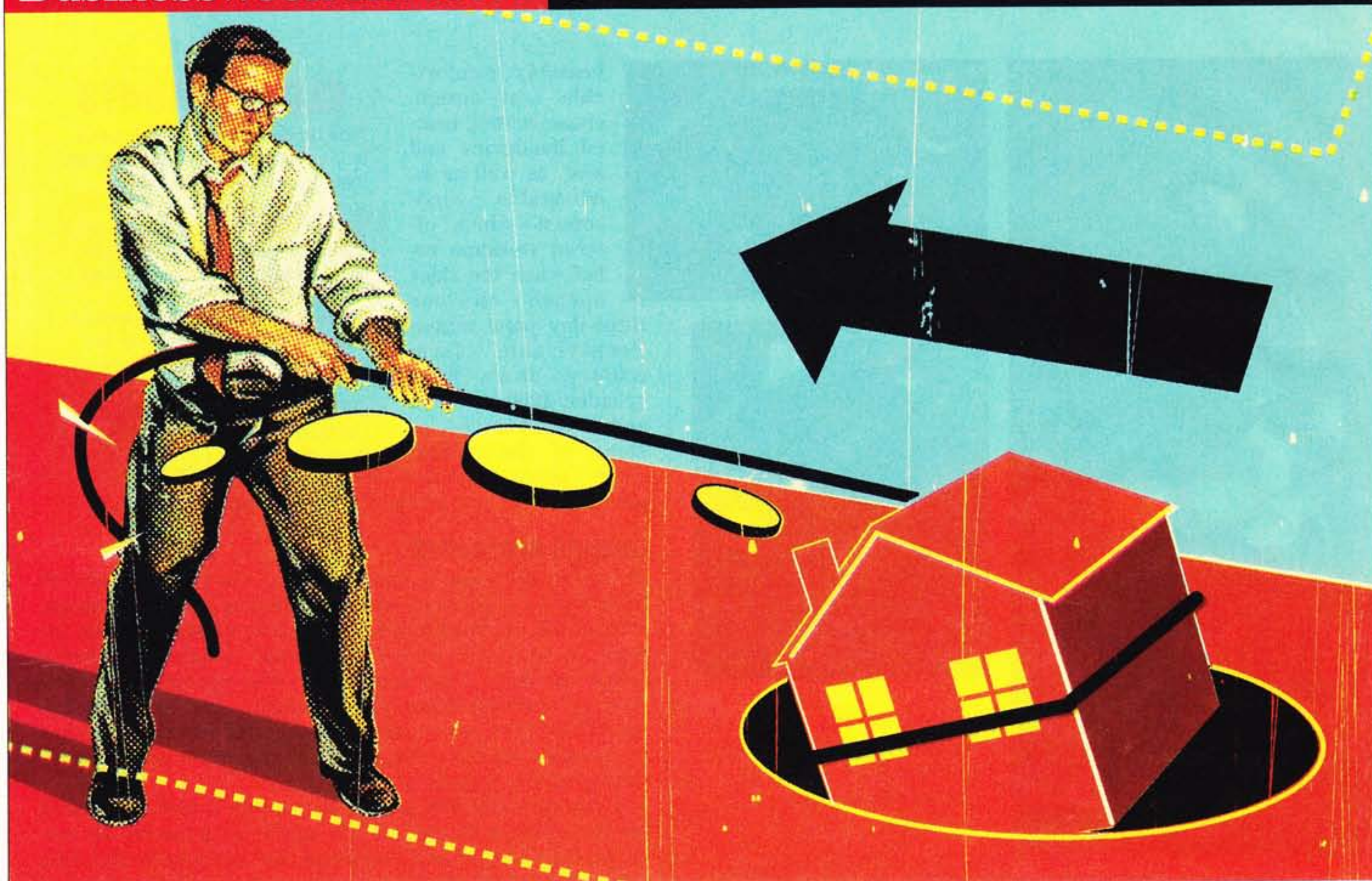

TAVIS COBURNS

Easy Money It's Not

Investing in tax liens can yield returns of 5% to 15% —after a lot of legwork. BY TODDI GUTNER

EARN UP to 24% with real estate tax-lien investments—they're "virtually 100% risk-free," claims one Web promoter. Late-night television and Internet ads regularly pitch these promises.

