WHAT THE PENDING LUXURY TAX MEANS TO HIGH-END RETAIL VEHICLE DEALERS AND THEIR FINANCING ENTITIES

Posted on April 8, 2022

Categories: Insights, Publications

Overview of the Luxury Tax, its Implementation, and Focus of this Bulletin

On March 11, 2022, the federal Department of Finance released draft legislative proposals known as the *Draft Select Luxury Items Act* (the "**Proposed Act**") to implement the Luxury Tax (the "**LT**") on vehicles, aircraft and vessels as announced in the April 2021 federal Budget. The LT would apply on certain transactions involving cars and aircraft priced or valued at $100,000 or more, and boats priced at $250,000 or more. The tax would be calculated as the lesser of (1) 20 percent of the value above the applicable price or value threshold, or (2) 10 percent of the full price or value of the vehicle, aircraft or vessel.

Originally, under the Budget Announcement, the LT was to take effect January 1, 2022. The legislative proposals delayed implementation until September 1, 2022 (the "**Implementation Date**").

This bulletin focuses on the impact of the proposed LT on vehicle transactions, focusing on the practical implications and concerns for high-end retail vehicle dealers. For guidance specifically on the proposed LT on aircraft transactions, refer to our Bulletin Not Yet Cleared for Takeoff: Draft Canadian Luxury Tax Legislation Raises Concerns for the Aviation Industry.

Overview of the Luxury Tax Imposed on "Subject Vehicles"

What Vehicles are and are not covered?

The LT is intended to be a one-time tax imposed on a "subject vehicle" above the $100,000 price threshold with a date of manufacture after 2018. A "subject vehicle" is a motor vehicle with four or more wheels designed or adapted primarily to carry individuals on highways and streets, has a seating capacity of not more than 10 individuals, and a weight not exceeding 3,856 kg. Therefore, motorcycles and commercial trucks and buses would generally be excluded, as would recreational and commercial vehicles designed for off-road use.

Specifically excluded are ambulances, hearses, police cars, fire trucks, and recreational home vehicles. Also excluded is a motor vehicle that is registered before the Implementation Date with a governmental authority, and in respect of which possession is transferred to the user of the vehicle before the Implementation Date.

Thus, there may be a flurry of high-end vehicle leases and purchases completed before the Implementation Date to avoid the imposition of the LT. There are, however, transitional rules that relieve the LT on transactions entered into under agreements before April 20, 2021 (the Budget Announcement).

There are also exemptions for vehicles acquired by a policing or military authority where the vehicle is equipped for policing or military activities, as applicable.

What Transactions are Taxed? Who is Taxed?

The LT is generally imposed on registered retail business vendors or lessors of a “subject vehicle” priced at or above the $100,000 threshold. The LT would arise at the time of the vehicle sale or commencement of the lease to a retail purchaser/lessee (consumer or end-user). Registered dealers selling or leasing such vehicles would be responsible for reporting and payment of the LT with quarterly returns due one month after each quarter.

After-sale improvements (other than repairs) made within one year after sale or commencement of the lease of the vehicle can also be taxed.

Tax Base

The price is calculated in reference to any excise taxes and customs duties included in the price (e.g., the $100 federal excise tax on vehicle air conditioners and any federal excise tax imposed on a fuel-inefficient vehicles). The price is calculated without reference to any provincial retail sales tax ("**PST**"), the Quebec sales tax ("**QST**") and the federal goods and services or harmonized sales tax ("**GST**" or "**HST**"), which are imposed on the LT. The price also includes delivery or freight charges.

Exempt Sales between Two Registered Persons

Where a registered dealer (vendor) sells a subject vehicle to another person registered in respect of subject vehicles under the Act, the purchaser could provide a prescribed purchase exemption certificate to the vendor to exempt the sale from LT. The certificate would include the registration number of the purchaser and unique identification number of the vehicle. In the certificate, the registered purchaser would acknowledge that the purchaser is assuming any liability to pay any amount of LT that is or may become payable by the purchaser. The vendor would retain the exemption certificate for audit purposes.

Dealer – and Finance Entity – Specific Concerns

The Dealer is Generally the Taxpayer, not the Customer

Unlike GST/HST, the LT is generally imposed directly on the registered dealer. It is not intended to be a direct tax on the consumer or end-user. The LT is imposed on the dealer at the time of the retail transaction (when the sale is completed or lease is commenced). The dealer is the "taxpayer", unlike GST/HST where the registered dealer is a tax collection "agent" on behalf of the Federal Government for taxes payable by the dealer's customers.

That distinction could impose greater risks on dealers, and could warrant the dealers addressing them in their commercial terms in their sale and lease agreements with customers. For example, under the GST/HST legislation, vendors/lessors, as the GST/HST collection agents on the Government's behalf, have direct recourse against their customers, the "taxpayers", to pursue payment of GST/HST. Under the Proposed Act, the LT would be imposed on the registered dealers, and absent specific terms in their agreements with customers, they could have no recourse against customers for any shortfall in recovery of the LT. If, for example, the LT was miscalculated and not fully embedded in the price, then the dealer would bear the cost of that shortfall, absent a specific indemnification or other contractual recourse mechanism against the customer.

The LT is Payable Upfront

As stated in the April 2021 Budget Announcement,

> "Upon purchase or lease, the seller or lessor would be responsible for remitting the full amount of the federal tax owing, regardless of whether the good was purchased outright, financed, or leased over a period of time."

