04/03/2007

Are Closing Costs Tax Deductible?

Much is said about the great tax benefits of becoming a homeowner. If you are looking to buy a house soon, you should know that the interest you pay on your mortgage loan will usually be completely tax deductible. That is, each year you can deduct the total amount of interest you have paid on your home loan. Depending on the size and terms of your loan, this could mean a deduction of several thousand dollar deduction each year. Not bad!

Yet, what about any of the other fees associated with the home purchase? Are those pesky upfront closing costs tax deductible? The answer is part of them may be deductible. Closing costs are made up of a laundry list of various charges. They include things like lenders fees, real estate appraisals costs, private mortgage insurance, homeowners insurance, recording fees, title searches and title insurance, as well as many other possible costs.

The unfortunate truth is that most of these fees are not deductible. There are a few exceptions however. These depend on when exactly you buy your house. For example, if you have to pre-pay any mortgage interest as part of your closing costs, that interest will be tax deductible. You may have to prepay if you close on any day other than the first of the month. This is typically the day your future mortgage payments will be due and if your home loan closes on the 15th perhaps, then your lender will require you to prepay interest for the 15 days before the next month begins. Since this is still interest, even though it is included in your closing costs you can deduct it from your yearly tax returns.

If you have to pay pro-rated property taxes, these will also be tax deductible. You pay this when the seller's property tax payment extends into the month you take possession of the home. At closing, you will be charged for the portion of the taxes due for the number of days you were the owner that month. The government then allows you to deduct this pro-rated property tax that year.

And do not forget about mortgage points! These are deductible. This is a percentage of the loan amount that you pay your lender at closing to basically “buy down” your interest rate. If you are purchasing a home, the total amount of loan points are fully deductible for that year's tax returns. If you are refinancing, the points can still be deducted, but the deductions must be amortized or spread out over the course of the loan.

Another exception comes if the property you are buying is a rental or investment property. In this case the transfer taxes that are a part of your closing costs will be deductible. Things like hazard insurance or association dues for rental properties are also tax deductible. Check with your financial advisor for more specifics on the tax benefits related to rental/investment home loans.

So while most closing costs are not deductible, you can still enjoy the great savings that come from mortgage interest and points!