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 KATHERINE V. DAVIS,

Respondents.

ON WRIT OF CERTIORARI
TO THE COURT OF APPEALS OF KENTUCKY

BRIEF OF THE NATIONAL ASSOCIATION OF STATE TREASURERS AS AMICUS CURIAE SUPPORTING PETITIONERS

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INTEREST OF AMICUS CURIAE

The National Association of State Treasurers ("NAST") is a nonprofit association established in 1976.[1] NAST's members include the Treasurers, or similar financial officers, of all 50 States, the District of Columbia, the Commonwealth of Puerto Rico, and several territories of the United States. These officials typically function as the chief financial officers of their respective States with primary responsibility for a wide range of fiscal functions, including, in most instances, the State's direct debt issuance and other capital market operations. Many of these officials are also responsible for approving, or have other oversight responsibility for, the debt issuance and general fiscal affairs of political subdivisions and other public bodies within their respective States.

NAST's membership also includes corporate affiliate members that provide accounting, financial, legal, or other advisory services to NAST's public members. NAST's affiliate organizations include the State Debt Management Network, the professional network of public sector employees responsible for the management and issuance of State debt, and the College Savings Plans Network, the professional network of public sector employees responsible for the management and supervision of qualified tuition programs.

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[1] The parties have filed letters with the Clerk giving blanket consent to the filing of amicus briefs in this case. Pursuant to this Court's Rule 37.6, NAST states that no counsel for a party authored this brief in whole or in part. Nor did any person or entity, other than NAST, its members, or its counsel make a monetary contribution to the preparation or submission of this brief.

NAST and its affiliate organizations conduct professional education programs, engage in the development and implementation of best practices, and participate in the development of federal laws and administrative regulations affecting State fiscal affairs. In view of the role and responsibilities of NAST's public members in the issuance of public debt by States and their public bodies, NAST has a strong interest in whether State tax exemptions that are limited to municipal bonds issued by the State and its subdivisions violate the dormant Commerce Clause. NAST believes that its members' extensive experience in the field of municipal bonds and similar public programs may assist the Court in addressing that question.

STATEMENT

1. *Municipal Securities*. Municipal securities are obligations issued by State or local government entities. These entities include the States themselves, State-created authorities, incorporated local municipalities and local authorities. The most common form of municipal securities are municipal bonds, which represent a promise by the issuer to repay the investor the principal amount of the bond according to a fixed schedule, along with interest.

There are two main categories of municipal bonds: general obligation bonds and revenue bonds. General obligation bonds are backed by the full faith and credit of the issuer to apply all sources of revenue, unless specifically limited, to payment of principal and interest. *See* Judy Wesalo Temel, The Bond Market Association, *The Fundamentals of Municipal Bonds*, 55-56 (5th ed. 2001). Revenue bonds typically are backed by a particular stream of revenue rather than general tax revenues, and are used to fund specific projects that the issuer expects will generate revenue to service the debt

(or are secured by a specific existing revenue stream). *See id*. at 58. For example, bonds issued to raise money for an airport or toll road may be funded by airport fees or tolls.

Public bodies issue municipal bonds to raise funds to support essential government services and other government operating requirements, and to fund public works projects and programs. Uses funded through municipal bonds include government buildings, waste remediation, utilities, transportation facilities (*e.g.*, highways, bridges, railroads, seaports and airports), educational buildings at all levels from elementary schools to colleges and universities, hospitals, and single and multi-family housing.

2. *Importance of Municipal Bonds to State and Local Governments*. In the 25 years from 1975 through 1999, the total value of new short- and long-term municipal bonds issued grew tenfold, from $26 billion in 1975 to $263 billion in 1999. The Bond Market Association, *supra* at 3. More than $350 billion of long-term municipal bonds were issued by States in each year from 2002 through 2006.[2]

The total value of outstanding municipal bonds has also increased dramatically, from approximately $399 billion in 1980 to $1.5 billion in 2000. *Id.* at 17. The Census Bureau reported a combined $1.68 trillion in outstanding State and local government debt in 2001-02, $1.81 trillion in 2002-03, and $1.95 trillion in 2003-04.[3]

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[2] *The Bond Buyer/Thomson Financial Yearbook* 14-15 (2006); Matthew Hanson, *Volume in '06 a Near Record*, The Bond Buyer, January 2, 2007, at 1.

[3] U.S. Census Bureau, State and Local Government Finances, 2001-02 (Census); 2002-03; 2003-04, *all available at http://www.census.gov/govs/www/estimate.html* (last revised July 9, 2007).

The continuing increase in municipal bond issues reflects the critical importance of this source of funding for State and local operations and capital programs.

Municipal bonds provide benefits to the issuer and its citizen constituents, as well as to the purchasers of the bonds. The issuing authority is able to fund important but expensive public projects and programs that could not be paid for out of current tax revenues. Citizens derive immediate benefits from projects paid for with borrowed funds, which can be repaid with revenues collected over time as the project continues to provide benefits to taxpayers. Purchasers of municipal bonds benefit from a profitable and historically safe investment. Although the pre-tax rate of return on municipal bonds is typically lower than the return on other investment vehicles, that difference is offset by the tax-advantaged status of municipal bonds.

