TAX INCREMENT FINANCING

IN MINNESOTA: AN OVERVIEW

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TAX INCREMENT FINANCING IN MINNESOTA[1]

I. PROJECTS AND DISTRICTS

A. **Projects.** Tax increment financing is used in conjunction with underlying development and redevelopment powers. Tax increments must be spent within particular geographic areas created under the development statutes. The basic planning area is referred to as a "Project," which also has other names:

City: Development District, created under Sections 469.124 to 469.134.

HRA: Redevelopment Project, created under Section 469.001 to 469.147.

EDA: Economic Development District, created under Section 469.090 to 469.1081, or Development District or Redevelopment Project created using City or HRA powers.

PORT AUTH.: Industrial Development Districts, created under Section 469.040 to 469.068, or special legislation.

All Projects require a general development or redevelopment plan, approved after a public hearing. The boundaries tend to be large areas within which the authority intends to promote development or redevelopment.

B. **TIF Districts.** TIF Districts are the specific parcels within a Project area from which tax increment will be captured. There are five general types:

1. Redevelopment District, Section 469.174, Subd. 10.

Qualifications:

(a) Parcels that make up 70% of the district are improved, and more than 50% of the buildings (excluding outbuildings) are structurally substandard to a degree requiring substantial renovation or clearance. To be considered "improved," at least 15% of the parcel's area must contain improvements. A building is not substandard if it complies with building codes or could be brought up to code at a cost of less than 15% of the cost of a comparable new building on that parcel. An interior inspection of property is required unless access is not possible after best efforts and evidence otherwise supports the findings; or

[1] Reflects Minnesota Statutes as amended through the 2005 legislative session.

(b) the district consists of vacant, unused, underused, inappropriately used, or infrequently used rail yards, rail storage facilities or excessive or vacated railroad rights-of-way; or

(c) the district consists of unused or underused tank facilities adjacent to railroad facilities, with a capacity larger than 1 million gallons (for districts filed for certification after June 30, 2000).

(d) the district is a "qualified disaster area," which generally means an area that meets certain criteria for improvement before a disaster, and more than 50% of the buildings are damaged by the disaster.

Term, restrictions: May collect increment for 25 years after the date of receipt of the first increment.

At least 90% of the increment must be used to finance the cost of correcting conditions that allow designation of redevelopment districts, including (but not limited to) acquiring properties containing substandard improvements or hazardous substances; acquiring adjacent parcels necessary to provide a site of sufficient size to permit development; demolition and rehabilitation; clearing of land; removal or remediation of hazardous substances; installation of utilities, roads, sidewalks and parking facilities.

2. Renovation and Renewal District, Section 469.174, subd. 10a.

Qualifications: The same parcel and area requirements apply as for a redevelopment district, but only 20% of the buildings need be structurally substandard; another 30% of the buildings must require renovation or clearance to remove conditions such as inadequate street layout, incompatible land uses, or obsolete buildings not suitable for improvement or conversion to other uses (that is, a lesser standard of blight).

Term, Restrictions: May collect increment for 15 years after the date of receipt of the first increment. At least 90% of the increment must be used to finance the cost of correcting conditions that allow designation of renovation and renewal districts, as described above for redevelopment districts.

3. Soils Condition District, Section 469.174, Subd. 19.

Qualifications:

(a) The presence of hazardous substances, pollution or contaminants requires removal or remedial action; and

(b) the estimated costs of removal and remedial action exceeds the fair market value of the land before the preparation; and

(c) the proposed removal or remedial action must be specified in a development response action plan approved by the Minnesota Pollution Control Agency.

The requirements of clause (b) need not be satisfied if each parcel either satisfied the requirements of that clause, or the estimated costs of the proposed removal or remedial action exceeds $2.00 per square foot for the area of the parcel.

Term, Restrictions: May collect increment for 20 years after the date of receipt of the first increment, for districts filed for certification after June 30, 1997. The increment may be spent only to: acquire parcels on which removal or remediation will occur; pay the cost of the removal or remediation; and pay allocated administrative expenses, including the cost of preparation of the development response action plan.

