POINT & COUNTERPOINT: THE CONSTITUTIONALITY OF TAX EXEMPTIONS FOR HOME STATE BONDS UNDER THE DORMANT COMMERCE CLAUSE

INTRODUCTION: The income tax system in Kentucky exempted interest on bonds issued by the Commonwealth of Kentucky but taxed interest on bonds from other states. In *Davis v. Department of Revenue*, a Kentucky court determined that the state's disparate tax treatment of bond interest discriminated against interstate commerce. While the decision is limited to the taxation of bonds under the Kentucky income tax system, its rationale may have a much broader application in increasingly competitive financial markets and raises questions about the ability of states to self-create tax incentives. In this article, Linda Beale argues that the home-state interest exemption should be viewed as constitutional and not violative of the dormant Commerce Clause. The NewsQuarterly encourages readers to submit responses or comments to this essay, which may be published in a subsequent issue.

— Christopher M. Pietruszkiewicz, LSU Law Center, Baton Rouge, LA

POINT: THE TAX EXEMPTION FOR HOME STATE BONDS, MISGUIDED THOUGH IT MAY BE, SHOULD NOT BE CONSIDERED TO VIOLATE THE DORMANT COMMERCE CLAUSE

*by Linda M. Beale**

In today's complex global markets, states finance state and local governmental activities through borrowing as well as through sales, use and income taxes. Because interest on state bonds is generally exempt from federal tax, states can issue bonds at a slightly lower rate yet remain competitive with other governmental or corporate bonds, lowering borrowing costs. To encourage residents' purchases, states may also exempt interest on their own bonds from state taxation. States generally do not extend that exemption to interest on other states' bonds.

Taxation of other states' interest in the context of a home-state interest exemption raises a difficult issue under the Supreme Court's dormant Commerce Clause (DCC) jurisprudence prohibiting state taxes that discriminate between intrastate and interstate activities or products. The two state courts that have addressed the issue have split in their answers. Ohio concluded that the exemption scheme is constitutional, while Kentucky concluded that it is not. *Compare Shaper v. Tracy*, 647 N.E.2d 550 (Ohio Ct. App. 1994), *cert. denied*, 516 U.S. 907 (1995), *with Davis v. Department of Revenue*, 197 S.W.3d 557 (Ky. Ct. App.), *review denied* (Ky. 2006), *petition for cert. filed*, 75 U.S.W.L. 3285 (U.S. Nov. 9, 2006)(No.06-666). This article briefly describes the Court's DCC jurisprudence and the *Davis* decision and considers arguments supporting the constitutionality of the home-state interest exemption.

THE SUPREME COURT'S DCC JURISPRUDENCE

The Commerce Clause empowers Congress to regulate interstate commerce, but the Supreme Court interprets it more broadly to establish—even *without* legislation—a framework for a unified national economy. The Court's DCC jurisprudence prohibits state regulation that discriminates against out-of-state products or actors, or places an undue burden on interstate commerce, applying a high level of scrutiny to facially discriminatory statutes and a balancing test to others.

State regulatory action subject to DCC analysis includes a state's exercise of its taxing power. The Court has consistently invalidated discriminatory taxes that give local businesses a competitive edge. Although acknowledging the need for a "delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing

* Wayne State University Law School, Detroit, MI.

powers," the Court finds that discriminatory taxes "invite a multiplication of preferential trade areas destructive of the free trade which the Clause protects." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977).

States actively participate in markets as purchasers of goods needed for state operation, as sellers of goods into the stream of commerce, and as investors or borrowers. Under the Court's DCC jurisprudence, a state may compete as a market participant so long as it does not impose conditions that regulate beyond its own market participation. Accordingly, the Court upheld a state's payments for abandoned cars that favored in-state processors, but rejected a state's imposing post-sale conditions on timber sales to ensure in-state processing.

THE ARGUMENT AGAINST **HOME-STATE BOND INTEREST EXEMPTION PROVISIONS**

The *Davis* court conclusively stated that Kentucky's interest exemption is facially discriminatory because it taxes one product (Kentucky's own bonds) differently from another product (other states' bonds). Although the *Davis* court did not address the issue directly, the fact that holding the scheme invalid merely protects state residents from their own state's taxes has been considered immaterial. Thus, courts have concluded that states discriminate when they tax in-state bank deposits at a lower ad valorem tax rate than the rate applied to out-of-state deposits, *St. Ledger v. Commonwealth*, 912 S.W.2d 34 (Ky. 1995), *vacated and remanded on other grounds*, 517 U.S. 1206 (1996), or when they exempt interest from certificates of deposit issued by in-state but not out-of-state banks. *Dominion Nat'l Bank v. Olsen*, 771 F.2d 108 (6th Cir. 1985). The differential taxation may encourage in-state residents to invest in in-state banks, providing those banks a commercial advantage over out-of-state competitors. Kentucky's interest exemption may similarly advantage the state by inducing taxpayers subject to its income tax to purchase its bonds rather than other states' bonds.

The core DCC discrimination concept is particularly indeterminate in the context of state taxing powers.

