

STATE OF MINNESOTA

Office of the State Auditor



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State Auditor

TAX INCREMENT FINANCING LEGISLATIVE REPORT

TIF Reports for the Year Ended December 31, 2007
TIF Audits Concluded for the Year Ended December 31, 2008

Description of the Office of the State Auditor

The mission of the Office of the State Auditor is to oversee local government finances for Minnesota taxpayers by helping to ensure financial integrity and accountability in local governmental financial activities.

Through financial, compliance, and special audits, the State Auditor oversees and ensures that local government funds are used for the purposes intended by law and that local governments hold themselves to the highest standards of financial accountability.

The State Auditor performs approximately 160 financial and compliance audits per year and has oversight responsibilities for over 3,300 local units of government throughout the state. The office currently maintains five divisions:

Audit Practice - conducts financial and legal compliance audits for local governments;

Government Information - collects and analyzes financial information for cities, towns, counties, and special districts;

Legal/Special Investigations - provides legal analysis and counsel to the Office and responds to outside inquiries about Minnesota local government law; as well as investigates allegations of misfeasance, malfeasance, and nonfeasance in local government.

Pension - monitors investment, financial, and actuarial reporting for approximately 730 public pension funds; and

Tax Increment Financing - promotes compliance and accountability in local governments' use of tax increment financing through financial and compliance audits.

The State Auditor serves on the State Executive Council, State Board of Investment, Land Exchange Board, Public Employee's Retirement Association Board, Minnesota Housing Finance Agency, and the Rural Finance Authority Board.

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TAX INCREMENT FINANCING LEGISLATIVE REPORT

TIF Reports for the Year Ended December 31, 2007
TIF Audits Concluded For the Year Ended December 31, 2008



January 15, 2009

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TAX INCREMENT FINANCING REPORT

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Office of the State Auditor Initial Notice of Noncompliance – City of Coleraine
Response to the Initial Notice of Noncompliance – City of Coleraine
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APPENDIX B

Office of the State Auditor Initial Notice of Noncompliance – City of Rochester
Response to the Initial Notice of Noncompliance – City of Rochester
Office of the State Auditor Final Notice of Noncompliance – City of Rochester

EXECUTIVE SUMMARY

Current Trends

- A total of **\$6,178,621** in tax increment revenues was returned to county auditors for redistribution as property taxes in calendar year 2007. (pp. 4-5)
- Ninety-two TIF districts were certified in Minnesota during calendar year 2007, while 133 TIF districts were decertified. (p. 19)
- Between 2006 and 2007, there was a 23% reduction in certification of housing districts and an increase of 14% in the certification of redevelopment districts. (p. 17)
- The number of economic development districts certified increased by 21% between 2006 and 2007. (p. 17)

Long-Term Trends

- For the 28 new authorities created since 2003, the average population is 915, if the single largest new authority is omitted. (p. 4)
- For the first time in five years, the number of housing districts certified in 2007 fell below the number of redevelopment districts and economic development districts certified. (p. 17)
- The number of redevelopment districts certified increased 10% overall between 2003 and 2007. (p. 17)
- The number of authorities that have not filed the required reporting forms by the statutory deadline of August 1st decreased 74% from 2003 to 2007. The increased training opportunities provided by the Office of the State Auditor and the improvement of the electronic reporting system contributed to the decrease in late filings. (p. 5)

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Scope and Methodology

In 1995, the Minnesota Legislature assigned compliance oversight for tax increment financing (TIF) to the Office of the State Auditor.¹ This oversight includes examining and auditing the use of TIF by political subdivisions, as authorized by the Minnesota Tax Increment Financing Act (TIF Act), and reporting the findings to the legislature.²

A development authority is statutorily required to publish certain financial information about each of its TIF districts in a newspaper of general circulation on or before August 15th of each year.³

The TIF Act also requires authorities to file annual reports with the Office of the State Auditor for each of their TIF districts. This reporting requirement applies to all TIF districts regardless of when they were created. Authorities must submit these reports on or before August 1st of each year, starting in the year in which the district is certified.⁴

To verify the accuracy of data reported by development authorities, the Office of the State Auditor compares the data submitted to TIF data reported by counties to the Minnesota Department of Revenue.

As required by law, a report containing a summary of the TIF reports and audits is provided annually to the chairs of the legislative committees with jurisdiction over TIF matters. This Thirteenth Annual Legislative Report was compiled from information received from the 443 municipalities and development authorities currently authorized to exercise TIF powers in Minnesota. The report summarizes the data received from approximately 2,097 unaudited TIF reports for the year ended December 31, 2007, and provides a summary of the violations cited in the limited-scope audits concluded by the Office of the State Auditor in 2008. This legislative report and prior legislative reports can be found on the website of the Office of the State Auditor at:

<http://www.auditor.state.mn.us/list.aspx?type=rpt&div=tif>.

¹ Minn. Stat. § 469.1771.

² Minn. Stat. §§ 469.174 through 469.1799 inclusive, as amended

³ Minn. Stat. § 469.175, subd. 5.

⁴ Minn. Stat. § 469.175, subd. 6.

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TAX INCREMENT FINANCING LEGISLATIVE REPORT

BACKGROUND

What Is Tax Increment Financing?

Tax increment financing (TIF) is a financing tool created by the legislature to promote economic development, redevelopment, and housing development in areas where it would not otherwise occur. A development authority, which could be a city, an entity created by a city, or an entity created by a county, “captures” the revenues generated by the increase in net tax capacity. New development within a designated geographic area, called a TIF district, generates an increase in tax capacity. The development authority uses the tax increment revenues to finance public improvements and other qualifying costs related to the new development.

Tax increment financing is not a property tax abatement program. The owner of the property located in the TIF district continues to pay the same amount of property taxes that would have been paid. Instead of being paid to the local taxing jurisdictions for their general use, however, the portion of property taxes generated by the new development is used to pay for public improvements and qualifying costs that make the development possible. Examples of such costs include: land and building acquisition, demolition of structurally substandard buildings, removal of hazardous substances, site preparation, installation of utilities, and road improvements. The costs that may be paid from tax increment revenues depend on the type of development activity taking place, the type of TIF district created, and the year in which the TIF district was created.

In some TIF districts, bonds are sold by the municipality or development authority at the outset of the development activity so that funds are available for front-end costs, such as pollution clean-up. The bonds are then fully or partially paid with tax increment revenues from the TIF district.¹ In other TIF districts, the authority or municipality advances or loans money from its general fund or any other fund for which it has legal authority. The loan or advance must be authorized by resolution of the governing body before money is transferred, advanced, or spent. The terms and conditions for repayment of the loan must be provided in writing and include, at a minimum, the principal amount, the interest rate, and maximum term.²

Pay-as-you-go (PAYG) financing is often used as an alternative to up-front bond financing. Under this type of bond, the development costs are initially paid by the developer pursuant to the terms of a (re)development agreement. After the qualifying costs are substantiated, the developer is then reimbursed pursuant to the terms of the

¹ Minn. Stat. § 469.174, subd. 3(a)(1).

² Minn. Stat. § 469.178, subd. 7.

PAYG note³ if, and when, tax increment is generated by the TIF district. Generally, in PAYG financing, the developer accepts the risks of failed development. If the tax base does not increase and tax increments are not generated as anticipated, then the developer does not get reimbursed.

The TIF Act and Compliance Support

The TIF Act governs the creation and administration of TIF districts.⁴ The TIF Act has been amended frequently since its creation in 1979. A TIF district is usually governed by the laws in effect in the year in which the request for certification of the district was made. Frequent changes in the law have created an added layer of complexity. The Office of the State Auditor holds annual TIF training sessions and workshops to assist development authorities and municipalities with TIF Act compliance issues. Figure 1 shows the TIF training events held by the Office of the State Auditor in 2008.

Figure 1.

TIF Training Events Held in 2008			
<u>Location</u>	<u>Type</u>	<u>Date</u>	<u>Registered Participants</u>
Bemidji	Workshop	June	48
St. Cloud	Workshop	June	87
New Ulm	Workshop	June	47
Walker	TIF Reporting Basics	September	19
Alexandria	TIF Reporting Basics	October	26
Pine Island	TIF Reporting Basics	October	16
St. Paul	TIF Reporting Basics	November	7

Who is Authorized to Create TIF Districts

Development authorities within municipalities may create TIF districts.⁵ Authorities include cities using the Municipal Development Districts Act, housing and redevelopment authorities (HRAs), port authorities, economic development authorities (EDAs), and rural development financing authorities. Counties do not have development authority but can establish entities that do have authority, e.g., county HRAs and EDAs.

³ Minn. Stat. § 469.174, subd. 3(b)(2).

⁴ Minn. Stat. §§ 469.174 to 469.1799, as amended.

⁵ Minn. Stat. § 469.174, subd. 2 and subd. 6. Counties are defined to be municipalities for county development authorities.

New Development Authorities

A development authority must be in place before a TIF district can be created. The number of authorities fluctuates from year to year. In 2007, eight new development authorities were created, for a total of 443 development authorities.

Figure 2.

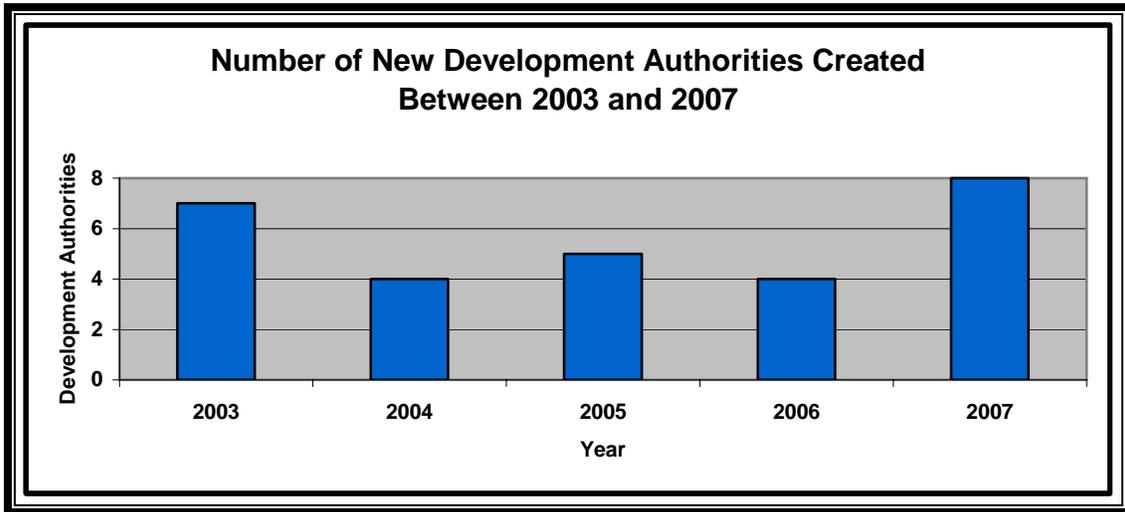


Figure 3.

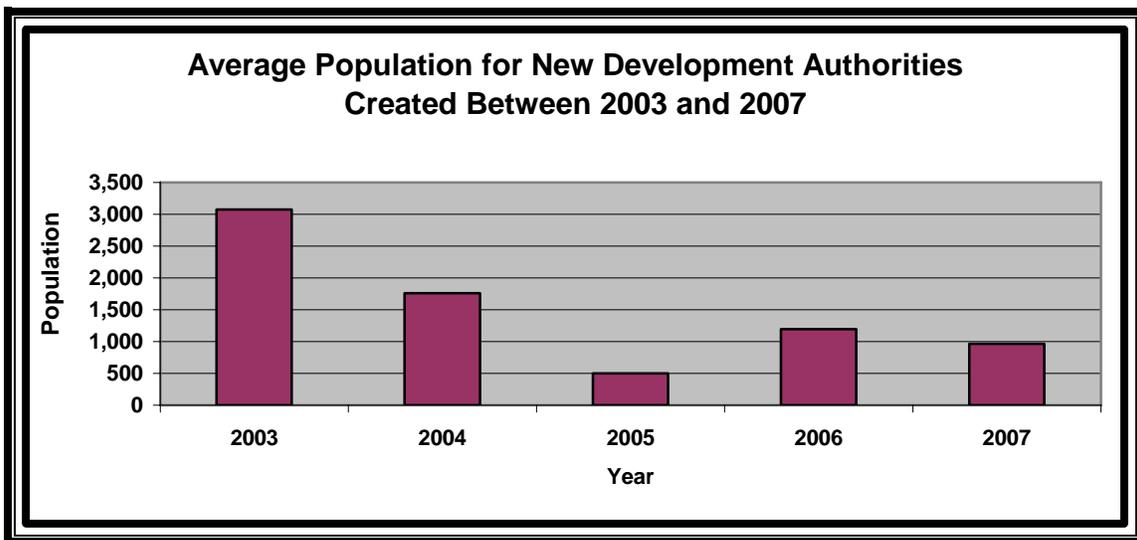


Figure 2 shows the number of new development authorities created over the past five years. Figure 3 shows the average population of the new development authorities each year. Since 2003, 28 new authorities have been created.⁶ Of the 28 new development

⁶ This number does not include the two county development authorities or the seven municipalities already using TIF that created an additional authority.

authorities, the average municipal population is roughly 1,690. The City of West St. Paul was added as an authority in 2003 and is the largest new authority to use TIF in the past five years. If we omit the population for West St. Paul from our data, the average population for the remaining 27 new authorities drops to 915.

Creation of TIF Districts

A development authority takes the first step in creating a TIF district by adopting a TIF plan for the district. The TIF plan outlines the development activity to be funded with tax increment and authorizes the use of tax increment to pay TIF-eligible project costs.⁷

To create a new TIF district, an authority must obtain approval of the TIF plan from the governing body of the municipality in which the TIF district is to be located after the municipality has published a notice for and held a public hearing.⁸ For example, if a city's port authority proposes to create a TIF district in the city, the city council must first approve the TIF plan for the district.⁹ If a county HRA proposes to create a TIF district in a township in the county, the county board must approve the TIF plan.

Before a TIF district is created, the development authority must also provide a copy of the proposed TIF plan and certain information about the proposed TIF district to the county auditor and the clerk of the school board, who in turn provide copies of these documents to the members of the county board of commissioners and the school board.¹⁰ The county board and school board may comment on the proposed district, but cannot prevent the creation of the district.¹¹

Returned Tax Increment

Tax increment revenues may be returned to the county auditor for redistribution to the city, county, and school district as property taxes. Some of the reasons tax increment is returned include excess tax increment and improperly received tax increment. In calendar year 2007, development authorities returned \$6,178,621 of tax increment as a result of the oversight work of the Office of the State Auditor, including voluntary payments made by authorities. From January 1, 1996, to date, a total of \$62,576,039 has been paid or returned to county auditors. This amount is then redistributed to the cities, counties, and school districts.

⁷ Minn. Stat. § 469.175, subd. 1.

⁸ Minn. Stat. § 469.175, subd. 3.

⁹ In many cases, the commissioners of the TIF authority include some or all of the council members.

¹⁰ Minn. Stat. § 469.175, subd. 2.

¹¹ In those situations in which the county is the municipality that must approve the TIF plan, the county board may prevent creation of a TIF district.

2007 SUMMARY DATA

Filing of Annual TIF Reports

A total of 443 development authorities had TIF districts for which they were required to file TIF reports with the Office of the State Auditor for the year ended December 31, 2007. These TIF authorities were required to file reports for 2,101 TIF districts. To date, the Office of the State Auditor has received reports for 2,098 of the 2,101 TIF districts.

Failure to File TIF Reports

Of the 443 development authorities required to file reports, 431 submitted complete reports by the statutory deadline of August 1st. On August 19, 2008, letters were sent to the remaining 12 development authorities, addressed to the governing board of the municipality, advising them that the required reports had not been filed.

Of the 12 authorities that had not filed complete reports by the statutory deadline, five still had not filed all of the required reports as of October 1, 2008. Pursuant to Minnesota law, a notice was mailed to each of the applicable county auditors to withhold tax increment that otherwise would have been distributed to the authorities from the identified TIF districts.¹² As of the date of this report, two authorities have not yet completed filing their reports.

