

**Ensuring that Student Loan Death
and Disability Discharges
Do Not Result in a Tax Penalty**



Exempting federal student loans discharged because of death or total and permanent disability from cancellation of debt income would ensure fairer tax treatment for some of the most vulnerable student loan borrowers.

1. **Borrowers should not be worse off after a total and permanent disability or death discharge than they were before.**
2. **The budgetary impact of exempting death and disability discharges from income is likely negligible.** A relatively small number of borrowers have their student loans discharged for death or disability each year. Most have little or no resources to pay these unexpected tax bills. Thus, the government gains little by trying to collect taxes from these borrowers. Yet, the impact to those who will be taxed will likely be profound.
3. **There is no evidence to suggest that borrowers who receive these discharges are hiding (or even own) significant assets.**
4. **Insolvency is insufficient to protect many vulnerable borrowers.** In general, the Internal Revenue Code allows taxpayers to exclude canceled debt from their income to the extent that the taxpayer was insolvent immediately prior to the discharge. The amount of canceled debt that is excludable is calculated by finding the excess of liabilities (total debts owed) over the fair market value of any assets. However, the insolvency provision does not distinguish between assets that are essential (such as a primary residence or transportation) and other assets. Borrowers get disability discharges because they have no future earning potential. We should not require them to give up the assets necessary to maintain basic necessities. In addition, many vulnerable borrowers are not aware of the insolvency exception.

Examples of the impact of tax consequences:¹

Borrower 1: Helen

Helen is a single mom. Her 20 year old son died in a car accident in 2012. Helen has three surviving children under the age of 18. She took out \$40,000 in ParentPLUS loans so that her son could go to the state university. Helen works in a call center making \$35,000 per year and receives no child support from the father of her children. She owns a home that she purchased with her ex-husband 15 years ago. It is now worth \$100,000 and has \$30,000 remaining on

¹ These examples assume that the amount reported on the 1099-C is for the full amount of the principal, interest, and fees. It also assumes that each of these borrowers claims the full \$2500 student loan interest deduction.

mortgage. She also owns a car worth \$5,000. (Total assets: \$100,000 (home) + \$5,000 (car) = \$105,000).

Because of Helen’s assets, she does not qualify for the insolvency exception. Without the cancellation of debt (COD) income, Helen would have qualified for approximately \$2,110 in the Earned Income Tax Credit. She would not owe any taxes and would have received a refund of approximately \$1,247. With the COD income, she no longer qualifies for the EITC and must pay \$6,801 to the IRS.

	Loan Balance Discharged	Total Asset Value	Total Debt	Extent of Insolvency (<i>Debt – Assets</i>)	Amount of loan to be included in income (<i>Debt – Insolvency</i>)	Estimated AGI	Estimated Tax Liability	Tax Liability w/o Cancellation of Debt Income
Helen	\$40,000	\$105,000	\$70,000	0	\$40,000	\$72,500	\$6,801	-\$1,247 (refund)

Borrower 2: Linda

Born in 1946, Linda receives \$831 per month in SSI/SSDI. She has a small single family house valued at \$115,000 in a low-income suburb of Boston, Massachusetts that she inherited from her father in 1985. She originally borrowed \$25,000 in 1990 to attend a trade school.

A spinal injury in 1998 left her totally and permanently disabled. Struggling to pay off her student loan, her balance has ballooned to \$58,450. In 2012, her loans were canceled.

After paying for her living expenses (utilities, co-pays and prescriptions, transportation, groceries, and incidentals) Linda has \$20 left at the end of the month.

Because of the value of her home, Linda will not qualify for the insolvency exception and will owe \$7,586 to the IRS.

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Linda	\$58,450	\$115,000	\$58,450	0	\$58,450	\$55,950	\$7,586	\$0

Borrower 3: Paul

Paul is a 50 year old disabled veteran. He has a service-connected disability that is 100% disabling. He receives \$800 per month in VA disability benefits. He purchased a home in Rochester, New York in 1989 that is now paid off. It is currently valued at \$50,000. Before entering the service, he attended a small private college, but never finished. His student loan debt was \$60,000 when it was discharged.

Although Paul is insolvent, the extent of his insolvency is only \$10,000 (\$60,000 - \$50,000) and does not relieve him of the tax consequences of his loan cancellation.

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Paul	\$60,000	\$50,000	\$60,000	\$10,000	\$50,000	\$47,500	\$5,474	\$0

For all of these borrowers, the cancellation of debt income will likely have collateral consequences. In order to pay the tax liability, these borrowers may need to sell their homes. Borrowers with loans canceled due to death or disability are already vulnerable. This added tax burden threatens their limited stability and resources.