

Kentucky Files Case with U.S. Supreme Court to Rule on Tax Exemption of Out-of-State Municipal Bonds

The \$2.3 trillion municipal bond market has developed amidst a set of long-accepted practices, beliefs and expectations. One fundamental principle is that the interest on bonds issued by state and local governments is exempt from taxation by the federal government. Interest on municipal bonds issued by an investor's state has been – with some exceptions - exempt from that state's taxation. A corollary to this has been - again, with some exceptions - that interest on out-of-state municipal bonds is subject to taxation by the investor's state of residence.

The premise that a state can tax the interest on an out-of-state bond has recently been challenged in Kentucky. This case, which has worked its way through the courts in Kentucky, (where the Kentucky Court of Appeals ruled in favor of the investor plaintiffs) alleges that Kentucky's practice of taxing the income earned on out-of-state bonds violates the Commerce Clause of the U.S. Constitution. Kentucky filed an appeal to the U.S. Supreme Court on November 15 in Department of Revenue of the Commonwealth of Kentucky and Finance and Administration Cabinet of the Commonwealth of Kentucky v. Davis. The plaintiffs have until December 15 to respond to Kentucky's petition.

Legal experts believe that the Commonwealth's appeal to the U.S. Supreme Court will revolve around the application of the dormant commerce clause, which forbids states to discriminate against interstate trade. Our intent in this commentary is not to go through all of the legal and constitutional issues, but rather to highlight the questions, and investment implications of this case. We also will briefly discuss the value of in-state tax exemption, and the possible effects on the market were the Supreme Court to rule in a way that changes the current market conventions.

Our role at present is to carefully monitor this case and its progress through the legal system. Should the Supreme Court not agree to hear the case, it is possible that plaintiffs from other states might try to bring a case with facts specific to them. On the assumption that the Court will decide to hear the case, there are several possible outcomes to consider:

- Whether Kentucky may continue to tax other states' bonds
- Whether the decision will apply exclusively to Kentucky, or be applicable to all states
- Whether Kentucky would be permitted to tax out-of-state bonds if they also tax in-state bonds, thereby removing any discrimination
- If there are changes, what date would they be effective, and would they be retroactive?
- Other states' responses to this ruling

A U.S. Supreme Court ruling in favor of the plaintiffs would have a dramatic impact on the municipal market. Historically, there are strong incentives for an investor in a high-tax state (i.e. New York, California, Massachusetts, New Jersey) to invest only in their own states' bonds. For example, in California the state tax rate on out-of-state bonds is 9.3%. Assuming a 4% coupon, a California investor would have to get an extra 37 basis points on an out-of-state-bond to make up for the state tax. For California residents with taxable income greater than \$1 million, the additional 1% tax surcharge increases the marginal tax rate to 10.3%, thereby requiring 41 extra basis points. The state tax is deductible at the federal level (assuming the client is not in the AMT), reducing the out-of-state penalty to 27 basis points for the maximum tax investor. In the current market, with California bonds yielding essentially the same as general market bonds, it does not make sense for that investor to buy out of state. However, if the investor no longer had to search for 37 or 41 extra basis points, he could invest in all states and diversify geographically without loss of yield.

We believe that if states are forced to treat all municipal bonds the same and not preferentially treat income of bonds from their home state, then investors will have an incentive to buy bonds from out-of-state in order to diversify their portfolios, both on a credit and geographic basis. This would have the effect of reducing demand for bonds from high tax states resulting in higher yields for those bonds. This increase in borrowing costs may add negative credit pressure. However, as relative yields rise in bonds of high tax states they may become attractive to out-of-state investors. How and when the market would reach a new equilibrium is unknown. In the past, however, markets do not respond to changes in taxation unless those changes are clear and/or close to being implemented.

As active managers of municipal bonds, we are following this case with keen interest. We manage portfolios tax efficiently and any change in a state's tax environment will impact our investment decisions. Since it is impossible to predict the outcome of the Supreme Court ruling, we believe that it is premature to make any major changes in our investment philosophy. However, we are watching the situation closely and will continue to update you on issues as they develop.

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