No. 06-666

IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,

Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,

Respondents.

On Writ of Certiorari
to the Court of Appeals of Kentucky

BRIEF FOR PETITIONERS

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QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

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BRIEF FOR PETITIONERS

OPINIONS BELOW

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JURISDICTION

The jurisdiction of the Court is invoked pursuant to 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause, U.S. Const. Art. I, § 8, cl. 3, provides that "[t]he Congress shall have Power . . . To regulate commerce . . . among the several States . . . ."

The relevant statutory provisions — Ky. Rev. Stat. Ann. § 141.020 and Ky. Rev. Stat. Ann. § 141.010 — are reproduced at Pet. App. A20—A23.

STATEMENT

Kentucky taxes interest income received by Kentucky taxpayers on bonds issued by sister States and their political subdivisions, but does not tax interest income received by Kentucky taxpayers on bonds issued by Kentucky or its political subdivisions.

The tax picture across the Nation is the same: 38 of the 43 States that tax net income or investment income, exempt interest income received on their own State bonds, but tax interest income received on sister State bonds.[1] Another 3 of the 43 States exempt interest income on some (but not all) of their own bonds, but tax interest income received on all sister State bonds. One State of the 43 exempts all State bond interest from its income tax; and one State exempts its own bonds but taxes sister State bond interest unless the sister State allows a reciprocal exemption. Seven States do not impose an income tax.

A. The Kentucky Income Tax Law

Kentucky taxes a resident individual "upon his entire net income," Ky. Rev. Stat. Ann. § 141.020(1), and a nonresident individual on net "income received by him from labor performed, business done, or from other activities in this state, from tangible property located in this state, and from intangible property which has acquired a business situs in this state," Ky. Rev. Stat. Ann. § 141.020(4).

[1]For simplicity, Petitioners use the term "State" to refer to a State, its political subdivisions, and their instrumentalities; the term "Kentucky" to refer to the Commonwealth of Kentucky, its political subdivisions, and their instrumentalities; and the terms "State bonds," "municipal bonds," and "bonds" to refer to bonds issued by the States, their political subdivisions, and their instrumentalities.

Kentucky computes "net income" subject to tax by starting with "gross income" as defined for federal income tax purposes. Ky. Rev. Stat. Ann. § 141.010(9). Section 103(a) of the Internal Revenue Code, 26 U.S.C. § 103(a), provides that "gross income does not include interest on any State or local bond," defined to mean "an obligation of a State or political subdivision thereof," 26 U.S.C. § 103(c)(1), with the term "State" including "the District of Columbia and any possession of the United States," 26 U.S.C. § 103(c)(2).

To arrive at taxable net income, Kentucky allows most of the deductions allowed to individuals under the federal income tax law, *see* Ky. Rev. Stat. Ann. § 141.010(10), and adds back certain other items, including "interest income derived from obligations of sister states and political subdivisions thereof," Ky. Rev. Stat. Ann. § 141.010(10)(c).

The effect of the federal exclusion and the Kentucky add-back, is that Kentucky taxes interest income received by Kentucky taxpayers on sister State bonds, but does not tax interest income received by Kentucky taxpayers on Kentucky bonds.

The incidence of Kentucky's tax on sister State bond interest falls almost entirely if not exclusively on Kentucky residents. This is because income from intangibles such as municipal bonds is taxable by the State of the bondholder's domicile, and is considered taxable by a State other than the bondholder's domicile only if the bonds have acquired a "business situs," *i.e.,* become "localized in some independent business or investment," outside the State of domicile. *Cf. Kentucky Department of Revenue v. Bomar*, 486 S.W.2d 532, 535 (Ky. 1972) (property tax case). Kentucky would tax a non-resident on sister State bond interest only in the rare cir-

cumstance when the sister State bonds have become "localized in some independent business" conducted in Kentucky by the non-resident.

B. The Municipal Bond Market

A municipal bond is an interest-bearing debt security obligating the issuer to pay specified principal and interest. "State and local governments issue bonds to raise capital for essential public facilities, services, infrastructure, and general capital improvements." Belmonte, *Tax-Exempt Bonds, 2003-2004* p. 246 (IRS Statistics of Income Division, September 2006).[2] *Cf. South Carolina v. Baker*, 485 U.S. 505, 531 (1988) (O'Connor, J., dissenting) (municipal bonds are "an essential source of funding" for States and their political subdivisions).

State and local governmental units issued over $891 billion of bonds during the two years 2005-2006, more than double the $425 billion of municipal bonds issued just 10 years before in 1995-1996.[3] By the end of 2006, total municipal bond debt outstanding of State and local governments verged over $2.4 trillion,[4] and by the end of the first quarter of 2007 total State and local bonds outstanding exceeded

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[2]Belmonte, *Tax-Exempt Bonds, 2003-2004* p. 246 (IRS Statistics of Income Division 2006), available at http://www.irs.gov/pub/irs-soi/04govbnd.pdf. The Internal Revenue Service Statistics of Income Division maintains detailed information on dollar volume of municipal bonds issued, purpose or use of bond proceeds, state-by-state volume and use of proceeds, as well as reports prepared by the Special Studies Special Projects Section of the Statistics of Income Division, accessible at http://www.irs.gov/taxstats/charitablestats/article/0,,id=97029,00.html.

[3]*The Bond Buyer/Thompson Financial 2007 Yearbook*, "Municipal Financing: 1896-2006" p. 14.

[4]*Id.* p. 100.

$2.466 trillion, up $211 billion over the first quarter of 2006.[5]

Municipal bonds finance the backbone of America. Of the $432 billion in municipal bonds issued in 2006, over 27% financed projects and programs related to education; over 10% financed transportation facilities; another 10% financed utilities projects; 9.2% financed health care projects; 7.3% financed housing projects and programs; 3% financed electric power projects; and 1.8% financed environmental projects. Bonds issued for general purposes, which include financing the daily operations of States and local governments in anticipation of quarterly tax revenues, accounted for 26.6% of the total.[6]

The trade press frequently describes municipal bonds as either "general obligation bonds" or "revenue bonds." The term "general obligation bond" refers to a bond backed by the full faith and credit of the issuer to apply all sources of revenue, unless specifically limited, to the payment of principal and interest according to the terms of the bond indenture. The term "revenue bond" is generally used to refer to bonds backed by a particular stream of revenue, such as tolls or user fees, rather than general tax revenues. General obligation bonds accounted for 35% of municipal bonds issued in 2006, while revenue bonds accounted for 65% of bonds issued.[7]

Congress has always excluded State bond interest from gross income subject to the federal income tax, begin-

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[5]Posner, "Tender Option Bond Trusts Drive Q1 Muni Holdings," *The Bond Buyer,* June 15, 2007.
[6]*The Bond Buyer/Thompson Financial 2007 Yearbook*, "Two Decades of Bond Finance: 1987-2006," p. 7, and "Two Decades of Note Finance: 1987-2006," p.13.
[7]*Id.*

ning with the very first federal income tax statute. Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 168. The federal tax exclusion "effectively lowers the borrowing costs of tax-exempt debt issuers, since bondholders are generally willing to accept an interest rate lower than that earned on comparable taxable bonds." Belmonte, *Tax-Exempt Bonds, 2003-2004* p. 246 (IRS Statistics of Income Division 2006). The tax-free status of municipal bonds allows the bond issuer to borrow money at a lower interest rate than it could obtain from other sources of financing. Investors are willing to accept lower interest rates precisely because of the advantages an investor gains from the tax exemption. The Bond Market Association, *The Fundamentals of Municipal Bonds* 27 (5th ed. 2001).

