No. 06-666

IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,

Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS

Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF FOR THE NATIONAL FEDERATION OF MUNICIPAL ANALYSTS, AS *AMICUS CURIAE* IN SUPPORT OF NEITHER PARTY

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INTERESTS OF *AMICUS CURIAE* [1]

The National Federation of Municipal Analysts ("NFMA") is a not-for-profit association of over 1,000 members, primarily research analysts, who evaluate credit and other associated risks in the state and local municipal bond market. These individuals represent, among other entities, mutual

[1] In accordance with Supreme Court Rule 37.6, the NFMA states that this brief was authored in its entirety by the counsel listed on the cover and that counsel to a party did not author this brief in whole or in part. No person or entity other than the *amicus curiae* and its counsel made a monetary contribution to the preparation or submission of this brief.

funds, insurance companies, broker/dealers, bond insurers, rating agencies and financial advisory firms. The NFMA was established in 1983 to promote professionalism in municipal credit analysis and further the skill level of its members through educational programs and industry communication. The NFMA furthers this goal by providing informed perspective regarding legal and regulatory matters relating to the municipal finance industry, and facilitating the flow of information between investors and issuing entities. The NFMA includes six constituent societies: (1) the Boston Municipal Analysts Forum; (2) the California Society of Municipal Analysts; (3) the Chicago Municipal Analysts Society; (4) the Minnesota Society of Municipal Analysts; (5) the Municipal Analysts Group of New York; and (6) the Southern Municipal Finance Society, as well as members unaffiliated with such societies.

The Respondents challenge long-standing state tax policies around which the existing system for financing the public expenditures of states, cities, towns and other public entities has developed. An affirmance in this case would require changes to the tax policies and laws of at least 42 states and would generate potentially prolonged legal and market uncertainty, thereby weakening the stability of the municipal bond market. The NFMA, as an organization dedicated to the existence of a sound municipal bond market, and its members, who are actively involved in the functioning of that market, have a substantial interest in ensuring that the consequences of such a profound change to the state tax treatment of municipal bonds be articulated to and understood by the Court as it evaluates the Respondents' challenge. In addition to providing context for the issue before the Court, the NFMA seeks to provide information about the benefits and burdens of the challenged state taxation practice that may be relevant should the Court determine that a "balancing test" approach should be applied to resolving the constitutional question presented.

SUMMARY

The NFMA does not offer an opinion in this brief concerning the central legal issue of this case, *i.e.*, whether Kentucky's exemption from its income tax of interest earned on municipal bonds issued in Kentucky violates the "dormant" aspect of the Commerce Clause because the same exemption is not granted by Kentucky to municipal bonds issued in other states. Instead, the NFMA submits this brief, in support of neither party[2], with the primary objective of providing the Court with information concerning the structure of the municipal bond market in general and municipal bond mutual funds in particular and the potential effects on such market of an affirmance of the Kentucky appellate court's decision.

Specific financial projections regarding the potential impact on any particular municipal issuers, or categories of municipal issuers, of a ruling by the Court affirming the lower Kentucky court would need to be based on a host of assumptions about the interaction of numerous factors that determine the ultimate borrowing cost for a particular municipal bond issue at a particular time. This brief instead explains in general terms how such a ruling would affect the tax-exempt bond market and, in particular, potentially realign borrowing costs for some of the larger municipal issuers while adversely affecting borrowing costs and/or market access for smaller municipal issuers.

ARGUMENT

I. THE EXISTING MUNICIPAL BOND MARKET.

A. Types of Municipal Bonds.

The municipal bond market is a market of great complexity, variety and importance with one central attribute: the

[2] Pursuant to Supreme Court Rule 37.3(a), counsel of record for both Petitioners and Respondents have consented to the filing of amicus briefs, including this brief, in letters that have been lodged with the clerk.

products offered in the market—municipal bonds—are generated solely by the public sector, namely the state and local governmental issuers that issue and sell such bonds in order to finance expenditures that address public needs. As described below, there are various categories and subcategories of municipal bonds, with attributes that vary significantly, but having in common the public nature of the bond issuers and the public purposes sought to be advanced by their capital-raising.

1. *General Obligation and Revenue Bonds.*

The vast majority by number and dollar amount of municipal bonds are federally tax-exempt bonds issued by states, cities, towns, counties and districts, or by public authorities issuing on their behalf, to finance long-term public capital expenditures, including the acquisition of public lands and the construction and improvement of public buildings and of transportation, water and sewer systems and other infrastructure. Such bonds are issued as "general obligation bonds" payable from the full faith and credit of the governmental issuer (*e.g.*, taxes and all other moneys available to the issuer for the repayment of the debt incurred), or, in the case of municipal bonds issued to finance facilities that generate sufficient revenues to repay the applicable debt, as "revenue bonds" payable solely from the fees, tolls and other charges paid by the users of the applicable facilities. In 2006, approximately $387 billion in long-term bonds were issued, of which approximately $115 billion were general obligation bonds and approximately $272 billion were revenue bonds. *See* Securities Industry and Financial Markets Association (SIFMA), *Municipal Bond Credit Report*, March 2007, *available at* archives1.sifma.org/assets/files/Municipal_Credit_Report_06Q4.pdf.

There are numerous variations on the prototypical general obligation or revenue bond issued to finance bridges, roads, schools, libraries, police stations, fire stations, public housing, health care facilities, parks and the like. Such variations include "double-barreled bonds" payable from a dedicated revenue stream and backed by the general obligation of the issuing jurisdiction; "dedicated tax" bonds with first priority vis-à-vis other municipal bonds against certain portions of sales taxes or other specialized taxes collected by the issuer; "moral obligation" bonds backed by a non-binding statement of legislative intent to appropriate funds if required to pay debt service; tax anticipation notes, revenue anticipation notes, deficit bonds and other types of bonds issued not to fund capital expenditures but to provide short-term or permanent financing of a governmental entity's operating expenses (such as the salaries and other compensation of public sector employees); and refunding bonds, issued to lower interest costs, extend repayment periods and/or change other terms associated with previously issued municipal bonds.

