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INSIGHT: The Often Unknown Tax Liability Facing Foreign Investors in U.S. Equities

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There is a significant mismatch between the value of U.S. equities held by foreign investors and U.S. estate tax returns filed for foreign estates, which could signal an unpleasant surprise for the executors of those estates.

As of June 2017, U.S. equities held by foreign investors amounted to $6,237,136 million. Even if only 20% were attributable to private individuals, this would translate into hundreds of billions of dollars in U.S. federal estate tax liability for non-U.S. investors. Yet only 349 estate tax returns were filed for foreign estates in 2014, the latest date for which statistics are available.

Many non-U.S. investors assume that the federal estate tax only applies to investments physically located in the U.S. and associate this solely with owning property such as a holiday home—but they are wrong.

Given the enormous value invested by foreign investors and that Foreign Account Tax Compliance Act (FATCA) and other mechanisms are now fully operational, the U.S. is increasingly looking into U.S. equities held by foreign investors, even if held in custody outside the U.S. The number of voluntary filings and discovered false or ''forgotten'' filings will continue to rise.

The U.S. has jurisdiction over U.S.-situated assets. Those are subject to a 40% federal estate tax rate applied to the fair market value and ''include American real estate, tangible personal property, and securities of U.S. companies. A nonresident's stock holdings in American companies are subject to estate taxation even though the nonresident held the certificates abroad or registered the certificates in the name of a nominee.''

As securities are usually traded and held on behalf of (private) investors in an Omnibus Customer Securities Account, the identity of an individual investor is not necessarily disclosed to the market or a share register, thus providing privacy on investment level.

In case someone believes that this privacy will help to mitigate U.S. federal estate tax, please continue reading.

The U.S. requires executors for nonresidents to file an estate tax return using Form 706NA if the fair market value at death of the decedent's U.S.-situated assets exceeds $60,000. The reporting duty and related liability falls to the statutory executor who is qualified in the U.S., and executors must file an estate tax return using Form 706NA within nine months. The Internal Revenue Service will then take six to nine months to assess the 706A filing before it will issue Form 5173 (the transfer certificate), provided the filing met all requirements.

If there is no executor, Treasury Regulation Section 20.2002-1 states that ''any person in actual or constructive possession of any property of the decedent is required to pay the entire tax to the extent of the value of the property in his possession.''

It is worth noting that informed non-U.S. financial institutions and intermediaries all over the world already started the required reporting concerning their deceased clients owning U.S.-situs assets to mitigate their risk years ago.

Common complications to this process are that a U.S. estate might be subject to lengthy and costly probate, that U.S. courts are not necessarily familiar with notarial and other forms of civil wills, foreign testamentary documents, and how to apply them on U.S. property. Private placement life insurance (PPLI) is one possible option worth considering to ensuring a quick transfer of assets outside a lengthy probate process.

Private placement life insurance (PPLI contracts are variable contracts, and their investment returns are not guaranteed.) Instead, they reflect the investment return of investments held in the policy contract's separate account. They can offer estate liquidity, creditor protection, generation-skipping, and non-probate planning

Life insurance proceeds paid upon death owned by a U.S. citizen or resident are paid free of income tax but are subject to U.S. estate tax. In contrast, ''the amount receivable as insurance on the life of a nonresident not a citizen of the United States shall not be deemed property within the United States.'' (Tax code Section 2105(a); Treas. Reg. Section 20.2105-1(g))

Directly investing in U.S.-situs assets as a non-U.S. investor creates potential U.S. estate tax liabilities. Specific structuring options like PPLI can reduce this liability. Among several other benefits, PPLI may be a reliable option for mitigating income and estate tax liabilities and, if correctly structured, may provide comparable benefits in the investor's home country, too.

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