What are discount points?

A: Points paid to a lender on origination of a mortgage are considered **interest** that is prepaid as it has not yet accrued as earned by the lender. Points essentially buy down the mortgage's interest rate from par for the life of the mortgage. When no points are paid or taken by the lender as a discount on origination of a mortgage, the interest rate stated in the note is the par market rate.

Depending on the purpose for obtaining mortgage funds, points are deductible for income tax reporting, either:

- fractionally throughout the life of the mortgage; or
- entirely in the year the mortgage is originated.

The general tax reporting rule for expensing interest, unless excluded from the rule, is that only the fraction of the points paid which accrues each month over the life of the mortgage, called the *life-of-loan* accrual, may be deducted against that year's income. In the year a mortgage is satisfied by prepayment, any prepaid interest not yet accrued — undeducted points — may then be deducted.

Excluded from the life-of-loan accrued reporting treatment is interest paid on a mortgage which finances:

- the purchase of an owner-occupied primary residence; or
- home improvements made to an owner-occupied primary residence.

The entire amount of points paid on a mortgage funding the purchase of the home you will occupy — not a second or vacation home — is allowed as a personal deduction in the year the mortgage is originated. This immediate deduction applies to all points paid in connection with the mortgage which finances the purchase or improvement of your primary home.

When your lender pays the points as a *discount* or an *add-on* to your mortgage, the points — as prepaid interest withheld by the lender — need to be deducted annually as they accrue over the life of the mortgage.

Your tax preparer knows how to report your points as a personal deduction.