3. *Tax-Exempt Status of Municipal Bonds*. From an investor's perspective, municipal bonds are distinguished from other capital market securities by their eligibility for favorable tax treatment, which gives them an advantage over other types of investments. *See* Robert S. Amdursky & Clayton P. Gillette, *Municipal Debt Finance Law Theory and Practice* § 1.3.4 (1992); The Bond Market Association, *supra* at 27-29. The favorable tax treatment accorded to municipal bonds allows State and local government entities to obtain funding for public projects at a lower interest rate than would otherwise be available to them. Federal law provides a significant tax advantage by generally exempting interest on municipal bonds from federal income tax. A large majority of the States also exempt municipal bonds from State (and in some instances local) taxation. State and local tax exemptions can provide a significant additional advantage to municipal bonds as compared to other investments.

Since the Sixteenth Amendment was ratified in 1913, Congress has generally accorded tax-free status to municipal bonds. *See* 26 U.S.C. §§ 103, 141-50; The Bond Market Association, *supra* at 27. The tax-free status of municipal bonds allows the bond issuer to borrow money at a lower interest rate than it could obtain from other sources of financing. Investors are willing to accept lower interest rates precisely because of the advantages they gain from the tax exemption. *Id.*[4]

It would be misleading to compare the published interest rate of a municipal bond to that of an investment without favorable tax treatment, because taxes on non-exempt bonds reduce the after-tax return to the bondholder. To compare the rate of return of a tax-free bond to that of a taxable bond, investors use the following formula to calculate the rate of return on a taxable bond that will yield the same income as a tax-free bond:[5]

$$\frac{\text{municipal bond yield}}{(1 - \text{marginal tax rate})} = \text{comparable taxable bond rate}$$

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[4] The Securities Act of 1933 includes an exception to the Act's registration requirements for securities issued by a State or political subdivision. *See* 15 U.S.C. § 77c(a)(2). The exemption was intended to "correspond[] generally with the line drawn by the courts as to what obligations of States, their units and instrumentalities created by them, are exempted from Federal taxation." H.R. Rep. No. 73-85, at 14 (1933). *See generally* Robert A. Fippinger, *The Securities Law of Public Finance*, §§ 2.2, 2.9.5 (2d ed. 1999). Section 401 of the Employment Security Amendments of 1970 amended the Securities Act of 1933 and the Securities Exchange Act of 1934 to further delineate the special status of municipal securities under the federal securities laws.

[5] *See* The Bond Market Association, *supra* at 28-29.

For example, a bondholder with a 33 percent marginal federal tax rate in a State without income tax, who purchases a municipal bond paying 5 percent interest per year will earn interest equivalent to a taxable bond that pays approximately 7.5 percent interest.

In comparing municipal bonds to other investments, taxpayers take into account not only the federal taxes that would be due on the income, but also State and local taxes. A State tax exemption for in-State municipal bonds can have a significant impact on an investor's decision to purchase in-State versus out-of-State bonds. The "essential variable" in computing the equivalent yield between taxed and tax-free bonds is the investor's marginal tax rate. The Bond Market Association, *supra* at 27. An investor who resides in a State with an income tax who purchases bonds that are free from State taxation as well as federal taxation increases his or her equivalent taxable yield. *Id.*

Favorable State tax treatment of municipal bonds increases the marketability of municipal bonds, and exemptions from State and local taxation may be particularly important to smaller issuers and those with less than perfect credit ratings.[6] Investors have increasingly sought bonds that are exempt from State (and in some cases local) taxation as well as federal taxation, and mutual fund managers have created State-specific bond funds to meet that demand. *See* Jerry Webman, *Managing Single-State Municipal Bond Funds* in The Handbook of Municipal Bonds 339-350 (Susan C. Heide, Robert A. Klein & Jess Lederman eds., 1994). The

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[6] *See* Robert Lamb & Stephen P. Rappaport, *Municipal Bonds* 2, 25-26 (2d ed. 1987); Dwight Denison, *Bond Market Reactions to Hurricane Katrina: An Investigation of Prices and Trading Activity of New Orleans Bonds*, Municipal Finance Journal 39-52 (2006).

percentage of municipal bonds held by mutual funds increased substantially between 1980 and 1999, from 1.6 percent of outstanding bonds to 33.7 percent. The Bond Market Association, *supra* at 17. The popularity of State-specific bond funds demonstrates that investors view exemption from State taxation as an important consideration when investing in municipal bonds. These funds also provide essential market intermediation for smaller and lower-credit issuers.

4. *This Case*. Respondents, two individual Kentucky taxpayers, filed this action in the Circuit Court of Jefferson County, Kentucky challenging the Commonwealth's taxation of income received from out-of-State municipal bonds. Kentucky, like most States, does not tax interest earned on bonds issued by the Commonwealth or its subdivisions, but it does tax interest earned on bonds issued by other States or their subdivisions. *See* Ky. Rev. Stat. Ann. § 141.010(9), (10).

The trial court granted Petitioners' motion for summary judgment. Pet. App. A15-A19. The court held that municipal bonds fall within the "market participant" exception to this Court's dormant Commerce Clause. *See, e.g., Reeves, Inc.* v. *Stake*, 447 U.S. 429, 436-37 (1980); *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794, 808-09 (1976). Accordingly, the court held, a State "clearly may pay a higher rate of interest to resident purchasers based upon the theories of distributing state created benefits and market participation." Pet. App. A18. The court observed that "[e]ach state has a legitimate interest in drawing upon a major source of tax revenue while creating an incentive for investors to purchase state bonds." *Id.* at A19. Because Kentucky's taxation of out-of-State bonds has a "reasonable, legitimate public purpose," the court held that it is constitutional. *Id.*

The Kentucky Court of Appeals reversed. Pet. App. A1-A13. The court of appeals held that Kentucky's tax on

the income derived from bonds issued by States other than Kentucky is "facially unconstitutional" because "it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." *Id*. at A6.

