Tax Treatment of Student Debt Cancellation

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Outline

1. Introduction
2. Higher education tax incentives
3. Student loans & Income-Driven Repayment
4. Tax treatment of student debt cancellation and the erroneous reading of Section 108(f)
5. Lessons: What does this say about the interaction of tax and non-tax programs?

Tax Incentives for Higher Education

- Direct:
  - Credits: American Opportunity Tax Credit and Lifetime Learning Credit. § 25A.
  - Deductions: Student loan interest. § 221.
- Indirect:
  - Scholarship exclusion. § 117.
  - Tax-free education savings plans. § 529 etc.
  - Charitable deduction & non-profit exemption
  - Exclusion of cancelled student loan debt. § 108(f)(5)…for now

Tax Incentives for Higher Education Have Been Largely Ineffective

- Federal tax credits & deductions have negligible effects on enrollment (Hoxby & Bullman, 2016; Bullman & Hoxby, 2015; LaLumia, 2010)
  - More information about credits may not help. (Bergman, Denning & Manoli, 2019)
- Unclear if education savings programs increase enrollment (Dynarski & Scott-Clayton, 2016)
- But direct aid and loans probably increase enrollment (Page & Scott-Clayton, 2016)

→ Suggests that timing, complexity, and liquidity issues hurt tax-based incentives relative to immediate cash or price reductions

Federal Student Debt

- Total outstanding debt: ~$1.7 trillion
- Distributes ~$100 billion per year to higher ed
- Average debt per borrower: $30-40,000
  - Undergraduate borrowing is capped at $31,000/$57,500
  - Graduate students & parents can borrow up to the full “cost of attendance” each year
- ~43 million borrowers
- 50-60% of current students take on some debt

Income-Driven Repayment Programs

- Pay 10-15% of “discretionary income” for 20-25 years, then remaining debt cancelled
  - PSLF: Pay for 10 years, then remaining debt cancelled
- 47% of debt in repayment
  - $546 billion
- 33% of borrowers in repayment
  - 9.2 million

Other Debt Discharge Programs

- Death & disability
- Closed school
- False certification
- Borrower defense
- Bankruptcy
- Settlement and compromise
  - Could be tool for broader debt cancellation

Section 108(f)(5)

“Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) after December 31, 2020, and before January 1, 2026, of [any student loan].”

Section 108(f), Pre-2021 and Post-2025

- Section 108(f)(1):
  - “In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged **if the individual worked for a certain period of time in certain professions for any of a broad class of employers.”**
- Interpreted to provide statutory exclusion only for Public-Service Loan Forgiveness (and similar programs)

Simple Tax Analysis

1) Cancellation of indebtedness is income. § 61(a)(11). *Kirby Lumber*.
2) Unless there is an exclusion in § 108.
3) The only student debt exclusion is § 108(f)(1) for PSLF.
4) Therefore, all other student debt cancellation, including IDR, is taxable.

But not so fast…

Pre-1973

- Section 117(a)(1)(A) (1958):
  - “In the case of an individual, gross income does not include any amount received as a scholarship at an educational institution.”
- Treasury Regulation § 1.117-4(c) (1956):

  Scholarships do **not** include:

  (1) “[A]ny amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either **compensation** for past, present, or future employment services or represents payment for services which are **subject to the direction or supervision of the grantor**.”

  (2) “Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research **primarily for the benefit of the grantor**.”

Tech. Advice Memo 5807039700A (1959)

- “Payments received under the *** State Medical Education Loan Scholarship Program fall within [Section 117], and **thus qualify as amounts received as a scholarship**.”
- “In the case with which we are here concerned, there has been **no employment relationship** between the grantor, the State of *** and the recipient, and there will be none, so payments made under the Program cannot be said to represent compensation for past, present, or future employment services.”
- **Not “subject to the direction or supervision of the grantor**.”

Bingler v. Johnson, 394 U.S. 741 (1969)

- Company paid employees a “stipend” while they were on leaves of absence to pursue graduate studies
- Required to work for employer for two years after earning degree
- Court upholds Treas. Reg. § 1.117-4(c):
  - “Here, the definitions supplied by the Regulation clearly are prima facie proper, comporting as they do with the ordinary understanding of ‘scholarships’ and ’fellowships’ as relatively disinterested, ‘no-strings’ educational grants, with no requirement of any substantial quid pro quo from the recipients.”
  - “The thrust of the provision dealing with compensation is that bargained-for payments, given only as a quo in return for the quid of services rendered—whether past, present, or future—should not be excludable from income as ‘scholarship’ funds.”

Rev. Rul. 73-256

- Revisiting student loan cancellation as a result of *Bingler v. Johnson.*
- "Under the facts presented in this case**, the amounts are cancellable on the condition that the recipient practice medicine in a rural area of the State**. This condition requires a substantial quid pro quo from the recipient, in that in return for receiving a medical education, he must perform services in an area selected by the grantor. Thus, although no employment relationship exists between the grantor and the grantees, the services required do not further an educational purpose and are designed to accomplish a basic objective of the grantor."
- **"Therefore, the cancellation of the loan is primarily for the benefit of the grantor within the meaning of section 1.117-4(c) of the regulations.**"

Tax Reform Act of 1976, § 2117

- “In the case of an individual, **no amount shall be included in gross income** for purposes of section 61 of the Internal Revenue Code of 1954 by reason of the discharge of all or part of the indebtedness of the individual under a student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual **worked for a certain period of time in certain geographical areas or for certain classes of employers**.”
- Similar language included in Revenue Act of 1978
- Made permanent part of the Tax Code by Deficit Reduction Act of 1984

Legislative History

- These provisions, including § 108(f), were direct responses to Rev. Rul. 73-256.
- Senate Report No. 94-938:
  - "Proponents of these programs believe that the loan cancellation is **not primarily for the benefit of grantor, as the Service has ruled, but for the benefit of the entire community** and that the exclusion from income of the amount of indebtedness discharged in exchange for these services would further the purpose of these programs. In addition, **proponents believe such exclusion would be consistent with the treatment of scholarships and fellowship grants which are not contingent upon the performance of needed services by the recipient**."

What Does All This Mean?

- Student loan cancellations, including for public service, were originally considered “scholarships”
- IRS changed its position in 1973 with respect to public-service forgiveness, because of potential “quid pro quo”
- Congress overruled IRS and said that such loans should still be treated like scholarships
- Therefore, we should read § 108(f) **NOT** as a **limited** exclusion only for PSLF, but rather as making sure a **general** exclusion **ALSO** applies to PSLF despite potential “quid pro quo”

Treatment of Interest Subsidies

- Subsidization and cancellation of student loan **interest** is already happening (subsidized loans, IDR, loan pause), without any assertion of taxation
- Rev. Rul. 75-537:
  - "Student loan interest subsidy payments made by the Commissioner of Education to lenders for the interest they agree not to collect from borrowers under the Higher Education Act of 1965 **are scholarships**, within the meaning of section 117(a) of the Code"
- So it seems like IRS is **currently** treating some aspects of student loan forgiveness as non-taxable scholarships

Takeaways

- Higher ed treatment in Tax Code provides little benefit, and may actually do harm
- Temporary exclusion in § 108(f)(5) may have been a mistake
  - Further supports mistaken idea that only COD described in § 108 is excluded
  - Only applies through 2025
- Mistakes and misinterpretations can often become “black letter” law through persistence of error and failure to read history
- Does this say something about the interaction of tax and non-tax policy?
  - Risk of using of federal credit programs to deliver transfers
  - Conflicting normative goals and interpretive frames