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U.S. Supreme Court to Rule on Constitutionality of State Tax Statutes Favoring In-State Municipal Bonds

On May 21, 2007, the U.S. Supreme Court agreed to review the closely-watched case of *Davis v. Kentucky Dep't Of Revenue of The Finance and Admin. Cabinet,* 97 S.W.3d 557 (2006). In granting Kentucky's *certiorari* petition, the Court has set the stage for a decision with nationwide impact on the existing practice of a substantial majority of states of treating interest on bonds issued by governmental entities in their state more favorably for tax purposes than interest on bonds issued by governmental entities in other states.[1] The Court will review a Kentucky state court decision that Kentucky's statute, which exempts interest on municipal bonds from state income taxes only if the bonds are issued in Kentucky, is unconstitutional under the U.S. Constitution. A Court decision upholding that ruling would significantly impact states with similar statutes, single-state mutual funds and, potentially, holders (directly or through mutual funds) of outstanding bonds in states with similar statutes, and could radically alter the municipal bond market landscape. Other state tax preferences for in-state financing programs, such as state-sponsored Section 529 college savings programs, may be indirectly impacted by the Court's decision.

The parties to the case, and non-parties interested in being heard through the filing of *amicus* briefs, will submit briefs to the Court this summer. The Court will likely hear oral argument in the fall of 2007 and issue a decision in the winter or early spring of 2008.

Those with an interest in the outcome of these proceedings, including bond market trade associations, should start planning now as to whether and how they want their voices heard by the Supreme Court on the merits of this matter via *amicus* briefs. In light of the Court's decision to hear this appeal, single-state bond funds and bond issuers for states with Kentucky-like tax statutes should evaluate the need to now make additional disclosures in their offering documents relating to the

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potential impact of this case.

Description of the Case and Issue Presented

The Davises, residents of Kentucky who paid Kentucky income tax on the interest they received on their out-of-state bonds, challenged the State's tax policy, which they claim constitutes illegal favoring of in-state versus out-of-state "commerce." The Davises base their claim on the so-called "dormant Commerce Clause," a judicial interpretation of the Commerce Clause of the U.S. Constitution that prohibits states from competing against each other in a way that burdens interstate commerce. A Kentucky appellate court ruled in early 2006 that Kentucky's tax policy violates the dormant Commerce Clause. That court reasoned that by granting an exemption only to its own bonds, the state was impeding interstate commerce by dissuading its residents from investing in bonds issued in other states. The Kentucky Supreme Court subsequently declined to hear an appeal of the matter, and the State of Kentucky sought review by the U.S. Supreme Court.

The U.S. Supreme Court has never considered the specific question of the permissibility of state tax preferences for bonds issued in the taxing state, and only two state courts have squarely addressed the question -- the *Davis* court and an appellate court in Ohio which upheld Ohio's similar state tax exemption, limited to bonds issued in Ohio, on the basis that there was no precedent for holding tax preferences unconstitutional in the context of municipal bonds.[2] So at this point, there is a split of decisions among the two states that have considered the constitutionality of these provisions under the U.S. Constitution.

The U.S. Supreme Court delayed a decision on the State of Kentucky's petition for review of the *Davis* case pending the release of the Court's decision in *United Haulers v. Oneida-Herkimer Solid Waste Management Authority.* The *Oneida* decision, released on April 30, 2007, held that flow control ordinances that favor a public entity engaged in a traditional governmental activity (waste disposal) but that do not discriminate among private entities do not "discriminate against interstate commerce" for purposes of the dormant Commerce Clause. However, no single rationale for the result mustered a majority of the justices. A plurality of the justices (Roberts, Breyer, Souter, and Ginsburg) rooted their opinion on the proposition that the flow control ordinance was nondiscriminatory because it did not favor particular private-sector enterprises, and determined that the ordinance survived a more relaxed level of scrutiny (the so-called *Pike* balancing test) applicable to dormant Commerce Clause review of nondiscriminatory statutes. Justice Scalia agreed that the ordinance was nondiscriminatory, but found that dispositive and rejected the need for any balancing test. Justice Thomas concurred in the result on the basis that he would discard the Court's entire dormant Commerce Clause jurisprudence. Three

Justices (Alito, Stevens and Kennedy) dissented, indicating that they saw no difference for dormant Commerce Clause purposes between state laws discriminating in favor of public-sector entities and state laws discriminating in favor of private sector enterprises.

