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**Davis v.**

**Department of Revenue of the Commonwealth of Kentucky**

(The “*Davis* case” or the “Kentucky Case”)

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## ■ Background

George and Catherine Davis, a Kentucky couple, sued the Commonwealth of Kentucky, arguing that its practice of taxing interest earned on out-of-state municipal bonds while exempting interest earned on in-state municipal bonds violated the dormant Commerce Clause of the U.S. Constitution, thereby restraining interstate commerce.

In 2006, the Kentucky Court of Appeals ruled in favor of the Davises and held Kentucky's differential tax treatment of municipal interest to be unconstitutional. The Kentucky Supreme Court declined to review that ruling, but at the Commonwealth's request, the U.S. Supreme Court (the "Supreme Court") decided to hear the case.

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## ■ [Supreme Court Decision](#)

For each case before it, the Supreme Court considers the record of proceedings in the lower court(s) and briefs containing the legal arguments of each side. *Amici curiae* (literally, “friends of the court,” who are not parties to the case) often provide information on a point of law or some other aspect of the case to assist the Court in its decision of the case; the Court may or may not consider that information. Oral argument is granted at some point after the Court begins its annual Term on the first Monday of October; attorneys for each side are allowed 30 minutes apiece to argue, after which the case is submitted for decision. The Court typically issues its written opinion(s) resolving the case, several weeks or months after oral argument.

In a 7-2 ruling, on May 19, 2008, the Supreme Court reversed the Kentucky Court of Appeals ruling and permitted states to exempt interest on their own bonds from taxation while taxing residents for interest on bonds issued by other states. The Supreme Court concluded that Kentucky’s differential tax practices on bonds does not favor in-state commerce to disadvantage competitors, but rather ensures that states can issue the debt needed to finance their essential governmental services.

This ruling echoes a previous ruling by the Supreme Court which stated that a government could show preference for itself if it served a public good.

Given that the Supreme Court has the final say on issues of federal constitutionality (absent subsequent amendment of the Constitution), its ruling should decisively settle the issue of whether differential tax treatment for in-state versus out-of-state municipal bond interest is unconstitutional, and resolve the various similar challenges now pending in several courts around the country.

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## ■ [Aquila's tax-free municipal bond funds](#)

Since the Supreme Court overturned the Kentucky court's ruling and upheld the constitutionality of in-state tax exemption, there should be no impact on the Fund/Trust.

Municipal bonds – and specifically, municipal bond funds like the Fund/Trust -- provide an important component of many financial plans. Most investors buy municipal bonds for two basic reasons: Safety and/or tax-free income.

Municipal bonds can provide some stability for your portfolio to counter the volatility of stocks while generating current or future income. Additionally, municipal bonds have had a very low default rate and are considered the next safest investment after U.S. Treasury securities. For example, Moody's Municipal Bond Default Study, of their rated issuers and defaulters for the period from 1970 through 2000, showed only 18 defaults out of over 28,000 issues.

Municipal bonds may also offer investors significant tax savings because they are generally exempt from regular Federal income tax, which can range as high as 35%.

Municipal bonds offer one additional and important benefit. They allow investors to invest, as many prefer to do, in areas or projects that they understand, and in projects/areas in which they have a beneficial interest, such as in their own states and communities.

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