

JOHN D. BLEDSOE

**THE GOSPEL
OF ROTH**

THE GOOD NEWS ABOUT
ROTH IRA CONVERSIONS
(AND THE CHANGES THAT CAN SAVE YOU MONEY!)



LANDMARC
P R E S S

*This book is dedicated to my mother Aggie Jenkins
who is the life of every party!*

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INTRODUCTION

THIS BOOK IS AN ATTEMPT to provide some clear guidelines about a very confusing topic: Roth IRA conversions. There have been many articles concerning Roth IRA conversions in both the general and financial press that have been filled with errors, inaccuracies, incorrect innuendo, and just downright bad advice. I have received many phone calls from people who discussed Roth IRAs with their stockbroker, butcher, banker, accountant, neighbor, the clerk at the brokerage house, or some other Roth “expert” who has given them some misinformation. I would like to take this opportunity to clear the air on the most common misconceptions about Roth IRA conversions.

MYTH NUMBER 1

“You should run the numbers and look at your situation before you decide if you should convert to a Roth IRA. Maybe even run your figures through one of those Roth IRA conversion calculators.”

WRONG.

Because you can undo Roth conversions in the future, you should convert first and run the numbers later. This is what I call the Roth Conversion Option or RCO. RCO is a strategy for converting all regular IRAs into Roth IRAs first and not deciding to actually commit to any of the Roth IRA conversions until later. Convert all regular IRAs (and available retirement plans) into several separate new Roth IRAs divided by asset class as early in the year as possible. Think January 4, 2010. Decide before the recharacterization deadline of October 15 the year after the conversion in which Roth accounts are to remain converted. For 2010 conversions, the deadline to unconvert is October 17, 2011. This decision that you will make before the 2011 deadline is based on all of the information known before the deadline, including the Roth account performance after conversion and other important factors. This would be a good time to run the numbers and use a Roth conversion calculator. The RCO is repeated every year you have regular IRAs or available retirement plans.

You do not have enough facts to make a good decision until you know the RCO results. If some of your converted Roth accounts go up by 40 percent before the deadline, it will result in a different answer than the accounts that stayed the same or went down in value. Deciding to convert to Roth IRAs now is like a doctor deciding to perform surgery without any x-rays or without even taking your temperature. Convert all of your regular IRAs and available retirement accounts to Roth IRAs on January 4, 2010, and wait until mid-2011. Then run the numbers and decide before the October 17, 2011, recharacterization deadline. And you can even pick and chose which Roth conversions to undo and which ones to keep before the deadline.

MYTH NUMBER 2

“You cannot use any of the money converted to a Roth IRA for five years without additional taxes and penalties.”

WRONG.

You may use up to 100 percent of the amount converted and contributed to a Roth even the day after you convert without any additional taxes (and no penalties if you are over 59½). The reason for this is that Roth IRAs use a very favorable accounting method called first in, first out or FIFO. What this means is that any withdrawals from a Roth will first be considered from the principal or basis, which is tax-free. After 100 percent of the amount of your conversions and contributions have been withdrawn then taxes or penalties may apply, but only if the five-year rule has not been met. People who are under 59½ will still be subject to the old 10 percent early withdrawal penalty on converted IRAs. That is exactly as it was before these people under age 59½ converted to a Roth. So to those of you who are under age 59½ and who have complained about this, I say GROW UP!

MYTH NUMBER 3

“It is better to convert to a Roth in 2010 and use the one-time government income tax deferral special to pay the tax in 2011 and 2012.”

MAYBE AND PROBABLY NOT.

2010 is a special year indeed, but mainly because the income restriction for Roth IRA conversions has been lifted starting then, which allows everyone to make the conversion. Also, for Roth conversions in 2010 only, you do not have to pay any income tax triggered by the conversion in the year 2010, but you may wait and recognize half the income from the 2010 conversion in 2011 and the other half in 2012. You do not have to defer payment of income tax on 2010 Roth conversions if you elect not to. Paying the taxes on 2010 Roth conversions in 2010 might actually be more appealing than the deferral to 2011 and 2012 because tax rates

may go up. The way you hedge your bet here is to use the RCO (see myth number 1) and wait until 2010 is over and see what income tax rates are announced for 2011. You actually have until the same October 17, 2011, deadline to commit to which year(s) you elect to pay the tax for 2010 Roth conversions. You should consult with a tax professional before April 2010 to make sure you pay enough in withholding or estimated payments to the IRS to avoid any penalties, no matter which option you end up taking.

