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Five ways to reduce new surtax

Certain high-income investors may be liable for a new 3.8% Medicare surtax on investment income in 2013. Unlike other tax changes in the American Taxpayer Relief Act of 2012 (ATRA) taking effect this year, this provision was part of the Patient Protection and Affordable Care Act of 2010 (PPACA). With some astute planning, you may be able to reduce the surtax you owe in 2013, or even eliminate it.

Basic premise: The 3.8% Medicare surtax applies to the lesser of your "net investment income" (NII) or the amount by which your modified adjusted gross income (MAGI) exceeds \$200,000 for single filers and \$250,000 for joint filers. For example, if you are a single filer with \$150,000 in NII and a MAGI of \$300,000 in 2013, the surtax is \$3,800 (3.8% of \$100,000 excess MAGI). Now that ATRA has increased the top income tax rate to 39.6% in 2013, you could pay a combined federal tax rate of 43.4% (39.6% + 3.8%) on certain income.

The PPACA definition of NII includes interest, dividends, capital gains, rents, royalties, nonqualified annuities,



income from passive activities, and income from the trading of financial instruments or commodities. But certain other items -- such as wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a nonpassive business, and distributions from qualified retirement plans and IRAs -- are excluded.

Consider strategies that may reduce your exposure to the new surtax. Here are five possibilities.

1. Municipal bonds: The income from tax-exempt municipal bonds does not count toward NII or MAGI. So adding ("munis") to your portfolio -- or increasing your current investment in munis -- is often a good way to decrease liability for the 3.8% surtax. Of course, you do not want to go overboard with any one investment, so plan accordingly.

2. Roth conversion: By converting funds in a traditional IRA to a Roth, you can seek tax protection in future years. For a Roth in existence at least five years, qualified distributions (e.g., those made after age 59½) are 100% tax-free. This sidesteps the surtax problem in the future.

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3. Passive activities: NII includes amounts generated by passive activities such as rental real estate. Therefore, if you own a business interest where you do not take an active role, you might have to pay the surtax. However, if you “materially participate” in the business, the income generally will not count as NII. **Caution:** Special rules apply to rental real estate activities.

4. Charitable remainder trusts: With a charitable remainder trust (CRT), you can generally claim a current tax deduc-

tion for the gift of the remainder interest, while receiving income for a period of years or your lifetime. The CRT can help avoid the surtax on highly appreciated capital gains. Obtain professional guidance for these trusts.

5. Annuities: By investing in a tax-deferred annuity, you can arrange to receive payments in retirement, while “leapfrogging” high-income years when you might be liable for the 3.8% surtax. This tax-deferral strategy may be advantageous if you expect to be in a lower tax bracket in retirement than you are now.

Of course, you don’t have to go it alone. Seek professional guidance concerning tax and financial matters.

Retirement savings: beauty before age

At what age should you start saving for retirement? The easy answer: whatever age you are right now. It is neither too early nor generally too late to begin, although the manner and method of savings will likely vary, depending on your stage of life. Here is a snapshot of what it may look like at different times.

The early years: For most people, your first starting salary does not provide much room for savings. But it is still important to develop good savings habits. For instance, if you work at a company that provides matching contributions to a 401(k), be sure to take advantage of the company match. Otherwise, you are leaving money on the table that may provide valuable income in retirement. Furthermore, you might be surprised to find out how much impact tax-deferred compounding can have over a long period of time.

The middle years: When you are in the middle of your working career, other obligations - such as buying a home, raising your children and building up funds to help pay for their educations - often take priority. Nevertheless, do not take your eye off the ball. To the extent possible, continue utilizing company retirement plans, IRAs and other savings vehicles. Note that a Roth IRA may provide tax-free payouts in retirement for qualified distributions (e.g., those received after age 59½). If you are rewarded with a raise, try to allocate at least part of it to your retirement savings plan.

The late years: This time of life may provide more opportunity for saving if the house is paid off and the kids are out of school. Also, you may benefit from seniority and career advancement, so your earnings could be higher than ever or near their peak. If you have not been as diligent through the years as you would have liked (see above), it is still possi-

ble to build a sizeable nest egg for retirement. The basic principles of using retirement plans and IRAs for tax-deferred growth remain.

Finally, don’t think that saving for retirement ends once you have retired. At this time, you must make some serious decisions and assess both your expected income and expenses. For instance, one major decision is when to take Social Security benefits so you are able to maximize the payouts. Also, you might decide to keep working past the age for receiving full Social Security retirement benefits (ranging between age 65 and 67, depending on the year of birth).



Due to longer life expectancies, you may need more retirement income than you initially imaged. Now is the best time to start saving to meet your objectives.

A bounce-back for charitable rollovers



Once again, time appears to be running out on a unique estate planning strategy for retirees. Under a special tax law provision, an individual aged 70½ or older can transfer funds directly from an IRA to a qualified charitable organization while paying zero tax on the distribution. Such a “charitable rollover” also counts as a required minimum distribution (RMD) for tax purposes.

