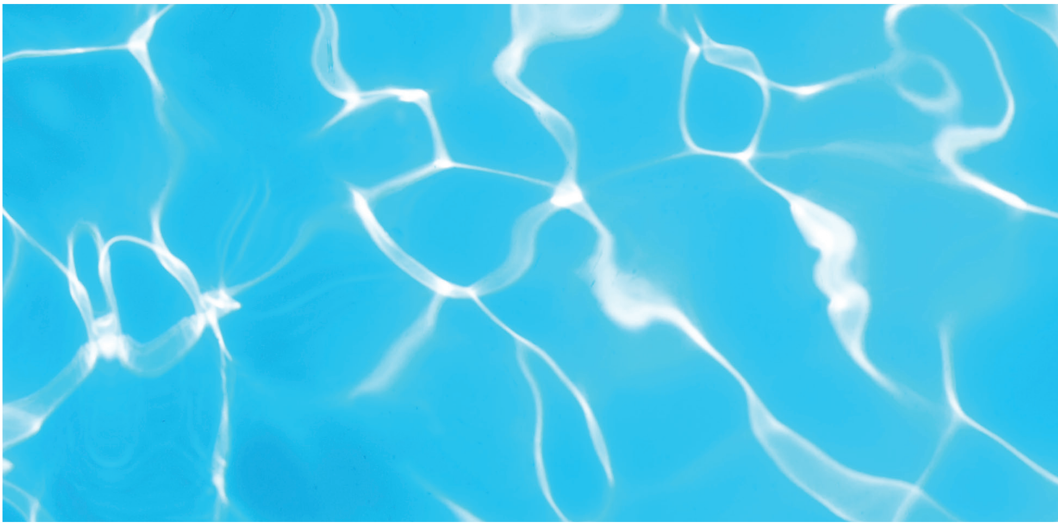
Tax Certificates and Tax Deeds Offer Challenging, Uncommon Investment Opportunities

~ Peter T. Currin

Real estate attorneys are occasionally asked to explain the nuances of tax certificates and tax deeds. What is the difference between a tax certificate and a tax deed? Are they good investments? Can you really acquire a piece of property by paying the back taxes? This article attempts to demystify tax certificates and tax deeds by explaining how these investments work and how they might appeal to different investors.



What are tax certificates?

Florida law requires that you pay all real estate taxes by March 31 of each year. If you don't pay those taxes, the law requires tax collectors to sell tax certificates to raise money to pay the unpaid taxes. A tax certificate is essentially a loan to the property owner to pay the owner's taxes. Tax certificates provide local governments with tax revenue that might otherwise go unpaid, while delaying—and usually avoiding—a forfeiture of the property.

Tax certificates are sold to the public online, usually by June 1 of each year. A tax certificate sale is conducted much like an auction, except instead of bidding on price, the bidders bid on the interest rate they will accept. Bidding, which is done in .25 percent increments, starts at 18 percent and can go as low as 0 percent. The bidder who bids the lowest interest rate is awarded the certificate. If more than one bidder bids the lowest rate, the winning bid is chosen at random by the auction software.

Let's assume that you bid—and win. In that case, you would immediately pay the delinquent taxes, penalties, costs of sale, and advertising fees. This combined amount becomes the "face amount" of your certificate. Thereafter, you would earn interest at the bid rate on the face amount of the certificate. Interest accrues until the date that the property owner "redeems" the tax certificate by paying it off, along with the accrued interest, penalties, advertising fees, and a small redemption fee. Although interest accrues at the bid rate on a per annum basis, the certificate purchaser is guaranteed a minimum return of 5 percent over the life of the certificate unless the bid rate was 0 percent. For instance, if you redeemed a certificate with a face amount of $1,000 and a bid rate of 0.25 percent, after six months, your accrued interest based on the bid rate would be $1.25, but you would receive $50 in interest, based on the 5 percent minimum. The 5 percent minimum interest is a key reason tax certificates make an appealing investment.

Note that certificates that receive no bids are awarded to the county and accrue interest at 18 percent. After the tax sale, the public may purchase tax certificates held by the county.

How are tax deeds different from tax certificates?

If you hold a tax certificate, you may file a tax deed application with the tax collector after two years, but no later than seven years, from April 1 of the year the tax certificate was issued. This seven-year period can be extended if the property owner declares bankruptcy. Note that during the first two years you own the certificate, you are prohibited by law from contacting the owner of the property.

