Special Tax Notice Regarding Rollovers, RI 37-22

This notice contains important Federal income tax and other information you will need before you decide how to receive your lump-sum payment from the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). To be of service to our customers, the Office of Personnel Management has worked with the Internal Revenue Service to present a general explanation of how P.L. 102-318 affects those who receive our benefits. However, the IRS remains the authority on tax matters and questions. Requests for additional or clarifying information should be directed to them. The official tax publications that govern how benefits are taxed are referenced at the end of this notice. OPM does not stock IRS publications. We cannot provide official tax information nor can we advise individuals on tax matters. The following discussion applies to the **taxable** portion of your lump-sum payment.

Summary

A taxable payment from the Office of Personnel Management (OPM) that is eligible for "rollover" can be paid in one of two ways. You can have **all or any part** of your payment either (1) paid in a "direct rollover" or (2) paid to you. A rollover is a payment of the taxable portion of your CSRS or FERS benefit to your individual retirement arrangement (IRA) or to another employer retirement plan. This choice will affect the tax you owe.

If you choose a **direct rollover** of the taxable portion --

- Your payment will not be taxable income in the year it is paid, and no income tax will be withheld.

- Your payment will be made directly to your IRA or, if you choose, to another employer retirement plan that accepts your rollover.

- Your payment will be taxable income later when you take it out of the IRA or the employer retirement plan.

If you choose to have the taxable portion of your benefit **paid to you** --

- You will receive only 80 percent of the payment, because OPM is required to withhold 20 percent of the payment and send it to the Internal Revenue Service as income tax withholding to be credited against your taxes.

- Your payment will be taxed in the year it is paid 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 59-1/2, you also may have to pay an additional 10 percent tax.

- You can roll over the payment by paying it to your IRA or to another employer retirement 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 IRA or employer retirement plan.

- If you want to roll over 100 percent of the payment to an IRA or an employer retirement plan, you must find other money to replace the 20 percent that was withheld. We cannot refund the 20 percent once it has been withheld. If you roll over only the 80 percent you receive, you will be taxed on the 20 percent that was withheld and that is not rolled over.

MORE INFORMATION

I. PAYMENTS THAT CAN AND CANNOT BE ROLLED OVER

Certain payments from the OPM are "eligible rollover distributions." This means they can be rolled over to an IRA or to another employer retirement plan that accepts rollovers. In general, only the "taxable portion" of your payment is an eligible rollover distribution. Information on the portion of your payment that is eligible for rollover is enclosed. The following types of payments cannot be rolled over:

Non-taxable Payments. In general, the nontaxable portion of your payment is not an eligible rollover distribution. If you have made "after-tax" employee contributions, these contributions will be non-taxable when they are paid to you, and they cannot be rolled over. (After-tax employee contributions generally are contributions you made from your own pay that was already taxed.)

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.

Required Minimum Payments. Beginning in the year you reach age 70-1/2, a certain portion of your payment cannot be rolled over because it is a "required minimum payment" that must be paid to you. **You must compute and exclude this amount from a direct rollover if you will be age 70-1/2 or older when the payment is made.**

II. DIRECT ROLLOVER

You can choose a direct rollover of all or any portion of your payment that is an "eligible rollover distribution" as described above. In a direct rollover, the eligible rollover distribution is paid directly from OPM to an IRA or another employer retirement plan that accepts rollovers (or is sent to you in a check made payable to the IRA or other retirement plan). If you choose a direct rollover, you are not taxed on a payment until you later take it out of the IRA or the employer retirement plan. OPM will not pay a direct rollover or withhold tax on taxable payments under $200, but recipients themselves may roll over such payments tax free within 60 days after receipt. The minimum direct rollover amount is $500 if you designate part of your payment as a direct rollover with the remainder payable to you. OPM will pay a direct rollover to only one IRA or retirement plan at any one time.

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 payment 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. See IRS Publication 590, Individual Retirement Arrangements, for more information on IRA's (including limits on how often you can roll over between IRA's).

