DIRECTIVE

Subject: *Bailey v. State of North Carolina; Emory v. State of North Carolina; Patton v. State of North Carolina*
Tax: Individual Income Tax
Law: G.S. 105-134.5 and G.S. 105-134.6
Issued By: Personal Taxes Division
Date: June 30, 2003
Number: PD-03-1 **(Important Note: this Directive has been replaced by Directive PD-04-1.)**

This Directive supplements previous Directives on this subject and addresses the consequences of rollover distributions from a qualifying tax-exempt *Bailey* retirement account. It also addresses the consequences of rolling over amounts from other retirement plans or IRAs into a qualifying tax-exempt *Bailey* retirement account. If you have any questions about this Directive, you may call the Personal Taxes Division of the North Carolina Department of Revenue at (919) 733-3565. You may also write to the Division at P.O. Box 871, Raleigh, North Carolina 27602-0871.

The information contained in this Directive is based on the rationale used by Superior Court Judge Jack A. Thompson in his Order Regarding the Optional Retirement Program for State Institutions of Higher Education, which he signed on November 19, 1999. This Order addressed when a participant in the Optional Retirement Program (ORP) is vested and how to determine the portion of the retirement benefits in the ORP that are subject to future income tax exemption under the *Bailey* settlement. Directive PD-00-1 explains Judge Thompson's Order in detail. The Department's position in this Directive is also consistent with the treatment of distributions from the Thrift Savings Plan when a participant in the Plan was "vested" in the employee component but not in the employer fixed percentage component as of August 12, 1989. Information regarding the treatment of distributions from the Thrift Savings Plan is contained in Directive PD-99-2.

The Economic Growth and Tax Relief Reconciliation Act of 2001

On June 7, 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). This Act made numerous changes with respect to pension portability. In general, beginning in 2002, distributions from most types of retirement plans may be rolled over into another retirement plan or into an IRA.

Because of the increase in rollover flexibility, especially for governmental §457 plans, the Department has issued this Directive to address the impact rollovers have on the tax-exempt status of State, local, and federal governmental retirement plans that qualify under the *Bailey* settlement.

Rollover Distributions From a Qualifying Tax-Exempt *Bailey* Retirement Account

Under the *Bailey* settlement, State, local, and federal governmental employees and retirees who were "vested" in a qualifying retirement system as of August 12, 1989 do not pay North Carolina income tax on their retirement benefits in future years. This means that retirement benefits are exempt from North Carolina income tax if the benefits are distributed from a qualifying *Bailey* retirement account in which the employee/retiree was "vested" as of August 12, 1989. If the employee/retiree rolls over any of the qualifying tax-exempt benefits into another retirement plan, the benefits retain their tax-exempt status **only** if the retirement plan into which the benefits are rolled over is also a qualifying *Bailey* retirement account in which the employee/retiree was "vested" as of August 12, 1989. Rollovers to IRAs will always result in a loss of the tax-exempt status since IRAs do not qualify under the *Bailey* settlement.

> *Example:* *Taxpayer A was "vested " in both the State's Deferred Compensation Plan (§ 457 plan) and the State's Supplemental Retirement Income Plan (§ 401(k) plan) as of August 12, 1989. In 2002, Taxpayer A elected to roll over the balance in his Deferred Compensation account into his Supplemental Retirement Income account. Future distributions from Taxpayer A's Supplemental Retirement Income account will be exempt from North Carolina income tax.*

> *Example:* *Taxpayer B was "vested" in the State's Deferred Compensation Plan (§ 457 plan) as of August 12, 1989; however, he was not vested in the State's Supplemental Retirement Income Plan (§ 401(k) plan) as of that date. In 2002, Taxpayer B elected to roll over the balance in his Deferred Compensation account into his Supplemental Retirement Income account. Future distributions from Taxpayer B's Supplemental Retirement Income account will be subject to North Carolina income tax, except for the $4,000 deduction provided by G.S. 105-134.6(b)(6).*

