No. 06-

IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY and FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

versus

GEORGE W. DAVIS and CATHERINE V. DAVIS,
Respondents.

On Petition for a Writ of Certiorari to the Court of Appeals of Kentucky

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

PARTIES TO THE PROCEEDING

The Petitioners are the Department of Revenue and Finance and Administration of the Commonwealth of Kentucky.

The Respondents are George W. Davis and Catherine V. Davis.

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PETITION FOR A WRIT OF CERTIORARI

The Department of Revenue and Finance and Administration Cabinet of the Commonwealth of Kentucky respectfully petition this Court for a writ of certiorari to review the judgment rendered by the Kentucky Court of Appeals on January 6, 2006.

OPINIONS BELOW

The opinion of the Kentucky Court of Appeals is reported at 193 S.W.3d 557 (Ky. App. 2006). Pet. App. 1 - 13. The order of the Kentucky Supreme Court denying the Petitioner's motion for discretionary review of that opinion is unreported and is reprinted at Pet. App. 14. The order of the Jefferson Circuit Court that was reversed by the opinion of the Kentucky Court of Appeals is also unreported and is reprinted at Pet. App. 15 - 19.

STATEMENT OF JURISDICTION

The judgment of the Kentucky Court of Appeals was rendered on January 6, 2006. Pet. App. 1. The Petitioners timely filed a timely motion for discretionary review with the Kentucky Supreme Court on February 2, 2006, which was denied on August 17, 2006. Pet. App. 14. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Art. I, § 8, cl. 1 provides that "[t]he Congress shall have Power... To regulate commerce with foreign nations, and among the several States, and with the Indian tribes."

The relevant statutory and regulatory provisions – Ky. Rev. Stat. §§ 141.020 and 141.010 and 103 Ky. Admin. Regs. 17:060 – are reproduced at Pet. App. 20 - 23.

STATEMENT OF THE CASE

Kentucky law provides that "[a]n annual tax shall be paid for each taxable year by every resident individual of this state upon his entire net income as defined in this chapter." Ky. Rev. Stat. Ann. § 141.020(1). "The entire net income of a full-year resident individual is subject to Kentucky income tax regardless of its source" and "[i]ncome from out-of-state sources is not exempt." 103 Ky. Admin. Regs. 17:060 § 1. Persons who become Kentucky residents during the year and Kentucky residents who become non-residents during the year are subject to Kentucky individual income tax upon their entire net income from any source while they are Kentucky residents. 103 Ky. Admin. Regs. § 17.060 §§ 2 (1) and 3(1). *See also* Ky. Rev. Stat. Ann. § 141.010(4), (6), and (7).[1]

"Net income" is defined in Ky. Rev. Stat Ann. § 141.010(11) as "adjusted gross income as defined in [Ky. Rev. Stat. Ann. § 141.010(10)]," minus various deductions further enumerated in Ky. Rev. Stat. Ann. § 141.010(11). Kentucky "[a]djusted gross income" is defined in Ky. Rev. Stat. Ann. § 141.010(10) as "gross income as defined in [Ky. Rev. Stat. Ann. § 141.010(9)], minus the deductions allowed individuals by section 62 of the Internal Revenue Code and as modified by [Ky. Rev. Stat. Ann. § 141.0101]" and adjusted further in Ky. Rev. Stat. Ann. § 141.010(10).

"Gross income" is defined in Ky. Rev. Stat. Ann. § 141.010(9) as " 'gross income' as defined in Section 61 of the Internal Revenue Code." Under Section 61 of the Internal

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[1] A nonresident individual, on the other hand, is subject to Kentucky income tax "only upon the amount of [net] income received by him from labor performed, business done, or from other activities in this state, from tangible property located in this state, and from intangible property which has acquired a business situs in this state." Ky. Rev. Stat. Ann. § 141.020(4). *See also* 103 Ky. Admin. Regs. 17:060 § 4.

