Student Loan Forgiveness and Repayment Programs

By: **Kent N. Schneider, J.D., CPA**

Due to rising tuition costs, the number and size of student loans have increased dramatically in recent years. Once the exclusive domain of college financial aid offices and hometown banks, education loans are now the subject of cable TV commercials and e-mail solicitations from major credit card companies. Indeed, for many, student loans are readily available. The problem starts after graduation when loan payments begin. For those students who pursue careers in the high-demand/low-reward public service arena, the repayment problem is especially acute.

Over the past 15 years, Congress has attempted to alleviate this problem by various means, including extending the repayment period for student loans, creating debt forgiveness and debt repayment programs, and even providing a tax deduction for the payment of student loan interest.[1] Private-sector employers in high-demand professions have joined in, offering their own student loan repayment plans as a recruitment tool.

As a result, recent graduates face a bewildering array of options for dealing with the substantial student debt that they have accumulated, often over the better part of a decade. Those who successfully negotiate this maze and find a repayment plan or debt forgiveness plan that meets their needs are often surprised by the income tax consequences of their decisions. To provide a roadmap for these students and their tax advisers, this article describes the more prevalent loan forgiveness and loan repayment programs, along with the associated tax consequences.

Overview of Student Loan Forgiveness and Reimbursement Plans

Student loan forgiveness plans fall into three categories. Most important are the federal loan forgiveness provisions connected with the extended loan repayment plans elected by qualifying borrowers who are incapable of paying off their education loans over the typical 10-year period. In addition, specialized loan forgiveness and loan repayment programs are available for borrowers who work for certain employers (e.g., the Peace Corps, the military, school districts with a high proportion of low-income or special needs students). Finally, hardship rules provide debt relief in extreme cases, such as the borrower's death or disability.

Loan Forgiveness Associated with Extended Repayment Plans

Student loan repayment schedules typically provide for monthly payments over a 10-year period. For most, the required monthly payments are manageable. But for those who accumulated debt over a

1 Sec. 221.

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five- to eight-year period while acquiring advanced degrees, the burden often is crushing.[2] To provide relief, Congress added the option of repaying student loans made by, or guaranteed by, the federal government over a maximum of 25 years.[3] Any unpaid balance at the end of the 25-year repayment period is canceled.[4]

More recently, Congress enacted the College Cost Reduction and Access Act of 2007, which includes a provision designed to encourage recent graduates to enter public service.[5] Under this provision, the unpaid balance of a student loan will be discharged after 10 years if the borrower is employed full-time in a public service job. For purposes of this rule, "public service jobs" are very broadly defined to include emergency management, military service, public safety, law enforcement, public health, public education, social work in a public agency, public interest law services, public child care, public service for individuals with disabilities and for the elderly, public and school-based libraries, and employment at tax-exempt Sec. 501(c)(3) organizations.[6]

Other Loan Forgiveness and Repayment Programs

In addition to the 25-year and 10-year loan forgiveness plans described above, numerous other programs encourage entry into high-demand fields by offering loan forgiveness or reimbursement for student loan payments. Some of the more prominent areas include military service, medical professions, employment at federal agencies, teaching, and volunteer service. The relief provided by these programs ranges from a modest debt forgiveness of $4,725 for a year of service in AmeriCorps or VISTA to a very generous loan repayment of up to $35,000 a year for service in the National Health Service Corps. These programs are summarized in the exhibit on p. 392.

Hardship Loan Forgiveness

Student loans can also be canceled as a result of a rare hardship suffered by the borrower. Student debt will be discharged if the student's school closed before he or she could complete the program. Discharge also will occur if the borrower dies or becomes totally and permanently disabled.[7] Finally, in extraordinarily rare cases, a court may discharge a student loan in bankruptcy. For this to occur, the bankruptcy court must find that loan repayment would cause "undue hardship on the debtor and the debtor's dependents."[8]

Tax Consequences of Student Loan Forgiveness and Reimbursement Plans

In general, when a lender forgives or discharges a borrower's debt, the amount of the cancelled debt is income that is taxable to the borrower.[9] The rationale for this rule is that when the lender forgives the debt, the proceeds of the original loan represent an increase in the taxpayer's wealth.[10] Thus, if a student used a credit card to finance his or her education and later negotiates a lower balance with the credit card issuer, the debt reduction is taxable to the student.

