southeastern states legal and statutory framework for state-issued bonds.

Diversified Trust's municipal bond strategy is a combination of three goals: liquidity, income and safety. We have elaborated in depth on the liquidity and income components in prior white papers, so this research report focuses on the structural mechanisms of state-issued municipal bonds, which provide the 'investor safety' element to this class of securities.

BY F. KNEELAND GAMMILL, CFA
Principal,
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This report summarizes the statutory framework and budget process of the states in Diversified Trust's Southeastern footprint to shed light on each state's borrowing programs. While DTC has clients in over 22 states, and we hold bonds issued in 49 states, our core client footprint includes: Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, Texas and Virginia. We hold a variety of tax-exempt bonds issued by each of these states, including general obligation (G.O.) bonds, appropriations bonds, revolving fund bonds, higher education bonds, and many others.

BY JAMES S. GILLILAND
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U.S. States' bonds, particularly G.O. bonds, are considered some of the safest fixed income investments in the world. These securities benefit not only from their transparent structural framework, but also from their superior credit history – no state G.O. bond has defaulted since Arkansas in 1933 – and from their strong legal and public policy environment, which is sustained by the well-established U.S. judicial system.

southeastern states legal and statutory framework for state-issued bonds.

	AL	AR	FL	GA	KY	LA	MS	NC	SC	TN	TX	VA
Constitutional Requirement for balanced budget?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
May deficits be legally carried forward to next fiscal year?	No	No	No	No	Yes	Yes	No	No	Yes	No	No	No
Does the Governor have sole mid-year spending reduction authority?	Yes	Yes	No	No	No	Yes	Yes	Yes	No	Yes	No	Yes
Are there formal debt limits?	Yes	No	Yes	Yes	No	Yes	Yes	No	Yes	No	Yes	Yes
Are there debt limit practices?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Is there a formal debt policy? I.e., amortization, modes of debt, etc.?	No	No	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Are there restrictions (i.e. super majority or referendums) to increasing major taxes?	Yes	Yes	Yes	No	No	Yes	Yes	No	No	Yes	Yes	No
Voter Initiative State?	No	No	Yes	No	No	No	No	No	No	No	No	No
Priority Lien of G.O. Debt Service specifically outlined in Constitution?	No	No	No	Yes	No	No	No	No	Yes	No	Yes	Yes
Does the State collect Income Tax (as part of bond trust estate)?	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	No	No	Yes

U.S. states' benefit from the following qualitative and quantitative credit strengths:

- States' treasury management is independent from the federal government, providing independent access to the markets.
- Unlike cities and counties and other local borrowers, states cannot legally file for bankruptcy.
- States have legal powers to raise taxes and user fees at will, as well as the right to manage their own cash reserves.
- States' primary role is to provide funding (primarily for education and social services) to local governments, rather than to directly provide these services, allowing flexibility to control expenditures.
- U.S. states bonds, as well as U.S. municipals in general, enjoy a strong legal and public policy environment, supported by a well established judicial system.

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Alabama (Aa1/AA/AA+)

Alabama's constitution clearly governs the state budget process, and it requires the governor to submit a balanced budget to the legislature and requires the legislature to pass a balanced budget. Due to the state constitution's limits on general obligation debt at $750 million, under Amendments 666 and 796, Alabama issues a large amount of lease debt and limited obligation debt. Amendment 666 requires the state make 'prompt and faithful' payments of general obligation bonds, which state officers interpret as giving these bonds priority lien on general fund revenues. State law also prohibits deficit spending and year-end deficits, as the governor is required to make cuts to appropriated spending to match actual revenues throughout each fiscal year to guarantee debt service payments. Though Alabama does not have a set timeline for budget adjustments to be made, so long as the executive branch approves agency spending cuts, the state's spending controls' practice is embedded in its governance framework. There are state constitutional restrictions on adjusting certain taxes such as property and sales taxes, but not on all revenues. Only a simple legislative majority is needed to increase the sales tax, but a constitutional amendment is required to increase the property tax rates which requires a three-fifth supermajority from both houses and must be approved by a majority of statewide popular vote. Alabama does not have a formal debt policy or formal multiyear financial forecasting, though it does practice these controls.

Tax Rate Schedule

Single		Married Filing Jointly	
Taxable Income	Marg. Tax Rate	Taxable Income	Marg. Tax Rate
$0 - $500	2.0%	$0 - $1,000	2.0%
$500 - $3,000	4.0%	$1,000 - $6,000	4.0%
Over $3,000	6.0%	Over $6,000	5.0%

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: Interest Taxed as ordinary income.

Capital Gains Tax: Net capital gains on all municipal bonds taxed as ordinary income.

