No. 06-666

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 Kentucky Court Of Appeals

BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION

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COUNTERSTATEMENT OF THE CASE

The Commonwealth of Kentucky's revenue code taxes "interest income derived from obligations of sister states and political subdivisions thereof," KRS 141.010(10)(c) and 12(c), but expressly exempts from taxation the interest income from its own state and municipal bonds, Ky. Const. § 171. Respondents George W. Davis and Catherine V. Davis, on behalf of themselves and others (collectively herein the "Respondents" or "Davises"), brought this suit against the Petitioners, the Commonwealth of Kentucky Revenue Cabinet and Commonwealth of Kentucky Finance and Administration Cabinet (collectively herein the "Petitioners"), alleging that Kentucky's tax scheme violates the Commerce Clause. The Davises seek, on their own behalf and on behalf of all others who were also required to include as part of their state taxable income the earnings they received from bonds issued by states other than Kentucky, a declaration that the tax is unconstitutional, an injunction to prevent further enforcement of the tax, and a refund of the unconstitutional taxes paid.

The trial court entered summary judgment in favor of the Petitioners. The Kentucky Court of Appeals reversed the trial court's decision, finding that Kentucky's tax scheme facially discriminates against interstate commerce and thereby violates the Commerce Clause. *Davis v. Department of Revenue of the Finance and Administration Cabinet, et al.*, 197 S.W. 3d 557, 564 (Ky. Ct. App. 2006).[1]

[1] Having held the tax scheme unconstitutional as a violation of the Commerce Clause, the Kentucky Court of Appeals did not address the Davises' federal Equal Protection and state Uniformity Clause claims.

The Petitioners moved the Kentucky Supreme Court for discretionary review, which the court denied on August 17, 2006. Pet. App. at p. 14. The Petitioners then sought further review from this Court on November 9, 2006.

REASONS FOR DENYING THE WRIT

The Petitioners have presented no compelling reason for this Court to review the Kentucky Court of Appeals' finding that Kentucky's bond tax scheme violates the dormant Commerce Clause. The decision is wholly consistent with this Court's dormant Commerce Clause precedent, and the Petitioners have not presented any issue that needs further review or clarification by this Court. Instead, the Petitioners disregard this Court's long line of dormant Commerce Clause precedent and urge this Court to grant certiorari because other states have discriminatory tax schemes, and because Petitioners claim a need to discriminate to protect their illegally-secured market position.

Even if there is an issue of interest to this Court in this case, other state tax and appellate courts are currently considering the same issues presented by the Petition. The Court should deny the petition and allow these issues to percolate further in the state courts. Moreover, the only opinion to conflict with that of the Kentucky Court of Appeals – *Shaper v. Tracy*, 647 N.E.2d 550 (Ohio Ct. App. 1994) – was decided prior to this Court's further development of the dormant Commerce Clause law in *Camps Newfound/Owatonna v. Town of Harrison, Maine*, 520 U.S. 564 (1997), *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) and *Granholm v. Heald*, 544 U.S. 460 (2005), for example. Even *Shaper* is consistent with the

Kentucky Court of Appeals with respect to Petitioners' primary issue presented here, that is whether Kentucky acts as a "market participant" in its taxation of extraterritorial bond interest. Thus, it remains to be determined whether any conflict among the states currently exists.

I. THE KENTUCKY COURT OF APPEALS' DECISION IS WHOLLY CONSISTENT WITH THIS COURT'S EXTENSIVE COMMERCE CLAUSE PRECEDENT.

A. The Kentucky Court of Appeals' Decision Is Consistent with the Commerce Clause's Prohibition Against Discriminatory Taxes.

Kentucky's tax scheme at issue here taxes income coming into Kentucky from the bonds of sister states and their political subdivisions, but exempts from taxation income derived from in-state bonds, thus providing either beneficial or burdensome tax treatment based solely on the income's state of origin.

It is a well-settled principle of law that "'[a] State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State.'" *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334, 342 (1992) (quoting *Armco v. Hardesty*, 467 U.S. 638, 642 (1984)); *see also Fulton Corp. v. Faulkner*, 516 U.S. 325, 339 (1996) ("a state tax impermissibly discriminates against interstate commerce when the state's taxing power effectively increases the tax burden for out-of-state transactions, thereby coercing taxpayers to conduct intrastate rather than interstate business."). Indeed, "[t]ime and again this Court has held that, in all but the narrowest circumstances, state laws violate the Commerce Clause if they mandate 'differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.'" *Granholm v. Heald*, 544 U.S. 460, 472 (2005) (quoting *Oregon Waste Sys. v. Department of Environmental Quality of Oregon*, 511 U.S. 93, 99 (1994)).

