RESTRICTIVE COVENANTS

Restrictive Covenants for Departing Executives

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Upon the termination of an employment relationship, a key employee often enters into various agreements with the employer that restricts subsequent activities of the employee. Such agreements may include non-competition agreements, agreements not to solicit employees/suppliers/customers, and confidentiality agreements. In some cases, the employee receives significant compensation for entering into such agreements, which may be paid out as a lump sum or over a period of years.

The tax landscape relating to restrictive covenants is mainly governed by section 56.4 of the Income Tax Act[1] (enacted in its current form on June 26, 2013), however, section 6 generally overrides section 56.4 in the case of employees. The rules in this area are extremely complex and filled with pitfalls for the unwary mainly due to a byzantine system of misleadingly narrow exceptions. Rather than walking through the rules, this article illustrates key concepts through several scenarios.

Scenario One: Employee Granting Covenant to Employer

The first scenario focuses on an employee who has no shareholding in his employer:

1. Mr. E is a Canadian resident who was employed at ABC Co. Mr. E's employment was terminated on December 31, 2014.
2. Upon termination, ABC Co required Mr. E to sign an agreement restricting his ability to engage in similar services to those he performed at ABC Co for a period of five years.

   The agreement specifies that on each anniversary date, ABC Co will review whether Mr. E has complied with the agreement throughout the year and at that time, will pay Mr. E $200,000 in satisfaction for his compliance for the year. Therefore, if Mr. E complies with the agreement throughout 2015 to 2019, Mr. E will receive a total of $1,000,000.

Subsection 6(3) considers a payment by an employer to its employee involving an agreement made immediately prior to, during or immediately after a period of employment to be employment income, unless the amount cannot reasonably be regarded as consideration for the employee's acceptance of employment, service, or covenant to do or not do something after termination of employment.

Accordingly, the payments received by Mr. E from ABC Co will be considered as employment income to Mr. E. What remains to be determined is the timing of the income inclusion for Mr. E as it may be accelerated beyond a mere "received" basis in particular circumstances.

If the arrangement entered into constitutes a salary deferral arrangement ("SDA"), the employee would be deemed to have immediately received any future amounts he is entitled to.[2] However, the definition of SDA contains a purpose test such that an arrangement would only be a SDA to the extent one of the main purposes is to defer the tax on salary or wages for services rendered in the year or a previous year.[3] If the entire $1,000,000 is for enticing Mr. E to enter into the restrictive covenant, the purpose test is likely not met and the arrangement should not be considered a SDA.

The application of subsection 6(3.1) will also expedite the timing of the income inclusion for Mr. E. If a covenant agreement was concluded 36 months before the end of a taxation year, subsection 6(3.1) would require the taxpayer to include into income any amounts that are receivable by the taxpayer at the end of that taxation year in respect of that agreement.[4] In other words, a maximum deferral of three years is permitted with respect to employment-related covenant payments. This three-year deferral for covenants is consistent with the scheme of the SDA rules whereby a deferral of up to three years is allowed before a compensation arrangement is considered a SDA.[5]

Subsection 6(3.1) applies in circumstances where the future amounts are "receivable" to the employee. Under common-law principles, an amount is not "receivable" until all condition precedents are satisfied. If the 2015 to 2019 payments were payable to Mr. E with no further conditions to be satisfied other than his promise not to compete, it is possible that all five years of payments would be considered "receivable" by Mr. E on December 31, 2014, the signing date of the agreement. In that case, subsection 6(3.1) would come into effect including both the 2018 and 2019 payments into the income of Mr. E for the 2018 taxation year (i.e., the taxation year that is more than 36 months after the covenant was granted).

However, because each annual payment does not vest until Mr. E has satisfied the conditions under the agreement in respect of the year, the payment in 2019 is likely not "receivable" at the end of 2018 and consequently, subsection 6(3.1) should not apply. As a result, Mr. E will include the amounts into employment income each year as they are received.

