



Industry Director's Directive #1 - United States Outer Continental Shelf Activity

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MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
 DIRECTOR, FIELD SPECIALISTS, LMSB
 DIRECTOR, PRE-FILING AND TECHNICAL GUIDANCE, LMSB
 DIRECTOR, INTERNATIONAL COMPLIANCE STRATEGY AND POLICY, LMSB
 DIRECTORS, FIELD OPERATIONS, NATURAL RESOURCES AND CONSTRUCTION, LMSB

FROM: Keith M. Jones /s/ Keith M. Jones
 Industry Director
 Natural Resources and Construction

SUBJECT: Industry Director's Directive #1 - United States Outer Continental Shelf Activity

This Memorandum provides notice and field direction about 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 (the "OCS").

Background/Strategic Importance:

In recent years, an increased number of foreign vessels have applied to enter and work in the OCS. Our analysis indicates that a significant number of foreign vessels permitted to work in the OCS do not comply with U.S. filing requirements. Three basic categories of foreign taxpayers engage in activities related to the exploration for, or exploitation of, natural resources in the OCS: (1) contractors that perform services on the OCS (such as seismographic testing, drilling, repair and salvage work); (2) vessel operators that transport supplies and personnel between U.S. ports and locations on the OCS; and (3) 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.

Income derived by foreign individuals and corporations from U.S. sources is generally taxable by the United States. I.R.C. §§ 871, 882. The rules for determining the source of services, transportation, and rental income (Internal Revenue Code sections 861(a)(3), 863(c)(1), and 861(a)(4), respectively) depend on where the services are performed, where the transportation begins and ends, and where the rental property is used.

Section 638(1) provides that the OCS is geographically within the United States for purposes of applying Chapter 1 of the Code, which includes all the rules for sourcing income. Thus, foreign contractors that provide services on the OCS are generally considered to perform those services in the United States and derive U.S. source income. They are also engaged in a U.S. trade or business for purposes of section 864 and therefore are subject to tax on a net basis at graduated rates.

Every foreign corporation engaged in a U.S. trade or business is obligated to file Form 1120-F (although some may only file protective returns). If the foreign corporation is required to withhold on payments made to employees, it must also file a Form 941 (Employer's Quarterly Federal Tax Return). A foreign corporation claiming it is exempt from U.S. tax under a bilateral U.S. income tax treaty must attach a Form 8833 (Treaty-Based Return Position Disclosure under Section 6114 or 7701(b)) to its Form 1120-F and report the treaty position and article it is relying upon, its treaty country of residence, and an estimate of the gross income exempt from tax by reason of the treaty. Failure to disclose a treaty-based return position may result in penalties under section 6712.

Treaty claims must be examined closely because certain U.S. treaties have special provisions that relate to the offshore oil and gas industry. Treaties can also vary in how the existence of a permanent establishment is determined (see Permanent Establishment articles) and in how taxable profits are computed (see Business Profits articles). Additionally, if a foreign corporation claims an exemption from tax, the corporation must meet the Limitation on Benefits article, if any, in that treaty.

Foreign corporations that derive income from transporting cargo and crew to locations on the OCS also derive U.S. source income under section 863(c)(1) because the transportation begins and ends within the United States, as defined by section 638(1). Provided their activities are regular and continuous, these companies are also engaged in a U.S. trade or business. In that event, they have filing requirements that are similar to those of foreign service providers.

Foreign corporations that charter out vessels on either a bareboat or a time charter basis (see Treas. Reg. § 1.883-1(e) (5) for definitions) also generally derive income from activities within the scope of section 638 for the period of time during which the vessels are engaged in the exploration for, or exploitation of, natural resources on the OCS. Income derived by foreign taxpayers from these activities is characterized as leasing or rental income and sourced based on where the vessel is used. I.R.C. § 861(a)(4); see *Tidewater Inc. v. United States*, No. 06-875, 2007 U.S. Dist. LEXIS 77147 (E.D. La. Oct. 17, 2007), *aff'd*, No. 08-30268, 2009 U.S. App. LEXIS 7785 (5th Cir. Apr. 13, 2009)). Consequently, because the OCS is a part of the United States under section 638(1), such income is sourced in the United States.

Foreign time charterers may be engaged in a U.S. trade or business because their employees continue to navigate and manage the vessel during the time charter period. A foreign bareboat charterer will generally not be engaged in a U.S. trade or business solely by reason of leasing a vessel to another person. However, because any rental payments under bareboat-charter arrangements with respect to vessels located in the United States for purposes of section 638 are sourced in the United States, the foreign bareboat charterer will be subject to a 30% gross basis tax under section 881. Under section 1441, the lessee (whether domestic or foreign) that uses the vessel in the exploration for, or exploitation of, natural resources is required to withhold this tax, and 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.

Planning and Examination Guidance:

NRC has established an Issue Management Team to determine the compliance impact of these activities, and help identify, develop, resolve, and improve Service coordination of issues related to these activities. Questions regarding this directive should be directed to the following Technical Advisors:

- For shipping issues, William Pfeil (202) 283-8415 (William.Pfeil@irs.gov);
- For natural resources and section 638 issues, Ellen Kolpin (713) 209-3644 (Ellen.K.Kolpin@irs.gov);
- For withholding tax issues, Robert Driscoll (713) 209-4456 (Robert.G.Driscoll@irs.gov);
- For employment tax issues, Kathy VanDeventer (619) 228-7944 (Kathy.VanDeventer@irs.gov).

Issue Tracking: Project Code 0555
Tracking Code 1555

Project established UIL Codes:

1. 638.03-01. US Outer Continental Shelf (OCS) - US Flag vessels engaged in Oil & Gas Exploration, Repair, or Maintenance
2. 638.03-02. US Outer Continental Shelf (OCS) - Foreign Flag vessels engaged in Oil & Gas Exploration , Repair, or Maintenance
3. 638.04-01. US Outer Continental Shelf (OCS) - Foreign Flag vessels engaged in Bareboat Charter Rents
4. 1441.05-01. US Outer Continental Shelf (OCS) – Withholding on Foreign-Flag Vessels engaged in Bareboat Charter Rents
5. 1441.05-02. US Outer Continental Shelf (OCS) – Withholding on Foreign-Flag Vessels engaged in Time or Voyage Charters for Services
6. 3401.01-06. US Outer Continental Shelf (OCS) – Income tax withholding, FICA, & FUTA for Foreign Employees working on Oil & Gas Rigs
7. 3401.01-07. US Outer Continental Shelf (OCS) – Income tax withholding, for Foreign Employees Working on Foreign Flag Vessels.

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cc: Commissioner, LMSB
Commissioner, TEGE
Deputy Commissioner, Operations, LMSB
Deputy Commissioner, International, LMSB
Director, Planning, Quality, Analysis & Support, LMSB
Director, Research & Workload Identification, LMSB
Division Counsel, LMSB
Chief, Appeals
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