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Proposed Changes to the Alternative Minimum Tax

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Introduction

On August 4, 2023, the federal government released draft legislation related to Budget 2023. Among many other changes, the draft legislation proposes to change the calculation of alternative minimum tax ("AMT") to better target the AMT to high-income individuals. Should the draft legislation be enacted in its current form, the proposed amendments related to the AMT would be effective for taxation years beginning after 2023.

The federal AMT operates as an alternative method to calculate taxes for individuals, where fewer deductions, exemptions, and tax credits can be subtracted compared to the regular income tax rules. This system was introduced to ensure that individuals benefiting from special tax advantages on income or deductions would always have to pay a certain minimum amount of tax. While there have been some minor adjustments, the current AMT rules have remained largely the same since they were first introduced in 1986.

The proposed changes are intended to address the concern that many wealthy individuals could significantly reduce or even completely avoid paying income tax in certain years due to specific tax deductions and benefits they receive. For some taxpayers, these suggested changes could result in a substantial increase in the amount of AMT they have to pay. However, these changes also involve raising the threshold at which the AMT exemption applies, meaning fewer individuals would need to pay the AMT.

This article will review the key changes proposed related to the federal AMT.

What Is AMT?

For most taxpayers, the AMT is not of concern because their regular taxes will likely be higher than what they would pay under the AMT. However, it may affect certain people, as well as estates and trusts, who get a significant portion of their income from capital gains or claim large deductions or credits to lower their taxable income. For example, the AMT may be applicable if you received a tax break for selling a small business, or if you are claiming a significant deduction from investments.

If you use tax software to do your taxes, it will automatically calculate both your regular income tax and the AMT. The AMT is calculated using the basic formula of A × (B – C) – D. A is the appropriate tax rate percentage; B is the individual's adjusted taxable income determined for AMT purposes; C is the individual's basic minimum tax exemption for the year; and, D is the individual's basic tax credit for the year. In any given year, you'll have to pay either the AMT or the regular federal income tax, whichever is higher. If the AMT is more than what you'd pay in regular taxes, you can use that extra tax you paid as a credit in the next seven years to offset any higher regular taxes. The AMT is essentially a prepayment of tax, as long as you can recover AMT paid within the seven-year period.

Provincial AMT may also apply, and is usually calculated as a percentage of the federal AMT applied.

Basic Exemption and Rate Increase

The draft legislation increases the basic exemption amount from $40,000 to the start of the fourth federal tax bracket (an expected amount of $173,000 for the 2024 taxation year) and will index the exemption amount annually to inflation.

Additionally, the AMT rate for individuals is increased from 15% to 20.5%

Broadening the AMT Base

The draft legislation increases the AMT capital gains inclusion rate to 100%, up from 80% currently. The exception for gifts to qualified donees is also removed, such that capital gains on gifts to qualified donees would be included at the 100% rate. Capital loss carryforwards and allowable business investment losses would apply at a 50% rate, decreased from the 80% rate currently applied.

Further, the draft legislation introduces an inclusion to the AMT base of 30% of the capital gains on donations of publicly listed securities. This inclusion also applies to the full benefit associated with employee stock options of publicly listed securities that have been donated. Under regular tax rules, these are not subject to any tax.

Under the new proposed regime, 50% of the following deductions would be disallowed:

- certain office and employment expenses;
- interest and carrying charges incurred to earn income from property;
- deductions for Canada Pension Plan, Québec Pension Plan, enhanced CPP, and Québec Parental Insurance Plan contributions;
- moving expenses;
- childcare expenses;
- disability supports and social assistance deductions;
- deductions for limited partnership losses of other years;
- non-capital loss carryovers;
- old age pension supplement;
- workers compensation;
- deductions for Canadian Forces and police designated for international missions; and
- Northern residents deductions.

Additionally, 50% of most non-refundable tax credits, including the basic personal amount, medical expense credit, disability credit, and tuition credit, may now be applied to reduce to AMT, as opposed to the full 100% reduction previously available.

Expenses connected with film property, rental property, resource property, and tax shelters that are limited under the current AMT regime would continue to be so limited in the future. The current 30% of capital gains eligible for the lifetime capital gains exemption included in the AMT base, the carryforward period of seven years, and the treatment of Canadian taxable dividends for AMT calculation purposes remain unchanged.

Exempt Trusts

Under the draft legislation, only a qualified disability trust is allowed to claim the basic exemption. Graduated rate estates would be exempt from the AMT.

The draft legislation also proposes to expand the list of certain trusts that will not be subject to the minimum tax, and would include:

- A mutual fund trust;
- A related segregated fund trust;
- A prescribed master trust;
- A trust in which some or all units are traded on a designated stock exchange;
- A graduated rate estate;
- An employee life and health trust;
- A trust governed under a number of plans, including an RRSP or TFSA;
- An investment fund, unless it is created with the main purpose of avoiding the minimum tax;
- A trust in which all of the beneficiaries are exempt from minimum tax;
- A trust that is otherwise exempt from tax under Part I;
- A trust deemed to have been created as a communal organization.

However, trusts not explicitly exempt from the AMT are more likely to pay the AMT under the new proposals, given that the basic exemption would no longer be available to trusts (other than qualified disability trusts).

Conclusion

The new proposed federal AMT rules could lead to considerably higher tax payments compared to the current rules, even though the basic exemption is set to increase. However, some taxpayers may no longer have to pay the AMT at all if the higher exemption amount offsets any increased inclusions in the AMT base.

For business owners who are contemplating tax strategies to generate substantial capital gains after 2023, it will be crucial to thoroughly evaluate the potential outcomes of these proposals. Similarly, taxpayers who are planning significant donations to registered charities should carefully analyze how this could affect their AMT liability under both the current and proposed rules. Given that AMT applies to most types of trusts as well, trustees and their advisors should carefully consider the potential implications of these proposed changes.

Individuals who will be impacted by these modifications should strategize to effectively handle the AMT to ensure that they can recover the AMT paid during the carryforward period, whenever feasible. This planning to mitigate the effects of AMT will be particularly vital for individuals who are nearing retirement and anticipate having lower taxable income in the future.

If these proposals under the draft legislation are enacted in their current form, they would take effect for taxation years beginning after 2023.