Without question, Kentucky's bond tax scheme "effectively increases the tax burden for out-of-state transactions, thereby coercing taxpayers to conduct intrastate rather than interstate business." *Fulton Corp.*, 516 U.S. at 339. In fact, virtually admitting that it violates the Commerce Clause, the Petitioners argue that the *very purpose* of the tax scheme is to discriminate so as to give an advantage in the financial markets to the state's bonds over those of sister states (or of other competing non-governmental debt instruments), in order to induce its residents to purchase the former instead of the latter. *See* Pet. at p. 12, 16. The Kentucky Court of Appeals concluded that "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." Pet. App. at p. A6. As a result, the court properly held that "under the facts presented in this case, we have no choice but to find that Kentucky's system of taxing only extra-territorial bonds runs afoul of the Commerce Clause." Pet. App. at p. A10.

The Kentucky court's decision was based upon, and is fully consistent with, this Court's repeated interpretation of Commerce Clause restrictions on state regulatory measures that affect interstate commerce. Most recently, in *Granholm v. Heald*, in which this Court struck down restrictive wine importation laws in Michigan and New York that favored in-state producers over their out-of-state rivals. The Court reminded that "[w]hen a state statute directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry." *Granholm*, 544 U.S. at 487 (internal citations omitted); *see also New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273-74 (1988); *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334, 342 (1992).

The Court's condemnation of discriminatory statutes has been particularly strong in the context of taxation. *See Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 331 (1977) (Court invalidating New York statute that reduced the transfer tax on securities sales if the sale of securities took place on an exchange within the state because the tax scheme "foreclos[ed] tax neutral decisions" and "creat[ed] both an advantage for the exchanges in New York and a discriminatory burden on commerce to its sister States."); *Fulton Corp. v. Faulkner*, 516 U.S. 325, 328 (1998) (Court invalidating as violative of the Commerce Clause North Carolina's "intangibles tax" under which the state allowed residents a tax deduction in an amount "equal to the fraction of the issuing corporation's income subject to tax in North Carolina").[2]

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[2] The Court reasoned:

> There is no doubt that the intangibles tax facially discriminates against interstate commerce. A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Id. at 333.

The Kentucky courts have consistently adhered to and enforced this Court's Commerce Clause jurisprudence, striking down another of Kentucky's discriminatory state taxes, an *ad valorem* bank deposit tax, because it taxed out-of-state bank deposits at a higher rate than in-state deposits. *See St. Ledger v. Commonwealth of Kentucky, Revenue Cabinet*, 912 S.W. 2d 34, 39 (Ky. 1995), *vacated on other grds.*, 517 U.S. 1206 (1996). The Kentucky Supreme Court reasoned:

> Residents making a choice of where to deposit funds will be influenced by the higher tax rate on out-of-state deposits. As a result, the statute "forecloses tax-neutral decisions and creates both an advantage for the [Kentucky banks] and a discriminatory burden on commerce to its sister states."

St. Ledger, 912 S.W. 2d at 39 (quoting *Boston Stock Exchange*, 429 U.S. at 331). Describing itself as "bound by constitutional proscriptions," the Kentucky high court found the discriminatory tax "clearly violative of the commerce clause." *Id.*

The tax schemes found infirm in all of these cases ensured that a taxpayer would consider the state tax implications of his transactions in deciding where to conduct business. The same is true here; in fact, according to the Petitioners, that is its very purpose. Pet. at p. 12, 16. Thus, the Kentucky court's decision invalidating the challenged tax scheme as facially unconstitutional under the Commerce Clause rests on solid precedent. Nothing provided by the Petitioners here suggests otherwise.

The fact that other states have similar protectionist tax measures does not bolster the Petitioners' argument against this Court's Commerce Clause precedent. Rather, as this Court found in *Granholm*, it is simply evidence of the balkanizing effect of discriminatory tax provisions:

> The current patchwork of laws – with some States banning direct shipments altogether, others doing so only for out-of-state wines, and still others requiring reciprocity – is essentially the product of an ongoing low-level trade war. Allowing States to discriminate against out-of-state wine "invite[s] a multiplication of preferential trade areas destructive of the very purpose of the Commerce Clause."

