No. 06-666

IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF KENTUCKY, ET AL.,

Petitioners,

v.

GEORGE W. DAVIS, ET UX.,

Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF OF THE TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

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INTEREST OF THE *AMICUS CURIAE*

The Tax Foundation submits this brief as *amicus curiae* in support of Respondents in the above-captioned matter.[1]

The Tax Foundation is a non-profit research

[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioners and Respondents have been obtained and filed with the Clerk of the Court.

organization founded in 1937 to educate taxpayers about sound tax policy. To this end, we disseminate information on taxes and promote tax systems that are simple, fair, and conducive to economic growth. The Tax Foundation works to further this mission by educating the legal community on issues relating to tax law, by explaining tax law concepts to lawmakers and the public in an understandable and relevant manner, and by advocating that judicial decisions on tax law promote principled tax policy. Accordingly, the Tax Foundation has a direct stake in the outcome of this case.

SUMMARY OF ARGUMENT

The Commerce Clause prohibits state laws like Kentucky's that effectively tax activity out-of-state while exempting identical activity occurring in-state. This Court has recognized, however, that this does not prohibit every state law that may affect economic decision-making, because permitting states to design tax systems that foster a competitive business climate goes hand in hand with the federalism and liberty that the Commerce Clause protects. By clarifying that "tax neutrality" means "competitive neutrality," this Court will reach the proper result here and remain consistent with its precedents.

This case also provides an opportunity for this Court to consider the domestic application of the Import-Export Clause of Article I, Section 10, which would prevent states from penalizing activity that crosses state lines. Further, this case could implicate the Privileges or Immunities Clause of the Fourteenth Amendment, which protects the right of citizens to cross state lines in pursuit of an honest living.

A ruling for Respondents in this case would not unduly infringe Kentucky's sovereignty, as states could still permit exclusion of all municipal bond interest from taxable income, as is done at the federal level and in

Indiana. Nor would a ruling for Respondents excessively impact the municipal bond market, as states would still have access to capital at competitive interest rates.

Finally, this Court should be cautious about suggesting that discriminatory taxes should receive greater constitutional scrutiny than discriminatory subsidies. A state subsidy program with identical economic effects as Kentucky's tax should undergo identical constitutional scrutiny; otherwise, states could continue discriminatory schemes in a different but equally harmful form.

ARGUMENT

I. THE COMMERCE CLAUSE EMBRACES THE PRINCIPLE OF COMPETITIVE NEUTRALITY, WHICH PROHIBITS STATES FROM TAXING ACTIVITY OUT-OF-STATE WHILE NOT TAXING IDENTICAL ACTIVITY IN-STATE.

By clarifying that "tax neutrality" means "competitive neutrality," and that states cannot tax activity out-of-state if identical activity in-state is left untaxed, this Court can reach the proper result in this case, remain consistent with its precedents, and chart a course that lessens the tension between discriminatory taxation and permissible state tax experimentation. Competitive neutrality means that this Court can uphold state tax "welcome mats" that foster new investment in labor and capital within a state, while retaining the power to invalidate state tax "exit tolls" that seek to protect a state's existing industry from interstate competition.

Kentucky's exclusion is just such an "exit toll." Since 1913, federal tax law has allowed taxpayers to exclude from gross income the interest generated by state and local municipal bonds. *See* 26 U.S.C. § 103.[2] Kentucky tax filers are instructed to start with federal gross income, then to add back in any municipal bond income earned from "other states and their political subdivisions." KY. REV. STAT. § 141.010 *et seq.* Kentucky is among 42 of the 43 income-taxing states that exclude interest from in-state municipal bonds but tax interest from out-of-state bonds. *See* Ethan Yale & Brian D. Galle, *Municipal Bonds and the Dormant Commerce Clause After* United Haulers, 44 STATE TAX NOTES 877, 878 (Jun. 18, 2007).

While this Court has consistently invalidated state statutes that discriminate against interstate commerce, those rulings have not resolved the tension between forbidden tax discrimination and permissible tax experimentation. On one hand, this Court has held that the Commerce Clause prohibits state laws like Kentucky's, which channel investment into the state by penalizing investments made out-of-state, thus "foreclos[ing] tax neutral decisions." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977). But this Court has recognized that not every state law that may affect economic decision-making is discriminatory, because permitting states to enact a lower tax rate, for instance, fosters a competitive business climate consistent with the federalism and liberty that the Commerce Clause protects. *See e.g.*, Clayton P. Gilette, *Business Incentives, Interstate Competition, and the Commerce Clause*, 82 MINN. L. REV. 447, 448 (1997) (arguing that state competition promotes the goals of the Commerce Clause). The Commerce Clause should be held to forbid a state from taxing an out-of-state activity if the state solely exempts identical in-state activity from taxation.

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[2] But gains realized from the sale of exempt bonds are taxed. Also, interest from private-activity municipal bonds is taxed federally under the Alternative Minimum Tax (AMT), which denies tax preferences to many high-income taxpayers. *See* 26 U.S.C. § 57(a)(5)(C).

A. The Commerce Clause, as interpreted by this Court's precedents, prohibits states from imposing a tax on activity out-of-state while leaving identical activity in-state untaxed.

