

2009

Post-Davis Conduit Bonds: At the Intersection of the Dormant Commerce Clause and Municipal Debt

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Cover Page Footnote

J.D. Candidate, 2010, Fordham University School of Law. I would like to thank my faculty advisor, Professor Andrew Sims, for his invaluable guidance and feedback through the note-writing process. I would also like to remind my family that none of this would have been possible without their love and support.

NOTES

POST-DAVIS CONDUIT BONDS: AT THE INTERSECTION OF THE DORMANT COMMERCE CLAUSE AND MUNICIPAL DEBT

*Sean Carey**

This Note addresses the constitutionality of the selective taxation of conduit bonds, a subset of municipal bonds that finance private enterprise, in the aftermath of the U.S. Supreme Court's decision in Department of Revenue v. Davis. In Davis, the Court determined that states could tax interest earned on out-of-state municipal bonds while exempting interest earned on its own bonds without violating the Commerce Clause of the Constitution. When issuing this ruling, the Court drew a distinction between municipal bonds issued on behalf of the government and municipal bonds issued on behalf of private industry. The question of whether or not selective taxation was constitutional as applied to municipal bonds issued on behalf of private industry was explicitly left for another day. This Note begins with a discussion of municipal bonds and the dormant Commerce Clause. Next, this Note reviews the arguments for and against subjecting conduit bonds to the selective tax system. Finally, this Note recommends the adoption of a sui generis assessment to identify bonds whose central purpose is economic protectionism so that they may be excluded from the selective tax system.

TABLE OF CONTENTS

| | |
|-----------------------------------------------------------------------------------------------------------------|-----|
| INTRODUCTION..... | 122 |
| I. AN OVERVIEW OF MUNICIPAL BONDS AND THE DORMANT COMMERCE CLAUSE..... | 125 |
| A. <i>Municipal Bonds</i> | 125 |
| 1. The Authority of State and Local Governments To Issue Municipal Bonds | 127 |
| 2. How Federal and State Governments Have Utilized the Tax Law To Influence Funding of Public Projects | 129 |

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| | |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----|
| a. <i>Federal Use of the Tax Law</i> | 130 |
| b. <i>The Process and the Pitfalls of the Federal Tax Subsidy</i> | 132 |
| c. <i>State Use of the Tax Law</i> | 134 |
| 3. The Existing Municipal Bond Market for Conduit Bonds | 136 |
| B. <i>The Dormant Commerce Clause</i> | 138 |
| 1. Standard Dormant Commerce Clause Analysis | 140 |
| 2. Market Participation Exception | 143 |
| 3. Government Entity Exception | 146 |
| 4. Discriminatory Taxation | 149 |
| II. ALTERNATE APPRAISALS: HOW THE QUESTION OF WHETHER CONDUIT BONDS ADVANCE THE CARDINAL CIVIC RESPONSIBILITIES OF GOVERNMENT SHAPES THE DORMANT COMMERCE CLAUSE ANALYSIS | 152 |
| A. <i>The Appraisal of Conduit Bonds</i> | 153 |
| B. <i>How the Appraisal of Conduit Bonds Affects the Dormant Commerce Clause Analysis</i> | 156 |
| 1. Standard Dormant Commerce Clause Analysis | 156 |
| 2. Market Participant Exception | 166 |
| 3. Government Entity Exception | 168 |
| III. RECOMMENDING A <i>SUI GENERIS</i> ASSESSMENT FOR EACH ISSUANCE OF CONDUIT BONDS | 173 |
| A. <i>The Solutions Proposed by Proponents and Critics of the Differential Taxation of Conduit Bonds Are Inadequate</i> | 173 |
| 1. Standard Dormant Commerce Clause Analysis | 174 |
| 2. Market Participation Exception | 176 |
| 3. Government Entity Exception | 177 |
| B. <i>An Argument for Adopting a Sui Generis Assessment for Each Issuance of Conduit Bonds</i> | 178 |
| CONCLUSION | 180 |

INTRODUCTION

In 2006, the New York Yankees received \$942.5 million in tax-exempt conduit bonds¹ to build a new stadium.² In 2008, the Yankees entered a

1. Conduit bonds are bonds in which a state or municipality serves as a conduit to provide financing for nongovernmental third parties. See *Dep't of Revenue v. Davis*, 128 S. Ct. 1801, 1805 n.2 (2008) (plurality opinion) (referring to municipal bonds used to finance projects by private entities as “private-activity,” “industrial-revenue,” or “conduit.”); see also *Frequently Asked Questions About State Debt*, <http://www.osc.state.ny.us/press/debtfaq.htm> (last visited Sept. 19, 2009) (using the phrase conduit bonds to refer to bonds issued by public authorities that are often issued for the benefit of nongovernmental third parties). I decided to use the phrase “conduit bonds” as opposed to “private-activity bonds” so as not to confuse bonds that provide financing for nongovernmental third parties with bonds that qualify for the federal tax subsidy. See I.R.C. § 141(a) (2006) (defining

second request for an additional \$370 million in tax-exempt conduit bonds.³ In the wake of the second request, a legal battle erupted between the Yankees and vocal critics trying to prevent the city from granting the second request.⁴ At the heart of this battle is the conflict over whether it is appropriate for New York City to help finance a privately owned baseball stadium.⁵

Fights about conduit bonds are fights about money. Although the specifics of how that money changes hands are highly technical, ultimately, money flows from the public to the private sector. With every transaction of this sort, a question arises: is this the type of project the government should be spending money on? This question invokes others: Does this project help the public at large? Does this project disproportionately help a select group of people? Is financing the private sector the best way to achieve the goals of the project?

Our federal system leaves these questions up to the state and local legislatures.⁶ The state and local legislatures issuing a given series of bonds are best situated to appraise the benefits and burdens of that series. However, these parties are restrained in their ability to issue bonds. States and local governments must abide by the Federal Constitution, case law, and fundamental principles of federalism when they sell debt to the public.⁷ These constraints, many of which date back to the earliest days of this country, were erected to prevent states and municipalities from exceeding their authority by opening their coffers to private interests and discriminating against interstate commerce for the benefit of in-state commerce.

Recently, a major restraint on state and municipal governments was removed. In *Department of Revenue of Kentucky v. Davis*,⁸ the U.S. Supreme Court determined that states and municipalities could tax interest earned on out-of-state municipal bonds while exempting interest on its own

private-activity bonds for the purposes of the Internal Revenue Code). See generally STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO STATE AND LOCAL GOVERNMENT BONDS (Comm. Print 2006) [hereinafter STAFF OF JOINT COMM. ON TAXATION, BACKGROUND] (using the phrase to apply interchangeably between bonds that provide financing for nongovernmental third parties and bonds that qualify for the federal tax subsidy).

2. Richard Sandomir, *Testy Tone at Hearing on Bonds for Yankees*, N.Y. TIMES, Jan. 15, 2009, at A30.

3. *Id.*

4. *Id.*

5. *Id.*

6. ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE 9–12 (1992).

7 For example, state and municipal governments may only borrow money if the money is for a public purpose; otherwise the issuance constitutes an unconstitutional taking under the Due Process Clause of the Fourteenth Amendment to the Federal Constitution. See *Green v. Frazier*, 253 U.S. 233, 238–39 (1920); see also *infra* Part I.A.1 (discussing the authority of state and local governments to issue municipal bonds and the limitations on that authority).

8. 128 S. Ct. 1801 (2008) (plurality opinion).

bonds without violating the Commerce Clause of the Constitution.⁹ This ruling hinged on a narrow government entity exception for typical and traditional local government functions identified one year earlier in *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Management Authority*.¹⁰ While the practice of taxing the interest on out-of-state municipal bonds and exempting the interest on in-state bonds was already ubiquitous in the United States, the decision raised the possibility that states and municipalities could apply the same discriminatory tax to conduit bonds. If this exception applies to conduit bonds, states and local governments could discriminate against interstate commerce for the benefit of in-state private industries despite more than two centuries of jurisprudence preventing such activity.¹¹

In determining the scope of its ruling, the Court drew a distinction between municipal bonds that directly finance public works and conduit bonds that finance private industry. The question of whether states and municipalities could tax interest earned on out-of-state conduit bonds while exempting interest on in-state conduit bonds was left for another day.¹² At the same time, the market for conduit bonds has ballooned, despite efforts by the U.S. Congress to curb their use.¹³ The enormity of this market and the very real possibility that the *Davis* decision could lead to a segmentation of national markets based on the powers and efforts of local industries requires this question to be evaluated in greater detail.

Part I of this Note begins with an overview of municipal bonds. This section explains state and local governments' authority to issue municipal bonds and the myriad ways that authority is abridged. This section also reviews how the federal government and the state governments have used tax laws to shape the municipal bond market and thereby influence the funding of public projects. The first half of Part I concludes with an examination of the existing municipal bond market for conduit bonds to show the size of the current market and to provide a snapshot of some existing issuances to illustrate how such bonds operate in practice.

The second half of Part I is dedicated to the dormant Commerce Clause, a corollary to the Commerce Clause that prevents states and municipalities from discriminating against interstate commerce. In the past, the dormant Commerce Clause prevented state and local governments from discriminating against interstate commerce for the benefit of in-state private industries. The discussion of the dormant Commerce Clause begins with an examination of the standard analysis conducted by courts to determine whether legislation violates the dormant Commerce Clause. The discussion then proceeds to exceptions to the dormant Commerce Clause. One such

9. *Id.* at 1819; see also U.S. CONST. art. I, § 8, cl. 3 ("The Congress shall have Power To . . . regulate Commerce . . . among the several States . . .").

10. 127 S. Ct. 1786, 1794–95 (2007) (plurality opinion).

11. See *infra* Part II.

12. *Davis*, 128 S. Ct. at 1805 n.2 (plurality opinion).

13. See *infra* notes 341–55 and accompanying text.

exception is the market participation exception, which allows states and municipalities to violate the dormant Commerce Clause and favor their own citizens when they are participating in the marketplace as mere purchasers or buyers. Another is the recently identified government-entity exception, which allows states and municipalities to violate the dormant Commerce Clause when the benefit accrues to a public entity while treating all private entities exactly the same.

Part II of this Note examines the conflict between proponents and critics of the differential taxation of conduit bonds. Each side's argument hinges on its analysis of these bonds. Proponents of differential taxation of conduit bonds argue that, although conduit bonds finance private industries, they are fundamentally public. Under this interpretation, conduit bonds are indistinguishable from governmental bonds for the purpose of applying the government entity exception and, for the reasons outlined in *Davis*, discriminatory taxation of such bonds is constitutional. Critics of differential taxation of conduit bonds argue that conduit bonds are fundamentally private and are therefore distinguishable from governmental bonds for the purpose of applying the government entity exception. Since the government entity exception is inapplicable, the discriminatory taxation of conduit bonds is unconstitutional under the dormant Commerce Clause.

Part III recommends the adoption of a *sui generis* assessment for each issuance of municipal bonds. This assessment, which would be similar in application to the public purpose test that already applies to every issuance of municipal bonds, would allow courts to distinguish conduit bonds whose central purpose is local economic protectionism. Once bonds whose central purpose is local economic protectionism are identified, these bonds can be excluded from the application of the selective tax system.

I. AN OVERVIEW OF MUNICIPAL BONDS AND THE DORMANT COMMERCE CLAUSE

A. MUNICIPAL BONDS

Generally, a bond is a confession of debt—a written acknowledgement that money was borrowed and that it will be repaid with interest.¹⁴ A municipal bond is a written acknowledgement that a state or local government borrowed money from a private party and that the citizens of the state or local government will repay the money with interest.¹⁵ State and local governments issue or sell municipal bonds to bondholders, and the citizenry repay the debt with tax revenue.¹⁶ The purpose of this practice

14. BLACK'S LAW DICTIONARY 187 (8th ed. 2004).

15. JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 434–35 (6th ed. 2003).

16. AMDURSKY & GILLETTE, *supra* note 6, at 11.

is the same as for collecting taxes: to fulfill the basic civic responsibilities of government.¹⁷

For state and local governments, the advantage of issuing bonds as opposed to collecting taxes is threefold. First, by borrowing money, these governments are able to finance more public work than their current tax revenues allow.¹⁸ Second, and with regards to long-term public projects, borrowing the money upfront and paying it back over time defers the cost of each project to the citizens who benefit.¹⁹ Third, if the money is used to finance revenue-generating public projects, such as bridges or tunnels, the revenue can be used to offset the debt.²⁰ The drawback is, of course, interest.²¹ While state and local governments are able to use the money almost as soon as the bonds are issued, they must pay the lenders for the benefit of the use.²² As a result, most states and municipalities issue bonds to finance long-term public projects and not to meet their immediate obligations.²³

The next section of this Note examines the shape of the municipal bond market. Part I.A.1 explains state and local governments' sources of authority to issue municipal bonds and the ways in which that authority is abridged. While state and local governments benefit from the ability to issue municipal bonds, they are restricted in their ability to do so.²⁴ The Federal Constitution, state constitutions, and, to some extent, state statutes limit state and local governments' freedom to borrow.²⁵ Part I.A.2 discusses how the federal government and state governments have used tax laws to manipulate the funding of public projects indirectly through the municipal bond market. Part I.A.2.a details the federal government's use of federal tax law, Part I.A.2.b discusses the process and the pitfalls of the federal government's use of federal tax law, and Part I.A.2.c explains how state governments have used state tax laws to manipulate the municipal bond market. Finally, Part I.A.3 discusses the existing municipal bond market for conduit bonds.

17. *Davis*, 128 S. Ct. at 1811 (plurality opinion) (citing *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1795 (2007) (plurality opinion)); Brief for the National Federation of Municipal Analysts, as Amicus Curiae in Support of Neither Party at 4–5, *Davis*, 128 S. Ct. 1801 (No. 06-666), 2007 WL 2115441 [hereinafter NFMA Brief].

18. See AMDURSKY & GILLETTE, *supra* note 6, at 11 (finding that local governments would underfund long-term capital projects if they were required to bear the entire financial burden immediately upon purchase).

19. *Id.* at 11–12.

20. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 4.

21. AMDURSKY & GILLETTE, *supra* note 6, at 11.

22. *Id.*

23. *Id.* at 10–12.

24. See, e.g., *id.* at 43–50.

25. See *infra* Part I.A.1.

1. The Authority of State and Local Governments To Issue Municipal Bonds

State and local governments' power to issue municipal bonds derives from the states' sovereignty, state constitutions, and, in the case of local governments, state statutes.²⁶ Today, every state in the union has the authority to issue municipal bonds.²⁷ Furthermore, every state has the authority to delegate authority to its subsidiaries.²⁸ Thus, via state statute, a state government may provide authority to a local government to issue municipal bonds.²⁹ In addition to empowering state governments to issue bonds, some state constitutions explicitly limit the authority of the state government to issue bonds.³⁰ For instance, some state constitutions limit the amount of debt that can be issued³¹ while others limit the means of payment.³²

State and local governments' power to issue municipal bonds is further limited by the U.S. Constitution.³³ The Fourteenth Amendment to the U.S. Constitution prevents states from depriving citizens of property without due process of law.³⁴ The Supreme Court has found that this limitation applies directly to taxes and thus indirectly to public debt.³⁵ Under the Court's interpretation of the Fourteenth Amendment, state and local governments may only borrow money if the money is for a public purpose.³⁶ If the money is for a private purpose, the bond issuance is an unconstitutional taking of property without due process of law.³⁷ As one might imagine, the public/private distinction is very fact specific.³⁸ There is no bright-line test for determining whether municipal bonds have a public purpose.³⁹

Perhaps because of the imprecise nature of this determination, the requirement that state municipal bonds have a public purpose has been applied neither strictly⁴⁰ nor universally.⁴¹ State courts have given a very

26. 64 AM JUR. 2D *Public Securities and Obligations* §§ 36–38, 50 (2008).

27. *Id.* § 36.

28. *Id.* § 50.

29. *Id.*

30. *Id.* § 40.

31. *Id.* § 41.

32. *Id.* § 43.

33. *Id.* § 39.

34. U.S. CONST. amend. XIV, § 1 (“No State shall . . . deprive any person of . . . property, without due process of law . . .”).

35. *Green v. Frazier*, 253 U.S. 233, 238–39 (1920).

36. *Id.* at 238.

37. *Green*, 253 U.S. at 238.

38. *Weber v. Kenai Peninsula Borough*, 990 P.2d 611, 614 (Alaska 1999); 64 AM. JUR. 2D *Public Securities and Obligations* § 95 (2008) (citing *Green*, 253 U.S. at 233).

39. *Citizens' Sav. & Loan Ass'n v. City of Topeka*, 87 U.S. (20 Wall.) 655, 664 (1874); see also *Weber*, 990 P.2d at 614 (“[T]here are no rigid categories establishing public versus private purposes; in each case, the analysis of public purpose must be made within the context of specific facts.” (citing *DeArmond v. Alaska State Dev. Corp.*, 376 P.2d 717, 721 (Alaska 1962))).

40. See *Brown v. Longiotti*, 420 So. 2d 71, 72 (Ala. 1982) (“[T]he trend among modern courts is to give the term ‘public purpose’ a broad expansive definition.” (citing Opinion of

broad reading to the public purpose requirement.⁴² Part of this broad reading is attributable to a desire to meet the evolving needs of the public.⁴³ Simultaneously, different state courts have developed different tests for determining whether funds are used for a private purpose.⁴⁴ At the same time, at least one court has reinterpreted its earlier test to identify additional prongs and thereby expand its purview.⁴⁵ Perhaps the most expansive—and at the same time, prescient—statement of purpose appeared in a case in Wisconsin in the late 1960s:

[T]he concept of public purpose is a fluid one and varies from time to time, from age to age, as the government and its people change. Essentially, public purpose depends upon what the people expect and want their government to do for the society as a whole and in this growth of expectation, that which often starts as hope ends as entitlement.⁴⁶

the Justices, 384 So. 2d 1051, 1053 (Ala. 1980)); *Times of Trenton Publ'g Corp. v. Lafayette Yard Cmty. Dev. Corp.*, 846 A.2d 659, 667 (N.J. Super. Ct. App. Div. 2004) (“The concept of public purpose is a broad one.”); *Town of Beloit v. County of Rock*, 657 N.W.2d 344, 353 (Wis. 2003) (“[T]he public purpose doctrine has been broadly interpreted.”).

41. Different states have developed different tests to determine whether or not a bond issuance has a public purpose. *See, e.g., Moschenross v. St. Louis County*, 188 S.W.3d 13, 22 (Mo. 2006) (applying the “primary effect[s]” test); *WDW Props. v. City of Sumter*, 535 S.E.2d 631, 635–36 (S.C. 2000) (applying a four-part test); *State ex rel. Wis. Dev. Auth. v. Dammann*, 280 N.W. 698, 709 (Wis. 1938) (adopting a two-prong test requiring that the purpose be (1) of public necessity, convenience, or welfare and (2) for an expenditure that is difficult for individuals to provide for themselves).

42. *Marshall Field & Co. v. Vill. of S. Barrington*, 415 N.E.2d 1277, 1282 (Ill. 1981) (“The consensus of modern legislative and judicial thinking is to broaden the scope of activities which may be classified as involving a public purpose, especially in the area of economic welfare.” (citing *People ex rel. City of Salem v. McMackin*, 291 N.E.2d 807 (Ill. 1972))); *see also Times of Trenton*, 846 A.2d at 667–69 (applying a broad reading of the public purpose doctrine); *Bryant v. City of Atlantic City*, 707 A.2d 1072, 1080 (N.J. Super. Ct. App. Div. 1998) (same).

43. *Times of Trenton*, 846 A.2d at 668 (citing *Roe v. Kervick*, 199 A.2d 834, 850–51 (N.J. 1964)); 15 EUGENE MCQUILLIN ET AL., *THE LAW OF MUNICIPAL CORPORATIONS* § 39:25 (3d ed. 2008) (“[I]t has been recognized that ‘public purpose’ should be broadly construed to comport with the changing conditions of modern life.”); *see also State ex rel. Warren v. Reuter*, 170 N.W.2d 790, 795 (Wis. 1969) (finding the concept of public purpose to be both fluid and contingent on the expectations of society).

44. *See, e.g., Moschenross*, 188 S.W.3d at 22 (applying the “primary effect[s] test” to determine if the primary intent of the public expenditure is to serve a public purpose or promote a private end); *Guenzel-Handlos v. County of Lancaster*, 655 N.W.2d 384, 389–90 (Neb. 2003) (limiting the inquiry to the pronouncements of the legislature); *WDW Props.*, 535 S.E.2d at 635–36 (applying a four-part test that requires the court to determine (1) the ultimate benefit to the public intended by the project, (2) whether public or private parties will be the primary beneficiaries, (3) the speculative nature of the project, and (4) the probability that the public interest will be served and the degree to which the public interest will be served).

45. *Compare Dammann*, 280 N.W. at 709 (adopting a two-prong test requiring that purpose be (1) of public necessity, convenience, or welfare and (2) for an expenditure that is difficult for individuals to provide for themselves), *with Beloit*, 657 N.W.2d at 350 (identifying the earlier test as a “firmly accepted . . . basic constitutional tenant,” but adding an inquiry into the remoteness and the primary purpose of the public benefit).

46. *Warren*, 170 N.W.2d at 795.

Several courts have even identified economic development as a legitimate public purpose for which public funds may be expended.⁴⁷ Within the past decade, courts have validated bond issuances for the benefit of commercial office and retail space in a blighted area;⁴⁸ of Busch Stadium, home ballpark of the St. Louis Cardinals;⁴⁹ and of a WalMart Supercenter.⁵⁰ While not all quarters are pushing towards the most lenient interpretation of the public purpose clause,⁵¹ at present, it is unclear whether or not the Federal Constitution provides any barrier to the ability of state and local governments to issue municipal bonds as long as the purpose for issuing a bond is arguably public.⁵²

Part I.A.2 of this Note explains how Federal and state tax laws affect the use and utility of municipal bonds. While tax laws do not directly limit the ability of state and municipal governments to issue municipal bonds, both state and federal tax laws play a large role in shaping the municipal bonds market. Such laws influence the types of public projects that are funded by bonds, the incidence of such issuances, and the behavior of bondholders who purchase the bonds.⁵³

2. How Federal and State Governments Have Utilized the Tax Law To Influence Funding of Public Projects

On a basic level, both the federal government and the state governments use the tax law to influence the municipal bond market in the same way—by exempting the income earned on municipal bonds from personal income tax.⁵⁴ Under these exemptions, the municipal bondholder does not have to pay income tax on the interest derived from the bonds.⁵⁵ Often the state and federal subsidy works in concert so that the purchaser's post-tax yield is increased by the taxable rate that would have otherwise been paid.⁵⁶

47. 15 MCQUILLIN, *supra* note 43, § 39:25.

