

Overview of Tax Increment Financing and Local Sales Taxes

**A Presentation to the
House Property and Local Taxes Division**

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by

Pat Dalton
Joel Michael
Research Department

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Tax Increment Financing (TIF)

What is TIF?

TIF is a method of dedicating incremental property taxes to use as a financing tool.

In Minnesota TIF is used by cities and development authorities for two purposes (and it is useful to think of them separately):

- To induce development or redevelopment
- To finance public improvements (unrelated to inducing development)

TIF Mechanics

TIF captures the taxes on the growth in tax base by certifying for a TIF district (when it is created):

- **Original tax capacity** (taxable value)
- **Original tax rate** (local taxing district rates)

Captured value = current tax capacity – original tax capacity

Tax increment = original tax rate * captured value

- Increment increases as values increase because of either **development** or **inflation** (growth in the market value of properties in the district unrelated to development)

Types of TIF Districts

District Type	Duration Limit
Economic development	8 years
Housing	25 years
Redevelopment	25 years
Renewal and renovation	15 years
Soils	20 years
Hazardous substance	25 years

But-For Test

- Municipal finding requirement
- Applies when TIF plan is approved and district created
- Based on municipalities “opinion”

- Two components:
 - Development won't occur without TIF
 - Will increase market value

Permitted Uses of TIF Revenues

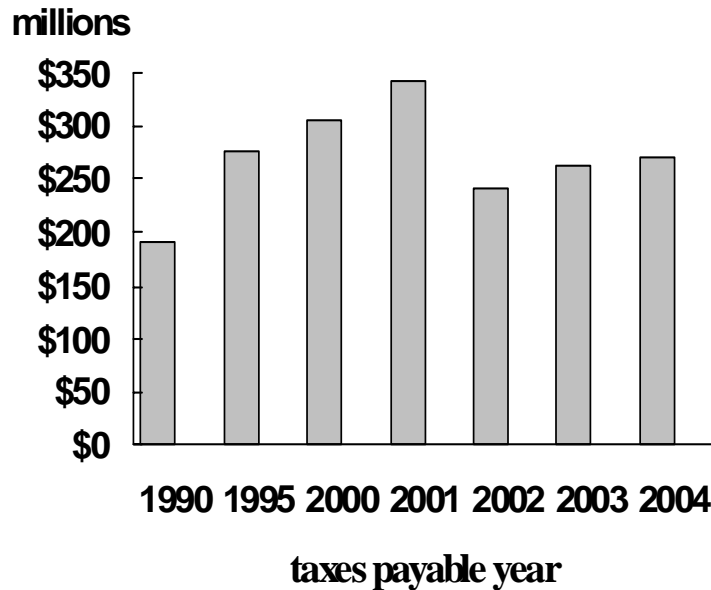
- Site acquisition and preparation
- Public improvements, e.g.:
 - Streets
 - Sewer and water
- Developer incentives (land write-downs, etc.)
- Limited private improvements, such as privately owned buildings (low income housing is a major instance in which can be and is used to construct to private improvements)

Prohibited Uses of TIF Revenues

Anything not explicitly permitted by the TIF Act:

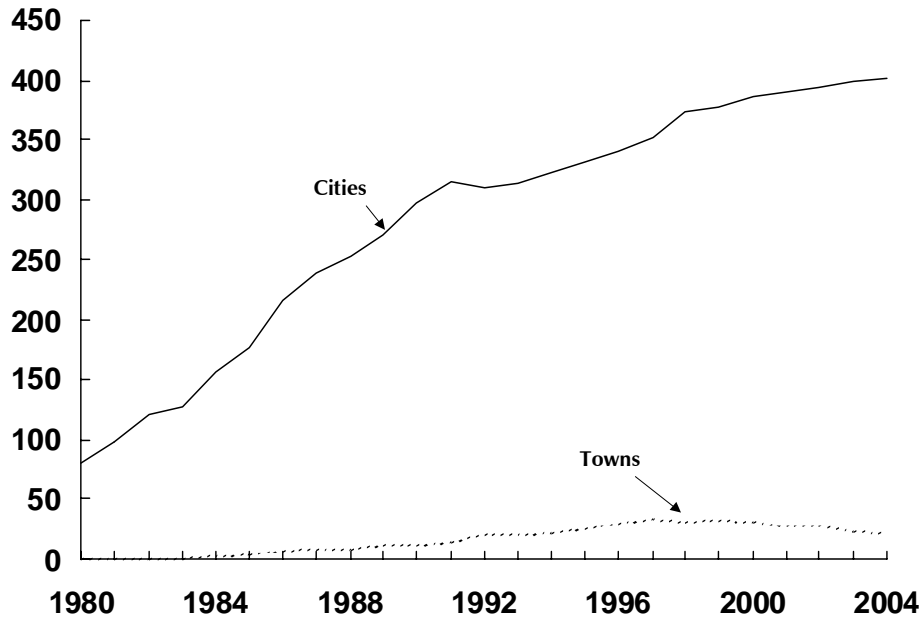
- Most government buildings
- Most private buildings and other improvements

