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FACING THE AIRCRAFT LUXURY TAX

TECHNICAL CHALLENGES REMAIN FOR BUYERS, BUT MOSTLY FOR VENDORS, LESSORS AND IMPORTERS

BY STEVEN SITCOFF

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 per cent 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, importation and lease of such vehicles, unless a specific exemption applies under the law.

In August 2022, I was asked by a reporter from a major news outlet whether Canadian businesses were ready for the tax: How could they be when the Canada Revenue Agency (CRA) was, at that point, still issuing forms and guidance documents for a tax that they knew was coming for more than a year.

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 CRA.

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 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 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 the vendor'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

WITH PROPER PLANNING AND ANALYSIS, IT MIGHT BE POSSIBLE TO MITIGATE THE IMPACT OF THE LUXURY TAX.

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. 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, irrespective of where an aircraft is registered, it might still be considered to be imported for purposes of the Luxury Tax; and the mere use of an aircraft in Canada by an owner might also be sufficient to trigger the tax. Second, the Luxury Tax was designed with a series of stringent anti-avoidance measures, and it imposes potentially high penalties for offences.

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 more than \$1 billion.

It is not often that a major labour union opposes a tax supposedly targeting wealthy consumers. In this instance, however, two major labour unions representing the aviation industry in Canada, Unifor and the International Association of Machinists and Aerospace Workers, issued clear statements opposing the Luxury Tax and voicing concerns as to the adverse impact it would have on aviation and Canadian economy.

In that light, the final Luxury Tax legislation, which passed into law in late June 2022, included a provision that was intended to delay its implementation 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.

Six primary technical issues were brought to the attention of the federal Department of Finance during a consultation period, but, when the Luxury Tax was passed into law, these issues were not remedied in the final legislation. These concerns include:

(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 per cent or more of the time for "qualifying flights". Qualifying flights for this purpose would include an air ambulance service, aerial firefighting, air flight training, 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 per cent threshold for this purpose is relatively harsh compared to the "primary use" standard (50 per cent), 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. However, the term "owner" is not defined for this purpose and it is thus unclear whether that term refers to the immediate legal owner or to an indirect or beneficial owner. This could be a critical oversight in Luxury Tax legislation, since business use aircraft are typically held in a distinct entity for risk management purposes. As a consequence, this exception might arguably only apply where the aircraft-owning entity is itself engaged in a qualifying business activity.

(c) The definition of a "qualifying flight" for purposes of the 90 per cent threshold excludes one that is operated for the "leisure" or "other enjoyment" of an owner or their guest. 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 passenger pays fair value for that flight.

(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, for purposes of the Luxury Tax, a charter flight is a qualifying flight if it is (i) sold by the seat, and (ii) 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. This is inconsistent with how the charter industry operates, since charters are typically sold by the flight and not by the seat.

(2) Unfair 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 CRA audit activity to monitor ongoing compliance. Moreover, a "change of use" could unexpectedly trigger the Luxury Tax in respect of an aircraft that ceases to be a qualifying subject aircraft. 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.

(3) Absence of legal recourse against purchasers. Legal liability for the Luxury Tax rests with the registered vendor, lessor or importer of an aircraft. Moreover, the registered vendor or lessor will bear the risk that such amount may not be recoverable

from their client because there is no legal means of recourse provided for under the Luxury Tax legislation. This is especially burdensome given that the registered vendor will be jointly liable for the Luxury Tax plus a penalty of 50 per cent 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 of aircraft. 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. The imposition of an application mechanism in order for importations to be exempt in this manner is impractical and, noting the significant delays typically involved in obtaining other tax clearance certificates from the CRA as well as the time pressures on aircraft transactions in the current market, concerns over processing delays could put importers in the position of having to forego the certificate process and absorb the Luxury Tax or otherwise jeopardize the transaction.

(5) Challenges for lessors of aircraft. The Luxury Tax generally becomes payable by a lessor upon providing a right to use an aircraft under a lease (unless the transaction is otherwise exempt). This upfront imposition of tax creates particular challenges for the cash flow of lessors, in terms of timing (i.e., will the lessor seek to recover its Luxury Tax cost upfront, or will it do so as part of the lease payments, in which case it is financing that cost until it is fully recovered), and in terms of the amount (since the Luxury Tax that will be due is based on the full value of the aircraft, as opposed to the value of the lease contract).

(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 nor accommodated in the legislation.

The Luxury Tax is complex, onerous and poorly understood by the aviation industry. Vendors, lessors and importers of aircraft in Canada should fully acquaint themselves with applicable registration, reporting, compliance and other obligations under the Luxury Tax to avoid potentially harsh penalties. It is crucial that registered vendors and lessors properly disclose in commercial agreements with clients that any Luxury Tax cost will be charged as part of the transaction. | **W**

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