

IRS 402(f) – Special Tax Notice

(For Plans Qualified Under Section 401(a), Section 403(a) Annuity Plans, or Section 403(b) Tax Sheltered Annuities)

This notice explains how you can continue to defer federal income tax on your retirement savings in the Virginia Retirement System (VRS). It contains important information you will need before you decide how to receive your Plan benefits.

This notice is provided to you by VRS because all or part of the payment that you will soon receive from VRS may be eligible for rollover by you or VRS to a traditional IRA, an eligible employer plan or, if you meet the requirements described in Part IV below, a Roth IRA. A rollover is a payment by you or VRS 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. A rollover to a Roth IRA does not allow you to continue to postpone taxation of your benefit until paid, but does allow future earnings to accumulate tax-free and may provide for subsequent tax-free distributions from the Roth IRA. The special rules that apply to a rollover to a Roth IRA are provided in Part IV below. Your payment cannot be rolled over to a SIMPLE IRA, or a Coverdell Education Savings Account (formerly known as an education IRA). 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).

An eligible employer plan is not legally required to accept a rollover. Before you decide to roll over your payment to another employer plan, you should find out whether the plan accepts rollovers and, if so, the types of distributions it accepts as a rollover. You should also find out about any documents that are required to be completed before the receiving plan will accept a rollover. Even if a plan accepts rollovers, it might not accept rollovers of certain types of distributions, such as after-tax amounts. If this is the case, and your distribution includes after-tax amounts, you may wish instead to roll your distribution over to a traditional IRA or split your rollover amount between the employer plan in which you will participate and a traditional IRA. 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 this plan. Check with the plan administrator that is to receive your rollover prior to making the rollover.

If you have additional questions after reading this notice, call the VRS Customer Contact Center toll free at 1-888-VARETIR (827-3847).

SUMMARY

There are two ways you may be able to receive a Plan payment that is eligible for rollover: (1) Certain payments can be made directly to a traditional IRA or Roth IRA that you establish or to an eligible employer plan that will accept it and hold it for your benefit ("Direct Rollover"), or (2) the payment can be made to you.

If you choose a **Direct Rollover** to a traditional IRA or eligible employer plan:

- Your payment will not be taxed in the current year and no income tax will be withheld.
- You choose whether your payment will be made directly to your traditional IRA or to an eligible employer plan that accepts your rollover. Your payment cannot be rolled over to a SIMPLE IRA or a Coverdell Education Savings Account because these are not traditional IRAs.
- The taxable portion of your payment will be taxed later when you take it out of the traditional IRA or the eligible employer plan. Depending on the type of plan, the later distribution may be subject to different tax treatment than it would be if you received a taxable distribution from this Plan.

If you choose to have a Plan payment that is eligible for rollover **paid to you**:

- VRS, as required by the IRS, will withhold 20 percent of the taxable amount and send it to the IRS as federal income tax withholding to be credited against your taxes. If you are a Virginia resident, an additional 4 percent of the taxable amount will be withheld and forwarded to the Virginia Department of Taxation as state 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 59 1/2, you may have to pay an additional 10 percent tax.
- You can roll over all or part of the payment by paying it to your traditional IRA or to an eligible employer plan that accepts your rollover within 60 days after you receive the payment. The amount rolled over will not be taxed until you take it out of the traditional IRA or the eligible employer plan.
- If you want to roll over 100 percent of the payment to a traditional IRA or an eligible employer plan, you must find other money to replace the 20 percent of the taxable portion that was withheld for federal taxes. If you roll over only the 80 percent that you received, you will be taxed on the 20 percent that was withheld and that is not rolled over. If you are a resident of Virginia, you will also need to use other money to replace the 4% withheld for state taxes.

You also may be eligible to roll over your distribution to a Roth IRA. The special rules applicable to rollovers to Roth IRA are described under Part IV below.

