Approved: 3-11-08
Date

MINUTES OF THE SENATE FINANCIAL INSTITUTIONS AND INSURANCE COMMITTEE

The meeting was called to order by Chairman Ruth Teichman at 9:30 A.M. on February 20, 2008 in Room 136-N of the Capitol.

All members were present.

Committee staff present:
Melissa Calderwood, Kansas Legislative Research Department
Ken Wilke, Office of Revisor of Statutes
Bev Beam, Committee Secretary
Jill Shelley, Kansas Legislative Research Department

Conferees appearing before the committee:
Pat Lightner, HSBC
Richard Cram, Dept. Of Revenue
Sandy Praeger, Insurance Commissioner
Scott Colby, NAIFA, KS
Jim Hall, ACLI
Ron Hein, Life Settlement Institute
Bill Sneed, State Farm Insurance
Natalie Brunson,Wheeler, State Farm

Others attending:
See attached list.

The Chair called the meeting to order.

Hearing on:

SB 499 - concerning sales taxation; relating to bad debts; deductions or refunds; requirements and procedures

Melissa Calderwood gave an overview of SB 499. She said this bill makes amendments to the Kansas Retailers sales tax act to allow a private label credit card account, a seller or lender who makes a proper election pursuant to Subsection C, or an assignee or affiliate of such seller or lender, to be entitled to claim a deduction on its sales and use tax returns or file a claim for refund of the state sales tax that the seller has previously reported and paid to the department, if certain conditions are met as specified in the bill.
The fiscal note provided to the Division of the Budget by the Department of Revenue estimates there would be a decrease in state revenue by $1.7 million in fiscal year 2009. Of that amount, the state general fund is estimated to decrease by $1.5 million and the state highway fund is estimated to decrease by $214,000 in fiscal year 2009. The bill also is estimated to decrease local reserves by some $434,000 for fiscal year 2009 and there is additional information that is charted out to fiscal year 2013 where the total would be a negative $2.493 million dollars. The Department of Revenue has indicated implementation of the bill would result in additional expenditures of $18,500 to reissue its sales tax publication.

Pat Lightner, HSBC testified in support of SB 499. Ms. Lightner stated Kansas' sales tax laws impose 100% of the sales tax up front on the full amount of the expected purchase price in installment or credit sales at the time of the sale even though the customer has not paid the full sales price for the goods. She noted, however, the general rule of sales tax is that sales tax is due only on the purchase price actually paid. Therefore, to ensure that sales tax is paid only on the actual price paid for credit or installment sales, the legislature enacted K.S.A. 79-3674 to provide for a refund or deduction of the sales tax in credit sales if the customer defaults because the customer would not have paid the full sales price for the goods. Ms. Lightner continued, stating that approximately 22 states allow the deduction or refund proposed in SB 499. She said this same legislation has been either passed or is pending in 10 states. She said SB 499 would have no real revenue impact because it is a technical correction that clarifies that Kansas retailers are entitled to this refund. She said this bill allows sellers that outsource their financing and lenders who are assignees of sellers to be on the same level

of competition as sellers who finance their own sales. She stated SB 499 clearly reflects legal, economic and practical realities of underlying business. (Attachment 1)

Richard Cram, Department of Revenue, testified in opposition to SB 499. Mr. Cram stated SB 499 is a dramatic departure from current Kansas law, which limits the ability to take a bad debt deduction on the sales tax returned to the retailer making the sale and collecting and remitting the sales tax. He said this proposal will allow private label credit card companies who were not a party to the original sales and did not report and remit the tax to the department, but who financed the sale, to receive sales tax refunds on uncollectible debt. He stated that the fiscal note on this proposal is estimated at negative $1.7 million. He said in addition, this bill proposes changes to statute that are not in compliance with the Streamlined Sales and Use Tax Agreement and could jeopardize Kansas' membership-in-good standing status. He said for that reason alone, the Department must strongly oppose this bill. (Attachment 2)

The Chair closed the hearing on SB 499.

The Chair opened the hearing on SB 624 and stated this is the beginning of a two-day hearing. She said the hearing will be continued to February 26. She said only the proponents will be heard today.
Hearing on:

SB 624 - concerning viatical settlements; pertaining to stranger-originated life insurance (STOLI)

Sandy Praeger, Kansas Insurance Commissioner, testified in support of SB 624. The Commissioner stated a STOLI is an arrangement that allows an investor without an insurable interest to profit from a life insurance policy on a stranger's death. She said The Kansas Insurance Department, as a regulatory agency, has jurisdiction over viatical and life settlements. A STOLI arrangement uses the same life insurance policy as the viatical or life settlement but the method used to obtain the death proceeds is an attempt to circumvent state insurable interest statutes. These laws are proposed to assure that when an individual purchases a life insurance policy on another person's life, the beneficiary of the insured must have an insurable interest in the life of the insured. She continued that the Kansas Insurance Department will continue to educate consumers and the public who might be considering a life insurance settlement to be aware of possible results of a STOLI arrangement including: the legality of the arrangement, loss of insurance capacity, loss of privacy and potential tax consequences. She said many insurers now require the individual to sign a statement that they are not intending to sell the policy after using premium financing to buy the policy. The Commissioner noted that exceptions to the viatical settlement act allow individuals with a wide range of hardships to legitimately sell their life insurance policies for immediate cash. She said SB 624 adds the hardship exception, "when the sole beneficiary predeceases the insured." (Attachment 3)

The Chair asked Ken Wilke for an overview of SB 624. Mr. Wilke said SB 624 deals with amendments to the viatical act. Mr. Wilke handed out a chart that compares the existing statute sections stating what SB 624 and SB 601 are so you would have some way of comparing the two. He noted there is an overlap in the two in the definition sections and there is an overlap in the amendments to K.S.A. 40-5008, but other than that, the amendments cover different sections within the existing bill. The amendments are found on page 1, lines 18 through 23 and lines 34 through 36. The reason that this section has been repealed and reinserted as new language is there was a provision put into this bill that required this act section to be reviewed by the legislature under the review provisions under the Open Records Act. It had to be done by July 1, 2007, he said. The legislature did not review it, so as a result, the protections against disclosure of records under the open records act vanished as a matter of law. After discussions in the revisor's office, we decided that probably the easiest way to deal with this issue is to repeal the existing statute and put it back in. You will note we now show this provision has to be reviewed prior to July 1, 2013. That is the reason this particular section was repealed and then reenacted. The same is true for new section 2. This is K.S.A. 2007 supp. 40-5009. There are some amendments that were put in as proposed amendments for the statute. On Page 7, Line 4, where it says, "where possible fraud . . ." down to the end of line 10, that is all new language. On line 33 through 41 you essentially have all new language again. Here we have a situation that the right to rescind has been changed from the existing 15 days to now the earlier 60 calendar days after the contract is executed or 30 days after the viatical settlement proceeds have been sent. New section 3 has been requested by the Insurance Department. Section 4 on page 10 is basically going into 40-5001 and changing the name of the

happened here is a fraudulent viatical settlement practice changed to include what is on page 12, line 10, which is STOLI. Section 6 amends 40-5003. This adds classes of people who have been deemed to have met the licensing requirements and create some exceptions.

The main change in Section 7 deals with policy settlement in five years of the date of issuance instead of two.

In Section 8 of this bill you will find that the amendments impose a fiduciary duty on the viatical settlement broker to represent only the interest of the viator. You will also see a change in the right of rescision from 15 days to 60 days after the viatical settlement contract is executed or 60 days after the proceeds have been paid.

Section 9 changes some time periods for certain violations from two years to five years.

Scott Colby, President, NAIFA Kansas, testified in support of SB 624 which he said would strengthen safeguards against stranger owned life insurance practices. He said NAIFA Kansas believes that stranger owned life insurance arrangements are not consistent with the intended purposes of insurable interest in Kansas. He said these arrangements erode principles designed to ensure that life insurance is used to protect the long term interest of parties associated with the insured. (Attachment 4)

James D. Hall, Amerian Council of Life Insurers testified in support of SB 624. (Attachment 5)

Natalie Brunson-Wheeler, State Farm Insurance, testified in support of SB 624. (Attachment 6)
The meeting adjourned at 10:30 a.m.

SENATE FINANCIAL INSTITUTIONS & INS. COMMITTEE
GUEST LIST

DATE: 2-20-08

NAME	REPRESENTING
Bill Sneed	State Farm
Patricia Lightner	HSBC & KS Financial Services Assn
Alex Kotoyantz	P.I.A.
Ken Gaches	KAFS
Jim HALL	ACLI
Michael Lovendusky	ACLI
Jeff Bottenberg	ACLI
John Peterson	Coventry
Bill Brady	"
Robert Woolley	"
Ron Hein	Life Settlement Institute
John Meetz	KID
LARRY MAGILL	KAIA
Brad Smoot	ACLI
Scott D. Colby, CLU/ChFC	NAIFA Kansas

Patricia Lightner
Regional Director
Government Relations

DATE: **February 20, 2008**

COMMITTEE: **Senate Financial Institutions and Insurance**

TESTIMONY: **In Support of SB 499**

PRESENTED BY: **Patricia Lightner, HSBC**

Kansas' sales tax laws impose 100% of the sales tax up front on the full amount of the expected purchase price in installment or credit sales at the time of the sale even though the customer has not paid the full sales price for the goods. However, the general rule of sales tax is that sales tax is due only on the purchase price actually paid. Therefore, to ensure that sales tax is paid only on the actual price paid for credit or installment sales, the legislature enacted K.S.A. § 79-3674 to provide for a refund or deduction of the sales tax in credit sales if the customer defaults because the customer would not have paid the full sales price for the goods.

