would be income from a "specified investment business"?

If the corporation does not carry on a business, paragraph (c) of the definition requires that 90% of the fair market value of the corporation be attributable to eligible interests in only *one* other corporation. If a taxpayer is selling a holding corporation that holds shares in more than one operating corporation, that taxpayer's interest in the holding corporation will likely not qualify as an eligible interest.

Paragraph (c) of the definition also seems to suggest that holding shares in another entity is not a business for purposes of the definition. This may indicate that a partnership that merely holds interests in a corporation or some other entity will not be carrying on a business (even though it may be carrying on a business for partnership purposes).

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[23] Proposed subsection 56.4(1).

Proposed subsection 56.4(3)(c) provides that the income inclusion rule in subsection 56.4(2) will not apply if the amount received for a restrictive covenant complies with eight separate conditions. All eight conditions must be satisfied for the exception to apply.[24]

1. The amount must directly relate to the taxpayer's disposition of an eligible interest in the partnership or corporation that carries on the business to which the restrictive covenant relates. If the eligible interest is capital property that is a share of a corporation of which 90% or more of the fair market value is attributable to eligible interests in one other corporation, then the amount must be related to the taxpayer's disposition of an eligible interest in the "other corporation" that carries on the business to which the restrictive covenant relates.

2. The disposition of the eligible interest must be to the purchaser, or to a person related to the purchaser, of the restrictive covenant.

3. As noted, the restrictive covenant must be a non-competition covenant.

4. The restrictive covenant must be granted to maintain or preserve the value of the eligible interest.

5. For a restrictive covenant granted since July 18, 2005, subsection 84(3) must not apply to the disposition.

6. The disposition of the eligible interest must not be one that is subject to the tax-deferred "rollover" rules in ITA section 85 or ITA subsection 97(2).

7. The amount must be added to the proceeds of disposition of the eligible interest.

8. The taxpayer and the purchaser must file a joint election pursuant to proposed subsection 56.4(14). In contrast to the situation in paragraph 56.4(2)(b), this election must be filed jointly whether or not the purchaser is carrying on business in Canada.

If an amount qualifies for the eligible interest exception under proposed subsection 56.4(3)(c),

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[24] Taxpayers can elect to have a different version of subsection 56.4(3)(c) apply in respect of covenants granted prior to November 9, 2006 but the purchaser and the grantor have to file a joint election to this effect no later than the 180th day after the proposed legislation receives Royal Assent.

the purchaser must treat the amount as part of the cost of the eligible interest.[25] This means that the purchaser will be able to neither amortize nor deduct the amount in calculating income.

Election Procedure

The exceptions under paragraphs 56.4(2)(b) and (c) require the filing of an election. This election must be made jointly with the purchaser in all cases under paragraph (c) and will often have to be made jointly under paragraph (b) as well.

Proposed subsection 56.4(14) sets out the election procedure. The election must be in prescribed form and must be filed along with a copy of the restrictive covenant on or before a specific date.

For a person who is a resident of Canada at the time that the person grants a restrictive covenant, the filing deadline is the grantor's filing due-date for the taxation year in which the restrictive covenant was granted. In all other cases (for example, if the grantor is a non-resident), the form must be filed within six months of the date the restrictive covenant was granted.

Recognizing that it might be hard to meet this deadline given that many deals will be several years old once the proposed legislation comes into force (if it ever does), a special rule applies to deals that were completed after the retroactive effective date of the legislation but prior to the legislation actually becoming law. In this case, the election must be filed within 180 days of Royal Assent.

As the proposed section is not yet law, there is not yet a published prescribed form. The 180-day rule could be rather difficult to comply with, therefore, if a taxpayer had to wait for the prescribed form. Imagine the difficulty of tracking down someone who purchased your business eight years ago in order to have that person sign a just-released prescribed form. In light of this, taxpayers can make a joint election under the proposed legislation by filing a jointly signed letter with the CRA.[26]

If a joint election is required, the joint election (whether the interim CRA letter or the actual prescribed form once it is released) should be signed as part of the closing documents. Until the legislation is passed and a form is actually prescribed, it may also be advisable for the purchaser to grant a power of attorney that authorizes the grantor to sign the prescribed form on behalf of the purchaser (just in case the CRA reverses its administrative policy on the jointly-signed letter).