Revenue Code, "interest received by or credited to the taxpayer constitutes gross income and is fully taxable." 26 C.F.R. § 1.61-7(a). This "[i]nterest income includes . . . interest on coupon bonds [and] interest on a corporate bond or debenture." *Id.* "[G]ross income does not include interest on any State or local bond" — i.e., any "obligation of a State or political subdivision thereof." 26 U.S.C. §§ 61(a), 103(a) and (c)(1); 26 C.F.R. § 1.61-7(b).[2]

Among the adjustments made to this federal gross income to arrive at Kentucky adjusted gross income is the inclusion or add-back of "interest income derived from obligations of sister states and political subdivisions thereof." Ky. Rev. Stat. Ann. § 141.010(10)(c). The effect of this provision is to provide an exemption from Kentucky income tax for interest income from bonds or obligations of the Commonwealth of Kentucky and its political subdivisions.[3]

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[2] Ky. Rev. Stat. Ann. § 141.050(1) states:

> Except to the extent required by differences between this chapter and its application and the federal income tax law and its application, the administrative and judicial interpretations of the federal income tax law, computations of gross income and deductions therefrom, accounting methods, and accounting procedures, for purposes of this chapter shall be as nearly as practicable identical with those required for federal income tax purposes.

[3] This exemption is reinforced by a number of statutory provisions that specifically exempt bonds of the Commonwealth from taxation. *See, e.g.*, Ky. Rev. Stat. Ann. § 164A.200 (Kentucky Higher Education Student Loan Corporation bonds); Ky. Rev. Stat. Ann. § 198.200 (Kentucky Housing Corporation bonds); Ky. Rev. Stat. Ann. § 224A.210 (revenue bonds or notes issued by the Kentucky Infrastructure Authority); Ky. Rev. Stat. Ann. § 154.20-035(12)(Kentucky Economic Development Finance Authority bonds and notes); Ky. Rev. Stat. Ann. § 56.514(3)(revenue bonds, notes and other obligations issued by State Property and Buildings Commission); Ky. Rev. Stat. Ann. § 56.869 (notes issued by the Kentucky Asset/Liability Commission).

The Respondents are "individual residents of Jefferson County, Commonwealth of Kentucky" who paid Kentucky income tax "on interest income derived from obligations of sister states and/or their political subdivisions." They brought this action for declaratory and injunctive relief and tax refunds in the Circuit Court of Jefferson County, Kentucky. The Respondents asserted that Kentucky's income tax violated the Commerce Clause by "discriminat[ing] on its face against the holders of obligations of sister states and/or their political subdivisions . . . by imposing a tax and corresponding burden on such interest income that is greater than that imposed on interest income derived from obligations of the Commonwealth of Kentucky and its political subdivisions." They also alleged that Kentucky's law violated the Equal Protection Clause and Sections 3 and 171 of the Kentucky Constitution, because "it does not tax in-state interest and out-of-state interest, otherwise similar in economic substance, at the same rate."

The Petitioners moved for summary judgment.[4] On August 30, 2004, the Jefferson Circuit Court granted the Petitioners' motion. Pet. App. 15 - 19. The court relied upon the market participant doctrine in ruling that Kentucky's law did not violate the Commerce Clause. Pet. App. 18 (*citing Reeves, Inc.* v. *Stake*, 447 U.S. 429 (1980) and *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794 (1976)). The court observed that "[w]hen a state issues municipal bonds, it participates in the bond market by supplying bonds in the market and paying interest on those bonds."

[4] The Petitioner Department of Revenue is the department of the Petitioner Finance and Administration Cabinet that "exercise[s] all administrative functions of the [Commonwealth of Kentucky] in relation to the [Commonwealth's] revenue and tax laws." Ky. Stat. Ann. §§ 131.030(1); 12.020, II, 7; 42.012; 42.014.

Pet. App. 18. Finally, the circuit court found that Kentucky's law otherwise had "a reasonable, legitimate purpose" and was therefore constitutional. Pet. App. 19.

The Respondents appealed the circuit court's order granting the Petitioners' motion for summary judgment to the Kentucky Court of Appeals. On January 6, 2006, the Court of Appeals rendered an opinion vacating the circuit court's decision and remanding the case for further proceedings. Pet. App. 1, 13. The court held that "[c]learly, Kentucky's bond taxation system is facially unconstitutional [under the Commerce Clause] as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds."[5] Pet. App. 6. It found that "none of the arguments in favor of its constitutionality offered by the [Petitioners] or relied upon by the [circuit court] are sufficient to save it." Pet. App. 10. The Court of Appeals stated the following with respect to the market participant doctrine:

> The [Petitioners'] 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." Therefore, the [Petitioners'] market participant argument is without merit.

