Supreme Court Upholds Tax-Exempt Status of Bonds Issued to Same-State Residents

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In a case that had threatened to undermine the ability of States to issue tax-exempt bonds, the Supreme Court upheld the right of the State of Kentucky to exempt from taxation the bonds of its own State, while taxing income derived from the bonds of other States. In Department of Revenue of Kentucky v. David, 128 S. Ct. 1801 (May 19, 2008), the Court considered whether Kentucky's differential tax treatment violated a rarely invoked section of the U.S. Constitution that prohibits States from erecting protectionist barriers against competition from other States. The Court found no such violation and thereby upheld a practice that has become inseparable from the structure and marketability of municipal bonds generally. Had Kentucky been forced to tax other States' bonds as favorably as its own bonds, the cost of issuing Kentucky bonds, and the State's ability to sell those bonds to its own residents, would have been seriously damaged. Other States would have been similarly damaged.