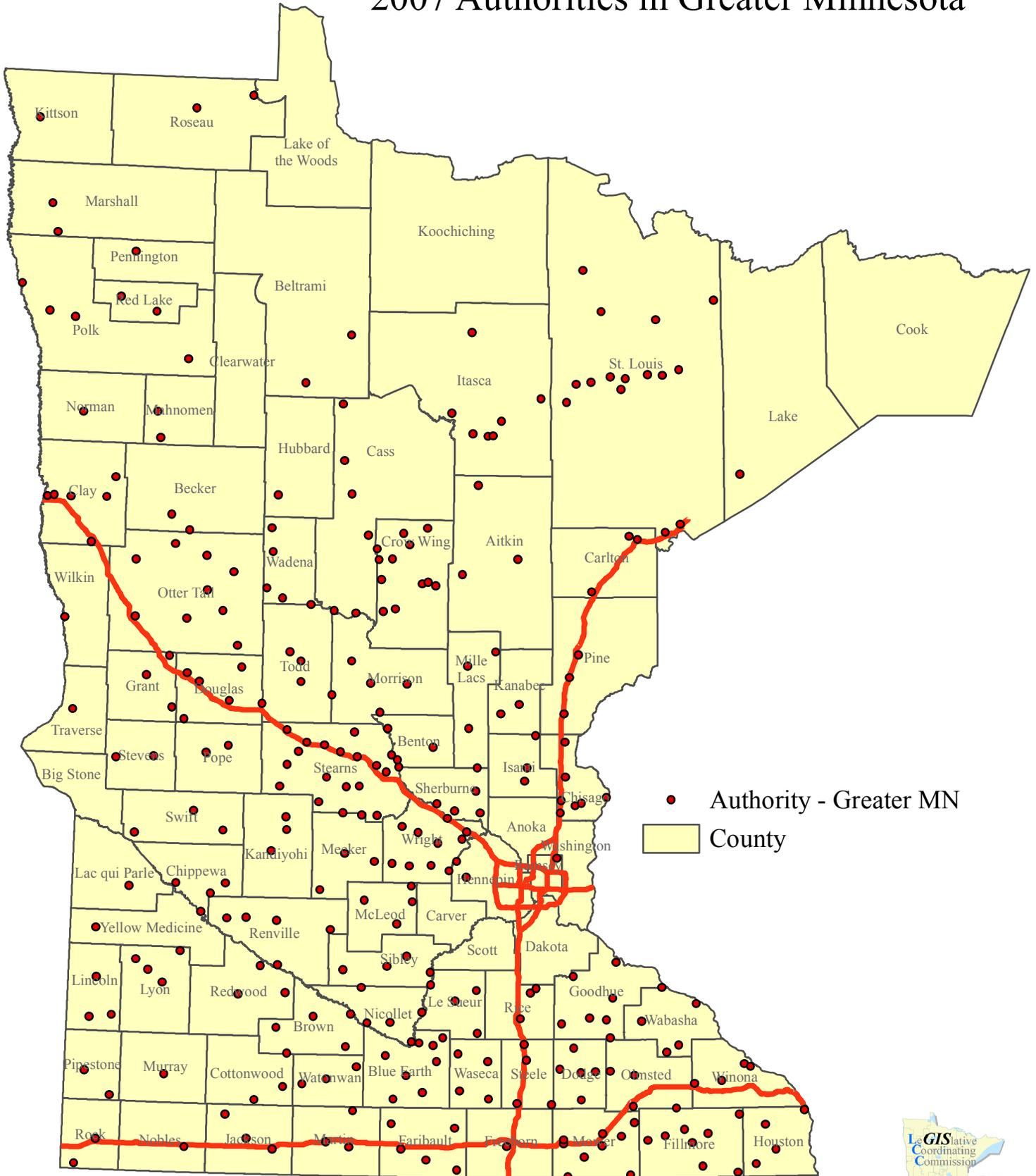
The number of authorities that have not filed the required reporting forms by the statutory deadline of August 1st has decreased significantly from 2003 to 2007. The increased training opportunities provided by the Office of the State Auditor and the improvement of the electronic reporting system have contributed to a 74% decrease in late filings.

Development Authorities by Location

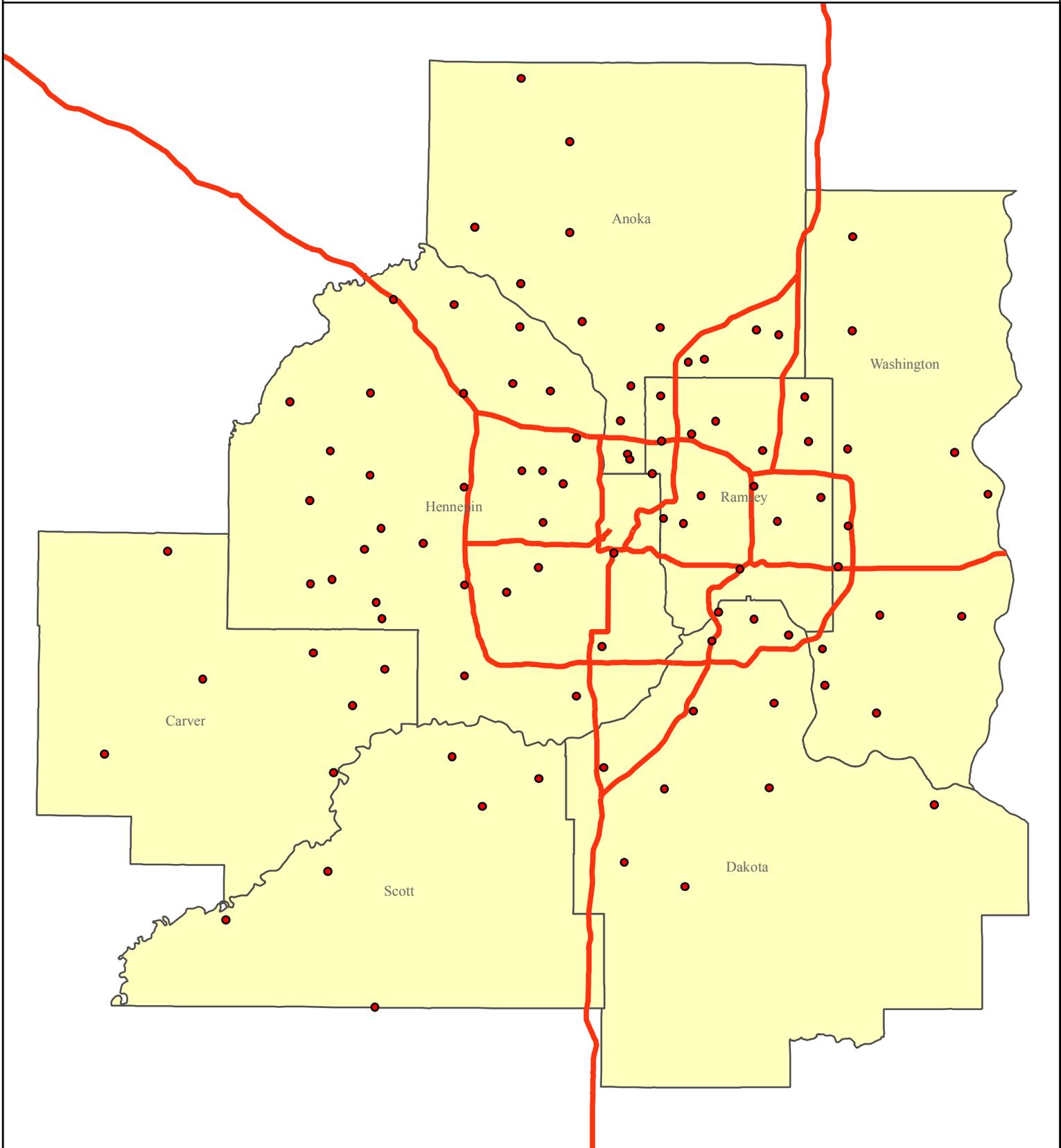
Development authorities using TIF powers are located throughout the State of Minnesota. Of the 443 development authorities, 336 are located in Greater Minnesota and 107 are located in the Seven-County Metropolitan Area (Metro Area). The following maps show the locations of those authorities.

¹² Minn. Stat. § 469.1771, subd. 2a. Any authority which has not filed complete TIF reports by October 1 will have 100% of the tax increment withheld from any payment scheduled to be made after October 1 until the authority has filed complete reporting forms with the Office of the State Auditor.

2007 Authorities in Greater Minnesota



2007 Authorities in Seven-County Metro Area



- Authorities - Metro
- Counties



Description of Maps 3 and 4

Map 3 identifies the various counties throughout the state that have created a separate authority to use TIF.¹³

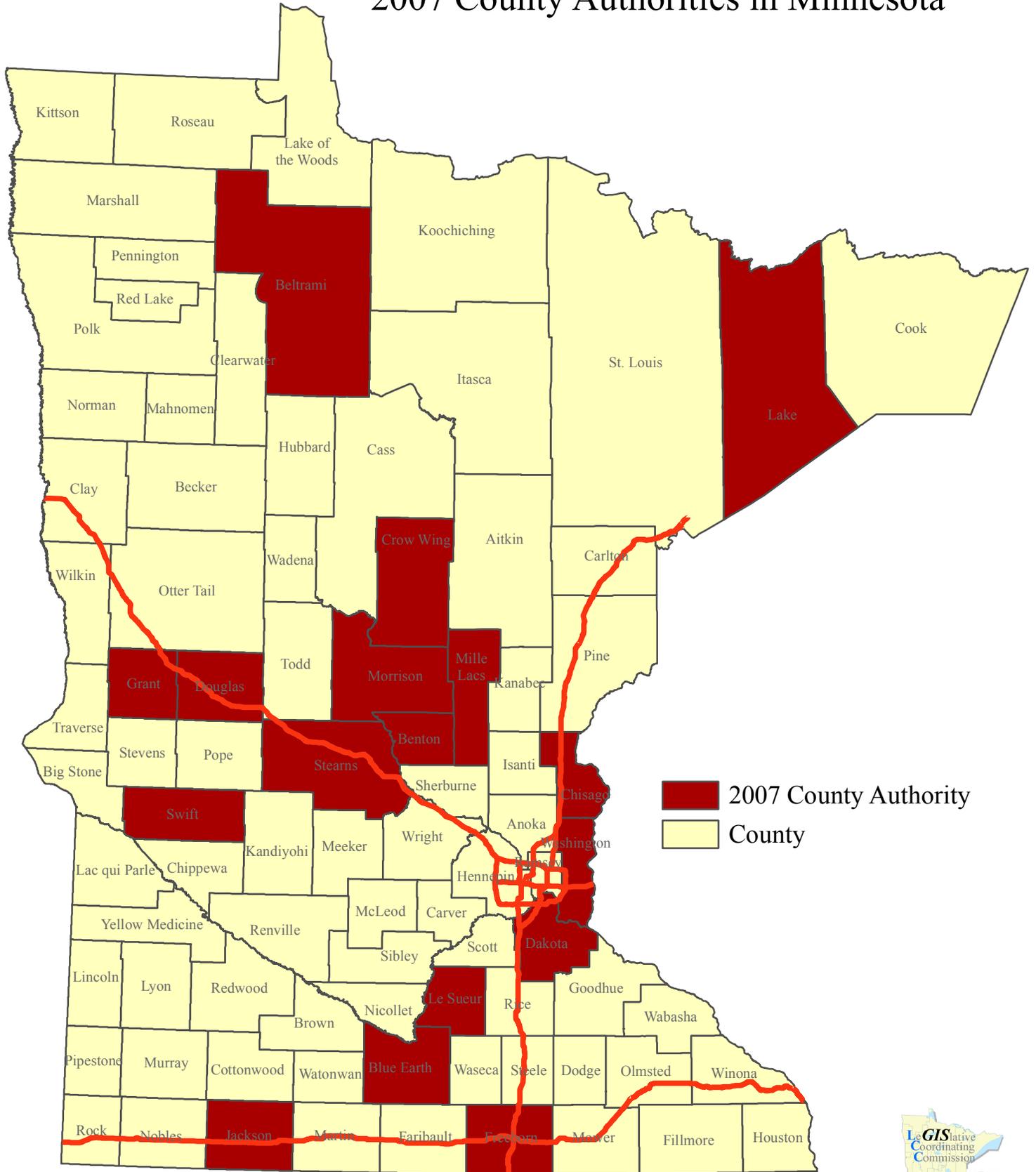
Map 4 shows the distribution of development authorities among the regional development commissions (RDCs). RDCs are authorized to transcend the boundary lines of local units of government and to work with them and on their behalf to develop plans and implement programs to address economic and governmental concerns of a regional nature.¹⁴ The RDCs in Minnesota are identified as follows:

- Region 1 Northwest RDC
- Region 2 Headwaters RDC
- Region 3 Arrowhead RDC
- Region 4 West Central Initiative Fund
- Region 5 RDC
- Region 6E Mid-Minnesota Valley RDC
- Region 6W Upper Minnesota Valley RDC
- Region 7E East Central RDC
- Region 7W RDC
- Region 8 Southeast RDC
- Region 9 RDC
- Region 10 RDC
- Region 11 Metropolitan Council

¹³ This map does not include multi-county or joint authorities.

¹⁴ Minn. Stat. § 462.383, subd. 2.

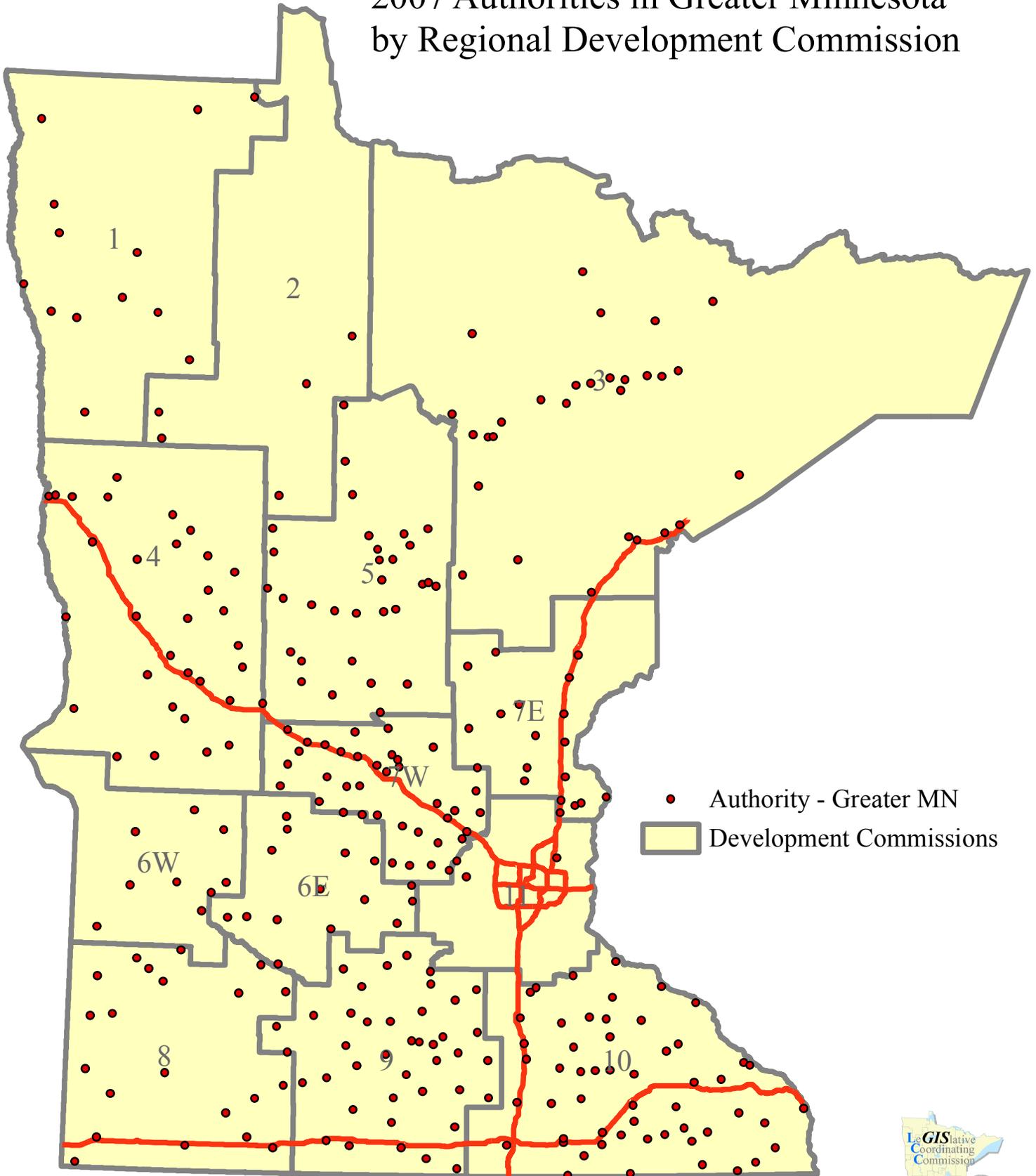
2007 County Authorities in Minnesota



 2007 County Authority
 County



2007 Authorities in Greater Minnesota by Regional Development Commission



Types of TIF Districts

The TIF Act divides TIF districts into the following categories based on the physical condition of the site and on the type of construction that is to occur:

- Redevelopment districts
- Economic development districts
- Housing districts
- Renewal and renovation districts
- Soils condition districts

In addition to the types of districts listed above, there are districts that were created prior to the enactment of the TIF Act (called Pre-1979 districts) and districts that have been created under special laws. Each type of TIF district has different requirements for its creation. Each type of district also has different maximum duration limitations and different restrictions on the use of tax increment revenue.

