STATE OF MINNESOTA
Office of the State Auditor

Patricia Anderson
State Auditor

TAX INCREMENT FINANCING LEGISLATIVE REPORT

TIF Reports For the Year Ended December 31, 2004
TIF Audits Concluded For the Year Ended December 31, 2005

Description of the Office of the State Auditor

The Office of the State Auditor serves as a watchdog for Minnesota taxpayers by helping to ensure financial integrity, accountability, and cost-effectiveness in local governments throughout the state.

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 250 financial and compliance audits per year and has oversight responsibilities for over 4,300 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 Oversight - monitors investment, financial, and actuarial reporting for over 700 public pension funds;

Tax Increment Financing (TIF) - promotes compliance and accountability in local governments' use of TIF 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.

Office of the State Auditor
525 Park Street, Suite 500
Saint Paul, Minnesota 55103
(651) 296-2551
state.auditor@state.mn.us
www.auditor.state.mn.us

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TIF Reports For the Year Ended December 31, 2004
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January 23, 2006

TIF, Investment and Financing Division
Office of the State Auditor
State of Minnesota

Assistant State Auditor/Director
Arlin Waelti

Staff
Maggie Gebhard, *Accounting Technician*
Lisa McGuire, *Auditor*
Kurt Mueller, *Auditor*
Marsha Pattison, *Finance Officer*
Suk Shah, *Auditor*

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TAX INCREMENT FINANCING REPORT

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TAX INCREMENT FINANCING LEGISLATIVE REPORT

EXECUTIVE SUMMARY

Enforcement Authority

This is the tenth year the Tax Increment Financing ("TIF") Division of the Office of the State Auditor ("State Auditor") has compiled information, conducted audits, and submitted an annual TIF Legislative Report to the chairs of the committees of the Legislature with jurisdiction over TIF matters, as well as other interested parties, pursuant to statutory enforcement provisions of Laws of 1995, chapter 264, article 5, section 34.

Database Information

The source of the compiled information in the TIF Legislative Report is unaudited TIF reports of municipalities and TIF authorities ("TIF Reports") submitted annually to the State Auditor. An upgraded database system was implemented in 2005, permitting portions of the TIF Reports for the 2004 reporting year to be pre-populated and allowing for easier on-line reporting. Seventy-six percent of all TIF Reports were filed on-line; over four times the number of on-line filings of 2001, the first year an on-line system was available. The State Auditor has received positive feedback on this new reporting system and intends to implement paperless TIF reporting next year.

Collaboration with Department of Revenue

Of significance in 2005 was the collaborative effort of sharing comparable TIF data between the Department of Revenue ("Revenue") and the State Auditor. In the initial review of data, substantial discrepancies were found. Several TIF districts had been reported to Revenue by counties that had not been reported to the State Auditor by TIF authorities. Revenue and the State Auditor carried out a yearlong project of reconciling this data, with appreciated assistance from county auditors, municipalities, and TIF authorities. A series of five workshops were held throughout the state on data management during the summer of 2005, attended by both city and county officials.

Tax Increment Financing Statistics

A total of 81 new TIF districts were certified in Minnesota in 2004, up from 76 new districts in 2003. There has been, however, an approximately 44 percent decrease in the number of new districts that have been certified between 2001 and 2004. The average amount of tax increment revenue per TIF district has declined from an average high of $150,253 in 2001 to an average of $115,789 in 2004. Both the decrease in the number of new districts and the average amount of tax increment revenue is likely the result of the 2001 elimination of the local education levy subject to capture by TIF authorities.

INTRODUCTION

The Legislature, in its 1995 Omnibus Tax Act, assigned compliance oversight responsibility for TIF to the State Auditor. The State Auditor was directed to examine and audit the use of TIF by political subdivisions, as authorized by the Minnesota Tax Increment Financing Act (the "TIF Act"). The State Auditor is to annually provide a summary of the findings and responses from these audits to the chairs of the legislative committees with jurisdiction over TIF matters.

This report is the tenth report the State Auditor has so submitted. This report is being distributed to (i) the Governor's Office, (ii) the Office of the Attorney General, (iii) members of the Legislature, (iv) local governmental authorities, and (v) members of the public who have requested information. For the year ended December 31, 2004, political subdivisions filed TIF reports for approximately 2,200 TIF districts with the State Auditor. This report represents the information received from those 2004 TIF Reports, as well as a summary of the audits completed by the TIF Division of the State Auditor in the year 2005.

BACKGROUND

What Is Tax Increment Financing?

Tax increment financing is a statutory financing tool to promote economic development, redevelopment, and housing in areas where it would not otherwise occur. A TIF 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 resulting from new development within a designated geographic area called a TIF district. The TIF authority uses the tax increments to finance public and other qualifying costs related to the new development that generated the increase in net tax capacity.

Tax increment financing is not a property tax abatement program. The owner of the property in the TIF district continues to pay the same amount of property taxes that would have otherwise been payable absent the existence of the TIF district. Instead of being paid to the various taxing jurisdictions for their general use, however, the portion of property taxes generated by the new development is used to pay public 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 depend on the type of project created, 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 project 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. In other TIF districts, the authority or municipality advances or loans money from its general fund or any other fund under which it has legal authority to do so. The loan or advance must be authorized by resolution of the governing body before money is transferred, advanced, or spent, whichever is earliest. 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.[1]

An alternative to up-front financing, known as pay-as-you-go financing, may also be used. Under this type of arrangement, the development costs are initially paid by the developer pursuant to the terms of a redevelopment agreement. The developer is then reimbursed pursuant to the terms of the agreement if, and when, tax increment is generated by the TIF district. Generally, in pay-as-you-go financing, the developer accepts the risks of failed development. If the tax base does not increase, and tax increments are not generated as anticipated, the developer does not get reimbursed.

The TIF Act

The TIF Act[2] governs the creation and administration of TIF districts. 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 district was created.

The TIF Act divides TIF districts into several types:

- Redevelopment districts
- Renovation and renewal districts
- Soils condition districts
- Housing districts
- Economic development districts

Each type of TIF district has different requirements for the creation of a district. 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 (called special districts). Each type of district also has different maximum duration limitations and different restrictions on the use of tax increment from the district.

Who Uses TIF?

The TIF Act authorizes TIF authorities to create TIF districts. TIF authorities include cities using the municipal development districts law, housing and redevelopment

[1] Minn. Stat. § 469.178, subd. 7.

[2] Initially, the TIF Act was codified at Minn. Stat. §§ 273.71 through 273.78. It has since been recodified and now consists of Minn. Stat. §§ 469.174 through 469.1799.

authorities, port authorities, economic development authorities, and rural development financing authorities.

Creation of TIF Districts

The TIF authority takes the first step in creating a TIF district by adopting a TIF plan for the district. The TIF plan provides information about the project being funded by tax increment from the TIF district and authorizes the use of tax increment from the district to pay TIF-eligible project costs.[3] To create a new TIF district, the TIF authority must obtain approval of the TIF plan for the district from the governing body of the municipality in which the TIF district is located after the municipality has published a notice and held a public hearing.[4] For example, if a city's port authority proposes to create a TIF district in the city, the city council must approve the TIF plan for the district. If a county's housing and redevelopment authority proposes to create a TIF district in a township in the county, the county board must approve the TIF plan.

Before a TIF district is created, the TIF authority must provide a copy of the proposed TIF plan and certain information about the proposed TIF district to the county auditor and the clerk of the school board, who in turn provide copies of these documents to the members of the county board of commissioners and the school board.[5] The county board and school board may comment on the proposed district, but cannot prevent the creation of the district.[6]

State Auditor's Role in TIF

The Legislature gave the State Auditor responsibility for determining whether local governments are in compliance with the TIF Act.[7] In January 1996, the State Auditor created a TIF Division to perform these TIF enforcement and data-collection functions. The operations of the TIF Division are funded exclusively from revenue derived by deducting a percentage of all tax increment that county auditors or treasurers distribute to TIF authorities and municipalities. The county treasurers deduct the revenue before distributing the tax increment to local governments, and then pay the deducted revenue to the Commissioner of Finance. The amount of revenue to fund the TIF Division varies with the number of TIF districts and the amount of tax increment they produce.

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3 Minn. Stat. § 469.175, subd. 1.

4 Minn. Stat. § 469.175, subd. 3.

5 Minn. Stat. § 469.175, subd. 2.

6 A county board may prevent creation of a TIF district in those limited situations in which the county is the municipality that must approve the TIF plan.

7 Minn. Stat. § 469.1771, subd. 1(b).

The State Auditor reviews all TIF reports it receives each year for substantial completeness and returns reports that do not meet this standard. In addition to reviewing all TIF reports for completeness, the TIF Division staff reviews the contents of many of the TIF reports each year for reporting accuracy and potential legal compliance issues. During the course of these in-depth reviews, the TIF Division staff may find situations where a TIF authority has received tax increment after the TIF district was required to be decertified or has made unauthorized expenditures of tax increment. From January 1, 1996 to date, the review of reports by the TIF Division staff and subsequent contact with reporting local government units, plus legal compliance audits and investigations performed by TIF Division staff, and additional voluntary payments to county auditors, has resulted in $29,429,808, including $9,972,936 in 2004, being paid or returned to county auditors. This amount was redistributed to the cities, towns, counties, and school districts in which the relevant TIF districts were located.

The TIF Division also has worked actively in the area of tax increment financing education on a statewide level. It conducted 5 workshops on TIF reporting in 2005 and anticipates presenting additional ones in 2006. The 2005 workshops were held in Bloomington, Anoka County (Andover), Winona, Murray County (Slayton) and Crookston.

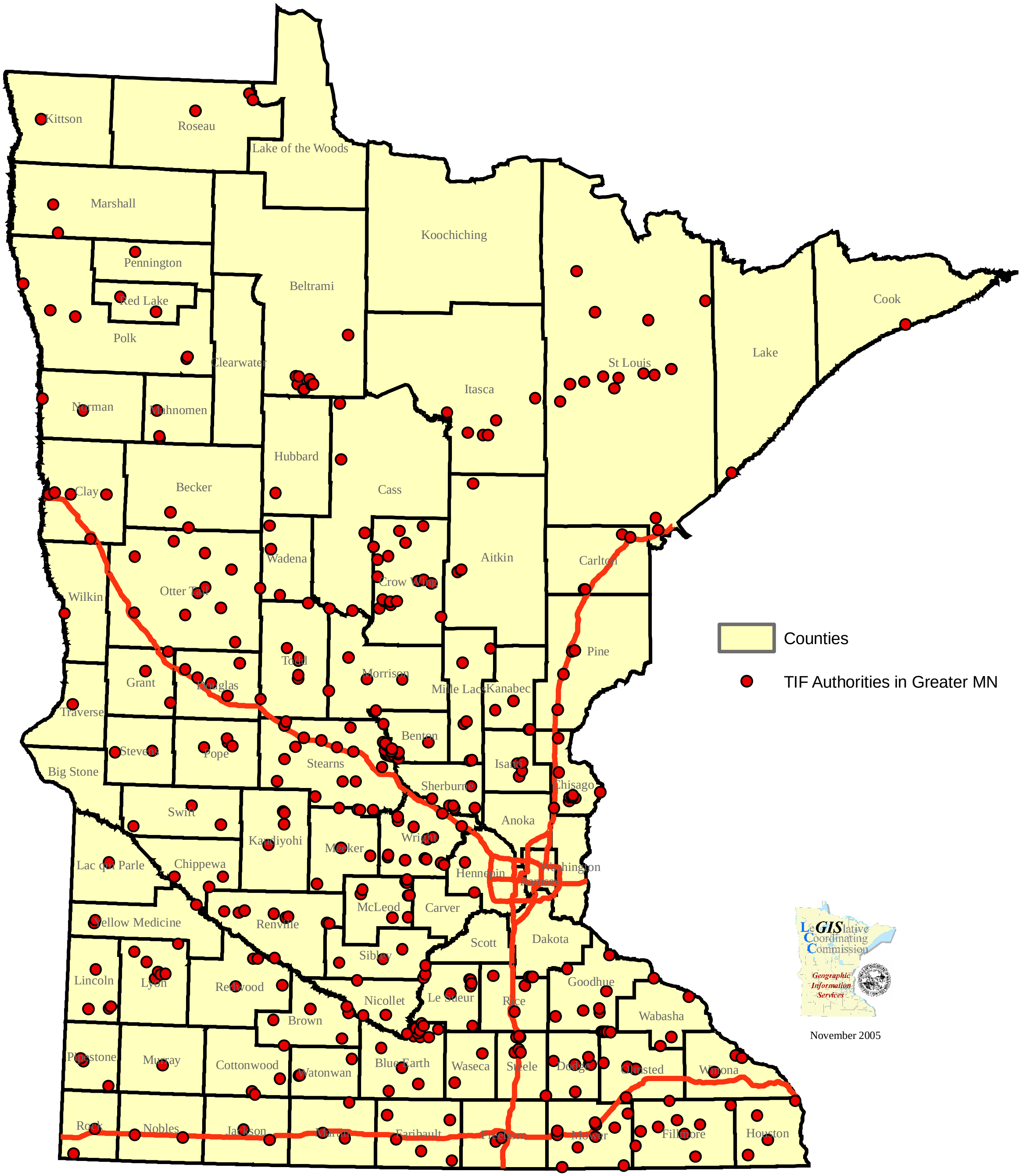
TAX INCREMENT FINANCING STATISTICS

Number and Type of TIF Districts

There were 449 TIF authorities with 2,210 active TIF districts in the state of Minnesota as of December 31, 2004. Of those 449 TIF authorities, 347 were in Greater Minnesota and 102 were in the Seven County Metropolitan Area. The following three maps show the locations of those TIF authorities on a county-by-county basis. The first map shows the TIF authorities in Greater Minnesota, the second map shows the TIF authorities in the Seven County Metro Area, and the third map shows the county authorities in Minnesota.

