

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue cap at the top. The globe in the top bulb is dark blue, while the globe in the bottom bulb is light blue. The hourglass is centered on the page.

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*Dormant Commerce Clause and State Treatment of  
Tax-Exempt Bonds*

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**Abstract.** Most states exempt from state income taxes the interest earned on bonds issued by that particular state and its political subdivisions, while taxing the interest earned on bonds issued by other states and their political subdivisions. Some argue that these state tax schemes violate the Commerce Clause by discriminating against out-of-state bonds. Courts in two states have examined this issue. On November 5, 2007, the U.S. Supreme Court heard oral arguments in one of these cases, *Department of Revenue of Kentucky v. Davis*.

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## CRS Report for Congress

# Dormant Commerce Clause and State Treatment of Tax-Exempt Bonds

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### Summary

Most states exempt from state income taxes the interest earned on bonds issued by that particular state and its political subdivisions, while taxing the interest earned on bonds issued by other states and their political subdivisions.<sup>1</sup> Some argue that these state tax schemes violate the Commerce Clause by discriminating against out-of-state bonds. Courts in two states have examined this issue. On November 5, 2007, the U.S. Supreme Court heard oral arguments in one of these cases, *Department of Revenue of Kentucky v. Davis*.

The Commerce Clause provides that “Congress shall have Power ... To regulate Commerce ... among the several States...”<sup>2</sup> The Supreme Court has long held that the Clause prohibits states from unduly burdening interstate commerce even in the absence of federal regulation. This restriction, known as the dormant or negative Commerce Clause, “reflect[s] a central concern of the Framers” that “the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation.”<sup>3</sup> Thus, the dormant Commerce Clause “prevent[s] a State from retreating into economic isolation or jeopardizing the welfare of the Nation as a whole, as it would do if it were free to place burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear.”<sup>4</sup> A further rationale is that out-of-state entities subject to any burden are likely not in a position to use the state’s political process to seek relief.<sup>5</sup>

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<sup>1</sup> For more information on government-issued bonds, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Government Debt*, by Steven Maguire.

<sup>2</sup> U.S. CONST. art. I, § 8, cl. 3.

<sup>3</sup> *Okla. Tax Comm’n v. Jefferson Lines*, 514 U.S. 175, 180 (1995).

<sup>4</sup> *Id.*

<sup>5</sup> See *Southern Pacific Co. v. Arizona*, 325 U.S. 761, 768 (1945).

The dormant Commerce Clause prohibits state laws that discriminate against interstate commerce.<sup>6</sup> Thus, while a state law that “regulates even-handedly to effectuate a legitimate local public interest” and has “only incidental” effect on interstate commerce is constitutionally permissible “unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits”<sup>7</sup> (“the *Pike* test”), a discriminatory state law is “virtually *per se* invalid.”<sup>8</sup> Traditionally, such laws have only been permissible if they meet the high standard of “advanc[ing] a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.”<sup>9</sup> It would appear, therefore, that the bond taxing schemes used by almost all of the states, which exempt the interest on state-issued bonds while taxing the interest on other states’ bonds, are facially discriminatory and should be subject to a high level of scrutiny.

However, a wrinkle to this analysis was added in April 2007 when the Supreme Court decided a case, *United Haulers Ass’n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Authority*,<sup>10</sup> in which a plurality of the Court subjected a facially discriminatory state law to a lower standard of scrutiny because it benefitted a public entity, as opposed to an in-state private entity. The challenged law required trash haulers to deliver waste to a processing facility owned by a public entity. The Court had previously struck down a similar law,<sup>11</sup> but distinguished the two cases because the processing facility in the prior case was privately owned while the *United Haulers* facility was publicly owned.

In *United Haulers*, the Court found “[c]ompelling reasons” for distinguishing between state laws that favor governmental units and those that favor in-state private entities over their competitors.<sup>12</sup> The Court, stating that “any notion of discrimination assumes a comparison of substantially similar entities,” reasoned that state and local governments are not substantially similar to private entities due to their public welfare responsibilities.<sup>13</sup> These responsibilities, the Court explained, meant that laws favoring governmental units have “any number of legitimate goals,” while laws favoring in-state private entities generally represent “simple economic protectionism.”<sup>14</sup> Thus, the Court

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<sup>6</sup> See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

<sup>7</sup> *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).

<sup>8</sup> *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 575 (1997) (internal citations omitted).