Redevelopment Districts – The primary purpose of a redevelopment district is to eliminate blighting conditions.¹⁵ Qualifying tax increment expenditures include acquisition of sites containing substandard buildings or improvements; demolishing and removing substandard structures; eliminating hazardous substances; clearing the land; and installing utilities, sidewalks, and parking facilities. Often, this is referred to as “leveling the playing field.” It allows developed cities to compete for development with outlying cities with bare land. Redevelopment districts are intended to conserve the use of existing utilities, roads, and other public infrastructure and to discourage urban sprawl.

Economic Development Districts – An economic development district does not meet the requirements of any other type of district but is in the public interest because it will (i) discourage commerce, industry or manufacturing from moving to another state or city; (ii) increase employment in the state; or (iii) preserve and enhance the tax base.¹⁶ Economic development districts are short-term districts (eight years). Tax increment revenues from economic development districts are used primarily to assist manufacturing, warehousing, storage and distribution, research and development, telemarketing, and tourism. Commercial development (retail sales) is excluded by law, except in small cities, as defined by the TIF Act.¹⁷

Housing Districts – The purpose of a housing district is to financially assist development of owner-occupied and rental housing for low- and moderate-income individuals and families.¹⁸ Tax increment revenues can be used in the construction of low- and

¹⁵ Minn. Stat. § 469.174, subd. 10(a)(1).

¹⁶ Minn. Stat. § 469.174, subd. 12.

¹⁷ Minn. Stat. § 469.174, subd. 27 and Minn. Stat. § 469.176, subd. 4c.

¹⁸ Minn. Stat. § 469.174, subd. 11.

moderate-income housing, as well as to acquire and improve the housing site. The requirements for qualified housing districts are tied to federal low-income tax credit guidelines, regardless of whether tax credits are used. The 2008 Legislature repealed the definition of “qualified housing.” Nevertheless, this more restrictive type of housing district designation continues to be used for qualified housing districts created prior to March 8, 2008.¹⁹

Renewal and Renovation Districts – The purpose of a renewal and renovation district is similar to that of a redevelopment district, except the degree of blight removal may be less, and the development activity is more closely related to inappropriate or obsolete land use.²⁰

Soils Condition District – The purpose of a soils condition district is to assist in the redevelopment of property which cannot be developed due to the existence of hazardous substances, pollutants, or contaminants. The presence of these materials requires removal or remedial action for the property to be used, and the estimated cost of the proposed removal and remediation must exceed the fair market value of the land prior to curative measures.²¹

TIF districts created prior to the enactment of the TIF Act are called Pre-1979 districts. Many of these TIF districts created prior to August 1, 1979, had significant amounts of debt outstanding on April 1, 1990. Tax increment from these districts can be used only to retire debt. Pre-1979 districts will not receive tax increment payments after August 1, 2009.²²

Special law may be enacted for one or more municipalities permitting the generation of tax increment revenues from geographic areas not meeting the definition of a type of TIF district authorized under general law. This type of district is referred to as an “uncodified” district. Examples are housing transition districts authorized for the cities of Crystal, Fridley, St. Paul, and Minneapolis, and a district with distressed rental properties in Brooklyn Park.

¹⁹ Minn. Stat. § 469.174, subd. 29.

²⁰ Minn. Stat. § 469.174, subd. 10(a).

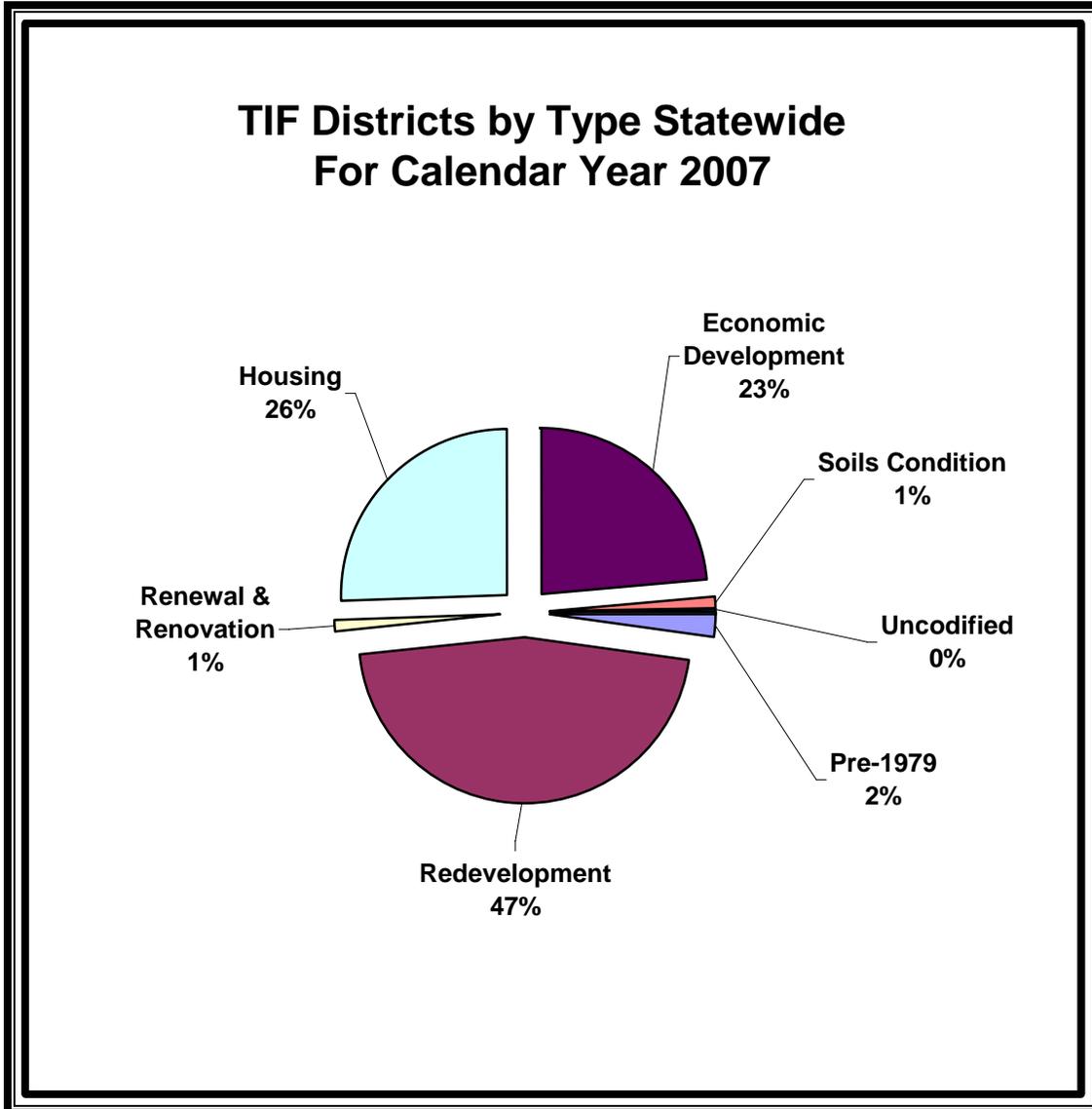
²¹ Minn. Stat. § 469.174, subd. 19.

²² Minn. Stat. § 469.176, subd. 1c.

Number of TIF Districts

As of calendar year 2007, 96% of TIF districts are redevelopment, economic development, and housing districts. Figure 4 shows TIF districts by type on a statewide basis.

Figure 4.



As shown in Figure 5 and Figure 6, redevelopment districts make up the largest percentage of districts in the Metro Area and in Greater Minnesota.

Figure 5.

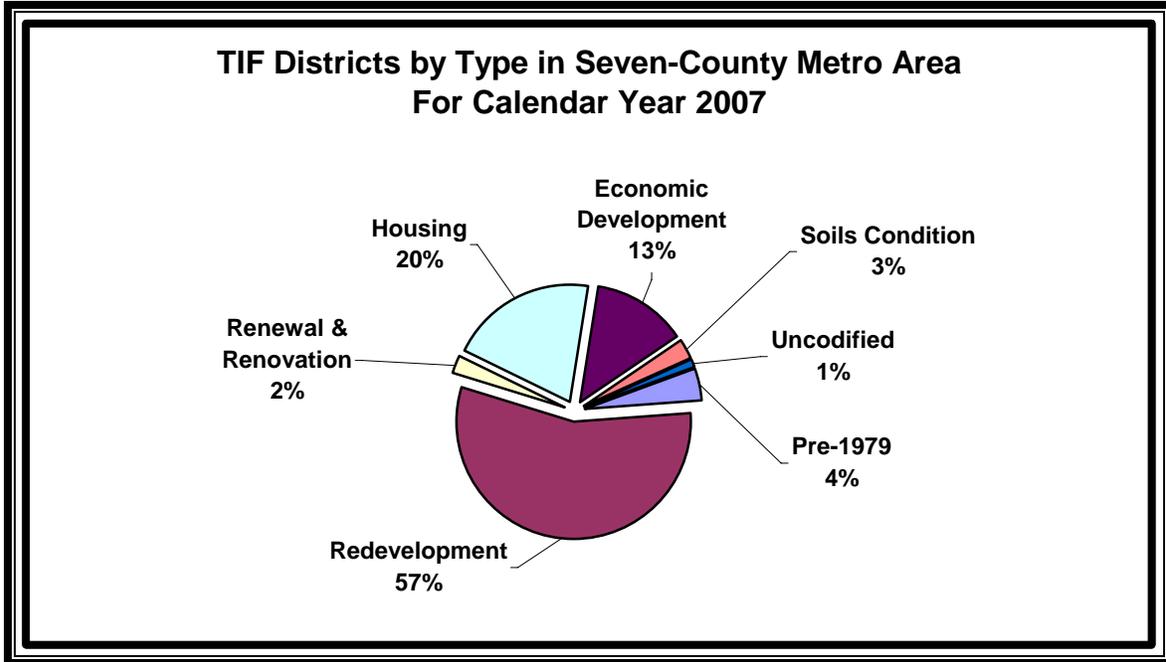
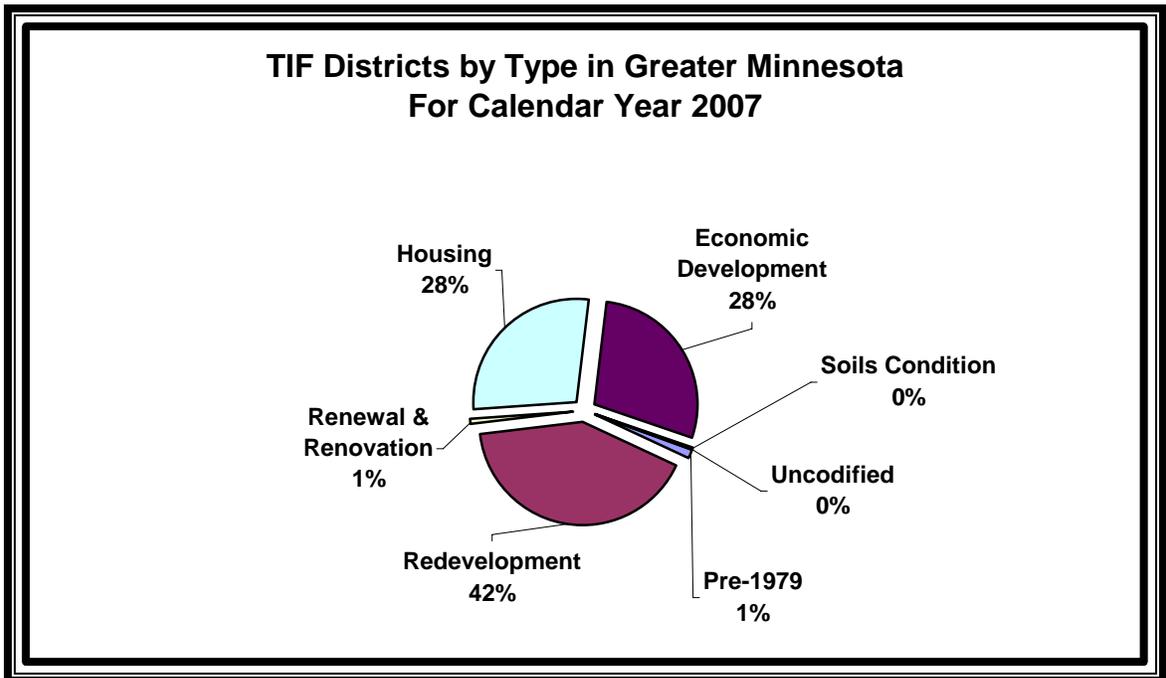


Figure 6.



Economic development districts focus on job production rather than on clearance and preparation of a development site. Therefore, Greater Minnesota, with open space and a critical need for employment, uses economic development districts more frequently than the fully-developed Metro Area. The land on which a district is established may be bare land. The eight-year term of the district is generally sufficient as less tax increment is needed for site preparation.

Figure 7 identifies TIF districts by Regional Development Commission (RDC). TIF districts are concentrated in the central and southern development regions of the state, with the largest concentration of districts located in Region 11, which is the Metro Area.

Figure 7.

TIF District Type by Region for Calendar Year 2007									
Regional Development Commission	Region	Total Districts	Pre-1979	Redevelopment	Renewal & Renovation	Housing	Economic Development	Soils Condition	Uncodified
Northwest RDC	1	37	1	15	0	18	3	0	0
Headwaters RDC	2	16	0	5	0	10	1	0	0
Arrowhead RDC	3	104	5	47	0	31	19	2	0
West Central Initiative Fund	4	182	1	73	0	57	51	0	0
Region 5 RDC	5	137	0	53	1	40	43	0	0
Mid-Minnesota Valley RDC	6E	71	0	26	1	15	29	0	0
Upper Minnesota Valley RDC	6W	45	1	25	0	6	13	0	0
East Central RDC	7E	84	1	37	3	21	22	0	0
Region 7W	7W	215	2	82	2	39	90	0	0
Southeast RDC	8	83	2	43	1	25	12	0	0
Region 9 RDC	9	172	2	78	3	46	43	0	0
Region 10	10	268	3	98	0	89	76	2	0
Metropolitan Council	11	684	30	382	17	139	90	19	7
Total		2,098	48	964	28	536	492	23	7

Districts Certified for Calendar Year 2007

Once a municipality approves the creation of a TIF district, the county auditor certifies the district. From the date the district is *certified*, the increase in property taxes generated by the new development is sent to the TIF authority to pay qualifying development costs. Figure 8 summarizes TIF district certification by type.

Figure 8.