MYTH NUMBER 4

“I don’t want to convert to a Roth IRA because Congress is going to change the law and start taxing Roth IRAs in the future.”

NOT LIKELY.

Congress can be unpredictable and certainly can make law changes at will, but taxing Roth IRAs would be unlikely for a couple of reasons. The accounting method that Roth IRAs use is FIFO (see myth number 2), and the gain from Roth IRAs would be hard to get to from a tax standpoint. In the past, when changes of this magnitude occurred, the existing participants have been “grandfathered” and protected from these changes. Also, it would be far easier for the politicians to raise more revenue simply by increasing tax rates across the board. Finally, it would create a huge uproar if the tax-free nature of Roth IRAs were ever threatened. I talked to many people who were fearful of this over a decade ago when the Roth IRA was first introduced who now are very glad they made the switch and conversion to a tax-free Roth IRA.

MYTH NUMBER 5

“It will take years for me to earn back the money in my Roth IRA to recover the loss that I would sustain from the income tax payment triggered by the Roth conversion.”

WRONG.

Many people who convert from a regular IRA to a Roth IRA have more spendable (after-tax) money from the very first day that they convert. If the conversion temporarily pushes you into a higher tax bracket, you may have less spendable money for a time (typically a very short time). The amount of excess spendable money created by the Roth conversion then usually grows even greater over time. No pain no gain clearly does not apply to the Roth IRA conversion. The Roth IRA conversion can be advantageous even for people with short-time horizons and even for people who need income from their IRAs right away.

MYTH NUMBER 6

“My regular IRA is my money, and it is worth what the brokerage statement says that it is worth.”

WRONG.

The regular IRA or retirement is always worth less than the account statement says that it is. That is because you have a partner in the IRA on every penny—the IRS. You are actually carrying a debt or a mortgage on your regular IRA. By converting to a Roth IRA, you are paying off this debt or mortgage and dissolving your IRS partnership. You owed the taxes on

the regular IRA or retirement plan all along and the cost of income tax at conversion is not a cost at all but the payment of a debt. When you run the analysis of a Roth IRA conversion in your situation (at the end of the RCO), you may discover that the Roth IRA conversion will provide much more in spendable dollars both now and in the future than any other alternative.

MYTH NUMBER 7

“My taxes will be lower in retirement so I would not want to convert to a Roth IRA now at a higher income tax rate.”

MAYBE NOT.

Most of the clients that I have had through the years thought that this would be the case. However, for almost all of them, the older they get, even through retirement, the higher their income tax bracket. This is particularly true for the folks who have saved well. Even if you are in lower tax brackets down the road, the Roth IRA conversion still may produce superior results in your situation. Be sure to use the RCO and run your specific numbers toward the end of the conversion option period.

MYTH NUMBER 8

“The best way for me to convert to a Roth IRA is to convert all my retirement accounts and regular IRAs in the same year.”

MAYBE NOT.

For many people, the most efficient way for them to convert to Roth IRAs is to convert over a few years to maximize the use of the lower income tax brackets if they can. For people who are not in the top income tax brackets (before they convert to a Roth), and who have some time before age 70½, converting over several years may

make more sense. Use the RCO every year and run the numbers before the end of the RCO period to see which strategy works best in your case.

MYTH NUMBER 9

“Converting to a Roth IRA will not be advantageous in my case because I have no other money to pay the tax except from my retirement accounts and IRAs.”

IT DEPENDS.

Converting to Roth IRAs just before you are age 70½ will often be beneficial even if you have to pay the tax from IRAs. This is due to the fact that regular IRAs have mandatory increasing annual withdrawals after age 70½. Roth IRAs have no lifetime mandatory withdrawals. If you are substantially younger than 70½ make sure that you have no other way to pay some of the tax on smaller conversions each year. With either situation, do the RCO and run your numbers toward the end of the recharacterization deadline.

MYTH NUMBER 10

“My regular IRA can be deferred for a long time after I turn age 70½, and when I die my spouse or heirs will be able to continue this deferral for a long time in the future.”