48. *WDW Props.*, 535 S.E.2d at 635–36.

49. *Moschenross*, 188 S.W.3d at 22.

50. *Bd. of Dirs. of Indus. Dev. Bd. v. Taxpayers*, 848 So. 2d 740, 748, 750 (La. Ct. App. 2003).

51. *See, e.g.*, *Brown v. Longiotti*, 420 So. 2d 71, 75 (Ala. 1982) (concluding that bond sale would primarily benefit individual lessee and thus not serve a significant public purpose); *State v. City of Orlando*, 576 So. 2d 1315, 1317 (Fla. 1991) (concluding that borrowing money for the primary purpose of reinvestment into additional debt instruments is not a valid public purpose); Hart H. Spiegel, *Financing Private Ventures with Tax-Exempt Bonds: A Developing "Truckhole" in the Tax Law*, 17 STAN. L. REV. 224, 240 (1965) (faulting the Internal Revenue Service for not applying the "business purpose" test to tax-exempt bonds).

52. *See, e.g.*, *State ex rel. Warren v. Reuter*, 170 N.W.2d 790, 795 (Wis. 1969).

53. *See infra* Part I.A.2.

54. *Compare* I.R.C. § 103(a) (2006), *with* KY. REV. STAT. ANN. § 141.010(10), (11) (LexisNexis 2006).

55. *Dep't of Revenue v. Davis*, 128 S. Ct. 1801, 1806–07 (2008) (plurality opinion); STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 2.

56. *Davis*, 128 S. Ct. at 1805 (plurality opinion).

To illustrate this point, assume there are two bonds—a corporate bond and municipal bond—and assume that each bond has an equal rate of interest and a comparable risk. Because taxes on income from municipal bonds are exempted from federal income tax, the municipal bond has a greater post-tax yield than the corporate bond. In this example, the purchaser collects a windfall. Now, assume that the municipality offers a lesser rate of interest than the corporate bonds. If the difference between the rates is offset correctly, the market will be indifferent to the pre-tax interest rate and the municipality will pay less for its debt.⁵⁷ This post-tax saving induces buyers to accept a lower interest rate and lowers the cost of raising capital for state and local governments.⁵⁸

At closer examination, however, the federal government and the state governments use their tax laws very differently, both in application and in underlying purpose. The next section of this Note examines the differences between these two systems.

a. *Federal Use of the Tax Law*

The federal government encourages state and local governments to issue municipal bonds by exempting municipal bonds from federal taxation.⁵⁹ Under this exemption, the municipal bondholder does not have to pay federal income tax on the interest derived from the bonds.⁶⁰

This exemption has several consequences. First, “[b]ecause interest income on the bonds is excluded from gross income, the [holder] is willing to accept a lower rate on the bonds than he might otherwise accept on a taxable investment.”⁶¹ Second, because the bondholder is willing to accept a lower rate of investment, issuers are able to borrow at a lower interest rate,⁶² and the cost of raising capital for state and local governments is lowered.⁶³ Finally, this subsidy, which accrues to the state and local bond

57. There is a great deal of literature challenging this assertion. *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 4–8. However, the stated assertion is the “ostensible reason for this regime.” *Davis*, 128 S. Ct. at 1805 (plurality opinion).

58. MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 215 (5th ed. 2005).

59. I.R.C. § 103(a) (2006) (“Except as provided in subsection (b), gross income does not include interest on any State or local bond.”).

60. NFMA Brief, *supra* note 17, at 5.

61. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 4.

62. GRAETZ & SCHENK, *supra* note 58, at 215.

63. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 4–5. Experts argue whether this exemption actually lowers the cost of raising capital. *See id.* at 7–8 (determining that the federal tax exemption is a source of inefficiency). However, the argument that the exemption does lower the cost of raising capital is the accepted rationale for the exemption. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1805 (2008) (plurality opinion) (“The ostensible reason for this regime is the attractiveness of tax-exempt bonds at ‘lower rates of interest . . . than that paid on taxable . . . bonds of comparable risk.’” (quoting GRAETZ & SCHENK, *supra* note 58, at 215)).

issuers through the tax benefit to the bondholders, operates at the expense of the federal government.⁶⁴

While the federal government ultimately bears the cost of this exemption, it gains a foothold in the municipal bond market.⁶⁵ By setting the parameters for the federal tax exemption, the federal government can influence the purchases of bondholders; by influencing these purchases, the federal government influences the type of projects state and local governments fund.⁶⁶ To illustrate, the federal tax exemption includes three major exceptions.⁶⁷ These exceptions include unregistered bonds,⁶⁸ which curb bondholder tax evasion by requiring ownership transfers to be recorded on a central list;⁶⁹ arbitrage bonds,⁷⁰ which prevent issuers from reinvesting bond proceeds at a materially higher yield than the yield on the borrowings;⁷¹ and unqualified private-activity bonds,⁷² which hinder issuers from financing nongovernmental operations and services.⁷³ By barring these types of bonds from the subsidy, the federal government funnels money toward more desirable public projects.⁷⁴

Of the major exceptions, only one has a complicated history: unqualified private-activity bonds.⁷⁵ Private-activity bonds are municipal bonds that finance nongovernmental entities or persons.⁷⁶ In many ways, this carveout targets the type of bonds targeted by the public/private distinction.⁷⁷ The

64. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 4–5 (“[The] implicit Federal subsidy [is] equal to the difference between the tax-exempt interest rate paid and the taxable rate that otherwise would be paid.”).

65. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 2.

66. *Id.*

67. I.R.C. § 103(b) (2006). These exceptions were not in place from the earliest days of the exemption; rather, they came about over time in response to major abuses. *See, e.g.*, *South Carolina v. Baker*, 485 U.S. 505, 508–09 (1988) (explaining how the exclusion of unregistered bonds was developed in response to the “growing magnitude of tax evasion”); STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1154–55 (Comm. Print 1987) [hereinafter STAFF OF JOINT COMM. ON TAXATION, ACT OF 1986] (detailing past abuses of arbitrage bonds and determining that they “have no economic substance, but are made profitable solely through the ability to borrow at tax-exempt rates”).

68. I.R.C. § 103(b)(3).

69. *Baker*, 485 U.S. at 508.

70. I.R.C. § 103(b)(2).

71. Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?*, 76 *FORDHAM L. REV.* 857, 890 (2007).

72. I.R.C. § 103(b)(1). The statute actually refers to private-activity bonds that are not qualified. *See id.* For convenience, this Note refers to these bonds as “unqualified.”

73. *See* STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 28–36 (discussing the tests for determining which private-activity bonds do not qualify for tax exemption, including an assessment of private business use). Note that while the exception for unqualified private-activity bonds constrains issuers from financing nongovernmental services and operations, it does not bar them from doing so. *See id.*

74. *See id.* at 28–31.

75. *See id.* at 12–20 (discussing the history of private-activity bonds).

76. *Id.* at 2.

77. *Compare* *Green v. Frazier*, 253 U.S. 233, 238–39 (1920) (finding that states may not tax for merely private purposes), *with* I.R.C. § 141 (identifying those purposes which are sufficiently private so as to invoke the federal subsidy).

difference, however, is that the federal government has a say in where the line is drawn.⁷⁸ The next section of this Note identifies the process of the federal tax subsidy as well as the pitfalls.

b. *The Process and the Pitfalls of the Federal Tax Subsidy*

The federal tax subsidy for state and local bonds provides a system for distinguishing bonds that are eligible for the federal tax subsidy from bonds that are not.⁷⁹ Under the terminology of the statute, bonds that are eligible for the federal tax subsidy are governmental bonds; bonds that are not eligible are private-activity bonds.⁸⁰

Private-activity bonds are defined by the use of bond proceeds and the manner in which the bonds are secured.⁸¹ The code provides that a municipal bond is a "private activity bond" if it meets one of two tests: (1) the "private loan financing test,"⁸² or (2) the combination of the "private business use test"⁸³ and the "private security or payment test"⁸⁴ (collectively the "private business test").⁸⁵ The Internal Revenue Code does not directly define governmental bonds; governmental bonds are simply bonds that fail the tests for private-activity bonds.⁸⁶ The private loan financing test is satisfied if more than \$5 million or five percent of the proceeds of a bond issuance are used to finance a private loan.⁸⁷ Alternately, if the proceeds of a bond issuance are used to finance a private loan, the issuance could evade classification as a private-activity bond if the private loan represents less than five percent of the total proceeds of the bond issuance and the private loan is less than \$5 million.⁸⁸ For example, a municipal bond issuance that includes a \$4.9 million loan to a private party

78. See I.R.C. § 141.

79. *Id.*; STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 28–36.

80. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 21. This distinction is defined entirely within the federal tax code. *Id.* To the extent that state codes recognize private-activity bonds, they either cross-reference the Internal Revenue Code or fail to define private-activity bonds and thereby tacitly accept the definition provided in the Federal Tax Code. See, e.g., ALA. CODE § 41-10-36(12) (LexisNexis 2000) ("[Private-activity bond] has the same meaning as that specified for such term in Section 141(a) of the code."); ALASKA STAT. § 37.15.800(e)(1) (2008) ("[P]rivate activity bond' means a bond described in [I.R.C. § 141] . . ."); ARK. CODE ANN. § 15-5-207(b)(32) (Supp. 2009) (cross-referencing I.R.C. § 146 for definition of private-activity bonds); COLO. REV. STAT. § 24-32-1703(2) (2008) (same); CONN. GEN. STAT. ANN. § 3-20(x) (West 2007) (same).

81. See I.R.C. § 141; see also STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 28–29 (explaining private-activity bond tests).

82. I.R.C. § 141(a)(2), (c).

83. *Id.* § 141(a)(1)(A), (b)(1).

84. *Id.* § 141(a)(1)(B), (b)(2).

85. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 28–29 (identifying the "private business test").

86. *Id.* at 28 ("The Code . . . does not define a governmental bond, but rather defines an impermissible private activity bond, i.e., a bond that is not a governmental bond.").

87. I.R.C. § 141(c)(1).

88. *Id.*

will be classified as a governmental bond if the total value of the bond issuance is \$100 million.

The private business test includes both the private business use test and the private security or payment test.⁸⁹ While the two subelements of the private business test are also called tests, they are more properly understood as prongs. A bond meets the requirements of the first prong, the private business use test, if more than ten percent of the total proceeds of the issue will be used for a private business use.⁹⁰ A bond meets the requirement of the second prong, the private security or payment test, if more than ten percent of the principal, or ten percent of the interest on the proceeds of the bonds, is secured by an interest in private property or paid for with private funds.⁹¹ If a bond issuance fails either prong, the obligation is, at least by definition, a “standard” governmental bond.⁹² Thus, under the private business use test, a private facility may be financed with governmental bonds, provided that bonds are neither secured by nor paid for with private payments.

While a debt obligation may be structured to transform what is properly understood as a private-activity bond into a government bond, this metamorphosis exists mostly on paper.⁹³ Whether or not a bond is a private-activity bond is not an accurate indicator of whether the bond has a public or private purpose. A bond issuance could be either a private-activity bond or a governmental bond depending on how its debt is structured.⁹⁴ Also, the types of bonds that are eligible for the federal tax subsidy are subject to frequent legislative adjustment.⁹⁵

The landscape of private-activity bonds is further complicated by the existence of qualified public-activity bonds.⁹⁶ Qualified public-activity bonds are private-activity bonds that, for various reasons, qualify for federal tax exemption.⁹⁷ For all of these bond issuances, the financing benefits nongovernmental persons.⁹⁸ However, the purposes for which qualified public-activity bonds may be issued include “the cardinal civic responsibilities” of government.⁹⁹ Exempt facilities bonds, for example, list among their exemptions transport facilities,¹⁰⁰ basic utilities,¹⁰¹ social

89. *Id.* § 141(b).

90. *Id.* § 141(b)(1).

91. *Id.* § 141(b)(2).

92. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 28.

93. *See id.* at 21–22.

94. *Id.*

95. *See id.* at 17–19 (listing and explaining every act that expanded the list of activities that are eligible for tax exemption).

96. I.R.C. § 141(e).

97. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 3–4.

98. *Id.* at 4.

99. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1811 (2008) (plurality opinion).

100. I.R.C. § 142(a)(1) (airports); *id.* § 142(a)(2) (docks and wharves); *id.* § 142(a)(3) (mass-commuting facilities); *id.* § 142(a)(11) (high-speed intercity rail facilities); *id.* § 142(a)(15) (certain highway or surface freight-transfer facilities).

housing projects,¹⁰² and sustainable development projects.¹⁰³ Similarly, qualified public-activity bonds include bond issuances for student loans¹⁰⁴ and qualified 501(c)(3) organizations,¹⁰⁵ including the American Red Cross,¹⁰⁶ Habitat for Humanity,¹⁰⁷ the Salvation Army,¹⁰⁸ and the United Way.¹⁰⁹ Essentially, a substantial portion of these qualified public-activity bonds fall somewhere in the gray area between public and private.¹¹⁰

As explained above, the federal government is not the only party that uses the tax law to manipulate the bond market. State governments have also created subsidies in order to influence purchasers and decrease the cost of raising capital. The next section of this Note addresses these laws and their consequences.

c. State Use of the Tax Law

In most states, in order to qualify for the in-state exemption from state income tax, the bondholder must purchase the bond from the state or local government where they reside.¹¹¹ In most states that exempt municipal bonds from state income tax, the bonds issued by sister states or their municipalities are not exempt from state income tax.¹¹²

101. *Id.* § 142(a)(4) (facilities for the furnishing of water); *id.* § 142(a)(5) (sewage facilities); *id.* § 142(a)(6) (solid-waste disposal facilities); *id.* § 142(a)(8) (facilities for the local furnishing of electric energy or gas); *id.* § 142(a)(9) (local district heating or cooling facilities); *id.* § 142(a)(10) (qualified hazardous-waste facilities).

102. *Id.* § 142(a)(7).

103. *Id.* § 142(a)(12) (environmental enhancements of hydroelectric generating facilities); *id.* § 142(a)(13) (qualified public educational facilities); *id.* § 142(a)(14) (qualified green-building and sustainable-design projects).

104. *Id.* § 141(e)(1)(E).

105. *Id.* § 141(e)(1)(G). The designation 501(c)(3) comes from a statute in the Internal Revenue Code that provides federal tax exemption for organizations that are operated exclusively for religious, charitable, or scientific purposes. *Id.* § 501(c)(3).

106. American Red Cross Home Page, Donate to the Red Cross, <http://www.redcross.org> (follow "Giving and Getting Involved" hyperlink; then follow "Donate" hyperlink) (last visited Sept. 19, 2009).

107. I.R.S. Priv. Ltr. Rul. 91-1914868 (Aug. 6, 2004).

108. The Salvation Army Adult Rehabilitation Center Home Page, <http://www.use.salvationarmy.org> (follow "Donations" dropdown menu; then follow "Tax Information" hyperlink) (last visited Sept. 19, 2009).

109. United Way of America, Accountability, <http://www.liveunited.org/about/accountability.cfm> (last visited Sept. 19, 2009).

110. It is this private character—applied here to private-activity bonds as defined by Internal Revenue Code but equally applicable to all conduit bonds—that complicates the analysis applied to governmental bonds in *Davis*. See *Dep't of Revenue v. Davis*, 128 S. Ct. 1801, 1811 (2008) (plurality opinion) (upholding the state tax exemption because it "favors a traditional government function without any differential treatment favoring local entities").

111. See NFMA Brief, *supra* note 17, at 8–10. If the bondholder purchases a municipal bond from a sister state or municipality, the bondholder must pay state income tax on the interest derived from the bonds to the state where they reside. *Id.*

112. Amicus Curiae Brief of the Securities Industry & Financial Markets Ass'n in Support of Petitioners at 6, *Davis*, 128 S. Ct. 1801 (No. 06-666) [hereinafter SIFMA Brief] ("[This system] provides for preferential tax treatment of [a State's] own municipal bonds over the municipal bonds of other States.").

The reason most states do not extend the exemption to out-of-state bonds is twofold. First, when a state provides an income tax exemption for in-state municipal bonds, that state is attracting in-state purchasers to buy its debt.¹¹³ If that state extended its in-state exemption to every state, residents of that state would have no monetary incentive to differentiate between that state's bonds and out-of-state bonds.¹¹⁴ Thus, demand for that state's municipal bonds would be reduced.¹¹⁵ Meanwhile, under the present system, the residents of every other state retain their incentive to differentiate and the pool of potential financing for the state that extends the exemption is significantly reduced.¹¹⁶ Second, any state that offers differential tax treatment for municipal bonds does so with the expectation that, by borrowing at a lower rate, that state will gain more in borrowing power than it forgoes in taxes.¹¹⁷ If a state extended the exemption to every state, that state would effectively subsidize the public projects of its sister states.¹¹⁸ Thus, unlike the federal exemption, the state income tax exemption serves an important limiting function, giving residents an incentive to differentiate between in-state and extraterritorial municipal bonds.¹¹⁹

In the United States, such a discriminatory tax system is ubiquitous.¹²⁰ Thirty-seven states employ this system or something substantially similar.¹²¹ Four states employ a comparable tax system that exempts some,

113. See *Davis*, 128 S. Ct. at 1805–06 (plurality opinion).

114. *Id.*

115. See *id.*

116. See *id.*

117. GRAETZ & SCHENK, *supra* note 58, at 215–16.

118. See *Davis*, 128 S. Ct. at 1805–06 (plurality opinion).

119. *Id.*

120. Brief of Alan D. Viard et al. as Amici Curiae Supporting Respondents at 13, *Davis*, 128 S. Ct. 1801 (No. 06-666) [hereinafter Viard Brief] (referring to this system as “selective municipal bond tax exemption”).

121. ALA. CODE § 40-18-4, -14(3)(f) (LexisNexis 2003); ARIZ. REV. STAT. ANN. § 43-1021(3) (2006); ARK. CODE ANN. § 26-51-404(b) (1997); CAL. REV. & TAX. CODE § 17133 (West 2004); COLO. REV. STAT. § 39-22-104(3)(b) (2008); CONN. GEN. STAT. ANN. § 12-701(a)(20)(A)(i) (West 2008); DEL. CODE ANN. tit. 30, § 1106(a)(1) (1997); GA. CODE ANN. § 48-7-27(b)(1)(A) (2009); HAW. REV. STAT. §§ 39-11, 47-13 (2008); *id.* § 235-7(a)(6), (b)(2) (Supp. 2008); IDAHO CODE ANN. § 63-3022M(1), (3)(b) (2007); KAN. STAT. ANN. § 79-32, 117(b)(i) (Supp. 2008); KY. REV. STAT. ANN. § 141.010(10), (11) (LexisNexis 2006); LA. REV. STAT. ANN. §§ 47:48, 47:293(9)(b) (2001 & Supp. 2009); ME. REV. STAT. ANN. tit. 36, § 5122(1)(A) (Supp. 2008); MD. CODE ANN., TAX-GEN. § 10-204(b) (LexisNexis Supp. 2008); MASS. ANN. LAWS ch. 62, § 2(a)(1)(A) (LexisNexis 2008); MICH. COMP. LAWS ANN. § 206.30(1)(a) (West Supp. 2009); MINN. STAT. ANN. § 290.01(19a)(1)(i) (West 2007); MISS. CODE ANN. § 27-7-15(4)(d) (West Supp. 2008); MO. ANN. STAT. § 143.121(2) (West Supp. 2009); MONT. CODE ANN. § 15-30-111(2)(a)(i) (2007); NEB. REV. STAT. § 77-2716(1)(c) (2003); N.H. REV. STAT. ANN. § 77:4(I) (LexisNexis 2009); N.J. STAT. ANN. § 54A:6-14 (West 2002); N.M. STAT. § 7-2-2(B)(3), -2(V) (2001); N.Y. TAX LAW § 612(b)(1) (McKinney 2006); N.C. GEN. STAT. § 105-134.6(b)(1)(b), (c)(1) (2007); N.D. CENT. CODE § 57-38-01.2(1)(g) (Supp. 2007); OHIO REV. CODE ANN. § 5747.01(A)(1) (LexisNexis 2008); OR. REV. STAT. ANN. § 316.680(2)(a) (West 2003); 72 PA. STAT. ANN. § 9901 (West 2000); R.I. GEN. LAWS § 44-30-12(b)(1) (Supp. 2008); S.C. CODE ANN. § 12-6-1120(1) (2000); TENN. CODE ANN. § 67-2-104(e)(1) (2006); VT. STAT. ANN. tit. 32, § 5811(18)(A)(i)(II)

but not all, in-state municipal bonds.¹²² Two states offer reciprocal treatment of municipal bonds.¹²³ The seven remaining states have no personal income tax.¹²⁴

The result of this ubiquitous system is a very large market for municipal bonds. Part I.A.3 outlines the current municipal bond market and identifies some recent trends.

3. The Existing Municipal Bond Market for Conduit Bonds

In 2007, state and local governments sold a record \$427.6 billion in bonds.¹²⁵ That year-end total was five percent over the previous record, set in 2005, and ten percent greater than the previous year's volume.¹²⁶ In 2005–2006, the latest period for which census data is available, the Census Bureau reported \$2.2 trillion in outstanding state and local government debt.¹²⁷ The majority of bonds issued each year are government bonds, which are generally used for the cardinal civic responsibilities of government.¹²⁸ Still, the use of tax-exempt bonds by state and local governments grew to over \$2.1 trillion by 2006.¹²⁹ In 2007, tax revenues lost from such bonds are estimated to be \$37 billion.¹³⁰

While not every bond issuance supports industrial development,¹³¹ many municipal bonds in the existing market do.¹³² In February 2008, the U.S. Government Accountability Office (GAO) released a report about the status

(2008); VA. CODE ANN. § 58.1-322(B)(1), (C)(2) (Supp. 2007); W. VA. CODE ANN. § 11-21-12(b)(1), (c)(2) (LexisNexis Supp. 2007).