Federal Income Tax: Federal income taxes are fully deductible from state taxable income.

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Arkansas (Aa1/AA/NR)

Arkansas' Revenue Stabilization Act of 1945 law requires a balanced state budget. The state constitution requires that money be appropriated each fiscal year for debt service, but there is no explicit mention of legal priority for debt service. State law forbids carrying deficits from one year to the next, and the governor has explicit authority to cut expenditures to remain statutorily compliant with state law. State spending controls through Arkansas' Revenue and Stabilization Act provides a mechanism to create balanced financial operations that automatically trigger cuts in state agency spending during economic downturns, providing cushion for scheduled debt payments. While the Arkansas constitution does not limit the amount of general obligation or revenue debt that may be issued, general obligation debt must be approved by voter referendum, though Arkansas is not a voter initiative state. Also, state law requires a supermajority from the legislature to raise taxes but it does not have high degree of flexibility to cut education funding to local school districts due to a state Supreme Court decision. Arkansas lacks a formal debt policy but it has good management practices, including the prohibition of variable rate debt or interest rate derivatives.

Tax Rate Schedule

Single & Married Filing Jointly	
Taxable Income	Marg. Tax Rate
$0 - $4,000	1.0%
$4,000 - $7,000	2.5%
$7,000 - $10,900	3.5%
$10,900 - $19,000	4.5%
$19,000 - $33,000	6.0%
Over $33,000	7.0%

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: Interest Taxed as ordinary income.

Capital Gains Tax: 30% of net long-term capital gains are excluded from taxation. The remaining 70% is treated as ordinary income. Net short-term capital gains are treated as ordinary income. If net capital losses exceed net capital gains, the excess is subtracted from other income, subject to an annual limit of $30,000.

Federal Income Tax: Federal income taxes are fully deductible from state taxable income.

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Florida (Aa1/AAA/AAA)

Florida has both constitutional and statutory requirements for a balanced budget, and the state constitution requires the state to raise revenues sufficient to defray expenses in each fiscal year. Florida does not have legal priority of payment of debt service over other payments, but the state constitution and Florida statutes require the appropriation of general fund balances sufficient to pay debt service on state general obligation bonds as they become due. Additionally, Florida statutes require the State Board of Administration to advise the governor and legislature of any need to appropriate funds to honor the state's general obligation pledge. When deficits are identified, action to reestablish balance is swift, with a plan created by the Governor and Chief Justice of the state Supreme Court, and approved by the Legislature Budget Commission to close the budget gap within 30 days of the shortfall being identified. The state cannot carry forward deficits and must address any projected deficit within the current fiscal year. If the deficit is projected to be greater than 1.5% of revenues, the legislature must act to resolve it. If it is less than 1.5%, it can be addressed by the Legislative Budget Commission. Florida has the right to raise taxes or fees with a simple majority vote from the legislature, however, for imposition of new taxes – such as a personal income tax – requires a constitutional amendment and 2/3 voter approval. While Florida is a voter initiative state, it requires a 60% super majority vote for initiatives to be approved. Florida does not collect income tax.

State Income Tax: None

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: **Interest income is not taxable.**

Capital Gains Tax: None

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Georgia (Aaa/AAA/AAA)

Georgia's governor is constitutionally required to submit a balanced budget to the legislature, and the legislature must adopt a balanced budget. The state has legal flexibility to issue debt for a variety of purposes, but debt service on all G.O. debt and state guaranteed debt may not exceed 10% of the prior year's state tax revenues. G.O. debt service is paid from the state's G.O. debt sinking fund, and if these funds are insufficient, from first money received into Georgia's general fund. To incur guaranteed revenue debt, the General Assembly makes a determination that the debt is self-supporting and appropriates an amount equal to maximum annual debt service to a common reserve fund. Georgia has strong statutory and constitutional provisions that limit growth in appropriations to net projected revenue from existing revenue sources, and it cannot carry over deficits from one year to the next. Additionally, the state enjoys flexibility to set and modify tax rates and fees, and needs only a majority vote in the legislature to pass rate adjustments or new taxes. Debt management is conservative, with rapid amortization of principal, with almost 70% due in 10 years. Georgia has a formal debt management policy that measures debt service against spending, debt to personal income and debt per capita. Georgia is not a voter initiative state.

Tax Rate Schedule

Single		Married Filing Jointly	
Taxable Income	Marg. Tax Rate	Taxable Income	Marg. Tax Rate
$0 - $750	1.0%	$0 - $1,000	1.0%
$750 - $2,250	2.0%	$1,000 - $3,000	2.0%
$2,250 - $3,750	3.0%	$3,000 - $5,000	3.0%
$3,750 - $5,250	4.0%	$5,000 - $7,000	4.0%
$5,250 - $7,000	5.0%	$7,000 - $10,000	5.0%
Over $7,000	6.0%	Over $10,000	6.0%

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: Interest Taxed as ordinary income.

