CANADA'S LUXURY TAX: PRACTICAL CHALLENGES FOR THE AVIATION INDUSTRY

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Canada's Luxury Tax: Practical challenges for the aviation industry

Canada's federal *Select Luxury Items Tax Act* (commonly referred to as the "Luxury Tax"), took effect on September 1, 2022. This law generally applies a tax of up to 10% of the value of certain passenger aircraft and automobiles having a value of over $100,000, and boats having a value of over $250,000, upon the sale, importations and leases of such vehicles, unless a specific exemption applies under the law.

To date, the Luxury Tax remains poorly understood notwithstanding that it is expected to have a broad impact on key industries. This can be attributed in large part to a lack of clear and timely guidance from the federal Department of Finance and the Canada Revenue Agency ("CRA").

Setting the record straight

The Luxury Tax was first introduced in the April 2021 budget announcement, purportedly as a tax on wealthy purchasers of luxury vehicles as a means of offsetting government spending on COVID-related measures. However, it became apparent upon the release of the draft legislation nearly a year later that the Luxury Tax generally does not apply to buyers or lessees of these vehicles. Rather, legal liability for the Luxury Tax generally rests with the registered vendors, lessors and importers. As such, the terms of the commercial transaction between the registered vendor or lessor and their client will be critical to ensure that the vendor's or lessor's ability to recoup its Luxury Tax cost will be adequately disclosed and provided for.

Moreover, the Luxury Tax generally applies to passenger aircraft having no more than 39 seats, sold under an agreement entered into on or after January 1, 2022 and manufactured after 2018, except for a pre-owned aircraft that meets the following criteria: (i) it is registered with a government before September 2022 otherwise than solely for a purpose incidental to its manufacture, offering for sale or transportation, and (ii) it was in the possession of a "user" before September 2022.[1] So, an unsold demonstrator aircraft that was held by a manufacturer or dealer would not meet the foregoing exception unless the aircraft was manufactured before 2019 (otherwise, an alternate exemption might still apply). Given that newer aircraft would generally be expected to be more fuel efficient and to have more safety features than older aircraft, it is unclear from a

policy perspective why the government chose to favour pre-owned aircraft in this manner.

Finally, any thought of registering an aircraft outside of Canada with the intent of avoiding the Luxury Tax would be ill-advised. First, the Luxury Tax Act incorporates a broad notion of importation which is based on that under the *Customs Act*.[2] Second, the mere use of an aircraft in Canada by an owner might trigger the Luxury Tax, irrespective of where the aircraft is registered.[3] Third, the Luxury Tax was designed with a series of specific and general anti-avoidance measures, and it imposes potentially high penalties for offences.

Political backdrop

In May 2022, the Parliamentary Budget Office produced a report which estimated that the Luxury Tax would result in lost aircraft sales of $30 million per year. This estimate was surprisingly low since it amounts to less than the typical purchase price of a single mid-size jet. By contrast, my own informal survey of aircraft manufacturers put the retail value of already cancelled transactions attributable to the Luxury Tax at over $1 billion.

It is of note that the two major labour unions representing the aviation industry in Canada, Unifor and the International Association of Machinists and Aerospace Workers, have issued clear statements opposing the Luxury Tax and voicing their concerns as to the adverse impact that it would have on the aviation industry and on the Canadian economy.

In that light, the final Luxury Tax legislation, which was passed into law in late June 2022, included a provision which was intended to delay its implementation to aircraft until sometime after September 1, 2022. The latter was based on a motion passed by the House of Commons' Standing Committee on Finance in late May 2022 so as to allow for further time to study the impact that the tax would have on the aviation industry. Notwithstanding the foregoing, the government announced on July 14, 2022 that the tax would nonetheless apply to aircraft transactions as of September 1, 2022.

