



MINNESOTA OFFICE OF THE STATE AUDITOR

TAX INCREMENT FINANCING REPORT

MARCH 10, 1998

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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 the state's more than 1,800 tax increment financing (TIF) districts to the Office of the State Auditor (OSA). 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 increments 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, para. (c) (1996).

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 increments 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. Who Uses Tax Increment Financing?

The TIF Act authorizes TIF authorities to create TIF districts. TIF authorities include housing and redevelopment authorities, economic development authorities, port authorities, rural development authorities, cities, and counties. In 1996, there were nearly 400 TIF authorities with active TIF districts. The TIF authority takes the first step in creating a TIF district by adopting a TIF plan for the district. The TIF plan provides information about the project being funded by tax increment from the TIF district, authorizes the use of tax increment from the district to pay TIF-eligible project costs, and establishes a budget for tax increment expenditures.⁴

The governing body of the jurisdiction in which the TIF district is located must approve the TIF plan for the district.⁵ For example, 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. 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.

Before a TIF district is created, the TIF authority must provide certain information about the proposed 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.⁶ The county board and school board

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, plus reasonable interest. 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 Minn. Stat. § 469.175, subd. 1 and subd. 6, para. (c)(3) (1996).

⁵ Minn. Stat. § 469.175, subd. 3 (1996).

⁶ Minn. Stat. § 469.175, subd. 2 (1996).

may comment on the proposed district, but cannot prevent the creation of the district (except that the county board may prevent creation of the district if the county is the municipality that must approve the TIF plan).

3. Overview of Tax Increment Financing Act

The Minnesota Tax Increment Financing Act⁷ (TIF Act) governs the creation and administration of TIF districts. 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
- 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 limitations, and different restrictions on the use of tax increment from the district:

- Pre-1979 districts;
- Redevelopment districts;
- Renovation and renewal districts;
- Soils condition districts;

⁷ 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.

- Housing districts;
- Economic development districts;
- Mined underground space districts; and
- Hazardous substance subdistricts.

A related statute⁸ 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.⁹

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

C. OSA'S TIF ENFORCEMENT AUTHORITY

The 1995 Omnibus Tax Act transferred the responsibility for ensuring that local governments comply with the TIF Act from the Department of Revenue to the OSA.¹⁰ 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.¹¹ 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.¹²

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 and three TIF auditors.

The operations of the TIF Division are funded exclusively from revenue derived by deducting 0.10 percent of all tax increment that county treasurers distribute to TIF authorities and municipalities. The county treasurers deduct the revenue before distributing the tax increment to the local

⁸ Minn. Stat. § 273.1399 (Supp. 1997).

⁹ 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.

¹⁰ Laws 1995, ch. 264, art. 5, sec. 34.

¹¹ Minn. Stat. § 469.1771, subd. 1, para. (b) (1996).

¹² 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.

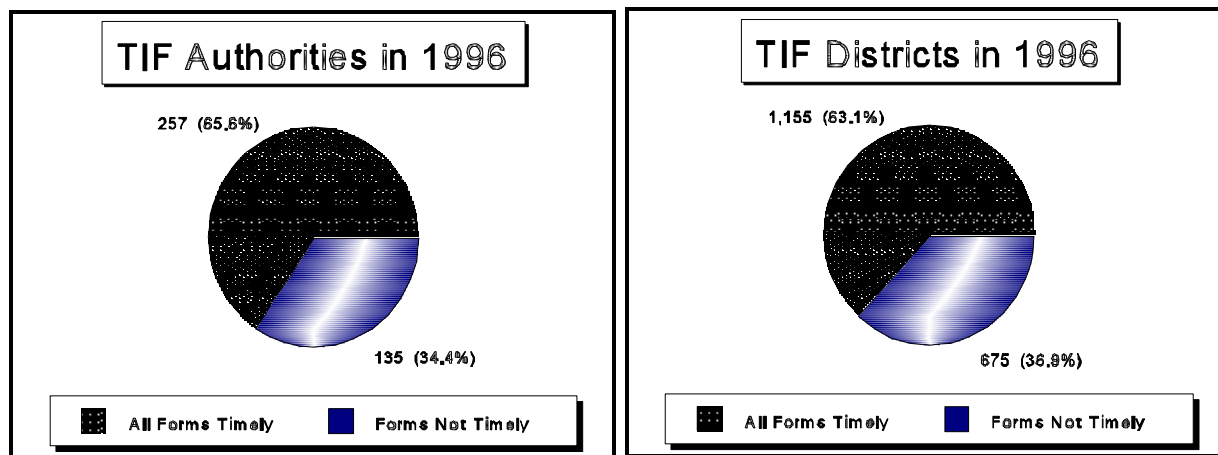
governments, and then pay the deducted revenue to the state treasurer. The amount of revenue to fund the TIF Division will vary with the number of TIF districts and the amount of tax increment they produce.

