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February 19, 2010

Commissioner Douglas H. Shulman  
Internal Revenue Service  
1111 Constitution Ave., NW  
Washington, D.C. 20224

Hon. William J. Wilkins  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Ave., NW  
Washington, D.C. 20224

Dear Commissioner Shulman and Mr. Wilkins:

Re: Estimated Tax Consequences of Roth IRA Conversions

We are writing to request guidance for taxpayers who convert a traditional IRA to a Roth IRA in 2010 under the provisions of the United States Pension Protection Act of 2006 and also pay federal estimated taxes under the annualization method.<sup>1</sup> Guidance is needed promptly so that individual taxpayers can properly file their first quarterly estimated tax payment for 2010 on April 15, 2010.

### Background

As you know, The Pension Protection Act of 2006 made significant changes to the tax provisions governing conversions from traditional IRAs to Roth IRAs. Under the prior rules, a taxpayer was required to pay tax on the pre-tax contributions and any gains on the

<sup>1</sup> The principal drafters of this letter were Elizabeth Pascal and Paul R. Comeau, with a substantial contribution from Michael Schler, and helpful comments from Peter H. Blessing.

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investments in the IRA at the time of the conversion. In addition, taxpayers with more than \$100,000 in federal adjusted gross income (individually or jointly) were not permitted to convert their IRAs. The new law eliminates the income ceiling for conversions beginning in 2010. In other words, anyone is now permitted to convert a traditional IRA, which requires tax payments on any withdrawals, to a Roth IRA, which permits tax-free distributions. In addition, if an individual chooses to convert an IRA in 2010, the taxable income from that conversion will be included half in 2011 and half in 2012, so as to defer and spread out some of the tax consequences. Taxpayers, however, instead may elect to report any income from the conversion on their 2010 federal tax returns.<sup>2</sup>

The Roth IRA conversion raises concerns regarding estimated tax payments for taxpayers using the annualization method. If a taxpayer elects in 2011, upon filing the 2010 tax return, to include the income from the conversion in 2010, under what circumstances will the taxpayer be subject to penalties if the taxpayer failed to account for that income in payments of estimated taxes for the first three quarters of 2010?

### Analysis

For taxpayers required to pay estimated taxes, I.R.C. §6654 requires payment of an amount equal to either 100 percent of the prior year's tax due<sup>3</sup> or 90 percent of the tax due for the current year in four equal installments to avoid the imposition of underpayment penalties. A taxpayer may also use an annualized installment method. Under this method, the taxpayer determines the amount of estimated tax due based on the annualization of the taxpayer's income in the periods prior to the due date of the estimated tax payment multiplied by the applicable percentage under IRC § 6654(d)(2)(C)(ii). A taxpayer who uses the annualization

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<sup>2</sup> See I.R.C. §408A (tax provisions relating to Roth IRAs).

<sup>3</sup> Taxpayers having adjusted gross income for the preceding year exceeding \$150,000 must pay estimated taxes in an amount equal to 110 percent of the prior year's tax due.

method must also file the underpayment of estimated tax penalty form (Form 2210), even if no penalty is due.<sup>4</sup>

According to I.R.S. Spokesman Eric Smith in an interview for the Wall Street Journal, the Service has not addressed the issue of potential underpayment penalties.<sup>5</sup> But there seems to be a general consensus that underpayment penalties would likely to be imposed in the absence of relief. An article on Vanguard's website warns that, although a taxpayer might decide in April, 2011 as to when to include the income from the conversion, the taxpayer might need to pay estimated taxes to avoid a penalty if the election is made to include the gain in income for 2010.<sup>6</sup>

We also note that when Roth IRA's were first introduced in 1998, underpayment penalties were not waived for taxpayers converting traditional IRAs to Roth IRAs.<sup>7</sup> Taxpayers were given the option of reporting the income from the conversion over a period of four years or making an election on their 1998 federal returns to report all of it in the year of the conversion. In addition, a 2001 Chief Counsel Advice concluded that the Service may not abate underpayment of estimated tax penalties where the penalty is based on income from a rollover to a Roth IRA.<sup>8</sup>

Publication 505 (*Tax Withholding and Estimated Tax*), in its "What's new for 2010" section, notes that taxpayers who rely on their 2009 tax returns to determine their 2010 estimated tax payments should take into consideration any Roth IRA rollover or conversion during the

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<sup>4</sup> See I.R.S. Publication 505, *Tax Withholding and Estimated Tax* (Rev. Jan. 2010).