Pet. App. 10 (footnotes omitted).

Pursuant to Kentucky Civil Rule 76.20, the Petitioners timely filed a motion for discretionary review of the Court

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[5] The Court of Appeals did not reach the Respondents' other federal constitutional claim, stating that "[g]iven our Commerce Clause analysis, we also find it unnecessary to engage in an Equal Protection analysis." Pet. App. 11.

of Appeals' opinion with the Kentucky Supreme Court. On August 17, 2006, the Supreme Court denied the Petitioners' motion. Pet. App. 14.

REASONS FOR GRANTING THE WRIT

I. THIS CASE PRESENTS AN IMPORTANT QUESTION OF FEDERAL CONSTITUTIONAL LAW ON WHICH THE COURTS BELOW ARE DIVIDED.

This case presents a pure question of federal constitutional law not dependent on the presence or development of any particular facts. Relying upon the Commerce Clause, the Kentucky Court of Appeals held unconstitutional on its face a provision of Kentucky's income tax law that taxed the interest income from bonds issued by Kentucky's sister states and their political subdivisions, while not taxing interest income from bonds issued by Kentucky and its political subdivisions. Pet. App. 6.

This decision is squarely at odds with the decision of the Ohio Court of Appeals in *Shaper* v. *Tracy*, 97 Ohio App.3d 760, 647 N.E.2d 550 (1994), *motion to certify den.*, 71 Ohio St.3d 1477, 645 N.E.2d 1257 (1995), *cert. den.*, 516 U.S. 907 (1995). The court in *Shaper* upheld against Commerce Clause challenge a state income tax law indistinguishable from Kentucky's law. 647 N.E.2d at 552. The Ohio court found that "neither the Supreme Court nor any case law examined has applied the Commerce Clause to a case such as this, where one governmental entity is taxing its residents for the interest earned on bonds issued by another government entity." *Id.* at 552, 553. The Ohio Court of Appeals rejected the application of the market participant doctrine, although it recognized that "[e]ach state has a legitimate interest in tapping a major source of tax revenue while adding an incentive for investors to purchase state bonds" and that "[t]hose investors then become the major beneficiaries of the issuance of the bonds for state issues, capital improvements and similar benefits." *Id.* at 552, 553 (internal quotation marks omitted). The Ohio court instead upheld its law based upon its conclusion "that the Commerce Clause was simply never intended to apply to acts of a sovereign on behalf *of itself* where the end result is to provide the taxing state with a competitive advantage over *another* sovereign." *Id.* at 552, 553-54 (emphasis by court).

The significance of this issue runs both broad and deep. First, the issue affects the overwhelming majority of the states. Kentucky and Ohio are two of thirty-eight states whose income tax laws subject interest earned on bonds issued by other states and their political subdivisions to taxation while exempting interest earned on their own bonds.[6] *The Bond Buyer/Thomson Financial 2006 Yearbook at* 102-03 (Source Media 2006). Another four states

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6 Ala.Code § 40-18-14(3)f (2003); Ariz. Rev. Stat Ann. § 43-1021(3) (West 2006); Ark.Code Ann. § 26.51-404(b)(5) (Michie 2005); Cal. Rev. & Tax Code § 17133 (West 2004); Colo Rev. Stat. § 39-22-104(3)(b); Conn. Gen. Stat. § 12-505(a)(4)(B)(West 2000); Del. Code. Ann. tit. 30, § 1106(a)(1)a. (1997); Ga. Code. Ann. § 48-7-27(b)(1)(A)(Michie 2005); Haw. Rev. Stat. § 235-7(a)(5), (b)(2)(2002); Idaho Code § 63-3022 M(1) and (3)(b) (2000); Kan. Stat. Ann. § 79-32, 117(b)(i)(1997); La. Rev. Stat. Ann. § 47.293(6)(a)(West 2001); Me Rev. Stat. Ann., tit. 36 § 5122 (A)(West 2005); Md. Code Ann., Tax-Gen. §§ 10-203 and 10-204 (a) and (b)(2004); Mass. Gen. Laws. Ann. Ch. 62, § 2(a)(1)(A)(2001); Mich. Comp. Laws § 206 30 (1)(a)(West 2003); Minn. Stat. Ann. § 290.01 (19a)(1) (1)(West 1999); Miss. Code Ann. § 27-7-15(4)(d)(West 2006); Mo. Rev. Stat. § 143.121(2)(b)(West 2006); Mont. Code Ann. § 15-30-111(1)(a)(2005); Neb. Rev. Stat. § 77-2716(1)(c)(2003); N.H. Rev. Stat. Ann. § 77.4(I)(2001); N.J. Rev. Stat. § 54A: 6-14 (West 2002); N.M. Stat. Ann. § 7-2-2(B)(3) and (V)(2001); N.Y. Tax Law § 612(b)(1) (West 1999); N.C. Gen. Stat. § 105-134.6 (c) (1)(2005); N.D. Cent. Code § 57-38-01.2(1)(g)(2005); Ohio Rev. Code Ann. §

