Alternative Minimum Tax (AMT)

The Alternative Minimum Tax (AMT) is an income tax calculation that can result in an unexpected tax bill for the unwary. The AMT rules apply a flat tax rate to income exceeding a certain threshold, which may result in a higher tax liability than would be payable under the ordinary rules. Advanced planning may help minimize the impact of AMT and allow individuals to organize their affairs in a more tax-efficient manner. While all provinces have their own AMT and even trusts are subject to AMT, we will only cover the specifics of the federal AMT as it applies to individual taxpayers.

Basics of the AMT

Purpose of AMT: The purpose of the AMT is to prevent high-income earners from paying little (or no) income tax by making excessive use of certain tax credits, deductions, and exemptions. For example, the 50% inclusion rate on realized capital gains and the dividend tax credit reflect preferential tax treatment. If a significant portion of a high-income earner's annual income came from capital gains and dividends, they may end up paying AMT.

Standard federal income tax calculation: You're likely familiar with the general rules around income tax. Certain types of income are taxed at varying rates. Taxpayers can use deductions to reduce their taxable income and can exclude other types of income altogether. Once we determine how much tax we need to pay, we may then use various refundable and non-refundable tax credits.

AMT federal income tax calculation: Your tax liability under AMT is calculated using a different set of rules. These rules allow fewer deductions and exemptions and add into income amounts that may not have been included in taxable income under the standard rules. This newly calculated amount is your "**adjusted taxable income**[1]" from which you may subtract the "**basic exemption amount**" ($40,000 in 2023; starting in 2024 it will be the beginning of the fourth tax bracket which is expected to be $173,000). Any excess is multiplied by the **AMT rate** (15% in 2023 and 20.5% in 2024). The basic minimum tax credit and certain non-refundable **credits**[2] may then be applied to arrive at the taxpayer's **AMT amount** which, if larger than the federal tax owing under the ordinary calculation, becomes the federal income tax liability for the year.

Another way to show this information is by way of a formula. The **AMT amount** is equal to:

((A – B) x C) minus D

Where

A: is the adjusted taxable income

B: is the basic exemption amount

C: is the AMT Rate, and

D: is the sum of basic minimum tax credit and other non-refundable credits.

If the **AMT amount** is

- Equal to or lesser than federal income tax[3], the federal tax payable does not change.
- Greater than federal income tax, **AMT amount becomes the <u>new federal tax payable</u>** for the tax year.

AMT Carryforward: If a taxpayer ends up paying AMT, there may be an opportunity to recover it, as long as they have sufficient taxable income in future years. A taxpayer can generally claim a credit against federal income tax equal to their available AMT carryforward amount. Amounts can generally be used against federal income tax payable in any of the seven years following the year in which the AMT is paid. Unused amounts will expire at the end of the applicable seven-year period.

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[1] The first step in determining exposure to AMT is calculating the "adjusted taxable income" and "minimum amount", which is completed in Part 1 of Form T691, Alternative Minimum Tax. This tax form and calculation starts with your taxable income reported at line 26000 of your tax return. Amounts are then added or subtracted, in whole or in part, to arrive at your adjusted taxable income.

[2] Some of the common disallowed tax credits include dividend tax credits, federal political contributions, investment tax credit or labour-sponsored funds tax credit.

[3] "federal income tax' means federal income tax payable as calculated under the standard rules

Changes in 2024: In addition to changing the AMT rate from 15% to 20.5% and the exemption amount from $40,000 to $173,000, there is also a broadening of the AMT base (the total amount of income that is taxed) by implementing the following changes:

- Increasing the AMT capital gains inclusion rate from 80% to 100%.
- Capital loss carry forwards and allowable business investment losses would apply at a 50% rate.
- Including 100% of the benefit associated with employee stock options.
- Including 30% of capital gains on donations of publicly listed securities.
- Disallowing 50% of a number of currently allowed deductions (such as: employment expenses not related to commission income, deductions for CPP/QPP, child care expenses, interest and carrying charges incurred to earn property income, and non-capital loss carryovers).
- Most non-refundable tax credits that are currently allowed to reduce the AMT will be limited to 50%.

These changes may lead to very different outcomes in 2023 versus 2024 in certain scenarios.

Let's look at four of these scenarios:

- Investor realizing significant gains from selling publicly traded securities
- Owner realizing significant gains from selling a business and using the Lifetime Capital Gains Exemption (LCGE)
- Employee disposing of substantial stock option positions
- Individual making substantial donation of publicly traded securities with accrued gain.

Examples:

Investor realizing significant gains from selling publicly traded securities

Max's only income comes from the sale of publicly traded securities held in a non-registered account with **a fair market value (FMV)** of $600,000 and an **adjusted cost base (ACB)** of $150,000, yielding a capital gain of $450,000.

