Tax Information for Pension Distributions

Information for:
All Funds

This fact sheet summarizes only the federal (not state or local) tax rules that might apply to your payment. The rules described are complex and contain many conditions and exceptions that are not included in this fact sheet. Therefore, you may want to consult with a professional tax advisor before you take a payment of your benefits from your retirement account.

The New Jersey Division of Pensions & Benefits (NJDPB) cannot give tax advice. You can find more specific information on the tax treatment of payments from qualified employer plans in Internal Revenue Service (IRS) *Publication 575 – Pension and Annuity Income,* IRS *Publication 590 – Individual Retirement Arrangements,* and IRS *Publication 571 – Tax-Sheltered Annuity (403(b) Plans)*. These publications are available from your local IRS office, the IRS's website at: ***www.irs.gov,*** or by calling 1-800-TAX-FORMS.

WHAT IS A ROLLOVER?

Payments received from a retirement plan are subject to income tax for the year in which they are received. You may want to postpone paying income tax on such distributions by placing those payments in a traditional IRA or another eligible employer-sponsored retirement plan. This procedure is called a rollover. When you draw these funds out of the traditional IRA or employer plan at a later date, they will then be subject to federal and state income tax. You can also do a rollover to a Roth IRA, although you will be taxed on the amount rolled over (reduced by any after-tax amount). However, later payments from the Roth IRA that are qualified distributions will not be taxed (including earnings after a rollover). If you are under age 59 1/2 at the time of the rollover, the 10 percent additional income tax (early distribution) will not apply.

A traditional IRA does not include a SIMPLE IRA or a Coverdell Education Savings Account (formerly known as an Education IRA). Payments cannot be rolled over to these types of IRAs.

An eligible employer plan includes:

- A plan qualified under section 401(a) of the Internal Revenue Code (IRC), including a 401(k) plan, profit-sharing plan, defined benefit plan, stock bonus plan, and money purchase plan;
- A section 403(b) annuity plan or section 403(b) tax-sheltered annuity; and
- An eligible section 457(b) plan maintained by a governmental employer.

Types of Rollovers

There are two ways you may be able to receive a 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. This is known as a direct rollover.

(2) The payment can be paid to you. Payments that you accept are subject to federal tax withholding. You have the option, within 60 days of receipt, of rolling over payments that are made to you. This is known as an indirect rollover.

Direct and indirect rollovers are discussed later in this fact sheet.

TYPES OF PAYMENTS THAT CAN BE ROLLED OVER

Taxable and certain non-taxable distributions from the New Jersey State-administered retirement systems may be rolled over. These include:

- Lump-sum withdrawals of member contributions;
- Lump-sum death payments to a beneficiary; and

- Annuity payments to beneficiaries under five-year certain options.

The amount eligible for rollover is the accumulation of any before-tax and after-tax contributions to the pension plan, and all earnings on the account.

TYPES OF PAYMENTS THAT CANNOT BE ROLLED OVER

- Payments spread over long periods. You cannot roll over a taxable distribution 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 life expectancy, your lifetime and your beneficiary's lifetime or life expectancies, or a period of 10 or more years;
- 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;
- Loans treated as distributions. The amount of a pension plan loan that becomes a taxable deemed distribution because of a default cannot be rolled over; and
- Corrective distributions of contributions that exceed tax law limitations cannot be rolled over.

DIRECT ROLLOVERS

You can choose a direct rollover of all or any portion of your payment that is an eligible rollover distribution as described in the previous sections. In a direct rollover, the eligible rollover distribution is paid directly from the retirement system to an IRA or another eligible employer plan that accepts rollovers. If you choose a direct rollover, you are not taxed on a payment until you later take it out of the IRA or employer plan. In addition, no income tax withholding is required for any taxable portion of your plan benefits if you choose a direct rollover.

Direct Rollover to a Traditional IRA

You can open an IRA to receive the direct rollover. If you choose to have payment made directly to an IRA, contact the IRA sponsor (usually a financial institution) to find out how to proceed. If you are a former employee or spousal beneficiary, and you are unsure how to invest your money, you can temporarily establish an IRA to receive your payment. 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 penalty or limitation. See IRS *Publication 590 – Individual Retirement Arrangements,* for more information on traditional IRAs (including limits on how often you can roll over between IRAs).

If you are a nonspouse beneficiary, the IRA you open to receive your direct rollover will be treated as an inherited IRA. See the "A Surviving Beneficiary Other than a Spouse" section for more information.

If you roll over after-tax contributions to a traditional IRA, that money cannot later be rolled over to an employer plan.

Direct Rollover to a Roth IRA

You can roll over a payment from the retirement system 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 percent additional income tax on early distributions will not apply, unless you take the amount rolled over out of the Roth IRA 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 59 1/2 (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 percent 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.

If you are a nonspouse beneficiary, the IRA you open to receive your direct rollover will be treated as an inherited IRA. See the "A Surviving Beneficiary Other than a Spouse" section for more information.

You cannot roll over a payment from the retirement system to a designated Roth account in an employer plan.