The widespread and longstanding practice of the States in exempting their own bonds from state income tax adds to the attractiveness of State bonds as investments for taxpayers of the issuing State. The importance of the State level exemption (versus the federal exclusion) is demonstrated by the rapid growth of so-called single state funds, *i.e.*, mutual funds that invest in the municipal bonds of a single State. After Congress changed the tax treatment of mutual funds so that bond mutual fund dividends would be exempt from state and federal tax,[8] these single state funds mushroomed in popularity. As of May 31, 2007, total mutual fund holdings of municipal bonds were $378 billion in municipal bond funds (a category including both diversified and single state funds) and $388 billion in tax-free money market funds (some of which are also single state funds).[9] The sin-

[8] *See* Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520 (codified at 26 U.S.C. § 852(b)(5)).

[9] Investment Company Institute, *Trends in Mutual Fund Investing May 2007* (2007), available at http://www.ici.org/home/trends_05_07.html.

gle largest municipal bond fund is a single state fund,[10] and industry sources estimated that at the end of 2005, 13% of all outstanding municipal bonds, or about $290 billion, were held by single state funds.[11]

C. Kentucky's Participation in the Municipal Bond Market

Kentucky and its political subdivisions had outstanding as of June 30, 2006 approximately $33.8 billion in bonds, consisting of $5.1 billion in State appropriation supported bonds; $3.3 billion in State non-appropriation supported bonds; $17.5 billion in county, city, special district, and local agency bonds; and $7.9 billion in industrial revenue bonds.[12]

The Kentucky Constitution, ratified in 1891, requires voter approval by general referendum prior to the issuance of general obligation bonds in amounts exceeding $500,000. Ky. Const. § 49. The Commonwealth has not issued any general obligation bonds since 1966; none are currently outstanding. Bonds issued by the Commonwealth (versus its political subdivisions) are currently classified by Kentucky as "appropriation supported bonds" and "non-appropriation supported bonds." The former category, while not "general

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[10] *The Bond Buyer/Thompson Financial 2007 Yearbook*, "Top 200 Municipal Mutual Funds: 2006," p. 102.

[11] Municipal Market Advisors, *Weekly Outlook,* Oct. 23, 2006.

[12] *See* Kentucky Finance and Administration Cabinet, *Supplementary Information to the Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2006* pp. 406-409 (2006), available at http://finance.ky.gov/ourcabinet/caboff/OOC/supplemental-reports.htm. Kentucky Finance and Administration Cabinet, *Local Debt Report FY 2006* Table I – Summary of Debts Outstanding by Governmental Unit (2006), available at http://www.gold.ky.gov/NR/rdonlyres/CDA11907-33DD-4B2E-A8D1-219DABFAC200/0/06302006DebtReport.pdf.

obligation bonds," includes bonds issued by various State authorities (such as the State Property and Buildings Commission, the Turnpike Authority of Kentucky, and the nine State universities), and are funded wholly or partially by biennial appropriations of the Kentucky General Assembly as well as project revenues, if any. The latter category consists of bonds issued by other State authorities (such as the Kentucky Housing Corporation and the Kentucky Higher Education Student Loan Corporation) which are secured solely by and payable solely from certain specified revenues, and which the General Assembly does not intend to support by appropriations.[13]

D. Proceedings Below

Respondents commenced this case in April 2003 as a declaratory judgment action in Jefferson Circuit Court, a Kentucky trial court of general jurisdiction. According to the Complaint, Respondents are Kentucky taxpayers who are "individual residents of Jefferson County," Kentucky, in which the Commonwealth's largest city, Louisville, is located.

The Complaint states that Respondents paid Kentucky income tax "on interest income derived from obligations" of sister States. J.A. 20. The Complaint asserts that Kentucky's income tax law violates the Commerce Clause by "discriminat[ing] on its face against the holders of obligations" of sister States " by imposing a tax and corresponding burden on such interest income that is greater than that im-

[13] *See* Kentucky Finance and Administration Cabinet, *Supplementary Information to the Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2006* p. 405 (2006).

posed on interest income derived from" Kentucky bonds. J.A. 25.

Petitioner Department of Revenue of Kentucky is a department of the Petitioner Finance and Administration Cabinet of the Commonwealth of Kentucky which "exercise[s] all administrative functions of the [Commonwealth of Kentucky] in relation to the [Commonwealth's] revenue and tax laws." Ky. Rev. Stat. Ann. § 131.030(1).

Petitioners filed an Answer to the Complaint, J.A. 29—38, and moved for summary judgment. The Jefferson Circuit Court granted the Petitioners' motion. Pet. App. A15—A19. The Circuit Court relied upon the market participation exception and held that Kentucky's law did not violate the Commerce Clause. Pet. App. A18. The Circuit Court held that "[w]hen a state issues municipal bonds, it participates in the bond market by supplying bonds to the market and paying interest on those bonds." Pet. App. A18.

The Circuit Court also found that "States have a legitimate interest in attracting local funds for local public works projects . . . . Each state has a legitimate interest in drawing upon a major source of tax revenue while creating an incentive for investors to purchase state bonds." Pet. App. A18−A19.

The Respondents appealed. The Kentucky Court of Appeals, in an Opinion rendered in January 2006, vacated the Circuit Court's judgment and remanded the case for further proceedings. Pet. App. A1, A13. The Court of Appeals held that "Kentucky's bond taxation system is facially unconstitutional [under the Commerce Clause] as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." Pet. App. A6.

The Court of Appeals did not dispute "that Kentucky acts as a market participant when it issues bonds," but held that "the market participant theory is inapplicable as a State's 'assessment and computation of taxes' is, clearly, 'a primeval governmental activity.'" Pet. App. A10 (footnotes omitted).

Petitioners timely filed a motion for discretionary review by the Kentucky Supreme Court, which on August 17, 2006, denied review. Pet. App. A14.

SUMMARY OF ARGUMENT

I. Kentucky's exercise of its power as an independent sovereign to tax sister State bond interest neither "discriminates against interstate commerce" nor threatens any of the principal purposes of the dormant Commerce Clause.

A. Kentucky's tax on sister State bond interest does not "discriminate against interstate commerce" because for Commerce Clause purposes Kentucky is not "similarly situated" to sister State bond issuers, and Kentucky bonds are not "substantially similar" to sister State bonds.

Kentucky is not a "substantially similar entity" to any other bond issuer, public or private, because no other issuer has the political responsibility of financing public works and public projects for Kentucky citizens. Nor are Kentucky bonds "substantially similar" to bonds issued by other entities in the two most important aspects of any debt instrument: use of proceeds and source of repayment.

The use of Kentucky bond proceeds is made unique by the nature of the projects and programs financed (Kentucky projects versus projects in other States) and by the

common citizenship of the primary beneficiaries or users of those projects (Kentucky citizens versus citizens of other States). The sources of repayment, taxes and project revenues which are an inherent aspect of Kentucky's sovereignty, cannot be accessed or subjected to the payment of sister State bonds or private bonds. No other issuer can ever own or become entitled to these sources of repayment.

B. Kentucky's tax law does not "discriminate against interstate commerce" because it treats all bond issuers, other than Kentucky itself, in exactly the same fashion.

The constitutional distinction drawn in *United Haulers* between an entity "vested with the responsibility of protecting the health, safety, and welfare of its citizens," and all other entities which do not share that governmental responsibility is an equally valid constitutional marker whether the entity on the other side of the line is a "private" entity or some other "public" entity.

Each of the four factors of the *United Haulers* analysis — governmental responsibility; legitimate goals unrelated to economic protectionism for in-state private businesses; a typical and traditional government function; and political accountability to those most directly affected by the law — fully supports the constitutionality of the Kentucky law when applied to the circumstances of this case.

C. Kentucky's disparate tax treatment of sister State bond interest income does not threaten any of the four principal purposes of the dormant Commerce Clause. Two of the four National goals that animate the Court's dormant Commerce Clause jurisprudence — national regulatory uniformity and political solidarity — are not jeopardized by the disparate treatment of sister State bond interest. The third

goal of a national free market is inapplicable to the business of government. The fourth goal of preventing "economic protectionism" of in-state private business neither applies to a State's actions on its own behalf nor would be advanced by invalidating the laws of more than 40 States.