K.S.A. § 79-3674 provides that "[a] seller is allowed a deduction from taxable sales for bad debts attributable to taxable sales of such seller that have become uncollectable." The amount of the refund or deduction is the unpaid percentage of the taxable purchase price multiplied by the amount of sales tax paid. For example, if there is a $100 credit sale and the customer only pays one-half of the sales price, then the Department is required to refund one-half of the sales tax. This ensures that only the actual purchase price paid is subject to sales tax.

SB 499 amends K.S.A. § 79-3674 to clarify that a retailer and a private label credit card lender may jointly claim a sales tax refund or deduction when sales tax is paid up front on the entire amount of the sales price of the goods in a credit sale and a portion of the purchase price is

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{JA364552;1}

FI&I Committee
February 20, 2008
Attachment 1

charged off for federal income tax purposes. A private label credit card lender is a company that provides financing for the sales of individual merchants. Private label credit cards are credit cards that have the name or logo of a retailer listed on the face of the card and can only be used by customers to make credit purchases in one of the retailer's stores (i.e., a Best Buy credit card). This is completely different from VISA/MasterCard because the issuing bank has no direct relationship with the retailer and the card can be used at any retailer's store. Private label credit cards issued by private label credit card companies allow Kansas retailers' customers to afford more purchases, thereby increasing sales in Kansas stores and to free the capital of Kansas retailers to be used to acquire more inventory, also increasing Kansas sales.

Under current law, Kansas merchants should be entitled to the refund when sales tax is paid up front on credit sales and the accounts are charged off. However, because the Department of Revenue under current law only allows claims by retailers that finance their own sales but denies claims by retailers that use finance companies to finance their private label credit cards, the bill is necessary to clarify the retailers' entitlement to the refund, to ensure that the legislature keeps pace with the fact that many retailers outsource their financing and to ensure consistent treatment for all retailers.

The language of the bill is limited to private label credit card lenders, as opposed to VISA/MasterCard lenders, to specifically and narrowly benefit Kansas based retailers. Due to the direct contractual relationship between Kansas retailers and the private label credit card companies, the Kansas retailers receive a direct benefit from this bill because the retailers receive the direct benefit of the deduction and, to the extent the retailer allows the lender to claim the refund, the private label credit card company is able to reduce its losses to the extent of the refund which will allow the lender to loosen its credit criteria and achieve the same return,

thereby allowing Kansas retailers to increase their sales (because more of the retailer's customers are able to obtain financing and, therefore make additional sales).

The fact that SB 499 does not apply to sales financed with VISA/MasterCard credit cards is consistent with the purpose of the bill to benefit Kansas retailers because VISA/MasterCard lenders to do not have a contractual relationship with the retailers whereas private label credit card lenders and Kansas retailers work together to increase the retailers' sales and target credit standards and expected losses. Retailers whose sales are financed by VISA/MasterCard lenders and VISA/MasterCard issuers have not tried to qualify for bad debt sales tax recoveries in states that have adopted similar legislation.

Approximately 22 states allow the deduction or refund proposed in SB 499. In addition, this same legislation has been either passed or is pending in 10 states. The States of California, Texas, New York, Pennsylvania and Georgia have all passed this bill and similar legislation is currently pending in Indiana, Illinois, Ohio, Tennessee and Florida. Pennsylvania passed its bill in 2007, New York in 2006, California in 2000, Texas was in 1999 and Georgia in 1998. This bill has proven to work well and be easy to administer in all of these states.

SB 499 would have no real revenue impact because it is a technical correction that clarifies that Kansas retailers are entitled to this refund. In the States of Georgia and Texas, prior private label credit card legislation was assigned a "zero" revenue impact. In California, prior private label <u>and</u> automobile financing legislation (which this bill does not include) was assigned a $4 to $6 million annual revenue impact. In addition, SB 499 would correct an inequity that results in the Department's current refusal to refund sales tax when a private label credit card account becomes worthless – i.e. where no sale has occurred.

The Kansas Department of Revenue always intended that Kansas retailers that financed their own credit sales be entitled to this refund or deduction. This same result should not change solely because the Kansas retailers are outsourcing their financing to private label credit card lenders. SB 499, allows sellers that outsource their financing and lenders that are assignees of sellers to be on the same level of competition as sellers that finance their own sales.

SB 499 would allow financial stakeholders to recover sales tax on worthless accounts, whether they be the finance companies or the selling retailers.

SB 499 is designed to allow the Department the same protection afforded the Departments in states with similar legislation (i.e., election form requirement). The language incorporated into this bill is consistent with and contains all protections requested by the Departments of Revenue of the states that have passed this legislation.

SB 499 clearly reflects legal, economic and practical realities of underlying business.

{JA364552:1}

KANSAS
DEPARTMENT OF REVENUE

Kathleen Sebelius, Governor
Joan Wagnon, Secretary

www.ksrevenue.org

Testimony to the Senate Committee on Financial Institutions and Insurance

Richard Cram

February 20, 2008

Opposition to Senate Bill 499

Senator Ruth Teichman, Chair, and Members of the Committee:

Senate Bill 499 is a dramatic departure from current Kansas law, which limits the ability to take a bad debt deduction on the sales tax return to the retailer making the sale and collecting and remitting the sales tax. This proposal will allow private label credit card companies that were not a party to the original sale and did not report and remit the tax to the department, but who financed the sale, to receive sales tax refunds on uncollectible debt. The fiscal note on this proposal (attached) is estimated at negative $1.7 million. In addition, Senate Bill 499 proposes changes to K.S.A. 2007 Supp. 79-3674 that are not in compliance with the Streamlined Sales and Use Tax Agreement and could jeopardize Kansas' membership-in-good-standing status. For that reason alone, the Department must strongly oppose this bill.

Under Kansas law, the retailer, or seller, is liable for the proper collection, reporting and remittance of sales tax. The retailer must register with the department and thereafter files periodic returns, reporting and remitting collected sales tax. Appropriately, only the registered retailer is allowed a deduction from taxable sales for bad debts. If the retailer sells an item and provides financing of the purchase price, the retailer collects and remits sales tax on the purchase price. If the transaction later goes into default, the retailer can deduct that sale from taxable sales as a "bad debt" on the retailer's sales tax return when the write-off occurs. Unlike a registered retailer, a private label credit card company has no responsibility for collection, reporting and remittance of sales tax. The private label credit card company merely provides financing for the transaction.

When an item is purchased using a private label credit card, the sales tax on the purchase is paid up front, and the retailer essentially "sells" or assigns the sale contract for the merchandise, without recourse, to the private label credit card company for a discounted price. The private label credit card company thereby assumes the risk of collection on the financed amount. That risk of collection includes the sales tax paid up front on the purchase transaction. Presumably, the private label credit card company is being compensated for assuming such risk. This proposal would shift to the State the risk of collection on a transaction financed through a private label credit card company for the

state sales tax, allowing the private label credit card company to recover that sales tax on a bad debt many years after the initial purchase transaction. The bill provides that the three-year statute of limitations for the private label credit card company to file the refund claim does not start to run until the date of the write-off. By the time the entity seeks its "bad debt" refund of sales tax, that previously remitted sales tax has long been spent by the State. Any refund on the bad debt, will be coming out of new sales tax revenues.

The department successfully litigated the tax policy of limiting deductions for bad debts to the retailer, and not allowing sales tax refunds on bad debts to third-party finance entities, in *In re the Appeal of Ford Motor Credit Company*, 275 Kan. 857, 69 P.3d 612 (2003). The amount in dispute in that case was approximately $4 million in sales tax and interest. This proposal would legislatively reverse that decision as to private label credit card companies. It will likely lead to further legislative requests to allow other types of third-party finance entities to take bad debt deductions.

This proposal also contains provisions contrary to the uniformity requirements in Section 320 (attached) of the Streamlined Sales and Use Tax Agreement ("Agreement"), which are contained in 2007 Supp. K.S.A. 79-3674.

Page 2, lines 3 through 11 of the bill make amendments to K.S.A. 2007 Supp. 79-3674(e) eliminating the requirement that the bad debt must be written off on the seller's books and records, which is not in compliance with Subsection C. of Section 320 of the Agreement.

Page 2, lines 12 through 18 make changes to K.S.A. 2007 Supp. 79-3674(f) that eliminate the subject of the sentence, leaving it grammatically incorrect and raising a question as to whether it is out of compliance with Subsection D of Section 320 of the Agreement. Also in those lines, the bill provides that when an entity receiving a bad debt refund later recovers any portion of that debt and the entity is not required to file periodic returns with the department, the entity can remit the tax on "any other return." This language should be changed to "a return as furnished by the secretary of revenue."