The *Davis* court gave short shrift to proffered justifications. It dismissed the *Shaper* case as unpersuasive. It considered irrelevant for Commerce Clause purposes the Supreme Court's opinion in *Bonaparte v. Tax Court*, 104 U.S. 592 (1881), in which the Court held that the Full Faith and Credit Clause did not require a taxpayer's state to exempt another state's bond interest because of its exemption in that other state. The *Davis* court concluded that a state's taxing function is regulatory, no matter how intertwined it may be with the state's market participation, citing the Supreme Court's view that tax assessment is "a primeval governmental activity." *New Energy Co. v. Limbach*, 486 U.S. 269, 277 (1988).

THE ARGUMENT IN FAVOR OF **HOME-STATE BOND INTEREST EXEMPTION PROVISIONS**

Economic equivalence of subsidies and taxes. The Court's DCC jurisprudence has been criticized for "uneasy juxtapositions and outright contradictions." Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 Mich. L. Rev. 895, 941 (1992). The DCC generally invalidates tax regimes that penalize out-of-state interests, but it permits states to provide cash subsidies to in-state businesses or cash grants to entice businesses from other states. As commentators have observed, economically equivalent taxing and spending provisions have the same negative impact on interstate commerce. *See, e.g.*, Edward A. Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning the Dormant Commerce Clause Prohibition on Discriminatory Taxation*, 29 Ohio N.U. L. Rev. 29 (2002). The resulting trade wars for business headquarters, factories and sports franchises, facilitated by either taxing or spending, call to mind the states' escalating economic warfare under the Articles of Confederation, when hurdles to commerce were imposed by states not yet united in a national economy.

The subsidy-tax distinction is therefore hard to reconcile with the Commerce Clause's motivating purpose. The Court may well fear that extending its DCC jurisprudence to cover states' spending decisions would result in problematic entanglement in states' budgetary and political processes. Yet, the DCC's interference with taxing decisions may represent similar encroachment on sovereign powers. In particular, there seems little reason to treat the state's decision to provide an exemption from state tax for its own bonds while taxing interest on other states' bonds as any more a Commerce Clause concern than a subsidy to its resident bondholders would be.

Indeterminacy of nondiscrimination test. The core DCC discrimination concept is particularly indeterminate in the context of state taxing powers. *See* Zelinsky, *supra.* All state taxes discriminate, in that they operate for the benefit of persons within the state's jurisdiction. Tax provisions inevitably distort business and investment decisions and affect interstate commerce, though perhaps incidentally. Moreover, discriminatory tax statutes are essentially notational variants for nondiscriminatory tax statutes accompanied by a discriminatory subsidy. Since the

Court has approved subsidies, the basis for any focus on discrimination is uncertain.

Furthermore, whether a home state interest exemption is discriminatory depends on the scope of the market considered. The Court permits differential taxes that relate to markets that are not naturally competitive, even though the result disadvantages out-of-state competitors. *General Motors Corp. v. Tracy*, 519 U.S. 278 (1997) (validating Ohio use tax exempting in-state, public utilities' sales but taxing independent marketers' sales).

If the market for the home-state bond interest exemption is defined as the bond market generally, the exemption does not discriminate against interstate commerce because only interest on home-state bonds (and federal bonds) is exempt. Interest on all other domestic *or* extraterritorial corporate and state bonds is subject to tax.

The market could also be viewed as a nondiscriminatory, single-product market for purchases of a particular state's bonds. The interest exemption is available to *all* taxpayers who buy the state's bonds, whether nonresidents or residents (though nonresidents generally would lack nexus for taxation).

Only if the market is limited to state bonds does the home state exemption appear to discriminate by providing an interest exemption to home-state bonds while taxing interest on all other states' bonds.

Linkage of states' roles as market participants and regulators. Even assuming arguendo that the home-state interest exemption scheme is discriminatory, the scope and rationale of the market participant doctrine are unclear. The focus on regulation implies state intervention in a *pre-existing market* that changes the terms of the market in ways that favor local businesses or activities over out-of-state businesses or activities. When a state sells a product, provides services for compensation or issues bonds, it is instead creating a *new stream of commerce* as a market participant. It is not clear why the DCC concern about inappropriate barriers to interstate commerce should be *more* offended when a state uses its taxing power to discriminate in contexts where it has created a new market than when a state uses its market clout discriminatorily as a consumer or vendor.

Most decisions invalidating state tax statutes find improper discrimination because the state provides a direct commercial advantage to local businesses. In the home-state bond case, however, the state acts simultaneously as market participant (issuing bonds) and market regulator (setting favorable tax rates on its own transactions to secure the lowest possible borrowing costs). Different DCC analysis of the intertwined functions seems misguided here: the state favors its proprietary transaction in *appropriate* opposition to and competition with other sovereign states. This is not analogous to the *Dominion* and *St. Ledger* cases where the state taxes indirectly regulate private parties. Nor is it analogous to a state's writing into timber sales contracts a "regulatory" requirement for in-state processing of state-sourced timber after the sale. Instead, the terms of the financial instrument are set in part in reliance on the ability to establish favorable tax treatment. If a state could not provide the tax exemption, interest rates on the state's bonds would likely need to be higher, costing the state more to borrow; else, the state could rationally assume that elimination of the exemption might lead to a flight of home-state taxpayers' capital to states offering bonds with higher interest rates and/or backed by higher credit ratings.