Your Right to Waive the 30-Day Notice Period: Generally, neither a direct rollover nor an amount paid to you can be made from the plan until at least 30 days after your receipt of this notice from VRS. Thus, 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 indicating whether or not you wish to make a direct rollover. Your distribution will then be processed in accordance with your election as soon as practical after it is received by VRS.

MORE INFORMATION

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I. PAYMENTS THAT CAN AND CANNOT BE ROLLED OVER

The lump-sum portion of the partial lump-sum option payment (PLOP) option payable from VRS and a refund of your accumulated contributions and interest may be “eligible rollover distributions”. This means the funds can be rolled over to a traditional IRA, to an eligible employer plan that accepts rollovers or, if you meet certain requirements explained below in Part IV, to a Roth IRA. Payments from VRS cannot be rolled over to a SIMPLE IRA, or a Coverdell Education Savings Account.

After-tax Contributions: If you made after-tax contributions to VRS, the portion of the payment representing these contributions may be rolled into either a traditional IRA, to certain employer plans that accept rollovers of the after-tax contributions or, if you meet certain requirements explained below in Part IV, to a Roth IRA. The following rules apply:

- a) Rollover into a Traditional IRA or Roth IRA: You can roll over the portion of your payment representing after-tax contributions to a traditional IRA or Roth IRA either directly or indirectly. VRS tells you how much of your payment is the taxable portion and how much is the after-tax portion.

If you roll over the after-tax portion to a traditional 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 non-taxable amount of any future distributions from the traditional IRA to be determined.

Once you roll over the portion of your payment representing your after-tax contributions to a traditional IRA or a Roth IRA, those amounts *cannot* later be rolled over to an employer plan.

- b) Rollover into an Employer Plan: As VRS is a qualified plan under Internal Revenue Code (IRC) section 401(a), you can roll over the portion of the payment representing your VRS after-tax contributions to another such 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 from one IRC section 403(b) tax-sheltered annuity to another IRC 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 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 VRS 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 which Cannot be Rolled Over: Some payments, or portions of payment, by law are not eligible rollover distributions. The following types of payments are among those which are not eligible rollover distributions and 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 a period measured by your life expectancy), or
 - your lifetime and your beneficiary's lifetime (or a period measured by your joint life expectancies), or
 - a period of 10 years or more.
- b) Required Minimum Payments: Beginning when you reach age 70-1/2 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.

Annuity payments made for your lifetime or for the combined lifetimes of you and your contingent annuitant are not eligible to be rolled over. However, a refund distribution or the lump-sum payment under the PLOP may be rolled over.

II. DIRECT ROLLOVER TO TRADITIONAL IRA OR ELIGIBLE EMPLOYER PLAN

A direct rollover is a direct payment from VRS to a traditional IRA or an eligible employer plan that will accept it. You can choose a direct rollover of all or any portion of your payment that is an eligible rollover distribution, as described in Part I above. You are not taxed on any taxable portion of your payment for which you choose a direct rollover until you later take it out of the traditional IRA or eligible employer plan. In addition, no income tax withholding is required for any taxable portion of your payment for which you choose a direct rollover.

Direct Rollover to a Traditional IRA: You can open a traditional IRA to receive the direct rollover. If you choose to have your payment made directly to a traditional IRA, contact an IRA sponsor (usually a financial institution) to find out how to have your payment made in a direct rollover to a traditional IRA at that institution. If you are unsure of how to invest your money, you can temporarily establish a traditional IRA to receive the payment. However, in choosing a traditional IRA, you may wish to make sure that the traditional IRA you choose will allow you to move all or a part of your payment to another traditional 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 a Plan: If you are employed by a new employer that has an eligible employer plan, and you want a direct rollover to that plan, ask the plan administrator whether the plan will accept your rollover. An eligible employer plan is not legally required to accept a rollover. Even if your new employer's plan does not accept a rollover, you can choose a direct rollover to a traditional IRA. 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 administrator of that plan 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 traditional 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 below. 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. See the paragraphs below entitled "Additional 10 Percent Tax If You Are Under Age 59 1/2" and "Special Tax Treatment If You Were Born Before January 1, 1936."