Tax Increment Revenues



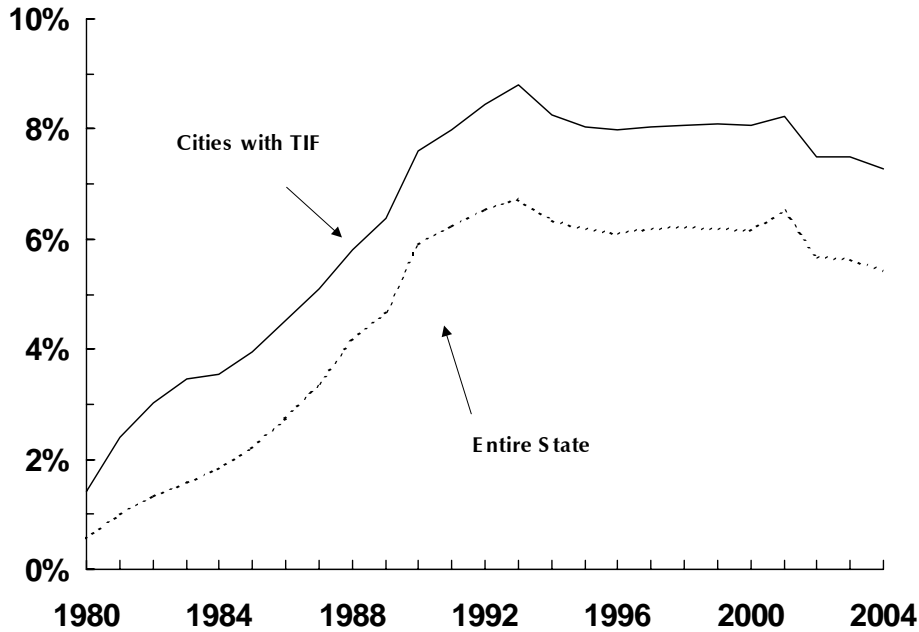
Source: Department of Revenue

Number of Cities and Towns with TIF Value



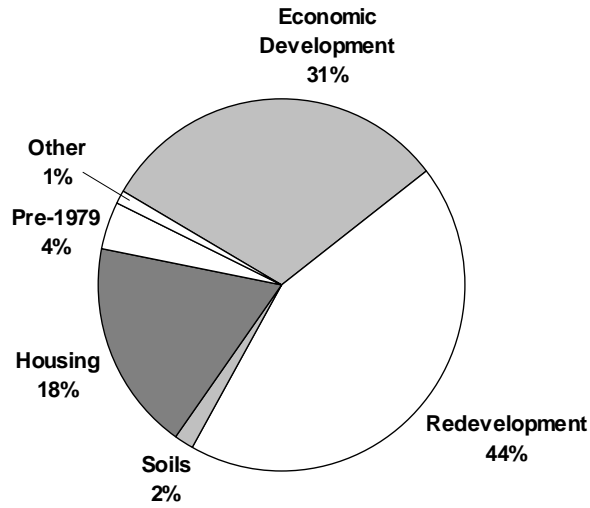
Source: Department of Revenue

Property Tax Base in TIF



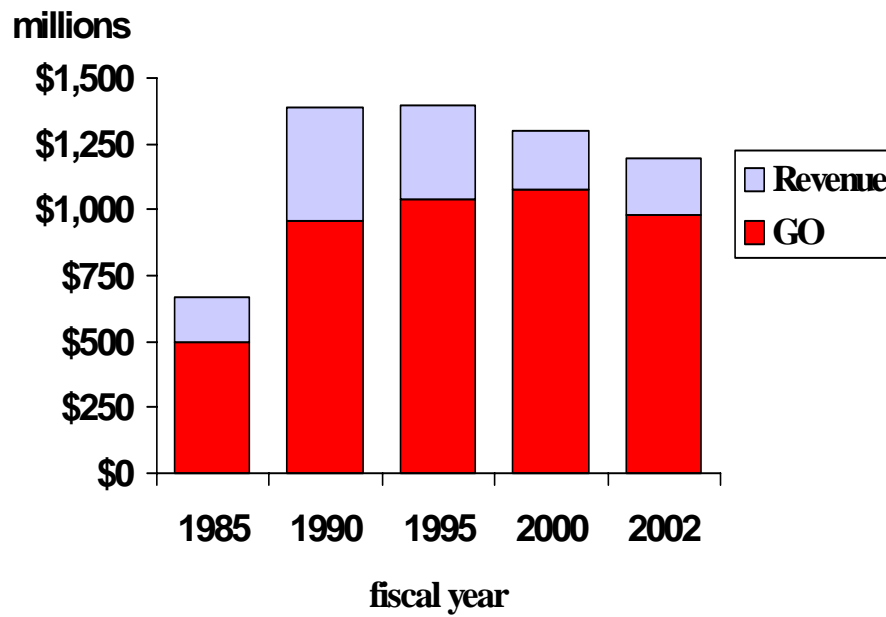
Source: Department of Revenue

TIF Districts by Type Calendar Year 2002 Total Number of Districts: 2,136



Source: Office of State Auditor

TIF Backed City Debt



Source: Office of State Auditor

Limitations on TIF

- 3-Year Rule: Certain activities (issue bonds or acquiring property) must be undertaken within 3 years after approving the TIF plan. Minn. Stat. § 469.176, subd. 1a (2004).
- 4-Year Rule: Activity (public or private) must occur on a parcel in a TIF district within 4 years after certification of the district or the parcel is dropped from the district. Minn. Stat. § 469.176, subd. 6 (2004).
- 5-Year Rule: Activities must be completed within 5 years after approval of the plan to qualify as in-district expenditures under the pooling rules. Minn. Stat. § 469.1763 (2004).
- Restrictions on pooling: Percentage limits apply to the amount of increment that may be collected for a district and spent on activities outside of the district. Minn. Stat. § 469.1763 (2004).
- Limits on Administrative Expenses Minn. Stat. § 469.176, subd. 3 (2004).

Property Tax Abatement for Economic Development

- City, county, and school district may “abate” only its own taxes.
- Abatement may be used for:
 - Development incentives
 - Public infrastructure financing
- Maximum duration limit is 10 years, but may be increased to 15 years, if only two units approve.
- Few limits on use.

Property Tax Abatement: Permitted Purposes

- Increase or preserve tax base
