



INTERNAL REVENUE SERVICE
HEARING OF PROPOSED REGULATIONS

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IRS Headquarters
1111 Constitution Avenue, N.W.
Room 4718
Washington, D.C. 20224
Tuesday, January 7, 2003

APPEARANCES:

On Behalf of Government:

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Acting Deputy International Tax Counsel
Office of Assistant Secretary for Tax Policy

Jeff Paravano, Treasury
Senior Advisor
Office of Assistant Secretary Tax Policy

Speaker:

David De Berry, The Hartford
Attorney

Question from Floor:

Dan Rinke
CCH Incorporated



1 PROCEEDINGS

2 [10:10 a.m.]

3 MR. O'SHEA: Okay, I guess we'll start. We're here for
4 the hearing on the disclosure and list tax shelter
5 regulations.

6 My name's William O'Shea. I'm the Deputy Associate
7 Chief Counsel of Passthroughs and Special Industries. I'll be
8 the moderator. To my far right is Jeff Paravano. He's the
9 Senior Advisor to the Assistant Secretary for Tax Policy. The
10 list you received listed Julian Kim, who couldn't make it
11 today. So we were very fortunate to get Jeff.

12 Also from Treasury is Carl Dubert. He's the acting
13 Deputy International Tax Counsel of the Office of the
14 Assistant Secretary for Tax Policy. To his left is Charlotte
15 Chyr. She's an attorney - one of the drafting attorneys with
16 Passthroughs and Special Industries.

17 The internal left is Tara Volungis. She's an attorney
18 with Passthroughs and Special Industries, another one of the
19 drafting attorneys on these regulations. To my immediate



1 right is Christine Ellison. She's the Branch Chief
2 responsible for these regulations and Passthroughs and Special
3 Industries.

4 I believe our speaker is here. We usually allow ten
5 minutes. Since we only have one speaker, we may be able to be
6 a little liberal on that. So, Mr. David De Berry from The
7 Hartford will speak.

8 MR. DE BERRY: Thank you. Good morning. Thank you very
9 much for allowing me this opportunity to speak, and also for
10 the courtesy that's already been extended to me in
11 rescheduling this hearing. I did appreciate that courtesy.

12 The aim of my comments is directed towards hopefully,
13 at least, improving the temporary regulations really in three
14 certain areas. I would respectfully urge you to define
15 certain terms that are now being used in the temporary
16 regulations. To clarify certain circumstances that are
17 alluded to in the temporary regulation. And to remove tax
18 insurance as a sole trigger of disclosure.

19 The outline of my comments today in this ten-minute
20 opportunity would be to expand a bit on the role and utility
21 of tax insurance, to expand a bit on what we see as the
22 perceived deficiencies in the temporary regulation; and to

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1 again point to the proposed language that we have respectfully
2 submitted.

3 If time allows - obviously, it's your determination - I
4 would love to entertain questions. If you want to interrupt
5 me as a better way of fielding questions, I don't mind that,
6 or perhaps at the end. However is more appropriate for the
7 panel.

8 With respect to the role and utility of tax insurance,
9 I would appreciate - we all could appreciate that tax
10 insurance really is part of a group of products, as
11 collectively referred to as transactional risk insurance.
12 Transactional risk insurance exists to facilitate
13 extraordinary transactions.

14 We have, for example, reps and warranty insurance,
15 which covers the representations that a seller would be making
16 to a buyer in connection with the sale, acquisition or merger
17 of a company.

18 We have stand-alone, environmental insurance, that may
19 cover a specific environmental risk associated with an
20 extraordinary transaction. We have specific litigation
21 insurance that may cover a listed litigation that is against
22 the company being acquired, and it could be an impediment to

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1 that deal. It wouldn't be a breach of a rep because it's been
2 disclosed, but now how do you transfer that risk?

3 Associated with this is tax insurance, which is why
4 we're here today. Tax insurance really comes in two places.
5 It comes in first in an indemnity that a seller would make to
6 the buyer. Say, you know, "We filed all our tax returns
7 properly and timely and there are no taxes owed, except for
8 what's been reserved in our books."

