ARIZONA STATE RETIREMENT SYSTEM (ASRS)

SPECIAL TAX NOTICE REGARDING NON-SURVIVOR BENEFIT PLAN PAYMENTS

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Federal Tax Information

Introduction

This notice contains important information you will need before you decide how to receive your lump sum payment or account balance withdrawal from the ASRS. Because the ASRS cannot provide you with tax advice and tax rules are complex, you may wish to consult a qualified tax professional before you make a withdrawal decision.

All or part of the payment that you will receive from the ASRS may be eligible for roll over to an IRA or an eligible employer plan. A rollover is a payment by you or the ASRS of all or part of your benefit to another plan or IRA that allows you to continue to postpone taxation of that benefit until it is paid to you. The term "IRA" as used in this notice includes only traditional IRAs and individual retirement annuities. It does not include Roth IRAs, SIMPLE IRAs or Coverdell Education Savings Accounts. An "eligible employer plan" includes a plan qualified under section 401(a) of the Internal Revenue Code, including a 401(k) plan, profit-sharing plan, defined benefit plan, stock bonus plan, and money purchase plan; a section 403(a) annuity plan; a section 403(b) tax-sheltered annuity; and an eligible section 457(b) plan maintained by a governmental employer (governmental 457 plan).

Overview

A lump sum payment from the ASRS can be processed in three ways: (1) all of the payment paid as a direct rollover to an IRA or to an eligible employer plan; or (2) all of the payment paid to you; or (3) some portion paid as a direct rollover with the remaining amount paid to you.

If you choose a **direct rollover** of all or any portion of your distribution:

- The amount rolled over will not be taxed in the current year and no income tax will be withheld.
- You choose whether your rolled payment will be made directly to an IRA or to an eligible employer plan that accepts your rollover.
- The taxable portion of your rollover payment will be taxed later when you take it out of the IRA or the eligible employer plan.

If you choose to have all or any portion of your lump sum **paid to you**:

- You will receive 80% of the taxable amount of the payment, because the ASRS is required to withhold 20% of that amount and send it to the IRS as income tax withholding to be credited against your taxes.
- The taxable amount of your payment will be taxed in the current year unless you roll it over. Under limited circumstances, you may be able to use special tax rules that could reduce the tax you owe. However, if you receive the payment before age 59½, you may have to pay an additional 10% tax.
- You can roll over all or part of the payment by paying it to your IRA or to an eligible employer plan that accepts your rollover within 60 days after the ASRS issues the payment. The amount rolled over will not be taxed until you take it out of the IRA or the eligible employer plan.
- If you want to roll over 100% of the payment to an IRA or an eligible employer plan, *you must find other money to replace the 20% of the taxable portion that was withheld*. If you roll over only the 80% that you received, you will be taxed on the 20% that was withheld and not rolled over.

Your Right to Waive the 30-Day Notice Period. After receiving this notice, you have at least 30 days to consider whether or not to have your withdrawal directly rolled over. If you do not wish to wait until this 30-day notice period ends before your election is processed, you may waive the notice period by making an affirmative election on the appropriate application indicating whether or not you wish to make a direct rollover. Your withdrawal will then be processed in accordance with your election as soon as is practical.

Payments eligible for rollover

Payments from the ASRS may be "eligible rollover distributions." This means that they can be rolled over to an IRA or to an eligible employer plan that accepts rollovers. The ASRS can tell you what portion of your payment is an eligible rollover distribution.

If you made *after-tax contributions* to the ASRS, these contributions may be rolled into either an IRA or to certain employer plans that accept rollovers of the after-tax contributions. The following rules apply:

- **Rollover of after-tax contributions into an IRA**. You can roll over your after-tax contributions to an IRA either directly or indirectly. The ASRS can tell you which portion of your payment is non-taxable. If you roll over after-tax contributions to an IRA, it is your responsibility to keep track of, and report to the IRS on the applicable forms, the amount of these after-tax contributions. This will enable the nontaxable amount of any future distributions from the IRA to be determined. Once you roll over your after-tax contributions to an IRA, those amounts CANNOT later be rolled over to an employer plan.
- **Rollover of after-tax contributions into an Employer Plan**. You can roll over after-tax contributions in your ASRS account to a qualified defined contribution plan or qualified annuity by direct rollover if the other plan provides separate accounting for amounts rolled over, including separate accounting for the after-tax employee contributions and earnings on those contributions. You CANNOT roll over after-tax contributions to a governmental 457 plan. If you want to roll over your after-tax contributions to an employer plan that accepts these rollovers, you cannot have the after-tax contributions paid to you first. You must instruct the ASRS to make a direct rollover on your behalf. Also, you cannot first roll over after-tax contributions to a traditional IRA and then roll over that amount into an employer plan.

