

PUBLICATION

Treatment of Interest from State and Local Bonds Being Debated

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On May 21, 2007, the U.S. Supreme Court agreed to hear arguments in a lawsuit that ultimately could impact the state income tax liability of numerous taxpayers located in various states. Arguments before the Court are scheduled for November 5, 2007. The tax laws in as many as 42 states could be affected, including most particularly the laws of Tennessee, Georgia, Alabama, Mississippi and Louisiana.

The Controversy. At issue in this lawsuit, *Davis v. Kentucky Department of Revenue*, is whether Kentucky can exempt from its income tax the interest earned by Kentucky taxpayers on bonds and other obligations issued by the State of Kentucky and its local governments, while at the same time imposing its tax on interest received by Kentucky taxpayers from bonds and other obligations issued by other state and local governments. The *Davis* taxpayers argued that this preferential treatment accorded interest earned on Kentucky bonds discriminated against interstate commerce in violation of the Commerce Clause of the United States Constitution. The Commerce Clause expressly provides that Congress has the power to "regulate Commerce... among the several States...." Existing U.S. Supreme Court precedent has interpreted that express delegation of power to implicitly prohibit state governments from discriminating against interstate commerce.

In its defense of this preferential treatment, the Kentucky Department of Revenue made several arguments before the Kentucky Court of Appeals. One such argument was that the implicit prohibition required by the Commerce Clause did not apply in this situation, since Kentucky and its local governments were simply issuing bonds in the marketplace that attracted investors because the interest was tax exempt. The Court of Appeals acknowledged such argument, but focused on the fact that the critical issue was not the economic terms under which the bonds were issued free of that State's income tax, but rather that the Kentucky statute discriminated against interstate commerce by specifically taxing the interest from bonds and other obligations issued by other state and local governments. After analyzing the facts, the Kentucky Court of Appeals concluded that such preferential treatment was facially unconstitutional under the Commerce Clause. Thereafter, the State of Kentucky sought a review by the U.S. Supreme Court.

What You Should Consider. The U.S. Supreme Court's agreement to hear this lawsuit does not necessarily indicate that the Court will reverse the Kentucky Court of Appeals and uphold Kentucky's preferential treatment, nor does it indicate that the Court will affirm the taxpayer victory rendered by the Kentucky Court of Appeals. However, if the U.S. Supreme Court affirms the Kentucky decision, that affirmation could directly impact taxpayers in other states having similar tax laws. Although it is very likely that the U.S. Supreme Court will not issue its opinion until 2008, similarly-situated taxpayers should consider taking protective action in the event the U.S. Supreme Court upholds the Kentucky decision.

While the procedural nuances of each state's laws must be reviewed in light of each taxpayer's particular situation, taxpayers should consider the following actions: (a) consider excluding the interest received from other state and local governments from taxable income when the return is filed, while attaching a specific written disclaimer to your return so advising the revenue department of your position in light of the *Davis* lawsuit; (b) consider filing protective claims for refunds with the revenue department for the open tax years for which prior income tax returns have been filed; and (c) in cases where your time period to request a refund of income tax relating to prior returns soon will expire, consider filing a protective lawsuit and also perhaps

consider negotiating an agreement with the revenue department or its legal counsel to hold your lawsuit in abeyance pending the outcome of the U.S. Supreme Court's opinion on this issue. You should consider all of the fore-going suggested actions, as well as any other potential actions, in conjunction with advice and counsel from your tax attorney.