Technical deficiencies and practical issues

While a number of technical issues had been brought to the attention of the federal Department of Finance during a formal consultation period before the Luxury Tax was passed into law, these were not remedied in the final legislation. These concerns include the following:

(1) The business use exception is overly restrictive and would, in many cases, be inapplicable to genuine commercial uses of aircraft

The Luxury Tax generally does not apply in respect of the sale of a "qualifying subject aircraft", which includes certain aircraft which, at the time of sale and for the year that follows, are expected to be used 90% or more of

the time for "qualifying flights".[4] Qualifying flights for this purpose would include an air ambulance service, an aerial fire fighting service, an air flight training service, or where certain commercial use criteria are met. With regard to the latter commercial use criteria, the following concerns should be noted:

a. The imposition of a 90% threshold for this purpose is relatively harsh compared to the "primary use" standard (i.e., 50%) which generally applies to other tests for the commercial use of assets under the *Income Tax Act* and the *Excise Tax Act*.
b. The definition of a "qualifying flight" includes one that is "conducted in the course of a business of an owner" of the aircraft and which is carried on with a reasonable expectation of profit.[5] However, the term "owner" is not defined for this purpose. So, it is unclear whether that term refers to the immediate legal owner or to an indirect or beneficial owner. This could be a critical oversight in the Luxury Tax legislation, since business use aircraft are typically held in a distinct entity for risk management purposes. As a consequence, the commercial use exception might arguably only apply where the aircraft owning entity is itself engaged in a business activity unless the business activity of an affiliate of the aircraft owner were considered to qualify in this regard.
c. The definition of a "qualifying flight" excludes one that is operated for the "leisure" or "other enjoyment" of an owner or the guest of an owner.[6] As such, a particular flight might be disqualified as a qualifying flight due to the underlying purpose of the passenger's flight, even if that flight is conducted on arm's length, commercial terms. By contrast, the applicable test for the deductibility of aircraft-related expenses for income tax purposes looks whether the aircraft entity—and not the passenger—incurred the particular expense for purposes of its business.
d. Charter service providers fulfill an important need in the Canadian market for alternative means of private air travel, especially given that much of the country is underserved by commercial airlines. However, a "qualifying flight" for purposes of the Luxury Tax only includes charters that are (i) sold by the seat, and (ii) where all or substantially all of the passengers on the flight are individuals that deal at arm's length with the operator and with all owners of the aircraft.[7] This is inconsistent with how the charter industry actually operates, since charters are typically sold by the flight and not be the seat. Restricting the charter exception in this manner will ensure that the Luxury Tax will apply in many instances where an aircraft is to be used on arm's length, commercial terms (such as to transport sports teams to away games, and for employees of mining companies to access remote job sites).

(2) Timing concerns and related audit risk

Whether an aircraft would constitute a qualifying subject aircraft, and thus be exempt from the Luxury Tax, on the basis that it is anticipated to meet the required level of use for qualifying flights, is determined prospectively. However, whether that criteria will actually be met could only be determined in hindsight. It is

thus expected that this disconnect will result in a significant increase in audit activity by the CRA to monitor ongoing compliance with these tests. Moreover, a "change of use" could unexpectedly trigger the Luxury Tax in respect of an aircraft that ceases to be a qualifying subject aircraft.[8] Unfortunately, there is no corresponding provision which would provide for a refund of Luxury Tax paid upon the sale of an aircraft where, as a result of a later change of use, an aircraft that is initially non-qualifying subsequently becomes a qualifying subject aircraft (unlike the GST/HST regime, which generally provides for the recovery of GST/HST paid on the acquisition of capital property in the event of a later change in use to a commercial activity).

(3) Absence of legal recourse against purchasers

Legal liability for the Luxury Tax rests with the registered vendor, lessor or importer of an aircraft. By contrast, under the GST/HST regime, the purchaser is liable for the tax and the vendor is merely the mechanism by which it is collected. Moreover, under the GST/HST regime, the vendor is provided with legal recourse to collect the tax from the purchaser, but there is no parallel mechanism under the Luxury Tax legislation, meaning that the registered vendor will be liable for the Luxury Tax and will bear the risk that such amount may not be recoverable from the purchaser. This is especially burdensome given that the registered vendor will be jointly liable for the Luxury Tax plus a penalty of 50%[9] if it knows, *or ought to have known*, that a purchaser's claim of being exempt from the Luxury Tax is false. Given the potentially high cost of the latter, registered vendors under the Luxury Tax regime would be well-advised to take steps to evidence proper due diligence in this regard.

