DELIVERING ON DEBT RELIEF

Proposals, Ideas, and Actions to Cancel
Student Debt on Day One and Beyond

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THE TAX TREATMENT OF STUDENT LOAN DISCHARGE AND CANCELLATION

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Introduction

Many of the proposals and reforms in this volume call for expanding the availability and amount of student debt cancellation,¹ by either streamlining or clarifying existing law, or by providing new regulatory pathways for debt cancellation consistent with the text and purpose of the Higher Education Act (HEA). But debt cancellation also raises some tricky tax issues, which in some circumstances could undermine much of the benefits of debt cancellation to individual borrowers.² Moreover, uncertainty about the tax treatment of the cancellation of debt has been used by policymakers to resist efforts to expand the availability of debt discharge and cancellation.³ To be truly successful, student debt reform needs to also incorporate clarification and simplification of the tax treatment of student debt cancellation and discharge. Fortunately, this is not that hard to do.

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The problem stems from the general tax principle that cancellation of indebtedness is treated as gross income for tax purposes.⁴ In the context of a typical commercial debt relationship, the logic behind this principle is simple: not having to pay back a debt is an economic gain to a person in the same way as if the person, say, won a lottery and used that money to pay off the debt.⁵ Borrowing money is not considered income, since there is an offsetting liability. But cancel that liability and now the person has a net gain that the tax system recognizes.

¹ Debt “cancellation,” “forgiveness,” and “discharge” are used interchangeably herein, reflecting the fact that different legal authorities use different language.

² See, e.g., Greg Crespi, *Should We Defuse the “Tax Bomb” Facing Lawyers Who Are Enrolled in Income-Based Student Loan Repayment Plans?*, 68 S.C. L. Rev. 117 (2016); Noam Scheiber, *An Expensive Law Degree, and No Place to Use It*, N.Y. Times, June 18, 2016 <https://nyti.ms/24VmZec> (“Yet in financial terms, there is almost no way for Mr. Acosta to climb out of the crater he dug for himself in law school, when he borrowed over \$200,000. The government will eventually forgive the loan—in 20 years—if he’s unable to repay it, as is likely on his small-town lawyer’s salary. But the Internal Revenue Service will probably treat the forgiven amount as income, leaving him what could easily be a \$70,000 tax bill on the eve of retirement, and possibly much higher.”).

³ See, e.g., John R. Brooks, *Why is the Department of Education Dragging Its Feet on Debt Relief for Disabled Veterans?*, Student Borrower Prot. Ctr. (Dec. 13, 2018), <https://protectborrowers.org/why-is-the-department-of-education-dragging-its-feet-on-debt-relief-for-disabled-veterans>.

⁴ See I.R.C. § 61(a)(11).

⁵ See, e.g., *U.S. v. Kirby Lumber*, 284 U.S. 1 (1931).

But applying this rule to student debt is problematic. Suppose a person borrowed heavily to go to law school—let's say an initial debt of \$250,000. Suppose further that this person enters a relatively low-paying job, but one that does not qualify for Public Service Loan Forgiveness, say as a private immigration attorney serving a low-income community. If that person enters income-driven repayment (IDR), she could keep her monthly loan payments at an affordable level and then have the remaining balance of her loan discharged after 20 or 25 years. If her principal in 20 years is still \$250,000 (and it could be quite a bit more), then applying this tax rule would mean she would have \$250,000 of gross income in the year of the cancellation, in addition to her other income. Under today's tax rates, that "income" would most likely be taxed at rates between 22% and 35%, depending on her marital status and other factors, and that tax would be immediately due.⁶

Even if we assume a relatively low average tax rate of, say, 25%, then in effect, the government did not cancel 100% of the loan—it cancelled 75% of the loan and then accelerated repayment of the rest. There is no good logic for such a policy—it undermines the whole purpose of student loan cancellation and causes hardship at exactly the time that the law is trying to provide relief. This is not just about lawyers and doctors. Social workers, teachers, nurses, members of the clergy, and others have relatively expensive graduate degrees and low salaries, but could still easily have to pay back over 20% of their otherwise-cancelled loan in taxes. And this problem is not limited to a few individuals. As of the third quarter of 2020, over half of all federal student loans in repayment were enrolled in an IDR plan—\$530 billion, owed by nearly 9 million borrowers.⁷

Moreover, the perceived risk of causing that hardship has led to reluctance among administration officials to extend debt cancellation more widely. For example, before Congress added a tax exclusion of total and permanent disability ("TPD") discharge (more on tax exclusions in a moment) there were cases of disabled veterans getting hit with unexpected tax bills for \$70,000 or more.⁸ The difficult politics of that outcome may have

⁶ For current tax rates and brackets see Rev. Proc. 2020-45, 2020-46 I.R.B 1016.

