



February 2, 2010

Dear Client,

If you have an IRA, the 2010 tax year presents a unique opportunity. As a result of recent changes in the tax law, even high-wage earners can now convert their Traditional IRA into a Roth IRA, which allows money to grow and be withdrawn tax-free. Additionally, taxpayers can continue to make contributions to a Roth IRA once a conversion has been made. Anyone with an IRA – no matter what their age or the size of the IRA – may want to consider whether converting their Traditional IRA to a Roth IRA is advantageous.

What are the benefits of conversion?

- **Future Tax Savings:** For those who believe income tax rates will eventually increase, now may be the perfect time to take advantage of today's historically low rates.
- **Income Diversification:** The Roth IRA may be able to provide tax diversification by adding tax-free income to the overall income received in retirement.
- **Wealth Transfer Tool:** This may be a perfect way to enable beneficiaries to stretch the account tax-free over their lifetimes. Roth IRAs permit the undistributed amount in the account to continue to be invested and grow tax-free (not tax-deferred, as used in a Traditional IRA) over the beneficiary's lifetime.

Should you wish to evaluate the benefits of a Roth conversion, Rushmore Investment Advisors is pleased to refer you to our own accountants with the firm TravisWolff. The professionals at TravisWolff have developed a comprehensive tax model that takes into account the above mentioned benefits and numerous other issues when advising if the conversion is beneficial for you and your legacy. A consultation fee does apply. To get started, please contact Mr. Bill Barnard at TravisWolff via phone at 972-590-5213 or via email at bbarnard@traviswolff.com. We have every confidence in Bill and his staff in guiding you through this process.

For additional references on this topic, we recommend visiting the website of John Bledsoe (www.gospelofroth.com) to read excerpts from his book *The Gospel of Roth*. This book discusses the advantages in a well thought out manner. Additionally, I have attached a recent IRS publication regarding Roth IRA conversions (Winter 2010/Volume 9).

As always, Rushmore Investment Advisors sincerely appreciates the opportunity to provide you with our portfolio management services. Should you ever have any questions, please do not hesitate to contact us at 800-564-8266.

Sincerely,

A handwritten signature in black ink, appearing to read "Brandt Heitzman".

Brandt Heitzman, CFP®
Director, Private Client Group

2010 Rules for Roth IRAs

Beginning January 1, 2010, the income and filing status requirements for rollovers (including conversions) to a [Roth IRA](#) will be eliminated. Additionally, for rollovers to a Roth IRA in 2010 **only**, a special 2-year option for reporting [taxable portions](#) of your rollover will apply.

Under the current rules, you can roll over a [traditional individual retirement arrangement](#) (IRA), a [SEP IRA](#), a [SIMPLE IRA](#) and an [eligible rollover distribution](#) (ERD) from your retirement plan (other than from a [designated Roth account](#)) and from a plan in which you are the named beneficiary to a Roth IRA only if you meet both these requirements:

- your [modified AGI for Roth IRA purposes](#) is \$100,000 or less; and
- your filing status is not married filing separate.

There are no such restrictions on rolling over amounts into a Roth IRA from either another Roth IRA or from a designated Roth account. Any previously untaxed amounts must be included in your gross income in the year of the rollover.

Under the new rules for 2010, regardless of your income or filing status, you will be able to roll over (convert) the following to a Roth IRA:

- your traditional IRA, SEP IRA or SIMPLE IRA;
- an ERD from your retirement plan (for example, a [401\(k\)](#) or a [403\(b\)](#) plan); or
- an ERD from a retirement plan for which you are a beneficiary.

For rollovers and conversions to a Roth IRA in 2010 only, you will have the option of reporting the taxable portion of your rollover in your gross income for 2010, or reporting half in 2011 and half in 2012.

Roth IRA Distributions

Roth IRAs are funded with after-tax contributions, so you don't have to pay income taxes on those contributions when they are distributed, and if the distribution is a "qualified distribution," earnings, too, escape being included in gross income. Therefore, knowing what constitutes a "qualified distribution" and other Roth IRA distribution rules may allow you to avoid income tax on any earnings that are distributed as well as the [additional 10% early distribution tax](#).

A "qualified distribution" from a Roth IRA is one made:

1. after 5 years – (measured from January 1 of the year for which you first made any Roth IRA contributions, including rollover or conversion contributions, and ending on the last day of the fifth year); and
2. a. on or after you are age 59 ½;
b. because you are disabled;
c. after you die; or
d. to buy, build or rebuild your first home.

