Do You Face Foreclosure on Your Home?

If you are one of millions of homeowners unable to pay the mortgage debt on your home, you may be facing what is called 'foreclosure,' the process by which a bank or other lender seizes your home to pay off the debt. Foreclosure is governed by state law, so you will need to become familiar with the laws in your state. Typically, the lender must wait a certain period of time (during which you are not making payments on the loan) before serving you notice of default.

With certain types of loans, known as 'recourse' loans, the lender will have the legal right to garnish your wages or take assets other than your home to satisfy the debt. With such loans, the lender could foreclose on your home, sell it to recover the debt, and then seize other assets if some debt remains outstanding.

However, with other kinds of loans and under some state laws, the lender can recover only the amount of money received through the sale of the home itself. That is, the lender can sell your home, but cannot seize any other assets. If your loan is secured this way, with only the home as security on the debt, it is called a 'non-recourse' loan.

Recourse Loans and Cancellation of Debt Income

If you have a 'recourse' loan and the lender wishes to foreclose on your home, the lender can do one of two things, after all legal requirements for foreclosure have been satisfied:

- forgive the remainder of your debt, or
- seek to collect the remainder of the debt from your other assets, such as wages.

If your lender forgives the mortgage debt, or a portion thereof, the amount forgiven is considered income to you, and is therefore taxable by the IRS. You will receive a tax form called 'Cancellation of Debt,' Form 1099-C, which lists the amount of debt that is being cancelled on line 2 of the form. Information on the IRS website (http://www.irs.gov/newsroom/article/0,,id=174034,00.html) answers questions about the process of foreclosure and debt cancellation.

When Cancellation of Debt is Not Income

As described further below, there are four circumstances in which your cancelled debt may not be considered taxable income by the IRS:

- If the debt is "qualified principal residence indebtedness;
- If you are bankrupt;
- If you are insolvent;
- If the debt is non-recourse.

Qualified Principal Residence Indebtedness

If the debt was used to acquire your principal residence, an amount up to $2 million may be discharged between January 1, 2007 and December 31, 2012 without tax consequences. You will have to reduce your tax basis in your home by the amount forgiven.

Bankruptcy

If you are in bankruptcy, your cancelled debt will not be income if it is discharged by the court overseeing the bankruptcy proceedings or pursuant to a plan approved by the court.

Insolvency

You are insolvent to the extent your liabilities exceed the fair market value of your assets. You can reduce your taxable cancellation of debt income by the extent of your insolvency.

Non-recourse Debt

As explained above, if money is lent on a non-recourse basis, the lender is limited to recovering the amount of the debt from the asset that secures it. Several states, by law, make mortgages for purchase of a principal residence a non-recourse loan.

If your mortgage debt is non-recourse, and the amount of forgiven debt is more than what you paid for the house, you may still be treated as having taxable income. You should consult your lawyer or a tax advisor for further information.