Capital Gains Tax: Net capital gains on all municipal bonds taxed as ordinary income.

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Kentucky (only Appropriation-backed debt outstanding: Aa3/A+, A+*)

While Kentucky's constitution requires the state to approve a balanced budget in each biennium, it also permits deficits between years one and two each of biennium. Kentucky has not issued G.O. bonds in over 40 years, and for borrowing purposes, it relies on various commonwealth corporations, commissions and authorities to issue appropriation-backed debt and on revenue bonds. These state agencies are permitted to issue debt only with the approval of specific projects and the biennial appropriation of debt service by the general assembly. To address deficits, the governor may unilaterally cut expenses as needed if the deficit is less than a 5% shortfall, but shortfalls above this require general assembly action. Kentucky does have flexibility to raise revenue, and may increase its income tax and sales tax rates, as well as raise new revenues, without voter approval, a credit positive. While the state does not produce formal long-range financial plans nor have a formal debt management policy or debt limit, it does have practices for each of these in place that are informal and in the decision-making process. Kentucky does have a formal 6-year capital plan and it does have by statute a budget reserve of 5% of general fund revenues. Kentucky is not a voter initiative state.

*other U.S. states that issue Appropriations-backed or revenue bonds versus G.O. bonds: Arizona, Colorado, Idaho, Indiana, Iowa, Kansas, Nebraska, North Dakota, South Dakota and Wyoming.

Tax Rate Schedule

Single & Married Filing Jointly

Taxable Income	Marg. Tax Rate
$0 - $3,000	2.0%
$3,000 - $4,000	3.0%
$4,000 - $5,000	4.0%
$5,000 - $8,000	5.0%
$8,000 - $75,000	5.8%
Over $75,000	6.0%

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: Interest is taxed as ordinary income.

Capital Gains Tax: Net capital gains on all municipal bonds, except for KY Turnpike Authority bonds, are taxed as ordinary income.

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Louisiana (Aa2/AA/AA)

The state constitution requires a balanced budget be adopted by the legislature, and if revenues fall short of projections, the governor is directly empowered to cut expenditures to ensure it meets the statutory requirement the budget remain balanced throughout the year. While Louisiana is legally permitted to end a fiscal year with a deficit, it must be eliminated by the end of the next fiscal year. Though Louisiana's constitution does not explicitly outline priority lien of debt service, the state practices this priority regardless. Louisiana's constitution prohibits G.O. debt service payments from exceeding 6% of the general fund balance, acting as a current and future debt limitation instrument, and Louisiana has a diverse tax structure including both personal income and sales taxes to support bond payments. Article VII of the state constitution limits how Louisiana may adjust revenues and taxes, requiring a two-thirds super majority when any revenue or property taxation bill is passed. Louisiana is not a voter initiative state.

Tax Rate Schedule

Single		Married Filing Jointly	
Taxable Income	Marg. Tax Rate	Taxable Income	Marg. Tax Rate
$0 - $12,500	2.0%	$0 - $25,000	2.0%
$12,500 - $50,000	4.0%	$25,000 - $100,000	4.0%
Over $50,000	6.0%	Over $100,000	6.0%

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: Interest on out-of-state bonds purchased on or after January 1, 1980, is taxed as ordinary income.

Capital Gains Tax: Net capital gains on all municipal bonds are taxed as ordinary income.

Federal Income Tax: Federal income taxes are deductible from state taxable income.

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Mississippi (Aa2/AA/AA)

It is a statutory requirement that the Mississippi budget must be balanced when adopted, and also state statute that general fund revenues and cash balances are reviewed at least monthly by the Treasurer and Department of Finance. Mississippi's constitution does not explicitly outline priority of G.O. debt service, though the state practices this. If revenues fall short of projections, the state is empowered to directly cut expenditures to ensure the statutory requirement the budget remain balanced throughout the fiscal year. Mississippi has the authority to raise revenues, including the authority to level and raise a broad range of taxes, though the state constitution requires a three-fifths super majority to pass tax increases. No deficits may be carried over to the following year, and by law, the executive branch must address revenue shortfalls of more than 2% after each fiscal year's fourth month by reducing spending. The state has the ability to issue bonds for a wide range of purposes, but all state debt must be authorized by legislation. Mississippi's constitutional debt limit is 1.5x the sum of all revenues the state collects in any one of the four preceding fiscal years, whichever is highest. The state has a debt policy limiting variable rate debt to 20% and short-term debt to 7.5% of general fund appropriations. Mississippi is not a voter initiative state.

