



MINNESOTA OFFICE OF THE STATE AUDITOR

TAX INCREMENT FINANCING REPORT

APRIL 12, 1999



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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 more than 1,900 TIF districts for the year ended December 31, 1997. 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 which have jurisdiction over tax increment financing.

B. BACKGROUND

1. What Is Tax Increment Financing?

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 or 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) (1998).

The up-front costs of TIF-subsidized development frequently have been financed with the proceeds of general obligation bonds, revenue bonds, or loans. 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:

- Minn. Stat. § 469.174 Definitions;
- Minn. Stat. § 469.175 Contents of TIF plans and procedures for approving and amending them, and reporting requirements;
- Minn. Stat. § 469.176 Limitations on expenditure of tax increment and maximum duration limits for TIF districts;
- Minn. Stat. § 469.1761 Income requirements for housing projects;
- Minn. Stat. § 469.1762 Arbitration of disputes over county costs;
- Minn. Stat. § 469.1763 Pooling restrictions and the five-year rule;
- Minn. Stat. § 469.1765 Rules governing guaranty funds;
- Minn. Stat. § 469.1766 Restrictions on developer payments;
- Minn. Stat. § 469.177 Computation of tax increment, requirement to repay excess increment, and deduction to fund OSA enforcement function;
- Minn. Stat. § 469.1771 Remedies for violations and OSA enforcement authority;
- Minn. Stat. § 469.178 Tax increment bonding;
- Minn. Stat. § 469.1781 Required expenditures of tax increment for a neighborhood revitalization program where certain bonds have been refunded;
- Minn. Stat. § 469.1782 Provisions applicable to TIF districts with extended durations as a result of special laws; and

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.

- 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:

- Pre-1979 districts;
- Economic development districts;
- Housing districts;
- Mined underground space districts;
- Redevelopment districts;
- Renewal and renovation districts; and
- Soils condition districts.

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.

A related statute⁵ grants special status to certain TIF districts which meet additional qualifications:

- Qualified housing districts;
- Qualified ethanol production facility districts;
- Qualified agricultural processing facility districts; and
- Qualified manufacturing districts.⁶

In addition, uncodified laws have authorized the creation of a wide variety of special-purpose TIF districts.

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,

⁵ Minn. Stat. § 273.1399 (1998).

⁶ The portion of the statute that granted special status to qualified manufacturing districts was repealed effective for districts for which certification was requested after June 30, 1994. Laws 1995, ch. 264, art. 5, sec. 4 and 49.

authorizes the use of tax increment from the district to pay TIF-eligible project costs, and establishes a budget for tax increment expenditures.⁷

The governing body of the municipality in which the TIF district is located must approve the TIF plan for the district.⁸ 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.⁹

Before a TIF district is created, the TIF authority must provide certain information about the proposed TIF district to the county board, county auditor, and school board and offer to meet with the county board and school board to discuss the proposed district.¹⁰ 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).

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.¹¹

4. Statistics on Use of Tax Increment Financing

A total of 415 TIF authorities had active TIF districts regarding which TIF authorities and municipalities were required to report information to the OSA for the year ended December 31, 1997. These TIF authorities and municipalities were required to file reports regarding 1,924 TIF districts. According to the information municipalities filed with the OSA, these 1,924 TIF districts consisted of the following types of TIF districts:

⁷ Minn. Stat. § 469.175, subd. 1 and subd. 6(c)(3) (1998).

⁸ Minn. Stat. § 469.175, subd. 3 (1998).

⁹ 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.

¹⁰ Minn. Stat. § 469.175, subd. 2 (1998).

¹¹ 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.

Pre-1979 districts	81
Economic development districts	700
Housing districts	273
Mined underground space districts	1
Redevelopment districts	805
Renewal and renovation districts	16
Soils condition districts	41
Districts authorized by uncodified laws	4
Not reported	<u>3</u>
Total	1,924

Please be advised that this is unaudited information. A number of municipalities reported that they had economic development, housing or redevelopment districts with certification request dates on or before July 31, 1979, which is impossible under the law. Any TIF district with a certification request date on or before July 31, 1979 is a pre-1979 district. In addition, the OSA has determined through TIF legal compliance audits that a number of municipalities incorrectly reported the types of their TIF districts.

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 1987.¹² This unaudited information was reported by municipalities for the year ended December 31, 1997.

CRD Year	Economic Development	Housing	Redevelopment	Renewal & Renovation	Soils Condition	Total
1987	37	8	42	n/a	n/a	87
1988	75	8	54	n/a	3	140
1989	110	13	54	n/a	5	182
1990	73	13	49	0	1	136
1991	26	8	17	0	2	53
1992	35	8	30	1	8	82
1993	52	15	48	3	8	126
1994	52	22	46	3	4	127
1995	64	43	67	3	8	185
1996	59	30	65	1	2	157
1997	<u>57</u>	<u>26</u>	<u>52</u>	<u>5</u>	<u>0</u>	<u>140</u>
Total	640	194	524	16	41	1,415

¹² This table does not include TIF districts reported to be pre-1979 districts, mined underground space districts, districts authorized by uncodified laws, and districts for which no type was reported. Data for years before 1987 was excluded. Many economic development districts created before 1987 were no longer required to report for the year ended December 31, 1997. Therefore, including pre-1987 data would have created the false impression that few economic development districts were created during those earlier years.

C. OSA'S TIF ENFORCEMENT AUTHORITY

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.¹³ The OSA may examine and audit the accounts and records of TIF authorities on a random basis to determine if they are complying with the TIF Act.¹⁴ 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.¹⁵

The OSA created a TIF Division to perform the TIF enforcement functions. The TIF Division began its enforcement activities on January 1, 1996. The TIF Division currently consists of a director, six TIF auditors, and an office specialist.

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.¹⁶ 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 they generate.

1. Annual Collection and Review of TIF Reports

Three statutory subdivisions impose annual reporting obligations on TIF authorities and municipalities and describe the TIF information they must submit.¹⁷ 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.

Pursuant to the authority granted in those statutes, the OSA has developed three forms for reporting the information required by the TIF-reporting subdivisions. These forms are called the "TIF

¹³ Laws 1995, ch. 264, art. 5, sec. 34.

¹⁴ Minn. Stat. § 469.1771, subd. 1(b) (1998).

¹⁵ 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.

¹⁶ The TIF enforcement deduction rate was increased from 0.10 percent to 0.25 percent effective for distributions of tax increment to TIF authorities and municipalities made after June 30, 1998. Laws 1998, ch. 366, sec. 79 and 91.

¹⁷ See Minn. Stat. § 469.175, subd. 5, 6 and 6a (1998).

Authority Report,” “Municipality Report,” and “Pooled Indebtedness Report.”¹⁸ All of the information requested by these forms is required by the TIF-reporting subdivisions or is used to verify the accuracy of the information those subdivisions require.

The TIF-reporting subdivisions predate by many years the forms that the OSA has developed for submitting the required information.¹⁹ Before the Legislature transferred responsibility for TIF enforcement to the OSA effective January 1, 1996, the Department of Revenue established the format for reporting some of the required TIF information, and the OSA established the format for other required TIF information to be reported in schedules included in the local governments’ annual financial statements.²⁰ The forms that the OSA’s TIF Division now uses for TIF reporting are relatively unchanged from the reporting formats previously developed by the Department of Revenue and the OSA.

In 1998, at the OSA’s request, the Legislature lengthened the time that TIF authorities and municipalities have to prepare their TIF reports by changing the filing deadline from July 1 to August 1 each year.²¹ This new filing deadline is effective starting with the TIF reports that must be filed in 1999.²² These are the TIF reports and disclosure statement for the year ended December 31, 1998.

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.²³ The Legislature changed the publication deadline from July 1 to August 15 effective starting with the publication that must be made in 1999.²⁴

In 1998, the Legislature also 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.²⁵ The withheld tax increment will be released and distributed whenever

¹⁸ For the reports for the year ended December 31, 1998, the name of the report on pooled indebtedness has been changed to the “Pooled Debt Report.”

¹⁹ See Laws 1979, ch. 322, sec. 4; Laws 1 Sp. 1985, ch. 14, art. 8, sec. 15; Laws 1 Sp. 1989, ch. 1, art. 14, sec. 7.

²⁰ As a general practice, the independent auditors hired to audit the local governments’ annual financial statements did not audit the TIF-information schedules.

²¹ Laws 1998, ch. 389, art. 11, sec. 2, 3 and 4.

²² Laws 1998, ch. 389, art. 11, sec. 29.

²³ See Minn. Stat. § 469.175, subd. 5(b) (1998).

²⁴ Laws 1998, ch. 389, art. 11, sec. 2 and 29.

²⁵ See Laws 1998, ch. 389, art. 11, sec. 8.

substantially complete TIF reports eventually are filed. These changes are effective starting with the TIF reports and annual disclosure statement that must be filed in 1999.²⁶

To establish expectations about how this process will work in 1999, the TIF Division staff began to review all TIF reports for substantial completeness in 1998. TIF reports that were not substantially complete were returned and treated as not filed.

A total of 415 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, 1997, which were due by July 1, 1998. These TIF authorities and municipalities were required to file reports for 1,924 TIF districts. Of the 415 TIF authorities with TIF districts for which filing was required, 176 had substantially complete TIF reports for all their TIF districts and copies of their annual disclosure statements filed with the OSA by the July 1, 1998 deadline.²⁷

In addition, the following 144 TIF authorities had at least some of the required TIF reports filed with the OSA by the July 1, 1998 deadline, but not all of the required reports were filed, not all of the required reports were substantially complete, or the copy of the annual disclosure statement was not filed by the deadline:²⁸

Adrian, City of	Bloomington Port	Cook County/Grand
Afton, City of	Authority	Marais Joint EDA
Aitkin, City of	Braham, City of	Cottonwood, City of
Albany, City of	Bricelyn, City of	Crookston, City of
Albertville, City of	Brooklyn Center	Crow Wing County HRA
Andover, City of	Brooklyn Park	Deerwood, City of
Apple Valley, City of	Brooten, City of	Delano, City of
Aurora HRA	Buffalo Lake	Detroit Lakes, City of
Austin, City of	Byron, City of	Dexter, City of
Avon, City of	Cambridge, City of	Dilworth, City of
Bagley HRA	Cass County HRA	Douglas County HRA
Bayport, City of	Cass Lake, City of	Eden Prairie, City of
Belle Plaine EDA	Centerville, City of	Eden Valley, City of
Benson, City of	Champlin, City of	Elk River, City of
Big Lake, City of	Chaska EDA	Falcon Heights, City of
Blackduck, City of	Chisago County HRA	Farmington, City of
Bloomington, City of	Chisholm, City of	Fergus Falls, City of
Bloomington HRA	Cokato, City of	Fergus Falls Port Authority
	Cold Spring, City of	Foley, City of

²⁶ Laws 1998, ch. 389, art. 11, sec. 29.

