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Score tax points for a mortgage

Are you or someone else in your family buying a home? Mortgage interest rates are still favorable by historical standards, but you might decide to pay one or more “points” to a lending institution to get a better rate.

Strategy: Factor taxes into the equation. Usually, you can write off the full amount of points paid on a loan taken out to buy a residence. For a refinancing, the deduction for points is generally spread out over a period of years.

Points are treated like other mortgage interest payments, so the cost may be deductible in a year in which you itemize. But the new Tax Cuts and Jobs Act (TCJA) could affect the deduction.

Here’s the whole story: A point equals 1% of the amount you borrow from the lender. For instance, if you’re charged two points on a $200,000 loan, it costs you $4,000. But the extra payment is worth it if you’ll save 10s of thousands in the long run.

The points paid on a new mortgage may be deductible if you meet certain requirements *(see box below)*. Under the TCJA, you can continue to deduct mortgage interest on the first $750,000 of a new debt to acquire a home, down from $1 million before 2018. This limit is scheduled to revert to $1 million in 2026.

If you’re refinancing an existing acquisition debt instead of taking out a new loan, you must amortize the points over the life of the refinanced loan.

Example: Assume you can obtain a more favorable rate for a 10-year mortgage if you agree to pay one point. The loan principal is $150,000, so the point costs you $1,500. Therefore, you can deduct $150 each year for the next ten years.

On the other hand, if you’re taking out a home equity loan or line of credit, the rules differ. The TCJA eliminates the deduction for mortgage interest paid on home equity debt for 2018 through 2025. But the loan can still qualify as acquisition debt if the proceeds are used for home improvements. In that case, you can write off the full cost of the points, subject to the limits for acquisition debt discussed above.

However, if you use the home equity loan proceeds for other purposes—say, to buy a car—the loan is treated as home equity debt. *Result:* You get no deduction for the mortgage interest, including any points.

If interest rates decline, you may decide to refinance a mortgage a second, third or even fourth time. In this situation, you can qualify for an immediate tax break on any leftover unamortized points from an earlier refinancing.

Tip: Deduct the full amount of points left over from the prior refinancing. You don’t have to amortize those points any longer.

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Tax checklist for points

Here’s a nine-point checklist for claiming current deductions for points.

1. You secure the loan with your principal residence.

2. You reside in an area where paying points is an established business practice.

3. You pay points equal to the amount being charged in your area.

4. You use the cash method of accounting (i.e., you report income in the year received and deduct expenses in the year paid).

5. You don’t pay the points as a substitute for other amounts on the settlement sheet (e.g., appraisal fees, inspection fees, title fees, attorney fees or property taxes).

6. Your down payment (plus any seller-paid points) is at least as much as the amount of points charged.

7. You use the loan to buy or build your principal residence.

8. Your lender computes the points as a percentage of the mortgage principal.

9. Your settlement sheet states the points as being paid by the buyer or seller.

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