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REPORT FROM WASHINGTON

Supreme Court Upholds Tax Treatment In Which Only In-State Governmental Bonds Are Tax-Exempt

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TO VIEW THE SUPREME COURT'S OPINION IN *DEP'T OF REVENUE OF KENTUCKY V. DAVIS*, PLEASE CLICK HERE.

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On May 19, 2008, the Supreme Court reversed 7-2 the Kentucky Court of Appeals' decision in *Dep't of Revenue of Kentucky v. Davis*. The Court held that a differential tax treatment exempting interest earned on bonds issued by it or its political subdivisions from state income taxation, without extending the same exemption for interest on bonds issued by other States or subdivisions, is constitutional. The Court reasoned that: (1) such a tax treatment is not prohibited by the Commerce Clause because it is not discriminatory for the purpose of benefiting in-state economic interests by burdening out-of-state competitors; and (2) the burden imposed on interstate commerce is a question best left to Congress. The Court thereby validated a system of taxation adopted by 41 states that affects trillions of dollars worth of state-issued bonds.

BACKGROUND

The *Davis* appeal arose from a class action complaint filed on behalf of Kentucky citizens who paid tax on interest income realized from bonds issued by out-of-state municipalities. A Kentucky statute provides a tax exemption for interest income derived from bonds issued by Kentucky, but makes no such exemption for bonds issued by other states. The complaint alleged that Kentucky's taxation structure violates both the Commerce and Equal Protection Clauses of the U.S. Constitution. The Commerce Clause not only gives Congress the power to regulate commerce among the states, but also prevents the states from favoring in-state businesses by discriminating against out-of-state businesses.

The Jefferson Circuit Court granted the Department of Revenue's motion for summary judgment, finding the Kentucky statute constitutional in part

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JUSTICE SOUTER
(Opinion of the Court)

because they "encourage states and cities to improve the lives of their citizens by keeping the benefits they generate within their borders." The court explained that those who buy in-state bonds "ultimately become the beneficiaries of the issuance of the bonds for state issues such as capital improvements [such] as quality schools, hospitals and roads."

However, the Kentucky Court of Appeals vacated the grant of summary judgment and remanded the case. The court stated that "[c]learly, Kentucky's bond taxation system is facially unconstitutional" because it "affords more favorable tax treatment to in-state bonds than it does to extraterritorially issued bonds." The Supreme Court of Kentucky denied discretionary review, and the Supreme Court granted certiorari.

THE SUPREME COURT'S DECISION

In the opinion of the Court, delivered by Justice Souter and joined in full by Justices Stevens and Breyer and in part by Chief Justice Roberts and Justices Ginsburg and Scalia, the Supreme Court reversed the Kentucky Court of Appeals' decision holding that Kentucky's "system of taxing only extraterritorial bonds runs afoul of the Commerce Clause." The Court held that a state law exempting interest earned from bonds issued by that state or its subdivisions from state income taxation, without extending the same exemption to interest earned from bonds issued by other state issuers, did not violate the Commerce Clause.

The Court began its analysis by outlining three lines of jurisprudence regarding both the Commerce Clause and its concern with "economic protectionism"—regulatory measures designed to benefit in-state competitors by burdening out-of-state competitors. First, under the traditional test, if the law discriminates against interstate commerce, it is valid only if it advances a legitimate local purpose that cannot be adequately served by reasonable, nondiscriminatory alternatives. Absent discrimination, the law will be upheld unless the burden imposed on interstate commerce is clearly excessive in relation to putative local benefits. Second, the "market participant" line of cases holds that states that go beyond regulation by participating in the market may favor their own citizens over others. Finally, in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Management Auth.*, 127 S. Ct. 1786 (2007), the Court stated that "when a law favors in-state business over out-of-state competition, rigorous scrutiny is appropriate," but that "it does not make sense to regard laws favoring local government and laws favoring private industry with equal skepticism." The Court reasoned that "[l]aws favoring local government . . . may be directed toward any number of legitimate goals unrelated to protectionism."

