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# When to Refinance Your Home

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There are a number of situations in which refinancing a home mortgage makes sense. For example, you may have purchased a home years ago when interest rates were much higher and now want to take advantage of a decline in mortgage rates. In addition, a homeowner with a volatile variable rate mortgage may want to switch to more predictable fixed-rate loan. You may even want to shorten the term of your loan.

## Is Refinancing Worth the Trouble?

Refinancing can be very beneficial, but it is not always the smart thing to do; the costs associated with refinancing must be balanced against any potential savings.

Generally, refinancing a fixed-mortgage makes sense when the interest rate on the current mortgage is at least 2 percentage points higher than the prevailing market rate. In some instances, however, following this “rule” may cost the homeowner a lot of money as a very small percentage point spread may justify refinancing if other factors are present.

## Other Factors Which Must Be Considered

There are a number of factors which must be considered in this “cost vs. benefits” calculation, including:

- **Closing costs:** Possible pre-payment penalties on the old loan, points and fees on the new loan, and attorney fees generally will total 3% to 4% of the loan amount and must generally be paid when the new loan closes. The borrower must consider the loss of earning power of these funds in future income projections.
- **Projected length of ownership:** The closing costs can be spread over the period of the loan; therefore, the longer the projected period of ownership, the smaller the spread between the old and new mortgages can be.
- **Loans in excess of certain limits<sup>1</sup> – Tax Cuts and Jobs Act of 2017 (TCJA):** For 2018 – 2025, mortgage interest on “acquisition” debt on a first and second residence, on total loan amounts of up to \$750,000 (\$375,000 MFS) is generally deductible; interest on debt in excess of these limits is not deductible. Acquisition debt refers to debt incurred to buy, construct, or substantially improve a qualified residence, and which is secured by a qualified home. This dollar limitation applies to debt incurred *after* December 15, 2017.

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<sup>1</sup> The discussion here concerns federal income tax law; state or local law may vary.

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- **Loans in excess of certain limits – before 2018 and after 2025:** Prior to the TCJA, a taxpayer could generally deduct the interest paid on total acquisition debt on two homes of up to \$1,000,000 (\$500,000 MFS). Additionally, interest on up to \$100,000 (\$50,000 MFS) of “home equity” debt could also be deducted. Home equity debt is debt which does not qualify as acquisition debt, but which is secured by a qualified home. Under the TCJA, deductibility of interest on up to \$1,000,000 of acquisition debt and up to \$100,000 of home equity debt is scheduled to return for 2026 and later years.

### The New Mortgage - Variable Rate vs. Fixed Rate

VARIABLE RATE	FIXED RATE
<ul style="list-style-type: none"><li>• Initially lower interest rate than with a fixed rate loan, but will increase if interest rates go up or decrease if interest rates go down.</li><li>• Most variable rate mortgages have a limit or a cap on annual rate increases and on lifetime increases.<sup>1</sup></li><li>• Usually preferred for short-term ownership of home; e.g., 2 - 3 yrs.</li></ul>	<ul style="list-style-type: none"><li>• Rate does not change if interest rates go up or down.</li><li>• Best for owners with a fixed income or those who plan to stay in their home for several years.</li><li>• Rates and monthly payments are higher than with a variable loan, at least in the early years.</li><li>• Fixed rate loans may not be assumable.</li></ul>

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<sup>1</sup> Be certain that an annual cap is part of the loan, and carefully examine the index to which the rate is tied.

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### How Many Months Will It Take to Break Even?

The real cost of refinancing is the closing costs. Determine how many months it will take to make up these costs from the savings under the new loan.

$$\frac{\$}{\text{Old Payment}} - \frac{\$}{\text{New Lower Payment}} = \frac{\$}{\text{Monthly Savings}}$$

$$\frac{\$}{\text{Closing Costs}} \div \frac{\$}{\text{Monthly Savings}} = \frac{\text{Number of Months to Break Even}}{\text{to Break Even}}$$

Refinancing an old home loan could mean lower monthly payments and perhaps changing from a variable rate mortgage to a fixed rate mortgage. However, if the projected time in the house is short, the closing costs may consume any potential savings.

As an additional alternative, if one plans to sell in a year or two, a variable rate mortgage with an initially lower rate may be advantageous.