The people of the United States adopted the Constitution in large part because their existing national government had no power to stop states from imposing trade barriers between each other, to the detriment of the national economy. "[States' power over commerce,] guided by inexperience and jealousy, began to show itself in iniquitous laws and impolitic measures . . ., destructive to the harmony of the States, and fatal to their commercial interests abroad. This was the immediate cause, that led to the forming of a convention." *Gibbons v. Ogden*, 22 U.S. 1, 224 (1824) (Johnson, J., concurring). Consequently, among the powers granted to Congress by the new Constitution was that "[t]o regulate Commerce . . . among the several States," a provision known as the Commerce Clause. U.S. CONST. art. I, § 8, cl. 3. Congress and the courts thus have the power to strike down laws that discriminate against interstate commerce.[3]

Nevertheless, states still have incentives to impede interstate commerce, as they always will. *See, e.g.*, *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 193 (1994) ("[A tariff] violates the principle of the unitary national market by handicapping out-of-state competitors, thus artificially encouraging in-state production even when the same goods could be produced at lower cost in other States."); *Dean Milk Co. v. Madison*, 340 U.S. 349, 354 (1951) ("In thus erecting an economic barrier protecting a major local industry against competition from without the State, Madison plainly discriminates against interstate

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[3] The power of federal courts to act when Congress is silent was inferred from the Commerce Clause (the "dormant" or "negative" Commerce Clause). *See e.g.*, *Willson v. The Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829).

commerce.”). When examining a statute under the Commerce Clause, this Court has looked for evidence that the state is foreclosing competitive neutrality—penalizing activity out-of-state while solely and effectively leaving identical activity in-state untaxed. Where a state is discriminating in this manner, the Court has invalidated the tax.

For instance, in *Boston Stock Exchange*, 429 U.S. at 318, New York had imposed a tax on stock transfers that used out-of-state brokers instead of in-state brokers. If a taxpayer switched from in-state to out-of-state brokers, New York would levy a higher tax. While this effective tax on activity out-of-state was correctly held to violate the Commerce Clause, this Court was careful to note that “(o)ur decision today does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry. . . . We hold only that in the process of competition no State may discriminatorily tax the products manufactured or the business operations performed in any other State.” *Id.* at 336-37. The Court’s ruling was concerned not with imposing uniformity, but rather with preventing the state from solely taxing activity out-of-state while leaving identical activity in-state untaxed.

In *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984), this Court described taxes invalidated in *Boston Stock Exchange* and *Maryland v. Louisiana*, 451 U.S. 725 (1981), as having impermissibly “impos[ed] greater burdens on economic activities taking place outside the State than were placed on similar activities within the State.” *Id.* at 404. In *Westinghouse*, New York imposed a franchise tax but then gave a credit for in-state, but not out-of-state, activity. *See id.* at 390-94. The Court ruled that because the credit solely exempted activity in-state from a tax levied on activity both in-state and out-of-state, it was no different from a discriminatory tax. “Nor is it relevant that New York discriminates against business carried on outside the State by disallowing a tax credit rather than by imposing a higher tax. The discriminatory economic effect of these two measures would be identical." *Id.* at 404. The Court was persuaded not only by the fact that New York had exempted activity in-state, but also that it had simultaneously imposed a tax on identical income earned out-of-state.

In *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984), Hawaii imposed a 20 percent tax on wholesale liquor sales but exempted local producers. The Court framed the exemption in terms of "burden," rejecting the state's claim that the tax merely benefited in-state production without burdening production for out-of-state markets. "Virtually every discriminatory statute allocates benefits or burdens unequally; each can be viewed as conferring a benefit on one party and a detriment on the other. . . . Consequently, it is irrelevant to the Commerce Clause inquiry that the motivation of the legislature was the desire to aid the makers of the locally produced beverage rather than harm out-of-state producers." *Id.* at 273. The issue in *Bacchus Imports* was that Hawaii had applied a tax on activity both in-state and out-of-state, but solely exempted activity in-state. This resulted in an impermissible effective tax on activity out-of-state, because identical activity in-state was left untaxed.

The Court applied this same rule in four other cases where states applied a tax to activity in-state and out-of-state, but effectively left activity in-state exempted:

- Pennsylvania could not impose fees on all trucks while reducing other taxes for trucks in-state only. *See Am. Trucking Ass'n v. Scheiner*, 483 U.S. 266, 286 (1987) ("[A] state tax that favors in-state business over out-of-state business for no other reason than the location of its business is prohibited by the Commerce Clause.").
- Ohio could not grant a tax credit to all ethanol producers, but disallow it for non-Ohio producers. *See*

New Energy Co. v. Limbach, 486 U.S. 269, 273 (1988) ("This 'negative' aspect of the Commerce Clause prohibits economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.").

- Massachusetts could not impose a general dairy tax and distribute the revenues to domestic producers only. *See West Lynn Creamery,* 512 U.S. at 199 ("The pricing order in this case, however, is funded principally from taxes on the sale of milk produced in other States. . . . The pricing order thus violates the cardinal principle that a State may not 'benefit in-state economic interests by burdening out-of-state competitors.'").
- Maine could not provide a general charitable deduction to all taxpayers, but disallow it only for organizations that primarily serve non-Maine residents. *See Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 581 (1997) ("A State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State.").

The concept of competitive neutrality is also clearly seen in two other areas of Commerce Clause law not directly at issue in this case: the constitutionality of compensating use taxes and the physical presence rule in business taxation.

This Court upheld the constitutionality of compensating use taxes in *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937). There, Washington state had imposed a tax on the use of certain personal property in-state, except where the property had been subject to the state's sales tax. *See id.* at 580-81. The purpose was to ensure that all property in-state was subject to tax, regardless of origin. The Court upheld the tax because it was compensating and did not discriminate against interstate commerce. *See id.* at 583-84 ("Equality is the theme that runs through all the sections of the statute. There shall be a tax upon the use, but subject to an offset if another use or sales tax has been paid for the same thing."). Use taxes are thus constitutional even though they tax activity out-of-state, because they do not exempt identical activity in-state from tax. If a state were to impose a higher use tax than sales tax, the state would be effectively penalizing activity out-of-state in violation of the Commerce Clause, as one court recently held. *See Molloy v. Gov't of the Virgin Islands*, No. 2006-51 (D.V.I. Jul. 25, 2007) (holding that a use tax imposed without a sales tax violates the Commerce Clause).

