Real Estate as a College Savings Tool

As regular readers may or may not know, my main college savings tool is Utah's excellent 529 plan, with funds in the plan invested very aggressively (50% international and 50% small value.) There are other, inferior ways to save for college, each of which has their own issues, including taxable accounts (high taxes), UGMAs (loss of control,) Coverdell ESAs (low contribution limits and no state tax break,) and even cash value life insurance (low returns.) However, one method that I think is worth of consideration, either on its own or combined with a good 529 plan is real estate investing. There are a number of ways to do this, obviously, but this post will discuss some ways in which I think real estate investing could have real merit as a college savings tool. I'll talk about the downsides at the end, but first let's list out 8 reasons why real estate is a good college savings tool.

1. The Time Frame is Right

Real estate isn't a great short term investment. But it can be a great investment in the 10-20 year range, about the period of time over which you ought to be saving for college. That's enough time to spread the transaction costs out over many years, get some reasonable appreciation, and pass through at least one bull and bear market.

The author’s family descending Pine Creek Canyon, Zion National Park

2. Returns Are High

I’m a fan of investing aggressively for college. Although the time frame is lower than retirement, the consequences of shortfall are so much less significant that one can afford to be aggressive. Real estate investing, like stock investing, has a long record of solid returns, which depending on leverage, can easily be in the 8-15% per year range. Even a paid off Cap Rate 6 property, not that hard to find, that gets 3% appreciation per year should get a 9% total return.

3. Becomes Less Risky as Time Goes On

Leveraged real estate investing automatically becomes less risky the closer you get to your goal, simply as a result of amortization of the loan. You don’t necessarily need to add bonds like many automatic 529 options in order to lower risk. If you use a 15 year mortgage on the property, it may even be completely paid off by the time the kid enters college.

4. Significant Tax Advantages

While I don't think the tax advantages of real estate investing are as good as using a 529 (you're not going to get a state tax deduction or credit for contributing, nor are rents and capital gains going to be completely tax-free forever if used for education), there are some tax advantages inherent in real estate investing. You can depreciate the property and that depreciation in the early years can make much of your cash flow somewhat tax-deferred. The only way to make the depreciation tax-free is to die before selling, but you can continue to defer the depreciation recapture by exchanging the equity into a more valuable property a la the Monopoly game. All of your investing expenses (mortgage interest, taxes, maintenance costs, travel to visit the property), of course, are also deductible.

5. Three Ways to Access the Money

There are three ways to get the money out so you can spend it on college. The first is simply to sell it. That causes two issues-first, you have to pay capital gains taxes and the transaction costs. Second, you then have to figure out something else to invest the money in since all of your college savings isn't needed at any given time.

The second way to access your money is to borrow it, a la whole life. You can get a home equity loan or refinance. Aside from the obvious downsides of having to pay interest to use your own money, loan-associated fees, and increasing the leverage and thus risk of the investment, this does have a certain appeal-i.e. no tax consequences.

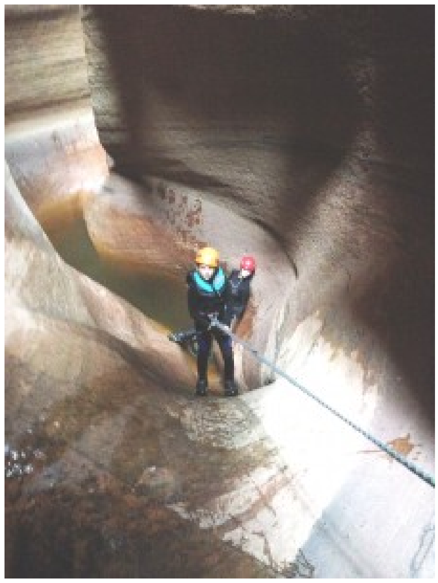
The third way to access your money is simply as an income stream. If you bought a $100,000 property with a Cap Rate of 6% and paid it off in time for college, it might then be worth $200,000. That paid-off property ought to kick out sufficient rent, after expenses, to pay $12,000 a year worth of college expenses. Obviously, you've paid much more into this investment than $12,000 * 4 years = $48,000, especially considering the time value of money, but you also still have an asset, probably worth even more, at the end of the college years. That asset can then be used for retirement, exchanged into a recreation property, used to pay for the next kid's college, gifted to the child as a graduation present (gift taxes would apply on such a large gift unless you used a trust to spread the gift over many years), or sold and used to buy something else you want.