²⁷ The percentage of TIF authorities with substantially complete reports for all its TIF districts filed by the July 1, 1998 was 42.4 percent.

²⁸ The percentage of TIF authorities without substantially complete reports for all its TIF districts but which filed something by the July 1, 1998 was 34.7 percent.

Frazeo, City of
Garrison, City of
Gaylord, City of
Gibbon, City of
Glencoe, City of
Glenwood, City of
Golden Valley, City of
Goodview, City of
Grand Rapids, City of
Grand Rapids HRA
Grant County HRA
Gully, City of
Hayfield, City of
Hopkins, City of
Inver Grove Heights, City of
Isle, City of
Jordan, City of
Kasson, City of
Kiestler, City of
Lake Crystal, City of
Lakeville, City of
Lindstrom, City of
Lino Lakes, City of
Long Prairie, City of
Luverne, City of
Madison Lake, City of
Mahnomon, City of
Mankato, City of
Maple Grove, City of
Maple Lake, City of
Maple Plain, City of

Marshall, City of
Maynard, City of
Melrose, City of
Milaca, City of
Montgomery EDA
Monticello, City of
Motley, City of
Mounds View EDA
Murdock, City of
New Brighton, City of
New Hope, City of
New Ulm, City of
New York Mills, City of
Nicollet, City of
Nisswa, City of
North St. Paul, City of
Northwest Minnesota
Multi-County HRA
Oakdale, City of
Olivia EDA
Onamia, City of
Pelican Rapids, City of
Pequot Lakes, City of
Pierz, City of
Pine Island, City of
Plato, City of
Preston, City of
Princeton, City of
Prior Lake, City of
Ramsey, City of
Red Lake, City of

Red Wing Port Authority
Rice, City of
Richfield HRA
Rochester, City of
Rockford, City of
Roseville, City of
St. Anthony, City of
Sandstone, City of
Savage, City of
Shakopee, City of
Sherburne County HRA
Shoreview, City of
Silver Bay, City of
Sleepy Eye, City of
Southeast Minnesota
Multi-County HRA
Spring Valley, City of
Springfield, City of
Twin Lakes Township
Waite Park, City of
Waldorf, City of
Washington County HRA
Waterville, City of
Welcome, City of
Wells, City of
White Bear Lake, City of
Willmar, City of
Windom, City of
Zimmerman, City of
Zumbrota EDA

In contrast, the following 96 TIF authorities had no reports for their TIF districts filed with the OSA by the July 1, 1998 deadline:

Annandale, City of
Appleton EDA
Arlington, City of
Barnum, City of
Battle Lake, City of
Beltrami County
Blue Earth, City of
Breckenridge, City of
Browns Valley, City of
Buffalo HRA
Buhl, City of

Butterfield, City of
Caledonia, City of
Cannon Falls, City of
Carver, City of
Chanhausen EDA
Chatfield, City of
Circle Pines, City of
Claremont, City of
Coleraine, City of
Cologne, City of
Columbia Heights EDA

Coon Rapids, City of
Cottonwood County
Crystal, City of
Dayton, City of
Deephaven, City of
Donnelly, City of
Duluth, City of
Duluth EDA
Dundas, City of
Eagan, City of
East Grand Forks, City of

Edgerton, City of
 Faribault, City of
 Fosston, City of
 Hallock, City of
 Hector, City of
 Hinckley, City of
 Howard Lake, City of
 Hutchinson, City of
 Isanti, City of
 Joint East Range EDA
 Kenyon, City of
 Lake City, City of
 Lake County HRA
 Lakefield, City of
 Le Roy, City of
 Lexington, City of
 Little Falls, City of
 Madison, City of
 Manhattan Beach, City of
 Medford, City of
 Medina, City of
 Mendota Heights, City of

Minneapolis Community
 Development Agency
 Montrose, City of
 Morgan, City of
 Mountain Lake, City of
 Nashwauk, City of
 New London, City of
 New Prague, City of
 North Branch, City of
 Osakis, City of
 Osseo, City of
 Park Rapids, City of
 Plainview, City of
 Racine, City of
 Redwood Falls, City of
 Renville, City of
 Rice County HRA
 Rogers, City of
 Rush City, City of
 St. Clair, City of
 St. Cloud HRA

St. Louis Park, City of
 St. Paul HRA
 St. Paul Port Authority
 St. Paul Park, City of
 St. Peter, City of
 Sartell, City of
 Sauk Centre, City of
 Spicer, City of
 Spring Lake Park, City of
 Starbuck, City of
 Stearns County HRA
 Tower, City of
 Vadnais Heights, City of
 Vergas, City of
 Virginia, City of
 Wabasso, City of
 Wahkon, City of
 Walker, City of
 Wheaton, City of
 Windom HRA
 Winthrop, City of

It appears there may have been some confusion among local governments regarding the July 1, 1998 filing deadline. Some TIF authorities and municipalities may have believed the deadline had been changed to August 1, 1998, even though the law provided that the amendment to the filing deadline is effective starting with the TIF reports that must be filed in **1999**.

As of August 1, 1998, the following 52 TIF authorities had no reports for their TIF districts filed with the OSA:

Annandale, City of
 Arlington, City of
 Beltrami County
 Breckenridge, City of
 Butterfield, City of
 Caledonia, City of
 Cannon Falls, City of
 Carver, City of
 Chanhassen EDA
 Coleraine, City of
 Cologne, City of
 Columbia Heights EDA
 Cottonwood County
 Dayton, City of
 Eagan, City of

Edgerton, City of
 Faribault, City of
 Fosston, City of
 Hallock, City of
 Hector, City of
 Hinckley, City of
 Howard Lake, City of
 Joint East Range EDA
 Lake City, City of
 Lake County HRA
 Lexington, City of
 Manhattan Beach, City of
 Medina, City of
 Morgan, City of
 Mountain Lake, City of

Nashwauk, City of
 New London, City of
 North Branch, City of
 Osseo, City of
 Plainview, City of
 Racine, City of
 Renville, City of
 Rice County HRA
 Rogers, City of
 Rush City, City of
 St. Clair, City of
 St. Louis Park, City of
 St. Paul Park, City of
 St. Peter, City of
 Spicer, City of

Spring Lake Park, City of
Starbuck, City of
Tower, City of

Virginia, City of
Wahkon, City of

Wheaton, City of
Winthrop, City of

As of August 1, 1998, the following 75 TIF authorities had filed some of the required TIF reports, but each still had at least one TIF district for which a required TIF report had not been filed, a required report was not substantially complete, or a copy of the annual disclosure statement had not been filed:

Aurora HRA
Bagley HRA
Battle Lake, City of
Belle Plaine EDA
Benson, City of
Big Lake, City of
Bricelyn, City of
Buffalo HRA
Byron, City of
Cambridge, City of
Cass County HRA
Centerville, City of
Champlin, City of
Chaska EDA
Chatfield, City of
Chisholm, City of
Circle Pines, City of
Cold Springs, City of
Coon Rapids, City of
Crow Wing County HRA
Deerwood, City of
Delano, City of
Dexter, City of
Donnelly, City of
Duluth, City of
Duluth EDA

East Grand Forks, City of
Elk River, City of
Farmington, City of
Garrison, City of
Glencoe, City of
Glenwood, City of
Gully, City of
Hayfield, City of
Hopkins, City of
Hutchinson, City of
Kenyon, City of
Kiester, City of
Lakefield, City of
Madison Lake, City of
Mahnomen, City of
Mankato, City of
Maple Plain, City of
Medford, City of
Mendota Heights, City of
Minneapolis Community
Development Agency
Montgomery EDA
New Brighton, City of
New Prague, City of
Nicollet, City of

Olivia EDA
Pelican Rapids, City of
Pequot Lakes, City of
Pine Island, City of
Plato, City of
Preston, City of
Prior Lake, City of
Red Wing Port Authority
Redwood Falls, City of
Richfield HRA
Roseville, City of
St. Anthony, City of
Sauk Centre, City of
Shakopee, City of
Silver Bay, City of
Stearns County HRA
Twin Lakes Township
Vergas, City of
Waldorf, City of
Walker, City of
Washington County HRA
Waterville, City of
Wells, City of
White Bear Lake, City of
Zumbrota EDA

As of April 9, 1999, the following eight TIF authorities still had no reports for their TIF districts filed with the OSA:

Carver, City of
Cologne, City of
Edgerton, City of

Medina, City of
Mountain Lake, City of
Tower, City of

Virginia, City of
Wheaton, City of

As of April 9, 1999, the following seven TIF authorities had filed some of the required TIF reports, but each still had one or more TIF districts for which substantially complete TIF reports or a copy of the annual disclosure statement had not been filed with the OSA:

Caledonia, City of
Cass County HRA
Howard Lake, City of

Lake County HRA
Mankato, City of

Medford, City of
Rogers, City of

In last year's Tax Increment Financing Report to the Legislature, the OSA compared the on-time filing rate for the 1995 TIF reports (due July 1, 1996) to the on-time filing rate for the 1996 TIF reports (due July 1, 1997). This data is not comparable to the information provided above regarding the 1997 TIF reports, because the TIF Division staff did not review all the 1995 or 1996 TIF reports for substantial completeness or return those reports that were not substantially complete.

In addition to the recent practice of reviewing all TIF reports for completeness, the TIF Division staff reviews the contents of some of the TIF reports each year for reporting accuracy and potential legal compliance issues. During the course of these content reviews, the TIF Division staff may find situations where a TIF authority has received 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 auditing performed by the TIF Division staff, has resulted in \$1.8 million being paid voluntarily to county auditors for redistribution.²⁹ 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.