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exempt interest earned on some bonds issued by them or their political subdivisions while taxing interest earned on all bonds issued by other states and their political subdivisions. *Id.*[7] *See also* Scott K. Attaway, Note, *The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds* 76 B.U.L. Rev. 737, 738, n. 4 (1996).

Second, states and local governments rely heavily upon the issuance of debt to finance public projects. Justice O'Connor in her dissent in *South Carolina* v. *Baker*, 485 U.S. 505 (1988) observed:

> Long-term debt obligations are an essential source of funding for state and local governments. In 1974, state and local governments issued approximately $23 billion of new municipal bonds; in 1984, they issued $102 billion of new bonds. Report of Special Master 20. State and local governments rely heavily on borrowed funds to finance education, road construction, and utilities, among other purposes. As the Court recognizes, States will have to increase the interest rates they pay on bonds by 28-35% if the interest is subject to the federal income tax. *Ante*, at 511. Gov-

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5747.01 (A)(1)(West 2002); Okla Stat. Ann. tit. 68, § 2358(A)(1)(West 2002); Or. Rev. Stat. § 316.680(2)(a)(2005); 72 Pa. Cons. Stat. Ann. § 7302 and 7303(a)(3) and (6)(West 2000); R.I. Gen. Laws § 44-30-12(a) and (b)(1)(2005); S.C. Code Ann. § 12-6-1120(1)(West 2000); Tenn. Code Ann. § 67-2-104(e)(2003); Vt. Stat. Ann. tit. 32, § 5811(18)(A)(i)(II)(2005); Va. Code Ann. § 58.1-322 (B)(1)(2004); W. Va. Code § 11-21-12(b)(1)(2005).

[7] One state (Utah) exempts its own bonds and those out-of-state bonds purchased after January 1, 2003 from issuers in states that do not tax interest income received from Utah bonds. *Id.* One state (Indiana) exempts all interest on bonds issued by states and their political subdivisions. *Id.* Six states do not impose an income tax. *Id.*

> ernmental operations will be hindered severely if the cost of capital rises by one-third. If Congress may tax the interest paid on state and local bonds, it may strike at the very heart of state and local government activities.

Id. at 531-32. A recent publication of the Statistics of Income Division of the Internal Revenue Service reports:

> State and local governmental units issued nearly $2.1 trillion of tax-exempt bonds between 1996 and 2002. The majority ($1.5 trillion) of these tax-exempt bonds were Governmental bonds, the proceeds of which helped finance public projects (such as schools, streets, and utilities). The balance, $0.5 trillion, comprised private activity bonds, the proceeds of which were used for qualified facilities (such as airports, docks and wharves, and solid waste disposal facilities), as well as to benefit Internal Revenue Code section 501(c)(3) organizations (such as hospitals and private universities).

Cynthia Belmonte, *Tax-Exempt Bonds, 1996-2002*, at 151 (SOI Bulletin Summer 2005), available at http://www.irs.gov/pub/irs-soi/02govbnd.pdf.

Credit is of course a matter of vital importance to state and local governments. As the Georgia Supreme Court noted almost a century ago:

> The government, whether it be the state or one of its political subdivisions, is dependent, for the due exercise of its powers, on certain instrumentalities needful and proper in the matter with which it is dealing. Credit is absolutely indispensable to any government, whether it exists in the form of a state government or in the form of the government of one of the political subdivisions of the state. It becomes necessary, in the life of a state, as well as of its political subdivisions, to be able to establish credit in order to carry on successfully and properly the governmental functions. One of the most usual and ordinary methods of using the

> credit of a government is by the issue of securities and placing them in the markets of the world for sale.