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.¹³ 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 must submit the required information to the OSA on or before July 1 of each year.

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 “Authority Report,” “Municipality Report,” and “Pooled Indebtedness Report.” 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.¹⁴ The OSA’s reporting format is relatively unchanged from that used by the Department of Revenue before responsibility for TIF enforcement was transferred to the OSA.

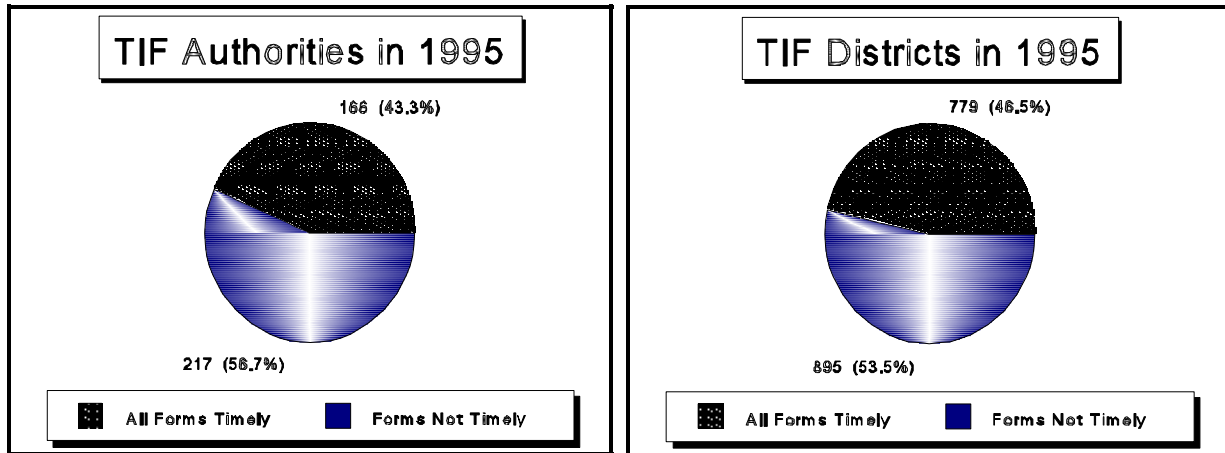
The quality and timeliness of the 1996 TIF reports (due on or before July 1, 1997) was improved compared to the 1995 TIF reports (due on or before July 1, 1996). For 1996, the OSA received all of the required reports for 65.6 percent of the TIF authorities and 63.1 percent of the TIF districts. There were 392 TIF authorities and 1,830 TIF districts in 1996.



¹³ See Minn. Stat. § 469.175, subd. 5, 6 and 6a (1996).

¹⁴ 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.

In comparison, for 1995, the OSA received all the required reports for only 43.6 percent of the TIF authorities and 46.6 percent of the TIF districts. There were a total of 383 TIF authorities and 1,674 TIF districts in 1995.



The table below provides information regarding the number of TIF reports that the OSA received during various periods of time for both 1995 and 1996.

	1995 Reports (due on or before July 1, 1996)	1996 Reports (due on or before July 1, 1997)
On or before July 1	166 TIF authorities 779 TIF districts	257 TIF authorities 1,155 TIF districts
July 2 through Aug. 1	394 TIF districts	331 TIF districts
Aug. 2 through Oct. 1	202 TIF districts	188 TIF districts
Oct. 2 through Dec. 1	149 TIF districts	92 TIF districts
After Dec. 1	87 TIF districts	51 TIF districts
Have not filed	63 TIF districts	13 TIF districts

The TIF Division is working continually to update its data base to accurately reflect the numbers of TIF authorities and TIF districts that are required to report and over which the OSA has enforcement authority. Consequently, the numbers presented above may vary slightly from the numbers reported by the OSA prior to the date of this report.