2. *Federally Tax-Exempt and Federally Taxable Municipal Bonds.*

Most general obligation or revenue bonds qualify for federal tax-exemption, *i.e.*, the interest on the bonds is exempted from federal income tax payable by the holder of the bonds, thereby permitting the issuer of the bonds to pay a lower interest rate that from the bond purchaser's perspective is competitive on an after-tax basis with a federally taxable debt instrument bearing a higher interest rate. Federal tax-exemption, however, is not an inherent characteristic of a municipal bond. The Internal Revenue Code does not provide federal tax-exemption for all municipal bonds issued to finance the public needs of state and local governments. For example, municipal bonds issued to finance multi-billion dollar unfunded deficits in future pension obligations of a state or city to its public employees do not qualify for federal tax-exemption, and are issued as federally taxable but generally state tax-exempt municipal bonds. This Court has held that federal tax-exemption of municipal bonds is not mandated by the U.S. Constitution, *see South Carolina v. Baker*, 485 U.S. 505 (1988), but rather is a legislative decision for the federal government, and accordingly the financing needs of state and local government municipal bond issuers and federal tax-exemption of municipal bonds are not now, and are not inherently, co-extensive.

3. *Conduit Bonds.*

A subcategory of revenue bonds consists of so-called "conduit" municipal bonds, which constitute a minority by dollar amount of revenue bond issues, and a smaller minority by dollar amount of all municipal bond issues, but nonetheless a meaningful component of the municipal bond market. Such municipal bonds are issued to provide governmental financing to non-governmental entities or persons conducting activities that the state legislature has determined serve a public purpose. Such municipal bonds frequently qualify for federal tax-exemption and, irrespective of federal tax-exemption, typically—though not always—qualify for state tax-exemption. The facilities or activities financed by conduit municipal bonds—which also are referred to as industrial revenue bonds, industrial development bonds or private activity bonds—include federally-insured or state-authorized student loans for higher education; low-income or mixed-income housing; hospitals, nursing homes, assisted living and other health care facilities; schools, colleges and universities; museums; social services agencies; solid waste disposal facilities; airports; docks and wharves; mass commuting facilities; sewage facilities; facilities for the furnishing of water or the local furnishing of electric energy or gas; local district heating or cooling facilities; hazardous waste facilities; high-speed intercity rail facilities; environmental enhancements of hydroelectric generating facilities; small manufacturing facilities and so-called "Liberty Bonds" issued to rebuild the areas devastated by the 9/11 terrorist attacks. State law may require that the public issuers of conduit bonds own the financed facilities for the duration of the bonds, but permit leasing of the financed facilities to the non-governmental user of the facility under terms that require that the lessee pay the debt service on the applicable municipal bonds. Federal tax-exemption statutes likewise require that certain facilities financed by such conduit municipal bonds—such as airports, docks and wharves, mass commuting facilities and environmental enhancements of hydroelectric generating facilities—be owned by state or local government for at least the duration of the bonds, while permitting leases to non-governmental users for portions of the useful life of the financed facility. In those instances where neither state nor federal law requires that the financed facility be governmentally owned, conduit bonds may be structured in a manner that the governmental issuer loans the proceeds of the municipal bonds to a non-governmental entity for construction of the financed facility and use of such facility for the legislatively approved public purpose.[3]

4. *Tax Credit Bonds.*

Yet another variation on the theme is provided by tax credit bonds, which do not benefit from federal interest tax-exemption, but instead provide the bondholder with federal tax credits that can be applied to reduce the bondholder's federal tax liability. Such municipal bonds, which include "qualified zone academy bonds", "clean renewable energy bonds" and "Gulf tax credit bonds" (to finance the rebuilding of hurricane-devastated areas), are in some instances state tax-exempt.

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[3] In the case of conduit municipal bonds, whether the financed facility is owned by the public issuer or a non-governmental entity, the debt service on the bonds generally is payable by the public issuer solely from the lease payments, loan payments or other revenues received from the non-governmental user of the financed asset, and not from any taxes or other public moneys.

B. Borrowing Cost Advantages Provided by Tax-Exemption.

State tax-exemption of municipal bonds generally entails exemption of interest income from state income taxes as well as any otherwise applicable local income taxes, and for certain issuers may also entail exemption from certain other state taxes, such as income taxes on capital gains or certain franchise or estate taxes. The borrowing cost advantage provided by state tax-exemption, which, in the case of federally tax-exempt bonds, is incremental to the cost advantage provided by federal tax-exemption[4] and, in the case of federally taxable but state tax-exempt municipal bonds, is the primary borrowing cost advantage, is influenced by factors such as then effective state (and, if applicable, local) income tax rates, the creditworthiness of the applicable municipal bond, the length of time it will be outstanding, and supply and demand elements. All other things being equal, the higher the state and local taxes otherwise applicable to the bond purchaser[5],

[4] The extent to which federal tax-exemption lowers the otherwise applicable interest rate on municipal bonds varies depending on a number of factors, such as then effective federal income tax rates, the creditworthiness of the applicable municipal bond, the length of time it will be outstanding, and supply and demand elements. For example, at the end of 2006, the borrowing costs on AAA-rated, 10-year municipal bonds on average were 80.3 percent of comparable, but federally taxable, U.S. Treasury securities, whereas at the end of 2005 the borrowing costs on such municipal bonds were 88.4 percent of comparable U.S. Treasury bonds. *See* Securities Industry and Financial Markets Association, *Municipal Bond Credit Report*, March 2007, at 2, *available at* archives1.sifma.org/assets/files/Municipal_Credit_Report_06Q4.pdf.