⁷ *Direct Loan Portfolio by Repayment Plan*, Fed. Student Aid (2020), <https://studentaid.gov/data-center/student/portfolio> (last accessed Nov. 18, 2020). These statistics likely undercount the number of borrowers who qualify for these plans, given the difficulties of enrolling and continuing to stay on the plans. Conversely, given these challenges, it is possible that a substantial share of borrowers who have enrolled in IDR to date will struggle to persist for 20 or 25 years, and therefore may never qualify to have their debts cancelled. See, e.g., Consumer Fin. Prot. Bureau, Midyear Update on Student Loan Complaints: Income-Driven Repayment Plan Application Issues (Aug. 2016), https://files.consumerfinance.gov/f/documents/201608_cfpb_StudentLoanOmbudsmanMidYearReport.pdf.

⁸ See, e.g., Judy Putnam, *Wounded Army Vet Wins the Battle But Loses the Tax War*, Lansing State J. (Oct. 20, 2017), <https://www.lansingstatejournal.com/story/opinion/columnists/judy-putnam/2017/10/20/putnam-wounded-army-vet-wins-battle-but-loses-tax-war/781458001/>.

led to reluctance at Federal Student Aid to make disability discharge automatic.⁹ And even after Congress added the TPD tax exclusion to the Internal Revenue Code in 2017, FSA still worried publicly about *state* tax implications (though incorrectly, in my view).¹⁰

Compounding the problem further is that, as just noted, not all student debt cancellation is currently taxable. As I discuss below, Congress and the IRS have created a patchwork of exclusions without any coherent reasons for treating some forms of student debt discharge differently than others. This just muddies the water further, creating more confusion and complication, as well as real human hardship.

None of this is necessary. Congress can, of course, easily solve this problem—and its action on TPD discharge in 2017 shows that this can be a bipartisan issue. But even in the absence of affirmative legislation, Treasury and the IRS have sufficient tools to exclude from gross income all forms of student debt cancellation. Indeed, as I discuss below,¹¹ the whole notion that student debt cancellation should be taxable at all is actually a misreading of the tax law. Fundamentally, student debt cancellation should be treated like a non-taxable scholarship—and was for many years, until a flawed ruling of the IRS in 1973 confused the issue. Since the IRS created this problem, it can also fix it. Furthermore, under other law that applies to debt instruments and to the taxation of debt cancellation, the IRS and Treasury should have sufficient legal authority to rule that student debt cancellation is not taxable. Finally, any cancellation can also be treated as an excluded payment for the promotion of the general welfare, particularly if granted as a disaster relief program related to COVID-19.

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Problems

As noted above, the general tax rule is that discharge of indebtedness creates income for tax purposes. But that general rule is subject to many exclusions and exceptions, some of which apply explicitly to student debt. In this

⁹ See, e.g., Daniel Uria, *Lack of Info, Fear Causing Thousands of U.S. Vets to Default on Student Loans*, UPI, Nov. 20, 2018 (quoting a Department of Education spokesperson: “The last thing we want to do is cause unintended consequences—like impact future federal student aid or create a state or local tax liability—for men and women who have given so much.”).

¹⁰ See Brooks, *supra* note 3.

¹¹ See “Solutions,” *infra*.

section, I summarize some of these exclusions and exceptions to illustrate how much of a patchwork the current treatment of student debt cancellation is. In this next section, I discuss why this patchwork is both a mistake and unnecessary.

- **Public Service Loan Forgiveness.** Section 108(f)(1) of the Internal Revenue Code excludes from gross income student debt discharge “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.”¹² A similar provision applies to loan repayment or cancellation under certain programs for healthcare professionals.¹³ The statutory wording is of course pretty broad, but the exclusion depends on the provisions of the loan itself, and as of now, that language only describes loans in PSLF or the equivalent,¹⁴ including “loan repayment assistance programs” at law schools and elsewhere.¹⁵
- **Disability Discharge.** Section 108(f)(5) excludes from gross income debt discharged on account of the death or total and permanent disability of the borrower. This provision was added only in 2017,¹⁶ and under current law it expires in 2026, at which point disability discharges would again become taxable.¹⁷
- **Closed School Discharge.** The Higher Education Act, in a roundabout and obscure way, provides an exclusion for debt discharged due to a closed school by cross-referencing the provision that applies to Public Service Loan Forgiveness.¹⁸ Indeed, this reference was so obscure that Treasury appeared not to

¹² I.R.C. § 108(f)(1).

¹³ I.R.C. § 108(f)(4).