The court of appeals rejected three arguments made by Petitioners in support of the constitutionality of Kentucky's tax code. *First*, the court declined to follow a decision of an Ohio appellate court holding that a similar taxation system does not violate the Commerce Clause. *See Shaper* v. *Tracy*, 647 N.E.2d 550 (Ohio Ct. App. 1994); Pet App. A7-A8. *Second*, the court held that this Court's decision in *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881), is inapposite because it addressed only the Full Faith and Credit Clause and not any issue under the Commerce Clause. Pet. App. A9. *Third*, the court rejected Petitioners' "market participant" argument. The court acknowledged that issuing bonds constitutes participation in the bond market, but it held that taxing income derived from bonds is an activity of the State as a market regulator. Because "the sole issue is Kentucky's decision to tax only extraterritorial bonds," the court held that "the market participant theory is inapplicable." *Id*. at A10.

The Supreme Court of Kentucky denied discretionary review of the court of appeals' decision. *Id*. at A14. This Court granted the petition for certiorari.[7]

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[7] NAST filed the lone *amicus curiae* brief in support of the petition, urging the Court to grant review to resolve the legal uncertainty created by the Kentucky court's decision.

SUMMARY OF ARGUMENT

1. State authority to exempt in-State municipal bonds from state taxation is a longstanding and widely-accepted aspect of State sovereignty. The States' authority to raise revenues includes the authority to issue public debt, because the issuance of debt is an indispensable alternative to taxation. For many decades, States have exercised this authority by providing tax preferences for in-State municipal bonds. Today more than 40 States provide such tax preferences. This Court's decision in *Bonaparte v. Tax Court*, 104 U.S. 592 (1881), indicated that such tax preferences are constitutionally permissible. Prior to the court of appeals' decision in this case, no court had ever held otherwise. The Court does not lightly declare such a long-established and widely accepted practice unconstitutional.

Congress has provided a federal tax exemption for municipal bonds since the inception of the federal income tax. Congress is well aware of the States' practice of exempting in-State municipal bonds from state taxation, and has taken no action to prohibit such exemptions. To the contrary, it has repeatedly approved interstate compacts that contemplate such preferences.

Declaring State tax preferences for in-State municipal bonds unconstitutional would harm State and local governments and upset the settled expectations of investors. State and local governments might be required to cut services, cancel projects, or raise taxes. Taxpayers who purchased out-of-State bonds expecting to pay taxes on the income would receive a windfall from the State Treasury if their taxes were retroactively refunded. And investors who purchased in-State bonds, accepting a lower interest rate in reliance upon the availability of a State tax exemption, would be harmed if the exemption were retroactively eliminated. Other important State

programs may also be placed at risk by an adverse ruling in this case.

2. When a State or local government enters the market the dormant Commerce Clause does not apply. The structuring, issuance, and sale of bonds constitutes direct market participation. Thus Kentucky and its public entities may favor their own citizens by offering them Kentucky bonds at a higher interest rate or a lower purchase price than they offer to other purchasers. Kentucky's tax exemption is economically equivalent to a higher interest rate for Kentucky taxpayers, and thus is constitutionally permissible. This Court's decisions holding that State tax exemptions benefiting private in-State businesses do not constitute direct market participation are inapplicable, because Kentucky's tax exemption benefits State and local government entities that directly participate in the market by issuing bonds.

3. Laws that treat in-State private business interests the same as out-of-State interests do not discriminate against interstate commerce for purposes of the dormant Commerce Clause. *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1797 (2007). Kentucky's tax exemption for in-State municipal bonds does not favor in-State private businesses at the expense of out-of-State businesses. Instead, it favors in-State government entities. The reasons for distinguishing between public and private entities, identified in *United Haulers*, apply with added force to the essential governmental function of issuing debt. Kentucky's tax exemption easily passes muster under the balancing test of *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970), because any burden on interstate commerce is clearly reasonable in relation to the local benefits derived from the exemption.

ARGUMENT

I. State Authority To Exempt In-State Municipal Bonds From State Taxation Is An Aspect Of The State's Sovereignty.

A. State Tax Exemptions For In-State Municipal Bonds Are A Longstanding And Widely-Accepted Exercise Of Sovereign Authority.

The authority of States to borrow money, like the authority to raise revenues through taxation, is a core aspect of State sovereignty. State and local governments must have access to capital markets in order to carry out their essential function of protecting and promoting the health, safety, and welfare of their citizens. By issuing municipal bonds, States and their political subdivisions are able to raise funds for costly projects that benefit State citizens over extended periods of time without having to depend entirely on tax revenues. In the absence of municipal bonds, many important State and local government initiatives would have to be delayed or cancelled.

Alexander Hamilton, perhaps the foremost authority on American public finance, observed that credit "is of the greatest consequence to every country." Alexander Hamilton, *Public Credit* in 2 The Works of Alexander Hamilton 294 (Henry Cabot Lodge ed. 1971) (1904). In *The Federalist*, Hamilton wrote that "individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants," and thus "an attempt by the national government to abridge [the States] in the exercise of [that authority] would be a violent assumption of power, unwarranted by any article or clause of its Constitution." *The Federalist* No. 32 (A. Hamilton). These principles

apply to revenues raised through public debt as well as through taxation.

