

HOT TOPIC! An Update . . .

In the October issue of *The Scrivener*, I described the Federal Court of Appeal's recent decision in *Manrell* (2003 CTC 5225) where a restrictive covenant helped the vendor "net" more after-tax dollars upon sale of his business. At that time, vendors of businesses were looking to this decision to determine how to best structure their buy-sell agreements—and to save more tax!

Shortly after that article was written, however, Minister Manly proposed amendments to the *Income Tax Act* that will significantly restrict the potential benefits to the vendor in this area. Here is a summary of events.

The Manrell Decision

In 1995, Manrell sold his business with a portion of the proceeds being received as a non-compete payment for which Manrell agreed not to compete in a defined geographic area for a certain period. Following the success of another case (*Fortino*, 2000 DTC 6060), Manrell filed a Notice of Objection to amend his return to report those proceeds as a tax-free receipt, similar to that earlier case. Success followed for Manrell when, at the Federal Court of Appeal, it was determined that the proceeds for the "right to compete" fell outside the domain of the *Income Tax Act* and were effectively a tax-free payment.

Given CCRA's strong opposition to this result and the very favourable outcome for taxpayers that resulted from this decision, it was noted in my previous article that CCRA was expected to take another "run" at this issue. Well, they didn't waste any time!

Minister Manley's Proposed Amendments

In response to the Federal Court of Appeal's recent decisions, Minister

Manley announced proposed amendments to the *Income Tax Act* that would significantly affect the tax treatment of amounts receivable by a taxpayer granting a restrictive covenant.

In general, the proposed amendments would cause any amount receivable on the sale of shares of a corporation, in respect of an agreement not to compete with the business carried on by the corporation, to be treated as ordinary income—therefore, fully taxable!

The proposed amendments, however, also include an exception to this ordinary income treatment. In particular, where proceeds are receivable in respect of an arm's length disposition of shares in a corporation and other proceeds are receivable by the taxpayer for a restrictive covenant relating to the corporation's business, then the amount receivable for the covenant may be treated as part of the proceeds for the disposition of the shares, but only to the extent that the covenant increases the fair market value of the shares. In this way, capital gains treatment could be obtained only for that portion of the proceeds.

It is intended that these proposals apply to amounts received or receivable after October 7, 2003, excluding amounts received before 2005 pursuant to a written agreement made on or before that date between parties dealing at arm's length.

As a result, there may be some opportunity to benefit for those considering the sale of their business . . . but the opportunity will now be severely restricted. ▲

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