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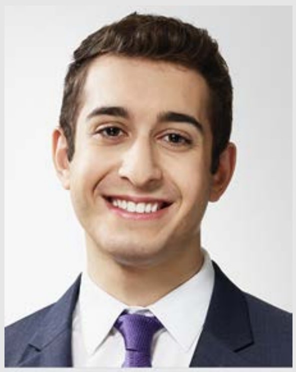

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In this article, the authors discuss the Canadian Federal Court of Appeal's judgment in *Pangaea One* and its implications. The case, which addresses the tax treatment of payments received by a taxpayer as consideration for executing a share purchase agreement, raises interpretive questions regarding an obscure and relatively new withholding tax rule.

On January 23 Canada's Federal Court of Appeal (FCA) released its reasons for judgment in *Pangaea One Acquisition Holdings XII SARL v. Canada*, 2020 FCA 21, *aff'g* 2018 TCC 158. The question before the courts was whether a payment received by the taxpayer as consideration for its agreement to execute a share purchase agreement constituted a payment for a restrictive covenant that was subject to withholding tax under paragraph 212(1)(i) of the Income Tax Act (Canada). The case raises an interpretive issue for an obscure and relatively new withholding tax rule that may be a trap for the unwary. This article discusses the case and considers its broader implications.

Background

In the 1990s creative Canadian tax planners came up with a bright idea: If part of the purchase price for a business were paid to its owner-managers specifically as consideration for their agreement not to compete with the purchaser, that payment could be treated as a nontaxable capital receipt. The idea was tested before the courts, and in two seminal decisions — *Fortino v. Canada*, 2000 DTC 6060, and *Manrell v. Canada*, 2003 FCA 128 — the FCA sided with the taxpayers by confirming the tax-free nature of those amounts.

On October 7, 2003, soon after the FCA decided *Manrell*, the Canadian Department of Finance announced rules to stop that type of planning. The initial legislative proposal was disproportionately harsh. After numerous redrafts over many years, ITA section 56.4 was finally enacted as part of the 2002-2013 technical bill.[1]

Basically, section 56.4 requires that all amounts a taxpayer receives regarding a restrictive covenant, as defined, be fully included in its income. ITA section 212(1)(i) extends the application of that provision to cross-border payments by imposing a withholding tax of 25 percent when a person resident in Canada pays or credits to a nonresident an amount for a restrictive covenant that would, if the nonresident were resident in Canada, be required by section 56.4(2) to be included in computing the nonresident's income. Moreover, section 212(13)(g) deems a nonresident payer of an amount that section 212(1)(i) would apply to if the amount were paid or credited by a person resident in Canada to be a

[1] Technical Tax Amendments Act, 2012 (Canada), S.C. 2013, c. 34, section 195.

resident of Canada (and thereby subject to withholding tax) if that amount affects, or is intended to affect: (1) the acquisition or provision of property or services in Canada; (2) the acquisition or provision of property or services outside Canada by a person resident in Canada; or (3) the acquisition or provision outside Canada of a taxable Canadian property.

While the legislative intention of section 56.4 is well understood to be to discourage the type of planning that succeeded in *Fortino* and *Manrell* by subjecting noncompetition payments to punitive taxation, the scope of the rule has remained highly uncertain because of the imprecise wording of the definition of the term "restrictive covenant," which is the trigger to the rule's application.

The Case

Pangaea One is the first case to analyze section 56.4, and it highlights the provision's far-reaching effects, particularly in cross-border transactions.

Pangaea is a nonresident company incorporated under the laws of Luxembourg. Pangaea, Thomvest Seed Capital Inc., and another shareholder owned the shares of Public Mobile Holdings Inc., a Canadian private company.[2]

In 2013 Canadian telecommunications giant Telus Communications Inc. offered to purchase all the shares of Public Mobile. However, under Public Mobile's unanimous shareholders' agreement, its shares could not be transferred without the prior written consent of the special majority shareholders, of which Pangaea was one.

In effect, Pangaea held a veto right over the transfer of Public Mobile's shares and made clear that it was unwilling to sell at the price offered by Telus. Thomvest entered into a letter agreement with Pangaea to pay $3 million in return for Pangaea's agreement to execute the proposed share purchase agreement (SPA) with Telus. The SPA was executed shortly thereafter.

Thomvest withheld 25 percent nonresident withholding tax on the $3 million payment to Pangaea. Pangaea filed an application for a refund of the withholding tax on the basis that it was entitled to a treaty exemption. The tax authorities refused the application, saying the payment was a restrictive covenant payment that did not benefit from any treaty relief. Pangaea appealed to the Tax Court of Canada (TCC).

