

# DAVIS v. KENTUCKY: RESOLVED

On May 19, 2008, as expected, the Supreme Court ruled in favor of Kentucky maintaining the status quo and allowing states to continue the practice of exempting interest on bonds issued within their borders while imposing income taxes on out of state issues.

The majority opinion of the Justices (7-2) stated that the Constitution did not prohibit the ability of the 42 States who currently make this distinction for tax purposes from continuing the practice.

The greatest potential impact of the alternative decision would have been felt by those states with the highest income taxes such as California, New Jersey and New York effectively raising the cost of state and local borrowings while negatively impacting the market value of outstanding municipal bonds.

We did not alter our investment process or strategy because in the event of an unlikely negative decision the cost of the hedge (state diversification) outweighed the benefits. The rationale for this decision was detailed in an October 2007 Special Commentary below.

In 2006, the Kentucky Court of Appeals ruled that the State of Kentucky violated the US Constitution's dormant Commerce Clause by exempting in-state municipal bond interest from taxation while taxing interest received on out-of-state municipal bonds. The case, known as *Davis v. Kentucky*, will now be heard by the US Supreme Court in its current session with a ruling expected to be announced sometime before June, 2008. Since the vast majority of states follow Kentucky's practice, a decision to uphold the Kentucky Court's ruling (and disallow a tax preference for in-state bonds) could have a material impact on the municipal market. It is our opinion that, overall, supply and demand for municipals would remain constant, but yield relationships within the market could shift noticeably with bond yields of higher tax states likely to rise while bond yields of states with no tax may actually fall.

As a manager of both national and state-specific portfolios, Breckinridge must pay close attention to this case and its potential impact on the relative performance of bonds throughout the market. Even a minor adjustment in yield relationships would be sufficient to change our strategy if we were convinced that the Supreme Court was likely to uphold the Kentucky ruling. Our view, however, is that it is far more likely that the decision will be overturned - preserving the status quo. We recognize we lack any special insight in making that judgment. Therefore, our approach in assessing the merits of a change in strategy has been to give the probability of either outcome an equal weighting. In the end, we conclude that the potential adjustment in yield relationships is still not sufficient to warrant a change in our current strategy for any of the portfolios we manage; single-state or national.

## OVERVIEW OF THE CASE

The Constitution's Commerce Clause gives Congress authority to regulate interstate commerce. The Clause is silent (dormant) with regard to the states having any such authority, so courts have interpreted that to mean that it's Congress's right exclusively. As a result, states have been generally forbidden from making any laws that discriminate against out-of-state enterprises. Since Kentucky's tax was discriminatory, this was the basis for the Kentucky Court's ruling. Over the years, however, the Supreme Court has allowed some exceptions to the dormant Commerce Clause. The two notable exceptions in this case are for a *Government Enterprise* and a *Market Participant*.

### *GOVERNMENT ENTERPRISE*

In a recent Supreme Court case, *United Haulers v. Oneida-Herkimer County*, the Court clearly broadened the exception for government enterprises. Specifically, in a 6-3 decision the Court ruled that government did not violate the dormant Commerce Clause when discriminating against out-of-state interests if:

- a) The discrimination favored a government entity rather than an in-state private business and...
- b) The discrimination occurred while the government was performing a traditional government function with a clear public benefit.

Kentucky's tax preference for in-state bonds would appear to pass these tests. The state's exemption of in-state interest only favors in-state governments (versus businesses) and raising capital certainly qualifies as both a traditional and important government function. Opponents of this view rely on a much narrower interpretation of the *United Haulers* decision arguing that the justices did not intend to extend the Government Enterprise exception to states that discriminate against other states.

### *MARKET PARTICIPANT*

Courts have long held that governments are free to favor local businesses (contractors, underwriters, bond attorneys, etc) when participating in a market. Kentucky plainly acts as a participant in the municipal bond market when it issues bonds. Therefore, the state maintains it has the right to promote the sale of its bonds by making them tax-exempt for its constituents. In effect, the exemption is simply a subsidy just as any business might offer to improve its prices and marketability. The Kentucky Court disagreed - ruling that once the State levies a tax on out-of-state bonds, its role changes from "market participant" to "market regulator" and the exception from the dormant Commerce Clause is no longer applicable. In other words, they viewed the preference as a tax penalizing out-of-state bonds rather than subsidy favoring in-state bonds. We believe The Supreme Court may take the other view – however, because of the uniqueness of this case it's hard to speculate on this particular argument.