In *Quill v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed under the Commerce Clause its rule that a state cannot impose a sales tax collection obligation on a business unless that business is physically present in the state. "Undue burdens on interstate commerce may be avoided . . . by the demarcation of a discrete realm of commercial activity that is free from interstate taxation. [The physical presence rule] create[s] a safe harbor for vendors whose only connection with customers in the taxing State is by common carrier or the United States mail." *Id.* at 314-15. While North Dakota in that case had argued that borders are irrelevant in our modern economy, this Court recognized that subjecting non-present businesses to state taxation often means that activity out-of-state is being unconstitutionally taxed.

Many states seek to export their tax burdens and impose taxes on businesses not physically present in the state, which by definition are taxes on activity occurring out-of-state. *See, e.g.*, *Tax Comm'r of the State of West Virginia v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 236 (W.V. 2006), *cert denied*, No. 06-1228 (Jun. 18, 2007) (upholding state income taxation of out-of-state business). This Court understood in *Quill* that limiting states to taxing only businesses that are physically present is a way to ensure that states are not burdening activity out-of-state more than activity in-state.

In this case, this Court has the opportunity to clarify that the Commerce Clause embraces the principles of competitive neutrality as outlined here and in the precedents. States cannot impose a tax on activity both in-state and out-of-state, and effectively exempt solely activity in-state, or impose a penalty on activity out-of-state while not penalizing identical activity in-state. This Court has consistently invalidated such laws under the Commerce Clause, and should do so again here.

B. Kentucky's law imposes a tax on activity out-of-state, while leaving identical activity in-state untaxed.

Kentucky residents who file the individual income tax form are instructed to start with their federal calculation of gross income, which excludes all municipal bond interest. *See* KY. REV. STAT. § 141.020(8)(a). Kentucky then requires that filers add in all interest income from non-Kentucky municipal bonds. *See* KY. REV. STAT. § 141.020(8)(a)(1). At no point are filers instructed to report, much less pay tax on, interest earned from Kentucky municipal bonds. The state therefore subjects individuals who have earned municipal bond interest outside of the state to reporting and payment obligations that are not imposed on those who have earned identical interest income in-state.

The law challenged here penalizes disfavored activity. Those who hold out-of-state municipal bonds are penalized because they engage in activity disfavored by a state practicing protectionism. The state tax code is designed to make investing in Kentucky bonds the only way such individuals can lower their effective tax rate on municipal bond income. The state has gone beyond differential treatment, which can be constitutional. Instead, it is penalizing activity simply because it crosses state lines.

C. This Court should recognize that Kentucky's law taxes activity occurring out-of-state, and thus differs from valid laws that do not.

The Commerce Clause cannot require absolute neutrality in state tax systems because to do so would destroy the states' sovereign tax powers. Permitting states to design tax systems that foster a competitive business climate is a feature of federalism that is protected by the Commerce Clause. Consequently, many state tax laws that affect economic decision-making or impose differential treatment are constitutionally permissible. For instance, states are free to reward certain activity in the form of exemptions or deductions from taxes without national uniformity. Also, different states can enact different tax rates, creating more favorable fiscal and economic climates, in which businesses might locate capital and labor.

If a state imposes a tax that applies both in-state and out-of-state, it cannot then solely exempt activity that occurs in-state from the tax. Similarly, a state may not effectively tax activity out-of-state while leaving activity in-state untaxed. Because Kentucky taxes the worldwide income of its residents, *see* KY. REV. STAT. § 141.010 *et seq.*, it cannot solely exclude income earned within the state from tax. Additionally, Kentucky cannot tax out-of-state bond investments while leaving in-state bond investments untaxed.

In *DaimlerChrysler Corp. v. Cuno*, 547 U.S. ___; 126 S. Ct. 1854 (2006), this Court faced[4] the question of whether a state's investment tax credit, conditioned on the location of new capital within the state, violated the Commerce

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[4] The Supreme Court ultimately dismissed the case for lack of standing, holding that the plaintiffs had not demonstrated any injury (i.e., the state had imposed no penalty on them). *See Cuno*, 547 U.S. at ___, 126 S.Ct. at 1854.

Clause. The lower court had held Ohio's investment tax credit to be unconstitutional because it was not "tax neutral." "[T]he economic effect of the Ohio investment tax credit is to encourage further investment in-state at the expense of development in other states and that the result is to hinder free trade among the states." *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738, 745 (6th Cir. 2004). Under this reasoning, any state tax law that differed from tax laws in other states would be constitutionally suspect. The case was also unusual because unlike many Commerce Clause cases, it did not involve an out-of-state taxpayer seeking to use the Clause to invalidate a protectionist law, but rather in-state taxpayers seeking to use the Clause to protect their state from interstate tax competition.

