

Short-Term Parking for 1031 Exchanges – (An Introduction to Land Banking) by Chris Miller

During my career helping investors find replacement properties, I have often received this request: “Do you have something I can ‘park’ my exchange money in temporarily while I search for a more permanent investment?” My answer to this question used to be “no.”

I have recently, however, found a solution that can achieve these goals. The answer is a land banking arrangement. In this arrangement, a land developer plans to build on a parcel, but not today. So he sells this parcel to investors with an option to buy the property back – in as little as 12 to 18 months. During the option period, the developer will pay a monthly option payment to investors – often more than they could earn from buying traditional real estate. The developer puts his “money where his mouth is” by placing a substantial amount of money (often in the neighborhood of \$250,000) in escrow as “earnest money,” or as a deposit. If the developer does not perform according to the contract, the investors keep that deposit – making sure the developer is motivated to repurchase the land.

At the end of the option period, the developer will purchase the land back from the investors at a negotiated appreciation price. So, an investor can expect to receive his principal back, plus some profit, in addition to the income he or she has received. During the option period, the investor is free to take their time searching for properties and doing due diligence – free from the pressure of a 45 or 180 day time window.

Income from land banking has a unique tax advantage. As an additional bonus, the income receives great tax benefits as well. Land, of course, can not be depreciated – but the tax benefits to this income are better! Under IRS rules, the income is classified as an option payment, which means it is not taxed until the land is sold. When the land is sold, it is taxed at *capital gain rates* (currently 15% vs. your higher income tax bracket.) So, no paying recapture later – the income is taxed lower, and that’s it.

Tell Me More About How Land Banking Works

As I mentioned earlier, a land banking deal starts when a developer has a parcel of land that he will not be building on for 1 year or longer. As he finishes the entitlement process, or completes other projects, the land sits there unused. The developer may want to pull his equity out of this property to deploy elsewhere but, especially in today’s lending environment, it is hard to find good loan terms on vacant land. Even if a reasonable loan can be secured, the developer can not pull all of his equity out of the deal.

How it Benefits the Developer AND the Investor

The land banking arrangement solves this dilemma. The developer can sell the land to an investor and have cash to immediately redeploy on other projects. Although the income plus appreciation he is paying the investors is usually above what other real estate investments will pay, it is still cheaper than the bank would charge. And, if he is a good developer, he can earn much more by re-deploying his funds into what he does best – erecting buildings.

Investors benefit because they can earn higher income from this passive investment, and because they finally have somewhere to “park” their money until a good alternative comes around.

That Sounds Good – But What is the Downside Risk?

As I say, I always look at the worst-case scenario when I review an investment. If I’m comfortable with the worst thing that can happen, then I will be comfortable making that investment. If the developer does not follow through on his end of the contract and buy the property, then investors will still own the property. They will collect the seller deposit from escrow, and evaluate their options. Since land-banking deals are all-cash, there is no bank to foreclose, so we don’t have that worry. Also, these deals involve land in the immediate path of development, not in Baker, California waiting for the day it becomes a suburb of Las Vegas. Investors can sell the land to another developer, and find something else to exchange into.

Any Other Drawbacks?

As I mentioned, there is no debt available on these land-banking deals, so if you have debt to replace as part of your exchange, we will need to find another place for that. This is where my often-used combo exchange can help. If you have \$1 million of equity and \$500,000 of debt to replace, we can find a 50% leveraged property and put \$500,000 of your equity into it. When we assume that \$500,000 of debt, we create \$500,000 of “free and clear” equity that is left at your accommodator account. We can put that into a land-banking deal, and be ready to exchange that again in 12 to 18 months.

If you think we will see lower prices one, two three or four years from now, and want to defer your taxes from property sales while waiting for these bargains, then this could be the investment for you.

If you have a 1031 exchange coming up, a land-banking option may be worth learning about now as a safe “Plan B” for when you find yourself with no ideas and five days left in your 45-day window. It is better to look at your options now than to try and learn with only a few days left. Rather than “rush” due diligence on a replacement property in those short few days and risk losing a deposit, paying taxes, or worse - buying a lousy property, it may be better to use land banking as a way to defer those taxes, and secure more time to find the right property. Of course, land banking arrangements will work for your non-1031 and even IRA funds as well. If a shorter hold period with predictable appreciation is what you are looking for, perhaps land banking is worth looking in to. If you have an exchange coming up, you may want to look into this sooner rather than later.

Land banking opportunities are available starting at \$100,000 of equity. These arrangements can provide for cash flow of up to 9% annually, tax-deferred. In addition to the benefit of tax deferral, this income is taxed only upon the property’s sale - at a lower capital-gains rate. This saves you money both now and later. Best of all, receiving this income doesn’t mean having to give up growth potential. If these features appeal to you, maybe land banking is worth a closer look.

Christopher Miller is a Senior Consultant with Midpoint Financial Services in Tustin, California and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator, and as an advisor helping clients through over two hundred 1031 exchanges. Chris has been featured as an expert in several industry publications and on television, is a candidate for the CCIM designation, and earned an MBA emphasizing Real Estate Finance from the University of Southern California. Call him toll-free at (877) 313 – 1868.

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