Mortgage Interest Rates and Points: Practical Advice for Your Clients

By W. Joey Styron, Peter Basciano, and James M. Grayson

W. Joey Styron is associate professor of accounting, Peter Basciano is assistant professor of finance, and James M. Grayson is associate professor of management, all at Augusta State University.

I. Introduction

In the process of arranging for mortgages to purchase or refinance property, clients often seek the advice of a tax professional. One of the issues is the payment of points. All tax professionals who work with individual taxpayers know the basic rules for deducting points. Points paid to acquire the taxpayer's principal residence are immediately deductible. Points paid for refinancing or for purchases of property other than a principal residence must be deducted ratably over the life of the mortgage.

The taxpayer often has the choice of paying points to obtain a lower annual interest rate on the mortgage. Under what conditions would it be advisable to pay points to obtain a lower interest rate? We have developed a model that helps the tax adviser determine if the payment of points is advisable.

II. Deductibility of Points and Mortgage Interest

A. Points

Points paid to acquire a person's principal residence are deductible in the year paid. There are several requirements that one must meet in order to qualify for the immediate deduction. In Rev. Proc. 94-27, 1994-1 C.B. 613, *Doc 94-3394*, *94 TNT 60-1*, the IRS announced that it will consider payments to be points if they meet all of the following five requirements:

1. On the settlement statement, the payments should be designated as points, loan origination fees, loan discount, or discount points.

2. They are calculated as a percentage of the principal amount of the mortgage.

3. They are paid in connection with obtaining a mortgage to acquire one's principal residence.

4. They are paid directly by the taxpayer and are not derived from loan proceeds.

5. In the area where the residence is located, the points conform to established business practice and are not in lieu of appraisal, inspection, title, attorney fees, property taxes, or other amounts that are ordinarily stated separately on the settlement statement.

Sometimes the purchaser negotiates to have the seller pay the points. Those seller-paid points are treated as a reduction to the purchase price. They are deductible by the buyer, assuming that all other requirements are met. The seller-paid points are treated as if they had been paid directly by the buyer. Furthermore, the points may be paid out of the buyer's down payment, escrow deposits, or earnest money.

There are numerous limitations on the amount that may be deductible as points:

1. If the amount of the mortgage loan exceeds the limitation on the amount that qualifies as acquisition indebtedness, the points on the excess loan amount are not deductible.

2. Points paid to acquire any property that is not the taxpayer's principal residence are not immediately deductible.

3. Points paid on a refinancing loan, home equity loan, or line of credit are not immediately deductible.

Although points paid on a refinancing loan are generally not immediately deductible, there are exceptions that have been allowed by the courts. In one case, the Eighth Circuit[1] allowed the taxpayer to immediately deduct points paid on a refinancing. The taxpayer had used a short-term balloon loan to acquire the residence and later obtained a long-term mortgage to refinance the balloon loan. However, the IRS has announced that it does not acquiesce in the court's decision.[2] In other words, outside of the Eighth Circuit, the IRS will continue to disallow immediate deduction of points paid to refinance a short-term balloon loan. However, in another case, the Tax Court ruled that points paid to refinance a variable rate loan with a fixed rate loan were not immediately deductible.[3]

In Rev. Rul. 87-22, 1987-1 C.B. 146, the IRS ruled that taxpayers may immediately deduct points paid in a refinancing that was partially used to make improvements to the residence. Only the part of the points paid on the loan amounts used for the improvements qualified for the immediate deduction.

As described above, although a taxpayer is entitled to an immediate deduction of the points, the taxpayer has the option of amortizing the points over the life of the mortgage. That would not generally be advantageous, but the possibility exists. For example, the taxpayer might expect a higher marginal rate in the future, and therefore might prefer to postpone the deduction.

B. Home Mortgage Interest Deductions

Although the immediate deduction of points is limited to the taxpayer's one principal residence, home mortgage interest is deductible on both a principal residence and one secondary residence. The principal residence is determined based on the amount of time that the taxpayer physically resides in the home. The principal residence is the one with the highest number of personal-use days by the taxpayer. Any other residence that is used personally by the taxpayer can be designated as the secondary residence.

