The Navigator

Alternative Minimum Tax (AMT)

How AMT is calculated

If you are a high income earner, you may be considering using tax shelters or other tax strategies to significantly reduce or eliminate your tax obligation this year. If you do take advantage of tax shelters, be aware of the impact of the Alternative Minimum Tax (AMT) which, if triggered, could result in an unexpected tax liability limiting the tax advantage you originally anticipated from your investment.

What is Alternative Minimum Tax (AMT)?

The Alternative Minimum Tax (AMT) provision has been in effect since 1986 as a means to bring fairness to the Canadian tax system. It prevents certain high income earners (and trusts) from paying little or no tax as a result of taking advantage of significant tax deductions, especially from those investment vehicles that generate losses that can be used to offset income from other sources.

Consequently, you are required to calculate your tax liability under two methods, both the regular and the AMT method, and pay the higher of the two amounts. This is the government's way of ensuring that you are required to pay at least a minimum level of tax (even though you are technically entitled to specific deductions that could have significantly reduced or eliminated your tax liability).

More specifically, AMT is a separate tax computation that adds back certain deductions to your regular taxable income in order to arrive at "adjusted taxable income". These deductions are referred as "tax preference" items because they are taxed at a lower rate than salary and interest income. Some common tax preference items that may trigger AMT are tax shelter deductions, interest expenses and/or carrying charges related to tax shelter loans, employee stock option deductions, Canadian dividends and capital gains. The adjusted taxable income is then reduced by a $40,000 exemption (designed to exclude low to mid-income earners from AMT) and multiplied by the lowest marginal federal tax rate of 15% to determine your federal minimum tax amount. If this minimum amount is greater than your regular federal taxes payable, the AMT calculated becomes your federal tax liability for the year. Finally, the applicable provincial AMT tax is applied to determine your final combined federal and provincial tax liability. Note that, although the Quebec Minimum Tax system mirrors that of the federal, there are a few differences in the calculation of adjusted taxable income for minimum tax purposes. You should consult with your tax advisor to determine if both federal and provincial AMT are applicable to you.

AMT is more likely to be triggered in a taxation year when you invest in tax shelters, such as flow-through shares and limited partnership units, which may allow you to take disproportionately high deductions when compared to your income that is subject to taxes at the regular rate. Other instances of when you might trigger AMT include years when you receive Canadian dividends and/or realize significant capital gains while

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having minimal other taxable income. The AMT amount can be a shock to a business owner who realizes a gain on the sale of their company and claims the lifetime capital gains exemption.

There are, however, certain situations when AMT does not apply. In the year of death, for example, AMT does not apply which is a much welcome exception due to the significant capital gains that can result from the "deemed disposition on death" rules which could otherwise trigger AMT. A capital gain resulting from the sale of eligible capital property that is qualified farm or fishing property, such as quotas, will not trigger AMT. AMT also does not apply in the case of personal bankruptcy.

Carryforward Provision

You can carry forward the difference between the AMT that you pay and your regular tax liability for seven years. The carryforward amount can be deducted from your regular tax liability that is in excess of the AMT liability in the next seven carryforward years or until it is used up. This provision allows you to use the AMT you paid as a credit against your future regular taxes up to the AMT amount in future years. In other words, you can still apply unused deductions and tax credits against your regular tax liability, but the government will ensure that you never pay less than the minimum tax every year. If you do not have income or are not otherwise taxable in these seven years, the AMT credit will be lost.

Calculation of AMT

Federal AMT works as follows:

- You calculate your federal tax payable under the normal graduated tax calculation and allowing for all regular tax deductions (Calculation A).
- Using Form T691, your taxable income from Calculation A is adjusted for certain items and multiplied by 15% to obtain the tax owing under the AMT method (Calculation B).
- You must pay the **greater** of Calculation A or Calculation B. If Calculation A is greater than Calculation B then there is no AMT to pay. But if Calculation B is greater than Calculation A, then the difference (Calculation B – Calculation A) is the AMT that is payable over and above your regular tax liability.

Also note that due to our graduated tax rate system, it is possible that even if you have tax preference items greater than $40,000, you may still not be subject to AMT since your other income may be high in relation to your tax preference items.

As an example, assume an individual Canadian resident has employment income of $300,000 and has tax preference items totalling $150,000. Therefore, her taxable income is now $150,000 for an approximate federal tax payable of $31,900 (i.e. Calculation A). However, her federal AMT is approximately $37,400 (Calculation B). She must pay the federal tax equal to the greater of the two calculations that is $37,400, plus any provincial tax/provincial AMT payable.

The difference between Calculation B and Calculation A (i.e. $5,500 federally) is the federal AMT that may be carried forward by the individual and credited against their taxes payable in any of the following seven years to the extent that Calculation A exceeds Calculation B in those following years.

Planning Opportunities

AMT can be thought of as an interest-free loan (in the form of a tax pre-

Since the AMT cannot be carried back to prior years and the carryforward expires after the seven-year period, it is important that you have proper planning in place if you are affected by AMT. You may consider not to fully deduct your RRSP in the year of contribution to increase your regular taxes payable and saving the RRSP deduction for a future year (RRSP deductions can be carried forward indefinitely).

payment) to the government for higher income earners who take certain large tax deductions. Your actual cost of AMT is generally the opportunity cost of the time value of money, assuming you can recover the AMT you paid within the carryforward years, although your cash flow is negatively impacted for the current year. There will be a real tax cost if you are unable to use the AMT credit against your future years' regular taxes. Since the AMT cannot be carried back to prior years and the carryforward expires after the seven-year period, it is important that you have proper planning in place if you are affected by AMT. You may consider not to fully deduct your RRSP in the year of contribution to increase your regular taxes payable and saving the RRSP deduction for a future year (RRSP deductions can be carried forward indefinitely). You may also wish to consider rebalancing your investment portfolio to earn more non-tax preference such as interest income that is taxed at the regular rate if you are concerned about losing the AMT credit.

Speak to your tax advisor for an estimate of your federal and provincial AMT, the amount of tax shelter deductions that you can use to reduce your taxable income before AMT is triggered and the planning strategies that are available to you if AMT does apply in the year.

Please contact us for more information about the topics discussed in this article.

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