Supreme Court Consideration of Limited Tax Exemption

The U. S. Supreme Court has agreed to rule in a case brought that challenges the Kentucky policy of exempting from state income tax the interest on bonds issued by local issuers. While the case concerns just Kentucky issuers and taxpayers, the fact situation applies to more than half of all states. For instance, Illinois exempts interest only on certain state agency bonds and debt of Puerto Rico, while some jurisdictions exempt interest from state and local income taxes.

The argument is based on the commerce clause of the U.S. Constitution. The Appellate Court ruling stated that the policy of taxing out-of-state bonds, but not state debt, violated the constitutional provision concerning interstate commerce.

If the Court upholds the Appellate Court, individual states will need to decide whether to tax municipal bond interest from local government units or to not tax interest on any municipal bonds. The effect on state revenues can be significant.

If all bond interest is exempted, a significant state revenue for many jurisdictions will need to be replaced. On a social/tax policy view, the concern is a perception of favoring "rich" bond investors. If all bond interest is to be taxed, the value of various bonds will fall, as will many mutual funds that are based on certain high tax states. Local governments would need to pay higher rates on future bonds; public perception may be that local governments are being penalized.

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GFOA Committee Warns of Underwriter Conflict of Interest

The Government Finance Officers Association (GFOA) represents over 16,000 state and local finance officers and is the primary association representing municipal bond issuers. The Debt Committee of the GFOA approved a draft update of its best practices for issuing debt at its meeting held on June 9, 2007. The draft is to be discussed by the GFOA Executive Board in October.

The draft specifically addresses a concern that has been hotly debated in the public finance industry: Should an underwriting firm be able to serve a bond issuer as financial advisor and then be able to resign and serve as underwriter for the same bonds on which it has previously advised? The draft clearly says no:

> "Due to inherent conflicts of interest, the firm acting as a financial advisor for an issuer should not be allowed to resign and serve as underwriter for the transaction being considered."

This statement seems to be a clear endorsement of a modification in the current Municipal Rulemaking Securities Board (MSRB) Rule G-23, which at present allows such role switching.

The National Association of Independent Public Finance Advisors (NAIPFA) started asking for a modification of Rule G-23 in letters to the MSRB in October 2005. Though the MSRB decided not to modify Rule G-23 in 2006, NAIPFA reinstated its request in a letter in 2007 and continues to identify what it believes are widespread abuses in the municipal bond market. With a GFOA endorsement for modification, pressure on the MSRB would increase significantly.

Commenting on the GFOA Debt Committee's action, *Bloomberg News*, the leading financial reporting firm in the industry, stated that the real problem is not only the role switching but:

> "That many unsophisticated issuers don't use financial advisers at all…Most issuers need objective, independent help when it comes to navigating the municipal bond market. Most of them [issuers] get it from their underwriters, hardly disinterested sources of advice."

The article stated that less than half, and in most years less than a third, of municipal bond issuers use financial advisors.