
Tax insurance protects against intangible drilling costs



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Tax insurance has protected individuals and corporations for about a decade. The typical corporate policy was generated to address potential tax liabilities created or shifted in a merger or acquisition. Although the identified risk might have been supported by a strong legal opinion, tax insurance provides the certainty needed to avoid lengthy escrow requirements or indemnification issues. In addition, tax insurance provides a practical buffer to IRS review.

The IRS has said that tax insurance is a “green light.” This means that the IRS is unlikely to focus its limited audit resources on a position that has been thoroughly vetted by an independent third party who concluded that the merits were strong enough to risk its own capital.

These same factors are present in the oil and gas drilling industry. Congress has crafted tax incentives to encourage investor support for oil and gas drilling. Although these tax incentives provide significant value, there is complexity and potential risk. The primary tax incentive permits partnerships to immediately deduct all domestic intangible drilling costs (IDC). As you might guess, the IRS has an extensive audit guide on how to review if IDC are properly deducted.

Risk Capital Partners, a brokerage specializing in tax insurance, has developed a protocol for IDC tax insurance in conjunction with two major insurers. IDC tax insurance can cover the loss of the deduction for both state and federal tax purposes, penalties, interest, and gross-up (the insurance recovery is taxable).

Structuring the policy

Ultimately, the insurance policy may be structured so that the investor is put back in the same position as if the deduction had been allowed. Although the maximum statutory liability may be insured, the investor may focus on different levels if that is attractive.

IDC tax insurance is underwritten on the same basis as steam boiler insurance: This means that the underwriting process is sufficiently rigorous to ensure that there will be no loss upon an IRS audit (or analogously that no steam boiler ever explodes). The insurers will assure themselves that the IDC deductions are valid before allowing the insurance to attach. Note that if the partnership and the insurer disagree on some deductions, the partnership may still choose to deduct these expenses immediately they just will not be protected by the insurance.

IDC tax insurance is a form of "long-tail" insurance. In comparison, your short-tail home insurance policy will pay out most losses in the year you purchase the insurance. As there is some time before an audit occurs, the IDC tax insurer will not be likely to pay losses until four or five years have passed. Because of the length of the tail, it is critical that partnerships only purchase protection from highly-rated insurers that will be there if a claim is ultimately payable.

Investors gain two benefits from IDC tax insurance. The obvious one is the peace of mind that the financial benefit derived from the tax deduction will be assured. The second is equally important. Investors may gain a greater level of trust for a drilling partnership willing to undergo an underwriting audit from a major financial institution. In the maverick oil and gas drilling marketplace, the drilling group that has been subject to this level of review may be less likely to be engaging in questionable financial practices.

Downside

There are some drawbacks to IDC tax insurance. It is not free, and therefore will subtract from profits otherwise distributable to partners and originators. It also places certain restraints on the drilling partnership during an IRS audit. Specifically, the insurers will have a "right to associate" in the audit process in order to make certain that the partnership does not hand over the "insured" deductions in exchange for having uninsured deductions stand. This last risk is applicable to any tax insurance and has not proven to be an insurmountable problem to date.

There are also some areas where tax insurance will not provide coverage. In certain circumstances, IDC can be deducted before the IDC is incurred. Nevertheless, the insurance policy must address defined expenses. This is only possible after the expenses are incurred. Typically, the insurer will promise to offer \$X million of coverage (the "Limit") and determine after drilling which expenses are covered.

Second, the drilling partnership will forfeit its right to expense IDC immediately if the initial tax return does not contain such an explicit election. In this situation, the IDC must be capitalized and amortized. A failure to elect cannot be reversed by amending the return, and such failure is uninsurable.

In sum, IDC tax insurance will not have value for all drilling partnerships, but it may provide a necessary edge in attracting investor capital for others. OGFJ

About the authors

Levi Pearson [levip@rcps.com] has more than 25 years of creating transactions in the insurance and reinsurance industries that cross disciplinary, regulatory, and national borders, including eight years at Swiss Re where he underwrote and designed the largest insurance transaction ever successfully completed.

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Doug Rogers served as the director of penalties and interest during the last five years of his 30 with the Internal Revenue Service. Under his guidance, the IRS enhanced the overall consistency of penalty application ensuring that they are developed as a separate compliance issue.

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