This Bill Analysis reflects the contents of the bill as it was presented in committee.

Bill Draft 2015-RBxz-4: Rollovers into Qualifying Bailey Plans.

2015-2016 General Assembly

Committee:	Revenue Laws Study Committee	**Date:**	January 12, 2015
Introduced by:		**Prepared by:**	Cindy Avrette
Analysis of:	2015-RBxz-4		Committee Counsel

***SUMMARY:** The bill draft would limit the tax exemption for retirement plan distributions from a qualifying Bailey account to the portion of the distribution attributable to a State, local, or federal government retirement plan.*

CURRENT LAW: G.S. 105-153.5 exempts from State income tax the amount received during the taxable year from one or more State, local, or federal government retirement plans to the extent the amount is exempt from tax pursuant to a court order in settlement of one or more of three cited cases. The most well-known of these cases was the *Bailey* case, and for purposes of this summary the three cases are collectively referred to as the *Bailey* case. A person is a member of the *Bailey* class if the person vested in one or more of the governmental retirement plans on or before August 12, 1989. The exemption applies to not only any defined benefits the retiree receives but also to any income distributed to the retiree from a supplemental retirement income plan, such as a 401(k) or a 457 plan.[1]

In 2002, the federal laws with respect to pension portability became much more flexible. The changes provided that contributions into most types of retirement plans could be rolled over into another retirement plan or IRA. The Department of Revenue issued a directive, PD-04-1, to address the tax consequences of rolling over amounts from non-qualifying *Bailey* retirement accounts into a qualifying *Bailey* retirement account. Under that directive, all distributions from a qualifying *Bailey* retirement account are tax-exempt, regardless of the source of funds.

BILL ANALYSIS: The bill draft would limit the tax exemption for distributions from a qualifying *Bailey* supplemental retirement plan to those distributions attributable to contributions to a qualifying plan. The limitation would mean that distributions in a qualifying *Bailey* supplemental retirement plan attributable to a rollover contribution from a non-qualifying retirement plan would be taxable to the same extent those distributions would be taxable if the contribution had remained in the non-qualifying plan. The draft provides that the portion of a distribution that is taxable would be determined in accordance with the methodology used by Superior Court Judge Jack A. Thompson in his Order Regarding the Optional Retirement Program (ORP) for State institutions for Higher Education, signed on November 19, 1999.

After the 2002 federal pension portability changes, the Department issued Directive PD-03-1 on June 30, 2003. Under that directive, the Department advised that if a *Bailey* retirement account included rollover contributions from a non-qualifying *Bailey* retirement account that only a portion of the distributions received would be exempt from State income tax. The Department based its directive on the rationale used by Judge Thompson in his Order Regarding the ORP. This Order addressed when a participant in the 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. This position was also consistent with the treatment of

[1] The Court issued several subsequent orders resolving questions about eligibility. One of the orders, issued in November 1998, held that participants in the State's Supplement Retirement Income Plan or the State's Deferred Compensation Plan are vested in the plan as of August 12, 1989, if they contributed to the plan by that date. If a person is vested in the plan, then all future withdrawals from the plan are exempt from tax.

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.

The Department rescinded this directive and replaced it with PD-04-1, in accordance with an Advisory Opinion issued by the Attorney General's Office. The Opinion advised that all benefits from state-created and state-administered plans should be treated as exempt from State income taxes if paid to persons vested in those plans as of August 12, 1989, regardless of the source of the funds. This draft essentially codifies the Department's first directive on this issue, PD-03-1.

EFFECTIVE DATE: The bill draft would become effective for taxable years beginning on or after January 1, 2016.

BACKGROUND: A question appeared in the newspaper column Money Matters in the summer of 2014 asking whether it was true a person could avoid paying as much as $116,000 in State income tax by transferring an IRA rollover valued at more than $2 million into a *Bailey* vested State retirement plan. The answer was yes. The Revenue Laws Study Committee found that this tax planning strategy allows a person to exempt from State income tax distributions from a private retirement plan that would otherwise be taxable except for the fact the person rolled the funds over into a State government *Bailey* plan.

The *Bailey* tax exemption originates from a U.S. Supreme Court case decided in 1989, *Michigan v. Davis*. Prior to 1989, many states, including North Carolina, provided state employees a retirement benefit in the form of an exemption from state income tax on their retirement income received from a state retirement plan. The U.S. Supreme Court ruled those tax exemptions violated the principle of intergovernmental immunity because the states did not provide a similar exemption for federal retirement income. States had to choose between exempting all governmental retirement income and taxing it. North Carolina chose to grant a $4,000 income tax exemption for government retirement benefits.[2]

Vested State employees sued the State arguing the change in the law was an unconstitutional impairment of contract. The N.C. Supreme Court ruled in favor of the State employees in *Bailey v. North Carolina*. Based on a trial court Order Approving Class Action Settlement on October 7, 1998, any governmental employee who vested prior to August 12, 1989, does not pay State income tax on retirement benefits received from a government retirement plan.

After the federal changes with respect to pension portability in 2002, the Department issued PD-03-1. The Department received several questions about its decision to tax a portion of a distribution from a qualifying tax-exempt *Bailey* retirement account that included rollover contributions from IRAs or other retirement plans. In response to those questions, the Department sought an opinion from the North Carolina Attorney General. The AG's opinion noted that the heart of the *Bailey* decision is the principle that the State entered into a contract with members and retirees of various State-created retirement plans, and part of that contract was that the benefits paid from those plans would be exempt from tax. Nothing in *Bailey* suggested that the contract for a tax exemption is limited to specific benefits contained in statutes or plan documents as of August 12, 1989. The opinion acknowledged that federal laws have enhanced the benefits available through *Bailey* accounts, including their investment options and portability; however, it advised that a plan's particular source of funding does not prevent the nature of its distribution from qualifying as benefits that are tax exempt under the *Bailey* decision.

The Department issued a new Directive in accordance with the AG's opinion, PD-04-1. Upon the issuance of the new Directive, the number of *Bailey* eligible participants choosing to make rollover contributions into their *Bailey* eligible plan increased from less than 200 in the beginning of 2004 to more than 1,400 in 2006. The number of *Bailey* eligible participants making rollover contributions into a *Bailey* eligible plan has plateaued to a range of 200 to 400 a year since 2007.

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[2] In 2013, the General Assembly repealed this income tax exemption for government retirement benefits, effective for the 2014 taxable year. It also repealed the $2,000 tax exemption allowed for private retirement benefits.