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What Is A Deed-In-Lieu?

There are unprecedented numbers of families faced with the possibility of foreclosure. A foreclosure-in-the-making situation looks something like this: you are financially strapped, have missed consecutive monthly mortgage payments, and have been unsuccessful in trying to sell your home to repay your loan.

If you are at the point of being willing to give up your home, but want to avoid foreclosure, you should be aware of two other options: short sale and deed-in-lieu of foreclosure transactions. You will still lose your home and negatively impact your credit rating by implementing either of these options, but they may be less painful than foreclosure (see our articles "What is Foreclosure?" and "Avoiding Foreclosure Scams").

Short Sale vs Deed-In-Lieu

The difference between a short sale and a deed-in-lieu of foreclosure transaction is determined by who is responsible for selling the property. In a short sale, you will be responsible for selling your house at a fair market value, even if it is less than the amount you owed on the mortgage. In exchange, the lender agrees to forgive the remainder of your loan.

In the deed-in-lieu of foreclosure transaction, you first give ownership of your property to the lender (with the lender's written consent) and the lender then assumes full responsibility for selling the house. Similar to a short sale, the lender will typically agree to forgive the remainder of your loan.

Short of filing for bankruptcy, which will delay but not stop foreclosure, a deed-in-lieu of foreclosure may be a good option for getting your finances back on track. A deed-in-lieu of foreclosure allows you sign over legal ownership to your home in exchange for the lender's agreement not to foreclose and to forgive the remainder of your debt. You may even receive more generous terms from the lender than you would in a formal foreclosure.

Better in the Long Run

A deed-in-lieu of foreclosure also might help your chances of getting another mortgage loan in the future, and it will definitely help avoid the lengthy legal process of foreclosure. Although it has a negative impact on your credit rating, deed-in-lieu of foreclosure is probably less harmful than a foreclosure.

The advantages to the lender include: the ability to receive title to the property immediately instead of having to wait for months for the foreclosure process to complete; significant financial savings on court costs and lawyers' fees; and, it enables them to resell the property so they can recoup some of their investment.

Before approving a deed-in-lieu of foreclosure transaction, the lender will require that your home be put on the market (listed with a real estate agent) for at least 30 days (three months is typical) and that there are no other liens on the property. Lenders would prefer that you sell the property rather than they assuming responsibility to sell it.

If you foresee, or are experiencing problems making your mortgage payments, contact a nonprofit organization that can help you negotiate with your lending institution.

What Will Happen?

The process for approving a deed-in-lieu foreclosure looks something like this. Both you and the lender will sign two legal documents, an agreement and a deed (warranty, quit claim, or a grant). The agreement describes the terms and conditions of deal including: a promise by the lender not to initiate foreclosure proceedings; a promise to terminate any existing foreclosure proceedings; and a promise to forgive any deficiency (the amount of the loan that isn't covered by the sale proceeds) that remains after the house is sold. The deed, gives legal ownership of the property to the lender.

The lender then confirms that your loan is "paid in full" and gives you two forms: One states that your debt is canceled; the other refers to the waiver of the right to a deficiency judgment (the lender's right to ask for the unpaid debt amount if it is not recovered totally by the sale of the property).

Taxable Income?

It is possible that a deed-in-lieu of foreclosure may generate taxable income based on the amount of your "forgiven debt. In other words, you might have to pay income tax on the amount of money remaining on your loan that was forgiven by the lender.

Here is why: You did not owe taxes on your original load because you were required to repay the loan (it was not a "gift"). However, when you agreed to not repay the entire amount of the loan, and the remainder of the debt was forgiven, the amount that was forgiven becomes "income" on which you owe tax.

The IRS is notified of this when the lender sends it IRS Form 1099C, which reports the forgiven debt as income to you.

However, there may be help. The Mortgage Debt Relief Act of 2007 generally allows taxpayers to exclude income from the discharge of debt on their principal residence. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for the relief.

This provision applies to debt forgiven in calendar years 2007 through 2012. Up to $2 million of forgiven debt is eligible for this exclusion ($1 million if married filing separately). The exclusion does not apply if the discharge is due to services performed for the lender or any other reason not directly related to a decline in the home's value or the taxpayer's financial condition