> *Example:* *Taxpayer C was "vested" in the State's Deferred Compensation Plan (§ 457 plan) as of August 12, 1989. In 2002, Taxpayer C elected to roll over the balance in his Deferred Compensation account into an IRA. Future distributions from Taxpayer C's IRA will be subject to North Carolina income tax, except for the $2,000 deduction provided by G.S. 105-134.6(b)(6).*

Rollovers Into a Qualifying Tax-Exempt *Bailey* Retirement Account

Retirement plan distributions rolled over into a qualifying tax-exempt *Bailey* retirement account are tax-exempt only if they are rolled over from another qualifying tax-exempt *Bailey* retirement account.

If a qualifying tax-exempt *Bailey* retirement account includes rollover distributions from IRAs or other retirement plans (other than another qualifying tax-exempt *Bailey* retirement account), only a portion of the retirement benefits is exempt from North Carolina income tax. To determine the portion of each distribution that is exempt from State income tax, the employee/retiree must determine the portion of the account balance at the time of retirement that is attributable to any rollover distributions from IRAs and other retirement plans (other than another qualifying tax-exempt *Bailey* retirement account). For simplicity, the portion attributable to rollover distributions from IRAs and other retirement plans (other than another qualifying tax-exempt *Bailey* retirement account) does not include any amounts earned subsequent to rollover. The following formula is used to determine the percentage of the retirement benefits received each year that are exempt from State income tax:

$$\frac{(B - R)}{B} = E$$

"E" is the exempt percentage.
"B" is the account balance at the time of retirement.
"R" is the portion of account balance at the time of retirement attributable to any rollover distributions from IRAs or other retirement plans (other than another qualifying tax-exempt *Bailey* account).

<u>Example:</u> Taxpayer X was "vested " in both the State's Deferred Compensation Plan (§ 457 plan) and the State's Supplemental Retirement Income Plan (§ 401(k) plan) as of August 12, 1989. In 2002, Taxpayer X elected to roll over the balance in his Deferred Compensation account into his Supplemental Retirement Income account. Future distributions from Taxpayer X's Supplemental Retirement Income account will be 100% exempt from North Carolina income tax.

<u>Example:</u> Taxpayer Y was "vested" in the State's Deferred Compensation Plan (§ 457 plan) as of August 12, 1989. In 2003, Taxpayer Y ceases his secondary employment with a private company and elects to roll over the $25,000 balance in his § 401(k) plan with the private company into his State Deferred Compensation account. When Taxpayer Y retires in 2010, his State Deferred Compensation account has a balance of $50,000. Future distributions from Taxpayer Y's State Deferred Compensation account will be 50% exempt from North Carolina income tax under the Bailey settlement. [($50,000 - $25,000) / $50,000 = 50%]. The portion of the distributions that are subject to tax (50%) will be eligible for the $4,000 deduction provided by

G.S. 105-134.6(b)(6). Therefore, if Taxpayer Y receives distributions totaling $5,000 from his Deferred Compensation account during 2011, $2,500 would be exempt from State income tax under the Bailey settlement and the remaining $2,500 would be excludable from State income tax under G.S. 105-134.6(b)(6).

<u>Example:</u> Taxpayer Z was "vested" in the State's Supplemental Retirement Income Plan (§ 401(k) plan) as of August 12, 1989. In 2003, Taxpayer Z elects to roll over $20,000 from his IRA into his Supplemental Retirement Income account. When Taxpayer Z retires in 2020, his Supplemental Retirement Income account has a balance of $60,000. Future distributions from Taxpayer Z's Supplemental Retirement Income account will be 67% exempt from North Carolina income tax under the Bailey settlement. [($60,000 - $20,000) / $60,000 = 67%]. Therefore, if Taxpayer Z receives distributions totaling $25,000 from his Supplemental Retirement Income account during 2021, $16,750 would be exempt from State income tax under the Bailey settlement and $4,000 would be excludable from State income tax under G.S. 105-134.6(b)(6).