## OTHER FACTORS

Supreme Court Justices are sworn to strictly uphold the Constitution, but it's unlikely they can completely ignore the consequences of changing a long standing practice. If the preference for in-state bonds is disallowed, legal precedent suggests that states would be liable for refunds of past taxes on out-of-state bonds. Fiscally, it could be quite painful.

States that try to eliminate the preference by taxing all municipal bond interest would have serious problems, both legally and politically. Taxing outstanding in-state bonds would be particularly difficult. Reflecting this concern, all 49 state treasurers (even those from states with no income tax) signed a brief urging the Supreme Court to overturn the Kentucky Court's ruling. Finally, it would be hard to argue that Congress, whose job it is to regulate interstate commerce, has been oblivious to the preference many states have granted in-state bonds for almost 100 years. Congress has allowed it, so the Supreme Court may well assume Congress has no objection to it.

## ANALYSIS OF RISK

On balance, we think the arguments for overturning *Davis v. Kentucky* are much more compelling, but the outcome is far from certain. Therefore, the possibility that states may no longer be allowed to give a tax preference to their bonds needs to be assessed. First, that means analyzing how much yield spread relationships are likely to change and the impact on performance for state-specific portfolios. Then, to the extent the value of some bonds would decline, the cost of restructuring a portfolio to avoid that risk must be determined. Finally, that cost needs to be weighed against an unbiased measurement of risk to evaluate whether the strategy is worthwhile.

Eliminating state tax preferences would eliminate much of the municipal market's segmentation. No longer would supply and demand be carved up into numerous "specialty-state" markets. Since almost all municipal bonds would be state tax-exempt, yields for issuers of similar quality (sector, rating, etc.) with similar structures (maturity, coupon, call features, etc.) would converge across the entire market at some fairly uniform level. States with high tax rates would see their yields rise (prices fall) as the supply of state-exempt bonds expanded to include the entire municipal market. Demand from these states would, in turn, extend into lower tax states, thereby causing yields in those states to decline (prices rise).

Despite these changes, there is no reason to expect an appreciable shift in the balance of supply and demand for the municipal bond market as a whole. If supply and demand remain constant, so too would the average yield for the overall municipal market. This average yield would then represent the equilibrium to which all state markets would become more closely aligned. Analyzing the potential impact of *Davis v. Kentucky* is a matter of measuring the average yield in the overall municipal market and then comparing it to yields in specific state markets. The difference, positive or negative, represents the amount that yields in a state will need to rise or fall in adjusting to the new equilibrium.

Measuring average bond yields for the overall municipal market and each major single state market is somewhat of a challenge. Our analysis will focus on just the high grade, intermediate-term segment of the market. Rather than rely on published yield curves and indices, we believe using actual yields of Breckinridge portfolios will provide more relevant data. Breckinridge manages a very large sample of national and state specific portfolios with very consistent profiles in terms of both structure and credit quality. Table-1 lists the average yield of the combined portfolios in each mandate as of 6/30/07. The average yield for the overall market is calculated by weighting the yield for each state mandate according to its 2007 market volume. The yield for the national market portfolios is weighted by the combined volume of *general market* states. Using this approach, we calculate an average municipal market yield of 4.002%. This represents the equilibrium yield for Breckinridge portfolios as of 6/30/07. In other words, on that date, absent any state tax preferences, the average market yield for ALL Breckinridge portfolios, both national and state-specific, would have been have been roughly 4.002%.