Determining the Amount of a Restrictive Covenant

If a taxpayer does not qualify for one of the exceptions to the general rule in subsection 56.4(2), the taxpayer may have to allocate an amount to the restrictive covenant.

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[25] Proposed subsection 56.4(4)(c).

[26] A copy of this letter can be found on the CRA's website at http://www.cra-arc.gc.ca/tx/bsnss/tpcs/lf-vnts/sllng/rstrctv/lttr-eng.pdf.

A glaring problem with the draft legislation is its assumption that it is possible to calculate the value of a restrictive covenant that is provided in the context of a larger transaction. If a vendor is selling his business with a non-compete clause, how much of the purchase price should be allocated to that agreement not to compete? In many situations, the purchaser would not purchase the business if the non-competition aspect of the agreement was not in place. However, it would be absurd to say that the whole value related to the non-competition agreement because the purchaser is in fact acquiring assets of a business and shares of a corporation.

Draft section 56.4 requires that buyers and sellers of a business take the extra step of allocating a portion of the purchase price to each individual restrictive covenant.

One may think that a simple way out of the dilemma of valuing the restrictive covenant would be to allocate all of the value in a share or asset sale to either the shares or assets and have the entire amount be taxed as a capital amount rather than income. However, section 68 comes into play. Section 68 requires that the allocation to a restrictive covenant be reasonable. As will be dealt with later when discussing section 68, this requires that the parties allocate a reasonable amount to any restrictive covenant that is given. One cannot simply ignore the restrictive covenant unless one can conclude that the covenant itself has no value. However, the mere presence of the covenant indicates that the covenant must have some value (otherwise, why would it be part of the transaction?).

As was noted when discussing section 68, it is not a foregone conclusion that the taxpayer will be able to rely on the allocation made by the parties to the agreement. In order for the negotiated allocation to be *prima facie* proof of the value of the restrictive covenant, the contracting parties must have engaged in "real bargaining" in respect of the allocation. In other words, the allocation must have been significant to each contracting party. The agreed allocation is not *prima facie* evidence of value if one of the parties is indifferent to the allocation. For example, amortization of goodwill results in a deduction that is equal to 7% (declining balance basis) of 75% of the amount paid for the goodwill. This works out to 5.25% amortization based on the amount paid for the goodwill. If the choice is between allocating to the restrictive covenant (and having that form part of the purchaser's goodwill) and some other depreciable asset, does one have to show a significant difference between the amortization rate of the goodwill and the depreciation rate of that other asset in order to show that "real bargaining" occurred?

If one is unable to show that real bargaining occurred in respect of the allocation to the restrictive covenant, it will be easier for the CRA to dispute that allocation (the CRA will not have to show a "fundamental mistake" in the foundation of the agreed-to allocation).

A Set of Exceptions Just for Non-Competition Covenants

Even if the general rule in subsection 56.4(2) applies to a taxpayer, the taxpayer might still be saved from actually having to determine the value of the restrictive covenant if the taxpayer can qualify for a second set of exceptions. This second set of exceptions avoids the application of section 68, which would otherwise require allocation of an amount to the restrictive covenant and deem that the allocated amount is received by the grantor of the covenant. If the grantor of the covenant is not deemed to receive a restrictive covenant amount and does not actually receive a restrictive covenant amount, proposed subsection 56.4(2) has no amount that it can apply to.

While qualification for the exception precludes the application of section 68, one has to consider section 68 in determining whether one qualifies for the exception. The exceptions require that no part of the consideration that can reasonably be regarded as consideration for the non-competition covenant be received by a person who is dealing with the grantor on a non-arm's-length basis. For example, assume that a shareholder provides a non-competition covenant on a sale of shares. If part of the share value relates to the granting of the covenant, there may have to be a premium allocated to the shares sold by the grantor. Otherwise, other non-arm's-length shareholders may end up receiving part of the amount that can reasonably be considered as consideration for the non-competition covenant. This requires consideration of section 68 and the reasonable range of consideration that can be said to relate to the covenant.

At first glance, there seems to be considerable overlap between the first and second set of exceptions. In a non-employee context, the first set of exceptions deal only with situations in which the grantor of the covenant is also the person who is selling property to the purchaser. In contrast, the second set of non-employee exceptions can apply to situations in which the grantor is not the person actually selling property.

In order to benefit from this second set of exceptions described in proposed subsection 56.4(5), the taxpayer must fit into one of the following four cases.

