



SPECIAL TAX NOTICE REGARDING REFUNDS

This notice contains important information you will need before you decide how to receive your refund from the Educational Employees' Supplementary Retirement System of Fairfax County (ERFC). This Notice explains how you can continue to defer federal income tax on your retirement savings.

SUMMARY OVERVIEW

A refund from the Plan that is eligible for "rollover" can be taken in two ways. You can have *all or any portion* of your payment either **1) PAID IN A "DIRECT ROLLOVER,"** or **2) PAID DIRECTLY TO YOU.** A rollover provides payment of your refund to your Individual Retirement Account (IRA) or to another eligible employer plan that allows you to continue to postpone taxation of your benefit until it is paid to you. The option you select will affect the tax you owe for the year your distribution is made.

A rollover may only be made to an IRA or to an eligible retirement plan. Your payment cannot be rolled over to a SIMPLE IRA, or a Coverdell Education Savings Account (formerly known as an "education IRA"). Rollovers can be made to a Roth IRA, but there are special rules for these rollovers. An "eligible employer plan" includes a qualified plan under section 401(a) of the Internal Revenue Code ("Code"), such as 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.

If you choose a **DIRECT ROLLOVER:**

- Your refund will not be taxed in the current year and no income tax will be withheld.
- Your refund will be transferred directly to your IRA, or, if you choose, to another eligible employer plan that will accept your rollover.
- Your refund will be taxed later, at the time you begin to withdraw it from either the IRA or the employer plan.

If you choose to have your refund **PAID DIRECTLY TO YOU:**

- You will receive only 80 percent of the total refund amount, because the Plan administrator is required to withhold 20 percent of the payment and send it to the IRS as income tax withholdings to be credited against your taxes.
- Your refund will be taxed in the current year unless you roll it over. 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 also may have to pay an additional 10 percent Federal tax.

- Within 60 days of receiving your refund directly, you can roll the refund over to your IRA or to another eligible employer plan that will accept the payment. The amount rolled over will not be taxed until you take it out of the IRA or employer plan.
- If you want to roll over 100 percent of the eligible refund to an IRA or another employer plan *after* you have received the 80 percent direct payment from ERFC, *you must find other money to replace the 20 percent that was withheld.* If you roll over only the 80 percent that you received, you will be taxed on the 20 percent that was withheld and not rolled over.

ADDITIONAL INFORMATION

- I. PAYMENTS THAT CAN AND CANNOT BE ROLLED OVER
- II. DIRECT ROLLOVER
- III. PAYMENT PAID TO YOU
- IV. SURVIVING SPOUSES, ALTERNATE PAYEES, AND OTHER BENEFICIARIES

I. PAYMENTS THAT CAN AND CANNOT BE ROLLED OVER

Refunds from the Plan and the lump-sum portion of Options D benefits (under the ERFC benefit structure) may be "eligible rollover distributions." This means that they can be rolled over to a traditional IRA or to another eligible employer plan that accepts rollovers. The Retirement Office will be able to tell you what portion of your refund or Option D lump-sum is an eligible rollover distribution.

After-Tax Contributions

If you made after-tax contributions to the Plan, 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:

A) Rollover into a Traditional IRA

You can roll over your after-tax contributions to a traditional IRA either directly or indirectly. The Retirement Office will be able to tell you how much of your payment is the taxable portion and how much is the after-tax portion. If you roll over your after-tax contributions to a traditional IRA, it is your responsibility to keep track of the rollover, and to report the amount of these after-tax contributions to the IRS on the

applicable forms. This will enable the non-taxable amount of any future distributions from the traditional IRA to be determined. **Note:** Once you roll over your after-tax contributions to an IRA, those amounts *cannot* be rolled over to an employer plan at a later date.

B) Rollover into an Employer Plan

You can roll over after-tax contributions to another employer plan that is qualified under Code section 401(a), or to a section 403(a) annuity plan using a 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 can also roll over after-tax contributions to a section 403(b) tax-sheltered annuity using a direct rollover, if the other tax-sheltered annuity 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 ERFC Plan administrator to make a direct rollover on your behalf. Note also: You cannot first roll over after-tax contributions to an IRA and then roll over that amount into an employer plan.

C) Rollover into a Roth IRA

Certain members can roll over after-tax contributions to a Roth IRA, subject to certain limits and special tax rules. Please consult your tax advisor.

