When To Pay Points

When it comes to comparing interest rates for a mortgage loan, homebuyers often have the option of choosing a loan with a lower interest rate by paying points. Simply put, a point is equal to 1 percent of the loan amount. For example, with a $100,000 loan, one point equals $1,000. Points are usually paid out-of-pocket by the buyer at closing.
Paying points may seem attractive, because a lower interest rate means smaller monthly payments. But is paying points always a good idea? The answer generally depends on how long you plan to stay in the house. Let's look at an example:
Bob and Betty Smith are shopping for loan rates on a $150,000 home. Their bank has offered them a 30 year loan at 7.5 percent with no points. This works out to a monthly payment of $1,049.

However, their bank has also offered them a loan at 7 percent if they agree to pay 2 points (or $3,000). At this lower rate, their monthly payment drops to $998, or a savings of $51 per month.

By dividing the amount they paid for the points ($3,000) by the monthly savings ($51), we see that they will have to own the house for 59 months (or just under 5 years) before they will start to see savings as a result of paying points. If Bob and Betty plan to stay in the house for many years, then paying points could make good sense. But if they see themselves moving to another house in the near future, they'd be better off paying the higher interest and no points. (Note: for simplicity, the above example does not take into account the time value of money, which would slightly lengthen the break-even time.)

Can you deduct points on your income taxes?

In the United States, one side benefit of paying points on a mortgage loan is that they are fully tax deductible for the same tax year as your closing. However, this does not apply to points paid for a refinance loan. For refinances, the IRS requires you to spread out the deduction over the life of the loan. For example, if you paid $5,000 in points for a 30-year refinance loan, you can only deduct 1/30 of the $5,000 each year for 30 years. If you pay off the loan early, though, you can deduct the remaining amount that tax year. As to this page and all pages regarding tax situations, please check with your tax professional.