1. Proposed subsection 56.4(6): Non-Competition Covenant Granted by an Employee.

2. Proposed subsection 56.4(7): Non-Competition Covenant Granted on a Disposition of a Business.

3. Proposed subsection 56.4(8): Non-Competition Covenant Granted on a Disposition of Property.

4. Proposed subsection 56.4(8.1): Non-Competition Covenant Granted on a Disposition of Shares to a Related Person over the age of 18 (an "Eligible Person").

As noted above, the definition of restrictive covenant is very broad. However, this second set of four exceptions applies only if the restrictive covenant is a non-competition agreement.[27]

Subsection 56.4(6): Non-Competition Covenant Granted by an Employee

Section 68 will not apply if an employee operating at arm's length with both the vendor and the purchaser provides a restrictive covenant not to compete with the purchaser and the consideration for that restrictive covenant is received by the vendor and not the employee.[28]

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[27] In respect of proposed subsection 56.4(6), see paragraph (d). In respect of proposed subsections 56.4(7),(8) and (8.1), see paragraph (b) of each of those proposed provisions.

[28] Proposed subsection 56.4(6).

This saves an arm's-length employee from being deemed to have received an amount for facilitating the transaction. This differs from the exception in subsection 56.4(3)(a) because the arm's-length employee in subsection 56.4(6) does not actually receive any compensation for granting the non-competition covenant. Accordingly, it is not appropriate to have the arm's-length employee pay any tax under the deemed receipt rules in section 68. However, section 68 would still apply if the arm's-length employee provides a restrictive covenant that falls outside the concept of a non-competition covenant.

In order for this exception to apply, each of the following six specific conditions must be met.

1. The employee must grant the covenant to an arm's-length purchaser.

2. The covenant must directly relate to the acquisition of an interest in the employee's employer, in a corporation related to the employer or in a business carried on by that employer. This interest would be sold by persons (the "vendors") other than the employee.

3. The employee must deal at arm's-length with the employer and with each vendor.

4. The covenant must be a non-competition covenant.

5. The employee must not receive any proceeds for granting the covenant.

6. The amount that can reasonably be considered to be consideration for the covenant must be received only by the vendors.

As noted, this exception is not available if the employee receives any amount for granting the covenant. Presumably, it would be permissible for the employee to receive a bonus from the employer as that would not be "proceeds" for granting the covenant. The bonus would be taxed as ordinary employment income in any event.

Subsection 56.4(7): Non-Competition Covenant Granted on a Disposition of Goodwill

Subject to a specific anti-avoidance rule[29], another exception applies if a taxpayer grants a non-competition covenant in connection with a disposition of goodwill.[30] The goodwill can be sold

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[29] The anti-avoidance rule is in proposed subsection 56.4(11). This anti-avoidance rule does not apply if the covenant was granted prior to November 9, 2006.

[30] See proposed subsection 56.4(7).

by the grantor[31] or by an eligible corporation of the grantor. In this provision, an eligible corporation is simply a taxable Canadian corporation of which the grantor of the covenant holds shares (whether directly or indirectly).[32]

If the grantor's eligible corporation is selling the goodwill, includes the non-competition amount as proceeds of sale of the goodwill and meets the other requirements of the provision, the grantor can provide a non-competition covenant without having to include the covenant amount in the grantor's income.

Only eight conditions have to be met to qualify for this exception. The eight conditions are as follows.

1. The grantor must deal at arm's length with the purchaser.

2. The restrictive covenant must be a non-competition covenant as defined in proposed paragraph 56.4(7)(b). The grantor must undertake to not provide property or services in competition with the property or services provided by the purchaser (or a person related to the purchaser) in the course of carrying on the business to which the non-competition covenant relates.

3. The grantor cannot receive any proceeds for granting the non-competition covenant.

4. The non-competition covenant amount must be included as proceeds of disposition of goodwill of the grantor (if the grantor is selling goodwill) or of the grantor's eligible corporation (if the eligible corporation is selling the goodwill).

5. It must be reasonable to consider that the non-competition covenant is granted to maintain or preserve the value of the goodwill that the purchaser acquired.