Of course, on June 30, 2007, state tax preferences did exist which is why yields for Breckinridge portfolios differed depending on the particular state mandate. Not surprisingly, the largest yield difference was for portfolios invested in California, the state with the highest tax rate (10.3%). As shown in Table-1, the average market yield for California portfolio was 3.926% or .076% below the estimated equilibrium yield of 4.002%. If state tax preferences were disallowed, we would therefore expect the average market yield for Breckinridge's California portfolios to rise by .076%. A simulated return analysis for these portfolios indicates that a .076% rise in yields would produce an average decline in market value of .31% (see Table-2).

Given that California yields would rise the most, the potential loss of .31% in market value represents the greatest exposure for any of Breckinridge's single-state portfolios. The question we then ask is whether it makes sense to restructure a portfolio in order to mitigate that potential loss. Such a restructuring would entail swaps out of in-state bonds into general market bonds. There would be a cost to pursuing that strategy. Table-3 shows Breckinridge's estimated average cost<sup>2</sup> of executing a swap which, at .19%, is substantially below that of the industry. Still, the .19% cost is a certainty. The .31% potential loss in market value has only a 50% probability (in an unbiased analysis of potential outcomes). What's more, the restructuring introduces a potential tax cost on out-of-state bonds should the Supreme Court overturn the Kentucky decision. Assuming a nine month holding period and 4% yield, the tax cost for a California resident would be up to .30% (10.3% of 4% for .75 years = .30%). Consequently, after incurring the cost of a restructuring, a portfolio would face an exposure in tax cost that's at least equal to the potential loss in market value it avoided. For this reason, we believe it is not appropriate to undertake such a strategy at this time.

## CONCLUSION

Breckinridge believes it's likely that the Supreme Court will overturn the Kentucky Court ruling and state tax preferences will be preserved. Ignoring this view however, we still conclude that the risk to any of our single-state portfolios is insufficient to warrant the cost of a restructuring. Therefore, our single-state strategy will stay focused on buying in-state bonds. At the same time, we will also continue to opportunistically buy out-of-state municipal bonds when after-tax returns warrant - or when they represent a significantly better value versus bonds available in-state. This approach has worked well for Breckinridge portfolios in the past. We expect it will work just as well in the future.

*The factual material in this paper is summarized from material obtained in referenced sources and is trusted to be accurate. The opinions contained herein are those of Breckinridge Capital Advisors, Inc. as of October, 2007. This analysis should be in no way considered a recommendation to invest in municipal bond portfolios managed by Breckinridge. All investments involve risk, including loss of principal.*

<sup>1</sup> Yale, Ethan, and Galle, Brian. "Muni Bonds and the Commerce Clause After *United Haulers*." Tax Notes. 11 June 2007. <http://www.taxanalysts.com>

<sup>2</sup> This cost reflects only Breckinridge's average cost of executing a swap. It does not include other costs such as custodial fees associated with transactions.

# TABLE 1

| State | Average Portfolio Market Yield (%) | YTD Issuance (Millions) |
|-------|------------------------------------|-------------------------|
| AL    | 4.052                              | 2,800                   |
| AZ    | 4.027                              | 5,209                   |
| CA    | 3.926                              | 45,148                  |
| CO    | 3.981                              | 5,008                   |
| CT    | 4.051                              | 2,488                   |
| FL    | 4.056                              | 15,708                  |
| GA    | 4.031                              | 6,830                   |
| HI    | 4.030                              | 961                     |
| KS    | 4.009                              | 1,907                   |
| KY    | 3.998                              | 2,637                   |
| LA    | 3.949                              | 3,443                   |
| MA    | 4.020                              | 8,452                   |
| MD    | 3.998                              | 4,204                   |
| MI    | 4.022                              | 5,127                   |
| MN    | 3.994                              | 4,831                   |
| MO    | 3.984                              | 5,123                   |
| MS    | 4.045                              | 1,280                   |
| NA*   | 4.037                              | 57,509                  |
| NC    | 3.983                              | 4,331                   |
| NJ    | 3.996                              | 9,655                   |
| NM    | 4.075                              | 1,200                   |
| NY    | 3.988                              | 19,890                  |
| OH    | 4.046                              | 5,343                   |
| OR    | 3.990                              | 3,305                   |
| PA    | 4.003                              | 8,684                   |
| RI    | 4.018                              | 983                     |
| SC    | 4.036                              | 2,476                   |
| TN    | 3.995                              | 2,243                   |
| UT    | 4.010                              | 1,663                   |
| VA    | 4.006                              | 6,678                   |
| WI    | 4.038                              | 3,141                   |
| WV    | 4.052                              | 1,433                   |
|       | <b>4.009</b>                       | <b>249,690</b>          |