III. PAYMENT PAID TO YOU

If your payment can be rolled over (see Part I above) and the payment is made to you, it is subject to 20 percent federal income tax withholding on the taxable portion (state or local tax withholding may also apply). The payment is taxed in the year you receive it unless, within 60 days, you roll it over to a traditional IRA or an eligible employer plan that accepts rollovers. If you do not roll it over, special tax rules may apply.

Federal Income Tax Withholding

Mandatory Federal Income Tax Withholding For Payments That Are Eligible Rollover Distributions: If any portion of your payment can be rolled over under Part I above and you do not elect to make a direct rollover, VRS is required by law to withhold 20 percent 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 Plan 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. No income taxes are withheld if your payments for the year are less than \$200.

Voluntary Federal Income Tax Withholding For Payments That Are NOT Eligible Rollover Distributions: If any portion of your payment is taxable but cannot be rolled over under Part I above or is rolled over to a Roth IRA, 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 percent will be taken out of this portion of your payment for federal income tax withholding. To elect out of withholding, ask the Plan Administrator for the election form and related information.

Federal income tax withholding applies to income that is subject to federal income tax. If no voluntary federal income tax withholding is elected, you may be required to make quarterly estimated income tax payments, and you may be subject to penalties if too little is withheld or paid. You may wish to contact your tax advisor or local IRS office if you have questions.

Sixty-Day Rollover Option: If you receive a payment that can be rolled over under Part I above, you can still decide to roll over all or part of it to a traditional IRA or to an eligible employer plan that accepts rollovers. If you choose a rollover, you must contribute the amount of the payment you received to a traditional 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 traditional IRA or the eligible employer plan. You can roll over up to 100 percent of your payment that can be rolled over under Part I above, including an amount equal to the 20 percent of the taxable portion 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 traditional IRA or the eligible employer plan, to replace the 20 percent that was withheld. On the other hand, if you roll over only the 80 percent of the taxable portion that you received, you will be taxed on the 20 percent that was withheld.

Example: The taxable portion of your payment that can be rolled over under Part I above 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 a traditional 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.)

In addition, special rules apply to rollovers to a Roth IRA. The special rules are provided in Part IV below.

If you are a resident of Virginia, the 4 percent state income tax withholding must also be factored in to determine the amount you would actually receive as a distribution or the amount you would have to replace to have a complete rollover.

Additional 10 Percent Tax If You Are Under Age 59 ½: If you receive a payment before you reach age 59 1/2 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 percent of the taxable portion of the payment. The additional 10 percent 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 an approved 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 percent tax.

The additional 10 percent tax will not apply to distributions from a governmental 457 plan, except when a distribution is attributable to an amount you rolled over to that plan (adjusted for investment returns) from another type of eligible employer plan or IRA. Any amount rolled over from a governmental 457 plan to another type of eligible employer plan or to a traditional IRA will become subject to the additional 10 percent tax if it is distributed to you before you reach age 59 1/2, unless one of the exceptions applies.

Qualified Public Safety Officers: If you are a qualified public safety officer who terminates employment in the calendar year in which you are age 50 or older, and receive an eligible rollover distribution, you are not required to pay the additional 10% tax on a payment that is eligible for rollover and is paid to you. You are a qualified public safety officer if you are "an individual serving a public agency (including state and local governments, departments, agencies and instrumentalities) in an official capacity, with or without compensation, as a law enforcement officer, as a firefighter, as a chaplain, or as a member of a rescue squad or ambulance crew."

