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APPENDIX 38 (IBFD ARTICLE BY MICHAEL KANDEV

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Tax Treaty Issues Regarding Payments for Inaction: A Canadian Perspective on Restrictive Covenants

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Contents

1. INTRODUCTION

More than ten years ago, the *Bulletin* published an article by Sanford Goldberg which outlined the difficulties in finding the proper tax treatment of payments for inaction, such as amounts paid in consideration for covenants not to compete.[1] The enduring importance of this issue is demonstrated by the ongoing debate in Canada regarding the taxation of payments for non-competition agreements and other restrictive covenants.

This article first reviews the current legislative proposals regarding the taxation of restrictive covenants in Canada.[2] It then discusses the cross-border implications of these proposals with particular focus on tax treaty characterization issues.

2. TAX TREATMENT OF NON-COMPETITION PAYMENTS IN CANADA

Covenants not to compete are an important consideration in the context of a sale of a business. Whether the sale is structured as an asset deal or as a share acquisition, the buyer typically requires that certain key persons who were involved with the target provide, as part of the overall deal, undertakings not to compete with the buyer in the relevant business sector in one or more particular markets for a certain period of time following the acquisition.

2.1. History

Prior to the 1997 decision of the Tax Court of Canada in *Fortino*,[3] the Canadian tax treatment of payments made in consideration for a non-competition covenant was not controversial. It was simply thought that such receipts were taxable one way or another. Therefore, separate non-competition payments were generally not structured into a deal. If they were, it was accepted that Canadian tax would arise as follows:

- where the covenanting party was a shareholder of the target being purchased through an acquisition of stock, a separate amount paid to that party would be taxed under the Income Tax Act of Canada ("the Act") as part of the proceeds of disposition of the shares of the target;[4]
- where the covenanting party was a corporation or partnership selling its business assets, any amount received by that entity to not compete with the purchaser of the assets would be subject to tax under the rules in the Act respecting "eligible capital property";[5] and
- where the covenanting party is simply an employee of the target, then, whether or not the sale is an asset or share deal, the payment would be ordinary employment income under Sec. 6(3) of the Act.

This paradigm was put into question in the *Fortino* decision, which considered the tax treatment of non-competition payments in the context of a share deal. In

1. Goldberg, Sanford, "The Taxation of Income from Inaction: An American Perspective", 49 *Bulletin for International Fiscal Documentation* 12 (1995), at 564. More recently, an article by Dr Ekkehart Reimer discussed the specific problems that arise under tax treaty law regarding income from omissions; see Reimer, Ekkehart, "How Tax Treaties Deal with Income from Omissions", 60 *Bulletin for International Taxation* 3 (2006), at 110.
2. For a discussion of the application of these rules to certain practical situations in the Canada/US cross-border context, see Brender, Mark, Richard Tremblay and William Corcoran, "Canadian Covenants not to Compete – Cross-Border Traps", 34 *Tax Management International Journal* 559 (2005).
3. 97 D.T.C. 55, affirmed 2000 D.T.C. 6060 (F.C.A.).
4. Sec. 42 of the Income Tax Act (Canada), R.S.C. 1985, Chap. 1 (5th Supp.), as amended. Sec. 42 deems the proceeds of disposition of property to include amounts received as consideration for warranties, covenants or other contingent or conditional obligations given by a taxpayer in respect of the disposition of property. This was also the approach suggested by the government in its Interpretation Bulletin IT-330R, "Dispositions of capital property subject to warranty, covenant, or other conditional or contingent obligations" (7 September 1990).
5. For purposes of the Act, "eligible capital property" is goodwill and other purchased intangibles without a fixed lifespan. For the seller, the sale of eligible capital property may result in including 50% of the proceeds as business income under Sec. 14 of the Act. See Interpretation Bulletin IT-143R3, "Meaning of Eligible Capital Expenditure" (29 August 2002), Para. 32; and Technical Interpretation 9800145, "Non-competition agreements, client lists" (27 April 1998).

that case, the Tax Court of Canada held that non-competition payments were non-taxable capital receipts on the grounds that they were *not* any of the following: (1) income from a source,[6] (2) eligible capital amounts,[7] or (3) consideration received for warranties, covenants or other conditional or contingent obligations given or incurred in respect of a disposition of property.[8] This ruling was affirmed in a brief decision by the Federal Court of Appeal.

