

**TAX INCREMENT
FINANCING REPORT**

February 2001

TAX INCREMENT FINANCING REPORT

TABLE OF CONTENTS

EXECUTIVE SUMMARY	iii
I. GENERAL INFORMATION	1
A. INTRODUCTION	1
B. BACKGROUND	1
1. What Is Tax Increment Financing?	1
2. Overview of Tax Increment Financing Act	2
3. Who Uses Tax Increment Financing?	4
4. Statistics on Use of Tax Increment Financing	5
C. OSA’s ROLE IN TIF	7
II. VIOLATIONS OF TIF ACT	9
A. “POOLING” OF TAX INCREMENT FROM 1979-82 TIF DISTRICTS	
City of Eden Prairie	10
B. LACK OF REASONS AND SUPPORTING FACTS FOR “BUT FOR” TEST	
Cook County/Grand Marais Joint EDA	11
C. LACK OF REASONS AND SUPPORTING FACTS FOR FINDING THAT	
PARCELS WERE “OCCUPIED” FOR PURPOSES OF QUALIFYING AS A	
REDEVELOPMENT DISTRICT	
Cook County/Grand Marais Joint EDA	12
D. INCOMPLETE MAP ACCOMPANYING PUBLIC HEARING NOTICE	
City of Jordan	12
E. TAX INCREMENT RECEIVED AFTER MAXIMUM DURATION LIMIT	
Chanhassen EDA	13
F. ADMINISTRATIVE EXPENSES IN EXCESS OF STATUTORY LIMIT	
City of Eden Prairie	14
G. COSTS NOT ELIGIBLE FOR PAYMENT WITH TAX INCREMENT	
1. City of Jordan	15
2. City of Deerwood	16
H. USES OF TAX INCREMENT NOT AUTHORIZED IN TIF PLAN	
1. City of Bricelyn	16
2. City of McGregor	17
3. City of Jordan	18
4. City of Braham	19
5. City of Lewiston	19

I. INADEQUATELY DOCUMENTED USES OF TAX INCREMENT	
City of Jordan	20
III. STATUTORY ISSUES	21
A. “BUT FOR” TEST	22
B. DETERMINING “OCCUPIED” PARCELS FOR PURPOSES OF QUALIFYING A TIF DISTRICT AS A REDEVELOPMENT DISTRICT	23
C. INTEREST ON INTERFUND LOANS	24
IV. CONCLUSION	24
EXHIBIT 1—Statistics on TIF Reporting for Year Ended December 31, 1999	27

TAX INCREMENT FINANCING REPORT

EXECUTIVE SUMMARY

Description of TIF

Tax increment financing (TIF) is a statutory tool to promote economic development, redevelopment, and housing in areas where it otherwise would not have occurred. A TIF authority, typically a city, a county, or an entity created by a city or county, captures the increase in net tax capacity resulting from new development within a designated geographic area called a TIF district. The TIF authority uses the tax increments, which are the property taxes paid on the captured increase in net tax capacity, to pay for TIF-eligible costs of the new development that generated the increase in net tax capacity.

The property taxes on the captured net tax capacity are paid to the TIF authority rather than to the city or town, county, and school district. The school district recovers most of the property tax revenue it loses to the TIF authority through an increase in state education aid payments.

OSA's Role in TIF

In the 1995 Omnibus Tax Act, the Legislature transferred authority for legal compliance oversight of all TIF districts in the state to the Office of the State Auditor (OSA). Local governments were required to file reports with the OSA for approximately 2,100 TIF districts for the year ended December 31, 1999. The TIF Act authorizes the OSA to examine and audit the accounts and records of TIF authorities on a random basis to determine whether they are complying with the TIF Act. The OSA is required to provide an annual summary of its findings of noncompliance with the state TIF laws and the responses to those findings by the governing bodies of the relevant municipalities. The following report is submitted to the chairs of the legislative committees with jurisdiction over tax increment financing.

Violations of TIF Act

The report summarizes the following findings of noncompliance made by the OSA and the municipalities' responses:

- Expending tax increment and TIF bond proceeds from TIF districts on activities outside the geographic areas of the TIF districts, even though the TIF Act did not authorize any tax increment or TIF bond proceeds to be spent on activities outside the TIF districts;
- Not setting forth in writing the reasons and supporting facts for findings that two TIF districts met the "but for" test;

- Not setting forth in writing the reasons and supporting facts for finding that a TIF district qualified as a redevelopment district;
- Not including a map of a TIF district in the published notice of the public hearing regarding approval of the TIF plan for the TIF district;
- Receiving tax increment from an economic development district after the statutory maximum duration limit;
- Spending tax increment on administrative expenses in an amount greater than that permitted by the TIF Act;
- Transferring tax increment to a municipality's general fund to compensate the municipality for the state aid offset and paying tax increment to a developer so that the developer could compensate the municipality for the state aid offset;
- Using tax increment to pay for costs for which the TIF plans did not contain a specific budget amount; and
- Not maintaining adequate documentation sufficient to allow the OSA to verify that payments made with tax increment were made for lawful purposes.

Statutory Issues

In addition, the report discusses the following statutory issues:

- The proper standards to apply in determining whether a local government has correctly drawn a TIF district's geographic borders and has successfully complied with the "but for" test.
- The correct standards to apply in determining whether at least 15 percent of a parcel is occupied by buildings, streets, utilities, or other improvements as part of the determination that a TIF district qualifies as a redevelopment district.
- The need to review the issue of TIF authorities paying interest on interfund loans and the appropriate rate of interest on such loans.

TIF Reporting Statistics

Exhibit 1, beginning on page 26 of this report, reviews the statutory reporting requirements for TIF districts and details the statistics on TIF reporting for the year ended December 31, 1999.

TAX INCREMENT FINANCING REPORT

I. GENERAL INFORMATION

A. INTRODUCTION

In the 1995 Omnibus Tax Act, the Legislature transferred authority for legal compliance oversight of all tax increment financing (TIF) districts in the state to the Office of the State Auditor (OSA). Local governments were required to file reports with the OSA for approximately 2,100 TIF districts for the year ended December 31, 1999. The OSA is required to provide an annual summary of its findings of noncompliance with the state TIF laws and the responses to those findings by the governing bodies of the relevant municipalities.¹ This report is submitted to the chairs of the legislative committees with jurisdiction over tax increment financing.

B. BACKGROUND

1. What Is Tax Increment Financing?

Tax increment financing is a statutory tool to promote economic development, redevelopment, and housing in areas where it otherwise would not have occurred. A TIF authority, typically a city, a county, or an entity created by a city or county, captures the increase in net tax capacity resulting from new development within a designated geographic area called a TIF district. The TIF authority uses the tax increments, which are the property taxes paid on the captured increase in net tax capacity, to pay for TIF-eligible costs of the new development that generated the increase in net tax capacity.

The property taxes on the captured net tax capacity are paid to the TIF authority rather than to the city or town, county, and school district. The school district recovers most of the property tax revenue it loses to the TIF authority through an increase in state education aid payments.

TIF is not a property tax abatement program. The owner of the property in the TIF district continues to pay the full amount of property taxes. The portion of those property taxes generated by the new development, however, is used to pay some of the development costs that the owner, developer, or local government otherwise would have paid.

Examples of TIF-eligible costs are land and building acquisition, demolition of structurally substandard buildings, site preparation, installation of utilities, road improvements, and construction of low- or moderate-income housing. The costs that are eligible to be paid from tax increment vary depending on the type of TIF district created and the year in which the district was created.

¹ Minn. Stat. § 469.1771, subd. 1(c) (2000).

The up-front costs of TIF-subsidized development frequently have been financed with the proceeds of general obligation bonds, revenue bonds, loans from external sources, or interfund loans, or through other financing arrangements. The debt service on those obligations is paid with tax increment generated by one or more TIF districts.