Granholm, 544 U.S. at 473; *see also* Jerome R. Hellerstein and Walter Hellerstein, STATE TAXATION at ¶ 4.13[2][e] (3d ed. 2001) (referring specifically to discriminatory state and municipal bond taxes at issue here and concluding "if ever one needed proof that such discriminatory state taxes [on extraterritorial state and municipal bond interest] Balkanize our national capital markets, one need look no further than the state-specific municipal bond funds that have arisen directly as a result of these discriminatory state taxes.").

B. The Kentucky Court of Appeals' Decision, Consistent with this Court's Precedent, Found No Valid Justification for Kentucky's Discriminatory Tax.

Facially discriminatory taxes, like Kentucky's bond tax scheme, "[are] virtually *per se* invalid," *Oregon Waste*, 511 U.S. at 99; *see also Granholm*, 544 U.S. at 476. Such "state statutes that clearly discriminate against interstate commerce are routinely struck down, unless the discrimination is demonstrably justified by a valid factor *unrelated to economic protectionism*." *New Energy Co. of Indiana*, 486

U.S. at 273-74 (emphasis added); *see also Granholm*, 544 U.S. at 487 ("When a state statute directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry.") (internal quotations omitted); *Chemical Waste Management*, 504 U.S. at 342 (same).

When faced with a Commerce Clause challenge to a facially discriminatory statute, the state must provide "more than mere speculation to support discrimination against out-of-state goods. The burden is on the State to show that the *discrimination* is demonstrably justified." *Granholm*, 544 U.S. at 492 (internal quotations omitted) (emphasis in original). The Petitioners offered ***no*** valid justification to the Kentucky courts (or this Court), much less a compelling one, for their discriminatory tax scheme.

1. Economic Protectionism Is Not a Valid Justification for Discrimination.

Despite this Court's repeated admonition that a legitimate justification must be "unrelated to economic protectionism," the Petitioners boldly admit that the only purpose for their discriminatory bond tax scheme *is* economic protectionism:

- "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. . . ." Pet. at p. 12.

- "It [the tax scheme] makes bonds of Kentucky and its political subdivisions competitive in this limited market with corporate bonds and bonds of other states. . . ." Pet. at p. 16.[3]

The Kentucky court recognized that fact, and for that reason, correctly held Kentucky's tax scheme unconstitutional.[4]

2. The Petitioners' Proffered Financial Implications of the Kentucky Court of Appeals' Decision Are Both Unsupported and Incorrect, Providing No Valid Justification for the State's Discriminatory Tax Scheme.

In the absence of any legal error in the Kentucky Court of Appeals' decision, the Petitioners have resorted to factually unsupported policy arguments, claiming that the court's decision will wreak financial havoc on the state. At least one economic study, however, refutes the Petitioners' arguments, concluding that states would actually *benefit* by ceasing their practice of exempting taxes on income derived from in-state bonds. *See* Cole, C. Steven, *et al.*, "The Capitalization of the State Tax Exemption Benefit in Municipal Bond Yields," 7 J. Fin. and Strategic Decisions 67 (Summer 1994) (available at http://www.studyfinance.com/

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[3] These admissions also refute the Petitioners' claims that Kentucky is "not similarly situated with" other states. Indeed, if they were not similarly situated, then Kentucky would have no need to discriminate in order to compete with the other states.

[4] As Petitioners admit, Pet. at p. 16, Kentucky's use of its taxation power to gain market share from competing states also puts nongovernmental issuers of debt securities at a disadvantage and deprives investors of a free and open market.

jfsd/pdffiles/v7n2/cole.pdf#search+'journal%20decisions%20capitalization%20of%20the%20state%20tax%20exemption').
The authors of that study reported that:

> [T]he costs to the state in the form of the lost tax revenues due to tax exemptions is significantly greater than the benefit in the form of reduced yields for in-state bond issues. In other words, the tax exemption is not a beneficial way to stimulate demand for in-state bond issues.

Id. at 68. Thus, whereas the Petitioners may speculate that they can reduce their borrowing costs by exempting taxes of in-state buyers, this study concluded otherwise, finding "that the cost to the states in the form of lost tax revenues is significantly greater than the estimated benefit of reduced interest costs to in-state issuers." *Id.* at p. 73. This conclusion is further supported by the fact that other states, such as Illinois, do not discriminate and yet have not experienced the grave financial impacts about which the Petitioners speculate. Instead, if the states would simply comply with the Commerce Clause and either tax all state and municipal bond interest or exempt all such bond interest, the states, taxpayers and investors would all benefit.