- Provide jobs
- Public infrastructure financing
- Redevelopment
- Provide services to residents
- Phase-in property tax increases

Comparison of TIF and Abatement

Feature	TIF	Abatement
Approval	City only	City, county, school
But-for Test	Yes	No
Blight Test	Yes/No	No
Duration	8 to 25 years	10 years
Use of Revenues	Restricted	Flexible

Local Sales Taxes

Authority to Impose

- Cities have a general authority to impose up to a 3% lodging tax for tourism purposes.
- In 1971 the legislature prohibited local governments from imposing or increasing a local sales or income tax. This means that all new local sales taxes or changes in existing local sales taxes require enacting a special law.
- Since 1971, local sales taxes have only been imposed under special law.
- In 1997 the legislature adopted local sales tax rules (Minn. Stat. § 297A.99) to be followed when authorizing any new local sales tax. The rules require that the imposition of the tax be approved at referendum, local sales taxes use the same base as the state tax, that it be a sales and use tax, that the tax expire for one year before it can be authorized for another purpose, and that the tax be administered by the Department of Revenue. All existing local sales taxes must conform to these rules as well.¹

Summary of the Local Sales Tax Provisions in Minn. Stat. § 297A.99

Local Taxes Subject to the Statutory Provisions

The statutory provisions apply to all local sales taxes authorized after June 2, 1997, unless the enabling legislation specifically exempts the local authority from these rules by reference. Starting January 1, 2000, the statutory provisions apply to and preempt any contrary provisions of all local sales taxes authorized before June 2, 1997.

