FROM LOOPOLE TO BLACK HOLE
TAXING RESTRICTIVE COVENANTS PURSUANT TO THE
PROPOSED
SECTION 56.4 OF THE INCOME TAX ACT

BY: DIANNE PRUPAS
MARCH 17TH 2012
FROM LOOPHOLE TO BLACK HOLE
TAXING RESTRICTIVE COVENANTS PURSUANT TO THE PROPOSED SECTION 56.4 OF THE INCOME TAX ACT

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."  

Tax practitioners in Canada have extensively criticized the draft legislation for lacking transparency (see Blair Dwyer, "Proposed Section 56.4 Still Draft After All these Years" 2011 British Columbia Tax Conference, Vancouver, Canada, online at: http://www.dwyertaxlaw.com/publication_restrictive_covenants_2011.pdf). Manon Thivierge, a partner at Heenan Blaikie Montréal, entitled her presentation on the proposed s. 56.4 amendments to the Income Tax Act at the Canadian Tax Foundation conference in November 2011 as "Restrictive Covenants and s. 56.4: Traps for the Wary" intending to convey the unintended risks to practitioners resulting from the complexity of the proposed legislation. I chose an analogy to a black hole in respect of the proposed s. 56.4 amendments because, in the words of Dr. G.H. George, "[t]he concepts associated with a black hole provide perhaps the most extreme departure which present day physics can provide from the “common sense” of our every day experience here on Earth." Presentation to a meeting of the St. John’s (Newfoundland) centre of the Royal Astronomical Society of Canada, 1989 March 15, internet: http://www.engr.mun.ca/~ggeorge/astron/blackholes.html.


4 Exceptions include covenants given by employees; covenants given in the context of an asset sale which requires that the taxpayer granting the restrictive covenant be carrying on the business being conveyed; and covenants given upon the sale of shares provided there is no multi-tiered corporate structure but which is subject to various additional requirements. A critical analysis of these exceptions is provided by David Louis in “Restrictive Covenant Rules, Restrictive Covenants: Last of the Unholy Trinity” CCH Tax Notes Issue No. 571, August 2010. A more detailed discussion of the exceptions is provided below in section 8 (The Exceptions).

5 Proposals to Amend the Income Tax Act and Related Legislation to Effect Technical Changes and to Provide for Bijural Expression in that Act.

6 Fortino v. The Queen (2000 DTC 6060 (F.C.A.), aff’g 97 DTC 55 (TCC) (“Fortino”).


That loophole is closing: on October 7, 2003, the Department of Finance proposed amendments to the Income Tax Act 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. The current draft of the proposed legislation is the Income Tax Amendments Act, 2010 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 and Manrell which, by 2003, had fully
Hereafter referred to as the “CRA”.

Amounts paid by arm’s-length parties under an agreement made prior to October 7, 2003 are excepted, provided that the amounts are received before 2005. See D. Jeffrey Harder “Valuation and Tax Issues” 2004 BCC p. 20:1 at p. 22.

Online at:

invalidated the Canada Revenue Agency’s 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. 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.
12 Justice Sharlow, who wrote the court’s decision in Manrell, was concerned about judicial “innovation” when he determined that non-competition payments were not to be treated as ‘property’ under section 248(1) and thereby radically changed the judicial landscape in this area.
14 The consequences of the Manrell decision include the difficulty in legislating amendments to the ITA that will close the loophole Justice Sharlow created; amendments which have been more than eight years in the making, and still counting.

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’ ironically engaged in by the Federal Court of Appeal in *Manrell* 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. 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.

Blair Dwyer, “Proposed Section 56.4 Still Draft After All these Years” 2011 British Columbia Tax Conference, Vancouver, Canada, online at: http://www.dwyertaxlaw.com/publication_restrictive_covenants_2011.pdf

The stated policy objectives set forth by the Supreme Court in respect of interpreting the ITA are to seek certainty, consistency, predictability and fairness under the Act for taxpayers in the organization of their affairs. See The Queen v. Canada Trustco Mortgage Co., [2005] 5 C.T.C. 215 (S.C.C.), at paragraphs 1, 12, 31, 42, 50 and 61.

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)\(^\text{15}\), 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)”\(^\text{16}\). 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.\(^\text{17}\)

The CRA, depending on the specific facts, had treated the proceeds of a restrictive covenant as either a disposition of eligible capital property or amounts received as consideration for contingent or conditional obligations in respect of such disposition of property.

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” 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, 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


22 The event horizon of a black hole is the boundary in spacetime beyond which events cannot be affected by agents outside of its gravitational pull. It is "the point of no return" where the gravitational pull is so great that escape is impossible. Stephen Hawking, “The Universe in a Nutshell”, online at: http://en.wikipedia.org/wiki/Event_horizon.

23 Moody, Clark and Baass, supra note 21, at p. 9: “...certain high-profile cases may have put further strain on the Department of Finance’s tolerance regarding non-competition schemes.”

structure which some tax commentators have described as “horrifically complex” causing “brain overload”; ... a black hole.

