U.S. Supreme Court Affirms Constitutionality of Tax Exemption Policies Underlying Municipal Bond Funds

In *Kentucky v. Davis*, the U.S. Supreme Court upheld the ability of a state and its political subdivisions to issue bonds exempt from state income tax while imposing an income tax on interest earned on bonds issued by other states. The holding reversed a decision by the court of appeals of Kentucky that found such differential tax treatment to be unconstitutionally discriminatory against out-of-state economic interests, and that had stood to alter the municipal bond market radically.

In overruling the Kentucky appeals court’s ruling, the Supreme Court relied in part on its prior holdings allowing a state to favor in-state interests when carrying out typical and traditional local government functions, especially those designed to benefit the public welfare. The Court characterized states’ issuance of debt to pay for public projects as a “quintessentially public function, with [a] venerable history,” explaining that proceeds from tax-exempt bonds afford states “a way to shoulder the cardinal civic responsibilities . . . [of] protecting citizens’ health, safety, and welfare.” The Court noted that differential tax policies like Kentucky’s afford states a competitive tool with which to attract investors to their bonds and judged that such policies do not foster the economic isolationism that the Court’s “dormant Commerce Clause” analysis might otherwise prohibit.

The Supreme Court’s decision also was based on an assessment of the impact a rejection of Kentucky’s differential tax treatment could have on the mutual fund and municipal bond markets. Because single-state municipal bond mutual funds purchase the bonds issued by smaller or lesser known municipalities that are not attractive in the national market, the Court said, “many single-state funds would likely disappear if the current differential tax schemes were upset.” Moreover, referring to the brief filed by the National Federation of Municipal Analysts in support of Kentucky’s defense of its differential tax policy, the Court explained that the Kentucky appeals court’s decision could threaten the tax-exempt mutual fund market, which in 2006 amounted to about $520 billion in long-term municipal bonds and $380 billion in short-term municipal bonds. A finding that Kentucky’s differential tax exemption is unconstitutional, the Court reasoned, would both jeopardize an enormous amount of public project financing and disrupt the mutual fund market at large.

Additionally, the Court noted that, in a supporting brief, all 49 other states had supported Kentucky’s differential tax policy, and 41 states had substantially similar policies. Kentucky’s “differential tax scheme is critical to the operation of an identifiable segment of the municipal financial market as it currently functions,” the Court observed, “and this fact alone demonstrates that the unanimous desire of the States to preserve the tax feature” is not a campaign toward unconstitutional economic protectionism.
The Court declined to address the constitutionality of Kentucky’s differential tax policy for income on certain private-activity bonds because the argument had not been sufficiently developed in the courts below.