Payments not eligible for rollover

- *Payments Spread over Long Periods*. You cannot roll over a payment if it is part of a series of equal (or almost equal) payments that are made at least once a year and that will last for your lifetime, or your lifetime and your beneficiary's lifetime, or a period of 10 years or more.
- *Required Minimum Payments*. Beginning either the April 1 after you reach age 70½ or the date you terminate employment, whichever is later, a certain portion of your payment cannot be rolled over because it is a "required minimum payment" that must be paid to you.
- *Corrective Distributions*. A distribution that is made to correct a failed nondiscrimination test or because legal limits on certain contributions were exceeded cannot be rolled over.

When payment is made by direct rollover

- *Direct Rollover to an IRA.* You can open an IRA to receive the direct rollover. If you choose to have your payment made directly to an IRA, contact the IRA sponsor to determine their procedures for receiving a direct rollover from the ASRS. If you are unsure of how to invest your money, you can temporarily establish an IRA to receive the payment. However, in choosing an IRA, you may wish to make sure that the IRA you choose will allow you to move all or a part of your payment to another IRA at a later date, without penalties or other limitations. See IRS Publication 590, Individual Retirement Arrangements, for more information on traditional IRAs (including limits on how often you can roll over between IRAs).
- *Direct Rollover to an Eligible Employer Plan*. If you want a direct rollover to an employer plan, ask the plan administrator of that plan whether it will accept your rollover. If the plan accepts rollovers, you should find out the types of distributions it accepts as a rollover (i.e. pre-tax and post-tax). An eligible employer plan is not legally required to accept a rollover. You should also find out about any documents that are required to be completed before the receiving plan will accept a rollover. If an employer plan accepts your rollover, the plan may restrict subsequent distributions of the rollover amount or may require your spouse's consent for any subsequent distribution. A subsequent distribution from the plan that accepts your rollover may also be subject to different tax treatment than distributions from the ASRS. Check with the administrator of the plan that is to receive your rollover before making your decision.
- *Change in Tax Treatment Resulting from a Direct Rollover*. The tax treatment of any payment from the eligible employer plan or IRA receiving your direct rollover might be different than if you received your benefit directly from the ASRS. For example, if you were born before January 1, 1936, you might be entitled to ten-year averaging or capital gain treatment, as explained below. However, if you have your benefit rolled over to a section 403(b) tax-sheltered annuity, a governmental 457 plan, or an IRA in a direct rollover, your benefit will no longer be eligible for

that special treatment. See the sections below entitled “Additional 10% Tax if You are under Age 59½” and “Special Tax Treatment if You Were Born before January 1, 1936.”

When payment is made to you

If your payment can be rolled over and the payment is made to you in cash, the taxable portion is subject to 20% federal income tax withholding as well as state tax withholding. The payment is taxed in the year you receive it unless, within 60 days, you roll it over to an IRA or an eligible employer plan that accepts rollovers. If you do not roll it over, special tax rules may apply.

- *Mandatory Withholding*. If any portion of your payment can be rolled over and you do not elect to make a direct rollover, the ASRS is required by law to withhold 20% of the taxable amount. This amount is sent to the IRS as federal income tax withholding. For example, if you can roll over a taxable payment of $10,000, only $8,000 will be paid to you because the ASRS must withhold $2,000 as income tax. However, when you prepare your income tax return for the year, unless you make a rollover within 60 days (see “Sixty-Day Rollover Option” below), you must report the full $10,000 as a taxable payment from the Plan. You must report the $2,000 as tax withheld, and it will be credited against any income tax you owe for the year. There will be no income tax withholding if your payments for the year are less than $200.
- *Voluntary Withholding*. If any portion of your payment is taxable but cannot be rolled over, the mandatory withholding rules described above do not apply. In this case, you may elect not to have withholding apply to that portion. If you do nothing, 10% will be taken out of this portion of your payment for federal income tax withholding. To elect out of withholding, ask ASRS for the election form and related information prior to filing your application.
- *Sixty-Day Rollover Option*. If you receive a payment that can be rolled over, you can still decide to roll over all or part of it to an IRA or to an eligible employer plan that accepts rollovers. If you decide to roll over, you must contribute the amount of the payment you received to an IRA or eligible employer plan within 60 days after you receive the payment. The portion of your payment that is rolled over will not be taxed until you take it out of the IRA or the eligible employer plan.

You can roll over up to 100% of your payment that can be rolled over, including an amount equal to the 20% of the taxable portion that was withheld. If you choose to roll over 100%, you must find other money within the 60-day period to contribute to the IRA or the eligible employer plan, to replace the 20% that was withheld. On the other hand, if you roll over only the 80% of the taxable portion that you received, you will be taxed on the 20% that was withheld.

Example: The taxable portion of your payment that can be rolled over is $10,000, and you choose to have it paid to you. You will receive $8,000, and $2,000 will be sent to the IRS as income tax withholding. Within 60 days after receiving the $8,000, you may roll over the entire $10,000 to an IRA or an eligible employer plan. To do this, you roll over the $8,000 you received from the Plan, and you will have to find $2,000 from other sources (your savings, a loan, etc.). In this case, the entire $10,000 is not taxed until you take it out of the traditional IRA or an eligible employer plan. If you roll over the entire $10,000, when you file your income tax return you may get a refund of part or all of the $2,000 withheld.