¹ Duluth's local sales and use tax is an anomaly. It was enacted in 1973 and for 10 years was the only local state tax in the state. It tends not to follow general practices. The city administers and collects its sales tax itself until December 31, 2005, and there is no requirement that proceeds be spent for a specific purpose, and there is no expiration provision.

Steps That a Local Government Must Follow to Impose a Local Sales Tax

A political subdivision must get special legislation authorizing the imposition of the sales tax. The statute requires that the governing body of the political subdivision pass a resolution indicating its desire to impose the tax prior to requesting the enabling legislation. The resolution must include information on the proposed tax rate, the amount of revenue to be raised and its intended use, and the anticipated date when the tax would expire. This resolution requirement was added during the 1998 session.

In 1999 the legislature began requiring a political subdivision to hold a local referendum at a general election² before imposing an authorized local sales tax. The revenue may only be used to fund specific capital improvements which must be identified at least 90 days before the referendum. This codifies existing practice since most special legislation authorizing local taxes passed in recent years already imposed these requirements.

Determination of the Local Tax Rate

The local tax rate is set in the legislation authorizing the tax. The statute clarifies that the full local tax rate applies to all taxable sales, even those that are taxed at a reduced rate by the state.

Definition of the Tax Base for the Local Tax

Generally the statute provides that the local sales tax applies to the same tax base, with the same exemptions, as the state sales tax. A taxable service is subject to the local tax if more than one-half of the service, based on the cost, is performed within the local jurisdiction. The following sales made within the local taxing jurisdiction are exempt from the local tax:

- purchases shipped outside the taxing jurisdiction for use in a trade or business outside of the jurisdiction;
- purchases temporarily stored in the taxing jurisdiction before being shipped by common carrier for use outside of the jurisdiction; and
- purchases that are subject to the direct pay provisions for interstate motor carriers under Minnesota Statutes, section 297A.90.

Requirements of a Complementary Use Tax

A complementary use tax³ is required in all jurisdictions with a local sales tax. Four local taxes enacted before 1997 did not include a use tax; a local use tax was imposed in these political

² A general election means either the state general election held on the first Tuesday after the first Monday in November of an even-numbered year, or a regularly scheduled election for local public officials for that political subdivision.

³ The use tax is imposed on the consumption or “use” of taxable items for which no sales tax was paid. The tax is imposed mainly on purchases by resident buyers from sellers located outside of the local taxing jurisdiction. The use tax removes the disadvantage to local businesses from competition with businesses located outside of the taxing area who are not required to collect the local sales tax.

subdivisions beginning January 1, 2000. Affected jurisdictions are noted in the chart on currently authorized local taxes (Table 1).

The statute also allows a credit against the use tax owed for a local sales or use tax paid to another political subdivision. This is similar to the credit against state sales and use tax for the amount of taxes paid to another state.

Collection, Administration, and Enforcement of Local Taxes

The statute requires the Commissioner of Revenue to administer and collect local sales and use taxes. This merely codifies existing practice. All local sales taxes, except for the tax imposed in the city of Duluth, have been administered and collected by the state. The city of Duluth, at its own request, is specifically exempted from the collection and administration provisions of the statute. However, the commissioner will begin to collect and administer the Duluth tax after December 31, 2005.

The local taxes are subject to the same penalties, interest, and enforcement provisions as the state sales tax. Refunds of excess state sales taxes paid must also include a refund of any excess local sales tax paid. The state deducts its collection and administration costs from the tax revenue returned to the local taxing jurisdiction. The net local tax revenue is paid to the local taxing jurisdiction on a quarterly basis.

