Supreme Court Upholds State Tax Exemptions for In-State Municipal Bonds

BY JOSEPH P. OPICH AND MATT WALDING

In a 7-2 decision published May 19, 2008, the U.S. Supreme Court upheld the ability of the states to provide a state income tax exemption for interest derived from in-state municipal bonds while subjecting interest derived from municipal bonds issued by other states and their political subdivisions to tax. The case, Department of Revenue of Kentucky v. Davis, involved a claim by Kentucky residents that Kentucky’s tax exemption limited only to interest derived from in-state municipal bonds provides a benefit to in-state economic interests and places a burden on out-of-state competitors that should be prohibited by the Commerce Clause of the U.S. Constitution. The Court held that the current state tax treatment of municipal bonds does not violate the Constitution because this preferential treatment allows the state to finance its “cardinal civic responsibilities” of protecting the health, safety, and welfare of its citizens.

The Court previously explained in a 2007 opinion that the Commerce Clause generally does not prohibit state government functions motivated by “legitimate objectives distinct from simple economic protectionism.” The majority opinion in Davis held that the in-state municipal bond tax exemption must be respected under the same principle, which the Court found to be particularly applicable in the context of the “quintessentially public function” of paying for public projects through state municipal bond issuances.

The Court in Davis noted that the current market practice of allowing for differential tax treatment of in-state and out-of-state municipal bond interest is unanimously supported by the states and is “critical to the operation of an identifiable segment of the municipal financial market as it currently functions.” The Court also noted that many single-state municipal bond funds invest in bonds issued by smaller and lesser-known issuers that do not attract interstate investors, and that such single-state funds would likely disappear if the current differential tax regimes of the states were upset.

There are currently 42 states, including New York and California, that provide differential state tax treatment of interest derived from in-state and out-of-state bonds, similar to the Kentucky exemption at issue in Davis. The Court’s decision in Davis provides certainty and relief to issuers and investors in the approximately $2.5 trillion municipal bond market, particularly with respect to the $150 billion market for single-state municipal bond funds.
If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

**New York**

Joseph P. Opich  
212-318-6596  
josehopich@paulhastings.com

Matt Walding  
212-318-6543  
mattwalding@paulhastings.com

---

1 Dep’t of Revenue of Ky. v. Davis, No. 06-666, slip op. at 6 (U.S. May 19, 2008).
2 Id. at 12.
3 Id. at 11, discussing United Haulers Ass’n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth., No. 05-1345 (U.S. Apr. 30, 2007).
4 Id. at 12.
5 Id. at 23.
6 Id. at 21.
7 In addition to resolving widespread market uncertainty with respect to the practical impact of the Davis case, the Court also resolved conflicting interpretations by state courts in Kentucky and Ohio of the Commerce Clause issue presented in Davis. See Shaper v. Tracy, 647 N.E. 2d 550 (Ohio Ct. App. 1994).