Kentucky v. Davis

Constitutional Protection for State Tax Exemptions for Bonds

— by Robert W. Doty —

In *Department of Revenue of Kentucky v. Davis*,[1] the U.S. Supreme Court affirmed the constitutionality of the long-standing practice of States' grants of tax exemptions for interest borne by their own securities and the securities of their local governments, while taxing the interest borne on governmental securities issued in other states. In the process, the Court reiterated its significant deference, within federal constitutional Dormant Commerce Clause jurisprudence, for traditional State and local undertakings.

Background

The tax exemptions facilitate the sale of municipal securities at lower interest rates to residents within individual States, reducing the costs of public projects and programs.[2] Correspondingly, the multiple tax exemptions serve as a significant barrier to interstate sales of municipal securities. According to the Court's decision, 41 States have similar tax structures.[3] In *Davis*, the Court received briefs from all 50 of the States—including those that do not have income taxes—in support of the constitutionality of Kentucky's tax structure. IMLA joined in a supportive *amicus* brief filed on behalf of nine national associations of state and local governmental officials,[4] which presented serious issues as to the cost implications for State and local governments nationwide if the Court's ruling went against Kentucky's tax scheme.[5]

The Supreme Court's decision reversed a ruling of the Court of Appeals of Kentucky on a matter of first impression in the state: that the bond taxation system discriminated against interstate commerce in violation of the Commerce Clause.[6] The Court of Appeals itself had reversed the trial court's ruling against the plaintiff taxpayers.[7] The trial court's ruling was based upon the "market participant" exception[8] to the so-called "Dormant Commerce Clause" of the United States Constitution. Actually, the Constitution does not contain a Dormant Commerce Clause; rather, the Court has implied one based on the language of art. I, § 8, clause 3 of the Constitution, which grants Congress the power "[t]o regulate Commerce...among the several States." As described by the majority in *Kentucky v. Davis*, the Supreme Court has "sensed a negative implication in" that language.[9]

In *Davis*, the plaintiff taxpayers had argued that Kentucky's tax exemption for governmental securities issued within the Commonwealth (like similar tax exemptions in other states) constituted discrimination.[10] The questions before the Supreme Court were whether the State discriminated against interstate commerce in violation of the dormant Commerce Clause through its differing treatment of interest income; and, if so, whether that discrimination was permissible.

A year previously, the Supreme Court had decided another Commerce Clause case, *United Haulers Ass'n., Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*,[11] upholding a local requirement mandating that private waste-haulers use locally-owned and operated waste disposal facilities. The Court had distinguished the facts of *United Haulers* from those in *C & A Carbone, Inc. v. Clarkstown*,[12] in which a local jurisdiction had used a private company to own and operate, as a financing mechanism, a mandated waste-transfer station. After a period of five years (under terms designed to provide an adequate return to the private owner-operator), the *Carbone* facility was to have been transferred to the local jurisdiction for a dollar. The Court in *United Haulers* distinguished *Carbone* on the ground that the facility had been owned privately, while that in *United Haulers* was a public facility.[13] In doing so, the Court's majority argued that a state-owned facility, especially in a traditional area of government activity like solid waste management, was different, because governments had greater interests than merely economic ones. For example, unlike private businesses, governments were to look to the protection of "the health, safety, and welfare" of the citizenry.[14] Accordingly, a governmental public preference was constitutionally different from a commercial private preference. The *Davis* Court described the holding in *United Haulers* as follows:

> Not only did the public authority acting in [*United Haulers*] process trash, but its governmental superiors forbade trash haulers to deal with any other processors. This latter fact did not determine the outcome, however; the dispositive fact was the government's own activity in processing trash. We upheld the government's decision to shut down the old market for trash processing only because it created a new one all by itself, and thereby became a participant in a market with just one supplier of a necessary service....*United Haulers* accordingly turned on our decision to give paramount consideration to the public function in actively dealing in the trash market....[15]

The Ruling

Given its decision in the *United Haulers* case, the substantial level of State sup-

port, and the long-standing, widespread use of the tax exemptions without challenge by Congress, it seemed unlikely that the Court would overturn the tax exemption at issue in *Davis*. This turned out to be the case: the majority in *Davis* held that the tax structure comported with the dormant Commerce Clause because it favored a traditional government function. The Justices in *Davis* produced seven opinions, and four concurred in whole or in part with the principal opinion constituting the Court's decision. As noted below, one section of the principal opinion had support only from a plurality of the Justices. Justice Thomas concurred in the result. Two of the concurring opinions (those of Justices Scalia and Thomas) criticized the concept of the Dormant Commerce Clause as implied constitutional law. Justices Kennedy and Alito dissented in two opinions.

