Is the Time Right for Land Banking?

Single family home starts are well below historical norms, particularly in the population segment that historically purchases their first homes – all in the face of a rising population. Explanations abound, from the assertion that current population segments that might normally purchase single family homes (millennials) are more attracted to rentals, that single family homes available in the market are simply priced too high or that the Colorado construction defect laws prevent delivery of affordable homes. While all of the above and other arguments have merit, it is questionable whether the current state of affairs is permanent since the statistics are overwhelmingly to the contrary.

On a national basis, the 20 year average for single family home deliveries is around 1 million units per year and we have been well below that since the market crash, at almost 4 million units short through 2015. (Of course, some of this can be explained by the absorption of overbuilding pre-crash and other holdover effects of the market slump). The other counterpoint is that the population is continuing to grow, which would suggest that more than average deliveries are needed to meet demand. If anything, demand growth in Colorado will outpace national growth, with population growth projections over the next 30 years of 2.9 million statewide and 2.3 million for the Front Range, which represents over 50% growth in that time period. If you figure even the low current rate of 64% home ownership, this translates to quite a few new home deliveries needed to meet demand. And if you think the spike in population represented by the millennials is just that, the population predictions belie that notion, forecasting that the demographic surge represented by the millennials will at least be matched by the population segments that follow.

You could make the case that the current rate of new home production is the "new normal," but it seems that a surge in new home sales at some point in the future is inevitable. Having said that, it would seem that banking land suitable to meet the predicted needs would be appropriate. Land banking also provides a hedge against inflation in land prices and assures an available inventory of land for development. Of course, the downside risk of land banking is that you may be caught holding land in a slow market, so it is not for the weak of heart. If you regret not having bought land after the market crash, the coming demographic shift might offer similar opportunities (and should be considered in your estate plan to transfer wealth to future generations).

We have previously illustrated several tax planning techniques that should be considered if you are planning or already have land banking investments. The first and most beneficial point is to take steps to ensure that the eventual sale of the banked land qualifies for capital gain treatment, which is achieved by avoiding activities that could bring you into the developer category before the sale. If you do intend to develop the land for retail sale, you can take steps to sell the land to a development entity from an existing investment entity and still preserve capital gain treatment, if the proper structure is used. It is worth taking some trouble to qualify for this tax benefit, since it effectively cuts your tax rate in half. Also consider the merits of holding the land during the investment period as agricultural or other business use property, such as grazing, farming (a hay field should qualify), etc., which can allow you to avoid a 3.8% surcharge tax on net investment income. If you plan to develop the land yourself, consider techniques that can allow you to defer the taxable event until the end of the project, not as the homes are sold (which is the norm, often resulting in tax payments well before cash is available from the project).

For more details on the tax techniques touched on above, refer to the following previous newsletters for a refresher (December 2014, January 2015 & February 2015 newsletters) or call to discuss.

The information in this newsletter was gleaned from a number of sources. If you have a particular question, or would like a citation to the source, please contact Zane Dennis at zane@richeymay.com or 303-721-6131.