ARIZONA STATE RETIREMENT SYSTEM (ASRS)

SPECIAL TAX NOTICE REGARDING PLAN PAYMENTS – MEMBER OR ALTERNATE PAYEE

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FEDERAL TAX INFORMATION

Introduction - This notice contains important information regarding your federal income tax options for your withdrawal of contributions from the ASRS. All references to "the Code" are references to the Internal Revenue Code of 1986, as amended. This notice summarizes the federal and Arizona tax rules which apply to your distribution. Because these rules are complex and contain many conditions and exceptions not discussed in this notice, you may want to consult with a professional tax advisor before you receive your distribution 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*, IRS Publication 590, *Individual Retirement Arrangements (IRAs)* and IRS Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans)*. These publications are available from your local IRS office, on the IRS website at www.irs.gov, or by calling 1-800-TAX-FORM.

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 SIMPLE IRAs or Coverdell Education Savings Accounts. There are special rules governing rollovers to Roth IRAs that are described below. 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).

You may have special rollover rights if you recently served in the U.S. Armed Forces. For more information, see IRS Publication 3, *Armed Forces' Tax Guide*.

Types of Plan Distributions - The Code classifies distributions into two types: (1) distributions you may roll over (eligible rollover distributions), and (2) distributions you may not roll over. You also may receive a distribution in which part of the distribution is eligible for a rollover distribution and part is not eligible for a rollover distribution. The ASRS will assist you in identifying which portion of your distribution is an eligible rollover distribution and which portion is not an eligible rollover distribution.

An eligible rollover distribution is any distribution to you of all or any portion of your withdrawal under the ASRS except:

(1) Substantially Equal Payments - You may not roll over a distribution if it is part of a series of substantially equal payments made at least once a year and which will last for: (1) your lifetime (or your life expectancy), (2) your lifetime and your beneficiary's lifetime (or life expectancies), or (3) a period of ten years or more.

(2) Required Minimum Distributions - If the ASRS makes distributions to you after you terminate employment and have attained age 70½, you may not roll over the portion (or all) of the distribution which is a "required minimum distribution." When you reach age 70½, beginning April 1 of the following calendar year 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.

(3) Hardship Distributions - A hardship distribution is not eligible for rollover.

(4) 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.

Examples of an "eligible rollover distribution" include: (1) a voluntary lump sum withdrawal of employer and employee contributions in lieu of an annuity retirement pension, (2) a voluntary election to receive up to 36 months of annuity payments in a lump sum upon retirement, and (3) a lump sum distribution of the present value of a small annuity under $100.00 per month.

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.

Direct Rollover - You may elect a direct rollover of all or any portion of an eligible rollover distribution. If you elect a direct rollover, the ASRS will pay the eligible rollover distribution directly to your designated IRA or to another eligible retirement plan which you have designated. An eligible retirement plan is: (1) a qualified employer plan described in

Code § 401(a), (2) an annuity plan described in Code § 403(a), (3) an eligible deferred compensation plan described in Code § 457(b) that is maintained by a state or political subdivision of a state or any agency or instrumentality thereof or, (4) an annuity contract described in Code § 403(b). A direct rollover amount is not subject to taxation until you receive a distribution from the IRA or eligible retirement plan.

If you elect a direct rollover, your election form must include identifying information about the IRA or eligible retirement plan. Prior to election, you will need to contact the financial institution that sponsors the IRA or the eligible retirement plan to: (1) determine if the IRA or eligible retirement plan will accept your direct rollover, and (2) determine the procedure for making a direct rollover to that IRA or eligible retirement plan.

Option to Rollover Distribution - The direct rollover explained above is not the only way to make a rollover. If you receive payment of an eligible rollover distribution, you still may roll over all or any portion of the distribution to an IRA or an eligible retirement plan that accepts rollovers. If you decide to roll over the distribution, you must make the rollover within 60 days of your receipt of the payment. The portion of your distribution you elect to roll over is not subject to taxation until you receive a distribution from the IRA or eligible retirement plan.

You may roll over 100% of your eligible rollover distribution even though the ASRS has withheld 20% of the distribution for federal income tax withholding and an additional 5% for state income tax withholding (see *Withholding on Eligible Rollover Distributions* below). If you elect to roll over 100% of the distribution, you must contribute other money to the IRA or eligible retirement plan within the 60-day period to replace the 25% withheld. If you elect to roll over only the 75% which you receive, the 25% withheld will be subject to taxation.

