FAQ: Can I Prepay Mortgage Interest and Taxes to Maximize 2009 Deductions?

If you own a home, the interest you pay on your home mortgage may be one of your most valuable tax breaks available each year. The home mortgage interest deduction is a particularly important tax break in the early years of a home loan, when most of a homeowner's payments each month go toward interest. In addition to home mortgage interest, two other valuable home-related deductions include the "points" (also known as loan origination fees or loan charges) associated with the loan as well as your property taxes.

To claim all of these deductions, however, you must itemize. In 2009, you might consider pre-paying a portion of your mortgage interest due in 2010, as well as possibly your real estate taxes, subject to certain limits. Prepaying your mortgage interest and real property taxes can be an effective year-end tax strategy, boosting the value of these tax deductions for 2009.

Mortgage interest and points

You may deduct "qualified residence interest" that you incur on up to $1 million that you borrowed to buy, build, or "substantially improve" your principal and/or a second residence, as long as the debt is secured by the home. You can also deduct interest paid on up to $100,000 of home equity debt incurred for any purpose. Moreover, you can generally deduct late fees and prepayment penalties incurred in connection with your mortgage debt.

Points. Points (also referred to as loan origination fees, loan discounts, discount points, or maximum loan charges) may also be deductible as interest. Points generally represent the cost of borrowing money (and can also include certain charges paid by the seller to a lender for the buyer's mortgage). Points must generally be amortized over the life of the mortgage. However, you may deduct points in full in the year they are paid if:

-- The loan is used to purchase or improve your principal residence;

-- The loan is secured by the residence;

-- The points did not exceed the points usually charged in the area where the loan was made; and

-- The points were computed as a percent of the amount of the loan.

Mortgage interest deduction

Generally, home mortgage interest is claimed as an itemized deduction on your Form 1040, Schedule A (Itemized Deductions). You cannot deduct your mortgage interest if you use Form 1040A or Form 1040EZ, however. If you paid $600 or more of mortgage interest (including certain points and mortgage insurance premiums) during the year on any one mortgage, you will typically receive a Form 1098, Mortgage Interest Statement, or similar statement from your mortgage holder. This is the statement used for reporting mortgage interest received. Your mortgage lender is required to provide you, as well as the IRS, with a copy of the Form 1098 reporting the mortgage interest you paid during the year. You should typically receive the Form 1098 for mortgage interest you paid in 2009 by January 31, 2010.

Pre-paying your January 2010 mortgage interest in 2009

Mortgage interest that you owe for January 2010 is deductible in 2009 if paid in December (by December 31). Typically, home mortgage interest is paid in the month following its accrual. For instance, a January mortgage payment generally pays December's interest. As such, if you pay your January 2010 mortgage interest payment by December 31, 2009, you can deduct your December interest in 2009 rather then in 2010.

Prepaying interest will not reduce the principal on your loan. Paying down the principal may be a better strategy than using the funds to prepay interest. You should also consider paying down debt for which the interest is not deductible (for example, credit card debt). Additionally, you'll need to consider your other itemized deductions for 2009. Our office can help you explore the pros and cons of all these strategies.

To ensure that your prepaid January 2010 mortgage interest payment is reflected on your 2009 Form 1098, you will want to make the mortgage interest payment by mid-December 2009. If you make your mortgage interest payment after your lender's 1098 is calculated, and sent to the IRS, you will have to compute the additional interest yourself and add it to the amount reported on your 1098. As a practical matter, too, some mortgage lenders have a policy, or even a clause in the mortgage note, not to accept any advance payment as a pre-payment. They will often balk at issuing a Form 1098 that states otherwise. Simply picking up the phone and confirming your bank's policy before you move ahead with this strategy is often any easy solution to any uncertainty down the road.

Pre-paying property taxes

You may also want to consider prepaying property taxes. You may be able to prepay your 2010 property taxes by December 31, 2009 if property tax prepayment is allowed by your local tax assessor. You should contact your local property tax collector's office to determine if prepayment is allowed. If your property taxes are collected in escrow by your mortgage lender, remember also that any prepayment of taxes to your lender is not considered a property tax payment for IRS purposes until the lender remits the payment to the property taxing authorities.

Real property taxes are generally claimed as an itemized deduction on Schedule A of your Form 1040. However, a temporary tax incentive for the 2009 tax year allows taxpayers who claim the standard deduction to also claim an additional standard deduction for property taxes, up to $500 individually and $1,000 for married couples filing a joint return.