Note: Soils districts could be created before June 30, 1995 based on unusual terrain and soils conditions, and had a maximum duration of 12 years after the date of plan approval. The 1995 amendments essentially changed a soils condition district to a hazardous waste district. The 1997 amendments extended the duration to 20 years after the date of receipt of the first increment.

4. Housing District, Section 469.174, subd. 11.

Qualifications: Must be a facility intended for occupancy in part by persons or families of low and moderate income. Up to 20% of the square footage of the buildings that receive tax increment assistance may consist of non-residential uses.

Term, Restrictions: May collect increment for 25 years after the date of receipt of the first increment. To maintain qualification as a housing district, residents' income must be limited as follows: *For Owner-occupied housing*, 95% of the units must be initially purchased by persons with income that is less than or equal to the income requirements for qualified mortgage revenue bonds under federal law. Generally, those requirements limit income to 100% of applicable median family income for 1 and 2 person households, 115% of median for 3 or more person households. The applicable median family income is the greater of the area or statewide median gross income. *For rental projects,* must satisfy the income requirements for qualified residential rental projects under Section 142(d) of the Internal Revenue Code , which generally specify that 40% of the units be occupied by persons with no more than 60% of the area median gross income, or 20% of the units at 50% of median income. *Legislation in 2005 removed a third income alternative: 50% of the units occupied by individuals with income 80% or less of the area median income.* The rental income requirements apply for the life of the district.

5. Economic Development District, Section 469.174, subd. 12.

Qualifications: The municipality must find that the district will (1) discourage business from moving to another state or municipality; (2) increase employment in the state; or (3) preserve and enhance the tax base of the state.

Term, Restrictions: May collect increment for eight years after the date of receipt of the first increment. *Note:* For districts filed for certification between June 1, 1993 and June 30, 2000, the duration was nine years after the date of receipt of the first increment, or eleven years after the date of plan approval, whichever date is first. For districts filed for certification before June 1, 1993, these periods were eight years and ten years, respectively.

Increment may not be used to assist developments if more than 15% of the buildings and facilities (on a square footage basis) are used for a purpose other than:

(1) manufacturing;

(2) warehousing, storage and distribution of tangible personal property (excluding retail sales);

(3) research and development related to the aforementioned activities;

(4) telemarketing if that activity is the exclusive use of the property;

(5) "tourism facilities;"

(6) "qualified border retail facilities;" or

(7) or space necessary for and related to the above.

Tourism Facilities: The term "tourism facility" means property that: (1) is in a county where the median income is no more than 85% of the state median income; (2) in a county in development regions 2, 3, 4 or 5, (3) is located in a city with a maximum population of 20,000; and (5) is a private meeting facility, a marina, hotel, motel, lodging facility or nonhomestead dwelling unit that, in each case, is intended to serve primarily individuals from outside the county. Tourism counties include: Aitkin, Becker, Beltrami, Carlton, Cass, Clay, Clearwater, Cook, Crow Wing, Douglas, Grant, Hubbard, Itasca, Koochiching, Lake, Lake of the Woods, Mahnomen, Morrison, Otter Tail, Pope, St. Louis, Stevens, Todd, Traverse, Wadena and Wilkin.

Qualified Border retail facilities: The 1997 legislature added this category

of permissible expenditures, effective for districts filed for certification after June 30, 1997. A qualified border retail facility is a retail facility (1) in a "small city" (as described below) that is located within 1 mile of the state border, (2) but not in the 7-county metropolitan area, (3) that will contain at least 25,000 square feet of retail space in new construction or buildings that will be substantially rehabilitated, and (4) the authority finds that without tax increment assistance the development or a similar competing development will occur in the bordering state or province.

Bedrock Soils Exception: The 1995 legislature added language that allows revenue derived from tax increment from an economic development district be used for site preparation and public improvements for any type of development if bedrock soils are present in 80 percent or more of the acreage of the district, the estimated costs of physical preparation of the site exceeds the fair market value of the land before completion of the preparation, and revenue derived from tax increments are expended only for the additional costs of preparing the site and installing public improvements required by unstable soils and the bedrock soils condition.

