The Business Library — Resource Report #24

Financings: Impact of Points on Your Total Mortgage Costs

Personal, Business, and Investment Properties

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Personal, Business, and Investment Mortgages

Definition: Points and origination fees are simply extra fees charged on a loan by a lender to increase the rate of return on that loan and to recapture the costs of processing and administering the loan. Generally, each point represents 1% of the borrowed amount. For example, two points on a $100,000 loan represent $2,000. An origination fee, if charged, usually is equal to one point. These extra costs are usually paid upfront when the loan is made.

* * *

If one or more points are being charged by the lender on a new or refinanced mortgage, you want to know how those points affect your overall or *effective* interest rate, i.e., the real cost of the mortgage loan. This is particularly important if a mortgage is repaid (or prepaid) in the first three to five years after the loan is made. Then the cost of the points is, in effect, amortized (written off) over the shorter period the loan is outstanding, i.e., from the date of the original loan to the date of repayment or refinancing.

Calculating effective interest rates is especially important if you have two or more offers from different lenders because you will need to evaluate those offers on the basis of their *effective* interest rates, not their *stated* interest rates, to make a valid comparison.

Illustration of Mortgage Loan

For example, if 4 points ($4,000) are charged on a 7%, $100,000, 25-year mortgage on your home, the effective interest rate is 7.46% over the full term of the mortgage. However, if that mortgage is repaid in three years (say you buy another house), the effective interest rate increases to about 8.5%. Basically, you take the $4,000 in points and divide by three years for an extra annual cost of $1,333. That's in contrast to a 25-year loan, where the points are spread over 25 years for an annual cost of $160 — $4,000 points divided by 25 years.

To help you compute the effective *cost of points*, the table on the next page was prepared by Steve Hopfenmuller, CPA and Tax Editor of *The Business Library*. It illustrates the impact of points on the actual interest rate you are paying on fixed-rate, 25-year mortgages. It is designed to help borrowers who are wondering whether they should trade a lower number of points for a higher interest rate (or vice versa). The numbers reveal, for example, that a 7% mortgage with a payment of 4 points (effective interest rate of 7.46%) is comparable to a 7.25% mortgage with a payment of 2 points (effective interest rate of 7.48%). Both loans are virtually identical to lenders, but they have quite a different impact on borrowers.

Effective Interest Rates for 25-Year Mortgages

Contract	Points at Closing			
Interest Rate	One	Two	Three	Four
5	5.10	5.20	5.30	5.40
5.25	5.35	5.45	5.55	5.65
5.50	5.60	5.70	5.81	5.91
5.75	5.85	5.96	6.06	6.16
6	6.11	6.21	6.32	6.43
6.25	6.36	6.47	6.58	6.69
6.50	6.61	6.72	6.83	6.95
6.75	6.86	6.97	7.09	7.20
7	7.11	7.23	7.34	7.46
7.25	7.36	7.48	7.59	7.71
7.50	7.61	7.73	7.85	7.97
7.75	7.87	7.98	8.10	8.23
8	8.12	8.24	8.36	8.48
9	9.12	9.25	9.38	9.51

Fractional points: If the points charged fall between whole numbers (say, between two and three points), you can still obtain the approximate effective cost from this chart. *Example:* If 2½ points are charged on a 7% loan, the effective interest rate is 7.29% (about halfway between the rates for two and three points, i.e., the difference between 7.23% and 7.34%).

Other mortgage maturities: You also can use this table to evaluate 20-year and 30-year mortgages since the effective interest rates are *not* substantially different. For 20-year mortgages, multiply the effective interest rate in the table by 101%; for 30-year mortgages, multiply the effective interest rate by 99%.

Early repayment of mortgage: The points are paid upfront (at closing) and the table on the prior page reflects a 25-year amortization (loan repayment period). As previously indicated, if the loan is repaid early, the effective annual cost can increase substantially since you are amortizing (writing off) the points over a shorter period of time.

Tax Treatment of Points

How long it takes you to recoup points paid at closing is one consideration in evaluating specific loan offers. Another consideration is when and how you claim points as a tax deduction.

For an original mortgage on your primary residence, all points are fully tax deductible in the year paid. For refinancings, the points are written off over the term of the mortgage.

If you own property for business or investment purposes (e.g., you rent property to another individual or family), you also must write off the points over the life of the mortgage. *Example:* Two points on a $100,000, 20-year mortgage on a business or investment property are deductible at the rate of $100 per year ($2,000 divided by 20 years).

