



STATE OF HAWAII EMPLOYEES' RETIREMENT SYSTEM

SPECIAL TAX NOTICE REGARDING ROLLOVER OPTIONS

You are receiving this notice because all or a portion of a payment you are eligible to receive from the Employees' Retirement System of the State of Hawaii (the "ERS") may be rolled over to an IRA or an employer plan. This notice is intended to help you decide whether to do such a rollover.

Rules that apply to most payments that are eligible for rollover are described in the "General Information About Rollovers" section. Special rules that only apply in certain circumstances are described in the "Special Rules and Options" section.

GENERAL INFORMATION ABOUT ROLLOVERS

What part of my benefits may I roll over?

Most payments from the ERS are not eligible for rollover. For example, monthly annuity payments and required minimum distributions after age 70½ (or after your death) are not eligible for rollover. You should complete IRS Form W-4P, "Withholding Certificate for Pension or Annuity Payments," to elect the federal income tax withholding that will apply to monthly annuity payments.

Generally, the only payments from the ERS that are eligible for rollover are: (1) one-time payments that represent a refund or partial refund of your own contributions (e.g., a refund or partial refund of your accumulated contributions or a distribution of your hypothetical account balance), (2) one-time payments made in connection with ordinary death benefits for Contributory Plan members, and (3) lump-sum death benefits paid to a member's beneficiary as part of retirement Option 1.

The ERS can tell you whether a payment is eligible for rollover.

How can a rollover affect my taxes?

You will be subject to federal income tax on any distribution that is eligible for rollover if you do not roll it over. If you are under age 59½ and do not do a rollover, you will also have to pay a 10% additional income tax on early distributions (unless an exception applies). However, if you do a rollover, you will not have to pay tax until you receive payments later, and the 10% additional income tax will not apply if those payments are made after you are age 59½ (or if an exception applies).

Where may I roll over the payment?

You may roll over the payment to either an IRA (an individual retirement account or individual retirement annuity) or an employer plan (a tax-qualified plan, such as a profit-sharing or 401(k) plan, a section 403(b) plan, or a governmental section 457(b) plan) that will accept the rollover. The rules of

the IRA or employer plan that holds the rollover will determine your investment options, fees, and rights to payment from the IRA or employer plan (for example, no spousal consent rules apply to IRAs, and IRAs may not provide loans). Further, the amount rolled over will become subject to the tax rules that apply to the IRA or employer plan.

How do I do a rollover?

There are two ways to do a rollover. You can do either a direct rollover or a 60-day rollover.

If you do a direct rollover, the ERS will make the payment directly to your IRA or an employer plan. You should contact the IRA sponsor (usually a financial institution) or the administrator of the employer plan for information on how to do a direct rollover. Also, you must complete the enclosed Form EC&B-123B.

If you do not do a direct rollover, you may still do a rollover by making a deposit into an IRA or eligible employer plan that will accept it. You will have 60 days after you receive the payment to make the deposit. If you do not do a direct rollover, the ERS is required to withhold 20% of the payment for federal income taxes. This means that, in order to roll over the entire payment in a 60-day rollover, you must use other funds to make up for the 20% withheld. If you do not roll over the entire amount of the payment, the portion not rolled over will be taxed and will be subject to the 10% additional income tax on early distributions if you are under age 59½ (unless an exception applies).

If I don't do a rollover, will I have to pay the 10% additional income tax on early distributions?

If you are under age 59½, you will have to pay the 10% additional income tax on early distributions for any payment from the ERS (including amounts withheld for income tax) that you do not roll over, unless one of the exceptions listed below applies. This tax is in addition to the regular income tax on the payment not rolled over.

The 10% additional income tax does not apply to the following payments from the ERS:

- Payments made after you separate from service if you will be at least age 55 in the year of the separation.
- Payments that start after you separate from service if paid at least annually in equal or close to equal amounts over your life or life expectancy (or the lives or joint life expectancy of you and your beneficiary) (e.g., monthly annuity payments).
- Payments made after you separate from service if you are a public safety employee and you are at least age 50 in the year of the separation. (Generally, for this purpose, a “public safety employee” is a State or County employee who provides police protection, firefighting services, or emergency medical services.)
- Payments made due to disability.
- Payments after your death.
- Corrective distributions of contributions that exceed tax law limitations.
- Payments made directly to the federal government to satisfy a federal tax levy.
- Payments up to the amount of your deductible medical expenses.

If I do a rollover to an IRA, will the 10% additional income tax apply to early distributions from the IRA?