Hamilton, who was the first Secretary of the U.S. Treasury and the architect of public credit for the new Nation, recognized that the issuance of public debt is an indispensable alternative to taxation as a means of raising government revenue. *See First Report on Public Credit* in 2 The Works of Alexander Hamilton, *supra* at 232 (describing "the great and invaluable ends to be secured by a proper and adequate provision, at the present period, for the support of public credit"). At Hamilton's urging, Congress assumed $25 million in State debt to achieve "an orderly, stable and satisfactory arrangement of the national finances." *Id.* at 244. Hamilton wrote that the "essence" of public debt is "promise," and asked, "Can the government rightfully tax its promise?" *Id.* at 284-85. He answered that it could not, reasoning that "[i]f the government had a right to tax its funds, the exercise of that right would cost much more than it was worth." *Id.* at 289.

In accordance with these principles, States have provided tax exemptions for in-State municipal bonds since the earliest days of State income taxes.[8] Today, 42 States provide preferential tax treatment for individual or corporate income earned on all or some in-State municipal bonds. *See* CCH 2007 State Tax Guide Charts ¶ 700-800, at 36,201-202.

Prior to the Kentucky Court of Appeals' decision in this case, *no* court had ever held that such tax preferences violate the dormant Commerce Clause. The shared understanding that State tax exemptions for municipal bonds are constitutional is supported by this Court's

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[8] *See, e.g.,* 1918 Mass. Acts 7; 1919 N.Y. Laws 1641-42.

decision in *Bonaparte v. Tax Court*, 104 U.S. 592 (1881). In *Bonaparte*, the Court addressed the question "whether the registered public debt of one State, exempt from taxation by the debtor State, or actually taxed there, is taxable by another State when owned by a resident of the latter State." *Id.* at 594. The Court held that it is. Although the Court's opinion specifically mentions the Full Faith and Credit Clause, it did not limit its holding to that Clause. To the contrary, it stated: "[W]e know of no provision of the Constitution of the United States which prohibits such taxation." *Id.* The Court held that a State "cannot secure such exemption [from taxation] *outside* of its own jurisdiction," without suggesting that an exemption *within* the State's jurisdiction is unconstitutional. *Id.* at 595 (emphasis added). The Court added, "While the Constitution . . . might have been so framed as to afford relief against such a disability, it has not been, and the States are left free to extend the comity which is sought, or not, as they please."[9] *Id.* Moreover, the taxpayer in *Bonaparte* made arguments based on Commerce Clause principles. *See* Plaintiff in Error Br. at 12 (States relinquished the right "to regulate, and even prohibit, commerce with their neighbors" in the Constitution, and therefore Maryland cannot "forbid subscriptions by its citizens to an Ohio or New York loan"); *id.* at 13 ("the people of New York or Pennsylvania would [not] have consented to forego their antecedent right to prohibit importations from Maryland, if they had understood that Maryland could still prohibit loans or sales to their governments"); *id.* at 17 (taxpayer's "two

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[9] The Articles of Confederation, unlike the Constitution, provided that "no imposition, duties or restriction shall be laid by any State on the property of the United States, or by either of them." Articles of Confederation art. IV, cl. 1.

main propositions" are that State taxation of its citizens' loans to other States (i) is "inconsistent with the mutual amity imposed on all the States by the Constitution" and (ii) violates the Full Faith and Credit Clause).

In the more than 125 years that separate this Court's decision in *Bonaparte* from the court of appeals' decision in this case, no court has held that State tax exemptions for municipal bonds are unconstitutional. Indeed, the issue was raised – and promptly rejected – in only one reported appellate case, *Shaper* v. *Tracy*, 647 N.E.2d 550, 553-54 (Ohio Ct. App. 1994). Given the importance of this issue, it undoubtedly would have been litigated more frequently if it had been regarded as doubtful.

The Court does not lightly declare such a long-established and widely accepted practice unconstitutional. *See, e.g., Walz v. Tax Comm'n of City of New York*, 397 U.S. 664, 678 (1970) (Although "no one acquires a vested or protected right in violation of the Constitution by long use, . . . an unbroken practice . . . is not something to be lightly cast aside."); *see also id.* at 681 (Brennan, J., concurring) ("The more longstanding and widely accepted a practice, the greater its impact upon constitutional interpretation."); *cf. Jackman v. Rosenbaum Co.*, 260 U.S. 22, 31 (1922) (Holmes, J.) ("If a thing has been practiced for two hundred years by common consent, it will need a strong case for the Fourteenth Amendment to affect it ...."). Here, it is the case for *upholding* Kentucky's tax exemption that is strong.

B. Congress Has Expressed Support For State Tax Exemptions For In-State Municipal Bonds.

Congress has provided a federal tax exemption for municipal bonds since the inception of the federal income

tax. *See* 26 U.S.C. §§ 103, 141-50. In 1976, Congress expanded the exemption, by allowing mutual funds to pass the exemption through to their shareholders.[10] Twice within the past decade, Congress has enacted legislation that recognizes the critical importance of State authority to borrow money by issuing bonds in times of crisis.[11]

Congress is well aware that many States have provided tax preferences for in-State municipal bonds.[12] Its acquiescence in this long-established and widespread practice indicates that Congress views it as consistent with constitutional requirements. *See General Motors Corp. v. Tracy*, 519 U.S. 278, 304-05 (1997) ("clear

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[10] Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1930, codified as amended at 26 U.S.C. § 852(b)(5)(B). Congress has legislated with particularity in the field of municipal bonds. *See generally* 26 U.S.C. §§ 103, 141-50; *supra* note 4 (municipal bonds exempt from federal securities registration requirements). For example, Congress has established specific limits on the availability of the federal tax exemption for so-called "private activity" bonds. *See* 26 U.S.C. § 141. If Congress had intended to limit (let alone prohibit) State tax exemptions for in-State municipal bonds, it is likely to have enacted specific legislation to that effect.

