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THE RELEASE OF DRAFT LUXURY TAX LEGISLATION CONTINUES TO RAISE SERIOUS CONCERNS FOR THE CANADIAN AVIATION INDUSTRY

BY STEVEN SITCOFF

On March 11, 2022, the federal Department of Finance released draft legislative proposals to implement the proposed Luxury Tax. First the good news: the Luxury Tax would be applicable only from September 1, 2022, and would not be retroactive to January 1, 2022 (as was previously the concern). Now the bad news: Pretty much everything else.

The Luxury Tax, which was introduced in the 2021 federal Budget, proposes to add a tax calculated as the lesser of 20 percent of the value above the latter price thresholds or 10 percent of the full value of the vehicle for cars and aircraft priced at $100,000 or more, and boats priced at $250,000 or more.

The following transactions in respect of an aircraft exceeding the applicable $100,000 threshold will generally be subject to the Luxury Tax (unless a specific exemption otherwise applies):

1. The sale of an aircraft, or a part interest therein (i.e., fractional sales can be subject to the Luxury Tax);
2. The importation of an aircraft into Canada;
3. The lease of an aircraft; and
4. After-sale improvements to an aircraft made within one year of acquisition (other than repairs).

Threshold for the application of the Luxury Tax

The presumed intent for the minimum price thresholds that limit the application of the Luxury Tax is to provide a safe harbour so as to exempt a reasonable range of vehicles from the ambit of the Luxury Tax. While the thresholds of $100,000 for cars and $250,000 for boats may arguably bear some relation to the range of such vehicles sold in the market, the same cannot be said for aircraft. Bearing in mind that the price threshold is not indexed to inflation and that aircraft transactions in Canada are frequently priced in U.S. dollars, the $100,000 limit is something of a moving target.

In any event, such considerations are more of a theoretical than a practical concern, as the starting price for new aircraft is typically closer to $1 million. If the intent of imposing a constraining

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threshold is to provide a genuine safe harbour for aircraft, the threshold should instead be set closer to $5 million. Moreover, while the Luxury Tax would not apply to aircraft manufactured before 2019, it would have been more effective to draft a grandfathering clause that excludes aircraft manufactured outside of a specific number of years preceding the year of acquisition, since the 2019 limit will effectively become meaningless with the passage of time.

Consequences for vendors and lessors

Canadian vendors and lessors of aircraft will generally be liable for the Luxury Tax (and, presumably, they will pass that cost on to their clients). Where an aircraft is instead imported into Canada (aside from certain temporary importations), the importer will generally be responsible for the Luxury Tax. A key exception to the application of the Luxury Tax to sales and importations will be where an exemption certificate is available (discussed below).

The registration regime in respect of the Luxury Tax previously announced for vendors will allow for the deferral of the Luxury Tax on importations and acquisitions of inventory until a sale is ultimately made to a non-registrant purchaser. Additional reporting and other compliance obligations would apply to vendors, in addition to some particularly harsh penalties for omissions and compliance failures (described below). As such, vendors should take the time to familiarize themselves with these obligations and ensure that proper internal systems are put in place.

A lessor will be responsible for the Luxury Tax (unless an exemption otherwise applies) at the time that it makes an aircraft available under a lease based on the "retail value" of the aircraft, which presents two challenges for the lessor from a cash flow perspective. First, the Luxury Tax is based on the full value of the aircraft, rather than the value of the leasing contract. Second, the lessor will need to decide whether they are willing to finance the recoupment of the Luxury Tax from their client by including a charge with the periodic lease payments rather than in a single upfront payment.

One important change in the draft legislation from earlier proposals settles previous concerns over the prospect of retroactivity. The earlier proposals were based on an effective start date of January 1, 2022, for the Luxury Tax. However, the draft legislation has a revised effective date of September 1, 2022. Moreover, aircraft delivered after that date under contracts made prior to April 20, 2021, (i.e., prior to the announcement of the Luxury Tax) will generally remain exempt from the Luxury Tax.

Previously announced exceptions from the Luxury Tax for certain qualifying users (e.g., governments, police departments, fire departments) or qualifying flights (e.g., air ambulance service, aerial firefighting) remain accounted for in the draft legislation.

Unfortunately, the exception for charters is still limited to charters sold by the seat to individuals who deal with all owners of the aircraft at arm's length. Given that the industry generally operates charters by the plane rather than by the seat, this exception will likely prove to be largely illusory.

Consequences for fractional aircraft sales

Based on the draft legislation, it will be difficult to qualify for an exemption certificate in the case of fractional aircraft sales. In particular, where there is a sale to multiple purchasers, the Luxury Tax applies unless an exemption certificate applies in respect of each purchaser and at the time of sale. However,

given that these programs typically sell part interests in a particular aircraft over a period of time, rather than at a single moment, it will be difficult to meet the latter criteria in many if not most instances.

Exemption for qualified commercial uses

A key concern relating to the Luxury Tax is that it would apply to the acquisition of an aircraft for genuine commercial purposes, such as a company in the resource industry that requires an aircraft to transport its employees to remote job sites that are not served by commercial airlines. The news release from the Department of Finance that announced the draft legislation on March 11, 2022, purports to address this issue as follows: "Relief for aircraft is proposed to be expanded to take into account qualifying flights that are conducted in the course of a business with a reasonable expectation of profit". Unfortunately, the draft legislation will still be too restrictive in many circumstances, as it does not go far enough to account for the manner in which aircraft operations are generally conducted.

