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Tax Alert — Canada

Alternative minimum tax: Significant changes will impact taxpayers in 2024

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

Proposed amendments to the alternative minimum tax (AMT) regime for high-income individuals were introduced in the 2023 federal budget, effective for taxation years beginning after 2023. On 4 August 2023, draft legislative proposals to implement these changes were released and various concerns were identified by stakeholders with respect to certain amendments during the consultation period. It is our understanding that the draft legislative proposals remain under development since they were not included in Bill C-59, *Fall Economic Statement Implementation Act, 2023*, which was tabled on 30 November 2023.[1] To date, the government has not provided additional information about the amendments or whether any comments received during the consultation period will be incorporated into subsequent draft legislative proposals.

Broadly speaking, the proposed amendments expand the AMT base by further limiting tax preference items, increase the basic exemption amount and the AMT rate, and extend eligibility for the general AMT exemption to additional types of trusts.

The federal government estimates that these amendments will generate an estimated $3.0 billion in additional revenues over five years.

In this Tax Alert, we provide an overview of the main amendments as currently proposed to the AMT calculation on individuals, discuss how the amendments may impact certain high-income individuals, and identify ways to minimize AMT exposure under the proposed regime.

[1] For more information on the measures included in Bill C-59, see EY Tax Alert 2023 Issue No. 44, *Bill C-59 to implement certain Budget 2023 and other previously announced measures receives first reading*.

Building a better working world

Background

AMT was originally implemented in 1986 to target high-income individuals by levying a basic income tax based on a simplified computation of taxable income. More specifically, the minimum tax is designed to ensure that individuals, including certain trusts, with high gross income, who would otherwise pay little or no income tax because they have a significant number of tax preference items, pay at least a minimum amount of tax for the year. Tax preferences are specific items that reduce taxable income or tax payable, such as the capital gains exemption or the tax credit for political donations.

Since its implementation, there have not been any significant reforms to the AMT regime. Currently, the government estimates that thousands of wealthy Canadians pay comparatively little income tax by making use of deductions and tax credits.

The AMT computation requires a parallel calculation to the regular income tax calculation that allows fewer deductions and exemptions to arrive at adjusted taxable income. The basic exemption amount, which is $40,000 under the current regime, is then deducted from adjusted taxable income, and the balance is multiplied by a flat federal minimum tax rate (currently 15%), which generates the AMT amount. Certain non-refundable tax credits may be deducted from this amount. An individual's final tax liability is the greater of the AMT amount and the regular income tax calculation.

AMT paid in one taxation year may be carried forward for up to seven years to reduce regular tax payable in a subsequent year, but only to the extent AMT in that subsequent year is less than regular tax payable. Thus, this arrangement generally creates a prepayment of tax through the AMT regime rather than a permanent additional tax.

Proposed changes

The proposed legislative amendments are intended to target high-income individuals by:

- Increasing the basic AMT exemption amount from $40,000 to the amount that corresponds to the lower threshold of the fourth federal income tax bracket, which is indexed annually to inflation and will be $173,205 in 2024. This basic exemption will be available to individuals and certain trusts.[2]

- Increasing the flat federal minimum tax rate from 15% to 20.5%.

[2] Graduated rate estates and certain other trusts are exempt from AMT.

- Broadening the AMT base to include additional income items and limiting certain deductions and credits. Some notable amendments include:

Description	Regular income tax	Current AMT regime	Proposed AMT regime
Capital gains inclusion rate			
► General rate, including capital gains allocated from a trust	50%	80%	100%
► Donation of capital property (other than publicly listed securities) to a registered charity	50%	0%	100%
► Qualified small business corporation (QSBC) shares	50%	80%	100%
► Donation of publicly listed securities	0%	0%	30%
Net capital loss carryforward rate	50%	80%	50%
Non-capital loss carryforward rate	100%	100%	50%
Allowable business investment losses (ABIL)	50%	80%	50%
Lifetime capital gains exemption rate	50%	50%	70%
Stock option benefit inclusion rate	50%	80%	100%
Certain credits and deductions[i]	100%	100%	50%

(i) Including, but not limited to, eligible charitable donations, interest and carrying charges incurred to earn property income or incurred on spousal loans, Canada Pension Plan contributions, moving expenses, and childcare expenses.

While there have been no changes to provincial AMT rules, provincial AMT is generally calculated by multiplying federal AMT by a prescribed provincial rate. As a result, provincial AMT will indirectly increase in 2024 and later years.

For additional information on the proposed legislative amendments and their impact on individuals, refer to the October 2023 edition of TaxMatters@EY: Family Wealth Edition.

