OFFICE OF THE LEGISLATIVE AUDITOR
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Evaluation Report Summary / April 2015

Mineral Taxation

State statutes that authorize taxes on taconite mining can be complex and outdated, and the distribution of taconite production tax revenues lacks transparency and predictability.

Key Facts and Findings:

- Minnesota law authorizes 12 taxes on mining taconite, but the taconite production tax, levied in lieu of property tax, generates the largest share of revenue by far.
- Legislative allocations for one-time grants of production tax revenue have lacked an application process and adequate oversight.
- To smooth out effects of high and low years of taconite production, the annual production tax is based on a three-year average of taconite tonnage, but it does not produce predictable revenue amounts, and it creates problems for companies paying the tax.
- Production tax revenue goes into 27 accounts to be distributed to local taxing jurisdictions and others in northeastern Minnesota. In 2014, 46 percent went directly to local jurisdictions, 41 percent to the Iron Range Resources and Rehabilitation Board, 12.5 percent to a Taconite Property Tax Relief account, and less than 1 percent to other accounts.
- Statutes do not make clear why 10 of the 27 accounts receiving production taxes have statutorily guaranteed amounts or why 4 have allocations indexed to increase with inflation.
- Production tax revenue in the Taconite Economic Development Fund, originally intended to pay for mining company projects, has been allocated by legislators for other uses, leaving the fund's purpose unclear.
- State law prevents use of the Taconite Economic Development Fund to buy mobile equipment, such as ore trucks.
- The mineral tax system can be complex, hard to understand, and can lack transparency. Confusing legal provisions, outdated statutes, and errors are factors.

Key Recommendations:

- The Legislature should establish a process to improve the use of production tax revenue for one-time grants to local jurisdictions.
- The Legislature should review whether the limited number of accounts receiving production taxes through either guaranteed allocations or allocations tied to inflation are accomplishing intended purposes.
- The Legislature should take steps to make annual allocations of production taxes more predictable for local taxing jurisdictions. One option is to set a new base year of allocations and guarantee that level of funding in future years.
- The Legislature should clarify the intended uses of the Taconite Economic Development Fund and allow its funding to pay for certain mobile mining equipment.
- The Legislature should ensure that outdated mineral tax statutes are deleted. The Department of Revenue should maintain accurate historical mineral tax data.

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Report Summary

Iron ore mining in northeastern Minnesota dates back to the 1880s. Today's mining companies mine taconite, a rock with low-iron content, because the natural iron ore deposit has been largely depleted. Aggregate is also mined in the state, but iron ore mining has been far more valuable.

Minnesota law authorizes 12 taxes on mining taconite, however 3 taxes would become active only if applicable producers began operating. Another 5 are ad valorem taxes that apply to specific property, such as lands adjacent to mining facilities.

The largest portion of mining tax revenue comes from Minnesota's production tax, which is imposed instead of a property tax on taconite production. In 2014, it generated nearly $110 million. The tax rate is applied to the taxable tonnage of taconite, which is calculated as a three-year average of tons produced. Thus, taxes in 2014 were paid on an average of taconite produced in 2013 and the preceding two years.

State statutes define how to distribute production tax revenue. Most revenues flow to (1) local taxing jurisdictions located within a statutorily defined Taconite Assistance Area in northeastern Minnesota and (2) the Iron Range Resources and Rehabilitation Board (IRRRB). The board, comprised of legislators from the Iron Range, is a state agency that promotes and invests in that region's businesses and communities.

Another significant mining tax is the occupation tax, imposed on mining companies' taxable income in lieu of the corporate franchise tax. It generated $15.8 million in 2014. This tax's revenue is deposited into the state's General Fund; 40 percent is to support elementary and secondary schools, and 10 percent is credited to the University of Minnesota.

Legislators have distributed some production tax revenue as one-time grants to local governments, but the process lacks sufficient safeguards.

A portion of production tax revenue is allocated to the Taconite Property Tax Relief account. This account pays for taconite homestead credits going to qualified property owners on the Iron Range. In recent years when the account received more money than was needed to pay for homestead credits, legislators appropriated remaining dollars as one-time grants, mostly for city projects.

The process legislators followed had shortcomings when compared against best practices for administering state grants. For example, it had no application process and offered no widespread notice on fund availability. The process lacked adequate oversight; it did not use grant agreements, and no one was formally in charge of following up as projects were completed. The Legislature should establish a formal process to make these one-time grants.

Production tax revenue is allocated into 27 separate accounts and then distributed to municipalities, counties, school districts, and IRRRB, among others.

In 2014, 41 percent of production tax revenue was allocated to accounts under IRRRB; 19.5 percent went to school districts; 13.6 percent to municipalities; 13.2 percent to counties; and 12.5 percent to the Taconite Property Tax Relief account. Allocations of less than 1 percent went to two smaller entities. From 2009 through 2014, total production tax revenue increased 12 percent, compared with an 11 percent increase in inflation.

The calculation of production taxes does not produce predictable amounts of revenue.

Because the production tax base is an average of taconite production over three

years, it lessens the impact of downturns in taconite production. It does not, however, produce predictable amounts of revenue for local taxing jurisdictions.

