



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

SEP 19 2008

The Honorable Sander Levin
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Levin:

As you know, the Department of Education (DOED) referred your letter to us regarding the income tax treatment of student loans that are forgiven under various provisions of the Higher Education Act of 1965 (HEA). The Treasury Department's Office of Tax Policy worked with the Internal Revenue Service (IRS) and DOED to analyze each of the specific provisions noted in your letter. A summary of that analysis and the legal conclusions reached is set forth below.

HEA Student Loan Programs

The HEA authorizes two programs, the Direct Loan program and the Federal Family Education Loan (FFEL) program, to assist students and parents in paying for postsecondary education.

Under the Direct Loan program, DOED makes subsidized and unsubsidized loans directly to students (Federal Direct Stafford/Ford Loans) and parents (Federal Direct PLUS Loans) {20 U.S.C. §§ 1087a-1087j; 34 C.F.R. part 685}. The Direct Loan program also includes a Federal Direct Consolidation Loan Program {20 U.S.C. § 1078-3(a)(4)(C); 34 C.F.R. § 685.216}.

Under the FFEL program, the lenders are non-federal entities such as banks, savings and loan associations, credit unions, schools, and state and private nonprofit agencies {20 U.S.C. § 1085(d); 34 C.F.R. § 682.101(a)}. A FFEL loan is generally insured by a state or nonprofit private organization loan insurance program.¹ When a loan insurance program pays a lender for a loss due to a borrower's default, the federal government guarantees a percentage of this amount {20 U.S.C. § 1078(c)(1)}. This percentage is generally limited to no more than 95 percent for recently issued loans, but it could be as high as 100 percent or as low as 75 percent {20 U.S.C. § 1078(c)(1); 34 C.F.R. § 682.404}.

¹ If the state is not served by a loan insurance program, a FFEL loan may be insured directly by DOED. Currently, every state is served by a loan insurance program. However, certain federally insured loans remain outstanding.

Background on Federal Tax Law

Generally, gross income for tax purposes means all income from whatever source derived, including income from discharge of indebtedness {Internal Revenue Code (Code) § 61(a)(12)}.

Notwithstanding the general rule, Code § 108(f)(1) permits discharges of student loans to be excluded from gross income if the discharge was pursuant to a loan provision authorizing discharge and the borrower worked for a certain period of time in certain professions for any of a broad class of employers. For this purpose, a “student loan” is a loan to assist an individual in attending an educational organization made by (A) the United States (or any instrumentality or agency thereof); (B) a state, territory, or possession of the United States, or the District of Columbia (or any political subdivision thereof); (C) certain tax-exempt public benefit corporations; and (D) under certain circumstances, the educational organization itself {Code § 108(f)(2)}.

Tax Consequences of Student Loan Discharges under the HEA

HEA §§ 460 and 428J: Teacher Loan Forgiveness

Sections 460 and 428J of the HEA provide for the forgiveness of student loans for teachers under the Direct Loan and FFEL loan programs, respectively. To be eligible for loan forgiveness, the borrower must be employed as a full-time teacher for five consecutive complete academic years in certain elementary or secondary schools that serve low-income families.

In the case of teacher-loan forgiveness under the Direct Loan program pursuant to HEA § 460, DOED is the lender, and thus the loans qualify as “student loans” for purposes of Code § 108(f)(2). Additionally, loan forgiveness for teachers under the Direct Loan program is conditioned on the borrower working for a certain period of time as a teacher for certain low-income schools. Thus, teacher-loan forgiveness under the Direct Loan program satisfies the requirements of Code § 108(f)(1) for income exclusion.

In the case of teacher-loan forgiveness under the FFEL program pursuant to HEA § 428J, the analysis is more complicated because DOED is not the holder of the loan at the time the debt is forgiven. The nominal private financial institution is not a lender described in Code § 108(f)(2). However, by statute, DOED ultimately is the source of funds for debt forgiveness through its obligation to guarantee substantially all of the forgiven amount. As guarantor, DOED pays the borrower’s debt to the private financial lender and then, in turn, discharges the borrower’s debt. As a matter of subrogation, DOED reasonably can be viewed as the lender for purposes of Code § 108(f)(2)(A). Additionally, as with the Direct Loan program, loan forgiveness under the FFEL program is conditioned on the borrower working for a certain period of time as a teacher for certain low-income schools. Thus, teacher loan forgiveness under the FFEL program satisfies the requirements for income exclusion under Code § 108(f).

