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Adams Challenge (UK) Limited: A Fresh Look at the Sourcing Rules with Respect to Oil and Gas Exploitation on the OCS

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A recent U.S. Tax Court (Court) ruling provides a useful reminder to non-U.S. persons operating on the U.S. Outer Continental Shelf (OCS) that any income earned in connection with activities on the OCS may be subject to U.S. federal income tax.

In *Adams Challenge (UK) Limited v. Commissioner*, 154 T.C. No. 3, the Court took a fresh look at income earned by a corporation incorporated under the laws of the United Kingdom (the Company) and engaged in post-production activities on the OCS. The Court held that personal service activities conducted on the OCS on behalf of the Company were related to the exploitation of oil and gas wells. Therefore, the Company was engaged in a U.S. trade or business pursuant to Internal Revenue Code (Code) Section 638, and any income from such activities was income effectively connected to the conduct of a trade or business in the United States (ECI) under Code Section 882 and subject to U.S. tax at regular graduated rates (unless otherwise exempt under an applicable income tax treaty). Further, the Court held that the Company was deemed to have a U.S. permanent establishment (PE) pursuant to the applicable income tax treaty, and thus any such income was not exempt from taxation based on any treaty benefits.

At issue in the *Adams Challenge* case was the question of whether the activities engaged in by the Company on the OCS were within the scope of activities related to the exploration and exploitation of natural resources and therefore constituted a U.S. trade or business. In this instance, the Company's sole activity was the charter of a vessel and crew to perform various decommissioning services in connection with oil and gas rigs on the OCS during the taxable years 2009 through 2011. At no time did the trade or business of the Company or the charter vessel in question include oil or gas exploration.

Effectively Connected Income

A non-U.S. corporation (or non-U.S. individual) that engages in a trade or business within the United States generally is subject to tax with respect to ECI. A non-U.S. corporation generally is subject to an additional 30% branch profit tax on such income (though this was not addressed in the case). For purposes of applying rules that determine the source of income as U.S. or non-U.S. source (which is relevant to whether income is subject to U.S. federal income tax, including as ECI), the scope of the geographical reach of the United States generally is limited to the fifty states and the District of Columbia. However, Code Section 638 (and the Treasury Regulations promulgated thereunder) expands the scope of the United States with respect to mines, oil and gas wells, and other natural deposits to include the OCS when income is related to a trade or

business engaged in, or related to, "the exploration and exploitation of natural resources."

The parties stipulated in *Adams Challenge* that the Company was engaged in a trade or business. The Company, however, argued that its post-production activities on the OCS were unrelated to the exploitation of oil and gas for purposes of Code Section 638 and thus did not separately give rise to a trade or business in the United States. Accordingly, per the Company's position, the activities could not produce ECI.

The Treasury Regulations provide examples of trade or business activities that are deemed to be engaged in or with respect to the exploration or exploitation of oil and gas wells for purposes of determining whether such activities will be treated as being conducted within the United States. Specifically, each of (1) a medical doctor travelling to the OCS drilling platforms to provide routine physical examinations of rig workers and (2) an individual cooking meals for crew on board a vessel chartered to explore for oil on the OCS, is treated as engaged in activities related to the exploration or exploitation of natural resources in the United States. The Treasury Regulations also contain an example in which a corporation is treated as earning income from the exploration of oil (a trade or business under Code Section 638) as a result of providing a vessel, equipment and crew through a time charter to another corporation that used the vessel, equipment and crew to explore for oil. These examples illustrate the wide scope of the types of activities that cause an entity to be "engaged in or related to the exploration for, or exploitation of," oil and gas wells, giving rise to U.S. source income when conducted on the OCS.

Consistent with the Treasury Regulations, the Court rejected the argument that post-production activities should not fall within the scope of Code Section 638, finding that the exploitation of oil and gas resources on the OCS includes many different types of essential activities including pre-production activities (bidding on offshore leases, getting permits, and drilling wells), production activities (staffing platforms, extracting resources, and performing repairs and maintenance) and post-production activities (plugging wells, decommissioning pipelines, and removing debris).

Based on the Company's activities, which included providing a chartered vessel and support services for the decommissioning of oil and gas wells on the OCS, the Court found that the Company was engaged in a U.S. trade or business related to the exploitation of oil and gas on the OCS. As such, the Court held that the Company's charter income, the Company's only income for the years in question, was ECI and therefore subject to U.S. federal income tax).

U.S. Permanent Establishment

The United States has entered into a number of bilateral income tax treaties in an effort to avoid the double taxation of multinational companies by determining how such companies will be taxed on income earned in each contracting state (each, a State). Under most such treaties, a member of one State is exempt from tax on business profits earned in the other State unless attributable to a PE in such other State – in which case that State has the right to tax income so attributable. Generally, a PE is a fixed place of business in the source State through which the trade or business (in whole or in part) is carried on. While business profits are subject to tax in the contracting state if attributable to a PE, this also can include income that otherwise would be exempt from tax or subject to a reduced rate of tax under such treaty, such as passive income (i.e., interest, dividends and royalties).

For purposes of the *Adams Challenge* case, the applicable treaty with the United Kingdom provides that a U.K. company is deemed to be carrying on business in the United States through a PE in the United States if the company carries on exploitation activities in the United States. The Court found that the Company's chartered vessel and crew was not engaged in mere "transport" of passengers or goods, but rather had been chartered as a support vessel with specialized equipment valuable for decommissioning activity -- and, therefore, the Company was carrying on exploitation activities in the United States. The Court rejected as without legal merit the argument that any income earned in connection with time spent at port, in transit, or idling at sea should not be attributable to the PE because the Company was not engaged in services or activities other than the decommissioning services for which the Company received a daily flat rate regardless of whether the ship was engaged in operations. Therefore, the Court held that all of the activities of the Company were related to, and were carried out in connection with, the exploitation of oil and gas wells on the OCS and therefore attributable to the Company's PE in the United States. Thus, the treaty allowed the income to be subject to tax in the United States.

Conclusion

The Court's holding in *Adams Challenge* provides a fresh look at the broad scope of activities captured under Code Section 638 and the related Treasury Regulations for purposes of determining whether a non-U.S. corporation is engaged in a trade or business in the United States and whether it has ECI. Taxpayers should be mindful of the extent to which applicable income tax treaties could give rise to a PE in the United States in the context of the activities covered by Code Section 638, thereby eliminating treaty protection for business profits and possibly other related income. This case makes clear that, as far as the Court is concerned, decommissioning activities on the OCS can result in U.S. federal income tax.