Tax implications of a home foreclosure

Many homeowners in North Dakota have suffered various degrees of damage to their homes because of the flooding and weather-related disasters in North Dakota. Some of them are facing difficult decisions on whether to fix or rebuild, sell, or simply walk away from their homes. Their difficult situations are compounded by outstanding mortgages that still have to be paid. Questions have arisen about the tax implications of walking away and letting a home go into foreclosure. Following is a general overview of the federal and North Dakota income tax implications of a home foreclosure.

There are two possible federal income tax consequences associated with a home foreclosure. A homeowner may have one or both of the following:

Taxable income from the cancellation of the outstanding mortgage debt.
Taxable gain from the sale of the home.

Taxable income from the cancellation of the outstanding mortgage debt

When a homeowner takes out a mortgage on a home, the amount of the money borrowed is not considered income that is subject to federal income tax because the homeowner is obligated to pay the money back to the lender. However, if a lender cancels or forgives part or all of the homeowner’s obligation to repay the loan, the cancelled portion of the outstanding debt may or may not be taxable income depending on whether it is a recourse debt or a nonrecourse debt.

A recourse debt is one where the homeowner is personally liable for payment of the debt. This means that, in addition to the home serving as collateral for the debt, the lender also has recourse against the debtor's other personal assets for satisfying the debt.

A nonrecourse debt is one where the homeowner is not personally liable for payment of the debt, in which case the home serves as collateral for the debt and the lender has no recourse against the homeowner's other personal assets. If the debt is a nonrecourse debt, the cancelled portion of the outstanding debt is not taxable income to the homeowner. Under North Dakota property law, home mortgages are generally treated as nonrecourse debts, and therefore the cancellation of an outstanding home mortgage debt generally does not create taxable income for the homeowner for federal income tax purposes.

Although cancellation of an outstanding home mortgage in North Dakota generally does not create taxable income, a foreclosure of a home could create a taxable gain from the sale of the home by the homeowner—see the next section.

Taxable gain from the sale of the home

A home foreclosure is treated as a sale (or, more technically, a disposition) of the home by the homeowner for federal income tax purposes. When property is disposed of by a taxpayer, the taxpayer calculates any gain or loss on the transaction by subtracting what is called the property's "tax basis" from the selling price. If the selling price is more than the property's tax basis, there is a gain. If the selling price is less than the property's tax basis, there is a loss.

The selling price in the case of a foreclosure also depends on whether the home mortgage debt is a recourse debt or a nonrecourse debt. Because home mortgages in North Dakota are generally nonrecourse debts, the selling price generally equals the outstanding loan balance immediately before the foreclosure. The tax basis of a home generally equals its purchase price plus any major improvements.

A gain on the disposition of property is generally taxable for federal income tax purposes. However, in the case of the disposition of a home, part or all of the gain may be excluded from income if the homeowner qualifies for the principal residence exclusion. If the home was the homeowner's principal residence for two years out of the five-year period ending on the date of the foreclosure, the homeowner may exclude up to $250,000 ($500,000 for married persons filing a joint return) of the gain from income.

A loss on the disposition of a home is not deductible by the homeowner.

Additional information

More detailed information and examples on the federal income tax treatment of a foreclosure is available on the Internal Revenue Service's web site. In particular, check out the information entitled Home Foreclosure and Debt Cancellation, where additional links to other pertinent information are provided.

North Dakota income tax implications

For North Dakota income tax purposes, any income or gain recognized on a foreclosure of a home is treated in the same manner as for federal income tax purposes. Because federal taxable income is the starting point in calculating an individual's North Dakota taxable income, any income or gain from a foreclosure that is included in federal taxable income is automatically included in North Dakota taxable income. Similarly, if no income or gain is included in federal taxable income, none is included in North Dakota taxable income.

Seek professional assistance

The information provided on this web site, or any other web sites referred to, is for informational purposes only and is not intended as a substitute for professional legal or tax advice. Homeowners are strongly advised to seek professional legal or tax advice for assistance with their personal tax matters. The information provided here is general in nature and is only intended to make homeowners aware that there may be federal income tax implications associated with a foreclosure. There are exceptions to these general rules, which are dependent on each homeowner's facts and circumstances. Therefore, the information provided on this web site may not be applicable to or suitable for every homeowner's specific circumstances or needs.