Page 2, lines 21 through 25 make changes to K.S.A. 2007 Supp. 79-3674(g) eliminating the reference to the statute of limitations applicable to refunds, K.S.A. 79-3609(b) and other language required by Subsection E of Section 320 of the Agreement.

Subsection G of Section 320 and K.S.A. 79-2674(g) requires that for purposes of reporting a payment received on a previously claimed bad debt, any payment later recovered on a debt previously written-off must be applied first proportionally to the taxable price of the property or service and the sales tax, and second to interest, service charges, and any other charges. The bill deletes that language and substitutes what is shown at page 2, lines 35 through 42, allowing those payments to be applied using any method that "reasonably determines the original purchase price and sales tax due," and further providing for allocation between taxable and nontaxable components. These provisions could be used to minimize recoupment of sales tax returned to the State on any recovered payments from bad debts.

The current language in K.S.A. 2007 Supp. 79-3674 required by Section 320 of the Agreement needs to be retained, so that Kansas remains in compliance with the Agreement.

Other concerns with the proposal include:

Lines 34 through 39 on page 1 describe the joint election executed between the seller and lender as to who gets to claim the refund. This document needs to be provided to the department.

The proposal states only the state sales tax would be credited or refunded. The sales tax processing system is not designed to exempt only state sales tax, and this provision may cause accounting and processing problems for an account. The department suggests that the exception for local sales tax be removed from the proposal.

MEMORANDUM

To: Mr. Duane Goossen, Director
Division of Budget

From: Kansas Department of Revenue

Date: 02/04/2008

Subject: Senate Bill 499
Introduced as a Senate Bill

Brief of Bill

Senate Bill 499 as Introduced, amends K.S.A 79-3674 of the retailers' sales tax act. The proposal allows private label credit card accounts to receive a state sales tax credit or refund on uncollectible bad debts.Local taxes would not be refunded. The proposal sets the requirements that must be met to qualify for the credit or refund of tax. The proposal modifies the statute to allow a private label credit card entity, vs. the seller, to apply for the credit or refund.

Only bad debts determined to be worthless on or after July 1, 2008 would qualify for the credit or refund. Private label credit cards are those cards as issued by a department store or other business that are only valid for sales at the issuers stores or affiliates. Bank credit cards such as VISA, MasterCard, Discover, and American Express are not private label credit cards. Credit cards that have a store name on the card, in which their usage may provide rebates or cash back points, are considered a bank credit card and would not qualify under this proposal .

The Act would be effective July 1, 2008.

Fiscal Impact

The proposal could result in the loss of $1.736 million annually in state sales tax revenue. Loss in the state general fund is estimated at $1.523 million and $214,000 to the state highway fund. The estimate is based on national consumer credit data which shows store credit card debt at approximately $84 billion nationally. The current charge-off percentage for consumer loans is 3.9%, taken from charge-off rates published by the Federal Reserve Bank. (This percentage fluctuates, as it was nearly 6% in the 2nd half of 2005.) Assuming 1% of the debt belongs to Kansas residents, or $840 million, and there is a charge-off rate of 3.9% ($32.76 million), the potential loss of sales tax annually would be $1.736 million annually. The loss of local sales tax is estimated at $434,000.

Administrative Impact

The proposal will result in the revision of sales tax publications at a cost of $18,500.

Administrative Problems and Comments

The proposal is a dramatic departure from current tax policy in which credits and refund of tax on bad debts is limited to the retailer who made the sale. This proposal would allow private label credit card companies that were not a party to the original sale but who assumed the financing of the sale to received sales tax credits or refunds on uncollectible debt.

From a tax policy standpoint, the seller of the goods is allowed a deduction from taxable sales for bad debts. When the seller "sells" the financing for a product to a financial institution, the financial institution assumes the debt and the inherent risks of collection. The ability to recover sales tax should the debt be deemed uncollectible is not available to the private label credit card company. This proposal would change that and allow the private label credit card companies to recover sales tax on a bad debt. The tax policy of limiting credits or refunds of tax to a seller was successfully argued at the Kansas Supreme Court In re the Appeal of Ford Motor Credit Company, 275 Kan. 857, 69 P.3d 612 (2000). There are numerous other cases that have been successfully argued in other states as well.

The proposal states only the state sales tax would be credited or refunded. The sales tax processing system is not designed to exempt only state sales tax and may cause accounting and processing problems for an account. It is respectively suggested that the exception for local sales tax be removed from the proposal.

Other concerns with the proposal include:
The joint election executed between the seller and lender as required by 79-3674(c) should be required to be sent to the Secretary of Revenue.

In 79-3674(f) it states for an entity which does not file sales tax returns with Kansas and the bad debt previously claimed is subsequently paid, the entity must report the tax on "any other return." This language is vague and may lead to processing concerns. It is suggested the language to changed to " a return as furnished by the secretary of revenue"

79-3674(g) gives the entity three years from the date the account is determined to be worthless to claim the refund. This phrase is too vague and may lead to refund claims for sales made many years earlier. It is in essence throwing out the 3-year statute of limitations. If this proposal is to be enacted, the department respectively suggests existing statutory language be maintained.

Taxpayer/Customer Impact

Legal Impact

D. Provide an alternative method for making "same day" payments if an electronic funds transfer fails.

E. Provide that if a due date falls on a legal banking holiday in a member state, the taxes are due to that state on the next succeeding business day.

F. Require that any data that accompanies a remittance be formatted using uniform tax type and payment type codes approved by the governing board.

Compiler's note: On October 1, 2005 the second sentence in Section 319(A) was amended as follows: "The state shall allow the amount of ~~the~~ any additional remittance ~~shall~~ to be determined through a calculation method rather than actual collections. Any additional remittances ~~and~~ shall not require the filing of an additional return." The amendment to this section became effective upon adoption.

Section 320: UNIFORM RULES FOR RECOVERY OF BAD DEBTS

Each member state shall use the following to provide a deduction for bad debts to a seller. To the extent a member state provides a bad debt deduction to any other party, the same procedures will apply. Each member state shall:

A. Allow a deduction from taxable sales for bad debts. Any deduction taken that is attributed to bad debts shall not include interest.

B. Utilize the federal definition of "bad debt" in 26 U.S.C. Sec. 166 as the basis for calculating bad debt recovery. However, the amount calculated pursuant to 26 U.S.C. Sec. 166 shall be adjusted to exclude: financing charges or interest; sales or use taxes charged on the purchase price; uncollectable amounts on property that remain in the possession of the seller until the full purchase price is paid; expenses incurred in attempting to collect any debt, and repossessed property.

C. Allow bad debts to be deducted on the return for the period during which the bad debt is written off as uncollectable in the claimant's books and records and is eligible to be deducted for federal income tax purposes. For purposes of this subsection, a claimant who is not required to file federal income tax returns may deduct a bad debt on a return filed for the period in which the bad debt is written off as uncollectable in the claimant's books and records and would be eligible for a bad debt deduction for federal income tax purposes if the claimant was required to file a federal income tax return.

1 D. Require that, if a deduction is taken for a bad debt and the debt is subsequently collected
2 in whole or in part, the tax on the amount so collected must be paid and reported on the
3 return filed for the period in which the collection is made.
4 E. Provide that, when the amount of bad debt exceeds the amount of taxable sales for the
5 period during which the bad debt is written off, a refund claim may be filed within the
6 member state's otherwise applicable statute of limitations for refund claims; however, the
7 statute of limitations shall be measured from the due date of the return on which the bad
8 debt could first be claimed.
9 F. Where filing responsibilities have been assumed by a CSP, allow the service provider to
10 claim, on behalf of the seller, any bad debt allowance provided by this section. The CSP
11 must credit or refund the full amount of any bad debt allowance or refund received to the
12 seller.
13 G. Provide that, for the purposes of reporting a payment received on a previously claimed
14 bad debt, any payments made on a debt or account are applied first proportionally to the
15 taxable price of the property or service and the sales tax thereon, and secondly to interest,
16 service charges, and any other charges.
17 H. In situations where the books and records of the party claiming the bad debt allowance
18 support an allocation of the bad debts among the member states, permit the allocation.
19
20 **Section 321: CONFIDENTIALITY AND PRIVACY PROTECTIONS UNDER MODEL 1**
21 A. The purpose of this section is to set forth the member states' policy for the protection of
22 the confidentiality rights of all participants in the system and of the privacy interests of
23 consumers who deal with Model 1 sellers.
24 B. As used in this section, the term "confidential taxpayer information" means all
25 information that is protected under a member state's laws, regulations, and privileges; the
26 term "personally identifiable information" means information that identifies a person; and
27 the term "anonymous data" means information that does not identify a person.
28 C. The member states agree that a fundamental precept in Model 1 is to preserve the privacy
29 of consumers by protecting their anonymity. With very limited exceptions, a CSP shall

Approved By:

Joan Wagnon
Secretary of Revenue

Kansas Insurance Department

Sandy Praeger, Commissioner of Insurance

TESTIMONY ON
SENATE BILL 624

SENATE FINANCIAL INSTITUTIONS AND INSURANCE COMMITTEE
FEBRUARY 20, 2008

Madam Chair and Members of the Committee:

Thank you for the opportunity to speak in support of SB 624 amending the Kansas Viatical Settlements Act of 2002. Under my administration at the Kansas Insurance Department, we take seriously our role in regulating, educating, and advocating for the residents of Kansas with regard to insurance products and agents. This legislation is an example of our department fulfilling those roles.