[5] Sample high income tax states include New York (7.7% maximum personal state income tax rate for 2006, plus, for New York City taxpayers, 3.648% maximum local income tax rate for 2006); California (9.3% maximum personal state income tax rate for 2006), New Jersey (8.97% maximum personal state income tax rate for 2006), North Carolina (8.25% maximum personal state income tax rate for 2006) and Ohio (7.25% maximum personal state income tax rate for 2006).

the more valuable to that bond purchaser the state tax-exemption becomes, and the larger the reduction in borrowing costs to the municipal bond issuer is as a result of the state tax-exemption; in lower or no income tax states, the reduction in borrowing rates resulting from the state tax-exemption is lower or non-existent. The amount by which borrowing costs are reduced in high tax states as a result of the combination of state tax-exemption for in-state municipal bonds and lack of exemption for out-of-state municipal varies over time, but is appreciable.[6]

The reduction in borrowing costs attributable to state tax-exemption of municipal bond interest is not fully commensurate with the potential state tax savings to purchasers of such bonds. Demand for bonds issued in a specific state from taxpayers within such state may not be sufficient to absorb all bond issues by such state's issuers or all bonds within particular bond issues. Accordingly, purchasers of bonds that are exempt from state income taxes in the issuing state may include taxpayers from other states that do not exempt such interest income, or that do exempt such interest income but have lower state income tax rates than the state in which the bond is issued. As noted below, a substantial portion of municipal bond issues that cannot be absorbed exclusively by purchasers within the issuing state, or by single-state mutual funds dedicated to purchasing bonds of the issuing state, are purchased by national municipal bond mutual funds and by other investors that are indifferent to the state tax exemption

[6] Per the calculations of the trading desk at the Eaton Vance mutual fund complex, as of July 16, 2007, annual yields on municipal bonds issued in New Jersey, New York and California were 0.20% (20 basis points), 0.12% (12 basis points) and 0.08% (8 basis points), respectively, lower relative to the Thomson Municipal Market Data (MMD) benchmark for the tax-exempt municipal bond market than yields on comparably credit-worthy bonds issued in states with relatively low state income taxes.

or that are induced to purchase by an attractive interest rate. The reduced (or nonexistent) state tax benefit to out-of-state purchasers is reflected in their demand for, and the interest rate payable on, the applicable municipal bonds.

C. Purchasers of Municipal Bonds.

Municipal bonds are purchased and held by individual investors, investment companies, insurance companies, commercial banks and other institutional investors. The following data provide a profile of the market as it exists today:

- As of the end of 2006, approximately $2.4 trillion in tax-exempt municipal bonds were outstanding. Ownership broke down as follows:
    - Individuals owned approximately $865 billion;
    - Investment companies owned approximately $802 billion;
    - Insurance companies owned approximately $364 billion;
    - Commercial banks and broker-dealers owned approximately $242 billion; and
    - Other institutional investors owned approximately $129 billion. *See* Securities Industry and Financial Markets Association, *Holders of Municipal Bond Securities*, available at www.sifma.org/research/pdf/Holders_Municipal_Securities.pdf.
- After individuals, the second largest category of holders of tax-exempt debt in the United States is registered investment companies, including mutual funds, unit investment trusts, closed-end funds and exchange-traded funds. *See* Investment Company Institute, *2007 Investment Company Fact Book*, at 10, *available at* www.ici.org/home/2007_factbook.

pdf. In 2006, over a third of all municipal bonds issued in the United States were purchased and held by mutual funds and other registered investment companies. *Id.*

- In 2006, tax-exempt mutual funds held approximately $365 billion in long-term bonds, of which approximately $155 billion were held in 481 single-state funds and approximately $210 billion in 230 national funds. *Id.* at table 4, p. 96, and table 6, p. 98.

- As of March 31, 2007, tax-exempt money market funds (a subcategory of mutual funds) held approximately $379 billion in short-term municipal bonds (including tax-exempt commercial paper, short-term notes, variable rate long-term bonds with put features and synthetic short-term notes with put features derived from long-term bonds). Of this amount, approximately $254 billion were held in national tax-exempt money market funds and approximately $125 billion in single state tax-exempt money market funds. *See* Lipper Analytical Services, *Tax-Exempt Fixed Income Fund Performance Analysis,* 1st Quarter 2007 Report.

- Municipal bond holdings in mutual funds were held through approximately 1,647,000 shareholder accounts in single-state long-term bond funds, approximately 2,527,000 shareholder accounts in national long-term bond funds and approximately 3,061,000 tax-exempt money market fund shareholder accounts. *See* Investment Company Institute, *2007 Investment Company Fact Book*, at table 10, p. 102, *available at* www.ici.org/home/2007_factbook.pdf.

- In addition, approximately $95 billion of municipal bonds were held in 276 closed-end municipal bond funds, and approximately $8.7 billion of municipal bonds were held in tax-exempt unit investment trusts. *Id.* at tables 11 and 13, pp. 103 and 105.

Because mutual funds are structured in a manner that permits ready identification of funds that buy only municipal bonds of a specific state versus funds that buy municipal bonds on a national basis, they provide the most reliable readily available data on the extent to which the currently prevailing state tax system drives bond purchasers to purchase bonds of a particular state. Based on the above-described recent data, approximately 42% of long-term municipal bonds owned by mutual funds, and approximately 33% of short-term municipal securities owned by money market funds, are owned by funds that target taxpayers of the state in which the bond issuer is located, and approximately 58% of such long-term municipal bonds and approximately 67% of such short-term municipal securities were purchased without regard to a match between the state of the bond issuer and the state of the fund's shareholders.