3. Approaching the 'Event Horizon'
Leading up to the Section 56.4 Amendments

On October 7, 2003, a mere seven months after the Federal Court of Appeal decision in Manrell (the rapidity of response some attribute to the visibility of the Conrad Black trial which drew attention to a significant chasm in the Canadian tax regime), the Department of Finance announced its intentions to amend the ITA to ensure that non-competition payments would be taxable.
Prior to the *Fortino* and *Manrell* decisions, according to Moody, Clark and Baass, Canadian case law was virtually “mute” on the tax treatment of restrictive covenant payments, however the CRA had previously issued a number of interpretative bulletins which gave guidance on the tax treatment of non-competition payments in the context of the sale of a business. As early as 1990, the CRA issued an interpretation bulletin which advised that such restrictive covenants in the context of an asset sale were to be considered dispositions of goodwill which is eligible capital property and taxable pursuant to section 14 (and not warranties given on the sale of property pursuant to section 42). The proceeds of a non-competition agreement in the context of a share sale were to be considered warranties given on the sale of property and taxable as part of the consideration for the sale of shares pursuant to section 42. Therefore proceeds from non-competition agreements were to be treated as proceeds from the disposition of eligible capital property in their own right, or treated as part of the proceeds from the property transaction itself. See paragraphs 5 and 6 of Interpretation Bulletin IT-330R:

5. For the rules in section 42 [of the ITA] to apply to a warranty obligation, it must be a commitment in respect of the disposition of a capital property. Generally, the commitment will relate in a specific way to such a property. For example, when the capital properties of a business are sold, the warranty obligation may
be an assurance concerning the vendor’s title to certain or all of those properties, or the amount of liabilities that are a charge on certain or all of the properties. Where capital properties of a business are sold, a non-competition covenant, given by the vendor not to carry on a competitive business, is considered to be in respect of the disposition of the goodwill of the business and is therefore not subject to section 42. Such a disposition is a disposition of eligible capital property and is subject to the provisions of section 14.

1. A warranty given on the sale of the shares of a corporation generally relates specifically to the underlying business properties and not to the shares themselves. For example, the warranty will usually relate to the title to these properties or the correctness of the financial statements. However, the wording of section 42 is sufficiently comprehensive to include such warranties as being given “in respect of” the disposition of the shares, and therefore section 42 applies to increase the proceeds of disposition of the shares by the amount received for any such warranty. In this regard, any amount received for a non-competition covenant referred to in paragraph 5 that is in respect of the disposition of shares comes within the provisions of section 42 as part of proceeds of disposition of the shares.

In 1995, the CRA provided further guidance on the interpretation of “property” in section 248(1)(a) of the ITA that was intended to unambiguously confirm that non-competition covenants were to be treated as dispositions of capital property for tax purposes. Section 248(1) of the ITA provides that:

“property” means property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes

(a) a right of any kind whatever, a share or a chose in action,
(b) unless a contrary intention is evident, money,
(c) a timber resource property, and
(d) the work in progress of a business that is a profession.
26 CRA document no. 9525077, November 8, 1995, as quoted in Tax Interpretations: online at: http://taxinterpretations.com/?page_id=1456 and quoted by Moody, Clark and Baass, Supra note 21, at page 2.

27 See the discussion regarding Fortino below. In the 1996 proceedings before the Tax Court of Canada in Fortino, the CRA failed to timely raise the argument that the payments were proceeds of a disposition of a “right of any kind” and though it sought to amend its pleadings, it was not permitted to do so without an adjournment which it chose not to take. The Crown was therefore barred from raising that argument on appeal, and the Federal Court of Appeal affirmed the decision of the Tax Court that the proceeds were in the form a non-taxable capital payment. However Manrell specifically addressed the subsection 248(1) property arguments for the treatment of non-competition payments as a capital gain and the Federal Court of Appeal rejected them.

In its Memorandum 952507 dated 8 November 1995 the CRA stated that:

Property is broadly defined in subsection 248(1) of the Act to include, “... a right of any kind whatever...” It is our view that where a taxpayer gives up his right to compete in a business under a contract, that right would be a property for the purposes of the Act and any consideration received by the taxpayer for giving up such right would generally be on account of capital.

Unfortunately for practitioners who are now burdened with interpreting the proposed section 56.4 amendments, the Federal Court of Appeal in Fortino and Manrell ultimately (and debatedly) rejected this interpretation.