The averaging cannot eliminate the ebb and flow in taxes generated. For instance, using dollars adjusted for inflation, the production tax generated $108.8 million in 2009 but only $87.6 million in 2010. Local government officials interviewed for this evaluation said volatility in taconite production is ill suited for their budgetary needs. Further, mining company representatives said the three-year averaging is difficult because the tax does not consider whether the company makes money.

Statutes do not make clear why only some accounts receiving production taxes have guaranteed allocations or allocations tied to inflation.

State law guarantees that 10 of the 27 accounts receiving production tax revenue will receive at least minimum amounts of funding. A guaranteed allocation is based on amounts received in 1983 or 1999, when two now-closed plants still operated. Calculating the allocations involves comparing one amount based on formulas in law and a second on the guaranteed amounts. The higher of the two amounts is allocated.

In addition, allocations into four accounts are tied to inflation. For only these four accounts, allocations increase automatically with inflation each year.

The Legislature should review the accounts with guarantees and automatic increases to determine whether these mechanisms meet their objectives. Further, the Legislature should take steps to make allocations of production taxes more predictable.

One option to increase predictability is to (1) establish a new base year of allocations into most or some of the 27 accounts and (2) guarantee those allocations into the future. In years with high levels of taconite produced, the tax would be sufficient to pay for more than the guaranteed allocation amounts. In years with low taconite tonnage, the new guarantees would be paid using other funds that receive production tax revenue. Under current law, existing guarantees are paid with production tax revenue from two funds: the Douglas J. Johnson Economic Protection Trust Fund and the Taconite Environmental Protection Fund. We recommend continuing reliance on those funds, although other options exist.

As part of the recommendation, the Legislature should determine which accounts will receive guaranteed allocations. The fewer accounts with a guarantee, the less production tax revenue has to be reserved to pay for the guarantees. A reasonable possibility is to focus on accounts that distribute production tax revenue directly to local taxing jurisdictions. In such an approach, accounts managed by IRRRB and others, such as the Range Association of Municipalities and Schools, would still receive allocations, but they would not receive guaranteed allocations in years with low taconite production.

Guaranteed allocations would produce more predictable amounts of revenue and could remove the need to use three-year averages of taconite production when calculating taxable tons. Removing such averaging would also benefit the taxpaying mining companies in years of low production. Without the three-year averages, however, the funds paying the guarantees would likely pay more following low-production years.

Production taxes in the Taconite Economic Development Fund, originally intended to pay for mining company projects, have been allocated for other uses, leaving the fund's purpose unclear.

The Taconite Economic Development Fund receives a production tax allocation that is held by IRRRB and distributed to mining companies after IRRRB approval of company proposals. The proposals are typically projects to improve plants and stationary mining equipment. To qualify, companies must review their proposals with representatives of their nonsalaried employees, and they must provide matching funds. Mobile equipment, such as an ore haulage truck, is ineligible.

Law changes in 2007 and 2009 required money not approved for company use by IRRRB to be deposited instead into the Taconite Environmental Protection Fund, which IRRRB controls. But the purpose of the Taconite Economic Development Fund expressed in law did not change.

The Legislature should clarify the intended uses of the Taconite Economic Development Fund. How to use the fund is a policy decision for the Legislature. If it chooses to continue using the fund for multiple purposes, the Legislature should explicitly state these purposes in law. If, instead, the Legislature chooses to use the fund in line with the fund's original intent, it should delete the provision that requires money from the fund to be deposited elsewhere.

Further, the Legislature should remove the prohibition against using the fund to pay for mobile mining equipment. Representatives of nonsalaried employees and companies suggested such a change would be beneficial.

The mining tax system can be complex and difficult to understand and can lack transparency.

Confusing legal provisions, outdated statutory references, and errors in documents are factors that reduce the tax system's understandability and transparency. The Legislature should ensure that outdated mineral taxation statutes are deleted.

The Department of Revenue should maintain accurate historical information on mineral taxation that is broadly accessible to users and corrected in real time as errors are found. The department is currently developing a proposal to accomplish this. It would create on its website a single source of updated historical data on mineral taxation. Future updates or errors would be automatically communicated to interested users. If such a proposal is not developed, the department should explore alternate methods for maintaining accurate mining tax data.

Summary of Agency Response

In a letter from the Department of Revenue, Commissioner Cynthia Bauerly wrote that the department regards OLA's report as part of an "ongoing process to improve Minnesota's mineral taxation laws." She described the department's Mining Tax Guide as a means to simplify complex tax statutes as well as provide detailed information on the production tax. The commissioner agreed with OLA on the need for mineral taxation information that is regularly updated to reflect changes in the distribution of the tax, new laws, or data corrections. Commissioner Bauerly stated that the department has already begun planning to offer current mining tax information on its website, along with an e-mail notification system to provide users with updates. She said, once completed, the website will offer users real-time access to a single source of accurate, comprehensive information on mining taxes.

The full evaluation report, *Mineral Taxation*, is available at 651-296-4708 or:
www.auditor.leg.state.mn.us/ped/2015/mintax.htm