Pangaea argued that the payment was not caught by section 56.4 because it was made under an agreement or undertaking that disposed of its property. The TCC sided with the government because it considered the payment taxable under section 56.4. Central to the TCC's decision was the preamble of the letter agreement, which referred to the amount being paid "as consideration for Pangaea's agreement to execute the SPA." Based on that, the TCC held that the letter agreement was an agreement or waiver of an advantage or right that affects, or is intended to affect, the taxpayer's acquisition or provision of property or services. It found an "obvious nexus" between the letter agreement and the subsequent sale of shares to Telus. Citing a lack of evidence, the TCC went on to decide that Pangaea had not disposed of its veto right under the letter agreement and that the payment thus did not fall under the exception in section 56.4(2).

In a short decision, the FCA dismissed Pangaea's appeal, which argued that the TCC erred by focusing on the letter agreement (which seemed to refer to the payment as consideration for Pangaea's execution of the SPA). According to Pangaea, the analysis should have focused on its waiver of its veto right under the unanimous shareholders' agreement. Because that waiver did not affect Pangaea's provision of property, it was not a restrictive covenant. The FCA reiterated that the letter agreement did not refer to veto rights and held that it was not an error for the TCC to focus on the agreement's terms.

The FCA rejected Pangaea's further argument that when read textually, contextually, and purposively, section 56.4 captures only noncompete agreements. It said the language clearly applies more broadly than that and was not persuaded by Pangaea's submissions on the provision's context and purpose.

In explaining its reasoning, the FCA said:

> The letter agreement between Pangaea and Thomvest is a "restrictive covenant," as defined, because the agreement is intended to affect the provision of property by Pangaea by having an effect on its disposition. The intention of the letter agreement is to require Pangaea to

[2]The shares of Public Mobile did not constitute taxable Canadian property.

sell its shares of Public Mobile by executing the share purchase agreement with Telus. In this way, the agreement is intended to affect the disposition by Pangaea of its shares of Public Mobile.

Commentary

The Meaning of Restrictive Covenant

Pangaea One is a missed opportunity by the FCA to provide a detailed analysis of the definition of the term "restrictive covenant" and thereby offer much-needed clarity regarding the proper scope of section 56.4, both domestically and cross border.

Under the relevant definition in section 56.4(1), a restrictive covenant requires two elements: (1) an agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer, whether legally enforceable or not; (2) that affects, or is intended to affect, 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.

The definition also contains two exclusions. One, which was argued in *Pangaea One*, applies to an agreement or undertaking that disposes of the taxpayer's property. The other, which was not relevant in the case, addresses an agreement or undertaking that is in satisfaction of a section 49.1 obligation.

The interpretive difficulties with the definition of restrictive covenant arise principally from the expression "affects, or is intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer."

First, the word "affects" is not used in that context anywhere else in the ITA (other than in section 212(13)(g)).[3] Merriam-Webster.com defines the transitive verb "to affect" to mean "to produce an effect upon: such as a: to produce a material influence upon or alteration in."

Obviously, the term is of highly uncertain scope and is unusual in the legislative drafting of the ITA. Arguably, it must take its meaning from the actual expression being defined — that is, "restrictive covenant," which is well understood in contract law. For instance, *Black's Law Dictionary* defines restrictive covenant by reference to noncompete covenants or, in the real-property sense, as "a private agreement, usually in a deed or lease, that restricts the use or occupancy of real property." Therefore, "affect" in this context should mean limit, prohibit, or restrict.

Next, the expression "acquisition or provision of property or services" is foreign to the ITA outside the restrictive covenant rules. In particular, the term "provision of property" is unknown to the ITA and is not equivalent to the notion of disposition of property, as the FCA seemed to suggest. That also seems clear from the first exclusion from the scope of a restrictive covenant, which juxtaposes those two expressions. The phrase "acquisition or provision of property or services" seems to have been borrowed from consumption tax law and appears to suggest the receipt and supply of goods and services in the context of commercial activity.

Our interpretation of the definition of a restrictive covenant is consistent with Pangaea's argument that it refers only to legal arrangements that restrict or limit the carrying on of a taxpayer's business. That reading is true to the provision's intention of covering noncompetes. Unfortunately, the FCA curtly dismissed Pangaea's submissions to the effect that the context and purpose of the provision indicate that it should apply only to address noncompetes. In doing so, the court did not follow its own jurisprudence in *Canada v. Lehigh Cement Ltd.*, 2014 FCA 103, in which it read the broadly worded specific antiavoidance provision of section 95(6) narrowly in light of the rule's clear object and purpose.