Discrimination arbitrarily limits the market for a state's bonds. By exempting interest earned on its own financial instruments from state income tax, while taxing the interest earned on the other states' financial instruments, Kentucky has limited the market for its own investment offerings by offering an uncompetitive after-tax interest rate to non-residents. By complying with the Constitution, states will open their investment sales to the entire national market for debt instruments.[5] Thus, the Petitioners' desire to protect an unconstitutional tax scheme may actually be to the state's financial detriment and again refutes any need for review by this Court.

C. Actions of Market Regulators Are *Not* Exempt from the Commerce Clause.

The Petitioners argue that this Court should grant review because their discriminatory tax scheme is nothing more than the act of a "market participant" and so not subject to Commerce Clause restrictions. This Court has regularly rejected arguments, such as the Petitioners make here, that attempt to equate taxation with market participation. In *New Energy Co. of Indiana*, for example, the Court held that the market participant doctrine did not shelter an Ohio sales tax credit given for the sale of ethanol produced in Ohio or in a sister state that gave a similar tax credit for ethanol produced in Ohio, but not for ethanol produced in other states. The Court explained:

[5] Once states compete in the financial markets without the protective benefit of coercive tax schemes, they will have to be more selective in what projects they choose to fund. They will compete for investors' dollars not just with respect to the interest rate offered, but on the merits of the projects funded by the investment sales. Indeed, Petitioners admit that a purpose of Kentucky's discriminatory tax scheme is to attract investors away from competitors' more creditworthy investments. Pet. at p. 12. As a result, the market will provide incentives for governments to be more careful in selecting and funding projects through bond sales. Likewise, investors will benefit from greater investment choices. Rather than being coerced by competing state tax codes to invest in their home states' projects – even if those bonds are less secure or fund less beneficial projects than those sold by competing states – they can choose their debt investments from a wider menu.

> 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. To be sure, the tax credit scheme has the purpose and effect of subsidizing a particular industry, as do many dispositions of the tax laws. That does not transform it into a form of state participation in the free market.

New Energy Co. of Indiana, 486 U.S. at 277.

The Court similarly held in *Camps Newfound/Owatonna, Inc.* that "a tax exemption statute cannot be characterized as a proprietary activity falling within the market-participation exception. . . . A tax exemption, even one that has the effect of a subsidy, is not the sort of direct state involvement in the market that falls within the market-participant doctrine." *Camps Newfound/Owatonna, Inc.*, 520 U.S. at 593; *see also Walling v. People*, 116 U.S. 446, 455 (1886) ("a discriminatory tax . . . is, in effect, a regulation in restraint of commerce among the States. . . .").

Thus, while a state may lawfully enter the market and engage in trade as a market participant the same as a private citizen, this Court has resolutely held that the basis for the market participant doctrine lies in the state's proprietary use of its own resources, *not* in the exercise of its regulatory taxing authority. Indeed, "[t]he grant of a tax exemption is not sponsorship since the government does not transfer part of its revenues," *Walz v. Tax Comm'n of City of New York*, 397 U.S. 664, 675 (1970), such as a market participant would. *See, e.g., Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 806-10 (1976) (state held to be market participant due to the fact that it bought scrap metal). The fact that Kentucky's tax scheme may benefit its actions as a market participant does not render its act of taxation one and the same as a market participant. A state's exercise of its taxing power is a separate and distinct action; and as this Court repeatedly has noted, taxation is the quintessential action of a market regulator, not a market participant. Such regulatory actions are always subject to the Commerce Clause restrictions of the state's power.[6]

Thus, as the Kentucky Court of Appeals correctly found, while it may be true that Kentucky acts as a market participant in the *sale* of its bonds, it clearly does not do so in *taxing* the income from the bonds of other states while exempting the income its residents derive from intrastate bonds. *See Shaper v. Tracy*, 647 N.E. 2d 550, 552 (Ohio Ct. App. 1994) ("[W]hen a state chooses to sell bonds and enter into the securities market, it is acting as a market participant. However, when a state chooses to tax its citizens, it is acting as a market regulator."). Although the Petitioners attempt to blur that distinction, their arguments are contrary to this Court's precedent and provide no reason for this Court to grant review in this case.