Because of the government's pleading inadequacies, the courts in *Fortino* could not consider the remaining possibility that the non-competition payments were proceeds of the disposition of capital property (comprising the right to carry on a business in competition with others), which would have given rise to a capital gain.[9] The subsequent decision in *Manrell* dealt with this outstanding possibility.[10] In that case, the Federal Court of Appeal reversed the Tax Court's decision that a non-competition covenant gave rise to a taxable disposition of capital property, and it held that the non-competition payments were non-taxable capital receipts. It ruled that the right to compete did not constitute "property" for purposes of the capital gains provisions of the Act.

It is interesting to note that neither *Fortino* nor *Manrell* considered the argument, which is accepted in the United States, that a payment in consideration for a covenant not to compete is a payment for not performing services and therefore gives rise to service income.[11] This argument may be acceptable in Canada on the basis of the *surrogatum* principle, which is applied in characterizing damages and contract cancellation payments and which essentially looks to the income tax nature of the amount being replaced by the receipt. A recent example of the application of this principle is a decision by the Tax Court of Canada dealing with the treatment of a cross-border settlement payment releasing a group of Canadian co-venturers from their obligations to pay rent under a charter agreement.[12] The question before the Court was whether the settlement payment was subject to the provision imposing a withholding tax on cross-border rental payments (Sec. 212(1)(d) of the Act). The Tax Court applied the *surrogatum* principle to hold that the settlement payment should be treated the same as the rental payments that would have been made had the Canadian co-venturers not decided to cancel the charter agreement.[13]

2.2. Legislative proposals – general aspects

The decisions in *Fortino* and *Manrell* created a tax avoidance issue. The Canadian Department of Finance therefore announced on 7 October 2003 that it would propose an amendment to the Act to ensure that non-competition payments were taxable, thus reversing the effects of these two decisions.[14] Detailed provisions were subsequently released on 27 February 2004.[15]

Briefly, proposed Sec. 56.4 of the Act sets out rules regarding amounts that are received or receivable in respect of a "restrictive covenant". The default rule taxes amounts that are received or receivable in respect of a restrictive covenant as ordinary income (proposed Sec. 56.4(2)). This provision is subject to three narrow exceptions that relate to restrictive covenants granted in the context of an employment relationship, a sale of the assets of a business, or the sale of the shares of a corporation that carries on a business.[16]

After the 2004 rules were first released, Canadian taxpayers and their advisers expressed deep concern with the design and ambit of the new legislation, which was seen for good reason to go far beyond the perceived mischief created by *Fortino* and *Manrell*. Issues were raised mainly with respect to the scope of the exceptions regarding restrictive covenants granted in the context of a sale of a business. They were seen as too narrow to exclude a variety of arrangements that would normally benefit from preferential tax treatment.[17] The taxpayers' most significant concern, however, was with the proposed amendments to Sec. 68. New Sec. 68(c) would allow the tax authorities to allocate a reasonable amount to a restrictive covenant whether or not the contracting parties had chosen to do so. This proposal was regarded as unnecessary and unreasonable as it would force upon taxpayers the application of the ordinary income treatment provided in Sec. 56.4(2) in cases where no tax was avoided and where favourable tax treatment would normally apply.

The draft legislation released on 18 July 2005 contained a rewrite of the proposals which appeared to be a limited response to some of these concerns. Mainly, the 2005 rules addressed certain situations involving a holding corporation[18] and added two narrow exceptions to the application of Sec. 68(c).[19] Unfortunately,

