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## LOAN ORIGATION FEES (POINTS)

By Victor Sy, CPA, MBA

Points are loan origination fees paid to a bank or mortgage company when you refinance or obtain a new loan on the purchase of your house or rental property. [Let's review 10 rules, tax traps, and tips:](#)

1. [Points are prepaid interest](#). Prepaid interest is not deductible up front. It is required to be amortized (deducted over the period of the loan). For example, three points on a \$100,000 30-year loan is \$3,000 and is deductible over 30 years at \$100 a year. A mere \$100 a year.
2. There is a significant exception that allows you to deduct points all at one time. Loan fees paid in connection with the [purchase of your principal residence](#) are deductible in full in the year paid. **UPDATE: A new IRS letter ruling allows you to amortize if you get no benefit from one-time deduction.**
3. This advantage applies only to your [principal residence](#), not to your second home, not to rental property.
4. Points to [refinance your old loan](#) are not deductible in one year and have to be amortized over the life of the loan. However, points to improve your principal residence may be deducted in the year of refinance.
5. The IRS used to require the actual payment of points from your own funds by a separate check. They now consider points as paid from your own pocket if your downpayment and escrow deposits are equal to or greater than the amount of the points. This is a kinder interpretation of the word "paid."
6. Lenders are [required to notify the IRS](#) of points paid by borrowers on Form 1098.
7. If you refinance for a [dual purpose](#) (improving residence and paying off car loan), you must allocate the loan fees using a ratio of the improvement against the total loan. This is called tracing. The use of the funds determines its deductibility. It does not matter which property was used to secure the debt.
8. If you [pay off your loan early](#), any remaining points may all be deducted in the year paid.
9. Taxpayers who use [temporary short-term financing](#) as one-step toward obtaining a permanent loan for home acquisition may be entitled to a current deduction of points.
10. [Seller paid-points](#) are deductible only if they are designated as points on the escrow final/settlement statement, computed as a percentage of loans, and paid in connection with the acquisition of your principal residence.

**TAX TRAP:** Wrap mortgages (AITD All Inclusive Trust Deed) are not considered secured and are therefore not deductible as points unless they are recorded and perfected.

**TAX TIP 1:** When given a choice between loan programs with low points loan origination fees (but higher interest rates) or low interest rate (but higher points), compute the break-even point in months. Do

you choose a low point program with higher rates or a low rate program with higher points? Divide the difference between the points by the monthly payment differential to compute your break-even point. For example, if there is a difference of \$2,400 between the points and a \$200 difference between the monthly payments, it will take you 12 months to recoup the point differential. If you intend to sell the house within a year, take the program with the lower points but higher interest rate. On the other hand, if you intend to stay on the property for more than 24 months, choose the program with the higher points and save lots of interest beyond 24 months. ☺

**TAX TIP 2:** If escrow closes at the end of the year and you receive no tax benefit (not enough deductions to itemize), IRS Letter Ruling 199905033 allows you amortize points. In other words, you can spread loan origination fees over the life of the loan instead of deducting and wasting points in the year of purchase.

**DEVELOPMENT:** A recent tax court decision in *Hurley v Commissioner* allowed taxpayer to immediately expense portion of loan origination fees related to refinance proceeds that were used to improve his home. For example, if you refinanced your home in 2011, paid points of \$2,000 to borrow \$100,000 of which \$50,000 was used to remodel your home, you can immediately deduct \$1,000 in 2011 and spread the rest over the life of the loan (typically 30 years).