<sup>9</sup> *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 278 (1988).

<sup>10</sup> *United Haulers Ass’n Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786 (2007).

<sup>11</sup> *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383 (1994).

<sup>12</sup> *United Haulers*, 127 S. Ct. at 1795. In dissent, Justice Alito, joined by Justices Stevens and Kennedy, disagreed that *United Haulers* could be distinguished from the prior case and wrote that the “public-private distinction drawn by the [majority opinion] is both illusory and without precedent.” *Id.* at 1804 (Alito, J., dissenting).

<sup>13</sup> *Id.* at 1795 (internal citations omitted).

<sup>14</sup> *Id.* at 1795-96 (internal citations omitted).

reasoned, such laws should not be viewed with “equal skepticism.”<sup>15</sup> The Court explained that treating them equally “would lead to unprecedented and unbounded interference by the courts with state and local government,” which was particularly inappropriate when the challenged law addressed a traditional government function such as waste disposal.<sup>16</sup>

A majority of the Court could not agree on the standard under which to examine laws favoring public entities. A plurality of four justices stated that the proper standard was the *Pike* test — that is, whether “the burden imposed on interstate commerce is clearly excessive in relation to the putative local benefits.”<sup>17</sup> The plurality did not find the challenged law’s burden to be excessive to its benefits, which included providing health and environmental benefits and an effective way to finance waste-disposal services.<sup>18</sup>

**Market Participant Doctrine.** The dormant Commerce Clause is not implicated when a state acts as a market participant as opposed to a market regulator. This is because the “Commerce Clause responds principally to state taxes and regulatory measures impeding free private trade in the national marketplace,” and “[t]here is no indication of a constitutional plan to limit the ability of the States themselves to operate freely in the free market.”<sup>19</sup> The market participant doctrine does not apply when the state is acting in its governmental capacity by assessing and computing taxes.<sup>20</sup>

## Court Cases

It appears only two cases have addressed whether state laws taxing interest earned on bonds issued by other states while exempting interest earned on bonds issued by that state violate the Commerce Clause. In 1994, an Ohio appellate court held in *Shaper v. Tracy*<sup>21</sup> that such treatment was constitutional. In 2006, the Kentucky court of appeals held the opposite in *Kentucky Department of Revenue v. Davis*.<sup>22</sup> In November 2007, the U.S. Supreme Court heard oral arguments in *Davis*.

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<sup>15</sup> *Id.* at 1795.

<sup>16</sup> *Id.* at 1796.

<sup>17</sup> *Id.* at 1797 (internal citations omitted). Justice Scalia, who otherwise joined the majority opinion, did not agree with the application of the *Pike* test. He wrote that he would follow precedent despite his belief that the Commerce Clause did not restrict state actions, but did not find any prior cases that required him to strike down the challenged law. *Id.* at 1798-99 (Scalia, J., concurring in part). Justice Thomas concurred only in the judgment and wrote to say that he “would discard the Court’s negative Commerce Clause jurisprudence” because it had “no basis in the Constitution and has proved unworkable in practice.” *Id.* at 1799 (Thomas, J., concurring in judgment).

<sup>18</sup> *See id.* at 1797-98.

<sup>19</sup> *Reeves, Inc. v. Stake*, 447 U.S. 429, 437 (1980).

<sup>20</sup> *See New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 277-78 (1988); *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 593-94 (1997).

<sup>21</sup> *Shaper v. Tracy*, 647 N.E.2d 550 (Ohio Ct. App. 1994), *appeal denied*, 645 N.E.2d 1257 (Ohio 1995), *cert. denied*, 516 U.S. 907 (1995).

<sup>22</sup> *Dep’t of Revenue of Kentucky v. Davis*, 197 S.W.3d 557 (Ky. Ct. App. 2006), *cert. granted*, 127 S. Ct. 2451 (2007).