Imposing and Repealing Local Sales Tax

To facilitate state administration of local taxes, the imposition of a tax may only begin on the first day of a calendar quarter. Repeal of a local tax is only effective starting on the last day of a calendar quarter. A local taxing jurisdiction must give the Department of Revenue at least 90 days notice before a tax is imposed or repealed. The notice provision was amended in 2003 to include Streamlined Sales Tax requirements. The tax will only be effective after the commissioner has given sellers located in the area at least 60 days notice and will apply to catalog sales only after the commissioner has given these sellers 120 days notice. The practical effect is that local taxing jurisdictions will have to give the commissioner more than 90 days notice.

The statute was amended in 1999 to require a break between the repeal of an existing sales tax and the reimposition of a sales tax for another purpose. A new local sales tax must now expire after completion of the specified project and the local government must wait one year after the expiration before imposing a new tax for a different project. A number of local governments in the past have had their sales taxes extended, and the allowed uses of the tax proceeds expanded, before the tax expired.

Determining the Site of a Delivery Sales for Local Tax Purposes

The 1999 Legislature added a provision dealing with the use of zip codes to determine whether a delivery sale is subject to a local sales and use tax. This was amended in 2003 to follow Streamlined Sales Tax requirements. Under the change, the lowest combined tax rate applies if an area includes more than one tax rate. For example, if a zip code includes both a portion of

Edina (with no local sales tax) and a portion of Minneapolis (with a half-cent local sales tax) the Minneapolis tax may not be collected. Nine-digit zip codes should be used, if available, to determine the tax rate.

Local Sales Taxes Authorized by Special Law

The following four tables show all the general local sales taxes that have been authorized by the legislature. With the exception of Cook County, only cities have been allowed to impose general sales taxes. Table 1 contains the local sales taxes that are currently imposed. Table 2 lists the political subdivisions that currently have authority to impose a local tax but have not yet enacted it. Table 3 lists the local sales taxes which were imposed but have expired. Table 4 lists the local general sales taxes which were authorized but were never imposed.

Table 1
Local Sales Taxes Currently Imposed

Taxing Jurisdiction & Year Authorized	Rate	Use of Revenues	Comments
Duluth – 1973	1.0%	Determined by the city council	Duluth is specifically exempted from the statutory provision requiring tax collection and administration by the Department of Revenue until January 1, 2005. The tax has no expiration date.
Rochester – 1983	0.5%	Various capital projects	This tax has been renewed three times, in 1989, 1992, and 1998. Initially enacted at 1.0% to raise \$16 million for a civic center and \$16 million for flood control; the rate was lowered to 0.5% in 1992. The latest extension allows the city to raise another \$76 million for various capital projects.
Minneapolis – 1986	0.5%	Convention center construction and maintenance	In 1992 the city was authorized to use excess proceeds for neighborhood early learning centers but the city has not done so. The tax has no expiration date.
Mankato – 1991	0.5%	Riverfront 2000 project; airport improvements	Originally the tax was to expire when \$25 million was raised for the Riverfront project; in 1996 this was changed to expire after an additional \$4.5 million was raised for the project.
St. Paul – 1993	0.5%	Civic center (40%); other projects (60%)	Originally set to expire when civic center bonds were paid off; changed in 1997 to an expiration date of December 31, 2030.
Cook County – 1993	1.0%	Cook County hospital and North Shore care center	Originally set to expire when \$4 million was raised for the hospital. Extended in 1997 to allow an additional \$2.2 million to be raised for the care center.
Hermantown – 1996	0.5%	Three specific infrastructure projects	Tax expires at the later of ten years or when sufficient funds have been raised for the three projects.
Two Harbors – 1998	0.5%	Three specific infrastructure projects	Tax expires when sufficient funds have been raised for the three projects.
Proctor – 1999	0.5%	Community center and streets	Tax expires when sufficient funds to pay for up to \$3.6 million in bonds for the center have been raised.
New Ulm – 1999	0.5%	Civic and community center	Tax expires when sufficient funds to pay for up to \$9 million in bonds for the center have been raised.
St. Cloud Area Cities – 2002 (includes St. Cloud, Sauk Rapids, Sartell, and St. Augusta)	0.5%	St. Cloud airport, other capital projects in each city	The cities of St. Joseph and Waite Park were also authorized to impose this tax upon voter approval but the referenda failed.

