

IRS Targeting Foreign Vessels in U.S. Offshore Oil and Gas Industry

by Kristen A. Parillo

Reprinted from *Tax Notes Today* as: 2009 TNT 218-4

TAX NOTES TODAY

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The IRS has announced that it will target foreign vessels working in the U.S. offshore oil and gas industry that may not be complying with U.S. filing requirements, a move hailed by the U.S. offshore marine service industry as essential for promoting fairer energy industry competition.

The IRS's Large and Midsize Business Division on October 28 issued a directive providing notice and field guidance about foreign taxpayers engaged in activities related to the exploration for, or extraction of, natural resources on the Outer Continental Shelf (OCS) in the Gulf of Mexico. The directive says the IRS's natural resources and construction industry group has established an issue management team to determine the compliance impact of those activities and to help identify, and improve the IRS's coordination of, related issues. (For LMSB-04-0909-037, see *Doc 2009-23950* or *2009 TNT 209-101*.)

The IRS explains in the directive that an increasing number of foreign vessels have applied to enter and work on the OCS and that an analysis shows that many of them do not comply with U.S. filing requirements.

"We're very happy the IRS has put this issue on its radar screen and will be stepping up enforcement efforts," said Ken Wells, president of the Offshore Marine Service Association, which represents the owners and operators of U.S.-flag offshore service vessels and other businesses that work in the U.S. offshore energy industry.

He said the number of foreign vessels working on the OCS in the Gulf of Mexico increased sharply around 2005, particularly in the aftermath of Hurricane Katrina, when many foreign vessels came to the Gulf of Mexico to do repair work. Wells also attributes the influx of foreign vessels to the increasing

amount of work being performed on the seabed, which requires larger, more sophisticated ships.

The directive notes that there are three basic categories of foreign taxpayers engaged in OCS activities: contractors that perform services on the OCS, such as seismographic testing, drilling, repair, and salvage work; vessel operators that transport supplies and personnel between U.S. ports and locations on the OCS; and owners or operators of foreign-registered vessels that charter out vessels on either a bareboat- or time-charter basis to persons engaged in OCS activities.

The directive explains that section 638(1) provides that the OCS is geographically within the United States for purposes of applying the Chapter 1 sourcing rules. Therefore, foreign contractors that provide services on the OCS are generally considered to be performing those services in the United States and deriving U.S.-source income. The contractors are also engaged in a U.S. trade or business for purposes of section 864, and thus are subject to tax on a net basis at graduated rates.

The directive says that all foreign companies engaged in a U.S. trade or business are required to file Form 1120-F, "U.S. Income Tax Return of a Foreign Corporation," and that if they are required to withhold on payments made to employees, they must also file a Form 941, "Employer's Quarterly Federal Tax Return." Foreign companies making a treaty-based claim must attach a Form 8833, "Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)," to the Form 1120-F. Failure to disclose a treaty-based return position may result in penalties under section 6712, according to the directive.

Foreign corporations that derive income from transporting cargo and crew to locations on the OCS have filing requirements similar to those of foreign service providers, the directive explains.

Income derived from foreign corporations that charter out vessels on a bareboat- or time-charter basis is characterized as leasing or rental income. The directive says those chartering vessels on a time-charter basis may be considered engaged in a U.S. trade or business if their employees continue to navigate and manage the vessel during the charter period.

Those chartering out vessels under a bareboat-charter arrangement are subject to a 30 percent gross basis tax under section 881. The lessee — whether U.S. or foreign — using the vessel in the exploration for, or extraction of, natural resources is required to withhold the 30 percent tax under section 1441 and to file a Form 1042, “Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.” Failure to do so may result in a penalty, the directive warns.

Wells said there is much consternation among U.S.-flag vessel owners because some of the foreign vessels appear to offer “suspiciously low” rates. He said that over time, the U.S. operators began to suspect that some foreign vessels were able to offer low rates because they weren’t paying U.S. taxes. However, the U.S. tax liabilities of foreign vessels performing work on the OCS didn’t seem to be a focus of the IRS’s attention at that time, he said.

That changed, however, when Superior Offshore International Inc., a Houston-based provider of subsea construction and commercial diving services to the offshore oil and gas industry, filed an amended Form 10-K in 2007. The company said it was restating its

earnings because two of its chartered foreign boats had not paid U.S. taxes. The amended filing indicated a liability of \$3.2 million. (The company has since filed for bankruptcy.)

“There was a huge buzz among the industry when that filing came out,” Wells said, adding that the filing raised questions about the U.S. tax liabilities of foreign vessel owners and the U.S. companies that hire them.

Wells said his organization submitted a request to the IRS’s industry issue resolution program in March, asking for clarity on the issue. “We never heard anything until this directive came out,” he said.

Wells said he is pleased that the IRS has taken up the issue and that he believes the enforcement initiative will help level the playing field. “Our U.S. vessels are at a disadvantage if so many of these foreign vessels are able to offer low rates by not paying U.S. taxes,” he said. “It is very important that the IRS ensure foreign vessels aren’t sidestepping their U.S. tax obligations so that we are able to compete.” ◆

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