



Wealth  
Management

# the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Aaron Fennell, MBA, CFA  
Portfolio Manager & Investment  
Advisor  
Tel: 416-313-6397  
aaron.fennell@rbc.com

RBC Dominion Securities  
181 Bay Street, Suite 2350  
Toronto, ON M5J 2T3  
www.aaronwfennell.com

## How the AMT rules may impact trusts

Historically, alternative minimum tax (AMT) applied in relatively narrow scenarios, such as when a trust earned mainly tax-preferred income, such as capital gains or dividends. However, the government introduced several changes to AMT that may now affect or have a bigger impact on certain trusts commonly used in tax and estate planning strategies. If AMT is triggered, trusts could face an unexpected tax liability, so it's important to understand when AMT may apply. This article explains what AMT is, summarizes the recent changes, and discusses the potential effect it may have on different types of trusts.

*Changes to AMT were proposed in the government's 2023 federal budget. The proposals were amended and confirmed in the 2024 federal budget and then passed into law on June 20, 2024. These changes to AMT are effective as of January 1, 2024. Additional amendments were proposed on August 12, 2024, with respect to flow-through shares and the deduction of investment counsel fees. These changes are not yet law but would also be retroactive to January 1, 2024, if enacted.*

### What is AMT?

As it relates to trusts, AMT is designed to prevent certain trusts from significantly lowering their taxes by using certain tax preferences, such as claiming certain tax deductions or earning tax-preferred income.

Consequently, trusts are required to compute their tax liability by calculating their regular tax and AMT. The AMT calculation allows fewer deductions, exemptions, and tax credits than the regular income

tax rules. Trusts pay either the regular tax or the AMT, whichever is highest. This is the government's way of ensuring trusts pay at least a minimum amount of tax.

If a trust is subject to AMT, it can carry forward the difference between the AMT paid and its regular income tax liability as a tax credit for seven years, or until it's used up. This AMT tax credit can be used to offset future regular taxes, to the extent the trust's regular tax liability exceeds its



AMT liability in future years. If this is the case, AMT is like a prepayment of tax. However, if the trust will be subject to AMT each year or will not have sufficient regular taxes payable in the next seven years, the AMT credit will expire, and the AMT paid becomes a permanent tax.

In addition to federal AMT, trusts may also be subject to provincial/territorial AMT, as for many provinces/territories, AMT is calculated as a percentage of federal AMT. This article focuses on federal AMT.

## What are the changes that may affect trusts?

Certain types of trusts, such as graduated rate estates (GREs), employee life and health trusts and employee ownership trusts (EOTs), are exempt from AMT. However, for those trusts that aren't exempt, AMT may be a concern under the new rules, especially since most trusts won't have access to the AMT exemption. The AMT exemption is only available to individuals and qualified disability trusts (QDTs) where if their income is less than a certain threshold, AMT will not be triggered. The government has increased this AMT exemption from \$40,000 to approximately \$173,000 in 2024. The exemption will continue to be indexed annually. The government has raised the AMT rate from 15% to 20.5% and will limit certain tax preferences (such as certain exemptions, deductions and credits).

Here are a few examples of particular importance, for purposes of calculating AMT:

- 100% of capital gains realized in the trust will now be included in income (as opposed to 50% for calculating regular income tax).
- 50% of the interest and carrying charges deduction will be allowed (as opposed to 100% for calculating regular income tax). Typical deductions include investment management fees or interest on borrowed funds that are used to invest.
- 50% of capital loss carry-forwards and non-capital loss carry-overs will be allowed (as opposed to 100% for calculating regular income tax).

## Which trusts may be affected?

The following are some common examples of when AMT may be triggered in a trust.

### A trust borrows to invest and deducts interest

Consider the common situation of a prescribed rate loan set up through a family trust. This structure is often set up to achieve income splitting with lower-income family members. In prior years, these types of trusts likely never owed much tax, if any. Instead, income would be earned in the trust and allocated to the beneficiaries and the

beneficiaries would then pay tax at their presumably lower marginal tax rates.

Assuming the trust earns investment income and incurs interest or carrying charges, AMT may now apply given that the rules disallow 50% of the interest and carrying charges deduction, including fees paid to investment counsel.

To illustrate, assume you loaned \$400,000 to a family trust at the Canada Revenue Agency's (CRA) prescribed interest rate of 2%. The trustee invested the funds and generated \$24,000 of investment income. The trustee must pay you the annual interest of \$8,000 and claims the interest paid as a deduction, leaving \$16,000 in the trust. However, under the new AMT rules, 50% of the interest deduction, or \$4,000, would be denied, resulting in \$20,000 of income subject to AMT (as opposed to \$16,000 for regular income tax purposes). Even if the trust allocates all \$16,000 of investment income to the beneficiaries and has the income taxed in their hands, the denied portion of the interest deduction would still be subject to AMT for the purposes of calculating the trust's taxes. In this case, AMT cannot be avoided even if the trust allocates all of its net income to beneficiaries.