If an employment-related covenant amount is already included in income under section 5 or 6, such an amount is carved out from the restrictive covenant income inclusion under the rules of section 56.4.[6]

Unlike an SDA, where an employer is generally entitled to a matching deduction in the same year as the employee's income inclusion,[7] a similar mechanism does not exist where subsection 6(3.1) applies. Subsection 6(3.1) deems an amount to have been received by the employee, but does not deem an amount to have been paid by the employer. As a result, the general 180-day rule in subsection 78(4) will prevent the employer from deducting such amount until it is paid. Had the facts been such that Mr. E was deemed by subsection 6(3.1) to have received his 2019 receipt in 2018, ABC Co would still not be entitled to deduct the 2019 payment until it was paid. In addition, since an employer's source deduction and T4 requirements only apply when amounts are paid,[8] ABC Co is not required to withhold on Mr. E's deemed income inclusion until the year of payment.

Furthermore, there may be a risk whether a significant payment to prevent a terminated key employee from competing in the future may be treated as a non-deductible capital outlay of the employer, despite it being includable in the employee's income.[9] Arguably, subsection 6(3) characterizes the payment to be remuneration from employment and subsection 78(4) deems remuneration to be an expense when paid. However, subsection 78(4) is a mere timing provision, and does not necessarily change the character of an expense from capital to income account in the hands of the employer.

Scenario Two: Employee/Shareholder Granting Covenant to Purchasing Shareholders

The second scenario reviews a situation where a departing employee is also a significant shareholder of the employer:

1. Mr. A, a Canadian resident, was employed at ABC Co.
2. Mr. A, Mr. B, and Mr. C are all unrelated to each other, and each held one-third of the shares of ABC Co.
3. On December 31, 2014, Mr. A terminated his employment at ABC Co. As part of the termination agreement, Mr. B and

[1] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[2] Subsection 6(11) of the Act and the definition of "deferred amount" in subsection 248(1).

[3] The definition of a "salary deferral amount" is contained in subsection 248(1).

[4] Subsection 6(3.1) deems the amount receivable to have been received at the end of the taxation year in question, which would result in the amount being included in employment income as received under subsection 6(3).

[5] This exception is contained in paragraph (*k*) of the definition of "salary deferral arrangement" in subsection 248(1).

[6] Paragraph 56.4(3)(*a*) of the Act.

[7] In respect of a salary deferral arrangement, paragraph 20(1)(*oo*) generally provides a corresponding deduction to the employer in the same year as the income inclusion.

[8] Paragraph 153(1)(*a*) of the Act.

[9] Paragraph 18(1)(*b*) of the Act.

Mr. C each purchased one-sixth shares of ABC Co from Mr. A, and Mr. A granted a restrictive covenant to Mr. B and Mr. C that he is not to compete with ABC Co for a period of five years. In return, Mr. A will receive $1 million from Mr. B and Mr. C.

Unlike the first scenario, subsection 6(3) should not apply to deem the amount to be employment income as the payment did not come from Mr. A's employer, ABC Co.[10] However, it remains a question of fact whether some portion of the $1 million is disguised salary for services performed by Mr. A to ABC Co and hence, would still constitute employment income under section 5 as "salary or wages."[11] If that is the case, subsection 6(3.1) and subsection 6(11) may also have to be considered with respect to the timing of the income inclusion.[12]

Assuming the $1 million does not constitute employment income under section 5, section 68 may apply to deem a reasonable allocation of the $1 million between proceeds received by Mr. A for his ABC Co shares and proceeds received for granting the non-compete covenant (irrespective of the existence of any allocation clause in the agreement).[13] The portion of the proceeds deemed to be received for the granting of the non-compete may be included in Mr. A's income under subsection 56.4(2) unless one of the exceptions in subsection 56.4(3) applies, discussed more below.

On the other hand, if section 68 does not apply, the legal agreement would govern how much of the $1 million relates to shares and how much relates to the covenant, i.e., if the agreement allocates only $10 to the covenant then only $10 would have to be considered under subsection 56.4(2). However, in order for section 68 not to apply, Mr. A must fall into the relieving provision of subsection 56.4(6) or 56.4(7).[14]

The exception in subsection 56.4(6) is available in situations where an employee grants a restrictive covenant not to compete with an arm's length party resulting from an acquisition involving the employer. At first blush, this provision appears to apply. However, the amount received by Mr. A actually falls outside of a number of the conditions of subsection 56.4(6), all of which (amongst others in the subsection) are required to be met:

