

# TAX INCREMENT FINANCING REPORT

## I. INTRODUCTION.

In the 1995 Omnibus Tax Bill, the Minnesota Legislature transferred authority for oversight of the state's 1,600+ tax increment financing districts to the Office of the State Auditor. Pursuant to Minn. Stat. § 469.1771, subd. 1(c), this report is prepared for the chairs of the legislative committees having jurisdiction over tax increment financing.

## II. BACKGROUND.

### A. What is Tax Increment Financing?

Tax increment financing (TIF) is a statutory tool to promote economic development, redevelopment, and housing in areas where it would not otherwise have occurred. A TIF authority, typically a city or other local unit of government, captures the additional property taxes generated by increases in property value within a specified development area and uses those additional property taxes to pay for TIF-eligible costs of development or redevelopment. Examples of TIF-eligible costs are land or building acquisitions, demolition of structurally substandard buildings, construction of low-income housing, site preparation, or installation of utilities. Authorized expenditures differ depending on the type of TIF district created. The owner of the newly-developed or redeveloped property continues to pay the full property taxes.

The up-front costs of TIF development are generally financed with the proceeds of bonds, revenue notes, or loans and the debt service is then repaid with tax increment generated within the district. In addition, pay-as-you-go financing arrangements have gained popularity. Under this scenario, the developer or property owner pays for the development costs up-front and is reimbursed if, and when, tax increment is generated in the district.<sup>1</sup> The risk of insufficient tax increment to pay the costs of development rests with the developer or property owner, rather than the TIF authority.

### B. Tax Increment Financing Users.

Tax increment financing is used by approximately 408 Minnesota cities or towns, as well as housing and redevelopment authorities, economic development authorities, port authorities, rural development finance authorities, and counties.

The governing body of the jurisdiction in which the TIF district is located must approve the creation of the district. For example, if a county housing redevelopment authority wishes to establish a TIF district, it must

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<sup>1</sup> A developer may only be paid for actual, TIF-eligible expenses incurred plus interest.

be approved by the county board. If a development authority other than a city, such as a port authority, is proposing to create a TIF district, the authority must have the approval of the municipality or municipalities in which the district rests. While the proposed TIF plan must be submitted to the school board and county board for comment, neither entity has the authority to amend the plan or prevent the creation of a TIF district.

**C. Tax Increment Financing Act.**

The Minnesota Tax Increment Financing Act<sup>2</sup> (TIF Act) governs the creation and administration of TIF districts. The primary provisions of the TIF Act include:

- z Minnesota Statutes § 469.174 Definitions;
- z Minnesota Statutes § 469.175 Establishing and modifying TIF plans and reporting requirements;
- z Minnesota Statutes § 469.176 Limitations on expenditure of increment and TIF district duration;
- z Minnesota Statutes § 469.1763 Pooling restrictions and the five-year rule;
- z Minnesota Statutes § 469.1766 Developer payment restrictions;
- z Minnesota Statutes § 469.177 Computation of tax increment;
- z Minnesota Statutes § 469.1771 Violations and OSA enforcement authority; and
- z Minnesota Statutes § 469.178 Tax increment bonding.

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

The TIF Act permits the establishment of the following types of TIF districts:

- z Redevelopment districts;
- z Renewal and renovation districts;
- z Soils condition districts;
- z Housing districts;
- z Economic development districts;
- z Mined underground space districts; and
- z Hazardous substance subdistricts.

In addition, the 1996 legislature authorized the establishment of housing replacement districts within the airport noise impact area after July 1, 1997.

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<sup>2</sup> Minn. Stat. § 469.174 - § 469.179.

### III. TAX INCREMENT FINANCING DEPARTMENT ACTIVITIES AND OVERSIGHT.

The 1995 Omnibus Tax Bill contained a provision which transferred the responsibility for enforcing the TIF Act from the Department of Revenue to the Office of the State Auditor (OSA). Pursuant to Minn. Stat. § 469.1771, subd. 1,<sup>3</sup> the State Auditor may examine and audit political subdivisions' use of tax increment financing to determine compliance with the law. The statute allows the OSA to examine and audit accounts and records on a random basis, without previous notice, whenever the State Auditor determines it to be in the public interest. Minnesota Statutes § 469.175 requires all TIF districts to file annual financial reporting forms with the State Auditor. These sections apply to all TIF districts, including districts certified prior to August 1, 1979.