Table 2

Political Subdivisions With Local Tax Authority Which Has Not Yet Expired

Taxing Jurisdiction & Year Authorized	Rate	Use of Revenues	Comments
Garrison – 1993	0.5%	City sewer system	Imposition requires a referendum at a general or special election; this was never held.

Table 3

Local Sales Taxes Which Were Imposed But Have Expired

Taxing Jurisdiction & Year Authorized	Rate	Use of Revenues	Comments
Willmar – 1997	0.5%	Library improvements	Expired December 31, 2001, after \$4.5 million was raised.
Winona – 1998	0.5%	Dredging Lake Winona	Expired December 31, 2001, after \$4.0 million was raised.

Table 4

Authorized Local Sales Taxes That Were Never Imposed

Taxing Jurisdiction & Year Authorized	Rate	Use of Revenues	Comments
Bloomington – 1986	1.0%	Metropolitan Stadium site improvements	The city never imposed it and legislative authority was repealed in 1987.
Thief River Falls – 1992	0.5%	Tourism convention facilities	Referendum not held at 1992 general election and authority expired.
Ely – 1992	1.0%	Wilderness Gateway project	The imposition of the tax was defeated at the required referendum.
Detroit Lakes – 1998	0.5%	Community center	The imposition of the tax was defeated at the required referendum.
Fergus Falls – 1998	0.5%	Convention and recreational center	The imposition of the tax was defeated at the required referendum.
Owatonna – 1998	0.5%	Owatonna Economic Development 2000 project	The imposition of the tax was defeated at the required referendum.
Hutchinson – 1998	0.5%	Civic center and recreational facilities	The imposition of the tax was defeated at the required referendum.
Bemidji – 1998	1.0%	Convention center	Referendum not held at 1998 general election and authority expired.
St. Cloud area cities – 1998 (includes St. Cloud, Sauk Rapids, Sartell, Waite Park, and St. Joseph)	1.0%	Central Minnesota Events Center and other regional infrastructure projects	Each city had to pass a referendum at the 1999 general election to enact the tax. The imposition of the tax was defeated at the required referendum in all cities except Sartell. New authority for a local sales tax in these cities was enacted in 2002 (see Table 1).

Department of Revenue Report on Local Sales Taxes

In 2003, the legislature mandated that the Department of Revenue prepare a report on the existing local sales taxes, including criteria used for granting authority, referendum requirements, and uses of the revenues. It was also asked to make specific recommendations regarding the appropriate role of local sales and use taxes in Minnesota's state and local tax system, and the criteria and process that should be used to secure state and local authority to impose a local sales tax.⁴

The recommendations included in the report were:

- A shift to granting general local sales tax authority is not advisable without some restrictions.
- Criteria for determining who may impose a tax should be designed so that the tax funds projects of "regional significance" and that those in the surrounding communities that will pay the tax participate in the referendum imposing the tax.
- That the funds be used for extraordinary capital projects rather than as a replacement for general funds for operating revenues or ordinary capital projects.
- That communities with a significant property tax base should look to property taxes as the initial source of project funding and sales tax should only be used if property taxes are insufficient.
- That the approval process for local sales taxes remain with the legislature but that objective criteria be laid out for projects that will meet legislative approval.

⁴ Minnesota Local Sales and Use Taxes. A Report to the 2004 Minnesota Legislature. Minnesota Department of Revenue. February 2004.