An alternative to bonded debt or loans, known as pay-as-you-go financing, is being used with increasing frequency. Under a pay-as-you-go financing arrangement, the property owner or developer pays the development costs up front and is reimbursed if, and when, tax increment is generated by the TIF district.² The risk of insufficient tax increment to reimburse all of the TIF-eligible costs rests with the property owner or developer, rather than with the TIF authority.³

2. Overview of Tax Increment Financing Act

The Minnesota Tax Increment Financing Act (TIF Act) governs the creation and administration of TIF districts.⁴ The following is a summary of the provisions of the TIF Act:

C	Minn. Stat. § 469.174	Definitions;
C	Minn. Stat. § 469.175	Contents of TIF plans, procedures for approving and amending them, and reporting requirements;
C	Minn. Stat. § 469.176	Limitations on expenditure of tax increment and maximum duration limits for TIF districts;
C	Minn. Stat. § 469.1761	Income requirements for housing projects;
C	Minn. Stat. § 469.1762	Arbitration of disputes over county costs;
C	Minn. Stat. § 469.1763	Pooling restrictions and the five-year rule;
•	Minn. Stat. § 469.1764	Ratification of pooling from 1979-82 TIF districts;
C	Minn. Stat. § 469.1765	Rules governing guaranty funds;
C	Minn. Stat. § 469.1766	Restrictions on developer payments;
C	Minn. Stat. § 469.177	Computation of tax increment, requirement to repay excess increment, and deduction to fund OSA enforcement function;
C	Minn. Stat. § 469.1771	Remedies for violations and OSA enforcement authority;
C	Minn. Stat. § 469.178	Tax increment bonding;

² The TIF authority may use tax increment to reimburse only those costs that are TIF-eligible and that the property owner or developer actually has incurred. The TIF authority must obtain from the developer, and retain in its files, documentation of the costs being reimbursed.

³ Even in situations where bonds are issued or the TIF authority receives an advance of funds, TIF authorities frequently structure the financing arrangements to shift the risk of insufficient tax increment from the TIF authority to the property owner or developer.

⁴ Laws 1979, ch. 322. Initially, the TIF Act was codified at Minn. Stat. §§ 273.71 through 273.78. In 1987, the TIF Act was recodified at Minn. Stat. §§ 469.174 through 469.179.

- C Minn. Stat. § 469.1781 Required expenditures of tax increment for a neighborhood revitalization program where certain bonds have been refunded;
- C Minn. Stat. § 469.1782 Provisions applicable to TIF districts with extended durations as a result of special laws; and
- C Minn. Stat. § 469.179 Presumptions regarding the effective dates of amendments to the TIF Act.

The TIF Act has been amended frequently since its creation in 1979. A TIF district usually is governed by the laws in effect in the year in which the district was created.

The TIF Act divides TIF districts into a number of types, each of which has different requirements for the creation of a district, different maximum duration limits, and different restrictions on the use of tax increment from the district:

- C Pre-1979 districts;
- C Economic development districts;
- C Housing districts;
- C Redevelopment districts;
- C Renewal and renovation districts; and
- C Soils condition districts.⁵

In addition, the TIF Act permits the creation of a hazardous substance subdistrict within a TIF district. A hazardous substance subdistrict has its own statutory requirements for the creation of a subdistrict, maximum duration limit, and restrictions on the use of tax increment. Furthermore, uncodified laws have authorized the creation of a wide variety of special-purpose TIF districts.⁶

A related statute⁷ grants special status to certain TIF districts which meet additional qualifications:

- C Qualified housing districts;
- C Qualified ethanol production facility districts;

⁵ The TIF Act used to authorize the creation of mined underground space development districts, but these provisions were repealed by the Legislature in 2000. *See* Laws 2000, ch. 490, art. 11, sec. 44(a) (repealing Minn. Stat. §§ 469.174, subd. 13 and 469.176, subd. 4a (1998)).

⁶ *See, e.g.*, Laws 1995, ch. 264, art. 5, sec. 44-47.

⁷ Minn. Stat. § 273.1399 (2000).

- C Qualified agricultural processing facility districts; and
- C Qualified manufacturing districts.⁸

3. Who Uses Tax Increment Financing?

The TIF Act authorizes TIF authorities to create TIF districts. TIF authorities include housing and redevelopment authorities, port authorities, economic development authorities, municipal redevelopment agencies, rural development financing authorities, cities, and counties. The TIF authority takes the first step in creating a TIF district by adopting a TIF plan for the district. The TIF plan provides information about the project being funded by tax increment from the TIF district, authorizes the use of tax increment from the district to pay TIF-eligible project costs, and establishes a budget for tax increment expenditures.⁹

The governing body of the municipality in which the TIF district is located must approve the TIF plan for the district.¹⁰ For example, if a city's port authority proposes to create a TIF district in the city, the city council must approve the TIF plan for the district. If a county's housing and redevelopment authority proposes to create a TIF district in a township in the county, the county board must approve the TIF plan.¹¹

Before a TIF district is created, the TIF authority must provide a copy of the proposed TIF plan and certain information about the proposed TIF district to the county auditor and the clerk of the school board, who in turn provide copies of these documents to the members of the county board of commissioners and the school board.¹² The county board and school board may comment on the proposed district, but cannot prevent the creation of the district (except that the county board may prevent creation of the TIF district if the county is the municipality that must approve the TIF plan).

⁸ The portion of the statute that granted special status to qualified manufacturing districts was repealed effective for districts with certification request dates after June 30, 1994. Laws 1995, ch. 264, art. 5, sec. 4 and 49.

⁹ Minn. Stat. § 469.175, subd. 1 and subd. 6(c)(14) (2000).

¹⁰ Minn. Stat. § 469.175, subd. 3 (2000).

¹¹ If a county's housing and redevelopment authority proposes to create a TIF district in a city, it is not clear whether the municipality that must approve the TIF plan is the city, the county, or both. *See* Minn. Stat. § 469.174, subd. 6 (2000).

¹² Minn. Stat. § 469.175, subd. 2 (2000).

Minnesota local governments' use of TIF is a controversial subject, as is evident from the frequent letters, published in newspapers around the state, criticizing or defending uses of TIF. Recently, controversies over uses of TIF have spawned litigation in Minnesota and throughout the United States.¹³

4. Statistics on Use of Tax Increment Financing

A total of 437 TIF authorities had active TIF districts for which TIF authorities and municipalities were required to report information to the OSA for the year ended December 31, 1999. These TIF authorities and municipalities were required to file reports regarding 2,103 TIF districts. According to the information municipalities filed with the OSA, these 2,103 TIF districts consisted of the following types of TIF districts:¹⁴

Pre-1979 districts	88
Economic development districts	737
Housing districts	333
Redevelopment districts	880
Renewal and renovation districts	21
Soils condition districts	40
Districts authorized by uncodified laws	3
Not reported	<u>1</u>
Total	<u>2,103</u>

Over the years, the number of TIF districts created annually has fluctuated. The following table lists the number of each type of TIF district grouped by the year of each TIF district's certification request date (CRD), starting in 1989.¹⁵ This unaudited information was reported by municipalities for the year ended December 31, 1999, and therefore does not include information about TIF districts which were decertified and not required to report for the year ended December 31, 1999.

¹³ See, e.g., *Minneapolis Community Dev. Agency v. Opus Northwest, LLC*, 582 N.W. 2d 596 (Minn. Ct. App. 1998); J. Gibeaut, "The Money Chase," *ABA Journal*, March 1999, p. 58.

¹⁴ This is unaudited information. The OSA has determined through TIF legal compliance audits that a number of municipalities incorrectly reported the types of their TIF districts.

¹⁵ This table does not include TIF districts reported to be pre-1979 districts, mined underground space districts, districts authorized by uncodified laws, districts for which no type was reported, and districts for which no certification request date was reported. TIF districts with certification request dates before 1989 also were excluded. Many economic development districts created before 1988 were no longer required to report for the year ended December 31, 1999. Therefore, including TIF districts with certification request dates before 1988 would have created the false impression that few economic development districts were created during those earlier years.

CRD Year	Economic Development	Housing	Redevelopment	Renewal & Renovation	Soils Condition	Total
1989	96	13	52	n/a	4	165
1990	69	12	46	0	1	128
1991	23	8	17	0	2	50
1992	33	11	29	3	7	83
1993	50	13	49	3	8	123
1994	51	22	41	3	4	121
1995	65	41	57	3	7	173
1996	62	31	68	1	2	164
1997	84	34	58	3	0	179
1998	68	29	63	2	1	163
1999	<u>43</u>	<u>30</u>	<u>42</u>	<u>2</u>	<u>1</u>	<u>118</u>
Total	<u>644</u>	<u>244</u>	<u>522</u>	<u>20</u>	<u>37</u>	<u>1,467</u>

The following tables summarize unaudited financial information reported to the OSA for the year ended December 31, 1999.¹⁶

Source of Funds	Prior Years	Calendar 1999	Total
Tax increment revenue	\$2,637,687,969	\$275,611,803	\$2,912,299,772
Interest on invested funds	403,599,783	18,583,486	422,183,269
Bond proceeds	2,641,357,580	178,491,424	2,819,849,004
Loan proceeds	143,270,978	51,244,280	194,515,258
Real estate sales proceeds	135,784,857	11,534,650	147,319,507
Rent/lease revenue	65,013,802	10,604,264	75,618,066
Grants	155,439,601	11,160,267	166,599,868
Transfers in	539,761,285	43,556,118	583,317,403
All other sources of funds	411,637,083	83,198,772	494,835,855
Total of reported sources of funds	<u>\$7,137,586,767</u>	<u>\$683,984,721</u>	<u>\$7,821,571,488</u>

¹⁶ The numbers in these tables are rounded to the nearest dollar. This table does not include a small number of TIF districts for which the OSA had not received 1999 TIF reports as of the date of this report.