Penick v. *Foster*, 129 Ga. 217, 58 S.E. 773, 775 (1907). The importance of credit extends to all levels of government. For 2002, "[a]lmost 50 percent of the total number of new money long-term Governmental bond issues were for small bonds with an issue price of less than $1 million." Belmonte, *supra* at 154. These bonds "were generally issued by smaller towns for purposes such as school buses, fire trucks, and other unspecified expenditures." *Id.*

Tax exemptions such as the one at issue in this case facilitate the vital function of borrowing by governments. Their role has been described as follows:

> If [outstanding public bonds] are held to be taxable, the inevitable result will be that the rate of interest is increased. If the rate of interest is increased, additional taxes would be required to pay it. No practical benefit would be derived. The operation of local government would be hampered and impeded and the funds and property of the issuing body materially affected.

In re Droll, 108 Neb. 85, 187 N.W. 876, 878 (1922). This point was echoed in *Fidelity Guarantee Mortgage Corp.* v. *Connecticut Housing Authority*, 532 F.Supp. 81 (D.Conn. 1982):

> The Connecticut Housing Finance Authority, ("CHFA"), was established by the Connecticut General Assembly in 1969 in order to alleviate the shortage of housing for low and middle income families and to encourage those families to settle in designated urban areas within the State. To achieve this end, CHFA is empowered to issue bonds the proceeds of which are made available as mortgage loans to qualified families. Because CHFA is a political subdivision of the State, the interest paid to bondholders on the bonds is tax exempt under provisions of the Internal Revenue Code.

> CHFA is thus able to offer the bonds at lower interest rates than would have to be paid by a private entity. This, in turn, enables CHFA to charge lower rates of interest on the mortgage loans to qualified borrowers.

Id. at 82 (footnotes omitted). *See also* Belmonte, *supra* at 151 (noting that tax exemption for state and local bond interest "effectively lowers the borrowing cost of tax exempt debt issuers, since bondholders are generally willing to accept an interest rate lower than that earned on comparable taxable bonds").

The decision of the Kentucky Court of Appeals, if allowed to stand, creates considerable uncertainty for a significant number of states and their political subdivisions in this critical area of public finance. State and local governments will not know for sure whether one of their costs of borrowing money will include providing "meaningful backward-looking relief" — tax refunds or the collection of back taxes from the impermissibly favored taxpayers — if their courts agree with the Kentucky Court of Appeals. *McKesson* v. *Division of Alcoholic Beverages and Tobacco, Department of Business Regulation of Florida*, 496 U.S. 18, 31, 39-41 (1990). They would also risk the complete loss of the ability to exempt their bonds or the interest therefrom if their courts opted for that approach as a prospective remedy. *Davis* v. *Michigan Dept. of Treasury*, 489 U.S. 803, 817-18 (1989)(stating that "[w]e have recognized, in cases involving invalid classifications in the distribution of government benefits, that the appropriate remedy 'is a mandate of equal treatment, a result that can be accomplished by withdrawal of benefits from the favored class as well as by extension of benefits to the excluded class' " and holding that the state courts were "in the best position to determine how to comply with the mandate of equal treatment").[8]

Under the Kentucky court's decisions, state and local governments will lose an important advantage in a limited market — their taxpayers — on which they rely as a source of funds raised through borrowing. Tax exemptions such as that at issue in this case allow state and local governments to pay less interest and offset advantages that bonds of other jurisdictions with higher credit ratings enjoy. *See* Robert Zipf, *How the Bond Market Works*, at 54 (2nd ed. 1997). The tax exemption influences a Kentucky resident to choose to acquire a bond issued by Kentucky or a Kentucky municipality over a bond issued by another state or other state's municipality that pays a higher rate of interest or has a stronger credit rating. If the Kentucky court's decision stands, state and local governments will lose this important edge in seeking to borrow from their taxpayers for the benefit of their respective constituencies.