The OSA TIF Department began its enforcement activities on January 1, 1996. The Department currently consists of a director and three audit staff.

Annual financial reporting forms, containing 1995 financial information from over 1,600 TIF districts throughout the state, were to be received by the OSA TIF Department on or before July 1, 1996. In previous years, a TIF district's financial information was included in the city's or development authority's audited financial statements. Although the reporting process itself was not new, it was the first year that reporting forms were received by the city or authority in the mail and returned to the OSA separate from the audited financial statements.<sup>4</sup>

The quality and timeliness of the financial reporting forms submitted was mixed. The quality of the unaudited 1995 financial information did not allow a meaningful comparison of data; thus, a comparative report was not prepared by the OSA. As of July 1, 1996, approximately 50% of the districts had failed to submit financial reporting forms as required by statute. Many districts contacted the OSA to request additional time to prepare the financial reports. The TIF Department staff also contacted cities and authorities to inform them of the reporting deadline and to request that the statutorily-required information be submitted to the OSA. As of December 31, 1996, approximately 8% of the districts still had not submitted the required annual financial reports to the OSA.

Since July, the TIF Department has spent a majority of its time reviewing reporting forms, calling or writing to clarify or obtain information, and answering questions or concerns received from citizens and government officials. In addition, the members of the TIF Department have been traveling throughout the state educating and training local government officials and employees on the proper administration of TIF districts and informing them of the problems discovered in the current reporting cycle. Also, several partial audits

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<sup>3</sup> Minn. Stat. § 469.1771, subd. 1 was effective January 1, 1996.

<sup>4</sup> Prior to 1996, the annual disclosure form and bonded debt report were filed with the Department of Revenue. The 1995 legislation consolidated all financial reporting and required such reports to be filed with the OSA.

were performed to clarify issues raised by information submitted in the reporting forms. In addition, over \$630,000 in excess increment has been voluntarily returned by TIF authorities to counties for redistribution pursuant to Minn. Stat. § 469.176, subd. 2, after correspondence from or conversations with the OSA TIF Department.

The current review and audit activities of the OSA TIF Department are financed with 0.10% of the tax increment distributed to cities and authorities administering TIF districts. Counties collect this amount prior to making tax distributions to the local units of government. The amount received annually by the department will vary depending on the number of active TIF districts and the amount of increment generated by these districts.

## VIOLATIONS

If the Office of the State Auditor (OSA) finds that a TIF authority is not in compliance with the TIF Act, a letter of noncompliance is sent to the governing body of the municipality that approved the TIF district. The letter details findings regarding the TIF district's violation of a provision of the TIF Act or related laws. The governing body of the municipality must respond in writing to the State Auditor within 60 days of receipt of the notification of noncompliance. 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 the findings, it must indicate the basis for its disagreement. Responses to the noncompliance letters are summarized by the OSA. The summaries and copies of the municipality responses must be reported to the chairs of the legislative committees with jurisdiction over TIF laws. All information on the violation must also be forwarded to the county attorney for enforcement action. In addition, the TIF Act provides for private legal action by a taxpayer living in the city, county, school district, or town in which the TIF district is located. The TIF Act also contains a requirement that all increment spent in violation of the law be repaid to the county auditor.

In compliance with Minn. Stat. § 469.1771, subd. 1(c), the following is a summary of the responses the OSA has received from the municipalities notified of TIF Act noncompliance. Copies of the noncompliance letters and the municipalities' responses are contained in the back of this report.

### I. POOLING VIOLATION.

The OSA sent a notice of noncompliance to the City of Foley on May 30, 1996.<sup>5</sup> The OSA found that the city pooled tax increment outside the boundaries of a pre-1982 TIF district in violation of the TIF Act. The TIF laws restrict the ability of an authority to "pool" increment, that is, to expend tax increment revenues on real property acquisitions or improvements located outside the boundaries of the TIF district that generated the tax increment revenue.

