

STATE AND LOCAL TAX CLIENT ALERT – MUNICIPAL BONDS

May 25, 2007

The United States Supreme Court recently granted certiorari with respect to a major case involving municipal bonds. The issue is whether Kentucky can tax interest on out of state bonds while exempting interest on its own bonds. Many states, including New York, have similar laws which exempt interest on bonds issued within the state, while taxing interest on out of state bonds. This, of course, produces a powerful incentive for investors to buy bonds issued within their home state.

In September 2006, Kentucky's Supreme Court refused to review an appellate court ruling holding it was unconstitutional for Kentucky to tax only out of state bonds. If Kentucky loses its appeal to the United States Supreme Court, it will be forced to decide whether to exempt all out of state municipal bonds or to tax all Kentucky municipal bonds. The outcome will no doubt have repercussions in all states that impose a personal income tax.

Based on the United States Supreme Court's consenting to hear the matter, it would be prudent for New York residents who own out of state municipal bonds, or national municipal bond funds, to file protective refund claims with New York. The purpose of the protective refund claim is to preserve the taxpayer's right to claim refunds for previous tax years, prior to the expiration of the statute of limitations for filing such a claim.

The Supreme Court is not expected to hear the case until the fall of 2007, and will likely not render a decision until sometime in 2008.