6. Sec. 3 is the main changing provision of the Act. It includes in the tax base all amounts which are income from a source, including but not limited to income from an office, employment, business or property. Although the wording of Sec. 3 is very broad, Canadian courts have generally restricted its application so that, in certain circumstances, it is possible to have a non-taxable receipt.
7. This is because the business was carried on by the corporate entity, not by the shareholders; therefore, the receipt could not be characterized as a receipt of eligible capital property.
8. The Tax Court held that Sec. 42 of the Act applies only to covenants that are conditional or contingent. The Tax Court concluded that the covenants were neither conditional nor contingent and that, therefore, none of the payments was taxable under Sec. 42.
9. Under the Act, only 50% of capital gains are currently taxable.
10. 2003 D.T.C. 5225 (F.C.A.), reversing 2002 D.T.C. 1222 (T.C.C.). See Kandev, Michael, "Non-Competition Payment not Taxable", 13 *Can. Current Tax* 74 (2003).
11. See *The Korfund Company Inc.*, 1 T.C. 1180 (1943).
12. *Transocean Offshore Limited (Appellant) v. Canada*, 2004 D.T.C. 2915.
13. This decision was affirmed by the Federal Court of Appeal on a different basis: 2005 D.T.C. 5201. The higher court decided that it did not need to consider the *surrogatum* principle as the wording of the withholding tax charging provision in Sec. 212(1) was sufficiently broad to apply to the settlement payment.
14. News Release 2003-049. See Kandev, Michael, "Non-Competition Payments to Become Taxable", 14 *Can. Current Tax* 13 (2003).
15. See Boidman, Nathan and Michael Kandev, "Controversies in Canada Respecting the Taxation of Non-Competition and Related Payments", 58 *Bulletin for International Fiscal Documentation* 10 (2004), at 494.
16. Proposed Sec. 56.4(3). The apparent purpose of these exceptions is to avoid the application of proposed Sec. 56.4(2) to amounts that would otherwise be taxable under the Act.
17. Either on account of eligible capital or capital gains.
18. The 2004 rules did not apply properly where a target was sold through a sale of the shares of a holding corporation.
19. New Secs. 56.4(5), (6) and (7) purport to address some of the most outrageous possible applications of Sec. 68(c). Arguably, however, these exclusions are so restrictive that they do little but emphasize the government's power to use this provision to allocate an amount to a restrictive covenant in any other circumstance. Sec. 56.4(6) addresses the situation where a non-shareholder employee grants a restrictive covenant for no consideration. Sec. 56.4(7) applies where the restrictive covenant was granted to ensure the transfer of business goodwill.

however, the rules that had raised uncertainty for taxpayers were not materially narrowed or eliminated.[20] As of yet, the proposed amendments have not been enacted into law.

2.3. Legislative proposals – international tax aspects

The restrictive covenant proposals, as they currently stand, contain amendments that are of particular significance in the cross-border context. Briefly, the changes would impose a withholding tax on payments by Canadian residents to non-residents in respect of a restrictive covenant. In certain cases, the withholding tax would apply to such payments between non-residents.

Specifically, the proposed changes are to Sec. 212 of the Act, which is the main provision of the rules, found in Part XIII of the Act, for imposing a 25% withholding tax on certain amounts paid or credited by persons resident in Canada[21] to non-residents. Generally, the withholding tax is levied on interest, dividends, royalties and other property-type income. Proposed Sec. 212(1)(i) would impose the withholding tax on an amount paid by an actual or deemed Canadian resident to a non-resident in respect of a restrictive covenant to which new Sec. 56.4(2) applies. Proposed Sec. 212(13)(g) would deem a non-resident payer to be a Canadian resident for purposes of Sec. 212 if a restrictive covenant granted by a non-resident to the payer affects, or is intended to affect, in any way whatever, the acquisition or provision of property or services in Canada, the acquisition or provision of property or services outside Canada by a person resident in Canada, or the acquisition or provision outside Canada of "taxable Canadian property".[22]

3. CROSS-BORDER ISSUES INVOLVING RESTRICTIVE COVENANTS

3.1. In general

The restrictive covenant proposals, if enacted in their present form, will likely have important implications for cross-border arrangements because the proposed rules may extend, beyond their application to non-competition covenants, to many ordinary commercial arrangements whose tax treatment is well established. This is due mainly to the ambit of the definition of "restrictive covenant", which is extremely broad. Sec. 56.4(1) defines "restrictive covenant" as:

> 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 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.

This definition not only covers non-competition covenants and other similar undertakings such as standard non-solicitation and non-divulgation agreements, but it may also apply to most other covenants contained in a commercial agreement. For example, an exclusive distributorship agreement will likely contain a restrictive covenant. Such an agreement may involve a distributor paying a specific amount to a manufacturer in order to obtain exclusive distributorship rights in a given market for a period of time. It seems accepted that a receipt in consideration for a promise by the manufacturer not to deal with other distributors in the given market will be ordinary business profits to the manufacturer which are taxable pursuant to Sec. 9 of the Act.[23] In the cross-border context, such an amount received by a non-resident manufacturer would be considered non-taxable in Canada.[24] Proposed Sec. 56.4, however, would appear to apply to such an agreement because the payment will be in respect of an agreement by the manufacturer that affects (i.e. limits) the manufacturer's ability to provide (i.e. sell) its goods to other distributors in the given market.

