Taxation of restrictive covenants – caution when trying to qualify for exceptions to full income inclusions!

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July 28, 2014

Our firm has written about the taxation of restrictive covenants many times before. You will find a link to a blog written late last year that explained the basic mechanics of the "new" restrictive covenant rules under section 56.4 of the Canadian *Income Tax Act* (the "Act"*)* here.

Section 56.4 of the Act is mind-numbingly complex. However, to oversimplify, if a person grants a restrictive covenant, such as a non-compete agreement (which is often part of a purchase and sale agreement for the sale of business), then the person granting the covenant needs to concern themselves with the new section 56.4. If section 56.4 applies, then any amount received or receivable by the grantor (or deemed to be received or receivable pursuant to section 68 of the Act – I call this the "deemed receipt" rule) in respect of that restrictive covenant grant will be taxed as a full income inclusion. This surprises many taxpayers. There are usually two responses when tax geeks like me give restrictive covenant grantors the bad news:

1. "*I didn't receive any amount for the restrictive covenant grant… it was just part of the purchase and sale agreement for the disposition of my shares [or assets]*."

My response to the above comment is that it doesn't matter if you didn't receive anything explicit for the restrictive covenant grant. Paragraph 68(c) will deem you to have an amount that is received or receivable and is reasonable in the circumstances irrespective of the form or legal effect of the contract or agreement. Ouch!

2. "*No one told me about these rules! Are you sure you're right*?!"

Yes… we understand that you likely have not been counselled on these challenging new rules. As mentioned in our previous blog, it is our firm's experience that many non-tax advisors are simply ignoring the new rules or are not aware of them. Frankly, to ignore the new rules is dangerous and something we do not recommend. And yes, we are right.

Thankfully, new section 56.4 contains some exceptions which broadly fit into two categories:

1. Exceptions to the full income inclusion rule – Subsection 56.4(3)

These exceptions are very narrow and not the subject of this blog. Suffice it to say, however, that many persons who enter into vanilla commercial transactions involving a restrictive covenant grant will not be able to avail themselves of the exceptions under subsection 56.4(3).

2. Exceptions to the "deemed receipt" rule – Subsections 56.4(6) and (7)

As mentioned above, paragraph 68(c) of the Act will deem a person to have an amount received or receivable in respect of a restrictive covenant on what is reasonable in the circumstances. There are

exceptions to the deemed receipt rule in subsections 56.4(6) and (7). If applicable, these rules can be very helpful if no amounts are directly received by the grantor since section 68 will not be applicable to deem amounts to have been received or receivable.

One of the conditions to be eligible for the exception to the deemed receipt rule is that "*no proceeds are received or receivable by the vendor for the granting of the restrictive covenant*" (see paragraphs 56.4(6)(e) and 56.4(7)(d)). Accordingly, many tax geeks (including me), became concerned about what the above phrase means. 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 respect this condition in a common law jurisdiction. If so, then the exception to the deemed receipt rule would not be available. Yikes! While it is possible to enter into a contract under seal (a very old concept of how to enter into a valid contract… Wikipedia has an interesting overview of this concept and can be viewed here), it is debatable whether this constitutes consideration although the better view, after debating this issue with many of my lawyer friends, is that a contract under seal does not require consideration.[1]

Given the above, some of my tax nerd friends and I, who are responsible for the Society of Trust and Estate Practitioners ("STEP") Canada Revenue Agency ("CRA") Roundtable decided to ask the CRA about their views on the above subject at the recent STEP National Conference. Below you will find the original question and the CRA's response. For those of you interested, you'll find all of the questions and answers for the 2014 Roundtable here.

QUESTION 15. Restrictive Covenants

In very general terms, the rules concerning restrictive covenants are divided into two categories, the first being where there is no consideration for the restrictive covenant, and the second being where there is consideration. The rules applicable to situations where there is no consideration are generally more widely applicable. However, a restrictive covenant is normally structured as a contract, and a contract requires that consideration be given by the parties. Accordingly, it would be common in drafting a restrictive covenant to state that the consideration is the sum of $1 and other valuable consideration etc. In these circumstances, does the fact that a contract of a restrictive covenant stipulates the amount of $1 mean that there is consideration, such that the elections, provided under subsection 56.4(7) are inapplicable? Is CRA prepared to accept that a nominal sum, merely to constitute a contract which is legally binding, does not constitute proceeds allocated to the restrictive covenant for this purpose?

CRA Response

While we understand that a nominal amount of consideration may be given by the parties in a contract relating to a restrictive covenant to ensure that the contract is legally binding, it is the CRA's view that this would still constitute an amount of proceeds received or receivable by the particular party for granting the RC. As such, the exceptions set out in subsections 56.4(6) and (7) could not apply because the respective conditions in paragraph 56.4(6)(e) and paragraph 56.4(7)(d) would not technically be met. In such cases, the amount of proceeds (or any additional amount deemed by paragraph 68(c)) received or receivable by the taxpayer for the RC would be taxable as ordinary income under subsection 56.4(2) unless one of the three exceptions in subsection 56.4(3) otherwise applies.

As such, taxpayers seeking relief in these circumstances may want to contact the Department of Finance Canada to outline their concerns on this issue.

The above answer was certainly not what practitioners were hoping to hear from the CRA. We were hoping that the CRA would say that administratively they would ignore the nominal consideration for purposes of ensuring that the exception to the deemed receipt rule would apply. Nope.

This is not a new issue and I have had many discussions with the Department of Finance on this issue over the years. However, we were hoping for administrative relief to be exercised by the CRA when administering the law. We will continue to have discussions with the Department of Finance on this important issue.

In the meantime, practitioners who advise on matters involving restrictive covenant grants should:

1. Seek specialized tax advice on section 56.4 early on in the planning;
2. Ensure that restrictive covenant contracts are done under seal[2] (assuming one subscribes to the camp that such a grant would not be for consideration); and
3. Keep their ears to the ground to see if the CRA changes their administrative position at some point in the future.

Like Einstein said, "*the hardest thing to understand in the world is the income tax*". The restrictive covenant rules are certainly illustrative of this.

[1] See *Friedmann Equity Developments Inc. v. Final Note Ltd*. 2000 SCC 34 ("Friedmann") at paragraphs 20 and 48.

[2] The Supreme Court of Canada has stated that a corporate seal, by itself, may not be sufficient to constitute a contact under seal. See Friedmann at paragraphs 36 and 37 for an overview of the requirements to create a contract under seal.