Example: Assume your eligible rollover distribution is $8,000 and you do not elect a direct rollover. The ASRS pays you $6,000, withholding $2,000 for income taxes. However, assume within 60 days after receiving the $6,000 payment, you decide to roll over the entire $8,000 distribution; to make the rollover, you will roll over the $6,000 you received from the ASRS and you will contribute $2,000 from other sources (your savings, a loan, etc.). In this case, you will not have any tax liability with respect to the ASRS distribution. The ASRS will report an $8,000 distribution for the year, and you will report an $8,000 rollover. Furthermore, when you file your income tax return, you may receive a refund of the $2,000 withheld. If you roll over only the $6,000 paid from the ASRS, the $2,000 you do not roll over is taxable. When you file your income tax returns, you still may receive an income tax refund, but the refund likely will be smaller because $2,000 of the distribution is taxable.

Generally, the 60-day rollover deadline cannot be extended. However, the IRS has the limited authority to waive the deadline under certain extraordinary circumstances, such as when external events prevented you from completing the rollover by the 60-day rollover deadline. To apply for a waiver, you must file a private letter ruling request with the IRS. Private letter ruling requests require the payment of a nonrefundable user fee. For more information, see IRS Publication 590, *Individual Retirement Arrangements (IRAs)*.

After-tax Contributions - If you made after-tax contributions to the ASRS, the after-tax contributions included in a payment to you from the ASRS are not taxed. If a payment is only part of your benefit from the ASRS (such as a voluntary election to receive up to 36 months of annuity payments in a lump sum upon retirement), an allocable portion of your after-tax contributions are included in the payment. The ASRS will assist you in identifying how much of your payment is the taxable portion and how much is the after-tax portion.

After-tax rollover to an IRA – You may roll over to an IRA a payment that includes after-tax contributions through either a direct rollover or a 60-day rollover. You must keep track of the aggregate amount of the after-tax contributions in all of your IRAs in order to determine your taxable income for later payments from the IRAs.

If you make a direct rollover of only a portion of the amount paid from the ASRS and a portion is paid to you or if you make a 60-day rollover to an IRA of only a portion of the payment made to you, the after-tax contributions are treated as rolled over last. For example, assume your lump sum distribution totals $12,000, of which $2,000 is after-tax contributions. In this case, if you roll over $10,000 to an IRA in a direct rollover or in a 60-day rollover, no amount is taxable because the $2,000 amount not rolled over is treated as being after-tax contributions.

After-tax rollover to an eligible retirement plan – You may directly roll over after-tax contributions from the ASRS to another eligible retirement plan if the other plan will accept the rollover and provides separate accounting for amounts rolled over, including separate accounting for the after-tax employee contributions and earnings on those contributions. For this purpose, an eligible retirement plan is: (1) a qualified employer plan described in Code § 401(a) (including another defined benefit plan), (2) an annuity plan described in Code § 403(a), or (3) an annuity contract described in Code § 403(b). You may NOT roll over after-tax contributions from the ASRS to a governmental 457 plan. If you want to roll over after-tax contributions to an eligible retirement plan that accepts these rollovers, you cannot have the after-tax contributions paid to you first; rather, the after-tax contributions must be transferred directly to the other eligible retirement plan. You must instruct the ASRS to make a direct rollover on your behalf.

Rollover to Roth IRA - If you roll over the payment to a Roth IRA, a special rule applies under which the amount of the payment rolled over (reduced by any after-tax amounts) will be taxed. However, the 10% additional income tax on early distributions described below will not apply (unless you take the amount rolled over out of the Roth IRA prior to attaining age 59½ and within five years, counting from January 1 of the year of the rollover).

If you roll over the payment to a Roth IRA, later payments from the Roth IRA that are qualified distributions will not be taxed (including earnings after the rollover). A qualified distribution from a Roth IRA is a payment made after you are age 59½ (or after your death or disability, or as a qualified first-time homebuyer distribution of up to $10,000) and after you have had a Roth IRA for at least five years. In applying this five-year rule, you count from January 1 of the year for which your first contribution was made to a Roth IRA. Payments from the Roth IRA that are not qualified distributions will be taxed to the extent of earnings after the rollover, including the 10% additional income tax on early distributions (unless an exception applies). You do not have to take required minimum distributions from a Roth IRA during your lifetime. For more information, see IRS Publication 590, *Individual Retirement Arrangements (IRAs)*.

