

M E M O R A N D U M

TO: KPERs Designated Agents

FROM: Joan Hancock, General Counsel
Laurie McKinnon, Assistant General Counsel

DATE: June 14, 2001

RE: Rollovers / New Partial Lump Sum Option

A Partial Lump Sum Option (PLSO) becomes available for KPERs retirants whose retirement date is on or after July 1, 2001. As a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836), there are different rules which apply to a retirant's ability to rollover a KPERs PLSO distribution that is an eligible rollover distribution, depending on when the distribution is made. The new federal tax law eases a number of the current restrictions regarding rollovers. However, the new tax law only applies to distributions made on or after January 1, 2002. Distributions made before January 1, 2002 are still subject to current law. This memorandum will address certain considerations which are applicable to PLSO distributions under both current law and the new federal tax law.

• **TAXABLE/NONTAXABLE BASIS RECOVERY**

Current law applies to any PLSO distribution made before January 1, 2002. Under current law, only the taxable portion of the lump-sum distribution available under KPERs' new PLSO is considered an "eligible rollover distribution." Thus, a determination must be made as to the taxable portion of a rollover distribution.

First, note that the PLSO will be subject to the same initial tax analysis as any KPERs retirement distribution—that is, the taxable and nontaxable portions of the benefit will be identified. The portion that is attributable to a member's post-tax contributions is not taxable upon distribution and may not be rolled over prior to January 1, 2002. Federal tax law prescribes the methodology for calculating the nontaxable basis. A pro-rata share of the nontaxable portion will be allocated to the PLSO. For example, if a person elects the PLSO at 20% of the actuarial present value of the lifetime benefit, then 20% of the nontaxable basis of the benefit will be allocated to the PLSO. Only the portion of the PLSO that would otherwise be taxable upon distribution is an eligible rollover distribution under current law. For example:

- Member J. Doe elects a 20% PLSO distribution.
- Because Doe is entitled to a lifetime pension with an actuarial present value of \$100,000, Doe's PLSO distribution will be \$20,000 (20% of \$100,000).
- Doe had \$1,000 in post-tax contributions to KPERs (that is, either pre-7/1/84 payroll-deduction contributions, or a lump-sum service purchase at any time with post-tax dollars, or a combination of both).
- Of his PLSO, Doe may roll over $\$20,000 - (.20 \times \$1,000) = \$20,000 - \$200 = \$19,800$.
- \$19,800 is Doe's "eligible rollover distribution."

Under the new federal tax law applicable to any PLSO distribution made on and after January 1, 2002, the above requirement that only the taxable portion of a distribution may be rolled over does not apply in certain circumstances. Under the new law, that portion of a distribution from a qualified plan that is nontaxable (*i.e.*, the after-tax employee contributions) may be rolled over to (1) a traditional IRA, or (2) another qualified trust which is a part of a plan which is a defined contribution plan, if made by a

direct rollover and if the plan provides separate accounting for the after-tax contributions and earnings thereon.

Finally, please note that the analysis with regard to determining the taxable and nontaxable portions of the PLSO has not been changed by the new federal tax law.

- **IRS REQUIREMENTS FOR EXEMPTING ELIGIBLE ROLLOVER DISTRIBUTIONS FROM CURRENT TAXATION.**

KPERS is an exempt trust under federal law, because it is a qualified plan under section 401(a) of the Internal Revenue Code ("IRC") (Determination Letters dated 10/19/99 and 3/5/01). IRC § 402 provides that an eligible rollover distribution ("ERD") from an exempt trust may be excluded from income if it is rolled over to an eligible retirement plan. Further, if directly rolled over to an eligible retirement plan, the ERD is not subject to otherwise-mandated federal income tax withholding.

Distributions before January 1, 2002. Under current law, IRC § 402 provides that an eligible retirement plan means:

- An Individual Retirement Account under § 408(a).
- An Individual Retirement Annuity under § 408(b).
- A qualified trust under § 401(a).
- An annuity plan under § 403(a).

Distributions on or after January 1, 2002: The new federal tax law retains the above list of eligible retirement plans and adds to the list of eligible retirement plans: 457 governmental deferred compensation plans and 403(b) tax-sheltered annuities. Thus, under the new law, eligible rollover distributions from qualified retirement plans, section 403(b) tax-sheltered annuities, and section 457 plans generally may be rolled over to any of these plans or arrangements. Such distributions may continue to be rolled over to an individual retirement account under § 408(a) or an individual retirement annuity under § 408(b). However, a distribution from a qualified plan is not eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under current law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over, the rollover would have to be made to a "conduit IRA" as under present law, and then rolled back into a qualified plan. Please refer to the questions and answers below for more specific information on rollover options.

