TAX ADVISOR

Paid Not To Compete

Is a book of business a capital asset?

TAX COURT

BY JAMIE GOLOMBEK

Proper procedure states that if you are buying a financial planning practice or "book" of business, you obtain a non-compete agreement to guarantee that the vendor won't continue to solicit business from the client base that he or she has sold to you.

The taxation of the value of just such a non-compete clause was the subject of a 2007 tax case (*Morissette v. The Queen, 2007 FCA 16*), which was just recently released in its official English translation.

Louis Morissette was an investment advisor with Laurentian Bank Securities Inc. (LBS) from January 2000 to October 2002, when he was terminated. Upon termination, he was paid a "severance" of $20,000 immediately (in 2002) and an additional $5,000 after six months time (in 2003).

Morissette reported each amount as a capital gain in his 2002 and 2003 tax returns respectively, arguing that the payments should be classified as proceeds received in respect of the sale of his client list, since they were based on the assets under his management at the time that he left.

The CRA objected and felt that the $20,000 payment represented a severance payment and therefore should be fully taxable and the $5,000 payment represented payment by LBS to Morissette in respect of a non-competition agreement and thus is also fully taxable as employment income.

THE $20,000 PAYMENT

While Morissette claimed it was a "payment for the purchase of clientele," LBS issued a T4A for 2002 in respect of this amount and classified it as "other income." There was no mention of it being a payment in respect of his clients.

In fact, LBS's vice-president of finance testified before the court that this amount was "severance pay calculated based on the commission income for the year of termination."

The Tax Court judge agreed and found the $20,000 to be fully taxable as employment income. Morissette appealed this decision to the Federal Court of Appeal.

During the appeal case, Morissette argued that the lower court judge made an error since he was not entitled to any severance and therefore, "the only possible explanation for the amount that was paid to him is the value for LBS of the clientele that he agreed to relinquish." He also argued that he was not employed long enough at LBS and did not generate enough revenue for the company to warrant such a large severance sum.

The Federal Court agreed and concluded that the $20,000 was not severance; however, it still concluded that the amount was fully taxable as employment income since it was payment to Morissette "for his covenant not to solicit the clients that were under his management."

This is consistent with the rules under the *Income Tax Act*, which provided that such a covenant, when exchanged for cash in conjunction with an employee's termination, is taxable as employment income.

THE $5,000 PAYMENT

The Tax Court judge looked to the terms of the termination agreement, which stated that LBS would pay Morissette "an additional amount of $5,000 in six … months, provided LBS has retained at least 75% of (his) assets under management." LBS even classified the $5,000 payment as "final payment – sale of clientele."

The Tax Court, referring to the Supreme Court's reasoning in the now-infamous 2004 Gifford decision (*Gifford v. The Queen, 2004 SCC 15*), concluded that although the clients may belong to the financial institution, an "investment advisor owns a certain right to the goodwill, and that right can be sold."

Accordingly, the Tax Court judge found that the $5,000 was indeed paid by LBS in respect of the sale of Morissette's client list and therefore was properly reported by him as a capital gain in his 2003 tax return.

While the CRA stated that it disagreed with this part of the Tax Court's decision, it chose not to appeal. AER

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