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Defending Competitive Neutrality Before the Supreme Court

Kentucky Department of Revenue v. Davis, U.S. Supreme Court No. 06-666

By
Joseph Henchman
Tax Counsel
Tax Foundation

On November 5, 2007, the U.S. Supreme Court heard oral arguments in a case brought by George and Catherine Davis, a Kentucky couple challenging that state's income tax exclusion for municipal bond interest. They argue that because Kentucky taxes interest earned on out-of-state bonds, and does not tax Kentucky bonds, the scheme violates the Commerce Clause of the U.S. Constitution. The Tax Foundation filed a brief supporting their challenge.

Taxpayers who invest in bonds issued by state and local governments have enjoyed preferential federal tax treatment since the beginning of the federal income tax in 1913. Interest earned on such bonds is excluded from gross income and thus not subject to federal income taxation.[1] In 1919, New York became the first state to extend this preference to the state income tax.

At the state level, all 43 income-taxing states exempt interest earned on bonds from their own state. However, 42 of those states (including Kentucky) tax the interest earned on bonds from all *other* states. For instance, if a Kentucky resident owns municipal city bonds from both Louisville, Kentucky, and neighboring Jeffersonville, Indiana, the taxpayer is penalized in that he or she must pay Kentucky state income tax on the Indiana bond interest, but not on the Kentucky bond's interest.

State "welcome mats" are permissible as long as they are available on a neutral basis to any taker.

States can constitutionally create incentives to invest within the state. Such actions (lowering tax rates or exempting certain activity from taxation, for instance) foster a competitive business climate consistent with the federalism and liberty protected by the U.S. Constitution. These state "welcome mats" are permissible as long as they are available on a neutral basis to any taker.

But Kentucky's law goes beyond this. Those who invest out-of-state do not merely

1 Although gains realized from the sale of such bonds are taxed, and interest from private-activity municipal bonds is taxed under the Alternative Minimum Tax (AMT).

lose an incentive; they are *penalized* with taxes. By taxing out-of-state activity while exempting identical in-state activity from taxation, Kentucky seeks to protect its economic policies from interstate competition. It has imposed an unconstitutional "exit toll," not a permissible welcome mat.

The Commerce Clause Protects Competitive Neutrality

The Framers of the U.S. Constitution included the Commerce Clause because of states' willingness to impose trade barriers between each other, and tax out-of-state economic activity, to the detriment of the national economy. Justice William Johnson wrote in 1824 that, under the Articles of Confederation, the inability of any authority to restrain such state laws was "destructive to the harmony of the States, and fatal to their commercial interests abroad." Consequently, the U.S. Constitution grants Congress the power to prevent state burdens on interstate commerce. In the absence of congressional action, federal courts can also strike down state laws that discriminate against interstate commerce.[2]

States continue to discriminate against interstate commerce, notwithstanding the Commerce Clause. The Tax Foundation regularly reports on the general trend of state laws and actions that target out-of-state residents for higher tax burdens, such as raising hotel taxes, imposing rental car taxes, and levying higher property taxes on nonresident owners. Some are clearly permissible, but some are not. In one illustrative case, the U.S. Supreme Court struck down a Madison, Wisconsin ordinance prohibiting the sale of milk unless it had been processed within five miles of the city. The Court held, "In thus erecting an economic barrier protecting a major local industry against competition from without the State, Madison plainly discriminates against interstate commerce." [3] (During the *Davis* oral argument in the Supreme Court, Justice Stephen Breyer asked whether municipal bonds are "like milk," referencing this case.)

States continue to discriminate against interstate commerce, notwithstanding the Commerce Clause.

While the Supreme Court has consistently struck down burdens on interstate commerce, these rulings have not drawn a clear line between forbidden tax discrimination ("exit tolls") and permissible tax experimentation ("welcome mats"). On one hand, the courts have been suspicious of states that tax activity occurring out-of-state while leaving identical in-state activity untaxed. On the other hand, the U.S. Supreme Court has used imprecise language in defining what the Commerce Clause prohibits.

