Mitigating clients’ exposure to U.S. federal estate tax

The death of any individual—whether a U.S. resident or not—can give rise to U.S. federal estate taxes[1] if the individual owns property in the United States at the time of death. Investment in Canada-domiciled Vanguard ETFs™ may help mitigate U.S. federal estate taxes and related filing obligations for clients while giving exposure to U.S. stocks to Canadian residents who are not U.S. citizens.

What triggers U.S. federal estate tax?

Generally, estates of non-U.S. resident, non-U.S. citizens who have died may be subject to U.S. federal estate taxation if the individual had assets located in, or tied to, the United States valued at more than USD 60,000 at the date of death. These assets are often referred to as **U.S. situs assets**.

U.S. federal tax law provides offsets, such as deductions and tax credits, against estate tax that may be due to eligible estates. In addition, there is a double taxation treaty (the “Treaty”) between the U.S. and Canada. The Treaty is designed to reduce or eliminate double estate taxation, which can occur when an individual dies while deemed to be resident or domiciled in one country but owns property in the other.

The Treaty also sets forth special rules that help determine the residency of the decedent—someone who has died—and the tax “situs” of his or her property. Under the Treaty, certain property is exempt from inclusion in a decedent’s gross estate. Also under the Treaty, Canadian resident estates may be able to reduce any U.S. federal estate tax by applying certain tax credits if eligible.

What are “U.S. situs assets”?

U.S. situs assets include all property and securities in which the estate of the person who died has an interest and which is located in or connected to the United States. Examples include (but are not limited to):

- U.S. real estate
- Tangible personal property located in the United States
- Stock in or bonds of U.S. corporations (private or public, even if held in a Canadian brokerage account)
- Municipal bonds
- Interests in U.S. mutual funds or ETFs
- Interests in certain trusts (for example, a Canadian registered plan, such as an RRSP) if assets held by the trust have U.S. situs (such as investments in U.S. mutual funds)
- Assets of a trade or business conducted within the United States
- U.S. retirement plans

[1] This article discusses U.S. federal estate taxation only. U.S. state estate tax may also apply in certain circumstances, depending on whether the U.S. situs property is physically located within a specific state (e.g., real property). States’ rules regarding situs, exemptions, and property subject to estate taxation vary and are outside the scope of this article. Similarly, Canadian federal and provincial taxes may apply, and are outside the scope of this article.

How is U.S. federal estate tax calculated?

While the calculation is quite complex, at a high level, non-U.S. estates would start with the total value of U.S. situs assets at the time of the person's death and subtract the pro-rata share[2] of certain debts, expenses, and other deductions[3] as permitted to arrive at the "taxable estate." U.S. federal estate tax would then be calculated on this figure and reduced by any applicable tax credits (such as the **unified credit** and foreign tax credits under the Treaty).[4]

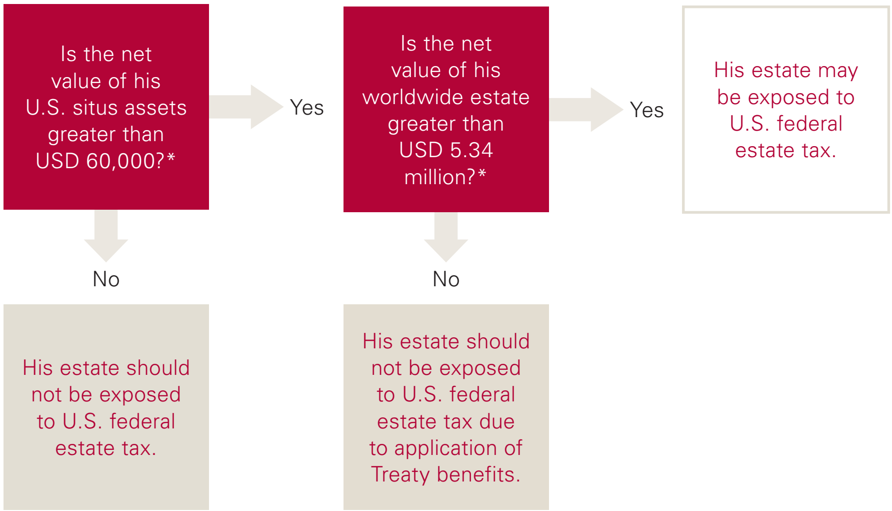
Figure 1 shows how to determine whether the estate of a deceased Canadian resident may be subject to U.S. federal estate tax. For non-U.S. estates, the unified credit effectively exempts USD 60,000 of U.S. situs assets from U.S. federal estate tax. Under the Treaty, Canadian residents may also be eligible for a credit of up to USD 2,081,800, effectively exempting from U.S. federal estate tax an estate with worldwide value up to USD 5.34 million.[5]

Figure 2 provides a simplified, hypothetical example of how the tax calculation might work for someone who died and left an estate worth USD 10 million.