As initially enacted in 1979, the TIF Act did not permit the expenditure of tax increment revenues outside a tax increment district's boundaries. Amendments to the laws in 1982<sup>6</sup> specifically permitted the expenditure of tax increments outside the district, but within the project area. However, the effective date of these changes was limited to new districts. Therefore, the authority to expend tax increment revenues outside the TIF district is only explicitly granted to TIF districts for which certification was requested after July 1, 1982.<sup>7</sup>

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<sup>5</sup> See Tab A.

<sup>6</sup> Minnesota Statutes § 273.74, subd. 1 (1982).

<sup>7</sup> 1982 Minn. Laws, pp. 888-92, ch. 523, art. 38, §§ 3, 5 and 10.

The City of Foley's TIF District 1-1 is a housing district, certified in 1980 and subject to the laws in effect in that year. The law does not allow the city to pool and expend increment outside the district.

All originally-budgeted expenses for low and moderate income housing in TIF District 1-1 have been paid. The city has continued to collect tax increment in this district and has pooled the increment amounts to pay the debt service on bonds issued for the construction of a wastewater treatment facility located outside the TIF housing district's boundaries. Approximately \$100,969 in tax increment had been transferred for the debt service on these bonds as of December 31, 1995.

The City of Foley responded to the OSA's letter of noncompliance on July 15, 1996. The city stated that it is the obvious purpose and intent in constructing a wastewater treatment system to provide necessary and essential services to residences and commercial establishments within the city, including structures within the TIF district. It alleged that, although the wastewater treatment plant is situated outside of the TIF district, distribution lines and sewer connections were located within the TIF district's boundaries. Therefore, the city felt it was reasonable to utilize TIF revenues from TIF District 1-1 to pay a pro rata share of the cost of the wastewater treatment plant and related improvements.<sup>8</sup>

The city's written response stated that the OSA had chosen to opine a narrow and limited interpretation of the law. The city alleged that the legislature did not intend to restrict the expenditure of tax increments to only public facilities located within the TIF district, regardless of how indispensable a public improvement located outside of the district is to development within the district. The city stated its expenditure of tax increment revenues from the housing district on a wastewater treatment facility complied with the more relevant and overriding objective of providing safe and affordable housing for low-income persons.

Pursuant to Minn. Stat. § 469.1771, subd. 1(b), the relevant information regarding the violation of the TIF Act by the City of Foley was forwarded to the Benton County Attorney on December 24, 1996. The OSA has not received a response regarding enforcement action from the Benton County Attorney. The City of Foley is also seeking special legislation in the 1997-1998 legislation session to allow the capture of an additional \$270,000 in years after 1996 for payment of debt service on the wastewater treatment facility bonds.

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<sup>8</sup> The city stated there are 36 households located within TIF District 1-1. The city represented the cost of the wastewater treatment plant and the related collector sewer lines to be \$1,725,000 and \$1,242,000 respectively. The households within TIF District 1-1 represented 4.8% of all households served by the wastewater treatment plant and 6.1% of households served by the collector sewer. Based upon those percentage amounts, the city stated that the pro rata share of the activity and administrative costs attributable to households within TIF District 1-1 is \$174,615.

## **II. FAILURE TO SUBMIT 1995 TIF DISTRICT REPORTING FORMS.**

The TIF Act requires that municipalities and authorities submit an annual financial report on their TIF districts to the OSA on or before July 1 of each year.<sup>9</sup> In the first week of 1997, noncompliance letters were sent to 21 TIF authorities who had failed to report 1995 financial information on their TIF districts.<sup>10</sup>

Seven of the 21 TIF authorities had responded to the letter of noncompliance by the time of this report.

On January 2, 1997, a letter of noncompliance was sent to the City of Browns Valley based on its failure to submit the 1995 TIF district reporting forms. The city responded on January 13, 1997 and submitted reporting forms for 1995.

On January 2, 1997, a letter of noncompliance was sent to Chisago City based on the city's failure to submit municipality forms for TIF District 1-2 and 2-1. In addition, the forms prepared by a CPA firm for Chisago City contained incomplete information. The city responded on January 24, 1997. The city accepted the OSA's findings that the reports submitted to the OSA were incomplete. Due to personnel changes in the city staff, the city administrator has now turned the TIF reports over to a new CPA firm for completion.