9 And that's a common provision, and that certainly a
10 very truncated version of what's a very common provision in
11 any acquisition agreement. Then that typically is covered by
12 an indemnity made by the seller or perhaps the seller's
13 parent. Then you also have the expected tax consequences from
14 the transaction.

15 The expected tax consequences typically provide -
16 typically don't have a guarantee from the seller, because
17 that's what the buyer's thought process has been; and that's
18 where they would more often come for the use of tax insurance.

19 The types of deals that we have been involved in that
20 we have issued tax insurance on, 355 spinoffs is probably the
21 number one. The ability to use NOLs - and maybe that stays
22 crystalized in my mind because that was our first tax

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1 insurance policy.

2 That had to do with a company that had NOLs. It had
3 been highly leveraged. And most of the NOLs came from a debt
4 structure it had. And it was now selling off a division, and
5 then the parent company would also be sold and merged. By
6 doing this kind of mitosis, this two-step process of sale, it
7 was going to realize a lot more money. But the sale of the
8 subsidiary division would trigger gain, but that would be
9 absorbed by the existing NOLs.

10 So the result was you had two buyers. One buying that
11 division, and then the one buying the parent company. Each
12 concerned with that tax indemnity provision that's standard in
13 an acquisition agreement. By providing a stand-alone, tax
14 insurance that covered those two buyers, that facilitated that
15 transaction and it went forward.

16 That was our first, and I guess that becomes a classic
17 model for when, you know, that's the type of transaction that
18 treated the need and use for tax insurance.

19 We've done Sub-S, second class of stock in connection -
20 also in connection with 360 - 338(h)(10) election, corporate
21 re-orgs. We've either insured or looked carefully on insuring
22 a personal, good-will type of issue, which triggers down now

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1 to what's, you know, a smaller type company, maybe regional
2 mid-market companies. And they're also obviously with the
3 Sub-S elections and also this personal, good-will type issue.

4 I would submit, candidly, that probably the most
5 controversial tax area that we've ever insured relates to
6 section 29 tax credits. It may well be that it's through that
7 that Treasury and the IRS has become aware of tax insurance.

8 With respect to section 29, our approach - and I could
9 really, I think, speak for the industry - has been to require
10 testing, reporting and maintenance of records to be certain
11 that each month's production of alternative fuel has been
12 confirmed, that there's been a significant chemical change.

13 The reason I point that out is, you know, we're here
14 really at that point requiring the kind of paperwork and the
15 type of analysis that you'd want to see in connection with a
16 facility. If they don't meet that, they're not covered.

17 What we do is we insure the credits for the alternate
18 few that's produced in any one month, provided that for that
19 one month they have this kind of testing and recordkeeping;
20 and that's been our approach to section 29.

21 The fundamental - the threshold, I should say - the
22 threshold criteria for tax insurance, before you get past an

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1 initial review of underwriting is whether or not it's a tax
2 shelter. We do not insure tax shelters. That has been that
3 way from the start, and it's certainly been that way, like I
4 say, not just for us but for our - you know, for the industry.

5 We define tax shelters in a two-step way. First is a
6 more objective test, and that is to see - and it really
7 follows what the IRS has promulgate. Whether there's a
8 promise of tax benefits with really no meaningful change in
9 the taxpayer's control over or benefit from the taxpayer's
10 income or assets. That's the first level. But it doesn't
11 stop there.

12 Because then we apply a second-level, subjective test,
13 which is, basically, "Would a prudent person - would a prudent
14 business person enter into this transaction apart from the tax
15 consequences?" - what we're about on legitimate, commercial
16 transactions.

17 In legitimate, commercial transactions these days, cash
18 flow is crucial and tax uncertainty jeopardizes cash flow.
19 Although the IRS is perhaps the world's most efficient tax
20 agency, the IRS can't operate on real time in providing
21 guidance to complex, commercial transactions. So, we are that
22 alternative. The historical alternative has been to get a tax

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1 opinion.