Currently, the charitable rollover break is scheduled to expire at the end of this year. Although this tax law provision could be extended again it is probably better to err on the side of caution.

Background: Previously, you could not directly transfer funds tax-free from an IRA to a charitable organization. Instead, you were required to pay tax on the distribution, regardless of your charitable intentions. The tax law also worked against retirees who wanted to use IRA funds for charitable donations but no longer itemized their deductions.

However, the pension Protection Act of 2006 (PPA) changed the rules for individuals aged 70½ and older. It allowed these retirees to transfer IRA funds directly to charity, up to an annual limit of \$100,000. Although no tax deduction was allowed, donors were not taxed on the distribution either. The PPA tax break was subsequently extended through 2009, then through 2011 by the 2010 Tax Relief Act. Finally, the new American Taxpayer Relief Act of 2012 (ATRA) reinstated the rules, retroactive to 2012, and extended them through 2013.

A qualified distribution is defined as one from either a traditional or Roth IRA that would otherwise be taxable. The distribution must be made directly from the IRA trustee to the charity.

Furthermore, the contribution must otherwise qualify as a charitable donation. If the deduction amount decreases because of a benefit received in return - for a dinner at a fund-raising event, for example - or the deduction would not be allowed due to inadequate substantiation, the exclusion is not available for any part of the IRA distribution.

Under a special rule for charitable donations, the IRS treats distributions from an IRA funded at least partially with nondeductible contributions as coming first from taxable funds and then from non-taxable funds. All the individual's IRAs are grouped together for this calculation.

Finally, an IRA participant is generally required to begin receiving RMDs in the year after the year in which he or she turns age 70½. A qualified charitable distribution counts toward this requirement.

Note that the same rules also apply to Roth IRAs. Roth IRA distributions to individuals older than age 59½ are often tax-free. But a portion of a distribution may be taxable for a Roth in existence less than five years. If you have both a traditional IRA and a Roth IRA, it generally makes sense to use the traditional IRA first for charitable distributions.

Caution: The charitable rollover technique is not for everyone. Obtain guidance as to how it would apply for your family's situation.

Don't make the same investment mistakes

We all make mistakes, but some of them turn out to be worse than others. For instance, the types of errors you might commit as an investor could haunt you for years, dramatically affecting your lifestyle.

Simple advice: Don't keep making the same investment mistakes over and over again.

Of course, that is easier said than done. To help you out, here are six tips for investors in the equities markets.

1. Show some patience. You cannot expect “instant gratification” whenever you make an investment. Adopt a view of



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the long term, and try to stay consistent with your overall plan despite any ups and downs in the short term. Recognize that you may have to hold assets for a period of time for the best results.

2. Face up to reality. Don't ignore what the numbers are telling you. For instance, if you have a favorite stock that is consistently underperforming, you should not continue to "throw good money after bad." Take your lumps and move on. Similarly, do not allow emotion to rule the stocks you decide to keep for the future.

3. Remain diversified. On the other hand, no matter what the numbers say, you should not sink all your dollars into a single investment. Although diversification offers no guarantee of success in a declining market, it remains a viable way of reducing overall investment risk. Build a balanced portfolio with the assistance of your investment advisers.

4. Do not overemphasize past performance. Are you familiar with the boilerplate language found in most investment-related documents? It states that, "Past performance is no guarantee of future results" (or something to

that effect). You probably do not pay much attention to it, but it is true. Instead of relying strictly on past performance, evaluate current and future prospects.

5. Factor in taxes. One important thing to remember as an investor is that it is how much you keep, not how much you earn, that really matters over the long term. Depending on the type of investment, and the timing of gains and losses, taxes may dilute a significant portion of your earnings. This is especially true in 2013 now that the top rate has been raised for upper-income investors and a new 3.8% Medicare surtax is a concern (see page 1).

6. Stay away from "market timing." Typically, market timing is based on acquiring stock when you think it will go up and selling stock when you think it will go down. It may work sometimes, but it can also backfire if your expectations are not met. It makes more sense to build a balanced portfolio based on your particular needs and tolerance for risk.

Finally, it also helps to develop an investment plan designed to meet your personal objectives, rather than taking a random approach. With professional assistance, you can cut down or eliminate some of those annoying mistakes that may have plagued you in the past.



Can You Count on Medicaid?

If a loved one is forced to enter a nursing home, Medicaid may help cover the costs, but eligibility is strictly limited on a state-by-state basis. In many states, the nursing home resident can have no more than \$2,000 in countable assets, while one-half of a spouse's joint assets may count for this purpose.

The list of "noncountable assets" is a short one, so elderly people may be encouraged to "spend down" to reach the threshold. However, assets that have been transferred may still count due to a 60-month look-back rule. Consult an estate-planning expert for more details.

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