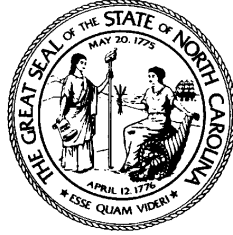

North Carolina Department of Revenue



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: August 23, 2004
Number: PD-04-1

This Directive amends and supersedes Directive PD-03-1, in which the Department advised that a proportionate ratio would be required to determine the tax exempt portion of a distribution from a qualifying tax-exempt *Bailey* retirement account when the account contained rollover distributions from IRAs or other retirement accounts (other than another qualifying tax-exempt *Bailey* retirement account). This position was 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, signed on November 19, 1999. The North Carolina Attorney General's Office recently advised the Department that the rationale used in Judge Thompson's Order is limited to ORP benefits and should not be used in determining the taxability of benefits distributed from the other plans that qualify for exemption from State taxation under the *Bailey* settlement. Therefore, the Department has changed its position regarding the taxability of distributions from a qualifying tax-exempt *Bailey* retirement account that contains rollover distributions from IRAs or other retirement accounts. (Participants in the Optional Retirement Program for State Institutions of Higher Education (ORP) should refer to Directive PD-00-1 to determine the taxability of distributions from the ORP.)

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 rollover distributions lose their character upon rollover, all distributions from a qualifying *Bailey* retirement account in which the employee/retiree was "vested" as of August 12, 1989, are exempt from State income tax regardless of the source of the funds contained in the account. Conversely, qualifying tax-exempt *Bailey* benefits rolled over into another retirement plan lose their character and would not be exempt upon distribution from the other plan unless that plan is a qualifying *Bailey* retirement

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account in which the employee was vested as of August 12, 1989. (Rollovers to IRAs will always result in a loss of tax-exempt status since IRAs do not qualify under the *Bailey* settlement.)

Taxpayers who may have paid North Carolina income tax on a portion of their benefits distributed from a qualifying tax-exempt *Bailey* retirement account based on the Department's previous position with respect to the proportionate ratio method described in Directive PD-03-1, should file an amended income tax return to exclude any qualifying benefits.

If you have 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.