INVESTMENT COMPANY INSTITUTE

MEMO# 19632

January 26, 2006

KENTUCKY APPEALS COURT RULES THAT KENTUCKY'S TAX ON OUT-OF-STATE MUNICIPAL BONDS IS UNCONSTITUTIONAL

 [19632] January 26, 2006 TO: FIXED-INCOME ADVISORY COMMITTEE No. 2-06 MONEY MARKET FUNDS ADVISORY COMMITTEE No. 1-06 TAX MEMBERS No. 4-06 RE: KENTUCKY APPEALS COURT RULES THAT KENTUCKY’S TAX ON OUT-OF-STATE MUNICIPAL BONDS IS UNCONSTITUTIONAL The Kentucky Appeals Court (an intermediate-level court) has held in Davis v. Department of Revenue1 that Kentucky’s tax on interest income derived from bonds issued by states other than Kentucky is facially discriminatory in violation of the Commerce Clause. The Kentucky statute exempts from Kentucky taxation interest income derived from bonds issued by Kentucky or its subdivisions; interest income derived from bonds issued by other states or their subdivisions is taxable. In holding that Kentucky’s bond taxation system is “facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds,” the Appeals Court rejected three arguments advanced by the state. First, the Court rejected arguments based on an Ohio court’s ruling that Ohio’s similar bond taxation system is constitutional, finding that the Ohio court failed to fully analyze the issue. Second, the Court rejected as inapposite arguments based on the 1881 U.S. Supreme Court decision in Bonaparte v. Tax Court2, in which the Supreme Court rejected the taxpayer’s argument that her state must exempt out-of-state bonds from tax under the Full Faith and Credit Clause. Finally, the Appeals Court rejected arguments based on the market participant theory, which “recognizes that when a sovereign acts as a consumer or vendor in commerce, its actions as a market participant are distinct from its actions as a market regulator.” The state argued that the “Commerce Clause is directed at the state’s actions as a market regulator,” and therefore the state’s actions as a market participant are exempt from Commerce Clause analysis. 1 No. 2004-CA-001940-MR, January 6, 2006. Go to http://opinions.kycourts.net/coa/2004-ca-001940.pdf to read the case. 2 104 U.S. 592 (1881). 2 The Appeals Court found that with respect to its imposition of taxes only on out-of-state bonds, the state was acting as a regulator, not as a market participant; therefore, the Commerce Clause is relevant to determining the constitutionality of the state’s bond taxation system. Lisa Robinson Associate Counsel