D. The constitutional principles of State sovereignty established by four lines of authority — federalism, immunity from suit, eminent domain, and the state taxing power — mandate the application of the *United Haulers* rule. These decisions, which cabin a State's sovereignty within its independent territorial and legal jurisdiction, and which simultaneously admit of no other sovereignty within that jurisdiction save the National Power, cannot be squared with an interpretation of the dormant Commerce Clause that would require a sovereign State to treat sister States for purposes of taxation any differently than all other entities.

II. The substantial reliance interests and settled economic expectations of the States and their bondholders, as well as Congress' repeated recognition of the disparate tax treatment of State bond interest, make judicial intervention both unwise and unnecessary.

Any change in the status quo would affect the settled economic expectations and contract rights of at least 42 States and millions of bondholders. Restraint is the wiser course of action, particularly appropriate where "considerations of state sovereignty" are so much in the balance.

Congress has studied the matter in excruciating detail, in the specific context of a thorough examination of state taxation of interstate commerce, and done nothing. The circumstances of this case present an inauspicious occasion for the Court to extend the constraints of the dormant Commerce

Clause to a market where the only “commerce” is conducted by the States themselves.

III. A sovereign State may use its regulatory taxing power to affect the economic terms of market participant relationships with its direct trading partners.

The bedrock principle of the Court’s market participation cases is that if the State is acting as a market participant, the dormant Commerce Clause does not constrain the use of the State’s regulatory power to set the terms of its market participation.

When Kentucky exempts interest income on its own bonds from its own income tax, Kentucky sets the terms and conditions upon which it will obtain essential bond financing. *Alexandria Scrap, Reeves,* and *White* all involved the use of the police power, a regulatory power every bit as primeval as the power to tax.

Kentucky’s bond interest exemption affects the terms of its own economic relationship as debtor with its bondholders as creditors during the course of an ongoing commercial relationship in which the State retains a continuous proprietary interest in the subject of the contract, namely its bonds. The exemption is nothing more than an economic term of Kentucky’s relationship with its direct trading partners, no more objectionable than a discount or a rebate would be if Kentucky bought goods or services. The taxation of sister State bond interest is nothing more than a revenue measure no more objectionable than the taxation of corporate bond interest.

ARGUMENT

Alexander Hamilton believed "that the individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants." Hamilton had no doubt that the States "would, under the plan of the convention, retain that authority in the most absolute and unqualified sense; and that an attempt on the part of the national government to abridge them in the exercise of it, would be a violent assumption of power, unwarranted by any article or clause of its Constitution." *The Federalist No. 32* (A. Hamilton).

Over 125 years ago, *Bonaparte v. Tax Court*, 104 U.S. (14 Otto) 592, 594 (1881), upheld the ad valorem taxation of sister State bonds by the bondholder's State of residence, and maintained that that "We know of no provision of the Constitution which prohibits such taxation." The Court held that within the jurisdiction of the taxing State, its sister State had none "of the attributes of sovereignty as to the debt it owes." *Id.* at 595. *Bonaparte* remarked that "[w]hile the Constitution . . . might have been so framed as to" exempt bonds of the issuer State from taxation in other States, "it has not been, and the States are free to extend the comity which is sought, or not, as they please." *Id.*

Hamilton offered his thoughts in defense of the scope of the National taxing power. *Bonaparte's* sweeping declaration anchored a Full Faith and Credit Clause case. But they frame this dormant Commerce Clause case as well. The stakes include not only the stability and efficiency of the $2.4 trillion municipal bond market, but the retained power of the States "to raise their own revenues for the supply of their own wants" and the constitutional status of the States as independent sovereigns in our federal system.

I. Kentucky's exercise of its power as an independent sovereign to tax sister State bond interest neither "discriminates against interstate commerce" nor threatens any of the principal purposes of the dormant Commerce Clause.

Since 1977, the Court has held that a state tax affecting interstate commerce is valid under the dormant Commerce Clause if "the tax is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); *American Trucking Ass'ns, Inc. v. Michigan Public Service Comm'n,* 545 U.S. 429, 437 (2005).[14]

Respondents have not alleged that Kentucky's tax on sister State bond interest received by individual taxpayers lacks a substantial nexus to Kentucky, is unfairly apportioned between Kentucky and other States, or is not fairly related to services provided by Kentucky. *See* Plaintiffs' Complaint, J.A. 13—28.

Nor would any such contention be well founded. Insofar as nexus with Kentucky is concerned, the tax only ap-

[14]For the past 30 years, the Court has not attempted any further analysis of a State tax statute which satisfies the *Complete Auto Transit* test. The conclusion to be drawn from this consistent methodology is that if the tax satisfies the nexus, fair apportionment, and fair relationship to State services requirements, any burden on the taxed article is constitutionally tolerable, because "it was not the purpose of the Commerce Clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business." *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938).

plies to bond interest income received by (i) individuals who are residents of Kentucky, and (ii) non-resident individuals if the bonds have acquired a business situs in Kentucky. Fair apportionment is not an issue because no other State can constitutionally tax the sister State bond interest income that is subject to Kentucky tax, and Kentucky cannot constitutionally tax a non-resident on sister State bond interest income unless the bonds have acquired a business situs in Kentucky.[15] The fair relationship between the Kentucky income tax and the services provided by Kentucky to its residents (and to non-residents whose bonds have acquired a business situs in Kentucky) is self-evident.

The only requirement of the *Complete Auto Transit* test put in issue by Respondents is whether Kentucky's tax on sister State bond interest income "discriminates against interstate commerce." The answer is no.

A. Kentucky's tax on sister State bond interest does not "discriminate against interstate commerce" because for Commerce Clause purposes Kentucky is not "similarly situated" to sister State bond issuers, and Kentucky bonds are not "substantially similar" to sister State bonds.

"[A]ny notion of discrimination [against interstate commerce] assumes a comparison of substantially similar

[15]Kentucky does tax a Kentucky resident on his "entire net income," Ky. Rev. Stat. Ann. § 141.020(1), which would include sister State bond interest income even if the bonds had acquired a business situs outside Kentucky. But Kentucky would give the resident taxpayer a credit for any tax paid to the business situs State, *see* Ky. Rev. Stat. Ann. § 141.070(1), obviating any issue of double taxation or fair apportionment among the States.

entities." *General Motors Corp. v. Tracy,* 519 U.S. 278, 824 (1997); *accord, United Haulers Ass'n, Inc. v Oneida–Herkimer Solid Waste Management Auth.,* 127 S.Ct. 1786, 1795 (2007) (same). "Disparate treatment constitutes discrimination only if the objects of the disparate treatment are, for the relevant purposes, similarly situated." *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 601 (1997) (Scalia, J. dissenting).

Kentucky is not a "substantially similar entity" to any other bond issuer, public or private, because no other issuer has the political responsibility of financing public works and public projects for Kentucky citizens. Nor are Kentucky bonds "substantially similar" to bonds issued by other entities in the two most important aspects of any debt instrument: use of proceeds and source of repayment.

The issuer of a Kentucky bond is the Commonwealth, one of its political subdivisions, or one of their instrumentalities, which together constitute "the one entity responsible for ensuring that the job gets done" for the citizens of Kentucky, versus "all other enterprises," *C&A Carbone, Inc. v. Town of Clarkston*, 511 U.S. 383, 411 (1994) (Souter, J., dissenting). Bonds issued by Kentucky finance Kentucky public works and support Kentucky public projects and programs. No other bond issuer, public or private, takes any responsibility whatsoever for Kentucky public works or Kentucky public projects and programs. Kentucky taxpayers who hold bonds issued by sister States are not provided public education, police and fire protection, or water and sewer services in Kentucky by any sister State.

