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Divorcing When Your Home Is Drowning in Debt

Divorce can be one of the most emotionally challenging ordeals a person can go through. And in these economic times, more and more divorcing couples are having to deal with the added stress of dealing with a house whose mortgage exceeds the current value of the property, a situation often referred to as being "underwater."

If you or someone you know is struggling with the compound problem of divorce and an underwater property, there are some avenues you can take to help relieve, or at least reduce, your problems. Ideally, you and your partner are going to be able to amicably come to an agreement without the need for litigation. However, if no agreement is made, the court will get the final opinion, and it might not be the most favorable.

"If you are getting a divorce, you need to come to a conclusion of what you can do in a unified fashion," says Sari Friedman, a divorce attorney in New York. "Once you go into divorce court, you have lost that control."

How Deep Are You?

Before your divorce progresses to the courts, you and your spouse are going to want to first assess the value of your home to gauge just how much debt the two of you may be facing.

"The first step is to get a realistic value on the house," says Daniel Green, an attorney at Begos Horgan & Brown. "You can do that through contacting a reputable realtor in your area."

Greens says couples usually won't need an appraiser unless their divorce leads to litigation, in which case both parties may want to consider hiring their own appraisers.

Next, couples should assess what liens may be on the property and how much these liens total. From here, you can determine whether your house is technically underwater and by how much.

Should You Stay or Should You Go?

Once you determine that your house is worth less than the mortgage, you need to determine whether you would like to keep the property or get rid of it. There are a number of reasons why someone may want to keep an underwater property, particularly if the couple has school-age children together.

"The question is what do you do with the underwater house," Green says. "Do you try to hold on to it? Do you have children in school and you want to keep them in the same district?

How to Walk Away

If you and your spouse decide it is in your best interest to relieve yourself of your underwater property, you have several options. One option to relieve yourself of your property is to put it on the market and conduct a short sale. While you and your spouse will relieve yourself of the majority of your debt obligation, you will still have to deal with the remaining debt that the sale does not cover.

"Lenders are loath to take ownership of the property," Green says. "They aren't anxious to start foreclosure, so they may let you list a property for sale. If the buyer then offers an amount less than the amount of the loan, the bank can release the lien in exchange for a payment on the balance owed that is less than the mortgage debt."

Deciding how much each spouse pays on the remaining debt can be negotiated amicably between the two parties outside of court. However, if the issue is put before a judge, the court may make the decision to split the debt equally.

"Usually if the partners owned the house equally, they could argue the debt is split evenly between the two," Friedman says. "But you could argue that one spouse is more of a money spouse and should pay more. However, this may not be true after you take into account any support that spouse may be supplying."

Foreclosure is another option for a couple. However, for many this is a less favorable option given the credit implications it can have on both parties.

Whether you decide to go with a short sale or a foreclosure, you and your spouse may suffer certain tax implications. Specifically, the IRS has long considered the amount of cancelled debt on either a short sale or a foreclosure as taxable income.

"In the confines of the divorce, the parties can come to an agreement as to how much each party will bare of the tax consequences of the cancelled debt," Green says. "If they can't make an agreement, the court may issue an award that either spouse must bare a certain percentage of tax liability."

Green says the court may look at the financial circumstances of each party to determine the tax liability or, depending on the state, factor in the causes of the breakdown of the marriage.

Changes in the law may offer some divorcing couples a degree of tax relief. Specifically, the Mortgage Forgiveness Debt Relief Act of 2007 allows married couples filing jointly to exclude a certain amount of cancelled mortgage debt from their taxable income. However, certain stipulations do apply, including the fact that these funds must have been used to buy, build or improve the couple's primary residence.

"This leads to another factor that your lawyer will certainly want documentation for, which is what was the borrowed money used for and do you have records to prove that," Green says.

Even if you are dealing with unique tax and home issues, most experienced divorce lawyers should be able to assist you through the divorce process. However, you may also want to additionally hire the services of a financial advisor or a tax planner.

"People who are getting divorced and own a house need good legal and financial advice because there are many possible strategies and which one is most effective for you will depend on a number of circumstances," Green says.