

BANKRUPTCY BEAGLE

SNIFFING OUT THE BEST FREE AND LOW COST INFORMATION ABOUT BANKRUPTCY.



If I Settle My 2nd Mortgage After Bankruptcy, Will I Owe Tax?

Question:

I filed bankruptcy Chapter 7 bankruptcy in 2008 and received a discharge. My 2nd mortgage was included in my bankruptcy and not reaffirmed. I have been paying interest only from that time but due to personal issues, I am trying to do a settlement with the bank; at this time they have put in for the approval. My question is what I would have to pay in taxes; at tax bill might make it unaffordable to settle my 2nd mortgage.

Answer

If a 2nd mortgage *loan* is discharged in bankruptcy (and not reaffirmed), it remains so forever. There are no tax consequences if the 2nd mortgage is later settled. The 2nd mortgage *lien* remains against your home until released one way or the other. If you later settle the 2nd mortgage after bankruptcy to remove the *lien*, there is no forgiven debt income tax liability because the *loan* was discharged in a prior bankruptcy.

Normally, a settled debt is subject to what the IRS refers as forgiven debt income tax liability. For example, let's say you owe a bank \$10,000, and the bank later agrees to accept \$4,000 as a full accord and satisfaction of that debt; the IRS considers the unpaid \$6,000 portion of that debt income because you received money and did not pay it back. As such, you would be liable to pay income tax on that \$6,000.

However, discharging a debt in bankruptcy is an exception to *paying* forgiven debt income tax. In essence, bankruptcy is one, giant, forgiveness of debt. But, the bank does not voluntarily forgive the debt; the bankruptcy, by operation of law, discharges debt. As a result, no tax burden.

About Bankruptcy Beagle:

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The bankruptcy discharge is permanent. So, no matter what you do in the future with regard to the debt, you cannot revive the discharged debt. So, with a 2nd mortgage, if you later settle that debt to deal with the lien, there is still no income tax consequence.

Note: you may still receive a 1099-C from the lender after you settle. Don't worry, that doesn't mean you *owe* tax; a 1099-C is merely a reporting document. All you will need to do is file IRS form 982 with your taxes to deal with the 1099-C.

A 2nd mortgage discharged in bankruptcy (and not reaffirmed) that is later settled to remove the lien, will not give rise to forgiven debt income tax liability.

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