Although *Oneida* stands for the proposition that, at least under certain circumstances, the Court will treat state laws that favor traditional government activities performed by public-sector entities less stringently under the dormant Commerce Clause than similar laws that favor in-state private enterprise at the expense of out-of-state actors, *Oneida* is not dispositive of the *Davis* case. The Court's decision to defer consideration of the *Davis* case until *Oneida* was decided suggests that some justices thought *Oneida* might be decided in a way that would obviate the need for further guidance by the Court on the issues raised in *Davis*; the Court's decision to review *Davis* reflects its conclusion that the narrow and fractured *Oneida* decision provides insufficient guidance for a resolution of *Davis.* The question of the constitutionality of Kentucky-type municipal bond tax statutes lives on because *Oneida* did not expressly address whether a statute that expressly disfavors out-of-state *public* actors (*i.e.*, municipal bond statutes that tax municipal bonds of out-of-state public issuers but expressly exempt municipal bonds of in-state public issuers) is "discriminatory" or "nondiscriminatory" for dormant Commerce Clause purposes. This question is central to the outcome of *Davis*, as in *Oneida* the plurality reiterated that "[d]iscriminatory laws motivated by 'simple economic protectionism' are subject to a 'virtually *per se* rule of invalidity,'" and Justice Scalia indicated that he would continue to enforce the dormant Commerce Clause against state laws that "facially discriminate against interstate commerce."

The Ramifications of a Court Decision Against Kentucky

A decision by the Court that Kentucky's tax statute is unconstitutional could have profound and far-reaching ramifications. If Kentucky's law is unconstitutional the same is true for close to forty states with similar tax preferences. In the wake of such a decision, states would be required to treat in-state and out-of-state bonds on a parity by either taxing income on bonds from every state or by exempting income on bonds from every state. (Because under the U.S. Constitution Congress has absolute power over interstate commerce, in theory Congress could enact legislation to restore the states' ability to employ disparate tax treatment in this context, but it is uncertain that Congress would choose to do so.) In either case, the state tax advantage of owning in-state bonds versus out-of-state bonds would disappear, as would the associated marketing advantage to states. State residents might, of course, still prefer their own state's bonds due to loyalty factors or greater familiarity with the credit, but the tax-based preference would be eliminated.

Among other ramifications, states with a high state and/or local tax burden, such as New York and California, could face a devaluation of their bonds, and an increase in their borrowing costs; singled-state mutual funds could lose their market niche.

The many states that offer preferential tax treatment, in the form of state tax deductions or tax credits, to residents who participate in the state's own Section 529 college savings plan versus some other state's plan might also feel the ripple effect of a Court decision in favor of state tax parity for municipal bonds.

Each state would have to decide how to achieve parity treatment and then pass state legislation which codifies the decision. The decisions would raise extraordinarily difficult economic, legal and public policy questions. Legislation to exempt all municipal bond income from state income taxation would mean lost tax revenue, but each state would have to assess such revenue losses against the political and borrowing cost implications of achieving parity by taxing municipal bonds issued within the state. Even if a state opts to tax all bond income at the same rate going forward, there will be additional complex considerations, including:

- whether to retroactively tax income earned on outstanding in-state bonds;
- whether to tax prospective income earned on outstanding in-state bonds; and/or
- whether to exempt all outstanding bonds from tax and only tax income earned on bonds issued after the Court's decision or after the enactment of the applicable new state tax legislation.

Such decisions will impact the size of the potential refund liability each state may face on claims by holders of out-of-state bonds for periods during which all or some in-state bonds were not or are not being taxed. These issues are discussed in further detail below. In addition, clauses in outstanding interest rate swaps that provide for a modification of the swapped rate upon an adverse change in tax treatment of bonds may be triggered.

