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Foreign Inbound Investment in a Coronavirus World: Beware the U.S. Estate Tax

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The ongoing COVID-19 pandemic continues to wreak havoc on global financial markets, adversely impacting currency exchange rates. Many non-US persons view the United States as a safe haven or ripe for opportunistic investment in these uncertain times. Although the US tax system is regarded around the world as complex and far reaching, it also provides non-US investors significant tax advantages. A primary advantage is the US income tax exemption for capital gains arising from sales or dispositions of most US non-real estate investments. As a result, many non-US investors have US investments, such as stock in US public companies, in their investment portfolio.

While non-US investors may secure significant income tax benefits, their investments in US property may be exposed to the US federal estate tax system. Many non-US families are surprised to learn that the US federal estate tax may be imposed on the value of US situs assets owned by a person who is neither a citizen nor a domiciliary of the United States (a "non-US person") at death. Since the US estate tax is currently imposed at a 40% rate and non-US persons may benefit from only a nominal exemption from the US estate tax, advanced planning is important.

US and foreign financial institutions are actively enforcing the collection of the US estate tax from non-US persons. As a result of worldwide increases in COVID-19 mortality rates and the growing need for tax revenue to offset pandemic-induced government stimulus spending, non-US persons should carefully structure their US investments in an effort to mitigate or avoid the US estate tax.

Who is Subject to US Estate Tax

For US citizens and US domiciliaries ("US persons"), the federal estate tax is imposed at a rate of 40% on the fair market value of worldwide assets owned or controlled at death. However, US persons benefit from an exemption of USD $11.58 million for tax year 2020, with increases each year through 2025 to account for inflation, although it is scheduled to return to pre-2018 levels in 2026.

In stark contrast, non-US persons are only subject to US estate tax on the value of their US gross estate, or US situs property owned or controlled by them, at death. Whether someone is domiciled in the United States depends upon whether that person (i) resides in the United States, and (ii) has the intent to remain there indefinitely. As a result, this is a subjective test that hinges on factors such as the location of a taxpayer's family, homes and personal property, and where the taxpayer receives medical care or engages in religious, political and social activities, to name a few. One's status as a US resident taxpayer or lawful permanent resident (*i.e.*, a green card holder) does *not* prevent that person from being classified as a non-US person for estate tax purposes.

Significantly, unlike the substantial estate tax exemption available to US persons, only the first USD $60,000 of US situs assets owned by non-US persons are exempt from US estate tax (unless an applicable tax treaty provides additional relief), with the remaining value subject to the 40% estate tax and the estate of the non-US person obligated to file IRS Form 706-NA, *United States Estate (and Generation-Skipping Transfer) Tax Return for Estate of Nonresident Not a Citizen of the United States*. This 40% tax bite out of the fair market value of the non-US person's US investment holdings at the time of death is not only tax inefficient, but also creates obstacles in transferring those assets to the non-US person's intended beneficiaries (often requiring an IRS transfer certificate for financial institutions to release financial assets and satisfactory evidence for title companies to facilitate real estate transfers) and in finding liquidity to pay the tax liability.

Assets Subject to US Estate Tax: US Situs Property

In the context of determining the US gross estate for a non-US person, or the asset base which may be subject to the 40% US federal estate tax, US situs property generally includes US real estate, shares in US companies, tangible personal property such as automobiles, furnishings, and jewelry physically located in the United States, and US brokerage accounts. Conversely, non-US situs property for estate tax purposes often includes savings accounts, checking accounts or certificates of deposit with a US bank (if such accounts are not used in a US trade or business); proceeds of a life insurance policy on the life of the non-US person, owned by the non-US person and issued by a US insurance company; non-US real estate; and shares in non-US corporations.

Cash and physical currency are considered tangible personal property for estate tax purposes and will be taxable if located in the United States at the decedent's death. Other assets are not as easily categorized as US situs or non-US situs for US estate tax purposes. For example, the US estate tax classification of partnership interests owned by non-US persons is not entirely clear. US bank accounts, while in many cases exempt from US estate tax, can easily be tainted by US trade or business activities and therefore converted into US situs property subject to US estate tax. Notably, even investments in US companies held through an account with a *non-US financial institution*, such as a bank in Hong Kong or Panama, may still be subject to US estate tax.

Where the foregoing US situs assets are owned directly by a non-US person, the estate tax exposure is clear. But what if such assets are owned through a Delaware limited liability company, a Texas corporation, a revocable trust, or even a non-US company or an offshore trust? The estate tax exposure of such assets is less clear and requires an analysis of the ownership chain leading from the US situs property to the non-US person. In the case of trusts—even irrevocable trusts—non-US persons should solicit advice from a qualified US attorney, who may then review the trust agreement or deed creating the trust and other trust documents, to ensure that no US estate tax exposure exists.

To be clear, what may avoid the US probate process, such as a revocable trust, or structures that may achieve various foreign legal or tax goals, may not, by itself, yield any benefit from a US estate tax perspective.

What's a Non-US Investor To Do?

The potential for 40% US estate tax exposure to non-US persons is not a theoretical risk. For example, a non-US person who owns a US vacation home, a US rental property, or an investment portfolio comprised of shares in US companies (whether or not maintained by a US or a non-US financial institution), in any case worth USD $560,000 at the time of his or her death, can generally expect to have a US estate tax liability of USD $200,000 (*i.e.*, [USD $560,000 value of US situs property – USD $60,000 exemption] x 40% estate tax rate).

Depending upon how the US investment is owned, additional costs beyond this USD $200,000 tax bill may arise, including hiring a lawyer to prepare and file an estate tax return and to guide the non-US person's family through the US probate process. All of these costs, including the substantial US estate tax liability, can be completely mitigated where ownership of the US investments is properly structured before the non-US person owner's death.

The ideal time to structure a non-US person's investment into US property is *before* the US property is acquired. However, even with existing US investments, non-US persons should work with a qualified US attorney to (i) confirm their status as a non-US person, and (ii) ensure that their current manner of holding the US investment will not give rise to US estate tax (and ideally will not be subject to the US probate process) upon their death. Several options exist for shielding a non-US person's US investments from estate tax, ranging from simple to complex, and many of such options have the effect of addressing the non-US person's other concerns, such as optimizing income taxes, enhancing confidentiality, and achieving estate planning goals.

Closing Thoughts

Global volatility in financial markets, forex and asset values make the United States to many an attractive and relative safe haven for new investment. As a result of the expansive application of the US estate tax—particularly to non-US persons given the modest USD $60,000 exemption to which they are entitled in the absence of an applicable tax treaty—non-US persons should carefully structure their new inbound investments into the United States and revisit existing holdings in an effort to mitigate US estate tax.

Without taking any action, or by taking ill-advised actions such as ownership of US investments through either a US company alone or an improperly structured trust, non-US persons and their families may continue to be subject to US estate tax and remain a long-term investment partner with the United States, which sooner or later will receive its nearly 40% share.

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