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Money At Work

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For Your Investment Planning Needs Contact:

Barbara Kazma 515-246-6362
Pat Johnson 515-244-5619

Iowa State Bank Investment Services
627 E. Locust Street
Des Moines, IA 50309
(888) 824-0111
(515) 244-3413

Barbara Kazma and Pat Johnson are registered representatives of LaSalle St. Securities, LLC. Securities are offered only through:

LASALLE ST. SECURITIES, L.L.C.
Member FINRA/SIPC
940 N. Industrial Dr.
Elmhurst, IL 60126

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Five ways to invest for college

According to the College Board, the trend of rising costs for college continues unabated (see box on page 2). Depending on your situation, you could easily pay six figures to put just one child through school. Double or triple that amount if you have several children.

So how can you manage to pay for your children's education? Even though the figures are daunting, you may be able to build up a college savings fund through astute investments. Of course, there are no guarantees, and you must contend with certain risks, but here are five common investment vehicles to consider.

1. Securities: If your child is still a tyke, you might allocate some of your investment dollars to securities such as stocks and bonds. Keep in mind, however, that liquidity becomes more of an issue as the child reaches his or her teens. Remember to balance the potential rewards against the inherent risks. By diversifying among different types of equities, you may be able to reduce overall investment risk. Note: There are no guarantees against loss of principal.

2. Zero coupon bonds: From a college savings viewpoint, the main advantage of zero coupon bonds is that the interest is deferred to maturity when you receive a lump sum. This may be coordinated with the time your child will be entering college. Nevertheless, you may have to report tax on the interest that accrues each year the bonds are held.

3. Certificates of deposit (CDs): A conservative approach toward college savings is to invest in CDs. With a federally insured CD, the principal is effectively backed by the U.S. government, up to $100,000.

4. U.S. Savings Bonds: This is another relatively conservative method of investing for college. You might include Series EE or inflation-indexed Series I bonds in your portfolio. You pay only half the face value of the bonds at the time of purchase. Note: If these savings bonds are bought in your child's name, they may be exempt from federal income tax if used to pay for college tuition (within certain limits).

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Five ways to invest for college

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5. U.S. Treasury Bills: If you need to generate income quickly, you may decide to invest in Treasury bills (T-bills) with short-term maturities. T-bills are backed by the U.S. government, and the income is exempt from state and local income tax.

Of course, this list is by no means all-inclusive. With proper assistance from a professional investment adviser, you can choose the investments that make the most sense for your family's situation

Average annual college costs*

	2007-2008	2006-2007	$ change	% change
Public 4-year school in-state	$13,589	$12,837	$752	5.9%
Public 4-year school out-of-state	$24,044	$22,811	$1,233	5.4%
Private 4-year school	$32,307	$30,497	$1,810	5.9%

*Tuition, fees, and room and board only.

Source: College Board

Nailing down the new mortage law

The new mortgage relief law signed late last year, officially named the Mortgage Forgiveness Debt Relief Act of 2007 - is designed to help debtors caught in the subprime mortgage crisis. But this new federal legislation creates other key tax breaks for homeowners. Here is a brief summary:

Debt forgiveness: This is the provision that has received the most media attention. Under the new law, up to $2 million of mortgage debt forgiveness on a principal residence is tax free. Normally, this would represent taxable cancellations-of-debt (COD) income. The special tax exclusion is available for a three-year period beginning January 1, 2007, and ending on December 31, 2009.

However, this new tax exclusion does not apply if the mortgage discharge is not directly related to a decline in the value of your home or some other financial condition. Also, it does not apply to taxpayers in a Title 11 bankruptcy.

Mortgage insurance: Prior to 2007, Congress had authorized a one-year deduction for mortgage insurance premiums as qualified residence interest. A deduction is available on your 2007 return for the full amount of insurance paid (for contracts issued after 2006) if your adjusted gross income (AGI) for the year does not exceed $100,000. But the deduction is gradually phased out and disappears entirely if your AGI exceeds $109,000.

The new law restores the deduction and extends it for three years. Under this provision, you may be able to claim deductions for premiums paid or accrued before 2011 (for contracts issued after 2006).

Home sale exclusions: The home sale exclusion allows you to realize a tax-free gain of up to $250,000 when you sell a home you have owned and used as your principal residence for at least two out of the five years before the sale. The $250,000 exclusion is doubled to $500,000 for married couples. However, prior to the new law, the $500,000 exlusion was available only if a husband and wife filed a joint tax return for the year of the sale.

In other words, if one spouse passed away and the other spouse did not sell the home until the following year or later, the surviving spouse was limited to the $250,000 exclusion. For sales after 2007, a surviving spouse may claim a $500,000 exclusion for a sale occurring within two years of death.

Remember that this is just an overview of the new law. Also, additional proposals are being considered by Congress. Do not take any action based on this information without consulting a tax professional.

