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Non-Competition Agreements and the Income Tax Act (Canada)

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The value of a non-competition agreement in the context of a business acquisition can be significant to a purchaser. However, it can also lead to significant and unintended tax consequences for a seller. This article will provide an overview of the specific provisions of the *Income Tax Act* (Canada) (the"Act") which relate to the taxation of payments received or receivable for a "restrictive covenant."

Restrictive Covenant

The Act defines a "restrictive covenant" as "an agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer, whether legally enforceable or not, that affects, or is intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer or by another taxpayer that does not deal at arm's length with the taxpayer, other than an agreement or undertaking: (a) that disposes of the taxpayer's property or (b) that is in satisfaction of an obligation described in section 49.1 of the Act that is not a disposition except where the obligation being satisfied is in respect of a right to property or services that the taxpayer acquired for less than its fair market value." The foregoing definition is a broad one and includes, among other types of restrictive covenants, non-competition agreements, and non-solicitation agreements.

"Income Inclusion" Rule

The default position under the Act often referred to as the "income inclusion" rule, is that a payment to a taxpayer as consideration for a restrictive covenant will be taxable as ordinary income, as opposed to a capital gain. Ordinary income treatment means that 100% of the payment is included in the seller's taxable income, whereas only 50% of a capital gain is included in the seller's taxable income. Therefore, capital gains treatment is significantly more favourable for a seller.

Common Exceptions

There are certain exceptions to the “income inclusion” rule, provided, among other things, that the seller granting the restrictive covenant (the “Grantor”) and the party receiving the benefit of the restrictive covenant (the “Purchaser”) deal at arm’s length. Some of the exceptions also require the Grantor and the Purchaser to file with Canada Revenue Agency (“CRA”), a joint election in the prescribed form (discussed in more detail below).

In the context of mergers and acquisitions (“M&A”), the more common exceptions are as follows:

- **Asset Sale** – As previously mentioned, a payment to the Grantor as consideration for a restrictive covenant will be taxable to the Grantor, as ordinary income. However, in certain instances, an exception to the “income inclusion” rule can occur in an asset sale when the amount received by the Grantor for a restrictive covenant is on account of eligible capital (e.g. goodwill). For this exception to apply, a joint election is required and must be filed by both the Grantor and the Purchaser. Where the joint election is made, the amount will be treated as an eligible capital amount to the Grantor and taxed as a disposition of eligible capital property.
- **Share Sale / Sale of Partnership Interest** – An exception to the “income inclusion” rule can occur in a sale of shares or in a sale of a partnership interest if the amount of the restrictive covenant directly relates to the disposition of property that is an “eligible interest” in a partnership or corporation that carries on the business which relates to the restrictive covenant. The Act defines an “eligible interest” as “capital property of the taxpayer that is: (a) partnership interest in a partnership that carries on a business; (b) a share of the capital stock of a corporation that carries on a business; or (c) a share of the capital stock of a corporation 90% or more of the fair market value of which is attributable to eligible interests in one other corporation.” For this exception to apply, the Grantor and the Purchaser must jointly elect to treat a portion of the amount received or receivable for the restrictive covenant as proceeds of disposition from the sale of the shares or partnership interest, to the extent that the payment increases the fair market value of the Grantor’s eligible interest. This amount will then be taxed as a capital gain (or loss), and any amount paid for the restrictive covenant in excess of the elected amount will be taxed as ordinary income. It should be noted that this exception is also subject to the following conditions being met:
    - The amount is a consideration for an undertaking by the Grantor not to provide, directly or indirectly, property or services in competition with the property or services provided or to be provided by the Purchaser (or by a person related to the Purchaser);
    - The restrictive covenant must be granted to the Purchaser (or a person related to the Purchaser) of the eligible interest;
    - The restrictive covenant must reasonably be considered to have been granted to maintain or preserve the value of the eligible interest disposed of to the Purchaser;
    - If the restrictive covenant is granted on or after July 18, 2005, subsection 84(3) of the Act does not apply to the disposition of the eligible interest, meaning there cannot be redemption, acquisition or cancellation of any shares in the capital stock of a corporation that are the eligible interest being disposed of; and
    - The amount must be added to the Grantor’s proceeds of disposition, as defined by section 54 of

the Act, for the purpose of applying the Act to the disposition of the Grantor's eligible interest.

Reallocation

Notwithstanding the foregoing, CRA has the authority to reallocate amounts that were part of a purchase price for shares or assets where it is reasonable to conclude that the amounts relate to the restrictive covenant. This will be the case even when the Grantor and the Purchaser have allocated a portion of the purchase price to the restrictive covenant if CRA deems the allocation to be unreasonable. However, CRA cannot reallocate amounts in certain circumstances where the following requirements are met:

- The restrictive covenant is granted by the Grantor to the Purchaser with whom the Grantor deals with at arm's length;
- The restrictive covenant is an undertaking by the Grantor not to provide property or services in competition with the Purchaser (or a person related to the Purchaser);
- No proceeds are received or receivable by the Grantor for granting the restrictive covenant;
- It is reasonable to conclude that the restrictive covenant is integral to an agreement in writing under which the shares of the capital stock of a corporation are disposed of to the Purchaser (or a person related to the Purchaser) and with whom the Grantor deals with at arm's length;
- The restrictive covenant must reasonably be considered to have been granted to maintain or preserve the value of the shares acquired by the Purchaser;
- Subsection 84(3) of the Act does not apply in respect of the disposition of the shares of the corporation; and
- The Grantor and the Purchaser have made a joint election under the Act.

Joint Election Filing Requirements

In terms of filing requirements, the Act provides that an election in prescribed form filed under any of the foregoing provisions is to include a copy of the restrictive covenant and be filed: (a) if the person who granted the restrictive covenant was a person resident in Canada when the restrictive covenant was granted, by the person with the Minister on or before the person's filing-due date for the taxation year that includes the day on which the restrictive covenant was granted and (b) in any other case, with the Minister on or before the day that is six months after the day on which the restrictive covenant is granted. Although CRA has not published a prescribed form, it has issued the following guidelines as to what is required:

- The seller / Grantor and the Purchaser have to file a jointly-signed letter to make the election.
- This letter must include the following information concerning both the Grantor and the Purchaser:
    - Full names

    - Social insurance numbers or business numbers
    - Addresses, and mailing addresses, if applicable
    - The taxation year in which the Grantor sold the restrictive covenant
    - The taxation year in which the Purchaser bought the restrictive covenant
- This letter must also include the following information concerning the restrictive covenant:
    - A description of the restrictive covenant
    - The full name of the taxpayer granting the restrictive covenant
    - The full name of the taxpayer receiving the consideration for the restrictive covenant
    - An indication that these parties deal at arm's length
    - Under which provision of section 56.4 of the Act is the election being made by the parties

The rules regarding the taxation of restrictive covenants are complex and this article is not intended to be an exhaustive review. Parties wishing to use restrictive covenants in their transactions should ensure that they seek proper tax and legal advice. If you need assistance with these matters, **please contact us**.