Use of Funds	Prior Years	Calendar 1999	Total
Land/building acquisition	\$1,081,753,771	\$74,269,884	\$1,156,023,655
Site improvement/preparation costs	536,244,946	48,056,977	584,301,923
Installation of public utilities	345,071,108	15,405,879	360,476,987
Parking facilities	156,529,629	12,173,440	168,703,069
Streets and sidewalks	196,109,391	17,817,590	213,926,981
Public park facilities	27,989,436	4,413,122	32,402,558
Social, recreational, conference facilities	103,176,163	76,726,632*	179,902,795
Bond principal payments	972,486,141	128,528,810	1,101,014,951
Bond interest payments	751,392,382	51,654,863	803,047,245
Loan principal payments	100,524,778	16,301,328	116,651,967
Loan/note interest payments	61,291,972	12,301,328	73,593,300
Administrative expenses	242,181,677	17,087,997	259,269,674
Transfers out	1,386,654,611	141,817,688	1,528,472,299
All other uses of funds	717,756,248	71,992,550	789,748,798
Total of reported uses of funds	<u>\$6,679,162,253</u>	<u>\$688,373,949</u>	<u>\$7,367,565,002</u>

*TIF authorities reported spending \$76,726,632 on social, recreational, and conference facilities during the year ended December 31, 1999, up sharply from the \$23,502,080 TIF authorities reported spending on such facilities in the year ended December 31, 1998. This increase was likely due to the 1999 amendment to Minn. Stat. § 469.176, subd. 4g, which prohibits the use of tax increment for publicly or privately owned social or recreational facilities and publicly owned conference facilities after January 1, 2000. This amendment applies to all TIF districts, regardless of their certification request dates, but does not apply to (1) expenditures made before January 1, 2000; (2) expenditures made under a binding contract entered before January 1, 2000; or (3) expenditures made under a binding contract entered pursuant to a letter of intent with the developer or contractor if the letter of intent was entered into before January 1, 2000. See Laws 1999, ch. 243, art. 10, sec. 2 and 29.

C. OSA's ROLE IN TIF

The 1995 Omnibus Tax Act transferred the responsibility for investigating and reporting whether local governments are in compliance with the TIF Act from the Department of Revenue to the OSA.¹⁷ The OSA may examine and audit the accounts and records of TIF authorities on a random basis to determine whether

¹⁷ Laws 1995, ch. 264, art. 5, sec. 34.

they are complying with the TIF Act.¹⁸ The 1995 act also transferred to the OSA the responsibility for collecting the information that TIF authorities and municipalities are required to report annually about their TIF districts.¹⁹

The OSA created a TIF Division to perform these TIF enforcement and data-collection functions. The TIF Division began its enforcement activities on January 1, 1996. The TIF Division currently consists of a director, eight TIF auditors, a legal analyst, and an office and administrative specialist. The TIF Division focuses on annual collection and review of TIF reports, on conducting legal compliance audits and investigations, and on education.

The OSA reviews all TIF reports it receives each year for substantial completeness and returns reports that are not substantially complete. Exhibit 1 to this report, beginning on page 26, reviews the statutory reporting requirements for TIF districts and details the statistics on TIF reporting for the year ended December 31, 1999.

In addition to reviewing all TIF reports for completeness, the TIF Division staff reviews the contents of many of the TIF reports each year for reporting accuracy and potential legal compliance issues. During the course of these in-depth reviews, the TIF Division staff may find situations where a TIF authority has received tax increment after the TIF district was required to be decertified or has made unauthorized expenditures of tax increment. From January 1, 1996, to date, the review of reports by the TIF Division staff and subsequent contact with reporting local government units, plus the legal compliance investigations and audits performed by the TIF Division staff, has resulted in nearly \$2.8 million being paid or returned to county auditors voluntarily or as the result of settlement agreements with county attorneys. This amount was redistributed to the cities, towns, counties, and school districts in which the relevant TIF districts were located.²⁰ In addition, the OSA's TIF enforcement activities may have prompted internal examinations that resulted in additional voluntary payments to county auditors of which the OSA is unaware.

Section II of this report discusses details of the various TIF legal compliance audits and investigations completed in the past year. Complete copies of the initial and final notices of noncompliance and the municipalities' responses are provided in the appendices to this report.

¹⁸ Minn. Stat. § 469.1771, subd. 1(b) (2000).

¹⁹ Laws 1995, ch. 264, art. 5, sec. 19 and 21. Prior to 1995, TIF authorities and municipalities reported certain statutorily required information to the Department of Revenue and other required financial information to the OSA.

²⁰ See Minn. Stat. §§ 469.176, subd. 2, and 469.1771, subd. 2 and 3 (2000). Some of the school districts which received these redistributions had their state aid decreased by the amount received from the redistributions, which resulted in a savings to the state's General Fund.

The TIF Division also has worked actively in the area of tax increment financing education on a statewide level. In June 2000, the OSA provided five workshops in four locations around the state to assist local governments with completing the TIF reports. This is the second year that the OSA has conducted workshops on TIF reporting. In October and November of 2000, the TIF Division presented a day-long seminar on the basics of tax increment financing, holding one seminar in Brainerd and the second in Brooklyn Center. These seminars were attended by over 250 local government officials and staff, state employees from the executive and legislative branches, and professional TIF advisors. This is the third year that the OSA has conducted these day-long seminars.

The operations of the TIF Division are funded exclusively from revenue derived by deducting 0.25 percent of all tax increment that county treasurers distribute to TIF authorities and municipalities.²¹ The county treasurers deduct the revenue before distributing the tax increment to the local governments, and then pay the deducted revenue to the state treasurer. The amount of revenue to fund the TIF Division will vary with the number of TIF districts and the amount of tax increment generated.

II. VIOLATIONS OF TIF ACT

If the OSA finds that a TIF authority is not in compliance with the TIF Act, a notice of noncompliance is sent to the governing body of the municipality that approved the TIF district in which the violation arose.²² The notice of noncompliance provides the facts and law upon which the OSA relied in making its finding that the TIF authority is not in compliance. In addition, the notice of noncompliance may inform the municipality that the TIF Act requires the TIF authority to pay an amount of money to the county auditor as required to redress certain violations of the TIF Act.²³

The governing body must respond in writing to the OSA within 60 days after receiving the notice of noncompliance. In its response, the municipality must state whether it accepts, in whole or in part, the OSA's findings. If the municipality does not accept any part of the findings, its response must indicate the basis for its disagreement with the findings.²⁴ The OSA must provide all information regarding unresolved findings of noncompliance to the county attorney, who may bring an action to enforce the TIF Act.²⁵

²¹ Minn. Stat. § 469.177, subd. 11 (2000).

²² Minn. Stat. § 469.1771, subd. 1(c) (2000).

²³ See Minn. Stat. § 469.1771, subd. 2 and 3 (2000).

²⁴ Minn. Stat. § 469.1771, subd. 1(c) (2000).

²⁵ Minn. Stat. § 469.1771, subd. 1(b) (2000). A new enforcement mechanism involving the attorney general applies only to final notices of noncompliance issued by the OSA after December 31, 1999. See Minn. Stat. § 469.1771, subd. 2b (Supp. 1999); Laws 1999, art. 10, sec. 5, 6, and 29. Therefore, this mechanism does not apply to any of the notices of noncompliance discussed in this report.

The OSA also must provide a summary of the responses it receives from the municipalities, and copies of the responses themselves, to the chairs of the legislative committees with jurisdiction over tax increment financing.²⁶ Appendices A through I of this report contain copies of notices of noncompliance regarding the cities of Braham, Bricelyn, Deerwood, Eden Prairie, Jordan, Lewiston, and McGregor, the Chanhassen Economic Development Authority, and the Cook County/Grand Marais Joint Economic Development Authority, and the municipalities' responses. Appendices J and K contain letters to the cities of Austin and Walker.²⁷ This section discusses the more significant findings, in terms of financial impact and frequency of occurrence, contained in these notices of noncompliance.