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[6] Moreover, it is well-established that a state may be a market participant in one aspect of a program while operating as a market regulator in implementing another. Therefore, courts must carefully review every aspect of a state's activity to determine whether it is one of a market participant or market regulator, *see, e.g., South-Central Timber Development v. Wunnicke*, 467 U.S. 82, 97-99 (1984) (Court distinguishing between state's action as market participant and market regulator), contrary to the Petitioners' attempt to blend the two separate actions into one.

D. The Kentucky Court of Appeals, Consistent with this Court's Precedent, Properly Held the State's Powers of Taxation Subject to the Commerce Clause.

To suggest that the Commerce Clause was not intended to apply where a state "is acting on its own behalf," Pet. at p. 14, is completely lacking in merit. This Court refuted this argument in *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82 (1984), wherein the State of Alaska attempted to restrict its sale of timber from state lands through the use of its state regulatory authority.[7] Furthermore, the argument is consistent with "[t]he very purpose of the Commerce Clause [which] was to create an area of free trade among the several states." *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 330 (1944); *see also Boston Stock Exchange*, 429 U.S. at 329 (Recognizing that the inherent limitation of a state's power to discriminate against interstate commerce "follows inexorably from the basic purpose of the Clause.").

The Petitioners' cited authority for this argument, the Ohio Court of Appeals' decision in *Shaper*, provides no support for their conclusion that the Commerce Clause does not apply to a state's tax designed to favor itself in its market activities. Indeed, unlike the Kentucky Court of Appeals here, the *Shaper* court failed to consider this Court's prior holdings that support the opposite conclusion.

[7] The Court reasoned that "although the State may be a participant in the timber market, it is using its leverage in that market to exert a regulatory effect in the processing market . . . " and thus violating the Commerce Clause. *Id.* at 98.

The Petitioners' reliance on *Reeves, Inc. v. Stake*, 447 U.S. 429 (1980), is similarly misplaced. Although the Petitioners cite *Reeves* as providing that under the Commerce Clause, there is "no indication of a . . . plan to limit the ability of the States themselves to operate freely in the free market," Pet. at 15 (quoting *Reeves*, 447 U.S. at 437), this quote is taken out of context. The Petitioners fail to include this Court's citation to Professor Tribe's discussion of the Commerce Clause which puts the statement in its proper context. *See Reeves*, 447 U.S. at 437 (quoting L. Tribe, American Constitutional Law 336 (1978) ("the commerce clause was directed, as an historical matter, only at regulatory and taxing actions taken by states in their sovereign capacity")). The Petitioners' inaccurate recounting of this decision is even more apparent when viewed in conjunction with the immediately preceding paragraph which insightfully provides, "[t]he basic distinction drawn . . . between States as market participants and States as market regulators makes good sense and sound law. . . . [T]he Commerce Clause responds principally to state taxes and regulatory measures impeding free private trade in the national marketplace. . . ." *Id.* at 437.[8]

[8] The Petitioners' only other authority cited in support of this argument, *Bonaparte v. Tax Court*, 104 U.S. 592 (1881), is equally unpersuasive. As the Petitioners candidly admit, the tax in *Bonaparte* was not challenged on Commerce Clause grounds, nor was the type of discriminatory tax challenged here at issue in *Bonaparte*. Instead, that case dealt only with the question of whether one state could tax interest earned by its own residents on the debt of another state. As the Court explained:

> The question we are asked to decide in this case is 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.

(Continued on following page)

To adopt the Petitioners' argument that the Commerce Clause does not apply to a state's taxation "on behalf of itself where the end result is to provide the taxing state with a competitive advantage over another sovereign" (Pet. at p. 14) would render the dormant Commerce Clause utterly meaningless and undo over a century of Commerce Clause precedent. Invariably, in any case involving the dormant Commerce Clause, one state discriminates (often by using its sovereign powers of taxation) in order to obtain a competitive advantage; and the argument could always be made that the competitive advantage sought was intended ultimately to benefit the state itself, usually with more income. Such "revenue generation[, however,] is not a local interest that can justify discrimination against interstate commerce." *C&A Carbone v. Town of Clarkstown*, 511 U.S. 383, 393 (1994). Moreover, the Court has clearly instructed that "[t]he paradigmatic . . . law discriminating against interstate commerce is the protective tariff or custom duty . . . ," *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 193 (1994), the income from which will always benefit the state.

