MC-97-5

Notice Number

New Jersey Department of Community Affairs
Division of Local Government Services

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Date

LOCAL FINANCE NOTICE

CHRISTINE TODD WHITMAN, GOVERNOR
JANE M. KENNY, COMMISSIONER
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NOTE TO READERS

This past summer, Governor Whitman enacted into law a two bill package that provides municipalities with additional options to manage its cash flow and property tax revenues; the ability to "sell" its tax levy, and the option of selling its tax liens in the current year, instead of the following year. In addition, Chapters 99 and 190 of the Laws of 1997 also clarify a number of technical issues regarding the sale of tax liens and other tax collection practice issues. Because of the scope and complexity of the changes, the Division is issuing three Local Finance Notices to assist local officials in managing their impact. The Notices are:

MC-97-5	Tax Lien and Tax Levy Sale Law - Information for Elected Officials
CTC-97-4	Tax Billing and Tax Lien Law Changes
CTC-97-5	Tax Levy Sale Procedures

MC-97-5 is being distributed to Mayors and Governing Body members through the municipal clerk and to tax collectors; the two CTC Notices are being sent directly to tax collectors, and collectors are directed to provide the chief financial officer with a copy. CTC 97-4 will also include a copy of both laws showing the statutory changes.

Tax Lien and Tax Levy Sale Law
Information for Elected Officials

The enactment of Chapters 99 and 190 continue efforts of the Whitman administration to provide local officials flexibility in managing their finances. These new laws create two new alternatives to managing municipal cash flow by permitting, to varying degrees, additional revenue to be anticipated in one year, by realizing revenues normally realized in the following year. When prudently considered and managed, utilizing one of these options may allow a municipality to provide property tax relief to its taxpayers and provide fiscal stability.

Using one of these options does not create new revenues, it accelerates recognition of existing revenues from a later year to an earlier one, and requires careful management to avoid a revenue shortfall in the later year. Further, once an option is elected, for all intents and purposes, it is a permanent change, for failing to accelerate revenue in one year may result in a revenue shortfall that will have to be made up from other sources.

BACKGROUND

These new tools address the way municipalities anticipate property tax revenues. Municipal officials recognize that the municipality serves as tax collector for the other tax districts (county, schools, and where they exist, fire districts). Because of this, the municipal tax levy includes the "reserve for uncollected taxes," the amount included in the tax levy that is the difference between the total amount of the individual tax levies and the amount the municipality expects to collect. Most municipalities do not collect 100 percent of their taxes because of a wide range of circumstances, i.e., bankruptcies, delinquencies, and other circumstances that result in taxpayers not keeping payments current.

The advantage to municipalities is that State law provides for interest to be charged on delinquent taxes: up to eight percent for the first $1,500 and up to 18 percent for all other amounts. In addition, State law now allows local government to charge penalties for larger delinquencies. Delinquent obligations are normally collected by placing a tax lien on the property, and selling a tax lien certificate to a third party investor who pays the municipality the amount of the unpaid taxes, plus any accrued interest and penalties. If a third party investor does not buy the certificate, it is held by the municipality. The failure of a property owner to redeem the certificate on a timely basis (two years for third party held certificates, six months for municipally held ones) subject the property to foreclosure action. In part due to the penalty provisions and other changes to tax lien law enacted several years ago, many municipalities sell most, if not all of their inventory of tax liens, because the investment community has found liens to be a very sound and lucrative investment.

Until now, State law required that the tax sale take place in the year following the delinquency with the accrued interest serving as a revenue source used to reduce property taxes in the budget. Thus, over a two year period, the municipality collected as much of the tax levy as practicable. Further, while each year's budget contains a reserve for collected taxes, it is, in part, offset by revenue reflecting the principal and interest collected from the tax sale and other enforcement methods.

THE NEW OPTIONS

The new law permits an accelerated tax lien sale, where the municipality is permitted to commence the tax sale process after the 11th day of the 11th month of the fiscal year, the time when all unpaid taxes become delinquent. The sale is held in the 12th month of the fiscal year, replacing the sale that took place after the close of the fiscal year described above. If all liens are sold, the tax levy is made whole. If planned to take place as part of the budget, it justifies a substantial reduction or elimination of the need for the reserve for uncollected taxes.