In the Tax Foundation's *amicus curiae* brief supporting a writ of certiorari, we argued that the Sixth Circuit's conception of "tax neutrality" under the Commerce Clause was restrictive, not protective, of interstate commerce. "[I]f taken literally, [it] mean[s] that a state cannot develop a tax policy that encourages growth and investment. Not even tax rate reductions or exemptions would be allowed under this literal language." Brief of Tax Foundation as Amicus Curiae Supporting Petition for Writ of Certiorari, *Daimler Chrysler Corp. v. Cuno*, (2005) (No. 04-1704), at 12. The reason is that virtually any tax change has some economic effect that may encourage or discourage behavior. Instead, we explained there, as we have explained here, that a better standard is "competitive neutrality"—forbidding laws that impose tariff-like punishment on out-of-state activity to protect native industry, but authorizing laws that seek to encourage the formation and deployment of new labor and capital. *See also* Phillip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 VAND. L. REV. 879 (1986). The key question for determining impermissible discrimination is whether a state is taxing or otherwise penalizing activity occurring out-of-state. Here, the municipal bond exclusion punishes out-of-state activity to protect in-state activity.

The investment tax credit at issue in *Cuno* was constitutional because it was competitively neutral—Ohio did not tax business income earned outside the state, nor did it exempt activity in-state from taxation while taxing activity out-of-state. *See* Brief of Council on State Taxation and National Association of Manufacturers as Amicus Curiae In Support of Petition for Writ of Certiorari, *DaimlerChrysler Corp. v. Cuno* (2005) (No. 04-1704), at 9 ("[T]he calculation of the Ohio investment credit includes no reference to out-of-state activity, which is neither incented or disincented."). Contrast that to the present case, where the effect of Kentucky's exemption is to tax only the income generated by investment in out-of-state municipal bonds. The Ohio investment tax credit was a "welcome mat," available on a neutral basis to any company from any state that invested capital in Ohio, while the Kentucky exclusion is an "exit toll," penalizing taxpayers who choose to do business in other states.

The Respondents in this case have suffered injury—they have had to suffer a penalty for engaging in activity out-of-state, while those who engaged in identical activity solely in-state have been exempted. Only those who have earned interest income out-of-state are required by Kentucky to report the amount and pay tax. The state seeks to influence economic behavior by imposing a penalty on those who invest in municipal bonds out-of-state.

Kentucky's law is also different from laws upheld by this Court that discriminate against interstate commerce, but do so only where the state is acting like any other market participant. *See, e.g.*, *Reeves, Inc. v. Stake*, 447 U.S. 429 (1980) (holding that a state in the business of selling cement to buyers may discriminate against out-of-state buyers); *Am. Yearbook Co. v. Sakew*, 409 U.S. 904 (1973) (holding same for printing services). In taxing interest income, Kentucky is not acting as a market participant, but as a sovereign state exercising the power of mandatory taxation. *Cf. New Energy Co.*, 486 U.S. at 277 ("[A]ssessment and computation of taxes [is] a primeval governmental activity."). Even if it could be said that Kentucky is "competing" with the private bond market, the relevant action in this case is its use of the taxing power, which is an exercise of governmental authority that no other market participant could exercise.

Some *amici* may point to this Court's recent decision in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 550 U.S. ___ (slip op. Apr. 30, 2007) (No. 05-1345), which held that a state may require waste haulers to use a state-run processing operation. *See id.* But there, the state law made no reference to activity out-of-state. The state did not effectively penalize out-of-state activity by leaving identical in-state activity unpenalized, nor was solely in-state activity exempted from burdens otherwise imposed. Non-governmental activity was barred regardless of where it occurred. Here, in contrast, Kentucky penalizes only some private investors—those who invest in bonds out-of-state. The Commerce Clause forbids the use of effective penalties on activity out-of-state while leaving identical activity in-state unpenalized, not the legal protection of a government-run enterprise from all private competitors. "[W]hile *United Haulers* lifts the presumption of unconstitutionality from laws favoring state-run businesses in competition with private business, it is doubtful that the Court would turn such a favorable eye on laws shielding state officials from the pressure of competition with rival state-run enterprises." Yale & Galle, *supra*, at 895.

Federalism guarantees that states retain autonomy over their tax systems so long as they do not enact protectionist measures that punish only out-of-state activity. This policy encourages competition conducive to economic growth. The Commerce Clause protects this competitive neutrality and does not prohibit states from bestowing benefits on a favored activity while leaving all other actors as they were. There is no injury in such a case, and to hold otherwise would essentially force states to subsidize out-of-state activity.

But where a state imposes a tax on activity out-of-state, while leaving identical activity in-state untaxed, the state is discriminating against interstate commerce and has run afoul of the Commerce Clause. Kentucky has done so here, and its punitive tax treatment of out-of-state bond interest should be invalidated.

II. THIS COURT SHOULD CONSIDER WHETHER THE KENTUCKY EXCLUSION VIOLATES THE IMPORT-EXPORT CLAUSE AND THE PRIVILEGES OR IMMUNITIES CLAUSE.

This Court might consider two other provisions of the Constitution that provide additional textual and historical support for the concept of competitive neutrality. This case provides an opportunity for this Court to hold that the Import-Export Clause of Article I, Section 10 applies domestically and prevents states from penalizing economic activity because it crosses state lines. This Court could also hold that Kentucky's taxation of out-of-state municipal bond interest violates the Privileges or Immunities Clause of the Fourteenth Amendment, which protects the right of citizens to engage in interstate transactions.

A. The Import-Export Clause of Article I, Section 10 prohibits states from penalizing activity that crosses state lines.

Article I, Section 10 of the Constitution states that "[n]o State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection laws. . . ." U.S. CONST. art I, § 10, cl. 2. The rationale for the Import-Export Clause was the same as the Commerce Clause: to stop states from endangering the national economy by imposing trade barriers. "[T]here is . . . wisdom and policy in restraining the states themselves from the exercise of the same power [taxation] injuriously to the interests of each other. A petty warfare of regulation is thus prevented, which would rouse resentments, and create dissensions, to the ruin of the harmony and amity of the states." 1 STORY CONST. § 497 (discussing the Import-Export Clause).