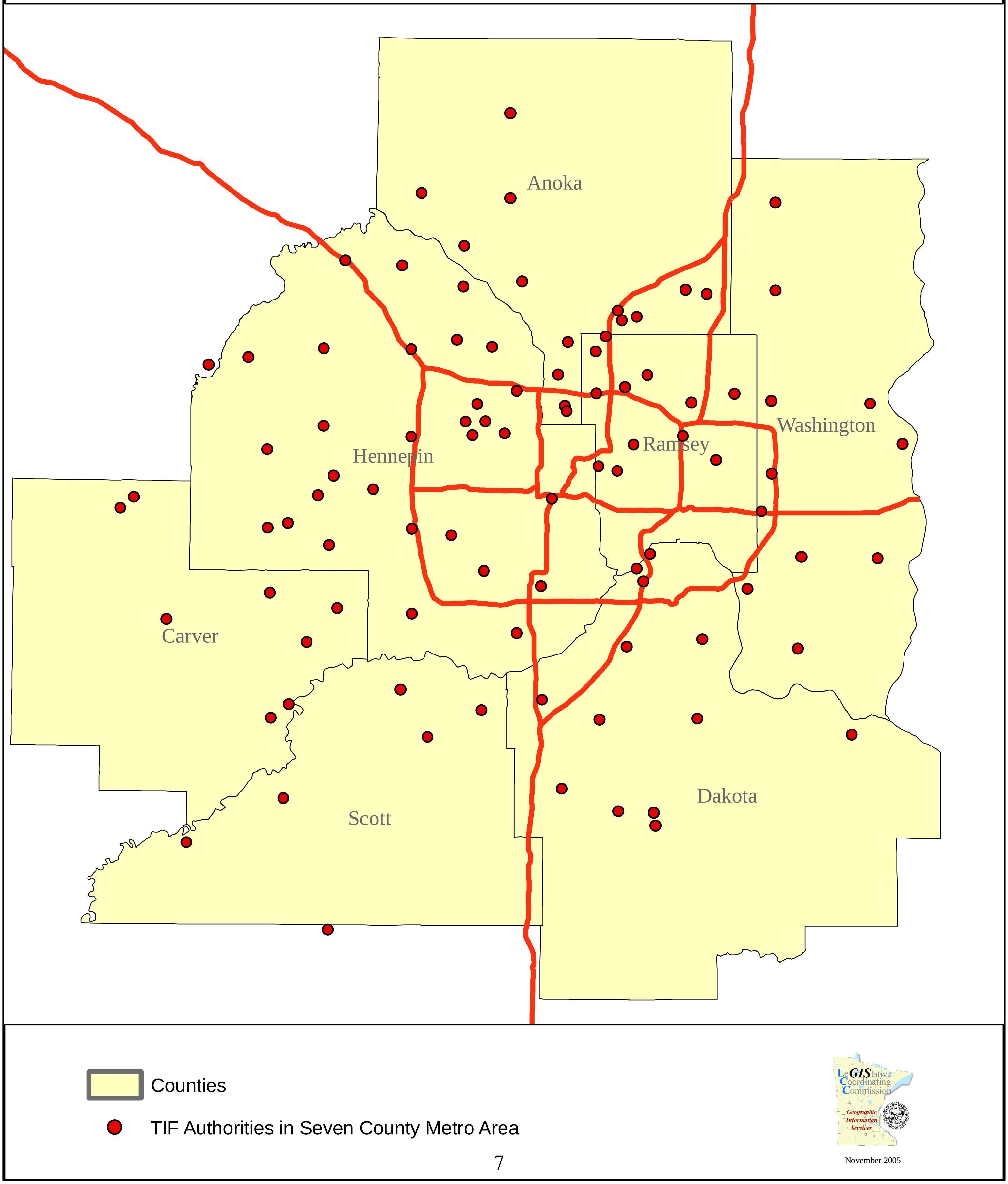
Map 1

2004 TIF Authorities in Greater Minnesota



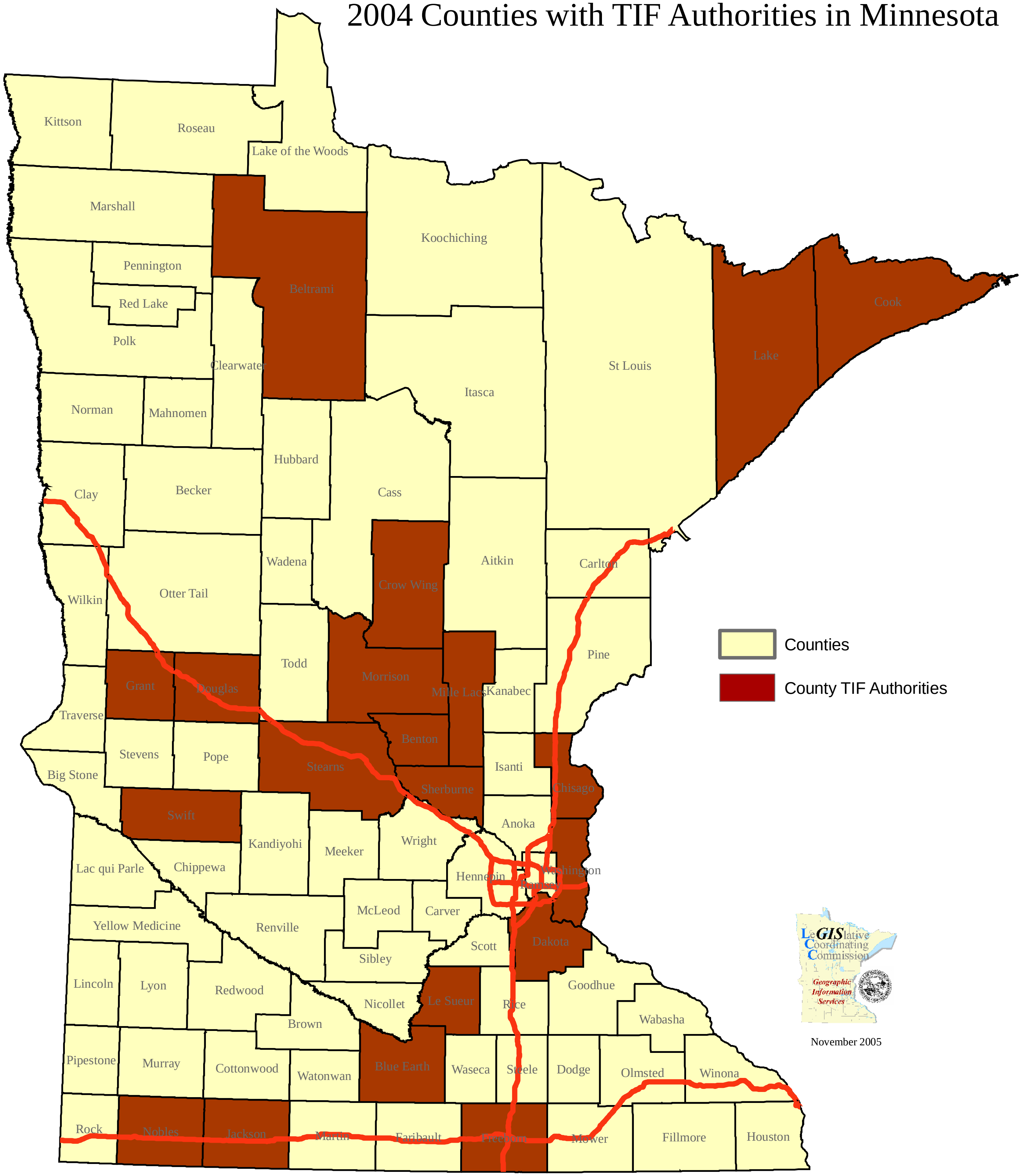
Map 2

2004 TIF Authorities in Seven County Metro Area



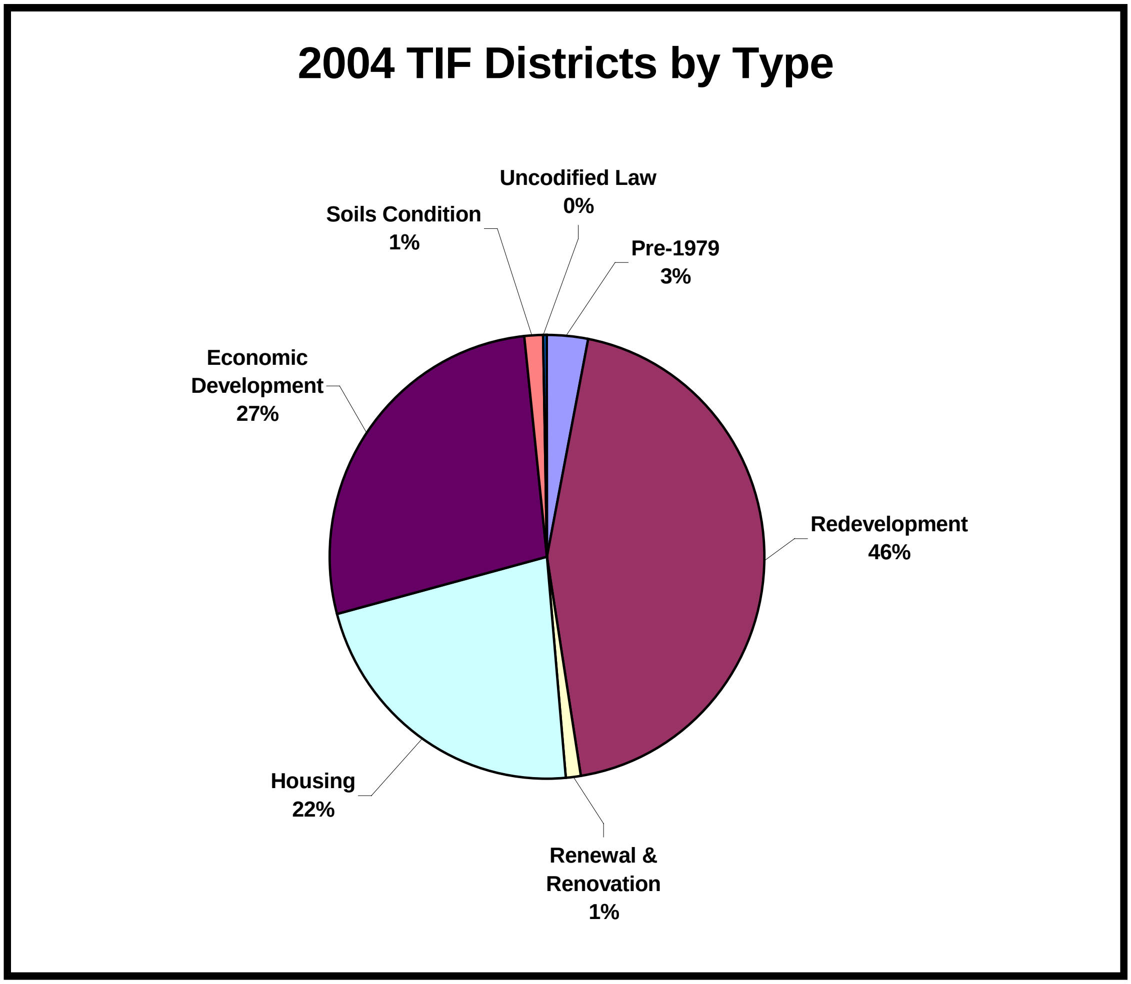
Map 3

2004 Counties with TIF Authorities in Minnesota



The 2,210 active TIF districts in the state consisted of the following types of districts:

