FLASH! – the CRA Can Reallocate to a Non-compete*

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Draft technical amendments to the Income Tax Act (released on February 27th, just as we were going to press) reveal that the CRA (the agency formerly known as the CCRA) will be given the ability to reallocate amounts to a non-competition or other restrictive covenant.

Remember, this is now a "bad thing": Last fall, the Department of Finance announced proposals whereby non-competition and other restrictive covenants could be fully taxable, thus reversing the former tax advantage that was available in certain circumstances. (An exception to fully-taxable status may apply on a share or partnership interest sale.)

However, when the proposals were first announced (on October 7th) one unanswered question related to whether the CRA would be given the ability to reallocate an amount to a non-compete, i.e., if no amount (or an insufficient amount) is allocated to the non-compete. Generally, such reallocations can be made pursuant to section 68, which allows such a reallocation to the extent reasonable.

Per the draft legislation, the answer is a resounding yes, as section 68 is to be amended to specifically provide for such a reallocation by an explicit reference to restrictive covenants. (The provisions do not apply for grants of restrictive covenants made prior to February 27, 2004.)

This proposal may place professionals in a difficult position in situations where it is apparent that the value of a non-compete has been understated either in an agreement of purchase of sale or a tax return: could the so-called “civil penalties” apply? So what was, just a few months ago, a golden tax planning opportunity, has been turned topsy turvy into a tax planning headache. Retribution?