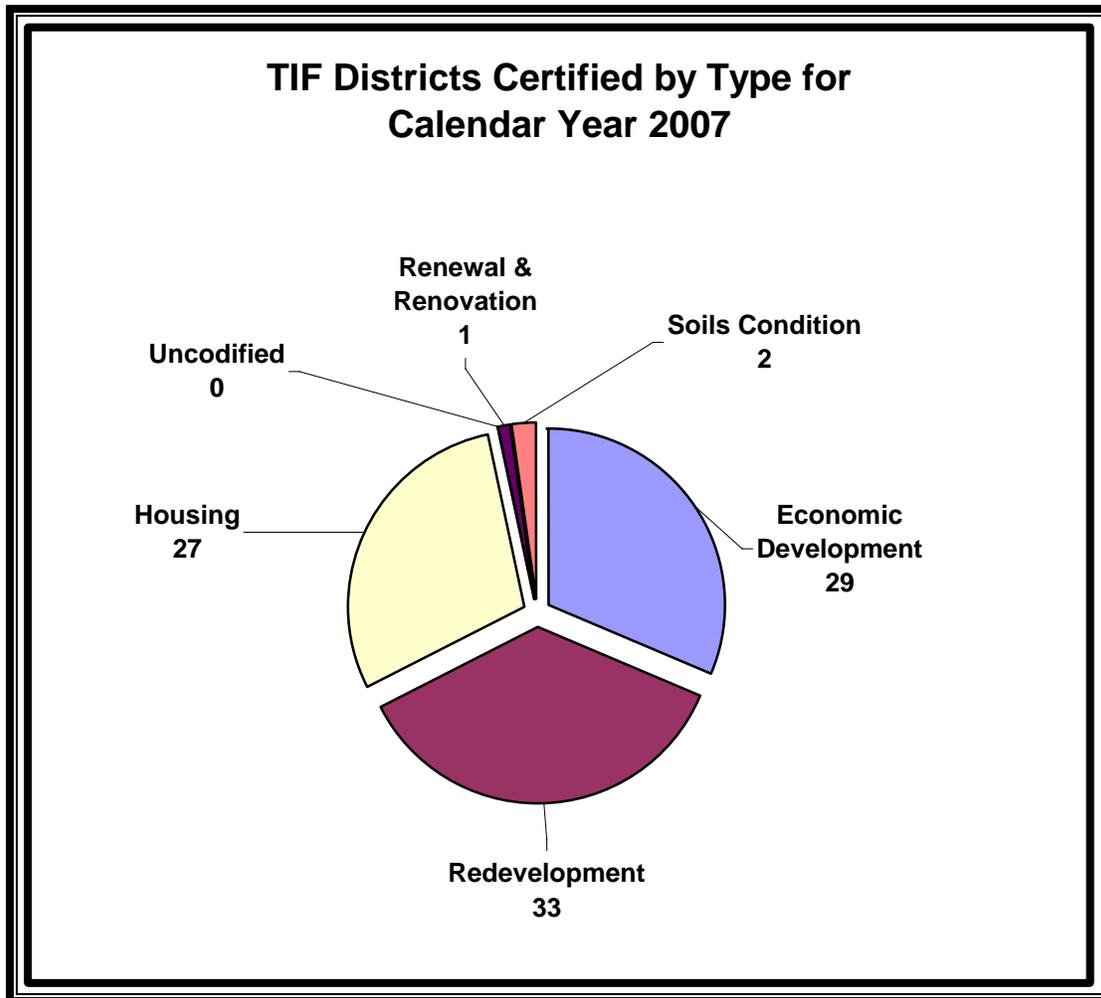
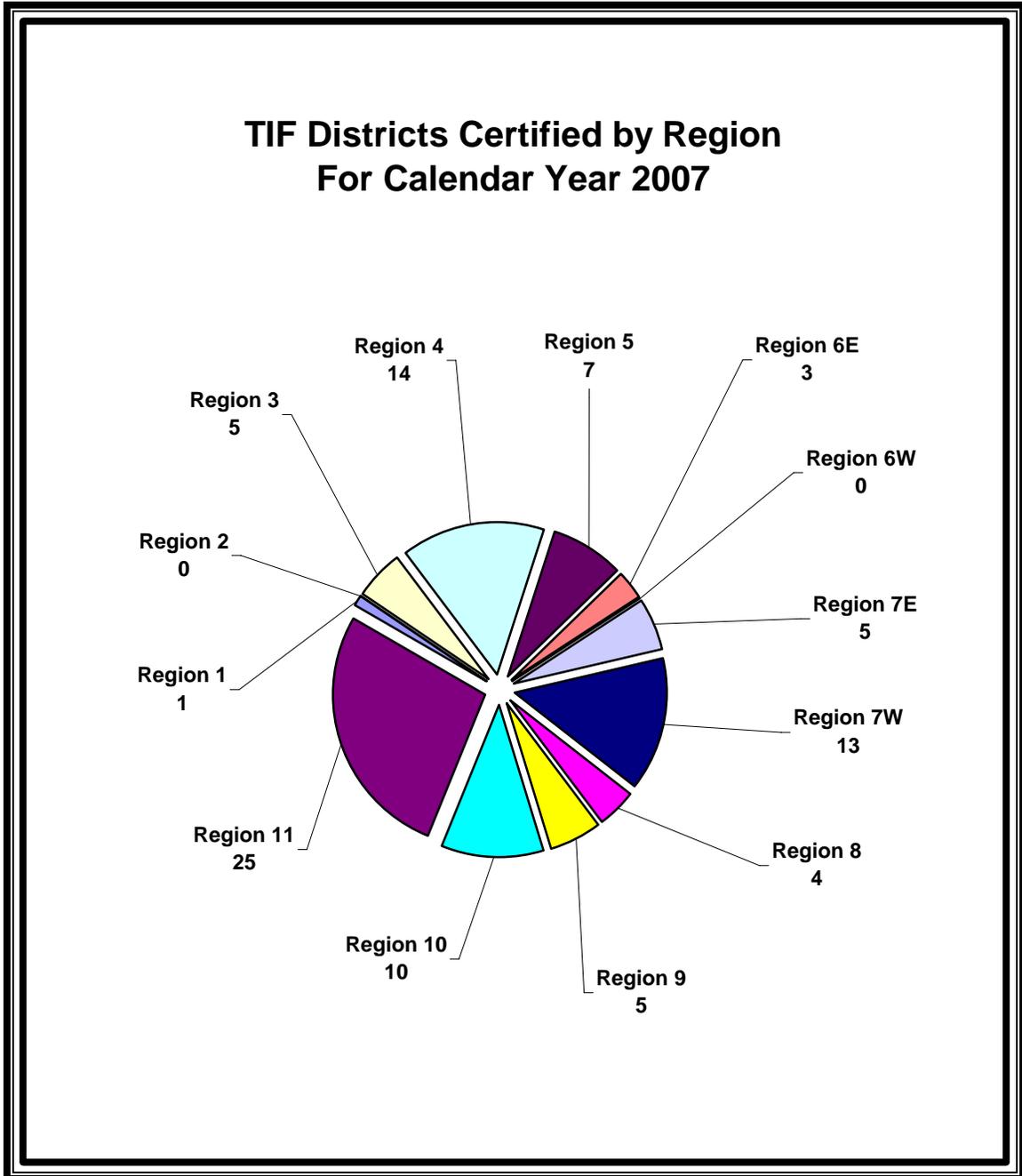


Figure 9 highlights that the largest number of new TIF districts certified in 2007 occurred in Region 11, which is the Metro Area.

Figure 9.

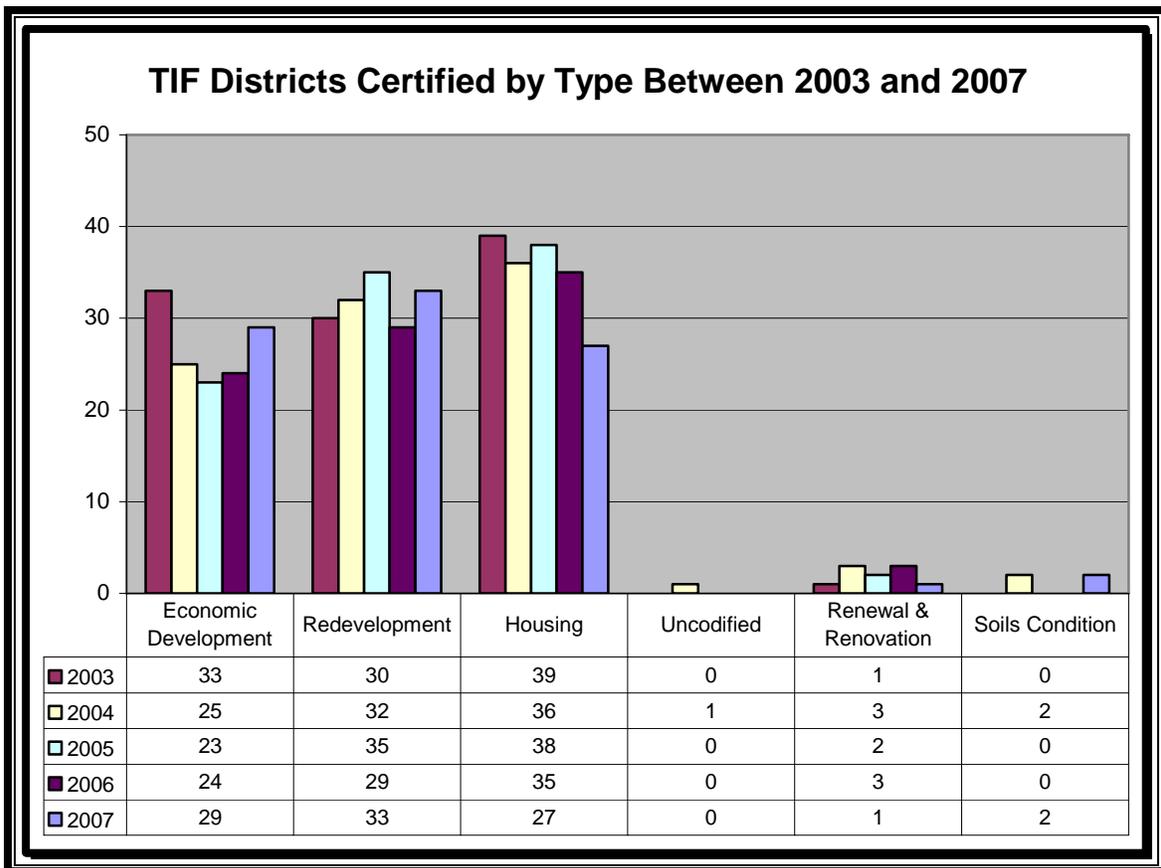


Five-Year Certification Trends

The total number of TIF districts certified between 2003 and 2007 has decreased by 12%. The number of economic development districts certified decreased by 12% between 2003 and 2007, but increased by 21% between 2006 and 2007. There was a 31% reduction of housing districts certified between 2003 and 2007, with a 23% reduction in housing districts between 2006 and 2007. The number of redevelopment districts certified increased 10% overall between 2003 and 2007, with an increase of 14% between 2006 and 2007.

Figure 10 compares the TIF districts certified by type since 2003. From 2003 through 2006, the number of housing districts certified each year was greater than the number of either redevelopment and economic development districts certified. In 2007, for the first time in five years, the number of housing districts certified fell below the number of either redevelopment districts and economic development districts certified.

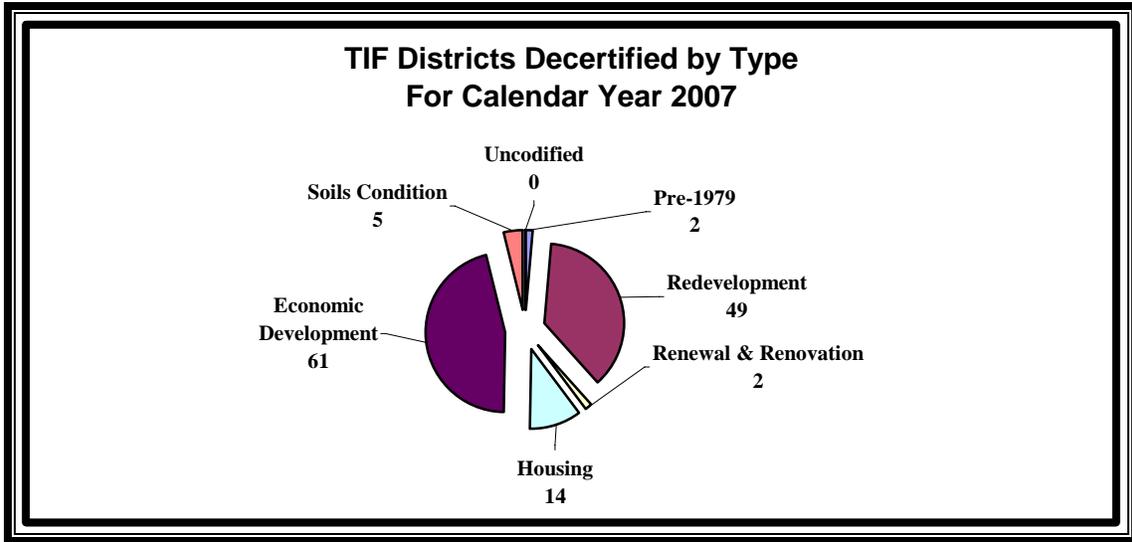
Figure 10.



Districts Decertified for Calendar Year 2007

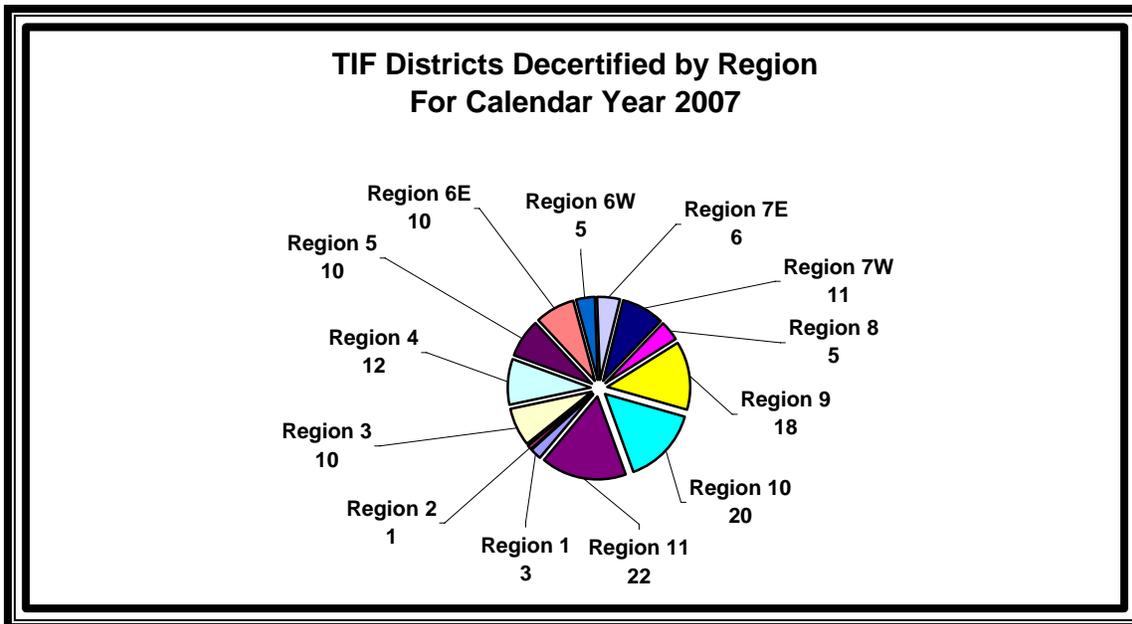
After the development costs are paid and the district's statutory time runs out, the district is then *decertified*, and all future property taxes are redirected to the local government units. As Figure 11 shows, the greatest number of districts decertified in 2007 were economic development districts.

Figure 11.



Looking at decertification by region, Figure 12 shows that the TIF districts decertified in 2007 were spread relatively evenly among the various regions.

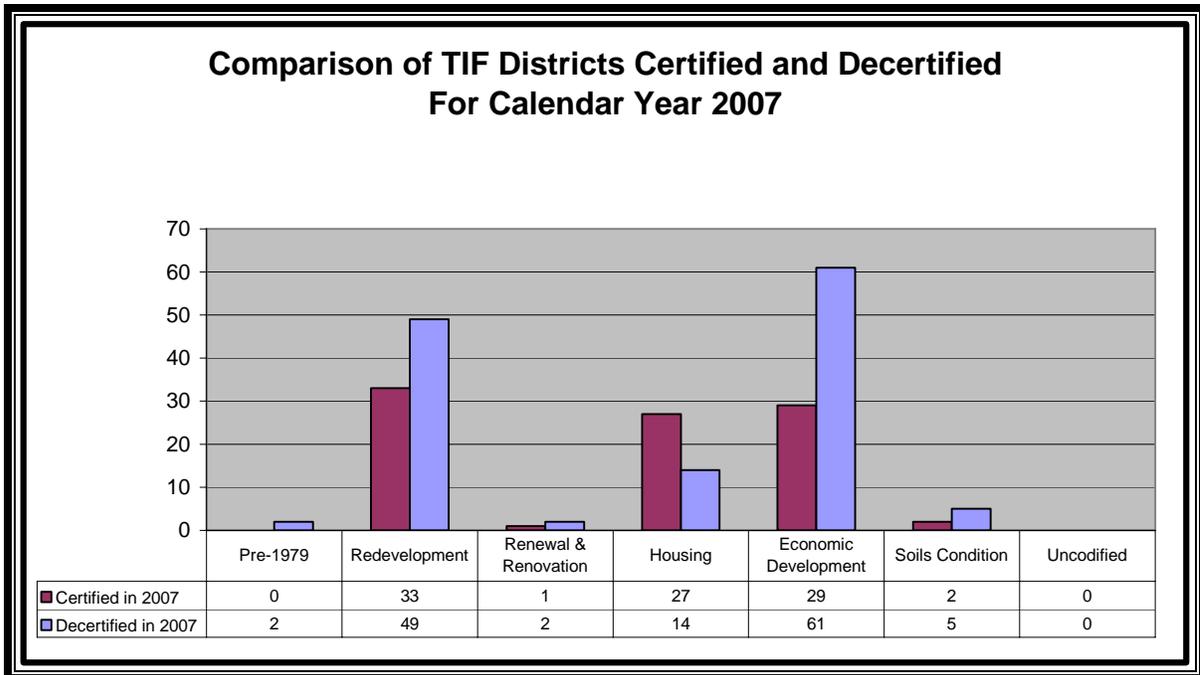
Figure 12.



Comparison of TIF Districts Certified and Decertified

Ninety-two TIF districts were certified in Minnesota during calendar year 2007, and 133 TIF districts were decertified. Figure 13 compares the number of districts certified and the number of districts decertified in 2007 by type of TIF district.