During the course of reviewing the TIF reports, 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. The review of reports by the TIF Division staff and

subsequent contact with reporting local government units has resulted in at least \$726,963 of tax increment being returned voluntarily to county auditors for redistribution.¹⁵ The OSA's TIF enforcement activities may have prompted internal examinations that resulted in additional repayments of tax increment of which the OSA is not aware.

2. TIF Legal Compliance Audits

During the past year, 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 in 1997.

To date, the TIF Division has initiated six on-site legal compliance audits. The TIF Division has issued initial findings of noncompliance regarding several of those audits and will issue final audit findings in the upcoming months.

Most of the TIF authorities that the TIF Division has selected to audit thus far were ones for which the OSA had reasonable evidence that the TIF laws had been violated. Usually, that evidence was provided in the TIF reports filed by the TIF authority and the municipality. In addition, the OSA was requested by a county HRA to conduct an audit of its own TIF districts due to concerns regarding past statutory violations. The TIF Division also selected one TIF authority for audit because its TIF reports were in such good order that a quick completion of the audit was anticipated. The on-site examination, however, revealed significant legal compliance issues that have required further review.

3. Education

In addition to collecting and reviewing the annual TIF reports and conducting legal compliance audits, 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 TIF statutes by local governments utilizing TIF was a primary factor behind many legal compliance issues. Since the OSA's 1997 Tax Increment Financing Report was issued, TIF Division staff have spoken at 14 educational seminars on the topic of tax increment financing and the OSA's oversight role. The OSA has participated in seminars presented by a variety of organizations including the League of Minnesota Cities, the Minnesota Association of County Officers, the Minnesota Association of Small Cities, the Minnesota Institute of Legal Education, the Minnesota Government Finance Officers Association, and the Minnesota Society of Certified Public Accountants.

¹⁵ See Minn. Stat. §§ 469.176, subd. 2, and 469.1771, subd. 2 and 3 (1996).

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.¹⁶ 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 contain notice to the TIF authority that it must pay an amount of money to the county auditor as required to redress certain violations of the TIF Act.¹⁷

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.¹⁸

The OSA 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.¹⁹ In addition, the OSA must provide all information regarding unresolved findings of noncompliance to the county attorney, who may bring an action to enforce the TIF Act.²⁰

A. FAILURE TO SUBMIT 1996 TIF REPORTS

The TIF Act requires TIF authorities and municipalities to submit information regarding their TIF districts to the OSA on or before July 1 of each year.²¹ Information regarding the timeliness of TIF report filing for 1995 and 1996 is provided on pages 5-6 of this report.

From July to November 1997, the OSA mailed noncompliance notices to the governing bodies of 98 municipalities to inform them that the OSA had not received 1996 TIF reports for one or more of the TIF districts in those municipalities on or before July 1, 1997. Appendix A contains copies of those noncompliance notices, and any responses to them, for the following municipalities:

Annandale, City of
Arlington, City of
Aurora, City of

Bagley, City of
Barnum, City of
Bayport, City of

Becker, City of
Blaine, City of
Boyd, City of

¹⁶ Minn. Stat. § 469.1771, subd. 1, para. (c) (1996).

¹⁷ *See* Minn. Stat. § 469.1771, subd. 2 and 3 (1996).

¹⁸ Minn. Stat. § 469.1771, subd. 1, para. (c) (1996).

¹⁹ Minn. Stat. § 469.1771, subd. 1, para. (c) (1996).

²⁰ Minn. Stat. § 469.1771, subd. 1, para. (b) (1996).

²¹ *See* Minn. Stat. § 469.175, subd. 5, 6 and 6a (1996).