Since Roth IRAs can be funded by regular contributions and *rollover contributions* (see related article, above) that can be made at different times, it is important to understand when the 5-year period has occurred for a qualified distribution. A *rollover contribution* is any amount rolled over from an employer-sponsored retirement plan, converted from a non-Roth IRA to a Roth IRA or moved from one Roth IRA to another Roth IRA. The following scenarios explain how to measure the 5-year period for "qualified distributions."

Roth IRAs made up of only regular Roth IRA contributions

The 5-year measurement period to determine whether a distribution is qualified begins with the first day of the tax year for which you make a regular Roth IRA contribution to **any** Roth IRA.

For example, assume you make a regular Roth IRA contribution to Roth IRA #1 on April 15, 2002, for the 2001 tax year. You then make a regular Roth IRA contribution to Roth IRA #2 on July 30, 2004. The 5-year measurement period for both Roth IRAs begins on January 1, 2001, the first day of the tax year for which you first made a regular contribution to any Roth IRA. Even if you withdrew all regular contributions and earnings (not as a [corrective distribution](#)) from both Roth IRAs on January 1, 2006, and then made a regular contribution on December 30, 2006, for the 2006 tax year to a new Roth IRA, the 5-year period would still be measured from January 1, 2001.

What about rollover contributions or traditional IRAs converted to Roth IRAs?

When you roll over money into a Roth IRA or convert a traditional IRA to a Roth IRA, the 5-year period for determining whether a distribution is qualified is measured from the year of the rollover or conversion **unless** you had previously made a contribution to any Roth IRA. In that case, the 5-year period starts with the first day of the tax year for which you made a regular Roth IRA contribution to **any** Roth IRA (the same as for regular Roth IRA contributions).

If a Roth IRA distribution is not a qualified distribution, how much of it is taxable?

There is a special order in which contributions (including rollover contributions) and earnings are considered to be distributed from your Roth IRA. Distributions come:

- first, from regular contributions;
- second, from rollover and conversion contributions (considered distributed from earliest years first) and within each rollover or conversion, in the following order:
 1. the taxable portion (the amount that you included in income because of the conversion or rollover),
 2. then the nontaxable portion; and
- finally, from earnings.

In applying these ordering rules, you must aggregate all the Roth IRAs you own and all the distributions made in a year. Also, you should disregard excess Roth IRA contributions and related earnings, and rollover contributions that came from other Roth IRAs for the above rules.

Example

Joe converted his traditional IRA of \$80,000 on October 15, 2005, to Roth IRA #1. At this time, Joe had no other Roth IRAs, and Roth IRA #1 was established with the October 15th conversion. So the 5-year period begins on January 1, 2005 (the first day of the taxable year for which a Roth IRA contribution was first made by Joe). His *Nondeductible IRAs, Form 8606*, filed with his 2005 income tax return shows that of the \$80,000 converted, \$20,000 is after-tax contributions. Joe included \$60,000 in his 2005 gross income. On February 23, 2009, Joe established a second Roth IRA, Roth IRA #2, by making a \$5,000 regular contribution. On December 15, 2009, Joe, then aged 60, took a distribution of \$7,000 from Roth IRA #1.

Joe's distribution was a nonqualified distribution because it was made on December 15, 2009, which is before the end of the 5-year period (January 1, 2005 to December 31, 2009) required for a qualified distribution. Although Joe met one of the requirements for a qualified distribution (after the age of 59 ½), he did not meet the 5-year-period requirement.

However, applying the Roth IRA distribution ordering rules, Joe's nonqualified distribution of \$7,000 is still not includible in gross income since it is considered distributed from:

Joe's regular Roth IRA contributions	= \$ 5,000
Part of the \$60,000 that Joe included in income at conversion	= <u>\$ 2,000</u>
	\$ 7,000

Does the 10% early distribution tax apply to non-qualified distributions from Roth IRAs?

Yes. Unless some Code [§72\(t\) exception](#) applies, the 10% early distribution tax under Code §72(t) applies to the portion of any nonqualified distribution that is included in gross income and to the portion of the nonqualified distribution that is from amounts rolled over or converted within 5 years prior to the distribution. However, the early distribution 10% tax is only applied to the portion of the rollover or conversion that you had to include in income at the time of the rollover or conversion. Solely for purposes of applying the Code §72(t) tax, each rollover or conversion contribution begins its own 5-year period (that is separate from the 5-year period used to determine whether the distribution is qualified). So, in the above example, if Joe was age 59 instead of 60 and no other Code §72(t) exception applied, even though none of the distribution is includible in gross income, he will have to pay the 10% early distribution tax. This is because part of the amount that he received (\$2,000) was attributable to the conversion he made within 5 years of receiving the distribution and was part of the converted amount he had to previously include in income (\$60,000). Joe will have to pay \$200 (\$2,000 x 10%) 10% early distribution tax under Code §72(t) with his Form 1040 tax return.