2. TIF Legal Compliance Audits and Investigations

Since last year's report to the Legislature, the TIF Division has spent the vast majority of its time communicating with local governments about the filing of their TIF reports, assisting them in preparing their reports, reviewing the reports that were submitted, and contacting local governments to obtain additional information where the submitted information appeared to be inaccurate or raised legal-compliance issues. Due to the significant amount of time spent assisting TIF authorities and municipalities in complying with the statutory reporting requirements, the TIF Division was able to conduct only a limited number of legal compliance audits or investigations during 1998.

From January 1, 1996 to date, the TIF Division has initiated seven on-site legal compliance audits, two of which are now complete. Since last year's report to the Legislature, the OSA has issued final audit findings regarding the Stearns County Housing and Redevelopment Authority (HRA), which are discussed in section II of this report. In addition, the TIF Division has issued initial findings of noncompliance regarding two of these audits and will issue the final audit findings in the upcoming months.

²⁹ See Minn. Stat. §§ 469.176, subd. 2, and 469.1771, subd. 2 and 3 (1998).

The OSA also conducts investigations of TIF authorities' uses of TIF. In an investigation, the OSA requests and reviews financial records and documents for one or more TIF districts; no on-site examination of records is conducted. Since last year's report to the Legislature, the OSA issued final investigation findings regarding the cities of Fergus Falls, Minneota, and St. James. The OSA's findings of noncompliance regarding these cities' TIF districts are discussed in section II of this report.

3. Education

In addition to collecting and reviewing the annual TIF reports and conducting legal compliance audits and investigations, the TIF Division has worked actively in the area of tax increment financing education on a statewide level. After the OSA assumed TIF enforcement and audit responsibility in 1996, it became clear that a lack of education and inconsistent implementation of the TIF Act by local governments was a primary factor behind many legal compliance issues. In October 1998, the TIF Division presented a day-long seminar on the basics of tax increment financing, which was attended by over 180 local government officials, staff, and professional advisors. The evaluations of this seminar were overwhelmingly positive, and the TIF Division intends to provide additional seminars on a variety of TIF-related subjects during 1999. In addition, TIF Division staff have participated in seminars organized by a variety of organizations including the League of Minnesota Cities, the Association of Metropolitan Municipalities, the Minnesota Association of County Officers, the Economic Development Association of Minnesota, and the Minnesota Institute for Legal Education. In past years, TIF Division staff also have spoken at conferences of the Minnesota Society of Certified Public Accountants and the Minnesota Government Finance Officers Association.

II. VIOLATIONS

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.³⁰ The noncompliance notice 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 noncompliance notice may inform the municipality that Minnesota law requires the TIF authority to pay an amount of money to the county auditor as required to redress certain violations of the TIF Act.³¹

The governing body must respond to the OSA within 60 days after receiving the noncompliance notice. In its written 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.³² The OSA must provide all information

³⁰ Minn. Stat. § 469.1771, subd. 1(c) (1998).

³¹ See Minn. Stat. § 469.1771, subd. 2 and 3 (1998).

³² Minn. Stat. § 469.1771, subd. 1(c) (1998).

regarding unresolved findings of noncompliance to the county attorney, who may bring an action to enforce the TIF Act.³³

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.³⁴ Appendices A through D of this report contain copies of notices of noncompliance regarding the Stearns County Housing and Redevelopment Authority (HRA) and the cities of Fergus Falls, Minnesota, and St. James. This section discusses the more significant findings, in terms of financial impact and frequency of occurrence, contained in these notices of noncompliance.

A. “POOLING” TAX INCREMENT FROM 1979-82 TIF DISTRICTS

City of Fergus Falls

On April 23, 1998, the OSA sent the City of Fergus Falls a notice of noncompliance. In the notice, the OSA found that the city had improperly transferred \$653,064 of tax increment from TIF District 3-1 to be spent on activities outside the geographic boundaries of that TIF district. In addition, the OSA found that the city had improperly transferred \$841,617 of tax increment from TIF District 4-1 to be spent on activities outside the geographic boundaries of that TIF district. TIF District 3-1 and 4-1 have certification request dates of August 6, 1979 and June 2, 1980, respectively. It is the OSA’s position that the TIF Act does not permit “pooling” of tax increment from TIF districts with certification request dates on or after August 1, 1979 and on or before June 30, 1982.³⁵

The city’s response did not dispute that it spent \$653,064 of tax increment from TIF District 3-1 on activities outside the geographic boundaries of that TIF district³⁶ or that the city had spent \$841,617 of tax increment from TIF District 4-1 on activities outside the geographic boundaries of that TIF district. Instead, the city argued that it was permitted to pool tax increment from these TIF districts because the TIF Act did not explicitly prohibit pooling. Furthermore, the city argued that the OSA lacks jurisdiction to find that a TIF authority violated any version of the TIF Act before it was recodified in 1987³⁷ and that the OSA lacks jurisdiction to find that a city violated the TIF Act on or

³³ Minn. Stat. § 469.1771, subd. 1(b) (1998).

³⁴ Minn. Stat. § 469.1771, subd. 1(c) (1998).

³⁵ “Pool” or “pooling” are words commonly used to describe spending tax increment on activities outside the geographic boundaries of the TIF district that generated the increment.

³⁶ The city provided the OSA with additional information, separate from its response to the notice of noncompliance, which indicated that the amount of TIF District 3-1’s tax increment that was spent on activities outside the TIF district was \$643,054 rather than \$653,064.

³⁷ See Laws 1987, ch. 291, sec. 175 to 180 and 244 (repealing Minn. Stat. §§ 273.71 to 273.78 and reenacting them at Minn. Stat. §§ 469.174 to 469.179).

before December 31, 1990.³⁸ Finally, the city argued that it was unfair for the OSA to find that the city was not in compliance with the TIF Act, because for years the city had been filing required TIF reports with the Department of Revenue and the OSA, and no state agency or office had informed the city that it was improperly spending tax increment until it received the OSA's April 23, 1998 notice of noncompliance.

On February 3, 1999, the OSA sent the city its final notice of noncompliance. The OSA reiterated its findings that the city improperly spent \$643,054 of tax increment from TIF District 3-1 on activities outside the geographic boundaries of that TIF district³⁹ and that the city had spent \$841,617 of tax increment from TIF District 4-1 on activities outside the geographic boundaries of that TIF district. The OSA noted that the statutory requirement to make a payment to the county auditor for violations of the TIF Act applied only to \$539,179 of the expenditures of TIF District 3-1's tax increment and to \$539,017 of the expenditures of TIF District 4-1's tax increment, because only these violations occurred after December 31, 1990.⁴⁰

The OSA's final notice of noncompliance addressed the arguments in the city's response. First, the OSA concluded that the city was not permitted to spend tax increment, or any other kind of public money, in any manner not authorized by statute, and the TIF Act did not authorize the city to spend tax increment outside the geographic boundaries of the TIF district that generated the tax increment. Second, the OSA found no statutory support for the city's arguments limiting the OSA's enforcement jurisdiction. Under Minnesota law, the versions of the TIF Act before and after its recodification in 1987 are treated as one and the same, so the OSA has jurisdiction to find that a TIF authority violated a pre-1987 version of the TIF Act. Furthermore, the effective-date provisions for the statutory amendments that gave the OSA jurisdiction over TIF enforcement did not limit the OSA's jurisdictions to violations occurring after December 31, 1990. Finally, the OSA noted that it was not given responsibility for conducting TIF legal compliance audits and making findings of noncompliance, and did not receive an appropriation to fund legal compliance audits, until January 1, 1996.

The OSA referred this matter to the Otter Tail County Attorney by letter dated February 10, 1999. Copies of the OSA's notices of noncompliance and the city's response regarding this matter are included in Appendix A.

³⁸ The act that created the violations statute, Minn. Stat. § 469.1771, in 1990 provided that the statute applies only to violations occurring after December 31, 1990. Laws 1990, ch. 604, art. 7, sec. 31(a).

³⁹ *See supra* note 36.

⁴⁰ Minn. Stat. § 469.1771, subd. 3 applies only to violations occurring after December 31, 1990. Laws 1990, ch. 604, art. 7, sec. 25 and 31(a).

B. FAILURE TO RETURN EXCESS INCREMENT

Stearns County HRA

On March 6, 1998, the OSA sent Stearns County a notice of noncompliance. In the notice, the OSA found that the Stearns County HRA improperly failed to return \$493,305 of excess tax increment from TIF District 15 (Cold Spring Granite) to the county auditor. If, in any year, a TIF district has sufficient revenue available to pay the remaining costs authorized by the TIF plan, any tax increment the TIF authority receives from the TIF district after that point in time is excess tax increment. Excess tax increment may be used only 1) to prepay any outstanding bonds, 2) to discharge the pledge of tax increment for such bonds, 3) to pay into an escrow account dedicated to the payment of such bonds, or 4) to return the excess amount to the county auditor for distribution to the municipality, county and school district.⁴¹

On May 20, 1992, the HRA adopted a resolution requesting that the county auditor decertify TIF District 15 effective for taxes payable in 1993. The county auditor decertified the TIF district and returned the captured net tax capacity of the parcels in the TIF district to the tax rolls for taxes payable in 1993. By the end of the fiscal year ended June 30, 1994, the HRA had paid all the costs authorized by the TIF plan. At that time, the HRA still had \$493,305 in the fund for TIF District 15. The OSA found that this money was excess tax increment and that the HRA was required to return it to the county auditor pursuant to Minn. Stat. § 469.176, subd. 2.

The county responded that the HRA created TIF District 68 (Cold Spring Granite Expansion) in November 1995 and transferred \$409,200 from TIF District 15's fund to TIF District 68's fund during the fiscal year ended June 30, 1996. The county argued this transfer was proper because 1) TIF District 15 was not decertified until it no longer had any remaining revenue to spend, 2) the TIF plan for TIF District 68 provided that the HRA intended to use \$410,000 of tax increment from TIF District 15 to finance some of the costs included in the budget for TIF District 68, and 3) on April 24, 1998, the HRA amended the TIF plan for TIF District 15 to authorize the transfer of \$410,000 to TIF District 68.