During the AIDS outbreak in the 1980s, terminally ill patients needed a way to access their life insurance policies to obtain cash for life-saving medication and care. Viatical comes from the religious word, viaticum, meaning communion given to a person near death. The viatical settlement was born. Terminally ill AIDS patients would sell their life insurance policies to an investor for a lump sum payment that was a portion of the policy's face amount. With the advent of the AIDS drug cocktails, many AIDS patients outlived their life expectancy creating, in some cases, a loss for investors paying the AIDS' patients premiums.

In the 1990s, life settlements became a viable option for individuals paying large premiums for a life insurance policy that was no longer needed. A couple with significant holdings may have purchased a life insurance policy with a death benefit sufficient to pay off their home, put their children through college and provide a nice lifestyle for the surviving spouse. When the children graduated from college, the home was paid off and they found themselves burdened by a large life insurance premium, the choice for such individuals was to surrender the policy for the accumulated cash value (money paid in premiums plus interest). Life settlements were the solution for the individual who no longer needed the life insurance policy. The individual could sell the policy to an investor for an amount greater than the accumulated cash value and the investor would pay the premiums for the right to receive the death benefit.

Viaticals and life settlements involve a life insurance policy being purchased with a legitimate insurable interest. However, when a life insurance policy is purchased with the intent to sell the policy after the incontestability period of two years to an investor looking to make a profit, such an arrangement has been dubbed stranger/investor-originated life insurance (STOLI). This effectively converts life insurance into an investment or security and is essentially a wager on an individual's life. The sooner the death, the greater the profit.

FI&I Committee
February 20, 2008
Attachment 3

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Consumer Hotline
800-432-2484

Website
www.ksinsurance.org

For example, investors will identify and induce older, high net worth individuals to obtain a life insurance policy sometimes with promises of "zero premiums" and an incentive payment. The investors and their firms will fully finance the transaction, paying the premiums for the life insurance contract. At the end of the contestability period, the individual is given the option of repaying the premium loan or transferring ownership of the policy to the investor in return for complete forgiveness of the loan plus a percentage of the death benefit. The remaining death benefit is paid to the investor on the death of the individual. If the individual dies during the two-year period, the net death benefit will be paid to the insured's beneficiaries.

So, to clarify, a STOLI is an arrangement that allows an investor without an insurable interest to profit from a life insurance policy on a stranger's death.

The Kansas Insurance Department, as a regulatory agency, has jurisdiction over viatical and life settlements. A STOLI arrangement uses the same life insurance policy as the viatical or life settlement but the method used to obtain the death proceeds is an attempt to circumvent state insurable interest statutes. These laws are proposed to assure that when an individual purchases a life insurance policy on another person's life the beneficiary of the insured must have an insurable interest in the life of the insured.

The Kansas Insurance Department will continue to educate consumers and the public who might be considering a life insurance settlement to be aware of possible results of a STOLI arrangement including: the legality of the arrangement, loss of insurance capacity, loss of privacy and potential tax consequences. Many insurers now require the individual to sign a statement that they are not intending to sell the policy after using premium financing to buy the policy.

Consumer advocacy and protection are primary functions of the Kansas Insurance Department. This bill contains many provisions which strengthen our ability to fulfill that responsibility. Seniors are particularly vulnerable to STOLI predators. STOLI transactions can have adverse consequences for seniors including unexpected income tax liability, limited future insurability and potentially higher life insurance rates for all of us. An individual can only be issued a certain amount of life insurance based on their net worth. If an individual enters into a STOLI transaction then needs to apply for life insurance for family or business succession purposes, the insured's application may be denied due to excessive prior insurance coverage. The denial could leave the family or business in financial jeopardy.

A STOLI arrangement has an investor with an interest in the insured individual's early demise. A five-year moratorium on life settlements that applies only to those policies acquired in violation of the spirit and intent of insurable interest laws will help eliminate the financial incentive for STOLI transactions and prevent wrongdoers from skirting the law. The moratorium is narrowly crafted so as not to adversely affect legitimate life insurance and life settlements.

Exceptions to the viatical settlement act allow individuals with a wide range of hardships to legitimately sell their life insurance policies for immediate cash including the following:

*The insured is terminally or chronically ill
*Death of the spouse
*The insured divorces
*The insured retires from full-time employment
*The insured becomes physically or mentally disabled and physician determines that the disability prevents the insured from maintaining full employment
*The insured is declared bankrupt

SB 624 adds the hardship exception, "when the sole beneficiary predeceases the insured."

I invite you to join me in supporting SB 624.

NATIONAL ASSOCIATION OF
INSURANCE AND FINANCIAL ADVISORS OF KANSAS

Senator Jim Barnett
120-S

Dear Senator Barnett:

On behalf of the National Association of Insurance and Financial Advisors in Kansas (NAIFA Kansas), we would ask your support for SB624, which would strengthen safeguards against stranger owned life insurance practices.

NAIFA Kansas is an organization of 950 individual insurance agents across the state of Kansas who are involved in the sales of life, health, property and casualty insurance.

NAIFA Kansas believes that stranger owned life insurance arrangements are not consistent with the intended purposes of insurable interest in Kansas. These arrangements erode principles designed to ensure that life insurance is used to protect the long term interest of parties associated with the insured.

Please take a moment to review the NAIFA Kansas concerns regarding SB624. NAIFA Kansas supports NAIC and/or the NCOIL model language. We ask you for your support of this legislation to help protect Kansas consumers.

Thank you.

Scott Colby,
President, NAIFA Kansas

Sandy Braden
Executive Director NAIFA Kansas

FI & I Committee
February 20, 2008
Attachment 4

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STOLI ALERT

December 2007 Volume 1 Issue 5

NAIC & NCOIL: DIFFERENT APPROACHES, SAME GOAL

Although their approaches differ, the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL) are each committed to deterring stranger-originated life insurance (STOLI).

At its Nov. 12-14 meeting in Las Vegas, NCOIL approved an updated Life Insurance Settlements Model Act that strengthens safeguards against STOLI transactions. NCOIL's model offers an alternative to the approach taken by the amendments to NAIC's Viatical Settlements Model Act approved by state regulators earlier this year. The NCOIL model aims to deter STOLI by:

- Defining and prohibiting STOLI transactions;
- Requiring life settlement providers to report data annually to state insurance commissioners that will assist regulators in determining if providers are initiating policies for the purpose of settling them;
- Barring premium finance providers from receiving any proceeds or consideration from the policy or policy owner that are in addition to the amounts required to pay the premium, interest and service charges under the premium finance agreement; and
- Allowing insurers to advise applicants in premium-financed transactions of the possible adverse consequences that might result from the later settlement of the policy, such as a stranger owning an interest in the insured's life, limits on future insurability higher premiums for additional coverage and tax liability.

The NCOIL model attempts to bring within its scope all manifestations of STOLI, whether they involve settlements, trusts or other practices.

The NAIC model addresses the most prevalent form of STOLI, transactions involving policy settlements. It establishes a limited five-year moratorium on the settlement of policies that have the characteristics of STOLI. It also requires life settlement brokers to disclose to policy owners vital information about settlement transactions, such as commissions and other purchase offers. NAIC's Life Insurance and Annuities (A) Committee is expected to examine proposals to deter STOLI transactions that do not involve a settlement.

"The model laws approved first by NAIC and now by NCOIL show that our state insurance policymakers recognize the implications of STOLI," said Frank Keating, president and CEO of the American Council of Life Insurers.

"NAIFA is very pleased that NCOIL has joined the NAIC in attempting to take a strong stand against STOLI," said John J. Healy, CEO of the National Association of Insurance and Financial Advisors. "State legislation addressing STOLI will be one of NAIFA's top priorities in 2008."

WHERE WE STAND

Lawmakers must act to deter stranger-originated life insurance (STOLI) in all its manifestations. STOLI violates public policies against using life insurance as a vehicle for wagering on human life. It can leave insureds with unknown or undisclosed costs and legal implications. It threatens to undermine the growing legitimate market for life insurance covering senior citizens, STOLI's targeted market.

In that connection, we strongly believe the amendments to the Viatical Settlements Model Act approved in June, 2007 by the National Association of Insurance Commissioners (NAIC) will address the most prevalent form of STOLI, which are transactions involving a policy settlement. The NAIC's limited five-year moratorium on settlements that have the characteristics of STOLI will significantly reduce the economic incentive for abusive transactions while having no impact on policy owners who purchased their policies legitimately and decide to sell them in the secondary market.

We also applaud the National Conference of Insurance Legislators (NCOIL) for developing a model law that seeks to deter all manifestations of STOLI, whether in the form of a settlement, a trust or other scheme. The NCOIL model addresses STOLI by, among other things, defining and prohibiting STOLI transactions and requiring life settlement companies to annually report data to state insurance commissioners.

We will work to the best of our abilities to enact effective legislation in every jurisdiction in the nation.