The following types of payments cannot be rolled over:

A) 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 life expectancy), **or**
- Your lifetime and your beneficiary's lifetime (or life expectancies), **or**
- A period of ten years or more.

B) Required Minimum Payments

Beginning when you reach age 70½ or retire, 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.

II. DIRECT ROLLOVER

You can choose a direct rollover of all or any portion of your refund that is an "eligible rollover distribution" as described above. In a direct rollover, the eligible rollover distribution is paid directly from the Plan to an IRA or another eligible employer plan that accepts rollovers. If you choose a direct rollover, you are not taxed on the payment until you take it out of the IRA or the employer plan.

Direct Rollover to an IRA

You can open an IRA to receive the direct rollover. (The term "IRA," as used in this Notice, includes individual retirement accounts and individual retirement annuities.) If you choose to have your refund made directly to an IRA, contact an IRA sponsor (usually a financial institution) to find out how to have your payment made in a direct rollover to an IRA at that institution. 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 consider whether the IRA you choose will allow you to move all or part of your payment to another IRA at a later date, without penalties or other limitations. For more information on IRAs, including limits on how often you can roll over monies between IRAs, see IRS Publication 590, *Individual Retirement Arrangements*.

Direct Rollover to a Plan

If you are hired by a new employer that has a plan, and you want to arrange a direct rollover to that plan, ask the plan administrator whether it will accept your rollover. If your new employer's plan does not accept a rollover, you can choose a direct rollover to an IRA. An eligible employer plan is not legally required to accept a rollover, so before you decide to roll over your payment to another employer plan, you should find out whether or not the plan accepts rollovers, and, if so, which distribution types it accepts as rollovers. If the employer plan accepts your rollover, the plan may provide restrictions on the circumstances under which you may later receive a distribution of the rollover amount, or may require spousal consent to any subsequent distribution. Check with the plan's administrator 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 in a taxable distribution directly from the Plan. For example, if you were born before January 1, 1936, you might be entitled to ten-year averaging or capital gain treatment, as explained on page 3. However, if you have your benefit rolled over to a section 403(b) tax-sheltered annuity, a governmental 457 plan, or a traditional IRA in a direct rollover, your benefit will no longer be eligible for that special treatment. For more information, see the following sections: "Additional Ten Percent Tax if You Are Under Age 59½" – and -- "Special Tax Treatment if You Were Born Before January 1, 1936."

III. PAYMENT PAID TO YOU

If payment is made directly to you, it is subject to 20 percent federal income tax withholding. The payment is taxed in the year you receive it, unless you roll it over within 60 days to a traditional IRA or to an eligible employer plan that accepts rollovers. If you do not roll it over, special tax rules may apply.

Income Tax Withholding

Mandatory Withholding

If any portion of the payment made to you is an eligible rollover distribution, the Plan is required by law to withhold 20 percent of that amount. This amount is sent to the IRS as income tax withholding. For example, if your eligible rollover distribution is \$10,000, only \$8,000 will be paid to you because the Plan must withhold \$2,000 as income tax. However, when you prepare your income tax return for the year, you will report the full \$10,000 as a payment from the Plan. You will report the \$2,000 as tax withheld, and it will be credited against any income tax you owe for the year.

Sixty-Day Rollover Option

If you receive an eligible rollover distribution payment, you can still decide to roll over all or part of it to an IRA or another eligible employer plan that accepts rollovers. If you decide to roll over, *you must make the rollover within 60 days after you receive that payment.* The rollover portion of your payment will not be taxed until you withdraw it from the IRA or the employer plan.

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

Example

Your eligible rollover distribution 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 to 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 IRA or employer plan. If you roll over the entire \$10,000, when you file your income tax return, you may get a refund of the \$2,000 withheld.

On the other hand, if 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 withheld \$2,000. (However, any refund is likely to be larger if you roll over the entire \$10,000.)

Additional Ten Percent Tax If You Are Under Age 59½

If you receive a refund before you reach age 59½, and you do not roll it over at that time, you may then have to pay an extra tax equal to 10 percent of the taxable portion of the payment, *in addition to* the regular income tax. The additional 10 percent tax does not apply to your refund if it is:

- (1) Paid to you because you separate from service with your employer during or after the year you reach age 55, or
- (2) Paid because you retire due to disability, or
- (3) Used to pay certain medical expenses, or
- (4) Paid directly to the government to satisfy a federal tax levy, or
- (5) Paid to an alternate payee under a qualified Domestic Relations Order.