A. "POOLING" OF TAX INCREMENT FROM 1979-82 TIF DISTRICTS

City of Eden Prairie

On November 10, 1999, the OSA sent the City of Eden Prairie a notice of noncompliance. In the notice, the OSA found that the city had improperly spent more than \$17 million of tax increment or TIF bond proceeds from TIF District 1 on activities outside the geographic area of TIF District 1 and more than \$800,000 of tax increment from TIF District 2 on activities outside the geographic area of TIF District 2. None of the tax increment or bond proceeds from these TIF districts was spent on activities within the geographic areas of the districts. The city requested certification of these TIF districts on October 6, 1981, and April 14, 1982. It was the OSA's position that the TIF Act did not permit "pooling" of tax increment or TIF bond proceeds from TIF districts with certification request dates after July 31, 1979, and before July 1, 1982.

The notice of noncompliance concluded that this finding was resolved by the enactment of Minn. Stat. § 469.1764 in 1999. By enacting this statute, the Legislature confirmed that pooling of tax increment from TIF districts with certification request dates after July 31, 1979, and before July 1, 1982, was not permitted by the TIF Act, except to pay debt service on city development district revenue bonds issued pursuant to Minn. Stat. § 469.129, subd. 2.²⁸ Those TIF authorities that improperly pooled tax increment from TIF districts with certification request dates after July 31, 1979, and before July 1, 1982, are now subject to a new law under which the pooling expenditures before December 31, 1999, are ratified, but such TIF districts now are required to restrict expenditures of tax increment for activities within and outside the district and are required to be decertified early.²⁹

²⁶ Minn. Stat. § 469.1771, subd. 1(c) (2000).

²⁷ These letters do not contain findings of noncompliance, but address TIF statutory issues which may be of interest to the Legislature if reviewing current TIF law.

²⁸ See Minn. Stat. § 469.1764, subd. 1 (Supp. 1999). City development district revenue bonds may not be issued under Minn. Stat. § 469.129, subd. 2 after April 30, 1990.

²⁹ See Minn. Stat. § 469.1764, subd. 3 and 4 (Supp. 1999).

The OSA did not refer this finding to the county attorney. Copies of the OSA’s notices of noncompliance and the city’s response regarding this matter are included in Appendix A.

B. LACK OF REASONS AND SUPPORTING FACTS FOR “BUT FOR” TEST

Cook County/Grand Marais Joint EDA

On July 14, 2000, the OSA sent Cook County a notice of noncompliance. In the notice, the OSA found that the county board did not set forth in writing the reasons and supporting facts for its findings that the Cook County/Grand Marais Joint Economic Development Authority’s (Joint EDA) TIF Districts 1-1 and 1-2 met the “but for” test. Prior to or at the time it approved the TIF plan for a new TIF district, the municipality was required to find—

[T]hat the proposed development or redevelopment, in the opinion of the municipality, would not reasonably be expected to occur solely through private investment within the reasonably foreseeable future and therefore the use of tax increment financing is deemed necessary.

Minn. Stat. § 469.175, subd. 3(2) (1990). This statutory provision is known as the “but for” test. The same statute provided that the “*municipality* . . . shall set forth in writing the reasons and supporting facts for its determination” that the new TIF district met the “but for” test. Minn. Stat. § 469.175, subd. 3 (1990) (emphasis added). In this case, the county was the municipality that approved the TIF plans for TIF Districts 1-1 and 1-2. Therefore, the county board, as the governing body of the municipality, was required to set forth in writing the reasons and supporting facts for its determination that TIF District 1-1 and 1-2 met the “but for” test. Neither the TIF plans nor the county board resolutions approving them contained or incorporated by reference a statement by the county board of its reasons and supporting facts.

The county’s response stated that several documents taken together contained the county board’s reasons and supporting facts for its findings that TIF District’s 1-1 and 1-2 met the “but for” test. In reviewing these documents, the OSA found no documentation showing that the *county board* set forth in writing the reasons and supporting facts for the county’s findings that TIF Districts 1-1 and 1-2 met the “but for” test. Similarly, the county board did not formally adopt reports prepared by outside entities as the board’s statement of the reasons and supporting facts for its findings.

On December 15, 2000, the OSA sent the county a final notice of noncompliance. The OSA reiterated its findings that the county board failed to set forth in writing the reasons and supporting facts for its findings that the Joint EDA’s TIF Districts 1-1 and 1-2 met the “but for” test. Absent such documentation, the creation of TIF Districts 1-1 and 1-2 was invalid, and the Joint EDA improperly received \$101,092 of tax increment from TIF District 1-1 and \$51,804 of tax increment from TIF District 1-2 through December 31, 1997. The Joint EDA received these tax increment payments after December 31, 1990, and therefore they were subject to the payment provisions of Minn. Stat. § 469.1771, subd. 2.

The OSA referred this matter to the Cook County Attorney by letter dated December 18, 2000. Copies of the OSA's notices of noncompliance and the county's response regarding this matter are included in Appendix B.

C. LACK OF REASONS AND SUPPORTING FACTS FOR FINDING THAT PARCELS WERE "OCCUPIED" FOR PURPOSES OF QUALIFYING AS A REDEVELOPMENT DISTRICT

Cook County/Grand Marais Joint EDA

On July 14, 2000, the OSA sent Cook County a notice of noncompliance. In the notice, the OSA found that the county board did not set forth in writing the reasons and facts supporting its finding that the parcels in TIF District 2-1 met the requirements for inclusion in a redevelopment district. In its response, the county stated that the Joint EDA returned to the county all tax increment received by TIF District 2-1 prior to its decertification on January 12, 1999, and the Office of the Cook County Auditor/Treasurer confirmed this fact. In its final notice of noncompliance, the OSA concluded that the return of the tax increment resolved this finding.

The OSA referred other findings of noncompliance in this matter to the Cook County Attorney by letter dated December 18, 2000. Copies of the OSA's notices of noncompliance and the county's responses regarding this matter are included in Appendix B.

D. INCOMPLETE MAP ACCOMPANYING PUBLIC HEARING NOTICE

City of Jordan

On February 4, 2000, the OSA sent the City of Jordan a notice of noncompliance. In the notice, the OSA found that the city did not comply with the notice requirements of Minn. Stat. § 469.175, subd. 3 when the city approved the TIF plan for TIF District 1-4. Although the city published a notice of public hearing regarding approval of the TIF plan for TIF District 1-4, the published notice did not include the required map of the area of the district from which tax increment was to be collected.³⁰ As a result, the OSA found that the city improperly received \$440,251.71 of tax increment from TIF District 1-4.

The city responded that the required map was inadvertently omitted from the public hearing notice. The city argued that the public had sufficient knowledge of the proposed TIF district because the public hearing notice contained a legal description of the property to be included in TIF District 1-4. The city further argued that "courts have ruled that good faith substantial compliance with law by a city is sufficient and that proceedings are not invalidated because of an error or omission in complying with applicable law."

³⁰ See Minn. Stat. § 469.175, subd. 3 (1990).

On May 24, 2000, the OSA sent the city a final notice of noncompliance. In the final notice, the OSA stated that whether the city's public hearing notice substantially complied with the requirements of Minn. Stat. § 469.175, subd. 3 and whether the doctrine of substantial compliance applies to these statutory requirements are determinations appropriate for the county attorney and the courts.

Accordingly, the OSA referred this finding to the Scott County Attorney for review. Copies of the OSA's notices of noncompliance and the city's responses regarding this matter are included in Appendix C.

E. TAX INCREMENT RECEIVED AFTER MAXIMUM DURATION LIMIT

Chanhassen EDA

On March 21, 2000, the OSA sent the City of Chanhassen a notice of noncompliance. In the notice, the OSA found the Chanhassen Economic Development Authority (EDA) improperly received \$711,167.96 of tax increment from TIF District 2-1 after the statutory maximum duration limit for the district. TIF District 2-1 is an economic development district. According to the applicable statute, this district reached its maximum duration limit on May 23, 1998, which was ten years after approval of the TIF plan. The OSA determined that the EDA received \$711,167.96 of tax increment from this district after May 23, 1998.

In its response, the city did not dispute that the maximum statutory duration limit of this district was reached on May 23, 1998, nor did the city dispute that the EDA received \$711,167.96 of tax increment from this district after May 23, 1998. Instead, the city's response stated that Minn. Stat. § 469.1771, subd. 2 did not require the EDA to pay back the increment received after the maximum statutory duration limit, because that statute does not require a violation payment in the event of "a failure to decertify a district at the end of the duration limit specified in the tax increment financing plan."³¹ The city also responded that the application of the maximum statutory duration limit would deprive the city of the full amount of tax increment intended by the Legislature. The city stated that the Legislature intended to permit the EDA to receive tax increment from this economic development district through the end of the eighth year after the year in which the EDA first received tax increment from this district.