> *Example 1:* C uses his credit card to pay for his tuition and books while completing his bachelor's and master's degrees. After graduation, he is unable to make the minimum monthly payments on his $20,000 credit card debt. Rather than risk C's filing for bankruptcy, the credit card company agrees to discharge $12,000 of the amount due. In this case, C must include the $12,000 in his gross income.

Moreover, a borrower cannot typically characterize loan forgiveness as a tax-free gift because the lender lacks donative intent.[11] As a consequence, many graduates discover to their chagrin that their student loan forgiveness results in a higher income tax liability. This general rule applies to those whose student loans are canceled due to hardships, such as death or disability, but not bankruptcy.[12]

EXECUTIVE SUMMARY

- The government and private entities offer various forms of relief from student loan debt, including programs that provide either debt repayment or forgiveness.
- In general, when a lender forgives or discharges a borrower's debt, including student loan debt, the amount of the cancelled debt is income that is taxable to the borrower. An exception to this rule is available to former students who perform public service in exchange for loan forgiveness.
- In order to qualify for the exemption from income inclusion for student loan debt forgiveness, the lender must be a qualifying lender and the lender must forgive or discharge the loan amount; the exemption does not apply if a third party repays the loan amount.

2 See generally Schrag, "Federal Student Loan Repayment Assistance for Public Interest Lawyers and Other Employees of Governments and Nonprofit Organizations," 36 *Hofstra L. Rev.* 29 (2007).
3 34 C.F.R. §685.209(c)(4)(i).
4 34 C.F.R. §685.209(c)(4)(iv).
5 College Cost Reduction and Access Act of 2007, P.L. 110-84, §401.
6 Id.
7 U.S. Department of Education, Student Aid on the Web, Discharge/Cancellation, http://tinyurl.com/6nfs3.
8 11 U.S.C. Section 523(a)(8).
9 Sec. 108(a).
10 Sec. 61(a)(12).
11 See, e.g., *Plotinsky*, T.C. Memo. 2008-244, in which the lender forgave a portion of the taxpayer's education loan as a reward for entering into a loan consolidation agreement with the lender and subsequently making 36 consecutive monthly loan payments on time.
12 Sec. 108(a)(1)(A).

Exhibit: Income tax consequences of student loan forgiveness and repayment programs

Student loan forgiveness and repayment program	Program description	Taxable to student?
Extended repayment plans		
Income-contingent repayment	Loan forgiveness after 25 years	Yes, unless employed in public service job
Income-based repayment	Loan forgiveness after 10 years; not available until July 2009	Yes, unless employed in public service job
Federal employees and military		
Federal student loan repayment program	Loan repayments up to $10,000 per year and $60,000 in total	Yes
Army and Navy (active duty)	Loan repayments up to $65,000	Yes
Army Reserve	Loan repayments up to $10,000	Yes
Air Force	Loan repayments up to $10,000	Yes
Health professionals		
National Health Service Corps loan repayment program	Loan repayments up to $50,000 for two-year commitment; no maximum	No
Nursing Education repayment program	Loan repayments up to 30% of qualifying loan balance annually for years 1 and 2; loan repayment up to 25% of qualifying loan balance for year 3	No
Primary and secondary school teachers		
Teacher Loan Forgiveness program (in general)	Loan forgiveness up to $5,000 of FFEL and DL loans for five consecutive years of full-time teaching in low-income school	No
Teacher Loan Forgiveness program (math, science, and special education)	Loan forgiveness up to $17,500 of FFEL and DL loans for five consecutive years of full-time teaching in low-income school	No
Perkins Loan cancellation (math, science, special ed., and other fields with shortage)	Loan forgiveness for full-time teaching in low-income school: 15% for years 1 and 2; 20% for years 3 and 4; 30% for year 5	No
Volunteer service		
AmeriCorps	Forgive $4,725 for one year of service	No
VISTA	Forgive $4,725 for one year of service	No
Peace Corps	Forgive 15% of Perkins loan for each year of service, up to 70% maximum	No
Hardship loan forgiveness		
School closes before student completes program	Entire loan is cancelled	Yes
Death of student	Entire loan is cancelled	Yes
Total and permanent disability of student	Entire loan is cancelled	Yes
Bankruptcy (very rare)	Entire loan may be cancelled where repayment results in undue hardship	No