6. The goodwill must not be the subject of a tax-deferred rollover under section 85 or subsection 97(2).[33]

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[31] To the extent that the goodwill is sold by the grantor of the covenant, this exception seems to overlap with the sale of goodwill exception set out in subparagraph 56.4(3)(b). However, the applicable conditions are not the same as for subparagraph 56.4(3)(b). While it is nice to have two possible exceptions in such a case, it adds to the overall complexity of the rules.

[32] See the definition of "eligible corporation" in proposed subsection 56.4(1).

[33] This requirement does not apply if the covenant was granted prior to November 9, 2006.

7. No part of the consideration for the non-competition covenant can be received, either directly or indirectly, by someone with whom the grantor does not deal at arm's length.[34]

8. The grantor, the eligible corporation (if applicable) and the purchaser must file a joint election.[35]

It makes sense that the covenant amount not be taxed separately as income of the grantor, given that the vendor of the goodwill includes the amount as proceeds of sale of the goodwill.

Subsection 56.4(8): Non-Competition Covenant Granted on a Disposition of Property Other than Goodwill

Subject to a specific anti-avoidance rule,[36] proposed subsection 56.4(8) provides an exception for a non-competition covenant granted on the disposition of non-goodwill property. This exception could apply on a sale of business assets (assuming that the assets do not include goodwill) or on a sale of shares.

For example, assume that an individual sells shares of an operating corporation or causes the individual's holding corporation to sell shares that the holding corporation owns in an operating corporation. In either case, the individual might have to give a non-competition covenant. Provided that the situation complies with nine separate conditions, section 68 would not apply to require an allocation to the non-competition covenant. In that case, the value of the non-competition covenant would be included in the price of the shares (again, a return to the way that things were usually handled in the pre-*Manrell* days).

If the grantor is selling the property, the consideration that can reasonably be regarded as for the covenant must be part of the sale proceeds of the property. If someone else (such as a holding corporation) is selling the property, neither the grantor nor any non-arm's-length individual can receive any consideration for the covenant.

In order to qualify under this exception, the situation has to meet up to nine conditions.

1. The vendor must deal at arm's length with the purchaser.

2. The non-competition covenant must be a non-compete agreement with the purchaser.

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34 This requirement does not apply if the covenant was granted prior to November 9, 2006.

35 See subsection 56.4(14) for the rules governing the filing of the joint election. See also the text in this paper under the subheading "Election Procedure".

36 See proposed subsection 56.4(11). This anti-avoidance rule does not apply if the covenant was granted prior to November 9, 2006.

3. The non-competition covenant must be integral to a written agreement whereby either:

   (a) the vendor sells property to the purchaser for consideration; or

   (b) shares of a corporation are disposed of by anyone (not necessarily the vendor).

4. If the vendor has sold property to the purchaser for consideration, the amount that could be viewed as consideration for the non-competition covenant must be included in the consideration for the disposition of the property.[37]

5. If shares of a corporation are disposed of to the purchaser, no part of the consideration for the non-competition covenant can be received, either directly or indirectly, by someone with whom the vendor does not deal at arm's length.

6. The disposition must not be a share redemption or a corporate acquisition or cancellation of shares (in other words, the disposition cannot be one to which subsection 84(3) applies).

7. The property must not be the subject of a tax-deferred rollover under section 85 or subsection 97(2).

8. No proceeds can be received by the vendor for the granting of the non-competition covenant.[38]

9. The non-competition covenant must be granted to maintain or preserve the fair market value of the property that the purchaser acquired.

This subsection expands on the exception provided for in proposed subsection 56.4(3)(c) by not requiring that the grantor be the same taxpayer as the one who is disposing of the shares.

The subsection also differs from proposed subsection 56.4(3)(c) in that subsection 56.4(8) does not require a joint election. This is another example of the proposed legislation becoming increasingly complicated as the Department of Finance attempts to deal with the criticisms and

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[37] Different wording applies in respect of this requirement if the covenant was granted prior to July 16, 2010.

[38] This requirement does not apply if the covenant was granted before July 16, 2010.

concerns voiced against earlier versions.

This exception still does not apply to many situations, however. If a corporation is selling its assets, this exception will not apply because the shareholder would normally be the individual granting the non-competition covenant but the corporation would be the person disposing of property. In this situation the condition set out in subparagraph 56.4(8)(c)(i) would not be met and section 68 could apply to deem consideration to be received by the taxpayer for the non-competition covenant.