Small Cities Exception: The 1997 legislature added a provision permitting expenditures from an economic development district for up to 15,000 square feet of a separately owned commercial facility in the city, if the revenues are used only to assist the facility directly, the assistance is necessary to develop the facility, and increments (except for administrative expenses) are spent within the TIF district. A small city must have a population of no more than 5,000 and be located at least 10 straight-line miles from any city with a population of at least 10,000. Population is determined by the federal census or, if more recent, state or metropolitan council estimates. This provision became effective for districts filed for certification after June 30, 1997.

Fiscal Disparities: For cities in the metropolitan area and the iron range tax relief area, the fiscal disparities contribution must be made from the property within economic development districts. For all other district types, the city may elect to make such contributions from inside or outside the district. This mandatory "within district" contribution became effective for economic development districts filed for certification after June 30, 1997.

6. Hazardous Substance Subdistricts.

Qualifications: Consists of parcels within a TIF District of any kind that are "designated hazardous substance sites" or are contiguous parcels that the authority expects to be developed together with the hazardous substance site.

"Designated hazardous substance sites" are parcels for which there is a state-approved "development action response plan," and the authority has entered into an agreement providing for removal actions or otherwise certified that it will finance such removal.

Term, restrictions: May collect increment from the subdistrict for up to 25 years after the date of receipt of the first subdistrict increment (which is, generally, the tax attributable to the "base value" of the parcel). This period overrides any shorter duration for the underlying TIF District, except that during the extended period, the increment may be used only to pay the cost of hazardous waste removal and related administrative costs, and the "base value" increment is no longer collected.

7. Hazardous Waste Extension.

The 1995 legislature added an alternative to hazardous substance Subdistricts. An authority, with approval of the municipality, may extend the duration of any TIF district if:

a. contamination is discovered after the district was established;

b. the authority elects not to create a hazardous substance subdistrict; and

c. the municipality pays for the cost of removal or remediation out of general revenues and not from tax increments.

If those tests are met, the district may be extended for the lesser of (1) 10 years after the district would otherwise have terminated; or (2) the number of additional years necessary to collect increment equal to the cleanup costs paid by the municipality from non-tax increment funds. Cleanup costs are restricted to actual costs of removal and remediation, including testing and engineering but excluding financing or interest costs. Cleanup costs are also reduced by any reimbursements or amounts recovered from private parties or other responsible parties.

This provision is available for any TIF District filed for certification after December 31, 1988.

8. Pre-1979 Districts.

TIF Districts created prior to August 1, 1979 are not generally subject to the TIF Act, except when the proposed development extends beyond the "scope of activity" in the project plan after May 1, 1988. After April 1, 2001, increment from a pre-1979 increment may be used only to pay bonds that were outstanding as of April 1, 1990, but in no event may increment be collected after August 1, 2009.

II. HOW INCREMENT MAY BE USED

A. **TIF Plan.** The use of increment must be spelled out in a TIF Plan approved by the city council (or county board for a county HRA) after public hearing, with 30-day notice to the county and school district, 10 days' published notice, and review by the planning commission. For housing and redevelopment districts, the individual county commissioner representing the site must also receive a notice at least 30 days before the *date of publication* of the hearing notice.

TIF Plans describe the estimated tax increment projections, financing budget and maximum debt to be issued. When approving the TIF Plan, the council must find (among other things) that (1) the proposed development would not reasonably be expected to occur solely through private investment in the reasonably foreseeable future and (2) the increased market value of the site that could reasonably be expected to occur without the use of TIF would be less than the increase in market value estimated to result from the proposed development, after subtracting the present value of the projected tax increments for the maximum duration of the district permitted by the TIF Plan. The finding in clause (2) became effective for districts filed for certification after June 30, 1995, but does not apply to "qualified housing districts," which are districts that meet somewhat tighter income restrictions than described above for housing districts.

