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Mortgage Points: Rules for Deduction

When it comes to mortgages, it's easy to be confused about whether a homebuyer may take a full tax deduction for "points"—a portion of the loan amount of usually one, two, or three percent—paid to his or her mortgage lender. Generally, because points are prepaid interest, you must deduct them over the term of the mortgage. However, the Internal Revenue Service (IRS) states that points are deductible in the year of actual payment, as long as *all* of the following conditions are met:

- 1) The loan is secured for your main home (the one you live in most of the time).
- 2) Paying points is an established business practice in the area where the loan was made.
- 3) The points paid were not more than the points generally charged in that area.
- 4) You report income in the year you receive it and deduct expenses in the year you pay them—also known as the cash method of accounting. Most individuals use this method to calculate their income tax liability.
- 5) The points paid were not in place of amounts that are ordinarily stated separately on the settlement statement at the time the loan is closed. For example, you cannot pay points in exchange for lower or no appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
- 6) The funds you provided at or before the time of closing, plus any points the seller may have paid, were at least as much as the points charged. The funds you paid do not have to have been applied to the points. They can include a down payment, escrow deposit, or funds you paid at or before the closing for any purpose. However, such funds may not have been borrowed from your lender or mortgage broker.
- 7) The loan is used to buy or build your main home.
- 8) The points were computed as a percentage of the principal amount of the mortgage.
- 9) The amount paid for points is clearly marked on the settlement statement as such. The points may be shown as paid from either your funds or the seller's funds.

If you meet all of the conditions stated above—and you itemize your deductions in the year in which you obtain your loan—you can deduct the full amount of points in the year they are paid, or you may spread the deduction out over the life of the loan. If you do not

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itemize your deductions, you may then spread the deduction out over the life of the loan. If you are spreading the points deduction out over the life of the loan and your mortgage ends earlier than the original loan term (through prepayment or refinancing), you may deduct any remaining balance in the year your mortgage ends. If your loan is for home improvement or if you used refinanced mortgage proceeds to improve your main home, you may fully deduct the points paid in the year they are paid, as long as you meet conditions 1–6 above.

In many cases, the tax deduction for points paid may be available to you. If you've bought or sold your primary residence, taken out a home improvement loan, or refinanced a mortgage, you may want to consult a tax professional to assist you in determining whether your mortgage points paid meet the deductibility criteria.

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