These percentages indicate that the national market is the predominant market for municipal bonds as a whole, but that there is a substantial and influential sector of municipal bond purchasers that generally will only purchase municipal bonds issued in a specific state. Similar statistics for municipal bonds purchased directly by individuals or other non mutual fund investors are difficult to obtain, but it is unlikely that direct purchaser trends would deviate substantially from those applicable to mutual fund and money market fund shareholders.

D. National and Single State Tax-Exempt Municipal Bond Funds.

The current municipal bond marketplace is in part a national market and in part a state by state market. National tax-exempt municipal bond funds, as their label suggests, are permitted to purchase federally tax-exempt municipal bonds issued in any state. They generally have substantially larger amounts of assets under management, and offer greater diversification, including geographic diversification, in their municipal bond portfolios, than do single state funds, and state tax-exemption plays no appreciable role in their selection of municipal bonds for their investment portfolios or in their shareholders' decision to invest in such funds.[7]

Single state tax-exempt municipal bond funds are required to invest substantially all their invested assets in bonds issued within the applicable state. Because of their sharply reduced geographic diversification and somewhat higher expense ratios relative to national funds (because the fund's fixed expenses generally are spread over a smaller asset base), single state funds appeal primarily to investors seeking to maximize their tax-exempt return by investing in a fund that will produce income that is not only federally tax-exempt but also state tax-exempt and, where applicable, locally tax-exempt (so-called "triple tax-exempt"). Accordingly, shareholders in single state funds almost invariably are taxpayers in the state to which the fund's portfolio investments are dedicated.

The formation and maintenance of single state funds, as well as their number and size, is driven by market demand. Single state funds currently exist for 42 states. *See* Lipper Analytical Services, *Tax-Exempt Fixed Income Fund Per-*

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[7] National tax-exempt municipal bond funds report to their shareholders for tax purposes the percentage of the applicable fund's annual income derived from bonds issued in each state, and shareholders can use such information to avoid state income tax payments on a prorated portion of tax-exempt interest income received from such funds, to the extent the states in which they pay taxes provide an exemption for municipal bond interest derived from bonds issued in the applicable states. However, because shareholders have no assurance that any particular percentage of a national fund's assets will be invested in any particular state's municipal bonds, such state tax-exemption generally is not a factor in their decisions to invest in a national fund.

formance Analysis, 1st Quarter 2007 Report. The following is a profile of the states for which no single state funds have been established, and of those for which such funds exist:

- The eight states that lack representation in the single state fund market are Alaska, Illinois, Indiana, Iowa, Nevada, South Dakota, Texas, and Wyoming.
- Five of these eight states lack a state income tax: Alaska, Nevada, South Dakota, Texas and Wyoming.
- Indiana has a state income tax, but exempts municipal bonds irrespective of whether the issuer is located in Indiana or in a sister state. Ind. Code An. § 6-3-1-3.5 (2007).
- The remaining two of these eight states, Illinois and Iowa, apply their state income tax to municipal bonds irrespective of whether the issuer is located within the state or in a sister state, with the exception of an exemption for a discrete number of in-state issuers. *See* Iowa Code § 12.91 (2007); 20 Ill. Comp. Stat. Ann. 3501/820-60 (2007).

Accordingly, there is almost total overlap between the states for which single state funds have been formed and the states that exempt from their state income taxes only municipal bonds issued within their borders. There is one exception: single state funds have been established for Florida, which has no state income tax. This exception reflects one instance where shareholder affinity to municipal issuers in their "backyard" has provided a sufficient basis for the marketing and viability of funds dedicated to a specific state's municipal bond offerings, but proves the general rule that single state funds are almost entirely a creation of the prevalent state income tax treatment of exempting income earned on in-state municipal bonds while taxing income earned on out-of-state municipal bonds.

National mutual funds generally have more assets to invest and a much wider variety of issuers to select from, and therefore are less likely to dedicate the time necessary to evaluate a small, obscure or infrequent municipal bond issuer or to purchase bonds issued by such public entities.

Single state funds, by contrast, are likely to sift through most if not all municipal bond issuers within the specific states to which they are dedicated and to familiarize themselves with, and purchase municipal bonds of, a broader range of municipal issuers within the state, including smaller, lesser-known and lower-rated issuers. Because a single state fund is required to invest substantially all of its assets in municipal bonds issued in one specific state, the analysts and portfolio managers assigned to a single state fund focus on the full spectrum of municipal bond issuers of the applicable state in a manner that analysts and portfolio managers of national mutual funds do not.

The large bond issues by well-known state-level issuers that are most readily purchased by national mutual funds constitute the largest proportion of the tax-exempt bond market by volume, but are only a small minority of the municipal bond market by number of bond issues. According to statistics compiled by the Internal Revenue Service, in 2002 almost 50 percent of the total number of new money long term municipal bonds issued to finance governmental assets had a bond issue size of less than $1,000,000, and were issued by smaller towns to finance school buses, fire trucks and similar public expenditures. The same study found that almost 75 percent of the total number of such municipal bonds had a bond size of less than $5,000,000, almost 84 percent a bond size of less than $10,000,000, and almost 92 percent a bond size of less than $25,000,000. Cynthia Belmonte, *Tax-Exempt Bonds*, 1996-2002 at 154, 168, *available at* www.irs.gov/pub/irs-soi/02govbnd.pdf. Although not all of such smaller bond issues were purchased in whole or in part by mutual funds, those that were are far more likely to have been purchased by single state tax-exempt mutual funds than by national tax-exempt mutual funds.