Figure 1

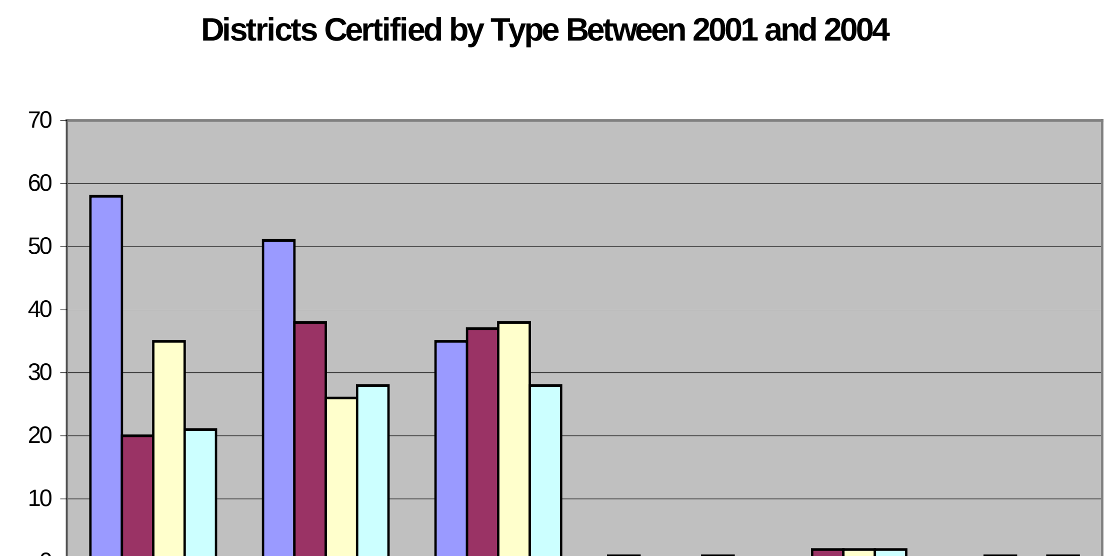


Types of Districts	State of Minnesota	Greater Minnesota	Seven County Metro Area
Pre-1979	66	32	34
Redevelopment	985	622	363
Renewal & Renovation	24	9	15
Housing	491	351	140
Economic Development	605	481	124
Soils Condition	33	13	20
Uncodified Law	6	0	6
Total	**2,210**	**1,508**	**702**

Districts Certified in 2004

A total of 81 new districts were certified in Minnesota in 2004. The following chart compares the districts certified by type since 2001. There has been an approximately 44% decrease in the number of new TIF districts that have been certified between 2001 and 2004. Two of the reasons for such a significant decrease in the creation of TIF districts may be that there is less tax increment available since the Property Tax Reform Act of 2001 and the fact that the restrictions on the use of tax increment have increased since 2001. The availability of other public subsidies such as tax abatement and job opportunity building zones ("JOBZ") may also account for the decline in the number of new TIF districts. Map 4 shows the TIF authorities that had TIF districts certified in 2004.

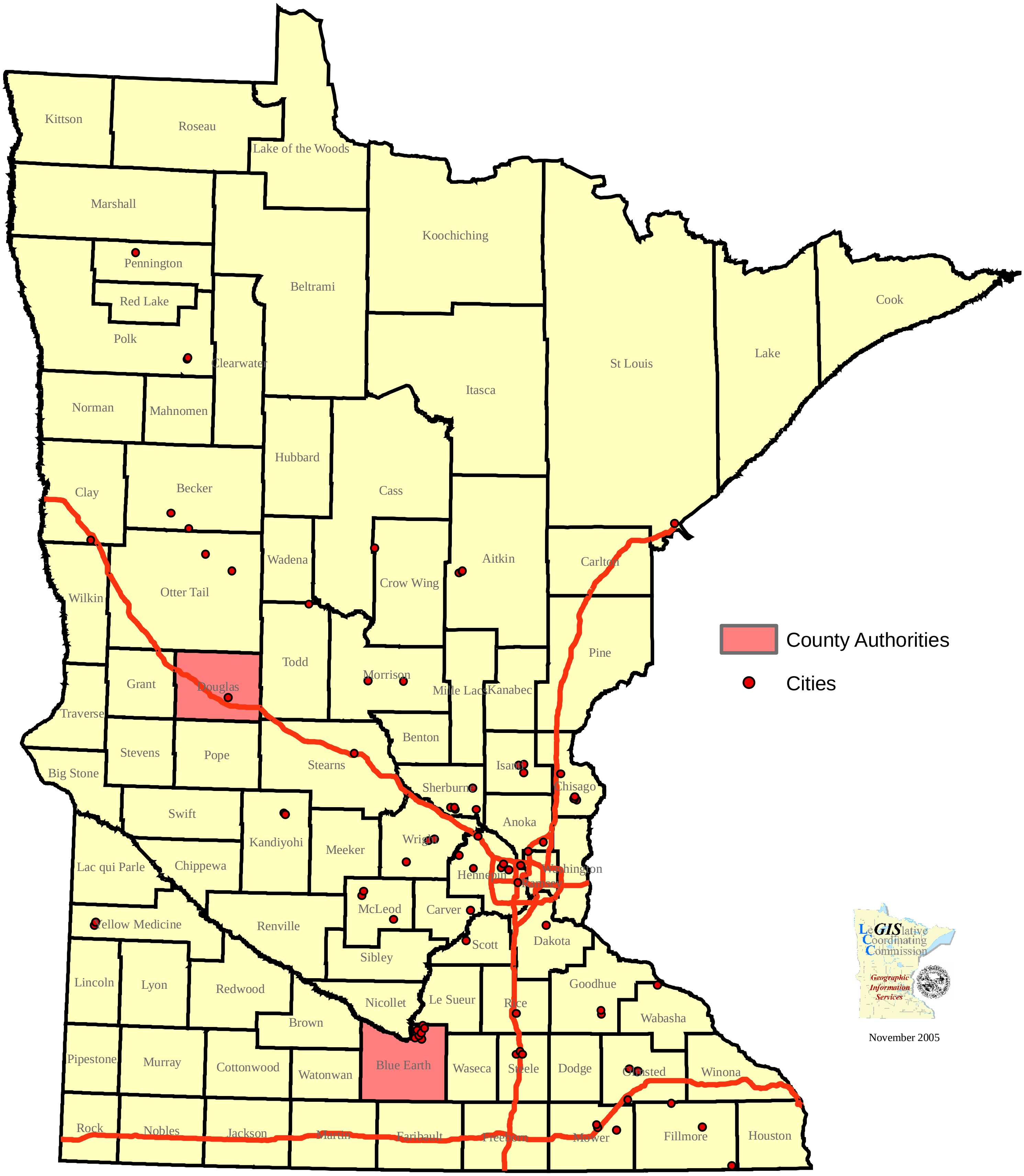
Figure 2



	Economic Development	Redevelopment	Housing	Special	Renewal & Renovation	Soils Condition
2001	58	51	35	1	0	0
2002	20	38	37	0	2	1
2003	35	26	38	0	2	0
2004	21	28	28	1	2	1

Map 4

Authorities with TIF Districts Certified in 2004



Special Taxing Districts

In 1998, the legislature authorized the creation of special taxing districts within TIF districts that suffered a deficit due to the changes in the property tax class rates.[8] The legislation allows a TIF authority to increase the taxes on property that is subject to an assessment agreement. As of December 31, 2004, 19 special taxing districts existed.

Pre-1979 Districts

TIF districts created prior to the enactment of the TIF Act are called Pre-1979 districts. There were 66 Pre-1979 TIF districts remaining as of December 31, 2004. Eleven of the 66 Pre-1979 TIF districts are no longer producing tax increment (they are decertified), but have not yet expended all tax increment received. Many of the active Pre-1979 districts still have a significant amount of outstanding debt. Until the funds from these districts are expended or returned to the county for redistribution to the respective taxing jurisdictions, these districts must submit annual reports to the State Auditor. All Pre-1979 districts must be decertified by 2009.

Uncodified Law Districts

For purposes of this report, Uncodified Law means special law enacted for one or more municipalities which permits the generation of tax increment revenues from geographic areas not meeting the definition of a type of TIF district authorized under general law. Examples of Uncodified Law include geographic areas designated as "*housing transition districts*", authorized for the cities of Crystal, Fridley, St. Paul, and Minneapolis, and "*distressed rental properties*", authorized for the Brooklyn Park Economic Development Authority. The authorities for these unique types of districts do not make the findings necessary for the establishment of types of districts in the TIF Act, but must make findings expressly defined in their respective uncodified law.

Special Legislation

In some cases, special legislation has been adopted to permit a TIF authority to extend the life of a TIF district or spend the tax increments from a TIF district in ways that would not be permitted under general state law. As of December 31, 2004, there were 70 TIF districts that have had special legislation passed.

TIF Reporting

The TIF Act requires TIF authorities to file annual reports with the State Auditor for each of their TIF districts. This reporting requirement applies to all TIF districts regardless of when they were created. TIF authorities must submit these reports to the State Auditor

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8 Minn. Stat. § 469.1791.

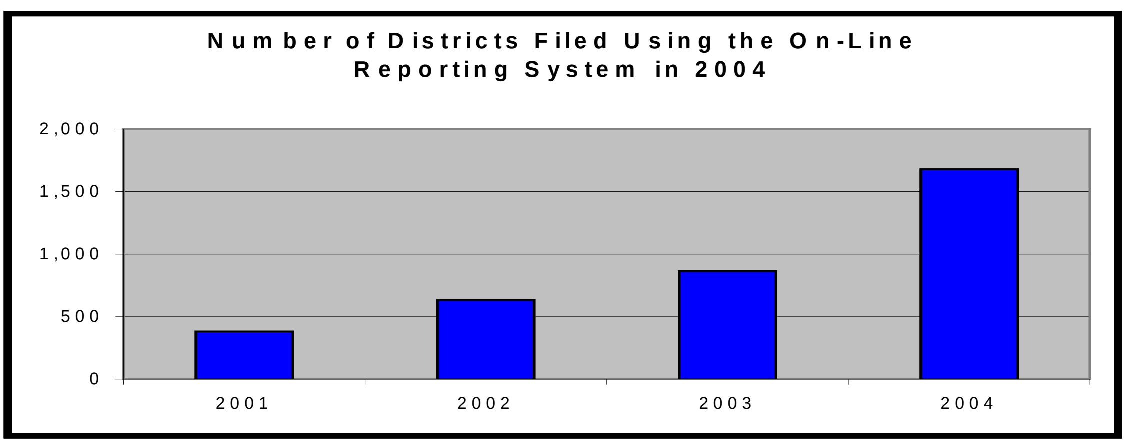
on or before August 1st of each year.[9] In addition to filing TIF reports, a TIF authority must publish certain statutorily required financial information about each of its TIF districts in a newspaper of general circulation on or before August 15th of each year.[10]

A total of 449 TIF authorities had TIF districts for which they were required to file TIF reports with the State Auditor for the year ended December 31, 2004. These TIF authorities were required to file reports for 2,210 TIF districts. Of the 449 TIF authorities required to file reports, 420 submitted complete reports by the statutory deadline. On August 16, 2005, the remaining 29 TIF authorities received a letter addressed to the governing board of the municipality, either the Mayor and Council or the County Board of Commissioners advising them the reports had not been filed. As of November 1, 2005, nine authorities still had not filed complete TIF reports. A second letter was sent to the governing board of the municipality to notify them that if the reports were not filed as of November 15, 2005, tax increment would be withheld from those districts.