**Shaper v. Tracy.** In the *Shaper* case, an Ohio court of appeals rejected the claim made by an Ohio taxpayer that the state’s bond taxing scheme was unconstitutional. The court began by agreeing with the taxpayer that the market participant doctrine did not apply because Ohio was acting as a market regulator, and not participant, when it determined how to tax out-of-state bonds.<sup>23</sup> However, the court then ruled that the taxing scheme did not implicate the Commerce Clause because the scheme benefitted the state.<sup>24</sup> The court based this conclusion on its analysis of the Supreme Court’s Commerce Clause jurisprudence, which the court found to only involve challenges to state actions giving in-state private entities a competitive advantage over out-of-state entities, and not challenges to state actions benefitting the state itself.<sup>25</sup>

The court, while noting that no Supreme Court decision was directly on point, found two cases to be useful. The first was *Bonaparte v. Tax Court*,<sup>26</sup> in which the Supreme Court determined that a state law exempting state-issued public debt held by residents, while taxing non-residents, did not violate the Full Faith and Credit Clause.<sup>27</sup> The court placed significance on the Supreme Court’s statements in *Bonaparte* that “the Constitution does not prohibit a State from including in the taxable property of her citizens so much of the registered public debt of another State as they respectively hold, although the debtor State may exempt it from taxation or actually tax it” and “[w]e know of no provision of the Constitution of the United States which prohibits such taxation.”<sup>28</sup> The second case was *South Carolina v. Baker*,<sup>29</sup> in which the Supreme Court held that the federal government could tax state-issued bonds.<sup>30</sup> While noting that the tax in *Baker* was not challenged under the Commerce Clause, the *Shaper* court quoted the Supreme Court’s statement that “[t]he owners of state bonds have no constitutional entitlement not to pay taxes on income they earn from the bonds and States have no constitutional entitlement to issue bonds paying lower interest rates than other issuers.”<sup>31</sup>

The court, after noting that Ohio had a “legitimate interest in tapping a major source of tax revenue” and bond purchasers are “major beneficiaries” of the public purposes for which the bond proceeds would be used, concluded by stating it could not hold the Ohio law unconstitutional “given the lack of any precedent to apply the Commerce Clause to this type of taxation scheme.”<sup>32</sup>

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<sup>23</sup> See *Shaper v. Tracy*, 647 N.E.2d. at 552.

<sup>24</sup> See *id.* at 552-53.

<sup>25</sup> See *id.*

<sup>26</sup> *Bonaparte v. Tax Court*, 104 U.S. 592 (1882).

<sup>27</sup> U.S. CONST. art. IV, § 1 (providing, in part, that “Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State”).

<sup>28</sup> *Shaper*, 647 N.E.2d at 553.

<sup>29</sup> *South Carolina v. Baker*, 485 U.S. 505 (1988).

<sup>30</sup> *Shaper*, 647 N.E.2d at 553.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 553-54.

**Dep't of Revenue of Kentucky v. Davis.** In the *Davis* case, the Kentucky court of appeals held that the state's bond taxing scheme violated the Commerce Clause. The court began by noting that the "'fundamental command' of the Commerce Clause is that 'a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State,'" and therefore discriminatory state laws were presumptively invalid.<sup>33</sup> Based on this, the court reasoned that "[c]learly, Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds."<sup>34</sup>

The court rejected the state's argument that it should adopt the *Shaper* court's holding, stating that the *Shaper* analysis was incomplete because "a potentially problematic and constitutionally infirm statute does not become permissible simply because it has not been previously found to be unconstitutional."<sup>35</sup> The court also dismissed the relevance of the *Bonaparte* decision because it dealt with the Full Faith and Credit Clause and not the Commerce Clause.<sup>36</sup> Finally, the court rejected the argument that Kentucky's taxing scheme did not implicate the dormant Commerce Clause because the state was acting as a market participant, explaining that Kentucky was a market participant when issuing the bonds but a market regulator when choosing how to tax its citizens.<sup>37</sup>

The U.S. Supreme Court heard oral arguments in the *Davis* case on November 5, 2007. A transcript of the oral arguments is available on the Supreme Court's website at [[http://www.supremecourtus.gov/oral\\_arguments/argument\\_transcripts/06-666.pdf](http://www.supremecourtus.gov/oral_arguments/argument_transcripts/06-666.pdf)].

**Effect of *United Haulers* on *Davis*.** As discussed, the Supreme Court decided *United Haulers* just prior to granting certiorari in *Davis*. Under the Court's jurisprudence prior to *United Haulers*, it seems there was a significant chance that Kentucky's bond taxing scheme would be unconstitutional because it facially discriminates against out-of-state entities, and the Court's jurisprudence suggested that such laws were impermissible unless the state could show the law served a legitimate state purpose and there were no other reasonable ways to advance that purpose. This high level of scrutiny is generally fatal to the challenged state law.