On January 27, 1999, the OSA sent the county its final notice of noncompliance. The OSA reiterated its finding that the HRA improperly failed to return \$493,305 of excess tax increment from TIF District 15 to the county auditor. The OSA informed the county that the excess tax increment statute requires a determination to be made during each year as to whether any excess tax increment exists, and that \$493,305 of excess tax increment existed in 1994. Therefore, the HRA's actions after 1994 to transfer some of the excess increment to TIF District 68 and to modify the TIF plan for TIF District 15 did not change the fact that the \$493,305 was excess tax increment in 1994. The only permitted use of this excess tax increment was to return it to the county auditor. In addition, the OSA informed the county that it is the OSA's position that an expenditure or transfer that was not authorized by the TIF plan at the time it was made cannot be validated by later modifying the TIF plan to authorize the prior expenditure or transfer. Finally, the OSA disagreed with the county's argument that TIF District 15 was not decertified in 1993. The county auditor decertified the TIF

⁴¹ Minn. Stat. § 469.176, subd. 2 (1998).

districts in 1993 when it returned all the net tax capacity of the parcels in the TIF districts to the tax rolls.⁴² Therefore, the 1998 modification of the TIF plan for TIF District 15 was not valid.

The OSA referred this matter to the Stearns County Attorney on February 1, 1999. Copies of the OSA's notices of noncompliance and the county's response regarding this matter are included in Appendix B.

C. TAX INCREMENT RECEIVED AFTER MAXIMUM DURATION LIMIT

City of St. James

On March 31, 1998, the OSA sent the City of St. James a notice of noncompliance. In the notice, the OSA found that the city improperly received \$91,000 of tax increment from TIF District 1-1 after the statutory maximum duration limit for this TIF district. The city approved the TIF plan for TIF District 1-1 on September 2, 1986. The statutory maximum duration limit for this TIF district was eight years from the first receipt of increment or ten years from approval of the TIF plan, whichever was earlier.⁴³ Ten years from approval of the TIF plan, September 2, 1996, was earlier than eight years from the first receipt of increment. Therefore, the city was not permitted to receive tax increment from TIF District 1-1 after September 2, 1996. The city improperly received \$91,000 of tax increment from this TIF district in December 1996.

The city responded that it retroactively waived the tax increment it received in 1988, the first year it received increment, by paying an equal amount to the county auditor in 1996. Therefore, according to the city, it did not first receive tax increment from this TIF district until 1989, and consequently it was entitled to receive all of the tax increment generated in 1996 under the duration limit measured eight years from the first receipt of increment. In addition, the city argued that if the duration limit measured ten years from approval of the TIF plan applied, the city was entitled to receive all of the tax increment generated in 1996, because the county allegedly advised the city that it was entitled to receive all this tax increment.

On January 8, 1999, the OSA sent the city its final notice of noncompliance. The OSA reiterated its finding that the city improperly received \$91,000 of tax increment from TIF District 1-1 after the statutory maximum duration limit. The city's response did not change the fact that the TIF district's statutory maximum duration limit was measured ten years from approval of the TIF plan, not eight

⁴² “‘Decertify’ or ‘decertification’ means the termination of a tax increment financing district which occurs when the county auditor removes all remaining parcels from the district.” Minn. Stat. § 469.174, subd. 28 (1998). The county auditor has the power and the duty to decertify a TIF district when requested to do so by the TIF authority. *See* Minn. Stat. § 469.177, subd. 12 (1998).

⁴³ Minn. Stat. § 273.75, subd. 1 (1986).

years from the first receipt of increment.⁴⁴ Furthermore, the county’s alleged communication to the city of a misinterpretation of the law did not negate the city’s obligation to comply with the statutory maximum duration limit or negate the OSA’s obligation to make this finding of noncompliance.

The OSA referred this matter to the Watonwan County Attorney by letter dated January 8, 1999. Copies of the OSA’s notices of noncompliance and the city’s response regarding this matter are included in Appendix C.

D. AMOUNTS SPENT ON LINE ITEMS EXCEEDED BUDGETED AMOUNTS

1. City of Fergus Falls

In the April 23, 1998 notice of noncompliance, the OSA found that the City of Fergus Falls improperly spent tax increment from several TIF districts in excess of the line-item budget in each district’s TIF plan:

<u>District Name</u>	<u>Line-Item Description</u>	<u>Budgeted Amount</u>	<u>Amount Expended</u>
TIF District 1-1	Land acquisition	\$265,000	\$287,962
	Administrative expenses	19,752	22,390
TIF District 3-1	Land acquisition	166,900	221,146
	Administrative expenses	16,000	18,161
TIF District 4-4	Land acquisition	630,000	718,609
	Site improvements	60,000	101,861
	Administrative expenses	30,000	40,716

Tax increment may be spent or transferred only as authorized in the TIF plan.⁴⁵ Therefore, the OSA found that the city improperly spent \$25,600 of tax increment from TIF District 1-1 on land acquisition and administrative expenses, \$56,407 of tax increment from TIF District 3-1 on land acquisition and administrative expenses, and \$141,186 of tax increment from TIF District 4-1 on land acquisition, site improvements and administrative expenses, without authorization in each district’s TIF plan.

The city responded that there is no statutory requirement for it to include line-item budgets in the TIF plans for these TIF districts. Therefore, according to the city, it did not violate the TIF Act when it spent more tax increment on land acquisition, site improvements, and administrative expenses than

⁴⁴ The final notice also informed the city that the TIF Act did not authorize the city to extend the duration of an economic development district, such as TIF District 1-1, by waiving the receipt of tax increment, especially when the alleged waiver was retroactive. Therefore, the city first received increment from TIF District 1-1 in 1988, not 1989. If TIF District 1-1 were subject to the duration limit measured eight years from the first receipt of increment in 1988, the city would have been entitled to receive tax increment through the end of 1996.

⁴⁵ Minn. Stat. § 469.176, subd. 4 (1998).

the amounts authorized in the TIF plans.⁴⁶ The city asserted that the TIF Act requires a TIF plan only to include estimates of costs which TIF authorities may exceed without consequence, provided the total tax increment expenditures for the TIF district do not exceed the total estimated tax increment expenditures in the TIF plan.

The OSA has found a number of TIF authorities that have disregarded line-item budgets, and employees of and attorneys for local governments have informed the OSA that disregarding line-item budgets is a widespread practice. While the number of local governments that engage in a practice does not negate a statutory limitation, it raises concerns about statewide enforcement of this issue by the OSA.

In the February 3, 1999 final notice of noncompliance, the OSA informed the city that it was withdrawing the finding regarding violations of the line-item budgets and would seek input from the the Legislature on this issue. Copies of the OSA's notices of noncompliance and the city's response regarding this matter are included in Appendix A.

2. City of Minneota

On March 31, 1998, the OSA sent the City of Minneota a notice of noncompliance. In the notice, the OSA found that the city spent or transferred \$89,273 of tax increment from its only TIF district for installation of public utilities, even though the TIF-plan budget authorized the city to spend only \$25,438 on installation of public utilities. The TIF plan also provided that the city intended to reimburse its General Fund for \$30,000 loaned from the General Fund to the TIF district. The OSA permitted the city to characterize \$30,000 of the \$89,273 spent or transferred for installation of public utilities as a repayment of the \$30,000 loan from the General Fund. Therefore, the OSA found that the city spent \$59,273 of tax increment on installation of public utilities, \$33,835 more than the \$25,438 authorized in the TIF-plan budget. The OSA also found that the city spent \$2,304 on administrative costs, \$554 more than the \$1,750 authorized in the TIF-plan budget. Tax increment may be spent or transferred only as authorized in the TIF plan.⁴⁷ Therefore, the OSA found that city improperly spent \$33,835 on installation of public utilities and \$554 on administrative costs without authorization in the TIF plan.

The city responded that “the City of Minneota’s Tax Increment Financing Development Plan did what it was established to do, ‘to provide an attractive site for a business considering leaving the state and develop a site where the potential for attracting other business is increased.’” According to the city, the cost of the utility improvements in the district exceeded what was estimated in the

⁴⁶ The OSA based its finding on Minn. Stat. § 469.175, subd. 6(c)(3), which requires a TIF authority to report “the amount budgeted under the tax increment financing plan” for at least five identified categories of costs. These five categories of costs include “acquisition of land and buildings,” “site improvements or preparation costs,” and “administrative costs.” Minn. Stat. § 469.175, subd. 6(c)(3) (1998). The city did not agree that this statute requires a TIF plan to include a line-item budget.

⁴⁷ Minn. Stat. § 469.176, subd. 4 (1998).

original TIF-plan budget. Development in the TIF district generated more tax increment revenue than was initially anticipated, and the city used that extra revenue to pay for the additional water and sewer improvements. The city argued that it did not use the funds on hand for any purpose not included in the original TIF plan.

The city's response did not provide any statutory authority allowing it to spend the extra tax increment on public utility improvement costs in excess of the TIF-plan budget. Therefore, the OSA referred this matter to the Lyon County Attorney by letter dated June 24, 1998.

After referring this matter to the Lyon County Attorney, the OSA engaged in further review of the line-item budget issue, as discussed above in section II.D.1.

On December 9, 1998, the OSA issued the city a second notice of noncompliance. In the second notice, the OSA informed the city that the OSA has discontinued making findings that a TIF authority violates the TIF Act by spending more tax increment on a line item than the TIF plan authorized, which was the basis for the initial notice of noncompliance. The OSA informed the city and the Lyon County Attorney that the OSA would seek input from the Legislature on this issue.

In the second notice of noncompliance, the OSA found that the city spent or transferred a total of \$75,664 of tax increment, \$28,114 more than the \$47,550 total estimated tax increment expenditures provided in the TIF plan.⁴⁸ A TIF authority must seek the municipality's approval of a TIF-plan modification if, among other things, the TIF authority increases the total estimated tax increment expenditures of a TIF district.⁴⁹ The city did not amend the TIF plan to increase the total estimated tax increment expenditures. Therefore, the OSA found that the city violated the law by spending more tax increment than the total estimated tax increment expenditures provided in the TIF plan.

The city responded by reiterating its response to the first notice of noncompliance. The OSA referred this matter to the Lyon County Attorney by letter dated December 22, 1998. Copies of the OSA's notices of noncompliance and the city's responses regarding this matter are included in Appendix D.