Withholding on Eligible Rollover Distributions - The portion of an eligible rollover distribution that you elect to receive is taxable to you unless, within 60 days, you roll over the distribution to an IRA or to another eligible retirement plan. In addition, the taxable portion of your eligible rollover distribution is subject to a mandatory 20% federal income tax withholding and a mandatory 5% Arizona state income tax withholding. For example, if your eligible rollover distribution is $8,000, the ASRS will pay you only $6,000 and remit to the IRS $1,600 as income tax withholding and remit to the Arizona Department of Revenue $400 as income tax withholding. You will receive a Form 1099-R from the ASRS reporting the full $8,000 as a distribution from the ASRS. The $2,000 withholding amount applies against any federal and state income taxes you may owe for the year. The direct rollover is the only means of avoiding this 20% federal and 5% state income tax withholding.

Withholding on Distributions Not Eligible for Rollover - The 20% withholding of federal income taxes does not apply to any portion of your taxable distribution that is not an eligible rollover distribution. You may elect whether to have federal income tax withholding apply to that portion. If you do not wish to have any income taxes withheld on that portion of your distribution, you will need to sign and date a withholding election form. The ASRS will provide you with a federal withholding election form (IRS Form W-4P) if your distribution includes an amount that does not constitute an eligible rollover distribution. If you do not return the federal withholding election form to the ASRS prior to the distribution, the ASRS will treat the failure to return the form as an affirmative election to have a 10% withholding apply. The 5% withholding of Arizona state income taxes applies to any distributions from the ASRS other than those made in the form of an annuity following retirement. The ASRS will provide you with a state withholding election form (Arizona Form A-4P) if your distribution is in the form of an annuity. If you do not return the state withholding election form to the ASRS prior to the commencement of your annuity, the ASRS will treat the failure to return the form as an affirmative election to have a 0% state income tax withholding apply.

Additional 10% Tax - If you receive a payment before you reach age 59½ and you do not roll it over, then, in addition to the regular federal and state income tax, you may have to pay an extra federal tax equal to 10% of the taxable portion of the payment. The additional 10% tax generally does not apply to: (1) payments made after you separate from service with your employer if you will be at least age 55 in the year of the separation; (2) payments made due to disability; (3) payments that start after you separate from service if paid at least annually as equal (or almost equal) payments over your life or life expectancy (or your and your beneficiary's lives or life expectancies); (4) payments made directly to the government to satisfy a federal tax levy; (5) payments made under a qualified domestic relations order; (6) payments that do not exceed the amount of your deductible medical expenses; (7) payments because legal limits on certain contributions were exceeded; or (8) certain payments made while you are on active duty if you were a member of a reserve component called to duty after September 11, 2001, for more than 179 days.

In general, if you roll over to an IRA and subsequently receive a payment from the IRA and you are under age 59½, you will have to pay the 10% additional tax unless an exception applies. In general, the exceptions to the 10% additional income tax for early distributions from an IRA are the same as the exceptions listed above for early distributions from a plan. However, there are a few differences for payments from an IRA, including:

- There is no exception for payments after separation from service that are made after age 55.
- The exception for qualified domestic relations orders (QDRO) does not apply (although a special rule applies under which, as part of a divorce or separation agreement, a tax-free transfer may be made directly to an IRA of a spouse or former spouse).
- The exception for payments made at least annually in equal or close to equal amounts over a specified period applies without regard to whether you have had a separation from service.
- There are additional exceptions for: (1) payments for qualified higher education expenses, (2) payments up to $10,000 used in a qualified first-time home purchase, and (3) payments after you have received unemployment compensation for 12 consecutive weeks (or would have been eligible to receive unemployment compensation but for self-employed status).

See IRS Form 5329 for more information on the additional 10% tax.

If you were born before January 1, 1936 - If your distribution is a lump sum distribution, and you were born before 1936, you may elect special tax treatment, but only if you do not roll over any part of the lump sum distribution. A lump sum distribution is a distribution, within one calendar year, of your entire withdrawal (including the nontaxable portion of your distribution) under the ASRS. You must have been a participant in the ASRS for at least five years before the year in which you received the distribution. You may elect special tax treatment, known as income averaging, by filing IRS Form 4972 with your income tax return. The instructions to IRS Form 4972 provide further details regarding the reporting of your lump sum distribution and describe the rules for determining whether a distribution qualifies as a lump sum distribution. As a general rule, you may not elect income averaging for a lump sum distribution if you elected income averaging with respect to a prior lump sum distribution you received.

Alternate Payees - In general, the rules summarized above that apply to payments to ASRS participants 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" (QDRO) which is an order issued by a court, usually in connection with a divorce or legal separation. In addition, your payment from the ASRS under the QDRO is not subject to the additional 10% tax described in this notice, even if you are younger than age 59½. However, if you are an alternate payee and roll over your QDRO distribution to another eligible plan or IRA, any distribution from that other eligible plan or IRA will be subject to the 10% additional income tax unless an exception discussed in this notice applies to such subsequent distribution.