On January 2, 1997, a letter of noncompliance was sent to the City of Eden Prairie based on its failure to submit 1995 TIF district reporting forms for certain city TIF districts. TIF Department staff had several conversations with city personnel regarding the failure to report. In these conversations, the city confirmed that, while these districts had expired, increment previously generated from these districts continued to be expended after expiration. Based upon the fact that tax increment continued to be expended, the city was advised of the OSA's position that statutory reporting for these TIF districts was required. The city responded in writing on February 10, 1997. The response detailed the city's position that as the tax increment districts were no longer in existence, reporting was not required. The city's response does not address the issue of the continued expenditure of tax increment generated prior to expiration of these districts.

On January 2, 1997, the City of Elysian was sent a letter of noncompliance for failure to submit the 1995 TIF district reporting forms. The city responded on February 10, 1997 by submitting reporting forms with no accompanying written response to the noncompliance letter.

On January 2, 1997, the City of Lakefield was sent a letter of noncompliance for failure to submit the 1995 TIF district reporting forms. The city responded on January 10, 1997. The city stated that it did not know of the requirement to submit the reporting forms until speaking to an OSA TIF Department staff member

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<sup>9</sup> Minn. Stat. § 469.175, subd. 5, subd. 6, and subd. 6a.

<sup>10</sup> See Tab B.

on October 7, 1996. The response letter stated the city is currently in the process of trying to complete the forms.

On January 2, 1997, the City of Le Sueur was sent a letter of noncompliance for failure to submit the 1995 TIF district reporting forms. The Le Sueur Economic Development Authority responded by submitting reporting forms on February 3, 1997.

On January 3, 1997, the City of Milaca was sent a letter of noncompliance for failure to submit the 1995 TIF district reporting forms for TIF District 2-2 Industrial Park Gorecki, TIF District 1-2 Centennial Addition, and TIF District 5 Middle School. The city responded on January 15, 1997, stating that information on two of these districts had been submitted to the OSA, although in a format not acceptable to the Auditor's Office. The information on TIF District 1-2 was delayed because of the difficulty in preparing the reporting forms. In past reporting years, the city had not prepared a separate budget for District 1-1 and District 1-2. The city was having difficulty separating the receipt and expenditure information for these two districts which resulted in the delay in reporting. The response letter stated that the city manager would be discussing the matter with the city council at a regular meeting on January 16 and would submit the reports as soon as possible. The city submitted 1995 reporting forms on February 3, 1997.

On January 2, 1997, a letter of noncompliance was sent to the City of New Brighton for failure to submit 1995 TIF district reporting forms. The city responded by submitting reporting forms for the city's TIF Districts 1 through 25 on January 10, 1997. The city stated that the volume of information requested caused the delay in its response. It had to retain auditors to complete the forms as they did not have enough city staff to handle such a project.

On January 2, 1997, a letter of noncompliance was sent to the City of St. Clair based on the city's failure to submit 1995 TIF district reporting forms. The city responded on January 7, 1997 stating that the delay was due to the fact that the city had not received the reporting forms until either August 19 or August 29, 1996. The city advised that it had mailed the reporting forms to the OSA on December 20, 1996. The OSA did not receive these forms and requested a copy from the city. A copy was then provided. The city felt that due to the delay in receipt of the forms, it had responded in a timely manner.

### **III. TAX ABATEMENT VIOLATION.**

The OSA sent a notice of noncompliance to the City of Houston on December 10, 1996.<sup>11</sup> The OSA found that the city expended tax increment for property tax abatement for a grocery store constructed within the TIF district. Although the TIF plan does not reference tax abatement, the development agreement requires the city to abate the property owner's real estate taxes for all amounts exceeding

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<sup>11</sup> See Tab C.

\$8,500 annually. City personnel and the city's attorney confirmed to the OSA that tax increment is being used to pay a portion of the real estate taxes of the property owner. The amount of tax increment expended to abate property taxes was approximately \$15,229 as of December 31, 1995.

A TIF authority must have express statutory authorization to expend tax increment. The TIF Act does not provide for the expenditure of tax increment for direct property tax abatement. Therefore, the OSA found that the City of Houston had no statutory authority to use tax increment from TIF District 1-1 to abate the property taxes of the grocery store.

