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Statement of Position
TIF Segregation of Funds

A development authority may spend tax increment only as authorized by the TIF Act. The TIF Act requires authorities to segregate each TIF district's tax increment in a special account or accounts on the official books and records of the authority.[1]

When the Office of the State Auditor (the OSA) reviews tax increment expenditures, it reviews whether the authority has an accounting system that allows it to establish which expenditures were paid with tax increment from a particular TIF district and which expenditures were paid with some other source of funds.[2] Each authority is required to segregate funds, to have an accounting system that keeps the receipts and disbursements of tax increment for each TIF district separate from the receipts and disbursements of all other money – including tax increment from other TIF districts.

Accounting Systems and Practices

The TIF Act directs the State Auditor to develop a uniform system of accounting and financial reporting for TIF districts. The system of accounting and financial reporting must, as nearly as possible:

(1) provide for full disclosure of the sources and uses of tax increment revenues in the district;
(2) permit comparison and reconciliation with the affected local government's accounts and financial reports;
(3) permit auditing of the tax increment revenues expended on behalf of a district, including a single district that is part of a multidistrict project or that is funded in part or whole through the use of a development account funded with tax increments from other districts

[1]Alternatively, "as otherwise established by resolution of the authority to be held by a trustee or trustees for the benefit of holders of the bonds," tax increment may be held by a trustee for the benefit of the bond holders. Minn. Stat. § 469.177, subd. 5
[2] Under the TIF Act, the "governing body" is ultimately responsible for financial reporting and compliance. Minn. Stat. § 469.174, subds. 5, 6. The "governing body" is generally the city council but, in the case of county HRAs and EDAs, the county board is the "governing body." In addition, according to the Governmental Accounting Standards Board (GASB), development authorities are component units of a governing body.

Reviewed: August 2013
Revised: July 2012

2007-3002

or with other public money; and

(4) *be consistent with generally accepted accounting principles.*[3]

The TIF Division uses the same government accounting system used by the Audit Practice Division of the OSA, including generally accepted accounting principles (GAAP), due process procedures and the standards of financial accounting and reporting for state and local governments of the Governmental Accounting Standards Board (GASB).

Fund Accounting

Governmental accounting systems are organized and operated on a fund basis. Under the accounting standards, a fund is a fiscal and accounting entity with a self-balancing set of accounts recording accounting activities which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with regulations, restrictions, or limitations.

A. <u>Capital Projects Funds and Debt Service Funds</u>

The funds most appropriate for TIF transactions are likely to be *capital projects funds* and *debt service funds*.

A capital projects fund is appropriate for financial resources used to acquire or construct major capital facilities. Accounting for tax increment revenues in a capital projects fund makes sense because most tax increment revenues are used in conjunction with the acquisition or construction of capital facilities. However, each TIF district must have its separate sub-account, and expenditures paid with some other source of funds should not be put in the TIF district sub-account. This type of accounting system allows the OSA to determine which expenditures were paid with tax increment revenues, and which expenditures were paid with some other source of funding.

Tax increment revenues can be put in a debt service fund if (1) all tax increment revenues are being accumulated solely for principal and interest payments maturing in future years, and (2) tax increment revenues are not being used for non-bond payments.[4]

B. <u>General Funds and Special Revenue Funds</u>

Tax increment revenues should not be put in the general fund because they can be used only for specific limited purposes. Tax increment is not used for on-going activity, with

[3] Minn. Stat. § 469.175, subd. 6 (emphasis added). Generally Accepted Accounting Principles (GAAP) require a city's accounting system to be structured to produce documentation that demonstrates which costs were paid with each district's tax increment so that legal compliance with the TIF Act can be demonstrated.

[4] The TIF Act treats each of the following as bonds: (1) bonds or other obligations issued by an authority under the TIF Act, (2) refunding bonds, (3) notes (including pay-as-you go notes), (4) interim certificates and debentures, and (5) interfund loans or advances qualifying under Minn. Stat. § 469.178, subd. 7. Private activity bonds issued under the Municipal IDB Act are not defined as bonds under the TIF Act.

the exception of administrative costs. Funding on-going activity is an integral part of the general fund. In addition, the general fund includes many different funding sources, making it difficult (if not impossible) to keep tax increment revenues separate.

Accounting for tax increment revenues in a special revenue fund is not favored because special revenue funds are highly restricted. It would be possible to have separate TIF debt service and TIF capital expenditures sub-accounts within the special revenue fund, but there would be a greater likelihood of co-mingling funds. Separate debt service funds and capital projects funds are a better solution.[5]

Prior Period Commingling

Depositing non-tax increment revenue into the same fund with tax increment revenue results in the improper commingling of these different sources of funds. When funds are commingled, the OSA cannot verify whether tax increment was spent or transferred in compliance with the TIF Act.

Such commingling of funds is a violation of Minn. Stat. § 469.177, subd. 5. In determining whether specific violations have occurred, the State Auditor considers the totality of the circumstances including, among other things, the materiality of the amount and the authority's experience, responsiveness, and maturity.

If funds have been commingled, the problem should be proactively addressed by the authority. A basic accounting system should be set up which identifies (1) where the tax increment revenues came from (identifying the TIF district and type); (2) where the tax increment revenues were deposited; (3) where the tax increment revenues were spent; and (4) what tax increment (by TIF district) remains available to be expended. Invoices and other documents in support of TIF eligible expenses should be gathered. They will be needed to untangle the prior period disorder. The accountant/clerk/finance officer is responsible for sorting, classifying and summarizing data.

There is no set procedure that must be used to segregate the funds. Each authority has its own characteristics and will need to establish its own procedure. The authority's accountant will be a valuable resource in designing a procedure. Steps to consider include the following:

- Identify the available records.
- Identify the non-TIF eligible expenditures.
- Identify information from general ledgers and CAFRs that show whether you have complied or tried to comply.
- Prepare spreadsheets that identify sources and uses and tie back to general ledger.
- Separate sources and uses by TIF district.

[5] Use of a special revenue fund, however, would be preferable to using the general fund. Separate TIF debt service and TIF capital expenditures sub-accounts can be created within a special revenue fund.

In developing a plan to correct the commingling of funds, the following should also be considered:

- Deficiencies in an accounting system *are* internal control issues.
- Material noncompliance could impact financial statements.
- Significant deficiencies in internal control must be reported in writing.
- The auditor needs to consider the impact of the deficiency. [6]

The authority should bring itself into compliance with the TIF Act whenever it becomes evident that tax increment has been used for non-TIF eligible purposes. If the authority is initiating and making reasonable efforts to segregate tax increment revenues, is responsive to correcting any expenditure of misappropriated funds, does not keep rearranging its segregation of tax increment revenue to meet the most current situation, and, if no extenuating circumstances exist, the OSA will not initiate an audit of an authority based on this issue alone.

In addition, the OSA will not provide an opinion on an authority's attempts to segregate tax increment revenue. The OSA retains authority to review the development authority's segregation of tax increment revenue in the future.

Governing bodies and authorities are now on notice regarding the need to segregate tax increment revenues. From this time forward, failure to segregate tax increment revenues may trigger an audit.

Conclusion

Books should be set up to achieve compliance, with appropriate fund accounts. The source of tax increment revenues should be tied to the use of tax increment revenues. The records retained should include invoices and other necessary documentation. Noncompliance issues should be addressed as soon as they become known.

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[6] Statement of Auditing Standards 112 (Communicating internal control related matters identified in an Audit).