[11] *See* Tax Benefits for Gulf Opportunity Zone, Pub. L. No. 109-135, 119 Stat. 2577 (2005), codified at 26 U.S.C. § 1400N(a)(1)(A) (following Hurricane Katrina); Tax Benefits for New York Liberty Zone, Pub. L. No. 107-147, 116 Stat. 21 (2002), codified at 26 U.S.C. § 1400L(d)(1) (following September 11 attacks).

[12] H.R. Rep. No. 88-1480, pt. 2, at 258-59 (1964) (listing States that exempt their own bonds from taxation, while taxing bonds of other States). *See also, e.g.,* H.R. Rep. No. 91-413 (1969) ("State and local governments generally do not directly tax the interest income on Federal bonds, but they tax the interest income on bonds issued by other States.").

indication" of fact that "Congress has done nothing to limit its unbroken recognition of the state regulatory authority" is that Congress views the States' actions as "well within the realm of what the States may reasonably promote and preserve") *cf. Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470, 493 (1974) ("Congress, by its silence over these many years, has seen the wisdom of allowing the States to enforce trade secret protection."). In addition, Congress has repeatedly approved interstate compacts under which public authorities such as the Port Authority of New York and New Jersey are authorized to issue municipal bonds that are exempt from taxation by the compacting States, even though those States tax income from other States' municipal bonds.[13]

Congress has expressed support for the tax-exempt status of municipal bonds, as well as the established practice of exempting in-State municipal bonds from State taxation. The dormant Commerce Clause should not be invoked to reach a contrary result.

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[13] *See, e.g.,* Port of New York Authority Compact, ch. 77, 42 Stat. 174 (1921); N.J. Stat. Ann. § 32:1-33; N.Y. Unconsol. Law § 6459; New Hampshire-Maine Interstate School Compact, Pub. L. No. 102-494, 106 Stat. 3153 (1992); Me. Rev. Stat. Ann. tit. 20-A, § 3647; N.H. Rev. Stat. Ann. § 200-F:1; Delaware-New Jersey Compact, Pub. L. No. 87-678, 76 Stat. 560 (1962); Del. Code Ann. tit. 17, § 1701; N.J. Stat. Ann. § 32:11E-1; Delaware River Joint Commission Compact, ch. 258, 47 Stat. 308 (1932); N.J. Stat. Ann. § 32:3-12; 36 Pa Cons. Stat. Ann. § 3503.

C. Declaring State Tax Exemptions For In-State Municipal Bonds Unconstitutional Would Harm The States And Defeat Investment-Backed Expectations.

If this Court were to declare Kentucky's tax exemption unconstitutional, it would cause significant disruption to municipal bond markets, as well as many State and local governments. State and local governments have issued municipal bonds in reliance upon the availability of State (and sometimes local) tax exemptions. In addition, States have assessed taxes and adopted budgets based on the expectation – supported by decades of unchallenged practice – that out-of-State bonds need not be granted the same exemption. If States were to grant a retroactive exemption to out-of-State bonds (which might be unavoidable if the State has made a contractual commitment that interest on in-State bonds will be exempt from State taxation), then States and their municipalities could face budget shortfalls that might necessitate reductions in government services, cancellation or delay of important government projects, or tax increases.

The expectations of municipal bond investors would also be upset by a holding that Kentucky's tax exemption is unconstitutional. Many investors have purchased in-State municipal bonds in reliance on the availability of a State tax exemption. These investors may have accepted a lower interest rate based on their expectation that interest would be exempt from State as well as federal taxes. If the State tax exemption is retroactively eliminated, the reasonable expectations of these investors will be defeated. Moreover, if the State tax exemption is eliminated for future years, the value of municipal bonds held by individual investors may fall significantly.

Similarly, investors such as Respondents purchased out-of-State bonds subject to the expectation that they

would be subject to taxation by Kentucky. Because these investors expected to pay State taxes, they may have demanded and received a higher interest rate as well as the benefits of greater diversification. If State taxes on out-of-State municipal bonds are retroactively eliminated, these investors will reap a windfall from the public fisc.

The effects of an adverse ruling in this case would likely extend beyond municipal bonds to other core State government activities. For example, many States sponsor College Savings Plans designed to assist their citizens in saving for their children's college education. Some States provide a tax exemption for State-sponsored plans, but not for plans sponsored by other States. If State tax exemptions for in-State municipal bonds violate the dormant Commerce Clause, then these exemptions for State-sponsored college savings plans may also be unconstitutional. Similarly, State tax exemptions for the pension income of retired State employees may be unconstitutional if the State does not provide a matching exemption to retired employees of other States. The dormant Commerce Clause should not be expanded to interfere with these core State financial programs.

II. The Principles Underlying The Market Participant Doctrine Confirm The Constitutionality Of Kentucky's Tax Exemption.

Although the Commerce Clause "does not in terms limit the power of States to regulate commerce," the Court has "long interpreted the Commerce Clause as an implicit restraint on state authority, even in the absence of a conflicting federal statute." *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1792 (2007). *But see id.* at 1798 (Scalia, J., concurring in part) (concluding that "the so-called 'negative' Commerce Clause is an unjustified judicial intervention"); *id.* at 1799 (Thomas, J., concurring in the judgment) (concluding that "[t]he negative Commerce

Clause has no basis in the Constitution"). The Court has repeatedly held, however, that "when a state or local government enters the market as a participant it is not subject to the restraints of the Commerce Clause." *White v. Massachusetts Council of Constr. Employers, Inc.*, 460 U.S. 204, 208 (1983). This "market participant doctrine" reflects the principle that "nothing in the purpose animating the Commerce Clause prohibits a State, in the absence of congressional action, from participating in the market and exercising the right to favor its own citizens over others." *Id.* at 207 (marks omitted). The doctrine embodies the Court's recognition that "[r]estraint in this area is also counseled by considerations of state sovereignty, the role of each State as guardian and trustee for its people." *Id.* at 207 n.3 (marks omitted).