4. The Fortino Decision

In Fortino, the shareholders of Fortino’s Supermarket Ltd. (“Fortino’s”) sold their common shares to their wives, and their wives in turn sold the shares to Food Market Holding Co. Ltd. (“Loblaws”) for a purchase price of approximately $7 million. Each of the vendors additionally signed a non-competition agreement for which they were paid separately the additional
28 Subsection 14.1 of the ITA provides:

14 Eligible capital property — inclusion in income from business

(1) Where, at the end of a taxation year, the total of all amounts each of which is an amount determined, in respect of a business of a taxpayer, for E in the definition "cumulative eligible capital" in subsection (5) (in this section referred to as an "eligible capital amount") or for F in that definition exceeds the total of all amounts determined for A to D in that definition in respect of the business (which excess is in this subsection referred to as "the excess"), there shall be included in computing the taxpayer’s income from the business for the year the total of

(a) the amount, if any, that is the lesser of
   (i) the excess, and
   (ii) the amount determined for F in the definition "cumulative eligible capital" in subsection (5) at the end of the year in respect of the business, and

(b) the amount, if any, determined by the formula \(2/3 \times (A - B - C - D)\) where

A is the excess,
B is the amount determined for F in the definition "cumulative eligible capital" in subsection (5) at the end of the year in respect of the business,
C is 1/2 of the amount determined for Q in the definition "cumulative eligible capital" in subsection (5) at the end of the year in respect of the business, and
D is the amount claimed by the taxpayer, not exceeding the taxpayer’s exempt gains balance for the year in respect of the business

amount of approximately $1.35 million. The shareholders did not report the non-competition payments in their personal income tax returns. The Minister of National Revenue assessed such amounts as eligible capital amounts pursuant to subsection 14(1) of the ITA considering the payments should have been included as part of the share price.

The taxpayers appealed, and on re-assessment the Minister of Revenue included all of the payments as income under Section 3 of the ITA.

29 *Manrell*, supra note 7, paragraphs 62-65.

The taxpayers then argued that the payment was for their personal goodwill, not income from a source, and that there was no provision in the ITA rendering them liable for income tax with respect to such payments; a windfall.

Justice Sharlow, in her Federal Court of Appeal decision in *Manrell*, provides a succinct summary of the arguments raised in *Fortino* and how they were addressed by the Federal Court of Appeal:

(1)
In the Tax Court proceedings in *Fortino*, the Crown’s first argument was that non-competition payments must be included as income. The Tax Court judge rejected that argument because the proceeds from granting non-competition covenants could not be considered to be income from a source under section 3 of the ITA.

(2) The Crown’s second argument at the Tax Court was that non-competition payments are “eligible capital amounts” and subject to section 14 of the ITA. That argument failed in the Tax Court because non-competition payments to a shareholder are not amounts paid in respect of the business carried on or formerly carried on by the shareholder, which is a condition to the application of section 14.

(3) The Crown’s third argument at the Tax Court was that the non-competition payments were consideration for warranties, covenants or other conditional or contingent obligations given or incurred in respect of a disposition of property pursuant to section 42 of the ITA. That argument also failed because a restrictive covenant is not a conditional or contingent obligation.

(4) The Crown’s fourth argument at the Tax Court was that the non-competition payments were proceeds from the disposition of property on the basis that the “right to compete” met the definition of property in subsection 248(1) of the ITA. However the Crown had failed to timely raise this argument at the Tax Court in *Fortino* so that argument was not considered in those proceedings.
The only issue before the Federal Court of Appeal in *Fortino* was whether the payments were income from a source under section 3. The Tax Court had previously decided that the non-competition payments were not taxable as eligible capital amounts under section 14, nor income from a source under section 3, and not a warranty, covenants or other contingent or conditional obligation under section 42. Rather by default and somewhat ambiguously, Justice Lamarre, writing the decision for the Federal Court of Appeal, dismissed the appeal and upheld the decision of the Tax Court that the non-competition payments were non-taxable proceeds in the nature of a capital receipt.

5. The Manrell Decision

In 2001, following the decision by the Federal Court of Appeal in *Fortino*, the Tax Court was faced with similar facts in *Manrell*: Tod Manrell owned a substantial interest in three operating companies that manufactured plastic bottles; he and the other shareholders of the operating companies sold their shares to 3154823 Canada Inc. for $14,626,000. The terms of the share sale agreement included provisions for the payment of approximately $4 million as consideration for non-competition agreements covering the span of four years from 1995 to 1998 inclusive. Tod Manrell declared the non-competition payments in his 1995, 1996, and 1997 tax returns as a capital gain and part of the proceeds of the disposition of the shares pursuant to section 42 of the ITA. After the 1996 Tax Court decision in *Fortino* which held such payments were non-taxable capital receipts, however, Todd Manrell sought to have his 1996 and 1997 taxes re-assessed. The CRA
confirmed the original assessments and Manrell’s appeal to the Tax Court was dismissed on the basis that the non-competition agreement fell within the definition of ‘property’ in subsection 248(1) of the ITA and were therefore taxable as capital gains. Manrell appealed to the Federal Court of Appeal.