Figure 13.



2007 REVENUES

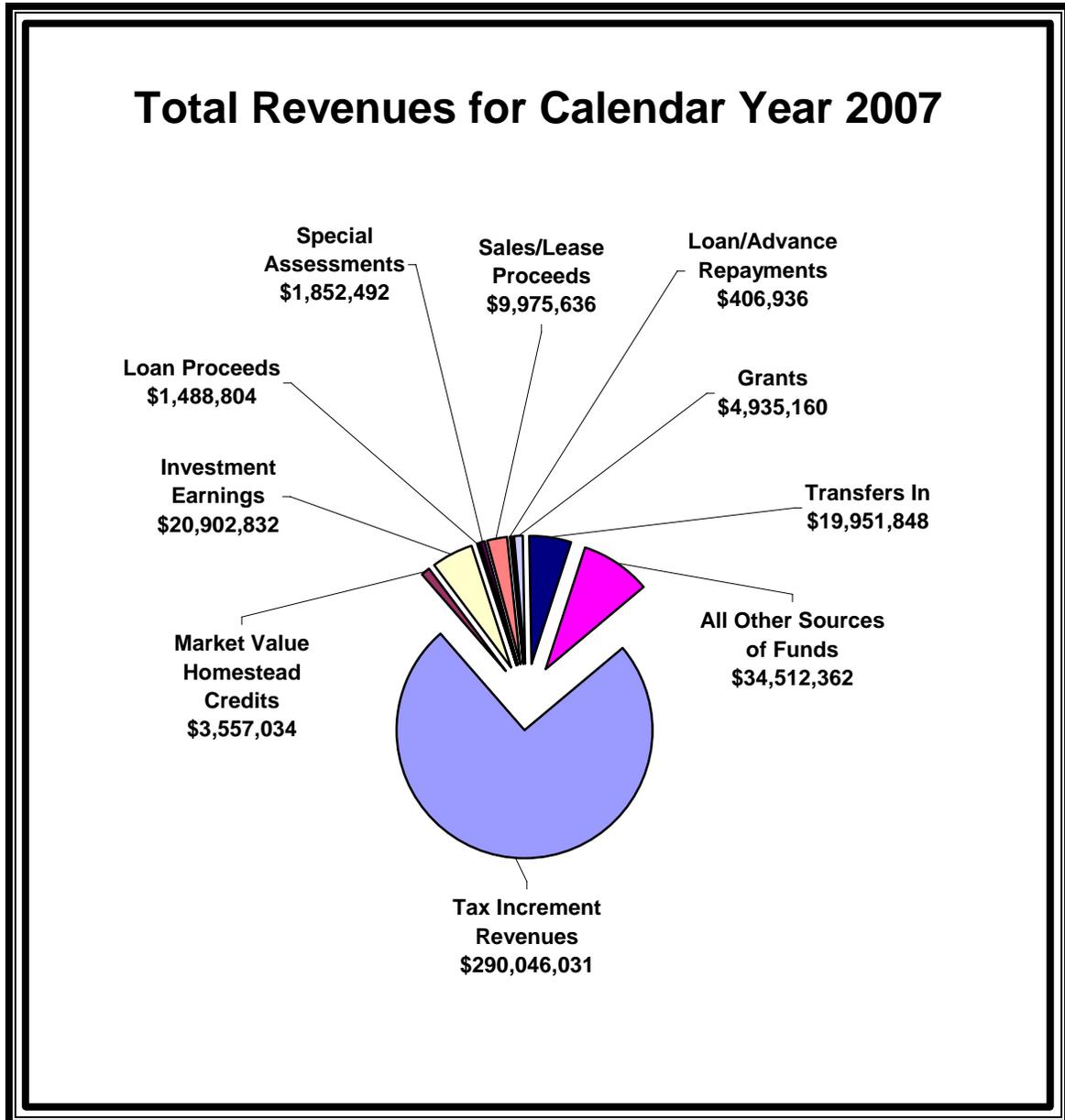
Development activity often receives revenues from a variety of financing sources. Revenues may include, among other funding sources: (i) local, state, and federal grants; (ii) special assessments; (iii) loans; (iv) bond proceeds; (v) interest earned on invested funds; (vi) sales and lease proceeds; (vii) market value homestead credits; and (viii) tax increment revenues.²³

The way in which revenues are reported can be confusing. The nature of generally accepted accounting principles results in some revenues of a project being accounted for twice. For example, a bond may be issued to pay for the authorized costs of a project, and tax increment revenue is then used to pay the principal and interest payments on the bond, and both appear in the TIF reports. To identify revenues without accounting for both bond proceeds and the expenditure of tax increment revenues for payment of bonded indebtedness, bond proceeds have been removed from Figure 14.

²³ Interest earned on invested funds, sales and lease proceeds, and market value homestead credits are often characterized as tax increment revenues.

Three other categories listed in Figure 14, (ix) loan proceeds, (x) loan/advance repayments, and (xi) transfers in, include forms of indebtedness for which tax increment revenues were expended for repayment, resulting in revenues being accounted for twice. Because it is not possible to ascertain from the reports the extent to which tax increment revenues were expended to repay such indebtedness, these three categories were not removed from Figure 14.

Figure 14.



Revenue by Region

Figure 15 illustrates the amount of tax increment generated by region and shows that a substantial share is generated in the Metro Area. Minneapolis and St. Paul are the most fully-developed and densely-populated cities in the state. The Metro Area (Region 11) generates the largest amount of tax increment per district due, in large part, to the higher property tax values within the region.

Figure 15.

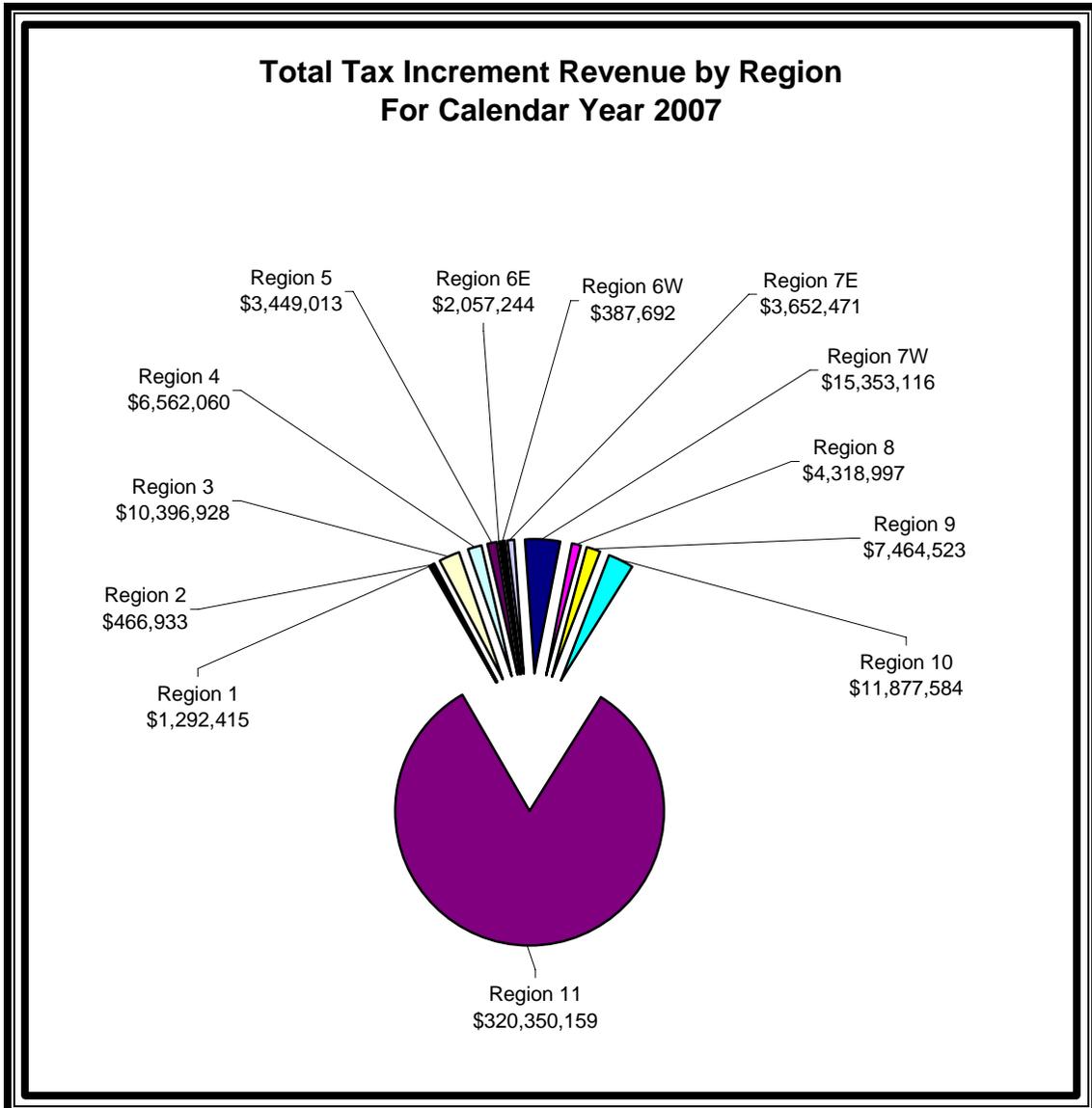
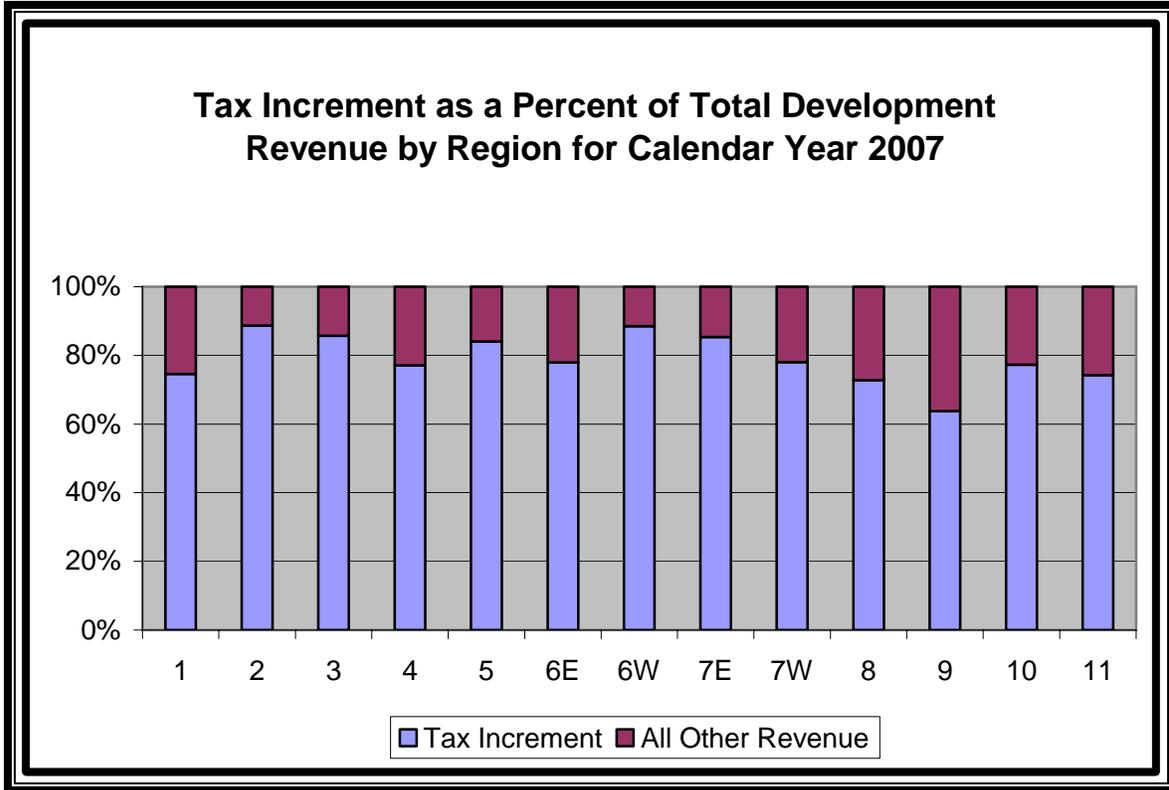


Figure 16 illustrates tax increment revenues as a percent of total revenues by region generated in calendar year 2007.

Figure 16.



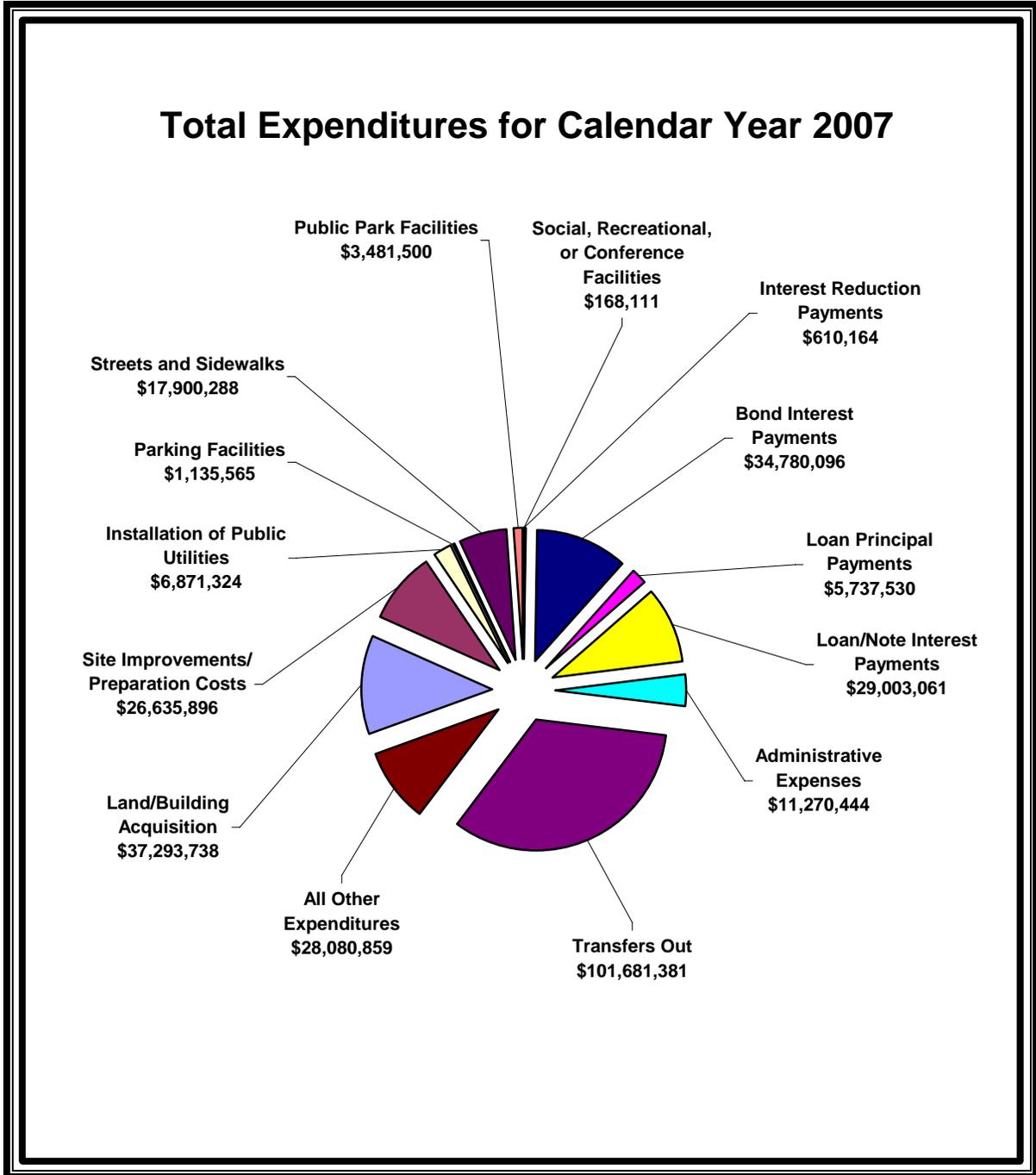
2007 EXPENDITURES

Expenditures for development activity must be made within limits set by state law. Tax increment revenues must be expended only as permitted in the underlying development authority and in the TIF Act.

As with revenues, the way in which expenditures are reported can be confusing. The nature of generally accepted accounting principles results in some costs of a project being accounted for twice. The information contained in the TIF reports includes both the authorized costs of a project and the costs associated with debt service (principal and interest). To identify expenditures without accounting for both the costs of the development activity and the costs associated with debt incurred to cover the costs of the development activity, bond principal payments have been removed from the table above and the two charts that follow. Two other categories listed in Figure 17 -- (i) loan principal payments and (ii) transfers out -- include substantial indebtedness for which tax increment revenues were expended for repayment. Since it is not possible to ascertain from the reports the extent to which tax increment revenues were expended to repay such indebtedness, those two categories were not removed.