Of the remaining nine authorities, six filed their reports by November 15, 2005. The remaining three authorities, Baxter, Butterfield, and Le Sueur EDA, had not filed all of the required reports as of November 15, 2005. Pursuant to Minn. Stat. §469.1771, subd. 2a, the State Auditor mailed a notice to the applicable county auditors to withhold tax increment that otherwise would have been distributed to the three authorities from the identified TIF districts. As of January 17, 2006, Baxter, Butterfield, and Le Sueur EDA still have not filed substantially complete 2004 TIF reports for their active TIF districts.

The State Auditor continued to make available to TIF authorities a system for submitting TIF reports on-line. The following graph shows the increased use of the State Auditor's on-line TIF reporting system since it was introduced in 2001. It is the intention of the State Auditor to have all reports submitted on-line for the 2005 TIF Reports that are required to be filed by August 1, 2006.

Figure 3

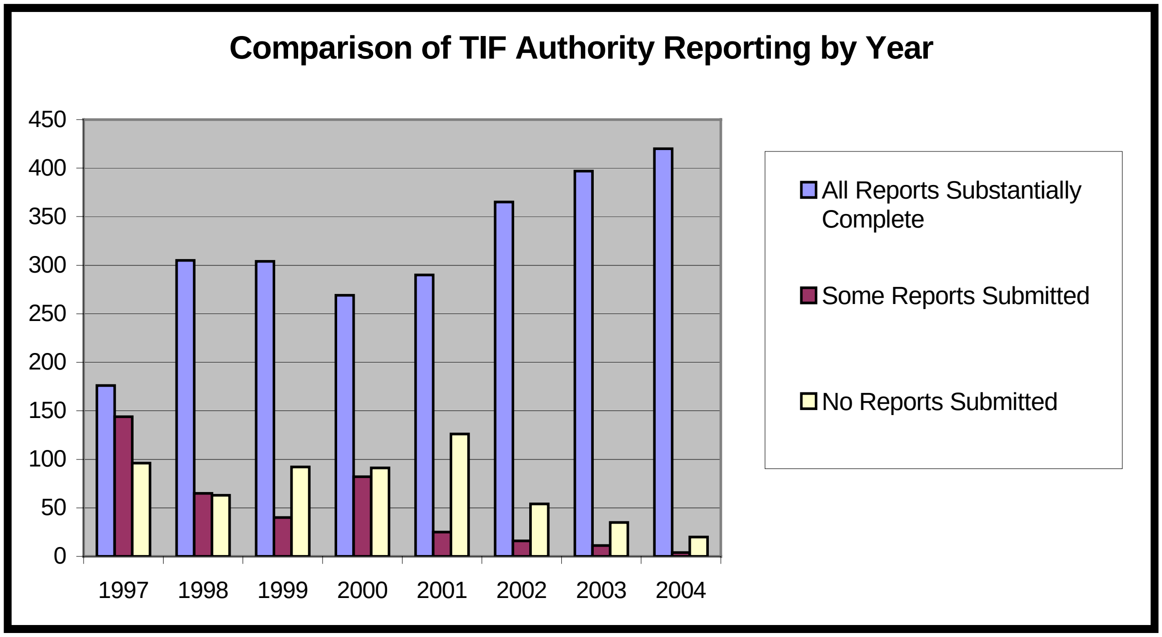


[9] Minn. Stat. § 469.175, subd. 6.

[10] Minn. Stat. § 469.175, subd. 5.

A system for submitting TIF reports on-line has been available since 2001 and is continually being upgraded. The following graph shows the number of TIF authorities since 1997 that filed by the statutory deadline: (1) substantially complete reports for all districts for which the TIF authority was required to submit reports; (2) incomplete reports; or (3) failed to submit any reports.

Figure 4



As indicated by the above chart, the number of TIF authorities that have filed complete reports by the statutory deadline has continued to grow steadily over the last several years. This increase is likely due to the fact that there has been an increased level of communication between the TIF authorities and the State Auditor's Office. The State Auditor has been working with TIF authorities to help them better understand what information is required to be submitted on the TIF reports and has been more open and available to answer questions or concerns. It is the State Auditor's goal to have all TIF authorities file by the August 1st deadline.

Returned Tax Increment

Since 1996 the TIF Division of the State Auditor, has seen $29,429,808 of tax increment returned to the various counties. These monies are then redistributed to the respective taxing jurisdictions. In 2004, TIF authorities returned tax increment to their respective counties totaling $9,972,936.

Project and TIF Revenues

Development activity often receives revenues from a variety of financing sources. Revenues may include (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 credit, and (viii) tax increment revenue, among other funding sources. These funding sources are shown in Figure 5.

Figure 5 – Revenues and Other Financing Sources

	Prior Years	Calendar 2004	Total	% of Total*
Tax Increment Revenue	$3,628,986,484	$255,661,176	$3,884,647,660	66.5%
Market Value Homestead Credit	$7,138,142	$3,126,677	$10,264,819	0.8%
Investment Earnings	$470,182,299	$7,472,420	$477,654,719	1.9%
Loan Proceeds	$217,519,013	$1,182,134	$218,701,147	0.3%
Special Assessments	$40,089,130	$2,804,790	$42,893,920	0.7%
Sales/Lease Proceeds	$282,057,102	$24,640,665	$306,697,767	6.4%
Loan/Advance Repayments	$5,479,024	$917,953	$6,396,977	0.2%
Grants	$215,239,262	$5,823,015	$221,062,277	1.5%
Transfers In	$596,319,383	$37,408,010	$633,727,393	9.7%
All Other Sources of Funds	$659,748,474	$45,634,104	$705,382,578	11.9%
Totals	$6,122,758,313	$384,670,944	$6,507,429,257	100.0%

*****_Percentage of Total 2004 Revenues_

Due to the nature of generally accepted accounting principles, the revenues of a project are 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. The annual TIF reports sent to authorities by the TIF Division require tax increment information to be submitted pursuant to these generally accepted accounting principles.

To more accurately identify revenues without accounting for both bond proceeds and the expenditure of tax increment revenues for payment of bonded indebtedness on the bonds, bond proceeds have been deleted from the table above and the two charts that follow. Three other categories listed in Figure 5, namely (i) loan proceeds, (ii) loan/advance repayments, and (iii) transfers-in, include forms of indebtedness for which tax increment revenues were expended for repayment, resulting in revenues being accounted for twice.

Due to the fact that it is impossible to ascertain the extent to which tax increment revenues were expended to repay such indebtedness, those three categories were not deleted. Accounting for revenues twice still exists in the above table and the two charts that follow.

Last year's report listed the total revenue and other financing sources for prior years of approximately $9.3 billion. This included bond proceeds, which have been excluded from this year's report. If bond proceeds were added into this year's numbers, the revenue and other financing sources would also be approximately $9.3 billion as opposed to the approximately $6.1 million listed in Figure 5. Thus, in last year's report bond proceeds of approximately $3.2 billion are accounted for twice under GAAP standards.

Last year's report listed calendar year 2003 revenue and other financing sources of approximately $496 million. If bond proceeds were deducted to avoid double counting, the revenue and other financing sources would be approximately $390 million. If bond proceeds were added back to the 2004 total for direct comparison with 2003, the revenue and other financing sources would be approximately $490 million as compare to the approximately $384 million as listed in Figure 5. Essentially, there is approximately a $6 million decrease in revenue and other financing sources from 2003 to 2004 whether or not bond proceeds are excluded.

Figure 6

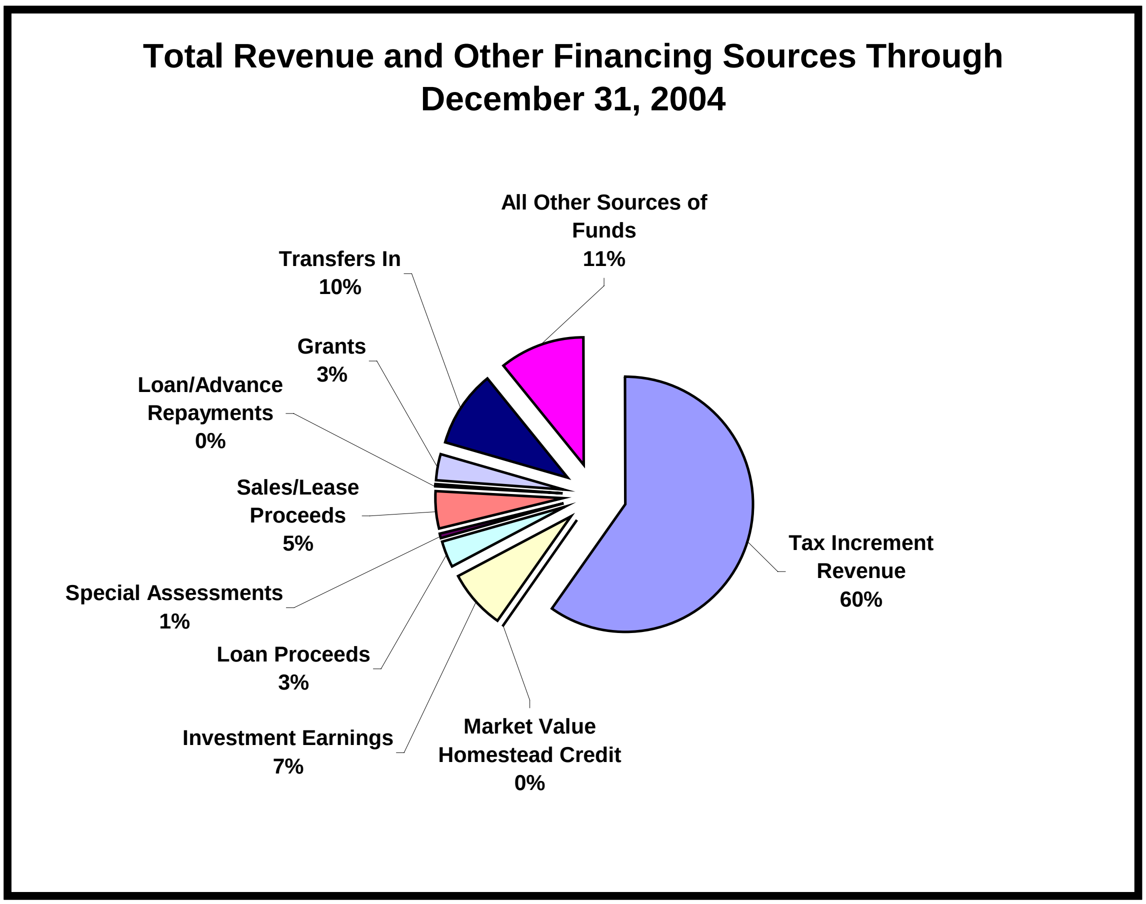
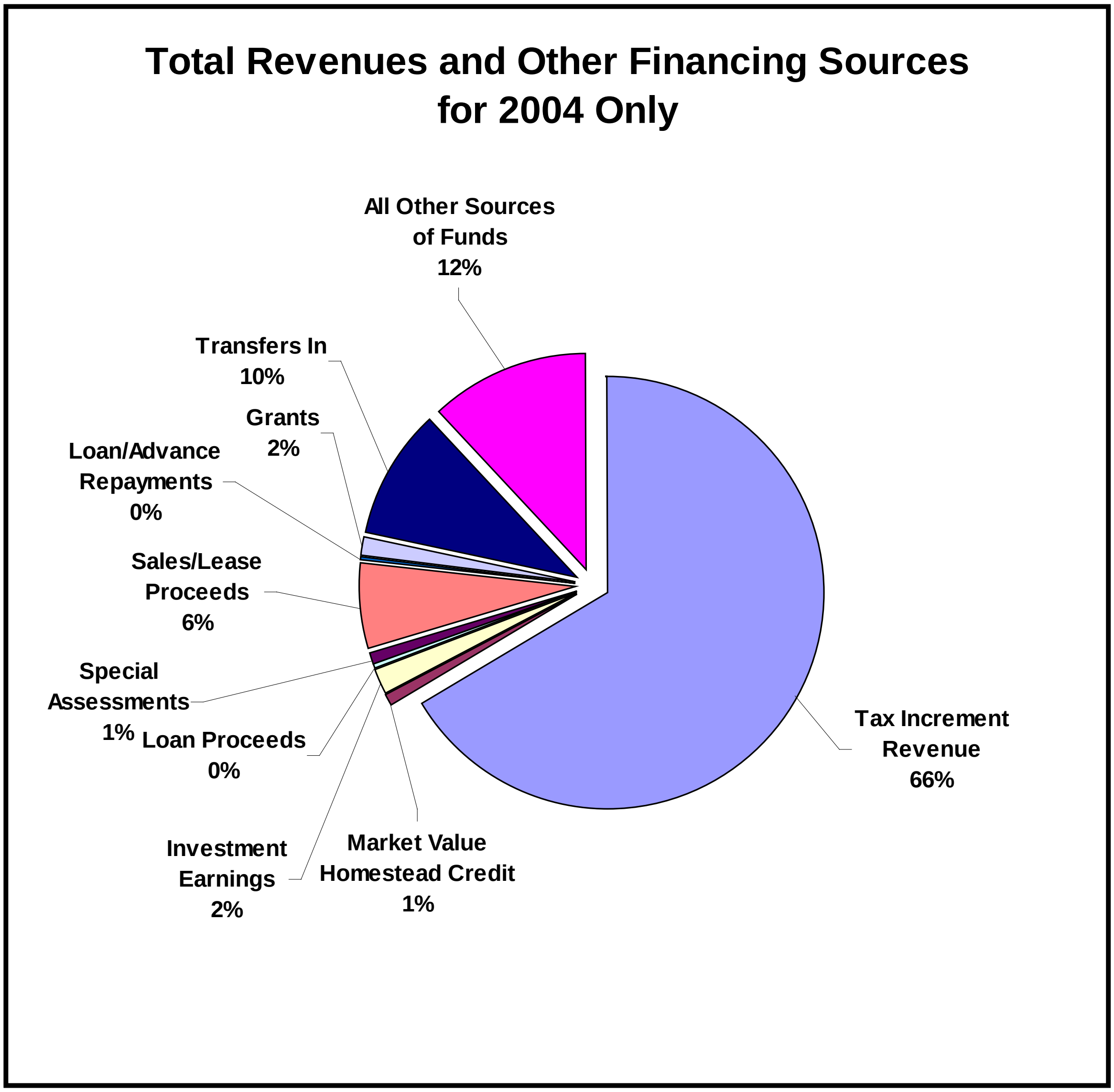