Impact of the proposed amendments on high-income individuals – Selected issues

The goal of the proposed amendments is to target high-income individuals to ensure they pay a share of tax proportionate to their income, while removing the application of AMT from most middle-class Canadians. As such, affected individuals must consider the impact of the proposed amendments on their personal income tax returns for 2024 and beyond.

It's important to note that the AMT rules do not apply to corporations, only individuals and certain trusts.

Below, we have identified a number of issues that will impact certain target groups. These target groups may want to carefully review their AMT exposure under the proposed amendments. While the AMT paid may be recoverable during the seven-year carryover period, additional planning may be required to recover the amount paid.

Portfolio investors

Individual investors with significant accrued capital gains may have a higher AMT exposure in 2024 and beyond because the capital gains inclusion rate is increased from 80% to 100% for AMT purposes.

As a comparison of the AMT against the federal income tax rate only, high-income individuals subject to the top federal income tax rate of 33% will have an effective federal income tax rate on capital gains of 16.5%, while the proposed federal AMT rate is 20.5%. Thus, an individual with significant capital gains after 2023 may be subject to a higher tax rate on that income.

For example, assume that an individual subject to the highest income tax rate incurs only $100 of capital gains in 2024. The following federal tax liability would result, before taking into account other deductions and non-refundable tax credits:

Description	Regular income tax	AMT
Capital gains	$100	$100
Inclusion rate	50%	100%
Taxable income	$50	$100
Applicable tax rate	33%	20.5%
Tax liability	$16.50	$20.50

Therefore, the proposed amendments will result in $4 of additional federal tax.

Flow-through shares

Individuals who invest in flow-through shares may experience two separate issues in relation to their investment under the proposed amendments.

1. At the time an investment is made, the income inclusion of the flow-through deduction for AMT purposes will now be subject to the higher proposed AMT rate of 20.5% instead of the current 15% rate. The higher rate may increase the probability that investing in flow-through shares will trigger AMT at the time of investment.

2. At the time that flow-through shares are sold, the capital gain realized by the investor, which may be significant given that the flow-through shares generally have a nominal cost basis, will now be subject to the 100% capital gains inclusion rate under the proposed AMT regime.

Consequently, additional forecasting may be required prior to making a flow-through share investment to assess the impact of the initial income inclusion and the disposition of the shares in light of the individual's projected income, deductions and credits.

Income splitting with family members

Individuals who have entered into prescribed rate loan arrangements with their lower-income spouse (or common-law partner) and/or children or grandchildren may find that the proposed restrictions on the deduction of carrying charges results in an AMT risk. Since the deduction for carrying charges, including interest incurred on funds loaned to a family member, will be limited to 50% of the amount paid, adjusted taxable income for AMT purposes will increase. Meanwhile, the interest income reported by the family member will remain subject to full taxation under both the regular tax and AMT regimes. The impact will be more pronounced for individuals who have entered or are considering entering into these arrangements at higher interest rates.

Consequently, the amendments, combined with the current higher prescribed interest rates and lower portfolio returns, may make these tax planning arrangements less favourable than in the past. For existing loan arrangements, it may be prudent to perform a similar cost/benefit analysis.

Charitable donations

Individuals who have made significant charitable donations may be impacted under the proposed rules since such donations will be subject to a 50% inclusion rate when calculating AMT. As such, these individuals may experience a reduced tax benefit if significant donations are made after 2023.

Individuals who plan to make significant donations may want to consider accelerating their plans to 2023 or spreading out the donations over several years to limit the exposure to AMT. Consult with your advisor to ensure that a tax-efficient outcome is achieved.

Shareholders of Canadian-controlled private corporations

Shareholders of Canadian-controlled private corporations (CCPCs) who are also active in the business have great flexibility in making decisions about their remuneration to pinpoint the optimal allocation between compensation and dividends. Since CCPCs have various tax characteristics that may trigger AMT for shareholders, especially when shares of the company are sold, increasing compensation paid may be beneficial to avoid AMT and reduce the CCPC's taxable income. While dividends received are unlikely to trigger AMT on their own, they may contribute to the shareholder's AMT liability. This may be a good time to revisit shareholder remuneration planning to minimize the impact of the proposed AMT regime while being mindful of other limitations, such as the tax on split income rules.

Example of the proposed AMT rules

To illustrate some of the proposed amendments, consider the following example (provincial taxes are ignored).

An individual has an unused lifetime capital gains exemption of $1,000,000 and reports the following items on his 2024 income tax return:

- $200,000 in portfolio capital gains;
- $50,000 capital loss carryforwards;
- $2,000,000 capital gain from the sale of QSBC shares;
- $200,000 in employee stock option benefits eligible for the one-half stock option deduction;
- $15,000 of carrying charges; and
- $35,000 of charitable donations.

