HAMILTON SMITH ASSOCIATES

The Tax Man Cometh….

High-profile, heated discussions and debates within Congress and the White House over the last year have accomplished at least one thing — everyone in the US who is not living under a rock is aware that we have created a large government spending deficit and there is little appetite or leadership to realistically cut spending. So the inevitable now occurs — taxes will go up.

But what taxes — and taxes on what assets? The details will impact our personal lives and the products we offer within the life insurance industry. *The insurance industry is not exempt*.

When any potential tax law change is discussed in terms such as 'revenue enhancement', 'cap on deductions' or subject to 'means testing', the underlying intent of the discussion is to generate increased tax revenue. Vague terminology encourages an audience to misunderstand and underestimate the personal impacts of a given tax law change. It also allows the speaker to hide the impact and soften the blow.

Then later, after tax laws are changed and real impacts are revealed, individuals digest the full meaning of a tax law change and may modify behavior as a result. Consumers often substitute similar activities or assets that are not heavily taxed. Reduction in consumer interest can cause fewer sales of the highly-taxed asset class and often reduced value of assets already in the class. For all industries including the life industry, this reduction impacts product design and features. Some possible points for life industry leaders to consider as our tax laws are massaged during 2013:

- Non-qualified annuities are already included in the definition of 'passive income' subject to the new ObamaCare health tax of 3.8% above a certain income level. Will consumers invest less in this asset class overall?
- Roth conversions now increase modified adjusted gross income (MAGI) and so indirectly can cause other investment income to become subject to the 3.8% tax. Roth IRAs can be funded with many assets classes including deferred annuities. Will new tax cause Roth conversion to be for smaller amounts or not at all to stay below the 3.8% tax-trigger thresholds?
- Should an employee continue to 'max out' pre-tax 401k plan contributions beyond the employer match? Or is old-fashioned maximizing behavior only building an even larger 401k balance subject to higher tax rates in the future when required minimum distributions are mandatory?
- Think big — will life insurance death proceeds become taxable in some manner as taxable assets classes expand? For instance, benefits about $X million — will these become taxable and seen as windfall money to beneficiaries? While not taxed directly, could life insurance proceeds be deemed to be 'passive income'? Current tax law taxes estates, so why not life insurance?

Final tax impacts have not solidified as of this writing, and some are mere conjecture just to make you think. We expect legislative discussions to continue well into 2013. The net message today is you must examine the value story behind any financial asset you offer to consumers today. You may need to revise your product offering and your messaging round it.

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