Therefore, the practice held invalid by the Kentucky Court of Appeals is one that is not only widespread among the states, but one that is one of great ongoing importance to the funding of public projects. The issue presented by this case will therefore certainly arise again. If this issue is not addressed now, the dormant Commerce Clause will not only mean one thing in Kentucky and quite another in Ohio, but there will be considerable doubt and uncertainty as to the validity of a practice engaged in by the great majority of states. This is also a practice which the states

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[8] Similarly, prospective purchasers and holders of these bonds would face the risk of efforts to collect back taxes in the event of a state court's adherence to the Kentucky court's decision. *McKesson*, 496 U.S. at 39-41. They would also face the risk of losing the state tax exemption prospectively if a state court held that to be the appropriate remedy. *Davis*, 489 U.S. at 817-18.

substantially rely "to raise capital for essential public facilities, infrastructure, and general capital improvements." Belmonte, *supra* at 151.

The potential ramifications of the decision below therefore consist of the crippling, and possibly the demise, of a practice of great importance to the states and their taxpayers, particularly those who provide the very capital to fund needed infrastructure and other public purposes.[9] It is a practice that enables the states to raise needed funds and serve their citizens at less cost. This Court should address this issue now to eliminate the uncertainty as to the validity of this salutary practice.

I. THE DECISION BELOW IS AT ODDS WITH PRIOR DECISIONS OF THIS COURT AND PRESENTS AN IMPORTANT CONSTITUTIONAL QUESTION THAT SHOULD BE SETTLED BY THIS COURT

This Court has admonished that under the dormant Commerce Clause, "the result turns on the unique charac-

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[9] The significance of this case extends beyond its particular context. For example, the Kentucky court's decision in this case calls into question tax exemptions for property owned by a taxing state but not property owned by other states. *See, e.g., State* v. *City of Hudson*, 231 Minn. 127, 42 N.W.2d 546, 549 (1950); *State ex rel. Taggart* v. *Holcomb*, 85 Kan. 178, 116 P. 251, 253 (1911); *City of Cincinnati* v. *Commonwealth*, 292 Ky. 597, 167 S.W.2d 709, 714-15 (1942); *Warren County* v. *Hester*, 219 La. 763, 54 So.2d 12 (1951). The rationale behind tax exemptions for property of a state and its municipalities is that in the absence of such an exemption, the public would be taxing itself to raise money to pay itself. *See, e.g., Van Buren Hospital and Clinics* v. *Board of Review of Van Buren County*, 650 N.W.2d 580, 586-87 (Iowa 2002). Under the Kentucky court's decision in this case, one could argue that a state must treat property within its jurisdiction that is owned by another state in the same manner for tax purposes as its own property — despite the obvious absence of the public policy justification for the exemption.

teristics of the statute at issue and the particular circumstances in each case." *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318, 329 (1977). *See also Freeman* v. *Hewitt*, 329 U.S. 249, 252 (1946) ("Suffice it to say that especially in this field opinions must be read in the setting of the particular cases and as the product of preoccupation with their special facts"). The decision below failed to heed this admonition.

None of the decisions relied upon by the Kentucky Court of Appeals addressed facts even remotely similar to those presented by this case. Discrimination against interstate commerce in the contexts of those cases consisted of "economic protectionism – that is, 'regulatory measures designed to benefit in-state *economic interests* by burdening out-of-state *competitors*.' " *Associated Industries of Missouri, Inc.* v. *Lohman*, 511 U.S. 641, 647 (1994)(emphasis added). In *Oklahoma Tax Commission* v. *Jefferson Lines, Inc.*, 514 U.S. 175 (1995), this impermissible discrimination against interstate commerce was described as follows:

> A state may not "impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to *local business*." . . . Thus, States are barred from discriminating against *foreign enterprises* competing with *local businesses* . . . and from discriminating against *commercial* activity occurring outside the taxing State . . .

Id. at 197 (emphasis added)(citations omitted). Such is not the case here. Instead, what is at issue in this case is not a tax law that "benefit[s] a private industry or business in the state, to the detriment of out-of-state businesses," but one where a sovereign is acting on its own behalf in the service of its citizens in a manner that favors itself over other sovereign states. *Shaper*, 647 N.E.2d at 552.

The states are not mere economic interests or business enterprises, but sovereigns that function as such. *Alden* v.