122. 35 ILL. COMP. STAT. ANN. 5/203(a)(2)(A) (West 2005 & Supp. 2009); 45 ILL. COMP. STAT. ANN. 35/80(e) (West 2005); IOWA CODE ANN. § 422.7(36) (West 2006); OKLA. STAT. ANN. tit. 68, §§ 2358.5, 2358.5A (West Supp. 2009); WIS. STAT. ANN. § 71.05(1)(c) (West 2004).

123. Utah employs the differential tax treatment for municipal bonds and extends reciprocal treatment to the bonds of states that do not tax Utah bonds. UTAH CODE ANN. § 59-10-114(1)(e), (5) (2008). Indiana exempts all municipal bonds. IND. CODE ANN. § 6-3-1-3.5 (LexisNexis 2007).

124. These states include Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming. See *Davis*, 128 S. Ct. at 1807 n.7 (plurality opinion).

125. Matthew Hanson, *Volume at a Record \$427.6B*, BOND BUYER, Jan. 2, 2008, at 1.

126. *Id.*

127. U.S. Census Bureau, http://www.census.gov/govs/estimate/0600ussl_1.html (last visited Sept. 19, 2009).

128. U.S. GOV'T ACCOUNTABILITY OFFICE, TAX-EXEMPT STATUS OF CERTAIN BONDS MERITS RECONSIDERATION, AND APPARENT NONCOMPLIANCE WITH ISSUANCE COST LIMITATIONS SHOULD BE ADDRESSED 3–4 (2008); NFMA Brief, *supra* note 17, at 4–5.

129. Peter Schroeder, *GAO: Rethink Tax-Exempts for Private Facilities*, BOND BUYER, Mar. 19, 2008, at 4.

130. *Id.*

131. For 2007, *Bond Buyer* indicated that at least sixty percent of all bond issuances support the bedrock purposes of health, safety, and welfare. Hanson, *supra* note 125 (determined by adding the 2007 totals for education, electric power, environmental facilities, health care, public facilities, transportation, and utilities for all bond and note issuances). It is probable that an even larger percentage of all municipal debt issuances are in furtherance of the bedrock principles, but it is difficult to prove with the available data. See *id.*

132. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 128, at 3 (finding governmental bonds “are generally issued for traditional public purposes”).

of tax-exempt bonds to the U.S. Senate Committee on Finance.¹³³ This report determined that, while “[p]revious legislation prohibited using qualified private activity bonds for certain facilities . . . many of these types of facilities are still being financed with tax-exempt governmental bonds.”¹³⁴ Facilities that are essentially private in nature, including sports stadiums,¹³⁵ hotels,¹³⁶ and golf courses¹³⁷ are being financed with tax-exempt governmental bonds.¹³⁸ Furthermore, “the broad discretion afforded to state and local governments allows them to use tax-exempt governmental bonds to finance facilities and activities that cannot be financed with private activity bonds.”¹³⁹ The GAO ended its report with a request that Congress consider “whether . . . facilities . . . that are privately used should continue to be financed with tax-exempt governmental bonds.”¹⁴⁰

Despite the request of the GAO, Congress has since raised the federal cap on private-activity bonds. On July 30, 2008, the Housing and Economic Recovery Act of 2008 (the Housing Act)¹⁴¹ raised the federal cap on private-activity bonds by \$11 billion.¹⁴² The purpose of the Housing Act was to “respon[d] to the subprime mortgage crisis and mounting foreclosures.”¹⁴³ Technically, the portion of the Housing Act that increases the federal cap on private-activity bonds sunsets in 2008.¹⁴⁴ When viewed in conjunction with a rollover provision that was also adjusted within the Housing Act, however, the volume cap is actually extended through 2010.¹⁴⁵ The increase is also technically limited to qualified housing issues,¹⁴⁶ allowing bonds to “refinance subprime mortgages, provide loans

133. *Id.*

134. *Id.* at intro.

135. *Id.* at 23. The GAO identified almost \$4 billion worth of municipal bonds funding stadiums and arenas with significant private business use in calendar year 2006. *Id.* at 20.

136. *Id.* at 29. The GAO identified eighteen large, full-service hotels that were financed with tax-exempt bonds between 2002 and 2006, several of which were rated three or four diamond by the American Automobile Association. *Id.* at 30.

137. *Id.* at 29. The GAO identified six golf courses that were opened in 2005 and financed, at least in part, with tax-exempt governmental bond financing. *Id.* at 30. The GAO further found that all of these golf courses were “among the better golfing facilities in their respective regions” including the Arnold Palmer Classic Silver Rock Resort golf course in La Quinta, California which was financed with over \$103 million worth of municipal bonds. *Id.* at 32–33.

138. *Id.* at 30.

139. *Id.* at 42.

140. *Id.* at 43.

141. Pub. L. No. 110-289, 2008 U.S.C.A.N. (122 Stat.) 2654 (codified in scattered sections of 12, 15, 26, 37, 38, and 42 U.S.C.).

142. *Id.* § 3021 (liberalizing the requirements of I.R.C. § 146).

143. Lynn Hume, *IRS Releases Data on States' Capacity for Housing Bonds*, BOND BUYER, Sept. 18, 2008, at 4.

144. See I.R.C. § 146(d)(5) (2006) (limiting increase in state ceiling cap to calendar year 2008).

145. *Id.* § 146(f)(6) (extending carryforward for qualified housing issues to 2010); see also Hume, *supra* note 143.

146. *Id.* § 146(d)(5)(B)(i)(7).

to first-time homebuyers, or finance multifamily housing projects.”¹⁴⁷ Ultimately, however, the cap increase leaves states and local governments free to allocate the balance of their private-activity bonds without reference to housing projects.¹⁴⁸

While this market has been allowed to develop unimpeded by its internal laws, a question remains as to whether or not it violates a separate canon of constitutional law—the dormant Commerce Clause. Part I.B reviews the history and purpose of the dormant Commerce Clause.

B. *The Dormant Commerce Clause*

The Commerce Clause of the U.S. Constitution expressly grants Congress the power “[t]o regulate Commerce . . . among the several States”¹⁴⁹ From this grant, the Supreme Court has inferred a “negative implication” that restrains the states from regulating such commerce.¹⁵⁰ This implication has come to be known as the dormant Commerce Clause.¹⁵¹

The purpose of the dormant Commerce Clause is “to prohibit state or municipal laws whose object is local economic protectionism, laws that would excite those jealousies and retaliatory measures the Constitution was designed to prevent.”¹⁵² If states were allowed to isolate themselves economically, the welfare of the nation as a whole could be jeopardized.¹⁵³ Preventing this “economic Balkanization” is the central rationale of the dormant Commerce Clause today,¹⁵⁴ just as it was a central rationale for revising the Articles of Confederation.¹⁵⁵ At the same time, the prevention

147. Hume, *supra* note 143.

148. *Id.* (“[T]he housing finance agencies can use the extra housing bond capacity in any order, before or after, they issue other bonds allocated under the PAB volume cap. Normally, they would have to use the oldest allocated bonds first.”).

149. U.S. CONST. art. I, § 8, cl. 3.

150. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1808 (2008) (plurality opinion). Judicial acknowledgement of the exclusive nature of the Commerce Clause dates to the first major case to parse the Commerce Clause. *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 236 (1824) (Johnson, J., concurring) (“The inferences . . . appear to me to be altogether in favour of the exclusive grants to Congress of power over commerce . . .”).

151. *Davis*, 128 S. Ct. at 1808 (plurality opinion). The first reference to the dormant aspect of the Commerce Clause was by Chief Justice John Marshall in *Gibbons v. Ogden*. 22 U.S. (9 Wheat.) at 189 (“The [Commerce Clause power] . . . must be placed in the hands of agents, or lie dormant.”); see also Steven Breker-Cooper, *The Commerce Clause: The Case for Judicial Non-Intervention*, 69 OR. L. REV. 895, 896 n.9 (1990) (identifying Marshall’s use of the term “dormant” in *Gibbons* and tracing it to *Willson v. Black Bird Creek Marsh Co.*, 27 U.S. (2 Pet.) 245, 252 (1829) (“We do not think that the [ordinance] can . . . be considered as repugnant to the power to regulate commerce in its *dormant* state” (emphasis added))).

152. *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 390 (1994).

153. *Okla. Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 180 (1995).

154. *Davis*, 128 S. Ct. at 1808 (plurality opinion) (citing “‘economic protectionism’” as the primary concern of the modern dormant Commerce Clause (quoting *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 273 (1988))).

155. *Hughes v. Oklahoma*, 441 U.S. 322, 325–26 (1979) (“[A] central concern of the Framers that was an immediate reason for calling the Constitutional Convention . . . [was] to

of economic isolation is not the sole concern of the Constitution.¹⁵⁶ Thus, a tension exists between the dormant Commerce Clause and the federal system's preference for local autonomy.¹⁵⁷ The dormant Commerce Clause acts to prevent economic seclusion, subject to every state's right to sovereignty.¹⁵⁸

The Commerce Clause is not an exclusive grant of power to the legislature;¹⁵⁹ therefore, the dormant Commerce Clause does not forbid states from affecting any aspect of interstate commerce.¹⁶⁰ There are arenas where, in the absence of a conflicting federal statute,¹⁶¹ states may regulate interstate commerce.¹⁶² For example, states and local governments may regulate government functions that are truly local.¹⁶³ Such functions, like port pilotage¹⁶⁴ and crabbing on the high seas, are better served by local regulation; uniform federal regulation would be impractical.¹⁶⁵ Where states may not regulate commerce, however, is where such regulation

avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation.”); *see also* THE FEDERALIST NO. 22, at 110 (Alexander Hamilton) (rev. ed., The Colonial Press 1901) (arguing that a primary defect of the federal system at that time was the lack of “federal superintendence” of interstate commerce).

156. *See Davis*, 128 S. Ct. at 1808 (plurality opinion).

157. *Compare* THE FEDERALIST NOS. 7, 11 (Alexander Hamilton), *supra* note 155, at 29–31 (arguing that the power to regulate commerce should reside in a central government as a barricade against disunity), *and* THE FEDERALIST NO. 42 (James Madison), *supra* note 155, at 241–42 (same), *with* THE FEDERALIST NO. 51 (James Madison), *supra* note 155, at 289–90 (arguing that power should be separated between the states and the central government as a bulwark against tyranny).

158. *See Davis*, 128 S. Ct. at 1808 (plurality opinion) (“[T]he Framers’ distrust of economic Balkanization was limited by their federalism favoring a degree of local autonomy.”); *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528, 546 (1985) (“The essence of our federal system is that within the realm of authority left open to them under the Constitution, the States must be equally free to engage in any activity that their citizens choose for the common weal . . .”).

159. The Supreme Court determined early on that the Commerce Clause power is not wholly exclusive. *See Cooley v. Bd. of Wardens*, 53 U.S. (12 How.) 298, 319 (1851); *Willson v. Black Bird Creek Marsh Co.*, 27 U.S. (2 Pet.) 245, 252 (1829).

160. Ernest A. Young, *Dual Federalism, Concurrent Jurisdiction, and the Foreign Affairs Exception*, 69 GEO. WASH. L. REV. 139, 139 (2001) (“By 1950, . . . the Court switched to a regime of *concurrent* regulatory jurisdiction, with state regulatory authority existing absent discrimination or a clear statement of preemptive congressional intent . . .”).

161. *Breker-Cooper*, *supra* note 151, at 895 (“There has never been any serious doubt that if Congress chose to regulate interstate commerce, any inconsistent state regulation would be invalidated by virtue of the supremacy clause.” (citing U.S. CONST. art. VI, cl. 2)).

162. *See, e.g., S.C. State Highway Dep’t v. Barnwell Bros.*, 303 U.S. 177, 185 (1938); *see also United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1796 (2007) (plurality opinion) (allowing flow-control ordinances for solid waste); *Cooley*, 53 U.S. (12 How.) at 313–14 (allowing governance to occur at the local level where uniform regulation would be impractical).

163. *Cooley*, 53 U.S. (12 How.) at 313–14.

164. *The Carrie L. Tyler*, 106 F. 422, 424 (4th Cir. 1901).

165. *State v. Bundrant*, 546 P.2d 530, 538–39 (Alaska 1976).

encumbers interstate commerce.¹⁶⁶ The dormant Commerce Clause is concerned with “economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.”¹⁶⁷ Accordingly, the dormant Commerce Clause is limited to the prevention of state regulation that discriminates against¹⁶⁸ or improperly burdens interstate commerce.¹⁶⁹

Part I.B.1 begins with a review of the standard dormant Commerce Clause analysis the Supreme Court has developed to determine whether an ordinance violates the Commerce Clause. Part I.B.2 addresses the market participation exception to the dormant Commerce Clause analysis—an exception that allows states to favor their own citizens without violating the dormant Commerce Clause, when acting in the marketplace as a market participant. Part I.B.3 discusses the government entity exception to the dormant Commerce Clause analysis—a newly recognized exception that allows states to provide economic protection for government entities without violating the dormant Commerce Clause. Finally, Part I.B.4 discusses discriminatory tax practices to emphasize that such practices are subject to the same analysis as any other discriminatory law.

1. Standard Dormant Commerce Clause Analysis

To determine whether an ordinance affecting interstate commerce violates the Commerce Clause, the Supreme Court has developed two lines of analysis.¹⁷⁰ First, where a statute discriminates against interstate commerce, the law is “virtually *per se* invalid.”¹⁷¹ Second, where a statute does not discriminate against interstate commerce, the statute “will be upheld unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.”¹⁷² The separation between these lines of analysis is not complete,¹⁷³ and the Court has identified some common ground at the margins.¹⁷⁴

166. *Or. Waste Sys., Inc. v. Dep’t of Env’tl. Quality*, 511 U.S. 93, 98 (1994) (“[The] ‘negative’ aspect [of the Commerce Clause] . . . denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce.”).

167. *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 273–74 (1988).

168. *Or. Waste Sys.*, 511 U.S. at 99 (“If a restriction on commerce is discriminatory, it is virtually *per se* invalid.” (citing *Chem. Waste Mgmt. v. Hunt*, 504 U.S. 334, 344 n.6 (1992); *City of Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978))).

169. *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970) (“Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.” (citing *Huron Portland Cement Co. v. City of Detroit*, 362 U.S. 440, 443 (1960))).

170. *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 390 (1994).

171. *Or. Waste Sys.*, 511 U.S. at 99; see also *City of Philadelphia*, 437 U.S. at 624.

172. *Pike*, 397 U.S. at 142 (citing *Huron*, 362 U.S. at 443).

173. *Gen. Motors Corp. v. Tracy*, 519 U.S. 278, 298 n.12 (1997) (“There is . . . no clear line between these two strands of analysis” (citing *Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth.*, 476 U.S. 573, 579 (1986))).

174. *Id.* (noting cases where the Court applied one line of analysis while relying on the other line of analysis).

Under the first line of analysis, a statute discriminates against commerce when it treats in-state and out-of-state economic interests differently, to the benefit of the former and the burden of the latter.¹⁷⁵ Under this analysis, incidental effects on the free flow of commerce are not enough to render a statute discriminatory.¹⁷⁶ The fundamental purpose of the ordinance must be to protect in-state markets from out-of-state markets.¹⁷⁷ If that is the case—even if the underlying goal is legitimate—the ordinance is discriminatory.¹⁷⁸ The archetypical discriminatory law cordons commerce within the state.¹⁷⁹

However, discriminatory statutes are not automatically invalid.¹⁸⁰ If a statute is found to be discriminatory, it is merely presumed to be invalid.¹⁸¹ Such statutes can survive this presumption of invalidity if they “advance[] a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.”¹⁸² Regardless, the standard for overcoming the presumption is very high.¹⁸³ “At a minimum such facial discrimination invokes the strictest scrutiny of any purported legitimate local purpose and of the absence of nondiscriminatory alternatives.”¹⁸⁴

The second line of analysis addresses statutes that do not discriminate against interstate commerce.¹⁸⁵ Where a statute does not discriminate against interstate commerce, the statute “will be upheld unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.”¹⁸⁶ This examination, adopted in *Pike v. Bruce Church, Inc.*¹⁸⁷ and commonly referred to as the *Pike* test,¹⁸⁸ is a cost-

175. *Or. Waste Sys.*, 511 U.S. at 99.

176. *Id.* (citing *Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979)).

177. *See Chem. Waste Mgmt., Inc. v. Hunt*, 504 U.S. 334, 342 (1992).

178. *See, e.g., id.* (holding a surcharge on out-of-state hazardous waste enacted for environmental benefit to be discriminatory); *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 522–24 (1935) (holding a statute preventing sale of out-of-state milk below in-state price floor for public health purpose to be discriminatory).

179. *Maine v. Taylor*, 477 U.S. 131, 138 (1986) (“In determining whether a State has overstepped its role in regulating interstate commerce, this Court has distinguished between state statutes that burden interstate transactions only incidentally, and those that affirmatively discriminate against such transactions.”).

180. *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988).

181. *See id.*

182. *Id.*

183. *Id.*

184. *Hughes v. Oklahoma*, 441 U.S. 322, 337 (1979).

185. *But see* Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091, 1283–84 (1986) (arguing that cases decided under the second line of analysis are actually invalid because of their discriminatory character).

186. *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970) (citing *Huron Portland Cement Co. v. City of Detroit*, 362 U.S. 440, 443 (1960)).

187. 397 U.S. 137 (1970).

188. *See, e.g., James D. Fox, State Benefits Under the Pike Balancing Test of the Dormant Commerce Clause: Putative or Actual?*, 1 AVE MARIA L. REV. 175, 175 (2003) (referring to the inquiry as the “*Pike* balancing test”). Note that the Court does not consistently apply the same term for this test. *See Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1808, 1817–18 (2008) (plurality opinion) (referring to the *Pike* test as, alternately,

benefit analysis.¹⁸⁹ It applies to laws that are directed at legitimate local concerns that have only an incidental effect upon interstate commerce.¹⁹⁰ Under the *Pike* test, a court first looks for a legitimate purpose and then measures the degree of benefit that the statute provides.¹⁹¹ Next, the court examines the burden.¹⁹² “[T]he extent of the burden that will be tolerated will . . . depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities.”¹⁹³ This is a low-threshold analysis; thus, laws normally survive.¹⁹⁴

There is no bright line separating “the category of state regulation that is virtually *per se* invalid under the Commerce Clause, and the category subject to the *Pike* balancing approach.”¹⁹⁵ Some academics have argued that this lack of distinction belies the illusory nature of the *Pike* balancing test.¹⁹⁶ Whether or not the *Pike* test is actually illusory and the Court is merely “suppressing protectionism” while claiming to apply it,¹⁹⁷ the Court

“*Pike* scrutiny,” “*Pike* enquiry,” “*Pike* balancing,” “*Pike* examination,” “*Pike* burden,” and “*Pike* comparison”); *Gen. Motors Corp. v. Tracy*, 519 U.S. 278, 298 n.12 (1997) (referring to it as the “undue burden test”).

189. *Davis*, 128 S. Ct. at 1817 (plurality opinion); *City of Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978); *Pike*, 397 U.S. at 142 (1970).

190. *Davis*, 128 S. Ct. at 1817 (plurality opinion); *City of Philadelphia*, 437 U.S. at 624; *Pike*, 397 U.S. at 142.

191. *Pike*, 397 U.S. at 142. The *Pike* test has also been framed as a three-prong inquiry. *See Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979) (“Under [the *Pike* test], we must inquire (1) whether the challenged statute regulates evenhandedly with only ‘incidental’ effects on interstate commerce, or discriminates against interstate commerce either on its face or in practical effect; (2) whether the statute serves a legitimate local purpose; and, if so, (3) whether alternative means could promote this local purpose as well without discriminating against interstate commerce.”). It is unclear whether this formulation is substantially different from the application outlined in *Pike* itself.

192. *Pike*, 397 U.S. at 142.

193. *Id.*

194. *See, e.g., Nw. Cent. Pipeline Corp. v. State Corp. Comm’n*, 489 U.S. 493, 525–26 (1989); *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 471 (1981).

195. *Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth.*, 476 U.S. 573, 579 (1986).

196. *See Fox*, *supra* note 188, at 213 (finding the *Pike* balancing test to be “ad-hoc” and “case-by-case” rather than a disciplined approach); *Regan*, *supra* note 185, at 1284–87 (finding the *Pike* test to be a general avenue to “suppress[] protectionism” as opposed to an actual balancing test). Many of these complaints stem from the difficulty courts have weighing the benefits and burdens of legislation and balancing the values against each other. *See Fox*, *supra* note 188, at 189. Justice Scalia has likened this process to “judging whether a particular line is longer than a particular rock is heavy,” *Bendix Autolite Corp. v. Midwesco Enters., Inc.*, 486 U.S. 888, 897 (1988) (Scalia, J., concurring), and has repeatedly expressed the belief that the balancing of the benefits and burdens of legislation is better left to the legislature. *See Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1821 (2008) (Scalia, J., concurring); *Bendix Autolite*, 486 U.S. at 895–98 (Scalia, J., concurring). Despite such criticisms, courts have continued to use the *Pike* analysis. *See, e.g., Ford Motor Co. v. Tex. Dep’t of Transp.*, 264 F.3d 493, 503 (5th Cir. 2001); *U & I Sanitation v. City of Columbus*, 205 F.3d 1063, 1070 (8th Cir. 2000); *Ass’n of Int’l Auto. Mfrs. v. Abrams*, 84 F.3d 602, 612–13 (2d Cir. 1996).

197. *Regan*, *supra* note 185, at 1284–87.

has continued to employ *Pike*,¹⁹⁸ at least in those cases where they are institutionally suited to do so.¹⁹⁹

2. Market Participation Exception

The Court has recognized a fundamental difference between market regulation and market participation.²⁰⁰ The Commerce Clause is directed at market regulation²⁰¹ and, by extension, so is the dormant Commerce Clause.²⁰² Market participation, however, exists outside of the realm of market regulation.²⁰³ The Commerce Clause was designed to break down trade barriers among the states;²⁰⁴ it was not intended to regulate state and local governments when they are participating in the marketplace.²⁰⁵

To address this difference, the Court developed an exception to the standard Commerce Clause analysis for states “that go beyond regulation and themselves ‘participat[e] in the market’ so as to ‘exercis[e] the right to favor [their] own citizens over others.’”²⁰⁶ Under the market participant doctrine, states may favor their own citizens when buying or selling goods or services without violating the dormant Commerce Clause.²⁰⁷ This exception constitutes “a single inquiry: whether the challenged ‘program constitute[s] direct state participation in the market.’”²⁰⁸ Conflicts arising under the market participation exception focus on whether the state action constitutes regulation or participation in the marketplace.²⁰⁹

198. *United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1797–98 (2007) (plurality opinion) (applying the *Pike* test).