Breckenridge, City of	Hector, City of	Pierz, City of
Browns Valley, City of	Hinkley, City of	Plato, City of
Caledonia, City of	Hollandale, City of	Proctor, City of
Cambridge, City of	Howard Lake, City of	Rice, City of
Chanhassen, City of	Hutchinson, City of	Rogers, City of
Chisago City, City of	Isanti, City of	Royalton, City of
Claremont, City of	Jordan, City of	Rush City, City of
Cokato, City of	Lake City, City of	Rushford, City of
Coleraine, City of	Lake County	St. Clair, City of
Columbia Hghts, City of	Lake Park, City of	St. James, City of
Dassel, City of	Lanesboro, City of	St. Joseph, City of
Dayton, City of	Le Sueur, City of	Sandstone, City of
Delano, City of	Lewiston, City of	Sartell, City of
Dexter, City of	Little Falls, City of	Springfield, City of
Dodge Center, City of	Mabel, City of	Starbuck, City of
Douglas County	Madison, City of	Stearns County, City of
East Grand Forks, City of	Mahnomen, City of	Swanville, City of
Edgerton, City of	Manhattan Beach, City of	Taylors Falls, City of
Elysian, City of	Medina, City of	Verndale, City of
Eveleth, City of	Minneapolis, City of	Virginia, City of
Farmington, City of	Montgomery, City of	Waconia, City of
Fosston, City of	Montrose, City of	Washington County
Fridley, City of	Mounds View, City of	Watertown, City of
Gaylord, City of	Mountain Iron, City of	Wayzata, City of
Glencoe, City of	New Brighton, City of	Wheaton, City of
Grand Rapids, City of	Nisswa, City of	White Bear Lake, City of
Gully, City of	North Branch, City of	Willmar, City of
Halstad, City of	Osseo, City of	Windom, City of
Hanska, City of	Park Rapids, City of	Wyoming, City of
Harmony, City of	Perham, City of	

Some of the municipalities' governing boards responded by filing the required reports, but did not provide written responses to the noncompliance notices. Therefore, for some of the municipalities listed above, Appendix A may contain only a copy of the noncompliance notice.

The OSA has received written responses or materially complete TIF reports for the districts of all of the municipalities listed above except the cities of Annandale (one district), Manhattan Beach (one district), Medina (four districts), and Plato (four districts). The OSA has not received an Authority Report for one of the districts in the City of Annandale. The OSA has received incomplete reports, or other information in lieu of reports, regarding the TIF districts in the cities of Manhattan Beach, Medina, and Plato.

As mentioned above, the OSA mailed a noncompliance notice to the City of Breckenridge. On July 18, 1997, the director of the TIF Division received a telephone call from a Breckenridge official indicating that due to the devastation of the city from the spring flooding, it would be quite some time before the city could prepare and submit the required reports for its two TIF districts. The TIF Division director responded that the OSA would not pursue any sanction against the city. The city recently submitted the reports for its districts.

The OSA referred the matter of the City of Columbia Heights' failure to file its 1996 TIF reports to the Anoka County Attorney by letter dated October 23, 1997. The City of Columbia Heights filed its reports with the OSA on November 3, 1997.

The OSA referred the matter of the City of Manhattan Beach's failure to file its 1996 TIF reports to the Crow Wing County Attorney by letter dated October 24, 1997. The City of Manhattan Beach has not filed completed reports with the OSA. The Crow Wing County Attorney has decided not to commence any legal action against the City of Manhattan Beach at this time because the city has retained a certified public account to prepare its reports.

The OSA referred the matter of the City of Springfield's failure to file its 1996 TIF reports to the Brown County Attorney by letter dated October 24, 1997. The City of Springfield filed its reports with the OSA on January 14, 1998.

B. FAILURE TO SUBMIT 1995 TIF REPORTS

The OSA's 1997 Tax Increment Financing Report included copies of noncompliance notices for failures to file 1995 TIF reports, and any responses to those notices, for the following cities: Browns Valley, Chisago City, Eden Prairie, Elysian, Lakefield, Le Sueur, Milaca, New Brighton, and St. Clair.