Issues Relating to Potential Taxation of Previously Issued Bonds

If the Court holds that disparate state tax treatment of out-of-state municipal bonds is unconstitutional, states may be exposed to refund claims by holders of out-of-state bonds for taxes previously paid on interest on those bonds. How a state decides to achieve parity treatment could have an impact on the level of refund exposure. A state could opt to apply the parity tax to all outstanding in-state and out-of-state bonds both prospectively and retroactively, which might minimize the refund claims but could raise other issues discussed below.

May a state seek to retroactively tax income on in-state bonds earned in past years?

Retroactive taxation of bond income is prohibited in a number of states by the state constitution. In states that do not have an express prohibition on retroactive taxation, due process considerations will limit retroactive taxation to situations deemed reasonable by the courts. The longest period of retroactive taxation of which we are aware that has been sustained against a due process challenge is three years. Moreover, courts have limited retroactivity to transactions consummated while the statute imposing retroactive taxation was on the horizon. In this context, courts may be asked to decide whether it is reasonable for a retroactive taxation period to go back further when the retroactive taxation is prompted by the need to comply with the federal Commerce Clause. This could leave states in the unenviable position of not being able to assess retroactive taxes but being subject to refund claims.

Would a state's attempt to tax interest on outstanding in-state bonds constitute an impairment of contract?

The federal constitution and many state constitutions limit a state's ability to legislate in a manner that impairs existing contracts. A bond is a "contract" for purposes of a federal contract clause analysis. The more difficult question is whether a state tax exemption, provided by a statute, is part of the bond contract and therefore protected against impairment. If the state tax-exemption is expressly incorporated into the bond documents, such tax treatment is likely to be considered part of the contract, both with respect to past and future accruals of interest on the bonds. If the state tax-exemption is not expressly incorporated into the contract, the law is somewhat uncertain, and the outcome may depend on how explicitly the language of the applicable tax statute promises or suggests that the state tax exemption will remain in place for the life of the bond. Even if the state tax-exemption is deemed part of the bondholder's contract, the constitutional "contract clause" is not an absolute protection. A contract obligation is not considered impaired unless the alteration in the law deprives the bondholders of a "substantial" right or remedy. In addition, courts also look to whether the challenged impairment is necessary to serve an important public purpose. In sum, if a state's efforts to implement constitutionally required tax parity were to include taxation of previously issued in-state municipal bonds, bondholders may have a variety of issues to litigate over.

What happens if a state does not retroactively tax in-state bonds?

If a state that had favored in-state bonds cannot or elects not to level the playing field by taxing past and future income on outstanding in-state bonds, it will face a higher potential refund liability to taxpayers who paid or pay state income tax on their out-of-state bonds. Such taxpayers would have a strong case that the tax on out-of-state bond income was invalid. Their refund claims would be limited only by applicable limitations periods and by the practical question of whether the refund amount is worth pursuing. Ultimately, it is unlikely that a state would have to refund the full amount of all taxes attributable to interest on out-of-state bonds in the applicable period, but the state's refund liability could nonetheless be substantial.

The Ramifications of a Court Decision In Favor of Kentucky

A decision by the Court that Kentucky's tax statute is constitutional may preserve the status quo, but the precise impact (or absence of impact) would depend on the rationale applied by the Court. If, for example, the Court focuses on the characteristics of general obligation bonds, or on comparisons between the taxation of out-of-state municipal bonds and in-state corporate bonds, questions may remain about categories of municipal bonds or state tax systems that differ from those described in the Court's decision.

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[1] A U.S. Supreme Court ruling would impact bonds issued by governmental entities, including state and municipality general obligation bonds, revenue bonds, housing bonds, conduit bonds for non-profits and other private activity bonds, in states that treat in-state bonds differently from out-of-stare bonds. The ruling would not impact bonds issued by Puerto Rico, Guam or the Virgin Islands, as their state tax exemption in all states is derived from federal statute, not state statutes.

[2] *Shaper v. Tracy*, 97 Ohio App.3d 760, 647 N.E.2d 550 (1994).

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If you wish to discuss the contents of this advisory, or for assistance with issues raised by the legal developments that are the subject of this advisory, please contact the Mintz Levin lawyers listed below or any other member of Mintz Levin's Public Finance section.

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