Maine, 527 U.S. 706, 713-715 (1999); *New York* v. *United States*, 505 U.S. 144, 162-63, 188 (1992). This Court has fashioned the market participant doctrine, recognizing that "nothing in the purpose animating the Commerce Clause prohibits a State, in the absence of congressional action, from participating in the market *and exercising the right to favor its own citizens over others*." *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794, 810 (1976)(footnotes omitted)(emphasis added). This Court has further stated that:

> [t]he Commerce Clause responds principally to state taxes and regulatory measures impeding *free private trade* in the national marketplace . . . There is no indication of a constitutional plan to limit the ability of the States themselves to operate freely in the free market.

Reeves, Inc. v. *Stake*, 447 U.S. 429, 436-37 (1980)(emphasis added)(citations omitted).

"Restraint in this area," this Court stated in *Reeves*, is "counseled by considerations of state sovereignty, the role of each state as guardian and trustee for its people." *Id.* at 438 (internal quotation marks omitted). In rejecting a claim of economic protectionism in violation of the Commerce Clause, this Court further explained:

> We find the label "protectionism" of little help in this context. The State's refusal to sell to buyers other than South Dakotans is "protectionist" only in the sense that it limits benefits generated by a state program to those who fund the state treasury and who the State was created to serve. Petitioner's argument apparently also would characterize as "protectionist" rules restricting to state residents the enjoyment of state educational institutions, energy generated by a state-run plant, police and fire protection, and agricultural improvement and business development programs. Such policies, while perhaps "protectionist" in

> a loose sense, reflect the essential and patently unobjectionable purpose of state government — to serve the citizens of the State.

Id. at 442.

As we have seen *supra*, the purpose of the tax exemption in question is to facilitate government borrowing by making it less costly for the government to enter the capital market. The purpose of a state's entry into the market is to raise needed funding for government purposes and public projects. The tax exemption is an inducement to persons subject to the state's income tax law — primarily its residents — to loan the state needed funds. It makes bonds of Kentucky and its political subdivisions competitive in this limited market with corporate bonds and bonds of other states and their political subdivisions that pay higher rates of interest or that have better credit ratings.

Therefore, this is a case of a state participating in a market in such a manner as to favor its interests and citizens over others. *Hughes*, 426 U.S. at 809-10. The State is inducing its citizens (or those persons otherwise subject to its tax laws) to loan it money to finance public purposes and projects that benefit and serve those citizens. *See, e.g.*, Belmonte, *supra* at 151 ("A bond is an interest-bearing security of indebtedness, i.e., an obligation by the issuer to repay a certain sum of money by a future date, with interest payable at a specified rate"). The tax exemption is essential to the state's marketing of its bonds to its residents, a "discrete, identifiable class of economic activity in which the [state and its political subdivisions are] major participant[s]." *White* v. *Massachusetts Council of Construction Employers, Inc.*, 460 U.S. 204, 211, n. 7 (1983)(holding that dormant Commerce Clause was not violated by a city executive order requiring all construction projects funded in whole or in part by the city or by city funds to be performed by a work force consisting of at least half bona fide residents of the city).

The Kentucky Court of Appeals relied upon *New Energy Company of Indiana* v. *Limbach*, 486 U.S. 269 (1988) in rejecting the application of the market participant doctrine to this case. Pet. App. 10. The linchpin of its holding was the following passage from that opinion:

> The market-participant doctrine has no application here. The Ohio action ultimately at issue is neither its purchase nor its sale of ethanol, but its assessment and computation of taxes – a primeval governmental activity.

Id. at 277. This language must be read in light of the facts before the Court in that case, *see Boston Stock Exchange*, 429 U.S. at 329; *Freeman* v. *Hewitt*, 329 U.S. at 252, which consisted of the effect of a tax credit scheme upon *private* purchases and sales of ethanol. The Petitioners submit that the Kentucky action ultimately at issue in this case is Kentucky's participation in a limited segment of the bond market. The tax exemption at issue is part and parcel of that market participation and in this context is not simply a "primeval governmental activity."

The application of the market participant doctrine by the Kentucky Court of Appeals therefore conflicts with prior decisions of this Court. The meaning of the passage from *New Energy* relied upon by the Kentucky court is a matter that can only be settled by this Court.

