



Subject to tax: foreign shipping businesses must start factoring in potential US taxes while negotiating time charters or bareboat charters on ships that might work on the US Outer Continental Shelf. Jocelyn Augustino/FEMA

Taxing times in the US Gulf

Away from the hubbub surrounding BP and Deepwater Horizon, the US taxman has shown up unannounced at the doors of several foreign shipowners on the US Outer Continental Shelf. Rajesh Joshi reports

DOZENS of foreign shipowners have received letters from the US Internal Revenue Service, asking them to clarify their status vis-à-vis the taxability of their income for work performed on the US Outer Continental Shelf in the Gulf of Mexico.

The IRS expects to issue further guidance by the end of June, which would clarify — and quite possibly expand — the scope of its pursuit of such owners and their foreign crews.

The guidance is expected to address employment taxes, and the withholding of social security and other dues from foreign employees' pay cheques.

The upshot for foreign shipping businesses, at the very least, is that they must start factoring in potential US taxes while negotiating time charters or bareboat charters on ships that might work on the OCS, by including tax gross-up clauses, for example. This would raise their price.

If a foreign charterer is engaged in OCS business taxable in the US, the IRS requires this taxpayer to pay a 30% withholding on the identified income to cover taxes that should have been paid.

However, legal experts said the IRS letters could not be wished away with such simple tactics as making time charters 30% more expensive. What was needed in most such cases, said Blank Rome partner Jonathan Waldron, was a frank personal meeting between a party engaged in OCS operations using foreign-flagged vessels and its tax adviser.

The IRS' promise of clarifying its position on withholding was likely to make companies focus on this issue even more, Mr Waldron said. This is because many foreign crew members do not have US social security numbers or tax identification numbers.

"Foreign employers may need to go through the procedure for obtaining these numbers for all foreign workers, even temporary ones," Mr Waldron added.

His point about seeking professional advice is well taken. The IRS letter gives the recipient 30 days from the date of receipt to file a US tax return, along with taxes due plus interest on the delay.

"This letter is not an audit of your tax return," says the document, reassuringly and ominously.

Lloyd's List understands there are at least dozens of such recipients. Blank Rome partner and business tax practice group leader Joseph Gulant confirmed there is strong anecdotal evidence to corroborate this, but could not provide names due to confidentiality.

Mr Gulant agreed that the letters had caused confusion, not to mention consternation, among the vast community of foreign shipowners engaged in some capacity or another on the OCS.

"These letters are a bolt out of the blue. The IRS has fired a shot across the bow of these foreign-owned businesses in an attempt to eliminate perceived competitive advantages over US-owned businesses," he said. These advantages often derived from the fact that foreign vessels offered lower rates because they were held by entities enshrined in low-tax or no-tax jurisdictions, Mr Gulant added.

The IRS letters attach a two-and-a-half page industry directive issued in October last year, which invokes the agency's authority over "foreign taxpayers engaged in activities related to the exploration for, or exploitation of, natural resources on the OCS".

According to the directive, an IRS analysis has indicated that a "significant number of foreign vessels permitted to work on the OCS do not comply with US filing requirements". The focus of the directive appears to be on corporate filers, and it is quite generic on how employees and their tax withholding are to be treated.

The directive states that the IRS' natural resources and construction industry group has established an

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Offshore Marine Service Association

issue management team to determine the compliance impact of OCS activities. It names four technical advisers to whom potential taxpayers may address questions related to shipping, natural resources, withholding and employment tax.

William Pfeil, the adviser designated for shipping, told Lloyd's List that he had since left this position, but confirmed that a "lot of delinquent returns" were filed after the letters went out, and there was "more voluntary compliance" in the aftermath of the directive.

The consensus, said Mr Pfeil, was that many of these taxpayers simply had no knowledge that they were subject to tax for activity on the OCS, and the IRS' outreach helped them to understand that they owed taxes.

Some of these filers have paid taxes, while others have claimed exemptions under tax treaties which the agency was reviewing, he said.

The IRS did not reveal how much was raised from these filers in back taxes and interest.

Mr Pfeil said the guidance expected by end-June would cover income tax, employment and withholding. It is expected to be issued in the form of a follow-up directive from IRS industry director for natural resources and construction Keith Jones.

The Offshore Marine Service Association, which represents owners and operators of US-flagged offshore service vessels and champions US-citizen crews operating this tonnage, voiced strong support for the IRS on this issue.

OMSA said: "This confirms something we have suspected for a long time, that many foreign vessels that work off leases granted by the US government and reap the benefits of America's oil and gas sector do not pay US taxes. Clearly, if the foreign boats start out with a 30% beneficial cost differential, that makes it hard for Americans to compete."

OMSA president Ken Wells told Lloyd's List that the IRS action was not to be construed as a blow against international commerce. He described work on the OCS as similar to a construction contractor being engaged to do business on the US mainland, and so being subject to US tax jurisdiction.