Figure 7



Average Tax Increment Generated Per TIF District

Tax increment revenues per district have fluctuated somewhat over the years. In 2002 notably, these revenues declined sharply. This was likely the result of the 2001 elimination of the local education levy subject to capture by TIF authorities, although other factors, such as the decertification of large, pre-1979 districts, may have also played a role. Figures 8 and 9 illustrate these trends. The averages need to be viewed with some caution. There is a wide range in the amount of revenues generated by different TIF districts. The range in the size of the TIF districts is further illustrated by Figure 10 on the next page.

Figure 8

Reporting Year	Number of Districts	Tax Increment Revenue	Average Per District
1996	1830	$247,189,000	$135,076
1997	1924	$285,983,000	$148,640
1998	2061	$287,972,245	$139,725
1999	2103	$275,611,803	$131,056
2000	2136	$293,370,294	$137,346
2001	2166	$325,448,944	$150,253
2002	2174	$222,241,011	$102,227
2003	2184	$255,817,248	$117,132
2004	2210	$255,661,176	$115,684

Figure 9

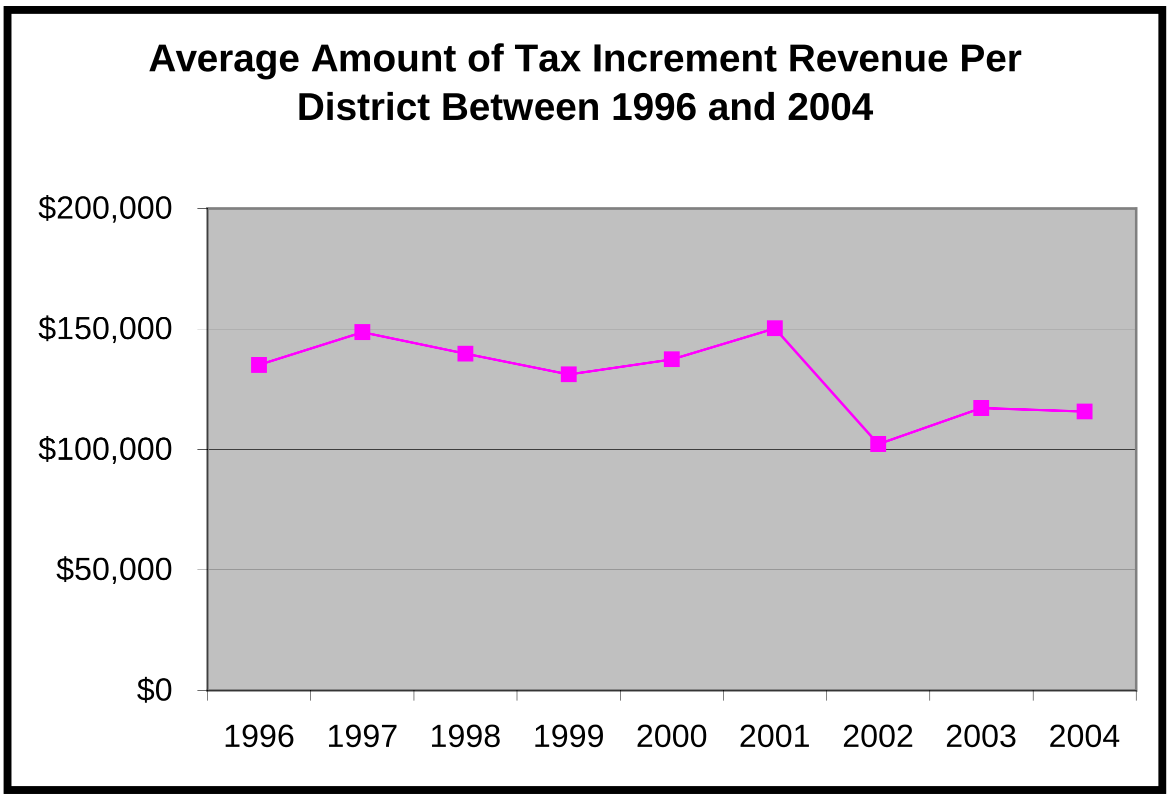
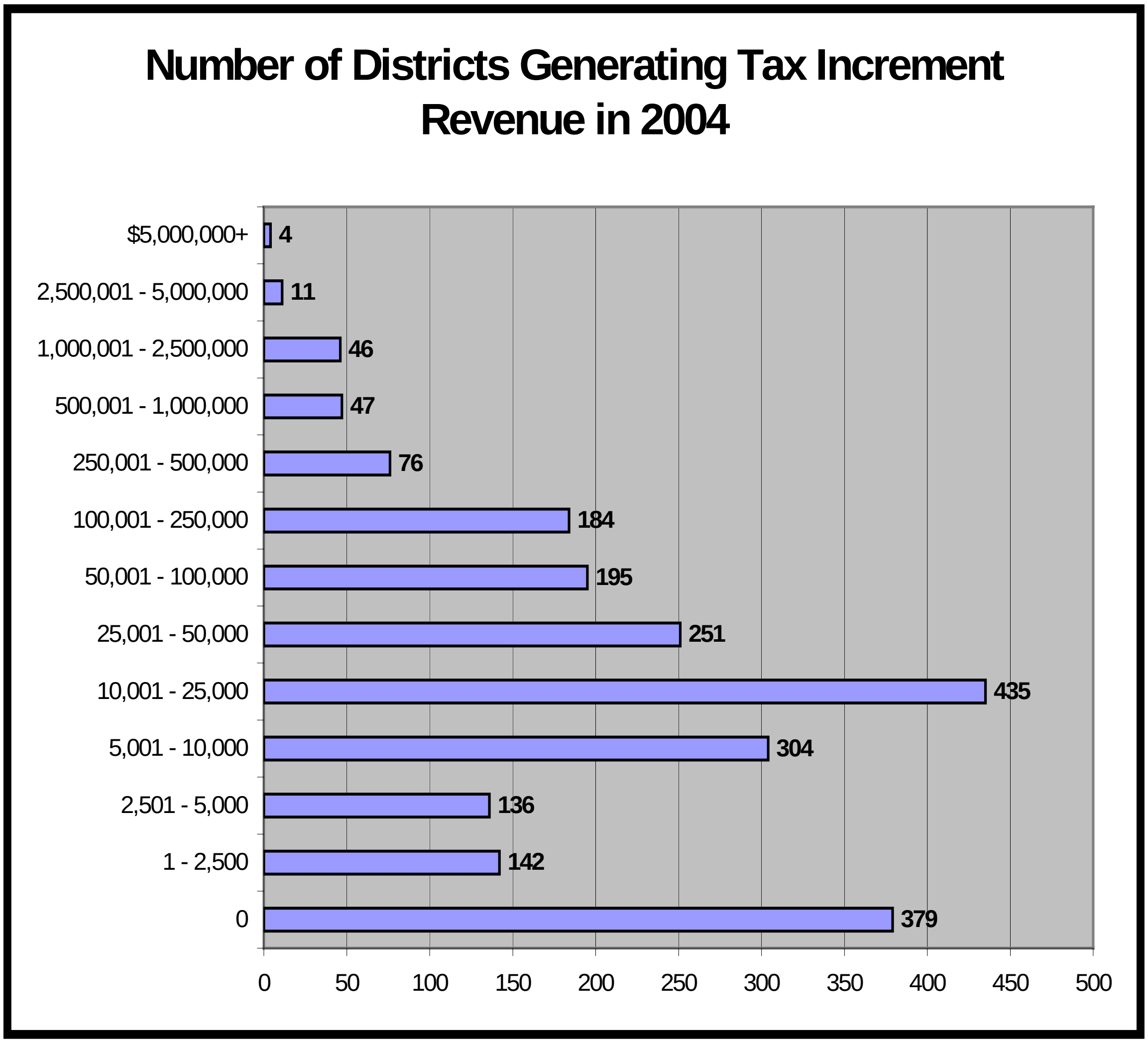


Figure 10



Project and TIF Expenses

Expenditures for development activity must be made within statutorily prescribed limitations. State and federal grant programs identify the uses for which grant monies can be used, prescribe bidding procedures, public hearing and other legal requirements. Tax increment revenues must be expended as permitted in its underlying development authority and in the TIF Act. Authorities are required to keep invoices for all expenditures made with tax increment revenues. Market value homestead credit, interest earned on invested TIF funds, and sales and lease proceeds generated from tax increment revenues are characterized as tax increment and must be expended accordingly. Figure 11 provides a summary listing of expenditures from tax increment revenues and other financing uses for 2004 and for prior years.