Absence of underlying Commerce Clause concerns. The home-state bond exemption scheme has not caused the frictions and barriers to commerce that led to the Founders' adoption of the Commerce Clause. Most states have similar laws for raising revenues from the bond markets. *See, e.g.*, Bond Market Association, State Tax Table (2006), at **http://www.investinginbonds.com/learnmore.asp?catid=8&subcatid=61**. It is telling that the *Shaper* and *Davis* cases did not involve claims by other states against home-state bond interest exemption schemes that taxed extraterritorial bond interest, even though states, as the market participants whose market efforts may be constrained, are arguably the persons of interest for Commerce Clause analysis. Instead, home-state taxpayers pursued DCC claims to avoid home-state income tax on extraterritorial interest income.

This lack of interstate tension reflects the impact of globalization and financial engineering on financial markets. Innovations create new commercial opportunities, crafting customized niche products that appeal to a particular range of customers. In securitization transactions, for example, the parts are often worth more than the whole because of this ability to tailor products to consumers' needs. In fact, a new industry has used home-state bonds to differentiate the market and sell new products—mutual funds with single state bonds—to permit taxpayers to enjoy the full tax exemption benefit. Commentators complain that finding home-state bond provisions unconstitutional would undercut the mutual fund industry's single state funds,

Most decisions invalidating state tax statutes find improper discrimination because the state provides a direct commercial advantage to local businesses.

decrease the attractiveness of in-state municipal bonds, and even threaten the vitality of in-state section 529 tuition funds.

Overlapping federalism, Full Faith and Credit, and DCC concerns. The fact that sovereign states are the competing parties is critical. State sovereignty underlies the market participant doctrine, *Reeves, Inc. v. Stake*, 447 U.S. 429, 438 & 446 n.18 (1980), but categorization as market participant or regulator is inadequate to decide this issue. The analysis should therefore focus on the underlying policies of harmony among sovereign states animating the Commerce and Full Faith and Credit Clauses and "Our Federalism." *See Younger v. Harris*, 401 U.S. 37, 44 (1971) (explaining "Our Federalism"). That requires a delicate balance between sovereigns acting in favor of their residents and interlinked members of the national union supporting the national economy.

While state tax regimes cannot discriminate against non-state actors, the essence of sovereignty is a state's power to discriminate against interference by other state actors within its own territory, to protect the state fisc and relationships with state taxpayers. There is no *interstate* governmental immunity doctrine corresponding to the doctrine that protects the *federal* government from state taxation. Under federalism's emphasis on autonomy, states should be free to craft effective tax and incentives systems to deal with a changing economy, rather than being tied to near-uniformity under indeterminate views of DCC requirements.

Accordingly, the Court's Full Faith and Credit Clause *Bonaparte* decision, which permitted bonds to be tax-free in the home state though subject to tax in other states, at the least provides a persuasive analogy for DCC analysis here.

CONCLUSION

A state's exercise of its taxing power in connection with its issuance of its own bonds demands a fresh DCC analysis. It is not clear that home-state bond interest exemption in the context of extraterritorial interest taxation should be considered discriminatory. Even if it is, in this context of closely intertwined market and regulatory functions, the overlapping focus on state sovereignty and interstate harmony addressed by the DCC, Full Faith and Credit Clause, and federalism supports an analysis that better encompasses modern theories of interstate relations and today's highly complex global financial markets. The courts should find the home-state bond exemption in the context of extraterritorial interest taxation constitutional. ■

COMING SOON

The Tax Lawyer

Volume 60, No. 1 – Fall 2006

The (Im)Balance of Externalities in Employment-Based Exclusions from Gross Income
Professor William P. Kratzke

Apportionability in State Income Taxation: The Uniform Division of Income for Tax Purposes Act and Allied-Signal
James H. Peters and Benjamin F. Miller

The Art of Taxation: Joseph Hemard's Illustrated Tax Code
Farley P. Katz

Income Recognition and Revenue Ruling 2003-10: A Large Ship Steered by a Very Small Rudder
Michael Baillif and Monique C. Reid

Volume 60, No. 2 – Winter 2007

Family Limited Partnerships: The Beat Goes On
Professor Walter D. Schwidetzky

Hot Asset Distributions and Partnership Revaluations
Professor Karen Burke

Equity Derivatives, Inbound Capital and Outbound Withholding Tax
David P. Hariton

A Green Mountain Miracle and the Garden State Grab: Lessons from Vermont and New Jersey on State Corporate Tax Reform
Clint Kakstys and Professor Mark J. Cowan

The Low-Income Housing Tax Credit: A Proposal to Address Concerns Regarding Non-Profit/For-Profit Partnerships
Bradley Myers

Solving Section 734(b)
Leigh Osofsky

A Penny Saved: Will Health Savings Accounts Provide Retirees with Necessary Health Benefits?
Michael P. Spiro

www.abanet.org/tax/pubs/ttl