The market participant doctrine applies when "the challenged program constitute[s] direct state participation in the market." *Reeves, Inc. v. Stake*, 447 U.S. 429, 435 n.7 (1980) (marks omitted). Thus, a State or local government acting as purchaser may choose to deal only with State or local residents, or with companies that employ a specified percentage of State or local residents. *See White*, 460 U.S. at 214-15 (upholding requirement that all construction projects funded in whole or part by funds controlled by the City of Boston must be performed by a workforce that includes at least 50 percent Boston residents). Similarly, a State acting as seller may choose to deal only with State residents. *See Reeves*, 447 U.S. at 446-47 (upholding South Dakota policy of selling cement from a State-owned plant only to residents of South Dakota). And a State may offer a subsidy that is limited to in-State purchasers. *See Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 809-10 (1976) (upholding a Maryland bounty for the destruction of automobile hulks that was available, as a practical matter, only to Maryland residents).

As the court of appeals recognized in this case, "No one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds." Pet. App. A10. The State or its political subdivisions are selling bonds and, in effect, "buying" the use of money. Whether viewed as a sale of bonds or a purchase of the use of money, the activity of Kentucky and its political subdivisions constitutes "direct state participation in the market" that triggers the application of the market participant doctrine.

It follows that Kentucky could choose to borrow money solely from its own citizens, and to sell bonds only to Kentucky citizens or taxpayers. *See White*, 460 U.S. at 214-15; *Reeves*, 447 U.S. at 436-40. Alternatively, Kentucky could choose to take the less drastic step of offering more favorable terms to in-State bond purchasers. *See Alexandria Scrap*, 426 U.S. at 809-10. These more favorable terms could take a variety of forms: a higher interest rate, a discounted purchase price, or a rebate for in-State purchasers.

Kentucky's tax exemption is economically equivalent to paying a higher interest rate to Kentucky taxpayers, or granting them a discount or rebate on the purchase price. By the same token, the lower interest rate accepted by Kentucky taxpayers in return for the tax exemption may be viewed as a form of implicit taxation. *See* Avishai Shachar, *From Income to Consumption Tax: Criteria for Rules of Transition*, 97 Harv. L. Rev. 1581, 1596 n.60 (1984) ("The lower rate of interest received on tax-exempt bonds relative to the rate of interest received on taxable bonds is an implicit tax on holders of tax-exempt bonds").[14] Given that it is constitutional for Kentucky to

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[14] Alexander Hamilton recognized that a borrower, "[r]elying upon the engagement of the government, express or implied, that he will receive (continued…)

grant its own taxpayers a discount or pay them additional interest, it makes no sense to hold that it is unconstitutional to provide an equivalent benefit in the form of a tax exemption.[15]

In establishing a tax preference for in-State municipal bonds, Kentucky was establishing the terms on which it borrows. Few if any State actions are closer to the core of State sovereignty. Respondents rely on decisions of this Court holding, in particular circumstances, that State tax exemptions for *private* businesses fall outside the boundaries of the market participant doctrine. Those decisions are readily distinguishable and should not be expanded to cover this case.

In *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 277 (1988), the Court held that the market participant doctrine did not apply to an Ohio tax exemption for ethanol produced by (i) Ohio producers and (ii) out-of-State producers in States that offered a reciprocal tax exemption to Ohio ethanol producers. The Court recognized that a tax credit scheme may have the

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what is promised him, without defalcation . . . is content with a less interest. . . . In this lower rate of interest he may be truly said to pay his tax or to purchase an exemption from it." 2 The Works of Alexander Hamilton, *supra* at 288.

[15] This case may be analogized to *White*. In *White*, the Court held that a State or local government may choose to do business only with contractors that hire State or city residents. *See* 460 U.S. at 214-15. Here, States are effectively "hiring" the use of money by issuing bonds, and thus may choose to give a preference to their own citizens. *See* Scott K. Attaway, Note, *The Case for Constitutional Discrimination In Taxation Of Out-Of-State Municipal Bonds*, 76 B.U. L. Rev. 737, 764 (1996).

purpose and effect of subsidizing a particular industry, but held that this equivalence "does not transform [the tax exemption] into a form of state participation in the free market." *Id.* at 277. The Court concluded that taxation is action "*in connection with the State's regulation of interstate commerce*." *Id.* at 278 (emphasis in original).

