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U.S. Supreme Court Accepts Certiorari in Municipal Bond Case; Consider Filing Now to Preserve Interest on Refund Claims

The Davis Case. The U.S. Supreme Court announced on May 21, 2007 that it has granted *certiorari* to review the decision of the Kentucky Court of Appeals in *Davis v. Dep't of Revenue of The Finance and Admin. Cabinet*, 197 S.W.3d 557 (2006). In *Davis*, the taxpayers mounted a challenge under the Commerce Clause of the U.S. Constitution to the distinction under Kentucky law between the treatment of interest on Kentucky obligations, which is exempt from tax, and the treatment of interest on obligations of other states, which is not. The Kentucky court found this scheme to be discriminatory on its face, and it rejected the Department of Revenue's argument that the discrimination was acceptable under conventional Commerce Clause analysis where the state was acting as a market participant, not a market regulator, in issuing Kentucky tax-exempt bonds. In the court's view, the real question was not whether the state's *issuance* of the bonds was inherently governmental, but rather whether *creating a tax preference* for income derived from the bonds was a governmental act:

> The Department's market participant argument is unavailing, however. No one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds. But Kentucky's issuance of bonds is not the issue. Rather, the sole issue is Kentucky's decision to tax only extraterritorial bonds. Thus, the market participant theory is inapplicable as a State's "assessment and computation of taxes" is, clearly, "a primeval governmental activity." Accordingly, "when a state chooses to tax its citizens, it is acting as a market regulator[,]" not as a market participant. Therefore, the Department's market participant argument is without merit.

Kentucky is one of about 40 states that offer a tax preference for interest on in-state governmental bonds, including Massachusetts. The starting point for determining the taxable income of individuals for Massachusetts tax purposes is federal gross income, which does not include interest on the obligations of any state, but Massachusetts law adds back to this amount interest on governmental obligations excluded under the federal Code, other

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than interest from obligations issued by Massachusetts or its political subdivisions, agencies or instrumentalities. A similar provision applies with respect to exempt-interest dividends received by a taxpayer from a mutual fund, but only to the extent that the exempt interest is derived from Massachusetts obligations. The Department of Revenue has issued a release setting forth its interpretation of which instruments are considered to qualify for exempt treatment under these provisions, and also noting in which cases gain on disposition of the obligation is considered to be exempt.

If the Supreme Court affirms the decision of the Kentucky Court of Appeals and further determines that taxpayers are entitled to refunds, then states like Massachusetts may need to choose between taxing all interest from state bonds, or exempting all such interest. The Court's resolution of the *Davis* case could touch other areas as well, including the preferential tax credits or deductions that many states afford for contributions to their own so-called Section 529 college-funding plans (Massachusetts does not provide such preferential treatment), and even the constitutionality of tax benefits offered to corporations as an economic development tool.

Refund Opportunity. In states like Massachusetts that offer preferential treatment to interest from in-state bonds, residents who have paid tax on interest from *out-of-state bonds* should consider protecting their rights by filing applications for abatement of the tax paid. Filing now could be particularly important for taxpayers in Massachusetts, because Massachusetts begins accruing interest on tax refunds only upon the filing of a complete and substantiated abatement application. The Supreme Court decision in the *Davis* case may not be known until June of 2008, which means that Massachusetts taxpayers who delay filing a refund claim could forfeit a year's worth of interest on their refund. In addition, taxpayers who delay could forfeit their ability to claim a 2004 tax refund due to the general three-year limitations period for filing refund claims, which in Massachusetts is three years from the due date, without regard to extensions, of the return for the period when the interest was earned.

For assistance in claiming a refund of Massachusetts tax on interest from out-of-state bonds, please contact Sullivan & Worcester's State and Local Tax group at SALT@sandw.com, or call David Nagle or another member of our group. In many instances, we can prepare and file refund claims quickly and at minimal cost.