On the other hand, Congress has created two exceptions to this rule: loan forgiveness for public service and payments under the National Health Service Corps loan repayment program.[13]

Tax-Free Loan Forgiveness for Public Service

The first exception is the exclusion granted to former students who perform public service in exchange for loan forgiveness. This exclusion is limited to loans that (1) are student loans, (2) are issued by a qualifying lender, and (3) include language in the loan document that provides for discharge if the borrower engages in public service.

Student loan: For purposes of this exclusion, a student loan is a loan made to an individual "to assist the individual in attending an educational organization."[14] Congress clearly defined an educational organization as one maintaining a regular faculty and curriculum for regularly enrolled students.[15] Unfortunately, scant guidance is available as to the type of expenses included in assisting one to attend school. The House Ways and Means Committee reports for the Taxpayer Relief Act of 1997[16] suggest that loan proceeds used to pay for not only tuition and fees but also room and board would be qualifying expenses.

Qualifying lender: Four types of qualifying lenders exist: (1) the federal government,[17] (2) a state or any of its political subdivisions,[18] (3) certain tax-exempt public benefit corporations that control a state, county, or municipal hospital,[19] and (4) educational organizations.[20] Loans made by the federal government are the most common, and loans made by educational organizations offer the greatest planning opportunities.

The federal government maintains four basic student loan programs: the Federal Family Education Loan program (FFEL), the William D. Ford Direct Loan program (DL), the Federal Perkins Loan program (Perkins), and the various loan programs authorized by the Public Health Service Act.[21] The key difference among these programs is the source of the student loans. Under the FFEL program, private lenders provide the money for student loans. To encourage lenders to participate, the federal government guarantees them against losses caused by borrower default. In contrast, the federal government provides the loans under the other programs. Thus, all DL student loans satisfy the "qualifying lender" requirement. On the other hand, the federal government makes, but does not guarantee, FFEL loans. As a result, FFEL student loans cannot qualify for the loan forgiveness exclusion unless they are incorporated into a consolidation loan under the DL program.

In addition to the federal government, an educational organization can also be a qualifying lender in limited circumstances. First, the school is a qualifying lender if it issues the loan to a student using funds provided by the federal government, a state government, or certain public benefit corporations.[22] This would seem to cover Perkins loans that are issued to students on the basis of financial need using federal funds.

More important from a planning perspective, a postsecondary institution can be a qualifying lender if it establishes a loan program designed to encourage students to serve in occupations or areas with unmet needs.[23] Such a program must require the student (or former student) to provide the designated services under the direction of a governmental unit or a Sec. 501(c)(3) tax-exempt organization in exchange for loan forgiveness. For purposes of this provision only, Congress clearly specified that forgiveness of a *refinanced* student loan can qualify for tax-free treatment.[24] However, this exclusion is not available if the loan is discharged because the student is employed by the lender or by the supervising government unit or tax-exempt organization.[25]

Under the CCRAA, the unpaid balance of a student loan will be discharged after 10 years if the borrower is employed full-time in a public service job.