As of the date of this report, 64 days had passed since the notification of noncompliance was sent. The OSA contacted city staff, the city's attorney, and a private consultant hired by the city to inquire as to the status of the city's response. The OSA was informed that a response to the letter of noncompliance had not yet been prepared by the private consultant, however, the city did intend to respond.

This report includes an October 10, 1996 letter submitted to the OSA by the City of Houston. Although this letter predates the OSA's notice of noncompliance, it details the city's earlier representations as to the validity of the use of tax increment for tax abatement.

#### **IV. ADDITIONAL LETTERS OF NONCOMPLIANCE.**

Additional letters of noncompliance were sent by the OSA in December 1996, and January and February 1997. A municipality has 60 days to respond to a notice of noncompliance. The OSA had not received responses from these cities at the time of issuance of this report. These additional noncompliance letters and the municipalities' responses will be addressed in a future report produced by the OSA TIF Department.

## STATUTORY ISSUES

In the current reporting cycle, the Office of the State Auditor (OSA) Tax Increment Financing (TIF) Department identified several areas where the OSA's interpretation of certain TIF Act provisions differs from some practitioners' interpretation. This report to the committees with jurisdiction over TIF laws identifies these conflicting statutory interpretations in order to facilitate public policy discussion and allow for clarification or amendment to current statutory provisions.

The following is a summary of the various provisions where statutory change or clarification may be necessary to eliminate issues or questions raised by differing interpretations.

### **I. AUTHORIZED EXPENSES IN REDEVELOPMENT OR RENEWAL AND RENOVATION DISTRICTS.**

The OSA TIF Department and TIF practitioners disagree on interpretation of the current language contained in Minn. Stat. § 469.176, subd. 4j. The section currently reads:

At least 90 percent of the revenues derived from tax increments from a redevelopment district or renewal and renovation district must be used to finance the cost of correcting conditions that allow designation of redevelopment and renewal and renovation districts under section 469.174. These costs include acquiring properties containing structurally substandard buildings or improvements, acquiring adjacent parcels necessary to provide a site of sufficient size to permit development, demolition of structures, clearing of the land, and installation of utilities, roads, sidewalks, and parking facilities for the site. The allocated administrative expenses of the authority may be included in the qualifying costs.

The OSA interprets this language as exclusive. As such, in redevelopment or renewal and renovation districts, TIF-qualifying expenditures are limited to acquiring sites containing substandard buildings and contiguous parcels of land, and financing related land-preparation improvements such as sewer, water, roads, and parking facilities. TIF practitioners disagree and interpret this language as exemplary. Under their interpretation, and in practice, tax increment revenues generated in redevelopment districts are used for above-ground development and rehabilitation expenses with such expenditures viewed as applying towards the 90 percent statutory requirement.<sup>12</sup> The OSA recommends that the language in Minn. Stat. § 469.176, subd. 4j be clarified through statutory change.

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<sup>12</sup> In addition, some practitioners have advised that this statutory section authorizes above-ground development on vacant parcels in the district. Rather than directly correcting blight with tax increment revenues, assisted development on vacant parcels is said to encourage "spillover" development on blighted parcels. Practitioners advise that this complies with subdivision 4j as it indirectly corrects the blight conditions that authorized creation of the redevelopment district.

## II. DEFINITION OF TAX INCREMENT REVENUES.

The term “revenues” is referenced throughout the TIF Act, but is not defined in the Act. Many of the restrictions contained in the Act apply to "tax increment revenues" or "revenues derived from tax increment."<sup>13</sup> The scope of this term is unclear without clarification. The OSA recommends that "tax increment revenues" and "revenues derived from tax increment" be defined in the TIF Act.

## III. PRIOR PLANNED IMPROVEMENTS.

Minnesota Statute § 469.177, subd. 4 is entitled "Prior planned improvements." It reads:

The authority shall, after diligent search, accompany its request for certification to the county auditor pursuant to subdivision 1, or its notice of district enlargement pursuant to section 469.175, subdivision 4, with a listing of all properties within the tax increment financing district or area of enlargement for which **building permits** have been issued during the 18 months immediately preceding approval of the tax increment financing plan by the municipality pursuant to section 469.175, subdivision 3. The county auditor shall increase the original net tax capacity of the district by the net tax capacity of each improvement for which a **building permit** was issued.