The "relevant purposes" here are the financing and provision of public works and programs in Kentucky. For

these purposes, sister States are no more "similarly situated" to Kentucky than the government of Egypt.

Both the use of proceeds and the source of repayment of Kentucky bonds distinguish them from bonds of any other issuer. Proceeds of Kentucky bonds finance Kentucky public projects and programs. Proceeds of sister State bonds, and proceeds of private entity financings, in no way pay for Kentucky public works and projects. The use of Kentucky bond proceeds is made unique by the nature of the projects and programs financed (Kentucky projects versus projects in other States) and by the common citizenship of the primary beneficiaries or users of those projects (Kentucky citizens versus citizens of other States).

The sources of repayment for Kentucky bonds also constitutionally distinguish Kentucky bonds from bonds of all other issuers. Kentucky pays the interest on and the principal of Kentucky bonds, from tax revenues collected from Kentucky taxpayers and from project/program revenues collected by Kentucky bond projects. These sources of repayment, which are an inherent aspect of Kentucky's sovereignty, not only do not support any sister State bonds or go to repay any corporate bonds. These sources of repayment cannot be accessed or subjected to the payment of sister State bonds or private bonds. No other issuer can ever own or become entitled to these sources of repayment.

The Court's analysis of whether "local distribution companies" (LDC's) and independent marketers of natural gas should be treated as "substantially similar entities" for Commerce Clause purposes in *General Motors v. Tracy* provides a framework for the inquiry here.

The *General Motors* Court began by noting that while LDC's and independent marketers did not compete in serving the captive, residential market for natural gas, the two types of entities did compete in serving the non-captive industrial end user market. 519 U.S. at 303. *General Motors* established that some competition between two types of entities, does not settle the question whether the entities are "substantially similar" for Commerce Clause purposes. Instead, the Court held that the issue was whether to "accord controlling significance to the noncaptive market in which they compete, or to the noncompetitive, captive market in which the local utilities alone operate." *Id.* at 303-304.

The teaching of *General Motors* directly applicable here is that the mere fact that Kentucky bonds and sister State bonds are debt obligations purchased by investors in interstate commerce, does not make the issuers or their bonds "substantially similar" for Commerce Clause purposes.

General Motors identified three reasons supporting its decision to give greater weight to the captive market, and "hence to treat marketers and LDC's as dissimilar" for Commerce Clause purposes. Each reason, in the circumstances of this case, militates against treating Kentucky as a "substantially similar entity" compared to sister State issuers.

"First and foremost," *General Motors* "recognize[d] an obligation to proceed cautiously lest we imperil" delivery of bundled gas services to the captive residential market. *Id.* Here, there is every reason to think that invalidating the disparate treatment of State bond interest would materially disrupt if not destabilize the municipal bond market and the public finance programs of more than 40 States. The financing of essential public works and government operations might well be imperiled.

Second, *General Motors* confirmed the Court's "lack [of] expertness and the institutional resources necessary to predict the effects of judicial intervention." That reason cuts, if anything, even more sharply here due to the complexity and sheer size of the municipal bond market.

Third, *General Motors* pointed out that "should intervention by the National Government be necessary, Congress has both the resources and the power" to take appropriate action. That observation counsels special restraint here, in light of Congress' longstanding recognition of the importance of bond financing to the States, Congress' awareness and approval of the disparate tax treatment of sister State bond interest, and the lack of any signal from Congress that intervention by the National Government is desirable.

Municipal bonds are issued by the sovereign States to finance public projects and programs. Because no State provides public works and services within a sister State's jurisdiction, the concept of a "similarly situated sovereign State" is an oxymoron. The Court should accord "controlling significance" to the mutually exclusive political responsibilities of State bond issuers, to the completely distinct use of proceeds of State bonds, and to the inherently independent sources of repayment for bonds issued by different States.

B. Kentucky's tax law does not "discriminate against interstate commerce" because it treats all bond issuers, other than Kentucky itself, in exactly the same fashion.

The Court's watershed decision last Term in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Management Auth.*, 127 S.Ct. 1786 (2007), is controlling here.

The Kentucky law does not "discriminate against interstate commerce" because it treats all issuers other than Kentucky itself — public, private, in-state, out-of-state — exactly the same. The dormant Commerce Clause requires no more.

United Haulers involved county ordinances which required all solid waste haulers to bring garbage to a processing facility owned and operated by a single public benefit corporation. The ordinances prohibited delivery of waste for processing at any other processing facility, whether in-state or out-of-state. The Court held that "because the flow control ordinances . . . benefit a clearly public facility, while treating all private companies exactly the same . . . . such flow control ordinances do not discriminate against interstate commerce for purposes of the dormant Commerce Clause." 127 S.Ct. at 1795.

The constitutional line drawn by *United Haulers* is between an entity "vested with the responsibility of protecting the health, safety, and welfare of its citizens," 127 S.Ct. at 1795, and all other entities which do not share that governmental responsibility. This line is an equally valid constitutional marker whether the entity on the other side of the line is a "private" entity or some other "public" entity. *United Haulers* would have reached exactly the same result had the plaintiff trash haulers wanted to deliver their garbage to some "public" trash processing facility out-of-state.

In concluding that a law which benefits an in-state public entity while treating all other entities exactly the same does not "discriminate against interstate commerce," *United Haulers'* reasoning focused on four factors: governmental responsibility; legitimate goals unrelated to economic protectionism for in-state private businesses; a typical and traditional government function; and political accountability to

those most directly affected by the law. Each of these factors, applied to the circumstances of this case, fully supports the constitutionality of the Kentucky law.

United Haulers first noted that "unlike private enterprise, government is vested with the responsibility of protecting the health, safety, and welfare of its citizens." 127 S.Ct. at 1795. This factor applies with equal force in comparing all sister States against Kentucky. Only Kentucky is "vested with the responsibility of protecting the health, safety, and welfare of *its* citizens" (emphasis supplied). Insofar as the "health, safety, and welfare" of Kentucky's citizens are concerned, a sister State has exactly the same responsibility as a private enterprise: none. Thus the same "compelling reasons" identified by *United Haulers* for treating "these laws [favoring a public entity] differently from laws favoring particular private businesses over their competitors," are no less compelling when the comparison is between a sister State and Kentucky.

United Haulers' second point was that unlike laws favoring in-state versus out-of-state private business which are "often the product of 'simple economic protectionism,'" a law "favoring local government, by contrast, may be directed toward any number of legitimate goals unrelated to protectionism." *Id.* at 1795—1796. The same conclusion obtains when a law favors the State itself versus its sister States.

The most obvious legitimate goal "unrelated to protectionism" is the State's need to finance the operations of government and the costs of capital projects. For many issuers, bond financing is not just an alternative to paying for capital projects out of current tax revenues. Bond financing is the only feasible way of paying for many capital projects.

Kentucky's tax on sister State bond interest in no way insulates private Kentucky businesses against competition from out-of-state private businesses. The tax on sister State bond interest is just as reasonable a means of raising revenue as taxing Kentucky taxpayers on interest paid by private bond issuers. Conversely, taxing interest income received by Kentucky taxpayers on Kentucky bonds, might reasonably be thought by the Kentucky General Assembly to be a zero sum game: any additional revenue collected would be offset by increased bond interest expense. Both the exemption for Kentucky bond interest and the taxation of sister State bond interest are reasonable means of achieving the legitimate goal of financing the operations of government, unrelated to protectionist measures favoring local private businesses.

The third element in the *United Haulers* analysis was the challenged law's suitability as a means of accomplishing a function that, like waste disposal, "is both typically and traditionally a local government function," with which the Court was "particularly hesitant to interfere" under "the guise of the Commerce Clause" when "Congress itself has recognized local government's vital role" in such matters. 127 S.Ct. at 1796.