(4) Challenges for importers

In order for the importation of an aircraft to be exempt from the Luxury Tax, the importer would first need to obtain a special import certificate from the CRA.[10] The imposition of an application mechanism in order for importations to be exempt in this manner is impractical. While the delay for processing the latter application is not yet known, it is noted that the process to obtain other tax clearance certificates from the CRA can be lengthy. As a result, in many instances the importer of an aircraft, which would otherwise qualify for a special import certificate and thus be exempt from the Luxury Tax, may find themselves unable to wait for one in order to avoid a delay which might jeopardize the transaction.

(5) Challenges for lessors

The Luxury Tax generally becomes payable by a lessor upon providing a right to use an aircraft under a lease[11] (unless the transaction is otherwise exempt). This upfront imposition of tax creates particular challenges for the cashflow of lessors. First, the Luxury Tax that will be due in this regard is based on the full value of the aircraft, rather than the value of the lease contract, even though the lessor may not be amortizing the full cost of the aircraft over the term of the lease. Second, in terms of timing, the lessor would be faced with the

difficulty of either trying to recoup its Luxury Tax liability in a single, upfront payment from its customer, or through increased lease payments (in which case the lessor would be financing the cost of the Luxury Tax until it is fully recovered from the lessee client).

(6) Challenges for sales of fractional interests in aircraft

It will generally be difficult for fractional aircraft sales to be exempt from the Luxury Tax because these arrangements are not properly contemplated in the legislation. For example, where there is a sale of an aircraft to multiple purchasers, the Luxury Tax applies at the time of sale unless an exemption certificate applies in respect of each purchaser at that time, [12] so a group of purchasers who would otherwise qualify for an exemption could be tainted by a single non-qualifying purchaser.

(7) Challenges for flight training schools

Ostensibly, the Luxury Tax is not intended to apply to acquisitions of aircraft principally for use by flight training schools. However, the latter would only apply to the extent that 90% or more of the expected use of the aircraft would consist of qualifying flights. [13] It should be noted that flight schools often do not own the aircraft that they use for flight training; rather, they lease the aircraft from other owners, while allowing the owners to use the aircraft when not otherwise booked for training purposes. Accordingly, if at least 90% of the overall flights on the particular aircraft, including those of the owner, are not used in the course of the flight school's activities (or for other enumerated qualifying purposes), then the aircraft would thus not be exempt from the Luxury Tax.

Takeaways

As noted above, the Luxury Tax is complex and onerous, and it remains poorly understood by members of the aviation industry. It is strongly recommended that vendors, lessors and importers of aircraft in Canada fully acquaint themselves with applicable registration, reporting, compliance and other obligations under the Luxury Tax to avoid the potentially harsh penalties which might otherwise apply. As well, it is crucial that registered vendors and lessors properly disclose in commercial agreements with their clients that any Luxury Tax cost will be charged as part of the transaction. Finally, with proper planning and analysis, it might still be possible to mitigate the potential application of the Luxury Tax to specific transactions in many instances.

[1] By virtue of the definition of a "subject aircraft" in section 2 of the *Select Luxury Items Tax Act*, S.C. 2022, c. 10, s. 135 (the "Luxury Tax Act"). All statutory references herein are to the Luxury Tax Act.
[2] Subsection 20(1).
[3] Subsection 26(1).
[4] See subsections 10(4) and 19(1), and paragraph 36(1)(c).
[5] Paragraph 10(3)(d).

[6] *Ibid*.
[7] Paragraph 10(3(b).
[8] Subsection 26(1).
[9] Paragraph 110(b).
[10] Subsection 21(5) and section 38.
[11] Subsection 25(1).
[12] Subsection 36(2).
[13] Subparagraph 10(3)(a)(xi).

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.