From Loophole To Black Hole

TAXING RESTRICTIVE COVENANTS PURSUANT TO THE PROPOSED SECTION 56.4 OF THE INCOME TAX ACT[1]

1. The Loophole

Darren Sukonick, a partner in the Corporate/Technology department of Torys LLP in Toronto, represented CanWest Global Communications Corp. in its purchase of Hollinger International Inc. ("HII") in 2000. He testified before a US. District Court in 2007 that the $80-million non-competition payments made to Conrad Black and other HII senior executives personally and which ultimately resulted in their fraud convictions, were intentionally structured as non-compete payments because "non-compete payments were not taxable in Canada at the time."[2]

That loophole is closing: on October 7, 2003, the Department of Finance proposed amendments to the Income Tax Act[3]whereby all payments received or receivable in respect of restrictive covenants (including non-competition agreements) from the sale of a business are taxable as income, subject only to limited exceptions[4]. The current draft of the proposed legislation is the *Income Tax Amendments Act, 2010*[5]that was published by the Minister of Finance on July 16, 2010 (the "Income Tax Amendments Act", the "proposed section 56.4 amendments" or the "proposed amendments").

The proposed amendments are the legislative fall-out from the Federal Court of Appeal's decisions in *Fortino*[6] and *Manrell*[7]which, by 2003, had fully invalidated the Canada Revenue Agency's[8] traditional approach of treating non-competition payments as proceeds from the disposition of capital property. The proposed amendments have not yet been implemented but if they do receive Royal Assent, the legislation will have retroactive effect to amounts received or receivable from October 7, 2003[9]. The amending provisions apply to all restrictive covenants granted upon the sale of a business, not merely to non-competition covenants. "Restrictive covenant" is defined in the draft subsection 56.4(1) as follows:

"[R]estrictive covenant", of a taxpayer, means an agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer (other than an agreement or undertaking for the disposition of the taxpayer's property or – 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 – for the satisfaction of an obligation described in section 49.1 that is not a disposition), 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.[10]

This paper is a commentary on the draft legislation as published on July 16, 2010. The author traces the evolution of the jurisprudence and the statutory lacunae that was the impetus behind the amendments, and then summarizes the draft legislation, underscoring its complexity. In the final analysis, the author challenges the kind of 'judicial innovation'[11]ironically engaged in by the Federal Court of Appeal in *Manrell*[12] that led to the proposed section 56.4. The *Manrell*decision, as this paper seeks to show, is so characterized by the author because of its fundamental departure from the "object and spirit" of the Act and the general intent of Parliament "to reach conduct of the taxpayer" that the legislation was designed to apply to[13]. The author further intends to underscore the point that in Justice Sharlow's enthusiasm to avoid judicial activism, her decision manifests an almost surreal degree of strict constructionism that was itself a radical departure from the history of the law and practice conventions in this area.[14]

2. Untethering the Income Tax Act

The immediate and overriding concern among practitioners is the complexity of the proposed amendments – they are expected to have stifling effects on papering otherwise commonplace commercial transactions. Though also noteworthy is the fact the proposed amendments suggest a continued trending by Canadian tax legislators towards the U.S. tax regime (which generally treats proceeds of non-competition agreements as ordinary income)[15], it is more their complexity coupled with further uncertainty created by their delayed implementation that is causing alarm. Blair Dwyer asserts this situation raises questions about the effect on "the rule of law [in this country]… because practitioners are being forced to comply with an unenacted piece of draft legislation that changes form more frequently than the shapeshifter Odo (of Star Trek Deep Space Nine fame)".[16] Indeed, the most strident of criticisms point to the delays and complexity of the proposed amendments as defeating the principal policy objectives behind statutory reforms: those of "certainty, consistency, predictability and fairness" under the Income Tax Act.[17]

It is the opinion of the author that the difficulties with the proposed s. 56.4 amendments are their lack of any pragmatic underpinnings: the tax treatment of non-compete payments are to be de-coupled from the very core of their *raison d'être*, the purchase and sale of a business; a capital transaction. Full income inclusion for non-competition payments under the proposed amendments – in order to attribute fair value to the restrictive covenant – results in a very "metaphysical exercise"[18] of differentiating between such proximate intangibles as a person's goodwill in the marketplace and his right to carry on a competitive business.

Before the *Fortino* and *Manrell* decisions, the CRA had customarily treated the proceeds from non-competition covenants in the sale of a business as a capital gain, which fit in easily with the tax treatment of the larger transaction: both had been treated as a disposition of "property" thereby facilitating the purchase price allocations that are often heavily negotiated in large business acquisitions. With these proposed amendments, however, the legislature rejected the CRA's approach[19], ignored the pragmatic realities of the business transaction itself and created (particularly with the many exceptions that need be superimposed on the income inclusion provisions to avoid undesired tax consequences) a labyrinthine structure which some tax commentators have described as "horrifically complex"[20] causing "brain overload"[21]; … a black hole.

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