<sup>5</sup> Kelly Greene, "You Converted to a Roth So What About the Taxes?" WSJ.com (Jan. 30, 2010).

<sup>6</sup> *Roth IRA conversions: Should you pay tax now or later?*, <https://personal.vanguard.com/us/insights/article/roth-ira-tax-now-later-12282009?link=mostViewed&linkLocation=Position3> (Dec. 28, 2009).

<sup>7</sup> See Greene, *supra*.

<sup>8</sup> CCA 200105062 (02/02/2001).

year, depending on whether the taxpayer elects to include all of the income in 2010.<sup>9</sup>

Nevertheless, prior precedent and current IRS publications do not address the issue as it applies to the annualization method. In particular, the CCA refers only to a discretionary waiver of penalties by the IRS, not to the interpretive issue under the annualization method discussed in this letter. In fact, where a taxpayer elects to annualize income to determine estimated tax payments, the first three estimated tax payments for 2010 will be based only on the income from the period(s) preceding the end of the estimated tax quarter rather than the income for the entire year, with the balance taken into account in calculating the fourth payment, due on January 15. Since the default rule for including the income from a conversion to a Roth IRA is to defer the income to 2011 and 2012, the income will not have definitively arisen at the time the estimated tax payment is calculated under the annualization method. Hence under that method, the income should not be taken into account for the first three estimated tax payments based on annualization, and should be includible in income only as part of the balance of estimated tax due for the January 15 payment.

Consider the example of a taxpayer who converts a traditional IRA to a Roth IRA in March, 2010. The estimated tax payment under the annualization method due April 15<sup>th</sup>, 2010 is based on the taxpayer's income between January and March, 2010. But since the taxpayer has not made any election by that date to include the income in 2010 and the default rule is to report the income in 2011 and 2012 as if it had arisen in those years, there is no income to report from the conversion as of April 15<sup>th</sup>. The same situation holds true for the second and third estimated tax payments due in 2010.<sup>10</sup> Consequently, the underpayment penalty should not apply to these payments.

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<sup>9</sup> Although the Publication refers to 2009 tax returns, the advice presumedly does not apply to taxpayers who rely on the 100% or 110% "safe harbor" to determine their estimated tax payments.

<sup>10</sup> Even though a taxpayer may not actually make the election to include the income in 2010 until a return is filed as late as October 15<sup>th</sup>, 2011, we realize that taxpayers will still need to conform to the requirement that they pay estimated tax on 90% of

### Conclusion

In light of the potential confusion surrounding the estimated tax consequences of a Roth IRA conversion and the estimated tax filing deadline approaching on April 15th, we recommend guidance from the Service on this issue.

The theory of the annualization method is that a taxpayer should be permitted to pay tax on the basis of “known” income that has actually arisen during the preceding months. It seems contrary to this rationale to require the taxpayer to include the Roth conversion income in the first three estimated tax payments of 2010 given that the income from the conversion does not definitively arise until the taxpayer “elects” on his or her 2010 tax return filed in 2011 to include the income in amounts reportable for 2010. Imposing underpayment penalties in respect of 2010 for a taxpayer’s failure to include income that is not taxable in 2010 absent an election in 2011 would undermine a taxpayer’s ability to take advantage of the annualization method for 2010. In effect, in order to be sure of avoiding penalties, every taxpayer using annualization would have to be aware of this issue as of April 15, 2010 and assume that the election to pay tax in 2010 would eventually be made; if the election subsequently is not made, the taxpayer would have a significant overpayment for 2010. This seems contrary to the purpose of the annualization method (to provide certainty to taxpayers on the basis of preceding events) and also of the statutory default rule for the income to be taxable in 2011 and 2012 (which seems intended to allow taxpayers to make the election on their 2010 returns without having to face the choice of either prepaying the tax during 2010 or risking penalties for 2010). This problem is limited to 2010, as it is only for conversions in 2010 that the default rule to defer the income exists.

Whether or not the Service agrees with our analysis of the amount due under the annualization method for determining estimated taxes in the context of Roth IRA conversions, we urge that it provide

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their 2010 income by January 15<sup>th</sup>, 2011, and 100% by April 15<sup>th</sup>, 2011, including income from the conversion to be included in 2010, to avoid an underpayment penalty.