For more information, see IRS *Publication 590 – Individual Retirement Arrangements (IRAs).* You should consult your tax advisor if you are interested in rolling over your distribution to a Roth IRA.

Direct Rollover to an Employer Plan

If you are employed by a new employer that has an employer plan, and you want a direct rollover to that plan, ask the administrator of that plan whether it will accept your rollover. An employer plan is not legally required to accept a rollover. You should also find out about any documents that are required to be completed before the receiving plan will accept a rollover.

If an employer plan accepts your rollover, the plan may restrict subsequent distributions of the rollover amount or may require your spouse's consent for any subsequent distribution. A subsequent distribution from a plan that accepts your rollover may also be subject to different tax treatment than distributions from the pension plan. Check with the administrator of the plan that is to receive your rollover prior to making the rollover.

Even if an employer 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 to roll your distribution over to an IRA or split your rollover amount between the employer plan in which you will participate and an IRA. To split your rollover payment, you must have the full amount paid to you in a single check — first do an indirect rollover of the before-tax amount to the employer plan, and then an indirect rollover of the after-tax amount to the IRA. See the "Indirect Rollovers" section.

If your new employer's plan does not accept rollovers, you can choose a direct rollover to a traditional IRA or Roth IRA. See the "Direct Rollovers" section.

Direct Rollover of a Series of Payments

If you receive eligible rollover distributions that are paid in a series of less than 10 years, your choice to make or not make a direct rollover for a payment will apply to all later payments unless you change your election. You are free to change your election for any later payments in the series. Contact your plan for further information on how to change your election.

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 retirement system. For example, if you were born before January 1, 1936, you might be entitled to 10-year averaging or capital gain treatment. 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.

Special Rules for After-Tax Contributions

After-tax contributions included in a payment are not taxed. If a payment is only part of your benefit, an allocable portion of your after-tax contributions is generally included in the payment.

You may roll over to an IRA a payment that includes after-tax contributions through either a direct rollover or a 60-day indirect 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 do a direct rollover of only a portion of the amount paid from the pension fund and a portion is paid to you, each of the payments will include an allocable portion of the after-tax contributions. If you do 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.

Example: *You receive a complete distribution of your benefit that 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 60-day rollover, no amount is taxable because the $2,000 not rolled over is treated as being after-tax contributions.*

You may roll over to an employer plan all of a payment that includes after-tax contributions, but only through a direct rollover (and only if the receiving plan separately accounts for after-tax contributions and is not a governmental section 457(b) plan). You can do a 60-day rollover to an employer plan of part of a payment that includes after-tax contributions, but only up to the amount of the payment that would be taxable if not rolled over.

Qualified Voluntary Employee Contributions

In addition to before-tax and after-tax salary deductions for the regular retirement system, some employees had salary deductions for an optional Qualified Voluntary Employee Contribution (QVEC) plan. Benefit payments made from a QVEC plan under one of the payment options listed above are eligible for rollover to an IRA, but not to an employer-sponsored retirement plan. Federal income tax withheld from QVEC distributions is optional; you either elect to have tax withheld or not. The applicable tax is calculated using the prescribed IRS tax rates.

SPECIAL TAX RULES THAT APPLY IF THE PAYMENT IS MADE DIRECTLY TO YOU

If you have the payment made to you, the taxable portion is subject to 20 percent federal income tax withholding. The taxable distribution is taxed in the year you receive it unless, within 60 days, you roll it over to an IRA or another eligible employer plan that accepts rollovers. See the "Indirect Rollovers" section. If you do not roll it over, special tax rules may apply.

Mandatory Withholding

If any portion of the payment to you is an eligible rollover distribution, the retirement system is required by law to withhold 20 percent of the amount. This amount is sent to the IRS as income tax withholding.

Example: *If your eligible rollover distribution is $10,000, only $8,000 will be paid to you because the retirement system must withhold $2,000 as income tax. When you prepare your income tax return for the year, you will report the full $10,000 as a payment from the retirement system. You will report the $2,000 as tax withheld and it will be credited against any income tax you owe for the year.*

You may determine the taxable amount of any withdrawal you make by calling the Office of Client Services' Automated Information System at (609) 292-7524.

Voluntary Withholding

If any portion of your payment is not an eligible rollover distribution and is taxable (such as a death benefit payment to an estate), the mandatory withholding rules described above do not apply. In this case, you may elect to not have the withholding apply to that portion. To elect out of withholding, you must complete a withholding certificate. If you do not complete this form, 10 percent tax will be withheld.

INDIRECT ROLLOVERS

If you have an eligible rollover distribution paid to you, you can still decide to roll over all or part of it to an IRA or another eligible employer plan that accepts rollovers — this is known as an indirect rollover. You must make the rollover within 60 days of the date you receive the payment. Once rolled over, the rollover amount will not be taxed until you take it out of 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 tax withholding. 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 eligible employer plan to replace 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 eligible rollover plan. To do this, you roll over the $8,000 you received from the retirement system and you add $2,000 from other sources (e.g., 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. When you file your income tax return, you report the $2,000 of tax withheld. Alternatively, if you roll over only $8,000, the $2,000 not rolled 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.*

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).*

Note: The indirect rollover option is not available to you if you are a nonspouse beneficiary.