In short, the courts in *Pangaea One* should have found that the payment was not subject to withholding tax. Public Mobile's unanimous shareholders' agreement required the consent of the special majority shareholders for a transfer of shares in Public Mobile. In other words, for the Telus transaction to occur, Pangaea was required to act. The Thomvest payment was made to encourage that; it did not restrict or prohibit Pangaea from doing anything. The FCA improperly inverted and recast the legal effect of the relationship between Thomvest and Pangaea

[3] It does appear 17 times in the ITA, but the most common context is statements to the effect that a rule does not affect the application of another rule.

as one whereby Pangaea waived its veto right. In any event, the payment was made in the context of Pangaea's investment activity. It did not affect its ability to buy or sell property or services.

The Canada-Luxembourg Tax Treaty

While it appears from the TCC decision that the taxpayer claimed the refund of the tax withheld by Thomvest under the Canada-Luxembourg tax treaty, that issue was not brought before the courts. That is regrettable; judicial guidance on the interaction of the ITA's restrictive covenant rules as applicable in a cross-border context with Canada's tax treaties would have been welcome.

None of the specific distributive rules in the Canada-Luxembourg tax treaty applied to the Thomvest payment, hence the question is whether either the business profits (article 7) or other income (article 21) provisions would provide treaty protection to Pangaea.

A 2014 technical interpretation issued by the Canada Revenue Agency describes the government's view on that question.[4] The facts were seemingly identical to those before the courts in *Pangaea One*: The CRA was asked whether under the circumstances, the Canada-Luxembourg tax treaty eliminated the withholding tax imposed domestically on a Luxembourg resident.

The CRA said the payment was not exempt from Canadian withholding tax under treaty article 7 because the provision applies only to profits from carrying on a business. Because the Luxembourg resident held the shares on account of capital, there was no reason to believe the payment constituted income from a business.[5]

The government also rejected the taxpayer's further argument that article 21 of the Canada-Luxembourg tax treaty restricted Canada's ability to tax the payment. Article 21 provides that where a taxpayer's income is not addressed in other articles of the tax treaty, it may only be taxed in the country where the taxpayer is resident, unless the income is derived from sources within the other country.

The CRA's reasoning was threefold. It found that the payment for the restrictive covenant was derived from sources in Canada because the payer was a Canadian resident, the letter agreement concerned the sale of shares of a Canadian resident corporation, and both the letter agreement and SPA were governed by Canadian law.

While it is questionable whether the CRA's sourcing analysis is correct, it might explain why the treaty question was not further argued before the courts in *Pangaea One.*

Conclusion

Many commercial transactions can get caught in the seemingly wide net cast by Canada's restrictive covenant rule in ITA section 56.4. That includes payments for noncompete covenants and lump sum payments for exclusive distribution rights.

Regrettably, the FCA's decision in *Pangaea One* provides no clear guidance on the proper ambit of section 56.4 and leaves questions about the application of Canada's tax treaties to cross-border restrictive covenant payments. Those concerns are exacerbated by the deeming rule in section 212(13)(g), which could potentially lead to Canadian withholding tax applying to transactions between two nonresidents.[6]

It remains to be seen whether Pangaea will appeal to the Supreme Court of Canada. ■

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[4] Technical Interpretation 2014-0539631I7.

[5] Conversely, another more recent CRA technical interpretation, Technical Interpretation 2017–0701291I7, shows that restrictive covenant payments that are subject to withholding tax under the ITA may sometimes benefit from a treaty exemption for business profits. The CRA considered whether lump sum payment for exclusive distribution rights constituted an amount under a restrictive covenant. After concluding that section 56.4 is broad enough to apply to that kind of payment, the CRA said it would still be exempt under article 7 of an undisclosed tax treaty because it is a business profit that is not earned through a permanent establishment in Canada. *See* Barry D. Horne and Eric Feunekes, "Cross-Border Restrictive Covenants," 99 *Int'l Tax* (Apr. 2018).

[6] For example, a payment regarding an exclusive distribution agreement for all North America, including Canada, made by a nonresident distributor to a nonresident manufacturer. For a further discussion, see Michael N. Kandev, "Tax Treaty Issues Regarding Payments for Inaction: A Canadian Perspective on Restrictive Covenants," 60(7) *Bull. Int'l Tax'n* (July 2006).