Canadian taxation treatment of restrictive covenants – Section 56.4

Kim G C Moody FCPA, FCA, TEP
September 6, 2013

Our firm has written on the Canadian taxation treatment of restrictive covenants many times. Our blogs of April 11, 2008 and July 20, 2010 are two small examples. In addition, I wrote an extensive paper for the Canadian Tax Foundation on this topic in 2008. However, some of the content of my 2008 paper is out of date given some extensive amendments to proposed section 56.4 subsequent to the release of that paper but much of it is still relevant.

As many Canadian practitioners know, section 56.4 of the Canadian *Income Tax Act* (the section that deals with restrictive convents) is now law given the enactment of Bill C-60 on June 26, 2013. Given such, it is very important for accountants and lawyers who advise on many types of "vanilla" commercial transactions to be aware of the implications of section 56.4. Section 56.4 is mind-bogglingly complex and will require an extensive review in every case to ensure that any possible negative implications are identified and mitigated to the extent possible.

As a simple example, consider the situation where Mr. Apple owns certain shares of a Canadian "Opco". Mr. Apple enters into a letter of intent to dispose of all of his shares of Opco to an arm's length purchaser. As part of the agreement, Mr. Apple agrees to a non-compete agreement which will restrict his ability to compete in a certain geographical area for a specified period of time. Such a non-compete agreement will be considered a restrictive covenant[1] for purposes of new section 56.4. Accordingly, what are the implications? Such implications are beyond the scope of this short blog but suffice it to say that even in this simple example the new rules will need to be carefully considered before finalizing the terms of the purchase and sale agreement. In a worst case scenario, the fair market value of the restrictive covenant granted by Mr. Apple could be included in his income and fully taxed. This compares unfavorably to what Mr. Apple may expect since he would likely view the sale of his Opco shares and the granting of a non-compete agreement to be treated as proceeds of disposition resulting in capital gains treatment. Capital gains are only half taxable in Canada therefore the fully taxable treatment on restrictive covenant grants is comparatively punitive. In addition, the $750,000 capital gains deduction ("CGD") (to be increased to $800,000 in 2014 and indexed thereafter) would not be available for any amounts taxed as a restrictive covenant. Ouch!

Also, the situation would be even more complex if Mr. Apple was a US citizen and a Canadian resident since Mr. Apple would also have to consider the US tax implications of the restrictive covenant grant (in addition to any CGD claimed).

It has been my experience that many advisors, especially accountants and commercial lawyers, have ignored the restrictive covenant rules likely due to such advisors not being aware of the implications. Such advisors will no longer have a choice but to pay attention to the newly enacted restrictive covenants rules. In addition, old transactions should be reviewed since much of section 56.4 has retroactive effect back to 2003.

1. A restrictive covenant is very broadly defined in section 56.4 and encompasses much more than non-compete agreements.