3. City of St. James

In the March 31, 1998 notice of noncompliance to the City of St. James, the OSA found that the city had spent \$25,850 of tax increment from TIF District 1-2 on site improvements, even though the TIF-plan budget only authorized the city to spend \$20,000 on site improvements. Tax increment

⁴⁸ The TIF plan estimated total expenditures of \$77,550, of which \$47,550 was to be paid from tax increment and \$30,000 was to be paid from the proceeds of a loan from the city's General Fund. The city spent a total of \$106,577, including \$75,664 of tax increment, \$30,000 of loan proceeds, and \$913 of other revenue.

⁴⁹ Minn. Stat. § 469.175, subd. 4(a) (1998).

may be spent or transferred only as authorized in the TIF plan.⁵⁰ Therefore, the OSA found that the city improperly spent \$5,850 on site improvements without authorization in the TIF plan.

The city responded that there was no statutory requirement for it to include a line-item budget in the TIF plan for TIF District 1-2. Therefore, according to the city, it did not violate the TIF Act when it spent more tax increment on site improvements than the amount that the TIF plan authorized for site improvements.⁵¹ The city asserted that TIF authorities and municipalities throughout the state believe the TIF Act requires a TIF plan only to include estimates of costs which TIF authorities may exceed without consequence, provided the total tax increment expenditures do not exceed the total estimated tax increment expenditures in the TIF plan. The city requested the OSA to seek legislative clarification of the statutory provision regarding line-item budgets before issuing any notices of noncompliance based on that provision.

In the January 8, 1999 final notice of noncompliance, the OSA informed the city that it was withdrawing this finding. The OSA also informed the city that the OSA would seek input from the Legislature on this issue. Copies of the OSA’s notices of noncompliance and the city’s response regarding this matter are included in Appendix C.

4. Stearns County HRA

In the March 6, 1998 notice of noncompliance, the OSA found that the Stearns County HRA improperly spent the following amounts of tax increment from several TIF districts in excess of the line-item budgets in each district’s TIF plan:

<u>District Name</u>	<u>Line-Item Description</u>	<u>Budgeted Amount</u>	<u>Amount Expended</u>
TIF District 15	Public improvements	\$456,224	\$535,823
	Administrative expenses	58,950	156,296
TIF District 22	Administrative expenses	4,000	12,113
TIF District 68	Administrative expenses	15,500	23,296

Tax increment may be spent or transferred only as authorized in the TIF plan.⁵² Therefore, the OSA found that the HRA improperly spent \$176,945 of tax increment from TIF District 15 on public improvements and administrative expenses, \$8,113 of tax increment from TIF District 22 on

⁵⁰ Minn. Stat. § 469.176, subd. 4 (1998).

⁵¹ The OSA based its finding on Minn. Stat. § 469.175, subd. 6(c)(3), which requires a TIF authority to report “the amount budgeted under the tax increment financing plan” for at least five identified categories of costs. These five categories of costs include “acquisition of land and buildings,” “site improvements or preparation costs,” and “administrative costs.” Minn. Stat. § 469.175, subd. 6(c)(3) (1998). The city did not agree that this statute requires a TIF plan to include a line-item budget.

⁵² Minn. Stat. § 469.176, subd. 4 (1998).

administrative expenses, and \$7,796 of tax increment from TIF District 68 on administrative expenses, without authorization in each district's TIF plan.

Stearns County responded that these findings were resolved by TIF-plan modifications it adopted in 1997 and 1998.

On January 27, 1999, the OSA sent Stearns County its final notice of noncompliance. The OSA informed Stearns County that it is the OSA's position that an expenditure or transfer that was not authorized by the TIF plan at the time it was made cannot be validated by later modifying the TIF plan to authorize the expenditure or transfer.

The OSA, however, withdrew these findings for the reasons discussed above and informed the county that the OSA would seek input from the Legislature on this issue. Copies of the OSA's notices of noncompliance and the county's response regarding this matter are included in Appendix B.

E. INADEQUATE DOCUMENTATION TO SUPPORT ADMINISTRATIVE EXPENSES

Stearns County HRA

In the March 6, 1998 notice of noncompliance to Stearns County, the OSA found that the Stearns County HRA lacked adequate documentation for expenditures of tax increment the HRA reported as being made for administrative expenses. The HRA reported that it spent \$156,296 of tax increment from TIF District 15 (Cold Spring Granite) on administrative expenses, but the OSA was unable to find adequate documentation or authorization to support \$121,476 of those expenditures. Of this amount, \$119,734 was charged in a single journal entry in the fiscal year ended June 30, 1994. The HRA calculated ten percent of the tax increment received from TIF District 15 over the life of the district, then deducted the amount of tax increment it had already spent on administrative expenses, and paid the difference to itself as an "administrative expense." Similarly, the OSA was unable to find adequate documentation or authorization to support the expenditures of \$13,850 of tax increment from TIF District 22 (St. Cloud Meat and Provision), which the HRA reported it spent on administrative expenses. Of this amount, \$8,945 was charged in three journal entries in fiscal years 1994, 1995, and 1996. The amount charged in each of these journal entries was equal to ten percent of the tax increment received during that fiscal year from TIF District 22.

In its response, Stearns County acknowledged that the HRA had no documentation to demonstrate that it actually incurred the "administrative expenses" that it had calculated by taking 10 percent of the tax increment received. The county contended that "[t]he usual and customary procedure at the time this district was established was to allow for the full 10 percent assessment of administrative costs regardless of the actual ability to provide proof of the cost of such item."

On January 27, 1999, the OSA sent Stearns County its final notice of noncompliance. The final notice reiterated the OSA's position that a local government may expend taxpayer dollars only on incurred, necessary government costs. Tax increment revenues are subject to no less stringent requirements. The TIF Act contains a statute that limits the amount of tax increment that may be spent on administrative expenses. A TIF authority may use tax increment to pay administrative

expenses it actually incurs *up to* ten percent of the total tax increment expenditures authorized by the TIF plan, or administrative expenses it actually incurs *up to* ten percent of the total tax increment expenditures for the project, whichever is less.⁵³ The statute does not authorize the TIF authority to transfer ten percent of the increment to itself and call that amount “administrative expenses” without regard for whether the TIF authority incurred any administrative expenses.

The OSA referred this matter to the Stearns County Attorney on February 1, 1999. Copies of the OSA’s notices of noncompliance and the county’s response regarding this matter are included in Appendix B.

III. STATUTORY ISSUES

Through municipalities’ responses to notices of noncompliance and questions received from city and county officials and employees, the OSA has identified a number of areas where the TIF Act is ambiguous or the OSA’s findings of noncompliance have conflicted with practitioners’ varying interpretations of the law. This report to the legislative committees with jurisdiction over TIF identifies these ambiguities and conflicting statutory interpretations in order to facilitate public policy discussion and allow for amendments to clarify the law retroactively or to change the law prospectively.

A. “POOLING” TAX INCREMENT FROM PRE-1982 TIF DISTRICTS

As discussed in section II.A. on page 14 of this report, the OSA found that the City of Fergus Falls violated the TIF Act by spending tax increment on costs of activities located outside the TIF district that generated the increment, which commonly is called “pooling” tax increment. The OSA’s past reports to the Legislature discussed similar findings of noncompliance regarding the cities of Cambridge, Deephaven, Foley, and Forest Lake. All of the TIF districts involved in these findings had certification request dates on or after August 1, 1979 and on or before June 30, 1982.

The laws applicable to TIF districts with certification request dates on or after August 1, 1979 and on or before June 30, 1982 do not permit the expenditure of tax increment to finance activities outside the geographic boundaries of a TIF district. Under the TIF Act enacted in 1979, the TIF plan was required to contain a statement of the TIF authority’s objectives for improvement of the *district*, a statement as to the development program for the *district*, including the property within the *district* which the TIF authority intended to acquire, and an estimate of the cost of the *district*.⁵⁴ Moreover, the municipality, prior to approving the TIF plan, was required to find that the TIF plan affords maximum opportunity for the development or redevelopment of the *district*.⁵⁵ These provisions, read together, permitted the TIF plans for TIF districts with certification request dates on or after August 1, 1979 and on or before June 30, 1982 to authorize tax increment to be spent only on costs of

⁵³ Minn. Stat. § 469.176, subd. 3(a) (1998).

⁵⁴ Minn. Stat. § 273.74, subd. 1 (Supp. 1979).

⁵⁵ Minn. Stat. § 273.74, subd. 3 (Supp. 1979).

activities within each “district.” The word “district” was defined to be synonymous with “tax increment financing district,” which meant a contiguous or noncontiguous geographic *area within a project* delineated in the TIF plan.⁵⁶ As a result, the TIF plans for TIF districts with certification request dates on or after August 1, 1979 and on or before June 30, 1982 could authorize tax increment to be spent only on costs of activities within each TIF district. Tax increment was permitted to be spent only as provided in the TIF plan.⁵⁷ Therefore, tax increment could be spent only as provided in the TIF plan on costs of activities within the TIF district.

A TIF authority was permitted to use tax increment to pay principal and interest on bonds issued to finance a project and to pay expenditures by a municipality to finance the capital and administration costs of a development district.⁵⁸ As discussed above, the same statute required all tax increment to be used in accordance with the TIF plan, and the TIF plan could authorize tax increment to be spent only on costs of activities within the TIF district. Therefore, tax increment could be spent on project costs only to the extent the activities of the project were within the TIF district. Consequently, if the area of the project (*e.g.*, development district) was larger than the TIF district contained within it, the TIF authority could not use tax increment to pay for costs of activities in the part of the project area that was outside the TIF district.

In 1982, the Legislature was asked to permit tax increment to be spent on costs of activities outside the geographic boundaries of the TIF district that generated the increment. In response, the Legislature amended the language of Minn. Stat. § 273.74, subd. 1 and Minn. Stat. § 273.74, subd. 3 to substitute “project” for “district” in several places:

A tax increment financing plan shall contain:

(a) A statement of objectives of an authority for the improvement of a ~~district~~.
~~The plan shall contain project;~~

(b) A statement as to the development program for the ~~district project~~, including the property within the ~~district project~~, if any, which the authority intends to acquire. ~~It shall also contain;~~

* * *

(e) Estimates of the following:

(1) Cost of the ~~district project~~, including administration expenses[.]