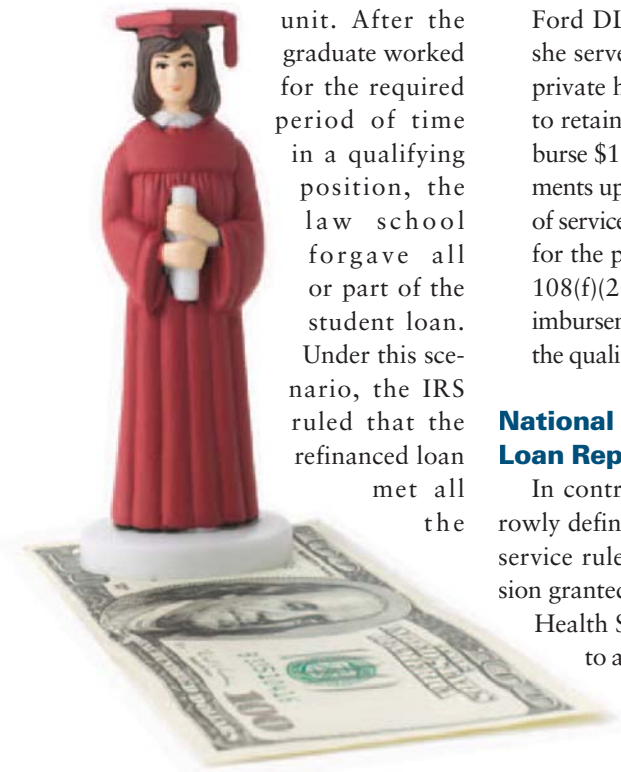
Loan discharge or forgiveness: To escape taxation, *the lender* must discharge or forgive the student loan. Even if the loan was a qualifying loan issued by a qualifying lender, the exclusion will not apply to third-party reimbursements for loan payments made by the student. This requirement is clearly illustrated by comparing *Moloney*,[26] a recent Tax Court decision, with Rev. Rul. 2008-34.[27]

In *Moloney*, the taxpayer accumulated approximately $55,000 in educational loans while attending law school. After graduation, she worked for the Baltimore County State's Attorney's Office, a qualifying public service job. In 2002, she received an award of $4,372 from the Janet L. Hoffman Loan Assistance Repayment Program (LARP) that was to be used to repay part of her school

13 Secs. 108(f)(1), (2), and (4).
14 Sec. 108(f)(2).
15 Secs. 108(f)(2) and 170(b)(1)(A)(ii).
16 Taxpayer Relief Act of 1997, P.L. 105-34.
17 Sec. 108(f)(2)(A).
18 Sec. 108(f)(2)(B).
19 Sec. 108(f)(2)(C).
20 Sec. 108(f)(2)(D).
21 42 U.S.C. ch. 6A.
22 Sec. 108(f)(2)(D)(i).
23 Sec. 108(f)(2)(D)(ii).
24 See the flush language immediately following Sec. 108(f)(2)(D)(ii).
25 Sec. 108(f)(3).
26 *Moloney*, T.C. Summ. 2006-53.
27 Rev. Rul. 2008-34, 2008-28 I.R.B. 760.

loan. Moloney satisfied the conditions of the award by continuing to work in the State's Attorney's Office, and the LARP paid $4,372 to the lender of Moloney's largest student loan. The taxpayer did not include this amount in her gross income, arguing that the LARP payment was essentially the equivalent of a discharge of indebtedness and should be excluded under Sec. 108(f). Noting that exclusions from gross income must be narrowly construed, the Tax Court ruled that the LARP payment was not a discharge of debt by the lender. Thus, Moloney was required to include the payment in her gross income for 2002.

Rev. Rul. 2008-34 illustrates how such a loan assistance repayment program can be structured to qualify for the exclusion. In this ruling, a law school offered a LARP that refinanced a graduate's original student loans. To qualify for the refinanced loan, the LARP required the graduate to work in a law-related public service position for, or under the direction of, a tax-exempt charitable organization or a government unit. After the graduate worked for the required period of time in a qualifying position, the law school forgave all or part of the student loan. Under this scenario, the IRS ruled that the refinanced loan met all the requirements of Sec. 108(f). Most notably, the lender discharged or forgave the loan in this case, rather than a third party, as in *Moloney*.



Although both the *Moloney* case and Rev. Rul. 2008-34 involved law school graduates, it is important to note that the "loan discharge or forgiveness" requirement applies to all types of public service professions. The critical issue is whether the debt relief is from the lender or from a third party.

> ***Example 2:*** *Q* accumulates $40,000 of Stafford loans under the William D. Ford DL program. After graduation, she serves as a science teacher at an inner-city high school. Over a five-year period, $17,500 of her student loan balance is discharged under the Teacher Loan Forgiveness program. These amounts are excluded from gross income under the public service exclusion of Sec. 108(f)(2).

> ***Example 3:*** *Q* accumulates $40,000 of Stafford loans under the William D. Ford DL program. After graduation, she serves as a teacher at an exclusive private high school. As an inducement to retain *Q*, the school agrees to reimburse $17,500 for her student loan payments upon the completion of five years of service. This payment will not qualify for the public service exclusion of Sec. 108(f)(2) because it is a third-party reimbursement and not a debt forgiven by the qualifying lender.

