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Tax Law ALERT

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Supreme Court Asked To Address State Taxation Of Bonds Issued By Other States

The United States Supreme Court has been asked to hear a case dealing with the manner in which states impose their income tax on bonds issued by other states or instrumentalities of other states. Depending upon the outcome, the case could impact the state tax liability of a substantial number of taxpayers. The State of Kentucky does not impose its income tax on the interest income from bonds issued by Kentucky or its political subdivisions, but does tax interest income on bonds issued by other states or their political subdivisions. This is a pattern followed by virtually all states that impose an income tax, including California and New York.

In *Davis v. Kentucky*, the Kentucky Court of Appeals held that exempting interest income from its own bonds but taxing the interest income from bonds issued by sister states is prohibited by the Commerce Clause of the United States Constitution (Article I, Section 8). The Commerce Clause gives the Congress the exclusive power to regulate commerce among the states. It has also been interpreted as prohibiting the states from enacting laws, including tax laws, that discriminate against interstate commerce. This aspect is referred to as the "dormant" commerce clause and as applied to state taxation, means that a state may not tax a transaction in interstate commerce more heavily than it would tax the same transaction if it occurred entirely within the state's borders.

The Kentucky Supreme Court declined to review the case so the Kentucky Department of Revenue filed a petition for certiorari, in which it has asked the United States Supreme Court to review the case. Because a Court of Appeals in Ohio has previously held that exempting interest from their bonds but taxing interest on another state's bonds is permitted under the Commerce Clause, there is a good chance that the Supreme Court will accept the case to resolve the conflict.

If the Supreme Court determines that this system of taxation does violate the Commerce Clause, taxpayers in many states may be entitled to receive refunds of state taxes paid in prior years, for those years that are still open under the applicable statute of limitations. In California the statute of limitations for individuals seeking a refund of taxes paid is the latest of: i) four years from the original due of the return without extensions; ii) four years from the date the return was actually filed if filed by the due date with extensions; or iii) one year from the date the tax was actually paid. In New York it is the latest of: i) three years from the original due date of the return without extensions; ii) three years from the date the return was actually filed if filed by the due date with extensions; or iii) two years from the date the tax was actually paid.

What Should You Do?

The statute of limitations for an individual claiming a refund in California for taxes paid attributable to the 2002 tax year, and in New York for the 2003 tax year, will close as early as April 17, 2007 for those individuals who filed on time or early. If you paid significant state income tax in these years attributable to bonds issued by other states or their political subdivisions, you should consider having your accountant file a protective refund claim before April 17, or the date otherwise determined to be applicable. You will have time to address subsequent years after the Court issues it decision.

Other types of taxpayers and taxpayers on a fiscal year may have different dates by which a claim for refund must be filed. Regular corporations (C corporations) in California and New York must pay tax on all of their state bond income, so this is not an issue for them.

A finding by the Court that the tax system is unconstitutional could be a mixed result for taxpayers. One way for states to cure the problem would be to impose tax on the interest income from their own bonds as well. Of course, this will increase the state's cost of issuing bonds. In California, the prohibition against imposing tax on California bonds is contained in the state's constitution so a constitutional amendment would be required in order for California to impose income tax on its own bonds.

We will publish another Client Alert when this issue is resolved. In the interim, please do not hesitate to contact us should you have any questions.

Tax Group

Los Angeles

C. DAVID ANDERSON	DANDERSON@LOEB.COM	310.282.2128
JOHN ARAO	JARAO@LOEB.COM	310.282.2231
MARLA ASPINWALL	MASPINWALL@LOEB.COM	310.282.2377
LEAH M. BISHOP	LBISHOP@LOEB.COM	310.282.2353
REGINA I. COVITT	GCOVITT@LOEB.COM	310.282.2344
TERENCE F. CUFF	TCUFF@LOEB.COM	310.282.2181
ANDREW S. GARB	AGARB@LOEB.COM	310.282.2302
THOMAS N. LAWSON	TLAWSON@LOEB.COM	310.282.2289
JEFFREY M. LOEB	JLOEB@LOEB.COM	310.282.2266
DAVID C. NELSON	DNELSON@LOEB.COM	310.282.2346
RONALD C. PEARSON	RPEARSON@LOEB.COM	310.282.2230
STANFORD K. RUBIN	SRUBIN@LOEB.COM	310.282.2090
PAUL A. SCZUDLO	PSCZUDLO@LOEB.COM	310.282.2290
ADAM F. STREISAND	ASTREISAND@LOEB.COM	310.282.2354
STUART P. TOBISMAN	STOBISMAN@LOEB.COM	310.282.2323
JOHN S. WARREN	JWARREN@LOEB.COM	310.282.2208
LAURA B. BERGER	LBERGER@LOEB.COM	310.282.2274
VIKRAM R. BHAGAT	VBHAGAT@LOEB.COM	310.282.2281
TARIN G. BROSS	TBROSS@LOEB.COM	310.282.2267
LINDA N. DEITCH	LDEITCH@LOEB.COM	310.282.2296
PAMELA J. DRUCKER	PDRUCKER@LOEB.COM	310.282.2234
STEVEN C. GOVE	SGOVE@LOEB.COM	310.282.2207
NEIL B. JANNOL	NJANNOL@LOEB.COM	310.282.2358
DEBORAH J. KORNEY	DKORNEY@LOEB.COM	310.282.2245
MIRIAM E. PAUL	MPAUL@LOEB.COM	310.282.2179
ALYSE N. PELAVIN	APELAVIN@LOEB.COM	310.282.2298
JONATHAN D. PETRUS	JPETRUS@LOEB.COM	310.282.2101
GABRIELLE A. VIDAL	GVIDAL@LOEB.COM	310.282.2362

New York

ELIOT P. GREEN	EGREEN@LOEB.COM	212.407.4908
JEROME L. LEVINE	JLEVINE@LOEB.COM	212.407.4950
LANNY A. OPPENHEIM	LOPPENHEIM@LOEB.COM	212.407.4115
LAURIE S. RUCKEL	LRUCKEL@LOEB.COM	212.407.4836
JOHN F. SETTINERI	JSETTINERI@LOEB.COM	212.407.4851
C. MICHAEL SPERO	MSPERO@LOEB.COM	212.407.4877
ALAN J. TARR	ATARR@LOEB.COM	212.407.4900
BRUCE J. WEXLER	BWEXLER@LOEB.COM	212.407.4081
PATRICIA J. DIAZ	PDIAZ@LOEB.COM	212.407.4984
H. SUJIN KIM	SKIM@LOEB.COM	212.407.4116
LAURA LAVIE	LLAVIE@LOEB.COM	212.407.4165
JENNIE E. MOONEY	JMOONEY@LOEB.COM	212.407.4181