Supreme Court Upholds Tax Breaks for Municipal Bonds

by Carolyn Coleman

Last Monday, the U.S. Supreme Court upheld the preferential tax break that 42 states give their residents who invest in bonds issued by those states and their municipalities. The ruling came as a relief to the $2.6 trillion municipal bond market, a primary vehicle that state and local governments rely upon to raise funds to finance public projects.

Voting 7-2, the justices rejected the argument that a state engages in unconstitutional discrimination against interstate commerce by exempting the interest on its own bonds from residents' taxable income while taxing the interest earned on the bonds from other states. The Kentucky Court of Appeals had accepted this argument in a case filed by Kentucky residents who paid state income tax on interest from out of state municipal bonds.

The case, Department of Revenue of Kentucky v. Davis, No. 06-666, highlights disagreements over what is known as the "dormant" or negative Commerce Clause. In Article I of the Constitution, the Commerce Clause grants Congress the power to regulate commerce "among the several states."

This clause has been interpreted to mean that the states themselves may not regulate interstate commerce by favoring local businesses over out-of-state interests.

Justice David H. Souter wrote the majority opinion that cited a Supreme Court ruling from last year's term — United Haulers v. Oneida-Herkimer Solid Waste Management Authority — as the basis of its holding that municipal-bond tax exemptions do not violate the dormant Commerce Clause and are acceptable in part because the tax breaks have a public benefit.

"This logic applies with even greater force to laws favoring a state's municipal bonds given that the issuance of debt security to pay for public projects is a quintessentially public function," Justice Souter wrote.

In United Haulers, the court rejected the argument that a waste disposal ordinance under which two New York counties required private trash haulers to deposit all their waste in a publicly owned facility, which charged rates higher than those in the private market, discriminated against interstate commerce in violation of the Constitution.

NLC, the National Governors Association, Government Finance Officers Association, 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 filed a brief urging the Supreme Court to overturn the Kentucky court and uphold the preferential tax treatment.

Joining Justice Souter in the majority were Chief Justice John Roberts Jr., and Justices John Paul Stevens, Stephen Breyer, Ruth Bader Ginsburg, Antonin Scalia and Clarence Thomas. Justices Anthony Kennedy and Samuel Alito dissented, arguing that the ruling further weakened the power of the interstate commerce provisions in the Constitution to encourage free and efficient markets.