The Import-Export Clause was thus conceived as barring states from imposing taxes on activity that crossed state lines. *See, e.g.*, Brannon P. Denning, "The Import-Export Clause" *in* THE HERITAGE GUIDE TO THE CONSTITUTION 176, 176-77 (David F. Forte ed., 2005) ("Evidence from the Constitutional Convention and the ratification debates suggest that the Framers intended the Import-Export Clause to complement congressional power to raise revenue and regulate interstate commerce by restricting the states' ability to tax commerce entering and leaving their borders."). Applied, the Import-Export Clause would provide a more focused and textual basis for the invalidation of any state tax "that is levied exclusively, or even primarily, on imports." *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 640 n.22 (Thomas, J., dissenting). Here, Respondents are importing municipal bond income from other states, and Kentucky is taxing that import.

The original meaning of the Import-Export Clause included domestic application, although the Supreme Court held otherwise in *Woodruff v. Parham*, 75 U.S. 123

(1868), when it stated that the restriction applied only to goods originating outside the United States. In doing so, the Court distinguished two prior cases that suggested the Clause applied domestically. *See Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 449 (1827); *Almy v. California*, 65 U.S. 169, 172-74 (1861). The basis for the *Woodruff* Court's conclusion was a lack of evidence to deny that the word "imports" was meant to be an "exclusive reference to foreign trade." *Id.* at 136. Subsequent research has undermined this ground, with scholars uncovering examples of the Founders and contemporaneous ratifying conventions, newspapers, laws, and writers using the word "imports" to describe interstate trade.[5] "The evidence suggests that the *Woodruff* Court was too hasty in its dismissal of Marshall's dictum in *Brown*, and wrong to recharacterize *Almy v. California*, because Justice Miller's reading of the Import-Export Clause was too narrow." Denning, *supra*, at 213. "Commerce" as used in the Constitution comprises both foreign and interstate commerce; a consistent reading of "imports and exports" would include foreign and interstate trade as well.

Kentucky's tax on municipal bond interest that crosses state lines, or the activity that generates such interest, is an impermissible duty on imports even if it is the activity that is taxed and not the goods. *Cf. Camps Newfound/Owatanna*, 520 U.S. at 574-75 (stating that a tax on activities used in relation to imported goods is the legal and functional equivalent to a tax on the imported goods). Not all interstate taxation is impermissible. This Court has held that "the Import-Export Clause prohibited only exactions on the right of importation," *Michelin Corp. v. Wages*, 423 U.S. 276, 295 (1976), that "create special protective tariffs *or particular preferences* for certain

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[5] *See generally Camps Newfound/Owatanna*, 520 U.S. at 621-33 (Thomas, J., dissenting) (detailing these examples); Denning, *supra*, at 188-215 (same).

domestic goods . . . ." *Id.* at 286 (emphasis added). "[T]he prohibition would not apply to a state tax that treated imported goods . . . in a manner that did not depend on the foreign origins of the goods." *Id.* at 298. A general tax on all municipal bond income would not violate the Clause. But here, a duty is imposed on all municipal bond interest not generated in Kentucky, and that duty is designed to discourage interstate activity and encourage domestic investment.

This case is an example of what the Import-Export Clause was designed to prevent: a state imposing a penalty on economic activity that crosses state lines. Rising at the Constitutional Convention to voice a concern that led to the Clause's adoption, Gouverneur Morris warned that states would try to tax each other to the detriment of national unity. "These local concerns ought not to impede the general interest. There is great weight in the argument, that the exporting States will tax the produce of their uncommercial neighbors." SUPPLEMENT TO MAX FARRAND'S THE RECORDS OF THE FEDERAL CONVENTION OF 1787, at 360 (James H. Hutson ed., 1987). Kentucky imposes a penalty on activity that crosses state lines. This Court should reconsider *Woodruff* and hold that Kentucky's law runs afoul of the Import-Export Clause.

B. The Privileges or Immunities Clause of the Fourteenth Amendment protects the right of citizens to cross state lines in pursuit of an honest living.

The Fourteenth Amendment, enacted after the Civil War, reads in part:

> "No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States. . . ."

U.S. CONST., amend. XIV, § 1. The U.S. Constitution also requires that the privileges and immunities enjoyed by citizens of a state must also be extended to other U.S. citizens in that same state. *See* U.S. CONST., art. IV, § 2. *See also* ARTICLES OF CONFEDERATION art. IV ("The better to secure and perpetuate mutual friendship and intercourse among the people of the different States in this Union, the free inhabitants of each of these States . . . shall be entitled to all privileges and immunities of free citizens in the several States. . . ."). Not until Reconstruction, however, was it considered necessary to adopt a constitutional amendment to protect citizens' basic civil rights from infringement by state governments.

Chief among these was the right to earn an honest living, which many states systematically violated in order to keep African-Americans in constructive bondage following the Civil War. In the *Slaughterhouse Cases*, 83 U.S. (16 Wall.) 36 (1873), the Supreme Court adopted a narrow view of the scope of rights guaranteed by the Clause, over four dissents. This decision has been harshly and consistently criticized by a distinguished assortment of judges and scholars. *See, e.g.*, RANDY BARNETT, RESTORING THE LOST CONSTITUTION 195-203 (2004); Laurence H. Tribe, *Taking Text and Structure Seriously: Reflections on Free-Form Method in Constitutional Interpretation*, 108 HARV. L. REV. 1221, 1297 n.247 (1995); Akhil R. Amar, *The Bill of Rights and the Fourteenth Amendment*, 101 YALE L.J. 1193, 1258-59 (1992); JOHN HART ELY, DEMOCRACY AND DISTRUST 22 (1980). *But see* ROBERT BORK, THE TEMPTING OF AMERICA: THE POLITICAL SEDUCTION OF THE LAW at 10 (1990) (describing the Clause as "a constitutional provision whose meaning is largely unknown.").

