Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Alternative Minimum Tax (AMT)

If you are a high income earner, you may be considering using tax shelters or other tax strategies to reduce or eliminate your tax obligation. If you take advantage of tax shelters, take certain deductions or earn Canadian dividends or capital gains, be aware of the impact of the alternative minimum tax (AMT). If AMT is triggered, you could face an unexpected tax liability, limiting the tax advantage you originally anticipated.

What is AMT?

AMT provision has been in effect since 1986 as a means to bring fairness to the Canadian tax system. It prevents high income earners and trusts from paying little or no tax as a result of certain tax incentives, including claiming certain tax deductions and earning Canadian dividends and capital gains.

Consequently, you are required to calculate your tax liability under two methods, both the regular and the AMT method. You pay the higher of the two amounts. This is the government's way of ensuring that you pay at least a minimum amount of tax.

AMT liability is determined in a separate tax computation based on your "adjusted taxable income". Adjusted taxable income is determined by taking your net taxable income and adjusting for certain "tax preference items". Tax preference items include tax shelter deductions, interest expenses and/or carrying charges related to tax shelter loans, employee stock option deductions, the lifetime capital gains exemption, Canadian dividends and realized capital gains. Your adjusted taxable income is then reduced by a $40,000 exemption and multiplied by the lowest marginal federal tax rate of 15%. Lastly, certain non-refundable tax credits are deducted to determine the AMT amount. If this AMT amount is greater than your net federal taxes payable, the AMT amount becomes your federal tax liability for the year. There is also provincial AMT. The applicable provincial AMT is applied to determine your final combined federal and provincial tax liability. You should consult with your qualified 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. AMT amount can also be a shock to a business owner who realizes a gain on the sale of their qualifying small business corporation shares and claims the lifetime capital gains exemption.

There are, however, certain situations when AMT does not apply. For example, there is an exemption from AMT in the year of death, 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. AMT also does not apply in the case of personal bankruptcy.

Carryover provision

If you are subject to AMT, you can carry over the difference between the AMT that you paid and your net tax liability for seven years. The carryover amount can be deducted from your regular tax liability in the next seven 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 to the extent your regular tax liability exceeds the AMT amount in future years. If you do not have sufficient regular taxes payable in the next seven years, the AMT credit is lost.

AMT illustration

The following is an illustration of Federal AMT:

Calculation A
You calculate your federal tax payable under the normal graduated tax calculation, allowing for all regular tax deductions and tax credits
Calculation B
AMT is calculated based on this formula: A * (B – C) – D Where: A: 15% B: The individual's adjusted taxable income C: 40,000 D: Allowable non-refundable tax credits. For the example below, assume tax credits of $2,250 (15% x $15,000).

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.

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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 deductions of $150,000 from a flow-through investment (tax shelter). Therefore, her taxable income is $150,000. Assuming an average federal tax rate of 22% and tax credits of $2,250 (15% x $15,000), the federal tax payable would be $30,750 (i.e. Calculation A).

Alternatively, the AMT calculation will adjust her taxable income to $300,000. Applying the above noted calculation, her federal AMT is $36,750 (Calculation B). She must pay the federal tax equal to the greater of the two calculations that is $36,750, plus any provincial tax/provincial AMT payable.

The difference between Calculation B and Calculation A (i.e. $6,000) 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 results in a pre-payment of tax for higher income earners who take certain large tax deductions or earn certain types of income. Your actual cost of AMT is generally the opportunity cost of the pre-paid taxes, assuming you can recover the AMT you paid within the carryover years. 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 credit 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 contributions in the year of contribution to increase your regular taxes payable. You can save the RRSP deduction for a future year (RRSP deductions can be carried forward indefinitely). If you are an incorporated business owner, you can consider taking a higher salary to use up the AMT credit.

Speak to your tax advisor for an estimate of your federal and provincial AMT, especially if you are considering the purchase of tax shelters or claiming the lifetime capital gains exemption. If you are subject to AMT, speak with a qualified tax advisor regarding the planning strategies that are available to you.

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This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal, and/or insurance advisor before acting on any of the information in this article.