On June 20, 2000, the OSA sent the city a final notice of noncompliance. In the final notice, the OSA reiterated its finding that the EDA improperly received \$711,167.96 of tax increment from TIF District 2-1

³¹ It is the OSA's position that the exception for exceeding the duration limit "specified in the tax increment financing plan" applies only to situations where the TIF authority or municipality chose to include in the TIF plan a maximum duration limit that was earlier than the otherwise applicable statutory limit. The last sentence of Minn. Stat. § 469.1771, subd. 2 is worded as an exception to a general rule. The general rule is that section 469.1771, subd. 2 applies to any receipt of tax increment after the maximum duration limit of the TIF district. The exception applies only to the amount of tax increment received after the maximum duration limit specified in the TIF plan, but before the otherwise applicable statutory maximum duration limit.

after the statutory maximum duration limit for the district. The EDA received these payments after December 31, 1990, the effective date of Minn. Stat. § 469.1771, subd. 2, and therefore these payments were subject to the provisions of that statute.

The applicable statute provided that the EDA was not entitled to receive tax increment from this economic development district “after eight years from the date of the receipt, or ten years from approval of the tax increment financing plan,*whichever is less.*” Minn. Stat. § 469.176, subd. 1(e) (1988) (emphasis added). The city approved the TIF plan for TIF District 2-1 on May 23, 1988. Eight years from the first receipt of tax increment, with the duration extension provided in Minn. Stat. § 469.176, subd. 1b(b), was December 31, 1999. Ten years from approval of the TIF plan was May 23, 1998, which is less than December 31, 1999. Therefore, according to the terms of the applicable statute, the maximum duration limit is May 23, 1998. The intent of the Legislature to limit the maximum duration limit to the earlier of the two dates is clear and explicit in the text of the statute.

The OSA referred this matter to the Carver County Attorney by letter dated June 30, 2000. Copies of the OSA’s notices of noncompliance and the city’s response regarding this matter are included in Appendix D.

F. ADMINISTRATIVE EXPENSES IN EXCESS OF STATUTORY LIMIT

City of Eden Prairie

On November 10, 1999, the OSA sent the City of Eden Prairie a notice of noncompliance. In the notice, the OSA found that the city improperly spent \$586,659 more tax increment or TIF bond proceeds from TIF Districts 1 and 2 on administrative expenses than permitted by statute. The administrative expense statute limited administrative expenses payable with TIF to “five percent of the total tax increment expenditures authorized by the tax increment financing plan or *the total tax increment expenditures for the district*, whichever is less.” Minn. Stat. § 273.75, subd. 3 (1980) (emphasis added). The city spent none of the tax increment or TIF bond proceeds from TIF Districts 1 and 2 on activities within the geographic areas of those districts, so the limit on the amount of tax increment or TIF bond proceeds which could be spent on administrative expenses, was five percent of zero dollars, or zero.³²

The city’s response did not dispute these facts, but it disputed the OSA’s finding based on a number of legal arguments. The city’s response also provided sufficient documentation to demonstrate that all of the payments on administrative expenses occurred on or before December 31, 1990, the effective date of Minn. Stat. § 469.1771, subd. 3. Therefore, the statutory payment provision did not apply to these expenditures.³³

³² See Minn. Stat. § 273.75, subd. 3 (1980).

³³ See Laws 1990, ch. 604, art. 7, sec. 31(a).

On April 19, 2000, the OSA sent the city a final notice of noncompliance. In the final notice, the OSA disagreed with the city's legal arguments and reiterated its finding that the city improperly spent \$586,659 more tax increment from TIF Districts 1 and 2 on administrative expenses than permitted by statute.

The OSA, however, did not refer this finding to the county attorney, because the city's response provided sufficient documentation to demonstrate that all of the expenditures on administrative expenses occurred on or before December 31, 1990, the effective date of Minn. Stat. § 469.1771, subd. 3. Copies of the OSA's notices of noncompliance and the city's response regarding this matter are included in Appendix A.

G. COSTS NOT ELIGIBLE FOR PAYMENT WITH TAX INCREMENT

1. City of Jordan

On February 4, 2000, the OSA sent the City of Jordan a notice of noncompliance. In the notice, the OSA found that the city's transfers of \$27,482.96 of tax increment from TIF District 1-4 to the city's General Fund were improper, because the transfers were made for reimbursement of the state aid offset or there was not sufficient documentation to demonstrate that the transfers were for costs authorized in the TIF plan.

The city responded that it deposited the tax increment from TIF District 1-4 in the city's General Fund to reimburse the city for the cost of public improvements in Development District 1, which the city paid with money from its General Fund.

On May 24, 2000, the OSA sent the city a final notice of noncompliance. In the final notice, the OSA reiterated its finding that the city's transfers of \$27,482.96 of tax increment from TIF District 1-4 to the city's General Fund were improper, because the transfers were made for reimbursement of the state aid offset or there was not sufficient documentation to demonstrate that the transfers were for costs authorized in the TIF plan. The city's response did not include documentation to show that these payments were for anything other than to reimburse the city for the state aid offset. The TIF Act does not authorize the expenditure of tax increment by a city to compensate itself for lost local government aid. OSA audit staff found no documentation indicating that the city made these transfers to reimburse the General Fund for expenditures the city made to pay costs authorized in TIF District 1-4's TIF plan. These transfers occurred after December 31, 1990, and were subject to the provisions of Minn. Stat. § 469.1771, subd. 3.

In the initial notice, the OSA also found that the city improperly spent \$900 of TIF District 1-5's tax increment to reimburse special assessments, because this was not a permitted use of tax increment from a soils condition district. The city's response did not include a response to this finding. In the final notice, the OSA reiterated its finding. This payment occurred after December 31, 1990, and was subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

The OSA referred this matter to the Scott County Attorney by letter dated May 25, 2000. Copies of the OSA's notices of noncompliance and the city's responses regarding this matter are included in Appendix C.

2. City of Deerwood

On August 9, 2000, the OSA sent the City of Deerwood a notice of noncompliance. In the notice, the OSA found that the city's payments of \$79,946 to a developer in order for the developer to make subsequent reimbursements of the state aid offset were improper. These payments were improper because they are not permitted under relevant Minnesota statutes and were not authorized in the TIF plan.

The city responded that it did not accept the OSA's finding because (1) the payments made by the developer to the city to reimburse the city for the state aid offset were not made with tax increment and (2) the city's legal counsel had advised the city to submit revised TIF Authority Reports for the years 1995 through 1999 to clarify the facts relating to the payments made by the developers.

On November 21, 2000, the OSA sent the city a final notice of noncompliance. In the final notice, the OSA reiterated its finding that the city's payments of \$79,946 made to the developer in order for the developer to make subsequent reimbursements of the state aid offset were improper. The OSA's finding of noncompliance was not based on the use of tax increment by the developer to make payments to the city, but instead was based on the use of tax increment by the city to make payments to the developer. As discussed in the initial notice of noncompliance, the city's tax increment payments to the developer were made for a purpose not permitted by statute, *i.e.*, to provide the developer with money so that the developer could reimburse the city for the state aid offset. Furthermore, these payments were not authorized in the TIF-plan budget, and tax increment may be spent only as authorized in the TIF plan.³⁴ These payments were made after December 31, 1990, and were subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

The OSA referred this matter to the Crow Wing County Attorney by letter dated November 22, 2000. Copies of the OSA's notices of noncompliance and the city's response regarding this matter are included in Appendix E.

H. USES OF TAX INCREMENT NOT AUTHORIZED IN TIF PLAN

1. City of Brice lyn

On November 8, 1999, the OSA sent the City of Brice lyn a notice of noncompliance. In the notice, the OSA found that the city improperly spent \$33,467 of tax increment on public improvements, because the TIF-plan budget did not authorize a specific amount for these kinds of expenditures. The OSA noted that the expenditures consisted of miscellaneous street and utility repairs made by the city during the years 1995-97. The OSA also found that the city improperly spent \$5,534 of tax increment on administrative expenses because these expenditures were not authorized in the TIF-plan budget.

³⁴ Minn. Stat. § 469.176, subd. 4 (1990).

The city responded that these expenditures were authorized because the text of various sections of the TIF plan mentioned these kinds of expenditures, and the TIF plan contained a lump-sum amount for several categories of costs, including, among others, installation of public utilities.