In a section of Justice Souter's opinion joined by Chief Justice Roberts and Justices Breyer, Ginsburg, Scalia, and Stevens, the Court held that "[i]t follows *a fortiori* from *United Haulers* that Kentucky must prevail." The Court continued: "It should go without saying that the apprehension in *United Haulers* about 'unprecedented . . . interference' with a traditional government function is just as warranted here, where the [Respondents] would have us invalidate a century-old taxing practice presently employed by

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41 States and affirmatively supported by all of them." The Court further explained that other states could properly be treated as private entities with respect to their state-issued bonds, and thus Kentucky, as a public entity, did not have to treat itself as "substantially similar" to other market participants.

The next section of Justice Souter's opinion, which Chief Justice Roberts and Justices Scalia and Ginsburg declined to join because they believed it was unnecessary in light of the preceding *United Haulers* analysis, examined the case under the "market participation" doctrine. While Justice Souter observed that Kentucky acts in two roles: issuing bonds and setting taxes, he noted that "the differential tax scheme makes sense only because Kentucky is also a bond issuer." Describing several systems in which government entities' commercial activities and regulatory efforts complement each other, Justice Souter stated that such situations, "prescribe exceptional treatment for this direct governmental activity in commercial markets for the public's benefit."

In a section of his opinion again joined by a majority of Justices, Justice Souter noted that all other forty-nine states had supported Kentucky as *amici curiae*. The Court stated that the differential tax treatment was "critical to the operation of an identifiable segment of the municipal financial market as it currently functions, and this fact alone demonstrates that the unanimous desire of the States to preserve the tax feature is a far cry from the private protectionism that has driven the development of the dormant Commerce Clause." In particular, one state objective may be to preserve single-state bond funds. These funds are dependent on differential taxation treatments to create single-state markets, and absorb securities issued by smaller or lesser-known municipalities that interstate markets tend to ignore.

The final part of the Court's opinion, which Justice Scalia did not join, analyzed whether the Kentucky taxation treatment created burdens that clearly outweigh the benefits of a state or local practice under *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970). Noting several difficulties with conducting such a balancing test, the Court declined to do so. Instead, the Court held that such a cost-benefit analysis was best left in the hands of the legislature, which could acquire more complete information than adversary trials would produce.

Concurring only in the judgment, Justice Thomas noted that he would discard entirely the Court's dormant Commerce Clause jurisprudence. He reasoned that the differential tax should be upheld solely because Congress had not decided to preempt it.

Justice Kennedy, joined by Justice Alito, dissented from the majority. Justice Kennedy asserted that the majority's opinion weakened the preventative force of the Commerce Clause and invited other protectionist laws, risking further dislocation and market inefficiencies based on the origin of products and commodities. Justice Kennedy wrote: "The tax imposed here is an explicit discrimination against out-of-state issuances for admitted protectionist purposes. It cannot be sustained unless the Court disavows the discrimination principle, one of the most

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JUSTICE KENNEDY
(Dissenting)

important protections we have elaborated for the Nation's interstate markets." Justice Kennedy distinguished *United Haulers* on the grounds that the challenged ordinance in that case applied equally to interstate and in-state commerce because the government had monopolized the relevant market; in contrast, Kentucky explicitly sought to differentiate between local and interstate commodities. Finally, Justice Kennedy suggested that differential taxation favoring local trade over interstate commerce poses a serious threat to the national free market because the taxing power is both flexible and potent.

IMPLICATIONS

In reversing the Kentucky Court of Appeals' decision, the Court has maintained the status quo for the nearly $2.1 trillion municipal bond market. Although, as the dissent stated, invalidation of the tax exemption would not have upset any contractual rights inherent in the bonds, investors' economic expectations regarding the tax consequences of the bonds no doubt were one of the factors that had influenced their investment. The Court's decision, accordingly, has ensured that investors' economic expectations that interest income on in-state municipal bonds would be exempt from taxation will remain undisturbed, absent the remote prospect of Congressional intervention.

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