EMPLOYMENT TAX AND EMPLOYEES ON THE OUTER CONTINENTAL SHELF

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On March 30, 2011, the Internal Revenue Service (the "IRS") released Industry Director's Directive #2 – Employment Tax and the Employees on the U.S. Outer Continental Shelf ("Directive #2"). Directive #2 provides notice and field direction on the application of section 3402 of the Internal Revenue Code,[2] the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Tax Act ("FUTA") to remuneration for work performed by nonresident alien employees on the Outer Continental Shelf in the Gulf of Mexico (the "OCS"). Directive #2 draws from the legal conclusions reached in Chief Counsel Advice 201027046 released on July 9, 2010. CCA 201027046 concluded that services performed by a nonresident alien employee on structures permanently or temporarily attached to the OCS, or on vessels or other devices engaged in activities related to the exploration for, or exploitation of, natural resources on the OCS are performed within the U.S. and that any remuneration paid for such services is subject to withholding of income tax, FICA and FUTA.

The IRS has determined that many employers fail to comply with their withholding obligations for nonresident alien employees working on the OCS. An OCS compliance steering committee has been established to help identify, develop, resolve and improve IRS coordination of issues related to OCS activities.

Income Tax Withholding

Employers that employ nonresident alien individuals on the OCS have withholding obligations with respect to compensation paid to those employees if the employees provide services in the United States. The definition of the "United States" for federal income tax purposes is very broad when analyzing whether personal services provided on the OCS are provided in the U.S.[3] Nonresident alien employees who perform services on structures permanently or temporarily attached to the OCS, or on vessels or other devices engaged in activities related to the exploration for, or exploitation of, natural resources on the OCS, are generally engaged in a U.S. trade or business.[4] Accordingly, the compensation paid to such nonresident alien employees is effectively connected with the conduct of a U.S. trade or business[5] and subject to withholding of income tax by the employer.

Section 1441 requires a 30% withholding tax on the gross amount of salaries, wages, compensation, remuneration, or other fixed or determinable annual or periodic income derived by a nonresident alien employee from U.S. sources. The withholding under section 1441 is not required, however, to the extent that withholding is required under section 3402.[6] Section 3402 simply requires that every employer making a payment of wages must withhold income tax. Although wages generally include all remuneration for services performed by an employee for an employer,[7] wages subject to withholding do not include remuneration for services performed in the U.S. by a nonresident alien employee if the remuneration is (or will be) exempt from income tax under a provision of the Code or an income tax treaty to which the U.S. is a party.[8]

A nonresident alien employee claiming an exemption from withholding under an income tax treaty must provide the employer with a Form 8233, Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual.

If no income tax treaty exemption from U.S. federal income tax withholding applies, a nonresident alien employee may claim withholding allowances on Form W-4, Employee's Withholding Allowance Certificate. Notice 2005-76, 2005-2 CB 947, provides special rules for nonresident alien employees to use in completing Form W-4 and for employers to determine how much income tax to withhold from wages. Modified rules applied for wages paid to nonresident alien employees during calendar year 2010,[9] but Notice 2005-76 continues to be fully in effect for wages paid on or after January 1, 2011.[10] If the nonresident alien employee does not furnish a fully completed Form W-4 to the employer, the employer is required to withhold as if the employee were a single person with no withholding allowances.

FICA and FUTA Withholding

For purposes of FICA and FUTA, wages include all remuneration for employment. Employment generally includes any service performed by an employee for an employer within the U.S. regardless of the citizenship or residence of either. For example, the employee and employer may be citizens and residents of a foreign country and the contract of service may be entered into in a foreign country, but if the services under the contract are performed within the U.S., such services may be deemed "employment" for FICA and FUTA purposes.[11] Section 3121(b)(4) provides an exception for FICA from the definition of "employment" if: (A) the services provided by an individual are on or in connection with a vessel that is not an American vessel, (B) the individual is employed on and in connection with such vessel when outside the U.S., and (C) either: (i) such individual is not a U.S. citizen, or (ii) the employer is not an American employer. Section 3121(h) defines an "American employer" for FICA purposes to include an individual who is a resident of the U.S., a partnership, if two-thirds or more of the partners are residents of the U.S., and a corporation organized under the laws of the U.S. or of any State. Section 3306(c)(4) provides a similar exception for FUTA from the definition of "employment," but the FUTA exception requires only that the services be performed on or in connection with a vessel that is not an American vessel as long as the individual is employed on and in connection with such vessel when outside the U.S.

FICA is calculated as a percentage of wages and imposed in addition to other taxes on those wages;[12] whereas, an employer is liable for FUTA in an amount equal to a certain percentage of total wages paid by the employer during the calendar year.[13] Wages that are covered by a totalization agreement, as evidenced by a certificate of coverage issued by a foreign country, are exempt from FICA.[14] An employer is never exempt from FUTA, however, under a treaty or totalization agreement. Additionally, an employer is subject to FUTA without regard to whether it is required to make contributions to, or its employees are eligible to receive benefits under, a state unemployment compensation law.[15]

IRS Enforcement of Noncompliance

The IRS' newly created OCS compliance steering committee is designed to help identify, develop, resolve and improve IRS coordination of issues related to OCS activities. In addition, the IRS advises employers subject to these withholding rules to provide all information related to OCS employment tax obligations directly to the examiner instead of filing delinquent returns with the Campus Centers, which will facilitate the proper calculation of employment tax. Some specific requirements under Directive #2 for OCS employers include: (A) accounting for quarterly employment tax periods during which an OCS employer had no employees working on the OCS by placing zeroes on the appropriate report; and (B) for employers with a continuing presence on the OCS, filing future quarterly employment tax return Forms 941 by using zeroes for any quarterly period during which they had no employees actually working in the OCS.

Examiners have been directed to notify the OCS compliance steering committee if the examiners are contacted by employers with questions about employment tax obligations for individuals employed on the OCS. With respect to planning and examination risk analysis, Directive #2 instructs examiners to address all relevant issues, including an employer's solicitation of Forms W-4, withholding, reporting, and payment of employment tax, and claims for tax exemption under an income tax treaty or totalization agreement and to challenge arguments by taxpayers who have not complied with the provisions of the Code relating to employment tax.

In conclusion, employers that employ nonresident alien individuals on the OCS should focus on their withholding obligations and should be prepared for potential IRS inquiries. OCS employers may also need to consider making adjustments to their tax compliance protocol going forward to ensure that the proper forms are filed with the IRS.

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[2] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code").
[3] *See* Andrius R. Kontrimas & Robert C. Morris, *Where is the "United States" for Federal Tax Purposes?*, 36 TEX. TAX LAW. 9 (2009).
[4] IRC sections 864(b) and 638(1); Treas. Reg. sections 1.638-1(a) and (c).
[5] IRC section 871(b).
[6] IRC section 1441(c)(4); Treas. Reg. section 1.1441-4(b)(1).
[7] IRC section 3401(a).
[8] Treas. Reg. section 31.3401(a)(6)-1(f).
[9] Notice 2009-91, 2009-48 IRB 717.
[10] Notice 2011-12, 2011-8 IRB 514.
[11] Treas. Reg. sections 31.3121(b)-3(b) and 31.3306(c)-2(b).
[12] IRC sections 3101, 3111 and 3121(a).
[13] IRC section 3301 and 3306.

[14] The Social Security Administration's website provides a list of countries with which the U.S. has entered into a totalization agreement: http://www.ssa.gov/international/agreements_overview.html.
[15] Rev. Rul. 75-87, 1975-1 CB 325.