

IRS Focuses on Foreign Companies and Offshore Services

Foreign companies that perform offshore services for the oil and gas industry on the Outer Continental Shelf in the Gulf of Mexico are now on the IRS radar screen, and so are the U.S. companies that hire them. The IRS is taking the position that these foreign companies and their foreign workers have “U.S. source income” and may be engaged in a U.S. trade or business. Therefore, the IRS contends the companies and their workers must file U.S. tax returns and pay U.S. taxes due on amounts earned from these offshore services. In addition, the IRS is likely to contend that the U.S. companies that hired the foreign companies should have withheld and remitted to the IRS 30% of the amounts they paid to the foreign companies.

The IRS has also made clear that, in addition to taxes and interest due, it intends to assert various penalties against both the foreign and the U.S. companies, as well as the foreign workers. The red flags recently raised on this issue were the IRS’s designation of Foreign Withholding as a Tier One Compliance Issue and the issuance of an Industry Directive dated October 28, 2009, which specifically targets activities on the Outer Continental Shelf in the Gulf of Mexico. Tier One Compliance Issues generally have the IRS’s highest priority and are subject to the greatest scrutiny by IRS auditors.

What Is U.S. Source Income?

Foreign companies paid for performing services in the United States are considered to have received “U.S. source income,” and the companies performing those services may have engaged in a U.S. trade or business. Foreign companies that engage in a U.S. trade or business are generally subject to U.S. income and employment taxes and are required to file Form 1120-F (U.S. Income Tax Return of a Foreign Corporation). They may also be required to file Form 941 (Employer’s Quarterly Federal Tax Return) and Form 940 (Employer’s Annual Federal Unemployment Tax Return) for payments made to their workers.

Unless certain exemptions apply, a U.S. company that pays U.S. source income to a foreign party must withhold U.S. income tax from the payments at a 30% rate. Generally, the U.S. company is required to deposit the withheld taxes with the IRS, report the payments on Form 1042-S, and file a Form 1042 by March 15 of the year after the payments. These obligations on the part of the U.S. company arise if the payments to the foreign company are considered “U.S. source income,” whether or not the foreign company is engaged in a U.S. trade or business. The U.S. company may be relieved of these obligations if the foreign company files certain forms claiming exemption from or reduced withholding.

Broad Definitions

The key to identifying U.S. source income is whether the services were performed or the income was earned in the “United States.” The extremely broad definition of the “United States” under section 638 of the Internal Revenue Code includes the Outer Continental Shelf for personal services relating to the “exploration and exploitation” of natural resources.

The IRS also uses an equally broad definition of “exploration and exploitation” of natural resources in a recent private letter and in the Industry Directive. In Private Letter Ruling 200823005 (Mar. 3, 2008) the IRS summarily concluded that income earned by foreign vessel owners that transported divers who undertook repair and remediation of oil and gas pipelines

and equipment is U.S. source income. Although the foreign vessel owners did not provide the divers, and the vessel crew was not directly involved in the exploration and exploitation of natural resources, the IRS attributed the activities of the divers to the foreign vessel owners.

The Industry Directive applies an even more expansive definition of “exploration and exploitation.” According to the Industry Directive, persons engaged in “exploration and exploitation” include: (1) contractors that perform services on the Outer Continental Shelf (such as seismographic testing, drilling, repair and salvage work); (2) vessel operators transporting supplies and personnel between U.S. ports and locations on the Outer Continental Shelf; and (3) owners and/or operators of foreign vessels that bareboat or time-charter to persons performing offshore services. Under the Industry Directive, therefore, a foreign vessel owner receives U.S. source income by merely providing a vessel under a bareboat charter arrangement to contractors engaged in activities that may relate to “exploration and exploitation.”

The question is, would such a broad definition of “exploration and exploitation” stand up to a court challenge? Even accepting that the divers in the private letter ruling and the contractors in the Industry Directive are indeed engaged in “exploration and exploitation” activities, their activities must be attributable to the captain, crew, and owners of the vessel before they are subject to U.S. tax. That connection could prove too tenuous for a court to accept. In *Ocean Drilling & Exploration Co. v. United States*, 24 Cl. Ct. 714 (1991), *aff'd*, 988 F.2d 1135 (Fed. Cir. 1993), the Claims Court held that providing insurance on mobile drilling rigs operating on the Outer Continental Shelf was not related to the “exploration and exploitation” of natural resources, and did not result in U.S. source income. That court ruling directly contradicts an example in the Treasury Regulations under section 638.

Foreign Vessels Owners Are Hearing from the IRS

Several hundred foreign vessel owners have received IRS letters requesting them to file U.S. tax returns and pay any tax and interest due, or provide a reason why they believe they are not required to do so. They were given 30 days to respond. The IRS identified these vessels using extensive information submitted to the U.S. Coast Guard for approval to operate foreign vessels with foreign nationals in U.S. waters, as well as through B1 visas which the U.S. State Department requires of foreign nationals who work on vessels in U.S. waters. The IRS then simply checked whether tax returns were filed by the vessel owners and workers.

The IRS can then learn from the foreign vessel owner which U.S. company hired it. The U.S. company will need to show it obtained appropriate documentation from the foreign vessel owner claiming exemption from withholding or reduced treaty withholding before any payment was made to the vessel owner. That documentation includes Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding, Form W-8BEN, or Certificate of Foreign Person’s Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States, Form W-8ECI.

If the U.S. company lacks such documentation, the IRS can assert the U.S. company failed to (1) withhold and deposit the 30% tax due on the amounts paid, and (2) file Form 1042 and Form 1042-S to report such payments. Penalties may also be asserted for failure to file tax returns or pay tax, failure to file correct information returns, and failure to furnish correct payee statements, as well as for negligence.

Preparation Is Essential

U.S. companies and foreign vessel owners should be ready to respond to IRS inquiries by analyzing the specific facts involved under U.S. tax laws. They may also consider challenging the IRS's broad definition of "exploration and exploitation" of natural resources; raising any available exceptions to or exemptions from U.S. tax return filing or withholding requirements; asserting available tax treaty exemptions or reductions; and seeking to have any penalties waived or reduced. Clearly, foreign vessel owners and the U.S. companies also need to look to the future and adjust their tax compliance procedures as needed.

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