---

[1] *Huntsman v. Commissioner*, 905 F.2d 1182 (8th Cir. 1990), *rev'g* 91 T.C. 917 (1988).

[2] AOD CC-1991-002 (Feb. 11, 1991).

[3] *Kelly v. Commissioner*, T.C. Memo. 1991-605.

Table 1 Minimum Holding Period to Break Even on a 30-Year Mortgage Immediately Deductible Points					
Marginal Tax Rate	Mortgage Term in Months	Original Loan Amount	Points Paid	Base Interest Rate	Minimum Holding Period to Break Even on the Points
35%	360	$100,000	1	6.00%	54
35%	360	$100,000	2	5.75%	55
33%	360	$100,000	1	6.00%	55
33%	360	$100,000	2	5.75%	55
28%	360	$100,000	1	6.00%	55
28%	360	$100,000	2	5.75%	55
25%	360	$100,000	1	6.00%	55
25%	360	$100,000	2	5.75%	55

Table 2 Minimum Holding Period to Break Even on a 15-Year Mortgage Immediately Deductible Points					
Marginal Tax Rate	Mortgage Term in Months	Original Loan Amount	Points Paid	Base Interest Rate	Minimum Holding Period to Break Even on the Points
35%	180	$100,000	1	6.00%	60
35%	180	$100,000	2	5.75%	60
33%	180	$100,000	1	6.00%	60
33%	180	$100,000	2	5.75%	60
28%	180	$100,000	1	6.00%	61
28%	180	$100,000	2	5.75%	61
25%	180	$100,000	1	6.00%	61
25%	180	$100,000	2	5.75%	61

The taxpayer is allowed to change the secondary-residence designation from year to year. However, the taxpayer is generally not allowed to change the secondary-residence designation within a tax year. In the following situations a midyear change in the secondary-residence designation is allowed:

1. If a taxpayer acquires a new residence during a tax year, the taxpayer can designate it as the new secondary residence, effective on the date of acquisition.

2. If a taxpayer changes to a new principal residence during a tax year, the taxpayer can designate the former principal residence as a secondary residence. The new principal residence might, or might not, be the former secondary residence.

3. If a taxpayer sells the secondary residence, or changes the secondary residence to the primary residence, the taxpayer can designate a new second residence, as of that day. The newly designated secondary residence might, or might not, be the former principal residence.

A vacation home that is rented for part of the year and used by the taxpayer for other parts of the year can qualify as a second residence. The residence must be personally used by the taxpayer for the greater of 14 days or 10 percent of the total number of rental days.

Home mortgage interest is deductible, within limits, as either acquisition indebtedness or home equity indebtedness. Acquisition indebtedness is a loan that was used to acquire or improve the residence. It includes loans to refinance acquisition indebtedness. Home equity indebtedness is a loan that was used for some purpose other than acquiring or improving a residence.

Interest on acquisition debt is deductible for a primary and secondary residence with a limit of $1 million of acquisition debt. Any interest on a debt exceeding that limit is only deductible for the interest on the first million dollars of debt.

Example 1. Assume that a taxpayer owes $1.2 million on a 6 percent mortgage that was used to purchase or improve the residence. For simplicity, assume that the principal balance was $1.2 million for the entire year. Total interest would be $72,000 (1,200,000 x .06). Of that amount, only $60,000 is deductible (1,000,000 x .06).