Questions to answer before retirement

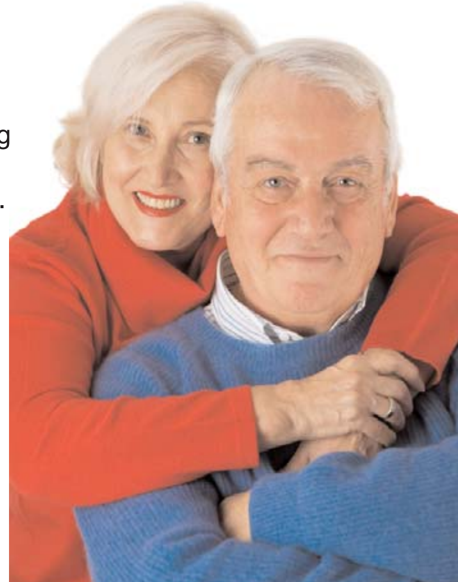
Once you reach your mid-fifties, financial thoughts should turn toward retirement planning. Here are several questions you should answer as part of the process.

Q. How much do you need to save?

A. The short answer often provided by financial experts is that you should set aside enough to produce between 70% and 80% of your current income. But that is an over-simplification. In reality, the amount you must save, depends on a variety of factors, including your objectives, projected living expenses, your expected retirement age, health status and the return/risk ratio of your portfolio. Have your personal situation assessed.

Q. When do your intend to retire?

A. If early retirement is a dream of yours, you may have to raise your savings goals or lower your expections - or both. For instance, if you retire five years early, you might plan on generating enough income to sustain you through, say, 30 years of retirement instead of 25. (These figures are purely hypothetical.) In addition, consider the tax consequences of retirement-plan distributions. Withdrawals made prior to age 59-1/2 are generally subject to a 10% penalty tax plus regular income tax.



Q. How does early retirement affect Social Security benefits?

A. The earliest point at which you can apply for Social Security retirement benefits is age 62. For those born from 1943 through 1954, benefits will permanently be reduced to about 75% of the amount that would have been available at full retirement age. For instance, if you were born from 1943 through 1954, full retirement age is 66. The age increases gradually for younger individuals. For those born in 1960 or after, full retirment age is is age 67. (A 30% reduction applies to early retirement.)

Q. How should you receive your retirement plan payments?

A. In most cases, there are two basic choices.

1. You can elect to be paid in the form of an annuity (e.g. monthly payments for life). There are numerous variations. A joint-and-survivor annuity allows your spouse to receive a portion of your benefit after you die, but it may reduce your own monthly payment. In contrast, a single-life annuity may provide a larger monthly payout, but no benefits for a surviving spouse.

2. You may take a lump-sum distribution of the full amount in your account. The primary advantage is that you can decide how your money is invested and you have complete access to the funds. However, you must pay a tax on the payout in the year of the distribution, unless you roll it over directly into an IRA (or other qualified plan).

Q. How should you invest your money?

A. For most individuals, the primary objective is to maintain a steady stream of income in retirement. As you near retirement, you should review your portfolio to see if it needs to be adjusted. Of course, diversification is generally recommended for investors.

Reminder: These are just some basic questions to answer. Various other factors, including your insurance needs, should be addressed before your retirement.

Supreme Court Rules on Investment Fees

A new U.S. Supreme Court case settles a long-standing controversy involving deductions of certain investment advisory fees. **Background:** An individual may deduct miscellaneous expenses only to the extent the annual amount exceeds 2% of his or her adjusted gross income (AGI). The same rule generally applies to trusts and estates. **Key exception:** Fees are not subject to this 2%-of-AGI floor if they would not have occurred had the assets not been held in a trust or estate. Now the Supreme Court has ruled that this exception does not normally apply to investment adviosry fees paid by a trust or estate. The decision resolves a conflict in the lower courts.

Benefits of a credit shelter trust

Do you expect to leave the bulk of your wealth to your spouse and children? If you own a significant amount of assets, some of your net worth may be eroded by estate taxes. However, one way you might be able to shelter your estate from federal estate tax is to use a "credit shelter trust" (also called a "bypass trust").

Background: Thanks to the unlimited marital deduction, any transfer of assets from one spouse to another is completely exempt from federal estate tax. Furthermore, for decedents dying in 2008, up to $2 million of assets can be effectively sheltered through the credit known as the estate-tax exemption. This exemption amount increases to $3.5 million for 2009.*

By combining these two tax breaks, you can pass a sizeable amount on to your heirs without any federal estate-tax erosion.

Example: John Jones, a successful business person, owns assets currently valued at $4 million. Under the terms of his will, all of the property is to be transferred to Mary, his spouse.

Assuming that John dies in 2008, the assets pass to Mary free of estate tax under the unlimited marital deduction. But the exemption for John's estate goes to waste. For instance, should Mary die in 2009, the exemption for her estate can shelter $3.5 million. The remaining $500,000 (adjusted for investment performance) is subject to estate tax.

Possible solution: John could leave half of his estate, or $2 million, to Mary outright and transfer the other half to a credit shelter trust. For instance, this can be accomplished by establishing the trust in his will (i.e., a testamentary trust). There are two common methods:

1. The will can provide that the income from the trust be distributed among the surviving spouse and children.

2. If there is concern about a surviving spouse's financial security, trust income can be paid to the spouse for life.

Going back to our example, the $2 million transferred to the trust is sheltered by the estate-tax exemption for John's estate. It bypasses Mary's estate completely. And when Mary dies, there's no estate tax on the $2 million she leaves to the children.

Net effect: With the credit trust, $4 million is transferred estate-tax-free.

Caveat: Take other factors, including state inheritance laws, into account. It is recommended that you seek assistance from an estate-planning professional.

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Questions?

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