The issue before the Federal Court of Appeal in Manrell was whether “a taxable capital gain arises when an individual receives a payment from the purchaser of the shares of a corporation as consideration for a promise not to compete with that corporation...”\(^{30}\); or, stated another way, “is the ‘right to compete’ a ‘right of any kind whatever’, and thus ‘property’ as defined for the purposes of the Income Tax Act?”\(^{31}\). Before reversing the Tax Court’s decision by finding that payments for the disposition of such rights did not constitute a taxable capital gain, Justice Sharlow of the Federal Court of Appeal set forth a comprehensive analysis of the origins and applications of subsection 248(1) of the ITA. Her approach was singular, as she described it: “this is a problem of statutory interpretation”\(^{32}\); in respect of which he took guidance from Justice Iacobucci in the 2001 Supreme Court case of Ludmer v. the Minister of National Revenue\(^{33}\) who stated that: “...when interpreting the Income Tax Act courts must be mindful of their role as distinct from that
34 Ibid., at paragraph 38, as quoted in Manrell, supra note 7 at paragraph 22.
36 Manrell, supra note 7 at paragraph 27.
37 Ibid., at paragraph 127.
38 Ibid., paragraph 37 (emphasis added).

of Parliament. In the absence of clear statutory language, judicial innovation is undesirable..."34

Justice Sharlow considered the ordinary meaning of “property” and then moved on to discuss the history of the Income Tax Act starting with the Income War Tax Act describing that statute as the earliest predecessor of the ITA and explaining that it did not define ‘property’ although it used the term in its “ordinary sense” in several provisions. Justice Sharlow then moved on to the definition of property contained in 1948 Income Tax Act which he explained contains the core of the definition of property that is in section 248(1) of the ITA. The 1948 Income Tax Act provides as follows:

127. (1) . . .

(af) "property" means property of any kind whatsoever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes a right of any kind whatsoever, a share or a chose in action. 37

Justice Sharlow then interpreted the 1948 definition of property, somewhat counterintuitively, that “‘a right of any kind whatever’ ... brings within the statutory definition everything that is within the broadest ordinary meaning of the word ‘property’.” 38 Within the foregoing parameters, and apparently
to avoid engaging in any ‘judicial innovation’, she ultimately rested her decision in *Manrell* on the basis that:

... [i]t is implicit in this notion of ‘property’ that ‘property’ must have or entail some exclusive right to make a claim against someone else. A general right to do something that anyone can do, or a right that belongs to everyone, is not the ‘property’ of anyone.

39 She therefore considered that the right to compete did not constitute property because no one other than Manrell was excluded from the right to carry on a competitive business. Justice Sharlow then decided that including non-competition provisions under the ambit of ‘property’ as defined in subsection 248(1) of the ITA as an unacceptable extension of statutory language:

[59]The trend of recent Canadian jurisprudence is that fiscal legislation should be interpreted in a purposive manner, taking into account the desirability of consistency and certainty. It is not acceptable to stretch statutory language in a taxing statute in order to achieve what may appear to be a reasonable result in a particular case.

40 Since the matter before the Federal Court of Appeal was an appeal from a Tax Court decision which held that the non-competition covenant fell within the definition of property under subsection 248(1), the only argument advanced by the Crown at the appeal was that non-competition payments constituted taxable capital gains given the definition of property under subsection 248(1). The Appeal Court had already disposed of the section 3 arguments (income from a source) in *Fortino*, and the section 42 arguments
(warranty) were conceded by the Minister of National Revenue at the Tax Court. When the Appeal Court in Manrell decided that non-competition agreements did not constitute ‘property’ under subsection 248(1), the amounts received for the non-competition provisions by Tod Manrell were simply not taxable.

6. The Lacunae

From November 5, 1996, the date of the decision of the Tax Court of Canada in Fortino, until October 7, 2003, when the Minister of Finance announced the proposed section 56.4 amendments to the ITA, non-competition payments were considered tax-free in the hands of their recipients. Justice Sachs of the Ontario Superior Court stated in his decision in Clegg v. Clegg, that in light of the Federal Court of Appeal’s decision in Fortino, potential income tax consequences from the non-compete payments Mr. Clegg received “if they do exist, are too speculative to qualify as a deduction for equalization purposes”. Clearly Lord Black’s tax advisors in 2000 weren’t wrong, even if his corporate governance advisors were extraordinarily so.

7. The Black Hole

The CRA, underscoring the uncertainty facing practitioners who must interpret the proposed amendments that - if implemented - will have retroactive effect, includes the following caveat on its website regarding the tax treatment of restrictive covenants:

**Note** Due to proposed legislation, the topic, restrictive covenants, is under review and the present content on this page may not reflect the accurate revised proposed legislation.

If the CRA cannot advise on a matter affecting tax payers, how can the public be held liable in respect thereof? In any event, the Income Tax Amendments Act, if it is enacted, will amply fill the lacunae created by the Fortino and Manrell decisions by providing for full income inclusion for proceeds from all restrictive covenants (not only non-competition payments). Furthermore, as noted above, it will apply on a retroactive basis so that any amount received or receivable for a restrictive covenant will be treated as ordinary income for income tax purposes and will apply to amounts received or receivable by a taxpayer after October 7, 2003, unless the amounts were received prior to 2005 and were pursuant to a restrictive covenant entered into on or before October 7, 2003 in an arm’s length transaction that was made in writing.
The general income inclusion rule of the proposed legislation is substantially complicated by the various exceptions which are necessary to avoid encompassing taxable proceeds covered by other provisions of the ITA. An outline of the exceptions follows.