The Supreme Court's interpretation of the Dormant Commerce Clause is, essentially, that given the Constitution's grant to Congress of affirmative power to regulate interstate commerce, the States are restricted, to a degree determined by the Court, in their own ability to regulate interstate commerce. In general, the Supreme Court has applied the Dormant Commerce Clause to restrain significant "economic protectionism" discrimination against interstate commerce in the absence of "a legitimate local purpose that cannot be served adequately by reasonable nondiscriminatory alternatives."[16] In the absence of discrimination against interstate commerce, the Court also has applied the Clause to prohibit burdens, to a degree the Court deems "clearly excessive in relation to the putative local benefits," upon economic interests in other states.[17]

The *Davis* decision yielded audible sighs of relief, especially among investors in municipal securities in high-tax States, such as California and New York. The municipal securities market is a highly conservative market that does not like surprises or changes. The *California Municipal Bond Advisor* referred to the decision as "a huge psychological boost," and opined that the municipal bond market "would have come to a screeching halt if the decision had upset the existing apple cart. It would have taken weeks, if not months, for investors to adjust to a new 'national' market."[18] Another constituency especially pleased with the decision was that of the single-state bond funds. The *California Municipal Bond Advisor* observed that:

> [t]he restaurants and bars near the home offices of the single-state funds no doubt saw an uptick in business after the court's decision. There was a lot to celebrate because the employees at those funds had more riding on the decision than just about anyone else in the municipal market.[19]

There are a number of key rationales in the *Davis* decision. First, *United Haulers* provided *a fortiori* precedent for the proposition that, unlike private businesses, governments exercising traditional governmental functions have "legitimate objectives distinct from the simple economic protectionism the Clause abhors."[20] According to the Court, this "logic applies with even greater force to laws favoring a State's municipal bonds, given that the issuance of debt securities to pay for public projects is a quintessentially public function, with the venerable history we have already sketched."[21] Second, the tax exemption granted by the vast majority of the States was a long-standing tradition in the municipal bond market, and all the States supported it. The Court noted: "It should go without saying that the apprehension in *United Haulers* about 'unprecedented ...interference' with a traditional government function is just as warranted here, where the Davises would have us invalidate a century-old taxing practice...presently employed by 41 States...and affirmatively supported by all of them."[22] Third, the tax exemption assisted Kentucky in funding public projects and programs through an effective cost-allocation structure:

> By issuing bonds, state and local governments 'sprea[d] the costs of public projects over time,'...much as one might buy a house with a loan subject to monthly payments. Bonds place the cost of a project on the citizens who benefit from it over the years,...and they allow for public work beyond what current revenues could support....Bond proceeds are thus the way to shoulder the cardinal civic responsibilities listed in *United Haulers*: protecting the health, safety, and welfare of citizens.[23]

Kentucky could treat other States as private entities, but, in its role as a public issuer, was not required to treat those private bond issuers (as so defined) equally to itself. Referring to its previous ruling in *Bonaparte v. Tax Court* (where it held that a foreign state was "properly treated as a private entity with respect to state-issued bonds that have traveled outside its borders"),[24] the Court found that, when viewed through the lens of *Bonaparte*,

> the Kentucky tax scheme parallel[ed] the ordinance upheld in *United Haulers*: it

continued on page 26

Robert W. Doty is president of American Governmental Financial Services Company (AGFS), a private company in Sacramento, CA. He is also Vice President of the National Association of Independent Public Finance Advisors, and has served as Chair of IMLA's Section on Economic Development, Taxation, and Finance. Mr. Doty is a former General Counsel to the Government Finance Officers Association, a former member of the Board of Governors of the National Federation of Municipal Analysts, and a recipient of the NFMA's Municipal Industry Contribution Award and of IMLA's Most Outstanding Associate Member Award. Mr. Doty served as principal drafter of IMLA's Financing Procedures Guidelines.



Kentucky v. Davis

cont. from page 25

> "benefit[s] a clearly public [issuer, that is, Kentucky], while treating all private [issuers] exactly the same."...There is no forbidden discrimination because Kentucky, as a public entity, does not have to treat itself as being "substantially similar" to the other bond issuers in the market.[25]

In a portion of the Court's decision supported by only a plurality of the Justices,[26] Kentucky's tax exemption was described as an inherent element of Kentucky's role as a securities issuer in the market:

> The Davises make a fair point to the extent that they argue that Kentucky acts in two roles at once, issuing bonds and setting taxes, and if looked at as a taxing authority it seems to invite dormant Commerce Clause scrutiny of its regulatory activity....But there is no ignoring the fact that imposing the differential tax scheme makes sense only because Kentucky is also a bond issuer. The Commonwealth has entered the market for debt securities....
>
> * * *
>
> [O]ur cases on market regulation without market participation prescribe standard dormant Commerce Clause analysis; our cases on market participation joined with regulation (the usual situation) prescribe exceptional treatment for this direct governmental activity in commercial markets for the public's benefit. The Kentucky tax scheme falls outside the forbidden paradigm because the Commonwealth's direct participation favors, not local private entrepreneurs, but the Commonwealth and local governments. The Commonwealth enacted its tax code with an eye toward making some or all of its bonds more marketable....Issuing bonds must therefore have the same significance under the dormant Commerce Clause as government trash processing....[27]

Using several definitions of the "market"—(1) "issuers and holders of all fixed income securities;" (2) "commerce solely in federally tax-exempt municipal bonds;" and (3) "the one for bonds within the State of issuance"[28] —Kentucky acted as a market participant in the bond market. In effect, a State in a role as a market participant need not restrain its competition under the Commerce Clause.

Specifically, the widespread practice of granting tax exemptions for governmental securities issued within a state has given rise to single-state municipal bond funds, which provide a critical market for the obligations of smaller, less well-known, local governments. Those local governments might not be able to fund their projects and programs, at least not at the same level, if the tax exemption was held to be invalid. That is because, without the tax exemption, there would not be sufficient rationale for the existence of those funds. As stated by the Court:

> An equally significant perception emerges from examining the third type of market for municipal bonds: the one for bonds within the State of issue, a large proportion of which market in each State is managed by one or more single-state funds. By definition, there is no discrimination against interstate activity within the market itself, but one of its features reveals an important benefit of intrastate bond markets as they operate through these funds. The intrastate funds absorb securities issued by smaller or lesser known municipalities that the interstate markets tend to ignore....There is little doubt that many single-state funds would disappear if the current differential tax schemes were upset....Nor is there any suggestion that the interstate markets would discover some new reason to welcome the weaker municipal issues that would lose their local market homes after a victory for the Davises here.[29]

Further, the Court found this "probable indispensability" of the scheme in maintaining single-state markets that served smaller municipal borrowers

> not only underscores how far the States' objectives probably lie from the forbidden protectionism for local business [but] also tends to explain why the States are so committed to a taxing practice that much scholarship says often produces a net burden of tax revenues lost over interest expense saved.[30]

For their part, the dissenters—Justice Kennedy, with Justice Alito joining—opined that, by ruling as it did, the majority "weaken[ed] the preventative force of the Commerce Clause and invites other protectionist laws, thus risking further dislocations and market inefficiencies based on the origin of products and commodities that should be traded nationwide and without local trade barriers."[31]

Conclusion

In summary, the decision in *Kentucky v. Davis* grants significant additional leeway to State and local governments in their regulation (in this case, regulation through the tax system) and in their use of governmental economic activity (in this case, issuing securities) to favor their own State and local governmental undertakings over out-of-state interests.

Notes

1. 128 S.Ct. 1801(2008).
2. An offsetting consideration is the loss of income taxes that would be paid otherwise on State and local government securities. The Court's decision refers to "much scholarship [that] says [the tax exemption] often produces a net burden of tax revenues lost over interest expense saved." *Id.* at 1817.
3. *Id.* at 1803.

