Trapped by Forgiveness: Taxing COD Income

By Kiran Sheffrin

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In this article, Sheffrin discusses the student loan debt crisis and problems with the current proposals for reform. She identifies two ways that the tax treatment of forgiven student loans can be used to achieve policy goals: partial recognition of cancellation of indebtedness income based on a household's ability to pay, and spreading the payment of amounts owed over a fixed number of years.

Introduction

The ongoing student debt crisis produces headlines in nearly every news cycle, and the topic is frequently discussed by students and scholars alike. Rising tuition costs and a sluggish job market exacerbate the problem as students are pressured to pursue graduate degrees, ultimately pushing them deeper into debt. There seems to be a general consensus that the student loan system needs reform. That landscape, however, is very complex, and its endless chain of acronyms (for example, LRAP, FFEL, ICR, IBR, PAYE, PLUS) resembles a vocabulary lesson more than the basis for a policy discussion. Proposed reforms offer a variety of sometimes competing solutions: debt forgiveness after 20 or 25 years with no tax consequences, preservation of unlimited tax-free debt forgiveness for public servants, and hard caps on the total amount of debt forgiveness available. Even the overall goal of reform is unclear; some want to use the student loan policy debate to lower the cost of higher education, while others argue that any debt forgiveness only drives tuition costs higher.

Much of the dialogue regarding the issue focuses on fair and equitable refashioning of repayment plans or on finding the optimal level of loan forgiveness. The tax consequences of those repayment plans, particularly the taxation of the forgiven debt — generally known as cancellation of indebtedness (COD) income — is often relegated to a footnote. Student-focused websites and informational materials warn that some types of loan forgiveness can result in a large tax bill, but most of the intellectual discourse and policy discussions do not comprehensively address the tax angle. Any meaningful reform must consider the tax consequences of debt forgiveness for student borrowers. The focus of this article is the treatment of COD income resulting from the forgiveness of student loans.

The Student Debt Crisis

The Department of Education recently reported that the number of those participating in loan forgiveness programs rose 40 percent in the last six months, an increase of 1.3 million people owing $72 million.[1] The Brookings Institution reported that the total outstanding balance on student loans exceeds $1 trillion.[2]

There is considerable disagreement regarding the policy on student loan repayment and forgiveness plans. Some groups advocate a more generous system for student debtors, while others want to focus the attention on the government's serious financial commitment to the plans. For example, Brookings estimated that with universal participation, the most popular loan repayment program, Pay As You Earn (PAYE), will cost taxpayers more than $14 billion annually.[3]

Many of the proposals for student loan reform include total tax-free treatment or nonrecognition of COD income after 10, 20, or 25 years for all students. Currently, nonrecognition of COD income is offered only to those who work in public service for 10 years. Some politicians emphasize that the system provides an incentive for students who want to work in underserved communities but are concerned about taking on crushing amounts of student debt.[4] Others argue that it actually encourages students to overborrow and ultimately contributes to the rising cost of higher education.

Current Repayment and Forgiveness Plans

The standard repayment plan requires a fixed payment per month for up to 10 years. A graduated

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[1] Josh Mitchell, ''Federal Plans That Forgive Student Debt Skyrocket,'' *The Wall Street Journal*, Apr. 21, 2014.

[2] Beth Akers and Matthew M. Chingos, ''Student Loan Safety Nets: Estimating the Costs and Benefits of Income-Based Repayment,'' Brookings Institution, Brown Center on Education Policy, Apr. 14, 2014, at 4.

[3] Akers and Chingos, *supra* note 2, at 19; Mitchell, *supra* note 1.

[4] *Id*.

repayment plan allows lower initial monthly payments, which gradually increase over 25 years. An extended repayment plan offers more flexibility, as a student can either make fixed or graduated monthly payments over a term of 25 years.

