SALISBURY TRUST
WEALTH ADVISORY SERVICES

Muni bonds at the U.S Supreme Court

Consistent with the practice in other states, Kentucky exempts from state income tax the interest earned on bonds issued by Kentucky or its political subdivisions, but it taxes in full the interest income from out-of-state bonds. In April 2003 Mr. and Mrs. Davis challenged the constitutionality of that tax treatment, pointing to the Commerce Clause of the U.S. Constitution and the Equal Protection Clause of the Fourteenth Amendment. They persuaded the highest state court in Kentucky that they were correct. "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to the in-state bonds than it does to extraterritorially issued bonds," the Court held.

The Kentucky Department of Revenue asked for help from the U.S. Supreme Court, and received it in May. By a 7-2 majority, with an unusual combination of liberal and conservative justices, the Court held that, when it comes to taxation, the Constitution permits states to discriminate between home-grown muni bonds and those issued outside the state. Had the decision gone the other way, the municipal bond market would have had some significant uncertainty cast upon it, so most people welcomed the high court's decision. However, in a footnote the Court leaves a cloud over muni bonds issued to further private development, because such bonds were not at issue in this case.

One might wonder why it has taken so long for a taxpayer to raise this constitutional question about municipal bond taxation. Perhaps taxpayers have been worried that, if discrimination against out-of-state bond interest is unconstitutional, there are two equally valid remedies: exempt all municipal bond interest income from tax, or tax all of it. Perhaps half of a tax-free loaf has been better than none.

(June 2008)

A Division of Salisbury Bank and Trust Company

19 Bissell Street
Post Office Box 1868

Lakeville, Connecticut
06039-1868

t: 860.435.9801
t: 800.222.9801

f: 860.435.5224
www.salisburybank.com