Borrowing money and issuing bonds to finance government projects and programs that cannot feasibly be paid from current revenues, are both typically and traditionally a State government function. The States came into the Union with substantial Revolutionary War debts. *See Alden v. Maine*, 527 U.S. 706, 716 (1999). Municipal bonds trace their history in the United States to the 1820's, when booming cities needed capital for public projects. ZIPF, HOW THE BOND MARKET WORKS 82 (1997). Total municipal bonds issued during each of the years 1896 through 1901 ranged from $128 million to $168 million; ran between $521 million

and $891 million each year from 1910 through 1918; and exceeded $2.0 billion annually in 15 of the 20 years from 1920 through 1939. *The Bond Buyer/Thompson Financial 2007 Yearbook,* "Municipal Financing: 1896-2006," p. 15.

Congressional recognition of and support for the "vital role" of municipal bond financing could not be more visible. The federal exclusion of State and local bond interest is well understood as "a kind of revenue sharing, enabling states and cities to borrow at interest rates lower than those on taxable obligations of similar quality." BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 15.1.1 (2007). Indeed, the United States Treasury Department classifies the exclusion as a federal "tax expenditure," *i.e.*, tax revenue foregone as a result of the exclusion of municipal bond interest from the federal income tax, and for fiscal year 2007 estimates the amount of this tax expenditure by the federal government at $36.8 billion. Budget of the United States Government, Fiscal Year 2007, Analytical Perspectives, Table 19-1: Estimates of Total Income Tax Expenditures.

The fourth and final factor in the *United Haulers* analysis was political accountability, that is, that "the most palpable harm imposed by the ordinances – more expensive trash removal – is likely to fall upon the very people who voted for the laws." 127 S.Ct. at 1797. The same is true of Kentucky's taxation of sister State bond interest and Kentucky's exemption for Kentucky bond interest. The burden of the tax on sister State bond interest falls almost entirely if not exclusively on Kentucky residents, the very people whose representatives voted for the law. The burden of the exemption for Kentucky bond interest is that Kentucky arguably loses the tax revenue that might have been collected by taxing its own bonds. That revenue loss must either be

offset by increased taxes or other governmental levies, or by reductions in the level of governmental services, or both, which in all events is borne by the citizens of Kentucky, the very people whose representatives voted for the law.

C. Kentucky's disparate tax treatment of sister State bond interest income does not threaten any of the four principal purposes of the dormant Commerce Clause.

The Court's dormant Commerce Clause jurisprudence recognizes four National interests or purposes as sufficient justification for invalidating State laws affecting interstate commerce: a need for uniform national regulation; minimizing political friction between the States; promoting a national free market; and avoiding "economic protectionism." None of these goals is compromised by the disparate treatment of sister State bond interest.

The first purpose is evident in cases focused on transportation rules and price control regulations which emphasize the National interest in avoiding inconsistent State regulations that could impede interstate commerce and undermine needed national uniformity. *See, e.g., Bibb v. Navajo Freight Lines, Inc.,* 359 U.S. 520 (1959); *Brown-Forman Distillers Corp. v. New York State Liquor Authority*, 476 U.S. 573, 582 (1986); *Healy v. Beer Institute, Inc.*, 491 U.S. 324, 339-340 (1989).

The Due Process Clause limitations on the taxing power of individual States provide more than sufficient protection against any inconsistency in State tax laws. No State can constitutionally tax the receipt of bond interest income by individuals other than its own residents and those few, if any, non-resident individuals whose bonds have acquired a

business situs in the taxing State. *Cf. Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 209-210 (1936) (States have no constitutional power to impose ad valorem tax on intangibles that have acquired a business situs in other jurisdictions). There is therefore no substantial possibility of conflict between State tax regimes applicable to the same income, no realistic risk of cumulative taxes to be avoided by a national uniform rule, and simply no job for the dormant Commerce Clause to do here.

The second purpose is a political goal of girding the Union against the destabilizing effects of state laws with extraterritorial effects and retaliatory state legislation enacted as a counterpunch to laws favoring local businesses in other states. *E.g., Granholm v. Heald,* 544 U.S. 460, 472 (2005) ("rule" prohibiting discrimination against interstate commerce "is essential to the foundations of the Union").

When Justice Cardozo wrote that dormant Commerce Clause review safeguards the Union against the effects of "rivalries and reprisals that were meant to be averted by subjecting commerce between the states to the power of the nation," *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 522-523 (1935), most of the States had only recently enacted income tax laws. The lesson of the intervening 70 years is that virtually all the States have found it desirable if not essential to use the state bond interest exemption to facilitate their access to the capital markets, and no State has ever challenged the taxation of its bonds by a sister State.

To the extent that the Commerce Clause should be interpreted to foster national "union and not division," and should be invoked "upon the theory that the peoples of the several states must sink or swim together," *id.* at 523, neither the goal nor the theory is threatened by the disparate tax

treatment of State bond interest. Forty two of 43 States with an income tax are swimming in the same direction. The dormant Commerce Clause does not require that they swim in the same lane, or require the Court to venture into really deep water by invalidating the disparate treatment of State bond interest in hopes of promoting the solidarity of the Union.

The third purpose surfaces in cases that extol the virtues of a national free market and warn against "economic balkanization." *E.g., Hughes v. Oklahoma*, 441 U.S. 322, 325-326 (1979); *H.P. Hood & Sons, Inc. v. Du Mond,* 336 U.S. 525 (1949) (Commerce Clause fosters for "every farmer and every craftsman . . . free access to every market in the Nation," and protects "every consumer" from "exploitation" by facilitating "free competition from every producing area in the Nation").

The free market rationale is attenuated here. The sovereign States are not farmers or craftsmen attempting to provide goods and services to the citizens of their sister States. A consumer of public goods provided and financed by Kentucky can never "look to . . . free competition" from other States to provide education, roads, sewers, prisons, and bridges for Kentucky.

Nor do the States or their citizens appear to have been economically exploited by the decentralized features of the municipal bond market. One man's economic balkanization is another man's market segmentation. Single state funds, which exist because of the disparate treatment of State bond interest, may well have provided essential market access for less populous States and local government issuers who would otherwise scratch and claw for national attention. The $2.4 trillion municipal bond market must be regarded as a howling success in providing essential capital to finance public works

and public projects, without any help from Adam Smith or the dormant Commerce Clause.

The fourth purpose of the dormant Commerce Clause is avoiding "economic protectionism — that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors," *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 192 (1994). *See, e.g., Granholm v. Heald,* 544 U.S. 460, 472 (2005); *Bacchus Imports, Ltd. v. Dias,* 468 U.S. 263 (1984).[16]

The evils of "economic protectionism" are not manifested when the only "in-state economic interest" is the taxing State itself. There are no "out-of-state competitors." Unlike an out-of-state private firm competing for local business, no sister State will cross the border to provide its own brand of public goods and services to the taxing State's citizens, whether the sister State's bond interest is taxable or not.

The Court itself has said as much, finding "the label 'protectionism' of little help" in analyzing the provision of public works by sovereign States to their respective citizens, *Reeves, Inc. v. Stake*, 447 U.S. 429, 442 (1980). To the contrary, "such policies, while perhaps 'protectionist' in a loose sense, reflect the essential and patently unobjectionable purpose of state government — to serve the citizens of the State." *Id.*

[16]*Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977), presents a slightly different fact pattern, because there the disparate treatment was between different types of out-of-state transactions, rather than in-state versus out-of-state transactions. The law was invalidated, however, because it was designed to steer business from out-of-state residents into the taxing state, to benefit an in-state private entity.

The Court of Appeals for the Second Circuit hit the nail on the head in *Freedom Holdings, Inc. v. Spitzer*, 357 F.3d 205, 218 (2004): "[T]here is simply no precedent to support the proposition that a state's generation of revenues at the expense of in-state and out-of-state economic interests alike is, without more, invalidly protectionist for Commerce Clause purposes."