8. The Exceptions

There are three exceptions to the proposed general income inclusion rule of the Income Tax Amendments Act, each with their various conditions or qualifications. These exceptions only apply if the transaction in which the restrictive covenant was granted was between parties dealing at arm's length.

1. **Employment Income** – The income inclusion rule will not apply if the payment on the restrictive covenant is required to be included in the calculation of the grantor's employment income.

1. **Eligible Capital Property** - If consideration for the restrictive covenant is part of the purchase price of the underlying asset, it will be treated as the proceeds of disposition of that asset and therefore as eligible capital property, provided the grantor and buyer jointly so elect. The election must be in the prescribed form and filed with their income tax return for the tax year in which the covenant was issued. If the election is not properly filed, the amounts will be treated as income to the seller under the income inclusion rule.
45 In the context of the sale of shares or a partnership interest in an active business, when the parties elect under paragraph 56.4(3)(c), they must indicate that each of the five requirements in that paragraph are met:

(i) the amount directly relates to the grantor’s disposition of an eligible interest;

(ii) the disposition of the eligible interest is to the purchaser of the restrictive covenant or a person related to that purchaser;

(iii) the amount is for an undertaking by the grantor not to provide property or services in competition with the purchaser or a person related to the purchaser;

(iv) the amount elected upon is the lesser of (A-B) and the consideration received by the grantor for the restrictive covenant, where

   A is what the fair market value of the grantor’s eligible interest would have been had all restrictive covenants been provided for no consideration; and

   B is what the fair market value of the grantor’s eligible interest would have been had no covenants been granted by any taxpayer (including a partnership) that held an interest in the business,

(v) the amount is included in the amount reported by the grantor as proceeds of disposition of the eligible interest.

1. **Shares and Partnership Interests** - In cases where the consideration for the restrictive covenants directly relates to the grantor's disposition of eligible capital property (an eligible interest, as defined in the ITA which include shares and partnership interests) and where the additional five conditions set forth in note 45 below are met, the grantor and buyer may elect to treat the consideration as proceeds from the disposition of eligible capital property. As above, the election must be in prescribed form and filed with the income tax return in the taxation year in which the covenant was granted. To the extent that the covenant increases the fair market value of the capital property being conveyed, such portion of the amount receivable
"First Principles" is also known as “deep reality physics” [http://www.metaresearch.org/cosmology/PhysicsHasItsPrinciples.asp](http://www.metaresearch.org/cosmology/PhysicsHasItsPrinciples.asp). Keeping with the black hole analogy, this entails seeking an interpretation of the jurisprudence and statutes that employs m-theory, where everything is united so that information going into a black hole is not destroyed but properly informs the law in this area (see “anti-de-sitter/conformal field theory correspondence” as described by Edward Teo. See [http://www.sciencedirect.com/science/article/pii/S0370269398008491](http://www.sciencedirect.com/science/article/pii/S0370269398008491).

Market value of the capital property being conveyed may be treated as part of the proceeds for the disposition of the capital property. Any amount received for the covenant that exceeds the amount by which the restrictive covenant increased the value of the capital property being conveyed will be taxable as ordinary income. for the covenant that is attributable to the increase in the

The CRA provides an illustration of the application of the Income Tax Amendments Act when this exception applies. See Appendix “A” attached hereto.

9. Searching For First Principles

If the Court of Appeal in Manrell considered it appropriate to refer back to the Income War Tax Act to determine the scope of the definition of ‘property’ under the ITA, it is perhaps worthwhile to refer further back to the earliest case law considering proceeds from property subject to taxation under applicable taxing legislation; first principles on the taxation of proceeds of property, so to speak.
The Court of King’s Bench in 1923, when it decided to tax the proceeds paid to directors of a company in connection with personal loan guarantees in Ryall (Inspector of Taxes) v. Hoare, and Ryall (Inspector of Taxes) v. Honeywill, the Court of King’s Bench, stated that: “To bring a sum within the Sixth Case ...[relating to any profit or gains]... there must be property producing the assessment, or the sum received must be received for some legal consideration” ... “we may say that where an emolument accrues by virtue of service rendered whether by way of action or permission, such emoluments are included in ‘Profits or gains.’”

It appears that in 1923, “property producing the assessment” and “an emolument accruing by virtue of service rendered whether by way of action or permission” were both taxable as “profits or gains” under the Sixth Case. Indeed, the use of the word “emolument” appears to blur distinctions between proceeds from property and income from a source. According to Merriam-Webster, an “emolument” means “the returns arising from office or employment”; an obsolete synonym of “emolument” is “advantage”; and an obsolete synonym of “advantage” is “interest” which in turn means, inter alia, a “right, title, or legal share in something”; a property interest. Furthermore, either interpretation of emolument in the context of a service rendered by way of an action or permission would have been encompassed by the taxing provisions of the Sixth Case.