Commissioner Douglas Shulman and Hon. William J. Wilkins  
February 19, 2010  
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guidance to taxpayers on this issue. In particular, if the Service disagrees with our recommendation in respect of the annualization method, we urge that it expeditiously advise taxpayers that, if they have a Roth IRA conversion in 2010 and wish to avoid penalties under the annualization method in the event that they eventually decide to elect to have the income taxed in 2010, they should pay estimated tax under the annualization method on the assumption that they will in fact make that election. Taxpayers should then either ensure that they have adjusted their withholding to account for the increase in income or they should make estimated tax payments that account for the taxable income from the conversion during 2010.

We appreciate your consideration of this letter. We would be pleased to answer questions you may have in this regard.

Very truly yours,

A handwritten signature in black ink, appearing to read "Peter H. Blessing", with a long, sweeping flourish extending to the right.

Peter H. Blessing  
Chair



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Eric Solomon

February 19, 2010

Jamie Woodward, Acting Commissioner  
New York State Department of Taxation and Finance  
Building 9A, Harriman Campus  
Albany, NY 12227

Dear Commissioner Woodward:

Re: New York Estimated Tax Consequences of Roth IRA Conversions

We are writing to request guidance for New York State taxpayers who convert a traditional IRA to a Roth IRA in 2010 under the provisions of the United States Pension Protection Act of 2006 and also pay estimated taxes to New York under the annualization method.<sup>1</sup> Guidance is needed promptly so that individual taxpayers can properly file their first quarterly estimated tax payment for 2010 on April 15, 2010.

### Background

As you know, The Pension Protection Act of 2006 made significant changes to the tax provisions governing conversions from traditional IRAs to Roth IRAs. Under the prior rules, a taxpayer was required to pay tax on the pre-tax contributions and any gains on the investments in the IRA at the time of the conversion. In addition, taxpayers with more than \$100,000 in federal adjusted gross income (individually or jointly) were not permitted to convert their IRAs. The new law eliminates the income ceiling for conversions beginning in 2010. In other words, anyone is now permitted to convert a traditional IRA, which requires tax payments on any withdrawals, to a Roth IRA, which

<sup>1</sup> The principal drafters of this letter were Elizabeth Pascal and Paul R. Comeau, with a substantial contribution from Michael Schler and helpful comments from Peter H. Blessing.

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permits tax-free distributions. In addition, if an individual chooses to convert an IRA in 2010, the taxable income from that conversion can be reported half in 2011 and half in 2012, so as to defer and spread out some of the tax consequences. Taxpayers may also elect to include any income from the conversion on their 2010 tax returns.<sup>2</sup>

The Roth IRA conversion raises New York State tax concerns regarding estimated tax payments for taxpayers using the annualization method. If a New York taxpayer elects in 2011, upon filing the 2010 tax return, to include the income from the conversion in 2010, under what circumstances will the taxpayer be subject to penalties if the taxpayer failed to account for that income in payments of estimated taxes for the first three quarters of 2010?

### **Analysis**

For taxpayers required to pay estimated taxes, New York Tax Law §685(c)(3) requires payment of an amount equal to either 110 percent of the prior year's tax due or 90 percent of the tax due for the current year in four equal installments to avoid the imposition of underpayment penalties. A taxpayer may also use an annualized installment method. Under this method, the taxpayer determines the amount of estimated tax due based on the taxpayer's income in the periods prior to the due date of the estimated tax payment. Tax Law §685(c)(4). A taxpayer who uses the annualization method must also file the underpayment of estimated tax penalty form, even if no penalty is due.<sup>3</sup>

Some financial analysts have warned about the potential for underpayment penalties resulting from the option for taxpayers to choose whether they report the income from the conversion on their 2010 returns filed in 2011, or on their 2011 and 2012 returns,. For example, an article on Vanguard's website warns that, although a taxpayer may decide in April, 2011 as to when to report the income from the conversion, the

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<sup>2</sup> See I.R.C. §408A (tax provisions relating to Roth IRAs).

<sup>3</sup> See New York State Department of Taxation and Finance, Publication 94 (Dec. 2009).



taxpayer might need to pay estimated taxes to avoid a penalty if the election is made to include the gain in income for 2010.<sup>4</sup>

We also note that when Roth IRAs were first introduced in 1998, penalties were not waived for taxpayers converting traditional IRAs to Roth IRAs. Taxpayers were given the option under the federal rules of reporting the income from the conversion over a period of four years or making an election on their 1998 federal returns to report all of it in the year of conversion. In a Technical Service Bureau Memorandum (“TSB-M”), the Department stated that New York would conform to the federal tax treatment of Roth IRAs.<sup>5</sup> More specifically, it stated that if a taxpayer chose to include the income in the year of conversion, the entire conversion income would be included in New York adjusted gross income for the change year.

