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Restrictive Covenants: Last of the Unholy Trinity

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This article is being written two years after an article I wrote called "Kill Bill: Is C-10 on the Ropes?" – a rant about the unholy triumvirate of (former) Bill C-10 proposals: the foreign investment entity (FIE), non-resident trust, and restrictive covenant rules. In keeping with the unholyness, Bill C-10, which died in September of 2008, sprung back to life last month in the form of the Income Tax Amendments Act, 2010 - an altered state that omitted the FIE and non-resident trust proposals.

As most readers are aware, courtesy of the federal budget, the FIE rules are now history, replaced by the pre-existing section 94.1: mercifully brief and relatively simple rules which hearken back to a bygone era. The non-resident trust rules, also dealt with in the budget, are still a work-in-process with yet another round of proposed legislation in the wings. A number of modifications may remedy some of the shortcomings. But the price will be even more complexity.

This brings me to the last of the Trinity - not dealt with in the budget, but which does appear in the new legislation - the restrictive covenant proposals. These proposals have been in a more or less constant state of revision since they were first introduced in 2003. When the new legislation arrived on my desktop, I can't say I was surprised to see that the proposals survived – the government had pretty well told us they were coming. Too bad, though: unlike the somewhat-esoteric non-resident trust proposals, the super-complex restrictive covenant proposals can potentially apply in any sale of a business.

Fully-Taxable Treatment – The Base Line

Because of the many articles and papers on this subject, I do not intend to go into detail on the restrictive covenant proposals[1]. But to refresh your memory, the cornerstone of the proposals is subsection 56.4(2) - the rule that, by default, all amounts received or receivable in respect of a restrictive covenant are fully taxable. Since this is obviously an undesirable result, one would first look to the limited exceptions to this result in subsection 56.4(3) that may (but more often than not, don't) apply if an amount is allocated to a restrictive covenant: besides an exemption for covenants given by employees[2], there is an asset sale exception (in respect of eligible capital), which in its simplicity assumes that the person granting the restrictive covenant (typically the shareholder) is carrying on the business (of course, this is typically the shareholder's corporation)[3]. There is also a share[4] sale exception[5] for non-competition covenants[6] which precludes complex corporate structures (e.g., a Holdco with separate subs to limit liability) and imposes various other requirements[7].

If the exceptions to subsection 56.4(2) do not apply, the main issue becomes the related proposal that allows the CRA to reallocate proceeds on a sale to restrictive covenants under proposed section 68, to the extent that the reallocated amount is "reasonable". The focus then shifts to some "relieving provisions" in respect of the section 68 reallocation which, if applicable, nullify this ability. Until the latest revisions to the proposals, apart from provisions directed toward covenants given by employees[8], the section 68 relieving provisions for sales of businesses have related to non-competition covenants given in respect of the disposition of goodwill[9] (directly or by an eligible corporation[10]), and the disposition of other property, including shares[11]. Needless to say, these relieving provisions are fairly stringent, complex (maybe "hodgepodge" is a better description) and in many cases, will not be applicable[12], leaving the vendor – shall we say – a sitting duck[13].

So What's New?

The latest revisions add a new section 68 relieving provision, pertaining to succession planning. As explained in our book, Tax and Family Business Succession Planning, the pre-existing relieving provisions apply only to a disposition to an arm's-length person, so that in the succession planning context, these exceptions will generally not be applicable.**[14]** Therefore, the presence of a restrictive covenant in a family business succession planning agreement, e.g., to be given in connection with a buy-out of a family member's interest, appeared to be problematic, since the CRA would be able to: (a) reallocate proceeds to a restrictive covenant; and (b) impose full taxation on the reallocated amount.