The limitation on home equity interest is a little more complicated. Interest is deductible on home equity debt of up to $100,000. However, there is another limitation. Section 163(h)(3)(C)(i) stipulates that qualifying home

Table 3
Minimum Holding Period to Break Even on a 30-Year Mortgage
Ratably Deductible Points

Marginal Tax Rate	Mortgage Term in Months	Original Loan Amount	Points Paid	Base Interest Rate	Minimum Holding Period to Break Even on the Points
35%	360	$100,000	1	6.00%	88
35%	360	$100,000	2	5.75%	88
33%	360	$100,000	1	6.00%	85
33%	360	$100,000	2	5.75%	85
28%	360	$100,000	1	6.00%	79
28%	360	$100,000	2	5.75%	79
25%	360	$100,000	1	6.00%	76
25%	360	$100,000	2	5.75%	76

Table 4
Minimum Holding Period to Break Even on a 15-Year Mortgage
Ratably Deductible Points

Marginal Tax Rate	Mortgage Term in Months	Original Loan Amount	Points Paid	Base Interest Rate	Minimum Holding Period to Break Even on the Points
35%	180	$100,000	1	6.00%	109
35%	180	$100,000	2	5.75%	110
33%	180	$100,000	1	6.00%	104
33%	180	$100,000	2	5.75%	105
28%	180	$100,000	1	6.00%	95
28%	180	$100,000	2	5.75%	95
25%	180	$100,000	1	6.00%	90
25%	180	$100,000	2	5.75%	90

equity debt may not exceed the fair market value of the property less any acquisition indebtedness on the property.

Example 2. A taxpayer purchased a home for $110,000 by paying $25,000 down and financing the remainder with a mortgage. He paid the $85,000 mortgage down to $80,000 and the fair market value of the home rose to $125,000. If he were to take out a second mortgage to use the proceeds for something other than improving the home, the debt would be home equity debt. His limitation on qualifying home equity debt would be the lesser of $100,000 or $40,000 (the difference between the fair market value of the home and the original mortgage). Interest on debt in excess of the limit would not be deductible.

III. Factors Affecting the Decision to Pay Points

The decision to pay points to obtain a lower interest rate is based on the present value of the relevant cash flows, including any tax shield resulting from the deduction of points and interest. One should compare the present value of the mortgage with the points to the present value of the mortgage without the points. The alternative with the lower present value is the optimum choice.

Several factors affect the present value of the mortgage. Some of the factors are known quantities and other must be estimated. Factors with known quantities include:

a. the number of points;

b. the interest rate on the mortgage;

c. the term of the mortgage;

d. the original amount of the mortgage principal;

e. the taxpayer's marginal tax rate; and

f. the tax treatment of the points — immediately deductible or ratably deductible.

Other factors must be estimated or assumed. The actual holding period of the mortgage must be estimated. The client might be planning to hold the mortgage for its entire term or planning to sell the property before the end of the term. Most mortgages are retired early because the taxpayer sells the property before the mortgage is paid. The marginal tax rate of the client is known at the time of the mortgage origination, and the model assumes that the marginal tax rate will not change. The other quantities used in the model are based on the factors described above. The model assumes a fixed rate mortgage without a balloon payment.

The model is shown below:

$$PV = DP(1 - T)\,B_0 + \sum_{t=1}^{H}\left(\frac{P_t - I_t(1 - T)}{(1 + k)^t} + \frac{B_H}{(1 + k)^t}\right)$$

where:

PV = present value of the loan with discount points

DP = discount points paid as a percentage of the loan amount

T = marginal tax rate of the borrower

B_0 = original loan balance

P_t = monthly principal payment at time t

I_t = monthly interest payment at time t

B_H = the principal balance outstanding on the loan at time H

k = after-tax interest rate on loan without discount points of identical maturity

The above equation indicates that the present value of a loan with immediately deductible discount points at any point in time (H) is equal to the after-tax cost of the discount points at time zero (the time of the mortgage origination), plus present value of the after-tax payments over the specified holding period (time 0 to H), plus the present value of the loan outstanding at the end of the specified holding period (H).