199. *Davis*, 128 S. Ct. at 1817–19 (plurality opinion) (determining that the judicial branch was not institutionally suited to perform a *Pike* test on the differential tax scheme); see also *Fulton Corp. v. Faulkner*, 516 U.S. 325, 342 (1996) (“[C]ourts as institutions are poorly equipped to evaluate with precision the relative burdens of various methods of taxation. The complexities of factual economic proof always present a certain potential for error, and courts have little familiarity with the process of evaluating the relative economic burden of taxes.” (quoting *Minneapolis Star & Tribune Co. v. Minn. Comm’r of Revenue*, 460 U.S. 575, 589–90 (1983))).

200. See *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 807–10 (1976).

201. U.S. CONST. art. I, § 8, cl. 3 (“The Congress shall have Power To . . . regulate Commerce . . . among the several States . . .”).

202. *Davis*, 128 S. Ct. at 1808 (plurality opinion) (“[A]lthough its terms do not expressly restrain ‘the several States’ in any way, we have sensed a negative implication in the provision since the early days . . .”).

203. *Reeves, Inc. v. Stake*, 447 U.S. 429, 436 (1980); see also *Hughes*, 426 U.S. at 810 (“Nothing in the purposes 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.”).

204. *Hughes*, 426 U.S. at 807; *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 533–35 (1949).

205. *White v. Mass. Council of Constr. Employers, Inc.*, 460 U.S. 204, 208 (1983).

206. *Davis*, 128 S. Ct. at 1809 (plurality opinion) (quoting *Hughes*, 426 U.S. at 810).

207. David S. Bogen, *The Market Participant Doctrine and the Clear Statement Rule*, 29 SEATTLE U. L. REV. 543, 543 (2006).

208. *White*, 460 U.S. at 208 (quoting *Reeves*, 447 U.S. at 436 n.7).

209. See, e.g., *Davis*, 128 S. Ct. at 1811–14 (plurality opinion); *White*, 460 U.S. at 209–10.

In *Hughes v. Alexandria Scrap Corp.*,²¹⁰ the Supreme Court found that the State of Maryland had participated in the market for abandoned automobiles when it provided a bounty to licensed scrap processors for the destruction of any vehicle previously titled in Maryland.²¹¹ The State created the bounty to alleviate its aesthetic problem of abandoned vehicles.²¹² In an attempt to limit this bounty to vehicles abandoned in Maryland, the State required non-Maryland scrap processors to provide additional documentation in order to collect.²¹³ Although this additional documentation was ostensibly a protection for automobile owners against unlawful conversion, the Court recognized that the documentation requirements were an encumbrance on the free transfer of such vehicles²¹⁴ and hampered the free flow of such vehicles across state lines.²¹⁵ Regardless, the Court determined that the Maryland statute was not the kind of law the Commerce Clause was designed to prevent.²¹⁶ By bidding up the price of abandoned automobiles, the State entered the market as a purchaser.²¹⁷ When acting as a purchaser, any state is able to “restrict[] its trade to its own citizens or businesses.”²¹⁸ “Nothing in the purposes 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.”²¹⁹ In *Hughes*, Maryland did not interfere with the integrity of the market; it participated in it.²²⁰

Similarly, the Court in *Reeves, Inc. v. Stake*²²¹ found that South Dakota acted as a market participant when, in a time of shortage, it restricted the sale of cement produced at a state-owned plant to South Dakotans.²²² The state-owned plant was originally built for the sole benefit of South Dakotans during an earlier time of shortage.²²³ Over the years, however, the plant produced more cement than the people could use and the plant began selling to out-of-state purchasers.²²⁴ In 1978, demand far outpaced

210. 426 U.S. 794 (1976).

211. *Id.* at 813–14.

212. *Id.* at 796. By rewarding scrap processors for destroying abandoned vehicles, Maryland incentivized the delivery of such vehicles and thereby sped its scrap cycle. *Id.* at 797.

213. *Id.* at 800–01. The additional documentation requirement, which was actually an amendment to the original statute, only applied to one category of abandoned automobiles, hulks (automobiles over eight years old that are inoperable). *Hughes*, 426 U.S. at 798, 800–01; see MD. CODE ANN., TRANSP. § 25-210(b) (LexisNexis 2009). At the time, hulks accounted for ninety-six percent of the market. *Hughes*, 426 U.S. at 800–01.

214. *Hughes*, 426 U.S. at 798.

215. *Id.* at 805.

216. *Id.*

217. *Id.* at 808.

218. *Id.*

219. *Id.* at 810 (footnotes omitted).

220. *Id.* at 806.

221. 447 U.S. 429 (1980).

222. *Id.* at 447 (Powell, J., dissenting).

223. *Id.* at 430–33 (majority opinion).

224. *Id.* at 432 (“Between 1970 and 1977, some 40% of the plant’s output went outside the State.”).

production and the plant returned to its earlier policy of serving South Dakota customers first.²²⁵ Reeves, Inc., an out-of-state ready-mix concrete distributor that was forced to cut production by seventy-six percent as a result of the resident-preference policy, brought suit against South Dakota for hoarding its resources in violation of the dormant Commerce Clause.²²⁶ The Court ultimately determined that the State was not hoarding its resources but was acting as a trader/manufacturer.²²⁷ In its capacity as a trader/manufacturer, the Court determined that, “when acting as proprietors, States should . . . share existing freedoms from federal constraints, including the inherent limits of the Commerce Clause.”²²⁸

Conversely, the Court did not find that Alaska acted as a market participant in *South-Central Timber Development, Inc. v. Wunnicke*.²²⁹ There, Alaska, under a special provision of a contract to sell timber, required purchasers to partially process the purchased timber in-state.²³⁰ The state argued that the provision was indistinguishable from the subsidy in *Alexandria Scrap*.²³¹ The Court held otherwise: “when Maryland became involved in the scrap market it was as a purchaser of scrap; Alaska, on the other hand, participates in the timber market, but imposes conditions downstream in the timber-processing market.”²³² The difference between directly subsidizing Alaskan timber processing and forcing buyers to employ such processing as a condition for purchase distinguished the practices.²³³ Fearful that the market participation exception would swallow the entire rule, the Court determined that “[t]he State may not impose conditions, whether by statute, regulation, or contract, that have a substantial regulatory effect outside of [the] particular market [in which they are participating].”²³⁴ In doing so, the Court formally rejected the argument that a state may act as a market regulator when the same end could have been achieved by the state as a market participant.²³⁵

225. *Id.*

226. *Id.* at 433. States may not hoard their resources under the guise of preserving them. See *Hughes v. Oklahoma*, 441 U.S. 322, 338 (1979) (invalidating Oklahoma law preventing commercial exportation of minnows born in natural streams); *City of Philadelphia v. New Jersey*, 437 U.S. 617, 629 (1978) (invalidating New Jersey statute conserving landfill space for benefit of residents); *Foster-Fountain Packing Co. v. Haydel*, 278 U.S. 1, 13–14 (1928) (invalidating Louisiana act forbidding interstate transportation of shrimp before in-state processing).

227. *Reeves*, 447 U.S. at 440 (“South Dakota, as a seller of cement, unquestionably fits the ‘market participant’ label more comfortably than a State acting to subsidize local scrap processors.”).

228. *Id.* 438–39.

229. 467 U.S. 82 (1984).

230. *Id.* at 99.

231. *Id.* at 95.

232. *Id.*

233. *Id.*

234. *Id.* at 97.

235. *Id.* at 98–99.

3. Government Entity Exception

The Court has also recognized a fundamental difference between economic protection of a private entity and economic protection of a government entity.²³⁶ Economic protection of government entities is not susceptible to standard Commerce Clause scrutiny.²³⁷ The Court based this decision on its determination that laws favoring states and municipalities are presumptively aimed at legitimate goals completely unrelated to protectionism.²³⁸ Rather than trying to protect in-state markets, laws favoring government entities are presumed to protect the health, safety, and welfare of the citizenry, and because these laws are not aimed at economic protectionism, they should not be invalidated by the dormant Commerce Clause.²³⁹ For convenience of use, this Note will refer to this exception as the “government entity exception.”²⁴⁰

An ordinance may benefit a public facility as long as it treats all private entities exactly the same.²⁴¹ This assertion derives from the tacit assumption that discrimination requires a comparison between substantially similar entities.²⁴² “[W]hen the allegedly competing entities provide different products, . . . there is a threshold question whether the [entities] are indeed similarly situated for constitutional purposes.”²⁴³ If the entities are not similarly situated, the entities are serving different markets and the bedrock purpose of the dormant Commerce Clause—“prohibit[ing] state or municipal laws whose object is local economic protectionism”²⁴⁴—is not served.²⁴⁵ Thus, where there is no competition between substantially similar entities, there is no local economic protectionism to prevent.²⁴⁶ Public and private facilities do not provide substantially similar products.²⁴⁷ “Unlike private enterprise, government is vested with the responsibility of protecting the health, safety, and welfare of its citizens.”²⁴⁸ Laws favoring government may be directed toward these cardinal civic responsibilities.²⁴⁹

236. *United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1795 (2007) (plurality opinion).

237. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1810 (2008) (plurality opinion).

238. *Davis*, 128 S. Ct. at 1809 (plurality opinion); *United Haulers*, 127 S. Ct. at 1795 (plurality opinion).

239. *Davis*, 128 S. Ct. at 1809 (plurality opinion); *United Haulers*, 127 S. Ct. at 1796 (plurality opinion).

240. The Court has drawn a sharp distinction between this exception and the market participant exception. *See Davis*, 128 S. Ct. at 1809 (plurality opinion) (“[*United Haulers*] was decided independently of the market participation precedents.”).

241. *United Haulers*, 127 S. Ct. at 1795 (plurality opinion).

242. *Gen. Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997).

243. *Id.* at 299.

244. *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 390 (1994).

245. *Gen. Motors*, 519 U.S. at 299.

246. *Id.* at 300.

247. *United Haulers*, 127 S. Ct. at 1795 (plurality opinion).

248. *Id.*

249. *Id.* at 1796.

The government entity exception is further justified as benefiting processes that are outside the ambit of the Commerce Clause.²⁵⁰ The dormant Commerce Clause is aimed at economic protectionism.²⁵¹ “[A] government function is not susceptible to standard dormant Commerce Clause scrutiny owing to its likely motivation by legitimate objectives distinct from the simple economic protectionism the Clause abhors.”²⁵² The Court warned against interfering “under the guise of the Commerce Clause” in cases where the state or municipality is engaging in “traditional governmental function[s].”²⁵³

Lastly, the Court identified additional reasons for recognizing a special exemption for laws that favor government entities.²⁵⁴ First, “treating public and private entities the same under the dormant Commerce Clause would lead to unprecedented and unbounded interference by the courts with state and local government.”²⁵⁵ The Commerce Clause precludes states from burdening the flow of interstate commerce; it does not give federal courts carte blanche to dictate the practices of state and local government.²⁵⁶ Second, in every prior application of the government entity exemption, the group bearing the greatest burden ratified the ordinance.²⁵⁷ Standard violations of the dormant Commerce Clause entail one state shifting its burdens onto its sister states.²⁵⁸ “[T]he Court has often recognized that to the extent that the burden of state regulation falls on interests outside the state, it is unlikely to be alleviated by the operation of those political restraints normally exerted . . .”²⁵⁹ Where those burdened by a law approve its implementation, “[t]here is no reason to step in and hand local businesses a victory they could not obtain through the political process.”²⁶⁰

In *United Haulers*, the Court found that Oneida County and Herkimer County did not violate the dormant Commerce Clause when they required all trash haulers to deliver solid waste to a single, publicly operated waste

250. *Id.*

251. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1808 (2008) (plurality opinion).

252. *Id.* at 1810 (citing *United Haulers*, 127 S. Ct. at 1796 (plurality opinion)).

253. *Id.* (citing *United Haulers*, 127 S. Ct. at 1796 (plurality opinion)). Thus far, the Court has only identified trash disposal and taxation of municipal bonds as traditional government functions. See *Davis*, 128 S. Ct. at 1811 (plurality opinion); *United Haulers*, 127 S. Ct. at 1798 (plurality opinion).

254. See *Davis*, 128 S. Ct. at 1810–11 (plurality opinion); *United Haulers*, 127 S. Ct. at 1795–97 (plurality opinion).

255. *United Haulers*, 127 S. Ct. at 1796 (plurality opinion).

256. *Id.*; *Maine v. Taylor*, 477 U.S. 131, 151 (1986).

257. See *Davis*, 128 S. Ct. at 1815 (plurality opinion) (determining that every state in the union affirmatively supports the discriminatory tax policy); *United Haulers*, 127 S. Ct. at 1797 (plurality opinion) (determining that most palpable harm falls on the citizens who voted for the ordinance).

258. *United Haulers*, 127 S. Ct. at 1797 (plurality opinion) (“Our dormant Commerce Clause cases often find discrimination when a State shifts the costs of regulation to other States . . .”).

259. *S. Pac. Co. v. Arizona ex rel. Sullivan*, 325 U.S. 761, 767–68 n.2 (1945).

260. *United Haulers*, 127 S. Ct. at 1797 (plurality opinion).

processing facility.²⁶¹ The counties passed the ordinance in response to a solid waste “crisis” threatening the health and safety of their citizens.²⁶² Under the ordinance, the Oneida-Herkimer Solid Waste Management Authority (the Authority), a public benefit corporation, became the only authorized solid waste processor.²⁶³ Private entities remained free to collect solid waste, but they were required to dispose of the waste at facilities owned and operated by the Authority.²⁶⁴ To cover the cost of recycling and remediation—functions ignored by private waste processing facilities in the lead-up to the solid waste crisis—these facilities collected above-market disposal charges.²⁶⁵ Private haulers sued.²⁶⁶ The private haulers argued that the flow-control laws violated the dormant Commerce Clause by keeping commerce within the boundaries of the state.²⁶⁷

The Court determined that this was not the type of ordinance with which the Commerce Clause was concerned.²⁶⁸ In doing so, the Court drew an important distinction between *United Haulers* and an earlier case with nearly identical facts, *C & A Carbone, Inc. v. Town of Clarkstown*.²⁶⁹ In *Carbone*, the Court found that a similar flow-control ordinance violated the dormant Commerce Clause.²⁷⁰ The *United Haulers* Court recognized the overlap between the cases but identified a key difference: the ordinance in *Carbone* supported a private facility; the ordinance in *United Haulers* supported a public one.²⁷¹ Based on the inherent differences between a public company and a private company, the Court determined that the *United Haulers* ordinance was excepted from the standard dormant Commerce Clause analysis.²⁷²

In *Davis*, the Court found that Kentucky did not violate the dormant Commerce Clause when it exempted state income taxes on income earned from in-state municipal bonds while taxing out-of-state municipal bonds.²⁷³ Kentucky passed this differential tax system to lower interest rates on

261. *Id.* at 1798.

262. *Id.* at 1790.

263. *Id.* at 1791.

264. *Id.*

265. *Id.*

266. *Id.* at 1792.

267. *Id.*

268. *Id.* at 1797 (“We hold that the Counties’ flow control ordinances, which treat in-state private business interests exactly the same as out-of-state ones, do not discriminate against interstate commerce for purposes of the dormant Commerce Clause.” (internal quotation marks omitted)).

269. *Id.* at 1793–95; *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 395 (1994).

270. *Carbone*, 511 U.S. at 395; see also *United Haulers*, 127 S. Ct. at 1793–95 (plurality opinion) (comparing the flow-control ordinance in *Carbone* to the flow-control ordinance in *United Haulers*).

271. *United Haulers*, 127 S. Ct. at 1793 (plurality opinion).

272. *Id.* at 1795–97.

273. *Id.* at 1819. This is an example of the discriminatory tax system that is ubiquitous in the United States. See *supra* notes 119–23 and accompanying text.

Kentucky bonds.²⁷⁴ Kentucky residents who paid income tax on interest earned from out-of-state municipal bonds sued.²⁷⁵ According to these residents, the selective tax exemption for in-state municipal bonds violated the dormant Commerce Clause by effectively banning out-of-state municipal bonds from Kentucky markets.²⁷⁶ The Court ruled in favor of Kentucky and determined that the selective tax exemption for municipal bonds—at least, as applied to those municipal bonds that finance public entities—is not the type of ordinance with which the Commerce Clause was concerned.²⁷⁷

4. Discriminatory Taxation

Discriminatory taxation is not subject to a separate analysis under the dormant Commerce Clause.²⁷⁸ Discriminatory tax cases are subject to the same inquiry as any other discriminatory law.²⁷⁹ Some states have attempted to justify discriminatory taxation under the market participant exception or as an equivalent measure to providing a subsidy.²⁸⁰ The Court has repeatedly found these arguments unavailing.²⁸¹

In *New Energy Co. of Indiana v. Limbach*,²⁸² the Court found that Indiana violated the dormant Commerce Clause when it offered tax credits for motor vehicle fuel sales but limited the tax credit to motor vehicle fuel produced either in-state or in a state that offered a reciprocal tax benefit.²⁸³ The state created the tax credit to spur the production of ethanol, an automotive fuel with environmental benefits over carbon-based fuel.²⁸⁴ Absent government aid, ethanol was too expensive to produce on a commercial scale.²⁸⁵ The State also included a reciprocity provision in the tax credit that limited the credit to ethanol produced in-state and ethanol produced in a state offering a reciprocal tax credit.²⁸⁶ According to Indiana, the reciprocity provision encouraged other states to adopt similar tax provisions, thereby making ethanol more cost effective.²⁸⁷ Indiana also advanced the alternative argument that, similar to Maryland's purchase of

274. *Davis*, 128 S. Ct. at 1805 (plurality opinion).

275. *Id.*

276. Brief for Respondents at 1, *Davis*, 128 S. Ct. 1801 (No. 06-666), 2007 WL 2808463, at *4.

277. *Davis*, 128 S. Ct. at 1817 (plurality opinion).

278. *See New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988).

279. *See id.*

280. *See id.* at 277–78; *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 588–89 (1997).

281. *See, e.g., New Energy*, 486 U.S. at 277–78; *Camps Newfound/Owatonna*, 520 U.S. at 589–90.

282. 486 U.S. 269 (1988).

283. *Id.* at 280.

284. *Id.* at 271.

285. *Id.*

286. *Id.* at 272.

287. *Id.* at 274.

automobile hulks in *Alexandria Scrap*,²⁸⁸ Indiana was participating in the market for ethanol and subject to the protection of the market participant exception.²⁸⁹ The Court found both of these arguments unconvincing.²⁹⁰ According to the Court, discriminatory taxation ordinarily violates the dormant Commerce Clause.²⁹¹ Here, the discriminatory taxation violated the dormant Commerce Clause because it created an economic barrier to competition.²⁹² By depriving certain products of a generally available beneficial tax treatment, the State created what amounted to a tariff.²⁹³ Furthermore, the State could not claim the protection of the market participant exception because taxation is a “primeval governmental activity” completely separate from market participation.²⁹⁴ While the tax credit scheme was economically equivalent to a state subsidy, the economic equivalence of tax to a subsidy does not make the tax constitutional.²⁹⁵ Taxation is a regulatory activity.²⁹⁶ Generally, when a state assesses and computes taxes, it acts as a market regulator, not a market participant.²⁹⁷

In *Camps Newfound/Owatonna, Inc. v. Town of Harrison*,²⁹⁸ the Court found that Maine violated the dormant Commerce Clause when it offered a property tax exemption on property owned by charitable institutions, but limited the exemption to charitable institutes operated for the principal benefit of Maine residents.²⁹⁹ A Maine nonprofit summer camp operating for the benefit of children of the Christian Science faith challenged the constitutionality of the property tax exemption as applied to charities operated for the principle benefit of nonresidents.³⁰⁰ While the camp did not organize for the explicit purpose of serving nonresidents, ninety-five percent of its campers were residents of other states.³⁰¹ The State claimed that the tax was an expenditure of government money to lessen its social service burden.³⁰² According to this argument, the State used the disparate real estate tax treatment to subsidize charities furthering the health, safety, and welfare of Maine citizens.³⁰³ In the alternative, Maine argued that, similar to Maryland’s purchase of automobile hulks in *Alexandria Scrap*, Maine was a purchaser in the market for charitable services and was

288. See *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 810 (1976).

289. *New Energy*, 486 U.S. at 277.

290. *Id.* at 277–78.

291. *Id.*

292. *Id.* at 275.

293. *Id.*

294. *Id.* at 277.

295. *Id.* at 278 (“Direct subsidization of domestic industry does not ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufacturers does.”).

296. *Id.*

297. *Id.* at 277–78.

298. 520 U.S. 564 (1997).

299. *Id.* at 595.

300. *Id.* at 567.

301. *Id.*

302. *Id.* at 588.

303. *Id.* at 588–89.

protected by the market participant exception.³⁰⁴ First, the Court rejected the argument that the disparate real estate tax was equivalent to a subsidy.³⁰⁵ Instead, the Court stated that there is a constitutionally significant difference between taxes and subsidies.³⁰⁶ The Court reasoned that while a subsidy ordinarily imposes no burden on interstate commerce, discriminatory taxes generally run afoul of the Commerce Clause.³⁰⁷ Next, the Court rejected the argument that the disparate real estate tax was equivalent to market participation.³⁰⁸ Relying heavily on its decision in *New Energy*, the Court determined that “[a] tax exemption is not the sort of direct state involvement in the market that falls within the market participation doctrine.”³⁰⁹

Part I.A discussed municipal bonds generally.³¹⁰ State and local governments are often authorized to issue municipal bonds provided that each issue has a public purpose.³¹¹ State and local governments have relatively few substantive limitations on their ability to issue bonds but, as a practical matter, federal and state tax laws determine the types of bonds that are issued.³¹² The current market for municipal bonds is enormous.³¹³

Part I.B discussed the dormant Commerce Clause.³¹⁴ The states are restrained from regulating interstate commerce.³¹⁵ However, states may participate in interstate commerce so long as their ultimate goal is not local economic protectionism.³¹⁶ The Court has developed an elaborate body of law to determine the ultimate goal of a given state action.³¹⁷

The question that emerges is whether states violate the dormant Commerce Clause when they apply a discriminatory tax system to conduit bonds. The Court has already determined that states may apply a discriminatory tax to governmental bonds.³¹⁸ Ultimately, the issue is whether the differences between conduit bonds and governmental bonds render the reasoning of *Davis* inapplicable. Advocates have come out on each side of this issue.