For instance, in one part of the *Boston Stock Exchange* case in 1977, the Supreme Court wrote that the Commerce Clause prohibits laws that "foreclose tax-neutral decisions."[4] Some commentators and at least one lower federal court (the Sixth Circuit Court of Appeals in *DaimlerChrysler v. Cuno*) interpreted this phrase to mean that the Commerce Clause forbids all tax law changes that may encourage or discourage economic activity to cross state lines.

Since virtually any tax change has some economic effect that may encourage or discourage behavior, the Tax Foundation joined the successful effort to persuade the U.S. Supreme Court to reverse the *Cuno* decision. Our brief warned:

2 The so-called dormant commerce clause is this power of the federal courts. *See, e.g.*, *Willson v. The Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829).

3 *Dean Milk Co. v. Madison*, 340 U.S. 349, 354 (1951).

4 *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 331 (1977).

> If taken literally, [the *Cuno* ruling] mean[s] that a state cannot develop a tax policy that encourages growth and investment. Not even tax rate reductions or exemptions [available to all taxpayers] would be allowed under this literal language.

Instead, we wrote 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. State laws that tax or otherwise penalize activity that occurs out-of-state, while protecting in-state activity from similar burdens, would be impermissibly discriminatory.

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.*

Past Supreme Court Cases Reflect Competitive Neutrality

The Tax Foundation's *Davis* brief analyzed past Supreme Court cases and found that they support the competitive neutrality framework. Like Kentucky's law, many of the challenged state laws imposed a tax on activity occurring out-of-state, while leaving identical activity in-state untaxed.

- *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977). New York imposed a tax on stock transfers executed by out-of-state brokers instead of in-state brokers. If an investor switched from in-state to out-of-state brokers, New York levied a higher tax.

The Supreme Court invalidated the tax, but noted that their decision "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."[5]

The Court's ruling showed a concern not with uniformity, but rather with preventing New York from solely taxing activity out-of-state while leaving identical activity in-state untaxed.

- *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984). New York imposed a franchise tax, but then gave a credit for in-state, but not out-of-state, activity. The Court concluded that this 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."[6]

Further, the Court explained that states cannot "impos[e] greater burdens on economic activity taking place outside the State than were placed on similar activities within the state."[7]

5 *Id.* at 336-37.

6 *Westinghouse*, 466 U.S. at 404.

7 *Id.*

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 activity out-of-state.

- *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 Hawaii's claim that the tax merely benefited in-state production without burdening production for out-of-state markets.

  The Court wrote, "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…. [I]t is irrelevant to Commerce Clause inquiry that the motivation of the legislature was the desire to aid the makers of the locally produced beverage rather than harm the out-of-state producers."[8] The tax was impermissible because Hawaii taxed activity out-of-state while leaving identical activity in-state untaxed.

- *American Trucking Association v. Scheiner*, 483 U.S. 266 (1987). Pennsylvania's imposition of fees on all trucks while reducing other taxes for trucks in-state only was invalidated because "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."[9]

- *New Energy Co. v. Limbach*, 486 U.S. 269 (1988). Ohio's grant of a tax credit to all ethanol producers except non-Ohio producers was disallowed because "the Commerce Clause prohibits economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors."[10]

- *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994). Massachusetts imposed a general tax on dairy producers, but distributed the revenues to domestic producers only. The Court struck down the pricing order, writing that it "violates the cardinal principle that a State may not benefit in-state economic interests by burdening out-of-state competitors."[11]

- *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997). Maine's charitable tax deduction was disallowed for organizations that primarily served non-Maine residents. The Court found the treatment discriminatory: "A State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State."[12]

[I]t is irrelevant to Commerce Clause inquiry that the motivation of the legislature was the desire to aid the makers of the locally produced beverage rather than harm the out-of-state producers.