- paragraph 56.4(6)(*c*) requires the covenant grantor to deal at arm's length with the employer and with the vendor in the acquisition – here, the vendor of the shares of ABC Co includes Mr. A himself, so this condition cannot be met;
- paragraph 56.4(6)(*d*) requires the covenant be an undertaking not to compete with the purchaser in the acquisition or with a person related to the purchaser – here, Mr. A entered into the covenant agreement with Mr. B and Mr. C not to compete with ABC Co, and ABC Co is not related to Mr. B or Mr. C (since each only owns 50% so neither controls and since Mr. B and Mr. C do not form a related group), so this condition cannot be met either;[15] and
- paragraph 56.4(6)(*e*) requires that no proceeds are received by the grantor for the covenant – here, if the agreement explicitly allocates nil to the covenant, Mr. A may meet this condition. However, pursuant to general principles of the common law of contracts, a contract must be entered into for consideration even if such consideration is nominal. Thus, *prima facie* it is impossible to satisfy this condition in a common law jurisdiction, and arguably the only way for this to be

[10] Subsection 6(3) requires the payee to be an officer of, or in the employment of, the payer.

[11] Definition of "salary or wages" in subsection 248(1) of the Act.

[12] Subsection 6(3.1) applies to the amount that would be included in income under subdivision a "Income or loss from an office or employment" if it were received in the year.

[13] Paragraph 68(*a*) allows for the allocation to proceeds of disposition of property, and paragraph 68(*c*) allows for allocation to a restrictive covenant.

[14] Subsection 56.4(5) allows for the non-application of section 68. However, subsection 56.4(5) is only applicable if the taxpayer meets the requirements of subsections 56.4(6) or (7).

[15] Subsection 251(2) governs relationship, and a corporation is only related to a person who controls the corporation or to a person who is a member of a related group that controls the corporation. In a situation where two shareholders each own 50% of the voting shares, neither shareholder can elect a majority of the directors, which is the hallmark of *de jure* control.

valid is if the contract is entered under seal. The Canada Revenue Agency ("CRA") was asked to comment on this in the 2014 Society of Trust and Estate Practitioners CRA Roundtable, and the CRA confirmed that even a $1 consideration in a covenant agreement will constitute proceeds and will exclude the taxpayer from the exception.[16]

Subsection 56.4(7) provides another exception to the section 68 deemed reallocation rule. This subsection is directed for a seller of a business, but again, Mr. A will fall outside its conditions. Similar to subsection 56.4(6), subsection 56.4(7) also requires the covenant be an undertaking not to compete with the purchaser (or a related person), and requires the grantor to have received no consideration for the covenant. As discussed in the context of subsection 56.4(6), Mr. A will fail the first and the second may be impossible to meet.

As neither of the above exceptions are met, section 68 applies to deem a portion of the $1 million proceeds to be consideration for the non-compete agreement, the amount of which would be fully includable in Mr. A's income under subsection 56.4(2), unless Mr. A qualifies for an exception contained in subsection 56.4(3).

Paragraph (*a*) and (*b*) of subsection 56.4(3) allows a taxpayer to avoid income inclusion under subsection 56.4(2) where the amount received is treated as either employment income or sale of an eligible capital property.[17] Since the amount received is neither characterized as employment income to Mr. A nor proceeds for a sale of eligible capital property, paragraphs (*a*) and (*b*) cannot be met. The last exception, paragraph 56.4(3)(*c*), is for a non-compete covenant granted as part of a sale of shares, but again, the non-compete must be for the taxpayer not to provide services in competition with the purchaser (or by a person related to the purchaser).[18] As discussed, Mr. A would not meet this condition and Mr. A would be required to allocate a reasonable portion of the $1 million (based on accepted valuation principles) as full income inclusion under subsection 56.4(2), while the remainder should constitute proceeds for his shares.

Although section 68 is drafted from the perspective of the vendor, it contains corresponding deeming rules for the purchaser. In paragraph 68(*a*), a vendor is deemed to have received proceeds of disposition for a property and the purchaser is deemed to have acquired that property for the same amount. Paragraph 68(*c*) contains wording to the same effect in respect of an amount paid or payable for the restrictive covenant grant. Therefore, from Mr. B's and Mr. C's perspective, each of them is deemed to have paid the $1 million under the same allocation as Mr. A is deemed to have received it.