Putting aside the particular tax treatment of “profits or gains” under the 1918 Income Tax Act of England, the coalescence in the 1923 case law between “property producing the assessment” and an “action or permission” (which reasonably would include a license and covenant, as well as their opposites, a prohibition and a restrictive covenant), both of which being emoluments, underscores a certain common basis from a tax perspective that has been parsed by amendments over time and, in this last interpretation of section 248(1) of the ITA by Justice Sharlow, into oblivion. It appears the English courts would have considered the proceeds from a permission or its opposite, a restrictive covenant, as taxable. Given this common law history of taxing legislation, it does not appear to be ‘judicial innovation’ to interpret a “right of any kind whatever” of section 248(1) to
include the right to compete so that proceeds from its disposition would be taxable.
Though Justice Sharlow had stated that “this is a problem of statutory interpretation”, she does acknowledge that the solution to this problem involves more than strict construction of statutory language:

[One]... must begin with the principle from E. A. Driedger, *Construction of Statutes* (2nd ed. 1983), at page 87:

Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament.

It would seem from the foregoing that he recognizes the value of a purposive approach. Examining further the meaning of a purposive approach as applied to an interpretation of the ITA and whether it could permit a reading of subsection 148(1) that would include a restrictive covenant, it warrants considering Justice Estey remarks in his majority reasons in *Stubart Investments Ltd. v. The Queen* where he seeks to “reach conduct of the taxpayer which clearly falls within "the object and spirit" of the taxing provisions.”


Manrell, supra note 7, at paragraph 47.

Iacobucci, J in Antosko et al v. the Queen, though recognizing the obligation not to alter the plain meaning of a statute, also stated:

... it is true that the courts must view discrete sections of the Income Tax Act in light of other provisions of the Act and of the purpose of the legislation, and that they must analyze a given transaction in the context of economic and commercial reality.

Consistent with the foregoing, non-competition agreements in the context of a sale of business were, for decades before Fortino, quietly being taxed as ‘property’ by the CRA with reliance on subsection 248(1)(a) of the ITA; an approach which went unchallenged since the ITA itself was implemented. The general acceptance of this tax treatment by the CRA was likely fostered by the sheer reasonableness of it, given the economic and commercial context in which these transactions occurred. Nevertheless, Justice Sharlow stated that she could “find nothing in the statutory context to support the proposition that the phrase “a right of any kind whatever” in the statutory definition of “property” is intended to require a non-exclusive, commonly held right to carry on a business to be treated as “property” for income tax purposes.” She apparently failed to consider the comments made earlier, at the Tax Court, by Justice McArthur when he explained that “the reasons
there is so little helpful jurisprudence on this subject is because of Interpretation Bulletin IT-330R which states that a receipt from a non-compete agreement is capital and taxpayers have been treating it as a capital gain.”

With her decision in Manrell, Justice Sharlow threw the evolution of law and practice in this area into a void: “... that the legal right to receive a non-competition payment is not “a right of any kind whatever” and thus not “property” as defined under the Act.” Justice Sharlow sought to rationalize her pronouncement that non-competition agreements did not constitute “property” under the Act on the basis that the ordinary meaning of “property’ has been interpreted as entailing an exclusive and legally enforceable claim and a shared right to carry on business did not meet this definition.”

Justice Sharlow’s shift away from CRA convention by excluding non-competition covenants from the scope of s. 248(1)(a) was supported by her reference to the definition of property provided by Professor Ziff in Principles of Property Law: 
Ibid., at paragraph 25.


[i]t is implicit in this notion of 'property' that 'property' must have or entail some exclusive right to make a claim against someone else. A general right to do something that anyone can do, or a right that belongs to everyone, is not the 'property' of anyone.

Professor Ziff has recently provided a more detailed characterization of property in his current edition of *Principles of Property Law*:

From an intuitive perspective the idea of property is perfectly straightforward: the term refers to those things one can own. Although it is both sensible and common to use such language, the law offers a different slant, one that tends to dwell more on the owning element. Property is sometimes referred to as a bundle of rights. That characterization means that property is not in fact a thing, but rather a right, or better, a collection of rights (over things) enforceable against others. Likewise, it has been said that "[t]he concept of ownership is no more than a convenient global description of different collections of rights held by persons over physical and other things". Explained another way, the term property signifies a set of relationships among people that concern claims to tangible and intangible items.

Without disputing the essential characteristic of 'property' as being a collection or rights which can be enforced against others, J.W. Harris in *Property and Justice*, states:

‘Property’ designates those items which are points of reference within ... the rules of a property institution, viz., trespassory, property-limitation, expropriation and appropriation rules. Such items are either

Thomas Raleigh, M.A., *An Outline of the Law of Property*, (Oxford: the subject of direct trespassory protection or else separately assignable as part of private wealth. Therefore, ‘property’ comprises (1) ownership and quasi-ownership interests in things (tangible or ideational); (2) other rights over such things which are enforceable against all-comers (non-ownership proprietary interests); (3) money; and (4) cashable rights. That is what ‘property’ is.