Similarly, a "take or pay" contract may be a restrictive covenant. Typically, such a contract obligates the purchaser to buy the product that is offered or to pay a specified amount if the product is not taken. If the product is not taken, the amount received by the seller may be a payment in respect of a "restrictive covenant" for purposes of proposed Sec. 56.4.

The effect of the exceedingly broad scope of the proposed rules in Sec. 56.4 is compounded by the proposed changes to Sec. 68, which would allow the tax authorities to allocate a reasonable amount to a restrictive covenant even when the parties to the agreement have either implicitly or explicitly chosen not to do so.

3.2. Withholding tax issues

The restrictive covenant proposals will potentially have unexpected implications for cross-border arrangements due to the interaction of two main factors. First, the proposed amendments to the withholding tax provisions of the Act represent a substantive change to the Canadian taxation of cross-border payments. If proposed Sec. 212(1)(i) is enacted in its present form, a withholding tax would likely become applicable to payments that were previously thought not to be subject to Part XIII. Thus, proposed Sec. 212(1)(i) may apply in respect of amounts payable by a Canadian taxpayer which relate to its foreign business activities and to competition in non-Canadian markets. The proposed legislation does not represent an established tax policy or legal interpretation that was previously understood to exist.[25] Arguably, restrictive covenants

20. See Kandev, Michael, "The Non-Compete Saga Continues ...", 1747 *CCH Tax Topics* 1 (2005).

21. This includes non-residents deemed to be resident in Canada for purposes of Part XIII.

22. Sec. 248(1) "taxable Canadian property": capital gains realized by a non-resident on the disposition of such property are taxable in Canada (see Sec. 2(3)), except where exempted by a tax treaty. "Taxable Canadian property" includes Canadian real estate and Canadian business assets.

23. Technical Interpretation 9418695, "Withholding Tax – Computer Software – *Silden* Case" (29 July 1994).

24. This is either because the non-resident is not carrying on a business in Canada (see Sec. 2(3)(b) of the Act) or because of the application of the business profits article of a tax treaty.

25. See Technical Interpretation 2003-0044351E5, "Non-compete payments to non-residents" (24 March 2004), stating that payments for non-

have little to do with passive income such as interest, dividends and other amounts derived from Canadian-based property rights and should not be subject to withholding tax.

These issues involving Sec. 212(1)(i) will be compounded if the proposed amendments to Sec. 212(13) of the Act are enacted in their present form because the withholding tax under Sec. 212(1)(i) may extend to dealings between non-residents. Going back to the exclusive distributorship example in 3.1., in the case of an agreement between a European manufacturer and a US distributor whereby the US distributor acquires from the manufacturer exclusive distributorship rights in the North American market (including Canada), the combined effect of proposed Secs. 56.4(2), 212(1)(i) and 212(13) would be that the US distributor may be required to withhold and remit tax in respect of at least part of the fee it pays to the European manufacturer in consideration for the exclusivity rights. Thus, the new withholding requirements will present significant difficulties if a contract does not differentiate between payments in respect of Canada and payments in respect of other jurisdictions.

3.3. Tax treaty issues

The legislative proposals will also potentially have unexpected effects on cross-border dealings because the proposed classification of restrictive covenant payments under the Act is not consistent with the application of Canada's tax treaties to a variety of cross-border payments. The reason is that the government proposes to include the new rules on restrictive covenants in Subdivision d of Division B of Part I of the Act. Part I contains the income tax provisions of the Act, and Division B sets out the rules for computing income. The central provision of Division B is Sec. 3(a), which includes in a taxpayer's income all amounts which are income from a source, including but not restricted to income from four enumerated sources: an office, employment, business and property. Detailed rules governing the calculation of net income from these four sources are provided in Subdivision a (office or employment) and Subdivision b (business or property) of Division B. Subdivision d of Division B deals with "other sources of income". This category contains miscellaneous items of income which are not income from the four enumerated sources and not net taxable capital gains.[26] Amounts that are required to be included in income by Subdivision d are economic income in the sense that they increase the taxpayer's ability to pay, but they are not necessarily income from a source and thus might otherwise be received tax free under case law.[27] Therefore, the "other income" provisions in Secs. 56 to 59.1 of the Act essentially provide the basis for taxing receipts that would otherwise escape taxation. The effect of this is that the application of Canada's tax treaties to amounts that were previously considered business income and that now may be caught by the proposed restrictive covenant rules will be obscured. Given that, under the scheme of the Act, amounts in respect of restrictive covenants are not classified as income from business, but are instead included in the residual category of "other sources of income", it may be thought that Art. 7 of a tax treaty[28] will no longer apply to such amounts, which were previously regarded as business income.

