NAPIER'S NOTES:

A Couple Minutes Is All It Takes.

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MEET THE 3.8% HEALTHCARE TAX

Say hello to my little friend.

— Al Pacino, Scarface

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There's a new tax in town. This tax seems more cuddly than most, even kind of cute. This tax is known by many different names, including the Healthcare Tax, the Net Investment Income Tax, or the Affordable Care Act Tax.

Now, he is just a tiny tax, perhaps a bit like a playful little wolf cub. Look at him having such fun, all 3.8% of him. As you may know, the tax is only applicable to single folks earning over $200,000 and married couples earning over $250,000. Let's compare this adorable little newcomer of a tax to the nasty estate tax you have heard about the last many decades (since about WW I, in fact).

Former Treasury Secretary Larry Summers has estimated that the estate tax manages to snare only about 1% of all assets transferred from one generation to the next. In the eyes of a government hungry for revenues, taxing only a few thousand estates every year is one lousy way to raise revenue. (Yes, only a few thousand estates actually pay tax every year!)

Why do so few estates pay tax? There are so many ways to avoid the estate tax, it has almost become a voluntary tax, IF one is willing to take advantage of them. For those unwilling to plan, charity is always a worthwhile alternative to paying estate tax.

So the new healthcare tax was born. Rather than impacting a few thousand taxpayers annually, like the estate tax, the new healthcare tax will directly affect about 3.7 million families in 2013. Within the next decade, it will chew in to over 7 million families. But the 3.8% tax is so small, what is the big deal? Can its bite be so bad?

Yes. The cute little healthcare tax will currently generate as much federal tax revenue as the estate tax; and because the thresholds for incurring the tax are NOT indexed for inflation, the revenues from this new tax will at least double in the next decade. So the cute little tax playing at your feet may soon grow to become the big bad wolf that ate your wallet, bite by bite, year by year.

Fortunately, there are at least some defenses to this teething little beast. Certainly, keeping your income below the taxable thresholds eliminates the tax. Deferring income through charitable remainder trusts or other means also has merit. Disbursing income among a wider group of beneficiaries, like children, may also be helpful.

Municipal bond interest and retirement income (e.g. from IRAs, etc.) are not subject to the tax nor are earnings distributed to an owner active in her business. Life insurance also becomes more compelling as earnings inside the policy avoid tax. Exchanging low basis assets inside an irrevocable grantor trust for high basis assets can also be beneficial.

You are wise to deploy all defenses to this tax that are available to you. Let the wolf chew on somebody else's wallet.

This cute little wolf cub wants you to pet him. Be careful - he may bite off 3.8% of your hand each year you do.