On March 6, 2000, the OSA sent the city a final notice of noncompliance. In the final notice, the OSA reiterated its findings that the city improperly spent \$33,467 on public improvements and \$5,534 on administrative expenses. The TIF-plan budget did not include amounts specifically for these categories of costs as required by statute.³⁵ Of the \$39,001 of improper expenditures, \$2,534 were made on or before December 31, 1990, the effective date of Minn. Stat. § 469.1771, subd. 3.³⁶ The remaining payments of \$36,467 were made after December 31, 1990, and were subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

The OSA referred this matter to the Faribault County Attorney by letter dated March 8, 2000. Copies of the OSA's notices of noncompliance and the city's responses regarding this matter are included in Appendix F.

2. City of McGregor

On January 31, 2000, the OSA sent the City of McGregor a notice of noncompliance. In the notice, the OSA found that the city improperly spent \$37,881 of TIF District 1's tax increment, because the TIF-plan budget did not specifically authorize these expenditures. The OSA noted that the TIF-plan budget for TIF District 1 included an estimate of total costs and a list of categories of costs labeled "alternative expenditures," but did not budget a specific dollar amount for any of the categories of costs as required by the TIF Act.³⁷

The city's response contained three reasons for its disagreement with the OSA's finding. First, the city responded that the TIF Act did not require the city to include a line-item budget in the TIF plan. Second, the city stated that a budget amount for interest payments on a limited revenue note could be calculated from information provided in the TIF plan. Third, the city stated that any defect in the TIF plan was cured by operation of law when the city issued the limited revenue note pursuant to Minn. Stat. § 469.178, subd. 4.

On July 3, 2000, the OSA sent the city a final notice of noncompliance. In the final notice, the OSA concluded that the TIF plan provided sufficient information to calculate a budget amount for interest payments. Therefore, the amount spent on interest was properly spent. The OSA, however, found that the city improperly spent \$15,665 of tax increment on non-interest categories of costs through December

³⁵ See Minn. Stat. § 469.175, subd. 6(c)(4) (Supp. 1987).

³⁶ See Laws 1990, ch. 604, art. 7, sec. 31(a).

³⁷ See Minn. Stat. § 469.175, subd. 6(c)(3) (1998).

31, 1998, because the TIF-plan budget did not authorize specific amounts for non-interest categories of costs. The OSA concluded that the TIF Act required the city to include a line-item budget in the TIF plan. The OSA also concluded the city did not issue the limited revenue note under Minn. Stat. § 469.178, subd. 4, so the defects in the TIF plan were not cured by operation of law. These payments were made after December 31, 1990, and were subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

The OSA referred this matter to the Aitkin County Attorney by letter dated July 5, 2000. Copies of the OSA's notices of noncompliance and the city's response regarding this matter are included in Appendix G.

3. City of Jordan

On February 4, 2000, the OSA sent the City of Jordan a notice of noncompliance. In the notice, the OSA found that the city improperly spent \$22,843.24 of TIF District 1-3's tax increment on public improvement costs, because the TIF-plan budget did not authorize a specific amount for this category of costs.

The city responded that it financed the public improvements with money from existing water and sewer funds and it intended to use tax increment from TIF District 1-3 to reimburse the water and sewer funds. The city's response indicated that a formal interfund loan was not established. The response argued that the "lack of documentation of an interfund loan does not invalidate the expenditure of tax increments for the cost of public improvements."

The OSA sent the city a final notice of noncompliance on May 24, 2000. In the final notice, the OSA reiterated its finding that the city improperly spent \$22,843.24 of TIF District 1-3's tax increment on unbudgeted costs. The transfer of TIF District 1-3's tax increment to the sewer and water funds would have been in compliance with the TIF Act only if a provision in the TIF Act authorized such a use of tax increment and the city had included an amount for such transfers in the TIF-plan budget. OSA audit staff found neither of these, and the city's response provided neither. The development costs authorized in the TIF plan were not paid with tax increment. When TIF District 1-3 generated tax increment, the city transferred the tax increment to the sewer and water funds and then spent it on costs not authorized in the TIF plan. Tax increment may be used only as provided in the TIF plan.³⁸ These payments occurred after December 31, 1990, and were subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

In the initial notice of noncompliance, the OSA also found that the city improperly spent \$5,671.47 of TIF District 1-3's tax increment on site improvement costs not authorized in the TIF-plan budget. The city's response did not include a response to this finding. In the final notice of noncompliance, the OSA reiterated its finding that the city improperly spent \$5,671.47 of TIF District 1-3's tax increment on site improvement costs not authorized in the TIF plan. This payment occurred after December 31, 1990, and was subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

³⁸ Minn. Stat. § 469.176, subd. 4 (1998).

In the initial notice of noncompliance, the OSA also found that the city improperly spent \$25,000 of TIF District 1-5's tax increment on land acquisition costs not authorized in the TIF-plan budget. The city responded that the TIF Act did not require the city to include a line-item budget in the TIF plan. In the final notice of noncompliance, the OSA reiterated its finding that the city improperly spent \$25,000 of TIF District 1-5's tax increment on land acquisition costs not authorized in the TIF-plan budget. The OSA concluded that the TIF Act required the city to include a line-item budget in the TIF plan. This payment occurred after December 31, 1990, and was subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

The OSA referred this matter to the Scott County Attorney by letter dated May 25, 2000. Copies of the OSA's notices of noncompliance and the city's response regarding this matter are included in Appendix C.

4. City of Braham

On July 14, 2000, the OSA sent the City of Braham a notice of noncompliance. In the notice, the OSA found that the city improperly spent \$23,166 of TIF District 1-1's tax increment through December 31, 1998, on administrative expenses, because the TIF-plan budget did not authorize a specific amount for this category of costs. The city made \$12,052 of these expenditures after December 31, 1990, and the city paid \$9,130 to the county auditor. Therefore, \$2,922 (\$12,052-\$9,130) was the amount subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

In the notice, the OSA also found that the city improperly spent \$5,164 of TIF District 2-2's tax increment through December 31, 1998, on administrative expenses, because the TIF-plan budget did not authorize a specific amount for this category of costs. These payments were made after December 31, 1990, and were subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

The city responded that it paid \$8,086 (\$2,922+\$5,164) to the county auditor, and the Office of the Isanti County Auditor confirmed this fact. Therefore, the OSA did not issue a final notice of noncompliance, and did not refer this matter to the county attorney. Copies of the OSA's notice of noncompliance and the city's response regarding this matter are included in Appendix H.

5. City of Lewiston

On July 14, 2000, the OSA sent the City of Lewiston a notice of noncompliance. In the notice, the OSA found that the city improperly spent \$156,053 of TIF District 1's tax increment and \$56,330 of TIF District 4's tax increment through December 31, 1998, because these expenditures were for categories of costs for which the TIF-plan budgets did not include specific amounts. The TIF-plan budget for TIF District 1 included an estimate of total costs, but did not budget a specific dollar amount for any of the categories of costs identified in the TIF Act, except administrative expenses. TIF District 4's TIF-plan budget also included an estimate of total costs, but did not budget a specific

dollar amount for any of the categories of costs. Accordingly, neither TIF plan contained a line-item budget as required by the TIF Act.³⁹ Tax increment may be spent only as authorized in the TIF plan.⁴⁰

The city's response stated that the TIF plans for TIF Districts 1 and 4 were defective for the reasons stated in the initial notice of noncompliance. The city, however, also stated that it should not be required to pay any penalty for the failure of the TIF plan to comply with the TIF Act, because (1) the city relied on the consultant who prepared the TIF plan to prepare a plan which met all the requirements of the TIF Act; (2) the city did not know the TIF plan was defective; (3) the state and county did not inform the city that the TIF plan was defective; and (4) all of the expenditures were for purposes permitted by the TIF Act. The city offered to resolve the finding of noncompliance by modifying the TIF plan.

The OSA sent the city a final notice of noncompliance on October 12, 2000. In the final notice, the OSA reiterated its findings that the city improperly spent \$156,053 of TIF District 1's tax increment and \$56,330 of TIF District 4's tax increment through December 31, 1998, because these expenditures were for categories of costs for which the TIF-plan budgets did not include specific amounts. The city can prevent continuing noncompliance in the future by modifying the TIF plan to comply with the requirements of the TIF Act, but modifying the TIF plan will not resolve the noncompliance that already has occurred. These expenditures were made after December 31, 1990, and were subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

In the initial notice of noncompliance, the OSA also found all expenditures of TIF District 2's tax increment made through December 31, 1998, were improper, because these expenditures were for categories of costs for which the TIF-plan budget did not include specific amounts. The city responded that no tax increment from TIF District 2 had been spent and that the amount reported as spent was still in an escrow account. The city offered to resolve this finding by paying the tax increment to the "various taxing authorities with jurisdiction over these parcels." Based on the city's representation that no tax increment from TIF District 2 had been spent, the OSA withdrew this finding in its final notice of noncompliance.