A taxpayer is responsible for paying the higher of the federal tax calculated under the ordinary rules, and the AMT amount. In this example, Max's federal tax liability in 2023 would be $50,523. This amount jumps by $6,063 (nearly 12%) to $56,785 under the new rules beginning in 2024.

	Ordinary Tax	**Current AMT Rules**	**New AMT Calculation**
Taxable Capital Gain inclusion rate	50%	80%	100%
Taxable Capital Gain	$225,000	$360,000	$450,000
AMT Exemption	n/a	$40,000	$173,000
Taxable Income/Adjusted Taxable Income	$225,000	$320,000	$277,000
Tax at applicable rate graduated/15%/20.5%	$50,523	$48,000	$56,785

Max should consider whether, all things considered, it's better to sell these securities before the end of 2023 or wait for a future year.

Owner realizing significant gains from selling a business and using the Lifetime Capital Gains Exemption

Gabrielle is thinking of selling the shares of her private company for a capital gain of $1 million dollars. The shares qualify for the **Lifetime Capital Gains Exemption (LCGE). In this example, Gabrielle would owe tax at the AMT Rate in both 2023 and 2024, however the amount is reduced significantly under the new rules.**

	Ordinary Tax Calculation	**Current AMT Rules**	**New AMT Calculation**
Capital Gain inclusion rate	50%	80%	100%
Taxable Capital Gain	$500,000	$800,000	$1,000,000
LCGE ($1,000,000)[4]	@50%=$500,000	@50%=$500,000	@70%=$700,000
AMT Exemption	n/a	$40,000	$173,000
Taxable Income/Adjusted Taxable Income	$0	$260,000	$127,000
Tax at applicable rate graduated/15%/20.5%	$0	$39,000	$26,035

Gabrielle should consider whether, all things considered, it's better to sell her company before the end of 2023 or wait for a future year.

Employee disposing of substantial stock option positions

Lily intends to exercise options to purchase publicly traded securities at a total exercise price of $300,000. The FMV is $500,000 so her **stock option benefit** is $200,000.

In this example, Lily's tax in 2024 would be less than if she earned the same stock option benefit in 2023. In 2023 there is AMT payable, while in 2024 the federal tax liability drops to $15,840 with no AMT.

	Ordinary Tax Calculation	**Current AMT Rules**	**New AMT Calculation**
Stock Option inclusion rate after deduction	@50%=$100,000	@80%=$160,000	@100%=$200,000
AMT Exemption	n/a	$40,000	$173,000
Taxable Income/Adjusted Taxable Income	$100,000	$120,000	$27,000
Tax at applicable rate graduated/15%/20.5%	$15,840	$18,000	$5,535

Lily may wish to speak with investment advisors, financial planners, and tax and legal advisors to determine the best approach going forward.

[4] Approximate amount reflecting expected 2024 indexing.

Individual making substantial donation of publicly traded securities with accrued gain

Sébastien is pleased to be in a position to make a significant donation to charity. Knowing it's considered one of the most tax-efficient ways of making a donation, he intends to do as he's done for a number of years and donate publicly traded securities with accrued gains. He understands this method to be one of the most tax efficient ways of giving.

He donates 25% of a publicly traded security he holds in a non-registered account, and takes the other 75% into income as his only source. The securities have a FMV of $500,000 and an ACB of $150,000.

	Ordinary Tax Calculation	Current AMT Rules	New AMT Calculation
Taxable capital gain on donated securities	$0	$0	$26,250
Taxable capital gain on sold securities	$131,250	$210,000	$262,500
AMT exemption	n/a	$40,000	$173,000
Taxable Income/Adjusted Taxable Income	$131,250	$170,000	$115,750
Tax at applicable rate	$35,715	$25,500	$23,729
Federal donation tax credit	$36,222	$36,222	$18,111
Federal Tax	$0	$0	$5,618

Sébastien should consider speaking with his financial and tax advisors to understand the implications of the AMT calculation changes on approaches to charitable gifting.

Considerations:

If the AMT is applicable to you now or you think it may be in the future, talk to your TD Wealth advisor and your tax advisors about managing the impact. Planning will be key and there may need to be some adjustments to your financial plan – especially if you need to generate more income to fully use the AMT credit in future years.

The manner in which you're invested, and the types of income streams generated by your portfolio may make you more or less susceptible to AMT. Similarly, the timing of certain transactions may have an impact on your AMT liability. Your tax and investment advisors should be consulted to determine how best to structure your affairs, including decisions with respect to portfolio holdings and income generation. Ultimately, your advisors should work together to ensure the financial plan and tax plan are coordinated.

(10/2023)