2 The problem with tax opinions are - as good as they are
3 - the problem with them include at least the uncertainty, you
4 know, to what is even the level of the opinion, and what does
5 it mean if it's a "should" opinion. There are assumptions and
6 representations that underlie the opinion. And at the end of
7 the day, it doesn't guarantee anything but a potential
8 lawsuit, based on a standard of malpractice.

9 So tax insurance provides a greater sense of certainty.
10 In fact, our colleagues call it tax opinion insurance. They
11 usually insist on an opinion. It's usually at the level of a
12 "should" opinion. Then they go about underwriting it.

13 That's one of the areas where The Hartford's been
14 distinctive, and that we don't require a formal opinion, per
15 se. We find them useful, but not a requirement; and that
16 could save the taxpayer some money.

17 We are a voice of conservatism. The underwriters of
18 tax insurance are paid to risk capital for their insurers and
19 for their re-insurers who, you know, audit us regularly, and
20 meet with us and determine whether or not to renew a treaty
21 with us. We're risking our capital and their capital by
22 providing certainty for prudent tax positions.

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1 Yes sir?

2 MR. PARAVANO: Could you explain any typical indemnities
3 that these policies might have, where the insurance company -
4 if it does pay - might have the right to recover from someone
5 else?

6 MR. DE BERRY: There's certainly no direct right of
7 indemnity. The potential right of subrogation that comes
8 about if, for example, there was a tax opinion that came in
9 that was poorly done.

10 Typically - at least in The Hartford policies - the
11 subrogation provisions are either non-existent or watered
12 down. Because that tax professional became part of the
13 process in underwriting the tax insurance.

14 There is another mechanism that's used to keep
15 everybody honest, if that is the force behind that inquiry,
16 and that is there is usually a significant retention. That's
17 the amount that the insured retains as the taxpayer's own
18 risk.

19 That significant retention is usually a sufficient
20 motivator to make certain that, you know, what we're receiving
21 is a full and complete analysis.

22 I just want to complete the answer and then I want to

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1 allow you to expand.

2 The other thing, too, is that typically we obtain
3 representations from the taxpayer - at least as to the facts
4 that are going on in a transaction, things like that. So,
5 it's not going to be that we - what we're insuring is, but in
6 fact we've insured that. That's not the case.

7 MR. PARAVANO: You said the insured sometimes retains
8 part of the risk. Is the insured in a typical case where you
9 have a buyer, a seller and an advisor, are they all the
10 insured? Is one of them the insured?

11 MR. DE BERRY: No, no, typically the - another good
12 question. Typically the insured is the buyer who's expecting
13 to realize certain tax consequences.

14 MR. PARAVANO: Is the beneficiary through the insured
15 requirement?

16 MR. DE BERRY: The insured is the beneficiary, right.
17 It's first-party coverage and it would go - if you were doing
18 a spinoff - which may not be the best example, because you'll
19 have shareholders who could be at risk, too.

20 But if you were a corporate entity doing the spinoff,
21 we will insure the risk that the spinoff was not tax free; and
22 we typically do it, by the way for those who are very much

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1 into spinoffs. We take out - we carve out the change of
2 control part.

3 We would insure that the spinoff is fine, as of this
4 time, and if there's a subsequent change of control, that's
5 not covered. Although, if there is a subsequent change of
6 control, you can come back and we'll consider insuring just
7 that element of the risk.

8 Is that an adequate answer? In other words, is the
9 taxpayer or the person who potentially could be left with the
10 tax bill -

11 MR. PARAVANO: In a 355, that could be the distributing
12 company.

13 MR. DE BERRY: That would be the distributing company.

14 MR. PARAVANO: In the typical sale transaction where it
15 might be a merger of a sub into another entity -

16 MR. DE BERRY: Right.

17 MR. PARAVANO: In that case it may be the surviving
18 entity.

19 MR. DE BERRY: That is correct. That's correct.

20 And, in that case - and that goes to the point about
21 defining tax insurance. It may well be the case that a reps
22 and warranty insurance policy is covering the tax indemnity in



1 that acquisition agreement.