WRONG.

Most IRA holders desire this so-called “stretch” or maximum deferral strategy for their IRAs. However, the mandatory taxable withdrawals are in reality much faster than desired. Did you know that in just 14 years

after you turn age 70½ more than half of your regular IRA will be lost to mandatory distributions in almost every case? This is due to those incessant and increasing annual mandatory taxable IRA withdrawals. Keep in mind that Roth IRAs have no lifetime mandatory withdrawals. If maximum income tax deferral is your desire, then the Roth is a much better vehicle.

SUMMARY

The conversion of a regular IRA to a Roth will be very beneficial to many people. Before you dismiss the Roth IRA as a bad idea or run the numbers, you really must convert to Roth IRAs using the Roth Conversion Option to see what the results are toward the end of this option period. Remember that if you make the conversions on January 4, 2010, you will have until October 17, 2011, to undo any or all of these Roth IRA conversions just as if they had never occurred. Or you may pick and choose among these Roth IRA conversions and leave any or all of them converted. If you do not convert in 2010, you will not have any options to go back and convert in the past. The RCO strategy will provide you with every possible option to maximize your regular IRAs and available retirement accounts under the best possible scenario. The result can be a huge increase in after-tax spendable money for you, both now and in the future.

If this has stirred your interest, read on. The ten chapters that follow will give you all the information you need to make intelligent decisions about how to use the Roth IRA conversion to sustain your hard-earned dollars.



THE ROTH CONVERSION OPTION

I F YOU FOLLOW MY ADVICE in the next few pages, you may increase your retirement spendable assets by over 40 percent! *Everyone should convert all of his or her IRAs to Roth IRAs on January 4, 2010.*¹ Many articles have been written about the major law change for Roth IRA conversions beginning in 2010. I find most of these articles vague at best, and more often than not, incorrect. Some of these articles are far more confusing than helpful.

Since the inception of Roth IRAs in 1998, you could only convert your traditional or regular IRA to a Roth IRA if your income was \$100,000 or less. But, starting in 2010, you can convert your regular IRAs and

¹January 4, 2010, is the *first* date everyone is allowed to convert to a Roth IRA. If you are reading this after that date you should convert as soon as you can following the instructions in this book.

other retirement plans to Roth IRAs regardless of income. Yes, you read that right—everyone can now convert to a Roth starting in 2010. And everyone should.

FOLLOW THE YOGI BERRA PRINCIPLE

This change in the law has all of the CPAs, financial planners, and engineers scrambling for their calculators and spreadsheet programs debating the virtue of potential Roth conversion for each situation depending on a dizzying array of assumptions about future income tax rates and the maximum number of angels that can dance on the eraser of a number 2 pencil. It is human nature to want to figure out the best answer before taking action; but this intuition is incorrect when it comes to Roth conversions. What you should do is take action, then figure out the best answer. Or to quote the great intellectual Yogi Berra, “When you come to a fork in the road . . . take it.” Convert first and calculate later.

The general repeating theme of almost every article about Roth conversions instructs and cautions people to calculate their Roth conversion “suitability” *before* they make the conversion, implying that a good decision can be made in this order (calculate before you convert). This premise is wrong. Dead wrong. Backwards.

Figuring out if you should convert to a Roth IRA before making the conversion is putting the cart before the horse. Convert first and ask questions later using the method outlined next. Do it exactly this way and I will explain all of the reasons later. The time line for the Roth Conversion Option is as follows:

STEP ONE: (January 4, 2010, 9:57 AM CST.) Convert all IRAs and available retirement plans into new Roth IRAs divided by asset class or investment type. Do not combine or mix with older Roth IRA accounts for now. Keep separate Roth IRAs for assets that were in retirement plans. No single Roth IRA account should exceed 20 percent of the total. If one

asset class or investment type exceeds 20 percent of the total divide it into two IRAs or more as needed.

STEP TWO: (December 3, 2010 at lunchtime.) Recharacterize or unconvert any Roth accounts that lost substantial value from the conversion date of 1/4/2010. These accounts should be converted again to Roth IRAs on January 3, 2011 at 9:57 AM CST.