Nevertheless, prior federal and New York State precedent do not address the issue as it applies to the annualization method. In fact, where a taxpayer elects to annualize income to determine estimated tax payments, the first three estimated tax payments for 2010 will be based only on the income from the period(s) preceding the end of the estimated tax quarter rather than the income for the entire year, with the balance taken into account in calculating the fourth payment, due on January 15. Since the default rule for including the income from a conversion to a Roth IRA is to defer the income to 2011 and 2012, the income will not have definitively arisen at the time the estimated tax payment is calculated under the annualization method. Hence under that method the income should not be taken into account for the first three estimated tax payments based on annualization, and should be includible in income only as part of the balance for the January 15 payment.

Consider the example of a taxpayer who converts a traditional IRA to a Roth IRA in March, 2010. The estimated tax payment under the annualization method due April 15<sup>th</sup>, 2010 is based on the

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<sup>4</sup> *Roth IRA conversions: Should you pay tax now or later?*, <https://personal.vanguard.com/us/insights/article/roth-ira-tax-now-later-12282009?link=mostViewed&linkLocation=Position3> (Dec. 28, 2009).

<sup>5</sup> TSB-M-98(7)I, 12/24/1998.

taxpayer's income between January and March, 2010. But since the taxpayer has not made any election by that date to include the income in 2010 and the default rule is to report the income in 2011 and 2012 as if it had arisen in those years, there is no income to report from the conversion as of April 15<sup>th</sup>. The same situation holds true for the second and third estimated tax payments due in 2010.<sup>6</sup> Consequently, the underpayment penalty should not apply to these payments.

### **Conclusion**

In light of the potential confusion surrounding the New York State estimated tax consequences of a Roth IRA conversion and the estimated tax filing deadline approaching on April 15<sup>th</sup>, we recommend guidance from the Department on this issue.

The theory of the annualization method is that a taxpayer should be permitted to pay tax on the basis of "known" income that has actually arisen during the preceding months. It seems contrary to this rationale to require the taxpayer to include the Roth conversion income in the first three estimated tax payments of 2010 given that the income from the conversion does not definitively arise until the taxpayer "elects" on his or her 2010 tax return filed in 2011 to include the income in amounts reportable for 2010. Imposing underpayment penalties in respect of 2010 for a taxpayer's failure to include income that is not taxable in 2010 absent an election in 2011 would undermine a taxpayer's ability to take advantage of the annualization method for 2010. In effect, in order to be sure of avoiding penalties, every taxpayer using annualization would have to be aware of this issue as of April 15, 2010 and assume that the election to pay tax in 2010 would eventually be made; if the election subsequently is not made, the taxpayer would have a significant overpayment for 2010. This seems contrary to the purpose of the annualization method (to provide certainty to taxpayers on the basis of preceding events) and also of

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<sup>6</sup> Even though a taxpayer may not actually make the election to include the income in 2010 until a return is filed as late as October 15<sup>th</sup>, 2011, we realize that taxpayers will still need to conform to the requirement that they pay estimated tax on 90% of their 2010 income by January 15<sup>th</sup>, 2011, and 100% by April 15<sup>th</sup>, 2011, including income from the conversion to be included in 2010, to avoid an underpayment penalty.

Jamie Woodward, Acting Commissioner  
February 19, 2010  
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the statutory default rule for the income to be taxable in 2011 and 2012 (which seems intended to allow taxpayers to make the election on their 2010 returns without having to face the choice of either prepaying the tax during 2010 or risking penalties for 2010). This problem is limited to 2010, as it is only for conversions in 2010 that the default rule to defer the income exists.

Whether or not the Department agrees with our analysis of the amount due under the annualization method for determining estimated taxes in the context of Roth IRA conversions, we urge that it provide guidance to taxpayers on this issue. In particular, if the Department disagrees with our recommendation in respect to the annualization method, we urge that it expeditiously advise taxpayers that, if they have a Roth IRA conversion in 2010 and wish to avoid penalties under the annualization method in the event that they eventually decide to elect to have the income taxed in 2010, they should pay estimated tax under the annualization method on the assumption that they will in fact make that election. Taxpayers should then either ensure that they have adjusted their withholding to account for the increase in income or they should make estimated tax payments that account for the taxable income from the conversion during 2010.

We appreciate your consideration of this letter. We would be pleased to answer questions you may have in this regard.

Very truly yours,



Peter H. Blessing  
Chair

cc: Robert D. Plattner, Deputy Commissioner