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United States Supreme Court Upholds State Tax Exemption for Municipal Bonds in Kentucky v. Davis

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In a 7-2 decision, the United States Supreme Court upheld on May 19, 2008 a Kentucky law allowing the state to exempt interest on bonds issued by the state or its political subdivision while taxing the interest earned on bonds from other states. *Kentucky v. Davis*, 553 U.S. __ (2008), is widely believed to have saved the state municipal bond market, which had seen a steep decline in investment after a Kentucky appeals court ruled that such preferential treatment violated constitutional maxims.

The highly anticipated decision overturned the Kentucky appeals court ruling, which held that Kentucky's preferential tax treatment on its bonds violated the "dormant commerce clause" of the U.S. Constitution. The Supreme Court recognized the broad exemption to the application of the dormant commerce clause when a state or local government enacts a law that discriminates in favor of itself rather than private parties. Furthermore, the Supreme Court noted that the dormant commerce clause does not apply when a local government engages in a traditional government function, and issuing bonds to pay for public projects is as traditional as it gets. This "traditional government function" or "public purpose" rationale emerged last year in *United Haulers Assn., Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 550 U.S. __ (2007), in which the Court ruled that states can enact laws that favor government operated businesses over private ones.

This important decision puts an end to the uncertainty surrounding a common state income tax exemption. The exemption is so common that, of the 43 states that impose an income tax on its residents, 37 states including Kentucky tax out-of-state municipal bond income while exempting income on all in-state municipal bonds, and four states tax out-of-state municipal bond income but exempt some in-state municipal bonds. Of the remaining states, Utah exempts interest on its own bond and extends the same treatment to the bonds of States that do not tax Utah bonds, and Indiana exempts all municipal bonds.

If the Supreme Court had upheld the Kentucky appeals court decision, states would have been forced to decide whether to tax the interest on in-state bonds or exempt interest on all bonds, like Indiana. Neither choice is very appealing to the states. Taxing interest on all municipal bonds would increase the borrowing cost for states and their subdivisions, and exempting interest on all municipal bonds regardless of origin would result in the reduction of the states' revenues. Such a modification would have severely disrupted the $2.5 trillion municipal bond market. States and municipal bond investors can breathe a bit easier now that the status quo has been upheld.

Interestingly, the Supreme Court refrained from addressing the constitutionality of state laws that exempt income from in-state issued private activity bonds. Private activity bonds are government bonds that are issued to finance private projects and are usually associated with local economic development and charitable projects. Given that the Supreme Court dodged the issue, the validity of the tax exemption provided for private activity bonds still remains unsettled and will remain unsettled until another taxpayer challenges the validity of such tax exemption.