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U.S. Supreme Court's Decision to Hear Municipal Bond Case Raises Constitutional, Procedural Questions

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Investing in municipal bonds has long been a tried-and-true way for investors to diversify, particularly those in high-income tax brackets. Targeted as a low-risk investment, perhaps the most attractive feature of municipal bonds is their status as being exempt from state and local tax when purchased within one's home state. We all know how this works. A New York resident doesn't pay tax on income generated by New York-issued state and local municipal bonds. However, a California resident purchasing the same type of investment bond would be subject to tax.

Well, a case originating in Kentucky is threatening to put the heretofore placid bond market into an unprecedented upheaval. The U.S. Supreme Court recently granted certiorari to a major case involving municipal bonds.[1] The decision will not only have repercussions on the entire bond market, but also will probably affect state tax folks a little bit as well. The issue is whether Kentucky can tax interest on out-of-state bonds while exempting interest on its own bonds. From a constitutional law perspective, that question raises interesting questions about the commerce clause of the U.S. Constitution and whether it can be applied to limit resident tax-friendly schemes. From a tax practice perspective, the message is much more straightforward: Taxpayers and practitioners should make sure to get their refund claims in early and often, making sure to preserve rights to potential refunds if the taxpayers in *Davis* prevail.

Davis and the 'Dormant' Commerce Clause

George and Catherine Davis, Kentucky residents, paid Kentucky income tax on interest they received from out-of-state bonds, and they proceeded to challenge the state's tax on that income, basing their claim on the so-called dormant commerce clause of the U.S. Constitution.

The dormant commerce clause refers to some implications of the commerce clause of the Constitution. The commerce clause grants Congress the power to enact legislation that affects interstate commerce. By implication, states are restricted from passing legislation that improperly burdens or discriminates against interstate commerce. The question whether the dormant commerce clause should be recognized, and how far it extends, has been the subject of extensive disagreement. A recent high-profile state tax case related to the dormant commerce clause was, of course, *Cuno v. Daimler Chrysler, Inc.,*[2] a much-written-about decision on the constitutionality of state tax credit schemes. In *Cuno*, the state of Ohio provided tax breaks to a company for installing equipment and machinery inside the state. The benefits were contingent, obviously, on the company locating its facility in the state. Opponents of that credit system (mainly taxpayers who felt the state was losing out on needed tax revenue) reasoned that it coerced companies into investing in Ohio, as opposed to other states, and thus discriminated against interstate commerce. The Sixth Circuit Court of Appeals agreed,[3] using that negative aspect of the commerce clause to strike down Ohio's investment tax credit. The U.S. Supreme Court agreed to hear the case and ultimately struck down the ruling, but on different grounds. According to Chief Justice John Roberts, writing for the majority, the plaintiff taxpayers simply lacked standing to bring the lawsuit in the first place. So the Court never got to the ultimate question about whether the Ohio scheme was constitutional.

Again, in *Davis*, the taxpayers argued that the state's scheme for taxing bond interest is unconstitutional. They claimed that the only reason for the difference in Kentucky's taxation of in-state and out-of-state bonds is the issuer's location outside the state. In its defense, Kentucky claimed that it met one of the exceptions to the dormant commerce clause, applicable when a state is acting "in the market," like a business or a customer, rather than as a market regulator. It also pointed to an Ohio appellate court case that upheld against commerce clause challenge a state income tax law indistinguishable from Kentucky's law.

However, the Kentucky Court of Appeals sided with the taxpayers, holding that the state's taxing scheme was unconstitutional, "as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds," and that none of the recognized exemptions to facially discriminatory taxing schemes applied.

The Supreme Court's decision to hear the case perhaps means that it will more explicitly weigh in on the issue of whether state-friendly tax schemes that favor in-state activities pass dormant commerce clause muster.

What's Next: Lessons Learned From the 'Other' *Davis* Case

In the meantime, in the face of these interesting constitutional questions, it's important for taxpayers and practitioners to not lose sight of the big picture. In addition to Ohio and Kentucky, 40 other states, including New York, have similar laws regarding in-state municipal bond interest. So that means 40 other states could have taxing schemes susceptible to the same type of attack as in *Davis*.

That's a lot of refund claims. And we hope taxpayers and practitioners won't wait for the Court's ultimate decision, which might not come until 2008, to actually get their refund claims in.