Figure 17 highlights the type of expenditures made by development authorities for calendar year 2007.

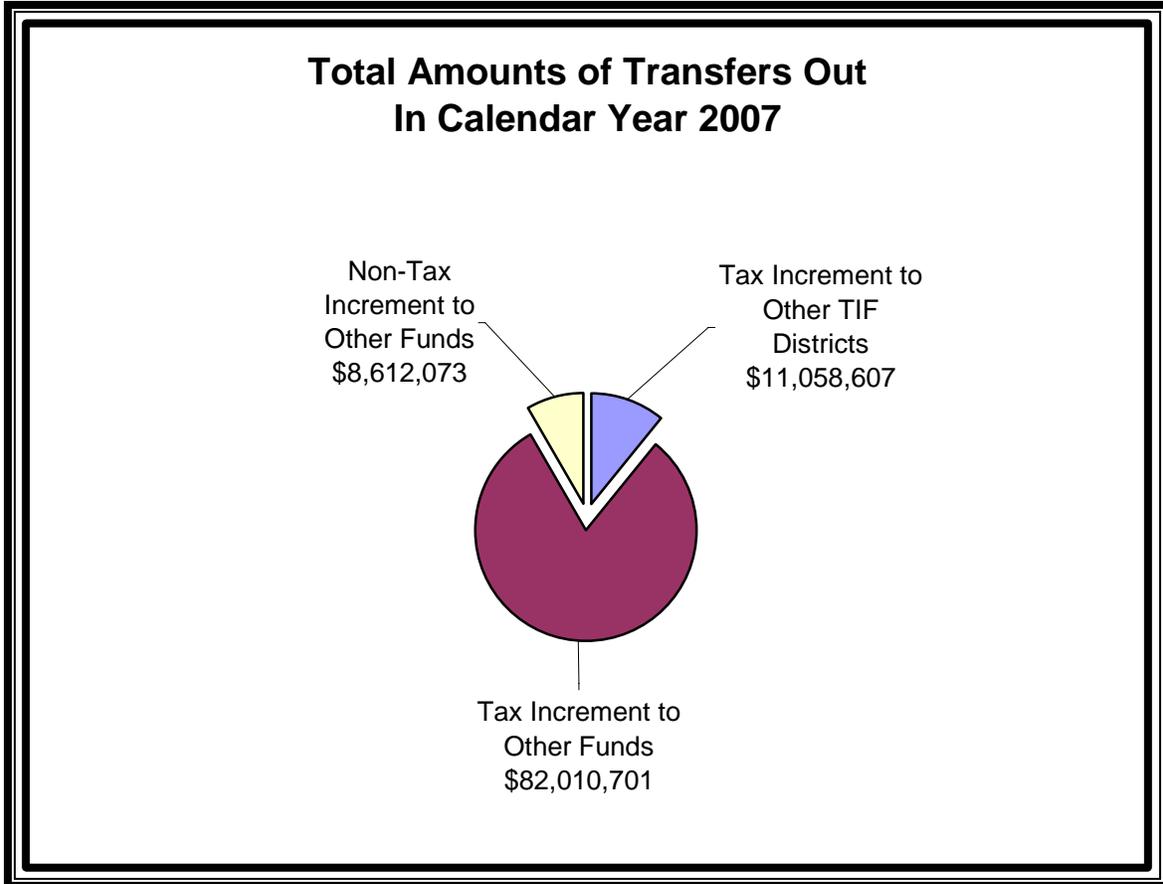
Figure 17.



As noted in Figure 17, the largest expense in 2007 was for transfers out of the TIF districts. Transfers out of the various TIF districts can be divided into three categories: transfers of tax increment to other funds, transfers of tax increment to other TIF districts,

and transfers of non-tax increment revenues to other funds. Figure 18 identifies the amounts transferred out of the TIF districts by category.

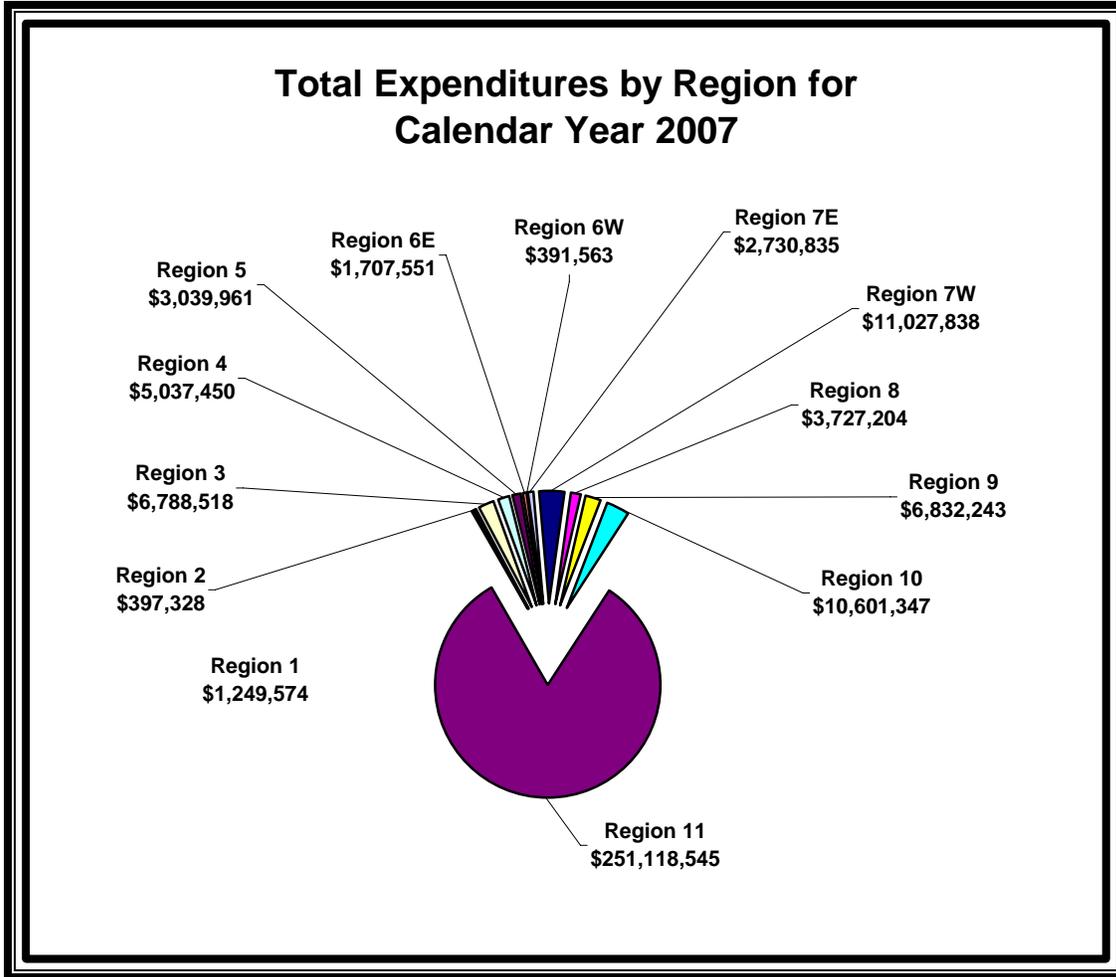
Figure 18.



The amount of tax increment transferred to other TIF districts accounted for approximately 11% of the \$101,681,381 transferred out in calendar year 2007. Very often, these transfers were made to offset deficits in the receiving TIF district(s), or to assist in paying outstanding expenses in the receiving TIF district(s). The amount of tax increment transferred out to other funds was 81% of the total. The vast majority of these transfers were made to make debt service payments on outstanding debt. For example, Minneapolis accounted for 62% of the \$82,010,701 of tax increment transferred to other funds. Minneapolis transferred tax increment for debt service payments. The final eight percent of the transfers out were transfers of non-tax increment revenue to other funds. The non-tax increment revenue includes revenue from such things as special assessments and grants.

Figure 19 highlights the total expenditures by region.

Figure 19.



FINDINGS AND RESPONSES

The Office of the State Auditor conducts informal reviews and limited audits of development authorities. After the completion of a TIF audit, if an authority is not in compliance with the TIF Act, an initial notice of noncompliance (Initial Notice) is sent to the governing body of the municipality that approved the TIF district in which the violation arose. The Initial Notice provides the findings, the basis for the findings, and describes the possible consequences of the noncompliance.

The municipality is required by law to respond in writing within 60 days after receiving the Initial Notice. In its response (Response), the municipality must state whether it accepts, in whole or in part, the findings and indicate the basis for any disagreement with the findings. After consideration of the municipality's Response, the Office of the State

Auditor submits its final notice of noncompliance (Final Notice) to the municipality. The Office of the State Auditor forwards information regarding unresolved findings of noncompliance to the appropriate county attorney, who may bring an action to enforce the TIF Act.²⁴

If the county attorney does not commence an action against the authority within one year after receiving a referral of a Final Notice and the matter is not otherwise resolved to the Office of the State Auditor's satisfaction, the Final Notice is referred to the Attorney General. If the Attorney General finds that the authority violated a provision of the TIF Act, and the violation was substantial, the Attorney General will commence an action in the tax court to suspend the use of TIF by the authority. Before commencing the action in the tax court, however, the Attorney General must attempt to resolve the dispute using appropriate alternative dispute resolution procedures. If the Attorney General commences an action and the tax court finds that the authority violated the TIF Act, and the violation was substantial, the tax court may suspend the use of TIF by the authority for a period of up to five years.²⁵

Summary of Findings and Responses

State law requires the Office of the State Auditor to provide a summary of the Responses it received from the audited municipalities and copies of the Responses themselves to the Chairs of the legislative committees with jurisdiction over tax increment financing.²⁶ This section of the report summarizes the various TIF legal compliance audits and investigations concluded as of December 31, 2008. Audits were completed, and Initial Notices and Final Notices were sent to the following municipalities:

1. City of Coleraine – An Initial Notice was sent on October 21, 2008. A Final Notice was sent on December 30, 2008.
2. City of Rochester – An Initial Notice was sent on September 19, 2008. A Final Notice was sent on November 24, 2008.

Complete copies of the Initial Notices and Final Notices and the municipalities' Responses are provided at the end of this report.

Exceeding Maximum Loan Interest Rates

City of Rochester

TIF Districts 20-1 through 30-1

²⁴ All information and communications remain confidential until the Final Notice is submitted.

²⁵ Minn. Stat. § 469.1771, subd. 2b(c).

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

In the Initial Notice, the Office of the State Auditor found that the interfund loans made by the City between January 1, 2003, and December 31, 2006, were made in violation of the TIF Act because the loans contained a 6.5% interest rate, which exceeded the authorized rates. Furthermore, any interest payments made on the interfund loans after 2006 would have been made in violation of the TIF Act. In its Response, the City acknowledged its mistake and agreed with the Office of the State Auditor's finding. The City proposed reallocating \$186,350 of loan interest payments to loan principal payments using a 4% interest rate. This reallocation would cause the districts to decertify earlier than previously expected.

In the Final Notice, the Office of the State Auditor acknowledged that the proposed correction advanced by the City exceeds the requirements of the statute relating to allowable interest rates. Based on the proposed correction, the documentation provided, and confirming communications with the City, the finding is considered resolved.

Failure to Meet the Income Requirements for Housing Districts

City of Coleraine

TIF District 2

In the Initial Notice, the Office of the State Auditor found that the City did not provide documentation to show that it had satisfied the income requirements for a housing district in TIF District 2. In its Response, the City provided two emails dated December 19 and 20, 2008. The emails were provided to attempt to explain how the income requirements of a housing district on the four-unit townhouse building and the 14-unit assisted living facility were met. However, no documentation was provided to substantiate that the income requirements had been met.

In the Final Notice, the Office of the State Auditor reiterated its finding that the City did not provide documentation to substantiate that it had satisfied the income requirements for a housing district.

Inadequately Documented Expenditures

City of Coleraine

TIF District 2

In the Initial Notice, the Office of the State Auditor found that the City did not substantiate that the \$62,499 of bond proceeds were spent on development costs in accordance with the TIF Act. In its Response, the City provided sufficient documentation to substantiate the use of \$62,499 in accordance with the TIF Act. Based on the documentation provided, the Office of the State Auditor considered this finding resolved.

Failure to Comply with the Four-Year Rule

City of Coleraine

TIF District 3

In the Initial Notice, the Office of the State Auditor found that the City retained parcels in TIF District 3 that did not qualify for retention under the four-year rule and, therefore, no tax increment could be taken from the parcels after August 9, 2006. In its Response, the City agreed with this finding and indicated that the TIF district would be decertified and tax increment returned to the county.

In the Final Notice, the Office of the State Auditor considered this finding resolved, subject to the receipt of a copy of the check returning the tax increment to Itasca County and a copy of the Decertification Confirmation Form signed by the Itasca County Auditor by January 30, 2009.

Failure to Segregate Tax Increment

City of Coleraine

TIF District 3

In the Initial Notice, the Office of the State Auditor found that the City had deposited tax increment from TIF District 3 into its general fund. The City's general ledger did not distinguish which expenditures from this fund were made with tax increment from a specific TIF district and which expenditures were made with non-tax increment. In its Response, the City agreed with this finding and indicated that the TIF district would be decertified and tax increment returned to the county.

In the Final Notice, the Office of the State Auditor considered this finding resolved, subject to the receipt of a copy of the check returning the tax increment to Itasca County and a copy of the Decertification Confirmation Form signed by the Itasca County Auditor by January 30, 2009.

Failure to Publish Public Hearing Notices

City of Coleraine

TIF Districts 3 and 4

In the Initial Notice, the Office of the State Auditor found that the City could not demonstrate that it complied with the publication requirements when it created TIF Districts 3 and 4 or when it modified the TIF plan for TIF District 4. The failure of the City to demonstrate that it complied with the publication requirements is insufficient to invalidate the establishment of these districts. However, it is considered sufficiently material for the matter to constitute a finding. In its Response, the City provided a copy of a letter prepared by David Drown Associates requesting the publication of the public hearing notice, the map for TIF District 3, copies of the affidavit of publication for the public hearing notice, and the required map for both TIF District 4 and the modification to TIF District 4. The City Response stated that an affidavit of publication for TIF District 3 was not found in the City files and, since this district was to be decertified, the City could not see a practical benefit in requesting a copy of the affidavit from the local newspaper.

In the Final Notice, the Office of the State Auditor considered the finding for TIF District 4 resolved and, since TIF District 3 will be decertified and tax increment returned to Itasca County, the Office of the State Auditor considered this issue moot for TIF District 3.

Unqualified Expenditures

City of Coleraine

TIF District 4

In the Initial Notice, the Office of the State Auditor found that the City spent \$20,000 of tax increment and/or TIF bond proceeds for an unqualified expenditure. If documentation were to be provided to support the City's explanation that \$20,000 was a qualified expenditure, the Office of the State Auditor would consider withdrawing its finding. In its Response, the City stated that a development agreement was in place that provided for 80% of the TIF revenue to be paid to the developer on a pay-as-you-go basis. The City also stated that, by mutual agreement, the reimbursement to the developer was to be placed in an account held by the City and that both the City and the developer understood the account was an asset owned by the developer. The City stated the \$20,000 in this account was loaned to the City by the developer for cable TV utility improvements. The City characterizes the \$20,000 as an asset of the developer. As such, the City asserts it cannot be tax increment. The City acknowledged that it lacks statutory authority to borrow money from private parties. No documentation was provided to support the City's explanation.

In the Final Notice, the Office of the State Auditor reiterated its finding that, because documentation was not provided to support the City's explanation, the City spent \$20,000 of tax increment and/or TIF bond proceeds for an unqualified expenditure.

APPENDIX A

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REBECCA OTTO
STATE AUDITOR

STATE OF MINNESOTA

OFFICE OF THE STATE AUDITOR

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SAINT PAUL, MN 55103-2139

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(651) 296-4755 (Fax)
state.auditor@state.mn.us (E-Mail)
1-800-627-3529 (Relay Service)

October 21, 2008

The Honorable John Sloan, Mayor
The Honorable Charles Appelholm, Council Member
The Honorable Holly Guyer, Council Member
The Honorable Shelley McCauley, Council Member
The Honorable Rick Sorenson, Council Member
City of Coleraine
PO Box 670
Coleraine, MN 55722

Re: City of Coleraine's TIF Districts—Initial Notice of Noncompliance

Dear Mayor Sloan and Council Members:

On July 15, 2008 through July 17, 2008, the Office of the State Auditor (OSA) performed an on-site examination of the tax increment financing (TIF) district records of the City of Coleraine (City). The examination covered the following districts: TIF District 2 (Dale Nordin Hsg Proj), TIF District 3 (Indust Parks Proj) and TIF District 4 (Wildwood Point). After careful consideration, the OSA finds that the City has not complied with state law governing the use of tax increment financing. This Initial Notice of Noncompliance (Notice) contains our findings and comments regarding the examination.