Even after the *Slaughterhouse Cases*, this Court has identified "pursuit of a common calling" as a privilege of national citizenship protected by the Constitution. *See United Bldg. & Constr. Trades v. Mayor*, 465 U.S. 208, 219 (1984). *See also* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW 450 (2d ed. 2002) ("The vast majority of cases under the [Article IV] privileges and immunities clause involve states discriminating against out-of-staters with regard to their ability to earn a livelihood.").

This Court has also consistently held that the Privileges or Immunities Clause protects the right to cross state lines without interference. Most recently, in *Saenz v. Roe*, 526 U.S. 489 (1999), this Court applied the Clause to strike down a California welfare benefits law that applied differently to California residents based on their prior interstate travel. *See Saenz*, 526 U.S. at 504 ("Because this case involves discrimination against citizens who have completed their interstate travel, the State's argument that its welfare scheme affects the right to travel only 'incidentally' is beside the point."). The Court specifically grounded the right to interstate travel in part in the Privileges or Immunities Clause, noting that while the law did not restrict travel *per se*, it discouraged the crossing of state lines with a punitive and discriminatory law. "It was the right to go from one place to another, including the right to cross state borders while en route, that was vindicated in *Edwards v. California*, 314 U. S. 160 (1941), which invalidated a state law that impeded the free interstate passage of the indigent." *Saenz*, 526 U.S. at 500. *See also id.* at 511 (REHNQUIST, C.J., dissenting) ("The right to travel clearly embraces the right to go from one place to another, and prohibits States from impeding the free passage of citizens.").

The Court has thus invalidated laws that discourage individuals from crossing state lines and enjoying the benefits of national citizenship, such as pursuit of an honest living. In *Colgate v. Harvey*, 296 U.S. 404 (1935), *overruled by Madden v. Kentucky*, 309 U.S. 83, 90-93 (1940), Justice Sutherland wrote for the Court: "[W]hen [a citizen] trades, buys, or sells, contracts or negotiates across the state line . . ., he exercises rights of national citizenship. . . ." *Id.* at 433. In *Madden*, which overruled *Colgate*'s broader reading of the Privileges or Immunities Clause, the Court nevertheless stated that the Clause protects "privileges and immunities arising out of the nature and essential character of the national government, and granted or secured by the constitution of the United States." *Madden*, 309 U.S. at 92 n.21. The Privileges or Immunities Clause protects the right of "all citizens to be free to travel throughout the length and breadth of our land uninhibited by statutes, rules, or regulations which unreasonably burden or restrict this movement." *Saenz*, 526 U.S. at 499, *quoting Shapiro v. Thompson*, 394 U.S. 618, 629 (1969). States can neither penalize the crossing of state lines nor impose burdens on those who exercise that right, such as with the California law invalidated in *Saenz*.

Here, Kentucky penalizes those who pursue a calling and engage in honest commercial activity that crosses state lines, while not imposing similar burdens on those whose activity does not cross state lines. As Justice Cardozo wrote, "The Constitution was framed . . . upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 523 (1935). Because this Court has held that pursuit of a common calling is such a privilege of national citizenship, and that states cannot enact laws that discourage the crossing of state lines, a law such as Kentucky's must be invalidated, for it discourages Respondents from commercially crossing state lines in pursuit of an honest living. This Court should consider re-evaluating the *Slaughterhouse Cases* and protect the rights of Respondents in a way that would be faithful to history and text.

III. A RULING FOR RESPONDENTS WOULD NEITHER UNDULY INFRINGE KENTUCKY'S STATE SOVEREIGNTY NOR EXCESSIVELY IMPACT MUNICIPAL BOND MARKETS.

A ruling for Respondents in this case would not infringe Kentucky's state sovereignty, as states could still permit exclusion of all municipal bond interest, as is done at the federal level and in Indiana, or tax all municipal bond interest. Nor would a ruling for Respondents excessively impact the municipal bond market, as state and local governments would still have access to capital at competitive interest rates.

A. A ruling for Respondents would not unduly infringe state sovereignty, as states could still allow a non-discriminatory municipal bond interest exclusion, or tax all municipal bond interest income.

This Court has been conscious that its rulings can have serious consequences, and that preserving a controversial rule is sometimes preferable to unleashing uncertainty and disrupting settled expectations. At least one *Amicus* urges this Court to reverse on this ground. *See* Brief of the Securities Industry & Financial Markets Association as Amicus Curiae Supporting Petitioners, *Kentucky v. Davis* (2007) (No. 06-666), at 5 ("If the municipal bond tax incentive evaporates, the demand for such bonds may likewise vanish, thus drying up a major source of funding for State projects."). But this case is not one of *fiat justitia ruat caelum*; a ruling for Respondents need not cause the sky to fall.

This Court should consider these concerns, but they neither dictate a result nor are they ultimately persuasive. The effect on settled expectations is just one consideration this Court has outlined for purposes of reversing lower courts and reconsidering previous decisions. *See, e.g.*, *Patterson v. McLean Credit Union*, 491 U.S. 164, 173-74 (1989) (outlining said considerations).