Indeed, the last time a major Supreme Court case came down on another state-friendly income tax scheme, many taxpayers were left with nothing but untimely refund claims and refund denial letters from their home state. Almost 20 years ago, the Supreme Court in *Davis v. Michigan*[4] held that taxing federal pension benefits while exempting state government pensions violated a federal statute and the doctrine of intergovernmental tax immunity by favoring state-retired employees over federal-retired employees. Many federal pensioners, however, weren't paying all that close attention and failed to get refund claims filed in time to cover affected tax years. Thus followed years of litigation, much of it in New York, where federal pensioners repeatedly lost in their attempts to recover refunds for years beyond the statute of limitations.[5]

So taxpayers and practitioners should make sure to get those refund claims in on time and learn from the mistakes of the past. New York, like many states, has a three-year statute of limitations. Section 687(a) of the New York Tax Law provides that a taxpayer may file a claim for a refund within three years of the date the return is filed or two years from the date the tax is paid, whichever is later. When a claim is filed during the three-year period, it is limited to the tax paid during the three years plus any extension for filing the return. Thus, assuming a 2004 tax return was timely filed on April 15, 2005, the statute would run on April 15, 2008.

At least one other state, however, has already started planning its defense. Anticipating a deluge of refund claims, the California Franchise Tax Board recently posted on its Web site that the Kentucky decision has no effect on California taxpayers who invest in out-of-state municipal bonds. Judicial decisions regarding the validity of Kentucky law do not affect California law, and California taxpayers must continue to follow existing California law and pay income tax on non-California municipal bond interest. Nevertheless, taxpayers can begin to file claims for refund, which the state will summarily reject, and the state advises taxpayers to write "Muni Bond" at the top of the return.

Refunds or Tax Bills?

Of course, this entire discussion about refund claims and statutes of limitations assumes that the result of a potential taxpayer victory in *Davis* will be refunds due to in-state residents who paid tax on out-of-state bonds. What if some states simply decide to take the more practical (and budget-friendly) approach, and just get rid of the in-state exemption altogether? That surely would rid the taxing scheme of its offensive interstate commerce problem. But it would go over like a lead balloon for taxpayers and for those in the bond market, not to mention the municipalities that rely on those vehicles for needed funding. And query whether such a change could be made retroactively, as it probably would have to be to cure the putative constitutional defect. Imagine getting a tax bill for three years worth of income tax on municipal bond interest that was previously exempt. That might create some waves.

Other Applications

In addition to affecting the bond market, the decision in *Davis* could affect other investment vehicles that provide in-state advantages. For instance, the ever-popular 529 college savings plans allow individuals to set aside money for their child's education and let it grow tax free. Many states, including New York, allow taxpayers to deduct part of their contribution when using an in-state plan. Also, of course, states offer many programs that provide special benefits to taxpayers choosing in-state development at the expense of going somewhere else. New York's Empire Zone program is one example. Will that in-state preferential treatment be deemed appropriate if the Supreme Court sides with the Kentucky Court of Appeals?

Conclusion

Of course, all of those questions are, as of now, premature. The Supreme Court hasn't even heard the *Davis* case yet, and it will likely be next year before we know of its decision. And, if past history is any guide, the Court's decision likely will create even more uncertainty and perhaps even warrant another column on the topic! But until then, the tax practice note is clear: Get those refund claims in, and wait. The failure to do so could be costly.

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FOOTNOTES

[1] *Davis v. Kentucky Department of Revenue of the Finance and Admin. Cabinet*, 97 S.W.3d 557 (2006).

[2] *Cuno. v. DaimlerChrysler*, 547 US __ , No. 04-1704 (decided May 15, 2006). (For the decision, see *Doc 2006-9420* [**PDF**] or *2006 STT 94-1* .)

[3] 386 F.3d 738, 6th Cir. 2004.

[4] *Davis v. Michigan Department of Treasury*, 489 US 803, 109 S. Ct. 1500 (1989).

[5] *See, e.g., Matter of the Petition of Behr,* Tax Appeals Tribunal (Apr. 23, 1998); *Matter of Guerrerio,* administrative law judge,(July 23, 1998); *Matter of the Petition of Wilbur I. and Elenora M. Coons,* Tax Appeals Tribunal, (May 29, 1997); *Matter of Harry Reiter,* Tax Appeals Tribunal (Feb. 27, 1997).