10. Goodwill

If a sufficient criteria for ‘property’ is "(2) ... rights over such things which are enforceable against all-comers (non-ownership proprietary interests)”, would it not be reasonable to consider the personal right to
compete, while not one which precludes others from competing in their own right, to be one which is proprietary to the person in possession and enforceable against all others not in possession, in the sense that it cannot lawfully be infringed or alienated unless conveyed by the person possessing that right? Restating the foregoing: given that a determinative characteristic of ‘property’ consists of the ability to exclude others from possession of the interest or right, would not a reasonable interpretation of that criteria, one which did not occasion any ‘judicial innovation’, fairly be satisfied by the the qualities of Tod Manrell’s human capital which includes his goodwill and his business knowledge in the industry of plastic bottle manufacturing, which human capital he can convey or exclude others from?

Thomas Raleigh, in his treatise, *An Outline of The Law of Property*, illustrated the nature of intangible property by describing the patent:
A patent, for example, confers on the author of an invention the right to prevent others from using his invention without his consent. This right has a money value, it may be separately dealt with; we regard it as a subject of property, a separate incorporeal thing.

His description of the patent compels an analogy to the non-competition covenant: both pertain to the right to engage in a specified conduct (in one case, making something in the manner set for the patent; in the other competing using the goodwill and know-how of the person subject of the non-competition covenant in a manner prohibited by the restrictive covenant), and neither affect the rights of others to engage in other conduct not subject of the patent or the covenant even if such other conduct would have the same effects or outcome. Conceptually equivalent, the non-competition covenant restricts anyone from competing in the proscribed manner (using the goodwill and know-how of the grantor in the manner proscribed by the covenant) though anyone may use other goodwill and know-how with the same effect as those subject of the restrictive covenant; the patent restricts anyone from engaging in the processes or materials subject of the patent though anyone may use other processes or materials with the same effect as those subject of the patent. In the case of Tod Manrell, it was the use of his personal accumulated goodwill and know-how which 3154823 Canada Inc. was paying to suppress, and which intangible property (aka human capital) Tod Manrell most definitely the power to exclude others from benefiting from.
Furthermore, can it reasonably be argued that the value of a non-compete covenant by an executive who operates and owns a company that is being sold is not inextricably linked to both the value of the company and the value of that executive’s personal and business goodwill in the industry in which the company operates? Justice McArthur of the Tax Court stated in his 2002 decision in *Manrell* that “[i]n return for disposing of the right to make plastic bottles in competition with the purchaser, Tod Manrell received the payment that is inextricably connected to the payment for the shares and other rights...”. It is uncontroversial that goodwill is treated as property under the ITA. Interpretation Bulletin IT-386R published by the Canada Revenue Agency on October 30, 1992 explicitly provides that non-competition payments constitute goodwill and are to be treated the same for tax purposes. IT-386R gives guidance on the interpretation of “Eligible Capital Amounts” as that term is used in subsection 14(1) and subparagraph 14(5)(a)(iv) and paragraph 14(5)(b) of ITA. In that information bulletin, eligible capital includes “goodwill” which is defined as including non-competition provisions. See below (emphasis added):

...
14 In addition to contending that the Bermans' shareholdings should be reapportioned to reflect both Fred Berman's efforts and Pat Berman's perceived discouragement of those efforts, counsel for Fred Berman submitted that should the terms of sale entail a non-competition agreement, Fred Berman is entitled to compensation directly relating to that agreement...

15 At the time of Budget Steel's sale, a non-competition agreement would be deemed to be part of the goodwill of the company (which, of course, Pat Berman will share). Given Fred Berman's ....likely willingness to enter into reasonable non-competition
arrangements to obtain a good price for Budget Steel, I do not propose to speculate as to what restrictions he may ultimately agree to with respect to future employment.

Justice Collver had no difficulty grouping payments for any non-competition agreement entered into by Mr. Berman together with the goodwill of the company, compensation for which were to be shared between the Bermans just as the proceeds of the shares of the company were to be. He further recognized that the nature of the non-competition covenants being given affected the purchase price of the business being sold. On a practical, common sense basis, without abstracting from the commercial realities of the transaction, Justice Collver properly understood that the non-competition covenants to be granted affected the purchase price of the property being sold, and proceeds from both were to be divided between the former spouses in the same way that other marital assets were to be divided.

When Justice Sharlow claimed in Manrell that ‘a right to compete’ was not a ‘right of any kind whatever’ and to hold otherwise was to stretch the limits of a reasonable interpretation of statutory language and engage in judicial innovation, it would seem she lost touch with the ‘object and spirit’ of the ITA, the broader common law history of taxing statutes and the commercial reality and economic context of non-competition provisions.

11. Conclusion
Justice Sharlow knew many would consider her decision to be “unsatisfactory in terms of fiscal policy.” But one is left to query her cost benefit analysis. The immediate costs were clear: taxpayers would seize the opportunity to shelter proceeds from the sale of a business under the guise of non-competition payments. She knowingly created this loophole that Conrad Black jumped through. It is her justification that is unclear. She sought to refrain from judicial innovation.