Some of the *amici* erroneously assume that any ruling for Respondents would result in this Court barring states from exempting or excluding municipal bond interest. This is not so. Kentucky could exempt all municipal bond interest, or none; the decision would be left to the commonwealth. If Kentucky chooses to exempt all municipal bond interest income from taxation, the state law would no longer discriminate against interstate commerce. Neither constitutional amendments nor upheaval would be required. Because the state's action would not be preordained from the judicial result, and because the state would still be able to select from many policy choices, its sovereignty is not threatened. Kentucky would simply be following in the path of Indiana and the federal government, both of which exempt all municipal bond interest without distinction.

B. A ruling for Respondents would not excessively impact municipal bond markets.

The municipal bond market is admittedly large. But tax exclusions, exemptions, and deductions are matters of legislative grace. They can be increased, decreased, rewritten, or repealed with little or no notice. As recently as 1986, the U.S. federal income tax code was overhauled, with many expectations repealed or revised. Many states, including Michigan, Ohio, and Texas, have recently overhauled their tax codes as well. Markets that exist solely to take advantage of the tax code, such as "state-specific" bond mutual funds, can be channeled into more productive uses after such changes. "States raised money from the bond market long before there were state-specific funds." Brian D. Galle & Ethan Yale, *Can Discriminatory State Taxation of Municipal Bonds Be Justified? Thoughts on the* Davis *Topside Briefs*, TAX NOTES (forthcoming

2007), *available at* http://ssrn.com/abstract=1014138, at 8. Of course, it is preferable that such revisions be done legislatively rather than judicially. But this Court is not being asked to rewrite Kentucky's tax code; it is instead being asked to uphold the Constitution.

This Court will hear arguments that an adverse ruling for Kentucky would result in deprivation of the states' access to capital. This will not occur, for two reasons. First, even assuming that all bonds (municipal and private) must be treated identically for tax purposes, this would simply mean that municipal bonds would have to compete on credit risk, rate of return, and the merits of the project rather than on tax benefits. Kentucky could, for instance, increase the rate of interest paid to bondholders in order to attract more capital. Furthermore, the reliability of tax revenues to repay debt might make these investments more attractive than private bonds. Only states with unsalvageable credit would have no access to capital in today's markets, and that fact would not change with or without the tax exclusion at issue here.

Second, the federal tax code will still exclude income earned from municipal bond interest from gross income. This exclusion has existed since 1913, and is not at issue here, nor in a conceivably related case. Municipal bonds will still enjoy this federal tax advantage over private bonds, regardless of any state action, and because federal rates are greater than state rates, the federal exclusion is more valuable. Of course, if states opted to exclude all municipal bond interest, rather than just domestic bonds, municipal bonds would become more valuable than they are at present, and demand for them would rise, not fall.

A ruling for Respondents still leaves Kentucky and other similarly situated states with the autonomy to indepdently structure their tax systems, provided that they are in conformity with the requirements of the

Constitution. This Court has not resorted to reliance on expectations regarding laws that discriminate against interstate commerce to sustain an otherwise invalid law. Here, where a ruling for Respondents would still enable states to exclude municipal bond interest, such arguments should not discourage this Court.

C. Invalidating Kentucky's discriminatory taxation of out-of-state municipal bond interest income will affect some states more than others.

High-tax states use the municipal bond interest exclusion to shield their higher taxes from interstate competition. This is because the higher a state's tax rate is, the more the exclusion is worth to its taxpayers. This Court should consider this protectionist motivation when evaluating whether the Kentucky law discriminates against interstate commerce.

To understand why high-tax states benefit from the exclusion, first assume that the exclusion did not exist. If a $1,000 state or local government bond had to pay a 10 percent return annually, or $100, to attract enough bond buyers, every investor would benefit equally. *See generally* Patrick Fleenor, "Tax-Exempt State and Local Bonds: A $20 Billion Gift to the Nation's Wealthiest Investors," in *Fixing the Alternative Minimum Tax: AMT Reform Requires Changes to Regular Tax Code*, TAX FOUNDATION SPECIAL REPORT NO. 155 (May 2007), at 9, *available at* http://www.taxfoundation.org/files/sr155.pdf.

However, because of the exclusion, investors who pay higher taxes get a better interest rate. Again assuming a $1,000 bond paying 10 percent, investors in the highest federal tax bracket (say 35 percent) are willing to buy the bonds for interest payments of 6.5 percent since the $35 in tax savings brings their annual earnings from the bond to the desired 10 percent. The $35 gain to state and local governments would equal the $35 in lost federal tax revenue. Investors in the 25 percent tax bracket would have to have a minimum interest rate of 7.5 percent, the point where the amount they save in taxes, $25 (25 percent of $100), brings their annual earnings from the bond to 10 percent.

Because state and local governments need to attract other investors, and not just those in the highest tax brackets, the highest rate necessary to clear the market must be given to all bond investors. So if a state offers a 7.5 percent interest rate to attract investors in the 25-percent tax bracket, bondholders in the 35-percent tax bracket get a better deal. They annually earn $110, instead of $100.

Consequently, the greater a state's income tax rate, the greater the benefit from the exclusion, and the interest rate the state must offer can be lower. States with the highest-tax individual income tax rates therefore have a stronger interest in preserving the municipal bond tax exclusion, because it enables them to protect those high tax rates from interstate competitive pressures. States with the lowest tax rates suffer because their comparative advantage in lower tax rates is eroded. This protectionist motivation for the exclusions is additional evidence that their purpose is, at least in part, to discriminate against interstate commerce.