- **THE FOLLOWING RELATED QUESTIONS HAVE BEEN RAISED, TO WHICH THE ANSWERS ARE PROVIDED BELOW:**

- (1) May a KPERS PLSO be rolled over to the member's section 457 deferred compensation account?

Distributions before January 1, 2002: No. Under current federal law, no distribution from KPERS may be rolled over to a section 457 deferred compensation account.

Distributions on or after January 1, 2002: Yes. Under the new tax law, an eligible rollover distribution from KPERS may be rolled over to a section 457 deferred compensation account. However, only the taxable portion of this distribution could be rolled over to a 457 plan.

- (2) May a KPERS PLSO be rolled over to the member's section 403(b) Tax Sheltered Annuity ("TSA") account?

Distributions before January 1, 2002. No. Under current federal law, no distribution from KPERS may be rolled over to a section 403(b) TSA.

Distributions on or after January 1, 2002. Yes. Under the new tax law, an eligible rollover distribution from KPERS may be rolled over to a section 403(b) TSA. However, only the taxable portion of this distribution could be rolled over to a 403(b) annuity.

- (3) May a KPERS PLSO be rolled over to the member's Board of Regents Retirement Plan Account?

Distributions before January 1, 2002: No. Because the Board of Regents Retirement Plan is a 403(b) plan, under current federal law, no distribution from KPERS may be rolled over to the Board of Regents Retirement Plan.

Distributions on or after January 1, 2002. Yes. The Board of Regents Retirement Plan is a 403(b) plan and, therefore, would be treated the same as any other 403(b) annuity under the new tax law—i.e., an eligible rollover distribution (but including only the taxable portion) could be rolled over into the Board of Regents Retirement Plan.

- (4) May a KPERS PLSO be rolled over to a 401(k) plan maintained by another employer?

Distributions before January 1, 2002: Yes. The taxable portion of the PLSO may be rolled over because a 401(k) plan is an exempt trust under IRC § 401(a).

Distributions on or after January 1, 2002: Yes. The taxable portion of the PLSO may still be rolled over to a 401(k) plan and, if the plan so provides, the nontaxable portion of the PLSO may also be rolled over.

- (5) May a KPERS PLSO be rolled over to another § 401(a) defined benefit plan?

Distributions before January 1, 2002. Yes. The taxable portion of the PLSO may be rolled over if the plan will accept a rollover. **Note:** The Internal Revenue Code does not require a qualified plan, 403(b) plan or 457 plan to accept a rollover payment, but a defined benefit plan may be more likely not to accept a rollover. KPERS accepts rollovers in payment of service-credit purchases. Other defined benefit plans may or may not accept a rollover distribution from KPERS.

Distributions on or after January 1, 2002: Yes. If the plan will accept a rollover. The new tax law still does not require a qualified plan, 403(b) plan or a 457 plan to accept rollovers. Further, we believe that, without IRS clarification, the nontaxable portion of a distribution could not be rolled over to a defined benefit plan—H.R. 1836 specifically provides for nontaxable portions to be rolled over only to a qualified defined contribution plan or a traditional IRA, as noted above. However, the conference committee report is more general and speaks in general terms of qualified plans. Thus, IRS guidance may liberalize this Code amendment.

- (6) May a KPERS PLSO be rolled over to an IRA?

Distributions before January 1, 2002. Yes. The taxable portion of a KPERS PLSO may be rolled over to a traditional IRA (including a conduit IRA), but that does not include a Roth IRA, SIMPLE IRA, or education IRA.

Distributions on or after January 1, 2002: Yes. The taxable portion of the PLSO may still be rolled over to a traditional IRA (including a conduit IRA), but it still may not be rolled over to a Roth IRA, SIMPLE IRA, or education IRA. However, under the new tax law, the nontaxable portion of the distribution could also be rolled over to a traditional IRA.

- (7) What forms does KPERS require in order to process a request for a direct rollover?

KPERS requires the member to elect the direct rollover by checking the correct box in section 2 of Part C of the KPERS-15, *Application for Retirement Benefits*, and to fully complete and execute all required portions of the KPERS-15.

In addition, KPERS requires completion of the KPERS-13/15R, *Rollover Verification*, by the member and the receiving rollover institution (see "eligible retirement plan" as described above).

Both the KPERS-15, *Application for Retirement Benefits*, and KPERS-13/15, *Rollover Verification*, are available on-line at www.kpers.org (click on Forms & Publications). 825125.1