HEA § 455(m)(2): Public Service Loan Forgiveness

Congress enacted forgiveness provisions for Direct Loans based on public service as part of the College Cost Reduction and Access Act of 2007 (Public Law 110-84) (CCRAA), effective

October 1, 2007. Under this provision, a borrower who is employed full time in qualifying public service, who is not in default, and who makes 120 monthly payments on an eligible Direct Loan may have the remaining outstanding balance of principal and accrued interest on the loan forgiven. For the reasons discussed above, Direct Loans qualify as “student loans” for purposes of Code § 108(f)(2). Additionally, loan forgiveness for public service is conditioned on the borrower working for a certain period of time in qualifying public service positions. Thus, public-service-loan forgiveness under the Direct Loan program satisfies the requirements for income exclusion under Code § 108(f)(1).

Also, we understand from DOED that, effective July 1, 2008, a FFEL borrower may consolidate a FFEL loan into a Direct Consolidation Loan. Thus, even though FFEL loans do not have a provision for loan forgiveness conditioned on public service, a FFEL borrower may satisfy the requirements for income exclusion under Code § 108(f)(1) by consolidating a FFEL loan into a Direct Consolidation Loan and meeting the requirements of the public service provisions.

HEA § 437(a): Death and Disability Discharge

HEA § 437(c): Closed School, False Certification, and Unpaid Refund Discharge

HEA § 464(g): Closed School Discharge

The Death and Disability discharge provisions of HEA § 437(a) apply to borrowers under the FFEL program who have either died or become permanently and totally disabled. The Closed School discharge provisions of HEA §§ 437(c) and 464(g) apply to borrowers under the FFEL and Direct Loan programs, respectively, who are unable to complete the school program because of a school closure. The discharge provisions of HEA § 437(c) also apply to borrowers under the FFEL program whose eligibility was falsely certified by the educational institution, or in cases where the educational institution did not refund loan proceeds that it owed to the borrower’s lender.

For the reasons discussed above, both Direct Loans and FFEL loans qualify as “student loans” within the meaning of Code § 108(f)(2). However, HEA §§ 437(a), 437(c), and 464(g) discharges are not based on the Code § 108(f)(1) requirement that the borrower work in a certain profession for a certain period of time. Thus, discharges under these sections do not satisfy the requirements for income exclusion under Code § 108(f)(1).

HEA § 455(e): Income-Contingent Repayment

HEA § 493C(b)(7): Income-Based Repayment

Under the Direct Loan program, a borrower may choose among a range of repayment options, which include an income-contingent repayment (ICR) plan and an income-based repayment (IBR) plan.

Under the ICR plan, the monthly repayment amount is generally based on the total amount of the borrower’s Direct Loans, family size, and adjusted gross income (including a spouse’s income) {34 C.F.R. § 685.208(k)(1)}. The amount of the payments cannot exceed 20 percent of a borrower’s discretionary income computed on the basis of a set formula. Each year, DOED recalculates a borrower’s annual payment based on changes in the borrower’s adjusted gross income, variable interest rate, income percentage factors in the annual notice, and poverty

guidelines. A borrower makes payments until the loan is repaid in full or until the loan has been in repayment through the end of the ICR period. In general, the maximum repayment period is 25 years {34 C.F.R. § 685.209(c)(4)(i)}. At the end of the ICR period, DOED cancels any unpaid portion of the loan {34 C.F.R. § 685.209(c)(4)(iv)}.

Congress enacted the IBR plan as part of the CCRAA, effective July 1, 2009. The IBR plan is available to a borrower based upon a showing of financial hardship. The IBR plan is similar to the ICR plan in that both cap the monthly payments at a percentage of discretionary income and DOED forgives the remaining balance at the end of 25 years.

For the reasons discussed above, Direct Loans qualify as “student loans” within the meaning of Code § 108(f)(2). However, loan forgiveness under an ICR or IBR plan is not based on the Code § 108(f)(1) requirement that the borrower work in a certain profession for a certain period of time. Thus, loan forgiveness under HEA §§ 455(e) and 493C(b)(7) does not satisfy the requirements for income exclusion under Code § 108(f). DOED currently notifies borrowers that they may have to pay income tax on debt forgiveness under the ICR program, and plans to provide similar notifications to borrowers under the IBR plan once it goes into effect.

Conclusion

Your letter asks whether student loan forgiveness under the HEA that does not satisfy the requirements for income exclusion under Code § 108(f) or any other provision of the Code should be excludable as a matter of policy. As evidenced by the exclusion provided under Code § 108 for bankrupt or insolvent taxpayers, the ability of a taxpayer to pay tax on income is often a consideration in determining whether to impose tax on that income. Student borrowers may not have the ability to pay tax on income resulting from loan forgiveness under the HEA. Should Congress legislate exclusions to address this or other policy concerns, the Treasury Department and the IRS would apply and administer any such statutory exclusion for loan forgiveness.

Thank you for bringing these questions and concerns to our attention.

Sincerely,



Eric Solomon
Assistant Secretary for Tax Policy

cc: The Honorable Margaret Spellings