Laws 1982, ch. 523, art. 38, sec. 3 (amending Minn. Stat. § 273.74, subd. 1).

⁵⁶ Minn. Stat. § 273.73, subd. 9 (Supp. 1979).

⁵⁷ Minn. Stat. § 273.75, subd. 4 (Supp. 1979).

⁵⁸ Minn. Stat. § 273.75, subd. 4 (Supp. 1979).

Before or at the time of approval of the tax increment financing plan, the municipality shall make the following findings, and shall set forth in writing the reasons and supporting facts for each determination:

* * *

(d) That the tax increment financing plan will afford maximum opportunity . . . for the development or redevelopment of the district project by private enterprise.

Laws 1982, ch. 523, art. 38, sec. 5 (amending Minn. Stat. § 273.74, subd. 3). These changes were made for the specific purpose of permitting tax increment to be spent on activities outside the geographic boundaries of the TIF district that generated the increment but within the broader project area that contained the TIF district.

The effective date of these changes, however, made them applicable only to new TIF districts for which certification was requested *after* June 30, 1982.⁵⁹ The language of this effective-date provision is unambiguous and clearly demonstrates that the Legislature intended the change in the law to permit pooling to apply *only* to TIF districts with certification request dates after June 30, 1982.

There is no dispute at the state level regarding the legislative history or intent of the TIF Act's initial lack of authorization to pool tax increment. Members of the House of Representatives Research Department, Senate Counsel and Research Department, and the Office of the Legislative Auditor agree that pooling from a TIF district with a certification request date on or after August 1, 1979 and on or before June 30, 1982 is not permitted.

As recently as 1997, the Legislature confirmed that pooling tax increment from pre-1982 TIF districts was not permitted in the language of legislation that authorized additional pooling authority for TIF authorities which experience a shortfall in tax increment revenue due to recent property tax class rate changes:

Notwithstanding the provision of Minnesota Statutes, section 469.1763, subdivision 2, *and the provisions of the tax increment financing act in effect for districts for which the request for certification was made before June 30, 1982*, revenues derived from increments may be spent on activities located outside of the district to pay binding obligations entered into before the day following final enactment. The amount qualifying under this subdivision to be spent outside the district is limited to an amount necessary to meet a binding obligation of the other district that cannot be paid by the other district because of the reduction in class rates under this section. Use of increments under this authority must be approved, in writing, by the commissioner of revenue.

⁵⁹ Laws 1982, ch. 523, art. 38, sec. 16.

Laws 1997, ch. 231, art. 1, sec. 19 (emphasis added). If pooling of tax increment from pre-1982 TIF districts were permitted already, the language italicized above would be unnecessary.

In responding to the OSA's notices of noncompliance on this issue, municipalities have suggested that if the Legislature wanted to prohibit pooling, it was required to enact a law stating that pooling was prohibited. The OSA disagrees with this position. Tax increment financing is a statutory tool. The TIF Act is an exception to the general rule of law that all property tax revenue must be distributed to the city/town, county, school district and any special taxing districts that levied the property taxes. Local governments may not create TIF districts or use tax increment in any manner unless authorized to do so by law. Absent statutory authorization, pooling is not permitted.

According to information reported by municipalities to the OSA for the year ended December 31, 1997, a total of 73 TIF districts have certification request dates on or after August 1, 1979 and on or before June 30, 1982. The following 54 TIF authorities created these TIF districts:

Barnum, City of	Long Lake, City of	Robbinsdale, City of
Chaska EDA	Luverne, City of	Rush City, City of
Cokato, City of	Madelia, City of	Rushford, City of
Coon Rapids, City of	Madison Lake, City of	St. Anthony, City of
Deephaven, City of	Mahtomedi, City of	St. Paul HRA
Dodge Center, City of	Mankato, City of	St. Paul Port Authority
Duluth EDA	Maple Grove, City of	Savage, City of
Duluth-Seaway Port Authority	Mendota Heights, City of	Shakopee, City of
Faribault, City of	Milaca, City of	Sleepy Eye, City of
Fergus Falls, City of	Minneapolis Community Development Agency	Truman, City of
Foley, City of	Montevideo, City of	Vernon Center, City of
Forest Lake, City of	New Brighton, City of	Virginia, City of
Fridley, City of	New Hope, City of	Waconia, City of
Golden Valley, City of	New Prague, City of	Watertown, City of
Good Thunder, City of	Olivia EDA	Wells, City of
Hibbing, City of	Owatonna, City of	Willmar, City of
Lakeville, City of	Pine Island, City of	Winona, City of
Le Sueur EDA	Redwood Falls, City of	Zumbrota EDA

This list does not include TIF authorities with TIF districts with certification request dates on or after August 1, 1979 and on or before June 30, 1982 if the municipality and TIF authority were not required to file TIF reports regarding these districts for the year ended December 31, 1997.

The OSA has not yet determined how many of the TIF authorities listed above have improperly pooled tax increment from their TIF districts with certification request dates on or after August 1, 1979 and on or before June 30, 1982. TIF authorities are required to report the amount of tax

increment pooled from each TIF district, regardless of its certification request date.⁶⁰ Of the TIF authorities listed above, only the cities of Cokato, New Hope, and St. Anthony reported that they had pooled tax increment from their TIF districts with certification request dates on or after August 1, 1979 and on or before June 30, 1982. The reports that indicated no tax increment had been pooled, however, may not be reliable. The OSA has found that the cities of Deephaven, Fergus Falls, and Foley pooled tax increment from their TIF districts with certification request dates on or after August 1, 1979 and on or before June 30, 1982, yet none of these TIF authorities reported that they pooled tax increment from these TIF districts.⁶¹ In carrying out its TIF statutory oversight responsibilities, the OSA likely will issue additional notices of noncompliance finding that TIF authorities have improperly pooled tax increment from TIF districts with certification dates on or after August 1, 1979 and on or before June 30, 1982, unless the Legislature changes the law.

The OSA believes that no statutory change is necessary to clarify this issue. The Legislature was asked to address this issue in 1982, and it declined to amend the TIF Act retroactively to permit pooling of tax increment from TIF districts with certification dates on or after August 1, 1979 and on or before June 30, 1982. This Legislature, however, may wish to address this issue through statutory change rather than continue to deal with special-law bills regularly introduced on behalf of local governments that have received notices of noncompliance.

B. EXCESS TAX INCREMENT AND VIOLATION PAYMENT STATUTES

If the Stearns County HRA had returned to the county auditor the \$493,305 from TIF District 15 that the OSA found was excess tax increment, the county auditor would have distributed it as follows:

[T]he county auditor . . . shall distribute the excess amount to the municipality, county, and school district in which the tax increment financing district is located in direct proportion to their respective local tax rates.

Minn. Stat. § 469.176, subd. 2 (1998). When the TIF Act uses the word “municipality,” it usually means the municipality that approved the TIF plan for the district.⁶² In this case, Stearns County was

⁶⁰ TIF authorities are required to publish an annual disclosure statement providing information about each of their TIF districts, including “the sum of increments paid, directly or indirectly, for activities and improvements located outside of the district.” Minn. Stat. § 469.175, subd. 5(b) (1998). In addition, the OSA requires TIF authorities to report this information in the TIF Authority Report.

⁶¹ In addition to these cities, the cities of Cambridge and Forest Lake also received notices of noncompliance finding that they improperly pooled tax increment from TIF districts with certification requests dates on or after August 1, 1979 and on or before June 30, 1982. These cities were not listed above because they were not required to file TIF reports for these districts for the year ended December 31, 1997.

⁶² *See, e.g.*, Minn. Stat. §§ 469.175, subd. 3 and 6a; 469.176, subd. 1(a); 469.1771, subd. 1(c) and subd. 5 (1998). The definition of “municipality” is not helpful in resolving this issue. *See* Minn. Stat. § 469.174, subd. 6 (1998).

the municipality that approved the TIF plan for TIF District 15. If the word “municipality” in the excess tax increment statute means Stearns County, then the county auditor would have been required to distribute the excess tax increment to Stearns County as the municipality, Stearns County as the county, and the school district in direct proportion to their respective local tax rates. It is not clear that the Legislature intended this result.

The OSA believes that the Legislature intended “municipality” in the excess increment statute to mean the city or town in which the TIF district is located, which is not necessarily the municipality that approved the TIF plan for the district. The OSA bases this interpretation on the listing of the three primary taxing jurisdictions—“the municipality [city or town], county, and school district,” the reference to “their respective local tax rates,” and the use of the phrase “in which the [TIF] district is located.” The OSA recommends that this issue be clarified by striking the word “municipality” and inserting the words “city or town” in the excess tax increment statute. The OSA further recommends that the effective date of this amendment be retroactive, so that it applies to all TIF districts with certification request dates on or after August 1, 1979.

The excess tax increment statute is not the only provision of the TIF Act that requires a TIF authority to make payments to the county auditor. If a TIF authority receives tax increment it was not entitled to receive or it spends tax increment in a manner not permitted by law, it must pay the county auditor an amount equal to the amount of tax increment it improperly received or spent.⁶³

When the county auditor receives a payment from a TIF authority for a violation, the county auditor must distribute the money as if it were returned excess tax increment, with one exception. If the county auditor receives the TIF authority’s payment more than 60 days after the municipality’s receipt of a notice of noncompliance requiring the payment, then no distribution is made to the municipality that approved the TIF district.⁶⁴ Clarifying the excess tax increment statute by striking the word “municipality” and inserting the words “city or town” also will clarify the statute regarding the redistribution of violation payments. If the city or town is the municipality that approved the TIF district and the violation payment is received after the 60-day period, the county auditor will distribute the money from the payment only to the county and the school district. If the county is the municipality that approved the TIF district and the violation payment is received after the 60-day period, the county auditor will distribute the money only to the city or town and the school district.⁶⁵ The OSA recommends that this issue be clarified through statutory change.

C. SPENDING TAX INCREMENT IN EXCESS OF LINE-ITEM BUDGET AMOUNTS

A TIF plan must include a line-item budget, because a TIF authority is required to report the line-item budget contained in the TIF plan:

⁶³ Minn. Stat. § 469.1771, subd. 2 and 3 (1998).