Against this backdrop, the Court has long adhered to the principle that while "[a] State's power to lay and collect taxes, comprehensive and necessary as that power is, *cannot* be executed in a way which involves a discrimination against [interstate] commerce." *Camps Newfound/Owatonna*, 520 U.S. at 576 (quoting *Pennsylvania v. West*

Bonaparte, 104 U.S. at 594. The question here is not whether Kentucky can tax its residents' income from other states' municipal bonds, but rather whether it can do so while at the same time exempting from taxation income derived from its own bonds. The *Bonaparte* court was not faced with the latter issue, and its holding is irrelevant to its resolution.

Virginia, 262 U.S. 553, 596 (1923)); *see also Chemical Waste Management, Inc.*, 504 U.S. at 342 (quoting *Armco*, 476 U.S. at 642) (tax discriminates in violation of the Commerce Clause if it "tax[es] a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State."); *Fulton Corp.*, 516 U.S. at 331 ("a state tax impermissibly discriminates against interstate commerce when the state's taxing power effectively increases the tax burden for out-of-state transactions, thereby coercing taxpayers to conduct intrastate rather than interstate business."); *Oregon Waste*, 511 U.S. at 99 (a tax that discriminates against interstate commerce "is virtually *per se* invalid"). As evident from this long line of precedent, a state's power to tax is subject to, and limited by, the Commerce Clause regardless of the purpose for the tax. The Court has never suggested otherwise.

E. The Kentucky Court of Appeals' Decision Does Not Contravene the Tenth Amendment.

As their last effort, the Petitioners suggest that the Kentucky court's decision may run afoul of the Tenth Amendment because it allegedly would require Kentucky to exempt from taxation income from other states' bonds. The decision below contains no such requirement, but instead requires only that Kentucky tax intrastate income no differently than interstate income.

In any event, where, as here, the plaintiff has challenged the constitutionality of a state's tax scheme, the Tenth Amendment does not apply. The Tenth Amendment is merely a restraint on *Congressional* efforts to "compel the States to enact or enforce a federal regulatory program," *Reno v. Condon*, 528 U.S. 141, 149 (2000), and is concerned with Congressional actions "seek[ing] to control or influence the manner in which States regulate private parties." *South Carolina v. Baker*, 485 U.S. 505, 514 (1988). In the present case, of course, it is the Constitution, not an act of Congress, that prohibits Kentucky's discriminatory tax scheme. Moreover, "[t]hat a State wishing to engage in certain activity must take administrative and sometimes legislative action to comply with federal standards regulating that activity is commonplace and presents no constitutional defect." *Baker*, 485 U.S. at 514-15.

II. THE PETITION IS PREMATURE.

Even if the Petitioners had presented an issue for potential review by this Court, there is no need for the Court to address it at this time. As demonstrated above, the Kentucky Court of Appeals' decision is wholly consistent with this Court's dormant Commerce Clause precedent. In addition, although the Petitioners correctly state that the Ohio and Kentucky Courts of Appeals reached different outcomes in the *Shaper* case and this case, even the Ohio court rejected the principal argument presented by the Petitioners as the basis of their petition here, that is, Kentucky's taxation of out-of-state bond interest is the action of a market participant. Consistent with the Kentucky court in this case, the Ohio court concluded, "when a state chooses to sell bonds and enter into the securities market, it is acting as a market participant. However, when a state chooses to tax its citizens, it is acting as a market regulator." *Shaper*, 647 N.E.2d at 552. Thus, the Petitioners' claim that their discriminatory actions of taxing bond interest on other states' bonds are those of a market participant finds no support in the law, not even from the

Ohio courts; and there is no meaningful conflict among the states on this issue.

Moreover, perhaps explaining its lack of discussion of other relevant Commerce Clause principles, the Ohio decision was rendered well over a decade ago, preceding some of this Court's key Commerce Clause decisions on discriminatory taxes, such as *Camps Newfound/Owatonna*, 520 U.S. 564 (1997) and *Fulton Corp. v. Faulkner*, 516 U.S. 325, 339 (1996).

Finally, the same issue is currently pending before other state tax and appellate courts, including North Carolina and Arizona, but has not yet fully developed in those states. Thus, even if these issues are of interest to the Court, it should refrain from reviewing them until more courts have had the chance to weigh in. Moreover, the passage of time will reveal if there is truly a "split" among the states or if any question of the Commerce Clause's application to states' regulatory powers exists that would necessitate this Court's review of those issues. Until then, these issues are best addressed by the states in accordance with this Court's extensive Commerce Clause precedent.

CONCLUSION

The Petitioners have presented no compelling reason for this Court to review this case; accordingly, the petition for writ of certiorari should be denied.

Respectfully submitted,

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