II. IMPACT OF REQUIRING STATES TO GIVE IDENTICAL STATE TAX TREATMENT TO MUNICIPAL BONDS ISSUED IN OTHER STATES.

If the Court determines that states that currently exempt from their income tax interest on their own municipal issuers' bonds are constitutionally required to either grant such exemption to municipal bonds issued in other states or to tax all bond interest at the same rate, a substantial reconfiguration of the municipal bond market will follow. Such a holding would require a change in the tax policies and laws of the 42 states that currently exempt only some or all of their own municipal issuers' bonds from the applicable state's income tax, and would likely require a change in the tax policies and laws of a 43rd state (Utah) which exempts out-of-state bonds only for states that reciprocally exempt Utah's municipal bonds. Although it is difficult to forecast with precision the overall impact of such a seachange or its impact on individual states, it is clear that the disruption to the existing municipal bond market, and the adjustment from a system that has prevailed for close to a century, would be substantial.

As described above, the current marketplace is in part a national market and in part a state-by-state market. National funds purchase a majority by dollar amount of the municipal bonds purchased by mutual funds, but a substantial dollar amount is purchased by single state funds. Although statistics for purchases of municipal bonds by individuals (primarily higher income individuals, since the value of tax-exemption increases with the bondholder's tax bracket) and other categories of municipal bond purchasers are harder to pinpoint, it is likely that many such purchasers also allocate their municipal bond holdings, at least to some extent, between bonds of the state in which they pay taxes (which provide a state tax benefit) and bonds issued in other states, which provide geographic and other types of credit diversification.

A determination that states are prohibited from limiting the state tax exemption to their own issuers' municipal bonds would eliminate relative tax treatment of in-state and out-of-state bonds as a consideration for municipal bond purchasers within a state. The relative value of a municipal bond would still vary state to state depending on the particular state's income tax rates and whether that state chose to subject all municipal bonds to such tax or to exempt all municipal bonds from such tax. Viewed in isolation, a determination by this Court that the dormant Commerce Clause requires each state to grant equally favorable state tax treatment to out-of-state bonds would increase relative demand in at least 42 states for municipal bonds issued in other states, with demand for out-of-state bonds increasing the most in the case of taxpayers in high tax states, where the tax advantage of buying in-state bonds is currently the highest. In theory, such demand shifts would reduce borrowing costs for issuers in states where the increase in demand from out-of-state bond purchasers was greater than the loss of demand from in-state bond purchasers, and increase borrowing costs for issuers in states where the loss of demand from in-state bond purchasers was greater than the increase in demand from out-of-state bond purchasers.

There would, however, be offsetting impacts on any demand realignment occasioned by an affirmance in this case. First, fiscal considerations could cause particular states to respond to constitutionally-mandated equal tax treatment of in-state and out-of-state municipal by taxing all municipal bonds. Such a response could reduce overall demand for municipal bonds—wherever issued—by tax-payers in such state. Second, an affirmance in this case would cause the virtual elimination of single state mutual funds as purchasers in the municipal bond market. Because national tax-exempt bond funds have a shifting group of shareholders from all or most states, the state tax treatment of municipal bonds in any particular state has a substantially diluted effect on the demand by such funds for municipal bonds from any particular state. Thus, any realignment in demand and borrowing costs resulting from equal state tax treatment of out-of-state bonds in states that previously exempted only in-state bonds would be diluted by the increased role of national mutual funds as purchasers in the municipal bond market.

As noted above, one predictable impact of the elimination of tax incentives for the purchase of municipal bonds issued in a specific state would be the disappearance, through consolidation into national mutual funds, of single state mutual funds. Although a handful of single state funds might continue to exist for a small number of states (such as Florida) with high populations that have a high affinity for local bond issuers, the current state tax system is the *raison d'etre* for virtually all single state funds, and they would cease to be financially viable in the absence of a tax advantage that outweighed their relative lack of diversification vis-à-vis national funds and their reduced asset base.

The main adverse impact of the disappearance of single state funds as a substantial category of purchasers in the municipal bond market would be felt by small municipal issuers, which, as discussed above, constitute the majority by number, albeit a minority by dollar volume, of municipal entities that rely on the municipal bond market for financing of public needs. Large municipal bond issues would continue to find a home with national bond funds and other categories of municipal bond purchasers, at interest rates that, depending upon applicable demand reconfigurations, may be higher or lower than they would be under the current state tax system. The smaller, lesser-known and lower-rated issuers that constitute the numerical majority of the municipal bond market would be adversely impacted by a number of factors. A principal category of buyers of their bonds, single state funds, no longer would be present in the market, and national mutual funds do not, and are unlikely to, focus their attention on such smaller bond issues.

Elimination of single state funds would lead to a reduction in the number of municipal mutual fund analysts employed within mutual fund complexes that offer a substantial number of such funds.[8] The reduction in personnel dedicated to evaluating municipal bonds issued in specific states for which single state mutual funds currently exist would translate into reduced purchases of the smaller and less familiar bond issues within each such state. In addition, national mutual funds place a higher premium on the liquidity of their holdings than do single state funds, which are willing to purchase less liquid municipal bonds of smaller and less familiar issuers because of the state tax advantage and the fund's mandate to purchase bonds issued within a specific state. The same liquidity concerns would likely impact demand for such bonds by individuals and other categories of municipal bond purchasers, who no longer would gain a state tax advantage as a countervailing benefit of owning such bonds. Such smaller issuers would stand to lose much of the intrastate market for the bonds that has developed under the currently prevailing state tax system without gaining much of an interstate market from its elimination.

As in other markets, the likely impact of a more national market for municipal bonds would be to tilt the market further towards larger, nationally-recognized market participants and to squeeze out or decrease the competitiveness of smaller and

[8] One such NFMA member estimates that such a consolidation might result in a decrease of up to 50% in the number of municipal analysts it employs. Other NFMA members with fewer single state funds estimate a lesser impact.

more obscure participants. The difference, of course, between the municipal bond market and other markets is that the municipal bond market involves cities, towns, school districts, fire districts and other public entities, rather than independently-owned hardware stores, bookstores, pharmacies and the like. Local public issuers of municipal bonds that may face substantially higher borrowing costs or, in some cases, lose market access for their bond issues as a result of a state's inability to use its tax policy to promote the interests of its public sector will not be replaced by national chains. Accordingly, constitutionally-mandated equal state tax treatment for out-of-state public issuers could have adverse consequences for the lower rungs of the state public sector in a multitude of states that currently use tax policy to bolster the capital raising capabilities of their in-state public issuers.