Income-based repayment (IBR) caps monthly payments at 15 percent of discretionary income, and a student is eligible for full forgiveness of the loan balance after 25 years.[5] PAYE is a relatively new plan, also income-based, that caps monthly payments at 10 percent of a student's discretionary income, with total loan forgiveness after 20 years.[6] To qualify for PAYE, the borrower must show ''partial financial hardship,'' meaning that the monthly payment under a standard 10-year repayment plan would exceed the payments under IBR. Once a borrower qualifies for PAYE, she can continue to use the plan and make low monthly payments for the full 20 years, regardless of her future financial situation. Under IBR or PAYE, any loan balance that is forgiven at the end of the term is generally considered taxable COD income to the borrower. Both programs, however, provide for nonrecognition of that COD income for borrowers who have worked for 10 years in a qualified public interest job serving underserved communities.

IBR and PAYE allow the student to calculate her monthly payments based on her individual income rather than as a household. Discretionary income is calculated using a borrower's adjusted gross income exceeding 150 percent of the poverty level.[7] In 2014 the poverty level for a single person is $11,670.[8] Therefore, a borrower earning $40,000 per year will have a monthly payment of $187 under PAYE. If a borrower makes 240 monthly payments (over 20 years), the total amount repaid, not accounting for interest, would amount to less than $45,000, and any remaining balance would be forgiven. Again, that forgiven amount is considered income, taxable at the borrower's marginal tax rate.

Tax Treatment of Loan Forgiveness

Typically, when a debt is forgiven, that amount must be included in gross income in the year it is forgiven.[9] There are situations, however, when the taxpayer is allowed to exclude it. A prominent example includes the exclusion for some forgiveness of mortgage debt. When Congress exempts borrowers from the recognition of COD income, it is offering them preferential tax treatment. There are many policy rationales for that treatment, mostly based on tax fairness principles such as ability to pay, horizontal equity, simplicity, and fairness. Because exceptions to recognition of COD income have considerable economic ramifications, they are relatively rare.

In the student loan context, section 108(f) governs the tax treatment of forgiven loans. Under this section, if the balance on a taxpayer's loan is forgiven by the government, a qualified educational institution, or a 501(c)(3) organization because the taxpayer has worked for 10 years in public service, the taxpayer does not have to recognize the COD income. A loan balance forgiven under any other repayment plan, such as IBR or PAYE, however, is treated as taxable income to a taxpayer, and must be included in his AGI. The COD income will be taxed as ordinary income in the year that it was forgiven. In 2008 the IRS clarified that only public service related repayment plans would be eligible for the tax-free treatment. In Rev. Rul. 2008-34,[10] the IRS offered guidance on whether the forgiven balance of a loan made under the Loan Repayment Assistance Program (LRAP) qualified as a tax-free discharge of COD income under section 108(f)(1) and (2). Because the LRAP provided loan forgiveness to the student only if he worked in a qualifying law-related position in public service, the forgiveness qualified.

Long-Term Effects of Forgiveness

When the balance on a student's debt is forgiven by the lender under any circumstances, that student essentially receives a subsidy. When the student does not pay taxes on the forgiven debt, that may constitute an additional benefit or ''double subsidy.'' In contrast, students who pay their entire tuition in after-tax dollars or use IBR or PAYE repayment methods receive no subsidy at all. The double subsidy is theoretically aimed at compensating individuals who are doing socially valuable work in underserved communities but typically receiving less standard compensation than they would from a for-profit company. However, many reformers want to extend it to all student loan borrowers after a 20- or 25-year term. The double subsidy for public service work may be warranted from a policy perspective because the prospect of $150,000 in graduate student debt looming over a student's head may discourage him from working for underserved communities. From a student's

[5]College Cost Reduction and Access Act, H.R. 2669, 110th Congress 2007-2008; ''Income-Based Repayment,'' *The Smart Student Guide to Financial Aid*, *available at* http://www.finaid.org/loans/ibr.phtml.

[6]Health Care and Education Reconciliation Act of 2010.