If, on the other hand, you roll over only $8,000, the $2,000 you did not roll over is taxed in the year it was withheld. When you file your income tax return, you may get a refund of part of the $2,000 withheld. (However, any refund is likely to be larger if you roll over the entire $10,000.)

- *Additional 10% Tax If You Are under Age 59½*. If you receive a payment before you reach age 59½ and you do not roll it over, then, in addition to the regular income tax, you may have to pay an extra tax equal to 10% of the taxable portion of the payment. The additional 10% tax generally does not apply to (1) payments that are paid after you separate from service with your employer during or after the year you reach age 55; (2) payments that are paid because you retire due to disability; (3) payments that are paid as equal (or almost equal) payments over your life or life expectancy (or your and your beneficiary’s lives or life expectancies); (4) payments that are paid directly to the government to satisfy a federal tax levy; (5) payments that are paid to an alternate payee under a qualified domestic relations order; or (6) payments that do not exceed the amount of your deductible medical expenses. See IRS Form 5329 for more information on the additional 10% tax.

Generally speaking, the additional 10% tax does not apply to distributions from a governmental 457 plan. However, if you roll your distribution from the ASRS into a governmental 457 plan, any subsequent distributions from the 457 plan that are attributable to the amount you rolled over from the ASRS to the 457 plan (adjusted for investment returns) will be subject to the additional 10% tax.

- *Special Tax Treatment If You Were Born before January 1, 1936*. Any taxable amount of your distribution that you do not roll over will be taxed in the year you receive it. However, if the payment qualifies as a “lump sum distribution,” it may be eligible for special tax treatment. A lump sum distribution is a payment, within one year, of your entire balance under the ASRS that is payable to you after you have reached age 59½ or because you have separated from service with your employer. For a payment to be treated as a lump sum distribution, you must have been a participant in the ASRS for at least five years before the year in which you received the distribution. The special tax treatment for lump sum distributions that may be available to you is described below.

- *Ten-Year Averaging*. If you receive a lump sum distribution and you were born before January 1, 1936, you can make a one-time election to figure the tax on the payment by using "10-year averaging" (using 1986 tax rates). Ten-year averaging often reduces the tax you owe.

There are other limits on the special tax treatment for lump sum distributions. For example, you can generally elect this special tax treatment only once in your lifetime, and the election applies to all lump sum distributions that you receive in that same year. You may not elect this special tax treatment if you rolled amounts into this Plan from a 403(b) tax-sheltered annuity contract or from an IRA not originally attributable to a qualified employer plan. If you have previously rolled over a distribution from this Plan (or certain other similar plans of the employer) you cannot use this special averaging treatment for later payments from the Plan. If you roll over your payment to an IRA, governmental 457 plan, or 403(b) tax-sheltered annuity, you will not be able to use the special tax treatment for later payments from that IRA, plan, or annuity. Also, if you roll over only a portion of your payment to an IRA, governmental 457 plan, or 403(b) tax-sheltered annuity, this special tax treatment is not available for the rest of the payment. See IRS Form 4972 for additional information on lump sum distributions and how you elect the special tax treatment.

Alternate payees

In general, the rules summarized above that apply to payments to employees also apply to payments to spouses or former spouses who are "alternate payees." You are an alternate payee if your interest in the ASRS results from a "qualified domestic relations order" which is an order issued by a court, usually in connection with a divorce or legal separation.

- If you are an alternate payee, you may choose to have a payment that can be rolled over, as described in this notice, paid in a direct rollover to an IRA or to an eligible employer plan or paid to you. If you have the payment paid to you, you can keep it or roll it over yourself to an IRA or to an eligible employer plan.
- If you are an alternate payee, your payment is generally not subject to the additional 10% tax described in this notice, even if you are younger than age 59½.
- If you are an alternate payee, you may be able to use the special tax treatment for lump sum distributions as described in this notice.

How to obtain additional federal tax information regarding ASRS payments

This notice summarizes only the federal (not state or local) tax rules that might apply to your payment. The rules described above are complex and contain many conditions and exceptions that are not included in this notice. Therefore, you may want to consult with a professional tax advisor before you take a payment of your benefits from the ASRS. Also, you can find more specific information on the tax treatment of payments from qualified employer plans in IRS Publication 575, Pension and Annuity Income, and IRS Publication 590, Individual Retirement Arrangements. These publications are available from your local IRS office, on the IRS' Internet Web Site at *www.irs.gov*, or by calling 1-800-TAX-FORMS.

State Tax Information

In accordance with Arizona state tax laws, the ASRS will withhold 5% of the entire amount of your distribution.