All data relating to the examination, including this Notice and its response, are not public until the OSA has issued its final report.¹

Please be aware that state law requires the City to respond in writing within 60 days after receipt of this Notice. Your response must state whether you accept the findings, in whole or in part, and must indicate the basis for any disagreement. After reviewing your response, the OSA is required to forward information on any unresolved issues to the Itasca County Attorney for review.²

If the City pays to the County an amount equal to the amount in noncompliance indicated in this Notice, the OSA will consider the finding to be resolved. The City receives its proportionate share of the redistribution of the funds that have been returned to the County, if the City makes the payment within 60 days after the City receives this Initial Notice of Noncompliance.³

¹ See Minn. Stat. § 6.715.

² See Minn. Stat. § 469.1771, subd. 1.

³ See Minn. Stat. § 469.1771, subd. 5.



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Mayor and Council, City of Coleraine
October 21, 2008
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BACKGROUND

The OSA examined the following TIF districts in the City of Coleraine.

TIF District	TIF District Name	District Type	TIF-Plan Approval Date	Certification Request Date	Certification Date
2	Dale Nordin Hsg Proj	Housing	March 27, 2000	July 3, 2000	August 7, 2000
3	Indust Parks Proj	Redevelopment	June 10, 2002	July 12, 2002	August 9, 2002
4	Wildwood Point	Redevelopment	October 28, 2002	November 4, 2002	November 13, 2002

FINDINGS OF NONCOMPLIANCE

The OSA's findings of noncompliance regarding the City's TIF districts are as follows:

Finding 1. TIF District 2— Failure to Meet the Income Requirements for Housing Districts

TIF District 2 must satisfy certain income requirements in order to qualify as a housing district:⁴

For owner occupied residential property, 95 percent of the housing units must be initially purchased and occupied by individuals whose family income is less than or equal to the income requirements for qualified mortgage bond projects under section 143(f) of the Internal Revenue Code.

The OSA requested documentation to substantiate that the property included in TIF District 2 satisfied the income requirements for a housing district. The City did not provide such documentation.

We find, for TIF District 2, that the City did not satisfy the income requirements for a housing district.

Finding 2. TIF District 2—Inadequately Documented Expenditures

In 2000, the City issued a \$150,000 revenue bond to pay for development costs in TIF District 2. Based on information contained in the City's financial records, it appears that \$62,499 of bond proceeds were spent for development costs. In addition, the City used \$58,362 of the bond proceeds to make a debt service payment in 2003. The remaining bond proceeds were used to pay for costs related to issuing the bond and other administrative expenses. However, the City did not provide documentation to substantiate that the \$62,499 of bond proceeds spent on development costs were spent on TIF-eligible expenditures.

⁴ See Minn. Stat. § 469.1761, subd. 2.

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Mayor and Council, City of Coleraine
October 21, 2008
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We find that the City did not substantiate that the \$62,499 of bond proceeds were spent on development costs in accordance with the TIF Act.

Finding 3. TIF District 3— Failure to Comply with Four-Year Rule

A TIF authority must perform certain activities on each parcel in a TIF district in accordance with the TIF plan within four years from the date the TIF district was certified, or the parcel(s) must be removed from the TIF district. This statute is known as the “four-year rule.”⁵

If, after four years from the date of certification of the original net tax capacity of the tax increment financing district pursuant to section 469.177, no demolition, rehabilitation, or renovation of property or other site preparation, including improvement of a street adjacent to a parcel but not installation of utility service including sewer or water systems, has been commenced on a parcel located within a tax increment financing district by the authority or by the owner of the parcel in accordance with the tax increment financing plan, no additional tax increment may be taken from that parcel.

TIF District 3 was certified on August 9, 2002. The City did not provide any documentation to substantiate that qualifying improvements were made to all of the parcels in TIF District 3 within four years from the date of certification.

We find that the City retained parcels in TIF District 3 that did not qualify for retention under the four-year rule and, therefore, no tax increment may be taken from the parcels after August 9, 2006.

Finding 4. TIF District 3—Failure to Segregate Tax Increment

A TIF authority must segregate the tax increment it receives from each TIF district in a special account or accounts on the city’s official books and records.⁶ An authority is required to have an accounting system that keeps the receipts and disbursements of each TIF district’s tax increment separate from the receipts and disbursements of cash from all other sources, including tax increment from other TIF districts. In addition, generally accepted accounting principles require an authority’s accounting system to be structured to produce documentation that demonstrates which costs were paid with each district’s tax increment.⁷

The City deposited tax increment from TIF District 3 into its general fund. The City’s general ledger did not distinguish which expenditures from this fund were made with tax increment from a specific TIF district and which expenditures were made with non-tax increment.

⁵ See Minn. Stat. § 469.176, subd. 6.

⁶ Minn. Stat. § 469.177, subd. 5.

⁷ See Governmental Accounting Standards Board’s Codification of Accounting and Financial Reporting Standards as of June 30, 2000, §§ 1100.101 and 1200.106.

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Mayor and Council, City of Coleraine
October 21, 2008
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We find that the City did not segregate the tax increment it received from TIF District 3 as required by the TIF Act. As a result, the City cannot demonstrate that any of its expenditures of TIF funds for this TIF district were made in accordance with the TIF Act.

Finding 5. TIF Districts 3 and 4—Failure to Publish Public Hearing Notices

The City is required to include in the public hearing notice a map of the area of the TIF district from which tax increment will be collected. If the project area in which tax increment may be spent is larger than the TIF district, the City also is required to include a map of the project area in which the tax increment may be expended.⁸ The City did not provide any documentation that a public hearing notice and the required maps were published for TIF Districts 3 and 4, as well as for the 2004 modification of TIF District 4.

We find that the City cannot demonstrate that it complied with the publication requirements when it created TIF Districts 3 and 4 or when it modified the TIF plan for TIF District 4. While the failure of the City to demonstrate that it complied with the publication requirements is insufficient to invalidate the establishment of these districts, it is considered sufficiently material for the matter to constitute a finding.

Finding 6. TIF District 4—Unqualified Expenditures

In 2005, the City issued a \$1,510,000 TIF Revenue Bond to pay for costs such as public utilities and streets. The City also entered into a development agreement to reimburse the developer for qualifying expenditures. Based on the information in the City's financial records, it does not appear that any payments have been made to the developer in accordance with this agreement.

While reviewing the City's ledgers and audited financial statements, the OSA discovered a \$20,000 expenditure that is identified as an "Internet Construction Loan." Tax increment or TIF bond proceeds cannot be used to pay for this type of expenditure, and it is not a qualified expenditure in the TIF Act.

In discussions with the City and the City's financial advisor, the OSA was told that the developer did not want the tax increment paid to him directly, but wanted to keep the funds in a City account. The OSA was told that the \$20,000 was a payment to the developer. That amount was then loaned to the City to pay for the costs of bringing cable and/or internet to the developer's housing development. The OSA could not find documentation indicating that any payment was made to the developer. In addition, there is no evidence that a written loan agreement exists between the City and the developer.⁹

Absent documentation to support the City's explanation, the OSA finds that the City spent \$20,000 of tax increment and/or TIF bond proceeds for an unqualified expenditure.

⁸ See Minn. Stat. § 469.175, subd. 3.

⁹ We note that it appears that the City does not have statutory authority to borrow from private parties, such as local developers.

OFFICE OF THE STATE AUDITOR

Mayor and Council, City of Coleraine

October 21, 2008

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CONCLUSION

The City's response to these findings must be submitted in writing to the Office of the State Auditor within 60 days after receipt of this notice. We are available to review and discuss the findings within this letter at any time during the preparation of your response. After reviewing your response, the State Auditor will issue the Final Notice of Noncompliance.

If you have any questions, please call me at (651) 296-7979. We look forward to receiving your response.

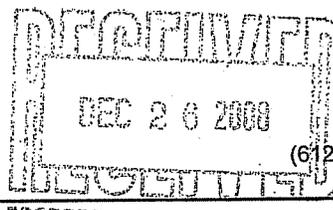
Very truly yours,



Arlin Waelti
Assistant State Auditor
TIF Division Director

cc: Sandy Bluntach, City Clerk/Treasurer

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Minneapolis Office:
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Minneapolis, MN 55419
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www.daviddrown.com

19 December 2008

Ms. Arlin Waelti, Assistant State Auditor
TIF Division Director
Office of the State Auditor
Suite 500
525 Park Street
Saint Paul, MN 55103-2139

**RE: City of Coleraine, MN
Initial Notice of Noncompliance**

Dear Ms. Waelti:

David Drown Associates serves as fiscal and economic development consultant to the City of Coleraine. We have been directed by the City Council to prepare a response to your office's letter of October 21, 2008 regarding City compliance with state law governing the use of tax increments. This letter identified six (6) incidents of non-compliance; the City's response to each follows.

Finding 1: TIF District No. 2 – Failure to Meet Income Requirements for Housing Districts.

Housing within this TIF District consists of one (1) four-unit townhouse building and one 14-unit assisted living facility. Three of the townhouse units have been sold and the fourth is rented. All of the assisted living units are operated as rental units.

The City has historically verified income compliance by non-written means. We have asked the developer and current owners to submit written documentation to help confirm income compliance. Attached is an email from Mr. Lee Aultman, the original developer of the housing project, confirming that three of the four townhouse units were initially purchased by individuals whose incomes were less than 100% of state median income at the time of sale. The fourth unit is rented to a family whose income is not qualifying. Also attached is copy of an email from the accountant for the Home and Comfort assisted living facility, stating that on average at least 63% of their residents have incomes at or below 80% of median county income. (A signed original of this emailed letter is being mailed to the City, and will be forwarded to you upon receipt.) That means that 8.82 of their 14 units have been rented to income-qualified residents. Looking at all rental units, we see that 8.82 of the 15 units or 58.8% are rented to qualified families. The actual percentage is probably much higher.

This written evidence confirms that all units that have been sold were initially sold to families making less than 100% of median state income, and that over 50% of rental units are rented to families with incomes less than 80% of median county income.

Finding 2: TIF District No. 2 -- Inadequately Documented Expenditures

Attached are copies of invoices documented expenditures totaling \$75,255, which exceed the \$62,499 of bond proceeds paid to the developer to reimburse site improvement expenses. These invoices and amount, summarized below, should adequately document this expenditure.

Midway Excavating	Excavation, fill and utilities	\$15,630
C&T Construction	Concrete work	8,680
SBS Inc.	Driveway	4,860
C&T Construction	Driveway approach	550
B&D Co.	Foundation and concrete work	28,114
Midway Excavating	Excavation, fill and utilities	<u>17,421</u>
		\$75,255

Finding 3: TIF District No. 3 – Failure to Comply with 4-Year Rule

Since no qualifying activity of any kind has taken place in this TIF District, we agree with the finding that all parcels in this TIF District should have been removed. The City will decertify this TIF District by resolution at its next scheduled meeting in January 2009. Since August 9, 2006 the City has collected TIF revenues totaling \$2,315.47. This amount, plus any future collections will be returned to the Itasca County Auditor.

Finding 4: TIF District No. 3 – Failure to segregate Tax Increment

The City accepts the finding that a separate fund was not established for this TIF District. However, since this TIF District has experienced almost no activity, and the limited number of receipts and disbursements of this TIF District are easily identified in City records, no harm has been done as the City can clearly document how TIF revenues were utilized. This satisfies the intent of TIF law.

As noted above, the City will decertify this TIF District and return increment collections to the County Auditor as soon as possible.

Finding 5: TIF District No. 3 and 4 – Failure to Publish Hearing Notices

For TIF District No. 3, we are submitting a copy of a letter prepared by David Drown Associates dated May 20, 2002 requesting the Scenic Range News to publish the public hearing notice and location map. A copy of the affidavit of publication was not found in our files. As the City is decertifying TIF District NO. 3, we see no practical benefit of seeking this affidavit from the Scenic Range News.

Copies of the affidavits of publication for TIF District No. 4 and Modification #1 to TIF District No. 4 are also attached.

Finding 6: TIF District No. 4 – Unqualified Expenditures

The \$1,510,000 Revenue bond issued by the City in 2005 was designed to be paid using tax increment revenues from a proposed hotel project along with special assessments levied on residential lots. When the hotel portion of the project did not materialize, a portion of the bond issue was called (paid off). The remaining bonds will be repaid with special assessment revenues. The companion development agreement for this project provided that 80% of TIF revenue would be paid to the developer on a pay-as-you-go basis. The developer planned to use these payments to fund a portion of his special assessment payments and other eligible expenditures.

As tax increment revenues are generated in this TIF District, by mutual agreement the 80% developer payment amounts are placed in an account held by the City. This account contains only the accumulated payments made to the developer, and both the City and the developer understand this account to be an asset of the developer. Using funds in this account, the developer authorized a \$20,000 loan to the City which was used for cable TV utility improvements.

We agree with OSA's assertion that the City lacks statutory authority to borrow money from private parties as a loan. This borrowing could have and should have been accomplished using a properly-documented bond or note. Fortunately, this loan has now been repaid in full and the City intends to be more careful with its borrowing practices in the future.

We do not agree with the OSA's assertion that the \$20,000 loan represents an unqualified TIF expenditure. The loan was made from a fund containing only the developer's dollars. As the City placed funds into this account, the payments converted from tax increments and became the developer's property. So, as this loan was made using developer funds and not tax increments, the loan cannot be considered an unqualified expenditure of tax increments.

Hopefully, the above responses fully address the OSA's questions and concerns. Should you have any further questions or concerns, please feel free to contact me directly.

Yours truly,

A handwritten signature in cursive script, appearing to read "D. Drown".

David P. Drown, President
David Drown Associates, Inc.

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REBECCA OTTO
STATE AUDITOR

STATE OF MINNESOTA

OFFICE OF THE STATE AUDITOR

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1-800-627-3529 (Relay Service)

December 30, 2008

The Honorable John Sloan, Mayor
The Honorable Charles Appelholm, Council Member
The Honorable Holly Guyer, Council Member
The Honorable Shelley McCauley, Council Member
The Honorable Rick Sorenson, Council Member

City of Coleraine

PO Box 670
Coleraine, MN 55722

Re: City of Coleraine's TIF Districts—Final Notice of Noncompliance

Dear Mayor Sloan and Council Members:

On October 21, 2008, the Office of the State Auditor (OSA) sent the City of Coleraine (City) an Initial Notice of Noncompliance (Initial Notice) regarding the following tax increment financing (TIF) districts: TIF District 2 (Dale Nordin Hsg Proj), TIF District 3 (Indust Parks Proj) and TIF District 4 (Wildwood Point). Our office received the City's response (City Response) on December 19, 2008, in a letter from David Drown, President of David Drown Associates, Inc.

This letter is the Final Notice of Noncompliance (the "Final Notice") of the Office of the State Auditor. It summarizes the initial findings, the City Response, and provides the OSA's final conclusion regarding the issues raised by the review. A detailed discussion of the basis for the findings can be found in the Initial Notice.

BACKGROUND

The OSA examined the following TIF districts in the City of Coleraine.

TIF District	TIF District Name	District Type	TIF-Plan Approval Date	Certification Request Date	Certification Date
2	Dale Nordin Hsg Proj	Housing	March 27, 2000	July 3, 2000	August 7, 2000
3	Indust Parks Proj	Redevelopment	June 10, 2002	July 12, 2002	August 9, 2002
4	Wildwood Point	Redevelopment	October 28, 2002	November 4, 2002	November 13, 2002

OFFICE OF THE STATE AUDITOR

Mayor and Council, City of Coleraine
December 30, 2008
Page 2

FINDINGS OF NONCOMPLIANCE

The OSA's findings of noncompliance regarding the City's TIF districts are as follows:

Finding 1. TIF District 2— Failure to Meet the Income Requirements for Housing Districts

In the Initial Notice, the OSA found that, for TIF District 2, the City did not provide documentation to substantiate that it satisfied the income requirements for a housing district. In the City Response, the City provided two emails dated December 19 and 20, 2008. The emails were provided to attempt to explain how the income requirements of a housing district on the four-unit townhouse building and the 14-unit assisted living facility were met.

The first email from Kara Winkelman, Business Manager for the Home and Comfort assisted living facility, stated that she generally does not ask residents to provide income information. Based on the information contained in Ms. Winkelman's email, it does not appear that the income guidelines were documented on an annual basis as is required for rental property in a housing district. In addition, no documentation was provided.

The second email from Lee Aultman stated that he qualified everyone at the time of purchase, but did not get their exact income. Even so, the income information contained in the email would not have satisfied the income requirements of the TIF Act. In addition, no documentation was provided.

The OSA reiterates its finding that the City did not provide documentation to substantiate that it satisfied the income requirements for a housing district.