TIF Plans may be modified using the same process as for approval of the initial plan. Generally, modifications that do not increase expenditures or debt or call for new land acquisition may be approved simply by resolution. Modifications will not trigger application of current statutes unless the boundary of the TIF District is expanded.

B. **General Restrictions.**

1. In addition to the specific limitations for each type of TIF District, tax increment may be spent only for specified purposes permitted in the underlying development statutes. Because the development statutes are often ambiguous, whether a particular activity is TIF-eligible may depend on the facts in each case.

2. Administrative expenditures are limited to 10% of the expenditures authorized in the TIF Plan, or 10% of actual increment expenditures, whichever is less. (The limit is 5% for districts created between August 1, 1979 and June 30, 1982). Administrative costs are defined to mean all expenditures of the authority other than land acquisition and relocation costs and costs "directly connected with the physical development of the real property in the district." Note: the County auditor may assess each TIF District for the county's cost of administering the district, and the fee may be paid from tax increment.

3. Increment may not be used to finance buildings that are used "primarily and regularly for conducting the business" of any unit of government, except for parking structures. Before January 1, 2000, increment could also be spent on a commons

area used as a public park, or a facility used for social, recreational or conference purposes. Amendments in 1999 prohibited such expenditures after January 1, 2000, whether the facilities are publicly or privately owned (with one exception—increment may still be used to finance privately-owned conference facilities).

4. An Authority may establish a guaranty fund to indemnity a person for liability for remediation costs under state or federal environmental law. The maximum term of the indemnity is 25 years, and the maximum amount is one-half of the remediation costs. The authority may deposit tax increments in the fund, and the municipality may also appropriate money for deposit in the fund.

5. The term "tax increment" was defined for the first time in 1997. The definition includes the actual tax increment (taxes paid on captured tax capacity), plus interest earnings on tax increment received after July 1, 1997. In addition, tax increment includes proceeds from the sale or lease of property purchased with tax increments, if the purchase occurred after June 30, 1997, and repayments of loans or other advances made with tax increment if the loan or advance was made after June 30, 1997.

6. If tax increments are spent outside the boundaries of the TIF district, expenditures are not permitted on improvements that primarily serve a decorative or aesthetic purpose, or serve a functional purpose but their cost is increased by more than 100 percent because of the selection of materials, design or type. (There is an exception for historic structures.)

C. <u>Geographic Restrictions</u>.

1. For districts created after June 30, 1995, no more than 20% of the increment (25%, in the case of a redevelopment district) may be spent outside the boundaries of the TIF District. However, increment from housing TIF districts may be spent to finance "housing projects" located anywhere in the broader Project area. Administrative costs are considered spent outside the district. There are also special rules that allow increased pooling for certain types of housing for low and moderate income persons. (For districts created between May 1, 1990 and June 30, 1995, similar pooling rules applied, with slight differences in the percentages permitted outside the district.)

2. Increment from districts created before May 1, 1990 may be spent anywhere within the Project boundaries, which permits "pooling" of increment from more than one district.

D. <u>Time Restrictions (other than duration)</u>.

1. 3-year rule: *Repealed by 2005 legislation.* Previously, within three years after the date of certification, one of three things must happen for the district to remain alive: bonds are issued to aid the Project (excluding industrial development revenue

bonds); the authority acquires property within the TIF District; or the authority causes public improvements to be constructed within the TIF District.

2. 4-year knock down rule: increment will not be collected from a particular parcel unless, within four years after the date of certification, demolition, rehabilitation or renovation of property or other site improvements has taken place by either the authority or the owner in accordance with the TIF Plan. Construction or major construction of an adjacent street qualifies as an improvement to a parcel, but utility improvements do not. If the parcel is "knocked-down" and later improved, it is reinstated in the TIF District but at the market value at the time of the reinstatement.

3. 5-year rule: for increment to be considered a spent expenditure within the TIF District, one of the following must occur within five years after certification of the district: (1) increment is paid to a "third party" for a TIF-eligible "activity"; (2) bonds, the proceeds of which are used to finance an activity, are sold to a third party and proceeds are reasonably expected to be spent within the five-year period (with certain limited exceptions); (3) binding contracts are entered with a third party for performance of an activity, and increment is spent under the contract; or (4) costs are incurred by a "party" and revenues are spent to reimburse a party.