Cautions on Property Refinancings

As a general rule, the interest rate difference between your existing mortgage and a refinancing should be at least two percentage points to recapture the upfront costs of a refinancing. Those costs can include points, appraisal fee, loan processing fee, legal costs (including the lender's), mortgage tax, and new title insurance.

After these costs are identified and totaled, ask yourself: Do the points apply to the *total* refinanced amount or just the new money you receive? Is all of the interest tax deductible? (There are limits, particularly for some home and investment financings.) Are you extending the mortgage beyond its original maturity date? (The interest paid beyond that date may not be tax deductible.) Are you likely to buy another home within the next five years? (If so, you may not recapture your refinancing costs.)

Be careful; think twice before replacing a relatively low fixed-interest-rate loan with a new variable rate loan, even if the new variable rate is less than the fixed rate. *A low fixed interest rate is a very valuable asset:* It can't be changed by the lender and you have the comfort of knowing the exact amount of your monthly mortgage payment today and over the life of your mortgage. ☐

References —

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Three points on a 7%, $100,000, 25-year mortgage increase the effective interest rate to 7.34% for the entire 25 years.

Exhibit 1

Before You Refinance, Ask Yourself These Questions

It pays to be prudent when effecting a mortgage financing or refinancing because you probably will be living with its terms for many years.

- Do the points apply to the *total* mortgage amount or just the *new money* you receive?
- Is all of the interest tax deductible? Have I extended the term of the mortgage beyond the maturity date of the original financing? If so, check with your accountant; your interest deductions may be restricted.
- How long will it take for me to recoup the upfront costs of refinancing? Two to four years is excellent.
- Will I be selling the property within the next five years? If so, I may not recapture my upfront refinancing costs.
- Is there a penalty for paying off the mortgage early? If so, how much is it and for how long is it applicable?
- Is the new mortgage assignable to a buyer when I sell the property?
- If I'm electing a variable interest rate, am I willing to live with the possibility that the interest rate could increase substantially? (Remember, the prime rate went to 20.5% in August 1981.)
- Will I need a formal appraisal of the property? If so, how much will it cost and what is the minimum appraisal value to obtain the financing?
- Do I want or need more life insurance to cover the mortgage debt? If so, would I be better off with level term insurance rather than mortgage life insurance, which decreases as the mortgage principal decreases?
- Can I rent the property without the lender's consent? This is a valuable option if I can't sell the property at a good price and I want to hold on to it until the market rebounds.

- Should I consider a home equity loan? It may be less expensive and easier to effect than a traditional mortgage.

- Rather than just refinance the outstanding amount on my existing mortgage, should I use this opportunity to borrow more money at the lower interest rate to consolidate some debt and/or provide extra cash for other uses? ☐

Exhibit 2

Tax Treatment of Points and Closing Costs

Points are loan charges paid by a borrower to a lender. They are considered interest if paid solely for the use of money, and not for the lender's services. Points are *fully* tax deductible in the year paid if:

- the payment of points is an established practice in the area where you received your loan,
- the points are for the purchase of your principal residence,
- the points are computed as a percentage of the principal amount of the debt, and
- your cash investment (e.g., downpayment on the home) is at least equal to the amount of the points.

You no longer have to pay the points with a separate check to deduct them. If the points are added to the loan amount, you can still deduct them, but only if your downpayment and any other cash amounts paid at closing equal or exceed the amount of the points. Even if the seller has agreed to pay you the points as part of your negotiations on the purchase of the property, you are still entitled to deduct the points rather than add the amount to your cost basis.

Closing costs: Other expenses paid in connection with the purchase of a home, such as commissions, legal expenses, application fees, transfer taxes, appraisal costs, and recording fees, are *not* currently tax deductible and become part of the cost (tax) basis of the residence. If you *prepay* a mortgage, any prepayment penalties are fully tax deductible in the year paid.

What about refinancings? Points paid to refinance an existing mortgage are tax deductible over the life of the loan.

What about business, investment, and rental properties? Points paid on both new and refinanced mortgages are tax deductible over the life of the loan. ☐

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This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **30** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

The information in *The Business Library* has helped more than 300,000 business owners, executives, entrepreneurs, investors, and individuals manage their companies and finances better, using several million copies of our reports, manuals, advisories, books, seminar workbooks, and newsletters to guide them in their business and family planning.

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