One of the main issues with triggering AMT in the trust in this situation is the potential for double tax on the investment income earned. The beneficiaries may be required to pay personal tax on the income that has been allocated to them from the trust. The trust will also be required to pay AMT, which might not be recoverable in the future.

Another issue with allocating out all of the trust income to beneficiaries and triggering AMT in the trust is that the trust may need to dip into the capital to pay the AMT liability or receive additional loans. This would not only reduce the amount of funds invested in the trust but also potentially affect the trust's ability to repay the loan in the future.

As a planning consideration, if the trust allows for it, it may make sense to retain some income in the trust to trigger regular tax and avoid AMT. The income retained in the trust should be sufficient to pay the trust's tax liability so the trust doesn't need to use capital.

To illustrate, assume you loaned \$2,000,000 to a family trust at the CRA's prescribed interest rate of 1%. The trustee invested the funds and generated \$100,000 of interest income. The trustee must pay you the annual interest of \$20,000 and claims the interest paid as a deduction, leaving \$80,000 in the trust. Any income retained in the trust is taxed at the top marginal federal rate of 33%.

Let's compare the estimated federal tax liability with the estimated AMT liability under the previous and new rules when:

- 1) The trust allocates all income to the beneficiaries to be taxed in their hands in 2023.
- 2) The trust allocates all income to the beneficiaries to be taxed in their hands in 2024.
- 3) The trust retains the necessary amount of income in the trust to avoid triggering AMT in 2024.

Although the effectiveness of prescribed rate loan trusts may not be as great as it once was, there may still be a benefit to maintaining these types of trusts as income splitting vehicles, reducing your family's overall tax bill.

	2023 Full income allocation	2024 Full income allocation	2024 Income allocation necessary to avoid AMT
<b>Interest income earned</b>	\$ 100,000	\$ 100,000	\$ 100,000
<b>Interest expense</b>	\$ (20,000)	\$ (20,000)	\$ (20,000)
<b>Trust net income</b>	\$ 80,000	\$ 80,000	\$ 80,000
<b>Income allocation to beneficiaries</b>	\$ (80,000)	\$ (80,000)	\$ (63,600)
<b>Trust taxable income</b>	\$ -	\$ -	\$ 16,400
<b>Adjusted tax income for AMT</b>	\$ -	\$ 10,000	\$ 26,400
<b>Regular federal tax payable (at 33%)</b>	\$ -	\$ -	\$ 5,412
<b>Federal AMT (at 20.5%)</b>	\$ -	\$ 2,050	\$ 5,412
<b>Trust capital</b>	\$ -	\$ (2,050)	\$ 10,988

From this illustration, it's evident that if the income retained in the trust is sufficient to create a federal tax liability at least equal to or greater than the AMT liability, the trust avoids AMT and simply pays the federal tax liability. Although the trust may be paying tax on the investment income at a higher tax rate than if the income was allocated out to the beneficiaries and taxed in their hands, there is no double taxation of the investment income.

As such, if you have a prescribed rate loan set up through a family trust that earns investment income and incurs interest or carrying charges (including investment counsel fees), please consult with your qualified tax advisor about whether the trust is still beneficial in your situation. Although the effectiveness of prescribed rate loan trusts may not be as great as it once was, there may still be a benefit to maintaining these types of trusts as income splitting vehicles, reducing your family's overall tax bill.

If AMT is a concern for your trust, speak with qualified tax advisor about ways to mitigate the effects of AMT. Possible solutions could include repaying the loan to reduce interest expense in the trust or retaining taxable income in the trust to avoid triggering AMT. Another

possible solution may be to forgo expense deductions in the trust to avoid triggering AMT, although this strategy may only prove beneficial if the beneficiaries receiving income have little to no income.

#### A trust that realizes mostly capital gains and/or Canadian dividend income

Certain types of income, such as capital gains and Canadian dividend income, are taxed more preferentially under regular income tax rules. As such, a trust that realized mostly capital gains and/or Canadian dividend income may already be subject to AMT under previous rules. However, given that under the new rules, 100% of capital gains realized in the trust will be included in income for AMT purposes (as opposed to 80% previously), AMT will likely have a larger effect on trusts that earn mostly tax-preferred income. Further, if a trust continues to earn mostly tax-preferred income each year, there may be no way to recover the AMT paid.

A trustee could consider distributing the dividend income or capital gains to beneficiaries to avoid the impact of AMT, but this may defeat the purpose of the trust. Distributing more income than necessary to the beneficiaries may not be what the settlor of the trust intended.