Suspicious? You should be. Tax-lien certificates, which are legal claims for unpaid real estate taxes, are sold at auction by counties and municipalities. Much of the bidding has become so competitive that it's tough to earn the hyped rates of return. Insurance companies, banks, pension funds, and agents working on behalf of individual investors dominate the market. What's more, some owners may have skipped out on their taxes for good reason—the real estate may not be worth what's owed. Investors could end up with a building or land that is worthless or an environmental hazard.

Still, investing in tax liens can be a smart way to make returns of 5% to 15%. That's if—and it's a big if—an investor understands state property tax laws, knows local real estate markets, and can master the often complex tax-lien auction procedures. "It's possible to get respectable returns, but if you cut corners on your due diligence, you're going to run into trouble," says Joel Moskowitz, a former environmental law partner at Gibson, Dunn & Crutcher in Los Angeles and author of *The 16% Solution: How To Get High Interest Rates in a Low Interest World With Tax Lien Certificates* ($26.95, Andrews and McMeel).

BIDDING TIME

Here's how tax liens pay off for investors: When a property owner fails to pay real estate taxes, the county or city places a lien on the property. Governments then auction off the liens, called tax certificates, to investors. In effect, the buyer is fronting the money to the government on behalf of the property owner. In return, the buyer has the right to future payments of the overdue taxes, plus penalties and interest for a certain period of time, which may run anywhere from two months to seven years. If the property owner doesn't pay, the lien holder gets title to the property, even jumping ahead of the first mortgage holder. After some legal costs, about $500, and an amount of time that varies by state, the lien holder can foreclose, evict the former owner, and sell the property. About half of the liens are paid off in the first year, with some 5% going into foreclosure.

More than 20 states authorize tax-lien certificate sales. State laws dictate the sale-and-foreclosure process, but some counties in certain states can still slightly modify the rules. In general, most counties have an annual sale and follow one of three auction procedures.

In one method, the state sets a high interest rate, which is essentially the opening bid. Would-be lien buyers then bid by offering to accept a lower rate on the lien. For example, at a recent Pinellas County (Fla.) auction, investors bid down Florida's 18% rate to an average of 3%. "Some liens were bid down to 0.5%," says Duane Zussy, the county's deputy tax collector.

As an incentive, Florida guarantees a minimum 5% total return regardless of the winning bid. So why doesn't the auction stop at 5%? By bidding the rate lower, investors are betting that the lien will be paid off in a few months and they'll earn a quick 5%. For example, assume an investor bid 3% on a $10,000 lien. The 3% rate kicks in only after 20 months. If the lien is paid off sooner, the state's 5% rate applies. So if the lien is paid off in three months, the investor would earn $500.

The second method works like a bond sale. The interest rate is fixed, and the investor who agrees to pay the most over the amount of taxes owed gets the lien. Colorado, which uses this method, sets its rate nine points above the Federal Reserve's discount rate as of Sept. 1 each year (rounded to the nearest whole percentage point). Currently, the state offers 10% for tax-lien certificates. Take that same $10,000 lien, and suppose an investor bought it for $10,500: That's a 5% premium. It would take six months to recoup the premium. If the lien were paid in 11 months, the investor would earn $917 in interest, but remember, the lien cost $500 over face value, so the net return is $417, or 4.17%. If the lien were paid in 24 months, the investor would net $1,500, a total of 15%, or 7.5% a year. Liens under $5,000 are sold at face value, says Gary Stoker, an accountant for Larimer County in Fort Collins, Colo.

Finally, some states, such as Iowa, keep the interest rate and lien price constant. Investors bid down the percentage of property the lien holder will own in the event of a foreclosure. In these auctions, institutions often bid the ownership percentage down to less than 1%. Once the ownership percentage is determined, the county uses a lottery to distribute the liens. That means investors can't choose a specific property they want—they only can hope they're offered it through the lottery. The winning lien holder becomes a partner with the property owner. So on that same $10,000 lien in Iowa, the investor earned the fixed rate per month of 2%, or $200, and 24% a year, or $2,400, for up to two years. Unless the property is a gem, it's better if the lien is paid rather than go into foreclosure.