Tax Rate Schedule

Single & Married Filing Jointly	
Taxable Income	Marg. Tax Rate
$0 - $5,000	3.0%
$5,000 - $10,000	4.0%
Over $10,000	5.0%

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: Interest Taxed as ordinary income.

Capital Gains Tax: Net capital gains from in-state muni bonds are tax-exempt, but are taxed as ordinary income for out-of-state bonds. Capital losses are limited to $3,000 per year.

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

North Carolina (Aaa/AAA/AAA)

The state constitution requires balanced budget approval and that the budget remains balanced through each biennium years. The governor has unilateral authority to reduce spending to maintain balanced budgets, but only after making provisions for state bond debt service, providing a de facto priority lien for state G.O. bonds. North Carolina has good budgetary flexibility in regard to its expenditures, and deficits are not permitted to be carried into future fiscal years. Once the budget is approved, the state monitors both revenue and expenditure performance on a regular basis. Budget adjustments have historically been implemented on a timely basis. The state has a debt affordability policy that limits debt issuance, and this policy requires rapid debt amortization. North Carolina has strong revenue-raising ability and can raise taxes without the need of voter approval or supermajority votes in its legislature, and it has good budgetary flexibility with regard to its expenditures. North Carolina is not a voter initiative state and it has formal cash reserve/savings requirements providing financial cushion. Additionally, the state uses both internal and outside consultants for its revenue and expenditure budget assumptions and a conservative investment policy whose results are reported monthly.

Tax Rate Schedule

Single		Married Filing Jointly	
Taxable Income	Marg. Tax Rate	Taxable Income	Marg. Tax Rate
$0 - $12,500	6.0%	$0 - $21,250	6.0%
$12,500 - $60,000	7.0%	$25,000 - $100,000	7.0%
Over $60,000	7.75%	Over $100,000	7.75%

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: Interest on out-of-state bonds is taxed as ordinary income.

Capital Gains Tax: Net capital gains on muni bonds issued after July 1, 1995 are taxed as ordinary income. The gain from sale or disposition of North Carolina bonds issued before July 1, 1995, is not taxable if the law under which the bonds were issued specifically excludes the gain.

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

South Carolina (Aaa/AA+/AAA)

By statute, South Carolina must approve and maintain balanced budgets, and the state constitution has debt limits in place. The state's autonomous budget and control board (BCB) is empowered by statue to take prompt corrective action to maintain balanced budgets, but only after state bond debt service is accounted for providing a de facto priority lien for state G.O. bonds. South Carolina has considerable revenue-raising ability and can raise its income and sales tax rates and approve new taxes without the need for voter approval or super majority votes in the legislature, and it has good expenditure control as well. While deficits may be carried over, they must be fully addressed in the next fiscal year's budget. South Carolina has a formal three-year financial forecast for each agency or department receiving more than 1% of the state's general fund appropriation, and these forecasts are presented to the Office of State Budget. The state may not issue bonds longer than 30 years and must amortize 80% of principal within the first 10 years after issuance. South Carolina's constitution calls for cash reserves to be funded at 5% of general fund revenue for the latest completed fiscal year.

Tax Rate Schedule

Single & Married Filing Jointly	
Taxable Income	Marg. Tax Rate
$0 - $2,800	0.0%
$2,800 - $5,600	3.0%
$5,600 - $8,400	4.0%
$8,400 - $11,200	5.0%
$11,200 - $14,000	6.0%
Over $14,000	7.0%

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: Interest Taxed as ordinary income.

Capital Gains Tax: Individuals can deduct 44% of the net long and short-term capital gains recognized in South Carolina. Income received from installment sales as well as capital gains distributions qualify for this deduction provided the more than one-year holding period requirement has been met.

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Tennessee (Aaa/AA+/AAA)

Tennessee's state constitution requires a balanced budget to be submitted by the governor and approved by the General Assembly, and the state cannot carryover any deficits. The state is authorized by its constitution to levy ad valorem taxes on all taxable property in the state to pay debt service on the state's general obligation debt, although Tennessee does not currently levy such a tax. The State Funding Board has a lien on all state special taxes (gasoline, vehicle registration & franchises) to pay G.O. debt service as well. The state practices multi-year forecasting and mid-year cost containment measures through the State Funding Board, on whose consensus budget assumptions are based. However, the Tennessee legislature must give consent in order to make mid-year spending adjustments. Offsetting this is the fact that Tennessee is not a voter initiative state, and that Tennessee does not require a legislative supermajority to raise taxes. Additionally, Tennessee has a well-delineated debt management policy and statutory minimum reserves requirements equal to 5% of state tax revenues for the general and education trust funds that has prevented the need for cash-flow borrowing. While Tennessee does not have a constitutional debt limit, it does have a provision that requires pledged bond revenues to be at least 1.5x the annual debt service requirement creating a debt limitation. Tennessee has autonomy to adjust most of its key revenues aside from payments in lieu of taxes from the Tennessee Valley Authority, which is owned by the federal government. The state does not collect income tax, however, which reduces the sources of bond repayment under its trust indenture.