The OSA referred this matter to the Winona County Attorney by letter dated October 20, 2000. Copies of the OSA's notices of noncompliance and the city's response regarding this matter are included in Appendix I.

I. INADEQUATELY DOCUMENTED USES OF TAX INCREMENT

City of Jordan

On February 4, 2000, the OSA sent the City of Jordan a notice of noncompliance. In the notice, the OSA found that the city improperly paid \$9,343.67 of TIF District 1-4's tax increment to a company to

³⁹ See, e.g., Minn. Stat. § 469.175, subd. 6(c)(4) (1988).

⁴⁰ Minn. Stat. § 469.176, subd. 4 (1998).

reimburse special assessments paid by the company under the TIF plan, because the city lacked documentation that showed the company was eligible to receive this money. The city paid the company \$16,071.36 through December 31, 1996, for reimbursement of special assessments. OSA audit staff found documentation indicating that the company had paid only \$6,727.69 of special assessments through December 31, 1996, leaving an undocumented balance of \$9,343.67.

The documents enclosed with the city's supplemental response to this finding indicated that as of December 31, 1996, the company had paid more than \$16,071.36 of special assessments. Based on this documentation, the OSA withdrew this finding in its final notice of noncompliance.

In the initial notice of noncompliance, the OSA also found that the city improperly spent \$404,115 of TIF District 2-1's tax increment, which the city reported as spent on reimbursement of site improvements paid by a business, because these expenditures were not supported by adequate documentation.

The city's response indicated that the business represented and warranted that project site improvements would be constructed, the project was constructed and the costs paid, and the city, based on these representations, reimbursed the business with TIF District 2-1's tax increment without first obtaining paid invoices from the business. The city's response further indicated that the city has requested paid invoices from the business and intends to forward this documentation to the OSA when it becomes available.

In the final notice of noncompliance, the OSA reiterated its finding that the city improperly spent \$404,115 of TIF District 2-1's tax increment on expenditures that were not supported by adequate documentation. The final notice stated that it was the OSA's position that a TIF authority may not reimburse a developer with tax increment unless the TIF authority obtains sufficient documentation from the developer to support payment. Absent such documentation, the OSA is unable to verify that all tax increment was spent on TIF-eligible expenditures in accordance with the TIF plan. Tax increment may be spent only as authorized in the TIF plan.⁴¹ These expenditures occurred after December 31, 1990, and were subject to the payment provisions of Minn. Stat. § 469.1771, subd. 3.

The OSA referred this matter to the Scott County Attorney by letter dated May 25, 2000. Copies of the OSA's notices of noncompliance and the city's response regarding this matter are included in Appendix C.

III. STATUTORY ISSUES

Through municipalities' responses to notices of noncompliance and questions received from city and county officials and employees, the OSA has identified certain issues regarding the TIF Act. This report to the

⁴¹ Minn. Stat. § 469.176, subd. 4 (1998).

legislative committees with jurisdiction over TIF identifies some of these issues in order to facilitate public policy discussion and allow for legislative action.⁴²

A. “BUT FOR” TEST

Before or at the time of approving the TIF plan for a new TIF district, the municipality must find—

[T]hat the proposed development or redevelopment, in the opinion of the municipality, would not reasonably be expected to occur solely through private investment within the reasonably foreseeable future and that the increased market value of the site that could reasonably be expected to occur without the use of tax increment financing would be less than the increase in the market value estimated to result from the proposed development after subtracting the present value of the projected tax increments for the maximum duration of the district permitted by the plan.

Minn. Stat. § 469.175, subd. 3(2) (2000). This required finding is known as the “but for” test, and compliance with this test is at the heart of the public policy rationale for permitting local governments to create TIF districts. If the proposed development would not have occurred solely through private investment, then the increased property tax revenue from the proposed development can be diverted to paying costs necessary to make the proposed development occur without depriving the city, county, and school district of an increase in tax base that otherwise would have occurred.

On the other hand, if a local government creates a TIF district to capture growth in property tax base that would likely occur solely through private investment, such action denies other affected local governments valuable and necessary growth in property tax base, which in turn can lead to increased local tax rates. Furthermore, it can create costs borne by every citizen within the state, since increased state education aids are paid to school districts that lose property tax base to TIF districts. The policy rationale behind TIF—using increased property tax revenue that otherwise would not exist to finance the development or redevelopment that generates the increased property taxes—is thwarted when TIF-district boundaries are drawn to include parcels that would be developed or redeveloped without TIF assistance.

In its January 1986 report on the use of TIF in Minnesota, the Office of the Legislative Auditor reported that “[m]ore than one-third of the cities we visited created at least one tax increment district to capture taxes from developments that would have occurred without TIF.”⁴³ The OSA questions the public policy rationale of having a TIF authority draw the boundaries of a TIF district to include property that the TIF authority knows will be developed or redeveloped solely through private investment. The OSA became

⁴² The OSA’s *Tax Increment Financing Reports* to the Legislature in prior years contain discussions of additional ambiguities and conflicting statutory interpretations, many of which have not yet been resolved.

⁴³ Office of the Legislative Auditor, *Tax Increment Financing*, January 1986, p. 46.

aware of a number of such occurrences in the past year.⁴⁴ The OSA brings these facts to the Legislature's attention to allow it the opportunity to consider under what circumstances, if any, it would be good public policy to permit a TIF authority to create a TIF district to capture increased property tax base that would have occurred solely through private investment.

The OSA also brings to the Legislature's attention certain statutory language that may limit challenges to a TIF authority's "but for" finding:

Once approved, the determination of the authority to undertake the project through the use of tax increment financing and the resolution of the governing body shall be conclusive of the findings therein and of the public need for the financing.

Minn. Stat. § 469.175, subd. 3 (2000).

The OSA views this language as limiting its ability to issue certain types of noncompliance findings as they relate to the "but for" test. The OSA brings these facts to the Legislature's attention to allow it the opportunity to consider whether a municipality's finding that a TIF district meets the "but for" test should preclude any legal action to compel a violation payment under Minn. Stat. § 469.1771, subd. 2 if the TIF district, in fact, did not meet the "but for" test. If the Legislature wishes to allow broader challenge to the legality of a municipality's "but for" finding, the Legislature may wish to consider amending Minn. Stat. § 469.175, subd. 3 or Minn. Stat. § 469.1771, subd. 2 to clarify the Legislature's intent.

B. DETERMINING "OCCUPIED" PARCELS FOR PURPOSES OF QUALIFYING A TIF DISTRICT AS A REDEVELOPMENT DISTRICT

A TIF district qualifies as a redevelopment district if, among other things—

[P]arcel consisting of 70 percent of the area of the district are occupied by buildings, streets, utilities, or other improvements and more than 50 percent of the buildings, not including outbuildings, are structurally substandard to a degree requiring substantial renovation or clearance[.]

Minn. Stat. § 469.174, subd. 10(a)(1) (2000). For purposes of this test, "a parcel is not occupied by buildings, streets, utilities, or other improvements unless 15 percent of the area of the parcel contains improvements." Minn. Stat. § 469.174, subd. 10(e) (2000). Based on information obtained during recent investigations and audits, it appears that some TIF authorities have included areas of mowed lawns, flower beds, gardens, and other landscaping when calculating what percentage of a parcel is occupied by buildings, streets, utilities, or other improvements. The OSA has concluded that these various landscaping

⁴⁴ See Appendices D, I, and J for OSA letters which discuss this issue in greater detail.

and gardening activities are not sufficient to consider a parcel “occupied” for the purpose of meeting the standard set forth in Minn. Stat. § 469.174, subd. 10(c).⁴⁵

The OSA brings these facts to the Legislature’s attention to allow it the opportunity to review the relevant statutes and determine whether it wishes to expressly include landscaping activity within the category of improvements that can be used in calculating whether a parcel is “occupied.”

C. INTEREST ON INTERFUND LOANS

Through reviews of annual reports, investigations, and audits, the OSA has found many examples of TIF authorities’ financing development and administrative costs in the early years of a TIF district, before tax increment is available to pay for them, by using cash available in other funds to make “loans” to the TIF district. Later, when the TIF district begins to generate tax increment, it is used to repay the interfund loan. The OSA has found many examples of TIF authorities then using TIF to pay interest on these interfund loans.