There's also an "off the shelf" approach. That's when counties allow investors to avoid the bidding process by going to the county tax collector and buying tax liens that failed to sell at auction. In those situations, investors pay only the amount of taxes owed and automatically get the state-mandated interest rate. Arizona, which has an annual rate of 16%, is one of the states that let investors buy leftover tax liens.

HANDING IT OFF

When investing in tax-lien certificates, you can hire an agent or do it yourself. For a $25,000 minimum investment, agents buy liens on behalf of an individual investor. They travel nationwide, do local research, attend tax-lien sales, and handle foreclosures. These agents charge hefty upfront fees, as much as 20% of the amount invested. Net of fees, these promoters say they can earn 6% to 10% a year for their clients. Such agents make a killing if one of the properties for which the investor holds a lien goes into foreclosure. If the property is sold, the agent receives one-third of the sale proceeds after expenses.

Be forewarned: These tax-lien agents aren't regulated. Since many started out in financial services, you can still try a background check. Call state security regulators and ask for the Central Registration Depository record to see if an agent has had trouble with regulators. You should also ask the agent for referrals from other investors. Do not give the agent your money outright. Instead, deposit it in an escrow account at a reputable bank and have all checks written from that account to the agent and the county. Have your lawyer review all documents. You want to make sure, for example, that your money is invested individually rather than in a pool with other investors. Otherwise, make sure the pool is registered with the Securities & Exchange Commission.

Buying tax liens on your own takes much more work (table). To help with your research, Internet sites such as taxsalelists.com, taxliens.org, and taxliens.com sell books that are chock-full of state laws and CDs that are filled with lists of upcoming sales and statistics on properties. You can get this information for free, or for a nominal fee, from the county treasurer or tax assessor's office.

When buying tax liens, it's best to stay close to home. That way, you can investigate the properties you're inter-

Intricacies you'll have to master include state property tax laws, local real estate markets, and tax-lien auction rules and procedures that can vary from county to county

THE LIEN MACHINE

Here are some common methods that authorities use to sell tax-lien certificates to investors:

- **INTEREST RATE IS BID DOWN, LIEN PRICE IS FIXED** Bidding starts at the highest interest rate allowed by the state and declines from there. Whoever agrees to accept the lowest interest rate wins the lien.
- **INTEREST RATE IS FIXED, LIEN PRICE FLUCTUATES** Starting with the amount of taxes owed, the bidding goes up from there. Highest cash offer gets the lien.
- **INTEREST RATE AND LIEN PRICE ARE FIXED** Investors bid down the percentage of ownership they agree to accept in the event of foreclosure. The liens are then offered to investors by lottery, and they have the opportunity to accept or decline.

ested in and familiarize yourself with one state's property-tax laws. You'll want to know how the local process works, so attend a few auctions before you make your first bid. And try to find sales in rural communities, since you're less likely to be competing against institutional investors. "If you're up against the big guys, try to bid on the liens they aren't interested in, like mobile homes or small parcels of raw land," says Dana Cook, a retired bank regulator and tax-lien investor in Dallas.

Once you've determined what kind of tax lien you will buy, get the list of liens from the county tax assessor's office. Parcel numbers identify property type, and when you know that number, you can find out square footage, date built, registered owner, and tax-appraised value from county records. Be sure there are no other liens on the property. Sometimes, counties misassign parcel numbers to properties. So to make sure you're bidding on the right one, do a drive-by inspection.

Even with the most diligent research, you may still run into a dead end. David Hoshour, an investment adviser in Charlotte, N.C., has found that many "of the tax liens were no longer available by the time of the sale because the taxes were paid off."

Despite the extra effort required to buy tax liens, they're an opportunity to earn decent returns in the current low-interest environment. Just make sure your spend enough time learning the ropes before you invest your money. ■

TO-DO LIST

More than 20 states offer tax-lien certificates. But rules differ widely, even from county to county within a state. Here are a few tips to help you navigate the process:

- Invest in areas close enough to visit, where you can gain a better understanding of property values
- Seek opportunities in rural areas, where there's less competition
- Know the state property-tax laws and the local auction process
- Attend an auction a few times before bidding
- Decide what kinds of real estate tax liens you want, such as those on condos or commercial properties
- Research the properties at the county tax assessor's office