Proposed subsection 56.4(8.1) potentially prevents a section 68 reallocation if a non-competition covenant is granted by a Canadian resident individual (the "vendor") to an "eligible person" – an individual related to the vendor who is 18 or older - in connection with a share sale of an eligible corporation (referred to as the "target corporation"), provided that no proceeds are received for granting the non-compete and several other requirements are met**[15]**. However, there seems to be at least one issue with the legislation: One of the requirements is that, if the shares of the target corporation are sold to a purchaser corporation, the vendor cannot (at any time after granting the non-compete) have an "interest" in either the target or purchaser corporation**[16]**. This appears to be problematic, for example, if there is a staged sale, or if, as a result of the transaction or otherwise, the corporation in question is indebted to the vendor.

Another section 68 relieving provision that has been widened relates to non-competition covenants when there has been a sale of goodwill by an eligible corporation**[17]**. The former requirement – a good example of the perversity of the proposals - was that a family member or other person not at arm's length with the vendor could not hold 10% or more of the shares of such a corporation. (To me, it's almost as if to say, if you split dividends or capital gains, the non-applicability of this relieving provision is your punishment.) This restriction has been dropped.

Where a non-resident gives a restrictive covenant, there is potentially non-resident withholding tax**[18]**, and in this context as well, it appears that section 68 could apply to reallocate a portion of the proceeds to the restrictive covenant. In view of the restrictions to taxable Canadian property in this year's federal budget - so that non-real-estate-based share sales are generally no longer taxable in Canada - would the CRA attempt to collect tax by reallocating in this manner? Of course, the same temptation might have been present in respect of a treaty-protected sale under the pre-existing regime**[19]**. However, under the new regime, some structures could involve the holding of Canadian companies by non-resident entities in low-tax jurisdictions. If the CRA is offended by such a structure, will this be a way of collecting taxes through the "back door"? If so, should the purchaser be concerned that the CRA could try to collect tax for failure to withhold?**[20]** What about directors' liability?

What's the Point of This – uh - Stuff?

At the centre of the proposals is the rule that, by default, fully-taxable treatment applies to non-competition or other restrictive covenants. Undoubtedly, this greatly complicates the provisions. So taking a giant step backwards, I ask a very basic question: Given that most of the instances in which the restrictive covenant proposals will apply pertain to a non-compete or other covenants given in connection with the sale of a business - which is essentially a capital transaction - what policy rationale is there for treating a restrictive covenant as fully taxable, rather than capital treatment applying?

I can't help wondering whether the answer may be to punish taxpayers. Punish them for their evil ways in treating non-competition covenants as tax-free, which led to all of this – uh - stuff. Or is it to punish tax advisors - to be saddled with all-but-incomprehensible legislation? But if that is your agenda – Sirs – it is not working. I point out that, since our corporate lawyers must dutifully seek our advice before putting a deal through, our future as tax drones is assured. So how about if we just treat restrictive covenants as capital - and call it a day?

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[1] For a concise discussion, see “Restrictive Covenants”, Mark Woltersdorf, Tax Topics No. 1875, February 14, 2008.

[2] Proposed paragraph 56.4(3)(a).

[3] Proposed paragraph 56.4(3)(b).

[4] Or partnership interest.

[5] Proposed paragraph 56.4(3)(c).

[6] Of course, a non-competition covenant is only one type of restrictive covenant. Other restrictive covenants may include exclusivity, non-solicitation, and confidentiality agreements, for example.

[7] For example, dispositions involving section 85 and subsection 97(2) rollovers, or deemed dividends on a redemption (etc.) under subsection 84(3) are problematic.

[8] Proposed subsection 56.4(6).

[9] Proposed subsection 56.4(7).

[10] Under the revised proposals, an “eligible corporation” is simply a taxable Canadian corporation of which the taxpayer holds shares directly or indirectly.

[11] Proposed subsection 56.4(8). Unlike paragraphs 56.4(3)(b) and (c) and subsection 56.4(7), for subsection 56.4(8) to be applicable, an election is not required to be filed.

