Podcast Transcript

Estate and Tax Planning for Globally Mobile Clients: Non-U.S. Persons Investing in U.S. Capital Markets

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Lee: The United States has a complex tax system that can differ from that of one's home country. For that reason, there are many tax issues non-Americans should be aware of before investing in stocks and other financial assets located in the United States. I'm Leeann Lee, and you're listening to BakerHosts.

On today's episode, we'll discuss the tax consequences of non-Americans investing in the U.S. stock market and other financial assets, as well as tax planning to minimize the impact from these investments. We're joined today by Private Wealth Partner, George McCormick, who is located in our New York office. In his practice, George focuses on tax and estate planning for international clients with a connection to the United States. Welcome to the show, George.

McCormick: Hi, Leeann. Thanks for having me here today.

Lee: So, to start us off, what are the primary tax issues or consequences a non-American should be aware of before investing in the U.S. capital markets?

McCormick: I would tell a non-U.S. client that investing in the U.S. capital markets, whether it is stocks, bonds, or other types of financial instruments, could have U.S. tax consequences. There could be income taxes that arise from their investment. There could also be estate taxes that would arise if they die while owning those assets.

Lee: Okay. So, you broke these taxes into two main categories. First, income tax and second, estate and gift tax. Could you discuss more about how the income tax is applied, to whom, and any tax breaks or benefits?

McCormick: U.S. income tax would arise primarily from dividends in the case of stock, and interest in the case of any sort of debt instrument, like a bond or other types of debt. With dividends from U.S. corporations, they are generally subject to a 30% withholding tax on the gross amount of the dividend. Similarly, with interest, there is generally a 30% withholding on the gross amount of the interest payment.

Now, there could be certain types of breaks or benefits that would minimize those taxes. The U.S. has income tax treaties, or double tax treaties or agreements, with many countries that lower the rate of the withholding tax on that income. So, while the general rule is that there is a 30% withholding tax on the gross amount of the dividend, if there is an applicable income tax treaty, amount of withholding could be somewhere around 10 to 15%. Sometimes with interest that applies as well, so that the tax rate on the withholding for interest payments is lower, again maybe 10, 15, or 20%.

There are some also exceptions that carve out the income from taxation altogether. So, for example, capital gains on the sale of a U.S. stock are generally not subject to tax for a non-U.S. taxpayer. Interest payments that arise from debt instruments that are considered portfolio debt or that qualify for the portfolio interest exception also are not subject to U.S. taxation. Now, that is very specific on what is the actual debt instrument. Many types of bonds, they're publicly traded, so, bonds from large U.S. corporations, generally do qualify for the portfolio interest exception. But a debt instrument with a U.S. individual, though, may not qualify if it is not structured properly. So, whether interest is accepted from taxation on the portfolio of interest exception is based on the terms of the debt instrument.

Lee: So, you also mentioned the estate and gift tax. Who does that apply to and how?

McCormick: The estate tax could apply when a non-U.S. person owns certain types of U.S. financial instruments. So, the most clear example is if a non-U.S. person owns stock of a corporation that is incorporated under the laws of the U.S. state. So, most publicly traded U.S. stocks fall into this category. So, if you're a non-U.S. person and you own stock in Apple or Tesla or Google, the general rule is that if you pass away while owning that stock, your investment in that stock will be subject to U.S. estate tax. And there is only a $60,000 exemption from the estate tax. So, a person that owns, for example, $10 million of U.S. stocks, there is generally going to be a 40% tax on that $10 million investment. So, almost a $4 million tax just because they invested in U.S. stocks.

With fixed income bond instruments, it is a little bit more complicated, because if they qualify for the portfolio debt exception, then they're not subject to estate tax. But it very much depends on, does it qualify for the portfolio interest exception? When it comes to other types of investments, like just cash in a U.S. checking or savings account, there is an exception from estate tax for that cash. But, a lot of times, non-U.S. people have brokerage accounts, and those brokerage accounts are not actually invested in cash. They're invested in money market funds that could be subject to estate tax. So, it is very important if a non-U.S. person has a lot of cash in the U.S. that they understand what it is invested in.

There is U.S. gift tax on certain types of these instruments and investments. So, generally, while U.S. gift tax does not apply on a gift of intangible property like stock, so a non-U.S. person can gift away stock in the U.S. corporation, there is no gift tax, even though there is estate tax. However, if there is cash in a U.S. account that may be subject to gift tax. The guidance on this from the IRS is not very clear, but what I would say is if you're a non-U.S. person and you have cash in a U.S. checking account, if you just gift that cash by transferring it or wiring it to another person, that probably would be subject to gift tax.

Now, there are some tax treaties that are out there that could minimize the tax on these various different types of investments and activities I just mentioned. And while I mentioned earlier that there are income tax treaties to minimize income taxation, we don't have quite as many estate and gift tax treaties as we do income tax treaties. So, there is only a large handful of cases where we have estate tax treaties that could minimize estate tax. But the U.S. does have estate and gift tax treaties with certain countries, like the United Kingdom, that can remove from the U.S. tax net a lot of different types of investments in U.S. financial products.

Lee: Now, what sort of planning opportunities are available to minimize the tax consequences of these investments?

McCormick: Well, I would advise the client to first understand what is the potential tax exposure from their investment, particularly estate tax exposure. And then, once you have an idea of whether investment would be subject to estate tax, and assuming that it is, then what can we do to minimize that?

One opportunity is to minimize investing directly in the U.S. So, if you have a client that could create a non-U.S. company and the non-U.S. company is the actual person or entity to invest in the U.S. stock market. Then what happens is is that non-U.S. company is the owner of the investment in, for example, Apple or Tesla stock and the non-U.S. individual client doesn't directly own that stock. So, if that person dies, they die owning shares of a non-U.S. company. They're not treated as owning shares of the underlying investments. Now, that works generally with a person who is a resident in a country where there are no adverse tax consequences to such an arrangement. But there are many countries where it is just not possible from a non-U.S. tax perspective to use a non-U.S. company as that sort of investment vehicle.

So, another consideration is trying to get investment exposure to the U.S. stock market, again, without directly investing in the U.S. stock market. So, for this, for example, like a client who lives in Europe, or their mutual funds or ETFs that are compliant from a European, a non-U.S., tax perspective and that mutual fund or that fund invests in the U.S. stock market, so the client gets the U.S. stock market investment exposure without directly investing in the U.S.

Lee: Great. So, one final question for you. There are clearly many issues to consider before someone invests in the U.S. markets. What are the main points you'd like them to take away from this conversation?

McCormick: I would like a non-U.S. person to understand that, first of all, there are potential U.S. tax consequences to investing in U.S. stocks, bonds, and other types of financial investments. There could be income taxes that arise from their investment. There also could be estate taxes that arise. So, before investing in the U.S. markets, they should have a clear understanding of what are the tax implications of the investments. And then, once they understand that, they should try to seek different types of planning opportunities to minimize their taxation.

Lee: This has been a fantastic conversation. Thank you again, George.

McCormick: Thanks, Leeann.

Lee: If you have any questions for George, his contact information is in the show notes, and as always, thanks for listening to BakerHosts.