STEP THREE: (September–October 15, 2011.) Analyze and run your conversion numbers based on all known factors including increases in Roth accounts since the conversions.

STEP FOUR: (October 17, 2011, 8:30 AM CST.) Unconvert or recharacterize any accounts not selected to remain Roth IRA conversions back to regular IRAs.

CINDERELLA STORY

As you can see, you should convert to a Roth IRA first, then run the numbers later. This is because the IRS gives you until mid-October of the year *following* the year of a Roth conversion to undo the conversion. This “do over” is technically called a *recharacterization*. Your Roth IRA conversion is not final or complete until you pass this deadline for unconverting or recharacterizing. To advise a client properly on whether to convert to a Roth IRA is impossible in advance of learning this vital information. You must know about any increase in the Roth account after the conversion date but before the deadline for unconverting to be able to “run the numbers.”

Even folks who otherwise would not ordinarily benefit from the Roth conversion may benefit greatly by converting if the value of the newly converted Roth goes up substantially during this option period. Like Cinderella and her pumpkin carriage, the Roth can be turned back into a regular IRA just as if nothing happened if you choose to do so before the deadline. The only way to have all the options and proper knowledge

to make an informed Roth conversion choice is to convert first and ask questions later.

THE DETAILS

2010 is a special year. There is good news on the horizon for anyone with retirement accounts beginning in 2010. The title of this book is *The Gospel of Roth*. Gospel means good news. This good news or gospel is due to a tax law change that was enacted in 2006 called the Tax Increase Prevention and Reconciliation Act (TIPRA). What a catchy title from a clever Congress. I love it when taxes go on sale, no matter what they call it.

TIPRA changed Roth IRA conversions in two major ways for the year 2010. First this new law allows taxpayers at *any* income level to convert to a Roth IRA in 2010. In the past, Roth IRA conversions have been limited to folks with an income level of \$100,000 or less. Beginning in 2010 and beyond, everyone can convert to a Roth IRA, regardless of income. Notice that this lifting of any income restriction for Roth conversions is not limited to 2010 but applies in the years afterward as well.

Second, for 2010 only, the conversion tax will not have to be paid in 2010, but can be postponed until 2011 and 2012. This law change will produce a remarkable opportunity that is unprecedented. TIPRA rocks.

SON OF A PREACHER MAN

Perhaps I was drawn to the Roth IRA because of all the religious overtones found in the Roth language. My father was a Church of Christ preacher, and I still vividly remember his teachings. When a regular IRA is changed to a Roth IRA, that process is called a Roth IRA conversion. So you have the opportunity to take your wicked tax-deferred IRA and convert it to a tax-free Roth IRA.

Conversions Happen

The Roth IRA conversion begins by having your IRA account renamed a Roth IRA. This happens when you instruct your bank, brokerage house,

insurance company, or other IRA trustee to make this change. This is simply a paperwork transaction. The underlying assets remain the same, but the account is typically given a new account number along with the new Roth IRA name.

So, if you had 500 shares of ABC mutual fund in a regular IRA, you now have the same 500 shares of ABC mutual fund in a Roth IRA. You can even continue to make changes to the investments within that account as usual. The value on the date of that conversion sets the exact amount of potential future taxable income that may be incurred as a result of that conversion. However, your conversion decision is not firm or final at that point.

You actually have until October 15 of the year following the year of conversion to unconvert this transaction. I believe Baptists call this backsliding instead of unconverting. The IRS calls this unconverting a recharacterization. You might call it a “do over.” What actually happens when you recharacterize or unconvert is that you instruct your trustee (bank, brokerage house, insurance company) to undo the Roth conversion. Then the same 500 shares of ABC mutual fund (or whatever funds the account is now invested in) are again titled in the name of a regular IRA. It is as if the transaction or conversion never took place.

The IRS is kind and reasonable in allowing you to do this. If your account value goes down after you make the conversion, it would be doubly sad to have to pay the tax at the higher amount and know your account has decreased in value. But you must make a Roth IRA conversion first, to enjoy this choice or option later. The option to keep or reject the Roth later is a great benefit to enjoy after you see what happens to your account value. If you make a Roth IRA conversion and the account goes up (sometimes substantially), you just might decide to leave it converted. This would be a doubly joyous occasion because you have seen your Roth IRA go up in value, yet the taxes due on this conversion would be based on a smaller amount.