¹⁴ Section 465 of the Higher Education Act also provides for a tax exclusion for certain forms of public service loan cancellation, which may be more or less extensive than the explicit exclusion in I.R.S. § 108(f). 20 U.S.C. 1087ee(a)(5).

¹⁵ See, e.g., Rev. Rul. 2008-34, 2008-2 C.B. 76 (LRAP programs can qualify for § 108(f) exclusion).

¹⁶ Pub. L. No. 115-97, sec. 11031, § 108(f), 131 Stat. 2054, 2081 (2017) (codified at I.R.C. § 108(f)(5)(A)(iii)).

¹⁷ I.R.C. § 108(f)(5)(A).

¹⁸ See 20 U.S.C. § 1087ee(a)(5) (PSLF loans); *id.* § 1087(c)(4) (incorporating § 1087ee(a)(5) for FFEL loans); *id.* § 1087e(a)(1) (incorporating FFEL terms for Direct Loans).

know about this exclusion until some Democratic Senators, including Sen. Elizabeth Warren, pointed it out in 2015.¹⁹

- **Borrower Defense Discharge.** There is no specific statutory exclusion for borrowers who have loans discharged because they assert a defense against repayment because a school's actions give rise to a state law cause of action. However, the IRS announced in early 2020 that it would provide a "safe harbor" in which it would not assert taxation against borrowers who had loans discharged by the Education Department under borrower defense or against borrowers who had private loans discharged under similar state law actions.²⁰ This general safe harbor grew out of narrower rulings that had originally applied only to former students of the closed for-profit Corinthian Colleges and American Career Institute chains.²¹ The IRS's rationale is that many, if not all, of the borrowers whose loans were discharged under borrower defense could claim an exclusion either because they were insolvent (for which a statutory exclusion applies)²² or because some general fraud or misrepresentation claim could be used to challenge whether the loan was valid in the first place.²³ The IRS reasoned that if it tried to figure out who should incur tax liability from among these borrowers, it "would impose a compliance burden on taxpayers, as well as an administrative burden on the IRS, that is excessive in relation to the amount of taxable income that would result,"²⁴ and thus the IRS has declined to assert taxation against all borrowers covered by the safe harbor. Importantly, however, the announcements are phrased only as an administrative decision by the IRS not to "assert" taxation due to discharge, not that the law clearly excludes the discharge from gross income. Moreover, it is not clear if the safe harbor applies to all borrower defense discharges.

¹⁹ See John R. Brooks, *Treasury Should Exclude Income From Discharge of Student Loans*, 152 Tax Notes 751, 753 (2016).

²⁰ Rev. Proc. 2020-11, 2020-6 I.R.B. 406.

²¹ See Rev. Proc. 2015-57, 2015-51 I.R.B. 863 (Corinthian Direct Loans); Rev. Proc. 2017-24, 2017-7 I.R.B. 916 (ACI Direct Loans); Rev. Proc. 2018-39, 2018-34 I.R.B. 319 (private loans for both).

²² I.R.C. § 108(a)(1)(B).

²³ See, e.g., Rev. Proc. 2015-57. The rulings are vague on the legal authority for the latter point, but likely were referring to something like the contested liability doctrine at issue in *Zarin v. Comm'r*, 916 F.2d 110 (3d Cir. 1990).

²⁴ Rev. Proc. 2020-11.

- **Bankruptcy.** If a borrower has her debt reduced or cancelled in bankruptcy as an “undue hardship”²⁵ or because non-dischargeability otherwise does not apply,²⁶ then the Internal Revenue Code excludes that cancellation from gross income.²⁷
- **Income-Driven Repayment.** Debt discharged under an IDR plan (other than PSLF) does not have an explicit statutory exclusion and thus is currently considered taxable, according to the Treasury Department.²⁸
- **False Certification.** Debt can also be discharged if the borrower was falsely certified by a school as being eligible for student loans.²⁹ The same exclusion in the HEA for closed school discharge also applies here,³⁰ but to my knowledge the IRS has not ruled on this issue.
- **Settlement and Compromise.** As with IDR, there is no clear statutory exclusion on point. If a borrower is able to renegotiate the amount of their loan—or if ED uses its settlement and compromise authority to unilaterally cancel some amount of student debt³¹—the IRS will need to determine whether the amount of the cancelled debt is taxable, considering, for example, whether some other exclusion (like insolvency) applies.
- **Interest Subsidies.** Under most of the IDR plans, the government covers some portion of the loan’s interest if a borrower’s payment is too small to pay it all. For example, under REPAYE, the government will cover half of any charged but unpaid interest.³² The government also covers some of the interest for Direct Subsidized Loans. This could be viewed as the government cancelling debt that would otherwise

²⁵ 11 U.S.C. § 523(a)(8).

