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Tougher minimum tax regime poses planning challenge

Wealthy clients who earn capital gains and make large donations will be hit

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Tax experts continue to work out how the federal government's proposed changes to the alternative minimum tax (AMT) will affect wealthy clients and how to mitigate the potential increase in taxes.

The proposed new AMT regime, outlined in the 2023 federal budget, is intended to better target the highest earners — primarily, those making $300,000 or more a year — and to fulfil the government's promise to ensure the wealthy "pay their fair share."

"It's not a wealth tax, but it's kind of like a wealth tax," said Kenneth Keung, director of Canadian tax advisory with Moodys Private Client Law LLP in Calgary. "It can only apply to very high-income earning people who are taking a massive amount of [deductions and credits associated with] tax-preferential items."

Kim Drever, regional tax leader with MNP LLP in Edmonton, wrote in an April publication that the AMT changes will particularly affect those "for whom a significant component of their income is represented by taxable capital gains and those claiming significant tax credits such as donations."

As a result, some clients may want to enact certain tax strategies before the revised AMT regime takes effect in 2024. (See "Proposed changes to the AMT".)

For example, a client considering selling their business "may want to think about getting this done before the end of the year," after which the AMT rate will rise to 20.5% from 15%, said Carol Bezaire, vice-president of tax, estate and strategic philanthropy with Mackenzie Investments.

Similarly, a client who wants to donate a large quantity of public shares might want to do so before 2024, when the capital gains inclusion rate for such donations under the AMT rises to 30% from 0%.

While the AMT will continue to be recoverable for up to seven years under the proposed changes, it's a tax clients should nevertheless try to avoid triggering, said Norman Brownstein, partner and head of sales at Oberon Capital Corp. in Toronto.

"That's money you should be getting back today, [but] now you're deferring it for at least a year," Brownstein said. "And interest rates are not at zero, so there's an actual cost to carrying that."

Clients with AMT payable in a given tax year may be able to recover it fully as early as the next tax year by deliberately triggering income, such as by withdrawing from an RRSP or RRIF earlier than they might otherwise, Bezaire suggested.

However, clients who sell their business and then retire may never recover the AMT if they don't generate enough income in subsequent years, Brownstein said: "[Incurring AMT is] dangerous [because] you might never get it back."

Clients with investment portfolios heavily tilted toward generating capital gains also could find themselves subject to the AMT regime.

At 20.5%, the tax on capital gains — which are fully included under the new AMT calculation — would be higher under the AMT regime than ordinarily. The highest possible tax on capital gains under the regular regime is 16.5% (i.e., half of the top federal income tax rate of 33%).

Clients might want to move their investment portfolio into a corporation so they can have greater control over the timing and type of distributions they receive — all with a view toward avoiding the AMT. However, Yogesh Bhatella, a tax partner with KPMG LLP in Vancouver, advised caution.

"We want to see the [draft] legislation, so if there's any anti-avoidance rule [addressing such planning], we want to be cognizant of that," Bhatella said during a 2023 federal budget webcast held by STEP Canada on April 20.

In addition, creating and maintaining a corporation to hold investments involves ongoing costs that might not be worth the expense. "AMT is a recoverable tax," Bhatella said.

Similarly, Keung said the AMT represents a relatively small potential cost to many wealthy clients that's "usually not worth planning around" due to the seven-year carry-forward period.

"In some cases, it's not perfect; there will be some [AMT] that falls off the table, but sometimes that's just collateral damage," Keung said. "[If a] person has just used the [$971,000 for 2023] lifetime capital gains exemption, completely tax-free, [and] there's going to be a little bit of unrecovered AMT, so be it."

Nevertheless, you should let your clients "know what AMT might be lurking, however small it is. That way the client can make an informed decision," said Evan Crocker, senior tax associate with Moodys Private Client Law in Vancouver.

Keung agreed: "Clients [should not be] surprised when there's a little bit of AMT you have to pay because of the portfolio structure."

Tax advisors expressed concern that the proposed AMT rules could lead to unintended and negative tax policy consequences.

"You're disincentivizing people to invest and put their capital at risk," said Henry Korenblum, vice-president of sales and tax planning with Oberon Capital in Toronto.

Bezaire said tax-preferred items "are in the Income Tax Act; they're not loopholes." And while wealthy clients are unlikely to stop making charitable donations because of the proposed changes to the AMT, they might change the amount donated and the timing of donations to avoid falling into the AMT in a particular year, Bezaire said.

Under the proposed AMT rules, not only is 30% of the capital gain on the donation of publicly traded securities included in the AMT calculation, but the donation tax credit also is reduced to 50% from 100%.

"So, maybe they don't make a bigger donation next year; it would be maybe half of what they wanted to do in 2024 and [the other] half in 2025," Bezaire said.

Said Bhatella: “As tax rules change, behaviours may change.”

Proposed changes to the AMT

The alternative minimum tax (AMT), first introduced in 1986, is a parallel method of calculating taxes incurred that allows fewer deductions, exemptions and credits than under the ordinary tax rules. The AMT also applies a flat 15% tax rate to income above $40,000. The taxpayer pays the AMT or regular tax, whichever is higher, but any AMT paid can be carried forward for up to seven years and recovered to the extent that regular tax exceeds AMT in those years.

Under changes proposed in the 2023 federal budget, the AMT rate will rise to 20.5%, but the exemption amount also will rise to an estimated $173,000 for 2024 and be indexed annually thereafter.

Capital gains will be fully included in income under the proposed rules, up from 80% of capital gains under the existing AMT regime, as will all benefits from employee stock options. The capital gains inclusion rate for donations of publicly traded securities will rise to 30% from 0%, matching the rate for capital gains eligible for the lifetime capital gains exemption.

Certain deductions and expenses, as well as most nonrefundable credits, will be limited to 50%. There will be no change to the seven-year carry-forward period, however.

All changes to the AMT would take effect in 2024. The government has not released draft legislation to implement the proposed changes, but stated further details about the revised AMT will be released later this year.

The proposed changes are expected to generate $3 billion in tax revenue over five years, according to the budget document.