The realignment of the municipal bond market occasioned by an affirmance in this case also would impact municipal bond investors. The value of outstanding municipal bonds issued in high tax states would decline by billions of dollars.[9]

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[9] For example, the outstanding principal amount of municipal bonds issued in California, New Jersey and New York, based on *The Bond Buyer* issuance statistics for the 1997-2006 period, is approximately $535 billion, $113 billion and $338 billion, respectively. The relative amounts of fixed rate municipal bonds and variable rate municipal bonds issued during the same period are approximately 81% and 19%, respectively. See Securities Industry and Financial Markets Association, *Municipal Bond Issuance – Coupon Type*, *available at* www.sitma.net/story.asp?id =2240. Discounting the approximate amount of outstanding bonds in the three sample states by a 19% factor to eliminate variable rate bonds (the interest rates on which would adjust upwards to compensate for any loss of value due to elimination of state tax exemption), the outstanding principal amount of long-term municipal bonds issued in those three states is approximately $433 billion, $91 billion and $274 billion, respectively. Assuming an affirmance in this case produces an increase in interest rates by 8, 20 and 12 basis points, respectively (see footnote 6, *supra*) in the applicable state-specific Lehman Brothers Municipal Bond Index rates in effect on July 16, 2007, and taking into account that bond prices move

All other things being equal, there would be commensurate increases in the aggregate value of bonds issued in lower tax states. It is an open question whether the adverse impact on investor psychology resulting from losses due to unanticipated legal changes in the structure of the municipal bond market would be offset by the unanticipated gains experienced by other investors in the same market as a result of the same unanticipated legal changes.

III. AFFIRMANCE WOULD PRODUCE WIDESPREAD AND POTENTIALLY PROLONGED LEGAL AND MARKET UNCERTAINTY.

As described in Section II above, a determination by the Court that the United States Constitution prohibits a state from exempting its public issuers' debt from state income taxation unless similar tax treatment is accorded to the debt of public issuers located in other states would result in a restructuring of the municipal bond market and affect borrowing costs and market access for a substantial segment of municipal issuers. These effects would be driven primarily by changes in the relative value to municipal bond purchasers of in-state versus out-of-state bonds.

In addition, the aftermath of such a Court decision would generate uncertainty by bond purchasers and bondholders over the tax treatment of municipal bonds in at least 42 states with tax statutes that treat some or all in-state municipal issuers more favorably than out-of-state municipal issuers.

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inversely to interest rates, the present value amount of the loss calculated by applying such rate differences to such outstanding principal amounts of long-term municipal bonds in those three states for the estimated remaining average life of such bonds of 7.12, 7.04 and 6.42 years, respectively, produces a dollar loss to investors in those three states of approximately \$2.43 billion (California), \$1.21 billion (New Jersey) and \$2.18 billion (New York), or a loss of approximately \$5.82 billion for owners of long-term bonds issued in those three states. Aggregate losses would be larger taking into account bonds issued in other high tax states.

Such uncertainty would linger during the period necessary for state legislatures and/or state and federal courts to decide whether to respond to such a prohibition by subjecting municipal bonds of their own public issuers to state income taxation or by expanding the exemption to municipal bonds issued in other states.

Such uncertainty would be compounded by uncertainty over whether states that resolved the required equalization of tax treatment of in-state and out-of-state municipal bonds by taxing in-state bonds would, in the case of outstanding bonds of in-state public issuers issued prior to the date of enactment of such change in tax treatment, (1) exempt such bonds for their remaining term, (2) subject such bonds to taxation prospectively or (3) subject such bonds to taxation for past periods as well as prospectively.[10] During the period of uncertainty as to state tax treatment, accurate valuation of municipal bonds would be impeded, diminishing the value of outstanding municipal bonds that are putatively exempt from state income tax and affecting the ability of municipal bond issuers in such states to capture the interest rate benefit of issuing putatively state tax-exempt bonds. The period of uncertainty could be prolonged by multi-year legal challenges to any determination by a state to tax outstanding bonds. In addition, if any state were to respond to the fiscal challenges presented by constitutionally-mandated equal state tax treatment of other states' bonds by taxing previously tax-exempt in-state bonds, the precedent set by such taxation of bonds originally sold on the premise of state tax-exemption could produce a substantial increase in bond purchasers' general perception of the degree of risk that favorable tax treatment of

[10] This Court has held that, with respect to prior periods, an unconstitutionally discriminatory tax may be remedied either by providing a tax refund process for taxpayers that paid the tax or by prompt retroactive taxation of taxpayers that did not pay the tax. *Des Moines Nat'l Bank v. Bennett*, 284 U.S. 239, 247 (1931).

outstanding bonds may be eliminated during the term of the bonds, thereby inflicting a generalized increase in borrowing costs on long-term municipal bonds, which currently are purchased and priced on the premise that the tax-exemption features will remain applicable for the term of the bonds.

Each affected state would have to assess whether to exempt all income earned from municipal bonds, in-state and out-of-state alike, or to tax all bond income at the same rate. The relative simplicity of that choice, however, is belied by a multiplicity of complicating, state-specific factors, which include, *inter alia*: the level of tax revenue generated by the particular state's tax on income from out-of-state bonds; the borrowing cost savings attributable to state tax-exemption of its issuers' bonds; the level of potential income tax refund liability to holders of municipal bonds issued in other states; the specific terms of the state's constitution, of its general statutes conferring tax-exempt status on its public issuers' bonds and of the enabling acts establishing each particular bond issuer; the state's own constitutional provisions regarding retroactive taxation; and perceptions of the risk that impairment of contract claims will succeed if a state decides to tax outstanding bonds sold on the basis of state tax-exempt status. Given the variety of complicating factors, a Court determination that equal state tax treatment of other states' municipal bonds is mandated by the Constitution would produce disparate resolutions of the legal dilemma faced by the states, creating an aura of generalized unpredictability around a product—municipal bonds—that is currently perceived as a safe haven for risk-averse investors.