Figure 11 – Expenditures and Other Financing Uses

	Prior Years	2004	Total	% of Total*
Land/Building Acquisition	$1,290,484,356	$54,073,779	$1,344,558,135	14.8%
Site Improvements/ Preparation Costs	$695,198,774	$25,311,371	$720,510,145	6.9%
Installation of Public Utilities	$349,850,755	$7,589,085	$357,439,840	2.1%
Public Parking Facilities	$186,506,783	$4,397,255	$190,904,038	1.2%
Streets and Sidewalks	$259,713,989	$6,568,679	$266,282,668	1.8%
Public Park Facilities	$32,900,256	$426,565	$33,326,821	0.1%
Social, Recreational, or Conference Facilities	$283,381,993	$134,031	$283,516,024	0.0%
Interest Reduction Payments	$24,857,223	$385,769	$25,242,992	0.1%
Bond Interest Payments	$967,873,457	$49,532,781	$1,017,406,238	13.6%
Loan Principal Payments	$180,244,258	$9,654,389	$189,898,647	2.6%
Loan/Note Interest Payments	$142,997,274	$19,834,553	$162,831,827	5.4%
Administrative Expenses	$249,090,159	$11,351,580	$260,441,739	3.1%
Transfers out	$1,725,614,619	$119,265,401	$1,844,880,020	32.7%
All Other Expenditures	$921,785,478	$56,084,266	$977,869,744	15.4%
Total	$7,310,499,374	$364,609,504	$7,675,108,878	100.0%

Percentage of Total 2004 Expenditures

Due to the nature of generally accepted accounting principles, the actual costs of a project are accounted for twice. For example, the original costs of a project are paid for from bond proceeds. Tax increment revenue is then used to pay the principal and interest payments on the bonds. The annual TIF reports sent to the authorities by the TIF Division require tax increment information to be submitted pursuant to these generally accepted accounting principles.

The information contained on the TIF reports includes both the authorized costs of a project as well as the debt service (principal and interest), resulting in expenditures being accounted for twice. To more accurately identify expenditures without accounting for them twice, bond principal payments have been deleted from the table above and the two charts that follow. Two other categories listed in Figure 11, namely (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 the extent to which tax increment revenues were expended to repay such indebtedness, those two categories were not deleted. It is believed, however, that substantial double counting is represented in those two categories. Therefore, some degree of accounting for revenues twice is still known to exist in the above table and the two charts that follow.

Last year's report listed the total expenditures and other financing uses for prior years of approximately $8.4 billion. This included bond principal payments, which have been excluded from this year's report. If bond principal payments were added into this year's numbers, the expenditures and other financing uses would also be approximately $8.4 billion as opposed to the approximately $7.3 billion listed in Figure 11. Thus, in last year's report bond principal payments of approximately $1.3 billion are accounted for twice under GAAP standards.

Last year's report listed calendar year 2003 expenditures and other financing uses of approximately $466 million. If bond principal payments were deducted to avoid double counting, the expenditures and other financing uses would be approximately $330 million. If bond principal payments were added back to the 2004 total for direct comparison with 2003, the expenditures and other financing uses would be approximately $502 million as compared to the approximately $364 million as listed in Figure 11. Essentially, there is approximately a $36 million increase in expenditures from 2003 to 2004 whether or not bond principal payments are excluded.

Figure 12

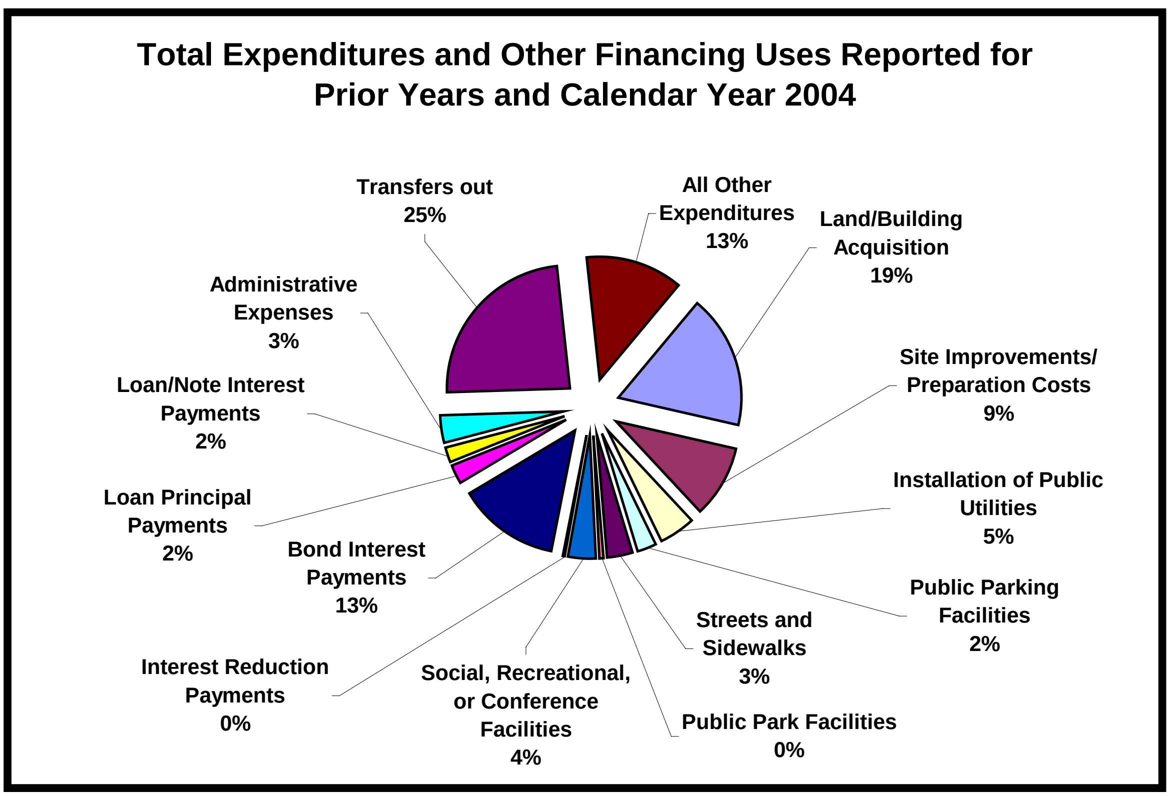
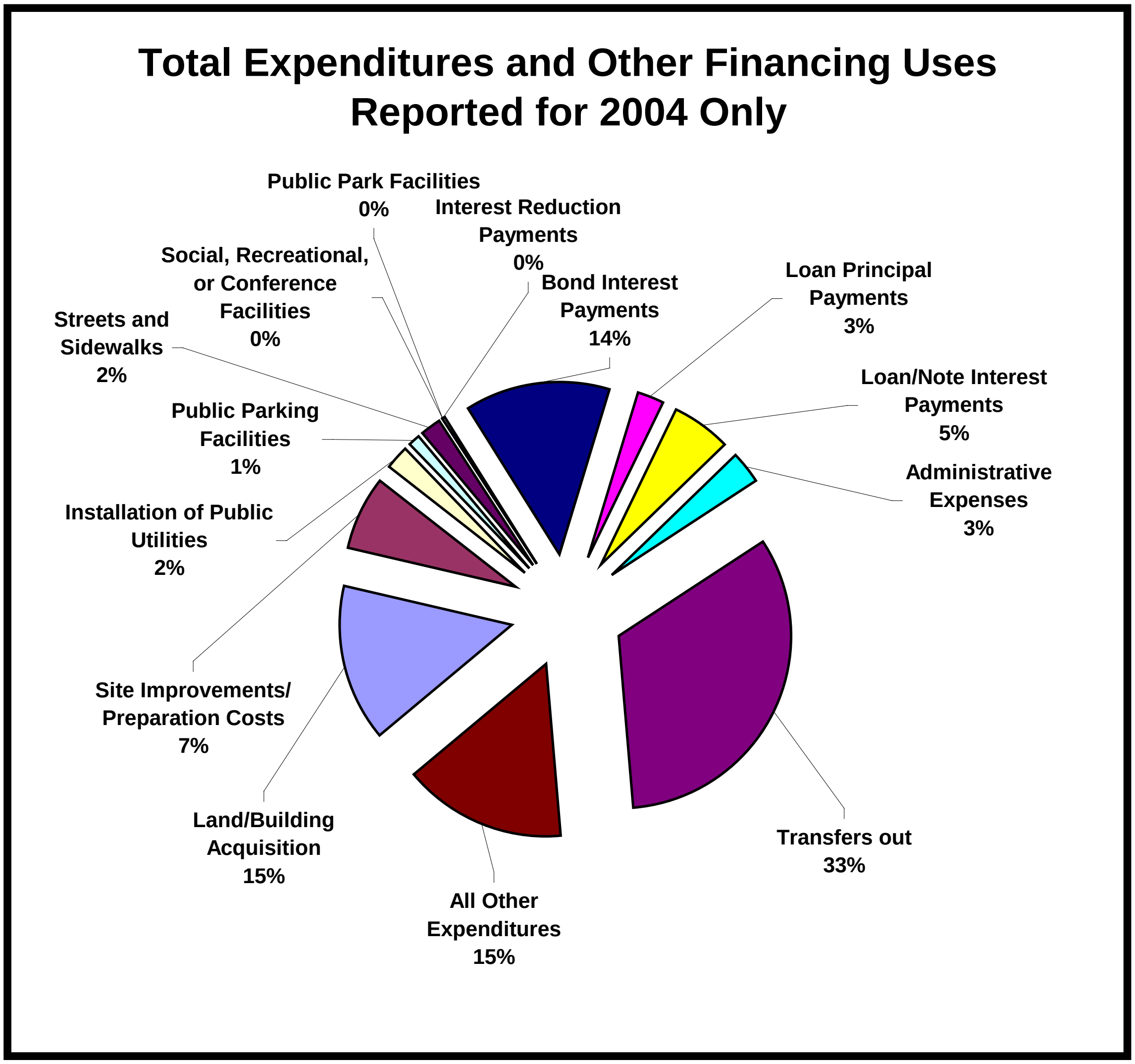


Figure 13



TAX INCREMENT FINANCING INITIATIVES

Increased Use of Online Reporting

In 2001, the State Auditor's Office developed an online reporting system for the required annual reports. Over the last few years, the use of the online reporting system has increased. This year the State Auditor created a new and improved online reporting system. The new system was created to allow for more features and was updated to be more user-friendly. The State Auditor has received positive feedback on this new reporting system and will continue to improve the system with the intention of implementing paperless TIF reporting in 2006.

Significant Decrease in Authorities Failing to File Reports

The State Auditor's Office was successful again this year in reducing the number of TIF authorities that failed to file substantially complete reports. Only three TIF authorities have not filed complete 2004 TIF reports.

Reporting Workshops

The State Auditor's Office has made substantial efforts to increase and improve communication with TIF authorities. Five workshops on TIF reporting were held in 2005 throughout the state with approximately 150 people in attendance. The 2005 workshops were held in Bloomington, Anoka County (Andover), Winona, Murray County (Slayton) and Crookston. It is the State Auditor's intention to hold reporting workshops again in the spring and summer of 2006.

Collaboration with Department of Revenue

The State Auditor's Office is collaborating with the Revenue, comparing data that is reported to both the State Auditor and Revenue. Revenue receives information from counties, such as tax capacity information of the TIF district, TIF-plan approval dates, certification request dates, certification dates and types of districts, approximately 16 months prior to the cities reporting the same information to the State Auditor's Office.

In working with Revenue, the State Auditor's Office is trying to ensure that basic TIF district information, such as the certification request and certification dates, is consistent between both offices. In an initial review of this information, the State Auditor found that there were a large number of TIF districts for which the certification request and/or the certification dates did not match. The State Auditor also found several TIF districts were reported to Revenue by the county, but were not reported to the State Auditor's Office by the TIF authorities.

The State Auditor's Office will continue to work with Revenue to determine additional ways to share information.

TIF Newsletter

In an effort to increase communication, the State Auditor's Office created the TIF newsletter. This newsletter is issued bi-monthly and contains a wide variety of information. For example, past newsletters have contained information on reporting requirements, TIF legislative changes, and tips for TIF authorities. The newsletter is sent by email to a diverse group of people. These include TIF authority representatives, county auditors, county assessors, private citizens, and anyone who has requested to be on the distribution list.

Management Letters

In the course of an annual financial audit, a management letter is often issued in which auditors discuss less significant issues and provide suggestions or improvements for local governments. The State Auditor had requested these management letters from all of the cities. The management letters that contained comments on the city's TIF districts were forwarded to the TIF Division. The TIF Division staff worked with cities to resolve the TIF issues identified in their management letters.

