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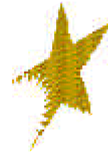

EXPECT THE BEST

Tax-Free Receipts? Not Any More

by Paul L. Schnier

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Paul Schnier chairs Blaney McMurtry's tax group. He restricts his practice to income tax law with emphasis on tax planning and implementation and advising as to the tax consequences of proposed transactions. He has advised a variety of public and private corporations on numerous domestic and international undertakings.

Paul can be reached at 416.593.3956 or pschnier@blaney.com.

This is one of those it-was-nice-while-it-lasted stories. It involves the tax treatment of payments for restrictive covenants, such as non-competition agreements.

Up to several years ago, this tax treatment had been fuzzy. The Canada Customs and Revenue Agency ("CCRA") couldn't quite seem to make up its mind about whether the payments should be taxed as income, as capital gains or as a third category of receipts, known as "eligible capital receipts".

Income and capital gains are fairly clear. Eligible capital receipts treatment is normally reserved for payments made for intangible property like goodwill. While eligible capital receipts are not considered to be capital gains, they are taxed in the same way. (Only 50 per cent of the receipt is included in income.)

In two well-known court cases, the CCRA lost all of the arguments it made for taxing payments for entering into restrictive covenants. As a result, the payments were considered non-taxable.

Naturally, this led to a flurry of non-competition agreements being negotiated in the context of sales of shares of companies, or sales of business assets, and amounts consequently being identified specifically as payments for the agreements not to compete.

Many people celebrated the tax-free dollars they were receiving, or were about to receive.

But while the party was going on, the Department of Finance was entertaining other ideas.

In a press release – some wags are calling press releases the new form of tax legislation – the Minister of Finance announced on October 7, 2003 that, effective that day, any payments received for restrictive covenants, including agreements not to compete, would be taxed as ordinary income.

An exception will be available for payments received in connection with a share sale so that the payment can be added to the sale price of the shares, thus preserving capital gains treatment.

In the context of an asset sale, there is no treatment specified for an agreement not to compete; however, most vendors will allocate such proceeds to goodwill, which is also taxed at a 50 per cent rate.

A payment for an agreement not to compete in any other context will be taxed as income.

(It should be noted that payments from an employer to an employee for an agreement not to compete have always been, and will continue to be, taxed as income under a specific section of the Income Tax Act.)

Of course, a bill to enshrine this new tax in law has not yet been introduced to Parliament and, considering the changing leadership of the current government, a bill likely will not be introduced or enacted for some time.

The press release states, however, that the new tax will be effective after October 7, 2003, except with respect to payments received before 2005 that are pursuant to written agreements between parties dealing at arms length signed on or before Oct. 7, 2003. (This is the usual sort of "grandfathering" that is provided when legislation is introduced in this fashion.)

Exactly what types of agreements are contemplated for exemption is not clear; nor is it clear just who might be covered by such agreements. The requirement is that the parties be dealing at arm's length – but this term has no definition.

Unfortunately, we will likely be operating in a vacuum until such time as legislation is enacted, and that could well be at a much later date.

But be forewarned, because you can count on the CCRA to argue that you have been forewarned!