The NFMA endeavors in the following sections to provide a brief overview of some of the legal issues that would likely contribute to market uncertainty in the aftermath of an affirmance by this Court.

A. If a State Decides Not to Retroactively Tax Income Earned on Its Own Issuers' Municipal Bonds During Periods When Out-Of-State Municipal Bonds Were Taxed, It Will Face Higher Refund Liability.

If a state is precluded by its own constitution[11] from or otherwise chooses not to implement retroactive taxation of previously tax-exempt in-state bonds, it will face likely refund liability to taxpayers who paid state income tax in prior years on interest derived from out-of-state bonds. Such taxpayers would assert, based upon this Court's affirmance and the principle of retroactivity laid out in *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86 (1993),[12] that the state's taxation of such income was invalid, and their refund claims would be limited only by applicable limitations periods on

[11] Numerous states have included in their constitutions an express prohibition on taxing interest earned on in-state bonds. *See, e.g.*, Ky. Const. § 171; Ohio Const. art. VIII, §§ 2k(D)(4), 2l(E), 2m(D), 2n(E), 2o(G), 2p(E) (interest on state bonds "shall at all times be free from taxation within the state"). In addition, various states have enacted statutes that create a covenant between the purchaser and the state in which the state agrees not to tax interest earned. *See, e.g.*, Cal. Gov't Code § 99016 (Deering 2007); Ga. Code Ann. § 32-10-49 (2007); Ky. Rev. Stat. Ann. § 58.580 (2006); N.Y. Pub. Auth. Law § 372 (McKinney 2004); Va. Code Ann. § 15.2-5361 (2007). These state-by-state variables would create further inconsistency across state lines.

[12] *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86 (1993) dictates that interpretations of federal law, including the Constitution, have full retroactive effect in cases involving taxation:

> When this Court applies a rule of federal law to the parties before it, that rule is the controlling interpretation of federal law and must be given full retroactive affect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our announcement of the rule . . . [W]e now prohibit the erection of selective temporal barriers to the application of federal law in noncriminal cases.

509 U.S. at 95.

refund claims based on the constitutional infirmity of a tax statute. The states are better sources than the NFMA for information as to the potential magnitude of such liability on a state-by-state basis, but the magnitude would likely be sufficient for at least some states to give substantial consideration to the option, if available, of retroactive taxation of in-state municipal bonds as an alternative to paying such refunds.

B. The Extent to Which States Can Retroactively Tax Income Earned on In-State Bonds in Past Years is Unclear, May Vary on a State-By-State and Issuer-By-Issuer Basis and is Likely to Lead to Litigation, Uncertainty and Devaluation of Municipal Bonds If Attempted.

Tax statutes may be retroactive, in the sense of applying to periods or transactions preceding enactment, if the operative legislation clearly so intends and due process considerations do not preclude such taxation.[13] In *Welch v. Henry*, 305 U.S. 134 (1938), this Court emphasized the case specific nature of analysis of whether retroactive taxation violates the Due Process Clause: "In each case it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation." *Id.* at 147 (upholding a retroactive tax that reached back three years). The Court has specifically rejected a taxpayer's reliance on existing tax legislation as in and of itself establishing a due process violation in the context of retroactive taxation; as the Court stated in *United States v. Carlton*, 512 U.S. 26,

[13] "[T]he need of the government for revenue has hitherto been deemed a sufficient justification for making a tax measure retroactive whenever the imposition seems consonant with justice and the conditions were not such as would ordinarily involve hardship." *Untermyer v. Anderson*, 276 U.S. 440, 449 (1928) (Brandeis, J., dissenting); *see also Reinecke v. Smith*, 289 U.S. 172 (1933); *U.S. v. Hudson*, 299 U.S. 498, 500-01 (1937).

33-34 (1994), "Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."

State courts have come down differently in various contexts involving retroactive taxation, and, in addition to this Court's interpretation of federal due process considerations as applied to retroactive taxation, each state's jurisprudence would need to be considered by the applicable state legislature and state courts as well as by holders of outstanding bonds issued in such state in determining the feasibility and validity of a state's responding to an affirmance in this case by legislating that taxpayers who held in-state municipal bonds that were issued, sold and valued as exempt from state income tax must pay taxes on income earned from those bonds in years past.[14] Moreover, because the jurisprudence surrounding retroactive taxation principally involves imposition of new taxes rather than revocation of express exemptions, the application of federal and state due process precedents to any such revocation would be a subject of additional uncertainty.

In short, if a state decided to retroactively tax income earned on in-state bond income, the case by case nature of balancing the fiscal needs of the state against the burden to taxpayers of being subjected to additional taxation in bygone tax years, and the varying periods for which different states might seek to impose retroactive taxation, would ensure prolonged legal uncertainty as to the validity of such taxation, and equally prolonged uncertainty as to whether such retro-

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[14] *See, e.g.*, *Gardens at West Maui Vacation Club v. County of Maui*, 90 Hawai'i 334 (1999); *Gunther v. Dubno*, 195 Conn. 284 (1985); *Brennan v. Kirby*, 529 A.2d 633 (R.I. 1987); *Slewett & Farber v. Bd. of Assessors*, 438 N.Y.S.2d 544 (1981); *Keniston v. Bd. of Assessors of Boston*, 380 Mass. 888 (1980); *Pabst v. Comm'r of Taxes*, 136 Vt. 126 (1978); *Collins v. Comm'n*, 1968 WL 225 (Or. Tax 1968); *Colonial Pipeline Co. v. Commonwealth*, 206 Va. 517 (1966); *Allen v. Franchise Tax Bd.*, 39 Cal.2d 109 (1952).

active taxation was effective to nullify the validity of refund claims by holders of out-of-state bonds during the periods in question. Such uncertainty would adversely affect states as well as bondholders, and the mere attempt to impose retroactive taxation by one or more states would jolt a municipal bond market that depends on stability and reliable tax treatment for its relatively low interest rates.

