

IRS Directive on Outer Continental Shelf Activity

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The Service's Large and Mid-Size Business division has issued a new directive regarding foreign taxpayers engaged in activities related to the exploration for, or exploitation of, natural resources on the Outer Continental Shelf in the Gulf of Mexico ("OCS"). LMSB-04-0909-037, Oct. 28, 2009, *Industry Director's Directive #1 – United States Outer Continental Shelf Activity*. There are three basic categories of foreign taxpayers that will undergo scrutiny:

- Contractors that perform services on the OCS,
- Vessel operators that transport supplies and personnel between United States ports and locations on the OCS, and
- Owners and/or operators of foreign-registered vessels that bareboat or time charter to persons that are engaged in activities related to the exploration for, or exploitation of, natural resources on the OCS.

The directive notes that in recent years, an increased number of foreign vessels have applied to enter and work in the OCS and that Service analysis indicates that a significant number of foreign vessels permitted to work in the area are not complying with United States filing requirements. In this regard, the Service's natural resources and construction industry group has established an issue management team to determine the extent of noncompliance. While a number of areas may be impacted, this article addresses employment tax compliance associated with foreign vessels and foreign crews.

Are Services Provided in the OCS Within the United States?

Federal employment taxes (*i.e.*, income tax withholding, the Federal Insurance Contributions Act (FICA), and the Federal Unemployment Tax Act (FUTA)) generally apply to services performed inside the United States. Section 638(1) provides that the OCS is geographically located

within the United States. Thus, foreign employees that provide services in the OCS are considered to perform services in the United States.

The FICA Tax

FICA has two components: an Old-Age, Survivors, and Disability Insurance (*i.e.*, social security) tax and a Medicare tax. Pursuant to section 3121(b), FICA generally applies to payments of wages for services performed as an employee in the United States, regardless of the citizenship or residence of either the employee or the employer. Although there are exceptions to FICA for nonresident aliens working in the United States based on visa status, these exceptions generally do not apply to workers performing services on vessels in the OCS. However, there is a specific FICA exception under section 3121(b)(4) for vessels based on the location of work performed and locality of vessel registration. This exception requires intense factual development and can lead to unpredictable results. For example, wages paid to some workers on a particular vessel may be subject to FICA taxes,

while wages paid to other workers on the same vessel may not be subject to FICA. Determining factors may include such facts as where the individual boarded and/or departed the vessel.

The question of whether services performed in the OCS are subject to FICA is further complicated by the existence of Totalization Agreements. In some cases, an employee will be subject to social taxes both in his home country and in a foreign location where the employee is working. The United States has entered into Totalization Agreements with 24 countries for the purpose of avoiding this dual taxation. These agreements must be considered when analyzing the applicability of FICA. While each Totalization Agreement is unique and should be reviewed for specific application, the basic rules are consistent. Under the general rule, an employee who would otherwise be subject to FICA tax and a foreign country's social tax remains subject exclusively to the social tax of the country in which the individual is working.

The general rule is the "territorial rule." Each agreement (except one, United States-Italy) includes an exception to the territorial rule designed to minimize disruptions in benefits coverage of the employee. Under this "detached worker rule" exception, an employee who is temporarily transferred to work for the same employer in another country remains covered only by the country from which he is sent. The detached worker rule applies to employees whose assignments are expected to last five years or less. Employees who are exempt from social taxes under an agreement must document their exemption by obtaining a certificate of coverage from the country that will continue to cover them. Accordingly, a particular individual working on a vessel in the OCS that is otherwise subject to FICA tax may be excepted from FICA depending on whether the individual is from a Totalization country and whether the individual has a certificate of coverage under the detached worker rule.

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The FUTA Tax

Section 3301 imposes an excise tax on every employer with respect to wages paid by the employer in the course of employment. FUTA is similar to FICA in that pursuant to section 3306, FUTA generally applies to payments of wages for services performed as an employee in the United States, regardless of the citizenship or residence of either the employee or the employer. As with FICA, there are exceptions to FUTA for nonresident aliens performing services in the United States based on visa status; however, these exceptions generally do not apply to workers performing services on vessels in the OCS. Again, similar to FICA, there is a specific FUTA exception under section 3306(c)(4) for vessels based on the location of work performed and locality of vessel registration. However, unlike FICA, Totalization Agreements do not apply to the FUTA tax.

Federal Income Tax Withholding

Pursuant to section 3402, every employer making a payment of “wages” is required to deduct and withhold income taxes unless a specific exception applies. Section 871(b)(1) provides that wages for personal services paid to nonresident alien employees are subject to graduated withholding in the same way as for United States citizens and residents if the wages are effectively connected with the conduct of a United States trade or business.

Under section 864(b), the term “trade or business within the United States” includes the performance of personal services within the United States. However, section 864(b)(1) provides an exception for nonresident aliens performing services in the United States for a foreign corporation for a short period of time (less than 90 days) who earn less than \$3,000. As with FICA and FUTA, there are exceptions to income tax withholding for nonresident aliens performing services in the United States based on visa status. However, these exceptions generally do not apply to workers performing services on vessels in the OCS. There are also income tax treaties that the United States has entered into with other nations that allow foreign workers to take a treaty position with respect to personal services performed in the United States. A properly documented treaty claim may alleviate the need for an employer to withhold income taxes from the pay of a nonresident alien’s wages. It should be noted that dependent services articles under many treaties may not apply if the employer has a permanent establishment in the United States.

Depositing and Reporting

Foreign corporations operating in the OCS often are unaware they are paying United States source wages and therefore have deposit and reporting responsibilities. These obligations can be significant.

Regulations sections 31.6011(a)-1 and 31.6011(a)-4 prescribe the filing of Form

941, *Employer’s Quarterly Federal Tax Return* for FICA and income tax withholding purposes. Similarly, for FUTA purposes, section 31.6011(a)-3 prescribes the filing of Form 940, *Employer’s Annual Federal Unemployment Tax Return*. Section 31.6302-1 requires that the employer timely deposit employment taxes. Every employer engaged in a United States trade or business who pays remuneration for services performed by an employee must give that employee a written statement regarding the remuneration paid during the calendar year. I.R.C. § 6051(a). Regulations section 31.6051-1(a) provides that the statement is Form W-2, *Wage and Tax Statement*. Failure to meet these obligations may result in significant penalty exposure.

Guidance

The Service’s industry directive provides guidance on foreign taxpayers engaged in activities related to the exploration for, or exploitation of, natural resources on the OCS. Foreign corporations are often unfamiliar with the complex rules that apply to the workers performing these services. As the Service focuses resources on foreign corporations conducting operations in the OCS, these foreign corporations must focus on achieving and maintaining employment tax compliance. Because of the uneven application of the FICA, FUTA and income tax withholding rules, this process can be a significant challenge for foreign corporations unfamiliar with these rules. ■