The *United Haulers* decision suggests a different outcome by indicating that a less stringent analysis applies when the state law benefits state and local governments as opposed to in-state private entities. Questions exist about how the Court may apply *United Haulers* to *Davis*, in part because only a plurality in *United Haulers* agreed it was appropriate to use the *Pike* test in examining the permissibility of state laws benefitting public entities. Furthermore, it is possible the Court will distinguish *Davis* from *United Haulers*. One basis for doing so is that the state law in *United Haulers* benefitted a

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<sup>33</sup> Dep't of Revenue of Kentucky v. Davis, 197 S.W.3d 557, 562 (Ky. Ct. App. 2006)(quoting *Associated Industries of Missouri v. Lohman*, 511 U.S. 641, 647 (1994) and *Armco Inc. v. Hardesty*, 467 U.S. 638, 642 (1984)).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 563.

<sup>36</sup> *See id.* at 564.

<sup>37</sup> *See id.*

publicly owned entity over private entities, while the one in *Davis* benefits states over other states.<sup>38</sup> The Court's analysis in *United Haulers* was based on its finding that while "any notion of discrimination assumes a comparison of substantially similar entities," governmental units and private entities are not "substantially similar" because the former have public welfare responsibilities not imposed on the latter. Thus, a key question in *Davis* seems to be whether Kentucky is "substantially similar" to the other states whose bonds it taxes;<sup>39</sup> if so, that could be constitutionally fatal for Kentucky's bond taxing scheme. On the other hand, if the Court does apply an analysis similar to *United Haulers* in *Davis*, this suggests that Kentucky's taxing scheme would be constitutionally permissible. Policy concerns, such as a desire to not upset the state bond market and the expectations of bond purchasers, could provide additional justifications for the Court to find the taxing scheme to be constitutional.<sup>40</sup>

## Congressional Authority to Address the Issue

Congress's authority under the Commerce Clause has been described as plenary and limited only by other constitutional provisions.<sup>41</sup> Congress may, therefore, regulate by expressly authorizing the states to take an action that would otherwise be an unconstitutional burden on interstate commerce.<sup>42</sup> Thus, if the Court were to hold that Kentucky's taxing scheme violates the dormant Commerce Clause, it appears Congress could authorize such tax treatment so long as it did not violate any other constitutional provision.

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<sup>38</sup> See also Ethan Yale and Brian Galle, *Muni Bonds and the Commerce Clause After United Haulers*, TAX NOTES, at 1042-1046 (June 11, 2007) (putting forth additional justifications for distinguishing the cases, including that there are no burdened in-state entities in *Davis* who could represent the views of burdened out-of-state entities in the Kentucky's political process).

<sup>39</sup> Compare Brief for Petitioners at 17-18, *Dep't of Revenue of Kentucky v. Davis*, No. 06-666 (U.S. July 19, 2007) (arguing Kentucky is not substantially similar to other states because no other state has the "political responsibility of financing public works and public projects for Kentucky citizens" or the responsibilities for bond repayment), with Brian D. Galle and Ethan Yale, *Can Discriminatory State Taxation of Municipal Bonds Be Justified?* TAX NOTES, at 158-59 (Oct. 8, 2007) (arguing that the proper comparison is between Kentucky's bonds and other states' bonds, and that the bonds are substantially similar because they are clearly "competing alternatives").

<sup>40</sup> See Joann M. Weiner, *Panelists: Court Will Uphold Status Quo in Municipal Bond Case*, TAX NOTES, at 441-42 (Oct. 29, 2007) (reporting that Professor Walter Hellerstein stated he believes the Court will use *United Haulers* as an "escape hatch" to uphold Kentucky's bond taxing scheme in order to not disrupt the expectations that have arisen from the states' tax treatment of bonds); see also, Edward A. Zelinsky, *Davis: Incoherence of Dormant Commerce Clause Nondiscrimination*, TAX NOTES, at 59-60, 61 (July 2, 2007) (arguing that the Supreme Court should use *Davis* to reconsider the dormant Commerce Clause's nondiscrimination concept because it makes no sense that "any tax expenditures can be transformed into an economically and procedurally equivalent direct expenditure" and the focus on protectionism and economic effect is overly broad because all state activity is "protectionist in nature").

<sup>41</sup> See, e.g., *Prudential Insurance Co. v. Benjamin*, 328 U.S. 408, 434 (1946).

<sup>42</sup> See *Quill v. North Dakota*, 504 U.S. 298, 318-19 (1992).