Tax Rate Schedule

Single & Married Filing Jointly	
Taxable Income	Tax Rate
Certain dividends, interest & unearned income only (Hall Tax)	6.0%

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: Interest Taxed as ordinary income.

Capital Gains Tax: Capital gains distributions from mutual funds are taxed as ordinary income. Capital gains on individual securities are not taxable.

Federal Income Tax: Federal income taxes are fully deductible from state taxable income.

Note: The first $1,250 for single filers and $2,500 for MFJ files is exempt. Also, individuals 65 yrs old or older with total annual income of $26,200 or less ($37,000 for joint filers) are exempt.

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Texas (Aaa/AA+/AAA)

Texas has a constitutional requirement to adopt a balanced budget. Despite not having a legal requirement to end a fiscal biennium in balance, the legislature must address any current deficit before a new budget can be approved, which effectively serves as a budget balancing measure. Texas' framework also has a constitutional pledge that state G.O. debt is secured by the first monies coming into the state treasury not constitutionally dedicated for other purposes. The state comptroller tracks revenue and expenditure performance monthly, but the Governor does not have unilateral authority to reduce state mid-year spending, which must also be approved by the legislature. Texas has adequate legal authority to adopt and increase taxes and fees, but one significant exception would be the adoption of a personal income tax that would require voter referendum, an amendment to the state constitution and also legislature approval. It also has a constitutional debt limit that states additional debt is not permitted if the maximum annual debt service on bonds payable from the general fund exceed 5% of the average general fund revenues for the previous three years. Texas also has a statewide capital plan and a Debt Affordability Plan, which is good. Texas does not collect income tax, however, which decreases the sources of bond repayment under its trust indenture. Texas is not a voter initiative state.

State Income Tax: None

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: None

Capital Gains Tax: None

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Virginia (Aaa/AAA/AAA)

The Commonwealth of Virginia's constitution requires a balanced biennium budget and that the budget must remain balanced throughout the year as well as each year of its biennium budget process. By statute, debt service must be included in the governor's budget, and if sufficient funds are not appropriated in the budget for timely G.O. bond debt service, the governor shall set aside from first general fund revenues a sum sufficient to pay G.O. debt service. When the state's Department of Taxation identifies revenue shortfalls, the governor has the express authority to cut spending up to 15% within the enacted budget without general assembly consent. There is no constitutional restraint on raising taxes and revenues, which may be raised by a simple majority of both houses of the legislature, but there are state debt limits, both of which are good for bondholders. Virginia's constitution sets out limits on the amount of general obligation debt that can be authorized and issued, but the recommendations set by the Debt Capacity Advisory Committee, though advisory, are far more conservative, and apply to all tax-supported debt, not just G.O. debt. The Treasury Board also promulgates guidelines for the structuring and issuance of debt, and much of the debt issued by the state and its bonding authorities must be approved by the Treasury Board. Virginia limits debt issuance to 1.15x the average annual income and sales tax receipts for the previous three fiscal years.

Tax Rate Schedule

Single & Married Filing Jointly	
Taxable Income	Marg. Tax Rate
$0 - $3,000	2.0%
$3,000 - $5,000	3.0%
$5,000 - $17,000	5.0%
Over $17,000	5.75%

State Tax on In-State Municipal Bonds: None

State Tax on Out-of-State Municipal Bonds: Interest Taxed as ordinary income.

Capital Gains Tax: Net capital gains on out-of-state municipal bonds are taxed as ordinary income. In-state bonds are exempt from net capital gains taxes.

Sources: See page 15

Southeastern States Legal and Statutory Framework for State-Issued Bonds

Sources

The majority of the text in each state summary is sourced directly and in many cases verbatim, from Standard & Poor's, through a variety of separate research reports. The tax tables are attributable to Bank of America Merrill Lynch's annual tax guide, which is derived from the non-profit website www.tax-brackets.org.

Standard & Poor's

An Overview of Key Payment Priority Provisions For U.S. State Debt – March 6, 2012

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