This look-back window, that begins on the date you convert and extends to the date that you have to go firm on the conversion (October

15 of the next year), is what I call the *Roth Option Period*. This Roth Option Period can be as long as 22½ months, or shorter if you start the conversion later in the year. Great opportunities abound in what I have dubbed the Roth Conversion Option or RCO. Remember, Gospel means good news. And this is good news.

The government only allows you to recharacterize or unconvert one time per year per account. The number of accounts that you can have, however, is unlimited. So you can break up your IRAs into several Roth IRAs giving each a separate Roth Conversion Option. You will want to strategize with your own accounts in the way that you break these up to give yourself maximum future flexibility.

For example, if you have a large IRA rollover that has five different mutual funds in it, you will want to convert them into five separate Roth IRAs, with each Roth IRA holding one mutual fund. That way, you get to pick and choose the ones that stay converted and the ones that you unconvert in the future. Since these five different mutual funds may perform differently, you can select the ones with the best returns to remain converted. Remember your window of opportunity to recharacterize or unconvert is until October 15 of the year following this Roth conversion. So to maximize the time period for potential asset growth, you will want to convert as early in the year as possible.

It's Absolutely Certain; No Ifs, Ands, or Buts

Harry S. Truman said that he longed for a one-armed economist because any time he asked an economist a question, the economist would give him an answer that included "on one hand this, and on the other hand that." I feel the way old Harry must've felt every time I read one of these complicated articles about Roth IRA conversions. Advice that is good, *and* specific, is rare.

So I would like to repeat the good and specific advice from Step One. I recommend that you convert every dollar in every IRA or available retirement account that you have to a Roth IRA on January 4, 2010, at

9:57 AM Central Standard Time. Is that specific enough for you? I repeat, *every man, woman, and child should convert every dollar of every account in an IRA or other available retirement account to a Roth IRA on January 4, 2010, at 9:57 AM Central Standard Time.*

The obvious reason to do this is so that you will have the potential benefit of the Roth conversion option. Remember that you have not actually committed to this Roth conversion until October 15, 2011. Actually, October 15 falls on a Saturday in 2011, so you have until October 17. Your last day to unconvert or recharacterize Roth IRA conversions made in 2010 is October 17, 2011. January 4, 2010, is the first business day of that year. January 1 falls on a Friday, which will be a fine holiday (and a legal one as well). I recommend that you sober up over that long holiday weekend to prepare for your upcoming Roth conversion on Monday, January 4, 2010. I will explain the 9:57 AM part toward the end of this book.

Forget Roth calculators, projections about future tax rates, and other minutia that may just confuse you along the way. Some have accurately called this “paralysis by analysis.”

The only way to take advantage of this great opportunity called the Roth Conversion Option is to actually convert your IRA accounts. I cannot think of any good reason why you would not participate in this Roth Conversion Option. By doing so, you hold all the cards. You may unconvert any and all accounts up until the deadline, but you don't get to convert in arrears. So if you do nothing and wait until 2011, you may have missed a great opportunity because the IRA conversion train may have left the station without you.

The No-Lose Situation

What if you convert a large IRA on January 4, 2010 (at 9:57 AM) that contains one mutual fund? Over the following one year and 10½ months the mutual fund goes up substantially—say 30 percent. Let's say the account was valued at \$1 million on January 4, 2010. By October 15, 2011, it would be worth \$1.3 million based on this

assumption. You then could leave the account converted realizing a tremendous financial benefit. If you were subject to taxes at a rate of 35 percent, you would owe \$350,000 in income tax on this conversion. You would have to pay \$175,000 in 2011 and \$175,000 in 2012. However, this might appear all the more compelling because at your decision point of October 15, 2011, your account was actually worth \$1.3 million. So you have the option to decide whether to complete this Roth conversion committing to pay the taxes on \$1 million with the knowledge that it's actually worth \$1.3 million. This would save 35 percent of the \$300,000 gain or \$105,000 in taxes. You just profited \$105,000 by using the RCO. That might be worth considering. I mean \$105,000 here and \$105,000 there and pretty soon we're talking about real money.

