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 (for tax years beginning before January 1, 2014);
G.S. 105-153.4 and G.S. 105-153.5 (for tax years beginning on or after January 1, 2014)
Issued By: Personal Taxes Division
Date: February 26, 2014
Number: PD-14-1

The Department issued five Directives (PD-99-1, PD-99-2, PD-00-1, PD-03-1, and PD-04-1) that addressed how the North Carolina Supreme Court's decision in *Bailey v. State of North Carolina* and the subsequent settlement of that case and two related cases (*Emory v. State of North Carolina* and *Patton v. State of North Carolina*) affected the income taxation of retirement benefits paid to former employees of the State of North Carolina, its local governments, and the federal government. Directives PD-03-1 and PD-04-1 addressed the consequences of (1) rollover distributions from a qualifying tax-exempt *Bailey* retirement account, and (2) rollover distributions into a qualifying tax-exempt *Bailey* retirement account. In summary, these Directives advised that rollover distributions lose their character upon rollover; therefore, all distributions from a qualifying tax-exempt *Bailey* retirement account, 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 tax-exempt *Bailey* retirement account.

At the time PD-04-1 was published, the law did not authorize designated Roth accounts within 401(k) or 457 plans nor permit funds in those accounts to be rolled over to Roth IRAs. Since that time, designated Roth accounts have been added to the North Carolina Supplemental Retirement Plan ("State 401(k) Plan) and the North Carolina Deferred Compensation Plan ("State 457 Plan"). In addition, participants in these plans can now roll over funds from the plans into designated Roth accounts and/or Roth IRAs (hereinafter collectively referred to as "Roth account," where applicable). This Directive supplements PD-04-1, and addresses the consequences of rollover distributions from a qualifying tax-exempt *Bailey* retirement account to a Roth account.

History of Roth Accounts

Roth IRAs have been available as a retirement investment option since 1998. A list of other significant dates when (1) the State 401(k) plan or the State 457 plan began (a) offering designated Roth accounts and (b) permitting participants to roll over distributions from non-Roth accounts into designated Roth accounts and (2) when distributions from the State 401(k) Plan or the State 457 Plan could be rolled over into Roth IRAs follows:

- January 1, 2006 – 401(k) retirement plans could offer designated Roth accounts to participants.
- June 1, 2006 – The State 401(k) plan allowed contributions to designated Roth accounts.
- January 1, 2008 – Distributions from both the State 401(k) Plan and the State 457 Plan could be rolled over into Roth IRAs.
- September 28, 2010 – Distributions from non-Roth 401(k) plans could be rolled over into designated Roth accounts within the same plan.
- December 14, 2010 – The State 401(k) plan allowed distributions from a non-Roth account to be rolled over into a designated Roth account within the same plan.
- January 1, 2011 – 457 retirement plans could offer designated Roth accounts to participants and distributions from 457 plans could be rolled over into designated Roth accounts within the same plan.
- April 1, 2011 – The State Deferred Compensation 457 plan allowed contributions to designated Roth accounts.
- April 4, 2011 – The State Deferred Compensation 457 plan allowed distributions to be rolled over into a designated Roth account.

Income Tax Treatment of a Rollover Distribution to a Roth Account

While a rollover distribution to a traditional IRA is generally not taxable at the time of rollover and the subsequent distributions from the traditional IRA are generally taxable, a rollover distribution to a Roth account is generally taxable at the time of rollover and the subsequent distributions from the Roth account are generally not taxable. If the rollover to a Roth account is from a qualifying tax-exempt *Bailey* retirement account, the rollover distribution is exempt from State income tax and deductible on the State return to the extent the rollover distribution was included as income on the taxpayer's federal income tax return. A qualifying tax-exempt *Bailey* retirement account is an account within a qualifying state, local or federal government retirement system for an individual who was vested in that account (see the previously cited Directives for qualifying systems and vesting dates). If the rollover distribution to a Roth account is from an account within a state, local or federal government retirement system but the system was not a qualifying system or the individual was not vested in that account to qualify for the *Bailey* tax treatment, the rollover distribution is taxable for State income tax purposes to the same extent taxable for federal income tax purposes except that the distribution qualifies for the $4,000 government retirement benefits deduction for tax years beginning prior to January 1, 2014. The $4,000 government retirement benefits deduction has been repealed effective for tax years beginning on or after January 1, 2014.

The Department's position regarding the rollover of distributions into a non-Roth IRA or non-Roth designated account remain as described in Directive PD-04-1.

Overpayments

Taxpayers who have paid North Carolina income tax on their rollover distributions from a qualifying tax-exempt *Bailey* retirement account into a Roth account on any of their 2008 through 2013 State income tax returns may file an amended State income tax return to request a refund of taxes overpaid if the tax year is in statute. G.S. 105-241.6(a) allows a taxpayer to request a refund of an overpayment of tax within the later of three years after the due date of the return or two years after payment of the tax. Consequently, the law does not allow taxpayers who timely filed and paid their 2008 and 2009 taxes to request a refund of any taxes paid on a rollover of distributions from a qualifying tax-exempt *Bailey* retirement account into a Roth account. Taxpayers who timely filed and paid their 2010, 2011, 2012, and 2013 taxes have until April 15, 2014, April 15, 2015, April 15, 2016, and April 15, 2017, respectively, to file an amended return requesting a refund of any taxes paid on a rollover of distributions from a qualifying tax-exempt *Bailey* retirement account into a Roth account. Taxpayers who paid the taxes for any of these periods after the due date have until two years after the payment of tax to request a refund of any taxes overpaid.

Questions

Questions about this Directive may be directed to the Income Tax Division, Personal Taxes Section at (919) 814-1066.