⁶⁴ Minn. Stat. § 469.1771, subd. 5 (1998).

⁶⁵ In this situation, without the clarification, one could conclude that the county, as both the municipality and the county, should receive nothing, and therefore all the money should be distributed to the school district.

(c) The annual financial report must also include the following items:

* * *

(3) for the reporting period and for the duration of the district, ***the amount budgeted under the tax increment financing plan***, and the actual amount expended for, at least, the following categories: (i) acquisition of land and buildings through condemnation or purchase; (ii) site improvements or preparation costs; (iii) installation of public utilities, parking facilities, streets, roads, sidewalks, or other similar public improvements; (iv) administrative costs, including the allocated cost of the authority; (v) public park facilities, facilities for social, recreational, or conference purposes, or other similar public improvements[.]

Minn. Stat. § 469.175, subd. 6(c)(3) (1998) (emphasis added). This requirement for each district's TIF plan to include a line-item budget for the use of tax increment from the ***TIF district*** (and all public funds to be spent in the district) is in addition to the requirement to include an estimate of the cost of the ***project***.⁶⁶ Tax increment may be spent only as authorized in the TIF plan.⁶⁷ If, for example, a TIF-plan budget indicates that the TIF authority will spend \$100,000 of tax increment from the TIF district on site improvements and the TIF authority spends \$125,000 on site improvements, the TIF authority has not spent tax increment as authorized in the TIF plan. It is the OSA's position that such unauthorized spending of tax increment violates the TIF Act.

In responses to notices of noncompliance containing findings on this issue, municipalities have responded that there was no legal obligation for a TIF authority to include a line-item budget in the TIF plan, and therefore a TIF authority does not violate the TIF Act when it spends more tax increment on a line item (*e.g.*, site improvements) than the amount that the TIF plan authorized for that item. Municipalities also have asserted that TIF authorities and municipalities throughout the state believe the TIF Act requires a TIF plan only to include estimates of costs which TIF authorities may exceed without consequence, provided the total tax increment expenditures do not exceed the total estimated tax increment expenditures in the TIF plan. These municipalities have requested the OSA to seek legislative clarification of the statutory provision regarding line-item budgets before issuing any notices of noncompliance based on this issue.

The OSA has found a number of TIF authorities that have disregarded line-item budgets, and employees of and attorneys for local governments have informed the OSA that disregarding line-item budgets is a widespread practice. While the number of local governments that engage in a practice

⁶⁶ See Minn. Stat. § 469.175, subd. 1(a)(5)(i) (1998).

⁶⁷ Minn. Stat. § 469.176, subd. 4 (1998).

does not negate a statutory limitation, it raises concerns about statewide enforcement of this issue by the OSA. Therefore, the OSA recommends that this issue be clarified through statutory change.⁶⁸

The OSA distinguishes the line-item-budget issue from situations where a TIF-plan budget contains no authorization to spend tax increment for a particular category of costs (*e.g.*, land acquisition) and the TIF authority spends tax increment on such a cost. Tax increment may be spent only as authorized in the TIF plan.⁶⁹ If a TIF authority spends tax increment on a category of costs not included in the TIF-plan budget, the OSA will find that the TIF authority is not in compliance with the TIF Act.

D. ENDING DISTRIBUTION OF TAX INCREMENT IN MID-YEAR

As discussed in section II.C. on page 17 of this report, the OSA found that the City of St. James received tax increment from an economic development district after the statutory maximum duration limit for the TIF district. For economic development districts with certification request dates on or before May 31, 1993, the TIF authority may not receive tax increment from the economic development district after eight years from the date of the first receipt of increment, or ten years from approval of the TIF plan, whichever is earlier.⁷⁰

If a municipality approved the TIF plan for an economic development district during the period from mid-July through mid-November and the duration limit measured from approval of the TIF plan is earlier than the duration limit measured from the first receipt of increment, the TIF authority may not receive tax increment from the second-half property taxes during the year in which the TIF district is decertified. In contrast, if the duration limit measured from the first receipt of increment is earlier, a statute explicitly provides that the TIF authority is entitled to receive all tax increment from taxes payable during the year in which the TIF district is decertified:

For purposes of determining a duration limit under this subdivision or subdivision 1e that is based on the receipt of an increment, any increments from taxes payable in the year in which the district terminates shall be paid to the authority. This paragraph does not affect a duration limit calculated from the date of approval of the tax increment financing plan[.]

⁶⁸ In the meantime, the OSA has discontinued making findings that a TIF authority violates the TIF Act by spending more tax increment on a line item than the TIF plan authorized. The OSA may resume making findings of noncompliance on this issue depending upon what action, if any, the Legislature takes.

⁶⁹ Minn. Stat. § 469.176, subd. 4 (1998).

⁷⁰ *See, e.g.*, Minn. Stat. § 273.75, subd. 1 (1979) and Minn. Stat. § 469.176, subd. 1(e) (Supp. 1987). For economic development districts with certification request dates after May 31, 1993, the TIF authority may not receive tax increment from the economic development district after nine years from the date of the first receipt of increment, or eleven years from approval of the TIF plan, whichever is earlier. Laws 1993, ch. 375, art. 14, sec. 10 and 24.

Minn. Stat. § 469.176, subd. 1b(b) (1998). TIF authorities such as the City of St. James have asserted they should be able to receive all increment from taxes payable in the year in which the TIF district is decertified, notwithstanding that under some circumstances the law does not permit this. County auditors have informed the OSA that it is inconvenient for them to halt distribution of tax increment during the middle of a year, because the property tax computer software calculates settlements of tax increment for the entire year. The OSA recommends that the Legislature consider whether the law should continue to require some economic development districts to be decertified in the middle of a taxes-payable year.

E. WAIVING RECEIPT OF FIRST TAX INCREMENT TO DELAY START OF DURATION LIMIT

Most of the statutory maximum duration limits are measured from the receipt of the first tax increment of the TIF district. A small increase in the market value of property in a TIF district might occur before any new development has occurred in the TIF district. This small increase in market value might result in a small amount of tax increment being generated. TIF authorities assert that they will not have adequate tax increment to fund proposed developments if their receipt of a small amount of tax increment starts the TIF district's duration limit. They would prefer to waive receipt of a small amount of tax increment during an early year in the life of the TIF district to obtain an additional year of a larger amount of tax increment (produced by the new development) at the end of the TIF district's life span.

For housing and redevelopment districts and hazardous substance subdistricts, the TIF Act provides a mechanism for delaying the first receipt of tax increment. The TIF authority may provide in the TIF plan, development agreement, or assessment agreement that tax increment will not be generated for the first time until 1) the market value of property in the TIF district reaches a minimum market value set in the plan or agreement, or 2) four years has elapsed since certification of the TIF district, whichever is earlier.⁷¹ If the TIF plan, development agreement, or assessment agreement contains a minimum-market-value provision, a small increase in market value that otherwise would result in tax increment being generated will not produce any tax increment. Consequently, the start of the TIF district's duration limit will be delayed.⁷²

This provision does not apply to other types of TIF districts, such as economic development districts. It is the OSA's position that when tax increment is first generated, it must be distributed to the TIF authority, and the duration of the TIF district must start; the only way to prevent the distribution of a small amount of tax increment starting the duration of the TIF district is to prevent the small amount of tax increment from being generated. The TIF Act does not permit a TIF authority to waive the first receipt of increment in order to delay the start of a TIF district's duration limit.

⁷¹ Minn. Stat. § 469.175, subd. 1(b) (1998).

⁷² If a TIF authority elects to use this mechanism to delay the start of the TIF district's duration, however, the maximum duration limit is reduced to 20 years after the first receipt of tax increment. Minn. Stat. § 469.176, subd. 1b(a)(5) (1998).

Municipalities have argued that their TIF authorities have a right to waive receipt of tax increment absent an explicit statutory prohibition against doing so. The OSA believes that no statutory change is necessary to clarify or address this issue.

F. INTEREST ON LOANS MADE WITH TAX INCREMENT

In 1997, the Legislature defined tax increment to include—

- (1) taxes paid by the captured net tax capacity, but excluding any excess taxes, as computed under section 469.177;
- (2) the proceeds from the sale or lease of property, tangible or intangible, purchased by the authority with tax increments;
- (3) repayments of loans or advances made by the authority with tax increments; and
- (4) interest or other investment earnings on or from tax increments.

Laws 1997, ch. 231, art. 10, sec. 2 (enacting Minn. Stat. § 469.174, subd. 25). Items (1) and (4) have one effective date, and items (2) and (3) have a different effective date. If a TIF authority uses tax increment to make an interest-bearing loan to a developer, the question arises whether (A) the interest paid by the developer becomes tax increment upon the effective date of item (4), “interest or other investment earnings on or from tax increments,”⁷³ and the principal repaid by the developer becomes tax increment upon the effective date of item (3), “repayments of loans or advances made by the authority with tax increments,”⁷⁴ or (B) the entire payment of principal and interest would be categorized under item (3).

It is the OSA’s position that approach (A) is more consistent with the language and the Legislature’s intent in enacting Minn. Stat. § 469.174, subd. 25. An attorney for a city, however, has advised the city that only reserve tax increment that has not yet been spent on project costs earns interest that is “interest or other investment earnings on or from tax increments” under item (4), and therefore interest earned on a loan to a developer for a project purpose is not included in item (4). Clarification of this issue would assist local governments in their compliance with the TIF Act. Absent any statutory change, the OSA will continue to address this issue as outlined above.

G. COMMINGLING OF TAX INCREMENT WITH OTHER KINDS OF MONEY

A provision in the TIF Act requires a TIF authority to segregate tax increment from each TIF district in a special account on the TIF authority’s books and records.⁷⁵ In auditing expenditures of tax

⁷³ Item (4) is effective for TIF districts with certification request dates after July 31, 1979 and payments and investment earnings received after July 1, 1997. Laws 1997, ch. 231, art. 10, sec. 25.

⁷⁴ Item (3) is effective for TIF districts with certification request dates after June 30, 1982 and repayments of advances and loans if those advances or loans were made after June 30, 1997. Laws 1997, ch. 231, art. 10, sec. 25.