Subsection 56.4(8.1): Non-Competition Covenant Granted on Disposition of Shares to an Eligible Person

The latest edition of the rules includes a new exception to the application of section 68 in the case of non-competition covenant granted as part of a disposition of shares to an eligible person.[39]

For the purpose of this exception, an eligible person is an individual who is related to the grantor and who has attained the age of 18 at or before the time in question.[40]

This exception was added to allow for non-arm's-length transactions. It could apply if a taxpayer sells shares of a corporation to a sibling or to an adult child. However, it would not apply in an estate freeze situation because the grantor of the non-competition covenant cannot retain an interest in the corporation that is being sold.

The following conditions must be met to qualify for the exception.

1. The non-competition covenant must be granted to an eligible person in respect of the grantor.

2. The non-competition covenant must be an undertaking of the grantor to not compete with the eligible person.

3. The non-competition covenant must be an integral part of a written agreement pursuant to which the vendor disposes of shares of the vendor's eligible corporation to the eligible person (or to an eligible corporation of the eligible person).

4. If the shares are sold to the eligible person's eligible corporation, the grantor must have no interest whatsoever in that corporation.

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[39] Proposed subsection 56.4(8.1).

[40] Definition of "eligible person" in proposed subsection 56.4(1). "Eligible" seems to be the *mot de choix* at the Department of Finance these days, as section 56.4 includes defined terms for "eligible person", "eligible interest" and "eligible corporation".

5. No proceeds can be received by the grantor in respect of the non-competition covenant.

6. No consideration for the non-competition covenant can be granted by an individual who does not deal at arm's length with the grantor.

7. The following section and subsections cannot apply: 84(3), 85 and 97(2).

8. The non-competition covenant must be granted to maintain or preserve the fair market value of the shares disposed of.

9. The fair market value of the share must be determined on the basis that the non-competition covenant is part of the share value.

This subsection is subject to the anti-avoidance rule set out in subsection 56.4(11).

Capital Gains Election

If a taxpayer grants a non-competition covenant and it does not fit into subsection 56.4(7), (8), or (8.1) solely because all or a part of the consideration is received by a non-arm's length individual, proposed subsection 56.4(9) applies to provide the taxpayer some elective relief.

The first paragraph of proposed subsection 56.4(9) provides that section 68 will apply only to the amount that is received by the non-arm's length individual (referred to in this section as the "allocable portion"). Therefore, section 68 will not apply to the amount received by an arm's length individual (assuming that but for the non-arm's length individual receiving part of the consideration, the transaction would have fit within an exception pursuant to proposed subsection 56.5 (7), (8) or (8.1).

This subsection goes on to provide that the taxpayer who granted the non-competition covenant and the non-arm's length individual may file a joint election deeming the allocable portion to be received by the taxpayer as a goodwill amount or as proceeds from the disposition of property (depending on which exception the taxpayer did not qualify because all or a part of the consideration is received by a non-arm's length individual). Proposed subsection 56.4(9)(c) provides that if this deeming election is filed, then consideration is not considered to be received by the non-arm's length individual and any others who filed the joint election with the taxpayer.

Anti-Avoidance Rules

Proposed subsections 56.4(10) and 56.4(11) provide two anti-avoidance rules. The first rule applies in respect of the eligible interest exception set out in proposed subsection 56.4(3)(c). The second rule applies in respect of the section 68 exceptions set out in proposed subsections 56.4(7) through (9).

These anti-avoidance rules serve to point out that proposed section 56.4 – in spite of all its

complexities – is not a complete code for restrictive covenants. If a taxpayer would have had to include the restrictive covenant amount in income in any event (even in the absence of proposed section 56.4(2) – that taxpayer cannot make an election to have capital treatment apply.

Conclusion

Proposed section 56.4 is extremely complicated. To its credit, the Department of Finance has responded to criticisms of the legislation but these responses just make the proposal even more complicated.

While the proposals are still proposals even after almost eight years, the proposals are still intended to apply on a retroactive basis. A practitioner who simply ignores the proposals does so at considerable peril.

Practitioners will now have to scrutinize each aspect of a transaction to see if that part of the transaction involves the granting of a restrictive covenant. If so, the practitioner will then have to try to fit the covenant into one of the exceptions. However, most of those exceptions apply only in respect of non-competition covenants. As a result, any amount that can be allocated to any other type of restrictive covenant will likely be subject to immediate taxation as ordinary income.