The concept of competitive neutrality is reflected in each of these cases. It is also clearly seen in two other areas of Commerce Clause

8 *Bacchus Imports*, 468 U.S. at 273.
9 *American Trucking*, 483 U.S. at 286.
10 *New Energy Co.*, 486 U.S. at 273.
11 *West Lynn Creamery*, 512 U.S. at 199.
12 *Camps Newfound*, 520 U.S. at 581.

law not directly at issue in *Davis*, the constitutionality of compensating use taxes and the physical presence rule in business taxation.

The U.S. Supreme Court upheld the constitutionality of compensating use taxes in *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937). The State of Washington had imposed a tax on the use of certain personal property in-state, but "subject to an offset if sales tax or another use tax had been paid for the same thing."[13] The Court held the use tax to be constitutional even though it taxed activity out-of-state, because identical in-state activity was not exempted from the tax. The purpose of the tax was to compensate and equalize tax burdens, not penalize out-of-state activity with additional tax burdens.

The Commerce Clause prohibits economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.

If a use tax were penalizing (in other words, setting the use tax paid for out-of-state activity higher than the sales tax paid on in-state activity, or disallowing offsets for previous tax paid), it would likely violate the Commerce Clause. One court recently held such a tax to violate the Commerce Clause. *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), the Supreme Court reaffirmed its long-standing rule that a state cannot impose on businesses a duty to collect sales taxes unless that business is physically present in the state. The Court explained that the rule prevented states from placing "[u]ndue burdens on interstate commerce" and "created a safe harbor for vendors whose only connection with customers in the taxing State is by common carrier or United States mail."[14]

The Court sought to stop states from taxing activity out-of-state, which arises because many states seek to export their tax burdens and impose taxes on businesses not physically present in the state. The Court understood in *Quill* that limiting states to taxing only those businesses physically present ensures that states are not burdening activity out-of-state more than activity in-state.

If a state imposes a tax that applies both in-state and out-of-state, it cannot then solely exempt activity occurring in-state from the tax. Similarly, a state may not effectively tax activity out-of-state while leaving activity in-state untaxed.

Kentucky's Law Violates Competitive Neutrality

Kentucky residents who file the individual income tax form are instructed to start with their federal calculation of gross income, which includes all income earned worldwide, but excludes all municipal bond interest. Kentucky then requires that filers add in all interest income from non-Kentucky municipal bonds.

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.

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

13 *Henneford*, 300 U.S. at 583-84.

14 *Quill*, 504 U.S. at 314-15.

to make investing in Kentucky bonds the only way such individuals can lower their effective tax rate on municipal bond income. Kentucky has gone beyond setting out "welcome mats"—differential treatment designed to foster a competitive business climate, which can be constitutional. Instead, it is imposing an "exit toll"—penalizing activity solely because it crosses state lines, while leaving in-state activity untaxed.

Put slightly differently, Mr. and Mrs. Davis have suffered an injury—they have had to pay a penalty in the form of higher taxes for engaging in activity out-of-state, while those who engaged in identical activity in-state have not been penalized. This contrasts with the *Cuno* case, where the Supreme Court found that none of the plaintiffs challenging the tax credits had suffered any injury. They had not been penalized, because Ohio did not burden out-of-state activity with taxes.

Those who hold out-of-state municipal bonds are penalized because they engage in activity disfavored by a state practicing protectionism.

The Tax Foundation's *Davis* brief urged the U.S. Supreme Court to hold explicitly that the Commerce Clause protects competitive neutrality. By guaranteeing that states retain autonomy over their tax systems as long as they do not enact protectionist measures that punish out-of-state activity, competition conducive to economic growth is encouraged. To rule otherwise would ignore the purposes behind the Commerce Clause and, as two scholars recently put it, "shield state officials from the pressure of competition."[15]

The Recent *United Haulers* Case Does Not Apply

On April 30, 2007, the U.S. Supreme Court handed down a decision in *United Haulers Association, Inc. v. Oneida-Herkimer Solid Waste Management Authority*.[16] There, the Court found no Commerce Clause violation when a state requires waste haulers to use a state-owned facility. *United Haulers* involved a state-run monopoly, so because competition was prohibited by law, there was by definition no discrimination. The state barred all competition, public or private, in-state or out-of-state, so the treatment was even-handed.