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LARRY KING LAWSUIT POINTS TO DANGERS OF STOLI

A lawsuit filed recently in California by CNN's Larry King describes a series of transactions, some of which have the earmarks of a life insurance arrangement called stranger-originated life insurance (STOLI).

Typically, with STOLI, a broker or speculator approaches a customer and encourages the purchase of a life insurance policy with the intent that the policy be sold to investors who have no insurable interest in the life of the customer. The investors pay the customer an agreed sum for the policy and then expect to profit by collecting the death benefit when the customer dies.

While promising cash upfront, STOLI promoters may fail to disclose the hidden dangers in these transactions. As alleged in the complaint, consumers can end up with the short end of the stick, losing vital insurance protection that could have protected their families from the financial risks associated with an unexpected death.

Moreover, because this is a largely unregulated market, many material facts may be undisclosed by STOLI promoters, such as the tax consequences, the amount received by intermediaries and the fair market value of the policy.

ACLI and NAIFA understand that legitimate policy owners may want to sell their policies in the secondary market when they decide they no longer need or want coverage. However, speculators whose only concern is profit should not be allowed to initiate and purchase life insurance on an individual they do not know and in whom they have no insurable interest.

Life insurance companies and agents are urging state legislators and regulators to adopt stronger laws and regulations that will protect consumers from abusive transactions and maintain the integrity of the life insurance product.

NAIC MODEL'S MORATORIUM PROTECTS PROPERTY RIGHTS

An Analysis of *Grigsby v. Russell*

A five-year moratorium on the settlement of life insurance policies that have the characteristics of STOLI does not violate the property rights of policy owners and does not run afoul of any United States Supreme Court ruling.

STOLI promoters who cite the United States Supreme Court case of *Grigsby v. Russell, 222 U.S. 149 (1911),* as authority against a limited five-year moratorium are wrong both legally and logically. Nothing in *Grigsby* strips the nation's legislators of their constitutional powers to regulate commercial transactions, including determining the rules governing the settlement of life insurance policies. A limited five-year moratorium on the settlement of policies that have the characteristics of STOLI is a major component of the amendments to the Viatical Settlements Model Act recently approved by the National Association of Insurance Commissioners.

Indeed, the opinion in *Grigsby* by Justice Oliver Wendell Holmes, Jr., reinforces the public policy against STOLI and specifically qualifies the property rights of life insurance policy owners. *"So far as reasonable safety permits,* it is desirable to give to life insurance policies the ordinary characteristics of property," Holmes wrote (emphasis added).

Grigsby essentially restates the opinion in *Connecticut Mutual Life v. Schaefer, 94 U.S. 457 (1876),* which says that a life insurance policy acquired in good faith remains valid even if the beneficiary's insurable interest ends. "Any person has a right to procure an insurance on his own life and assign it to another, provided it be not done by way of cover for a wager policy," the *Connecticut Mutual* case says.

continued on next page

TIMELINE

October, 2007

RESEARCH: The consulting firm Conning & Co. estimates that the life insurance settlement business grew to some $6.1 billion in 2006.

STATES:
Connecticut: The General Assembly Insurance and Real Estate Committee conducts a hearing on life settlements and STOLI.

Massachusetts: The Joint Committee on Financial Services conducts a hearing on H. 1052, legislation supported by ACLI and NAIFA that, with minor differences, is based on the amendments to the Viatical Settlements Model Act developed by the National Association of Insurance Commissioners.

Utah: The Department of Insurance seeks input on the NAIC model.

November, 2007

NCOIL: The National Conference of Insurance Legislators approves revisions to the Life Insurance Settlements Model Act, which attempts deter all forms of STOLI by, among other things, defining and prohibiting STOLI and requiring life settlement providers to disclose data to state insurance departments.

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That is essentially what happened in *Grigsby.* John C. Burchard purchased a life insurance policy and paid the first two premiums. Subsequently, however, Burchard ran short of money while in need of a surgical procedure. To raise funds, he sold the life insurance policy to a physician, A.H. Grigsby, who had no insurable interest in Burchard's life. After Burchard died, a dispute arose between Grigsby and Burchard's estate over who should receive the death benefit. Holmes' opinion upheld Grigsby's claim to the death benefit, while reinforcing the distinction between policies purchased in good faith and those purchased as cover for a wager on human life.

"And cases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith," Holmes wrote.

Holmes' opinion clearly establishes the framework for applying different rules to policies purchased as a means to wager on human life than to policies purchased in good faith. Moreover, Holmes' qualification that life insurance policies should have the ordinary characteristics of property "so far as reasonable safety permits" restates the long-standing legal doctrine that property rights are not absolute.

Federal and state lawmakers place restrictions on property rights in a variety of contexts, such as zoning laws, sales of certain products to minors and sales of pharmaceuticals. It is the legislature's role to identify different—sometimes competing—public interests and then draw the lines between, for example, which property can be developed commercially, and which cannot; which products can be sold to minors, and which cannot; and which pharmaceuticals can be sold with a prescription, without a prescription or not at all.

The same holds true of life insurance policies. In order to deter insurance fraud, state legislators have already decided to place some restrictions on the settlement of life insurance policies through the enactment of two-year "wet ink" laws, which bar the sale of a life insurance policy for two years after the policy is issued. By the same token, state legislators have the right to decide to deter STOLI by enacting a five-year moratorium on the settlement of policies that have the characteristics of STOLI.

That is the constitutionally-granted authority of the legislative branch of government. And as the Grigsby opinion shows, Justice Holmes would approve.

CONGRESS ASKS TREASURY TO WARN SENIORS OF STOLI DANGERS

Two senior members of the House Ways and Means Committee have asked the U.S. Treasury Department to alert elderly taxpayers of the adverse tax consequences of participating in STOLI transactions.

Reps. Richard Neal, D-MA, who chairs the Select Revenue Measures Subcommittee, and Phil English, R-PA, the subcommittee's top Republican, said in a letter to Treasury Secretary Henry M. Paulson that STOLI may have a serious impact on unsuspecting elderly Americans.

"STOLI transactions take advantage of the secondary market in life insurance settlements at the expense of elderly Americans who are left with an unexpected tax liability," Neal and English wrote.

"Our concern with STOLI policies is not intended to inhibit the ability of individuals to legitimately settle life insurance policies. Rather, we seek Treasury's assistance in notifying elderly taxpayers of the adverse tax consequences of investing in a product that is in fact 'too good to be true,'" they wrote. "We recommend that Treasury issue a Notice or other form of public guidance outlining the potential tax consequences of participating in a STOLI transaction."

continued on next page

COURTS: Television personality Larry King files a multimillion lawsuit against a life settlement broker alleging breach of fiduciary duty in connection with a transaction that has the characteristics of STOLI. King charges that he was approached to purchase a life insurance policy with the intent that it would immediately be sold to investors. The defendants failed to consider whether the life insurance coverage would be more valuable to King and his family for estate planning purposes, King alleges.

MEDIA: The *Wall Street Journal* features an expansive article on Coventry Financial and the market for life settlements, mentioning life insurer concerns about STOLI (as opposed to the settlement of legitimately-acquired life insurance policies) and noting the litigation involving Larry King.

The *Washington Post* features an article on Larry King and STOLI on the front page of its business section. The article mentions the efforts by NAIC and NCOIL to deter STOLI.

continued from previous page

Neal and English say that depending upon the structure, a STOLI transaction can be classified as a split-dollar life insurance arrangement, which is governed by a Treasury regulation (Treas. Reg. §1.7872-15). The rules concerning cancellation of indebtedness may also come into play on settlement of the policy, they add. In certain cases, the terms for the initial arrangement may not qualify as true indebtedness, thus exposing the insured to income inclusion. The insured may also be taxed on the value of the promotional incentive or cash payment received. STOLI promoters, meanwhile, may be liable for information reporting.

"State legislators, regulators and industry groups have questioned whether STOLI transactions satisfy the fundamental requirement that the owner of the policy have an insurable interest consistent with state law and public policy," Neal and English say.

STOLI policies are similar to the "wager policies" considered against public policy and rejected by the United States Supreme Court in *Warnock v. Davis, 104 U.S. 775 (1882),* they add.

STOLI Alert is published by the American Council of Life Insurers and the National Association of Insurance and Financial Advisors.

Readers are encouraged to copy and share the information contained in *STOLI Alert.*

For further information about *STOLI Alert* and the issue of stranger-originated life insurance, please contact us.

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TESTIMONY SUPPORTING SB 624

BY

JAMES D. HALL

AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

STATE OF KANSAS

COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE

SENATOR RUTH TEICHMAN, Chair

February 20, 2008

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FI&I Committee
February 20, 2008
Attachment 5

Good morning, Madam Chairman and members of the Committee. My name is Jim Hall. I am a Regional Vice President of State Relations for the American Council of Life Insurers. Thank you for the opportunity to testify today in strong support of Senate Bill 624. We appreciate the leadership of Commissioner Praeger and the Insurance Department in developing this legislation.

The ACLI is a national trade association of 353 member life insurers representing 93 percent of the life insurance premiums and 94 percent of the annuity considerations in the United States.