Finding 2. TIF District 2—Inadequately Documented Expenditures—RESOLVED

In the Initial Notice, the OSA found that the City did not substantiate that the \$62,499 of bond proceeds were spent on development costs in accordance with the TIF Act.

In the City Response, the City provided sufficient documentation to substantiate the use of \$62,499 of bond proceeds spent on development costs in accordance with the TIF Act. Based on the documentation provided, the OSA considers this finding resolved.

Finding 3. TIF District 3— Failure to Comply with Four-Year Rule

In the Initial Notice, the OSA found that the City retained parcels in TIF District 3 that did not qualify for retention under the four-year rule and; therefore, no tax increment may be taken from the parcels after August 9, 2006.

In the City Response, the City agreed with this finding. In addition, the City stated that this district would be decertified at the next scheduled City Council meeting in January 2009. The City will also return \$2,315.47 plus any future collection of tax increment to the Itasca County Auditor. Based on this information, the OSA will consider this finding resolved subject to the receipt of the following

OFFICE OF THE STATE AUDITOR

Mayor and Council, City of Coleraine
December 30, 2008
Page 3

documentation: a copy of the check returning the tax increment to Itasca County and a copy of the Decertification Confirmation Form signed by the Itasca County Auditor by January 30, 2009.

Finding 4. TIF District 3—Failure to Segregate Tax Increment

In the Initial Notice, the OSA found that the City did not segregate the tax increment it received from TIF District 3 as required by the TIF Act. As a result, the City cannot demonstrate that any of its expenditures of TIF funds for this TIF district were made in accordance with the TIF Act.

In the City Response, the City stated that it accepts this finding. The City also indicated that it will decertify this TIF district and return tax increment collections to the Itasca County Auditor. Based on this information, the OSA will consider this finding resolved subject to the receipt of the following documentation: a copy of the check returning the tax increment to Itasca County and a copy of the Decertification Confirmation Form signed by the Itasca County Auditor by January 30, 2009.

Finding 5. TIF Districts 3 and 4—Failure to Publish Public Hearing Notices—RESOLVED

In the Initial Notice, the OSA found that the City cannot demonstrate that it complied with the publication requirements when it created TIF Districts 3 and 4 or when it modified the TIF plan for TIF District 4. While the failure of the City to demonstrate that it complied with the publication requirements is insufficient to invalidate the establishment of these districts, it is considered sufficiently material for the matter to constitute a finding.

In the City Response, the City provided a letter prepared by David Drown Associates requesting the publication of the public hearing notice and the map for TIF District 3 as well as copies of the affidavit of publication for the public hearing notice and required map for both TIF District 4 and the modification to TIF District 4. The City Response stated that an affidavit of publication for TIF District 3 was not found in the City files and since this district was to be decertified, the City could not see a practical benefit in requesting a copy of the affidavit from the local newspaper.

Based on the documentation provided with the City Response for TIF District 4, the OSA considers this finding resolved. In addition, since TIF District 3 will be decertified and tax increment returned to Itasca County, the OSA will consider this issue moot.

Finding 6. TIF District 4—Unqualified Expenditures

In the Initial Notice, the OSA found that, absent documentation to support the City's explanation that the \$20,000 used for the "Internet Construction Loan" was not tax increment, the OSA finds that the City spent \$20,000 of tax increment and/or TIF bond proceeds for an unqualified expenditure.

In the City Response, the City stated that a development agreement was in place that provided for 80% of the TIF revenue to be paid to the developer on a pay-as-you-go basis. The City also stated that, by mutual agreement, the reimbursement to the developer was to be placed in an account held by the City and that both the city and the developer understood the account was an asset owned by the developer. The City

OFFICE OF THE STATE AUDITOR

Mayor and Council, City of Coleraine

December 30, 2008

Page 4

states that the \$20,000 in this account was loaned to the City by the developer for cable TV utility improvements. The City characterizes the \$20,000 as an asset of the developer. As such, the City asserts it cannot be tax increment. The City acknowledges that it lacks statutory authority to borrow money from private parties.

Because documentation was not provided to support the City's explanation that the \$20,000 was not tax increment, the OSA finds that the City spent \$20,000 of tax increment and/or TIF bond proceeds for an unqualified expenditure.

CONCLUSION

If you have questions, would like additional information, or if we can be of assistance in the future, please do not hesitate to contact me. I can be reached at (651) 296-7979.

Very truly yours,



Arlin Waelti
Assistant State Auditor
TIF Division Director

cc: Sandy Bluntach, City Clerk/Treasurer

APPENDIX B

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REBECCA OTTO
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September 19, 2008

The Honorable Ardell Brede, Mayor
The Honorable Pat Carr, Council Member
The Honorable Dennis Hanson, Council Member
The Honorable Ed Hruska, Council Member
The Honorable Marcia Marcoux, Council Member
The Honorable Sandra Means, Council Member
The Honorable Robert Nowicki, Council Member
The Honorable Bruce Snyder, Council Member

The City of Rochester

201 4th Street SE
Rochester, MN 55904

Re: **Rochester TIF Districts— Initial Notice**

Dear Mayor Brede and Council Members:

On July 7, 2008 and August 8, 2008 the Office of the State Auditor performed an on-site examination of certain records of twelve tax increment financing districts (TIF Districts) located in the City of Rochester (City). The limited scope audit (Audit) covered TIF District No. 2-2 (Redevelopment District) and TIF District Nos. 20-1 through 30-1 (Housing Districts). All of these districts are currently active.

The Audit examined, on a test basis, evidence supporting the City's compliance with the TIF Act.¹ We reviewed and/or tested the TIF District Reports filed with our office through the year ended December 31, 2006, the City's comprehensive annual financial reports (CAFRs), TIF plans, general ledgers, invoices, interfund loans agreements/resolutions, documents verifying incomes of initial home purchasers, loan closing documents, and other supporting documents against the requirements of the TIF Act.

After careful consideration, we find that the City has not complied with state law with respect to the use of tax increment financing in its Housing Districts. This initial notice of noncompliance (Initial Notice) contains our finding regarding the Audit.

¹ See Minn. Stat. §§ 469.174 to 469.1799.

OFFICE OF THE STATE AUDITOR

Mayor and Council, City of Rochester
September 19, 2008
Page 2

State law requires the City to respond in writing to our office within 60 days after receipt of this Initial Notice. Your response (Response) must state whether you accept the finding, in whole or in part, and indicate the basis for any disagreement. At the conclusion of our Audit, if the finding remains unresolved, a final notice of noncompliance (Final Notice) will be submitted to the City. If our office finds evidence that the City has violated a provision of the TIF Act for which a remedy is provided, we will forward the relevant information to the Olmsted County Attorney for review.² All data relating to this Audit, including this Initial Notice and its Response, are not public until our office has issued its Final Notice.³

FINDING OF NONCOMPLIANCE

Our finding of noncompliance regarding the Housing Districts is as follows:

Finding 1. TIF District Nos. 20-1 through 30-1 (Housing) – Loan interest rates

TIF District Nos. 20-1 through 30-1 were created between calendar years 2001 and 2004 to further, among other things, affordable housing goals in the City. From 2001 through 2006, the City used non-TIF funds (internal loans) to finance the housing costs shown in the TIF plan for each of its Housing Districts. The City also used tax increment from each Housing District to pay itself interest on the interfund loans at a 6.5% rate, and to make loan principal payments.

The TIF Act states, in part, that the maximum interest rates permitted to be charged on interfund loans or advances is the greater of the rates specified under section 270C.40 or 549.09 as of the date the loan or advance is made.⁴ The following interest rates are the rates specified in those sections for the years 2001 through 2008.

Year	270C.40	549.09	Max. Rate
2001	9%	6%	9%
2002	7%	2%	7%
2003	5%	4%	5%
2004	4%	4%	4%
2005	4%	4%	4%
2006	6%	4%	6%
2007	8%	5%	8%
2008	8%	4%	8%

² See Minn. Stat. § 469.1771, subd. 1.

³ See Minn. Stat. § 6.715.

⁴ Minn. Stat. § 469.178, subd. 7.

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Mayor and Council, City of Rochester
September 19, 2008
Page 3

As indicated by the information provided, any interfund loan issued by the City between January 1, 2003 and December 31, 2006 that contained a 6.5% interest rate was issued in violation of the TIF Act because the maximum allowable rate authorized by the Act was 5% in 2003, 4% in 2004 and 2005, and 6% in 2006.

We find that the interfund loans made by the City between January 1, 2003 and December 31, 2006 were made in violation of the TIF Act because the loans contained a 6.5% interest rate and that rate exceeded the rates authorized by the TIF Act. Furthermore, even though this Initial Notice goes through December 31, 2006, any interest payments made on the interfund loans after 2006 were made in violation of the TIF Act because the applicable TIF Act provision relates to the date the loan was made and not to when the interest payments were made.

CONCLUSION

As noted above, the City's Response to this finding must be submitted in writing to our office within 60 days after receipt of this Initial Notice. Our TIF Division staff is available to review and discuss the findings and comments herein at any time during the preparation of your Response. After reviewing your Response, the Office of the State Auditor will issue its Final Notice.

If you have any questions, please call me at (651) 296-7979. We look forward to receiving your Response.

Very truly yours,



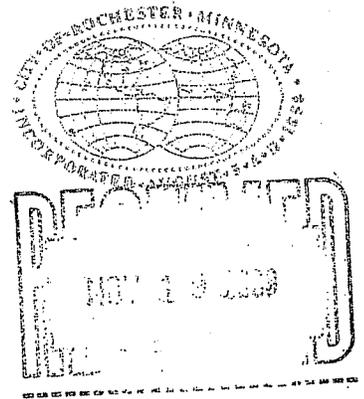
Arlin B. Waelti
Assistant State Auditor
TIF Division Director

Cc: Dale Martinson, Finance Director

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Mayor Ardell F. Brede
201 4th Street SE - Room 281
Rochester, MN 55904-3782
Phone: (507) 328-2700 - Fax: (507) 328-2727



November 17, 2008

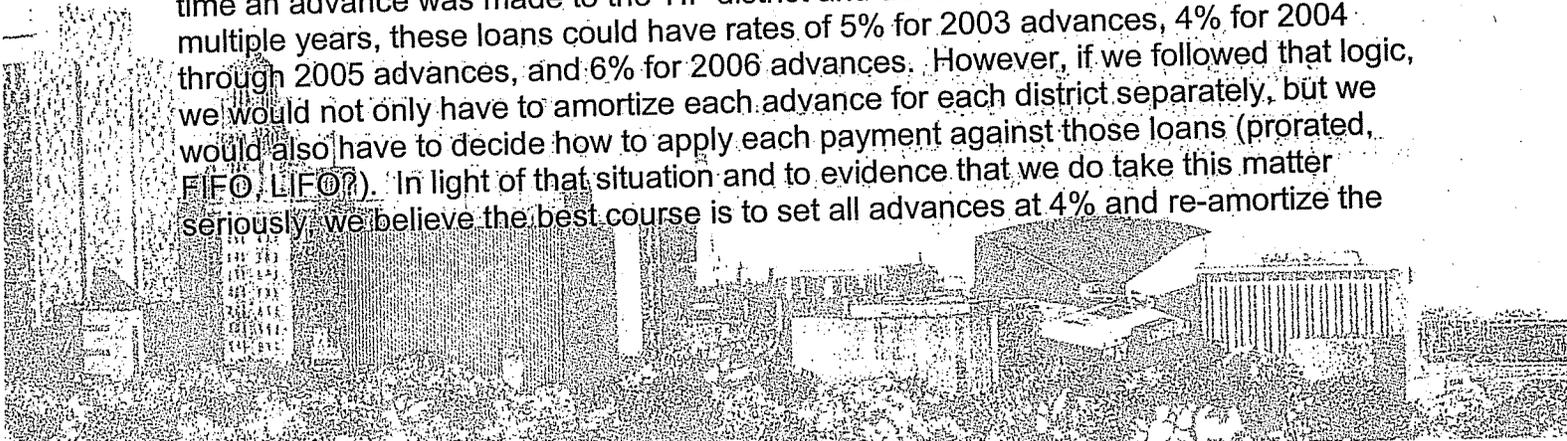
Arlin B. Waelti
Assistant State Auditor
TIF Division Director
Suite 500
525 Park Street
Saint Paul, Minnesota 55103-2139

Dear Ms. Waelti:

We are in receipt of your Initial Notice letter on our Rochester TIF Districts dated September 19, 2008. We understand that through your on-site examination of twelve of the City's tax increment financing districts (TIF Districts), you noted one finding regarding our Housing Districts. That finding states that interfund loans made from other City funds to pay for TIF eligible expenses during certain years were set at interest rates that exceeded allowable rates. Specifically, you have found that loans made between January 1, 2003 and December 31, 2006 at 6.5% exceeded the allowable rates over those years which ranged from 4% to 6%. This was an oversight on our part and we agree with your finding. We have made changes to our procedures to include checking the maximum allowable rate prior to seeking approval of interfund advances from the City Council.

To address this error, I as Mayor of the City of Rochester, and on behalf of the City Council, propose to set all advances in these housing districts at 4% and re-amortize the loans. This will cause a reallocation of \$186,350 of payment amounts previously applied to interest to now be applied to principal as reflected in the attached spreadsheet. The net effect of this action will cause the districts to retire earlier than previously expected.

It is important to note that this correction will actually exceed the requirements of the statute relating to allowable interest rates. Because "loans" are technically made each time an advance was made to the TIF district and advances on each district spanned multiple years, these loans could have rates of 5% for 2003 advances, 4% for 2004 through 2005 advances, and 6% for 2006 advances. However, if we followed that logic, we would not only have to amortize each advance for each district separately, but we would also have to decide how to apply each payment against those loans (prorated, FIFO, LIFO?). In light of that situation and to evidence that we do take this matter seriously, we believe the best course is to set all advances at 4% and re-amortize the



loans on that basis. Thus, our proposed resolution of this issue should more than correct for the error from a financial perspective and lead to an even earlier retirement of the districts.

We respectfully request that this official response be accepted by the Office of the State Auditor as an appropriate resolution to this one finding of the audit dated September 19, 2008. Upon confirmation of said acceptance, we will direct City staff to proceed with the adjustments as noted in the attached spreadsheet.

Sincerely,

A handwritten signature in cursive script, reading "Ardell F. Brede". The signature is written in black ink and is positioned above the printed name.

Ardell F. Brede
Mayor
City of Rochester



REBECCA OTTO
STATE AUDITOR

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OFFICE OF THE STATE AUDITOR

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November 24, 2008

The Honorable Ardell Brede, Mayor
The Honorable Pat Carr, Council Member
The Honorable Dennis Hanson, Council Member
The Honorable Ed Hruska, Council Member
The Honorable Marcia Marcoux, Council Member
The Honorable Sandra Means, Council Member
The Honorable Robert Nowicki, Council Member
The Honorable Bruce Snyder, Council Member
The City of Rochester
201 4th Street SE
Rochester, MN 55904

Re: **Rochester TIF Districts— Final Notice**

Dear Mayor Brede and Council Members:

On September 19, 2008, the Office of the State Auditor (OSA) sent the City of Rochester (City) an Initial Notice of Noncompliance (Initial Notice) regarding TIF District Nos. 20-1 through 30-1 (Housing Districts). The OSA received the City's Response (City's Response) on November 19, 2008, in a letter from Ardell F. Brede, Mayor.

This letter is the Final Notice of Noncompliance (Final Notice) of the OSA. It summarizes the Initial Notice, the City's Response, and provides the OSA's final conclusion regarding the finding raised by the Audit.

FINDING OF NONCOMPLIANCE

Only one finding of noncompliance was made.

Finding 1. TIF District Nos. 20-1 through 30-1 (Housing) – Loan interest rates-RESOLVED

In the Initial Notice, the OSA found that the City charged interest rates on its interfund loans that exceeded the rates authorized by the TIF Act. The OSA did not compute a finding amount due to the complexity of the loan agreements and the various assumptions that could apply.

OFFICE OF THE STATE AUDITOR

Mayor and Council, City of Rochester

November 24, 2008

Page 2

In the City's Response, the City acknowledges its oversight and agrees with the OSA finding. The City proposes reallocating \$186,350 of loan interest payments to loan principal payments, using a 4% interest rate, which will cause the districts to decertify earlier than previously expected.

The OSA acknowledges that the proposed correction advanced by the City exceeds the requirements of the statute relating to allowable interest rates. Based on that acknowledgement, the documentation provided, and confirming communications with the City, the OSA considers this finding resolved.

CONCLUSION

The OSA appreciates the cooperation it received from the City during this process. If you have questions, would like additional information, or if we can be of assistance in the future, please do not hesitate to contact me.

Very truly yours,



Arlin B. Waelti
Assistant State Auditor
TIF Division Director

Cc: Dale Martinson, Finance Director