"The IRS is not changing fundamental rules here, but is simply addressing what, quite frankly, has been a black hole in the form of companies not paying taxes," Mr Wells said.

He cited the example of one foreign company, which publicly reported that it had to pay the IRS \$3.2m because foreign vessels it chartered had not paid US taxes.

Mr Wells also welcomed the prospect of a follow-up directive that might provide clarity on income tax withholding for foreign labourers who work on the OCS. He said keeping track of vessels on the OCS was an easier task for the IRS, thanks to US Customs and Border Protection arrival and departure records and Automatic Identification System data.

"It is dicier to determine who exactly is working on these boats and how US tax law applies to these workers. We hope the IRS' second guidance leads to

The letter of the law

Lloyd's List has obtained the letter that the US Internal Revenue Service is understood to be sending to shipowners. It is reproduced below, with names and identities removed:

Our research indicates that for a number of the past 10 tax years, [company name] has been involved in activities related to the exploration and exploitation of natural resources on the US Outer Continental Shelf. As such, you are responsible to file one or more tax returns with the Internal Revenue Service. We have no record of receiving your tax return(s) for the relevant tax years. If you have filed the returns(s), please give us the name, address, and employer identification number shown on each return filed. Also, please tell us the date that you filed the returns(s) and the amount of tax, if any, paid with each.

If you are not required to file, please tell us the reason you are not required to file a tax return. If you are required to file, please attach the return(s) to this letter and send them to us within 30 days of receipt of this letter. Include your payment for any tax due, plus interest as provided by law.

If your address as shown above is incorrect, please change it so we can update our records. We have enclosed a self-addressed envelope for your convenience and a copy of this letter for your records.

This letter is not an audit of your tax return. If you have any questions, please contact the person whose name and telephone number are shown above.

employers taking steps to address this aspect," Mr Wells said.

Mr Waldron agreed with Mr Pfeil's comment about foreign employers and individuals unwittingly facing possible US tax liability.

However, in the context of the upcoming guidance, Mr Waldron observed: "This appears to confirm that the IRS would be very aggressive. It fits with the agency's recent sabre-rattling on its tax enforcement, and the uptick in US protectionist tax policies. The onerous and counter-intuitive tax rules raised by the directive are no longer a theoretical concern — we now are seeing them in action."

OMSA is separately spearheading an effort to get the US regulatory system to revoke the agreement that allows foreign ships to transport specialist equipment for construction or modification of offshore installations in the US Gulf.

Mr Wells said: "We see this issue and the IRS directive as linked. Not only do we believe these vessels have been carrying substantial amounts of cargoes that only US vessels should carry, but we now find out that they are cheating our country out of tax revenue as well." He added that the Jones Act was an integral part of the fabric of US society, not just for job creation, but also for the government's tax revenues.

Mr Waldron and other experts downplayed the possibility that the spotlight on BP in the aftermath of the Deepwater Horizon oil spill, as well as the increased distrust of foreign corporations, would make the IRS' next steps on recovering back taxes on the OCS any more aggressive.

Still, it is hard to resist recycling a comment Mr Wells made last autumn: "This is a bad time for anyone to be seen as a tax cheat in America, let alone a foreign corporation."

Why the US taxman came calling

- The US Outer Continental Shelf is enshrined in a statute on "submerged lands". These lands are defined variously as "lands beneath navigable waters" and "seabed and subsoil of submarine areas adjacent to US territorial waters, over which the US has clear jurisdiction".
- Generally, the OCS begins three to nine miles from shore depending on the US state, and extends 200 miles outwards, or farther if the continental shelf as defined extends beyond 200 miles.
- Increasing specialisation of deepwater exploration in the past decade created a need for certain types of vessels not constructed in the US.
- The 2005 hurricanes spurred significant extra demand for foreign tonnage to perform repair and construction work on the Gulf of Mexico OCS.

- Due to all these factors, an unusually large number of foreign ships and crews stayed for extended periods, often beyond the 180-day threshold for tax purposes.
- The US cabotage sector and some politicians grew concerned that these foreign companies were enjoying a competitive advantage over US vessels and crews.
- The Internal Revenue Service last October decided to take a closer look at the issue. It issued a directive that said foreign companies active on the OCS could be liable to pay US taxes, subject to exemptions under treaties with other nations. Claims for treaty exemptions "must be examined closely", the directive said.
- The directive singled out three types of

- companies: (1) contractors that provide services such as drilling, testing, salvage or repair; (2) vessels that transport supplies and personnel between a US port and the OCS; (3) owners and operators of foreign-flagged ships that bareboat or time charter tonnage to persons engaged in the exploration for, and exploitation of, natural resources on the OCS.
- Foreign shipowners now have started receiving letters asking for an explanation as to whether they are US taxpayers, and if so, why they have not filed returns.
- The IRS is in the process of issuing further guidance on employment taxes and employee withholding — issues that the first directive covered only in broad terms.