Wealth Management

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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Alternative minimum tax (AMT) and the proposed changes that may affect high-income earners

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The government proposed a number of changes to AMT in the 2023 federal budget that broaden the impact it may have on high-income earners. Due to this overhaul, AMT may now impact you, when it may not have in the past. If AMT is triggered, you could face an unexpected tax liability so it's important to understand the proposals.

Although not yet law, the government released draft legislation for consultation. The consultation period ends September 8, 2023. This article explains what AMT is, summarizes the proposed amendments, and discusses the potential effect it may have on you.

What is AMT?

AMT has been in effect since 1986 as a means to prevent high-income earners (and certain 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 compute your tax liability by calculating your regular tax and AMT. You pay either the regular tax, or the AMT, whichever is highest. The AMT calculation allows fewer deductions, exemptions, and tax credits than the regular income tax rules. This is the government's way of ensuring that you pay at least a minimum amount of tax.

How is AMT calculated?

AMT is calculated based on this formula: A * (B – C) – D, where:

A = the AMT rate
B = the AMT base (also known as adjusted taxable income)
C = the AMT exemption
D = the allowable non-refundable tax credits

Under the AMT calculation, you take your federal taxable income and adjust for certain tax preferences (i.e., exemptions, deductions, and credits) to arrive at your AMT base. Tax preferences include tax shelter deductions, employee stock option deductions, the lifetime capital gains exemption, Canadian dividends and realized capital gains.

Your AMT base is then reduced by an exemption amount (currently $40,000, federally). The exemption amount is a deduction available to all individuals (and certain trusts such as graduated rate estates).

You then apply a fixed AMT rate (currently 15%, federally) to your AMT base, net of the exemption, to arrive at a resulting tax amount.

Lastly, you deduct certain allowable non-refundable tax credits from the resulting tax to determine your federal AMT liability for the year. Non-refundable tax credits can be used to reduce your taxes but cannot generate a tax refund even if the amount of the credits exceeds your tax liability.

If your federal AMT liability is greater than your federal income tax liability, you pay the federal AMT amount. You may also be subject to provincial/territorial AMT. For many provinces/territories, provincial/territorial AMT is calculated as a percentage of federal AMT.

A qualified tax advisor can help you determine if you have an AMT liability for a given year by preparing a draft tax return for you that factors in all of your relevant circumstances, such as income, deductions, exemptions, and tax credits.

AMT carryforwards

If you are subject to AMT, you can carry forward the difference between the AMT you paid and your regular income tax liability as a tax credit for seven years, or until it is used up. This AMT tax credit can be used to offset your future regular taxes, to the extent your regular tax liability exceeds your AMT liability in future years. In this sense, AMT is like a prepayment of tax.

If you do not have sufficient regular taxes payable in the next seven years, your AMT credit will expire and becomes a permanent tax. You may have an issue recovering your AMT credit if you claim the same types of exemptions, deductions and credits every year.

AMT exceptions

AMT doesn't apply 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. AMT also doesn't apply in the case of personal bankruptcy.

What are the proposed changes to AMT?

In the 2023 federal budget, the government proposed several changes to the AMT calculation that are aimed at high-income individuals. The proposed changes are expected to come into force on January 1, 2024. In particular, the government proposed:

- To raise the AMT rate from 15% to 20.5%

In the 2023 federal budget, the government proposed several changes to the AMT calculation that are aimed at high-income individuals.

- To increase the AMT exemption from $40,000 to approximately $173,000 in 2024, which essentially increases the income level necessary to trigger AMT. The exemption amount would be indexed annually to inflation.
- To broaden the AMT base by further limiting certain tax preferences (such as certain exemptions, deductions, and credits).
- To allow only 50% (instead of 100%) of certain non-refundable tax credits to reduce AMT.

Please refer to the appendix of this article for a table that compares the regular tax calculation against the current and proposed AMT calculation.

Who could be affected by AMT?

Individuals

AMT is intended to affect high-income individuals who are able to significantly lower their taxes through the use of certain tax preferences found in the tax system. To be clear, AMT generally won't apply if you have significant employment income and don't claim any large deductions or tax credits. Here's an example:The following illustration compares your estimated federal tax liability with your estimated AMT liability under proposed rules, assuming you've earned $300,000 of employment income.

	Regular tax calculation	2024 AMT calculation
Employment income	$ 300,000	$ 300,000
Taxable income / Adjusted taxable income	**$ 300,000**	**$ 300,000**
AMT exemption		$ (173,000)
Net AMT taxable income		**$ 127,000**
Federal tax (at graduated rates) / AMT (at 20.5%)	$ 74,646	$ 26,035
Non-refundable tax credits* (100% / 50%)	$ (2,740)	$ (1,370)
Federal tax / AMT	**$ 71,906**	**$ 24,665**

Since the regular tax of $71,906 is greater than AMT of $24,665, you'd have no AMT liability.

* Non-refundable tax credits include the basic personal amount, the base CPP and EI amount, and the Canada employment amount.

The government mentioned that under these proposed changes, they expect that more than 99% of the AMT paid by individuals would be paid by those who earn more than $300,000 per year, and about 80% of the AMT paid would be by those who earn more than $1 million per year. As such, most individuals won't be impacted by these proposed changes to AMT.