The classification of amounts in respect of restrictive covenants as "other sources of income" under the Act is not, however, determinative of their tax treaty characterization. The domestic tax law classification of items of income or capital should not be confused with the categories of income in the distributive rules of tax treaties, which may indeed resemble the income schedules found in domestic tax law.[29] The distributive rules of tax treaties require independent classification of items of income or capital for treaty purposes. Thus, whether Art. 7 allows the source state to tax a payment in respect of a restrictive covenant is a matter to be determined by the source state on the basis of the treaty.[30]

For Art. 7 to apply to a payment in respect of a restrictive covenant, the amount must be "profits" for purposes of the treaty. Of course, the characterization of an item of income or capital for treaty purposes is not divorced from domestic law. According to Art. 3(2), if the term "profits" is not defined in the relevant treaty, the term must, unless the context otherwise requires, be given its domestic law meaning.[31] Regarding amounts in respect of restrictive covenants which have usually been thought to be business profits, it is arguable that proposed Sec. 56.4 would not affect their characterization as "profits". The reason is that the charging provision (Sec. 56.4(2)) does not classify receipts for restrictive covenants for domestic tax law purposes, but merely includes those receipts in the tax base. Moreover, no rule has been proposed that would establish the proper relationship between the rules in the Act dealing with business income and the new section on restrictive covenants. Thus, Sec. 56.4(2) appears to be merely a special provision. It is therefore arguable that Art. 7 of a treaty will continue to apply to items of income which were formerly considered business profits under the Act, but which may be taxed under the proposed rules on restrictive covenants. Accordingly, on this basis, Canada would be barred from levying a withholding tax under proposed Sec.

competition covenants are subject to withholding obligations under Sec. 212(1)(d) of the Act, which deals with rents, royalties and other similar payments. It should be noted that this Technical Interpretation was issued after the Technical Bill of 27 February 2004.

At a meeting of the Canadian Branch of the International Fiscal Association (IFA) on 8 May 2006, an official of the Department of Finance expressed the view that his Department has always taken the position that the Part XIII withholding tax applies to payments for restrictive covenants. Neither this Technical Interpretation nor the Department of Finance's views appear to be supported by case law or any prior administrative views.

26. Subdivision d includes amounts such as child support payments, unemployment insurance benefits, and pension benefits.

27. See generally Hogg, Peter, Joanne Magee and Jinyan Li, *Principles of Canadian Income Tax Law* (Scarborough, Ontario: Carswell, 5th ed., 2005), Chap. 12.

28. Most of Canada's tax treaties closely follow the OECD Model Tax Convention on Income and on Capital. References to tax treaty articles are to the provisions of the OECD Model.

29. Vogel, Klaus, *Klaus Vogel on Double Taxation Conventions* (Deventer, the Netherlands: Kluwer, 3rd ed., 1997), at 358.

30. See Avery Jones, John F., et al., "The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model", [1984] *British Tax Review*, at 14, 50. See also Para. 32.3 of the Commentary on Arts. 23 A and 23 B of the OECD Model.

31. For how "profits" are determined for purposes of Sec. 9 of the Act, see *Canderel v. Canada*, 98 D.T.C. 6100 (S.C.C.).

212(1)(i) on payments for restrictive covenants received by a non-resident without a permanent establishment in Canada.

More problematic is the treatment of non-competition payments connected to the sale of a business, such as the payments in *Fortino* and *Manrell*.[32] These cases held that such amounts were non-taxable capital receipts. Proposed Sec. 56.4 will change the tax treatment of non-competition payments as determined by the *Fortino/Manrell* case law by including them in the tax base. As stated above, however, Sec. 56.4 does not classify payments for restrictive covenants as business income or otherwise. Thus, it is questionable whether the proposed rules would completely overrule the holdings in *Fortino* and *Manrell*. Absent a clear domestic classification of non-competition payments, their proper treaty characterization poses difficult issues.