The other option, the sale of the tax levy, is more complex. Under this model, the municipalities contracts with an investor who agrees to "purchase" the entire tax levy. In this case, the term "purchase" means that the investor agrees to ensure that the municipality receives its entire tax levy (less tax title liens and properties on installment payments), by agreeing to pay the difference between what the municipality actually collects in taxes, and the total tax billing for the period (what they should collect if all taxpayers pay). That payment can be made quarterly, following each tax collection cycle, or annually, after the fourth quarter is collected.

To accomplish this, prior to adoption of the annual budget, the municipality must advertise, receive bids or publicly auction, and award a contract (which must be reviewed by the Division prior to budget adoption) to a third party to buy the tax levy. Generally, this means the municipality enters into a contract with the successful bidder, that involves the following:

1. At the end of each tax collection quarter, the buyer will pay the municipality the difference between what was owed in taxes for the quarter, and what was paid. As an alternative, this could be done once, after the fourth quarter's taxes are collected.
2. Depending on the amount and quality of anticipated delinquencies, the buyer may pay the municipality a premium over the value of the liens (in financial terms, some portion of the spread between the buyer's cost of paying the municipality the obligation, and the interest the buyer expects to earn over the life of the delinquency).
3. The levy buyer will earn interest on the delinquencies until the amount is finally paid.
4. Once fourth quarter taxes are received and final delinquencies known, the municipality advertises the tax sale and notifies delinquent property owners that unless they pay their obligations, the levy buyer will receive the tax sale certificate.

Now owning the certificates for all delinquent properties, in most cases, the buyer will arrange for "servicing" the liens, that is contacting and working with the property owners to pay off their obligations. If the certificates are not redeemed after two years, the levy buyer has the option of commencing foreclosure (as any tax certificate buyer could always do) on the property.

Suffice to say, this option will involve careful research and consideration of the bid specification and the contract with the levy buyer to ensure the municipality receives the maximum benefit. The law also permits a number of variations and options on this general theme that may benefit the municipality or the levy buyer. These are reviewed in Local Finance Notice CTC-97-5. Legal counsel and financial advice should be part of the municipality's review if this alternative is undertaken.

From a budget and accounting standpoint, the "new" revenue is handled as a reduction to the normally calculated reserve for uncollected taxes. For an accelerated lien sale, the amount permitted as a reduction would be the amount calculated through what is known as the delinquency formula. This formula estimates the amount of revenue that will be received from delinquent taxes and is based on the previous year's delinquent collection and tax sale experience. For a tax levy sale, the amount is derived from the contract of sale, and if there is a premium over 100 percent, that is considered as a special item of revenue.

In addition, in both cases, the first time one of these options is executed, the municipal chief financial officer or registered municipal accountant must prepare a three year fiscal impact statement that projects the effect of the accelerated revenue on future years' budgets.

Both options have similar effects; they permit recognition of those taxes that normally remain uncollected in the current year to be anticipated as part of the current year's budget. In doing so, they permit a substantial reduction in, or in some cases, elimination of the reserve for uncollected taxes. They may also result in a loss of interest and penalties that would otherwise accrue to the municipality, though they may be offset by savings in the total tax levy.

Because the practices require advancing revenues that are normally recognized in the following year, it is a revenue for the following year. The challenge to local officials is to tailor the use of these tools to match the cash flow needs of the community.

The new laws also include many technical details on how transactions are handled. They also contain many provisions clarifying and improving the way tax liens and sales are handled under normal circumstances. These are covered in the other Local Finance Notices in this series.

To conclude, these two new options for revenue management provide opportunities for prudent fiscal management. Properly used, they can reduce property tax burdens and improve municipal cash flow. Arbitrarily or improperly utilized, they can have a negative impact on the fiscal health of the community. We are confident that these tools will be used prudently.

Beth Gates, Director
Division of Local Government Services

Distribution: Municipal Clerk to distribute to Mayor and Governing Body
Tax Collector to distribute to Chief Financial Officer