Direct Rollover to an Employer Retirement Plan. If you are employed by a new employer that has a retirement plan and you want a direct rollover to that plan, ask the administrator of that plan whether it will accept your rollover. An employer retirement plan is not legally required to accept a rollover. If your new employer's retirement plan does not accept a rollover, you can choose a direct rollover to an IRA.

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 in the series unless you change your election. You are free to change your election for any later payment in the series by contacting OPM.

III. PAYMENT PAID TO YOU

If you have the payment made to you, it is subject to 20 percent Federal income tax withholding. The payment is taxed in the year you receive it unless, within 60 days after receiving it, you roll it over to an IRA or another plan that accepts rollovers. If you do not roll it over, special tax rules apply.

Mandatory Federal Income Tax Withholding. If any portion of the payment to you is an eligible rollover distribution, OPM 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 OPM 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 OPM. 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 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 employer retirement plan that accepts rollovers. If you decide to roll it over, you must make the rollover 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 IRA or the employer retirement 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 retirement 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 employer retirement plan. To do this, you roll over the $8,000 you received from OPM, 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 retirement 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.

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 tax refund is likely to be larger if you roll over the entire $10,000.)

Additional 10 Percent Tax If You Are Under Age 59-1/2. If you receive a payment before you reach age 59-1/2 and you do not roll it over, the, 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 does not apply to your payment if it is (1) paid to you because you separate from service with your employing agency during or after the year you reach age 55, (2) paid because you retire due to disability (as determined by IRS), (3) paid to you as equal (or almost equal) payments over your life or life expectancy (or your and your beneficiary's lives of life expectancies), or (4) used to pay certain medical expenses. See IRS Form 5329, Return for Additional Taxes…, 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 within 1 year, of your entire balance under CSRS or FERS that is payable to you because you have separated from service with your agency. For a payment to qualify as a lump-sum distribution, you must have been a participant under CSRS or FERS for at least 5 years. The special tax treatment for lump-sum distributions is described below.

Five-Year Averaging. If you receive a lump sum distribution after you are age 59-1/2, you may be able to make a one-time election to figure the tax on the payment by using "5-year averaging." Five-year averaging often reduces the tax you owe because it treats the payment much as if it were paid over 5 years.

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 "10-year averaging" (using 1986 tax rates) instead of 5-year averaging (using current tax rates). Like the 5-year averaging rules, 10-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 under CSRS or FERS (if any) 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. If you have previously rolled over a payment from OPM, you cannot use this special tax treatment for later payments from OPM. If you roll over your payment to an IRA, you will not be able to use this special tax treatment for later payments from the IRA. Also, if you roll over only a portion of your payment to an IRA, 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 you elect the special tax treatment.

IV. 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 benefit results from an order issued by a court, usually in connection with a divorce or legal separation. Some of the rules summarized above also apply to a deceased employee's beneficiary who is not a spouse. However, some exceptions for payments to surviving spouses, alternate payees, and other beneficiaries should be mentioned.

If you are a surviving spouse, you may choose to have an eligible rollover distribution paid in a direct rollover to an IRA or paid to you. If you have the payment paid to you, you can keep it or roll it over yourself to an IRA, but you cannot roll it over to an employer retirement plan. If you are an alternate payee, you have the same choices as the employee. Thus, you can have the payment paid as a direct rollover or paid to you. If you have it paid to you, you can keep it or roll it over yourself to an IRA or to another employer retirement plan that accepts rollovers. If you are a beneficiary other than a surviving spouse or alternate payee, you cannot choose a direct rollover, and you cannot roll over the payment yourself.

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 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 section 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 5 years of service under CSRS or FERS.

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 above 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 OPM. Also, you can find more specific information on the tax treatment of payments from qualified retirement plans in IRS Publication 575, Pension and Annuity Income, IRS Publication 590, Individual Retirement Arrangements, and IRS Publication 721, Tax Guide to U.S. Civil Service Retirement Benefits. These publications are available from your local IRS office or by calling 1-800-TAX-FORMS or on the IRS website at www.irs.gov.