The tax deed application initiates a foreclosure of the property. In making the tax deed application, you must surrender your tax certificate, redeem all other outstanding certificates on the property, pay any other back taxes or current taxes owed on the property, and pay certain other fees and costs. After you file the tax deed application, the Clerk of the Circuit Court notifies the property owner and lien holders about the pending tax deed sale and then advertises the sale. Unless the property owner or a lien holder brings the taxes current, the Clerk of the Circuit Court proceeds with the tax deed sale. In Sarasota County, tax deed sales are conducted in person at the Clerk of the Circuit Court's office. If you are the certificate holder, note that third parties have the same ability to bid on the tax deed as you do, so you have no particular advantage regarding acquiring the tax deed. Investors should not view the purchase of a tax certificate as a guaranteed way of acquiring the underlying property.

Assuming you are the certificate holder who filed the tax deed application, you would make the opening bid at the tax deed sale. The minimum opening bid is all taxes, interest, costs and fees paid until the sale. If the property is homestead property, you have to add one-half of the latest assessed value of the property to the minimum opening bid. So long as you, the tax deed applicant, are not the purchaser at the sale, you will receive all of the money paid for the certificate and the tax deed application, as well as 1.5 percent interest per month from the time you made the application until the tax deed is sold.

A tax deed is not the same as a warranty deed. The holder of a tax deed does not automatically hold marketable title to the property. Tax deed purchasers often approach the property owner and offer a nominal payment for a quitclaim deed to acquire the property's marketable title. When that doesn't work, tax deed holders must file a quiet title action to establish marketable title to the property.

Is there more to this story?

Investing in tax certificates and tax deeds is not without risk. Sometimes property owners stop paying taxes on purpose because their property has relatively little value. A property might be small or landlocked. It might be submerged lands, an easement, or unsuitable for building. Investors who inadvertently purchase tax certificates on "valueless" property may find themselves the only bidders at the tax deed sale, meaning they will get a tax deed for the property instead of a cash payment. If the property is worth less than they paid for the certificate and tax deed application, they will lose money. If you plan to bid on tax certificates, consider doing some level of due diligence on the underlying properties to make sure they have sufficient value relative to the unpaid taxes.

This due diligence is problematic, however. So many people bid on tax certificates that an investor must usually bid on scores of certificates hoping to win just one or two, and it is time-consuming to do due diligence on that many properties. Most investors do abbreviated due diligence by looking at the assessed value of the property and other factors. For instance, some investors target improved properties and avoid vacant land. Other investors target residential properties encumbered by institutional loans, since this increases the chance that someone—namely, the mortgage holder—will redeem the tax certificate prior to the tax deed sale. Some certificate purchasers target parcels with modest value because these are likely to be overlooked by other investors, meaning less competition and (hopefully) a higher winning bid rate.

To make matters worse, over the last few years, large institutional investors have all but monopolized tax certificate investing. Institutional buyers have lots of money to invest and can bid on many certificates. They buy certificates in bulk with little due diligence and can afford to lose money on the occasional "loser." Institutional buyers often bid 0.25 percent, which is the lowest bid possible that still enjoys the 5 percent minimum return. The most recent information published on the Sarasota County Tax Collector website indicates almost 92 percent of the tax certificates for property assessed at or above $50,000 were sold for 0.25 percent. Until recently, institutional buyers could enter hundreds or thousands of bids in the same auction by using alter egos, which increased their chances of being awarded the certificate in the case of a tie bid. The private investor entering a single bid—even a low bid like 0.25 percent—had almost no chance of winning the certificate. However, the Sarasota County Tax Collector and some other tax collectors around the state have updated their rules and software to eliminate this practice, which may open the door for private investors to reenter the tax certificate arena.

Although tax certificate investing may be dominated by large institutional investors, tax deed investing is a different story. Tax deed buyers are more likely to be local and more likely to have researched the property. A prudent tax deed buyer will review the property's value, examine the property's title, and perhaps even inspect the property. Note that a properly conducted tax deed sale will eliminate most title encumbrances—including mortgages—but certain governmental liens survive a tax sale. Buying tax deeds is a more deliberate, property-specific exercise than buying tax certificates. Tax certificate buyers buy in bulk, with the expectation of a modest return on investment. A tax certificate buyer who acquires the property usually does so by necessity, not by design. Tax deed buyers are intent on acquiring the property, usually with an eye toward quieting title, making any necessary repairs, and reselling the property at a profit.

Summary

Tax certificates and tax deeds offer challenging, uncommon investment opportunities, particularly for patient, hands-on investors. Both investments are rooted in unpaid property taxes and both can provide a worthwhile return if approached correctly. Beyond that, tax certificates and tax deeds are very different and appeal to different investors.

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