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

Special Tax Treatment

If your eligible rollover distribution is not rolled over, it will be taxed in the year you receive it. However, if it qualifies as a "lump sum distribution," it may be eligible for special tax treatment. A lump sum distribution is a payment of your entire balance under the Plan (and certain other similar plans of the employer) made within one year, that is payable to you because you have reached age 59½, or because you have separated from service with your employer (or, in the case of a self-employed individual, because you have either reached age 59½ or have become disabled). For a payment to qualify as a lump sum distribution, you must have been a participant in the Plan for at least 5 years. The special tax treatment for lump sum distributions is described below.

Ten-Year Averaging

If You Were Born Before January 1, 1936

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 "ten-year averaging" (using 1986 tax rates). Ten-year averaging often reduces the tax you owe.

Capital Gain Treatment

If You Were Born Before January 1, 1936

In addition, if you receive a lump sum distribution and you were born before January 1, 1936, you may elect to have the part of your payment that is attributable to your pre-1974 participation in the Plan (if any) taxed as long-term capital gain at a rate of 20 percent.

There are other limits on 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. If you have previously rolled over a refund from the Plan (or certain other similar plans of the employer), you cannot use this tax treatment for later payments from the Plan. If you roll over your payment to a

traditional IRA, governmental 457 plan, or 403(b) tax-sheltered annuity, this special tax treatment is not available for the rest of the payment. Additional restrictions are described in IRS Form 4972, which has more information on lump sum distributions, and how to elect the special tax treatment. You may not elect this special tax treatment if the amounts you rolled over into this Plan were drawn from a 403(b) tax-sheltered annuity or amounts from an IRA that were not originally attributable to a qualified employer plan.

IV. SURVIVING SPOUSES, ALTERNATE PAYEES, AND OTHER BENEFICIARIES

In general, the rules that apply to payments to employees as summarized above, also apply to payments to surviving spouses of employees and to spouses or former spouses who are "alternate payees." You are an alternate payee if your interest in the Plan 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 a surviving spouse or an alternate payee, you may choose to have a payment that can be rolled over as described in Section I, 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 you can roll it over yourself to an IRA or to an eligible employer plan. Thus, you have the same choices as the employee.

If you are a beneficiary other than a surviving spouse or an alternate payee, you have only one option to continue deferring taxes on the refund you receive: you can choose a direct rollover to an IRA. The money must be transferred directly from ERFC to the financial institution that holds your IRA, and your IRA must be established specifically to receive the refund that you will receive as the result of the member's death. The money that is transferred to the IRA will be treated as an inherited IRA, and cannot be rolled over tax-free from the IRA to an employer retirement plan or to another IRA. Another difference from the rules that apply to members and to surviving spouses is that if you choose not to take a direct rollover, the amount you receive is not subject to 20% mandatory federal withholding.

If you are a surviving spouse, an alternate payee, or another beneficiary, your payment is not subject to the additional 10 percent tax described in Section II above, even if you are younger than age 59½.

If you are a surviving spouse, an alternate payee, or another beneficiary, you may be able to use the special tax treatment for lump sum distributions and the special rule for payment as described in Section III. If you receive a payment because of the employee's death, you may be able to treat the payment as a lump sum distribution if the employee met the appropriate age requirements, whether or not the employee had five years of participation in the Plan.

HOW TO OBTAIN ADDITIONAL INFORMATION

This notice summarizes only the federal (not state or local) tax rules that might apply to your payment. The rules described here 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 Plan. You can also find more specific information on the tax treatment of payments from qualified retirement plans in the 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 Web site at www.irs.gov, or by calling 1-800-TAX-FORM.

VIRGINIA STATE TAX WITHHOLDING RULES

The State of Virginia requires withholding at the rate of 4 percent on any refunds where federal tax has been withheld, unless you indicate that you are not subject to Virginia state taxes for one of the following reasons: (1) you are not a resident of Virginia; (2) you incurred no income tax liability for last year and do not expect to incur a liability for this year; (3) you expect your Virginia adjusted gross income to be less than \$5,000 if single; \$8,000 if married and filing a joint return; or \$4,000 if married and filing a separate return.