The Treaty also provides for "small estate relief" for certain estates of Canadian residents who are non-U.S. citizens. If the value of the decedent's worldwide gross estate at the time of death does not exceed USD 1.2 million, then the estate's total U.S. situs assets are generally exempt from U.S. federal estate tax.[6]

Another provision under the Treaty provides for a potential credit[7] of U.S. federal estate tax (and other U.S. taxes that may be triggered by someone's death, such as state inheritance tax) paid against Canada's "gains at death" tax on the deemed realization of capital gains at death. This credit is limited to offsetting the gains at death tax on income or gains arising out of the U.S. or from property situated in the U.S.

Figure 1. My client is a Canadian resident, non-U.S. citizen. Could his estate be subject to U.S. federal estate tax?


Is the net value of his U.S. situs assets greater than USD 60,000?*
Yes
Is the net value of his worldwide estate greater than USD 5.34 million?*
Yes
His estate may be exposed to U.S. federal estate tax.
No
His estate should not be exposed to U.S. federal estate tax.
No
His estate should not be exposed to U.S. federal estate tax due to application of Treaty benefits.

*Assumes no reduction of the unified credit for lifetime gifts and that estate is eligible for Treaty benefits.

[2] Pro-rata share is the proportion of total expenses that the decedent's U.S. gross estate bears to a decedent's worldwide gross estate.

[3] A discussion of the availability of the marital deduction on assets left to a spouse is outside the scope of this brief. Additional factors affecting a taxable estate include gift tax paid on lifetime gifts and generation-skipping transfer tax, both of which are also outside the scope of this brief.

[4] In order to obtain the benefits of the credits referred to in this brief, documentation and filing of tax forms may be required.

[5] Figures are current as of the date of this publication but are subject to change.

[6] U.S. situs property of a small estate of a non-U.S. citizen residing in Canada may be subject to U.S. estate tax even if the estate is eligible for small estate relief if certain circumstances apply: small estate relief does not apply to U.S. real property, including interests in U.S partnerships or corporations holding real property in the United States.

[7] This double taxation credit relief may not be available in all Canadian provinces.

Figure 2. Calculating U.S. federal estate tax: a simplified illustration.

Jane is a Canadian resident who is not a U.S citizen. At her death in 2014, she had U.S. situs assets worth USD 1 million and a worldwide estate worth USD 10 million. Deductible expenses and debts totalled USD 500,000. She was not married and made no lifetime gifts.

1,000,000	U.S situs asset value
-50,000	Pro-rata share of deductible expenses and debts (500,000 * 1,000,000/10,000,000)
950,000	Taxable U.S. estate
326,300	Gross estate tax (248,300 + (39% x 200,000))
-208,180	Unified credit The greater of 13,000 or (1,000,000/10,000,000 * 2,081,800)
118,120	**U.S. federal estate tax due**

Note: This hypothetical situation is for illustrative purposes only.

How can Vanguard help?

An interest in a Canadian investment product, even one which invests in the stocks or bonds of U.S. corporations, is considered to be an interest in a Canadian situs entity as the investment product (such as an ETF) is generally opaque. For example, a Vanguard Investments Canada ETF with an investment mandate based on U.S. stock indexes allows investment in the U.S. stock market without triggering U.S. federal estate tax because the investor is deemed to be investing in a Canadian situs asset—the ETF—rather than looking through to the location of the assets in the underlying portfolio of the ETF.

Additional matters an investor may want to consider with their legal, financial or tax advisor include:

- Use of a Canadian entity (for example, a corporation or partnership) to hold U.S. investment properties
- Estate and gift planning, especially if you own property in multiple countries or travel frequently
- Reducing the value of U.S. situs assets or worldwide estate, taking into consideration any income-tax consequences that may result, such as using any capital losses to offset resulting capital gains

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