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Class Action Against Illinois Section 529 Programs Alleges That Tax Parity Is Constitutionally Required

Litigation over the constitutionality of state tax benefits restricted to a state's own financing programs has spread to Section 529 college savings programs from the municipal bond sector, which has generated a case that currently awaits a U.S. Supreme Court decision.

On May 15, 2007, Maryam Ahmad, individually and on behalf of a class of Illinois taxpayers who invest in out-of-state Section 529 programs, brought suit in the Circuit Court of Cook County, Illinois. The complaint challenges the constitutionality of provisions of the Illinois Income Tax Act that provide a deduction from adjusted gross income of up to \$10,000 for investments in the "College Illinois!" prepaid tuition program and the "Bright Start" and "Bright Directions" college savings programs, but that do not offer a similar deduction for investments in Section 529 programs sponsored by other states. The lawsuit asserts that the Illinois tax statute facially discriminates against interstate commerce in violation of the so-called "dormant" Commerce Clause of the United States Constitution. The lawsuit also alleges a violation of a provision of the Illinois constitution that requires reasonable classifications of the objects of taxation.

According to the complaint, the lead plaintiff in the *Ahmad* lawsuit pays taxes in Illinois but invests in Indiana's Section 529 program because the fees are lower than those of the Illinois programs. The complaint indicates that there are "several hundred, and probably several thousand," similarly situated class members and seeks:

- class certification,
- a declaratory judgment that the Illinois tax deduction for in-state Section 529 programs violates the federal and Illinois

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constitutions,

- a declaratory judgment that the members of the class are entitled to tax refunds in the amount of the Illinois income taxes they would have saved if the deduction were available for out-of-state Section 529 programs,
- an order obligating Illinois to create a common fund in an amount equal to the tax refunds claimed plus interest, and
- attorneys' fees.

The *Ahmad* class action was filed a week before the U.S. Supreme Court decided to review a Kentucky case, *Davis v. Kentucky*, in which a Kentucky appellate court held that Kentucky's practice of exempting from state income taxation interest on municipal bonds issued in Kentucky while taxing interest on municipal bonds issued in other states violates the dormant Commerce Clause of the United States Constitution. The U.S. Supreme Court is expected to issue a decision in early 2008 on the constitutionality of such a preferential tax exemption in the context of municipal bonds. The *Davis* case and the issues it raises are discussed in our May 21, 2007 advisory, *U.S. Supreme Court to Rule on Constitutionality of State Tax Statutes Favoring In-State Municipal Bonds*.

It is likely that the *Ahmad* class action has been filed in order to stake out a claim for the eventuality that the U.S. Supreme Court declares tax statutes favoring a state's own financing programs unconstitutional. It would not be surprising to see similar class action litigation initiated in the near future in other states with tax preferences for in-state Section 529 plans. Because there are differences between municipal bonds and Section 529 programs, the eventual U.S. Supreme Court decision in *Davis v. Kentucky* will not necessarily be dispositive of the constitutionality of non-parity tax treatment of out-of-state Section 529 programs. It is likely, however, that plaintiffs in the *Ahmad* case and any similar cases involving Section 529 programs that may be filed in other states will await a decision in *Davis*, and evaluation of which way such decision cuts for Section 529 programs, before devoting substantial additional resources to pursuing their claims.

In the meantime, revenue officials in close to 30 states with non-parity tax deductions, tax credits or other tax benefits for in-state Section 529 programs will need to consider the potential revenue ramifications if the U.S. Supreme Court in *Davis* and/or other courts faced with *Ahmad*-type litigation decide that non-parity statutes are unconstitutional. As suggested by the relief requested in *Ahmad*, the plaintiffs will, effectively, seek to obtain retroactive tax credits or tax deductions for their investments in out-of-state Section 529 programs.

If non-parity tax benefits are declared unconstitutional, state revenue officials may be faced with a choice between an unanticipated, and unbudgeted, expansion of tax expenditures for contributions to Section 529 programs, on the one hand, or a politically and legally problematic attempt to retroactively revoke tax credits or deductions previously granted to taxpayers who made contributions to in-state Section 529 programs.

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If you wish to discuss the contents of this advisory, or for assistance with issues raised by the legal developments that are the subject of this advisory, please contact the Mintz Levin lawyers listed below or any other member of Mintz Levin's Public Finance section.

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