If you think that a 30 percent increase over a 22½ month period sounds extreme, please consider recent history. Over the past 30 years, the S&P 500 index has gone up by at least 30 percent nine times. That's almost one-third of the time. No one can predict the future, and I certainly don't know if your accounts will go up or down. However, there is a great likelihood that you will be very happy to have this RCO and to monitor your own account performance.

Maybe your IRAs are worth less now than they were a few years back by locking in a lower value for taxation, and watching the future come to you; this timing of the RCO seems really attractive.

This Roth Conversion Option does not cost you anything other than a little preparation. It is strictly a paperwork transaction handled by the IRA custodian or trustee. It is like a mulligan or a do over in golf. Some corporate executives have been under scrutiny lately for backdating their incentive stock options—an illegal practice where executives picked an advantageous lower price on their company stock that would profit them immensely in the future. The RCO is a legal way for you to backdate your own stock options. The Roth Conversion Option is like betting on a recorded football game that you have already seen.

You will have ample time to analyze and consider the many potential benefits that a Roth IRA conversion may have for you in your specific situation during the ensuing one year and 10½ months after you convert. That is 651 days. You will have time to finish reading this book and other books on the subject. You may even recommend *The Gospel of Roth* to others. You can run Roth calculators until your brain turns into mush. You will be able to employ professional advisors to help you with this decision. You will have time.

RCO THINKING: TO KEEP AS ROTH OR UNCONVERT—THAT IS THE QUESTION

Actually you should not decide on the Roth conversion specifics until you have used the RCO and seen the results. This way you are able to more accurately analyze how much and what accounts to keep converted to a Roth, if any, and you may know more about future proposed tax rate changes and your own situation. You will also be able to select—after the fact—which Roth accounts to keep converted and which ones to unconvert from each of your separate Roth IRAs. You can even choose to keep converted just a portion of a Roth conversion and unconvert the rest.

You have the chance with each converted Roth IRA to use the great line that Gilda Radner coined as the character Emily Litella on *Saturday Night Live*: “Never Mind!”

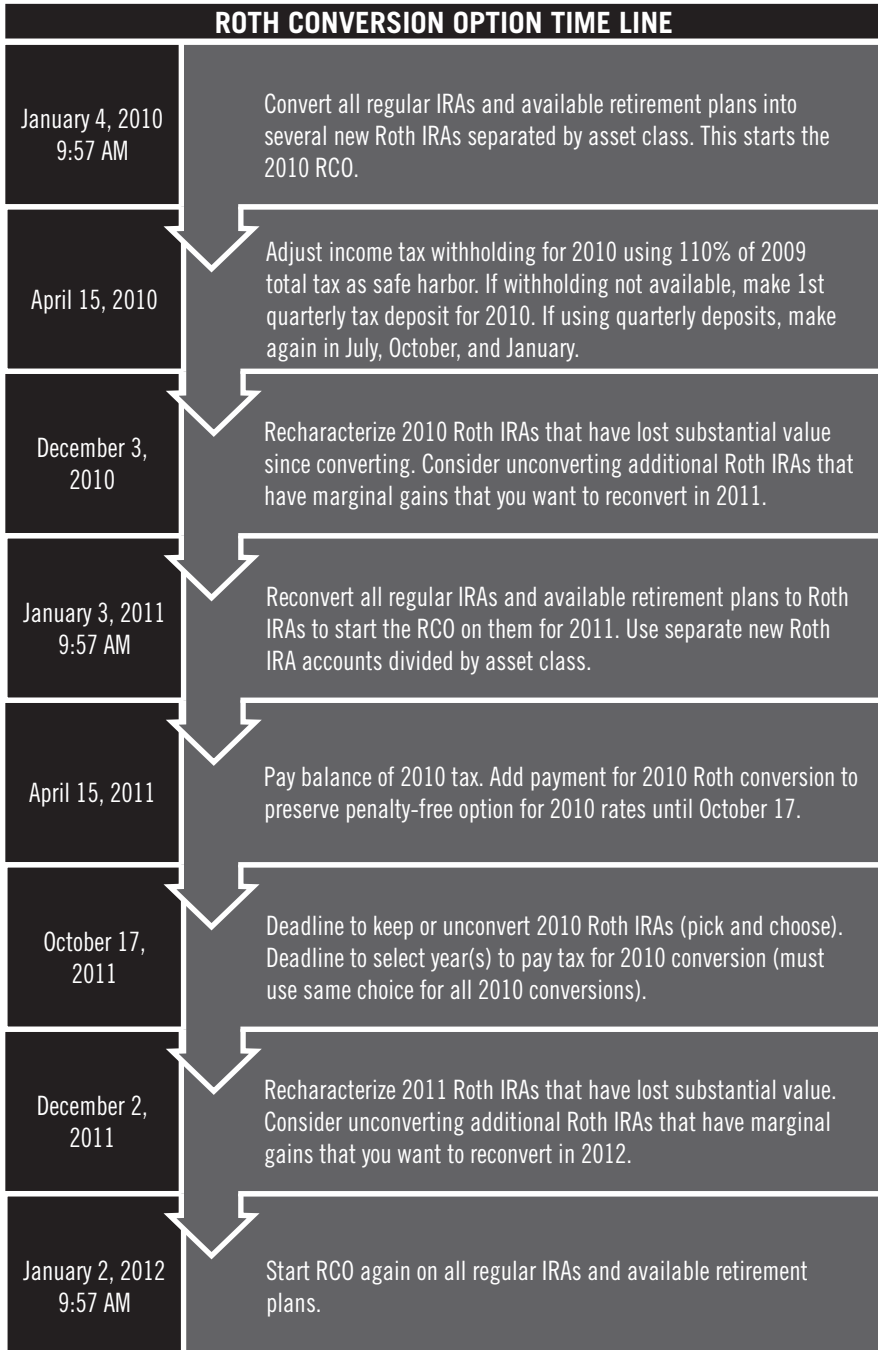
Anyone who would like to take advantage of this free one-time opportunity that will give you more financial options in the future should make this Roth conversion on January 4, 2010. The special 2010 deferral of tax to 2011 and 2012 makes it possible to take this Roth Conversion Option without even having to increase the amount of estimated tax that you pay to the IRS until after you have gone firm with any Roth conversions on October 17, 2011. When the IRS gives you a mulligan, I suggest you take it.