Under a lease, the GST/HST/QST/PST is payable by the lessee on the periodical lease payments. However, the LT would be payable by the dealer upfront, and either be recouped upfront, or recovered through increased lease payments by the dealer or a financing entity to whom the vehicle and lease are assigned.

The cash flow and financing implications of the LT would have to be carefully considered and managed. The amount of GST/HST/QST/PST would be increased as the result of any upfront payment made by the lessee on account of the LT or any increases to the ongoing lease payments to recoup and finance the LT paid upfront by the dealer to the Federal Government.

Under a conditional sale, the LT and GST/HST/QST/PST on the sale price, inclusive of the LT, would have to be paid by the dealer upfront. Consideration would need to be given to whether, and to what extent, the LT would be reimbursed upfront by the customer or financed over time under the financing terms. Once again, the cash flow and financing implications would have to be carefully considered and managed by the dealer and/or financing entity.

How would the LT Rebates for Export Sales be Passed-Through to Retail Customers?

It would undermine the competitiveness of Canadian dealers if their sales to customers of high-end vehicles for export were subject to the LT.

Where a registered dealer sells a subject vehicle to a customer that is subject to the LT on the completion of the sale, and the purchaser subsequently exports the vehicle, the dealer may apply for a rebate of the tax in the dealer's reporting period in which the vehicle is exported, subject to meeting the following conditions:

1. The purchaser cannot be a registered vendor of the subject vehicles.
2. The registered dealer has reported and accounted for the tax as part of its net tax for the reporting period in which the LT became payable.
3. The subject vehicle is not used in Canada between the time of its sale and exportation, except to the extent reasonably necessary or incidental to its manufacture, offering for sale, transportation or exportation.
4. The subject vehicle is not registered with the Government of Canada or any province between the time of its sale and exportation, except if the registration is done solely for a purpose incidental to its manufacture, offering for sale, transportation or exportation.
5. The purchaser exports the subject vehicle as soon after the sale is completed as is reasonable having regard to the circumstances surrounding the exportation and, if applicable, the normal business practice of the purchaser and vendor, and
6. The purchaser provides to the dealer, and the vendor retains, evidence satisfactory to the Minister of National Revenue (the "**Minister**") of the export of the subject vehicle from Canada by the purchaser, or
7. Prescribed conditions are met.

There is the issue of how effective this rebate mechanism would be to level the competitive landscape with foreign competitors of dealers. Certain of these conditions overlap with the point-of-sale GST/HST relief for zero-rated exported supplies of goods made by vendors (i.e. taxed at a 0% rate for GST/HST purposes). Whereas GST/HST relief is allowed at point-of-sale, the LT rebate mechanism means that the LT is still imposed by the dealer on the completion of the sale, subject to recovery by rebate at a later time, if all the conditions for the export rebate are met.

How would the dealer and purchaser address this timing difference? Would the dealer collect the LT amount upfront in the price, and refund the amount of the LT after receiving the rebate? That would incentivize the purchaser to satisfy the vendor that all the conditions have been satisfied after the completion of the sale. The sale agreement would have to satisfactorily cover off the export rebate mechanism between the parties. The vendor would assume residual risk for subsequent disallowance of the rebates, subject to any protection available from the purchaser under an indemnification.

Security Requirements for Registered Vendors/Dealers

As security for any tax or other amounts that may become payable by a registered retail vehicle dealer, the dealer may need to post security with the Minister. If the security requirement were not satisfied, then the Minister could withhold refunds owing to the dealer under the Proposed Act or other federal fiscal legislation, including the GST/HST legislation, to apply toward the required amount of security.

Used Vehicle Dealers

Used vehicle dealers would have to be satisfied that LT has appropriately been paid on a subject vehicle that has previously been registered with the Government of Canada or any province, or which has been imported, otherwise its sales could be subject to the LT.

Takeaways

Due to the unique nature of the LT, there are consequential challenges, concerns and risks that dealers and their financing entities need to address. In addition to what we have discussed above, non-compliance can give rise to offences and significant penalties. Dealers and their financing entities have to be pro-active in exercising appropriate due diligence, and in designing contractual terms to alleviate concerns and risks, while passing-on any potential tax savings, such as on export sales, to customers to facilitate sales.

The additional costs imposed on high-end vehicle sales and leases could ultimately be detrimental to sales and leases of these vehicles in Canada. These effects could adversely affect the automotive industry and the economy more broadly on a long-term basis. The imposition of the LT appears to run counter to the Federal Government's strategy to promote the growth of the automotive sector in Canada. The automotive sector is of critical importance to the Canadian economy. Jobs and direct and indirect investment in the automotive industry are at stake. It is particularly unfortunate to burden the automotive industry at this time, as the industry is still coming out of the damaging effects caused by the extended COVID lockdowns, and the lingering consequential supply chain issues.

Another concern is the $100,000 price threshold. There is no indexing for inflation. With annual inflation currently running at over 7% in Canada and supply chain issues worldwide, including chip shortages, how long until the $100,000 price threshold is no longer considered an adequate threshold for determining whether a vehicle is a "luxury", as opposed to a barrier inhibiting middle class vehicle purchases and leases?

The Department of Finance has invited commentary on the draft legislation through to April 11, 2022 by emailing fin.luxury-luxe.fin@fin.gc.ca. Automotive dealers and other stakeholders may wish to convey their concerns that the LT would have, if enacted, to their Members of Parliament.

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