IV. THIS COURT SHOULD BE CAUTIOUS NOT TO SUGGEST THAT DISCRIMINATION ANALYSIS APPLIES TO TAXES BUT NOT SUBSIDIES.

The current Kentucky law cannot accurately be described as a subsidy, and the constitutional scrutiny of discriminatory taxes is well-settled. But this Court should be cautious not to suggest that discriminatory taxes are more constitutionally suspect than discriminatory subsidies. The competitive neutrality protected by the Commerce Clause prohibits states from imposing burdens on activity out-of-state and in-state while solely exempting activity in-state from those burdens. Similarly, a state cannot impose burdens on activity out-of-state while leaving unburdened identical activity in-state. Both subsidies and taxes that violate these principles should undergo identical constitutional scrutiny.

A. This Court has in the past rejected formalism in favor of economic reality, but has not extended that fully into the realm of discriminatory subsidies.

On numerous occasions, this Court has distinguished constitutional statutes from unconstitutional ones by looking at actual facts, rather than merely the words the statute uses or the form it takes. *See, e.g.*, *Complete Auto*, 430 U.S. 274, 288-89 (1977) ("There is no economic consequence that follows necessarily from the use of the particular words . . . and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect."); *Thomas v. Union Carbide Agric. Products*, 473 U.S. 563, 586 (1985) (*quoting Crowell v. Benson*, 285 U.S. 22, 53 (1932)) ("In deciding whether the Congress, in enacting the statute under review, has exceeded the limits of its authority . . ., regard must be had, as in other cases where constitutional limits are invoked, not to mere matters of form, but to the substance of what is required."); *New York v. United States*, 326 U.S. 572, 583 (1946) ("[W]e reject limitations upon the taxing power of Congress derived from such untenable criteria . . . ."); *United States v. Classic*, 313 U.S. 299, 313 (1941) (considering the practical operation of an election law that was formally open but restrictive in practice). Where a statute uses unconstitutional means or pursues unconstitutional ends, this Court should not cut short its inquiry just because the form is not unconstitutional.

Unfortunately, while this Court gives proper scrutiny to discriminatory taxes, comparable scrutiny is not given to discriminatory subsidies. Nineteen years ago, this Court wrote, "Direct subsidization of domestic industry does not ordinarily run afoul of [the Commerce Clause]; discriminatory taxation of out-of-state manufacturers does." *New Energy Co.*, 486 U.S. at 278. *See also West Lynn Creamery*, 512 U.S. at 199 ("We have never squarely confronted the constitutionality of subsidies, and we need not do so now. We have, however, noted that direct subsidization of domestic industry does not ordinarily run afoul of the negative Commerce Clause.").

These dicta contrast with statements by this Court suggesting that existence of discriminatory treatment merits constitutional scrutiny regardless of form. *E.g.*, *Westinghouse*, 466 U.S. at 404-05 ("Nor is it relevant that New York discriminates against business carried on outside the State by disallowing a tax credit rather than by imposing a higher tax. . . . We have declined to attach any constitutional significance to such formal distinctions that lack economic substance."); *Bacchus Imps.*, 468 U.S. at 273 ("The determination of constitutionality does not depend upon whether one focuses upon the benefited or the burdened party.").

The Court should take this opportunity to clarify that subsidies do not get a constitutional free ride. The question to ask regarding permissive and barred state action should not be whether it is in the form of a tax or a subsidy, but whether it imposes a penalty in a discriminatory way.

B. A state subsidy program with the identical economic effect of Kentucky's law here should be subject to the same discrimination analysis.

States should not be able to convert a discriminatory tax into a discriminatory subsidy, and escape constitutional scrutiny. The Tax Foundation criticized the Sixth Circuit decision in *Cuno* for this reason. *See* Chris Atkins, *Federal Court Ruling May Hurt Tax Competition, State Tax Reform*, TAX FOUNDATION FISCAL FACT NO. 16 (2004) ("Making a distinction between subsidies and tax incentives seems highly formalistic. . . . Ohio can bypass the *Cuno* ruling by simply changing the tax incentive program into an investment subsidy."). The touchstone should not be the formal structure, but the economic effect.

The same danger is faced here. To avoid this result, courts should analyze a challenged subsidy for discrimination against interstate commerce no differently from an analysis of a challenged tax. Kentucky's statute challenged here effectively penalizes activity out-of-state by exempting solely identical activity occurring in-state. The competitive neutrality protected by the Commerce Clause prohibits states from imposing burdens on activity out-of-state and in-state while solely exempting activity in-state from those burdens, or imposing burdens on activity out-of-state while leaving unburdened identical activity in-state. Any law that does so should be held unconstitutional, be it tax or subsidy. This case presents an opportunity for this Court to reaffirm its statements in *Westinghouse* and *Bacchus Imports*, and value economic reality and presence of penalties over formalized categories.

CONCLUSION

Because the challenged statute penalizes those who engage in activity out-of-state by subjecting investment in out-of-state municipal bonds to tax burdens not borne by taxpayers investing in-state, this Court should hold the Kentucky exclusion unconstitutional. In doing so, this Court would not unduly infringe upon state sovereignty nor excessively impact municipal bond markets.

This Court could also consider the Kentucky exclusion in light of the Import-Export Clause and the Privileges or Immunities Clause, because it imposes an impermissible duty on activity that crosses state lines and burdens individuals who cross state lines in pursuit of an honest living, in contravention of the rights those clauses are designed to protect. This Court should also be cautious not to suggest that discriminatory taxes are scrutinized more intensively than discriminatory subsidies.

For the foregoing reasons, *Amicus* respectfully requests that this Court affirm the decision below.

Respectfully submitted,

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