[7]''Pay as You Earn Student Loan Repayment Plan,'' Debt.org, *available at* http://www.debt.org/students/obama-pay-as-you-earn/.

[8]Akers and Chingos, *supra* note 2, at 7.

[9]Section 61(a)(12).

[10]2008-2 C.B. 76.

own financial perspective, when saddled with so much debt, it may seem irresponsible not to seriously consider a well-compensated career in the private sector. It is important, however, to create a system that continues to provide the right incentives for student borrowers. To do so, policymakers must consider the economic principles of ''moral hazard,'' ''limited information,'' and ''time-inconsistent preferences.''

Moral hazard occurs when a person will not bear the true costs of a decision and therefore can take a risk without fear of consequence. Student loan forgiveness is a classic example of that principle because students can defer paying off the lion's share of their student debt with relatively low monthly payments and then have the balance of that debt forgiven after 10, 20, or 25 years. That may lead some to settle for ill-fitting or lower-paying positions simply to avoid repayment rather than seeking to find employment that will allow them (or rather force them) to pay that debt.

Because of limited information, students may simply not factor in the ultimate tax costs of forgiveness programs when they decide to take on more debt. For example, in a difficult job market, college graduates will often opt for an expensive certification or master's program to improve their job prospects. Students who carry debt from their undergraduate education see no consequences in taking on more debt for an elective degree because after 20 years, that amount will be forgiven. That can be dangerous, however, because under most repayment plans, unless the student spends 10 years working in public service, the student will be taxed on the COD income when that debt is forgiven. A borrower who earns $40,000 per year will have a remaining balance of $55,000 on his student loans after 20 years under the PAYE program. At that taxpayer's marginal tax rate of 25 percent, he will owe $13,750 in tax, representing 34 percent of his annual income.

Another economic consideration is that students (and the young in general) are often poor long-term planners and have what economists call ''time-inconsistent preferences,'' in which immediate payoffs are valued much more than future costs. Under that theory, students overvalue the short-term increases in salary that could come with a degree, while undervaluing the burden of the loans necessary to gain that degree. That valuation can have a drastic effect on the amount of debt they choose to take on.

Loan forgiveness programs can also affect borrowers unequally. A study done by the New America Foundation found that loan forgiveness disproportionately benefits graduate student borrowers who take out large loans but are more likely to have higher incomes over time.[11] Perhaps unsurprisingly, a Brookings study found that forgiveness programs benefit borrowers who attend more expensive schools.[12]

Clearly then, the double subsidy of allowing the nonrecognition of COD income from forgiven student loans can have a dramatic influence on students during the cost benefit analysis portion of the decision to pursue an additional degree, tipping the scales heavily in favor of the perceived benefit. However, the potential effect on students' decision to take on more debt and the tax consequences stemming from that decision have not been extensively discussed or seriously debated by Congress when considering debt forgiveness. In fact, many of the proposals recommend that all repayment plans include total nonrecognition of COD income.

A double subsidy could encourage less wealthy students — who are concerned about taking on more debt — to look for public interest jobs solely to be eligible for the forgiveness treatment. For example, in a strong legal market, law students may not need to be as concerned about their student loans because summer associate positions — the path to a well-paying associate position and a relatively easy way to pay off loans — are plentiful in large metropolitan areas. However, in a depressed job market, a high-paying law firm job is not a reality for the majority of students, and loan forgiveness programs with no tax burden look especially attractive. When presented with the option of pursuing a mid-paying job (perhaps at a small firm or solo practice) that would allow them to pay off their loans and live a modest life, they might choose to pursue a lower-paying position at a nonprofit based solely on the potential for increased debt forgiveness.