ENFORCEMENT

In addition to the less formal reviews, the TIF Division of the State Auditor's Office conducts field audits of TIF authorities. After completion of a TIF field audit, if the State Auditor finds that a TIF authority is not in compliance with the TIF Act, the State Auditor will send a notice of noncompliance to the governing body of the municipality that approved the TIF district in which the violation arose. The notice of noncompliance provides the basis upon which the State Auditor relies when making a finding and describes the possible consequences of the noncompliance.

The governing body is required by law to respond in writing to the State Auditor within 60 days after receiving the notice of noncompliance. In its response, the municipality must state whether it accepts, in whole or in part, the State Auditor's findings and indicate the basis for any disagreement with the findings. 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.

If the county attorney does not commence an action against the TIF authority within one year after receiving a referral of a notice of noncompliance from the State Auditor and the matter is not otherwise resolved to the State Auditor's satisfaction, the State Auditor refers the notice of noncompliance to the Attorney General. If the Attorney General finds that the TIF 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 TIF 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 TIF 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.[11]

Since the State Auditor's Office was given oversight responsibility by the Legislature, the State Auditor has issued a total of 62 notices of noncompliance or audit reports. The State Auditor's Office has been questioned whether it focuses its attention on fourth-class

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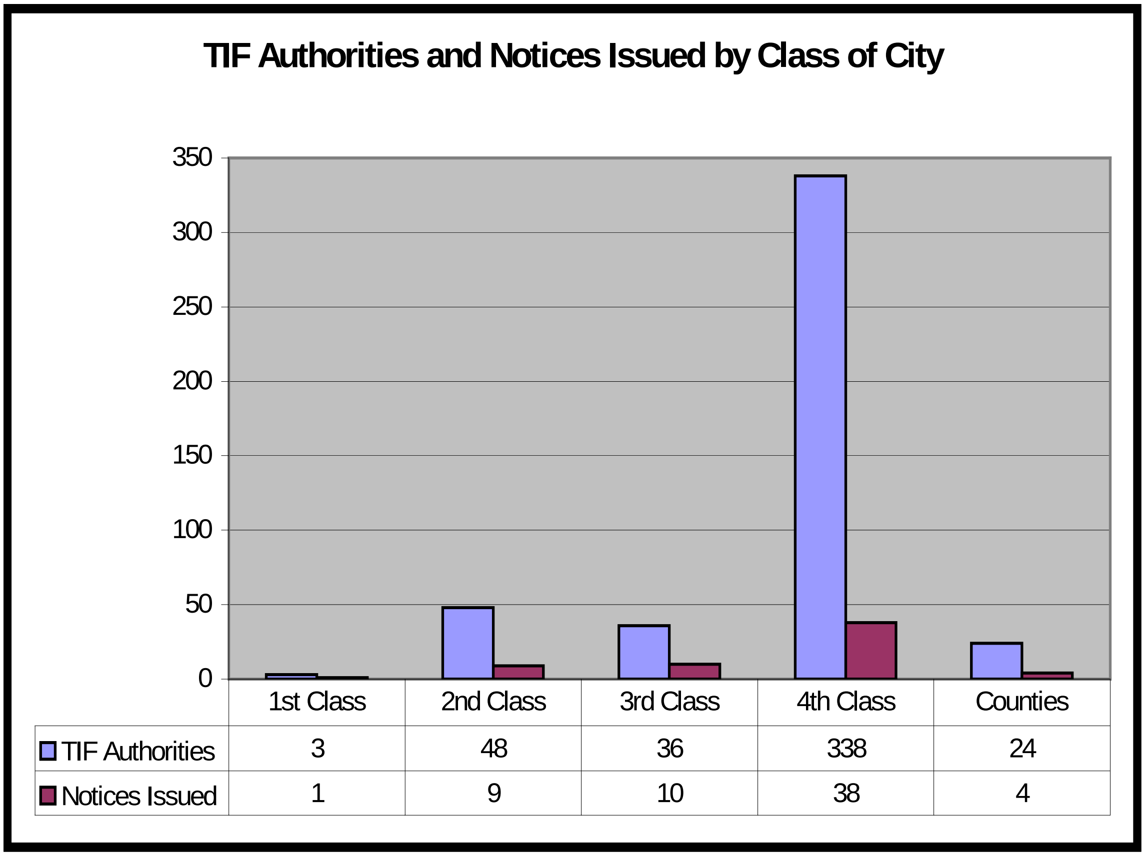
[11] Minn. Stat. § 469.1771, subd. 2b(c).

cities. In reality, the State Auditor has audited or reviewed a variety of the 449 TIF authorities that are required to file reports with the State Auditor's Office. Fourth-class cities constitute a substantial portion of the cities in the State. The following graph shows both the number of cities or counties that use TIF as well as the number of cities or counties in which the State Auditor has issued a notice of noncompliance within the different classes.

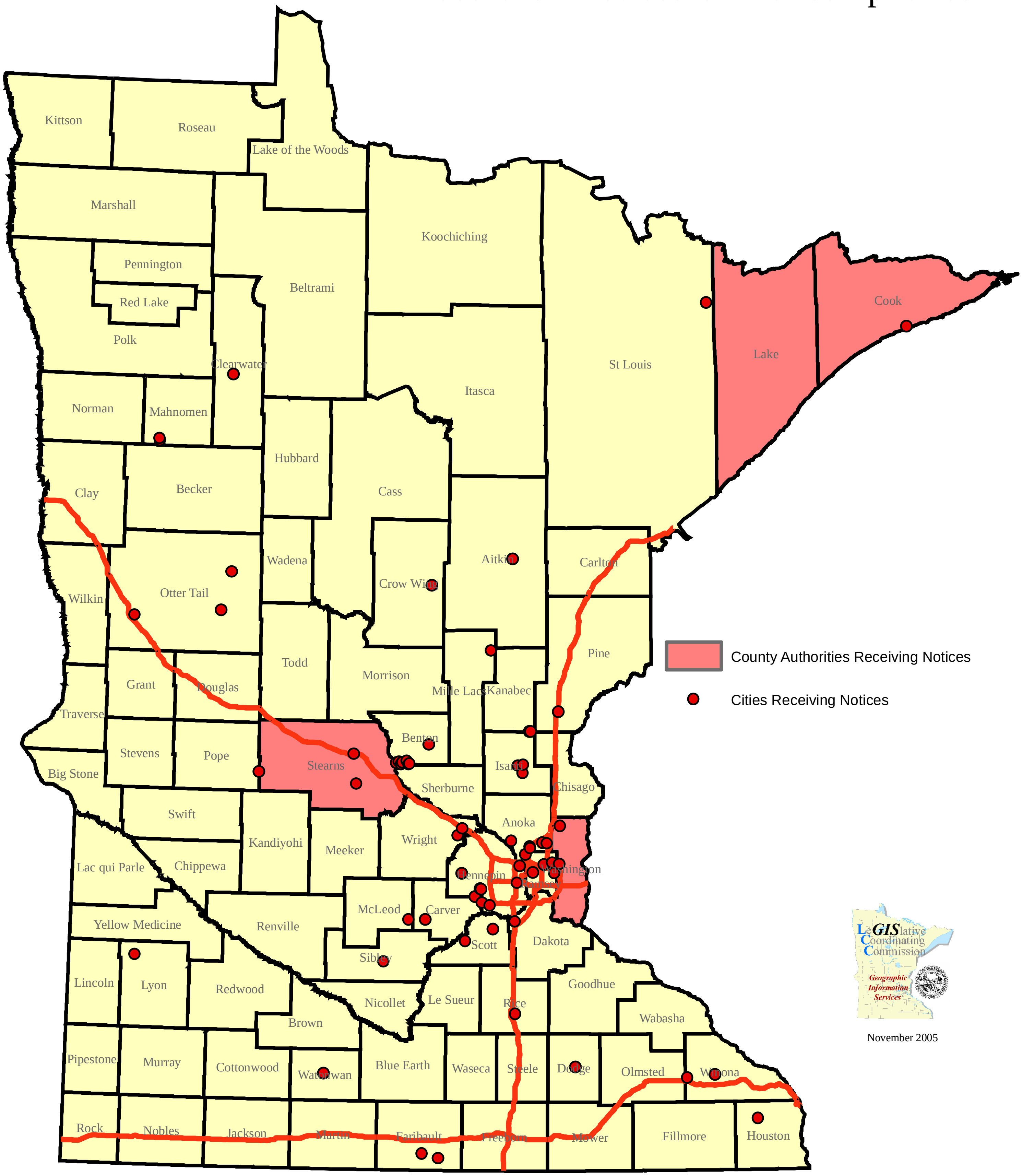
Figure 14



In addition, the following map illustrates the various cities or counties that have received a notice of noncompliance from the State Auditor.

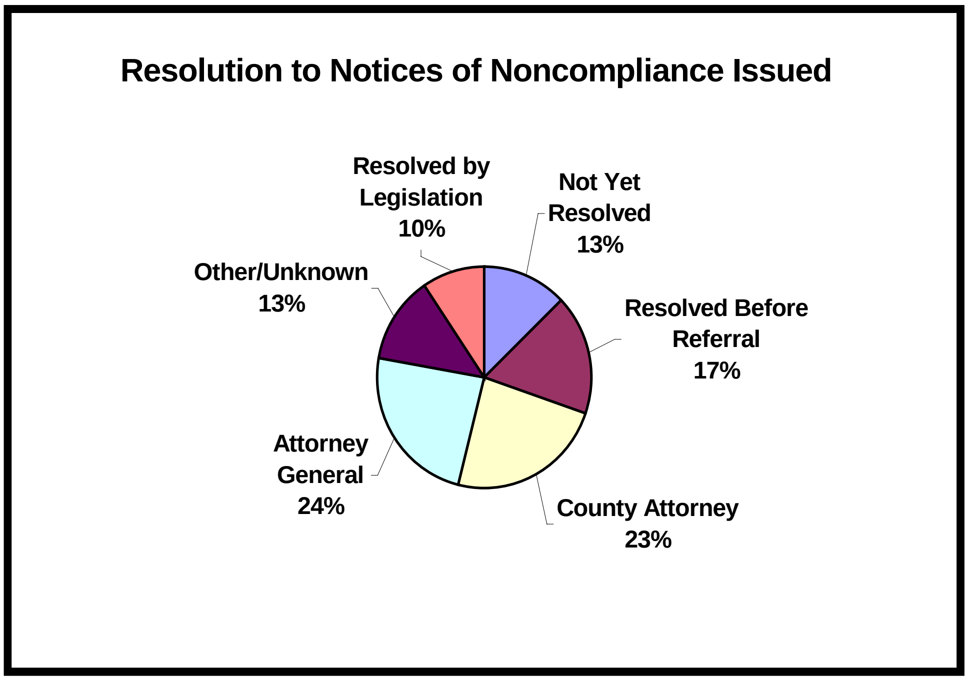
Map 5

Record Of Notices Of Noncompliance



As mentioned above, the State Auditor's Office has issued a total of 62 notices of noncompliance. The County Attorney or the Attorney General has resolved many of the notices of noncompliance. There are other notices that have not yet been resolved that are either with a County Attorney or the Attorney General. In addition, there have been situations in which the State Auditor has made findings of noncompliance and the Legislature has then enacted legislation that resolves the finding. The following graph illustrates how the notices of noncompliance have been resolved.

Figure 15



Summary of Findings

The State Auditor must provide a summary of the responses it received from the municipalities audited and copies of the responses themselves to the chairs of the legislative committees with jurisdiction over tax increment financing. This section of the report discusses details of the various TIF legal compliance audits and investigations completed as of December 31, 2005. Field audits were completed and initial and final notices of noncompliance sent to the following municipalities:

1. City of Albert Lea – An initial notice of noncompliance was sent on August 10, 2005. A final notice of noncompliance was sent on October 31, 2005.
2. City of Gaylord – An initial notice of noncompliance was sent October 15, 2004. A final notice of noncompliance was sent on March 17, 2005.
3. City of Prior Lake – An initial notice of noncompliance was sent on March 16, 2005. A final notice of noncompliance was sent on April 12, 2005.

4. City of St. Michael – An initial notice of noncompliance was sent on December 27, 2004. The final notice of noncompliance was sent on April 12, 2005.