National Health Service Corps Loan Repayments

In contrast to the complex and narrowly defined loan forgiveness for public service rule described above, the exclusion granted to payments by the National Health Service Corps is much simpler to apply and more liberal in result. For tax years beginning after 2003, payments received under §§338B(g) or 338I of the Public Health Service Act are excluded from gross income.[28] Moreover, these payments are also specifically excluded from wages subject to FICA taxes.[29]

Both provisions of the Public Health Service Act are intended to increase the availability of primary health care services in underserved areas of the country. Section 338B(g)[30] describes the federally run National Health Service Corps loan repayment program, and §338I[31] describes similar programs administered by the states with matching federal funds. Given the description of this exclusion in Sec. 108(f)(4), taxpayers who qualify for loan repayments under these programs automatically qualify for the exclusion.

> ***Example 4:*** *G* accumulates $40,000 of Stafford loans under the William D. Ford DL program. After graduation, he serves as a registered nurse in an area of the country lacking adequate medical facilities. The Nursing Education Repayment Program reimburses *G* for the entire amount of his student loans over a two-year period. These repayments would not qualify for exclusion under the public service exclusion of Sec. 108(f) because they are in the form of reimbursements. But because these payments were provided by the National Health Service Corps, they are excluded from *G*'s income under Sec. 108(f)(4).

Planning Implications

To enjoy tax-free relief of student loans, the borrower must receive loan reimbursements under one of the National Health Service Corps programs or must qualify for the Sec. 108(f)(2) exclusion of loan forgiveness for public service.

Tax-Free Loan Forgiveness for Public Service

To qualify for tax-free loan forgiveness for public service, the loan must be (1) a student loan (2) made by a qualifying lender (3) discharged or forgiven by the lender. Of these three requirements, the last two require the greatest attention.

28 Sec. 108(f)(4).

29 American Jobs Creation Act of 2004, P.L. 108-357, §320(b)(5), amending Social Security Act §209(a)(17) (42 U.S.C. Section 409(a)(17)).

30 Codified at 42 U.S.C. Section 254l-1.

31 Codified at 42 U.S.C. Section 254q-1.

Use a qualifying lender: To qualify for tax-free loan forgiveness for public service, it is essential that a qualifying lender makes the loan. For most students, this means the federal government. Students who obtained Stafford or PLUS loans from the U.S. Department of Education via the William D. Ford DL program satisfy this requirement. If the student loan is from a private lender, such as those made under the FFEL program, the loan must be converted into a DL consolidation loan prior to cancellation.

Educational institutions can also be qualifying lenders if they loan funds provided by a governmental source. Perkins loans are a common example. More important, as illustrated in Rev. Rul. 2008-34, a school could become a qualifying lender by using federal or state funds to refinance student loans for graduates entering public service careers.

Obtain loan forgiveness, not reimbursement: The public service exclusion provided by Sec. 108(f)(2) requires that the student loan be forgiven by the lender. For example, debtors do not recognize income when their loans are forgiven under programs for persons teaching in low-income schools and serving in AmeriCorps, VISTA, or the Peace Corps. In contrast, loan reimbursements received from third parties do not qualify for the exclusion from income. Thus, federal employees and military personnel are subject to tax on the amounts received under these repayment programs because they are in the form of a reimbursement and not a direct discharge of debt.

National Health Service Corps Loan Repayment Program

Unlike persons engaged in public service, most health professionals can receive tax-free loan assistance without satisfying the previously mentioned requirements of using a qualified lender or obtaining debt forgiveness rather than a reimbursement. Amounts received by qualifying medical care providers and researchers from the National Health Service Corps loan repayment program or from similar, state-administered programs are not taxable under Sec. 108(f)(4), even though they are reimbursements.

Conclusion

Today, student loans are ubiquitous, and programs providing for repayment or forgiveness of these loans are becoming more prevalent. Consequently, a growing number of clients will need help from their tax advisers to navigate this complex area.

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EditorNotes

Kent Schneider is a professor of accountancy at East Tennessee State University in Johnson City, TN. For more information about this article, please contact Prof. Schneider at kent@etsu.edu.