Restrictive covenant rules – good news update!

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On July 28, 2014, our firm published a blog that discussed a recent Canada Revenue Agency ("CRA") announcement at the 2014 Society of Trust and Estate Practitioners ("STEP") Roundtable. The announcement involved the taxation of restrictive covenants under subsection 56.4(2) of the Income Tax Act (the "Act"). Specifically, the issue revolved around whether or not certain exceptions to the broad application of the taxation of restrictive covenant receipts could be avoided because of the strict application of the legislative requirement 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) of the Act).

As most commercial lawyers know, consideration is usually needed in order to make a contract valid and therefore there is usually a nominal amount of consideration granted in order to make the restrictive covenant grant – like a non-competition agreement – valid. The question posed was whether or not the nominal consideration granted would make the exceptions (under paragraphs 56.4(6)(e) and 56.4(7)(d) of the Act referred to above) to the "deemed receipt" rule under paragraph 68(c) applicable. The CRA announced and subsequently published in Technical Interpretation 2014-0522961C6, the following:

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 restrictive covenant. 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.

As mentioned in our July 28, 2014 blog, we were disappointed with the answer and made the following suggestions for practitioners:

1. Seek specialized tax advice on section 56.4 early on in the planning;
2. Ensure that restrictive covenant contracts are done under seal; and
3. Keep their ears to the ground to see if the CRA changes their administrative position at some point in the future.

Well, great news! At the CRA Roundtable table of the 66th Annual Tax Conference of the Canadian Tax Foundation held today, the CRA was posed the following question:

Would the CRA consider amending the position set out in document number 2014-0522961C6 (June 2014) to the effect that the allocation in an agreement of $1 of consideration to a restrictive covenant,

merely to ensure that the agreement constitutes a legally binding contract, does not constitute proceeds for the purpose of paragraphs 56.4(6)(d) and (7)(e)?

The CRA responded by saying that they would administratively accept that $1 of consideration (but not a dollar more) to make the contract legally valid would not constitute proceeds for purposes of paragraphs 56.4(6)(e) and paragraphs 56.4(7)(d). Again, great news and kudos to the CRA for reconsidering its earlier administrative position. Practitioners and taxpayers should carefully plan for this new position when dealing with the granting of restrictive covenants and the resulting tax implications under section 56.4.