2 MR. PARAVANO: So the seller may have given the
3 indemnity. The buyer may have the liability. The seller may
4 have to pay, and you may pay the seller.

5 MR. DE BERRY: Or the buyer. Actually, on that one, it
6 goes either - the coverage can be buyer based or seller based.

7 If it's buyer based, sometimes what the result of that
8 is they can argue for a reduced retention - a reduced escrow
9 amount between the buyer and the seller, and that facilitates
10 the transaction. If it's seller based, obviously, if the
11 seller was an equity fund and it's worried about, you know,
12 having to make a full and final distribution to its investors,
13 it allows this deal to happen more fluidly.

14 MR. PARAVANO: Typically, the advisors are not insured.
15 You said they are involved in the insurance process, but
16 they're typically not named as an insured?

17 MR. DE BERRY: They're never named. The question is
18 whether they're named in a subrogation provision or not, and
19 typically for, you know, obvious commercial reasons they're
20 not - at least by us.

21 I think it goes without saying that an acquisition is
22 one of the most significant events in the life of a company,



1 and the tax treatment of these transactions is complex and
2 often uncertain. It's against that backdrop that, you know,
3 tax insurance and all of the transactional risk insurance
4 exists to facilitate these transactions.

5 That really is why I suggested in my written comments
6 that to make tax insurance a sole triggering event to now
7 compel disclosure will have a negative effect on the economy.
8 Because to the extent we are facilitating these transactions,
9 if you hinder that, then obviously we think that's only going
10 to hinder economic growth.

11 Right now M&A activities are at an 18-year low.
12 Capital is tight. And like I said earlier, cash flow is
13 crucial. The ability to transfer or remove tax risk is always
14 a significant component of any transaction. Sometimes it's
15 the crucial component in a transaction.

16 We know that even today our President is announcing tax
17 cuts to further fuel the economy; and that the President's
18 focus is on the stock market. I think we can take notice that
19 M&A activity is **a** driver of stock prices in the market. To
20 the extent that, you know, there's a greater fluidity of
21 capital and transfers, and to the extent there's a greater



1 prospect of M&A transactions, the stock market does better to
2 that extent and the economy does better to that extent.

3 MR. PARAVANO: Do you have any idea the number of these
4 types of policies that might be written in a given year?

5 MR. DE BERRY: Yes. One of the leading brokers did a
6 survey at the third quarter of 2002. It would be
7 inappropriate for me to name names, but based on that survey,
8 I would say that there was in 2001 maybe 50 to 60 tax
9 insurance policies or programs that were underwritten.

10 My strong suspicion - and I'm speaking on an industry
11 basis - my strong suspicion for 2002 is that the number is
12 probably about half of what it was in 2001, just because of
13 the reduced activity in M&A transactions. I want to give you
14 a sense of what that means, what 50 or 100 policies mean.

15 My limit of liability is \$25 million. So I could put
16 at risk \$25 million.

17 MR. PARAVANO: For a transaction?

18 MR. DE BERRY: Right for a transaction for tax
19 insurance.

20 What will sometimes develop in connection, for example,
21 with spinoffs - that's, by the way, usually sufficient for
22 like the personal good-will issue and your Sub-S questions -



1 depending on the context. That's often sufficient.

2 When we get to spinoffs and corporate re-orgs, it's -
3 usually that's immaterial to one of the parties in the
4 transaction. What can develop - will develop - are programs
5 of insurance. Where one carrier joins others, and a group of
6 us then insure the risk in the aggregate. Sometimes it's done
7 on a layered approach. I take the first ten. You take the
8 hit after me. Sometimes it's a quote - quoted share. We all
9 share and share alike.

