



All that's hot in the mutual fund industry

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Supreme Court to Hear Landmark Muni Bond Case

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An upheaval in the taxation of muni bond funds appears to be one step closer, thanks to the Supreme Court's decision yesterday to hear litigation on the matter.

Investors George and Catherine Davis have been fighting a lengthy legal battle that claims the traditional tax treatment of interest paid on municipal bonds is a violation of interstate commerce laws. In a major victory for the couple, a state court in Kentucky sided with them. The matter has now found itself before the Supreme Court, which has decided to hear the case.

Interest on debt securities typically isn't taxable to investors within the state in which the debt was issued, explains Jim Alt, a partner in the Minneapolis office of law firm **Dorsey & Whitney**. That way states and municipalities can offer debt with lower-yielding interest payments, since the earnings for investors won't be eroded by taxes. At the same time, states will tax interest payments made by securities that were issued in other states.

The Kentucky state court, however, has ruled that the disparity in treatment of local municipal debt and debt from other states is a violation of commerce law, Alt adds. That appeals process has since been brought to the Supreme Court, which is expected hear the case this fall and reach a decision before June of next year.

A variety of factors imply that the Supreme Court is taking the litigation seriously, Alt maintains. For example, the Supreme Court ruled that states have the authority to restrict certain types of commerce to publicly operated enterprises.

The court reached the decision last month regarding *United Haulers Association v. Oneida-Herkimer Solid Waste Management Authority*. Local regulations within the state of New York specified that solid waste could be disposed of only within landfills operated by Oneida-Herkimer Solid Waste Management Authority, which is a public entity. In that case, United Haulers claimed that the policies interfered with interstate commerce. The Supreme Court, however, ruled that the regulations treated all privately owned landfills equally, so it didn't interfere with interstate commerce.

While landfills are pretty far removed from the fund industry, many of the concepts within the decision could apply to policies that states have regarding taxation of municipal bond funds, Alt says. With that in mind, the Supreme Court could have simply referred the matter back to the Kentucky Supreme Court with instructions to review it in the context of the recent United Haulers decision.

"It's a little surprising that they didn't do it," Alt says. "Normally, they would simply send the matter back to the state and say review it."

Yet, the Supreme Court may simply believe that the United Haulers decision isn't conclusive in regards to taxation issues of local debt. At the same time, the Supreme Court recognizes the significance of the matter.

"This is a really big item," Alt says. "They understand the basic bond scheme of some 40 states is called into question, and the Supreme Court realizes that that is important."

If the Supreme Court determines that the current taxation of municipal bonds is a violation of commerce regulations, then states would have two possible remedies. One would be to tax all municipal debt interest payments equally. A second would be to not tax interest payments on any municipal debt.

It is unclear which approach states would use, says Niels Holch, executive director of the Coalition of Mutual Fund Investors. Yet, most investors only purchase municipal securities from within their home states, since those bonds are tax favored.

States would probably lose only minimal tax revenues by dropping their taxes on interest payments made from municipal securities, Holch speculates. That could make dropping the taxes on out-of-state municipal interest payments more palatable for states, he says.

The end result is that investors could choose from among bond funds from a variety of states, which would give investors more choices, he says. Many baby boomers will turn to municipal bond funds for tax-free income, he notes. That could make taxing all municipal debt income troublesome for states.

Either way, the fund industry would need time to brace for any changes in taxation of municipal bond funds because the shift would be substantial, adds Paul Dykstra, a partner with **Bell, Boyd & Lloyd**.

"I would have to think that they would have some grace period when investments will be affected," he says.

Some investors may still prefer state-specific funds so they can make investments in their local communities or within cities that they are already knowledgeable about, he says. That factor, however, may still not provide enough demand for state-specific municipal bond funds. That's particularly true with smaller states that don't have larger populations of investors.

Municipal bond funds for those states tend to have higher expense ratios because they lack the economy-of-scale savings found in bigger funds. If the Supreme Court does throw out the current taxation of municipal bond funds, those smaller funds may be merged into other state funds in order to lower fund expense ratios, he maintains.

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