

MEMO# 22519

May 20, 2008

U.S. Supreme Court Upholds Kentucky's State Tax Exemption for Residents Holding In-State Municipal Bonds

[22519]

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TO: FIXED-INCOME ADVISORY COMMITTEE No. 11-08

MONEY MARKET FUNDS ADVISORY COMMITTEE No. 10-08

TAX MEMBERS No. 18-08 RE: U.S. SUPREME COURT UPHOLDS KENTUCKY'S STATE TAX EXEMPTION FOR RESIDENTS HOLDING IN-STATE MUNICIPAL BONDS

The U.S. Supreme Court has issued a 7-2 decision in *Kentucky v. Davis* [\[1\]](#), permitting states to exempt from tax the interest received by their residents from in-state municipal bonds while taxing residents on interest received from out-of state municipal bonds. The Court's decision reverses the holding of a Kentucky State Court in *Davis v. Department of Revenue*. [\[2\]](#) In upholding Kentucky's tax exemption, the Court considers, among other factors, the adverse impact on single-state municipal funds and the important market such funds create for smaller issuers.

Court's Analysis Generally Considers Two Factors

The Court generally considers two factors in its decision supporting Kentucky's favorable tax treatment of residents holding in-state municipal bonds. First, the Court follows its decision in *United Haulers Assn., Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 550 U.S. ____ (2007). *United Haulers* held that a state ordinance requiring trash haulers to deliver solid waste to a public authority's processing plant did not violate the Commerce Clause because the ordinance addressed what was "both typically and traditionally a local government function." [\[3\]](#) Like the state activity in *United Haulers*, the bond proceeds at issue in *Kentucky v. Davis* are used to address "the health, safety and welfare of citizens." [\[4\]](#) The Court also finds that Kentucky's tax exemption is not discriminatory because it "favors a traditional government function without any differential

treatment favoring local [private] entities over substantially similar out-of-state interests.” [5]

Second, the Court considers the markets impacted by Kentucky’s and other states’ exemptions. Specifically, the Court gives significant weight to the market for “bonds within the State of issue, a large proportion of which ... is managed by one or more single-state [mutual] funds.” [6] The Court notes that single-state funds invest in securities “issued by smaller or lesser known municipalities that [national] interstate markets tend to ignore.” [7] Many of these single-state funds would disappear if current state exemptions were eliminated. The disappearance of single-state funds would adversely impact smaller municipal issuers and radically change the way that such issuers finance long-term municipal projects.

Forty-nine states submitted a brief as Amici Curiae unanimously supporting Kentucky’s tax exemption. The Court finds the states’ view to be strong evidence that Kentucky’s favorable tax treatment for in-state municipal bonds does not protect private local interests and instead is “critical to the operation of an identifiable segment of the municipal financial market...” [8] The Court notes the history of state bond financing at the beginning of its opinion, finding that “funding the work of government this way ... goes back to the 17th century.” [9]

Court Does Not Address Private Activity Bonds

The Court expressly declines to rule on the issue of whether tax exemptions for residents holding bonds used to finance projects by private entities (called private activity, industrial revenue or conduit bonds) violates the Commerce Clause. Although raised by one of the Davises' amici, this issue was not stressed by the Davises or sufficiently developed in the amicus brief. Additionally, the Court states that it cannot tell what the consequences would be of holding that Kentucky’s tax exemption for private activity bonds violates the Commerce Clause. However, the Court assumes that such a ruling “could disrupt important projects that the States have deemed to have public purposes.” [10]

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endnotes

[1] Go to <http://www.supremecourtus.gov/opinions/07pdf/06-666.pdf> to read the decision.

[2] See Institute [Memorandum](#) (19632) to Fixed-Income Advisory Committee No. 2-06, Money Market Funds Advisory Committee No. 1-06 and Tax Members No. 4-06, dated January 26, 2006.

The Kentucky Supreme Court declined review. See Institute [Memorandum](#) (20310) to Fixed-Income Advisory Committee No. 4-06, Money Market Funds Advisory Committee No. 2-06 and Tax Members No. 30-06, dated August 23, 2006.

[3] *Kentucky v. Davis*, No. 06-666, May 19, 2008 (slip op., at 10) citing *United Haulers* (slip op., at 12).

[\[4\]](#) Ibid., at 12.

[\[5\]](#) Ibid., at 13.

[\[6\]](#) Ibid., at 21.

[\[7\]](#) Ibid.

[\[8\]](#) Ibid., at 23.

[\[9\]](#) Ibid., at 4.

[\[10\]](#) Ibid., at 2, fn 2.

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