10 The largest program ever done was involved with a
11 spinoff, and that was in 2001, and that high-water mark was
12 about \$450 million of tax insurance, and that facilitated a
13 spinoff that was, you know, a publicly traded company. It was
14 all over the Wall Street Journal.

15 In fact, by the way, there were private letter rulings
16 issued in connection with that spinoff. One private letter
17 ruling that was issued before the transaction closed dealt
18 with what we thought was the most germane issue. I don't want
19 to speak in too much detail, because that would be
20 inappropriate.

21 But the - the IRS department letter ruling didn't find
22 what was more like - what we thought was more the per number,

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1 and that's still not a sufficient uncertainty that they went
2 ahead and bought this program of insurance; and then after the
3 insurance closed - I think in year two - the IRS issued
4 another private ruling that dealt with that per number, which
5 you know made us all look like very wise underwriters.

6 But that was the high-water mark in 2001. As a result
7 of a lot of events - most significantly 9/11 - where as a
8 result of that there's been a somewhat shrinkage in insurance
9 and re-insurance capacity. My suspicion is today the high-
10 water mark for a program would be in the area of \$200 million,
11 maybe \$250 million in terms of how much capacity there is.

12 MR. O'SHEA: Okay, can you wrap it up in the next five
13 minutes?

14 MR. DE BERRY: Yes, sir. Okay.

15 In wrapping up, I would ask you - first, I want to
16 thank you again for your time and consideration of these
17 comments. I would ask that you consider very carefully the
18 proposed language that we have submitted. What we have tried
19 to do is focus on the indicia of abusive schemes, and if tax
20 insurance is associated with any of those indicia, disclose
21 it. But we would urge you to not make it a sole triggering
22 event.



1 We think that's counterproductive to our own - to the
2 public policy here. We don't think tax insurance is a red
3 flag to the IRS. WE think it's a green flag. That it shows
4 that a prudent underwriter has determined that the risk - to
5 risk its capital, based on the prudence of this tax position.
6 We are a voice of conservatism. To the extent that tax
7 professionals come and seek tax insurance, we are creating
8 really a culture of compliance.

9 Lastly, we are the only non-governmental voice that's
10 motivated to judge tax positions with extreme prudence. We
11 don't get paid for issuing an opinion. We don't get paid for
12 promoting a transaction. We get paid because we promptly
13 assess the prudence of a tax position.

14 Thank you. Yes, sir?

15 MR. DUBERT: One final question that's probably an
16 unfair question since you came here to talk about the U.S. tax
17 insurance market. Is there much of a tax insurance market in
18 other countries that you're aware of?

19 MR. DE BERRY: That's a great questions. Yes, there is.
20 Well, I don't know - I can't quantify it.

21 We're asked routinely, you know, to look at risks
22 abroad and I know that there is a European counter market to



1 transactional risk insurance, and sometimes we're asked to
2 just add capacity to their thought process.

3 So, I do know that it exists. I don't know the breadth
4 of it.

5 MR. DUBERT: Okay. Thank you.

6 MR. O'SHEA: Do you know how many claims are made? I
7 mean, you talked about the level of insurance, but how many
8 claims have been paid off?

9 MR. DE BERRY: You're with one of the re-insurers,
10 aren't you, Mr. O'Shea.

11 The life span of a tax insurance policy tends to be six
12 or more years. And if you recognize that a transaction is
13 going to happen and it may get reported a year later, and it
14 may not get audited until three years later, you'll see that
15 our report card doesn't really begin until the fourth year of
16 having been in tax insurance. We're in our fifth year. So,
17 the report card is still - we're in our second marking period,
18 to keep that analogy.

19 The only - and the way we define a claim is, notice of
20 examination that is, you know - any time the issue is raised,
21 it doesn't have to be a 30-day letter. It doesn't have to be
22 a write up by the revenue agent. It's having identified the



1 issue brings it in as a notice of claim for us.