The treaty distributive rules that appear to have particular relevance to this situation are Arts. 7, 13 and 21. The applicability of these treaty provisions to outbound cross-border non-competition payments was discussed in a Technical Interpretation provided on the basis of the law as it stood before the legislative proposals dealing with restrictive covenants were first announced.[33] The Canadian government was asked to determine the domestic and treaty tax treatment of a non-competition payment made by a Canadian purchaser of a Canadian target to the former German parent of the target. Regarding domestic law, the government stated that Sec. 212(1)(d) of the Act would impose a withholding tax on the non-competition payment.[34] Regarding treaty law, the government was of the opinion that none of the distributive rules of the 2001 Canada–Germany tax treaty, which generally follows the OECD Model, applied to limit Canada's right to tax the payment.[35]

The outcome suggested by this Technical Interpretation would give rise to double taxation for non-resident recipients. If Canada finds that none of the distributive rules applies to the non-competition payment, Canada will not limit its taxing rights in respect of that payment. Accordingly, under the proposed legislation, the 25% withholding tax under Sec. 212(1)(i) will not be reduced. Moreover, the residence state of the recipient of the non-competition payment may not relieve the entire tax as the residence state would only be obliged to provide double taxation relief with respect to taxes levied "in accordance" with the treaty (Arts. 23 A and 23 B of the OECD Model).

This result is not satisfactory. In addition, there are strong arguments that, under the legislative proposals on restrictive covenants, this Technical Interpretation is incorrect. Regarding Art. 7, in the request for a Technical Interpretation, the taxpayer advised the government that Germany would include the non-competition payment in its business income. On this basis and since the foreign (German) parent had no permanent establishment in Canada, it was argued that Art. 7 of the Canada–Germany treaty prevented Canada from taxing the non-competition payment. The government responded that if Canada did not consider the non-competition payment to form part of the business income of the former parent, Canada would not apply Art. 7 of the treaty. Thus, according to the Canadian government, the domestic characterization of the payment by the residence state could not be used for purposes of determining the application of the treaty distributive rules by the source state.

Nonetheless, arguments to the contrary are tenable. As explained above, the legislative proposals on restrictive covenants do not provide a clear domestic tax classification of non-competition payments. This makes it difficult to characterize such payments for treaty purposes. Moreover, this situation may result in double taxation which is contrary to the general purpose of tax treaties. At the same time, the domestic law of the residence state may provide a clear classification of non-competition payments. This provides a "context" which may be strong enough to require that a meaning different from the domestic meaning be given to undefined terms in the distributive rules of the treaty. Specifically, since Germany treats non-competition payments as business profits, it may be desirable to use this meaning of "profits" in order to apply Art. 7 and thus give effect to the purpose of the treaty.[36] Under this approach, Canada would be barred from levying a withholding tax on non-competition payments made to a non-resident without a permanent establishment in Canada. Arguably, this should also be the appropriate outcome under the 1980 Canada–United States treaty (as amended) since, as noted in 2.1., non-competition payments are treated as service income for US tax purposes.

If Art. 7 does not apply, Art. 13 may be applicable. This was not the position adopted in the Technical Interpretation mentioned above. Both the taxpayer and the government were of the view that, since *Manrell* held that a non-competition covenant does not give rise to a taxable gain, Art. 13 of the treaty did not apply. If Canada uses its domestic law to determine the meaning of the word "gain", which usually it does,[37] Art. 13 does not apply. Reimer, however, set out powerful normative arguments showing that, in certain circumstances, there may be a "context" which requires that a different meaning of "gain" be used.[38] This would be the case where the non-competition covenant is connected to an alienation to which Art. 13 applies and where the residence state does not treat the restrictive covenant differently from the main transaction.

Finally, if no other treaty distributive rule is applicable, Art. 21 should be considered. In the above Technical Interpretation, the taxpayer suggested that Art. 21 did not apply as the *Fortino/Manrell* case law held that non-competition payments were on account of capital and thus were not "income". The government's response on this point was not clear,[39] but, in any event, the government did not need to formulate a clear posi-