EARLY WITHDRAWAL PENALTIES FOR TAXABLE DISTRIBUTIONS MADE TO YOU

If you receive a payment before you reach age 59 1/2 and you do not roll it over, in addition to the regular income tax, you may have to pay an extra tax equal to 10 percent of the taxable portion of any payment. This does not apply if the payment is:

- Paid to you because you separate from employment with your employer during or after the year you reach age 55;
- Paid to you because you retire due to disability;
- Paid to you as equal (or almost equal) payments over your life or life expectancy (or the lives or joint life expectancy of you and your beneficiary);
- Paid to your beneficiary after your death;
- Used to pay certain medical expenses and does not exceed the amount of your deductible medical expenses;
- Paid directly to the government to satisfy a federal tax levy;
- Paid to an alternate payee under a qualified domestic relations order (QDRO);
- Paid to a public safety employee who has separated from service after attaining age 50; or
- Paid to you as a corrective distribution of contributions that exceed tax law limitations.

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 to the extent the 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 previously listed applies.

If you do a rollover to an IRA and receive a payment from the IRA when you are under age 59 1/2, you will have to pay the 10 percent additional income tax on early distributions from the IRA, unless an exception applies. In general, the exceptions to the 10 percent 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 QDROs 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; and
- 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).

OTHER SPECIAL TAX TREATMENTS

If your distribution is not rolled over, it will be taxed in the year of receipt. If it 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 retirement system that is payable to you because you have reached age 59 1/2 or have separated from service with your employer. For a payment to qualify as a lump-sum distribution, you must have been a participant in the retirement system for at least five years. The special tax treatment for lump-sum distributions is described below.

If You Were Born Before January 1, 1936

If you were born on or before January 1, 1936, and receive a lump-sum distribution that you do not roll over, special rules for calculating the amount of the tax on the payment might apply to you. For more information, see IRS *Publication 575 – Pension and Annuity Income.*

WHO IS AFFECTED BY THESE TAX RULES?

In general, the rules summarized above apply to payments to employees, surviving spouses of employees, nonspouse beneficiaries, and to spouses or former spouses who are alternate payees. You are an alternate payee if your interest in the retirement system results from a QDRO issued by a court, usually in connection with a divorce or legal separation.

Surviving Spouse

If you receive a payment from the retirement system as the surviving spouse of a deceased member, you have the same rollover options that the member would have had, as described elsewhere in this fact sheet. In addition, if you choose to do a rollover to an IRA, you may treat the IRA as your own or as an inherited IRA.

An IRA you treat as your own is treated like any other IRA of yours, so that payments made to you before you are age 59 1/2 will be subject to the 10 percent additional income tax on early distributions (unless an exception applies) and required minimum distributions from your IRA do not have to start until after you are age 70 1/2.

If you treat the IRA as an inherited IRA, payments from the IRA will not be subject to the 10 percent additional income tax on early distributions. However, if the member had started taking required minimum distributions, you will have to receive required minimum distributions from the inherited IRA. If the member had not started taking required minimum distributions from the retirement system, you will not have to start receiving required minimum distributions from the inherited IRA until the year the member would have been age 70 1/2.

A Surviving Beneficiary Other Than a Spouse

If you receive a payment from the retirement system because of the member's death and you are a designated beneficiary other than a surviving spouse, the only rollover option you have is a direct rollover to an inherited IRA. Payments from the inherited IRA will not be subject to the 10 percent additional income tax on early distributions. You will have to receive required minimum distributions from the inherited IRA.

Qualified Domestic Relations Order

If you are the spouse or former spouse of the member who receives a payment from the retirement system under a QDRO, you generally have the same options the member would have. For example, you may roll over the payment to your own IRA or an eligible employer plan that will accept it. If you are an alternate payee other than the spouse or former spouse of the member, you only have the option to do a direct rollover to an inherited IRA. Payments under the QDRO will not be subject to the 10 percent additional income tax on early distributions.

HOW AN OUTSTANDING LOAN BALANCE AFFECTS YOUR DISTRIBUTION

If you have an outstanding loan from the retirement system, your benefit may be offset by the amount of the loan, typically when your employment ends. Unless you do a 60-day rollover in the amount of the loan offset to an IRA or employer plan, the loan offset amount is treated as a distribution to you at the time of the offset and will be taxed, including the 10 percent additional income tax on early distributions, unless an exception applies.

RULES FOR ARMED FORCES

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.*

NOTICE PERIOD

Generally, payment cannot be made from the retirement system until at least 30 days after you receive notice. Thus, you have at least 30 days to consider whether or not to have your payment 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 payment will then be processed in accordance with your election as soon as practical after it is received by the NJDPB.

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New Jersey Division of Pensions & Benefits
P.O. Box 295, Trenton, NJ 08625-0295

(609) 292-7524
For the hearing impaired: TRS 711 (609) 292-6683
www.nj.gov/treasury/pensions