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SUPREME COURT UPHOLDS STATE INCOME TAX EXCLUSION FOR MUNICIPAL BOND INTEREST

By: Louis S. Nunes, III



The U.S. Supreme Court has ruled that a Kentucky statute that excluded interest on municipal bonds issued by Kentucky or any political subdivision in Kentucky did not violate the Commerce Clause of the United States Constitution. *Department of Revenue of Kentucky et al. v. Davis*, No. 06-666 (U.S., 5/19/2008). In so ruling, the Court reversed the decision of the Court of Appeals of Kentucky.

Many states, including Louisiana, have a statutory scheme similar to Kentucky's, under which interest on that state's obligations is exempt from state income tax, while interest on other states' obligations is subject to tax. After the opinion of the Court of Appeals of Kentucky, the validity of these statutory schemes was in question. The resultant uncertainty had two primary consequences for Louisiana (and other states). First, taxpayers in Louisiana filed protective claims for refund of Louisiana income taxes that they paid on interest they received on out-of-state bonds. This presented a foreboding budget problem. Second, the appeal of municipal bonds was diminished, given the possibility that an adverse decision might have required the states to tax all interest on all bonds (including their own) in order to avoid refunding taxes collected on other states' bonds. The Court's decision renders the claims for refund invalid and settles the uncertainty surrounding future bond issues.

The Court's decision addressed "governmental bonds." Many commentators expressed concerns that any decision would relate only to governmental bonds and not private activity bonds. Governmental bonds are issued to finance governmentally owned projects. In contrast, private activity bonds are issued by state or local governments to finance certain types of privately owned projects. Although not directly addressing private activity bonds, the Court suggested that it would reject any similar challenge to the state tax treatment of interest on private activity bonds.

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VENTURE CAPITAL &
EMERGING COMPANIES

WHITE COLLAR CRIME

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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