Some commentators, and some justices, wonder if the decision should be read more broadly than that. Kentucky's *Davis* counsel argued that United Haulers stands for the view that a state favoring itself (such as by foregoing tax revenue in the form of excluding bonds from taxation) is constitutional. Justices David Souter and Stephen Breyer seemed receptive to this argument, suggesting that governments should be able to discriminate in favor of in-state activity when performing "traditional government functions" such as "producing electricity" or operating "libraries, schools, [and] streets."

Prior Supreme Court attempts to draw a line between "traditional government functions" and non-traditional functions have been abandoned as unworkable.[17] Following the approach suggested by Souter and Breyer would potentially swallow the rule, because any discrimination in favor of in-state economic activity can be said to better something or someone in-state. The rule would become nonsensical: states cannot penalize out-of-state activity so as to better in-state activity, except when in-state activity is bettered.

The Supreme Court should not accept the argument that *United Haulers* meant more

15 Ethan Yale & Brian D. Galle, Municipal Bonds and the Dormant Commerce Clause After United Haulers, 44 State Tax Notes 877, 895 (Jun. 18, 2007).

16 550 U.S. ___ (slip op. April 30, 2007) (No. 05-1345).

17 *See, e.g.*, *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985).

than it said. That case simply upheld a state's power to exclude all competition from its monopoly. Kentucky has not monopolized the bond market, and in-state municipal bonds freely compete with many other types of bonds.

If Kentucky prevails, an expanded *United Haulers* exception would give free reign for states to recreate the chaos and balkanization present before the adoption of the Commerce Clause.

Kentucky's Law Also Violates Two Other Constitutional Protections

The Tax Foundation's brief urged the Court to consider two other provisions of the Constitution that provide additional textual and historical support for the concept of competitive neutrality. We explained that the *Davis* case provides the opportunity for the Court to hold that the Import-Export Clause of Article I, Section 10 applies domestically and prevents states from penalizing economic activity just because it crosses state lines. We also pointed to the Privileges or Immunities Clause of the Fourteenth Amendment, which protects the right to cross state lines in pursuit of an honest living.

The Import-Export Clause

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…." The Import-Export Clause, as it is known, was inserted into the Constitution for much the same reason as the Commerce Clause: to stop states from endangering the national economy by imposing trade barriers.

The Supreme Court should not accept the argument that United Haulers *meant more than it said.*

The Framers expected that the Clause would apply domestically—that states would be barred from burdening interstate trade, as well as international trade.[18] The Supreme Court applied the Clause domestically in two cases in 1827 and 1861,[19] but reversed itself in *Woodruff v. Parham*, 75 U.S. 123 (1868). The *Woodruff* Court held that there was no evidence that the word "imports" referred to anything except international trade.[20]

Subsequent research has undermined this conclusion. Scholars have discovered examples from the Founders and contemporaneous ratifying conventions, newspapers, laws, and writers using the word "imports" to describe domestic trade. As one scholar explained, "The evidence suggests that the *Woodruff* Court was too hasty in its dismissal of [earlier cases], because [their] reading of the Import-Export Clause was too narrow."[21] In 1997, Supreme Court Justice Clarence Thomas outlined much of this scholarship in a dissenting opinion, and urged the Court to reconsider *Woodruff* and apply the Clause domestically.[22]

Of course, not all interstate taxation is impermissible. The Supreme Court has written that the Import-Export Clause bars only "exactions" that "create special protective tariffs or particular preferences for certain domestic goods."[23] "The prohibition would not apply to a state tax that treated imported goods…in a

18 *See, e.g.*, Supplement to Max Farrand's The Records of the Federal Convention of 1787, at 360 (James H. Hutson ed., 1987) (Statement of Gouverneur Morris) ("There is great weight in the argument, that the exporting States will tax the produce of their uncommercial neighbors.").

19 *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 449 (1827); *Almy v. California*, 65 U.S. 169, 172-74 (1861).