32. Both cases dealt with payments in consideration for non-competition covenants provided by the shareholders of a target corporation which was sold in a share deal.
33. See note 25, supra.
34. The result would be the same under proposed Sec. 212(1)(i).
35. Pronouncements made by an official of the Department of Finance at a meeting of the Canadian Branch of IFA on 8 May 2006 seem to support this view.
36. This approach is supported by Para. 12 of the Commentary on Art. 3 of the OECD Model.
37. See *Haas Estate v. Canada*, 99 D.T.C. 1294 (T.C.C.).
38. Reimer, supra note 1, at 116.
39. The government's reply was: "Even if Article 21 of the Treaty does not apply, Canada would still not be precluded from taxing the non-compete payment under Part XIII."

tion as Art. 21 of the Canada–Germany treaty does not limit source taxation. The main question under Art. 21 is whether non-competition payments are "income" for treaty purposes. Unless the context otherwise requires, Canada must use the domestic meaning of the undefined treaty term "income"; "income", however, is not defined in the Act. Moreover, the Act uses "income" both to refer to the tax base and to designate a receipt from a productive source, as opposed to an amount on account of capital.[40] A recent decision of the Canadian Federal Court of Appeal indicates that "income" should be given the meaning referring to the tax base.[41] On this basis, a non-competition payment taxed under proposed Sec. 56.4 will be "income" for treaty purposes and Art. 21 will generally apply. The effect of this is that, under OECD Model-type treaties, Canada will be barred from imposing its withholding tax absent a permanent establishment.

In almost all of Canada's treaties, however, Art. 21 or its equivalent does not limit source taxation in respect of items of income derived from Canada.[42] The terminology of these provisions varies. Some treaties refer to items of income "arising" in Canada (see e.g. the Canada–United Kingdom treaty). Other treaties require that the amounts be derived from "sources" in Canada (see e.g. the Canada–France treaty). The different language makes it questionable whether a Canadian resident payer would always lift the restriction on the taxing rights of the source state (Canada). The decision in *Fortino* held that the non-competition payment was not income "from a source". Arguably, proposed Sec. 56.4 does not change this. If this is the case, treaties that use this terminology do not allow source-state taxation of non-competition payments.

4. CONCLUSION

The ongoing debate in Canada regarding the taxation of payments in consideration for restrictive covenants demonstrates the difficulties in classifying amounts for inaction for domestic tax purposes. The Canadian government has failed to adequately address this issue in the current legislative proposals dealing with restrictive covenants. This raises important problems regarding the application of Canada's tax treaties to cross-border payments for restrictive covenants. If the proposals are enacted in their present form, the new rules will apply in a broad variety of situations and may result in double taxation. The solutions to these problems suggested in this article would limit the proposed withholding tax on restrictive covenant payments in various circumstances, as discussed above. Considering this, the Canadian Department of Finance should review the cross-border implications of the restrictive covenant rules before tabling them in Parliament.

In a broader perspective, this discussion may be relevant to situations where a tax system (usually of a schedular type) taxes amounts without classifying them for domestic tax purposes.[43] Considering the characterization difficulties that may arise in applying a tax treaty in such circumstances, these situations may present a context that requires the source state to use a meaning of an undefined term in the distributive rules of the relevant treaty that is different from the domestic meaning.

40. See Hogg et al., supra note 27, Chap. 4.
41. *Beame v. Canada*, 2004 D.T.C. 6102 (F.C.A.).
42. See e.g. the relevant article in Canada's treaties with Germany (Art. 21(3)), France (Art. 21(2)), the Netherlands (Art. 21A(2)), the United Kingdom (Art. 20A(3)) and the United States (Art. XXII.1).
43. Considering the difficulties in classifying payments for inaction, this course of action is particularly tempting with respect to such payments.

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CCH Tax/Federal Income Tax/Tax Window Files/Tax Window Files/2000s/2004/March/[2003-0044351E5] Non-Compete Payments to Non-Residents

Non-Compete Payments to Non-Residents

March 24, 2004

Window On Canadian Tax Commentary

Document number: 2003-0044351E5

Income Tax Act: 212(1)

Information Circulars: IC 70-6R5, Advance Income Tax Rulings

Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA.

Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

PRINCIPAL ISSUES: Whether non-compete payments made to non-resident are subject to 212(1)(d)(iv)?

POSITION: Yes

REASONS:The payments are made pursuant to an agreement between a person resident in Canada and a non-resident person not to use any other thing whatever.

XXXXXXXXXX 2003-004435
S.E. Thomson

March 24, 2004

Dear XXXXXXXXXX :

Re: Non-Compete Payments to Non-Residents

This is in reply to your letter of October 28, 2003, in which you ask for our views on the taxation of non-compete payments paid to a non-resident. The hypothetical facts that you have presented to us are as follows:

? Cancol is a resident of Canada, and carries on business in Canada.

