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Deductibility of Points and Other Closing Costs

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What is the deductibility of points and other closing costs?

When you take a loan to purchase a first or second residence (or to refinance an existing loan on a first or second home), you generally will be charged closing costs (also known as settlement charges). These generally include points as well as attorney's fees, recording fees, title search fees, appraisal fees, and other loan or document preparation and processing fees. The question you will face is whether you can deduct these fees immediately or whether they are added to the cost basis of your home.

What are points?

Points are costs that are often charged to you by a lender when you take a loan secured by your home. One point equals 1 percent of the loan amount borrowed. (For example, 1.5 points on a $100,000 loan would equal $1,500.) If the points are charged for services provided by the lender in preparing or processing the loan, then they are not deductible. However, if the lender charges the points as up-front interest and in return gives you a lower interest rate on the loan, then the points may be deductible.

> **Tip:** It doesn't matter whether your lender calls the charge points or a loan (or mortgage) origination fee. If this charge represents prepaid interest, it may be deductible.

Are points deductible and when?

Points charged as prepaid interest are deductible over the term of the loan except when they are paid on a loan used to buy or improve your primary residence. Points are deductible for the tax year in which they are paid if you meet all of the following conditions:

- Your loan is secured by your main home
- Paying points is an established business practice in the area where the loan was made
- The points paid were not more than the points generally charged in that area
- You use the cash method of accounting (most individuals use this method)
- The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes
- The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged
- You use your loan to buy or build your main home
- The points were computed as a percentage of the principal amount of the mortgage
- The amount is clearly shown on the settlement statement as points charged for the mortgage. The points may be shown as paid from either your funds or the sellers

For more information on deducting points, see IRS Publication 936.

What if the points are withheld by the lender from the loan proceeds?

If the loan is for the purchase of your primary residence, any points withheld by the lender will be deductible as up-front interest if (at or prior to the closing of the loan) you pay a down payment, escrow deposit, or earnest money equal to the charge for points. If, however, the loan is used to improve your primary residence, then the points paid related to the home improvement loan may be deducted in the year paid (if certain criteria are met).

Can you deduct points paid by the seller?

Yes, these can be deducted by you as an up-front interest charge. However, because they are also considered a reduction in the cost of the home, you must lower your cost basis in the home by an amount equal to the points paid by the seller.

Can you deduct points charged on a mortgage secured by a second home?

Yes, but they must be deducted ratably over the term of the loan.

> **Example(s):** If you pay $3,000 in points on a 30-year mortgage secured by a second home, you can deduct $100 in points each year during the term of the loan.

If you are amortizing the deduction of points on a loan over the term of that loan and the loan ends early, how do you treat the points you have not yet deducted?

If the loan ends early (because, for example, you sell the home or refinance the mortgage), you may fully deduct the remaining points for the tax year the loan ends.

How are points paid on a refinanced loan treated?

Points paid on a refinanced loan must be amortized over the life of the loan. However, there is one exception: If part of the loan is used to make improvements to your primary residence, you can deduct that portion of the points allocable to the home improvements made in the year the points are paid (if certain criteria are met).

> **Example(s):** Suppose you take a cash-out refinance mortgage for $100,000 and pay two points ($2,000). Then, $90,000 is used to pay off the principal debt owed on the old mortgage, $4,000 is used to pay off bills, and $6,000 is used to put in a new kitchen. Since 6 percent ($6,000 divided by $100,000) is used for home improvement, then $120 (6 percent of $2,000) may be deducted in the year the loan is taken. The remaining $1,880 in points must be deducted ratably over the life of the loan.

Can other closing costs be deducted?

Other closing costs that are charged to you, such as attorney's fees, recording fees, title search fees, appraisal fees, owner's title insurance, and other loan or document preparation and processing fees, are not deductible. Rather, they are added into the cost basis of your home.

> **Example(s):** Over and above points, assume that your closing costs on a loan you take to purchase a $200,000 home total $1,500 dollars. Your initial cost basis in that home would be $201,500.

> **Caution:** Fees that you pay at closing, placed in escrow to cover costs that you will be required to pay later (e.g., fire insurance premiums), are not added to the basis of your home.

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