2 We've had two that I'm aware of. If I'm omitting one
3 it's my own memory loss. But in both those two instances, the
4 claim was simply the examination that happened, and the
5 examination agreed with us. There's not a - there was no
6 payment made. Okay?

7 And I don't know what the status is with my colleagues
8 on that. They - we all tend to be somewhat tight-lipped about
9 that.

10 MR. O'SHEA: Do you put anything in your insurance about
11 they have to defend to a certain level or anything like that?

12 MR. DE BERRY: Yes, absolutely! There's a - they have
13 to defend, mitigate loss as if there were no insurance; and
14 it's a mitigation of loss provision that's commonly referred
15 to in the industry.

16 MR. O'SHEA: But like - I mean, it seems like sometimes
17 people are litigating and you can't exactly figure out why.
18 They have dead losers.

19 Are they required by your insurance to litigate to a
20 certain level?

21 MR. DE BERRY: No. We're paying for that. So we're not
22 going to, you know, throw good money after bad, so to speak.

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1 If the position turns out to be unsound, and we can see
2 that. Perhaps we went out and got our own opinion from an
3 outside tax professional and realize this is unsound, we're
4 not going to require it.

5 Plus, the reality is that typically we're insuring a
6 single issue, and the taxpayer, you know, wants to keeps its
7 rapport with the IRS, and there's no tax insurance policy that
8 I'm aware of where that kind of control has been transferred
9 over to the insurer.

10 Because their position, properly in our view, is that
11 "Look, you've got only one single issue." I can understand
12 you not wanting us to horse trade that issue, to your
13 detriment, but we don't want the tail wagging the dog either
14 here. We've accepted that as a commercially reasonable
15 philosophy. So we don't - it's not the case that we could
16 make them fight all the way.

17 There's a mitigation of loss provision. We have a
18 right to be informed. We really just don't want to see the
19 horse trading going on in the issue, but that's as far as it
20 goes. It doesn't become a catalyst for, you know, some
21 stubborn, you know, position that's not supported by the tax
22 law.

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1 MR. O'SHEA: Any other questions by the panel?

2 [No verbal response.]

3 MR. O'SHEA: Okay, thank you very much.

4 Was there anyone else who had a quick question or
5 anything?

6 MR. RINKE: I have a quick question. On these
7 transactions, once they're reported to the IRS, you don't also
8 have to report the fact that you might have tax insurance, do
9 you - on the transaction?

10 MR. DE BERRY: Is that for me?

11 MR. RINKE: Well, whoever.

12 MR. O'SHEA: Well, having tax insurance can be one of
13 the triggering events that you have to report. So I don't
14 know, on the reporting form does it actually ask. Is there a
15 line, do you have tax insurance?

16 MS. VOLUNGIS: It would say "with contractual
17 protection," and then it would ask you to clarify.

18 MR. O'SHEA: So you do have to -

19 MS. VOLUNGIS: Give a description of why it was a
20 reportable transaction.

21 MR. RINKE: Would that be a red flag to the IRS, then?
22 I mean, does that create an eyebrow raising, something that



1 you'll scrutinize more closely?

2 MR. O'SHEA: I mean, disclosures are - an awful lot of
3 legitimate transactions are going to be disclosed. It's not
4 like just because you disclose we're going to go after you.
5 But, I mean, obviously disclosure is there so that we can look
6 at it.

7 I don't know how to answer it any better than that.

8 MR. RENKE: Sure everybody discloses, but the question
9 is, the fact that someone buys insurance to protect themselves
10 from any tax liability sort of does send a red flag up,
11 doesn't it?

12 MR. O'SHEA: Well, not necessarily. As he just
13 testified, there are a lot of legitimate reasons for having
14 the tax insurance. Really it's more like a green flag, as he
15 says.

16 I think his testimony was excellent, and I think the
17 Service will recognize that.

18 [Pause.]

19 MR. O'SHEA: Okay, that concludes the hearing for today.
20 Thank you very much.

21 [Whereupon, at 10: 43 a.m., the proceedings were
22 adjourned.]