

November 18, 2009

Dear Client,

We wanted to make sure that you are aware of an interesting tax and retirement strategy that will become available at the start of 2010.

What is the opportunity?

The opportunity we're referring to is the ability to convert an existing Traditional IRA to a Roth IRA. Prior to 2010, this option existed only for taxpayers with less than \$100,000 in adjusted growth income (AGI). Starting on January 1, 2010, this income limit has been eliminated and anyone, regardless of income, is eligible to convert a Traditional IRA to a Roth IRA.

Why do we think this is an opportunity?

A Roth IRA provides two major advantages over a Traditional IRA. First, all distributions from a Roth IRA (generally after a 5-year holding period and reaching age 59 ½) are tax-free, while distributions from a Traditional IRA are taxed as ordinary income. If you own a Roth IRA and die, the distributions continue to be tax-free for your beneficiaries. Second, as an owner of a Roth IRA, you and your spouse beneficiary are not subject to the Required Minimum Distribution Rules that apply to a Traditional IRA. (Required Minimum Distributions are required if your Roth IRA is inherited by a non-spouse beneficiary, but these distributions can be spread over the life expectancy of the beneficiary). So, by converting a Traditional IRA to a Roth IRA, you exchange tax-deferred growth to tax-free growth, exchange taxable withdrawals to tax-free withdrawals, and eliminate any requirement that assets be removed from the IRA during your or your spouse's lifetime.

What's the catch?

Of course, there's always a catch. You must pay taxes (at ordinary income rates) on any amounts converted from a Traditional to a Roth IRA in the year of conversion. Essentially, the owner is treated as if he or she withdrew the assets from the Traditional IRA and re-contributed the assets to the Roth IRA.

For assets converted in 2010, there is a special tax break that allows the owner to not report any income in 2010, but instead report one-half of the income from the conversion in 2011 and one-half in 2012. However, any taxes so deferred will be taxed at the rates in effect in those years. Since tax rates are currently scheduled to go up after 2010, it may or may not be advantageous to defer the taxes depending on the amount of the conversion and the owner's expected marginal rates in those years. (Inverness has strategies

available, including natural resource investments, which can be used to reduce or offset this income. Call us if you would like more information on these strategies.)

Why do I want to pay taxes sooner than I have to?

As financial advisors, we normally try to find ways for our clients to defer taxes, not pre-pay them. So why are we now talking to you about a strategy that does exactly the opposite? Because of the special tax and estate planning advantages offered by Roth IRAs, we believe that some of you can reap significant long-term savings and estate planning advantages from converting and paying taxes sooner rather than later. While we think that anyone who owns a Traditional IRA (and even some who do not currently have an IRA, as discussed below) should review their options, the conversion opportunity offers significant potential savings in the following circumstances:

- You do not need to draw on IRA assets for cash flow;
- You have a relatively long period before drawing on IRA assets for cash flow;
- You can afford to pay the taxes on the amount converted out of non-IRA assets;
- You expect your tax rate at the time of expected withdrawal to be higher than your current rate; or
- You want to leave IRA assets to the next generation free of income tax burdens.

If you expect to draw on the IRA for cash flow in the future, the key is tax rates. Conversion probably makes sense if you expect your tax rates to be higher at the time of the withdrawal than at the time of conversion, and probably does not make sense if you expect your tax rates to be lower at the time of the withdrawal than at the time of conversion.

Do I have to convert all of my IRA assets to take advantage of this opportunity?

No, you can convert any amount you want. For example, if you are not subject to the highest marginal rates, you can determine how much you can convert without pushing yourself into the next tax bracket.

I'm interested, but what happens if my IRA drops in value after I convert? Haven't I paid too much tax?

Let's say you convert \$50,000 of Traditional IRA assets on January 2 and find that the account is worth \$40,000 on June 1. It looks like you may have paid too much in taxes, since your tax bill would have been lower if you had waited and converted on June 1. The good news is you have a "do-over" called a "recharacterization." If for any reason you do not like the results of your conversion, you can undo the conversion and move the assets back to a Traditional IRA as if you had never converted the assets. While the recharacterization does not recoup your market losses, it does save you the taxes you would have paid. You have until October 15 of the year following the year of the conversion to complete the recharacterization, as long as you obtain an automatic extension of your tax return for that year (even if you still file by April 15).

The rules on recharacterization create some interesting strategies that involve holding different asset classes in separate Roth IRA accounts. Also, there are strategies that allow you to reconvert IRA assets that have been recharacterized, sometimes immediately. These strategies are too complex to cover in this letter, but let us know if you would like to learn more.

All of my retirement assets are in 401(k) Plans. Do I have an opportunity to convert these to Roth IRA assets?

Even if you do not have an IRA, you may be able to take advantage of this opportunity. If you have assets in a company-sponsored 401(k) Plan (or other qualified retirement plan) and are allowed to take a distribution from the plan, you could take advantage of the Roth IRA conversion. You might be allowed to take a distribution from your 401(k) Plan in one or more of the following circumstances:

- You have a 401(k) Plan from an old employer.
- You have assets in your current 401(k) Plan that were rolled over from a previous employer. Most plans allow rollover assets to be distributed from the 401(k) Plan at any time, even while employed.
- Your current 401(k) Plan allows for in-service distributions. Many plans allow such distributions after the employee has reached age 59-1/2.

If you are eligible to take a distribution from your qualified plan, you can roll over these assets into a Traditional IRA and then convert the Traditional IRA to a Roth IRA under the rules described above.

Can Congress change the rules and make Roth IRA distributions taxable?

In this day, anything is possible. But if history is any guide, any change to the tax rules regarding Roth IRA assets would be on a prospective basis, and assets already in the Roth

IRA would continue to be exempt. Since Roth IRA principal has already been taxed, we think it is very unlikely that Congress would subject these assets to a second tax. If anything happens, and we think this is very unlikely, the worst result would be that earnings would be subject to tax on distribution, and this is no worse than the result had the assets never been converted.

What's the bottom line?

Whether you would benefit from this opportunity involves some complicated analysis using assumptions about current and future tax rates, the time until IRA assets are needed for cash flow, and estate planning needs. Your Inverness Team has access to a number of sophisticated models, and can work with your tax professional to help you determine whether this interesting strategy is right for you.

As always, please contact any member of your Inverness team if you have any questions or concerns, or would like more information.

Cordially,

Your Inverness Team

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