   The term "third party" excludes the party receiving TIF assistance and the "municipality or the development authority or other person substantially under the control of the municipality." Therefore, clause (4) permits the typical "pay as you go" reimbursement where the initial costs are incurred by the developer within the 5-year period. See Section III.B.

   Note: the 5-year rule applies only to districts requested for certification after April 30, 1990.

E. **Parcels Excluded From TIF Districts (the "Green Acres Exclusion").** Any parcel that qualified for special tax treatment under green acres, open space or agricultural preserves provisions in any of the five calendar years before the request for certification may be included *only in* (1) a qualified housing district, or (2) a district in which at least 85% of the planned buildings and facilities (on a square footage basis) are "qualified manufacturing facilities" or "qualified distribution facilities" or a combination of the two. A qualified manufacturing facility includes space used for manufacturing tangible personal property and space necessary for and related to the manufacturing activities (such as office space). A qualified distribution facility must be used to conduct *all* of the following activities: store or warehouse tangible personal property; take orders for shipment, mailing or delivery; prepare personal property for shipment, mailing or delivery; and ship, mail or deliver property. To be a "qualified" facility of either type, the owner must pay at least 90 % of the employees of the facility at least 160% of the federal minimum wage for individuals over the age of 20.

A "green acres" restriction was first enacted in 1995, and originally prohibited inclusion of special tax parcels in *any* district in the metropolitan area; elsewhere, these parcels could be

placed in a district only if 85% of the building square footage was used for manufacturing. Amendments in 1996 allowed the manufacturing exception statewide, and added a statewide exception for qualified housing districts Amendments in 1998 created the rules described above for qualified manufacturing and distribution facilities, which are effective for districts filed for certification after April 30, 1998.

F. **Statute of Limitations.** The 2003 legislature added a time limit for taxpayers to file lawsuits challenging the findings made at the time a TIF Plan is adopted. Any action must be filed by the *later* of (1) 180 days after the TIF Plan is approved, or (2) 90 days after the date of request for certification of the district. As long as the district is filed for certification within 90 days after approval of the TIF Plan, clause (1) will control. Any later filing, however, will extend the period for challenges.

III. TYPE OF FINANCING

A. **Bonds.** Bonds secured by tax increments are issued when there is a need for initial capital to finance public or private improvements. Typically, the bonds are general obligation bonds backed by the full faith and credit of the municipality. As long as at least 20% of the debt service on the bonds is reasonably expected to be paid with tax increments, the bonds may be issued without election. Cities and authorities may also issue revenue bonds, secured solely by tax increment revenues. Such bonds may be issued without election, but carry higher interest rates than general obligation bonds.

If bonds are issued, the authority will typically require that the developer sign an "assessment agreement," which establishes a minimum market value of the improvements upon completion. Other types of security may also be required, such as a guaranty of debt service in the event of a tax increment deficiency, a letter of credit during the construction period, or other forms.

B. **Pay As You Go.** An alternative to bond financing is a "pay as you go" arrangement with the developer. The developer pays for various TIF-eligible costs initially, and the authority promises to reimburse the developer from tax increment over time as it is generated. The developer (rather than an unrelated bondholder) bears the risk that the increments will be insufficient to repay the costs incurred.

This arrangement may be structured as a revenue note or bond issued to the developer, with an interest component to compensate the developer for costs of financing the improvements up front.

C. **Interfund Loans.** Interfund loans paid with tax increments were expressly authorized for the first time in 2001. The municipality must adopt a resolution stating the terms of the loan. Interest is limited to the higher of the statutory judgment interest rate or the rate on unpaid income taxes. (For loans approved in 2006, the rate maximum rate is 6%, but the resolution may provide for annual adjustment to reflect changes in the statutory rates.) The 2001 legislation ratified pre-existing interfund loans if the maximum interest rates are met.