In addition, the OSA had mailed noncompliance notices to the governing bodies of 17 other municipalities to inform them that the OSA had not received 1995 TIF reports for one or more of the TIF districts in those municipalities on or before July 1, 1996. The 60 days for the municipalities' governing bodies to respond to the OSA's findings of noncompliance had not expired yet when the OSA issued its 1997 Tax Increment Financing Report; consequently, copies of those notices were not included in the 1997 report. Appendix B contains copies of those noncompliance notices, and any responses to them, for the following municipalities:

Annandale, City of
Chanhassen, City of
Douglas County
Frazee, City of
Gaylord, City of
Harmony, City of

Lake County
Maplewood, City of
Minneapolis, City of
Mountain Lake, City of
North Branch, City of
Park Rapids, City of

Red Lake Falls, City of
Swanville, City of
Waconia, City of
Walker, City of
White, Town of

C. “POOLING” VIOLATIONS

1. City of Foley

The OSA’s 1997 Tax Increment Financing Report included copies of a May 30, 1996 noncompliance notice to the City of Foley and the city’s response. At issue was the city’s use of tax increment from a TIF district created in 1980 to pay bonds used to fund a wastewater treatment plant located outside of the TIF district. The OSA has taken the position that the laws applicable when the TIF district was created did not authorize the use of tax increment generated by the district to pay for any activities outside of the district. The city disagreed with the OSA’s findings and continued to expend tax increment on activities outside of the TIF district’s boundaries.

The Benton County Attorney declined to commence any action against the City of Foley before the 1997 legislative session because the city intended to seek special legislation to legalize its expenditures of tax increment for activities outside of the TIF district. Special legislation was introduced but was not enacted.

The Benton County Attorney continued to decline to commence any action against the city because the city again intended to seek special legislation during the 1998 session. By letter dated July 21, 1997, the Benton County Attorney advised the OSA that “[s]o long as the city of Foley continues to comply with all requests for information, reporting requirements and other reasonable directives of the OSA, Benton County sees no point in taking action against Foley.” Special legislation has been introduced during the 1998 session which retroactively would make legal the city’s expenditures of tax increment from this district to pay the bonds for the wastewater treatment plant located outside of the district, provided the expenditures were made before January 1, 1998.

In 1996, after receiving the notice of noncompliance, the City of Foley spent \$23,451 of tax increment for activities outside of the TIF district. As of December 31, 1996, the city had spent \$125,420 of tax increment for activities outside of the TIF district. TIF reports for the year ended December 31, 1997 have not been filed yet with the OSA. Consequently, it is unknown whether any additional increment was spent on activities outside the district during 1997.

2. City of Forest Lake

The OSA mailed the City of Forest Lake a noncompliance notice dated December 23, 1996. In the notice, the OSA found that the city had improperly spent a substantial sum of tax increment generated by a TIF district created in 1980 to pay bonds that financed a water storage and filtration facility located outside of the district. The OSA has taken the position that the laws applicable when the TIF district was created did not authorize the use of tax increment generated by the district to pay for any activities outside of the district. In addition, the OSA found that total expenditures exceeded

the TIF district's budget and that the statutory limit on reimbursement of administrative expenses was exceeded.

The city responded that the amount of tax increment it spent to pay the bonds that financed activities outside of the TIF district was \$11,906.80, much less than the OSA had found based on the city's own records. The city agreed to repay the TIF district for the \$11,906.80 of increment that the city caused to be spent on activities outside the district and for the \$22,273.00 of excess administrative expenses. The city also agreed to request the county auditor to decertify the district as of December 31, 1997 and to return to the county auditor all excess increment in the district's account when it was decertified.

The Washington County Auditor has decertified the district. The city has not returned any increment yet to the county auditor because the city is examining its records to determine the correct amount to be returned. The issue of expenditures in excess of the TIF district's budget is still under review by the OSA. Copies of correspondence regarding this matter are included in Appendix C.

3. City of Cambridge

The OSA mailed the City of Cambridge a noncompliance notice dated January 9, 1997. At issue was the city's transfer of tax increment from a TIF district created in 1980 to other TIF districts, and expenditures in excess of budgeted amounts for land acquisition and administrative expenses.

