ARIZONA STATE RETIREMENT SYSTEM (ASRS)

SPECIAL TAX NOTICE REGARDING PLAN PAYMENTS – SURVIVOR BENEFITS

Phoenix (602) 240-2000
Tucson (520) 239-3100
Toll-free (800) 621-3778
www.azasrs.gov

FEDERAL TAX INFORMATION

***INTRODUCTION* -** This notice contains important information regarding your federal income tax options for your survivor benefit distribution from the ASRS. All references to "the Code" are references to the Internal Revenue Code of 1986, as amended. This notice summarizes only the federal (not state or local) 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*, and IRS Publication 590, *Individual Retirement Arrangements*. These publications are available from your local IRS office, on the IRS' website at www.irs.gov, or by calling 1-800-TAX-FORM.

SPOUSE BENEFICIARY/ALTERNATE PAYEE

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 survivor benefit 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 required minimum distributions to you, you may not roll over the required minimum distributions.

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

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 benefit 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 benefit 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.

If your ASRS distribution is a series of payments over a period of less than ten years, each payment is an eligible rollover distribution. Your election to make a direct rollover will apply to all payments unless you advise the ASRS of a change in your election.

If your distribution exceeds $500, you may elect a direct rollover of all or any part of your distribution, provided the portion directly rolled over is at least $500. If your distribution is at least $200 but less than $500, you must elect either a direct rollover of the entire amount or accept a direct distribution of the entire amount. If your distribution is less than $200, you must take a direct distribution and are not eligible to roll over.

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 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 20% withheld. If you elect to roll over only the 80% which you receive, the 20% withheld will be subject to taxation.

Example: Assume your eligible rollover distribution is $5,000, and you do not elect a direct rollover. The ASRS pays you $4,000, withholding $1,000 for income taxes. However, assume within 60 days after receiving the $4,000 payment, you decide to roll over the entire $5,000 distribution. To make the rollover, you will roll over the $4,000 you received from the ASRS and you will contribute $1,000 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 a $5,000 distribution for the year, and you will report a $5,000 rollover. Furthermore, when you file your income tax return, you may receive a refund of the $1,000 withheld. If you roll over only the $4,000 paid from the ASRS, the $1,000 you do not roll over is taxable. When you file your income tax return, you still may receive an income tax refund, but the refund likely will be smaller because $1,000 of the distribution is taxable.

***AFTER-TAX CONTRIBUTIONS* -** If your deceased spouse made after-tax contributions to the ASRS, you may roll over these contributions into either an IRA or certain eligible retirement plans that accept rollovers of the after-tax contributions. The following rules apply:

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. The ASRS will assist you in identifying how much of your payment is the taxable portion and how much is the after-tax portion. 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 you to determine the nontaxable amount of any future distributions from the IRA. Once you roll over the after-tax contributions to an IRA, you may NOT later roll over those amounts to an eligible retirement plan, but may roll over the after-tax contributions to another IRA.

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 – Except as provided in the next sentence, you may directly roll over after-tax contributions from the ASRS to another eligible retirement plan (including a defined benefit 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. 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 5 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 5 years. In applying this 5-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 20% federal income tax withholding. You may not waive this withholding. For example, if your eligible rollover distribution is $5,000, the ASRS will pay you only $4,000 and remit to the IRS $1,000 as income tax withholding. You will receive a Form 1099-R from the ASRS reporting the full $5,000 as a distribution from the ASRS. The $1,000 withholding amount applies against any federal income tax you may owe for the year. The direct rollover is the only means of avoiding this 20% withholding.

***WITHHOLDING ON DISTRIBUTIONS NOT ELIGIBLE FOR ROLLOVER* -** The 20% withholding 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 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.

***10% PENALTY TAX* -** The 10% penalty tax does not apply to survivor benefit distributions to a beneficiary. However, if you roll over the survivor benefit, the taxable portion of any distribution you receive from your IRA or eligible retirement plan before you reach the age of 59½ is subject to a 10% penalty tax in addition to federal income taxes unless an exception applies. See IRS Form 5329 for more information on the 10% penalty tax.