Justice Estey, in his reasons for judgment in the 1986 Supreme Court case of Golden v. The Queen describes the role of the judiciary as seeking a construction of taxation statutes that is in harmony with the evident purposes of the Income Tax Act:

10 In Stubart Investments Limited v. The Queen the Court recognized that in the construction of taxation statutes the law is not confined to a literal and virtually meaningless interpretation of the Act where the words will support on a broader construction a conclusion which is workable and in harmony with the evident purposes of the Act in question. Strict construction in the historic sense no longer finds a place in the canons of interpretation applicable to taxation statutes in an era such as the present, where taxation serves many purposes in addition to the old and traditional object of raising the cost of government from a somewhat unenthusiastic public.

Perhaps more forceful are the words of Justice Harlan from 1961, when he wrote the dissent in the U.S. Supreme Court case of Poe v. Ulman, a case involving a state statute that prohibited the sale of contraceptives:

The balance of which I speak is the balance struck by this country, having regard to what history teaches are the traditions from which it developed as well as the traditions from which it broke. That tradition is a living thing. A decision of this Court which radically departs from it could not long survive, while a decision which builds on what has survived is likely to be sound.
APPENDIX “A”

Treatment of a restrictive covenant

Assumed facts

Terence and Isabelle each own 50 of 100 common shares of X Ltd., which carries on a business. The adjusted cost base (ACB) of their shares is nil.

Both Terence and Isabelle receive $900,000 for selling their 50 shares of X Ltd. to Y Ltd. Terence receives $150,000 for his restrictive covenant, and Isabelle grants a restrictive covenant for which she is to receive $50,000.

The required elections and prescribed forms are filed on time.

Application of proposed rules

Isabelle

Because Isabelle is to receive $50,000 for her restrictive covenant, she may add part of those proceeds to the $900,000 she is to receive for the sale of her shares of X Ltd. The part of the $50,000 that can be added to those share proceeds is the amount by which the value of her share interest would increase if the covenant (and all restrictive covenants that may reasonably be considered to relate to a disposition of an interest in the business by any taxpayer) were provided for no consideration.

1. Capital gain equals $950,000 ($950,000 proceeds less nil ACB)

Where proceeds of disposition are:

$900,000 in proceeds of disposition for shares of X Ltd.

plus $50,000 of the covenant proceeds (which can be added to the proceeds of disposition from the sale of the business), determined as follows:

Lesser of:

i. $50,000 (amount receivable)

ii. $100,000 (value by which Isabelle's share interest in X Ltd. would increase if covenants provided by her and Terence were provided for no consideration when compared with a sale in which no covenant is granted; that is 50% of $200,000), calculated as follows:

To the extent

$1 million (50% of $2 million if covenants for no consideration)
is more than
$900,000 (50% of $1.8 million, if no covenant granted).

2. **Ordinary income** equals nil ($50,000 less $50,000 allocated to proceeds of disposition for shares).

**Terence**

Because Terence is to receive $150,000 for granting a restrictive covenant, he may add a part of those proceeds to the $900,000 he is to receive for the sale of his shares of X Ltd. The part of the $150,000 that can be added to those share proceeds is the amount by which the value of his share interest would increase if the covenant (and all restrictive covenants that may reasonably be considered to relate to a disposition of an interest in the business by any taxpayer) were provided for no consideration.

1. **Capital gain** equal $1 million ($1 million proceeds less nil ACB)

**Where proceeds of disposition are:**

$900,000 in proceeds of disposition for shares of X Ltd.

**plus**

$100,000 of covenant proceeds (which can be added to the proceeds of disposition from the sale of the business), determined as follows:

**Lesser of:**

i. $150,000 (amount receivable)

ii. $100,000 (value by which Terence's share interest in X Ltd. would increase if covenants provided by him and Isabelle were provided for no consideration when compared with a sale in which no covenant is granted; that is, 50% of $200,000), calculated as follows:

**To the extent**

$1 million (50% of $2 million if covenants for no consideration)

is more than

$900,000 (50% of $1.8 million if no covenant granted).

2. **Ordinary income** equals $50,000 ($150,000 less $100,000 allocated to proceeds of disposition for shares).

BIBLIOGRAPHY

Legislation


Income Tax Act, 1918 (8 & 9 Geo. 5, c. 40), Sch. D, paragraph 2, Sixth Case.

Canada Revenue Agency, Interpretation Bulletin IT-386R, October 30, 1992, online: http://www.cra-arc.gc.ca/E/pub/tp/it386r/it386r-e.txt


Jurisprudence


Fortino v. The Queen (2000 DTC 6060 (F.C.A.), aff’g 97 DTC 55 (T.C.C.).


Secondary Materials: Monographs

Merriam-Webster, online at [http://www.merriam-webster.com](http://www.merriam-webster.com).

Secondary Materials: Articles

David Louis, “Restrictive Covenant Rules, Restrictive Covenants: Last of the Unholy Trinity” *CCH Tax Notes Issue No. 571, August 2010*.
Ronald B. Standler, “Is Judicial Activism Bad” online at [www.rbs0.com/judact.pdf](http://www.rbs0.com/judact.pdf).