Consider the examples of students A, B, C, and D. Student A is interested in public interest work. To finance his education, however, he must take out loans. His ability to pay is very low. He decides to go into public interest law and is comfortable with that decision because he knows that in 10 years, the remaining balance on his loans will be forgiven and he will not have to pay taxes on the forgiven amount. He is committed to a life in public interest and will be a valuable asset to the community. Student B is in a similar economic position to student A. However, because she knows the majority of her loans will be forgiven in 10 years (with no tax consequences), she takes on more student loans

[11]Jason Delisle and Alex Holt, ''The Case for Obama's Fixes to Income-Based Repayment,'' New America Foundation, Mar. 13, 2014.

[12]Akers and Chingos, *supra* note 2, at 19.

to finance additional expenses, such as a vacation after taking the bar exam, moving expenses, and a new car. Student C is also in a similar economic position to student A and is married. Her husband has no student debt and makes a salary of $260,000 per year. Student C files separately and bases her PAYE payments on just her income. After 10 years, her loans will disappear without any tax consequences to her or her husband. Finally, student D wanted a job in big law immediately after graduation but could not find one. He is very worried about his student debt and hears about the loan forgiveness available through public interest work. However, that type of law does not suit him so he is miserable and is not serving the community as well as someone who is truly enthusiastic about the work. He quits his public interest law job after five years. Now not only does he still have a large amount of outstanding loans, he potentially wasted five years of vital career development.

Examining those fictitious student examples elucidates some of the issues surrounding tax-free debt forgiveness. Student A is the perfect example of why the loan forgiveness programs and the complementary nonrecognition of COD income are in place. Student B exemplifies moral hazard because she knows she will not be responsible for paying for the additional amount of debt and takes on unnecessary expenses. Student C shows that allowing borrowers to base their monthly repayment amounts on individual income can create inequalities between married and single persons. Student D is an example of the danger in offering an attractive program with a double subsidy, which could result in long-term harm to students.

Student Loan Reform Proposals

There are many commentary and reform suggestions regarding repayment and forgiveness plans, but this section highlights three in particular. In an October 2013 discussion paper, Susan M. Dynarski and Daniel Kreisman of the Hamilton Project suggested an alternative repayment plan called Loans for Educational Opportunity (LEO), in which ''payments will automatically rise and fall with a borrower's earnings . . . [and a] fraction of earnings will be deducted from each paycheck, with a larger fraction taken when incomes are high and a smaller fraction when incomes are low.''[13] Under LEO, the loans will be forgiven after 25 years and the taxpayer will not recognize or pay tax on any of the forgiven amount. ''Employers would withhold loan payments from paychecks just as they withhold deductions for Social Security and income taxes.''[14] The borrower would pay a fixed rate of income, starting at 3 percent for the first $10,000 and rising with income, but the rate would cap out at 10 percent.[15]

The New America Foundation's March 2014 proposal takes a different approach, which suggests capping the Public Service Loan Forgiveness Program at $30,000.[16] It also proposes creating a two-tiered system in which loans would be forgiven after 20 years if the initial loan was less than $40,000, and after 25 years for initial loans of more than $40,000. The proposal would also require those who make more than $35,000 per year to pay back their loans at a higher rate. The PAYE plan guarantees that once borrowers qualify for PAYE by showing ''partial financial hardship,'' their monthly payments will always be lower than their payments under the standard 10-year repayment plan. Under the New America Foundation proposal, that cap would be removed and high-income earners would not be able to continue to pay low monthly amounts to get more forgiveness at the end of the repayment term. Finally, the New America Foundation proposes keying IBR to household income rather than individual income and suggests nonrecognition on COD income for all student loan forgiveness.

The Obama administration's fiscal 2015 budget proposal offers a plan similar to the New America Foundation's, and it has created considerable controversy. The plan would expand PAYE to all student borrowers, regardless of when they took out their loans.[17] It would also cap loan forgiveness for people who work in public service for 10 years at $57,500.[18] The proposal suggests a two-tiered system in which loans would be forgiven after 20 years for those who borrow $57,500 or less, and after 25 years for those who borrow more. It would also eliminate payment caps and base IBR on household instead of individual income. Finally, the plan proposes total nonrecognition of COD income from all loan forgiveness.

