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FAQ and information

## Home Foreclosure and Debt Cancellation: FAQ and information

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### **What is Cancellation of Debt?**

If you borrow money from a commercial lender and the lender later cancels or forgives the debt, you MAY have to include the cancelled amount in income for tax purposes.

The lender is usually required to report the amount of the canceled debt to you and the Internal Revenue Service (IRS) on Form 1099-C.

### **Is Cancellation of Debt always taxable?**

Not always. The most common situations when Cancellation of Debt is not taxable involve:

1. Bankruptcy – Debts discharged through bankruptcy are not taxable.
2. Insolvency – You are insolvent when your total debts are more than the fair market value of all your assets. If you can show to the IRS that at the time the lender canceled the debt you were insolvent, the Cancellation of Debt is not taxable.
3. Non-recourse Loan – A non-recourse loan is a loan for which the lender's only remedy is to repossess the property financed or used as collateral. Forgiveness of a non-recourse loan resulting from a foreclosure does not result in cancellation of debt. However, it may result in other tax consequences.

### **Foreclosure tax consequences**

#### **First: Taxable Cancellation of Debt income**

If the lender forgives any portion of the mortgage owed this may have income tax consequences, unless the you qualify for one of the three above mentioned exemptions (Bankruptcy, Insolvency, or Non-recourse Loan)

## Second: Reportable gain from the disposition of the home

Foreclosure is treated as a sale of the home for tax purposes. Congress enacted a law, which offers up to \$250,000 (\$500,000 if married) tax-free sales home profits. To qualify, the seller(s) must have owned and occupied their principal residence an “aggregate” two of the five years before the home sale or foreclosure. Occupancy need not be continuous.

If you do not meet the residency requirement, you may still exclude all or part of the gain if the foreclosure was by reason of health, change of employment, or unforeseen circumstances.

**Example.** A borrower bought a home in August 2005 and lived in it until it was taken through foreclosure in September 2007. The original price was \$170,000, the home is worth \$200,000 at foreclosure, and the mortgage debt canceled at foreclosure is \$220,000. At the time of the foreclosure the borrower has total liabilities totaling \$250,000 and assets totaling \$230,000.

### Cancellation of Debt:

Mortgage prior to foreclosure	220,000
Fair market Value	200,000
Cancellation of Debt	<b>20,000 income</b>

### Insolvency:

Total Liabilities	250,000
Total Assets	230,000

Since the borrower has more liabilities than assets, the borrower is insolvent and the \$20,000 of Cancellation of Debt is nontaxable.

### Gain

Fair Market Value	200,000
Purchase Price	170,000
Total Gain	<b>30,000 capital gain</b>

Borrower has \$30,000 of gain. However, the gain is not taxable because the borrower lived in the home for more than 2 years.

## How can Legal Aid Service of Collier County (LAS) help?

LAS provide Controversy Resolution to income-eligible taxpayer of Collier County. To be eligible

the amount in controversy must not exceed \$50,000 for any taxable year and your current income cannot exceed 250% of federal poverty guideline.

To find out if you are eligible, call us at

- Naples Office (239) 775-4455
- Immokalee Office (239) 657-7442

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