PRORATIONS

Understanding Prorations

Proration is defined as the act of dividing property taxes, interest, insurance premiums, rental income, etc., between buyer and seller proportionately to time of use or the date of closing. In a typical sale/purchase closing, the item most routinely prorated is the ad valorem taxes for that year. Since ad valorem taxes are paid at the end of the year in which they are due (they can be paid as early as October 1st or as late as January 31st of the next calendar year without penalty in most Texas counties), any closing taking place before October 1st will generally show a charge to the seller from January 1st to the closing date and a credit to the buyer for the same period. Unless negotiated otherwise, this allows the seller to pay taxes for the time that he or she actually had ownership, use and enjoyment of the property. Around October 1st, tax notices will be sent to the new owners for the year. They will be expected to pay taxes (usually through their mortgage company escrow account) for the full year. Taking into account the credit that they received at closing, the new owners actually pay taxes only for the time during which they had ownership, use and enjoyment of the property. Title companies use the best information available when prorating taxes prior to October 1st (when official figures are released by tax authorities). This best-available information is usually the tax amount paid for the prior year.

In closings that occur after official tax figures are released (generally October 1st), title companies will normally charge each party their pro rata tax amount and pay the taxing authorities directly. This allows title companies to insure that taxes have been paid when issuing their mortgage title policies.

Loan assumptions usually involve several prorations, such as taxes, interest and escrow accounts. Most hazard insurance companies do not allow existing policies to be assumed. Consequently, the buyers must provide and pay for a new policy at the closing. The seller can cancel his or her policy after the closing and receive a refund of the unearned premium directly from their local insurance agent.

A loan assumption closing involving prorations is usually handled in the following manner. The escrow account is purchased by the buyer and credited to the seller. The account must be "sufficient" at the time of transfer (any shortages must be collected from the seller and added to the existing balance). Unless negotiated otherwise, the tax proration is handled in the same way. Interest on the mortgage must also be prorated at the time of closing. Since interest is paid in arrears (a May payment covers April interest), the buyer is usually credited with the interest from the first of the month in which the closing occurs to the closing date; the seller is charged with this same amount. For example, if a closing occurs May 21st, the buyer's first payment will be due June 1st. The June payment covers interest for the month of May, so the buyer is reimbursed for the time the seller still had ownership and use of the property (from May 1st to May 21st).

This discussion assumes that the buyer will take possession of the property at closing. Obviously, if a buyer is allowed to take possession of the property prior to the actual closing, the contract should reflect this fact and stipulate whether or not the proration date is changed accordingly. The title company will always follow any specific requirements and instructions the contract contains regarding prorations.