Finance College Education
Using Rental Property

Richard Hart, EA, CAA, *earned a degree in accounting and has since acquired experience putting his knowledge to work in the construction, manufacturing, service, restaurant, banking, and real estate industries for more than 13 years. In 2006, Richard opened his own practice, Hart & Associates Tax Consulting and Preparation Services, to specialize in tax accounting and has earned the credentials of Enrolled Agent and Certified Acceptance Agent with the Internal Revenue Service. He has effectively helped hundreds of clients to successfully navigate US tax law and preserve their wealth. Hart & Associates is a NARPM® Affiliate Member, based in Henderson, Nevada.*

Do you have young children that you plan on sending to college? That is going to be an expensive endeavor, isn't it? Did you know that you could possibly use a rental real estate investment to subsidize or pay for your child's education? How?

The key is that you would need to buy a rental property when the child is very young. This is important because you will need the property to appreciate in value (keeping in mind there are natural ups/downs in the real estate market). Since capital appreciation is the key, do your due diligence to purchase a property in a very good location. The goal here is not to find a cheap rental in a bad part of town. Your objective in this scenario is to find a property in a desirable neighborhood with a very good school district so that you can attract quality long-term tenants, which gives you the best chance for capital appreciation over time. Try to find a rental property that will cover all of its own operating expenses for the next 15-18 years. Even if you had to kick in some funds, if the property were in the right location, it would make sense to do so for the purpose of this tax plan. It would be preferable if you could also buy the property in cash, but that is not required.

Once your child is ready for college, pull the cash out with a line of credit or cash out refinance. You will use this cash to pay your child's tuition fees. Although the interest payments will not be deductible on your schedule E rental tax return, you will not pay income taxes for the loan; and realistically, if you have owned the property for 15-18 years, the future rental income that the property is generates should cover the loan for your child's college education. Thus, in effect, the tenant is paying for the education costs. Word of caution: Do not over pay for a property. If you get caught in a real estate bubble, there will be no way to get the appreciation you need for this plan to work. Be wise and prudent in your purchase.

Here is where extra tax planning comes into play: After 15-18 years, the property will be significantly depreciated, so if you turn around and sell it, you will face capital gains and depreciation recapture taxes. This has the potential of undoing all of the hard work of having the rental pay for the college education. To ensure this does not happen, you have two options:

1. Sell your primary property after your child is out of college and move into the rental property for two years. The rental property becomes your primary residence, and you will now fall under the primary home exclusion on capital gains.
2. Keep the property, put it into a trust, and have your children inherit it after you die. The fair market value (FMV) at the time of your death becomes their cost basis, and if they sell immediately, they pay no capital gains at all (assuming properties meet estate limits).

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