If you receive a payment from an IRA when you are under age 59½, you will have to pay the 10% additional income tax on early distributions from the IRA, unless an exception applies. In general, the exceptions to the 10% additional income tax for early distributions from an IRA are the same as the exceptions listed above for early distributions from the ERS. 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 (or after age 50 if you are a public safety employee).
- 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.
- There is an exception for certain payments made while you are on active duty if you were a member of a reserve component called to duty after September 11, 2001, for more than 179 days.
- 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).

Will I owe State income taxes?

As of December 31, 2009, distributions from the ERS are not subject to State of Hawaii income tax. However, the laws affecting the taxation of distributions may change. Please consult with a qualified tax advisor prior to completing your retirement election forms.

If you are a resident of or domiciled in another state, you should consult the tax authorities in that state as to the state income taxation of your pension benefits.

SPECIAL RULES AND OPTIONS

If your payment includes 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. If you have pre-1987 after-tax contributions maintained in a separate account, a special rule may apply to determine whether the after-tax contributions are included in a payment.

You may roll over to an IRA a payment that includes after-tax contributions through either a direct rollover or a 60-day 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). You should consult with your own tax advisor regarding rollovers of after-tax amounts and distributions of after-tax amounts in connection with rollovers of pre-tax amounts.

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.

If you miss the 60-day rollover deadline

Generally, the 60-day rollover deadline cannot be extended. However, the IRS has 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 submit a private letter ruling request to 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).

If you were born on or 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.

If you roll over your payment to a Roth IRA

You can roll over a payment from the ERS to a Roth IRA. Prior to January 1, 2010, you could make a rollover to a Roth IRA only if your modified adjusted gross income was not more than \$100,000 for the year the payment was made to you and, if you were married, you filed a joint return. These limitations do not apply to payments made to you from the ERS after 2009.

If you roll over the payment 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% additional income tax on early distributions will not apply (unless you take the amount rolled over out of the Roth IRA within 5 years, counting from January 1 of the year of the rollover). For payments from the ERS during 2010 that are rolled over to a Roth IRA, the taxable amount can be spread over a 2-year period starting in 2011.

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 59½ (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 5 years. In applying this 5-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% 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. For more information, see IRS Publication 590, Individual Retirement Arrangements (IRAs).

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

If you are not an ERS member

Payments after death of the member. If you receive a distribution after the member's death that you do not roll over, the distribution will generally be taxed in the same manner described elsewhere in this notice. However, the 10% additional income tax on early distributions does not apply, and the special rule described under the section "If you were born on or before January 1, 1936" applies only if the member was born on or before January 1, 1936.

If you are a surviving spouse. If you receive a payment from the ERS 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 notice. 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 59½ will be subject to the 10% 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 70½.

If you treat the IRA as an inherited IRA, payments from the IRA will not be subject to the 10% 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 ERS, you will not have to start receiving required minimum distributions from the inherited IRA until the year the member would have been age 70½.

If you are a surviving beneficiary other than a spouse. Effective July 1, 2010, if you receive a payment from the ERS because of the member's death and you are a designated beneficiary other than a surviving spouse, you will be able to do a direct rollover to an inherited IRA. This is the only rollover option that you will have. Payments from the inherited IRA will not be subject to the 10% additional income tax on early distributions. You will have to receive required minimum distributions from the inherited IRA.

If you are a nonresident alien

If you are a nonresident alien and you do not do a direct rollover to a U.S. IRA or U.S. employer plan, instead of withholding 20%, the ERS is generally required to withhold 30% of the payment for federal income taxes. If the amount withheld exceeds the amount of tax you owe (as may happen if you do a 60-day rollover), you may request an income tax refund by filing Form 1040NR and attaching your Form 1042-S. See Form W-8BEN for claiming that you are entitled to a reduced rate of withholding under an income tax treaty. For more information, see also IRS Publication 519, U.S. Tax Guide for Aliens, and IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities.

Other special rules

If a payment is one in a series of payments for less than 10 years, your choice whether to make a direct rollover will apply to all later payments in the series (unless you make a different choice for later payments).

If your payments for the year are less than \$200 (not including payments from a designated Roth account in the ERS), the ERS is not required to allow you to do a direct rollover and is not required to withhold for federal income taxes. However, you may do a 60-day rollover.

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.

FOR MORE INFORMATION

The ERS encourages you to consult a professional tax advisor before taking a payment from the ERS. Also, you can find more detailed information on the federal tax treatment of payments from employer plans in: IRS Publication 575, Pension and Annuity Income; IRS Publication 590, Individual Retirement Arrangements (IRAs); and IRS Publication 571, Tax-Sheltered Annuity Plans (403(b) Plans). These publications are available from a local IRS office, on the web at www.irs.gov, or by calling 1-800-TAX-FORM.