Jabez² has a large IRA rollover account that is worth \$800,000. He is invested in eight different investments worth \$100,000 each. He converts all eight investments into eight separate Roth IRA accounts on January 4, 2010 (first column). Then in early October 2011, the accounts have the values shown in the second column:

Roth IRA	1/4/2010	10/1/2011
1	\$100,000	\$106,000
2	\$100,000	\$118,000
3	\$100,000	\$111,000
4	\$100,000	\$104,000
5	\$100,000	\$134,000
6	\$100,000	\$101,000
7	\$100,000	\$128,000
8	\$100,000	\$113,000

Jabez is excited because all of his accounts increased in value. In his situation, we advise Jabez (in early October 2011) to leave his Roth IRAs number 5 and number 7 converted and recharacterize or unconvert the rest and he does just that by the October 17, 2011, deadline. You will better understand this recommendation after you read the remainder of this book. This is funny because all of the Roth conversion calculations that Jabez did back in 2009 told him not to convert. But we are able to give Jabez better and more accurate advice that has a very different outcome because he used the RCO and then ran the numbers after seeing the results 22 months later. By using the RCO, Jabez has all the options. He can leave all or any percentage of his IRAs converted or he can unconvert any or all of them before the October 17, 2011, deadline. With the RCO, Jabez has more than a prayer.

²All of the names of the folks in the examples are taken from the bible—it is the *gospel* of Roth, after all.



This RCO opportunity reminds me of the great Will Rogers quote, “Don’t gamble! Take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don’t go up, don’t buy it...” The RCO allows you to do just that with your taxes.

In the chapters that follow, you will learn how converting to a Roth might yield 40 percent or more to your spendable retirement assets. You will understand the best methods for Roth conversion and how to figure out when to convert in every situation and when not to convert, as well as the potential Roth disadvantages. I will show you how to maximize the power of the Roth conversion and strategies for now and the future. You will learn the right questions to ask and get answers for your specific situation, and I might even show you how to be a Roth star. With the RCO, the IRS is not giving you just one “do over,” like my golf buddies do; they are actually giving you a bucket of mulligans!