In *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 589 (1997), the Court held that the market participant doctrine did not apply to a Maine tax exemption for charitable organizations that primarily serve State residents. As in *Limbach*, the Court assumed that a direct subsidy to in-state businesses or charities may be constitutional, but held that a tax exemption is not. *Id.* at 589. The Court's opinion includes the broad statements that "a tax exemption statute cannot be characterized as proprietary activity falling within the market participant exception" and "[a] tax exemption is not the sort of direct state involvement in the market that falls within the market-participation doctrine." *Id.* at 593.[16]

This case is readily distinguishable from decisions such as *Limbach* and *Camps Newfound/Owatonna*. In those cases, the State granted a tax exemption to private

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[16] In *Camps Newfound/Owatonna,* the Court cited *Walz v. Tax Comm'n of City of New York*, 397 U.S. 664 (1970), as support for the proposition that there is a "constitutionally significant difference between subsidies and tax exemptions." 520 U.S. at 590. *Walz* was an Establishment Clause case; the basis for the distinction between subsidies and tax exemptions in *Walz* was that subsidies entail greater government entanglement in the activities of religious entities. 397 U.S. at 690-91. Because "entanglement" is not an element of Commerce Clause analysis, the basis for the distinction in *Walz* does not apply to this case.

entities, and the Court concluded that a tax exemption cannot be viewed as direct State participation in the market. In this case, in contrast, Kentucky's tax exemption does not benefit private entities, but instead benefits State and local government entities that are directly participating in the market. Because Kentucky and its public issuers are direct market participants, the State has broad authority to favor in-State residents in its own commercial dealings. In these circumstances, a tax exemption does not raise the same constitutional concerns as a tax exemption that benefits private businesses. As the Court observed in *Reeves*, the State's action can be described as "'protectionist' only in the sense that it limits benefits generated by a state program to those who fund the state treasury and whom the State was created to serve." 447 U.S. at 442.

As noted above, p. 20, the State could achieve exactly the same result by offering in-State purchasers of municipal bonds a higher interest rate or rebate in lieu of a tax exemption. If Kentucky sold bonds to a citizen who owed a debt to the State (*e.g.*, an unpaid fine, a judgment in a civil case, or unpaid taxes), it is difficult to see why the dormant Commerce Clause would prevent the State from offsetting the debt against the rebate on the municipal bonds.

The Court generally refuses to draw constitutional lines based on formalistic distinctions that lack economic substance. *See, e.g., West Lynn Creamery, Inc., v. Healy*, 512 U.S. 186, 201 (1994) ("[O]ur cases have eschewed formalism for a sensitive, case-by-case analysis of purposes and effects."); *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 99 n.11 (1984) ("It is the substance of the transaction, rather than the label attached to it, that governs Commerce Clause analysis."). In *Regan v. Taxation With Representation of Washington*, 461 U.S. 540, 544-46 (1983), the Court recognized that "[b]oth tax exemptions and tax deductibility are a form of

subsidy," and treated Congress's decision to withhold tax-exempt status from organizations that engage in substantial lobbying as constitutionally equivalent to a (permissible) subsidy to organizations that refrain from lobbying.

In short, Kentucky and its political subdivisions participate directly in the market by borrowing money and issuing bonds. A tax exemption is one of many ways in which State and local governments are free to favor their own citizens when they enter the market, and thus it should not be prohibited under the dormant Commerce Clause. This Court's cases holding that a tax exemption for private in-State businesses falls outside the market participant doctrine are inapposite.

III. Kentucky's Tax Exemption For In-State Municipal Bonds Is Constitutional Because It Treats All Private Businesses The Same.

A. Laws That Treat All Private Businesses The Same Do Not Discriminate Against Interstate Commerce For Commerce Clause Purposes.

In construing the "dormant" aspect of the Commerce Clause, the Court has recognized that "[r]estraint in this area is . . . counseled by considerations of state sovereignty, the role of each State as guardian and trustee for its people." *White*, 460 U.S. at 207 n.3 (marks omitted). Considerations of State sovereignty play a central role in this case.

To determine whether a law violates the "so-called 'dormant' aspect of the Commerce Clause," the Court first asks "whether it discriminates on its face against interstate commerce." *United Haulers*, 127 S. Ct. at 1793. "Discriminatory laws motivated by 'simple economic protectionism' are subject to a 'virtually *per se* rule of invalidity'"; nondiscriminatory laws are valid "unless the

burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits." *Id.* at 1793, 1797, quoting *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).[17]

In *United Haulers*, the Court held that State and local laws "which treat in-state private business interests exactly the same as out-of-state ones, do not 'discriminate against interstate commerce' for purposes of the dormant Commerce Clause." 127 S. Ct. at 1797. *United Haulers* upheld the validity of "flow control" ordinances that require trash haulers to deliver solid waste to a government-owned waste processing facility. *Id.* at 1790. The Court recognized that it had invalidated a "quite similar" ordinance in *C & A Carbone, Inc. v. Clarkstown*, 511 U.S. 383 (1994). 127 S. Ct. at 1790. Indeed, the Court observed, "[t]he only salient difference" between the two cases was that the ordinance in *Carbone* involved a private waste processing facility, while the ordinances in *United Haulers* "require haulers to bring waste to facilities owned and operated by a state-created public benefit corporation." *Id.* The Court held that the difference between public and private entities is "constitutionally significant." *Id.*

The Court found that there are "[c]ompelling reasons" to "treat[ ] laws [that favor a public entity] differently from laws favoring particular private businesses over their competitors." *Id*. at 1795. *First*, discrimination

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[17] State taxes are permissible under the Commerce Clause so long as they (i) are sufficiently connected to the State to justify a tax, (ii) are fairly related to benefits provided to the taxpayer, (iii) do not discriminate against interstate commerce, and (iv) are fairly apportioned. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 287 (1977). The only requirement at issue here is the non-discrimination requirement.