The OSA, however, has been unable to find any statutory authority for a TIF authority to charge interest on an interfund loan. Furthermore, if charging interest on interfund loans were permitted without any limit on the interest rate, TIF authorities could earn excessive rates of return at the expense of their TIF districts.

The OSA brings these facts to the Legislature’s attention to allow it to consider legislation addressing the issue of charging interest on interfund loans and the rate of interest which may be charged.

IV. CONCLUSION

The TIF Division may be contacted at the following addresses and telephone/fax numbers:

Office of the State Auditor
Tax Increment Financing Division
505 Spruce Tree Centre
1600 University Ave. W.
St. Paul, MN 55104
Telephone: (651) 642-0767
Fax: (651) 642-0769
email: tifdivision@osa.state.mn.us

⁴⁵ See Appendices B and K for OSA letters which discuss this issue in greater detail.

The TIF Division's staff is available to answer questions you may have relating to TIF. Please feel free to contact any of our staff at the telephone numbers listed below.

Bill Connors, TIF Division Director	(651) 642-0837
Marsha Pattison, Office and Administrative Specialist	(651) 642-0767
Hassan Bastani	(651) 642-0775
Thomas Carlson	(651) 642-0824
Matthew Gaetz	(651) 643-2132
Lisa McGuire	(651) 642-0815
Kurt Mueller	(651) 642-0832
Suk Shah	(651) 642-0719
James Silen	(651) 642-0823
David Stallworth	(651) 642-0892
Linda Thomas	(651) 642-0836

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EXHIBIT 1

Statistics on TIF Reporting for Year Ended December 31, 1999

Three statutory subdivisions impose annual reporting obligations on TIF authorities and municipalities and describe the TIF information they must submit.⁴⁶ All three TIF-reporting subdivisions apply to all TIF districts regardless of when they were created. All three subdivisions mandate that TIF authorities and municipalities submit the required information to the OSA on or before August 1 of each year. In addition to filing TIF reports, a TIF authority must publish certain statutorily required financial information about each of its TIF districts in a newspaper of general circulation on or before August 15 of each year.⁴⁷

In 1998, the Legislature enacted Minn. Stat. § 469.1771, subd. 2a, which establishes a procedure for tax increment to be withheld by the county auditor if the TIF authority or municipality fails to file reports containing the required TIF information, or a copy of the annual disclosure statement, by the statutory deadline.⁴⁸ The withheld tax increment will be released and distributed whenever substantially complete TIF reports eventually are filed. These changes were effective starting with the TIF reports and annual disclosure statement that were required to be filed in 1999.⁴⁹

A total of 437 TIF authorities had TIF districts for which they and their municipalities were required to file TIF reports with the OSA for the year ended December 31, 1999, which were due by August 1, 2000. These TIF authorities and municipalities were required to file reports for 2,103 TIF districts.

The OSA returns TIF reports that are not substantially complete and treats them as not filed. Of the 436 TIF authorities with TIF districts for which filing was required,⁵⁰ 304 had substantially complete TIF reports for all their TIF districts and copies of their annual disclosure statements filed with the OSA by the

⁴⁶ See Minn. Stat. § 469.175, subd. 5, 6, and 6a (1998). The 2000 Omnibus Tax Act repealed Minn. Stat. § 469.175, subd. 6a and amended Minn. Stat. § 469.175, subd. 5 and 6. See Laws 2000, ch. 490, art. 11, sec. 23, 24, and 44. As a result, beginning with the TIF reports that must be filed in 2001 for the year ended December 31, 2000, the municipality that approved a TIF district no longer is required to report information about the district to the OSA.

⁴⁷ See Minn. Stat. § 469.175, subd. 5 (2000).

⁴⁸ See Laws 1998, ch. 389, art. 11, sec. 8.

⁴⁹ Laws 1998, ch. 389, art. 11, sec. 29.

⁵⁰ The City of Granite Falls was not required to file 1999 TIF reports by the August 1, 2000, statutory deadline, because the city was recovering from a tornado which struck in 2000.

August 1, 2000, deadline.⁵¹ In addition, 40 TIF authorities had at least some of the required TIF reports filed with the OSA by the August 1, 2000, deadline, but either (1) not all of the required reports were filed, (2) not all of the required reports were substantially complete, or (3) the copy of the annual disclosure statement was not filed by the deadline.⁵²

In contrast, the following 92 TIF authorities had no reports for their TIF districts filed with the OSA by the August 1, 2000, deadline:

Afton, City of	Coon Rapids, City of	Hinkley, City of
Albany, City of	Corcoran, City of	Howard Lake, City of
Bagley HRA	Crosby, City of	Hutchinson, City of
Battle Lake, City of	Dayton, City of	Isle, City of
Baxter, City of	Deerwood, City of	Lake County HRA
Benson, City of	Dexter, City of	Lanesboro, City of
Biwabik, City of	Dodge Center, City of	Litchfield, City of
Blue Earth, City of	Dundas, City of	Madison, City of
Blue Earth County	Eagle Lake, City of	Madison Lake, City of
Brandon, City of	East Grand Forks, City of	Maple Plain, City of
Browns Valley, City of	Edgerton, City of	Mapleview, City of
Buffalo Lake, City of	Elysian, City of	Medford, City of
Butterfield, City of	Fairfax EDA	Montgomery EDA
Carver, City of	Frazee, City of	Montrose, City of
Cass Lake, City of	Garrison, City of	Moose Lake, City of
Chatfield, City of	Gibbon, City of	Mountain Lake, City of
Clarkfield HRA	Glenwood, City of	Murdock, City of
Coleraine, City of	Good Thunder, City of	Nashwauk, City of
Cologne, City of	Grand Meadow, City of	New Brighton, City of
Cook County/Grand	Grant County HRA	Newport, City of
Marais Joint EDA	Hilltop, City of	North Branch, City of

⁵¹ The percentage of TIF authorities with substantially complete 1999 TIF reports for all their TIF districts filed by the August 1, 2000, deadline was 69.7 percent. In comparison, the percentage of TIF authorities with substantially complete 1998 TIF reports for all their TIF districts filed by the August 2, 1999, deadline was 70.4 percent, and the percentage of TIF authorities with substantially complete 1997 TIF reports for all their TIF districts filed by the July 1, 1998, deadline, was 42.4 percent.

⁵² The percentage of TIF authorities without substantially complete 1999 TIF reports for all their TIF districts, but which filed something by the August 1, 2000, deadline was 9.2 percent. In comparison, the percentage of TIF authorities without substantially complete 1998 TIF reports for all their TIF districts, but which filed something by the August 2, 1999, deadline was 15.0 percent. The percentage of TIF authorities without substantially complete 1997 TIF reports for all their TIF districts, but which filed something by the July 1, 1998, deadline was 34.7 percent.

North Mankato, City of
Norwood/Young America,
City of
Orr, City of
Orr EDA
Pelican Rapids, City of
Racine, City of
Richmond, City of
Rockford, City of
Rogers, City of
Rush City, City of

St. Clair, City of
St. Joseph, City of
Sartell, City of
Slayton, City of
Spring Lake Park, City of
Springfield, City of
Starbuck, City of
Verndale, City of
Virginia, City of
Wabasha, City of

Wabasso, City of
Wadena, City of
Waite Park, City of
Waldorf, City of
Wanamingo, City
Warroad Port Authority
Waubun, City of
Wheaton, City of
Willmar, City of
Woodbury, City of

On August 11, 2000, the OSA mailed notices to 132 TIF authorities informing them that the OSA had not received substantially complete 1999 TIF reports for one or more of their TIF districts as of August 1, 2000, and that tax increment from those districts would be withheld pursuant to Minn. Stat. § 469.1771, subd. 2a. On November 27, 2000, the OSA mailed notices to county auditors to withhold distributions of tax increment from identified TIF districts to the following 24 TIF authorities because, as of November 21, 2000, the OSA had not yet received substantially complete 1999 TIF reports for the identified TIF districts:

Albany, City of
Bagley HRA
Baxter, City of
Biwabik, City of
Browns Valley, City of
Cologne, City of
Cook County/Grand
Marais Joint EDA
Dexter, City of

Dodge Center, City of
East Grand Forks, City of
Elysian, City of
Hilltop, City of
Howard Lake, City of
Hutchinson, City of
Madison, City of
Maple Plain, City of
Montgomery EDA

Northwest MN Multi-
County HRA
Norwood/Young America,
City of
Sartell, City of
Verndale, City of
Waldorf, City of
Wheaton, City of
Willmar, City of

As of January 31, 2001, 14 of these TIF authorities had not filed substantially complete 1999 TIF reports for certain TIF districts.