	Regular income tax ($)	Current AMT ($)	Proposed AMT ($)
Income			
Taxable capital gain (portfolio)	100,000	160,000	200,000
Taxable capital gain (QSBC shares)	1,000,000	1,600,000	2,000,000
Employee stock options	200,000	200,000	200,000
Total income	***1,300,000***	***1,960,000***	***2,400,000***
Deductions			
Net capital loss carryforward	25,000	40,000	25,000
Lifetime capital gains deduction	500,000	500,000	700,000
Employee stock option deduction	100,000	40,000	0
Carrying charges	15,000	15,000	7,500
Total deductions	***640,000***	***595,000***	***732,500***
Taxable income	660,000	1,365,000	1,667,500
AMT basic exemption	N/A	40,000	173,205
Net adjusted taxable income	***660,000***	***1,325,000***	***1,494,295***
Federal tax before non-refundable tax credits	***193,514***	***198,750***	***306,330***
Non-refundable tax credits			
Basic personal amount	2,123	2,123	1,062
Canada employment amount	215	215	108
Donations and gifts	11,514	11,514	5,757
Total non-refundable tax credits	***13,852***	***13,852***	***6,927***
Total federal tax payable	***179,662***	***184,898***	***299,403***

Since the AMT liability is greater than the regular federal income tax amount, the individual would owe $119,741 (that is, $299,403 less $179,662) of AMT in 2024 in addition to regular federal tax of $179,662.

In the example above, the proposed rules require significantly more cash flow in 2024 to fulfill the individual's tax obligation. While the additional AMT paid may be recoverable during the seven-year carryover period, additional planning may be required to ensure there is sufficient income in the carryover period to recover the AMT paid in respect of the 2024 taxation year.

Tax planning considerations

Individual portfolio investors

With the new capital gains inclusion rate of 100% for AMT purposes, one potential strategy to reduce AMT exposure for individuals and certain trusts is "capital gain harvesting." The strategy addresses a fundamental difference in the way taxable income for AMT purposes is calculated — that is, "net gains" realized in the year are subject to a 100% inclusion rate for AMT purposes, but net capital losses carried forward are deducted from income at their "net" inclusion (typically 50%).

Thus, in a year where an investor incurs substantial capital losses, there may be an advantage to triggering gains to offset the net capital loss to avoid AMT on those gains in a future year.

To illustrate this, consider the example below where a $100 capital loss is recognized in Year 1, but a $100 capital gain is realized in Year 2. The capital loss is carried forward to Year 2 where it may be claimed against the capital gain. Under the proposed AMT rules, the entire capital gain in Year 2 is included in taxable income, but only 50% of the capital loss from Year 1 is deductible resulting in $50 of taxable income for AMT purposes. If the capital gain was recognized in Year 1 instead, it would be fully offset by the capital loss.

	No capital gains harvesting		Capital gains harvesting	
	Year 1 ($)	Year 2 ($)	Year 1 ($)	Year 2 ($)
Capital gain	0	100	100	0
Capital loss	(100)	0	(100)	0
Prior year capital loss	0	(50)	0	0
Taxable income for AMT purposes	0	50	0	0

For investors with significant unrealized capital gains or net capital losses from prior years, it may be beneficial to trigger capital gains in 2023 which may be offset by the net capital loss carryforward balance.

Similarly, investors with capital gains reserves may reduce the reserve claimed in 2023 to accelerate gains that may be offset by net capital losses carried forward.

In certain circumstances, another strategy may be to transfer an investor's portfolio to a holding company. Although, there may be a slight cost due to lack of integration in certain provinces, AMT does not apply to corporations.

Consult with your advisor to assess your potential AMT exposure under the proposed rules and whether any planning strategies can be implemented.

Items not impacted by the proposed AMT rules

Amid the changes to the AMT calculation, certain components of the rules are unchanged, including:

- The principal residence exemption remains available to shelter a capital gain realized on the sale of an eligible principal residence.
- The special foreign tax credit remains fully deductible against AMT taxable income.
- The dividend gross-up amount remains fully deductible in the AMT calculation and no dividend tax credit is allowed.

Next steps

While AMT is a targeted measure and intended to raise revenue from high-income individuals, it is also a measure that may reward sound planning. For that reason, consult with your advisor to assess whether any planning may be available before the proposed AMT rules come into effect, and to determine how to minimize exposure in 2024 and subsequent years.

Learn more

To learn more about the proposed AMT regime, please contact your EY or EY Law advisor, or one of the following professionals:

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