Kentucky's tax on sister State bond interest is no more "economic protectionism" than Kentucky's tax on bond interest paid by in-state and out-of-state corporate bond issuers alike. It would make no sense for Kentucky to tax its own interest payments to bondholders as a means of raising revenue: the revenue dog would merely be chasing its interest expense tail.

In short, two of the four National goals that animate the Court's dormant Commerce Clause jurisprudence — national regulatory uniformity and political solidarity — are not jeopardized by the disparate treatment of sister State bond interest. The third goal of a national free market is inapplicable to the business of government. And the fourth goal of preventing "economic protectionism" of in-state private business neither applies to a State's actions on its own behalf nor would be advanced by invalidating the laws of more than 40 States.

D. The constitutional principles of State sovereignty mandate the application of the *United Haulers* rule.

United Haulers establishes that if a State tax law applies in exactly the same fashion to all entities — in-state, out-of-state, public, or private — other than the State itself,

the law does not "discriminate against interstate commerce" for purposes of the dormant Commerce Clause.

The Court's decisions from four lines of authority that establish the fundamental principles of State sovereignty — federalism, immunity from suit, eminent domain, and the state taxing power — directly reinforce the constitutional boundary drawn by *United Haulers.* These decisions, which cabin a State's sovereignty within its independent territorial and legal jurisdiction, and which simultaneously admit of no other sovereignty within that jurisdiction save the National Power, cannot be squared with an interpretation of the dormant Commerce Clause that would require a sovereign State to treat sister States for purposes of taxation any differently than all other entities.

The Court has frequently adopted Madison's assurance that the "jurisdiction [of the National Government] extends to certain enumerated objects only, and leaves to the several States a residuary and inviolable sovereignty over all other objects." *The Federalist No. 39* (J. Madison), *quoted in, e.g., Garcia v. San Antonio Metropolitan Transit Authority,* 469 U.S. 528, 550 (1985). This "dual sovereignty" of each of the States and the National Government is often described as "a defining feature of our Nation's constitutional blueprint." *Federal Maritime Comm'n v. South Carolina Ports Authority*, 535 U.S. 743, 751 (2002); *Gregory v. Ashcroft,* 501 U.S. 452, 457 (1991).

The States' "residual sovereignty" is both implicitly and explicitly vouchsafed by the Constitution. "Residual sovereignty" is "implicit, of course, in the Constitution's conferral upon Congress of not all governmental powers, but only discrete, enumerated ones," and that implication is "rendered express by the Tenth Amendment's assertion that '[t]he

powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.'" *Printz v. United States*, 521 U.S. 898, 919 (1997).

While these and other federalism decisions concern themselves primarily with the interaction and interrelationship of the enumerated powers of the National Government versus the retained powers of the respective States, the Court has unremittingly held that none of the States surrendered any of their sovereignty to their sister States in the plan of the Constitution. "Rather, they entered the Union 'with their sovereignty intact.'" *Federal Maritime Comm'n*, 535 U.S. at 751, *quoting Blatchford v. Native Village of Noatak,* 501 U.S. 775, 779 (1991). The constitutional result is that the States are "independent sovereigns in our federal system," *e.g., Bates v. Dow Agrosciences LLC,* 544 U.S. 431 (2005); *Medtronic, Inc. v. Lohr,* 518 U.S. 470 (1996).

An essential attribute of the "residuary and inviolable" sovereignty retained by each of the States is the mutual exclusivity of the sovereignty of the States vis-à-vis each other. Chief Justice Marshall made this point in *The Schooner Exchange v. McFadden*, 11 U.S. (7 Cranch) 116 (1812), when he analyzed the scope of national sovereignty versus other independent nations. "The jurisdiction of the nation within its own territory is necessarily exclusive and absolute. It is susceptible of no limitation not imposed by itself. Any restriction upon it, deriving validity from an external source, would imply a diminution of its sovereignty to the extent of the restriction, and an investment of that sovereignty to the same extent in that power which could impose such restriction." *Id.* at 136.

The constitutional line drawn by *United Haulers* between the relevant governmental entity and all other entities — "private" or "public" — which do not share the governmental entity's responsibility for the welfare of its citizens, respects the independent sovereignty of the States. Any dimmer line requiring a taxing State to treat sister States any differently than private entities within its own territory and jurisdiction, would necessarily derogate from the taxing State's "inviolable" and "independent" sovereignty vis-à-vis its sister States. *Cf. Texas v. White*, 74 U.S. (7 Wall.) 700, 725 (1868) ("The Constitution, in all its provisions, looks to an indestructible Union, composed of indestructible States. . . [there can be] no loss of separate and independent autonomy to the States, through their union under the Constitution.").

The basic principle is geographical: State sovereignty does not cross the state line. The Court's adjudication of other matters where the sovereignties of different States have collided cleaves to this principle.

In *Nevada v. Hall*, 440 U.S. 410 (1979), for example, Nevada contended that its sovereign immunity from unconsented suit in its own courts, traveled with a state employee into California, so that a suit in California court could not be maintained against Nevada on *respondeat superior* grounds for its employee's negligence. The Court rejected Nevada's argument that "the Constitution implicitly establishes a Union in which the States . . . must respect the sovereignty of one another," *Id.* at 424-425. The Court held "nothing in the Federal Constitution . . . obligates" one State to an "enforced respect for the sovereignty" of a sister State within the former's jurisdiction. *Id.* at 425, 426. The Court adopted, in the context of State sovereignty, the same principle established by *The Schooner Exchange*: that the essential nature of State sovereignty is that it yields only to the National Power, so

that any requirement that one State yield, within its own jurisdiction, to the sovereignty of a sister State, necessarily contradicts the former's independent sovereignty.

Georgia v. Chattanooga, 264 U.S. 472 (1924), reached a similar result in the eminent domain context. Georgia, which owned property located in Tennessee, maintained that Tennessee could not take its property by eminent domain. The Court restricted Georgia's sovereignty to the south side of the state line. The Court affirmed the general rule that "land acquired by one state in another state is held subject to the laws of the latter and to all the incidents of private ownership." Accordingly, "the sovereignty of Georgia was not extended into Tennessee. . . . [Georgia] occupies the same position [in Tennessee] as does a private corporation authorized to own and operate a railroad." 264 U.S. at 480, 481.

This same principle of the mutual exclusivity of State sovereignty in matters of state taxation runs through the Court's Due Process Clause decisions that limn the boundaries of State power to subject intangibles, such as bonds, to ad valorem tax. There the general rule is that intangible property is "localized" at the owner's domicile, and only the State of domicile can tax the value of the intangibles. *Farmers' Loan & Trust Co. v. Minnesota*, 280 U.S. 204 (1930). The exception is that when intangibles, such as bonds, have acquired a "business situs" other than in the State of the owner's domicile, the intangibles are subject to ad valorem taxation by the State of their "business situs," and may not be constitutionally taxed by the State of the owner's domicile. The basis for the rule is that the States' "'spheres of activity are enforced and protected by the Constitution, and therefore it is impossible for one State to reach out and tax property in another without violating the Constitution.'" *Wheeling Steel*

Corp. v. Fox, 298 U.S. 193, 209 (1936), *quoting United States v. Bennet,* 232 U.S. 299, 306 (1914).

Bonaparte v. Tax Court, 104 U.S. (14 Otto) 592 (1881), likewise chose the state line as the boundary for State sovereignty in the context of an ad valorem intangible property tax on State bonds. The taxpayer in *Bonaparte* argued that the Full Faith and Credit Clause required Maryland to respect the laws of the issuing States with respect to the taxability of their own bonds. The Court rejected the contention with a statement that covered a larger constitutional landscape: "We know of no provision of the Constitution which prohibits such taxation." *Id.* The rationale of the Court's decision, however, was based on the same fundamental understanding of State sovereignty urged here: "No State can legislate except with reference to its own jurisdiction. One State cannot exempt property from taxation in another. Each State is independent of all the others in this particular." 104 U.S. at 594.