"assumes a comparison of substantially similar entities." *Id.* (marks omitted). Public entities are not substantially similar to private entities, because only public entities are "vested with the responsibility of protecting the health, safety, and welfare of [their] citizens." *Id.* *Second*, "it does not make sense to regard laws favoring local government and laws favoring private industry with equal skepticism." *Id.* "When a law favors in-state business over out-of-state competition, rigorous scrutiny is appropriate because the law is often the product of 'simple economic protectionism.'" *Id*. at 1795-96, quoting *Wyoming* v. *Oklahoma*, 502 U.S. 437, 454 (1992). In contrast, laws favoring local government "may be directed toward any number of legitimate goals unrelated to protectionism." 127 S. Ct. at 1796. *Third*, treating public and private entities the same under the dormant Commerce Clause "would lead to unprecedented and unbounded interference by the courts with state and local government." *Id*. The Court observed that "the dormant Commerce Clause is not a roving license for federal courts to decide what activities are appropriate for state and local government to undertake, and what activities must be the province of private market competition." *Id.* *Fourth*, federal courts should hesitate to interfere with laws concerning a "typical and traditional" local government function, particularly when "Congress itself has recognized local government's vital role" in the activity at issue. *Id.* *Fifth*, "the most palpable harm imposed" by the laws "is likely to fall upon the very people who voted for the laws." *Id.* at 1797.

B. Kentucky's Tax Exemption Does Not Favor In-State Private Businesses Over Out-Of-State Businesses, And Thus Does Not Discriminate Against Interstate Commerce.

The Court's decision in *United Haulers* strongly supports the conclusion that Kentucky's tax exemption for in-State bonds is constitutionally permissible. Kentucky

provides a tax exemption for municipal bonds issued by State and local government entities, not private businesses. Because Kentucky's law does not favor in-State private business at the expense of out-of-State businesses, it does not discriminate against interstate commerce for purposes of the dormant Commerce Clause.

The reasons the Court identified for its decision in *United Haulers* are equally if not more compelling in this case. Kentucky and its political subdivisions, unlike private entities, are responsible for furthering the health, safety, and welfare of Kentucky's citizens. Kentucky's tax exemption for in-State municipal bonds furthers legitimate goals unrelated to protectionism. The tax exemption facilitates the borrowing of funds by the Commonwealth and its political subdivisions to support important government programs and projects. The State tax exemption supports State and local programs, just as the federal government supports such programs by exempting municipal bonds from federal taxation. By providing Kentucky citizens with an additional incentive to purchase Kentucky bonds, the Commonwealth may increase the participation of its own citizens in its financial affairs. Such participation may lead to a more informed electorate, provide an additional check on State and local government, and attract investors who are better informed and more committed to the projects funded with their money.

Treating municipal bonds the same as privately-issued bonds would lead to "unprecedented and unbounded" interference with State and local government. States have been granted wide latitude to borrow money from their own citizens on terms set by the State and agreed to by investors. As described above, pp. 17-18, declaring State tax exemptions for municipal bonds unconstitutional at this late date would cause significant disruption to the municipal bond market and to State and local governments.

Moreover, the issuance of municipal bonds is a typical and traditional local government function. If anything, the power to raise revenues by borrowing money is an even more "typical and traditional" State function than the power to dispose of waste. And as noted above, pp. 15-16, Congress has recognized the importance of tax-exempt municipal bonds and given the States wide leeway in this area.

As in *United Haulers*, the most palpable harm from Kentucky's tax exemption is likely to fall upon the very people who voted for the laws. The availability of an exemption from Kentucky's income tax is primarily of concern to Kentucky taxpayers. Kentucky's taxpayers – including those who do not purchase in-State municipal bonds – have a built-in incentive to oppose excessive tax exemptions, which reduce tax revenues and must be balanced by tax revenues from other sources.

Other States have not complained that they are harmed by Kentucky's law. To the contrary, an overwhelming majority of States has enacted tax exemptions like Kentucky's. These exemptions tend to offset any loss of municipal bond sales to Kentucky taxpayers by *increasing* sales to in-State taxpayers.

In sum, the principles recognized by this Court in *United Haulers* strongly support the conclusion that Kentucky's tax exemption does not discriminate against interstate commerce. Indeed, this case is easier than *United Haulers* in at least one significant respect: In *United Haulers*, the local ordinances at issue completely excluded out-of-state competitors by requiring all waste to be sent to a government-owned facility. Here, Kentucky has not required Kentucky taxpayers to buy only Kentucky bonds. Instead, it has provided an incentive, in the form of a tax exemption, for Kentucky taxpayers who purchase bonds issued by the Commonwealth and its issuing entities. An incentive to purchase bonds issued by

a public agency is not "discrimination" against interstate commerce for purposes of the dormant Commerce Clause.

C. The Laws At Issue Are Valid Under The *Pike* Balancing Test.

The plurality in *United Haulers* concluded that State and local laws that treat all private businesses the same "are properly analyzed under the test set forth in *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970)." 127 S. Ct. at 1797. Under that test, the Court will uphold the law at issue "'unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.'" *Id.*, quoting *Pike*, 397 U.S. at 142. Assuming that test applies to tax exemptions, Kentucky's exemption for in-State municipal bonds passes easily.

Here, as in *United Haulers*, there is no indication that Kentucky's tax exemption has any disparate impact on out-of-State businesses as opposed to in-State businesses. Kentucky taxpayers are taxed on interest income from bonds issued by corporations and other private entities whether they are issued by Kentucky businesses or out-of-State businesses.

To the extent Kentucky's tax exemption imposes any burden on interstate commerce, it is not excessive in relation to the public benefits of Kentucky's tax exemption. The exemption makes it possible for Kentucky and its public issuers to borrow funds to finance government initiatives at a lower interest rate, while providing an incentive to the State's own citizens to participate in financing such initiatives. Accordingly, Kentucky's tax exemption easily survives *Pike* analysis.

CONCLUSION

The court of appeals' decision should be reversed.

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