For ratably deductible points, the model is modified as shown below.

$$PV = DPB_0 - \sum_{t=1}^{H}\left(\frac{\left(\frac{DPB_0}{n}\right) * T}{(1 + k)^t}\right) + \sum_{t=1}^{H}\left(\frac{P_t - I_t(1 - T)}{(1 + k)^t}\right) + \frac{B_H}{(1 + k)^t}$$

Equation 2 above indicates that the present value of a loan with ratably deductible discount points at any point in time (H) is equal to the cost of the discount points at time zero, less the present value of the accumulated tax shield resulting from the payment of discount points over the specified holding period (time 1 to H), plus the present value of the after-tax payments over the specified holding period (time 0 to H), plus the present value of the loan outstanding at the end of the specified holding period (H).

IV. Results

Our review of local advertised mortgage rates for several mortgage companies indicates that for each additional point paid, the base interest rate decreases by 0.25 percent.[4] For example, with zero points, the base interest rate might be 6.25 percent. With one point, the base rate would likely be 6 percent, and with two points, the base rate would likely be 5.75 percent. Using those combinations of points and interest rates, the tables show the results of the models that determine the minimum holding period required for the mortgage, given the payment of points. With any holding period below what is shown in the tables, the taxpayer is better off not paying the points. With any holding period above that shown, the taxpayer is better off paying the points. Tables 1 and 2 assume a 30-year and a 15-year mortgage, respectively, with immediately deductible points. Tables 3 and 4 assume a 30-year and a 15-year mortgage, respectively, with ratably deductible points. All the tables use the same combinations of points and interest rates. Even though one would expect to pay a lower rate with a shorter-term mortgage, the relationships between points and the interest rates remain the same.

A. Immediately Deductible Points

As shown in tables 1 and 2, for immediately deductible points the taxpayer must hold the mortgage for at least 55 months to break even when paying points on a 30-year mortgage. For 15-year mortgages, the break-even point is at least 60 months. For taxpayers with lower marginal tax rates, the break-even point creeps slightly upward.

For immediately deductible points, the marginal tax rate has virtually no effect on the break-even point. However, the term of the mortgage does have some effect. Shorter-term mortgages have a higher break-even point.

B. Ratably Deductible Points

As shown in tables 3 and 4, for ratably deductible points, the results are different. For taxpayer with a marginal tax rate of 35 percent, the break-even point is 88 months on a 30-year mortgage and 110 months on a 15-year mortgage. Interestingly, the break-even point declines as the marginal tax rate declines. For taxpayers with a marginal tax rate of 25 percent, the break-even point on a 30-year mortgage is 77 months; on a 15-year mortgage, it is 91 months.

For ratably deductible points, the marginal tax rate has much more effect on the break-even point. Also, the term of the mortgage has a more dramatic effect when the points are ratably deductible.

If mortgage rates change, the results for tables 3 and 4 would change. If mortgage rates increase, the break-even point would increase for the situation in which points are ratably deductible. For immediately deductible points in tables 1 and 2, the results would be relatively insensitive to a change in mortgage interest rates.

V. Summary and Conclusions

The decision to pay points in exchange for a decrease in the base interest rate depends on several factors. In the current mortgage rate environment, for immediately deductible points, taxpayers should pay points only if the expected holding period is at least 55 months on a 30-year mortgage or 60 months on a 15-year mortgage.

For ratably deductible points, the expected holding period should be even higher. For taxpayers with lower marginal rates of 25 percent, the minimum holding period should be at least 77 months on a 30-year mortgage or 91 months on a 15-year mortgage. If the expected holding period is less, the taxpayer should avoid paying points. At higher marginal tax rates of 35 percent, the minimum expected holding period should be at least 88 months on a 30-year mortgage and 110 months on a 15-year mortgage.

[4] *See, e.g.*, http://www.moneycentral.msn.com/loan/loanres.asp.

Several assumptions underlie those results. The marginal tax rate is assumed to be constant and does not change. Based on published mortgage rate advertisements, it is assumed that paying one point will reduce the base interest rate by 0.25 percent. To make the decision to pay points, the taxpayer must estimate the expected holding period of the mortgage. Finally, as in all tax and financial planning decisions, it is assumed that the tax laws for deductibility of mortgage interest and points will not change.