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FINANCIAL ADVISORY SUPPORT

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 by preventing certain high income earners (and trusts) from paying little or no tax as a result of taking advantage of significant tax deductions, especially those that generate losses that can be used to offset other income sources.

Consequently, you are required to calculate your tax liability under two tax calculation methods, both the regular and the AMT method, and pay the higher of the two tax calculations. This is the government's way of ensuring that you are subject to paying at least the minimum federal tax on all your taxable income (before taking specific deductions that significantly reduced or eliminated your tax liability).

More specifically, AMT is a separate tax computation that adds back certain deductions from tax preference items to your regular taxable income which is then reduced by a $40,000 exemption designed to exclude low to mid income earners from AMT. Next, the resulting adjusted taxable income is subject to tax at the lowest marginal federal tax rate of 15% to determine your federal minimum amount. If this minimum amount is greater than your regular federal tax, AMT 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 the adjusted taxable income for minimum tax purposes. You should consult with your personal tax advisor to determine if both federal and provincial AMT are concerns for you.

When are you at greatest risk of triggering AMT? 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 allow you to take specific deductions to significantly reduce your otherwise high taxable income. Other instances when you might trigger AMT include years when you realize significant capital gains while having minimal other taxable income.

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 would otherwise trigger AMT. Another situation where AMT does not apply is 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 in excess of the AMT liability in the 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 up to the AMT amount in each of those 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 in each and every year.

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 (we'll call this **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.

Some common "tax preference" items that could create AMT are tax shelter deductions, interest expenses related to tax shelter loans, employee stock option deductions, and capital gains. Note that RRSP deductions of any amount will no longer affect your AMT calculation.

As an example, assume an individual Canadian resident has employment income of $300,000 and has tax preference items totaling $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 or $37,400 plus of course the provincial tax/provincial AMT.

The difference between Calculation B and Calculation A (i.e. $5,400 federally) is the federal AMT that can be **refunded** to the individual in any of the following seven years to the extent that Calculation A exceeds Calculation B in those following years. However, this tax is refunded without interest.

Therefore, AMT can be thought of as an interest-free loan (in the form of a tax pre-payment) to the government for higher income earners who take certain large tax deductions.

Speak to your own personal tax advisor for an estimate of your federal and provincial AMT and the amount of tax shelter deductions that you can use to reduce your taxable income before federal AMT is triggered.