ACLI strongly supports SB 624. The bill offers amendments to Kansas' current viatical settlements act, which was enacted in 2002. These amendments were developed by the National Association of Insurance Commissioners and were incorporated into the NAIC's Model Viatical Settlement Act, which is the basis for Kansas' law. Senate Bill 624 also contains amendments that were developed by the National Conference of Insurance Legislators as a part of their Life Settlements Model Act. The purpose of these amendments is to stop a recently discovered practice known as Stranger Originated Life Insurance or "STOLI." These amendments are designed to offer the Kansas Insurance Department a stronger tool to protect Kansas consumers and to ensure effective regulation of the viatical and life settlement marketplace.

A fundamental principle of life insurance since the 18th century is "insurable interest." Insurable interest stands for the proposition that at the time a life insurance policy is issued, the person who procures the policy, or causes the policy to be procured, must have a lawful and substantial economic interest in having the life of the individual insured continue, as distinguished from an interest that would only arise by, or would be enhanced in value by, the death of the insured. The Kansas insurable interest law is found at K.S.A. 40-450.

Unfortunately, Madam Chairman, the insurable interest doctrine is today being turned on its head by third party investors who instigate the issuance of life insurance policies on elderly people in whom the investors have no insurable interest. The sole purpose of acquiring those life insurance policies is to profit from the death of the insured. These schemes are increasing in number and sophistication and they require immediate action on the part of public policy makers to protect senior citizens from the real and hidden perils of such transactions. For example, seniors may face unexpected taxes and fees, loss of insurance capacity and loss of medical privacy. In addition, promoters of these schemes may induce seniors to mislead insurers on policy applications.

A stranger-originated life insurance transaction, or a "STOLI," is a transaction where an investor, a life settlement company or their agent approaches a consumer and convinces the consumer to purchase life insurance on him or herself with the promise of free insurance and money to be made. The insured is often paid a fee in order to participate in the transaction. The insured may also be promised that his or her beneficiaries may receive a small portion of the policy proceeds. The elderly consumer obtains a non-recourse loan (secured only by the policy) that is arranged by the life settlement company. The loan carries an exorbitant interest rate (in some cases as much as 17%) and is usually scheduled to mature very soon after the two-year life settlement moratorium in the state's current viatical settlement law. The life settlement company then assists the individual in selling the policy to financial investors, who repay the loan in exchange for ownership of the policy.

A STOLI transaction is, in effect, an arrangement where an investor - a stranger to the insured - owns the right to receive the death proceeds. The only way for the investors to recover their money is for the insured to die. As Justice Oliver Wendell Holmes noted in Grigsby v. Russell, 22 US 149 (1911), *"a contract of insurance upon life in which an insured has no interest is a pure wager that gives the insured a sinister counter interest having the life come to an end."* The Grigsby

opinion went on to note, *"And cases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith."* The ACLI agrees with Justice Holmes and is opposed to STOLI transactions because of their potential negative impact on the Kansas life insurance market and on the availability and affordability of life insurance for older Kansans.

One of the most important provisions of SB 624 is the proposed addition of a strictly limited five-year moratorium on life insurance settlements such as those that are initiated by investors ultimately for their own profit, not for the benefit of the insureds and their beneficiaries. The bill targets these transactions without adversely impacting consumers' ability to sell policies that were purchased for legitimate financial protection purposes but which are no longer wanted or needed. For example, the bill allows policyholders to settle their policies *at any time* if they experience a change in life circumstances, such as illness, loss of employment, divorce or death of the intended beneficiary. Additionally, the two-year settlement moratorium found in existing Kansas law would be preserved for most policy purchases (i.e., those where the policyholders use their own assets or traditional premium financing to purchase the policy, and where the policy has not been pre-evaluated for settlement in connection with the issuance of the policy).

The result: In transactions such as the one described earlier, investors have to wait five years to get their hands on a policy that was initiated with the intent of settling it. This significantly reduces the economic incentives for STOLI transactions to occur, as investors will be far less likely to engage in these transactions if their investment dollars are tied up for five rather than two years, especially given that the target market for these STOLI settlements are seniors age 65 and older. An added benefit of this legislation is that it does not preclude any form of premium financing – it simply ensures that any such premium financing works primarily for the benefit of the insured, not the third-party investors. Ultimately, therefore, it is the elderly insurance consumer who stands to benefit from this legislation, which will help stop abusive transactions before they occur and before seniors are put in harm's way.

Madam Chairman, I again want to thank you for this opportunity to testify today. We express our appreciation to Commissioner Praeger and the Kansas Insurance Department for their leadership on this issue. By enacting the anti-STOLI provisions of SB 624, Kansas will be protecting consumers from abusive STOLI transactions and will be providing for effective regulation of the viatical and life settlements marketplace. I would be happy to answer any questions you or members of the committee may have.

STRANGER-ORIGINATED LIFE INSURANCE

SENATE BILL 624

The Kansas Insurance Department is proposing an important bill, SB 624, to provide needed regulation of a growing practice known as stranger-originated life insurance or "STOLI."

What Is STOLI?

- Sophisticated investors or their agents entice older individuals with whom the investors have no prior relationship and in whom they have no insurable interest to purchase life insurance.
- The investors provide the individuals with funds to pay the policy premiums and additional compensation. In exchange, the investors arrange to receive the policy proceeds when the insureds die.

The Dangers of STOLI

- STOLI is morally repugnant.
  - STOLI investors make money by betting that the insureds will die soon.
  - The quicker the insured persons die, the more money STOLI investors make.
- STOLI is bad for consumers.
  - Individuals may not be told that, unlike life insurance benefits, STOLI transactions can result in taxable income.
  - Individuals' capacity for life insurance may be used up in STOLI transactions, leaving them unable to obtain needed coverage to protect their families or businesses in the future.
  - As a part of the STOLI transaction, the consumers' personal medical information is distributed beyond their control to investors they don't know.
  - The growth in STOLI transactions threatens to restrict the availability of life insurance to older persons and to raise the cost of life insurance for all consumers.
- STOLI is bad for the life insurance industry.
  - STOLI circumvents the insurable interest laws by allowing investors who are otherwise legally prohibited from directly buying life insurance on strangers to nevertheless obtain ownership of those policies and to profit from the death of the original owners.
  - Life insurance receives favorable tax treatment because it is intended to protect widows, orphans, and businesses from being decimated by the death of family members or business associates. STOLI threatens that consumer-friendly tax treatment.

The Solution

- The Insurance Department's bill changes Kansas law to conform to the recently updated NAIC Viatical Settlements Model Act and to incorporate the best of the NCOIL Life Settlements Model Act.
- The Insurance Department's bill addresses STOLI transactions through a five-year moratorium on selling STOLI policies.
- The Insurance Division's bill protects insureds' right to sell insurance policies for legitimate reasons, such as sickness, divorce, or change in financial circumstances.

EXAMPLES:

Stalsberg vs. New York Life and Annuity **– US District Court, Utah**
Case # 2:07-cv-00029-BSJ

A 2007 lawsuit filed by Stalsberg against New York Life and Annuity for wrongful rescission of a $3.5 million life insurance policy issued in 2005 when the insured was 82 years old. New York Life counter-claimed and filed a motion for summary judgment. In its motion for summary judgment, New York Life pointed out that during deposition under oath, Stalsberg admitted that 1) he was approached by a life insurance broker who was representing a life settlement company; 2) that he (Stalsberg) was led to believe that he could profit on the sale of a life insurance policy insuring his life without having to pay any premiums on the policy; 3) that Stalsberg applied for and obtained the life insurance policy for the ostensible benefit of his family trust, but with his actual intent being to sell the policy to investors two years after its issuance; 4) that Stalsberg borrowed all of the money needed to pay the premiums on the policy through a non-recourse loan arranged by the settlement provider through a bank that partners in the settlement provider's program – a loan which carried an above market interest rate that was secured solely by the policy and that was scheduled to mature 26 months after inception; and 5) Stalsberg admitted that he intended to sell the policy "between 24 and 26 months" after its issuance, at which point the loan would be repaid, financial investors would be the sole beneficiaries of the policy, and Stalsberg would hope to make a small profit on the sale of a speculative interest in his life.

The case is pending on the various motions that have been filed so far.

Life Product Clearing LLC v. Linda Angel, **F.Supp.2d ___, 2008 WL 170193 (S.D.N.Y.)(Jan. 22, 2008) (No. 07 Civ. 475 (DC).**

The United States District Court for the Southern District of New York on January 22, 2008 issued a decision relating to STOLI. Concluding that defendant Angel had sufficiently alleged a plausible claim that her father had obtained a life insurance policy with the prior intent to transfer it to a stranger with no insurable interest in his life, the court denied the stranger-plaintiff a judgment on the pleadings. A trial is pending.

On November 15, 2005, Leon Lobel-a retired butcher who was then seventy-seven years old-established the Leon Lobel Insurance Trust, naming himself as the "Initial Beneficiary." The same day, he applied for a $10 million life insurance policy, designating the Trust as the sole beneficiary. The premium for the Policy for the first year alone was $572,000, an amount Lobel could not afford. The Policy was issued on December 14, 2005. Six days later, Lobel sold his interest in the Trust-and thus the right to any insurance proceeds upon his death-to plaintiff Life Product Clearing LLC (LPC) for $300,000. Lobel received payment of that amount on January 5, 2006. Five days later, he died. After a year-long investigation, the insurance company paid the face value of the Policy plus interest-$10,712,328 .77-to the Trust.