[12] For example, all of the section 68 relieving provisions relate to non-competition as opposed to other types of restrictive covenants. Dispositions involving section 85 and subsection 97(2) rollovers, or (in the case of subsection 56.4(8)) deemed dividends on a redemption (etc.) under subsection 84(3) are problematic. Finally, no proceeds may be allocated to the covenant.

[13] Although the relieving rules in subsection 56.4(7) and (8) (in the case of a share sale) require that no portion of the proceeds in respect of restrictive covenant be received or receivable by a non-arm's length individual or by another taxpayer in which the non-arm's length individual holds an interest, where those relieving provisions are not applicable solely because this requirement is not met, then subsection 56.4(9) allows for a joint election (in the manner provided by subsection 56.4(14)), so that the part or all of such “allocable portion” of the consideration for the restrictive covenant can be treated as a goodwill amount/proceeds of disposition in the hands of the person granting the restrictive covenant. Where the election is made but the proceeds are actually received or receivable by a corporation, partnership or trust, it is deemed to be an agent of the taxpayer granting the restrictive covenant to the extent that the amount designated in the election is transferred to the taxpayer within 180 days from the date of receipt.

[14] See “Restrictive Covenants”, at ¶1107 of the book.

[15] For example, dispositions involving section 85 and subsection 97(2) rollovers, or deemed dividends on a redemption (etc.) under subsection 84(3) are problematic. In determining the proceeds of disposition of the shares under section 69, the shares are to be valued on the basis that the restrictive covenant is part of the share – i.e., the proceeds cannot be discounted based on the value of the restrictive covenant.

Similar requirement/elections as described in note 13 apply to any portion of the proceeds in respect of the restrictive covenant received or receivable by a non-arm's length individual or taxpayer in which the non-arm's length individual holds an interest. To the extent that the allocable portion is received or receivable by an eligible corporation of the vendor (i.e., a taxable Canadian corporation in which the vendor is a direct or indirect shareholder), an election may be filed in which the eligible corporation is deemed to be an agent for the vendor for the amount designated. In this case, however, the tax consequences of this election are more severe: it is required not only that the amount be transferred within 180 days of receipt, but that it is included in the vendor’s

income under subsection 56.4(2) – i.e., as fully-taxable income. Is the advantage of this election vis-à-vis a section 68/subsection 56.4(2) reassessment that it avoids the tax cost of a distribution?

[16] Proposed paragraph 56.4(8.1)(c).

[17] I.e., under subsection 56.4(7).

[18] Per proposed paragraph 212(1)(i). It is intended that withholding tax apply to payments from one non-resident to another in respect of Canadian restrictive covenants, per proposed 212(13)(g). (The provision deems the non-resident payor to be a resident of Canada in respect of an amount to which paragraph 212(1)(i) would apply (if the amount were paid or credited by a resident of Canada), and that amount affects or is intended to affect: (i) the acquisition or provision of property or services in Canada, (ii) the acquisition or provision of property or services outside Canada by a person resident in Canada, or (iii) the acquisition or provision outside Canada of a taxable Canadian property.) It appears that the proposal has been revised to overcome certain technical arguments to the effect that it is ineffective.

[19] However, depending on the wording of the particular treaty, it might be argued that an amount relating to a restrictive covenant is treaty-protected.

[20] Proposed paragraph 68(c) provides that “the part of the amount that can reasonably be regarded as being consideration for the restrictive covenant is deemed to be an amount received or receivable by the taxpayer . . . ” Proposed paragraph 212(1)(i) provides for Part XIII tax on “an amount that would, if the non-resident person had been resident in Canada throughout the taxation year in which the amount was received or receivable, be required by . . . subsection 56.4(2) to be included in computing the non-resident person ’ s income for the taxation year”.

It appears that relieving provisions, notably subsection 56.4(8) if applicable, may prevent an income inclusion under subsection 56.4(2) and consequently the application of paragraph 212(1)(i). Query, however, whether this would give a great deal of comfort to a purchaser. Perhaps an indemnity might be obtained.