⁷⁵ Minn. Stat. § 469.177, subd. 5 (1998).

increment, the OSA reviews whether a TIF authority has an accounting system that allows it to establish which expenditures were paid with tax increment from a particular TIF district and which were paid with some other source of revenue. A TIF authority may spend tax increment only as authorized by the TIF Act and bears the burden of demonstrating it has complied with the law.

The OSA has found that it is common practice for a TIF authority to have a separate capital project fund for each TIF district and to deposit into the fund all sources of revenue that will be used to pay for the public investment in the development to be assisted by each TIF district. For example, a TIF authority might deposit into the capital project fund for TIF District 1 the tax increment from the TIF district, plus special assessment revenue collected from property in the district, plus a grant from the Department of Trade and Economic Development obtained to assist the development in the TIF district. In addition, the TIF authority might deposit in the fund the interest earned on the balance in the fund.⁷⁶

The practice of depositing tax increment and non-tax increment revenues into the same fund may or may not violate the requirement to segregate the tax increment from each TIF district in a special account. If the TIF authority records each deposit of money into the fund as a deposit into a revenue account for that specific kind of money (*e.g.*, tax increment, special assessments, grant, interest earnings), and codes each expenditure as being from a particular kind of revenue within the fund, then the tax increment will be segregated. The TIF authority will be able to demonstrate which expenditures were made with tax increment, which were not, and how much tax increment is left.

It appears that many TIF authorities record each deposit of money into the fund as a deposit into a revenue account for that specific kind of money, but do not code the expenditures in a like manner. The result of this practice is that the TIF authority cannot demonstrate whether tax increment or some other kind of money was used to make a particular expenditure, and cannot demonstrate how much tax increment remains in the fund. In such a situation, the deposit of non-tax increment revenue in the same fund with tax increment results in the improper commingling of these different kinds of money.

The consequences of commingling become apparent when the OSA finds that a particular expenditure was improper or the balance in a fund is excess tax increment that must be returned to the county auditor. In responding to these findings, municipalities have asserted that a TIF authority should be able to declare the source of revenue used to make an expenditure many years after the expenditure was made. If the OSA finds that an expenditure early in the life of a TIF district violated

⁷⁶ Some interest earned on tax increment balances is tax increment and some is not, depending on the certification request date of the TIF district and when the interest revenue is received. *See* Minn. Stat. § 469.174, subd. 25 (1998). *See also* section III.F. on page 32 of this report. Most TIF authorities deposited interest earned on tax increment in the same fund as the tax increment, and did not code expenditures so that it can be determined which were made with “raw” tax increment and which were made with interest earned on tax increment. These TIF authorities will not be able to demonstrate that a particular expenditure was made with interest that is not tax increment, rather than with tax increment, if the OSA finds that the expenditure violated the TIF Act.

the TIF Act, the TIF authority will declare that the expenditure was made with non-tax increment revenue. If the OSA finds that the balance in the fund is excess tax increment, the TIF authority will declare that all the early expenditures were made with tax increment, and therefore the remaining balance is non-tax increment revenue. It is the OSA's position that such arguments are not valid in the absence of accounting records that verify what kinds of revenue was spent on specific costs and what kinds of revenue constitute the fund balance.

The OSA believes that no statutory change is necessary to clarify this issue. If the TIF authority's accounting system does not allow it to demonstrate that an identified expenditure was made with non-tax increment revenue rather than tax increment, the OSA will continue to issue its findings. Similarly, if the TIF authority's accounting system does not allow it to demonstrate which expenditures were made with tax increment, and consequently it cannot demonstrate how much tax increment remains in the fund, the OSA will continue to issue its findings.

H. PAYING FOR LAND ACQUISITION WHEN NO LAND WAS ACQUIRED

The OSA has discovered a number of situations where a TIF plan provides that the TIF authority will spend tax increment to acquire land, and the TIF authority reported spending tax increment for "land acquisition," but the TIF authority acquired no land in connection with the development. Instead, the developer purchases the land, or it is land the developer has owned for years before the new development, and the TIF authority reimburses the developer for some or all of its "land acquisition" cost. This practice frequently is referred to as a "land write down," because it produces the same economic result as if the TIF authority had acquired the property and then resold it to the developer for a lesser amount.

It appears that TIF plans state that the TIF authority will acquire and resell property because many of the economic development authority statutes do not permit the authority to use public funds to reimburse a developer for land acquisition costs it incurred.⁷⁷ TIF authorities argue that they should not be required to acquire property and then resell it because of the cost added by such transactions and the risk of incurring liability from being in the chain of title. This practice, however, is contrary to existing law. The OSA recommends that the Legislature review this issue.

The more troubling issue is the practice of reimbursing a developer for "land acquisition" costs in a situation where the developer for years has owned the property to be developed. To create a TIF district, the municipality must find that the proposed development would not have occurred but for the use of tax increment.⁷⁸ When the tax increment is used primarily to reimburse the developer for land purchased years before the proposed development occurs, it casts doubt on the validity of the municipality's "but for" finding. Moreover, the fact that the TIF authority characterized the payment to the developer as being for land acquisition, rather than as payment or reimbursement of a cost directly associated with the new development, fuels the perception that there were no other costs

⁷⁷ See, e.g., Minn. Stat. §§ 469.012, subd. 1(6), (7), (21), and (30); 469.059, subd. 2, 4, and 12; 469.101, subd. 2, 4, 5, 10, and 18; and 469.126, subd. 2(1), (2), and (8) (1998).

⁷⁸ See Minn. Stat. § 469.175, subd. 3(2) (1998).

associated with the new development that legally could be paid with tax increment. The OSA recommends that the Legislature review this public policy issue.

I. DIFFERENCES BETWEEN LAWS AUTHORIZING ADDITIONAL POOLING

In 1997, the Legislature enacted an uncodified law which appropriated money to the Department of Revenue to make grants to any municipality (*i.e.*, a city or county) that has TIF districts which will not generate sufficient tax increment to pay the existing, binding obligations of those TIF districts due to reductions in property tax class rates also enacted in 1997.⁷⁹ This law also authorized the municipality to apply to the Department of Revenue for authorization to pool tax increment from a TIF district, even if the law otherwise did not permit pooling from that district because it had a certification request date before June 30, 1982, or even if the pooling would exceed the applicable statutory limit,⁸⁰ to cover a shortfall on the existing, binding obligations of another TIF district caused by the class rate reductions.⁸¹ This law did not address whether the Department of Revenue could authorize pooling of tax increment from one TIF district created by a TIF authority (*e.g.*, a port authority) to a TIF district created by a different TIF authority (*e.g.*, an economic development authority).

In 1998, the Legislature enacted a statute which authorizes cities to create special taxing districts to generate property tax revenue necessary to cover shortfalls on the existing, binding obligations of their TIF districts because of reductions in the property tax class rates enacted during 1997 and 1998.⁸² The statute also authorizes a city to require a TIF authority to transfer any available tax increment from one of its TIF districts to any TIF district in the city that will not have sufficient revenue to cover its existing, binding obligations because of the class rate reductions, even if the TIF district with the shortfall was created by a different TIF authority than the one that created the district that transfers the tax increment.⁸³ The statute does not address whether a city may require a TIF authority to transfer tax increment even if the law does not permit pooling of tax increment from the transferring district or even if the transfer would exceed the applicable limit on pooling. The statute does not require the city to apply to the Department of Revenue for authorization to make the transfer of tax increment. Finally, the statute does not apply to TIF districts created by county TIF authorities and located outside any city.

Thus, the provisions in the 1997 uncodified law and the 1998 statute that authorize pooling are materially different in four respects: 1) the former applies to all municipalities (*i.e.*, cities or counties), whereas the latter applies only to cities; 2) the former authorizes pooling even when the

⁷⁹ Laws 1997, ch. 231, art. 1, sec. 19, subd. 1 and 3.

⁸⁰ *See* Minn. Stat. § 469.1763, subd. 2 (1998).

⁸¹ Laws 1997, ch. 231, art. 1, sec. 19, subd. 2.

⁸² Laws 1998, ch. 389, art. 11, sec. 10 (enacting Minn. Stat. § 469.1791).

⁸³ Minn. Stat. § 469.1791, subd. 3(c) (1998).

general law does not or the pooling would exceed the applicable statutory pooling limit, whereas the latter does not; 3) the former requires the municipality to apply to the Department of Revenue for permission to pool tax increment, whereas the latter does not require the city to apply; and 4) the latter permits a city to require a TIF authority to transfer tax increment to a TIF district even if the TIF district with the shortfall was created by a different TIF authority than the one that created the district that transfers the tax increment, whereas the former does not give this power to a municipality. It is not clear that the Legislature intended these differences between the 1997 uncodified law and 1998 statute. The OSA recommends that the Legislature review this issue.

J. ISSUES RAISED IN MEMORANDUM TO TIF RECODIFICATION TASK FORCE

The Tax Increment Financing Recodification Task Force completed its work by recommending that the Legislature not recodify the TIF Act. Instead, the task force forwarded to the Legislature a list of statutory issues for the Legislature to consider addressing. A copy of this list, in the form of a memorandum from Joel Michael of the House Research Department to members of the task force, is included in Appendix E.

The OSA contributed a number of the statutory issues included in this list. The fact that the OSA identified an issue, however, does not mean that the OSA believes the relevant statute is ambiguous. The list also identifies a number of provisions in the TIF Act that the OSA believes are ambiguous or, if applied literally, would lead to an absurd result. For example, if the definition of “administrative expenses” were applied literally, payments of principal on tax increment financing bonds and payments of principal and interest on pay-as-you-go obligations would be included in administrative expenses.⁸⁴ It is the OSA’s position that the Legislature did not intend this result. In addition, the OSA has been unable to apply the statute that places a restriction on the amount of land that a TIF authority may acquire using the proceeds of tax increment financing bonds.⁸⁵

The OSA recommends that the Legislature examine these issues to determine if the law is clearly stated and consistent with good public policy, and enact changes to the TIF Act where necessary.

⁸⁴ See Minn. Stat. § 469.174, subd. 14 (1998). See also item number 2 on page 1 of the December 17, 1998 memorandum.

⁸⁵ See Minn. Stat. § 469.176, subd. 5 (1998). See also item number 12 on page 3 of the December 17, 1998 memorandum.

IV. CONCLUSION

In December 1998, the TIF Division moved its offices to a new location:

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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.

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