20 *See Woodruff*, 75 U.S. at 136.

21 Brannon P. Denning, *Justice Thomas, the Import-Export Clause, and* Camps Newfound/Owatonna v. Harrison 70 Colo. L. Rev. 155, 213 (1999).

22 *See Camps Newfound/Owatanna, Inc. v. Town of Harrison*, 520 U.S. 564, 640 (Thomas, J., dissenting).

23 *Michelin Corp. v. Wages*, 423 U.S. 276 (1976); *Id.* at 286.

manner that did not depend on the foreign origins of the goods."[24]

Kentucky's tax on municipal bond interest 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. Because a tax on activities relating to importing has been held to be functionally equivalent to a tax on importing,[25] Kentucky's penalty on interstate economic activity is an impermissible duty.

The Privileges or Immunities Clause

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…." While states have always been required to extend any privileges or immunities enjoyed by their state's citizens to other U.S. citizens in that same state,[26] not until Reconstruction was it considered necessary to adopt a constitutional amendment to protect citizens' basic civil rights from infringement by state governments.

Kentucky's tax on municipal bond interest is an example of what the Import-Export Clause was designed to prevent.

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.[27]

Even after the *Slaughterhouse Cases*, the Supreme Court has 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), the Court applied the Clause to strike down a California welfare benefits law that applied differently to California residents based on their prior interstate travel. 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.

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*,[28] 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…." In *Madden v. Kentucky*, 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."[29]

The Privileges or Immunities Clause protects the right of "all citizens to be free to travel

24 *Id.* at 298.

25 *See Camps Newfound*, 520 U.S. at 574-75.

26 *See* U.S. Const., art. IV, ß 2; Articles of Confederation art. IV.

27 *See, e.g.*, Randy Barnett, Restoring the Lost Constitution 95-203 (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.").

28 296 U.S. 404, 433 (1935), *overruled by Madden v. Kentucky*, 309 U.S. 83, 90-93 (1940).

29 *Madden,* 309 U.S. at 92 n.21.

throughout the length and breadth of our land uninhibited by statutes, rules, or regulations which unreasonably burden or restrict this movement."[30] 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*.

Kentucky's law is invalid under the Clause because the state 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. Otherwise, Mr. and Mrs. Davis, and others like them, would be discouraged from commercially crossing state lines in pursuit of an honest living.

The Tax Foundation's brief urged the Court to consider re-evaluating the *Slaughter-house Cases* so as to protect the rights of Mr. and Mrs. Davis in a way that would be faithful to history and text.

The Municipal Bond Exclusion Helps High-Tax States Avoid Tax Competition

Pointing to Tax Foundation research, our *Davis* brief argued that the municipal bond exclusion is designed to help high-tax states shield their higher rates from interstate competition.[31] We argued that this protectionist motivation should be considered by the Court as it determines whether Kentucky's law is constitutional.

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.

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. Of course, the same principle applies for state and local income taxes.

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.

States can neither penalize the crossing of state lines nor impose burdens on those who exercise that right.

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 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

30 *Saenz*, 526 U.S. at 499, *quoting Shapiro v. Thompson*, 394 U.S. 618, 629 (1969).

31 *See* 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.

additional evidence that their purpose is, at least in part, to discriminate against interstate commerce.

Striking Down Kentucky's Law Would Not Harm State Financing

The Tax Foundation's brief also rebutted doomsday scenarios given by organizations seeking to maintain the municipal bond interest exclusion. Some of these organizations have written briefs in the *Davis* case supporting Kentucky, urging the Court to sustain the exclusion because otherwise states will have no access to capital. For example, the Securities Industry & Financial Markets Association predicted, "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."

States with the highest 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.