In words that apply just as directly to this case as they did to State bond debt over a century ago, *Bonaparte* noted that "if a State could protect its securities from taxation everywhere, it might succeed in borrowing money at reduced interest." But the Court resolved the case on the same principle underlying the decision in *United Haulers,* namely that because the issuing State cannot exercise "any of the attributes of sovereignty as to the debt it owes" on its bonds "outside of its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as individuals." 104 U.S. at 595.

The holding of *United Haulers* and its application in this case are thus entirely consonant with, indeed mandated by, the fundamental constitutional principle that the States

are independent sovereigns vis-à-vis each other, and the concomitant constitutional rule that State sovereignty does not cross state lines.

II. The substantial reliance interests and settled economic expectations of the States and their bondholders, as well as Congress' repeated recognition of the disparate tax treatment of State bond interest, make judicial intervention both unwise and unnecessary.

Substantial reliance interests and settled economic expectations loom largely in this case. A $2.4 trillion municipal bond market essential to the States' ability to finance not only capital projects but their daily operations, has functioned smoothly for decades on the business assumption that disparate treatment of State bond interest is constitutionally permissible.

That business assumption has been priced into every outstanding State bond issue, one way or the other. At least four fifths of the States operate under budgets that reflect not only revenues collected from taxes on sister State bonds, but bond interest expense that is materially affected by the exemption for interest income on their own bonds.

Over 35% of all municipal bonds outstanding in 2006 were held by individuals and households, and another 33% were held by mutual funds, money market funds, and closed end funds, in all probability on behalf of individual investors.[17] The State tax treatment of municipal bonds has been taken as a given by all these bondholders.

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[17] *See The Bond Buyer/Thomson Financial 2007 Yearbook* p.100 (2007).

It is therefore no overstatement to say that any change in the status quo would affect the settled economic expectations and contract rights of at least 42 States and millions of bondholders.

Would the municipal bond market be destabilized? Would the market be transmogrified into a brave new world in which States with weaker balance sheets would become governmental junk bond issuers and smaller, local issuers might find no demand whatsoever for their bonds? Would the States struggle for years with the fiscal consequences of a radical change in the ground rules of municipal finance? We don't know. But we do know that it's bad business to push a 2.4 trillion pound gorilla out of his cage without any idea of where he's headed or what he's going to do when he gets there.

In similar Commerce Clause cases, the Court has determined that restraint is the wiser course of action. *General Motors v. Tracy*, 519 U.S. 278, 304 (1997) ("we lack the expertness and the institutional expertise to predict the effects of judicial intervention"). Restraint is particularly appropriate where "considerations of state sovereignty" are so much in the balance, and especially here where the only sellers of the product are the States themselves, so that "the competing considerations in cases involving state proprietary action will be subtle, complex, politically charged, and difficult to assess under traditional Commerce Clause analysis," *Reeves, Inc. v. Stake*, 447 U.S. 429, 439 (1980).

Justice Holmes' assessment of an analogous fact pattern in *Padell v. New York*, 211 U.S. 446, 448 (1908), is apropos. "[T]he mode of taxation is of long standing, and, upon questions of constitutional law, the long-settled habits of the community play a part as well as grammar and logic. .

. . [T]he fact that the system has been in force for a very long time is of itself a strong reason against the belief that it has been overthrown by the 14th Amendment, and for leaving any improvement that may be desired to the legislature."

It would be a gross understatement to merely say that Congress has been well aware of the disparate treatment of sister State bond interest for decades. Congress has studied the matter in excruciating detail, in the specific context of a thorough examination of state taxation of interstate commerce, and done nothing. Lack of action speaks louder than words.

In 1959, Congress enacted legislation that generally prohibited State taxation of income derived from the sale of tangible personal property in interstate commerce unless the out-of-state vendor's activities amounted to something more than "solicitation," Act of September 14, 1959, Pub. L. 86-272, 73 Stat. 555, *codified at* 15 U.S.C. § 381. Section 201 of that Act directed the House Committee on the Judiciary and the Senate Finance Committee to "make full and complete studies of all matters pertaining to the taxation by the States of income derived within the States from the conduct of business activities . . . which are a part of interstate commerce, for the purpose of recommending to the Congress proposed legislation providing uniform standards to be observed by the States in imposing income taxes on income so derived."

The resulting Report of the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, presented to Congress in 1964, began by noting that "for 175 years, the courts have had to shoulder the entire responsibility for balancing the conflicts between the tax policies of the States and the national policy of assuring

the free flow of commerce." Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives, *State Taxation of Interstate Commerce*, H.R. Rep. No. 88-1480, vol. 1, at iii (1964).

The Special Subcommittee Report, as part of its review of state taxation of "interest on governmental obligations," called to Congress' attention in 1964 that "twenty one States exempt interest on obligations issued by the taxing State or its subdivisions; fourteen consider such interest taxable," and three "exempt interest of this kind to varying degrees." *Id.* at 258 and nn. 10-11 (listing States). The Special Subcommittee then reported that "twenty nine States tax all interest on obligations issued by other States or the political subdivisions of other States," that "[e]ight States exempt such interest," and that in one State "the status" of interest on sister State obligations "is uncertain." *Id*. at 259 and nn. 12-13 (listing States).

In an Appendix to its Report, the Special Subcommittee provided Congress with a detailed description, complete with citation to the applicable State statute or regulation, of each State's treatment of interest on municipal bonds. For example, "Alabama exempts interest . . . on obligations of Alabama and its subdivisions. Ala. Code tit. 51 §§ 384(2)(d), (f). Interest on obligations of other States and their subdivisions is taxable. Reg. § 384.2(f)." H.R. Rep. No. 88-1480, vol. 2, at A371. Or, again for example, "Interest on obligations of California and its subdivisions and of other States and their subdivisions is taxable. Code § 24271." *Id.* at A377.

Congress' alphabetical, state-by-state, statute-by-statute examination of the widespread and longstanding prac-

tice of the States in exempting interest on their own bonds, but taxing interest on sister State bonds, could not have been more thorough. Yet when the Special Subcommittee formulated its recommendations in 1965 for legislative action by Congress, *see* Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives, *State Taxation of Interstate Commerce*, H.R. Rep. No. 89-952, vol. 4 (1965), the disparate treatment of sister State bond interest was not mentioned. After years of detailed study, and with its eye focused on "conflicts between the tax policies of the States and the national policy of assuring the free flow of commerce," Congress apparently did not even consider exercising its affirmative Commerce Clause power to take the action that Respondents ask this Court to require under the dormant Commerce Clause.

This is not a situation where judicial action under the dormant Commerce Clause is called for because the matter is too localized and fragmented to get on the Congressional radar screen. Quite the contrary. This matter is so vital to the public finance market, and is a concern of such obvious national dimension, that the Court may safely indulge the inference that Congress' failure to take any action since 1965 to disturb the settled expectations of the States and their bondholders warrants leaving well enough alone. "Given these factors, *Alexandria Scrap* wisely recognizes that, as a rule, the adjustment of interests in this context is a task better suited for Congress than this Court." *Reeves, Inc. v. Stake*, 447 U.S. 429, 439 (1980).

The circumstances of this case present a particularly inauspicious occasion for the Court to extend the constraints of the dormant Commerce Clause to a market where the only

"commerce" is conducted by the States themselves.[18] A more fitting opportunity for judicial restraint would be difficult to imagine. The Court should not rush in where Congress failed to tread.

III. A sovereign State may use its regulatory taxing power to affect the economic terms of market participant relationships with its direct trading partners.

The bedrock principle of the Court's market participation cases is that if the State is acting as a market participant, the dormant Commerce Clause does not constrain the use of the State's regulatory power to set the terms of its market participation.