Unfortunately, a common theme of those proposals (and reform proposals in general) is that none of

[13]Dynarski and Kreisman, ''Loans for Educational Opportunity: Making Borrowing Work for Today's Students,'' Hamilton Project, Oct. 2013, at 6, 13, *available at* http://www.hamiltonproject.org/files/downloads_and_links/THP_DynarskiDiscPaper_Final.pdf.

[14]*Id*. at 7.

[15]*Id*. at 13.

[16]Delisle and Holt, *supra* note 11; Delisle, ''Obama Budget Reforms Income-Based Repayment, Reduces Windfall Benefits,'' New America Foundation, Mar. 4, 2014, *available at* http://www.edcentral.org/obama-administration-announces-major-reforms-income-based-repayment/.

[17]White House, ''Fiscal Year 2015 Budget of the U.S. Government,'' at 178 (Mar. 4, 2014).

[18]*Id*.; Delisle, ''Obama Budget Reforms,'' *supra* note 16.

them sufficiently analyze the tax consequences regarding forgiveness of student loan debt. There are three distinct policy issues regarding debt forgiveness that, while complementary, deserve individual consideration: the decision to forgive loans taken out by people doing public service work for 10 years; the decision to forgive loans taken out by people who are using IBR, PAYE, or income-contingent repayment plans after either 20 or 25 years; and the decision on how to treat COD income for both of those groups. There has been a serious discussion about the first two issues, but the tax treatment of the COD income from loan forgiveness is often glossed over. Even the most comprehensive studies simply state that students and policymakers should consider the tax consequences of each plan. Another common approach is to combine the discussion of the tax treatment of COD income with the discussion regarding forgiveness of loans. For example, some argue that the government should forgive loans after 20 years and also have a tax-free discharge of that debt (the double subsidy). Others propose eliminating forgiveness altogether for non-public servants. Neither of those arguments gives separate consideration to the COD forgiveness factor.

The tax treatment of forgiven student loans does not need to be so static. In fact — although it is criticized for its complexity — one virtue of the tax system is that it is able to make dynamic evaluations of a taxpayer's ability to pay according to a long list of economic attributes and provide narrowly targeted treatment in unique situations, for example, tax credits to people who meet specific criteria or the required contingencies attached to tax-free forgiveness of bankruptcy or mortgage debt. In the student loan context, the government does not necessarily have to tax or forgive COD income in its entirety, or require full payment on that income in the tax year that it is assessed. New tax laws could create a system that is more progressive and nuanced, allowing the IRS to determine tax liability based on information about current earnings, past earnings, household income, expenses, and number of children.

Also, proposals for total nonrecognition of COD income from loan forgiveness programs do not calculate the potential lost tax revenue. A taxpayer who gets $100,000 of loans forgiven and is in the 35 percent tax bracket avoids paying $35,000 in taxes — revenue that could be used towards other valuable government programs and expenditures. That effect would quickly multiply as the popularity of loan forgiveness programs increases. A system that retained taxation on COD income, but made exceptions and allowances for people facing hardships, would be a more equitable approach.

A New Proposal

I recommend introducing the concepts of partial recognition and income averaging in the context of COD income from loan forgiveness. That could be accomplished by analyzing a taxpayer's ability to pay using two elements: (1) household income instead of individual income, and (2) factors such as a household's past income, current income, and number of children. If the tax law reflected those factors, a taxpayer could determine whether he would be eligible for partial recognition of the COD income or to average the recognition of the income over a period. That approach is fair because it reflects a taxpayer's individual circumstances and could be successfully implemented with information routinely made available to tax authorities.

