

Municipal Bonds: State Tax Exemption Hangs in the Balance

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In May 2007 the United States Supreme Court determined to hear the appeal of the State of Kentucky in a case that could have broad implications for (1) the value of investors' municipal bond portfolios, (2) the fiscal health of state and local governments, and (3) the ability of local governments to borrow at attractive rates from local investors. The controversy revolves around a state's ability to continue the common practice of treating as tax exempt the interest on bonds issued by in-state governmental entities while taxing the interest accruing on bonds issued outside the state. Generally, interest on municipal bonds is also federally tax exempt.

Currently, most states maintain this tax distinction between in-state and out-of-state issues in an effort to enhance demand for in-state bonds, thereby lowering governmental financing costs. According to a recent article in *CNNMoney.com*, the effect of the double tax exemption is to reduce the state's borrowing costs by anywhere from 10 to 25 basis points. (Illinois exempts only interest on certain Illinois issued bonds [i.e. a small universe of issues that finance specific identified development projects as opposed to the State's general obligation bonds].)

The case at issue was originally filed in Kentucky by George and Catherine Davis, who contended that Kentucky's policy of taxing out-of-state municipal bonds while exempting income from in-state issues violated the Equal Protection Clause of the United States Constitution. The appellate court in Kentucky affirmed a lower court decision in favor of the Davis', which led to the appeal by the State to the U.S. Supreme Court. Oral arguments were heard on November 5, 2007 and the High Court is expected to render its decision by June 2008.

The potential implications of a decision in the Davis' favor are subject to considerable speculation. If states respond to a ruling which is adverse to the State of Kentucky by treating all municipal bond interest as taxable, the change in the laws may cause devaluation of certain bond portfolios; particularly funds made up of single state issues. This would be especially true for funds comprised of bonds issued by "high state income tax states," such as California, New York, New Jersey, and Massachusetts. It might, on the other hand, increase demand for existing bonds from states like Illinois, Texas, Washington, and other jurisdictions where the lack of in-state tax incentives has driven issuers to offer higher yields.

In addition, if Kentucky's appeal is denied and particularly if states react by placing all municipal bond issues on equal footing by extending the tax exemption to out-of-state issues, the fiscal health of state tax coffers may be tested as taxpayers with out-of-state bond issues pursue refund claims for prior state income taxes paid. (Counsel in the oral argument before the Supreme Court stated that approximately \$4 million of refund claims are currently pending in Kentucky.)

In any event, individuals with taxable out-of-state municipal bonds living in a jurisdiction that currently maintains the "Kentucky-style" tax scheme for bond interest should consider filing "protective refund claims" for tax years in which the statute of limitations may expire before June 2008, when the Supreme Court decision is expected to be published.

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