"Our cases make clear that if a State is acting as a market participant, rather than as a market regulator, the dormant Commerce Clause places no limitation on its activities." *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82, 94 (1984). "[W]hen a state or local government enters the market as a participant it is not subject to the restraints of the Commerce Clause," *White v. Massachusetts Council of Construction Employers, Inc.*, 460 U.S. 204, 208 (1983). Just as a "private market participant" operates free "from federal constraints" imposed by the dormant Commerce Clause, so do States "when acting as proprietors," *Reeves, Inc. v. Stake*, 447 U.S. 429, 439 (1980).

[18] *Cf. In re Trade-Mark Cases*, 100 U.S. (10 Otto) 82, 96 (1879) ("[C]ommerce among the States means commerce between the individual citizens of different States.").

Kentucky, its political subdivisions, and their instrumentalities have borrowed nearly $34 billion in the municipal bond market, and annually pay billions of dollars in interest and principal payments to their creditor bondholders. A private market participant such as a corporate bond issuer no more directly participates in the corporate debt market than Kentucky participates in the municipal bond market.

Although it believed that "no one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds," the Kentucky Court of Appeals mistakenly concluded that "the market participant theory is inapplicable as a State's 'assessment and collection of taxes' is, clearly, 'a primeval government activity.'" Pet. App. A10. This view confuses a label with an analysis.

To the contrary, the Court's market participation cases neither preclude a State from using its regulatory power to set the economic terms of its continuing contractual relationships with its direct trading partners, nor disable a State from regulating or taxing third party transactions occurring in the market in which it participates.

A. A State's market participation may include the exercise of regulatory power without transgressing any dormant Commerce Clause limitations.

Because the dormant Commerce Clause is inapplicable to a State's actions as a market participant, Boston in *White* could use its regulatory powers to restrict out-of-state participation in the work crews on city projects, South Dakota in *Reeves* could use its regulatory powers to restrict the sale of state-produced cement to in-state buyers, and Maryland in *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794

(1976), could use its regulatory powers to restrict the payment of bounties to in-state scrap processors.

When Kentucky exempts interest income on its own bonds from its own income tax, Kentucky sets the terms and conditions upon which it will obtain essential bond financing. This exercise of regulatory power goes no further than what *Reeves* envisioned and approved: "'*the Government enjoys the unrestricted power* to produce its own supplies, to determine those with whom it will deal, and *to fix the terms and conditions upon which it will make needed purchases*.'" 447 U.S. at 439 n.12 (*quoting Perkins v. Lukens Steel Co.*, 310 U.S. 113, 127 (1940) (emphasis supplied).

None of *Alexandria Scrap*, *Reeves*, or *White* involved State participation in a market which the State did *not* regulate pervasively. The notion that "market participation" and "market regulation" are mutually exclusive, is a false dichotomy.

White acknowledged that the challenged Boston order, a quintessential across-the-board regulation mandating the composition of work crews on all projects funded by the City, "*regulates* employment contracts between public contractors and their employees." 460 U.S. at 211 n.7 (emphasis supplied). *White* nonetheless held that the relevant inquiry was "whether the city is participating in the marketplace when it provides city funds for building construction," *Id.* at 210. The Court concluded that whether the regulatory order would have a significant impact on firms employing "permanent work crews composed of out of State residents" was "not relevant," because "only after it is decided that the city is regulating the market rather than participating in it . . . need it be determined whether any burden on interstate

commerce is permitted by the Commerce Clause." *Id.* at 209-210.

Alexandria Scrap approved a Maryland bounty program that was part and parcel of a regulatory regime established by "a comprehensive statute," 426 U.S. at 796, pursuant to which Maryland's market participation — its deemed purchase of abandoned automobile hulks — took place within the framework of an integrated regulatory program in which all participating processors were required to be licensed; a different division of bounty payments was established for vehicles other than hulks received from licensed suppliers versus unlicensed suppliers; and a different set of procedures was established for the payment of bounties for destruction of hulks versus other vehicles. Yet Maryland's use of its primeval regulatory police power to implement its market participation, was no obstacle to the Court's conclusion that "Maryland has entered into the market itself," 426 U.S. at 806, or the Court's finding that the Maryland regulatory bounty program was "the entry by the State itself into the market as a purchaser, in effect, of a potential article of interstate commerce," 426 U.S. at 808.

Reeves referred with approval to a host of lower court decisions upholding state regulations requiring State purchases of goods and services to be made exclusively or preferentially from in-state sources versus out-of-state suppliers, 447 U.S. at 437 n.9, *citing*, *inter alia, American Yearbook Co. v. Askew*, 339 F.Supp. 719 (MD Fla. 1972), *sum. aff'd* 409 U.S. 904, and noted that "numerous courts have rebuffed Commerce Clause challenges directed at similar preferences that exist in a substantial majority of the states." *Id. (citation omitted)*. That the *Reeves* Court used the terms "market participant" and "market regulator" as conceptual shorthand for the conclusions reached by an analysis, rather than as substi-

tutes for analysis, is evident in note 14 of the Court's opinion: "We have no occasion here to inquire whether subsidy programs unlike that involved in *Alexandria Scrap* warrant characterization as proprietary, rather than regulatory, activity." *Id.* at 440.

It is therefore simplistic, and incorrect, to read the Court's market participation cases as holding, in any respect whatsoever, that the exercise of a regulatory power such as the power to tax, can never be part of a State's market participation. *Alexandria Scrap, Reeves, and White* all involved the use of the police power, a regulatory power every bit as primeval as the power to tax.

B. The dormant Commerce Clause does not preclude State taxation or regulation of a market in which it participates.

Maryland's market participation in *Alexandria Scrap* did not preclude Maryland from taxing the income of the hulk processors to which its regulatory bounty was paid. Nor did Boston's market participation in *White* prohibit Boston from taxing the income of the construction crews whose composition it regulated.

The Court of Appeals' error traces to three cases in which the State was not a market participant at all, but tried to equate taxation or regulation of transactions between third parties to "participation" in the market by the State. *E.g., South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82, 98 (1984); *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 271 (1988); *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564, 594 (1997).

South-Central Timber, *New Energy*, and *Camps Newfound* imposed necessary conceptual limits on the market participation exception. If a State could use its market power to impose downstream restrictions on its trading partners, or could transmute the assessment and collection of taxes, standing alone, into State "participation" in the free market, the market participation exception would swallow the dormant Commerce Clause rule.

These precedents in no way foreclose the use of a State's regulatory power to affect the economic terms of its relationship with its direct trading partners. In *New Energy* and *Camps Newfound* the State had no direct trading partners. The State's only claimed "participation" in the market was the taxation of market transactions between third parties. In *South-Central Timber* the State conceded that it "participate[d] in no way" in the relevant timber processing market to which its regulation applied.

Kentucky's bond interest exemption affects the terms of its own economic relationship as debtor with its bondholders as creditors "during the course of an ongoing commercial relationship in which the [State] retain[s] a continuing proprietary interest in the subject of the contract," 467 U.S. at 99. Kentucky does not attempt to transform naked taxation or regulation of third party transactions, into "market participation" by Kentucky. Kentucky sells its bonds to buyers and pays interest and principal to its bondholders just like any private bond issuer sells bonds and pays interest and principal to its bondholders.

There is no compelling reason that Kentucky's tax exemption for interest received on its own bonds cannot be separated, for Commerce Clause analysis, from its taxation of sister State bond interest. The exemption is nothing more

than an economic term of Kentucky's relationship with its direct trading partners, no more objectionable than a discount or a rebate would be if Kentucky bought goods or services. The taxation of sister State bond interest is nothing more than a revenue measure no more objectionable than the taxation of corporate bond interest.

CONCLUSION

The judgment of the Kentucky Court of Appeals should be reversed.

Respectfully submitted,

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