\*NA = National Portfolios (No State Bias)

|   |         |
|---|---------|
| Total YTD Municipal Issuance (Millions):                    | 249,690 |
| Market Yield Weighted by Portfolio Mandate as of 06/30/07:  | 4.009%  |
| Market Yield Weighted by Municipal Issuance as of 06/30/07: | 4.002%  |

Source: Breckinridge Capital Advisors portfolio holdings as of 6-30-07 and Bloomberg

## TABLE 2

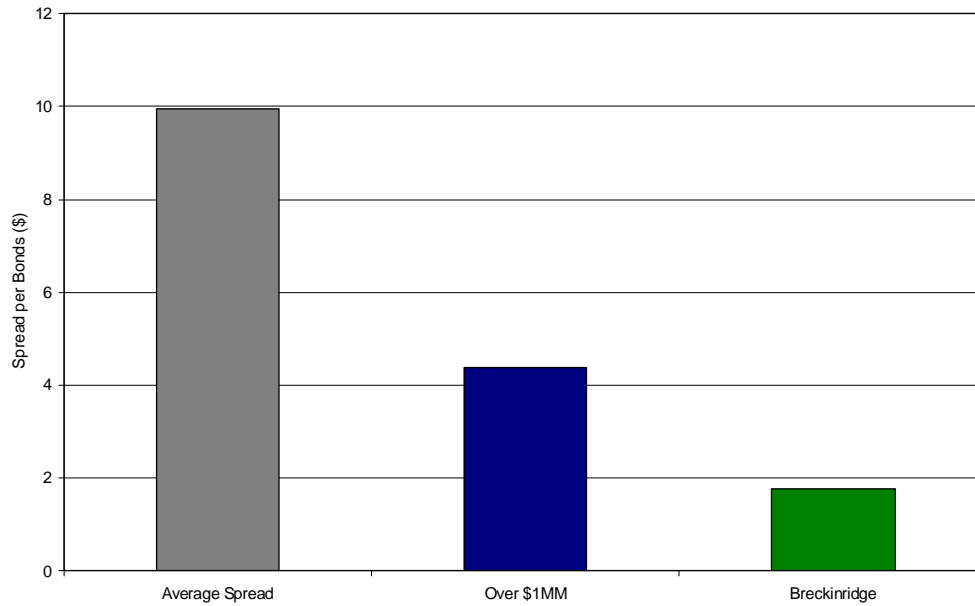
### TOTAL RETURN FOR IMMEDIATE .076% YIELD INCREASE IN ALL MATURITIES

|   | Combined Breckinridge<br>California Portfolios |
|---|--|
| Beg Par -- incl cash                          | 364,900,482.58                                 |
| Beg Mkt Value -- plus acc int                 | 386,712,487.60                                 |
| End Mkt Value -- plus acc int                 | 385,521,462.69                                 |
| Total Return \$                               | -1,191,024.91                                  |
| <b><u>Total Return %</u></b>                  | <b><u>-0.308%</u></b>                          |
| <i>Blue = Ending values and total returns</i> |  |

Source: Breckinridge Capital Advisors portfolio holdings as of 6/30/07

# TABLE 3

**AVERAGE SPREADS FOR INTRADAY TRADES 2006**



**Source: MSRB / Breckinridge Capital Advisors, Inc.**

*\*Transaction data excludes the following sectors: Hospital, Airport, AMT, Housing, Tobacco. Y-axis refers to Dollars/\$1,000 bond. For example, the "Breckinridge" spread of roughly \$2 equates to just under a 20 basis point spread. It is Breckinridge's opinion that the spreads reflected will be consistent for 2007 trades.*

# SOURCES

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