However, the mirror treatment breaks down when Mr. B and Mr. C looks to subsection 56.4(4) – which at first glance appears to align the tax treatment of the restrictive covenant payment between payer and payee. Paragraph 56.4(4)(*a*) provides a deduction to the employer when the amount is paid to its employee, while paragraph 56.4(4)(*b*) and (*c*) applies to require capitalization where the payee elected under subsection 56.4(3). None of these apply to the covenant portion here. With no specific provisions to rely on, the portion relating to the covenant is likely a payment on capital account under general principles even though it is treated as income at the hands of Mr. A.

However, what type of property should this amount be capitalized to? The amount cannot be an eligible capital expenditure since Mr. B and Mr. C do not personally carry on a business.[19] The most logical solution may be to capitalize the amount to the shares purchased, but it is questionable whether that is acceptable given paragraph 68(*c*) explicitly deems that portion to be a payment that is differentiated from the property referred to in paragraph 68(*a*). Perhaps the covenant portion is a "tax nothing." If so, this would be an obviously unfair outcome, but Parliament is free to enact an asymmetrical tax result. Or perhaps the amount should be capitalized to some type of right associated with the right to

[16] CRA Views *Document* 2014-0522961C6.

[17] Paragraphs 56.4(3)(*a*) and 56.4(3)(*b*) provided exceptions for the amount included under section 5, section 6 and in the description of E in the definition of "cumulative eligible capital" in subsection 14(5) of the Act.

[18] Subparagraph 56.4(3)(*c*)(ii) of the Act.

[19] Definition of "eligible capital expenditure" in subsection 14(5).

enforce the covenant that would disappear after the terms of the covenant ends.

Scenario Three: Employee/Shareholder Granting Covenant to Employer With Share Cancellation

What if Mr. A had entered into a share cancellation and non-competition agreement with ABC Co for $1 million upon termination instead of the agreement with Mr. B and Mr. C? Since the payment is made by ABC Co to its employee, Mr. A, the portion that reasonably relates to the non-competition agreement will be includable in Mr. A's income as employment income under subsection 6(3). Further, section 68 still applies as Mr. A does not meet the exceptions in subsection 56.4(6) and (7):

- One of the conditions in 56.4(6) is that the grantor must deal at arm's length with the vendor of the shares – here, they are the same person.
- One of the conditions in 56.4(7) is that subsection 84(3) does not apply to the disposition – here, subsection 84(3) applies to the share cancellation.
- Both subsections require that there be no consideration paid for the covenant – as discussed, this condition may be impossible to satisfy as the provision of consideration is required for the contract to be valid.

From ABC Co's perspective, the covenant portion falls into paragraph 56.4(4)(*a*) by virtue of it being treated as employment income. As such, ABC Co will be entitled to a deduction, which is an equitable result given the income inclusion at the hands of Mr. A. Also, since subsection 6(3) deems the covenant portion to be income from employment, ABC Co will have corresponding source withholding and T4 requirements.

As illustrated, the restrictive covenant rules are complex and companies need to have a working knowledge of these rules before drafting covenant agreements. Although the scenarios above focused on non-competition agreements, the restrictive covenant rules are extremely broad and can apply to any agreement, undertaking, or waiver that affects in any way whatever, the acquisition of provision of property or services.[20]

As a final consideration, the granting of a restrictive covenant may attract GST to the extent it is a "taxable supply," which could be the case if the covenant is granted in the course of "commercial activity."[21] Ordinarily, this should not apply in an employer-employee situation, but the issue should be reviewed as part of any planning involving a restrictive covenant.

[20] Definition of a "restrictive covenant" in subsection 56.4(1).

[21] See GST Headquarters Letter RITS no. 7940, March 27, 2000; and GST Headquarters Letter RITS no. 8293, March 27, 2000. The definitions of "taxable supply" and "commercial activity" are contained in subsection 123(1) of the *Excise Tax Act*, R.S.C. 1985, c. E-15.