The IRS could allow partial recognition of forgiven debt for some taxpayers who demonstrate a low ability to pay. For others who are able to pay the tax but would face a hardship paying the tax on the entire amount forgiven in a single year, the IRS could allow the income to be recognized over time. A taxpayer who earns $40,000 per year may find it impossible to pay $13,750 in taxes in one year for a forgiven loan balance of $55,000, but may be able to pay the tax over three or five years, paying as little as $2,500 per year.

Those principles are already used in the context of the IRS's offer in compromise program, a relatively successful program that was expanded in January 2014.[19] Authorized by section 7122, an OIC allows taxpayers, in limited circumstances, to offer the IRS an amount of money less than their tax debts in order to satisfy all of their debts; or in other words, compromise. This is not to suggest that a ''let's make a deal'' mentality should always be applied when evaluating whether COD income should be taxable, but there are useful tools in the OIC program criteria. For instance, the IRS considers, *inter alia*, the taxpayer's ability to pay using income, expenses, and asset equity.[20] If a compromise is accepted, the money can be paid through a lump sum or periodic payments.

[19]''When the IRS calculates a taxpayer's reasonable collection potential, it will now look at only one year of future income for offers paid in five or fewer months . . . and two years of future income for offers paid in six to 24 months,'' as well as expanding what qualifies in the estimation of allowable living expenses. IRS release, ''IRS Announces More Flexible Offer-in-Compromise Terms to Help a Greater Number of Struggling Taxpayers Make a Fresh Start,'' *available at* http://www.irs.gov/uac/IRS-Announces-More-Flexible-Offer-in-Compromise-Terms-to-Help-a-Greater-Number-of-Struggling-Taxpayers-Make-a-Fresh-Start.

[20]IRS, ''Offer in Compromise,'' *available at* http://www.irs.gov/Individuals/Offer-in-Compromise-1; Robert E. McKenzie, ''New IRS Offer in Compromise Policies,'' Forbes.com, May 27,

(Footnote continued on next page.)

I also suggest that the IRS look at household income rather than individual income when analyzing a taxpayer's ability to pay the tax on COD income. The current system treats similarly situated people differently, which violates the policy goal of horizontal equity. Married taxpayers can file and report their incomes separately and make lower monthly loan payments, which contributes to the inequality between a household with one income earner and a household with two. Requiring taxpayers to report their household income would more accurately reflect their ability to pay the tax on the forgiven COD income in a given year because it would more closely mirror the economic realities of their financial situation.

A tailored and more equitable means of achieving policy goals does not require a complicated new apparatus or agency. My proposal would require the IRS to provide an additional worksheet on a taxpayer's return that would collect information — most of which is reported elsewhere on the return — to calculate how much, if any, COD income should be recognized and if the taxpayer is eligible to average the tax owed on that income. The worksheet would examine the taxpayer's household income, number of children, and other tax attributes to get a more complete picture of his ability to pay the tax.

2012, *available at* http://www.forbes.com/sites/irswatch/2012/05/27/new-irs-offer-in-compromise-policies/.

The results of the worksheet would create four options: total nonrecognition of COD income, which may apply, for example, to someone who serves in public service for 10 years; partial recognition of COD income that may apply to people with a very low ability to pay; income averaging of the recognition of COD income that would allow people with the ability to fully pay the tax but would be unduly burdened by having to pay it all in one year to spread the recognition of the COD income over three to five years; and full recognition and immediate payment of COD income for those with a high ability to pay. The worksheet may also allow taxpayers to use a combination of partial recognition and income averaging. Policymakers will decide the exact criteria that would make someone eligible for partial recognition of COD income and the criteria for income averaging. This proposal suggests a taxation-focused analysis, consistent with policy goals, that is absent from the political debate.

Conclusion

Ultimately, the repayment and forgiveness plans will likely be reformed in the near future, and it is poor public policy to ignore the tax issues that arise in those important policy discussions. The tax treatment of forgiven loans, in fact, may present an area in which groups with different ideologies can compromise and create an opportunity to implement a more progressive, equitable, and fair tax policy.