Part II of this Note discusses the alternate appraisals between proponents and critics of the discriminatory taxation of conduit bonds and how that appraisal affects the dormant Commerce Clause analysis.

304. *Id.* at 589.

305. *Id.* at 589–90.

306. *Id.*

307. *Id.* at 591.

308. *Id.* at 593.

309. *Id.*

310. *See supra* Part I.A.

311. *See supra* Part I.A.1.

312. *See supra* Part I.A.2.a–b.

313. *See supra* Part I.A.2.c.

314. *See supra* Part I.B.

315. *See supra* Part I.B.

316. *See supra* Part I.B.

317. *See supra* Part I.B.

318. *See supra* Part I.B.3.

II. ALTERNATE APPRAISALS: HOW THE QUESTION OF WHETHER CONDUIT BONDS ADVANCE THE CARDINAL CIVIC RESPONSIBILITIES OF GOVERNMENT SHAPES THE DORMANT COMMERCE CLAUSE ANALYSIS

States can apply differential tax treatment to in-state and out-of-state government bonds without violating the Commerce Clause.³¹⁹ It is unclear, however, whether it is constitutional for states to apply the differential tax treatment to in-state and out-of-state conduit bonds.³²⁰ Amici have come out on both sides of the issue.

One group of amici has argued that states may tax in-state and out-of-state conduit bonds differently without violating the Commerce Clause.³²¹ These amici—herein referred to as “proponents of differential taxation”—maintain that the *Davis* holding applies equally to every type of municipal bond.³²² According to proponents of differential taxation, the fact that conduit bonds occasionally finance private activities does not upset the *Davis* analysis.³²³

A separate group of amici has argued that states cannot apply differential tax treatment to conduit bonds without violating the Commerce Clause.³²⁴ These amici—“critics of differential taxation”—argue that the private character of conduit bonds renders the logic of *Davis* inapplicable.³²⁵ Critics of differential taxation further argue that, in addition to being distinguishable from *Davis*,³²⁶ the differential taxation of conduit bonds is unconstitutional under the standard dormant Commerce Clause analysis.³²⁷

319. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1819 (2008) (plurality opinion).

320. *Id.* at 1805 n.2. When determining the scope of its ruling, the Court drew a distinction between municipal bonds and state-issued “private-activity” bonds. *Id.*; see also *supra* note 1 (discussing the difference between “private-activity” bonds and “conduit” bonds).

321. Brief of the Government Finance Officers Ass’n et al. as Amici Curiae Supporting Petitioners, *Davis*, 128 S. Ct. 1801 (No. 06-666), 2007 WL 2115436 [hereinafter GFOA Brief]; Brief of Multistate Tax Commission as Amicus Curiae in Support of Petitioners, *Davis*, 128 S. Ct. 1801 (No. 06-666), 2007 WL 2115443 [hereinafter Multistate Tax Comm’n Brief]; Brief of the National Ass’n of State Treasurers as Amicus Curiae Supporting Petitioners, *Davis*, 128 S. Ct. 1801 (No. 06-666), 2007 WL 2088645 [hereinafter NAST Brief]; Brief Amicus Curiae of Nuveen Investments, Inc. in Support of Petitioners, *Davis*, 128 S. Ct. 1801 (No. 06-666), 2007 WL 2088646 [hereinafter Nuveen Brief]; SIFMA Brief, *supra* note 112.

322. GFOA Brief, *supra* note 321, at 16–23 (arguing that states and local governments have the authority to apply differential taxation to all state and local obligations); Multistate Tax Comm’n Brief, *supra* note 321, at 11–13 (same); NAST Brief, *supra* note 321, at 2, 9–10 (same); Nuveen Brief, *supra* note 321, at 7–10 (same).

323. GFOA Brief, *supra* note 321, at 16–22; Multistate Tax Comm’n Brief, *supra* note 321, at 11–13; NAST Brief, *supra* note 321, at 2, 9–10; Nuveen Brief, *supra* note 321, at 6–10.

324. Brief of the Tax Foundation as Amicus Curiae in Support of Respondents, *Davis*, 128 S. Ct. 1801 (No. 06-666), 2007 WL 2808464 [hereinafter Tax Found. Brief]; Viard Brief, *supra* note 120.

325. Viard Brief, *supra* note 120, at 25.

326. *Id.* at 8 (distinguishing government bonds from bonds issued for the benefit of private parties).

327. Tax Found. Brief, *supra* note 324, at 5–10; Viard Brief, *supra* note 120, at 9–13.

At the heart of this conflict is the appraisal of conduit bonds.³²⁸ Proponents of differential taxation have determined that conduit bonds advance the cardinal civic responsibilities of government.³²⁹ Critics of differential taxation have determined that conduit bonds do not advance the cardinal civic responsibilities of government.³³⁰ These determinations underlie and inform every argument for and against finding the differential tax treatment of in-state and out-of-state conduit bonds to be constitutional.³³¹ Understanding the larger conflict between proponents and critics of differential taxation requires understanding both why amici disagree about how to appraise conduit bonds³³² and how that appraisal influences each argument.³³³

A. *The Appraisal of Conduit Bonds*

The basis of the argument of proponents of differential taxation is that conduit bonds advance the cardinal civic responsibilities of government.³³⁴ Municipal bonds cannot be issued for the sole benefit of private industry.³³⁵ Even where private industries are the direct recipients of the tax benefit, as is the case for conduit bonds, the ultimate beneficiary must be the citizenry.³³⁶ Were that not the case, the bond issuance would be unconstitutional regardless of the constitutionality of any subsequent taxation.³³⁷

Proponents of differential taxation find additional support in the inefficiency inherent in a contrary result.³³⁸ According to these amici,

328. Compare NAST Brief, *supra* note 321, at 3 (claiming that debt obligations issued by public bodies support essential government services, public works programs, and government operating requirements), with Viard Brief, *supra* note 120, at 25 (finding that roughly one-quarter of municipal bonds are issued for the benefit of private firms).

329. NAST Brief, *supra* note 321, at 3; Nuveen Brief, *supra* note 321, at 10 (“Municipal Bonds are used for . . . public purposes.”).

330. Viard Brief, *supra* note 120, at 25 (“Private-activity bonds, are issued by state and local governments acting merely as conduits for non-governmental organizations.”).

331. See *infra* Part II.B.

332. See *infra* Part II.A.

333. See *infra* Part II.B.

334. See NAST Brief, *supra* note 321, at 11 (explaining that conduit bonds advance public purposes); see also *supra* Part I.A.1 (explaining the public purpose doctrine).

335. *Green v. Frazier*, 253 U.S. 233, 238 (1920) (“[I]t has come to be settled that the authority of the States to tax does not include the right to impose taxes for merely private purposes.” (citing *Fallbrook Irrigation Dist. v. Bradley*, 164 U.S. 112, 155 (1896))).

336. *Bolton v. Wharton*, 161 S.E. 454, 457 (S.C. 1931).

337. See *id.*; *supra* notes 33–39 and accompanying text. The amici do not identify the public purpose doctrine but they do address the requirement that municipal bonds have a public purpose. See, e.g., NAST Brief, *supra* note 321, at 3 (finding municipal bonds “support essential government services and other government operating requirements, and . . . fund public works”); Nuveen Brief, *supra* note 321, at 6–7 (arguing that municipal bonds benefit the citizenry as opposed to discrete private interests).

338. GFOA Brief, *supra* note 321, at 24 (arguing that the economic impact of the selective tax system “is not properly understood as a ‘burden [upon] interstate commerce.’” (quoting *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 145 (1970))); NAST Brief, *supra* note 321, at 9–10.

when state and local governments issue conduit bonds they make the determination that it is more efficient to outsource their cardinal civic responsibilities than to perform the service themselves.³³⁹ States frequently make such determinations in other arenas.³⁴⁰ Since state and local governments are already allowed to selectively tax in-state and out-of-state government bonds, to prevent states and local governments from efficiently outsourcing that responsibility would be at best draconian and at worst perverse.³⁴¹

Critics of differential taxation challenge this characterization.³⁴² According to these amici, the constitutionality of a discriminatory tax system hinges on the beneficiary of the tax, not the service.³⁴³ Where the beneficiary of the tax is a government entity, the ordinance is protected under *Davis*.³⁴⁴ Where the ultimate beneficiary is a private entity, the ordinance is stripped of that protection.³⁴⁵

Critics of differential taxation find additional support from the history of conduit bonds, which can be and have been issued to benefit private industry.³⁴⁶ Congress passed the Revenue and Expenditure Control Act of 1968 (the 1968 Act) to deal with the increased volume of municipal bonds in support of private activity.³⁴⁷ The 1968 Act revoked the federal tax exemption for interest earned on bonds that supported industrial development.³⁴⁸ According to Congress, “since the primary obligor was not a State or political subdivision” such bonds “were not obligations of a State . . . or any political subdivision within the meaning of [the federal tax exemption statute].”³⁴⁹ Congress passed the Mortgage Subsidy Act of 1980 to address the dramatic increase in a subspecies of conduit bonds: mortgage subsidy bonds.³⁵⁰ These bonds, which were issued to finance mortgage loans for single-family homes, were not subject to the strictures of the Revenue and Expenditure Control Act of 1968.³⁵¹ Congress, still

339. See Nuveen Brief, *supra* note 321, at 10–11; see also NAST Brief, *supra* note 321, at 11; STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 17–19.

340. Robin Cheryl Miller, Annotation, *Privatization of Governmental Services by State or Local Governmental Agency*, 65 A.L.R. 5th 1, 1 (1999) (“Governmental privatization, under which private firms are engaged to provide services that civil servants might have provided, is a burgeoning phenomenon.”); see, e.g., *Burum v. State Comp. Ins. Fund*, 184 P.2d 505 (Cal. 1947) (discussing privatization of legal services); *Robinson v. Bd. of County Comm’rs*, 504 P.2d 263 (Kan. 1972) (discussing privatization of ambulance services).

341. See GFOA Brief, *supra* note 321, at 8–12; Nuveen Brief, *supra* note 321, at 10–11.

342. See Viard Brief, *supra* note 120, at 21–23.

343. See *id.*

344. See Dep’t of Revenue v. *Davis*, 128 S. Ct. 1801 (2008) (plurality opinion).

345. See *id.* at 1819.

346. See Viard Brief, *supra* note 120, at 25.

347. Pub. L. No. 90-364, 1968 U.S.C.C.A.N. (82 Stat.) 251.

348. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 12–13.

349. H.R. REP. NO. 90-1533, at 32 (1968) (Conf. Rep.).

350. Pub. L. No. 96-499, 1980 U.S.C.C.A.N. (94 Stat.) 2599. By 1980, the volume of mortgage subsidy bonds had grown to \$10.5 billion. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 13.

351. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 13. The Mortgage Subsidy Act of 1980 did not ban mortgage subsidy bonds, but it did limit the types

facing the expansion of the private-activity bond market, passed the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),³⁵² which further restricted the availability of the federal tax exemption for conduit bonds.³⁵³ A mere two years later, Congress was “extremely concerned with the volume of tax-exempt bonds used to finance private activities”³⁵⁴ and responded with the Deficit Reduction Act of 1984, which imposed volume limitations on the aggregate amount of such bonds.³⁵⁵ Two years after that, Congress passed the Tax Reform Act of 1986,³⁵⁶ legislation meant to quell the rising tide of tax-exempt conduit bonds.³⁵⁷ While these acts concern the federal tax exemption rather than the state tax exemption, they illustrate the tendency of state and local governments to issue municipal bonds for the benefit of private industry.³⁵⁸ Thus, despite the claims of the proponents of differential taxation, critics of differential taxation argue there is a legitimate likelihood of unnecessary privatization.³⁵⁹

Proponents of differential taxation challenge this characterization.³⁶⁰ Proponents assert the history of the federal tax exemption for conduit bonds only illustrates momentary federal budgetary concerns, not the constitutionality of the state and local government differential tax system.³⁶¹ They argue that one of the measures outlined above challenged the legality of the differential tax system.³⁶² This position is buttressed by subsequent congressional measures to increase the ambit of the federal tax exemption for conduit bonds and lessen the volume limitations on the aggregate amount of such bonds.³⁶³

This disagreement is the fundamental conflict between proponents and critics of differential taxation.³⁶⁴ Every other argument about the

of mortgage subsidy bonds that are entitled to the federal subsidy. *Id.* Today, two types of mortgage subsidy bonds are entitled to the federal subsidy: qualified mortgage bonds and qualified veterans’ mortgage bonds. I.R.C. § 146(e)(1)(A), (C) (2006).

352. Pub. L. No. 97-248, 1982 U.S.C.C.A.N. (96 Stat.) 324.

353. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 13–14.

354. STAFF OF JOINT COMM. ON TAXATION, ACT OF 1986, *supra* note 67, at 4.

355. Pub. L. No. 98-369, 1984 U.S.C.C.A.N. (98 Stat.) 494.

356. Pub. L. No. 99-514, 1986 U.S.C.C.A.N. (100 Stat.) 2085.

357. *See* STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 14–16.

358. *See* Viard Brief, *supra* note 120, at 25.

359. *See id.*

360. GFOA Brief, *supra* note 321, at 4–8 (claiming that Congress has let the matter of municipal bond tax exemption rest); NAST Brief, *supra* note 321, at 11–14 (focusing the historical inquiry on the Court’s noninterference with the differential tax system).

361. *See* GFOA Brief, *supra* note 321, at 4–8; NAST Brief, *supra* note 321, at 11–16.

362. *See* GFOA Brief, *supra* note 321, at 4–8; NAST Brief, *supra* note 321, at 11–16.

363. *See, e.g.*, Energy Policy Act of 2005, Pub. L. No. 109-58, 2005 U.S.C.C.A.N. (119 Stat.) 594 (authorizing a second type of tax-credit bond for clean renewable energy facilities eligible for federal tax exemption); Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 1988 U.S.C.C.A.N. (102 Stat.) 3342 (adding high-speed intercity rail facility to the list of facilities available for federal tax-exempt financing).

364. This argument has only become sharply focused on the character of conduit bonds in the wake of *Davis*. *See* Leading Cases, *Dormant Commerce Clause—State Taxation of Municipal Bonds*, 122 HARV. L. REV. 276, 277 (2008).

constitutionality of the differential taxation of conduit bonds stems from this central disagreement.³⁶⁵

B. *How the Appraisal of Conduit Bonds Affects the Dormant Commerce Clause Analysis*

In *Davis*, the Court identified four key considerations for evaluating whether the differential tax treatment of in-state and out-of-state government bonds is constitutional.³⁶⁶ These considerations include the dormant Commerce Clause analysis,³⁶⁷ the market participant exception to the dormant Commerce Clause analysis,³⁶⁸ the government entity exception to the standard dormant Commerce Clause analysis,³⁶⁹ and the *Pike* test.³⁷⁰ Both proponents and critics of differential taxation generally agree that these are the key considerations for evaluating the constitutionality of the differential tax treatment of in-state and out-of-state conduit bonds.³⁷¹ Their conclusions, however, differ widely.³⁷²

1. Standard Dormant Commerce Clause Analysis

Proponents of differential taxation have not argued that the differential taxation of conduit bonds will survive the standard dormant Commerce Clause analysis.³⁷³ While not quite conceding that the differential taxation

365. See *infra* Part.II.B.

366. *Dep't of Revenue v. Davis*, 128 S. Ct. 1801, 1808–19 (2008) (plurality opinion).

367. *Id.* at 1808–10.

368. *Id.* at 1811–14.

369. *Id.* at 1810–11.

370. *Id.* at 1817–19.

371. For examples of proponents of differential taxation identifying these considerations when evaluating the constitutionality of the differential tax treatment of conduit bonds, see GFOA Brief, *supra* note 321, at 1–3; Multistate Tax Comm'n Brief, *supra* note 321, at 3–4; NAST Brief, *supra* note 321, at 9–10; Nuveen Brief, *supra* note 321, at 2–5; and SIFMA Brief, *supra* note 112, at 3–5. For examples of critics of differential taxation identifying these considerations as key for evaluating the constitutionality of the differential tax treatment of conduit bonds, see Viard Brief, *supra* note 120, at 5–8. Additionally, there is no agreement that these are the only considerations for evaluating the constitutionality of the differential tax treatment of conduit bonds. See, e.g., Tax Found. Brief, *supra* note 324, at 15–21 (arguing that the conflict can be resolved by reference to the Privileges and Immunities Clause of the Fourteenth Amendment); Nuveen Brief, *supra* note 321, at 10–20 (arguing for a *sui generis* exception for the differential taxation of municipal bonds based on the system's prevalence and importance); SIFMA Brief, *supra* note 112, at 11–17 (arguing for a *sui generis* exception for the differential taxation of municipal bonds based on the instability and price uncertainty that would result if the system were revoked). However, the dormant Commerce Clause, government entity exception, market participant exception, and *Pike* test are generally held up as the principal considerations. See *Davis*, 128 S. Ct. at 1808–19 (plurality opinion).

372. Compare SIFMA Brief, *supra* note 112, at 18 (determining that the differential taxation of municipal bonds is constitutional), with Tax Found. Brief, *supra* note 324, at 29 (“[The] Court should hold the [state] exclusion unconstitutional.”).

373. See, e.g., GFOA Brief, *supra* note 321 (eschewing standard dormant Commerce Clause analysis and focusing on the exceptions); NAST Brief, *supra* note 321 (same); Nuveen Brief, *supra* note 321 (same).

of conduit bonds is unconstitutional under the standard dormant Commerce Clause analysis, most proponents of differential taxation have argued that the differential taxation of all municipal bonds—not just conduit bonds—should be subject to an exception.³⁷⁴ Most of the key exceptions proposed by these amici were discussed explicitly by the *Davis* plurality³⁷⁵ and are addressed elsewhere in this Note.³⁷⁶ A separate key exception, a *sui generis* exemption for all municipal bonds, is best discussed here.

The argument for a *sui generis* exception for all municipal bonds is founded in equity and the state's authority as sovereign.³⁷⁷ Proponents of differential taxation reason that it would be inequitable to invalidate the differential taxation of municipal bonds given the long history of allowing such taxation.³⁷⁸ Since the founding of this nation, state and local governments have issued debt obligations to raise capital in order to promote the health, safety, and welfare of their citizens.³⁷⁹ For almost a century—since the earliest days of income taxes³⁸⁰—states have likewise been empowered to exempt their debt obligations from taxation.³⁸¹ Today,

374. GFOA Brief, *supra* note 321 (arguing for a *sui generis* exception and the government entity exception); Multistate Tax Comm'n Brief, *supra* note 321 (arguing for the government entity exception); NAST Brief, *supra* note 321 (arguing for a *sui generis* exception, the market participation exception, and the government entity exception); Nuveen Brief, *supra* note 321 (arguing for a *sui generis* exception and the government entity exception); SIFMA Brief, *supra* note 112 (arguing for government entity exception). The approach followed by these amici is similar to the *Davis* Court's analysis. See *Davis*, 128 S. Ct. at 1808–19 (plurality opinion). In *Davis*, the Court invoked the standard dormant Commerce Clause analysis, *id.* at 1808–10, but clearly applied the dormant Commerce Clause exceptions to the facts of the case, *id.* at 1810–19.

375. *Davis*, 128 S. Ct. at 1810–19 (plurality opinion).

376. See *infra* Part II.B.2–4.

377. GFOA Brief, *supra* note 321, at 3 (arguing that the differential tax system is a “natural and salutary consequence of the distinctive relationship between a sovereign and its citizens”); Multistate Tax Comm'n Brief, *supra* note 321, at 11 (“State governments are sovereigns, for which the whole notion of competition, and the very concerns of the Commerce Clause, do not apply.”); NAST Brief, *supra* note 321, at 11–18 (arguing that state authority to exempt in-state municipal bonds from state taxation is an aspect of state sovereignty); Nuveen Brief, *supra* note 321, at 9 (determining that states have the inherent power to raise funds through debt issuances and provide favorable tax treatment of those debt issuances).

378. GFOA Brief, *supra* note 321, at 3 (“Since the inception of modern state income taxes during the Progressive Era, state governments have granted preferential tax exemptions for the interest earned on in-state municipal bonds and have had no reason to question their validity.”); NAST Brief, *supra* note 321, at 11–12 (tracing the history of both municipal bonds and the differential taxation of municipal bonds); SIFMA Brief, *supra* note 112, at 8 (stating that a contrary decision would overturn “a widespread network of statutes and governmental programs that have developed based on settled law since 1881”).

379. NAST Brief, *supra* note 321, at 11 (“Alexander Hamilton, perhaps the foremost authority on American public finance, observed that credit ‘is of the greatest consequence to every country.’” (quoting ALEXANDER HAMILTON, PUBLIC CREDIT NO. 2, in 1 REPORTS OF THE SECRETARY OF THE TREASURY OF THE UNITED STATES (Duff Green 1828))).

380. NAST Brief, *supra* note 321, at 12; see, e.g., 1918 Mass. Acts page no. 7; 1919 N.Y. Laws page no. 1641–42.

381. See GFOA Brief, *supra* note 321, at 3; NAST Brief, *supra* note 321, at 11–12; SIFMA Brief, *supra* note 112, at 7–8.

use of the discriminatory tax system is widespread.³⁸² Thirty-seven states employ this system or something substantially similar;³⁸³ four states employ a comparable tax system;³⁸⁴ and two states offer reciprocal tax treatment for municipal bonds.³⁸⁵ Outstanding state and local government debts subject to this tax treatment total at least \$2.2 trillion.³⁸⁶ Such a long-standing and widely accepted practice is not lightly revoked.³⁸⁷

For the whole time that this practice became widespread, Congress knew of the practice³⁸⁸ and actively supported it.³⁸⁹ For the past ninety years, Congress exempted all municipal bonds issued by states and municipalities from federal taxation.³⁹⁰ Over the past eighty-seven years, Congress authorized numerous interstate compacts, several of which formed public authorities empowered to issue municipal bonds that are subject to the discriminatory tax system.³⁹¹ Congress explicitly addressed the selective tax system in 1976, when it expanded the federal tax exemption on municipal bonds to allow mutual funds to pass the tax savings on to their shareholders.³⁹² Furthermore, within the past decade Congress twice

382. GFOA Brief, *supra* note 321, at 7–8 (determining that the differential taxation of municipal bonds is “a widespread, longstanding, and uninterrupted practice by the States that, until very recently, has gone unchallenged”); NAST Brief, *supra* note 321, at 12 (“Today, 42 States provide preferential tax treatment for individual or corporate income earned on all or some in-State municipal bonds.”); Nuveen Brief, *supra* note 321, at 4–5 (“The importance and popularity of such single-state [municipal bond] funds are well-demonstrated by the fact that there are 481 of them currently available in the market” (citing INV. CO. INST., 2007 INVESTMENT COMPANY FACT BOOK 96, 98 (47th ed. 2007)), available at <http://www.icifactbook.org>)).