LUMP SUM DISTRIBUTION - If your distribution is a lump sum distribution, and your deceased spouse was 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 survivor benefit (including the nontaxable portion of your distribution) under the ASRS. 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 your deceased spouse elected income averaging with respect to a prior lump sum distribution she/he received after December 31, 1986, or after she/he attained age 59½.

ALTERNATE PAYEES - In general, the rules summarized above that apply to payments to spouse beneficiaries 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 59 ½. 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 before you reach the age of 59½ is subject to a 10% penalty tax in addition to federal income taxes unless an exception applies. See IRS Form 5329 for more information on the 10% penalty tax.

NON-SPOUSE BENEFICIARY & ELECTING SPOUSE BENEFICIARY

ELIGIBILITY FOR ROLLOVER (INHERITED IRA) – These rules apply to non-spouse beneficiaries and spouses who elect to be treated as a non-spouse beneficiary by rolling over the spouse’s distribution to an IRA and electing to treat the IRA as an inherited IRA. You either may receive a direct distribution of the survivor benefit or may directly roll over the survivor benefit to an inherited IRA you establish to receive the distribution. If you receive the survivor benefit directly, you subsequently may not roll over the survivor benefit to an inherited IRA. If you roll over the survivor benefit to an IRA, the rollover must be by a direct transfer (i.e., direct rollover) from the ASRS to the IRA. You may not roll over the survivor benefit distribution to any retirement plan other than to an IRA. You also may not roll over any distribution that the member would have had to take as a “lifetime” required minimum distribution for the year of the member’s death. The Code treats the rollover IRA as an “inherited” IRA. This means you, at a later date, may not transfer the IRA assets to another IRA you own or to any other retirement plan. The inherited IRA must be titled in a manner that reflects the decedent and the beneficiary, such as “Jessica Jones, as beneficiary of William Jones.” If you elect a direct rollover of the survivor benefit to an IRA, the ASRS will pay the survivor benefit directly to the IRA you have designated. A direct rollover amount is not subject to taxation at the time of the rollover. The taxable portion of your direct rollover will be taxed later when you take it out of the IRA. The 10% penalty tax for distributions before age 59½ will not apply to a later distribution from the IRA, even if you are not age 59½ at the time of the distribution.

If your distribution exceeds $500, you may elect a direct rollover of all or any part of your distribution provided the portion directly rolled over is at least $500. If your distribution is at least $200 but less than $500, you must elect either a direct rollover of the entire amount or accept a direct distribution of the entire amount. If your distribution is less than $200, you must take a direct distribution and are not eligible to roll over. In addition, non-spouse beneficiaries must roll over to an inherited IRA by December 31 of the first calendar year following the year of death. Spouse beneficiaries must roll over by December 31 of the later of (1) the first calendar year following the year of death, or (2) the calendar year the member would have reached 70 ½.

AFTER-TAX CONTRIBUTIONS - If the deceased member made after-tax contributions to the ASRS, you may roll over these contributions to the IRA you establish to receive the rollover. However, if you roll over after-tax contributions to an IRA, it is your responsibility to keep track of, and to report to the IRS on the applicable forms, the amount of these after-tax contributions. This will enable you to determine the nontaxable amount of any future distributions from the IRA.

If you make a direct rollover of only a portion of the amount paid from the ASRS and a portion is paid 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, no amount is taxable because the $2,000 amount not rolled over is treated as being after-tax contributions.

ROLLOVER TO INHERITED ROTH IRA - If you roll over the payment to an inherited Roth IRA, a special rule applies under which the amount of the payment rolled over (reduced by any after-tax amounts) will be taxed.

If you roll over the payment to an inherited Roth IRA, the same minimum distribution rules apply to the inherited Roth IRA as apply to distributions from a traditional IRA. In general, you will need to commence receiving distributions for each year beginning with the year after the member's death. Since you have already paid income tax on the entire amount rolled over to the inherited Roth IRA (reduced by any after-tax amounts rolled over), any further distributions from the inherited Roth IRA will not be subject to income tax or the 10% additional income tax on early distributions even though you have not attained age 59½. For more information, see IRS Publication 590, *Individual Retirement Arrangements (IRAs)*.