### **A trust does not, or is not permitted to, distribute all of its income or capital gains to beneficiaries**

In planning for blended or modern families, a spousal trust is often established where the spouse or common-law partner is entitled to receive all of the income of the trust during their lifetime and on their death, any remaining capital will be distributed to the children from a previous marriage or relationship. In these cases, the trust document may restrict the distribution of capital gains to the spouse or common-law partner to protect the children's residual interest in the capital of the trust. As such, while the spouse or common-law partner is alive, all of the capital gains are taxed in the trust. Since 100% of capital gains realized in the trust will now be included in income for AMT purposes (as opposed to 50% for calculating regular income tax), the trust will be subject to AMT each year on the capital gains, with no way to recover it in future years.

There are other situations where a trustee may not be able to distribute all of the trust's income or capital gains to the beneficiaries. For example, a trust may be established to provide for a family member such as an adult child, child with a disability or elderly parent, who can't manage their own financial affairs. If tax-preferred types of income are retained and taxed in the trust, the trust may be subject to AMT.

Please note that spousal trusts, joint partner trusts and alter ego trusts are exempt from AMT for the year in which a deemed disposition occurs due to the death of a beneficiary.

### **A trust with capital loss carry-forwards**

A trust can incur a capital loss if it disposes of capital property, such as securities, for proceeds less than its cost. If a trust realizes a capital loss in a particular year, the trust must first apply that loss against capital gains realized in the same year. If it can't use the loss in that year, it becomes a net capital loss, which can be used to reduce capital gains in any of the three preceding years or in any future year. Please note that a trust can't apply net capital losses against capital gains that have been allocated out to a beneficiary. If a trust uses the capital loss carried forward in a future year, only 50% of it can be applied to reduce capital gains for AMT purposes (as opposed to 100% for calculating regular income tax). This may need to be considered when the trustee is determining the timing of the sale of securities in the future and whether to distribute capital gains to beneficiaries.

### **A trust with non-capital loss carry-forwards**

A non-capital loss includes a loss from employment, business or property. Assume a trust owns a rental property which incurs a rental loss in a particular year. The

A trust can incur a capital loss if it disposes of capital property, such as securities, for proceeds less than its cost. If a trust realizes a capital loss in a particular year, the trust must first apply that loss against capital gains realized in the same year.

rental loss becomes a non-capital loss which can generally be carried back three years or forward for 20 years. Please note that a trust can't apply non-capital losses against income that has been allocated out to a beneficiary. If the trust earns rental income in a future year, it might consider benefitting from a prior-year non-capital loss, but if it claims the non-capital loss carry-over, 50% of the loss carry-over would be denied for AMT purposes.

### **GREs open for longer than 36 months**

An estate that designates itself as a GRE will generally be subject to tax at graduated tax rates for the first 36 months of its existence. However, there are often many reasons that an executor may need more than 36 months to administer an estate. In such an instance, the estate will no longer be exempt from AMT after the 36 months.

### **Planning opportunities**

If you're a trustee of a trust and suspect the trust 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 for the trust. Consider the timing of transactions that may be impacted by AMT, for example, if the trust is looking to use up capital loss or non-capital loss carry-forwards. You may now want to try matching gains and losses in the same year to avoid the 50% AMT adjustment for loss carry-overs. To some extent, planning can be carried out when you complete the trust's tax return. You can determine at that time how much of the loss carry-over to apply to avoid triggering AMT.

Also, if the trust has previously paid AMT and has expiring AMT credits, consider making use of these credits or potentially leaving more income to be taxed within the trust. Since the AMT credit can't be carried back to prior years and the carry-forward expires after seven years, it's important that the trust has proper planning in place if it's expected to be affected by AMT. A qualified tax advisor can help determine if a trust has an AMT liability for a given year by preparing a draft tax return that factors in all of its relevant tax attributes.

*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.*



---

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)\*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Wealth Management Financial Services Inc. (RBC WMFS), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the “Companies”) and their affiliates, RBC Direct Investing Inc. (RBC DI)\* and Royal Mutual Funds Inc. (RMFI). \*Member – Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. “RBC advisor” refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI or RBC DS. Estate and trust services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies, RBC DI or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. In certain branch locations, one or more of the Companies may carry on business from premises shared with other Royal Bank of Canada affiliates. Notwithstanding this fact, each of the Companies is a separate business and personal information and confidential information relating to client accounts can only be disclosed to other RBC affiliates if required to service your needs, by law or with your consent. Under the RBC Code of Conduct, RBC Privacy Principles and RBC Conflict of Interest Policy confidential information may not be shared between RBC affiliates without a valid reason. ®/™ Trademark(s) of Royal Bank of Canada. Used under licence. © Royal Bank of Canada 2024. All rights reserved.