Complete copies of the initial and final notices of noncompliance and the municipalities' responses are provided in the appendices, found in Volume II to this report.

Costs Not Eligible for Payment with Tax Increment

City of Gaylord

TIF District 1-1

In the initial notice of noncompliance,[12] the State Auditor found that the City used tax increment from TIF District 1-1 for various costs including Christmas lights for the city, donations to the Gaylord Ambulance Relief as well as the fire department, alley paving contribution and the fire hall driveway.

The city council responded that it relied on the advice of their professional consultants. In addition, the City stated that the purchase of Christmas lights enhanced and would beautify the community making it economically appealing to potential residents and business owners and therefore qualifies as a tool for redevelopment . . . the fire hall serves an essential service for protecting public property and enhanced response time . . . the donations were reimbursement for the burning of blighted homes . . . the alley paving contribution was done to contribute to the redevelopment efforts in the area, and helped alleviate the financial burden on the local citizens who inevitably would have to pay for this if financial assistance wasn't provided by the City.

In its final notice of noncompliance, the State Auditor found that $21,649 of TIF District 1-1's tax increment was spent on costs not authorized by the TIF Act. The City did not provide documentation to substantiate that the costs listed in the finding were qualifying redevelopment costs to be paid with tax increment.

TIF District 3-1

In the initial notice of noncompliance, the State Auditor found that the City used $34,287.27 of TIF District 3-1's tax increment for costs related to the construction of a 4,000 square foot office building, which contains the local Agricultural Stabilization Conservation Service (ASCS) office. The city council's response indicates that any and

[12] The Gaylord Housing and Redevelopment Authority (HRA) was the TIF authority for several of the TIF districts at the time that the districts were created. The City has since transferred the administration and authority of the TIF districts to the city's Economic Development Authority (EDA). The EDA has also created some of the TIF districts within the city. However, the annual TIF reports list the city as the TIF authority and are signed by the city administrator. Therefore, we will refer to the TIF authority for all of the TIF districts as the "City".

all expenditures from TIF District 3-1 were for site improvements and the City believes the costs were authorized by the TIF Act. However, according to the documentation provided by the City, tax increment was used, in part, to assist in the improvements and construction of a building to be used by the local ASCS office. The City's response indicated that it believed that these were authorized expenditures based on the advice they received from their financial consultant.

In its final notice of noncompliance, the State Auditor reiterated its finding that $34,287.27 of TIF District 3-1's tax increment was spent on costs not authorized by the TIF Act. The local ASCS office was a building used primarily used for conducting business of the federal government. Tax increment may not be used for this purpose.

All TIF Districts

In the initial notice of noncompliance, the State Auditor found that the City used tax increment from all of the City's TIF districts to pay for costs such as dues to professional organizations, magazine subscriptions, assessor fees, training and travel costs, insurance costs to the League of Minnesota Cities and undocumented administrative expenses. The city council's response indicated that the City believed that the expenditures were TIF-eligible, authorized and substantiated expenditures that could be paid for with tax increment.

In its final notice of noncompliance, the State Auditor reiterated its finding that the City improperly spent $109,544.57 of tax increment on unsubstantiated expenses, and/or for costs not eligible to be paid for with tax increment. Nothing in the City's response substantiated that the expenditures detailed in the finding were qualifying costs to be paid with tax increment.

Unauthorized Expenditures of Tax Increment for a Housing District

City of Gaylord

TIF District 2-2

In the initial notice of noncompliance, the State Auditor found that $58,570 of TIF District 2-2's tax increment was spent on improvements that benefited commercial users or users other than the low and moderate-income housing, and that none of these improvements were directly related to the housing project.

The city council's response conceded that $58,570 of the tax increment from TIF District 2-2 (a housing district) was transferred to TIF District 2-1 (a redevelopment district) and spent on improvements that benefited users other than low and moderate-income housing. The response further stated that because the user benefiting from the expenditures in question created jobs that inevitably created a need for housing, tax increment from the housing district could be utilized in TIF District 2-1 based on a related housing need or connection between both parties.

In its final notice of noncompliance, the State Auditor reiterated its finding that $58,570 of the tax increment from TIF District 2-2 was expended on improvements that benefited commercial users or users other than the low and moderate-income housing, and that none of these improvements were directly related to a housing project. The TIF Act requires that the tax increment generated from a housing district be used solely to finance the costs of a housing project. Having a connection to housing or creating a need for housing is not sufficient to qualify as a housing project.

Unauthorized Expenditures of Tax Increment for an Economic Development District

City of Gaylord

TIF District 2-6

In the initial notice of noncompliance, the State Auditor found that all tax increment expenditures ($56,683) from TIF District 2-6 were spent in violation of the TIF Act, because the tax increment was used to assist in the development of a hotel.

The city council's response concedes that the tax increment was spent to assist a hotel but does not concede that this was done in purposeful disregard of the law or in a fashion inconsistent with the overall purpose by which TIF was created. The City also states that the action to proceed with the project was based solely on the advice and counsel of its professional advisors. The city council's response noted that the TIF Act did allow for financing of tourism facilities.

In its final notice of noncompliance, the State Auditor reiterated its finding that all tax increment expenditures from TIF District 2-6 ($56,683) were in violation of the TIF Act, because the tax increment was used to assist in the development of a hotel. While it is true that tax increment from an economic development district may be used to assist tourism facilities, the City did not provide documentation to substantiate that it met the definition of a tourism facility at the time TIF District 2-6 was created. In fact, the City received a letter from its legal counsel in 2000 that stated their legal counsel did not believe that the district even qualified as an economic development district.

Unauthorized Retention of Interest Earned on Tax Increment

City of Prior Lake

TIF Districts 2-7 and 2-8

In the initial notice of noncompliance, the State Auditor found that the City did not credit TIF Districts 2-7 and 2-8 with the interest earned on those districts' fund balances. In its response, the city concurred with the State Auditor's finding and directed city staff to incorporate the finding into the City's current and future TIF projects.

In its final notice of noncompliance, the State Auditor reiterated its finding that the City did not allocate interest or investment earnings on or from tax increment to the appropriate TIF funds for the years 2001, 2002, and 2003.

City of St. Michael

TIF Districts J & B Drainage, Business Center, and Countryside Cottages

In the initial notice of noncompliance, the State Auditor found that the City improperly spent $12,953 of interest or investment earnings on or from tax increment from TIF Districts J & B Drainage, Business Center, and Countryside Cottages because the City did not allocate these amounts to the appropriate TIF funds. The City's response stated that the calculation furnished to the State Auditor's Office was based upon the City's long-term investment rate, and that it would be more appropriate to calculate interest on tax increment using the City's short-term investment rate. The City agreed to make a prior period accounting adjustment to transfer funds from the General Fund to the appropriate TIF funds based upon estimated interest earnings for the applicable periods.

In its final notice of noncompliance, the State Auditor reiterated its finding that the City did not allocate interest or investment earnings on or from tax increment to the appropriate TIF funds.

Inadequately Documented Expenditures

City of Gaylord

TIF District 2-1

In the initial notice of noncompliance, the State Auditor found that $2,865,735.50 of TIF District 2-1's TIF bond proceeds or tax increment was improperly spent, because the TIF authority did not provide documentation to substantiate the expenditures or the expenditures are in violation of the TIF Act. The City's response included references to various folders and stated that the expenditures were proper. The response further stated that if any fault exists, it was the fault of city hall and not the City.

In its final notice of noncompliance, the State Auditor reiterated its finding that $2,865,735.50 of TIF District 2-1's TIF bond proceeds or tax increment was improperly spent, because the TIF authority did not provide documentation to substantiate the expenditures were made in compliance with the TIF Act.

TIF District 2-7

In the initial notice of noncompliance, the State Auditor found in the initial notice that $614,475.30 of TIF bond proceeds and TIF District 2-7's tax increment was improperly spent, because the city had insufficient documentation to show it actually incurred these costs or that the costs were authorized by the TIF plan for the TIF district.

The City's response referenced various file folders and concluded that all expenses incurred in TIF District 2-7 were made under a simple desire to comply with the law. However, the folders did not contain documentation, such as ledgers, to substantiate that the City actually incurred the $614,475.30 in costs or that the costs were authorized by the TIF plan for TIF District 2-7.

In its final notice of noncompliance, the State Auditor reiterated its finding that $614,475.30 of TIF bond proceeds and TIF District 2-7's tax increment was improperly spent, because the TIF authority has insufficient documentation to show it actually incurred these costs or that the costs were authorized by the TIF plan for the TIF district.

City of St. Michael

TIF District J & B Drainage

In the initial notice of noncompliance, the State Auditor found that the City improperly spent $13,059 of tax increment from the J & B Drainage TIF District on costs not authorized by the TIF Act because the City lacked documentation to substantiate that this amount was to reimburse the City for administrative expenses.

In its response, the City stated that it did not accept this finding, and requested that this finding be modified to "look back" only a few years rather than the eight years involved in the finding. The City agreed to repay $5,282.06 of the $13,059 and delivered a check in that amount to the County with the understanding that the check would be held until the City received the final notice of noncompliance. The $5,282.06 represents the amount of undocumented administrative charges for the years 2002 and 2003. The City also agreed to keep contemporaneous records for all administrative expenses charged to its TIF districts in the future.

In its final notice of noncompliance, the State Auditor reiterated its finding that the City improperly spent $13,059 of tax increment from the J & B Drainage TIF District on costs not authorized by the TIF Act because the City lacked documentation to substantiate that this amount was to reimburse the City for administrative expenses.

Inadequate Documentation to Substantiate Compliance with Income Restrictions for Housing Districts

City of Gaylord

TIF District 2-3

In the initial notice of noncompliance, the State Auditor found that TIF Districts 2-2 and 2-3 did not satisfy the income requirements for housing districts. The City's response stated that it acknowledges the fact that the City must comply with Minn. Stat. § 469.1761, subd. 3, but believes that the property owner receiving the TIF benefit should be the one with the burden of monitoring and substantiating that the income restrictions are met.

In its final notice of noncompliance, the State Auditor reiterated its finding that TIF Districts 2-2 and 2-3 did not satisfy the income requirements for housing districts.

Unauthorized Expenditures

City of Albert Lea

TIF District 5-5

In the initial notice of noncompliance, the State Auditor found that the City improperly spent $192,945 of tax increment from TIF District 5-5 through December 31, 2003. The City spent this tax increment in excess of the total estimated tax increment expenditures authorized in the TIF plans.

In its response, the city stated that it concedes most of the facts stated in the State Auditor's initial notice of non-compliance, however the response also states "it is unable to explain the absence of the needed modification of the TIF District," but indirect evidence (experienced staff and professional advisors) strongly suggests that the modification was made. In the alternative, failure to modify the TIF plan was a technical defect that does not suffice to overturn governmental action.

In its final notice of noncompliance, the State Auditor reiterated its finding that the City improperly spent $192,945 of tax increment from TIF District 5-5 through December 31, 2003, because the City spent this tax increment in excess of the total estimated tax increment expenditures authorized in the original or modified TIF plan. The City did not provided any direct or indirect documentation that substantiates it modified the TIF plan of TIF District 5-5 to increase its total estimated tax increment expenditures. The City's failure to provide such documentation, required by law to be retained, clearly demonstrates the City did not modify the TIF plan to increase total tax increment expenditures. The failure of the City to authorize the expenditure of tax increment revenues above those expenditures authorized constitutes an illegal expenditure. Contrary to the City's position, the State Auditor's Office does not find that an illegal expenditure of $192,945 constitutes a mere technical defect under the TIF Act.

CONTACT INFORMATION

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

Office of the State Auditor
TIF, Investment and Financing Division
525 Park Street, Suite 500
St. Paul, MN 55103
Telephone: (651) 296-4716
Fax: (651) 297-3689
Email: tifdivision@auditor.state.mn.us

Arlin B. Waelti, Assistant State Auditor/Director	(651) 296-7979
Maggie Gebhard, Accounting Technician	(651) 296-7446
Lisa McGuire, Auditor	(651) 296-9255
Kurt Mueller, Auditor	(651) 297-3680
Marsha Pattison, Finance Officer	(651) 296-4716
Suk Shah, Auditor	(651) 296-7001

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