Some common examples of when AMT may be triggered are where:

- As a farmer or business owner, you sell your qualified farm property or qualifying small business corporation shares and claim the lifetime capital gains exemption (LCGE). Even if you don't claim the LCGE, generating a significant amount of capital gains could trigger AMT as the regular average tax rate on capital gains is less than the new AMT rate of 20.5%.
- As a philanthropist, you make a sizable donation to registered charities during your lifetime. In some cases, you may donate publicly listed securities in-kind. Not only is the donation tax credit halved for AMT purposes, but also 30% of the capital gain realized on the donation of the security in-kind is included in income for AMT purposes. Please keep in mind that AMT does not apply on death, as such, donations made through the estate will not be affected by these proposals.
- As an investor, you invest in tax shelters, such as flow-through shares and limited partnership units, which may allow you to take large deductions and claim tax credits.
- As an investor, the majority of your income is derived solely from capital gains or from a combination of dividend income and capital gains. Due to the preferential tax rate on these types of income, AMT may apply and the effect of AMT may be even more pronounced where you borrow to invest and deduct your interest expense or carrying charge.

Note, under current rules, AMT may apply if most of your income is derived from eligible dividends, due to the preferential tax rate on this type of income. However, under proposed rules, since the average tax rate on dividends above $173,000 is greater than the new AMT rate of 20.5%, AMT will likely not apply if you receive only eligible dividends, even if it's a significant amount.

Here's an example that compares your estimated regular federal tax liability and AMT liability under the proposed rules, assuming you have an investment portfolio totalling $10 million dollars, $5 million of which was invested with borrowed funds. Your portfolio earns $100,000 of interest income, $400,000 of eligible dividends, and $140,000 of capital gains. Due to your borrowings, you have an interest expense of $250,000 for the year.

Certain types of trusts, such as graduated rate estates and employee life and health trusts, are currently exempt from AMT.

	Regular tax calculation	2024 AMT calculation
Interest income	$ 100,000	$ 100,000
Eligible dividends (grossed up by 38% / not grossed up)	$ 552,000	$ 400,000
Capital gains (50% of gain / 100% of the gain)	$ 70,000	$ 140,000
Total	**$ 722,000**	**$ 640,000**
Less: interest expense (100% deductible / 50% deductible)	$ (250,000)	$ (125,000)
Taxable income / Adjusted taxable income	**$ 472,000**	**$ 515,000**
AMT exemption		$ (173,000)
Net AMT taxable income		**$ 342,000**
Federal tax (at graduated rates) / AMT (at 20.5%)	$ 131,406	$ 70,110
Non-refundable tax credits* (100% / 50%)	$ (1,950)	$ (975)
Dividend tax credit	$ (82,909)	$ -
Federal tax / AMT	**$ 46,547**	**$ 69,135**
Additional tax due to AMT		**$ 22,588**

Since the minimum tax of $69,135 is greater than the regular tax of $46,547, you'd have an AMT liability and owe $69,135 in federal taxes.

Trusts

Certain types of trusts, such as graduated rate estates and employee life and health trusts, are currently exempt from AMT. However, for those trusts that are not exempt, AMT may be of a concern under the new rules. This is because the basic exemption isn't available to most trusts (except for certain trusts such as graduated rate estates) and therefore trusts won't have the exemption to offset against the broader AMT base.

For example, an issue may exist where a prescribed rate loan has been established using a family trust. You may have setup such a trust to income split with lower-income family members. Assuming the trust earns investment income and also incurs interest or carrying charges, AMT may apply given that the proposed rules disallow 50% of the interest and carrying charges deduction.

* Other non-refundable tax credits include the basic personal amount, the base CPP and EI amount, and the Canada employment amount.

Planning opportunities

If you suspect you might be subject to AMT under the new rules, speak with a qualified tax advisor to determine your AMT exposure as well as the potential steps you can take to reduce AMT. You may also want to speak to a qualified tax advisor about the timing of your transactions that may be impacted by AMT, for example, if you are making a large donation or exercising employee stock options.

If you have previously paid AMT and have expiring AMT credits, speak with your qualified tax advisor about making use of these credits. Since the AMT credit cannot be carried back to prior years and the carryforward expires after seven years, it is important that you have proper planning in place if you expect to be affected by AMT or have paid AMT.

For example, if you have an AMT liability or are unable to use expiring AMT credits, you can defer claiming an RRSP deduction to increase your regular taxes payable. RRSP deductions can be carried forward indefinitely so you can always claim them in a future year when you are not affected by AMT. Similarly, you can consider generating additional taxable income, perhaps through RRSP or RRIF withdrawals. Alternatively, if you are an incorporated business owner, you can consider drawing a higher salary from the business.

This article may contain 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.

Appendix

The following table compares the regular tax calculation against the current and proposed AMT calculation:

	Regular Tax	Current AMT	Proposed AMT
Tax rate	Graduated (15%, 20.5%, 26%, 29%, 33%)	15%	20.50%
AMT exemption		$40,000	$173,000
Taxable income			
Inclusions (non-exhaustive list):			
capital gains inclusion rate	50%	80%	100%
capital gains eligible for the lifetime capital gains exemption (LCGE)*	0%	30%	30%
capital gains on donated publicly listed securities	0%	0%	30%
employee stock option benefit on donated publicly listed securities	0%	0%	30%
eligible dividend income*	138%	100%	100%
non-eligible dividend income*	115%	100%	100%
Deductions (non-exhaustive list):			
interest and carrying charges to earn income from property	100%	100%	50%
limited partnership losses of other years	100%	100%	50%
certain employment expenses, moving expenses, childcare expenses	100%	100%	50%
workers' compensation, social assistance payments	100%	100%	50%
capital loss carry-forwards	100%	80%	50%
allowable business investment losses	100%	80%	50%
non-capital loss carryovers	100%	100%	50%
employee stock option deduction	100%	100%	0%
Tax credits			
Dividend tax credit			
eligible dividends*	15%	0%	0%
non-eligible dividends*	9%	0%	0%
Non-refundable tax credits, including:			
basic personal amount, donation tax credit, medical expense tax credit, disability credit, tuition credit, etc.	Varies	100 % of the credit calculated under regular tax	50 % of the credit calculated under regular tax

* No change