The Luxury Tax is proposed not to apply to a sale, importation or lease provided that the aircraft constitutes a "qualifying subject aircraft" (defined below). Prior to the closing of the sale transaction, a purchaser would need to prepare an exemption certificate in prescribed form setting out certain information, along with a declaration as to the aircraft constituting a "qualifying subject aircraft" at that time, to be provided to the vendor to keep in its records. By contrast, in order for the importation of an aircraft to be exempt from the Luxury Tax, the importer would first need to file an application with the Canada Revenue Agency by providing similar information in prescribed form in order to obtain a special import certificate. While the delay for processing the latter application is not known, it would be prudent to expect that the process of obtaining a special import certificate might be somewhat time consuming. In the case of a lease, it is uncertain what (if anything) might be required for the lessor to confirm that the aircraft is a "qualifying subject aircraft", as there is no specific requirement in the draft legislation for a certificate or other declaration.

In broad terms, an aircraft will qualify as a "qualifying subject aircraft" if at least 90% of the proportionate use of the aircraft over the preceding year (or, in the case of a newly-acquired aircraft, the use that is reasonably anticipated throughout the first year of ownership) is in the course of "qualifying flights" which originate or terminate in Canada and which are conducted in the course of a business carried on by the "owner" for a reasonable expectation of profit, and other than for the leisure, recreation, sport or other enjoyment of an "owner", the guest of an "owner", or a lessee. However, there are a number of concerns with this proposed definition, in particular:

1. While the draft legislation includes dozens of defined terms, a glaring omission is what constitutes an "owner", namely whether this refers to the direct legal owner of the aircraft or perhaps it has a more expansive scope which would include an indirect owner (such as the shareholder of an intermediate holding company). This is especially important since, in practice, aircraft are generally owned in a separate entity from other business operations for risk management purposes. Therefore, unless the aircraft entity were to carry on its own independent business activity (i.e., as distinct from the business of any related entity), this exception would generally be inapplicable.
2. The draft legislation might disqualify a particular flight from being a "qualifying flight" based on the mere presence of an "owner" or lessee on that flight, irrespective of whether it is conducted on arm's length commercial terms and with the owner or lessee paying market charter rates.

Anti-avoidance rules

The draft legislation includes a broad range of anti-avoidance measures, including the following:

1. (1) It is clear that the application of the Luxury Tax cannot be circumvented by simply registering the aircraft in a foreign jurisdiction unless the aircraft is otherwise exempt (e.g., it is a "qualifying subject aircraft"). First, the use in Canada of an aircraft that is owned by an "owner" is generally subject to the Luxury Tax. Second, in making an importation of an aircraft into Canada subject to the Luxury Tax, the draft legislation specifically references the Customs Act, which takes a broad approach as to what constitutes an importation.
2. Transactions conducted between persons not dealing at arm's length or for nominal consideration are deemed to take place at the fair market value of the aircraft.
3. The transfer of ownership of an aircraft by means other than a sale and which is delivered or made available in Canada is deemed to be a sale and thus subject to the Luxury Tax.
4. In addition to the various specific anti-avoidance rules, the draft legislation includes a general anti-avoidance rule under which a transaction (or series of transactions) that is considered to be an "avoidance transaction" (i.e., one that results in a reduction, avoidance or deferral of the tax that would have otherwise applied) will have the tax consequences redetermined as is considered reasonable in the circumstances.

Penalties and offences

The draft legislation sets out a number of potential civil penalties and, notably, criminal offences, that apply in a variety of circumstances, such as in respect of a failure to file a return or to comply with a demand or order, filing of false or deceptive statements, and to intentional avoidance of the Luxury Tax. This liability can extend to purchasers and vendors of an aircraft, as well as to other persons who may be implicated in an offence.

Also noteworthy is that a vendor that knows or "ought to have known" that a purchaser's declaration as to being exempt is false will be jointly and severally, or solidarily, liable with the purchaser for a penalty equal to 150 per cent of the tax. Accordingly, it would be prudent for vendors to take steps to demonstrate that they exercised an appropriate level of due diligence in such circumstances (such as requiring such purchasers to sign a carefully worded attestation document).

Takeaways

While some of the concerns raised by the draft legislation might be unintentional and thus capable of being remedied through drafting revisions, there is a broader concern that the Luxury Tax would, nonetheless, generally apply to the acquisition of aircraft for legitimate commercial purposes. Furthermore, it is important to recognize the harsh impact that the Luxury Tax, if enacted, would have on jobs and businesses in the Canadian aviation industry, not to mention hindering Canada's ability to attract direct foreign investment.

While the federal government has estimated that the Luxury Tax would raise $120 million annually from acquisitions of cars, boats and aircraft, it should be noted that the Canadian aviation industry represents some 47,000 jobs and $12.1 billion of direct, indirect and induced economic activity. Moreover, the mere threat of the Luxury Tax has already been directly responsible for the cancellation of hundreds of millions of dollars in aviation transactions. As such, the potential long-term impact that the Luxury Tax will have on the Canadian aviation industry in particular and, more generally, on the Canadian economy, must not be overlooked.

A further consultation period on the draft legislation closed on April 11, 2022. It is strongly encouraged that members of the Canadian aviation industry convey to their Member of Parliament the detrimental impact that the Luxury Tax, if enacted, would have on their business and on the people they employ. | **W**