LPC then sued Lobel's daughter, Linda Angel, the personal representative of Lobel's estate, for a declaration that LPC is the rightful beneficiary of the Trust. Angel counterclaimed against LPC , the Trust and its Trustee, Jonathan S. Berck, contending that Lobel's transfer of his interest in the Trust to LPC was void as against public policy. Angel argued that the transaction involved an impermissible "wager policy", maintaining that LPC, a stranger to her father, gambled on his life, wagering $300,000 that he would die sooner rather than later. In fact, the "wager" turned out to be extraordinarily successful because Lobel died within days, and LPC stands to earn more than $10.7 million from its $300,000 investment.

In denying LPC's motion for a judgment on the pleadings, the Court found that the policy in this case is an example of a recent development in the life insurance industry that has "bloomed into a new and very controversial cottage industry": the acquisition of life insurance by an insured-usually an elderly person-for sale to a third party. The Court also opined that "these policies are lawful only if the insured purchases the policy with a good-faith intent to obtain insurance for the benefit of his family, loved one, or business; they

are not lawful if the insured purchases the policy with the intent to resell it to a stranger at the earliest possible moment."

***Life Partners v. Morrison,* 484 F.3d 284 C.A.4 (Va.) (4/30/07).**

A settlement provider victimized a consumer by offering compensation less than that required by the Virginia Viatical Settlement Regulation. When the provider was sued for the minimum compensation required by law, it attempted to escape regulation by denying jurisdiction based on lack of Virginia license. The Fourth Circuit upheld the federal district court opinion requiring Life Partners to hold a provider license in every state it does business. The Opinion affirmed the authority of the states to regulate viatical settlements and clarifies many aspects of the relationship of settlements to insurance and bolsters arguments for greater state regulation of viatical providers.

In tracing the history of viatical settlements, the court observed that, "The need for regulating the business of viatical settlements became apparent from the beginning. The power imbalance between the viator and the provider creates a substantial potential for abuse. The viator is usually in a weakened physical condition, often facing imminent death, often in financial hardship due to medical and healthcare costs, and often ignorant of industry practices. The provider, on the other hand, has extensive resources, is usually backed by investors, and is armed with sophisticated industry knowledge. Moreover, because of his illness and lack of time and energy to 'comparison shop' for the best payment, a viator often agrees to sell at a drastically reduced price, particularly when he fails to understand the nature and value of the rights that he has in the insurance policy that he is selling. The potential for harassment of the viator after the sale is also real, as the providers, acting under the terms of the viatical settlement, closely monitor the viator's health, subjecting him to regular medical examinations. In addition, the life insurance industry began to face new risks, including the increased risk of fraud, as potential insureds sought to hide their illnesses in order to obtain policies and thereafter to sell them to viatical settlement providers. Finally, many have questioned the ethics of an industry whose profits depend on, and whose investors hope for, the early death of its customers."

Business Week Magazine, April 23, 2007. "The High Price of Free Insurance."

The gains for selling one's life insurance policy may be significantly less than the promoters claim. "Interest payments, lenders' fees, and broker commissions can take a big bite out of policy holders' profits. John Shannon, an 82-year-old Arizona resident, discovered that when his $4.4 million policy was sold last October for $1.1 million. Once the loan that financed the policy's premiums was repaid, Shannon was left with $361,256, according to court documents in the lawsuit Shannon filed over the sale. Worse, the terms of the deal required him to hand over 51% of the remaining funds, almost $200,000, to the lender and promoter, Cove Management of LaJolla, California. The two sides settled for an undisclosed sum. 'The people who put these deals together see there's profit to be made and they do their best to take it all.' says Thomas David, a Miami attorney who represented Shannon."

Independent.co.uk

You can bet your life this policy will end in tears

US money men are making a fortune out of buying and selling life insurance. Should we worry? Oh yes, says Stephen Foley

And the biggest question of all: are the Wall Street brainboxes who brought us the sub-prime mortgage meltdown charting a similar course for the life insurance market?

Some of the finest minds in finance are, as we speak, working on new ways to chop up and repackage old life insurance policies for sale on the global markets. They are creating insurance derivatives for the speculators to play with. Goldman Sachs has already launched an index of human life expectancy on which investors can bet money.

There are too many echoes of what has happened in the mortgage market to ignore, and insurance industry players, finance experts and politicians are among those with a queasy, uneasy feeling that we might be watching the beginnings of something bad. Something that could become the big financial scandal of the next decade.

"The lure of easy money is seducing participants into the secondary market for life insurance and putting life insurers in compromising positions," says Cynthia Crosson, analyst at the credit-rating agency Fitch.

"Capital from hedge funds, investment banks and pension funds in search of higher returns is flowing into the secondary market, enticing policyholders, producers and some insurers with the potential for large cash payouts, significant commissions and higher revenues, respectively. The flow of capital to date and the potential for this market have created a gold-rush atmosphere."

The main risk, says Ms Crosson, is that the buying and selling of policies in a secondary market "will distort the very purpose of life insurance by breaking the insurable interest link between an insurer, policyholder and beneficiary".

Which is why Goldwyn and Sylvia Schroeder, a couple in their seventies from Sacramento, California, have been in the national news in the US these past few weeks. The couple were targeted by an insurance agent who offered Goldwyn Schroeder $1,000 to fill out a survey about his health, but it turned out to be a legal document allowing access to their medical records. Sylvia Schroeder, meanwhile, was offered a life insurance policy. The policy would be for millions of dollars, the agent claimed, and when she passed away, the payout would go to a complete stranger. She was offered money to co-operate. "They said if they took life insurance out on me, they would give me as much as $60,000 to $120,000," she told local television.

The bewildered Schroeders – by turns scared and tempted – are among seniors caught up in a growing trend for "stranger-originated life insurance", or Stoli.

Individuals have long been able to sell their life insurance policies to so-called "life settlement" firms. The company takes on the premiums and takes the windfall on your death, in return for an upfront payment that is substantially larger than the surrender value of the policy.

It is a trend that took off in the Eighties, when terminal Aids patients needed cash to pay medical bills that their health insurance was walking away from, but now it is gradually changing the nature of life cover.

Many rich individuals buy life insurance with at least half an eye on selling it before their death, treating it more like an investment. And, increasingly, brokers are targeting senior citizens like the Schroeders, asking them to take out insurance specifically in order to sell it on. The Sacramento couple appear to have caught the blunt end of the sales practices, but other approaches are more sophisticated. One such is premium financing, where an investment company lends money to pay for life insurance premiums in the expectation that an individual will pay it back by selling the policy.

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Because insurance firms and state laws typically require you to be taking it out for yourself, and not for the benefit of a stranger, this is risky and complicated. Some sales practices are above board, others are not. Some Stoli deal structures are clearly unacceptable, others are in a legally grey area. What is clear, amid all the confusion, is that there are vast profits to be made from life settlement.

This year, there is a battle royal going on in state after state across the US, as life insurers try to crimp Stoli and limit the size of the life settlement market, and as the settlement companies lobby to allow the market to grow.

There are no firm figures for its size – some estimates suggest it could reach $160bn (around £80bn) over the next few years – but growth appears to be exponential, having almost doubled in several of the past few years.

Wall Street has weighed in with its own well-funded lobby group, the Institutional Life Markets Association (ILMA) , set up by Goldman Sachs, UBS, Bear Stearns and others, to keep the market growing. After all, they need more second-hand policies to feed the derivatives market. So far, the repackaging of old policies through securitisations and structures akin to collateralised debt obligations (the structured finance products created out of sub-prime mortgages) has been done on an ad hoc basis between the banks and a small pool of investors. Within a year, though, participants say, there could be a public securitisation offering, rated by the credit-rating agencies and tradable on an exchange. Then we really are off to the races with these products.

This is why, says Jack Kelly, lobbyist for the ILMA, it is vital that dubious sales practices are stamped out right now and there is clarity on what is allowed and not allowed when life policies are taken out and sold on. "If people are recruiting seniors, conspiring and agreeing in advance to sell a policy even before the policy is written, ILMA opposes that," he said.

"But if someone wants to go out and buy insurance, after being told by the insurance agent that one of the options they have some day is to sell it, then they should be able to have that option. What we are fighting for is transparency at what I call the 'coffee table' level, at the point when a person actually sits down and decides whether to sell their policy – that principal point of contact where we need to know who is getting what commissions and what the policyholder is getting for their dollar."

Last week, politicians in Indiana held hearings on how to limit Stoli; in California, the Schroeders' case will be on the minds of politicians holding a hearing on whether to set new limits on when life insurance policies can be sold. Some 25 states are considering new legislation.

In all of these states, politicians will be acutely aware that there was a symbiotic relationship between the growth of the mortgage securitisation market and the take-up of sub-prime and other exotic mortgages, together with their accompanying dubious or even fraudulent mortgage broker sales practices.

Whatever the laws they write in the coming year, the most important law may yet be the one of un-intended consequences.