The city disagreed with the OSA's findings and responded that interest earned on tax increment, which the city had accounted for as tax increment, had been transformed into unrestricted, non-tax-increment revenues by a provision in the 1997 Omnibus Tax Act.²² Therefore, according to the city, most of the amounts that the OSA had identified as unlawful transfers or expenditures of tax increment were in fact expenditures of non-tax increment revenues which the city was free to transfer or spend in any manner without being subject to any TIF-law restrictions or OSA oversight. Copies of correspondence regarding this matter are included in Appendix C.

By letter dated April 28, 1997, the OSA referred this matter to the Isanti County Attorney, who in turn referred it to the Chisago County Attorney. Subsequently, the OSA commenced a TIF legal compliance audit of the City of Cambridge, which is ongoing. As of the date of this report, the Chisago County Attorney has not commenced any legal action against the City of Cambridge regarding this matter.

4. City of Deephaven

The OSA mailed the City of Deephaven a noncompliance notice dated March 6, 1997. The notice contained the following findings by the OSA: 1) the city had used tax increment to pay

²² See Laws 1997, ch. 231, art. 10, sec. 2 and 25.

administrative expenses in excess of the statutory limit, 2) the city was holding excess increment that must be returned to the county auditor, and 3) the city acted improperly when it transferred tax increment to an account that would pay for reconstruction of a bridge located outside the district. The TIF district at issue was created in 1980. As of December 31, 1996, the city was holding approximately \$1.2 million in tax increment generated by the TIF district, either in the TIF district's account or in the bridge reconstruction account. The only remaining expenditures authorized by the TIF plan were for reconstruction of the bridge located outside of the district. The OSA has taken the position that the laws applicable when the TIF district was created did not authorize the use of tax increment generated by the district to pay for any activities outside of the district, such as reconstruction of the bridge. Because the only expenditures authorized by the TIF plan were not permitted under the TIF laws, the city lacked authority to spend any of the tax increment it was holding within the TIF district, much less outside of it. Therefore, the OSA found that the \$1.2 million was excess increment which the city was required to return to the county auditor.²³

The city disagreed with the OSA's findings. The city also sought special legislation during the 1997 session which would have permitted the city to retain the excess increment and to spend it on reconstruction of the bridge located outside of the district. The special legislation was not enacted. During the 1998 session, special legislation has been introduced which would permit the city to retain the excess increment and to spend it on reconstruction of the bridge. Copies of correspondence regarding this matter are included in Appendix C.

The OSA referred this matter to the Hennepin County Attorney by letter dated November 7, 1997. As of the date of this report, the Hennepin County Attorney has not commenced any legal action against the City of Deephaven regarding this matter.

D. OTHER NONCOMPLIANCE ISSUES

1. City of Houston

The OSA mailed the City of Houston a notice of noncompliance dated December 10, 1996. At issue was the city's use of tax increment for property tax abatement or reimbursement. This noncompliance notice was included in the OSA's 1997 Tax Increment Financing Report.

After issuing the 1997 report, the OSA received the city's formal response to the noncompliance notice wherein the city disagreed with the OSA's findings. The city referenced language in the development agreement, not the TIF plan, which authorized the expenditure of tax increment revenue to reimburse the developer for certain authorized development costs. The city took the position that property tax abatement and/or reimbursement was the vehicle for payment of those development costs. Copies of correspondence regarding this matter are included in Appendix D.

²³ Minn. Stat. § 469.176, subd. 2 (1996).

The OSA forwarded this matter to the Houston County Attorney by letter dated April 28, 1997. As of the date of this report, the Houston County Attorney has not commenced any legal action against the City of Houston regarding this matter.

2. City of Jordan

The OSA mailed the City of Jordan a noncompliance notice dated January 9, 1997. The OSA had received documents from the city which indicated that, as of December 31, 1995, the city had used \$40,000 of tax increment to reimburse itself for state aid it did not receive as a result of the state aid offset.²⁴ The OSA has taken the position that the TIF laws do not authorize using tax increment to reimburse a city for revenue lost under the state aid offset.

The city responded that it spent the \$40,000 of tax increment on public improvements that qualify for reimbursement from tax increment as a means of reimbursing the city for the lost revenue. The OSA's TIF auditors performed an on-site inspection of the city's records and could find no documentation supporting the city's claim that it spent the \$40,000 on TIF-eligible expenses. The city subsequently hired consultants to put the city's records in order. The city has communicated that the consultants have completed their work and the city's records are ready for examination. Copies of correspondence regarding this matter are included in Appendix D.