(Emphasis added.) This section requires that an authority or city notify the county auditor of all properties within the TIF district for which "building permits" have been issued during the 18 months immediately preceding approval of the TIF plan. The county auditor must then increase the original net tax capacity of the district by the net tax capacity of each improvement for which a building permit was issued.

Several cities have contacted the OSA with questions about this section. Many cities have changed the name of their building permits to "zoning permits." The zoning permits serve the same purpose as the building permits and evidence prior planned improvements. However, as the statutory language refers to "building permits," cities are unsure if they must notify the county auditor of the improvements undertaken on parcels to be included in the TIF district for which zoning permits were issued. Under a strict interpretation of the current language, such notification is not required. The OSA recommends that this section be examined and either the title or the language of the subdivision be changed to clarify the legislative intent.

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<sup>13</sup> It is the OSA's position that interest earned on tax increment is revenue derived from tax increment. It is not the consistent practice of current TIF districts to apply the restrictions in the TIF Act to interest earned on tax increment. The proper meaning of the term “revenues” is also raised when reviewing situations involving TIF-developed land sale proceeds and LGA contributions.

#### **IV. TAX INCREMENT BONDING**

The OSA TIF Department and TIF practitioners disagree on the restrictions applicable to the proceeds of bonds financed in part by tax increment. Minnesota Statute § 469.178, subd. 1, reads:

Notwithstanding any other law, no bonds, payment for which tax increment is pledged, shall be issued in connection with any project for which tax increment financing has been undertaken except as authorized in this section. The proceeds from the bonds shall be used only in accordance with section 469.176, subdivision 4, as if the proceeds were tax increment, except that a tax increment financing plan need not be adopted for any project for which tax increment financing has been undertaken prior to August 1, 1979, pursuant to laws not requiring a tax increment financing plan.

The statutory language indicates that all proceeds of bonds for which any tax increment is pledged must be used only in accordance with § 469.176, subd. 4, as if the proceeds were tax increment. Frequently, bonds are issued with several sources of revenue pledged for debt service payment. Tax increment is sometimes pledged only as a contingent source of revenue to be used if other revenue sources prove insufficient. It is the position of the OSA that the language of § 469.178 requires that all proceeds of those bonds to which tax increment is pledged, in whole or in part, are to be treated as tax increment. This is not the current practice among TIF authorities. The OSA recommends that the language be examined and the legislative intent clarified.

#### **V. PROJECT VS. DISTRICT**

The term "project" is defined in Minn. Stat. § 469.174, subd. 8. The term "tax increment financing district" is defined in Minn. Stat. § 469.174, subd. 9. In practice, a project (also called a development district by many practitioners) is a large geographic area which encompasses one or more contiguous or noncontiguous TIF districts. The terms project and district are used in various sections of the TIF Act in a manner seemingly inconsistent with the definitions set forth in the Act.

The use of the term "project" in certain statutes greatly expands the area in which authorization exists to expend tax increment.<sup>14</sup> For example, as it is used in Minn. Stat. § 469.176, subd. 1a, it sustains the existence of a TIF district as long as bonds have been issued for improvements anywhere within the project area,<sup>15</sup> even if such improvements are unrelated to the anticipated development within the TIF district. The OSA recommends that these provisions be revisited and the use of the terms "project" and "district" be clarified where necessary.

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<sup>14</sup> Some examples of sections using the term "project" in a seemingly inconsistent way include: Minn. Stat. §§ 469.174, subd. 11; 469.176, subd. 1a; 469.176, subd. 4d; and Minn. Stat. § 273.1399.

<sup>15</sup> A large number of TIF plans reviewed by OSA staff define the "project area" as the entire city limits.

## **CONCLUSION**

This report has provided background information to the legislature regarding tax increment financing, violations found in the first reporting cycle, and statutory issues subject to conflicting interpretations. The violation information was provided pursuant to Minn. Stat. § 469.1771, subd. 1(c). The statutory issues section, detailing problem areas in the statute encountered thus far, is provided to facilitate public policy discussion and promote clarification or amendment to current statutory provisions.

If further information regarding existing tax increment financing districts is desired, a request for such may be made to the TIF Department of the Office of the State Auditor.