383. See *supra* note 120 and accompanying text.

384. See *supra* note 121 and accompanying text.

385. See *supra* note 122 and accompanying text.

386. U.S. Census Bureau, http://www.census.gov/govs/estimate/0600ussl_1.html (last visited Sept. 19, 2009).

387. NAST Brief, *supra* note 321, at 14; see, e.g., *Walz v. Tax Comm’n of N.Y.*, 397 U.S. 664, 678 (1970) (“[While] no one acquires a vested or protected right in violation of the Constitution by long use, . . . an unbroken practice . . . is not something to be lightly cast aside.”); see also GFOA Brief, *supra* note 321, at 9 (“To force the States to shoulder these breathtaking . . . costs, despite their reasonable and substantial reliance on extant understandings of the dormant Commerce Clause, is wholly inequitable.”).

388. H.R. REP. NO. 88-1480, pt. 2, at 258–59 (1964) (listing states that exempt their own bonds from taxation, while taxing bonds of other States); see also H.R. REP. NO. 90-413, at 172 (1969), reprinted in 1969 U.S.C.A.N. 2027, 2252 (“State and local governments generally do not directly tax interest on Federal bonds, but they tax the interest income on bonds issued by other States.”).

389. GFOA Brief, *supra* note 321, at 7–8 (determining that Congress has expressed support for state tax exemptions for in-state municipal bonds); NAST Brief, *supra* note 321, at 14–16 (same).

390. I.R.C. §§ 103, 141–50 (2006); NAST Brief, *supra* note 321, at 16.

391. NAST Brief, *supra* note 321, at 16. Congress signed the first such compact in 1921. See Port of New York Authority Compact, ch. 77, 42 Stat. 174, 176–78 (1921). Since then, Congress has authorized a number of similar compacts. See, e.g., New Hampshire-Maine Interstate School Compact, Pub. L. No. 102-494, 106 Stat. 3153 (1992); Delaware River Joint Commission Compact, ch. 258, 47 Stat. 308 (1932).

392. See NAST Brief, *supra* note 321, at 15; Scott K. Attaway, Note, *The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds*, 76 B.U. L. REV. 737, 742 (1996); see also Tax Reform Act of 1976, Pub. L. No. 94-455, 1976 U.S.C.A.N.

enacted legislation empowering states to issue additional tax-exempt bonds.³⁹³ The pervasiveness of these practices “indicates that Congress views [the selective tax system] as consistent with constitutional requirements.”³⁹⁴

According to the proponents of discriminatory taxation, to revoke the power to exempt in-state municipal bonds from state taxation at this late date would upset the reasonable expectations of bond issuers and purchasers.³⁹⁵ After decades of Congressional acquiescence to the municipal bond exemption and reasonable reliance on that acquiescence, the expectations of the market have been settled.³⁹⁶ Invalidating the exemption now would vastly disrupt both the operation of state and local governments and the municipal bond market.³⁹⁷ State and local governments have incurred massive financial obligations based on the understanding that these exemptions are constitutional.³⁹⁸

Furthermore, if the judiciary rescinds the exemption, the rescission may apply retroactively, jeopardizing state and local budgets.³⁹⁹ “States could be forced to refund all recently paid taxes on out-of-state municipal bond interest, and most would effectively be required to forego taxing the interest on all outstanding out-of-state municipal bonds.”⁴⁰⁰ Without the taxes earned on these bonds, governments would either have to cut back services or issue additional debt to account for the shortfall.⁴⁰¹ These consequences

(90 Stat.) 1930 (amending the Internal Revenue Code to allow mutual funds to pass the tax savings on municipal bonds to their shareholders).

393. NAST Brief, *supra* note 321, at 15; *see also* Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, 2005 U.S.C.C.A.N. (199 Stat.) 2577 (authorizing a new type of qualified private-activity bond); Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 2002 U.S.C.C.A.N. (116 Stat.) 21 (authorizing \$8 billion in exempt-facility bonds to finance the reconstruction of southern Manhattan in the aftermath of 9/11).

394. NAST Brief, *supra* note 321, at 15; *see also* Gen. Motors Corp. v. Tracy, 519 U.S. 278, 304–05 (1997) (finding that Congressional inaction is a “clear implication” that states were within their power to act); GFOA Brief, *supra* note 321, at 7–8 (determining that Congress tacitly expressed support for state-tax exemptions for in-state municipal bonds).

395. GFOA Brief, *supra* note 321, at 8–12; NAST Brief, *supra* note 321, at 17–18; Nuveen Brief, *supra* note 321, at 15–20; SIFMA Brief, *supra* note 112, at 11–17.

396. *See, e.g.*, NAST Brief, *supra* note 321, at 17 (“State and local governments have issued municipal bonds in reliance upon the availability of State [and local] tax exemptions. In addition, States have assessed taxes and adopted budgets based on the expectation . . . that out-of-state bonds need not be granted the same exemption.”).

397. *Id.* at 17–18.

398. GFOA Brief, *supra* note 321, at 12 (“Given that many outstanding bonds will not mature for another thirty years, [invalidating the differential tax system] would cost state governments billions of dollars in foregone tax revenue.”); NAST Brief, *supra* note 321, at 3 (“More than \$350 billion of long-term municipal bonds were issued by States in each year from 2002 through 2006.” (citing BOND BUYER, THE BOND BUYER/THOMPSON FINANCIAL YEARBOOK 14–15 (2006))); Nuveen Brief, *supra* note 321, at 11 (“[T]here was more than \$2 trillion in state and local bonds outstanding as of March 2007.”); SIFMA Brief, *supra* note 112, at 11 (“The municipal bond market is enormous . . .”); Hanson, *supra* note 125.

399. NAST Brief, *supra* note 321, at 17–18.

400. GFOA Brief, *supra* note 321, at 2.

401. Nuveen Brief, *supra* note 321, at 16–17 (“The state would then have to choose whether, in light of the new economic situation, it would (1) pay a higher rate of interest to

would, of course, be matched by a windfall for in-state purchasers of out-of-state municipal bonds—a result that is manifestly unfair.⁴⁰² Alternatively, if states and municipalities are both willing and able to revoke the tax exemption for in-state municipal bonds,⁴⁰³ the value of municipal bonds already held by in-state investors could drop substantially.⁴⁰⁴ In-state municipal bondholders purchased bonds at a lower interest rate in reliance on the application of the tax exemption.⁴⁰⁵ Without the tax exemption, the value of these investments would plummet and the reasonable expectations of the investors would be defeated.⁴⁰⁶

The argument that equity requires a *sui generis* exception for the differential taxation of municipal bonds from the standard dormant Commerce Clause analysis is buttressed by the argument that the state has authority to do so as sovereign.⁴⁰⁷ Like the equity argument, the state sovereignty argument derives much of its force from the long history of municipal bonds.⁴⁰⁸ According to some proponents of differential taxation, because states and municipalities have taxed municipal bonds since the advent of the income tax, states and municipalities have acquired the power to do so.⁴⁰⁹ Given the longstanding acquiescence to the usurpation of this power, if the power to tax municipal bonds must be abridged it should be

state residents to offset the taxes, (2) require state residents to pay the taxes, or (3) forego collecting taxes on all municipal bonds, regardless of the state of origin.”); *see also* NAST Brief, *supra* note 321, at 9 (“State and local governments might be required to cut services, cancel projects, or raise taxes.”).

402. NAST Brief, *supra* note 321, at 18.

403. States and municipalities may not be constitutionally able to revoke this tax exemption. *See* GFOA Brief, *supra* note 321, at 11 (“For most States, the option of taxing the interest earned on in-state municipal bonds that investors have already purchased would be impracticable, if not legally foreclosed.”); NAST Brief, *supra* note 321, at 17 (positing that states that made a contractual commitment that interest on in-state bonds will be exempt from state taxation may not break that commitment).

404. NAST Brief, *supra* note 321, at 17 (“[I]f the State tax exemption is eliminated for future years, the value of municipal bonds held by individual investors may fall significantly.”); Nuveen Brief, *supra* note 321, at 16 (“Any conceivable alteration of the state income tax exemption . . . would alter the economics of bond fund investments, with the potential to shift billions of dollars in value.”); *see also* SIFMA Brief, *supra* note 112, at 14–15 (“Investors who continue to trade in the municipal bond market would face the consequences of the uncertainty caused by disruption of the status quo.”). *But cf.* Tax Found. Brief, *supra* note 324, at 23–25 (arguing that a repeal of the tax provision would not unduly impact municipal bond markets).

405. GFOA Brief, *supra* note 321, at 17 (“Because of the tax exemption, . . . taxpayers are willing to accept a lower pre-tax rate of return on in-state municipal bonds.”); NAST Brief, *supra* note 321, at 17 (“Many investors have purchased in-State municipal bonds in reliance on the availability of a State tax exemption.”); *see also* Nuveen Brief, *supra* note 321, at 12–15 (linking the rise in single-state municipal bond funds with the tax benefits for municipal bonds); SIFMA Brief, *supra* note 112, at 17 (“The valuation process of municipal bonds is . . . a complicated one, taking into consideration things like their typically low default rate, taxable rate (if any), and other factors specific to the issuing municipality.”).

406. NAST Brief, *supra* note 321, at 17; Nuveen Brief, *supra* note 321, at 16; SIFMA Brief, *supra* note 112, at 14–15.

407. GFOA Brief, *supra* note 321, at 3–8; NAST Brief, *supra* note 321, at 11–18.

408. GFOA Brief, *supra* note 321, at 3–8; NAST Brief, *supra* note 321, at 11–16.

409. GFOA Brief, *supra* note 321, at 3–8; NAST Brief, *supra* note 321, at 11–16.

abridged by Congress—not the courts.⁴¹⁰ Essentially, these amici argue that the Supreme Court should yield and let Congress devise a rule.⁴¹¹ In support of this position, proponents of differential taxation note that “[t]here is a strong tradition of . . . deferring to Congress’s superintendence of interstate commerce” in matters of state taxation.⁴¹² More importantly, only Congress is capable of drafting a purely prospective remedy.⁴¹³ While a prospective remedy would not avert every evil, it would avert the most egregious ones.⁴¹⁴

This argument finds support in the *Davis* decision.⁴¹⁵ In *Davis*, the Court determined that that “government function[s] [are] not susceptible to standard dormant Commerce Clause scrutiny.”⁴¹⁶ Such functions evade the standard dormant Commerce Clause analysis because their motivations are presumed to be legitimate.⁴¹⁷ Legitimate motivations, distinct from “simple economic protectionism,” are not the target of the Commerce Clause and should not be subject to it.⁴¹⁸ In *Davis*, the Court applied this reasoning to the discriminatory tax system for general municipal bonds.⁴¹⁹ In doing so, it determined that “the issuance of debt securities to pay for public projects is a quintessentially public function.”⁴²⁰ This determination was primarily founded upon the venerable history of municipal bonds⁴²¹ and the core purpose of such bonds—to shoulder the cardinal civic responsibilities of government.⁴²²

Critics of differential taxation argue that the differential taxation of conduit bonds are not subject to any exception from the Commerce Clause⁴²³ and should be found unconstitutional under the standard dormant Commerce Clause analysis.⁴²⁴

410. GFOA Brief, *supra* note 321, at 8 (finding that Congress is expressly charged with the duty to superintend the Commerce Clause and that the courts should not interfere in the face of tacit Congressional approval of the practice); NAST Brief, *supra* note 321, at 14–16 (tracing the history of congressional approval of the differential taxation of municipal bonds); *see also* Multistate Tax Comm’n Brief, *supra* note 321, at 4–5 (finding a similar result based on an argument other than state sovereignty); Nuveen Brief, *supra* note 321, at 5 (same).

411. *See, e.g.*, GFOA Brief, *supra* note 321, at 8.

412. GFOA Brief, *supra* note 321, at 12.

413. *Id.* at 2 (“Only Congress could craft a purely prospective remedy that applied solely to municipal bonds that have not yet been issued.”).

414. *See id.*

415. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1808–11 (2008) (plurality opinion).

416. *Id.* at 1810 (citing *United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1796 (2007) (plurality opinion)).

417. *Id.* at 1809–10.

418. *Id.* at 1810.

419. *Id.* at 1810–11.

420. *Id.* at 1810.

421. *Id.*

422. *Id.* at 1810–11. These cardinal civic responsibilities are protecting the health, safety, and welfare of citizens. *Id.* at 1811.

423. Tax Found. Brief, *supra* note 324, at 13–14; Viard Brief, *supra* note 120, at 21–26.

424. Tax Found. Brief, *supra* note 324, at 5–10; Viard Brief, *supra* note 120, at 9–13.

The basic contention of critics of differential taxation is that differential taxation of conduit bonds violates the dormant Commerce Clause.⁴²⁵ The critics contend that differential taxation of conduit bonds violates the dormant Commerce Clause because it promotes in-state businesses at the expense of out-of-state businesses.⁴²⁶ Under the selective tax exemption, a state does not tax residents on interest income from in-state municipal bonds.⁴²⁷ At the same time, the state taxes residents for interest income earned on out-of-state municipal bonds.⁴²⁸ These provisions work together to benefit in-state interests and burden out-of-state economic interests.⁴²⁹ In-state economic interests benefit because local industries financed with such bonds are able to borrow at a lower cost.⁴³⁰ Simultaneously, since municipal bonds do not offer competitive rates of return absent offsetting tax breaks, out-of-state borrowers are effectively barred from the in-state market.⁴³¹ With extraterritorial bonds effectively barred from the market, in-state bonds have substantially less competition.⁴³² At the same time, out-of-state purchasers receive lower returns than in-state purchasers on the same securities.⁴³³

According to these critics, the differential taxation of conduit bonds is exactly the kind of activity the dormant Commerce Clause is designed to prevent.⁴³⁴ Under the first line of dormant Commerce Clause analysis, a statute that discriminates against interstate commerce is virtually per se invalid.⁴³⁵ A statute discriminates against commerce when it treats in-state and out-of-state economic interests differently to the benefit of the former and the burden of the latter.⁴³⁶ Here, the state taxes all out-of-state

425. Tax Found. Brief, *supra* note 324, at 5–10; Viard Brief, *supra* note 120, at 9–13.

426. Tax Found. Brief, *supra* note 324, at 11 (finding the tax system upsets the principle of competitive neutrality by taxing out-of-state activity for the benefit of in-state activity); Viard Brief, *supra* note 120, at 9 (finding the tax break creates an unconstitutional in-state subsidy).

427. See *supra* note 54 and accompanying text.

428. *Id.*

429. Tax Found. Brief, *supra* note 324, at 5–10; Viard Brief, *supra* note 120, at 9–13.

430. Tax Found. Brief, *supra* note 324, at 10 (“The state tax code is designed to make investing in [in-state] bonds the only way such individuals can lower their effective tax rate on municipal bond income.”); Viard Brief, *supra* note 120, at 9 (“[The] exemption grants a tax reduction to [in-state] residents who purchase [in-state] municipal bonds.”).

431. Tax Found. Brief, *supra* note 324, at 3–4 (arguing that the tax break seeks “to protect a state’s existing industry from interstate competition”); Viard Brief, *supra* note 120, at 10–11 (arguing that the tax break discourages in-state purchasers from transacting with out-of-state sellers).

432. Tax Found. Brief, *supra* note 324, at 3–4 (finding that the selective municipal-bond tax exemption inhibits competition and discriminates against interstate commerce); Viard Brief, *supra* note 120, at 16 (same).

433. Tax Found. Brief, *supra* note 324, at 14 (determining the selective municipal bond tax exemption “penalizes only . . . those who invest in bonds out-of-state”); Viard Brief, *supra* note 120, at 16 (“By inhibiting such competition and discriminating against interstate commerce, the selective municipal bond tax exemption has greatly reduced investor well-being.”).

434. Tax Found. Brief, *supra* note 324, at 4; Viard Brief, *supra* note 120, at 10.

435. *Or. Waste Sys., Inc. v. Dep’t of Env’tl. Quality*, 511 U.S. 93, 99 (1994).

436. *Id.*

municipal bonds and exempts conduit bonds that finance local industry.⁴³⁷ This reduces the supply of bonds in the in-state market providing competitive returns.⁴³⁸ With the supply reduced, the market for in-state conduit bonds increases.⁴³⁹ The cost of this benefit is borne by out-of-state municipal bonds that are effectively barred from the in-state market.⁴⁴⁰ In fact, the fundamental purpose of this system is just that: to protect in-state securities from, and at the expense of, extraterritorial securities.⁴⁴¹ These are not incidental effects on the free flow of commerce; this is a cordoning off of commerce,⁴⁴² affecting roughly one-fourth of a \$2.2 billion industry.⁴⁴³

While discriminatory statutes are virtually per se invalid, they are not automatically invalid.⁴⁴⁴ A facially discriminatory statute can survive the strong presumption of invalidity if it “advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.”⁴⁴⁵

Critics of differential taxation argue that the selective tax treatment of conduit bonds does not meet this standard.⁴⁴⁶ According to these critics, states could employ nondiscriminatory practices to achieve the same purposes as conduit bonds by issuing government bonds instead of conduit bonds.⁴⁴⁷ These bonds would be used to fund facilities and services comparable to those operated by private entities.⁴⁴⁸ The principle difference, however, is that these facilities and services are run by governmental agencies.⁴⁴⁹ The *United Haulers* Court directly addressed this issue.⁴⁵⁰ In *United Haulers*, the Court ruled on a flow-control ordinance requiring trash haulers to deliver solid waste to a single waste processing facility.⁴⁵¹ Trash haulers challenged the ordinance because the single waste processing facility charged higher fees.⁴⁵² The case for these

437. Tax Found. Brief, *supra* note 324, at 10; Viard Brief, *supra* note 120, at 5.

438. See Viard Brief, *supra* note 120, at 10–11.

439. See Tax Found. Brief, *supra* note 324, at 3–4; Viard Brief, *supra* note 120, at 10–11.

440. See Viard Brief, *supra* note 120, at 10–11.

441. See Tax Found. Brief, *supra* note 324, at 3–4; Viard Brief, *supra* note 120, at 10–11.

442. See Tax Found. Brief, *supra* note 324, at 3–4; Viard Brief, *supra* note 120, at 16.

443. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 128, intro.

444. *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988).

445. *Id.*

446. See Tax Found. Brief, *supra* note 324, at 26–29; Viard Brief, *supra* note 120, at 12.

447. Tax Found. Brief, *supra* note 324, at 15 (“The Commerce Clause . . . does not prohibit states from bestowing benefits on a favored activity while leaving all other actors as they were.”); see also Viard Brief, *supra* note 120, at 12 (offering an alternative solution: “A direct subsidy to municipalities, quite simply, would not discriminate against interstate commerce.”).

448. See, e.g., *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1805 n.2 (2008) (plurality opinion); Viard Brief, *supra* note 120, at 25.

449. See *Davis*, 128 S. Ct. at 1805 n.2 (plurality opinion); Viard Brief, *supra* note 120, at 25.

450. *United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1792–97 (2007) (plurality opinion).

451. *Id.* at 1786–98.

452. *Id.* at 1792.

haulers was compelling; the Court had already determined that a nearly identical flow-control ordinance was unconstitutional.⁴⁵³ Ultimately, the *United Haulers* Court distinguished this earlier precedent⁴⁵⁴ and determined the later flow-control ordinance was constitutional.⁴⁵⁵ The earlier flow-control ordinance required trash haulers to deliver solid waste to a private waste processing facility.⁴⁵⁶ The later flow-control ordinance required haulers to deliver solid waste to a government facility.⁴⁵⁷ The *United Haulers* Court noted that, had the earlier facility been public, the ordinance would have been constitutional.⁴⁵⁸ Nothing in the Constitution prevents a state from owning the types of facilities that are sponsored by conduit bonds.⁴⁵⁹ At least one critic has argued that, since states can employ the nondiscriminatory practice of financing state-created benefit corporations to achieve the same purpose as issuing conduit bonds,⁴⁶⁰ such bonds do not overcome the strong presumption of invalidity.⁴⁶¹

If an ordinance fails the first prong of the dormant Commerce Clause analysis, the ordinance is invalid.⁴⁶² The second prong, the so-called *Pike* analysis,⁴⁶³ is a backstop.⁴⁶⁴ It provides an additional layer of review to ensure that statutes do not evade the letter of the law while flouting its purpose.⁴⁶⁵ Under the argument advanced by critics of differential taxation, since the selective tax system as applied to conduit bonds fails the first prong of the dormant Commerce Clause analysis,⁴⁶⁶ there is no need to analyze the system under the less restrictive second prong.⁴⁶⁷ Assuming, arguendo, that the second prong did apply to the selective tax system as applied to conduit bonds, the system would still be unconstitutional.⁴⁶⁸ Under the second prong, a statute "will be upheld unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits."⁴⁶⁹ This test is a cost-benefit analysis.⁴⁷⁰

453. *Id.*; *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 394–95 (1994).

454. *United Haulers*, 127 S. Ct. at 1795 (plurality opinion).

455. *Id.* at 1798.

456. *Carbone*, 511 U.S. at 387.

457. *United Haulers*, 127 S. Ct. at 1791 (plurality opinion). Specifically, the facility was a state-created public benefit corporation. *Id.*

458. *Id.* at 1793–95.

459. *See Dep't of Revenue v. Davis*, 128 S. Ct. 1801, 1819 (2008) (plurality opinion).

460. *Id.*

461. *See New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988); Viard Brief, *supra* note 120, at 25–26.

