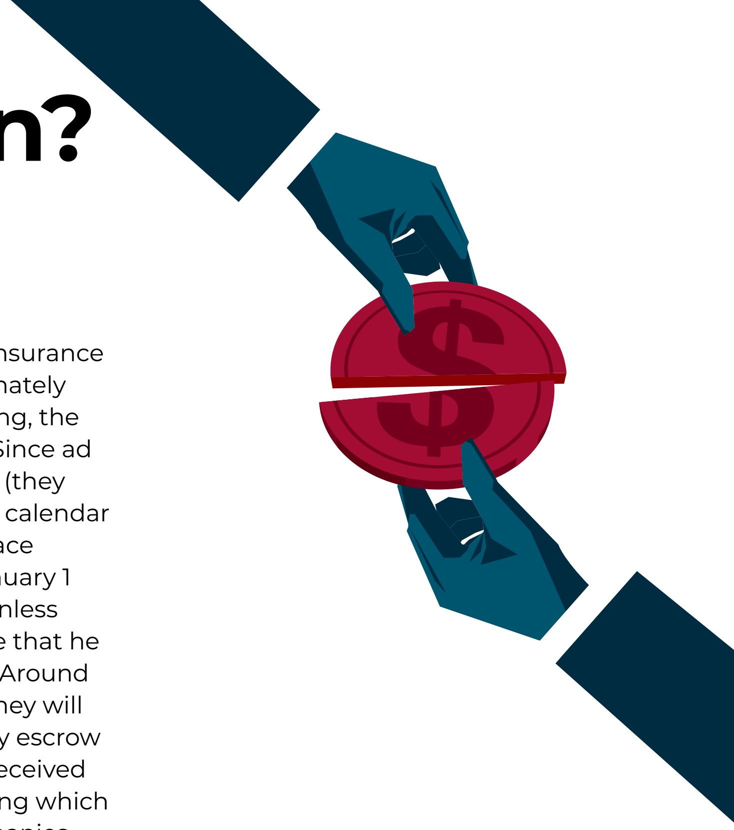
What Is Proration?

And How Does It Work?



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 1 or as late as January 31 of the next calendar year without penalty in most Texas counties), any closing taking place before October 1 will generally show a charge to the seller from January 1 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 1, 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 1 (when official figures are released by the 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 1), 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 mortgagee 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 the policy after the closing and receive a refund of the unearned premium directly from their local insurance agent.

How a Loan Assumption Closing Involving Proration is Handled

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 21, the buyer’s first payment will be due June 1. 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 1 to May 21).

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. Whenever the contract contains specific requirements regarding prorations, the title company will follow the instructions of the contract.

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