Special Tax Treatment If You Were Born Before January 1, 1936: If you receive a payment from a plan qualified under section 401(a) or 403(a) annuity plan that can be rolled over under Part I and you do not roll it over to a traditional IRA or an eligible employer plan, the payment 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 Plan (and certain other similar plans of the employer) that is payable to you after you have reached age 59 1/2 or because you have separated from service with your employer (or, in the case of a self-employed individual, after you have reached age 59 1/2 or have become disabled). For a payment to be treated as a lump-sum distribution, you must have been a participant in the plan 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 "Ten-year averaging" (using 1986 tax rates). Ten-year averaging often reduces the tax you owe.

Capital Gain Treatment: If you receive a lump-sum distribution and you were born before January 1, 1936 and you were a participant in the Plan before 1974, you may elect to have the part of your payment that is attributable to your pre-1974 participation in the Plan taxed as long-term capital gain at a rate of 20 percent.

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 a traditional IRA, governmental 457 plan, or 403(b) tax-sheltered annuity, you will not be able to use special tax treatment for later payments from that IRA, plan, or annuity. Also, if you roll over only a portion of 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. See IRS Form 4972 for additional information about lump-sum distributions and how you elect the special tax treatment.

IV. SPECIAL RULES FOR A ROLLOVER TO A ROTH IRA

Direct Rollover to a ROTH IRA: You may instruct the Plan to transfer your distribution directly to a Roth IRA, if you meet the following requirements:

- Your modified adjusted gross income (MAGI) must not exceed \$100,000, and if you are married, you must file joint income tax returns. Beginning in 2010, this requirement will no longer apply. You are responsible for determining if you are eligible to make a rollover to a Roth IRA.
- If you roll your distribution directly into a Roth IRA, the entire taxable portion of the rollover (amounts other than after-tax contributions), will be taxable income to you in the year of the rollover. Subsequent distributions from the Roth IRA may qualify as tax-free distributions. You should consult with a tax advisor to determine the tax consequences of future distributions from the Roth IRA.
- No income tax withholding is required for any taxable portion of your payment for which you choose a direct rollover. However, you are responsible for paying the taxes due for the year of distribution. You must have other money from which you can pay the taxes, however you may elect to have voluntary withholding apply to the taxable portion of your distribution.
- Generally, the 10% penalty tax for distribution prior to age 59 ½ does not apply to the rollover. However, it may later apply if you subsequently withdraw the money from the Roth IRA under certain circumstances.

Once rolled to a Roth IRA, you CANNOT subsequently roll your distribution to an employer plan, even if the Plan accepts designated Roth contributions.

V. SURVIVING SPOUSES, ALTERNATE PAYEES, AND OTHER BENEFICIARIES

In general, the rules summarized above that apply to payments to employees 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 an "approved domestic relations order," 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 Part II above, paid in a direct rollover to a traditional 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 a traditional IRA or to an eligible employer plan. Thus, you have the same choices as the employee. In addition, you may be able to roll the payment over to a Roth IRA if you meet the MAGI and filing status requirements under Part IV above. You may elect to treat the Roth IRA as your own or establish it in the name of the decedent with you as beneficiary.

If you are a beneficiary other than a surviving spouse or alternate payee, you may choose to have a payment that can be directly rolled over to a traditional IRA, as described in Part II above, to have the benefit paid to

you, or to a Roth IRA, if you meet the requirements under Part IV above. You may not roll over a payment that is made directly to you, nor may you choose to roll over the payment to an eligible employer plan. The IRA accepting the transfer is treated like a non-spouse inherited IRA, under which benefits must be distributed in accordance with the required minimum distribution rules. In general, distributions from the inherited IRA must either be paid to you in full within five years of the deceased participant's death or must commence within 12 months of the participant's death and be paid over your life expectancy. The benefits cannot be rolled over from the inherited IRA to any other IRA or employer plan.

As explained above, if you are a surviving spouse, an alternate payee, or another beneficiary, your payment is generally not subject to the additional 10 percent tax described in Part III above, even if you are younger than age 59 1/2.

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, as described in Part III above. 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 FEDERAL TAX INFORMATION

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 the plan administrator or a professional tax advisor before you take a payment of your benefits from your Plan. 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-FORMS.

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