462. *Or. Waste Sys., Inc. v. Dep't of Env'tl. Quality*, 511 U.S. 93, 99 (1994).

463. *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970) (establishing the test); Fox, *supra* note 188, at 176 (referring to the inquiry as the "*Pike* rule").

464. *See supra* notes 188–99 and accompanying text.

465. *See supra* notes 188–99 and accompanying text.

466. Tax Found. Brief, *supra* note 324, at 26–29; Viard Brief, *supra* note 120, at 12.

467. *See C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 390 (1994).

468. Viard Brief, *supra* note 120, at 8 ("[T]he selective municipal bond tax exemption fails that balancing test.").

469. *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970) (citing *Huron Cement Co. v. Detroit*, 362 U.S. 440, 443 (1960)).

At least one group of critics of differential taxation claims that the selective tax system as applied to conduit bonds fails this test.⁴⁷¹ These amici concede that the selective tax system has a legitimate purpose: to fund the work of government.⁴⁷² The selective tax system induces citizens to lend money to state and local governments at favorable rates of interest and lowers the cost of financing public works.⁴⁷³ This purpose applies equally to conduit bonds.⁴⁷⁴

Critics of differential taxation contend, however, that the selective taxation of conduit bonds does not advance its purported purpose.⁴⁷⁵ Although it is generally accepted that the selective tax exemption allows municipalities to lower their financing costs,⁴⁷⁶ these critics have argued that a simple economic evaluation proves this is not the case.⁴⁷⁷ According to these amici, when state and local governments exempt income earned on in-state bonds, they lose revenue.⁴⁷⁸ At best, this system is “a wash economically.”⁴⁷⁹ At worst, this system fails to recoup its tax losses.⁴⁸⁰ Simultaneously, the burdens of the selective tax system are immense.⁴⁸¹ The selective tax system for municipal bonds has segmented the national market for municipal bonds.⁴⁸² “When every state attempts to obtain the bulk of its municipal financing from its own residents and to discourage them from purchasing municipal bonds issued by other states, . . . [t]he diversification, liquidity and cost savings offered by an unimpeded national municipal bond market are lost.”⁴⁸³ This is exactly the kind of “economic Balkanization” the dormant Commerce Clause was created to prevent.⁴⁸⁴

470. *Id.*; see also *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1817 (2008) (plurality opinion); *City of Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978).

471. See, e.g., Viard Brief, *supra* note 120, at 8 (“The harms caused by the selective exemption far outweigh the doubtful benefits.”).

472. *Id.* at 18 (recognizing that the market Balkanization caused by the selective exemption attempts to provide an offsetting benefit by lowering a state’s financing costs).

473. See NFMA Brief, *supra* note 17, at 8–10.

474. See *id.* at 6–7.

475. See, e.g., Viard Brief, *supra* note 120, at 18–19.

476. See, e.g., STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 4–5; GRAETZ & SCHENK, *supra* note 58, at 215.

477. See, e.g., Viard Brief, *supra* note 120, at 18–19.

478. *Id.* at 18 (“The state effectively takes money out of one pocket and places it in another.”). Other groups have reached a similar conclusion. See, e.g., STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 4–5.

479. Viard Brief, *supra* note 120, at 18.

480. *Id.* at 18–19 (“[A] state government may actually be worse off financially for choosing this route to reduce its financing costs.”).

481. See Viard Brief, *supra* note 120, at 17–18.

482. *Id.* at 18.

483. *Id.* at 15.

484. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1808 (2008) (plurality opinion) (citing “economic protectionism” as the primary concern of the dormant Commerce Clause).

Even though most laws survive the *Pike* analysis,⁴⁸⁵ critics of differential taxation reason that the differential taxation of conduit bonds does not.⁴⁸⁶

Separate from the dormant Commerce Clause analysis, critics of differential taxation refute the claim that the differential taxation of municipal bonds is privity to a *sui generis* exception.⁴⁸⁷ Thus, according to critics of differential taxation, the proponents' main argument for differential taxation of municipal bonds is unfounded.⁴⁸⁸

2. Market Participant Exception

Under the market participant doctrine, states and municipalities may discriminate in favor of their own citizens when they act as market participants.⁴⁸⁹ States and municipalities act as market participants when they buy or sell goods or services.⁴⁹⁰ According to proponents of differential taxation, when states and municipalities sell municipal bonds, they are acting as market participants.⁴⁹¹ Thus, when states and municipalities exempt municipal bonds from in-state taxation, they are permissibly favoring their own citizens in accordance with the market participant exception.⁴⁹²

Proponents of differential taxation find additional support for this argument from the fact that the programs funded by municipal bonds would not exist in the absence of government action.⁴⁹³ "When the state is creating commerce that would not otherwise exist, it has greater freedom to shape that commerce than when it is intruding into a previously existing private market."⁴⁹⁴ According to these proponents, this creation of commerce underlies the market-participant rule.⁴⁹⁵ Under this argument, by sponsoring public works that the market does not naturally produce, the

485. See, e.g., *Nw. Cent. Pipeline Corp. v. State Corp. Comm'n of Kan.*, 489 U.S. 493, 525–26 (1989); *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 472 (1981).

486. See, e.g., Viard Brief, *supra* note 120, at 8.

487. See, e.g., *id.* at 16 (determining that the states' role as sovereign is both "obviously true" and "irrelevant to this case"); see also Tax Found. Brief, *supra* note 324, at 22–26 (arguing that overturning the differential tax system would not infringe state sovereignty).

488. See Tax Found. Brief, *supra* note 324, at 9. The second contention of proponents of differential taxation—that differential taxation of conduit bonds is protected by state sovereignty—has not been explicitly addressed by critics of differential taxation.

489. See *White v. Mass. Council of Constr. Employers, Inc.*, 460 U.S. 204, 208 (1983) (citing *Reeves, Inc. v. Stake*, 447 U.S. 429, 436 n.7 (1980)); see also *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 810 (1976).

490. See *Hughes*, 426 U.S. at 810; Bogen, *supra* note 207, at 543.

491. See, e.g., NAST Brief, *supra* note 321, at 18–24; Nuveen Brief, *supra* note 321, at 6–10.

492. See, e.g., NAST Brief, *supra* note 321, at 24; Nuveen Brief, *supra* note 321, at 10.

493. NAST Brief, *supra* note 321, at 4; Nuveen Brief, *supra* note 321, at 10–15; see also Attaway, *supra* note 392, at 757 n.138.

494. Attaway, *supra* note 392, at 754 (quoting LAURENCE H. TRIBE, *CONSTITUTIONAL CHOICES* 146 (1985)).

495. See Nuveen Brief, *supra* note 321, at 10–15; Attaway, *supra* note 392, at 755.

government is acting as a market participant and is subject to the market participant exception.⁴⁹⁶

Critics of differential taxation characterize the discriminatory taxation of municipal bonds very differently.⁴⁹⁷ According to these critics, there is a sharp distinction between market participation and market regulation.⁴⁹⁸ Taxation, they argue, is market regulation.⁴⁹⁹ Under the selective municipal bond tax exemption, the state imposes a benefit through the income tax system.⁵⁰⁰ This benefit derives after the transaction is completed.⁵⁰¹ Thus, the transaction and the taxation are separate actions.⁵⁰² When a state provides a tax exemption on the proceeds of conduit bonds after the transaction is completed, the state is acting as a market regulator.⁵⁰³ Under this argument, market regulation and market participation are fundamentally separate acts.⁵⁰⁴ This point undercuts the core justification for the market-participant exception: to allow states to act as traditional market participants.⁵⁰⁵

To a certain degree, *Davis* already resolved the market participation argument.⁵⁰⁶ In *Davis*, a plurality determined that the market participant exemption applies to states when they sell municipal bonds.⁵⁰⁷ The plurality conceded that, under previous authority, it appeared that states

496. Nuveen Brief, *supra* note 321, at 10–15; see ROBERT COOTER & THOMAS ULTEN, LAW AND ECONOMICS 46 (1988).

497. See, e.g., Tax Found. Brief, *supra* note 324, at 13–14; Viard Brief, *supra* note 120, at 21–23.

498. See, e.g., Viard Brief, *supra* note 120, at 21–23.

499. Tax Found. Brief, *supra* note 324, at 14 (“In taxing interest income, [the state] is not acting as a market participant, but as a sovereign state exercising the power of mandatory taxation.”); Viard Brief, *supra* note 120, at 23 (arguing that taxing is a “quintessentially regulatory” act).

500. Viard Brief, *supra* note 120, at 22 (“[The state] uses the income tax system to discriminate after the market transaction has occurred and separate from it.”); see, e.g., KY. REV. STAT. ANN. §§ 141.010, 141.020 (LexisNexis 2006).

501. See Viard Brief, *supra* note 120, at 22.

502. *Id.*

503. Tax Found. Brief, *supra* note 324, at 11–15; Viard Brief, *supra* note 120, at 21–23.

504. Viard Brief, *supra* note 120, at 22 (“There is a substantive distinction between a state’s decision to discriminate against interstate commerce by means of its governmental taxing authority and a state’s decision to discriminate as a market participant by paying different rates of interest to different holders.”); see also Tax Found. Brief, *supra* note 324, at 11–15.

505. Tax Found. Brief, *supra* note 324, at 14 (“Even if it could be said that Kentucky is ‘competing’ with the private bond market, the relevant action in this case is its use of the taxing power, which is an exercise of governmental authority that no other market participant could exercise.”); Viard Brief, *supra* note 120, at 22–23 (“The market participant exception has been traditionally justified by analogizing states to private market participants, with the implication that states should be as free to act in the market in the same manner as private parties.” (citing *Reeves, Inc. v. Stake*, 447 U.S. 429, 439 & n.12 (1980))).

506. See *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1811–14 (2008) (plurality opinion).

507. See *id.* Some of the Justices did not join this part of the analysis because they thought the application of the government entity exemption adequately resolved the issue. See *id.* at 1821 (Roberts, C.J., concurring) (finding the case readily resolved by *United Haulers*); *id.* at 1821 (Scalia, J., concurring) (same).

would invite dormant Commerce Clause scrutiny by setting taxes.⁵⁰⁸ The plurality went on, however, to distinguish cases such as *New Energy* and *Camps Newfound/Owatonna*, where the differential tax scheme affected private parties.⁵⁰⁹ Essentially, the plurality agreed with the proponents of the market-participant rationale for the discriminatory tax system, determining that, under the selective tax system, the state acts in two roles at once.⁵¹⁰ According to the Court, “[i]t simply blinks this reality to disaggregate . . . [the] two roles and pretend that in exempting the income from its securities, [the State] is independently regulating or regulating in the garden variety way that has made a State vulnerable to the dormant Commerce Clause.”⁵¹¹ The state is participating in the market “and its tax structure is one of the tools of competition.”⁵¹²

3. Government Entity Exception

Under the government entity exception, states and municipalities may discriminate in favor of government entities at the expense of private entities.⁵¹³ The government entity exception is an acknowledgement of the fundamental differences between economic protection of a private entity and economic protection of a government entity.⁵¹⁴ These differences include the purpose of such a law, the presence of discrimination, the presence of interference, and the presence of ratification.⁵¹⁵ In *Davis*, the Court determined that the government entity exception applies to the differential taxation of government bonds.⁵¹⁶

The first fundamental difference between economic protection of a private entity and economic protection of a government entity is the purpose of each law.⁵¹⁷ Laws favoring private entities beget “simple economic protectionism”—the core evil the Commerce Clause was designed to prevent.⁵¹⁸ Laws favoring government entities can further a number of legitimate purposes completely unrelated to economic

508. *Id.* at 1811–12 (plurality opinion).

509. *Id.* at 1812 (“[T]here is no ignoring the fact that imposing the differential tax scheme makes sense only because [the State] is also a bond issuer.”).

510. *Id.*

511. *Id.*

512. *Id.*

513. *Id.* at 1810.

514. *See id.* at 1810–11; *United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1795–97 (2007) (plurality opinion).

515. NAST Brief, *supra* note 321, at 25–26 (“The Court [has] held that the difference between public and private entities is ‘constitutionally significant.’” (quoting *United Haulers*, 127 S. Ct. at 1790 (plurality opinion))).

516. *See Davis*, 128 S. Ct. at 1819 (plurality opinion).

517. *United Haulers*, 127 S. Ct. at 1795–96 (plurality opinion); *see also* NAST Brief, *supra* note 321, at 26.

518. *United Haulers*, 127 S. Ct. at 1795–96 (plurality opinion) (citing *Wyoming v. Oklahoma*, 502 U.S. 437, 454 (1992)).

protectionism.⁵¹⁹ As mentioned earlier, proponents of differential taxation and critics of differential taxation disagree about on which side of the ledger the differential taxation of conduit bonds falls.⁵²⁰

Proponents of differential taxation argue that the selective tax exemption for in-state municipal bonds furthers the legitimate goal of protecting citizens' health, safety, and welfare.⁵²¹ This position is grounded in their earlier assessment of conduit bonds as essentially public.⁵²² These amici have also argued that the exemption incentivizes citizens to participate in each state's financial affairs.⁵²³ Participation in such financial affairs can have numerous benefits, including a more informed citizenry and an additional check on local government.⁵²⁴ These wholly legitimate goals are completely unrelated to protectionism.⁵²⁵ Here, "[b]ecause [the selective tax system] does not favor in-State private business at the expense of out-of-State businesses, it does not discriminate against interstate commerce for purposes of the dormant Commerce Clause."⁵²⁶

Critics of differential taxation argue that the selective tax exemption for in-state conduit bonds favors private entities and begets simple economic protectionism.⁵²⁷ The government entity exemption is founded upon the fundamental difference between economic protection of private entities and the economic protection of government entities.⁵²⁸ According to these amici, conduit bonds fund private entities.⁵²⁹ Thus, in the most fundamental sense, the government entity exception is inapplicable.⁵³⁰

519. *Id.*; Multistate Tax Comm'n Brief, *supra* note 321, at 7; NAST Brief, *supra* note 321, at 27. Such legitimate purposes include funding educational programs at all levels; building government buildings; erecting bridges, highways, and airports; constructing public utilities and hospitals; and funding low income housing. Multistate Tax Comm'n Brief, *supra* note 321, at 7; NAST Brief, *supra* note 321, at 3.

520. *See supra* Part II.A.

521. *See, e.g.*, GFOA Brief, *supra* note 321, at 18 (noting that the differential tax system enables "a range of public services and public works" (citing J.W. TEMEL, THE FUNDAMENTALS OF MUNICIPAL BONDS 53-55 (5th ed. 2001))); Multistate Tax Comm'n Brief, *supra* note 321, at 7 ("State and local governments issue municipal bonds to raise funds to support general government needs or to fund public works projects and programs." (citing NAST Brief, *supra* note 321, at 3)); NAST Brief, *supra* note 321, at 27 ("The tax exemption facilitates the borrowing of funds by [Kentucky] and [their] political subdivisions to support important government programs and projects.").

522. *See supra* Part II.A.; *see also* NAST Brief, *supra* note 321, at 3; Nuveen Brief, *supra* note 321, at 10-11.

523. NAST Brief, *supra* note 321, at 27 (determining that local citizens have a greater interest in local bonds); Nuveen Brief, *supra* note 321, at 10-13 (determining that the differential tax system encourages state citizens to develop and utilize a specialized knowledge of local conditions and local investments).

524. NAST Brief, *supra* note 321, at 27; Nuveen Brief, *supra* note 321, at 10-13.

525. *See* NAST Brief, *supra* note 321, at 27-29; Nuveen Brief, *supra* note 321, at 10-20.

526. NAST Brief, *supra* note 321, at 27.

527. *See* Tax Found. Brief, *supra* note 324, at 3-15; Viard Brief, *supra* note 120, at 9-21.

528. *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1795-96 (2007) (plurality opinion).

529. *See* NFMA Brief, *supra* note 17, at 6-7.

530. *See* NAST Brief, *supra* note 321, at 24-25.

The second fundamental difference, critics argue, is the presence of discrimination.⁵³¹ While the differential taxation of municipal bonds appears to involve per se discrimination between in-state municipal bonds and out-of-state municipal bonds, this is not the case.⁵³² Discrimination “assumes a comparison of substantially similar entities.”⁵³³ When entities provide substantially different products, they may be serving different markets, in which case the entities would not be in competition.⁵³⁴ The discriminatory burden that the Commerce Clause is designed to reach is a burden on competition.⁵³⁵ Without competition, there is no burden on interstate commerce.⁵³⁶

Proponents of differential taxation argue that in-state municipal bonds do not compete with any other debt issuances because municipal bonds and private debt issuances are not substantially similar.⁵³⁷ State and local governments are “vested with the responsibility of protecting the health, safety, and welfare of [their] citizens.”⁵³⁸ Municipal bonds are issued to help state and local governments meet these responsibilities.⁵³⁹ According to proponents of differential taxation, this purpose distinguishes municipal bonds from private debt issuances.⁵⁴⁰ Because they serve different markets, municipal bonds and private debt issuances are not in competition.⁵⁴¹ Any differential treatment of these products is, under the government entity exception, nondiscriminatory.⁵⁴²

Critics of differential taxation dismiss this argument, claiming that the differential taxation of municipal bonds affects the municipal bonds issued by sister states and municipalities.⁵⁴³ They argue that even if all municipal

531. *United Haulers*, 127 S. Ct. at 1795 (plurality opinion); NAST Brief, *supra* note 321, at 25–26.

532. See GFOA Brief, *supra* note 321, at 18–20; NAST Brief, *supra* note 321, at 27; SIFMA Brief, *supra* note 112, at 5–8.

533. *United Haulers*, 127 S. Ct. at 1795 (plurality opinion) (quoting *Gen. Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997)).

534. See *id.*; *Gen. Motors*, 519 U.S. at 299.

535. See *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 390 (1994).

536. *Gen. Motors*, 519 U.S. at 299.

537. NAST Brief, *supra* note 321, at 27; Nuveen Brief, *supra* note 321, at 2–3.

538. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1809 (2008) (plurality opinion) (alteration in original) (quoting *United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1795 (2007) (plurality opinion)).

539. *United Haulers*, 127 S. Ct. at 1795–96 (plurality opinion). This characteristic of municipal bonds has been challenged with regards to conduit bonds, a subcategory of municipal bonds. See NFMA Brief, *supra* note 17, at 6–7; Viard Brief, *supra* note 120, at 25.

540. See GFOA Brief, *supra* note 321, at 16–19; Multistate Tax Comm’n Brief, *supra* note 321, at 8–9; NAST Brief, *supra* note 321, at 27; Nuveen Brief, *supra* note 321, at 2–3; SIFMA Brief, *supra* note 112, at 6–7.

541. GFOA Brief, *supra* note 321, at 16–18; Multistate Tax Comm’n Brief, *supra* note 321, at 8–9; NAST Brief, *supra* note 321, at 26–27.

542. Multistate Tax Comm’n Brief, *supra* note 321, at 9; NAST Brief, *supra* note 321, at 27; Nuveen Brief, *supra* note 321, at 3.

543. Tax Found. Brief, *supra* note 324, at 3–4 (likening the differential taxation system to an “exit toll” hindering interstate commerce); Viard Brief, *supra* note 120, at 9–10 (determining that state subsidies of in-state transactions discourages transactions with out-of-state sellers).

bonds funded public health, safety, and welfare, that feature alone would not distinguish in-state municipal bonds from out-of-state municipal bonds.⁵⁴⁴ Both bond issuances serve the same market and are in direct competition.⁵⁴⁵

Proponents of differential taxation disagree with these critics' characterization.⁵⁴⁶ According to proponents of differential taxation, in-state municipal bonds do not compete with out-of-state municipal bonds because, when a state enters an extra-state market, they are treated like any other market participant.⁵⁴⁷ Although extraterritorial municipal bonds advance the health, safety, and welfare of the citizens of their respective sister states, when state governments sell bonds outside their borders they lose the benefit of sovereignty.⁵⁴⁸ As regular market participants, their municipal bonds do not compete with in-state municipal bonds.⁵⁴⁹ Thus, because in-state municipal bonds do not compete with any other debt issuances, the differential tax treatment of municipal bonds is not discriminatory.⁵⁵⁰

The Court in *Davis* has already resolved this issue as applied to government bonds.⁵⁵¹ The Court agreed with the proponents' reasoning that, when a state enters an extra-state market, they are treated like any other market participant.⁵⁵² As applied to conduit bonds, the issue returns squarely to the argument over whether conduit bonds benefit private industry or whether they benefit the public.⁵⁵³ The outcome hinges on how conduit bonds are characterized.

The third fundamental difference between economic protection of a private entity and economic protection of a government entity is the presence of interference.⁵⁵⁴ According to proponents of differential taxation, examining laws favoring public entities under standard dormant Commerce Clause analysis "would lead to unprecedented and unbounded

544. See Viard Brief, *supra* note 120, at 9–10 (determining that in-state and out-of-state municipal bond funds are in competition).

545. See Multistate Tax Comm'n Brief, *supra* note 321, at 13–14; Viard Brief, *supra* note 120, at 9–10.

546. See generally GFOA Brief, *supra* note 321, at 16–19; Multistate Tax Comm'n Brief, *supra* note 321, at 4–11; NAST Brief, *supra* note 321, at 27; Nuveen Brief, *supra* note 321, at 2–3.

547. See NAST Brief, *supra* note 321, at 13 (citing *Bonaparte v. Tax Court*, 104 U.S. 592, 594 (1881)).

548. See *Bonaparte*, 104 U.S. at 594 (holding that the registered public debt of one state is taxable by another state when "owned by a resident of the latter State").

549. See NAST Brief, *supra* note 321, at 13; SIFMA Brief, *supra* note 112, at 8–9.

550. NAST Brief, *supra* note 321, at 13; SIFMA Brief, *supra* note 112, at 8–9.

551. See *Dep't of Revenue v. Davis*, 128 S. Ct. 1801, 1805 n.2 (2008) (plurality opinion) (drawing a distinction between governmental bonds and private-activity bonds); *id.* at 1819 (resolving the issue as applied to governmental bonds).

