Executives of US Companies can be surprised: US Estate Taxes may apply!

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With the advent of Stock Options and other equity based incentive compensation plans, much thought has been given to the personal income tax consequences for the Non-U.S. Resident Non-Citizen (NRNC) executive.[1] We all know, by now, for instance that higher "bonus" type payment rates apply in some European jurisdictions for this type of equity compensation. A variety of tools have been developed to help mitigate against this problem, such as split payroll and certain other offshore compensation vehicles. What is often overlooked and little understood are the US estate tax consequences for the NRNC executive who happens to still own/hold US company stock,[2] at the time of his or her death. When that happens, there is often a big surprise to the surviving spouse or the heirs. In order to receive a "close out" letter on any brokerage or bank account from a decedent, the IRS requires a filing of a Form 706 (the Estate Tax Return.) This is due even for NRNC persons when they hold US situs property at the time of their death.

Why, then, should there be any concern for someone residing outside of the US whose accounts indeed may also reside outside the US? IRS regulations deem US company stock to be property "situs" in the US irrespective of where it is held. And, if it is held (by a NRNC person) at time of death his/her death it could trigger a US "death tax" for up to 45%[3] of the value of that stock. The first question for the deceased estate will be whether the NRNC (deceased) executive is from a "Treaty Country"[4] – if so, then there may be a credit for foreign estate taxes paid which could, like the income tax credit, make the problem disappear. However, there may be no foreign tax credit available if there is no Estate Tax Treaty, in which case the problem exists. Such is the case, for example, for Belgian executives today who hold stock of a US company at the time of their death since Belgium does not currently have an Estate Tax Treaty in place with the US. The problem is quite profound since the "exclusion amount" (that amount that is exempt from this tax) is only USD60,000 for NRNCs as compared with the USD2 million[5] currently available to US citizens. (Current US law provides that the exemption amount for US citizens will go up to USD3.5 million, but the very low threshold of USD60,000 exemption for NRNC is not currently slated to increase.)

Here's how it works: the US applies a "transfer tax" on all property, tangible and intangible, *situated in* the United States at the time of death.[6] The following is a list of the four types of property that will be treated as "situated in the US" and subject to this tax (unless otherwise provided by treaty):

1. Real Property located in the US.
2. Tangible personal property located in the US (Such as art, jewellery, furniture, etc.).
3. A debt obligation of a citizen or resident of the US, a domestic partnership or corporation, a domestic estate or trust, a US state or political subdivision thereof or the District of Columbia.
4. Stock of corporations organised in or under US law.[7]

This article focuses primarily on the last category: US company stock.[8] If the NRNC holds US company stock at the time of death, the IRS will not allow liquidation (sale) or transfer until the Executor of the Estate has filed a Form 706-NA declaring the values and **paying any taxes due.** Typically, this form is required to be filed within nine months following the date of death. (Often an extension is requested and granted for an additional six months, but only if the estimated taxes are still paid within the nine months from date of death period.) The mechanics and calculations of this IRS Form are beyond the scope of this article. (Readers are advised to contact a competent professional advisor, tax lawyer or certified public accountant to understand these details.)

So, what about stock options? This is a bit more complicated and somewhat unsettled area of the law.[9] Essentially, if the underlying stock represented by the options would qualify as "situs in the US" and the holder had an unfettered right to exercise at the time of death, then these too will be included in the decedents "gross estate" for US Federal tax purposes and be subject to the same estate or "Death" tax mentioned above. The assumption should be that if the options were for the exercise of stock in a US public company and they were fully vested and "in-the-money" then they too will be subject to this estate tax problem by the NRNC person.

So, what can you do about this Problem?

It has been said on many occasions that the US estate (Death) tax is the only voluntary tax that the US administers. The reason for this is that the US allows a variety of estate planning techniques, typically involving trusts, to be used to lawfully avoid paying this tax. This is no less true for the NRNC. There are a variety of options available during life to postpone or even avoid this tax.

One simple vehicle, familiar to many, is to transfer the shares (upon the death of the NRNC stockholder) into a Qualified Domestic Trust ("QDOT") for the benefit of the surviving spouse. This special trust can be set up prior to death or after death, but prior to filing the Form 706-NA

with the IRS. There are a variety of restrictions that must be observed, such as a requirement for at least one US trustee – either a US citizen or domestic corporation – and certain other restrictions on distribution of income and principle.[10] This strategy, however, only postpones and does not eliminate the problem.

Other vehicles could include the use of offshore companies or foundations; however, these vehicles demand careful attention since compliance with both US law and the law of the home country will be required. In addition, although seemingly attractive at first blush, these schemes can involve considerable set up and maintenance costs which would clearly burden the assets as well.

The simplest solution could be to liquidate the shares and decide based on current tax planning what to do with the proceeds. Setting aside the obvious current income tax consequence to that decision, there are, of course, US security law implications[11] for sales by "insiders" of US company stock which is privately held. These restrictions, of course, must be observed. If the NRNC has charitable interests, these assets would be the perfect ones to choose for giving to a non-profit or charitable foundation.

Clients are always better served by consulting a competent legal advisor before proceeding with any of these strategies.

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END NOTES:

1. *Portner, "German Law Lags over Taxation of Stock Options," LEXIS, 2001 Worldwide Tax Daily 80-13(4/25/01); Takagi, "Tax Aspects of Japanese Stock Options Explained," LEXIS, 2001 Worldwide Tax Daily 50-23 (3/14/01); [FIND – law review article generally on taxation of US stock options by NRNC – specifically in Europe.]*
2. *For the purposes of this article, US company stock shall mean shares of stock of a statutory legal entity incorporated or formed under the laws of a state of the United States. N.B. that certain foreign tax treaties provide further guidance on situs of corporate stock. See e.g. US-South Africa Treaty Art. III(2)(d) – situs based on where corporation was "created or organised".*
3. *The rates range from 18% on taxable estates of USD10,000 to 45% on taxable estates over USD2,000,000 for descendents dying in 2008, based on the cumulative amount of taxable estate and taxable gifts. IRC §2001(c).*
4. *The following is a list of countries with which estate tax treaties are in force. Note, not all treaties are identical in their provisions regarding the topics concerned in this article. Australia, Austria, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Sweden (expired on 1/1/2008); Switzerland & United Kingdom.*
5. *The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") provides for the threshold amount for a taxable gross estate to go up to USD3.5 million in 2009 with full repeal in 2010 and reversion to 2001 threshold amounts in 2011. Most commentators currently agree that Congress will likely address this issue and change the law sometime after the 2008 presidential elections.*
6. *IRC §§ 2104 and 2105; Reg. 20.6018-1(b)(1)).*
7. *N.B. There are extensive IRS regulations on defining property not situated in the US See IRS Reg. 20.2105-1.*
8. *For a detailed analysis of issues affecting other categories of US situs property, such as partnership interests, bank accounts, trusts' interests, mutual funds and retirement plans, etc. See BNA Portfolio 837-2nd.*
9. *See Crocker v. Helvering, 76 F.2d 974 (D.C. Circuit 1935) holding decedent was owner of stock as optionee based on a variety of factors and c.f. Lockie Est. v. Commissioner, 21 T.C. 64(1953), where, unlike Crocker the decedent held no voting or dividend rights.*
10. *IRC sections 2056A-B.*
11. *15 U.S.C. § 78j(b).*

"Understanding the exposure of assets to US estate and gift taxation" *June 2005, Issue 157*

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