C. The Extent to Which States Can Prospectively Tax Income Earned on In-State Bonds Issued on the Premise of State Tax-Exemption is Unclear, May Vary on a State-By-State and Issuer-By-Issuer Basis and is Also Likely to Lead to Litigation, Uncertainty and Devaluation of Municipal Bonds If Attempted.

A bond is a "contract" for purposes of an analysis under the Contract Clause. U.S. Const. art. I, § 10, cl. 1; *see W.B. Worthen Co. ex rel. Bd. of Comm'rs of Street Imp. Dist. No. 513 of Little Rock, Ark. v. Kavanaugh*, 295 U.S. 56 (1935).[15] It is less clear whether, for purposes of impairment of contract analysis under the Contract Clause of the Constitution, state tax exemption is a "term" of the bond that the state is prohibited from "impairing." The wording of general taxation statutes conferring a state tax-exemption on municipal bonds issued within the state, as well as of issuer-specific enabling acts that confer state tax-exemption specifically to that issuer's bonds, vary substantially, and the precise wording may affect a court's determination whether the statute creates a statutory covenant to maintain such tax-exempt treatment for the term of bonds issued pursuant to the

[15] *See also* 64 Am. Jur. 2d Public Securities and Obligations § 27 ("The federal constitution and many state constitutions contain provisions prohibiting laws impairing the obligation of contracts, and public bonds, including the bonds issued by the various states of the Union and their political subdivisions, have been uniformly and consistently held to constitute contracts within the purview of such provisions").

applicable statute or is merely a statement of current tax treatment.

Precedent is sparse on whether extracontractual law that is not an express covenant with bondholders might be considered a "term" of a bond for purposes of an impairment of contract analysis.[16] In evaluating impairment of contract claims against state taxation of outstanding bonds previously treated as state tax-exempt, courts would need to decide whether the particular statutory provisions establishing state tax-exemption in effect at the time of issuance of a specific municipal bond are deemed to be part of the bond contract, and, if so, whether the state tax exemption is a "central" or "substantial" component of such contract.[17] Even a court

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[16] A court that has passed on the direct question is the Michigan Supreme Court in *City of Pontiac v. Simonton*, 271 Mich. 647 (1935), which opined that "laws in existence at the time of the issuance of municipal bonds, under the authority of which such bonds are issued, enter into and become a part of the contract to such an extent that the obligation of the contract cannot thereafter be impaired or fulfillment of the bond obligation hampered or obstructed by a change in such laws. But a contract obligation is not impaired by a change of law unless such change deprives a party of a substantial right or remedy." *Id.* at 651 (citing *Von Hoffman v. City of Quincy*, 71 U.S. 535 (1866). The *City of Pontiac* case has never been cited outside of the state of Michigan, except in one Arkansas case, *McArthur v. Smallwood*, 281 S.W.2d 428 (Ark. 1955), which was subsequently overruled. *See also* 64 Am. Jur. 2d Public Securities and Obligations § 27: "[T]he bar against impairment does not calcify the bond law beyond all possibility of amendment. The contract obligation is not impaired unless the alteration in the law deprives the bondholders of a substantial right or remedy."

[17] *Compare, e.g., Hutchinson, Shockey, Erley & Co. v. Evansville-Vanderburgh County Bldg. Auth.*, 644 N.E.2d 1228 (Ind. 1994) (holding that the legislature cannot change the maturity dates or interest rates on an outstanding bond) *with Morton Arboretum v. Thompson*, 605 F. Supp. 486 (D.C. Ill. 1984) (amendment of Toll Highway Act to create Highway Authority did not constitute an impairment of the bond contract; "[t]hough Bondholders' rights have been somewhat altered, they have not been 'substantially impaired.' Most importantly, Bondholders' right to payment—

determination that a change in tax treatment of an outstanding municipal bond is an impairment of the bond contract would not end the legal inquiry; an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose. *See United States Trust Co. of New York v. New Jersey*, 431 U.S. 1, 25-26 (1977).

The paucity of caselaw concerning these questions and the layers of issues involved in resolving an impairment of contract claim indicate that resolution of these matters will be far from predictable. State courts might ultimately reach disparate conclusions from state to state and/or bond issue by bond issue. The hazards of such prolonged uncertainty would fall both on holders of outstanding in-state bonds, who would be unable to predict the ultimate tax treatment or value of such bonds, and on the states, which faced with a potential but undetermined constitutional requirement to maintain the state tax-exemption on outstanding in-state bonds may be forced to choose between exempting all outstanding out-of-state bonds—and sustaining the associated loss of tax revenues—or taxing outstanding out-of-state bonds at the risk of an incremental refund obligation to their holders if the outstanding in-state bonds are ultimately determined to be constitutionally immune from state income taxation.

CONCLUSION

The NFMA presents the information herein in order to provide the Court with context concerning the scope, complexities and dynamics of the municipal bond market, as well as to outline the possible impact on such market of an affirmance. The NFMA hopes that this information helps inform the Court's decision-making process.

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the fundamental substantive right for which all the other procedural rights were conferred by the Resolution—has been assured." *Id*. at 492 (citing *City of El Paso v. Simmons*, 379 U.S. 497 (1965) and *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942)).

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