552. See *id.* at 1819.

553. See *supra* Part II.A.

554. *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1796 (2007) (plurality opinion); NAST Brief, *supra* note 321, at 26.

interference by the courts with state and local government.”⁵⁵⁵ Such interference would convert the dormant Commerce Clause into a “roving license” for federal courts to oversee state and local governments.⁵⁵⁶ Under this argument, federal courts should not be allowed to oversee the selective tax treatment of municipal bonds since this treatment encompasses the traditional and typical state government function of revenue generation.⁵⁵⁷

According to critics of differential taxation, the laws do not favor public entities; they favor private parties.⁵⁵⁸ The Court’s reluctance to investigate local government only applies where “a local government engages in a traditional government function.”⁵⁵⁹ A court will be hesitant to intrude only where a statute has a legitimate purpose unrelated to simple economic protectionism and does not discriminate against interstate commerce.⁵⁶⁰ When state and local government is not engaging in a traditional government function, courts must intercede.⁵⁶¹ Thus, the standard dormant Commerce Clause analysis is not merely appropriate for a review of the differential taxation of conduit bonds; it is required by the Constitution.⁵⁶²

As explained at the outset of Part II, the ultimate issue is whether the differences between conduit bonds and governmental bonds render the reasoning of *Davis* inapplicable.⁵⁶³ Part II.A identified the different groups that have argued each side of the issue.⁵⁶⁴ Part II.A also identified the reasoning supporting the conflicting analyses,⁵⁶⁵ and Part II.B went on to explain how each analysis informed the argument for and against the constitutionality of the discriminatory tax system as applied to conduit bonds.⁵⁶⁶ Part III of this Note identifies a solution that addresses the concerns of proponents and critics of the discriminatory taxation of conduit bonds. The solution is to appropriate a strict interpretation of the public purpose test as a litmus test for whether the discriminatory taxation of a given bond issuance violates the dormant Commerce Clause.

555. GFOA Brief, *supra* note 321, at 17 (reasoning that such oversight would lead to “unprecedented and unbounded” interference (quoting *United Haulers*, 127 S. Ct. at 1796 (plurality opinion))); NAST Brief, *supra* note 321, at 26 (citing *United Haulers*, 127 S. Ct. at 1795–96 (plurality opinion)); Nuveen Brief, *supra* note 321, at 8 (determining that such oversight is “unwarranted under the guise of the dormant Commerce Clause doctrine”).

556. NAST Brief, *supra* note 321, at 26.

557. GFOA Brief, *supra* note 321, at 17; NAST Brief, *supra* note 321, at 26; Nuveen Brief, *supra* note 321, at 8.

558. *See, e.g.*, Tax Found. Brief, *supra* note 324, at 8–10; Viard Brief, *supra* note 120, at 20–25.

559. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1810 (2008) (plurality opinion) (citing *United Haulers*, 127 S. Ct. at 1796 (plurality opinion)).

560. *See* Tax Found. Brief, *supra* note 324, at 11; Viard Brief, *supra* note 120, at 22–23.

561. Tax Found. Brief, *supra* note 324, at 10; Viard Brief, *supra* note 120, at 22–23.

562. Tax Found. Brief, *supra* note 324, at 10.

563. *See supra* note 316 and accompanying text.

564. *See supra* notes 321–27.

565. *See supra* Part II.A.

566. *See supra* Part II.B.

III. RECOMMENDING A *SUI GENERIS* ASSESSMENT FOR EACH ISSUANCE OF CONDUIT BONDS

The question of whether conduit bonds advance public or private interests has shaped the arguments for and against the differential taxation of these bonds.⁵⁶⁷ These arguments ignore the inherent variety among individual issuances of such bonds.⁵⁶⁸ State and local governments have only narrow limitations on their ability to issue municipal bonds.⁵⁶⁹ As a result, state and local governments are often free to structure municipal bonds how they see fit.⁵⁷⁰ Because of this variety, any assessment of conduit bonds that views all conduit bond issuances as either inherently public or inherently private is either overbroad or underinclusive.

The final part of this Note argues for a *sui generis* assessment of each issuance of conduit bonds that is similar to the public purpose test. This part begins by outlining the arguments forwarded by proponents and critics of differential taxation and identifying their strengths and weaknesses. The part goes on to explain what a *sui generis* assessment of each issuance would entail, the benefits of such an assessment, and the foreseeable burdens of adoption. This part concludes with a balancing of the benefits and the burdens of a *sui generis* assessment and a final determination that the benefits outweigh the burdens.

A. *THE SOLUTIONS PROPOSED BY PROPONENTS AND CRITICS OF THE DIFFERENTIAL TAXATION OF CONDUIT BONDS ARE INADEQUATE*

Both proponents and critics of the differential taxation of conduit bonds found their arguments on their determinations of the general character of conduit bonds.⁵⁷¹ While the determinations are alternately overbroad or underinclusive, the arguments are often sound. The next section of this Note examines the merits of the arguments advanced by proponents and critics of the differential taxation of conduit bonds. At certain points, the assessment requires the universe of conduit bonds to be divided into discrete groups: conduit bonds that advance public interests (public-interest conduit bonds) and conduit bonds that advance private interests (private-interest conduit bonds). For now, the difference between these groups is theoretical; the discussion of how to distinguish public-interest conduit bonds from private-interest conduit bonds is left for Part III.B.

567. See *supra* Part II.A.

568. See STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 21–22.

569. See *id.*; see also *supra* Part I.A.1 (discussing the limits on state and local governments' power to issue bonds).

570. See STAFF OF JOINT COMM. ON TAXATION, BACKGROUND, *supra* note 1, at 21–22.

571. See *supra* Part II.A.

1. Standard Dormant Commerce Clause Analysis

The purpose of the dormant Commerce Clause is to “to prohibit state or municipal laws whose object is local economic protectionism.”⁵⁷² The standard dormant Commerce Clause analysis is designed to target such laws and invalidate them.⁵⁷³ Proponents of the differential taxation of conduit bonds essentially evade this argument and forward a *sui generis* exception for all municipal bonds.⁵⁷⁴ This argument is rooted in equity and the authority of states as sovereigns.⁵⁷⁵ According to these proponents, equity requires that the current system of differential taxation remains in force because states and municipalities have undertaken large-scale capital projects on the presumption of their validity; because in-state bondholders relied on the application of the tax exemption; and because revocation of the tax exemption would create an inequitable windfall for in-state bondholders who purchased out-of-state municipal bonds with the understanding that the interest on such bonds would be subject to state income tax.⁵⁷⁶ These proponents further argue that, due to long-standing congressional acquiescence, the authority to institute a differential tax system has been subsumed into the authority of states as sovereigns.⁵⁷⁷

As applied to private-interest conduit bonds—as opposed to all municipal bonds—these arguments are unpersuasive. First, with regard to the equity argument, the market for conduit bonds is only a portion of the municipal bond market.⁵⁷⁸ Since private-interest conduit bonds only make up part of the market for conduit bonds, the consequences of invalidating the differential tax system are of a lesser magnitude than the proponents posit. While it is impossible to know the exact size of this impact, it is unreasonable to believe that invalidating the exemption as applied only to private-interest conduit bonds would jeopardize state and local budgets.⁵⁷⁹ Second, although in-state bondholders relied on the application of the tax exemption when they purchased the municipal bonds, the differential tax system is merely a body of laws that act upon the bond issuance after the transaction is complete—it is not a contractual provision included in the bond.⁵⁸⁰ The bondholders reap the benefit of the differential tax system but they are not entitled to it.⁵⁸¹ Finally, unlike the retroactive rescission feared

572. *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 390 (1994); *see also supra* notes 152–58 and accompanying text.

573. *See supra* notes 152–58 and accompanying text.

574. *See supra* notes 373–422 and accompanying text.

575. *See supra* notes 373–422 and accompanying text.

576. *See supra* notes 378–406 and accompanying text.

577. *See supra* notes 407–22 and accompanying text.

578. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 128, at 3–4 (finding the large majority of bonds in the municipal bond market are governmental bonds).

579. *Cf.* Tax Found. Brief, *supra* note 324, at 23–25 (arguing that the municipal bond market would not be affected by repeal of the differential tax treatment).

580. *Id.* at 23 (positing “tax exclusions, exemptions, and deductions are matters of legislative grace”).

581. *Id.*

by proponents of the differential tax system,⁵⁸² the proposed solution of invalidating the differential tax as applied to private-interest conduit bonds does not create a windfall for in-state purchasers holding out-of-state municipal bonds.

Proponents' second argument for *sui generis* exception—that the power to selectively tax all municipal bonds has been usurped by states as sovereigns—is unavailing as applied to all municipal bond issuances, not merely private-interest conduit bonds.⁵⁸³ Proponents found their argument on the long-standing congressional acquiescence to the differential tax system and the “strong tradition of . . . deferring to Congress’s superintendence of interstate commerce” in matters of state taxation.⁵⁸⁴ These arguments belie the fact that the power to regulate interstate commerce lies with Congress, not the states.⁵⁸⁵ For all of proponents’ claims of acquiescence, it is unclear how Congress’s tolerance of the selective tax system transfers an enumerated power from the federal government to the states.

Critics of differential taxation correctly argue that the selective taxation of conduit bonds promotes in-state business at the expense of out-of-state businesses.⁵⁸⁶ By definition, conduit bonds fund private interests—regardless of whether those private interests ultimately benefit the public.⁵⁸⁷ When a state selectively exempts the interest earned on in-state conduit bonds from income tax while taxing the interest earned on out-of-state conduit bonds, it is promoting in-state businesses at the expense of out-of-state businesses.⁵⁸⁸ The selective tax exemption ultimately exists to protect local economies and, thus, it is exactly the kind of activity the dormant Commerce Clause is designed to prevent.⁵⁸⁹ Since the selective taxation of private-interest conduit bonds does not survive the dormant Commerce Clause inquiry, it is necessary to determine whether the

582. See NAST Brief, *supra* note 321, at 18.

583. See Tax Found. Brief, *supra* note 324, at 22–26 (arguing that overturning the differential tax system would not infringe state sovereignty); Viard Brief, *supra* note 120, at 16 (determining that the states’ role as sovereign is both “obviously true” and “irrelevant to this case”).

584. GFOA Brief, *supra* note 321, at 12.

585. U.S. CONST. art. I, § 8, cl. 3 (“The Congress shall have Power To . . . regulate Commerce . . . among the several States . . .”).

586. Tax Found. Brief, *supra* note 324, at 5–10; Viard Brief, *supra* note 120, at 9–13.

587. See *supra* note 1 and accompanying text.

588. See Tax Found. Brief, *supra* note 324, at 5–10; Viard Brief, *supra* note 120, at 9–13.

589. See Tax Found. Brief, *supra* note 324, at 5–10; Viard Brief, *supra* note 120, at 9–13. Since the differential tax exemption fails the first prong of the dormant Commerce Clause analysis, there is no need to reach the second prong. See *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). However, based on the plurality’s holding in *Davis*, it is unlikely that the selective taxation of private-interest conduit bonds would fail the second prong of the standard dormant Commerce Clause analysis. See *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1810 (2008) (plurality opinion) (determining that the *Pike* analysis is ill-suited for assessing the benefits of overturning the differential tax system).

selective taxation of private-interest conduit bonds is subject to any of the exceptions to the standard dormant Commerce Clause analysis.⁵⁹⁰

2. Market Participation Exception

Under the market participation exception, states and municipalities may discriminate in favor of their own citizens when they act as market participants.⁵⁹¹ According to the Court, the dormant Commerce Clause is directed at market regulation, and market participation exists outside of the realm of market regulation.⁵⁹² Proponents of differential taxation argue that the selective tax system constitutes market participation.⁵⁹³ Critics of differential taxation claim that taxation is the classic case of market regulation and that states can not claim the protection of the market participant exception when regulating a market.⁵⁹⁴

Taxation is market regulation.⁵⁹⁵ Although proponents try to aggregate the sale of municipal bonds and the subsequent tax exemption into a single act of market participation,⁵⁹⁶ the taxation of the bonds and the sale of the bonds are separate.⁵⁹⁷ A state does not participate in a market when it taxes its citizens.⁵⁹⁸ In a part of the *Davis* plurality joined by only two Justices, Justice David Souter argues otherwise, attempting to distinguish the sale of governmental bonds from unconstitutional discriminatory taxes.⁵⁹⁹ According to Justice Souter, the selective taxation of governmental bonds is materially different from the taxes in *New Energy* and *Camps Newfound/Owatonna* because the taxation of governmental bonds does not affect private parties.⁶⁰⁰ While this argument may be valid,⁶⁰¹ it is inapplicable to conduit bonds.⁶⁰² Conduit bonds affect private parties and, therefore, the discriminatory taxation of conduit bonds is indistinguishable

590. See *supra* Part I.B.

591. See *White v. Mass. Council of Constr. Employers, Inc.*, 460 U.S. 204, 208 (1983) (citing *Reeves, Inc. v. Stake*, 447 U.S. 429, 436 n.7 (1980)).

592. See *Reeves*, 447 U.S. at 436.

593. See *supra* notes 492–96 and accompanying text.

594. See *supra* notes 497–505 and accompanying text.

595. See *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 588–89 (1997); *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988).

596. See NAST Brief, *supra* note 321, at 24; Nuveen Brief, *supra* note 321, at 10.

597. See Viard Brief, *supra* note 120, at 22 (“There is a substantive distinction between a state’s decision to discriminate against interstate commerce by means of its governmental taxing authority and a state’s decision to discriminate as a market participant by paying different rates of interest to different holders.”); see also Tax Found. Brief, *supra* note 324, at 11–15.

598. See, e.g., *Camps Newfound/Owatonna*, 520 U.S. at 588–89.

599. *Dep’t of Revenue v. Davis*, 128 S. Ct. 1801, 1811–14 (2008) (plurality opinion).

600. *Id.* at 1814 (“The Kentucky tax scheme falls outside of the forbidden paradigm because the Commonwealth’s direct participation favors, not local private entrepreneurs, but the Commonwealth and local governments.”).

601. See *id.* at 1821 (Roberts, C.J., concurring) (deciding not to reach the market participation analysis because the case was decided under the government entity exception); *Id.* at 1821 (Scalia, J., concurring) (same).

602. See *supra* note 1 and accompanying text.

from the unconstitutional discriminatory taxes in *New Energy* and *Camps Newfound/Owatonna*.⁶⁰³

3. Government Entity Exception

Under the government entity exception, economic protection of a government entity against private entities is not susceptible to Commerce Clause scrutiny.⁶⁰⁴ This exception is founded on the fundamental difference between those laws whose object is local protectionism and those laws whose object is advancing the public interest.⁶⁰⁵ The Court identified four fundamental differences between these practices: the purpose of the law, the presence of discrimination, the presence of interference, and the presence of ratification.⁶⁰⁶ In *Davis*, the plurality determined that this exception applies to the selective taxation of governmental bonds.⁶⁰⁷

Proponents of selective taxation argue that the selective taxation of conduit bonds is subject to the government entity exception.⁶⁰⁸ Under this argument, conduit bonds—despite financing private industry—advance the public interest.⁶⁰⁹ States and municipalities issue such bonds for the traditional and typical state government function of revenue generation for public works that benefit the citizenry, not for the protection of local industries.⁶¹⁰ The differential taxation of in-state municipal bonds is nondiscriminatory because discrimination “assumes a comparison of substantially similar entities”⁶¹¹ and in-state municipal bonds, by nature of being issued by the sovereign for a public purpose, are dissimilar from all other debt issuances.⁶¹² Examining the selective tax system under the standard dormant Commerce Clause analysis “would lead to unprecedented and unbounded interference by the courts,” thereby converting the dormant Commerce Clause into a “roving license.”⁶¹³ Finally, although proponents of selective taxation never addressed the issue of ratification, the argument for ratification as applied to conduit bonds would likely be identical to the argument for ratification as applied to government bonds: in both instances, the burden of the state regulation—here, the extra taxes by

603. Cf. Tax Found. Brief, *supra* note 324, at 7–10 (comparing compensating use taxes, which were found constitutional in *Henneford v. Silas Mason Co.*, 300 U.S. 577, 588 (1937), with the discriminatory tax in *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273–74 (1988)).

604. See *Davis*, 128 S. Ct. at 1810 (plurality opinion).

605. See *id.* at 1809; *United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1796 (2007) (plurality opinion).

606. See *id.* at 1810–11.

607. See *id.* at 1819.

608. See *supra* notes 521–26, 537–42, 546–50, 555–57 and accompanying text.

609. See *supra* notes 521–26.

610. See *supra* notes 338–41, 360–63 and accompanying text.

611. *United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1795 (2007) (plurality opinion) (quoting *Gen. Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997)).

612. See *supra* notes 537–42 and accompanying text.

613. See NAST Brief, *supra* note 321, at 26.

residents who purchase out-of-state municipal bonds—falls on the citizens of the state rather than on the citizens of a sister state.⁶¹⁴

Critics of selective taxation argue that the selective taxation of conduit bonds is not subject to the government entity exception.⁶¹⁵ Their core contention is that the purpose of the tax exemption is simple economic protectionism.⁶¹⁶ Additionally, these critics argue that differential taxation of in-state conduit bonds is discriminatory because conduit bonds compete against all other debt issuances.⁶¹⁷ Finally, these critics argue that courts are only reluctant to intrude when a statute has a purpose unrelated to simple economic protectionism.⁶¹⁸

Proponents of selective taxation of conduit bonds are correct that the government entity exception applies to the selective taxation of conduit bonds—provided that the conduit bonds actually do advance the public interest.⁶¹⁹ As discussed earlier, not every issuance of conduit bonds actually advances the public interest.⁶²⁰ Where an issuance of conduit bonds does not advance a legitimate public interest, the purpose of the tax exemption is economic protectionism and the tax exemption is unconstitutional.⁶²¹ Thus, both proponents and critics are correct in their reasoning. The issue, then, is how to distinguish between conduit bonds that advance a legitimate public interest and conduit bonds that do not. Part III.B advances a workable solution.

B. AN ARGUMENT FOR ADOPTING A *SUI GENERIS* ASSESSMENT FOR EACH ISSUANCE OF CONDUIT BONDS

In order to distinguish between private-interest conduit bonds and public-interest conduit bonds, the Court should perform a *sui generis* assessment that is similar to the public purpose test. Currently, the public purpose test is used to determine whether a bond issuance violates the Fourteenth Amendment of the U.S. Constitution.⁶²² Under this test, if the revenue generated by the issuance is used for a private purpose, the bond issuance is an unconstitutional taking of property without due process of law.⁶²³

A *sui generis* assessment would apply a framework similar to the public purpose test to determine whether a bond issuance is issued solely for the purpose of simple economic protectionism. Like the public/private distinction of the public purpose test, the economic protectionism inquiry would be very fact specific. Also like the public purpose test, each state

614. See *Dep't of Revenue v. Davis*, 128 S. Ct. 1801, 1811–14 (2008) (plurality opinion); see also *supra* note 1 and accompanying text.

615. See *supra* notes 527–30, 543–45, 558–62 and accompanying text.

616. See *supra* notes 527–30 and accompanying text.

617. See *supra* notes 543–45 and accompanying text.

618. See *supra* notes 558–62 and accompanying text.

619. See *Davis*, 128 S. Ct. at 1810–11 (plurality opinion).

620. See *supra* notes 134–40 and accompanying text.

621. See Tax Found. Brief, *supra* note 324, at 5–10; Viard Brief, *supra* note 120, at 9–13.

622. See *supra* notes 33–52 and accompanying text.

623. See *supra* notes 33–52 and accompanying text.

would have license to develop a test for determining whether the purpose of a bond issuance is simple economic protectionism. The universal element of this assessment, however, would be that the inquiry is centered on whether the object of the issuance is simple economic protectionism. If the object of an issuance is simple economic protectionism, the issuance is constitutional, but selective taxation of the issuance is not.

There are three primary benefits to adopting this *sui generis* framework. First, this solution targets the specific issuances prohibited by the dormant Commerce Clause.⁶²⁴ Thus, states are able to utilize the private sector to benefit the general public but are prevented from Balkanizing the private sector by insulating local markets.⁶²⁵ Second, this solution limits the impact on the municipal bond market since the only bonds affected by the practice are private-interest conduit bonds. Finally, because the proposed framework is essentially an outgrowth of the public purpose doctrine, courts applying this test will have the benefit of the case law that developed the state public purpose tests.

There are two significant burdens to adopting this *sui generis* framework. First, it is unclear what impact the implementation of *sui generis* assessment would have on the municipal bond marketplace. Any forecast of the impact of instituting this framework is purely speculative, and competing concerns tend to predict alternate outcomes.⁶²⁶ This burden is limited somewhat by the scope of the proposed assessment: it only applies to conduit bonds, and the selective tax exemption will only be invalidated if the object of the individual bond issuance is simple economic protectionism. Second, this decision could dramatically increase the judicial workload since any citizen subject to a selective tax exemption who purchases an out-of-state conduit bond would potentially have a cause of action.

On balance, the benefits of *sui generis* assessment outweigh the burdens. The development of the dormant Commerce Clause analysis illustrates that the core concern of the Court has been to tailor the analysis to allow state action that falls short of local economic protectionism.⁶²⁷ Preventing such protectionism is the core concern of the Court, and the fears about the consequence to the marketplace and judicial workload, though legitimate, are secondary. Therefore, the Court should adopt this *sui generis* framework.

624. See *supra* notes 149–51 and accompanying text (discussing the purpose of the dormant Commerce Clause).

625. See *supra* notes 152–58 and accompanying text (discussing how the dormant Commerce Clause works to prevent economic Balkanization).

626. Compare NFMA Brief, *supra* note 17, at 16–23 (predicting a widespread realignment of the municipal bond marketplace in the event the differential tax system was invalidated), with Tax Found. Brief, *supra* note 324, at 23–24 (determining that the revocation of the differential tax system would not have a significant impact on the municipal bond market).

627. See *supra* Part I.B.

CONCLUSION

The U.S. Supreme Court has yet to determine if the selective taxation of conduit bonds violates the dormant Commerce Clause. Proponents and critics of selective taxation have argued that conduit bonds should be viewed as either inherently public or inherently private and that the application of the dormant Commerce Clause analysis should hinge on this assessment. This Note recognizes the inherent variety of conduit bonds and recommends the adoption of a fact-specific, *sui generis* assessment to determine whether the ultimate purpose of the bonds is local economic protectionism. By tailoring the inquiry to deny the benefit of the selective tax system only from those bonds that stifle interstate commerce, the solution proposed by this Note retains the fundamental protection of the dormant Commerce Clause while leaving state and local governments free to employ their powers.