The decision of the Kentucky Court of Appeals is also at odds with this Court's decision in *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881). At issue in that case was "whether the registered public debt of one State, exempt from taxation by the debtor State, or actually taxed there, is taxable by another State when owned by a resident of the latter State." 104 U.S. at 594. This Court held that "[w]e know of no provision of the Constitution of the United States which prohibits such taxation." Id. It reasoned:

> It is true, if a State could protect its securities from taxation everywhere, it might succeed in borrowing money at reduced interest; but, inasmuch as it cannot secure such exemption outside of its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as individuals. While the Constitution of the United States might have been so framed as to afford relief against such a disability, it has not been, and the States are left free to extend the comity which is sought, or not, as they please.

Id. at 595. This reasoning is consistent with that of the later case of *Georgia* v. *Chattanooga*, 264 U.S. 472 (1924):

> Land acquired by one State in another State is held subject to the laws of the latter and to all the incidents of private ownership. The proprietary right of the owning state does not restrict or modify the power of eminent domain of the state wherein the land is situated . . . The sovereignty of Georgia was not extended into Tennessee. Its enterprise in Tennessee is a private undertaking. It occupies the same position there as does a private corporation authorized to own and operate a railroad, and, as to that property, it cannot claim sovereign privilege or immunity.

Id. at 480-81 (citations omitted). *See also Nevada* v. *Hall*, 440 U.S. 410, 424-27 (1979) (holding that sovereign immunity of one state is not required to be honored by courts of another state).

The Kentucky Court of Appeals dismissed *Bonaparte* as inapplicable because the challenge there was premised upon the Full Faith and Credit Clause (Art. IV, § 1). Pet. App. 9. The *Bonaparte* Court's reasoning which formed the basis of its holding was not so narrow, however. It expressly stated that "*no provision* of the Constitution . . . prohibit[ed] such taxation," id. at 594 (emphasis added), and that a State outside of its own jurisdiction "must go into the market as a borrower, subject to the same disabilities in this particular as individuals." *Id.* at 595.

The decision of the Kentucky court conflicts with *Bonaparte*. Kentucky's law treats bonds of other states and their political subdivisions in the same manner as bonds issued by private issuers. The Kentucky Court of Appeals held that this was not enough; that instead Kentucky must effectively allow other states' sovereignty to cross state lines into Kentucky, thereby entitling those states' bonds to the same legal stature as bonds issued by Kentucky. This is squarely at odds with the conception of the extent of a state's sovereignty expressed in *Bonaparte* and later cases, as well as the holding of *Bonaparte* that any favorable tax treatment of another state's bonds was strictly a matter of comity on the part of the taxing state.

Perhaps viewed another way, the Kentucky court's decision overlooks the threshold Commerce Clause principle that "any notion of discrimination assumes a comparison of substantially similar entities." *General Motors Corp.* v. *Tracy*, 519 U.S. 278, 298-99 (1997). *See also Kraft General Foods, Inc.* v. *Iowa Dept. of Revenue*, 505 U.S. 71, 80, n. 23 (1992). With respect to Kentucky's taxing jurisdiction, other states and their political subdivisions are not similarly situated to Kentucky and its political subdivisions. Those other states do not come into the Kentucky market as sovereigns but instead as private entities. *Bonaparte*, 104 U.S. at 595.

Finally, the view of the dormant Commerce adopted by the Court below commandeers Kentucky's tax laws to subsidize other states' public debt if it wishes to exempt its own debt from taxation. In *New York* v. *United States*, the Court stated that "[i]n providing for a stronger central government, the Framers explicitly chose a Constitution that confers upon Congress the power to regulate individuals, not States." 505 U.S. at 166. "The allocation of power contained in the Commerce Clause, for example, authorizes Congress to regulate interstate commerce directly; it does not authorize Congress to regulate state governments' regulation of interstate commerce." *Id.* The Kentucky Court of Appeals' decision *mandates* what should instead be a matter of comity and is inconsistent with the Constitution's Tenth Amendment.

Therefore, the decision of the Kentucky Court of Appeals is contrary to prior decisions of this Court. It presents a pure question of law — the meaning and scope of the Constitution's dormant Commerce Clause — whose determination is dependent solely upon an analysis of this Court's precedents. Thus, it is an issue that can only be settled by this Court and one whose resolution cannot be aided by further consideration by lower courts.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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