

U.S. Supreme Court Ruling Upholds Constitutionality of Differential State Tax Treatment of Interest on In-State versus Out-of-State Municipal Bonds

Earlier this week, in *Department of Revenue of Kentucky v. Davis*, the U.S. Supreme Court upheld the constitutionality of Kentucky's version of a typical state income tax provision that exempts interest on municipal bonds issued by in-state issuers, but not out-of-state issuers. Reversing the ruling by the Kentucky Court of Appeals that Kentucky's approach violated the "dormant" Commerce Clause of the U.S. Constitution, the Supreme Court's decision largely puts to rest concerns over the constitutionality of similar differential taxation provisions employed by a large majority of the states.

Interest received on bonds issued by state or local governments is generally exempt from federal income tax. Most states provide their residents with a comparable exemption from state income tax, but in these states the exception generally applies only to interest on bonds of in-state issuers, not out-of-state issuers. The respondents in *Davis* — bondholders who had paid Kentucky income tax on interest on out-of-state bonds — argued that this approach discriminates against interstate commerce in violation of the "dormant" Commerce Clause of the U.S. Constitution. The U.S. Supreme Court rejected the bondholders' argument. Citing the principle that "discrimination assumes a comparison of substantially similar entities," the Court held that "Kentucky, as a public entity, does not have to treat itself as being substantially similar to the other bond issuers in the market."

One point was not conclusively resolved by the Court's opinion. The opinion addressed the constitutionality of differential tax provisions as applied to municipal bonds generally, the issuance of which the court characterized as a "quintessentially public function." The Court expressly declined to consider the constitutionality of differential tax provisions as applied to a subset of municipal bonds called "private activity bonds" — state or local governmental bonds used to finance projects by private parties — although dictum in the Court's opinion appears to signal an inclination to uphold the constitutionality of such provisions.

The Supreme Court's ruling, while not unexpected, averts the wide-scale turmoil that could have ensued from an affirmation of the Kentucky Court of Appeals, including uncertainty as to the state tax treatment of over a trillion dollars of outstanding municipal debt, the demise of single-state municipal bond funds, and other disruptions in the market for municipal bonds.

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