? Parentco is the parent company of Cancol, and is a resident of Germany. Parentco has never carried on business in Canada.

? Canco2 is a resident of Canada, and deals at arm's length with Canco1 and Parentco.

? Canco1 sells the assets of its business to Canco2.

? Canco2 pays a non-compete payment to Parentco.

You would like to know if the non-compete payment paid by Canco2 to Parentco is subject to Part XIII tax in Canada. In your view, Part XIII would not apply to the payment, for the following reasons:

1. The courts in Tod T. Manrell v. The Queen 2003 DTC 5225 found that the non-compete payments in that case were payments for the disposition of a right to compete. Although the right was capital property, it was a non-exclusive, commonly held right, and was therefore not included in the definition of "property" in subsection 248(1) of the Act, and did not give rise to a taxable capital gain.

2. Part XIII applies only to items of "income", not to payments on account of capital.

3. It is your understanding that Germany would include the non-compete payment in the business income of Parentco. Since Parentco does not carry on business in Canada through a permanent establishment, it is your view that Article 7 of the Canada-Germany Tax Agreement (the "Treaty") would prevent Canada from taxing the
non-compete payments.

4. The definition of the term "royalties" in Article 12 of the Treaty does not include non-compete payments.

5. Since the non-compete payment is not for the disposition of "property", Article 13 of the Treaty does not apply.

6. Since the non-compete payment is not "income", Article 21 of the Treaty does not apply.

7. Article 24 of the Treaty requires that Canada not subject German nationals to taxation more burdensome than nationals of Canada in the same circumstances. Therefore, since non-compete payments are not taxable when paid to a Canadian resident (prior to October 7, 2003), they should not be taxable when paid to a non-resident.

<u>OUR COMMENTS</u>

Your questions appear to involve actual taxpayers and a factual situation. As such, we are unable to definitively reply to your question until we have had the opportunity to review all the facts and related documentation. Such a review is conducted by the relevant tax services office where the query relates to a completed transaction, or by this directorate where the arrangement is the subject matter of an advance income tax ruling request submitted in the manner set out in Information Circular 70-6R5. We nevertheless offer the following general comments regarding the relevant provisions of the Act. Since these comments are general in nature, they may or may not apply in your situation and are not binding on the Canada Revenue Agency.

In our view the non-compete payment to Parentco would be subject to Part XIII withholding tax under subparagraph 212(1)(d)(iv) of the Income Tax Act (the "Act"). Subparagraph 212(1)(d)(iv) of the Act provides that a non-resident person shall pay an income tax of 25% on an amount paid by a person resident in Canada to the non-resident person that is made pursuant to an agreement between the person resident in Canada and the non-resident person under which the non-resident person agrees not to use any thing referred to in subparagraph 212(1)(d)(i). Subparagraph 212(1)(d(i) applies to any property, invention, trade-name, patent, trademark, design or model, plan, secret formula, process or other thing whatever. In our view, the right to compete is an "other thing whatever".

1. Subparagraph 212(1)(d)(iv) does not require that there be proceeds of disposition from the sale of property in order to apply. Rather, it applies when a payment is made pursuant to an agreement under which the non-resident person agrees not to use any other thing whatever, whether or not that "thing" is also property under the Act.

2. Part XIII applies whether the payment described is on account of income or capital, and this is apparent from a reading of several of the provisions of section 212.

3. If Canada does not consider the non-compete payment to form part of the business income of Parentco, Canada would not apply Article 7 of the Treaty, and would not be precluded from taxing the non-compete payment under Part XIII.

4. We agree that Article 12 of the Treaty does not apply.

5. We agree that Article 13 of the Treaty does not apply.

6. Even if Article 21of the Treaty does not apply, Canada would still not be precluded from taxing the non-compete payment under Part XIII.

7. Article 24 of the Treaty applies to "nationals" in the same circumstances. Non-compete payments to a German national who is a non-resident would be taxed the same as if they were paid to a Canadian national who is a non-resident.

Note that we have not considered how the draft amendments to the Act released on February 27, 2004 might impact on our response.

We trust that we have been of some assistance.

Yours truly,

Olli Laurikainen, C.A., Manager
for Director
International & Trusts Division
Income Tax Rulings Directorate