4. Brief of the Government Finance Officers Association, National Governors Association, National League of Cities, National Conference of State Legislatures, National Association of Counties, Council of State Governments, U.S. Conference of Mayors, International Municipal Lawyers Association, and International City/County Management Association as *Amici Curiae* Supporting Petitioners, 2007 WL 2115436 (U.S.) (hereinafter, the "State and Local Amicus Brief").
5. The State and Local Amicus Brief argued that "a decision to invalidate Kentucky's tax scheme would force state treasuries to absorb billions of dollars in transition costs, a large-scale financial disruption that is manifestly unfair given the reasonableness of the States' reliance on the validity of a ubiquitous tax policy." The Brief also pointed out more specifically the serious costs of retroactive impacts involving tax refunds and prospective losses of future tax collections. *Id.* at 4.
6. Davis v. Dept. of Revenue of the Fin. and Admin. Cabinet, 197 S.W.3d 557 (Ky. Ct. App. 2006).
7. Davis v. Revenue Cabinet, Commonwealth of Ky., No. 03CI03282, 2004 WL 5358776 (Ky. Cir. Ct. Aug. 30, 2004).
8. In general, the "market participant" exception allows governments engaged in economic activity within a market to engage in discriminatory behavior as would other competitors. *See Davis*, 128 S.Ct. 1801, 1809 (2008) (citing *White v. Mass. Council of Constr. Employers, Inc.*, 460 U.S. 204, 208 (1983) "[W]hen a state or local government enters the market as a participant it is not subject to the restraints of the Commerce Clause").
9. 128 S.Ct. at 1808.
10. Justice Kennedy's dissent pointed out that "discrimination against out-of-state bonds is the whole purpose of the law in question." *Id.* at 1827. The State and Local Amicus Brief argued that the Kentucky tax exemption "treat[ed] all private businesses exactly the same; and it concern[ed] an activity—borrowing money—that is a traditional and core governmental function. It therefore [did] not discriminate against interstate commerce." State and Local Brief at 15-16. The Brief further argued that the tax costs to the States from a ruling against Kentucky would be "wholly inequitable." *Id.* at 9.
11.127 S.Ct. 1786 (2007).
12. 511 U.S. 383 (1994).
13. 127 S.Ct. at 1790.
14. *Id.* at 1789.
15.128 S.Ct. 1801, 1813 (2008).
16. *Id.* at 1808 (inside quotes and citations omitted).
17. *Id.* (inside quotes and citations omitted).
18. *A Huge Victory for Muni Bonds After Several Months of Tough News*, CALIF. MUNICIPAL BOND ADVISOR at 1 (June 2008). The "tough news" referred to by the title related to market disruptions associated with the credit crisis.
19. *Id.* The Court's decision cited, repeatedly, an *amicus* brief filed on behalf of the National Federation of Municipal Analysts (NFMA), a group that includes significant numbers of mutual fund analysts among its members.
20. 128 S.Ct. at 1810.
21. *Id.* (citations and footnotes omitted.)
22. *Id.* at 1811 (citations and footnotes omitted).
23. *Id.* at 1810-11 (citations and footnotes omitted).
24. 104 U.S. 592 (1882).
25. 128 S.Ct. 1801, 1811 (2008) (citations and footnotes omitted).
26. For example, Chief Justice Roberts concurred in the decision based only on *United Haulers*, finding no need to proceed with the alternative "market participant" analysis. *Id.* at 1821.
27. *Id.* at 1812, 1814 (citations and footnotes omitted).
28. *Id.* at 1815.
29. *Id.* at 1817 (citations and footnotes omitted).
30. *Id.* This rationale fails to take into account two additional significant market segments for tax-exempt securities issued by smaller jurisdictions. Those are (1) individual investors, whose importance has been emphasized by the Securities and Exchange Commission repeatedly over the years, and (2) the lease-purchase private placement market, involving banks and corporate investors. The lease-purchase market is a substantial, hidden market about which scant data exist. Nevertheless, large quantities of local government securities issued by smaller issuers are sold in that market on a continuous basis. Another important development appears to be in the offing: The dual rating scales of the major rating agencies have been challenged by numerous State and local governmental securities issuers. Single-rating scales, in which corporate and municipal securities are rated based upon common criteria, appear to be emerging. Such a development should lead to significant upgrades in the ratings of State and local securities, and correspondingly, should make securities of smaller issuers more readily salable in the general municipal securities market.
31. *Id.* at 1830. **ML**

CORRECTION:
In the last issue of the *Municipal Lawyer*, the name of the Joseph I. Mulligan, Jr. Distinguished Public Service Award recipient on page 2 should have read Susan Emery McGannon.

NEWS FROM IMLA *continued from page 5*

I am so proud to serve as your President/Queen! There is not a finer group of attorneys anywhere. You all are hard-working and dedicated public servants, and you unselfishly share your wealth of knowledge with your fellow colleagues every day. For this, and for all the things you do for our citizens, I thank you. **ML**

ORDINANCES *continued from page 23*

port of these Texas cities, the TCAA has made the study available for free to any city that would like to use it. TCAA hopes that the study will be of benefit to any city that faces similar court challenges.

Mick McKamie is the City Attorney for the City of Boerne, Texas. He also practices trial law and represents governmental entities as a significant portion of his practice. He is a graduate of the University of Texas, Texas Tech School of Law, and holds a Masters degree in Public Administration from Texas Tech. His e-mail is Mick@McKamieLaw.com. Wayne Olson is in private practice in the area of municipal and public law, with an emphasis in real estate development and land use law (primarily in the areas of zoning, planning, and development matters). He serves as the City Attorney for several cities in the North Texas area. Wayne graduated from Southern Methodist University with a B.B.A. degree in real estate, and holds his law degree from the University of Texas School of Law. He can be reached at Wolson@toase.com. Scott Houston is the General Counsel for the Texas City Attorneys Association (TCAA), an affiliate organization of the Texas Municipal League (TML), with a membership of over 400 attorneys. Scott is also the director of legal services for TML, and can be reached at SHouston@tml.org. **ML**