The Supreme Court should certainly consider the value of not disrupting settled expectations, but in this case, such concerns are not convincing. Tax breaks are a matter of legislative grace, and can be increased, decreased, rewritten, or repealed with little or no notice. In 1986, the federal income tax code was overhauled, with many expectations repealed or revised, and many states 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 mostly owned and run by gigantic financial firms, can be channeled into more productive uses after such changes. Of course, it is preferable that such revisions be done legislatively rather than judicially. But the Court is not being asked to rewrite Kentucky's tax code; it is instead being asked to uphold the Constitution.

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. 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. Put simply, "States raised money from the bond market long before there were state-specific funds."[32]

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.

Simply put, if the Supreme Court sides with Mr. and Mrs. Davis, Kentucky and other

32 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.

states will still have the autonomy to independently structure their tax systems, provided that they are in conformity with the requirements of the Constitution. Mere reliance on expectations should not persuade the Supreme Court to sustain a law that is unconstitutional and economically detrimental to the nation.

Discriminatory Subsidies Are Just As Bad As Discriminatory Taxes

Kentucky's exclusion cannot accurately be described as a subsidy, and the fact that discriminatory taxes are subject to heightened judicial scrutiny is well-settled. But the Tax Foundation's brief urged the Supreme Court to be cautious not to suggest that discriminatory taxes are more constitutionally suspect than discriminatory subsidies. Both subsidies and taxes that violate the principles of competitive neutrality should undergo identical constitutional scrutiny.

In *West Lynn Creamery*, the Supreme Court put off the issue of discriminatory subsidies. "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."[33]

Both subsidies and taxes that violate the principles of competitive neutrality should undergo identical constitutional scrutiny.

This statement contrasts with earlier ones in *Westinghouse*, where the Supreme Court explicitly "declined to attach any constitutional significance to…formal distinctions that lack economic substance,"[34] and in *Bacchus Imports*, where the Court rejected the relevance of whether the discriminatory action is in the form of benefit or burden.[35]

States should not be able to convert a discriminatory tax into a discriminatory subsidy, to get a constitutional free ride. The Tax Foundation criticized the lower court's decision in the *Cuno* case for this reason: "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."[36] The touchstone should not be the formal structure, but the economic effect.

The same danger is faced in *Davis*. To avoid this result, courts should analyze a challenged subsidy for discrimination against interstate commerce no differently from a challenged tax. Kentucky's statute challenged here effectively penalizes activity out-of-state by exempting identical activity occurring in-state. The competitive neutrality protected by the Commerce Clause prohibits states from 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.

Conclusion

Because Kentucky's law 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, it is unconstitutional. Such a finding would neither infringe upon state sovereignty nor excessively impact municipal bond markets.

The Supreme Court could also consider the Kentucky exclusion in light of the Import-

33 *West Lynn Creamery*, 512 U.S. at 199.

34 *Westinghouse*, 466 U.S. at 404-05.

35 *See Bacchus Imps.*, 468 U.S. at 273.

36 Chris Atkins, *Federal Court Ruling May Hurt Tax Competition, State Tax Reform*, Tax Foundation Fiscal Fact No. 16 (2004).

Export and Privileges or Immunities Clauses, because Kentucky is imposing an impermissible duty on activity that crosses state lines and burdening individuals who cross state lines in pursuit of an honest living, in contravention of the rights those clauses are designed to protect.

The Court should also be cautious not to suggest that discriminatory taxes are scrutinized more intensely than discriminatory subsidies, and should be aware of the protectionist effects of the municipal bond interest exclusion.

A decision in favor of Mr. and Mrs. Davis gives the Court the opportunity to embrace the principles of competitive neutrality, which would permit states to design tax systems that foster a competitive business climate, while ensuring that discriminatory schemes are invalidated. A judicial decision incorporating the arguments made in the Tax Foundation's brief would go far in establishing a tax law system that is simple, fair, and conducive to economic growth, while remaining consistent with case law developments and the U.S. Constitution.

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Editor and Communications Director, Bill Ahern

Copy Editor, Alicia Hansen

Tax Foundation
2001 L Street, NW, Suite 1050
Washington, DC 20036
(202) 464-6200
(202) 464-6201 fax
www.TaxFoundation.org
TF@TaxFoundation.org