6. Insulation From Stock Market Returns

Although there is some correlation between the general economy, real estate returns, and stock market returns, real estate income streams tend to have quite low correlation with the overall stock market. Combining a 529 plan invested in stocks with a real estate investment can provide some real diversification. Obviously, putting a big wad of money into a single property could be considered the antithesis of diversification, especially with regards to any possible appreciation.

7. Opportunity to Teach the Child

One of the things I really like about using real estate as a college savings investment is the opportunity to teach the child financial principles. I use my 529s to teach my kids about taxes, stocks, bonds, dividends, appreciation, and compound interest. But I think a real estate investment would be even more useful. I could teach the kids about rents, inspections, appraisals, mortgages, interest rates, appreciation, depreciation, amortization, property management, and perhaps most importantly, I could teach them about work. If you manage the property yourself, every time the property needs something, you drag the kid down to the property with you to deal with the tenants, collect the rent, fix the toilet, paint the fence etc. “This is your college fund, kid. Better take care of it.” If you buy the property in the college town, the kid could become the property manager in college, providing him the ability to work for his income and valuable skills. He could even live in the property, using the rents from his chosen roommates to pay his own college expenses, building valuable life and business experience.



The author’s eldest rappeling in her first technical canyon, Keyhole Canyon, Zion National Park

8. Estate Planning

If you give the child the property (especially in the beginning, when it isn't worth much), this has the added of bonus of getting money out of your estate. Obviously, this is not much of an issue for most docs in many states given the high federal estate tax exemption amount, but it is a potential opportunity to reduce estate taxes. You would obviously lose control over the asset (like an UGMA account) but you could reduce that loss through the creation of a trust.

Downsides

There are also a number of downsides to doing this, especially compared to using a 529 account. The most obvious is the loss of the tax benefits of a 529. It's tough to beat an upfront state tax break plus tax-free growth. You also lose liquidity when compared to a good 529 invested in stocks. It's relatively easy to pull a few thousand out of a 529 every month, semester, or year. It's much harder to match your cash flows from real estate to your college cash needs. Plus, both home equity loans and selling the house have significant costs that a 529 does not. These downsides are the same whether you're buying properties directly or whether you're involved in syndicated real estate as has been discussed a number of times on this forum. Real estate investing also requires expertise and skill that buying and holding index funds in a 529 simply doesn't. It's an inefficient market, and just as there are plenty of people who use their skill, expertise, hard work, and luck to boost their returns, there are plenty of people who do not get good return due to lack of skill, luck, and hard work.

Of course, there is also the issue of real estate investing being part investment and part second job. While a second job gives you the opportunity to teach your child to work, it also means you're going to be doing some additional work you wouldn't otherwise be doing. You may simply wish to use your time for something else. Even if you're not a do-it-yourselfer, it's far easier to hire an advisor to manage a 529 than to find one to acquire and manage real estate properties without significant input from you. Finally, as mentioned, buying a single investment property instead of thousands of stocks is the classic "Put all your eggs into one basket and watch it very closely" vs "don't put all your eggs in one basket" conundrum. If that property does poorly or requires significant unforeseen expenses, it may not work nearly as well as a more diversified approach.

In the end, the most important thing about college savings is starting early, saving enough, and choosing investments with the potential for your money to actually grow significantly faster than inflation over the relatively short time period you have. Stock index funds in a good 529 are a fantastic option. Selected real estate investing may also work well for the right person/family, either on its own or in combination with the 529.