States that Grant General Authority to Impose a Local Sales Tax

State	General authority to Cities	General authority to counties	Comments
Alabama	Yes	Yes	One tax per city and county
Alaska	Yes	Yes	
Arkansas	Yes	Yes	County tax is a credit against city tax
California	Yes	Yes	
Colorado	Yes	Yes	
Kansas	Yes	Yes	
Louisiana	Yes	Yes	
Missouri	Yes	Yes	
Nebraska	Yes	Yes	
New Mexico	Yes	Yes	County tax must be used for specified purposes
New York	Yes	Yes	Allowed to exempt certain items from the local tax base
North Carolina	Yes	Yes	
Oklahoma	Yes	Yes	
Tennessee	Yes	Yes	
Texas	Yes	Yes	
Utah	Yes	Yes	One rate limit for general purposes , an additional amount allowed for special purposes
Virginia	Yes	Yes	
Washington	Yes	Yes	
Arizona	Yes	Yes (limited)	Only counties below a certain size may impose the tax
South Dakota	Yes	No	Revenue raised from tax above 1% must be used for capital projects
Idaho	Yes (limited)	Yes (limited)	Limited to resort cities <10,000 population; resort counties less than 350,000 population
Ohio	Yes (limited)	Yes	Limited to resort cities
New Jersey	Yes (limited)	No	Limited to cities meeting certain class criteria specified in statute
North Dakota	Yes (limited)	No	Applies only to home-rule charter cities
Florida	No	Yes (limited)	Only for specific purposes
Iowa	No	Yes (limited)	Tax does not apply to fuel, hotel, energy, lottery
Mississippi	No	Yes (limited)	
Georgia	No	Yes	
Nevada	No	Yes	
Pennsylvania	No	Yes	
South Carolina	No	Yes	

States that Grant General Authority to Impose a Local Sales Tax

State	General authority to Cities	General authority to counties	Comments
Wisconsin	No	Yes	
Wyoming	No	Yes	
Illinois	No	No	With special legislation only
Connecticut	No	No	
Delaware	No	No	
Hawaii	No	No	
Indiana	No	No	
Kentucky	No	No	
Maine	No	No	
Maryland	No	No	
Massachusetts	No	No	
Michigan	No	No	
Montana	No	No	
New Hampshire	No	No	
Oregon	No	No	
Rhode Island	No	No	
Vermont	No	No	
West Virginia	No	No	
Minnesota	No	No	With special legislation only

Relation between local sales tax authority and state aids

States that permit a general authority to impose a local sales tax, usually do not provide much general purpose aid to local governments. States seem to follow one of two philosophies as it relates to state-local fiscal relations:

- the state tries to equalize resources available to local governments to provide necessary services (Minnesota is in this group); or
- the state grants local governments maximum revenue flexibility and autonomy, but makes little effort to ensure resource equity between individual jurisdictions.

Of the eight states that make general purpose aid payments of \$100 or more- only Arizona grants general local sales tax authority to cities. Of the 20 states that grant local sales tax authority to cities, general purpose aid payments to cities is \$10 or less in 16 of those states.

State General Purpose Aids to Cities and General Authority for Cities to Impose a Local Sales Tax

State	General aid per capita	General city sales tax authority?	State	General aid per capita	General city sales tax authority?
Wyoming	\$232	No	Washington	6	Yes
Rhode Island	189	No	Oklahoma	4	Yes
Massachusetts	162	No	Colorado	4	Yes
Arizona	145	Yes	Alabama	4	Yes
Michigan	130	No	Kansas	3	Yes
Wisconsin	129	No	Texas	2	Yes
Connecticut	107	No	Maryland	2	No
Minnesota	100	No	Alaska	0	Yes
			California	0	Yes
New Hampshire	70	No	Delaware	0	No
North Dakota	58	Yes ⁵	Georgia	0	No
New York	58	Yes	Hawaii	0	No
Illinois	57	No	Indiana	0	No
Ohio	54	Yes ⁶	Iowa	0	No
Idaho	42	Yes ⁷	Kentucky	0	No
Maine	37	No	Mississippi	0	No
Florida	29	No	Missouri	0	Yes
N. Carolina	26	Yes	Montana	0	No
W. Virginia	26	No	Nebraska	0	Yes
Louisiana	11	Yes	Nevada	0	No
Oregon	10	No	New Jersey	0	Yes ⁸
Arkansas	10	Yes	New Mexico	0	Yes
S. Carolina	9	No	Pennsylvania	0	No
S. Dakota	8	Yes	Tennessee	0	Yes
Virginia	8	Yes	Utah	0	Yes
Vermont	6				

Source for city aid per capita: Texas Municipal League Report, March 2004.

⁵ Only home rule charter cities

⁶ Only resort cities.

⁷ Only resort cities with a population of less than 10,000.

⁸ Only cities that meet certain class criteria