DISTRIBUTIONS YOU RECEIVE - The taxable portion of a survivor benefit that you elect to receive is taxable to you in the year you receive the distribution. The 10% penalty tax does NOT apply to survivor benefit distributions to a beneficiary. If you elect to roll over the distribution to an IRA, for each year beginning with the year after the member's death, you must take a minimum required distribution. Any distribution you subsequently take from the IRA is taxable to you in the year you receive the distribution, and is not eligible for rollover to another IRA or to any other retirement plan. The IRA trustee or custodian, or your tax advisor, can help you determine the amount of each year's required distribution amount.

FEDERAL INCOME TAX WITHHOLDING - If you receive directly, rather than roll over, an eligible rollover distribution, the taxable portion of the distribution is subject to 20% federal income tax withholding. You may not waive this withholding. For example, if you elect to receive a taxable eligible rollover distribution of $5,000, the ASRS will pay you only $4,000 and will send to the IRS $1,000 as income tax withholding. You will receive a Form 1099-R from the ASRS reporting the full $5,000 as a distribution from the ASRS. The $1,000 withholding amount applies against any federal income tax you may owe for the year. The direct rollover is the *only* means of avoiding the 20% withholding. Note that taxes with regard to the distribution may exceed the 20% withheld. To the extent a distribution represents a current year's or any prior year's required minimum distribution, the ASRS will withhold 10% federal income tax, however, you may elect a lesser amount.

LUMP SUM DISTRIBUTION - If your distribution is a lump sum distribution and the deceased participant was born before 1936, you may elect special tax treatment. A lump sum distribution is a distribution, within one calendar year, of your entire survivor benefit (including the non-taxable portion of your distribution) under the ASRS. 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.

INHERITED IRA GUIDELINES FOR A BENEFICIARY

Pension Protection Act of 2006 - The Pension Protection Act (PPA) of 2006 introduced the opportunity for a non-spouse beneficiary to roll over to an inherited IRA. The *Special Tax Notice Regarding Plan Payments* provides information about an inherited IRA. The information provided here is a general guideline for your convenience. It is recommended that you seek the advice of a tax professional or contact the Internal Revenue Service for additional information.

The PPA uses the member's age (under or over age 70½) in the calendar year of death, the member's status (retired or non-retired), and the calendar year in which you roll over to determine how the ASRS treats the survivor benefit as noted below.

1. The non-retired or retired member did not reach the age of 70½ in the calendar year of death.

If you roll over:

(1) In the calendar year of the member's death, you may roll over all or a portion of the survivor benefit.

(2) In the calendar year following the member's year of death, a minimum distribution must be paid to you and you may roll over all or a portion of the remaining survivor benefit.

Non-spouse beneficiaries must roll over by December 31 of the first calendar year following the year of death. You cannot roll over after this date.

Spouse beneficiaries must roll over by December 31 of the later of (1) the first calendar year following the year of death, or (2) the calendar year the member would have reached 70 ½.

2. The non-retired member was at least 70½ in the calendar year of death AND the member was not terminated.

The member's estate may be entitled to a required minimum distribution in the calendar year of death. The remaining funds are the survivor benefit.

If you roll over:

(1) In the calendar year of the member's death, you may roll over all or a portion of the survivor benefit.

(2) In the calendar year following the member's year of death, a minimum distribution must be paid to you and you may roll over all or a portion of the remaining survivor benefit.

You must roll over by December 31 of the first calendar year following the year of death. You cannot rollover after this date.

3. The retired member dies after reaching age 70 ½.

If you roll over:

(1) In the calendar year of the member's death, you may roll over all or a portion of the survivor benefit.

(2) In the calendar year following the member's year of death, a minimum distribution must be paid to you and you may roll over all or a portion of the remaining survivor benefit.

You must roll over by December 31 of the first calendar year following the year of death (to avoid tax penalties).

Estates and Trusts - Estates are not eligible to roll over. Some trusts may be eligible to roll over to an inherited IRA and would require a written opinion from your tax counsel.