The OSA intends to send TIF auditors to perform a second on-site examination of the City of Jordan's records. To prepare for the legal compliance audit, the TIF Division has requested that the city provide copies of the TIF plans for all of its districts. As of the date of this report, the city has not provided the requested copies of the TIF plans.

3. City of Lexington

The OSA conducted a legal compliance audit of one of the city's TIF districts. As a result of that audit, the OSA mailed the City of Lexington a notice of noncompliance dated January 13, 1997. The noncompliance notice addressed issues regarding failure to document compliance with the three-year "knockout" rule,²⁵ insufficient documentation of TIF-eligible expenditures, an unauthorized transfer of tax increment to an economic development fund, and payment of unauthorized administrative expenses. The city disagreed with the OSA's findings. Following receipt and review of the city's response and its TIF reports for the year ended December 31, 1996, the OSA is continuing its dialogue with the city regarding these statutory issues. Copies of correspondence regarding this matter are included in Appendix D.

²⁴ See Minn. Stat. § 273.1399 (Supp. 1997).

²⁵ Minn. Stat. § 469.176, subd. 1a (1996).

4. City of Pine City

The OSA mailed the City of Pine City a noncompliance notice dated March 6, 1997. The TIF plan for a housing district the city had created provided that a housing project would be built on a particular parcel and that increment from that parcel would be used to pay some of the costs of the housing project. The project, however, was built on a different parcel than the one identified by the plan. Consequently, the OSA found that no tax increment from the district could be spent on the housing project. The city responded that none of the tax increment from the district had been spent on the housing project or anything else. The city voluntarily requested decertification of the district and returned \$13,717.49 of tax increment to the county auditor. Copies of correspondence regarding this matter are included in Appendix D.

5. City of St. Cloud / St. Cloud HRA

The OSA mailed the City of St. Cloud a noncompliance notice dated November 14, 1997. The OSA found that the St. Cloud HRA was not in compliance with state TIF laws when it increased the bonded debt shared by several TIF districts to an amount greater than that budgeted in the TIF plans without following proper procedure. If the amount of bonded debt is to be increased, the municipality first must approve an amended TIF plan providing for the increase, and such approval may be given only after notice and a public hearing.²⁶ The city was required to respond to the noncompliance notice within 60 days after receiving it.²⁷ As of the date of this report, the OSA has received no response from the city. The OSA will refer this matter to the Stearns County Attorney.²⁸ Copies of correspondence regarding this matter are included in Appendix D.

6. Other TIF Legal Compliance Audits

The OSA has commenced TIF legal compliance audits of four local governments in addition to the City of Cambridge and the City of Jordan. Those audits are ongoing. The OSA will provide the results of those audits in future reports to the Legislature.

²⁶ Minn. Stat. § 469.175, subd. 4 (1996).

²⁷ Minn. Stat. § 469.1771, subd. 1, para. (c) (1996).

²⁸ *See* Minn. Stat. § 469.1771, subd. 1, para. (b) (1996).

III. STATUTORY ISSUES

The OSA's 1997 Tax Increment Financing Report contained a discussion of five issues regarding interpretations of the TIF laws: (1) authorized expenses in redevelopment districts, (2) the lack of a definition of "tax increment," (3) prior planned improvements, (4) tax increment bonding, and (5) confusing uses of the words "project" and "district." Provisions in the 1997 Omnibus Tax Act addressed the issues of authorized expenses in redevelopment districts and the lack of a definition of "tax increment." The other three issues have not been addressed yet.

This report does not contain a discussion of statutory issues because of the ongoing work of the TIF Recodification Task Force. The OSA will reserve presenting further statutory issues to the Legislature until input into the recodification process is requested. The OSA remains ready to assist the members and staff of the TIF Recodification Task Force in any manner that is requested.

IV. CONCLUSION

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

Bill Connors, TIF Division Director	(612) 296-9255
Christine MacDonald, TIF Auditor	(612) 296-7001
Pamela Mattila, TIF Auditor	(612) 297-3675
Matthew Gaetz, TIF Auditor	(612) 282-6118