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United States Senate

SPECIAL COMMITTEE ON AGING

WASHINGTON, DC 20510-6400

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April 6, 2009

The Honorable Timothy Geithner
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Secretary Geithner:

As Chairman of the Special Committee on Aging and a member of the Banking, Housing and Urban Affairs Committee, I take seriously my responsibility to protect and advocate on behalf of seniors, particularly with regard to ensuring that seniors are treated fairly in the marketplace and have access to accurate and unbiased information related to their finances. Recently, I have become concerned with some aspects of the rapidly growing secondary market in life insurance. At present, there is little transparency with respect to this market, as well as a significant amount of confusion and variation among state and federal authorities as to the appropriate regulatory approach to the transactions involved.

Until recently, an individual with a life insurance policy who no longer needed it or could no longer afford it had two choices: surrender the policy for its cash value or stop paying premiums and allow the policy to lapse. The emergence of the life settlement industry provides consumers with the alternative of selling their policies to investors for less than the net death benefit, but for more than the cash surrender value. Originally developed as a response to the AIDS epidemic in the 1980s, the life settlement market has experienced exponential growth in recent years. It is estimated that the face value of policies sold to investors had grown from about $2 billion in 2002 to $12 billion in 2007.[1] This is largely due to the tertiary market in life settlements in which investors purchase fractional interests in securitized bundles of policies in a manner similar to the trading of mortgage-backed securities. Industry analysts predict that the potential market will exceed $160 billion over the next few decades.[2]

Legitimate life settlements can provide a valuable option for seniors who no longer want or need their existing life insurance policies, and need cash to pay costly medical bills not covered by Medicare or long-term care expenses. However, recent news reports,[3] complaints by state law enforcement,[4] and notices from investor advocates[5] identify potential risks for both seniors who sell their policies in the secondary market, as well as for seniors and others who invest in these

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[1] Conning Research & Consulting, Inc., *Life Settlements: New Challenges to Growth 2008* (Hartford, Connecticut: 2008).
[2] Ibid.
[3] Matthew Goldstein, "Death Bonds: Inside Wall Street's most macabre investment scheme yet," Business Week (July 30, 2007).
[4] People of the State of New York v. Coventry First LLC et al,, New York Supreme Court, New York County, No. 404620-2006, (10/26/2006). http://www.oag.state.ny.us/media_center/2006/oct/complaint.pdf.
[5] FINRA, Notice to Members 06-38, August 2006.

transactions. For example, on the seller side of the transaction, there is potential for seniors to have unexpected tax liability, loss of insurability, undisclosed commissions or even bid-rigging by brokers, and possible legal liability to their insurance companies in certain circumstances.

All of the companies and life settlement associations interviewed by the Committee acknowledged that they could not provide an opinion on the tax liabilities affecting seniors and investors given that the Internal Revenue Service (IRS) has not clarified the proper tax calculation for policies sold as life settlements in the secondary market. Consequently, they advise their clients to seek advice from a professional tax advisor. However, tax professionals may not be able to properly advise their clients on their tax liabilities given that the tax code and the IRS regulations are unclear about life settlement transactions.

According to the Congressional Research Service, because the tax code and IRS regulations are unclear, the proceeds received for participating in a life settlement transaction may be considered ordinary income and taxed at the personal income tax rate of as high as 35 percent. An alternative interpretation suggests that a life settlement transaction could be taxed at capital gain tax rates, generally at 15 percent. In the case of stranger-originated life insurance (STOLI), under either interpretation, any forgiven nonrecourse loan amount would be taxable as ordinary income. In addition, insurance premiums not paid by the insured and/or promotional gift received may be treated as ordinary income. In all of these cases, if the income is not reported, normal penalties would apply for underreporting of income.

The Committee understands that such transactions raise issues of state law which are not in the jurisdiction of the Department of the Treasury. However, in December 2007, the Department of the Treasury sent a letter to Congressman Richard E. Neal, Chairman of the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, addressing the tax treatment of life settlement transactions. The letter stated that the Treasury was "working closely with the Internal Revenue Service on how best to address these transactions." Yet, the Committee found that no action has been taken to date. Therefore, I request that you direct the IRS Commissioner to take immediate action to clarify the tax treatment and consequences of life settlement transactions for both consumers and investors.

It is extremely important that seniors have a clear understanding of the tax treatment of these transactions so that they do not face unexpected financial consequences or penalties. I would appreciate a response prior to a Committee hearing we have scheduled regarding life settlements on April 29, 2009. Please contact Cara Goldstein of the Committee's staff on (202) 224-5364 if you have questions concerning this matter.

Sincerely,

Herb Kohl

Herb Kohl
Chairman