How stranger-originated life insurance evolved

1884

Former New York insurance commissioner and civil rights crusader Elizur Wright urges life insurance reform when he observes policies auctioned to speculators.1876

US Supreme Court holds that, due to public policy concerns, life insurance cannot be used as a vehicle for wagering on human life.

1980s

Aids grips the US. This prompts "viatical settlements" that allow sufferers, when terminally ill, to sell life policies on to third-party investors, with the aim of raising money before they die.

1990s

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People marketing viatical settlements look for new ways to make money as policy features such as "accelerated death benefits" – allowing the terminally ill to receive benefits of policies early – become more common. Stranger-originated life insurance begins to emerge.2001

The National Association of Insurance Commissioners approves a new life insurance settlement Act amid mounting concern about possible abuses – but the Stoli market still grows.

2007

US insurance law-makers begin crackdown amid fears over Stoli and how its practitioners operate. Insurers now permitted to ask if someone has had a life expectancy examination and if they have an agreement to sell their policy on to a third party, before policies are issued.

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Congress of the United States
Washington, DC 20515

November 16, 2007

The Honorable Henry M. Paulson
Secretary, United States Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

We are writing to request your assistance with a serious tax issue impacting unsuspecting elderly Americans. The issue relates to a life insurance product known as Stranger-Originated, or Stranger-Owned, Life Insurance ("STOLI"). STOLI transactions take advantage of the secondary market in life insurance settlements at the expense of elderly Americans who are left with an unexpected tax liability. *Business Week* recently devoted its cover story to the legal and public policy concerns raised by products that wager on the life expectancy of elderly Americans.

From the information we have received, there are currently several variations of the product being marketed. For example, some arrangements use a life insurance trust to procure the policy. However, in each case the key to the transaction is an elderly individual, often with a high net worth. In a typical STOLI transaction, an elderly individual, on average 80 years old, is marketed a policy that claims to provide millions of dollars of "free" insurance coverage on his or her life. We understand that these policies are aggressively marketed, and, in certain cases, the individual receives an expensive dinner voucher or cruise as part of the promotion.

In a typical transaction, the individual "purchases" the policy with a non-recourse premium loan, secured only by the policy's value on the secondary market. The loan is generally financed by the promoter or a lender obtained by the promoter. The terms of the non-recourse loan vary, but in most cases the loan term is two to three years. In certain transactions the individual also receives an upfront cash payment. In almost all cases, the insured is unable to pay off the loan and interest on maturity and is therefore economically compelled to sell the policy. Before such sale, if the insured dies during the term of the policy, the death benefit is paid to their heirs after the loan and interest are repaid.

If the proceeds of the sale of the policy exceed the remaining loan premium and interest, the insured receives the excess proceeds. At this point, the policies are sold on a secondary market. The investor becomes the owner of the policy and receives the proceeds on death of the insured. It is clear from the outset that the terms and pricing of the policies all but guarantee that the insured will be economically compelled to settle the policy, and the investor will receive the proceeds on the death of the individual. As reported by *Business Week*, promoters have also begun to create a third market in "death bonds" based on the investor insurance pools.

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State legislators, regulators, and industry groups have questioned whether STOLI transactions satisfy the fundamental requirement that the owner of the policy have an insurable interest consistent with state law and public policy. From the outset, the parties to the transaction contemplate that the policy will be settled at the end of the term, with the investor receiving the death benefit. After the policy is settled, the investor's interest is enhanced on death of the individual, rather than on the insured's continued life. Thus, STOLI policies are similar to the wager policies considered against public policy and rejected by the Supreme Court in Warnock v. Davis, 104 U.S. 775 (1882).

While we acknowledge that the state law treatment of a STOLI policy is not within the jurisdiction of the Department of Treasury, the federal tax consequences to the insured on the settlement of a STOLI transaction have been the subject of increasing commentary and concern. Depending upon the structure, the transaction can be classified as a "split-dollar life insurance" arrangement as defined in Treas. Reg. §1.7872-15. The rules concerning cancellation of indebtedness income may also come into play on settlement of the policy. In certain cases, the terms for the initial arrangement may not qualify as true indebtedness, thus exposing the insured to income inclusion. Also, depending upon the value of the promotional incentive or cash payment, the insured could be taxed on the value of the promotion received. Depending upon the structure of the product promoters may also be liable for information reporting.

Our concern with STOLI policies is not intended to inhibit the ability of individuals to legitimately settle life insurance policies. Rather, we seek Treasury's assistance in notifying elderly taxpayers of the adverse tax consequences of investing in a product that is in fact "too good to be true." We recommend that Treasury issue a Notice or other form of public guidance outlining the potential tax consequences of participating in a STOLI transaction. While we recognize that STOLI products can take various forms that potentially alter the tax treatment, we believe that guidance could be crafted to address these variations.

We appreciate your attention to this important matter and look forward to working with you to resolve this issue of importance to the American taxpayer.

Sincerely,

Richard E. Neal, Chairman
Select Revenue Measures Subcommittee
House Committee on Ways and Means

Phil English, Ranking Member
Select Revenue Measures Subcommittee
House Committee on Ways and Means

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

December 11, 2007

The Honorable Richard E. Neal
Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Neal:

Thank you for your recent letter to Secretary Paulson regarding the potential tax consequences to a taxpayer who participates as the insured individual in a Stranger-Originated, or Stranger-Owned, Life Insurance ("STOLI") transaction. After consulting with the Office of Tax Policy, I want to provide you with the following response to your letter.

Your letter describes a typical transaction in which an individual purchases a life insurance policy with a nonrecourse premium loan with a two to three year term. If the individual dies during the term of the loan, a portion of the death benefits under the policy is used to pay off the loan and the remainder is paid to the individual's heirs. If, on the other hand, the individual is still alive at the end of the loan term, the policy is sold – sometimes at a gain – and later may be resold on a secondary market.

Such a transaction raises a number of state law issues, including the application of state insurable interest laws, which are not within the jurisdiction of the Department of Treasury. It is important, however, that a taxpayer who receives economic benefits from participating in such an arrangement report and pay tax on an appropriate amount of income. Factual differences among arrangements, however, may lead to different treatment under the tax law. The Treasury Department is working closely with the Internal Revenue Service on how best to address these transactions, and we will carefully consider the issues discussed in your letter as part of that process.

Thank you for sharing your views on this important matter.

Sincerely,

Kevin I. Fromer
Assistant Secretary for Legislative Affairs

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State Farm®
Providing Insurance and Financial Services
Home Office, Bloomington, Illinois 61710

February 19, 2008

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The Honorable Ruth Teichman
Chair Senate Financial Institutions & Insurance
State Capital – Room 241E
Topeka, KS 66612

Re: Kansas Senate Bill 624

Dear Senator Teichman,

State Farm Life Insurance Company wishes to express support for Senate Bill 624, which would restrict the sale of stranger originated life insurance (STOLI). Senate Bill 624 incorporates language from the NCOIL Life Settlement Model Act as well as language from the NAIC Viatical Settlement Model which establishes robust consumer protections while protecting policyholder rights.

STOLI, a practice where speculators entice seniors to take out policies and then profit when they die, are schemes aimed to circumvent state and civil interest and abuse the social purposes of life insurance. Insurable interest is non-existent in these arrangements. State Farm Life Insurance Company does not support any STOLI sales since they create a tax burden for the policyowner, jeopardize future insurability, and constitute wagering on the life of the insured.

Senate Bill 624 contains key provisions balancing policyholders' interest and rights. Key provisions include:

- A definition of STOLI coupled with a provision that makes engaging in STOLI schemes, including those involving a trust, unlawful. (SB 624 § 6)
- A limited five-year settlement prohibition targeting transactions with characteristics of STOLI such as non-recourse financing, settlement guarantees, or life expectancy evaluations. (SB 624 § 9)
- Protection of consumer property rights by permitting any-time settlements for cause such as death of spouse; divorce; disability; bankruptcy; loss of job; or chronic or terminal illness. (SB 624 § 9)
- Expanded consumer right to rescind a settlement contract to 60 days. (SB 624 § 2c)
- Settlement reporting requirements to enable regulators to identify and stop STOLI transactions. (SB 624 § 7a)
- Prohibition of advertising representing that insurance is "free" or "no cost". (SB 624 § 3h)
- Disclosure to insurers of any plan to originate, renew or finance a policy prior to or within 5 years of policy issue. (SB 624 § 8(b(8))
- Elimination of the "accredited investor" exemption from the definition of "viator", which would otherwise allow transactions involving policy owners with $1 million or more in net worth to completely escape regulation and engage in "wet ink" STOLI transactions. (SB 624 § 5(r))

FI&I Committee
February 20, 2008
Attachment 6

- A comprehensive definition of "life settlement contract" which includes policy transfers regardless of when they occur if they include indicia of STOLI, and transfers which do not fall within a legitimate settlement exception, such as non-recourse financing arrangements, debt forgiveness, or settlement guarantees. (SB 624 § 5(p))

It is in the best interests of life insurance customers to end STOLI transactions. SB 624 protects the public and life insurance customers in particular.

With warmest regards, I remain,

Very truly yours,

Natalie Brunson-Wheeler, Counsel