²⁶ See, e.g., Austin Smith, *Not All Student Loans Are Non-Dischargeable in Bankruptcy and Creditors Know This*, Student Borrower Prot. Ctr. (March 18, 2019), <https://protectborrowers.org/not-all-student-loans-are-non-dischargeable-in-bankruptcy-and-creditors-know-this>.

²⁷ I.R.C. § 108(a)(1)(A).

²⁸ See Letter from Eric Solomon, Assistant Sec’y for Tax Policy, Dep’t of Treasury, to Hon. Sander Levin, U.S. House of Representatives 4 (Sept. 19, 2008) (on file with author).

²⁹ 20 U.S.C. § 1087(c)(1).

³⁰ See 20 U.S.C. § 1087(c)(4); *supra* note 18.

³¹ See 20 U.S.C. § 1082(a)(6); see also Luke Herrine, *The Law and Political Economy of a Student Debt Jubilee*, 658 Buff. L. Rev. 281, 341–97 (2020).

³² 34 C.F.R. § 685.209(c)(2)(iii)(B).

be accruing, or perhaps as the government paying part of a bill the borrower owes. Under either theory, standard tax law would say that the payment should be taxable.³³ The IRS has ruled that interest subsidies paid to private lenders under the old Federal Family Education Loan Program should be considered non-taxable “scholarships,”³⁴ but as far as I can tell it has not ruled on the more modern interest subsidies under IDR or the Direct Loan Program generally. That said, no one is claiming that interest subsidies are taxable.

In general, Congress, ED, and the IRS have been moving in the right direction, slowly plugging holes and providing relief where they can, starting first with the rediscovery of the exclusion for closed school (and false certification) discharge in 2015, then the statutory exclusion for TPD discharge in 2017, and then the IRS’s borrower defense safe harbor in 2020. But the law still lacks necessary clarity and remains fragile—especially in the cases of TPD and borrower defense. Moreover, there is still no explicit exclusion that applies to IDR or to a possible debt cancellation under settlement and compromise, either of which would be vastly bigger than other types of cancellation. More is needed.

Solutions

Congress can fix this problem, of course, simply by expanding the applicability of section 108 of the tax code. But assuming Congress will act is, sadly, usually a mistake. While legislation is not impossible given some of the bipartisan interest in the issue and in reauthorization of the Higher Education Act, the Biden Administration will likely have to act through regulation and other administrative action on this issue. But they should do so clearly and confidently, because the entire assumption that student debt cancellation should be taxable is based on a flawed reading of the tax law rooted in a bad decision of the IRS in 1973.³⁵

³³ See, e.g., *Old Colony Tr. Co. vs. Comm’r*, 279 U.S. 716, 729 (1929) (“The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.”).

³⁴ Rev. Rul. 75-537, 1975-2 C.B. 32; see I.R.S. Gen. Couns. Memo 33,721 (Jan. 4, 1968) (student loan interest subsidies would be income to the borrower but for § 117).

³⁵ For a detailed history of the IRS’s back-and-forth on this question, see Richard C.E. Beck, *Loan Repayment Assistance Programs for Public-Interest Lawyers: Why Does Everyone Think They Are Taxable?*, 40 N.Y.L. Sch. L. Rev. 251, 258–71 (1995); see also John R. Brooks, *Treasury Should Exclude Income From Discharge of Student Loans*, 152 Tax Notes 751, 752–53 (2016).

A typical tax law analysis of this issue would go something like this: cancellation of indebtedness is taxable unless there is an exception in the tax code. The only clear exception is for debt cancelled due to public service (and now also death or disability). Therefore, all other student debt cancellation is taxable. But that thinking gets backwards *why* section 108(f) exists. It exists not to provide a narrow exception to taxability. Rather, it exists to plug a hole in the broader *non-taxability* of student debt forgiveness. Understanding why requires unpacking some history.

Student loan cancellation programs are likely as old as student loans themselves. They extend at least back to the 1950s, when some states provided loan cancellation for doctors, teachers, and others who worked in specific under-served geographic areas.³⁶ National Defense Student Loans (the predecessor of Perkins Loans) also provided an early form of loan cancellation for teachers.³⁷ The IRS ruled on several occasions in the 1950s and 60s that the loan cancellation from these programs was *not* taxable, because the cancellation should be

The IRS ruled on several occasions in the 1950s and 60s that the loan cancellation from these programs was not taxable, because the cancellation should be considered a non-taxable “scholarship” under Internal Revenue Code section 117.

considered a non-taxable “scholarship” under Internal Revenue Code section 117.³⁸ Under then-current regulations, a payment could not qualify as a “scholarship” if it was actually compensation for services, but since the services in question—such as working in a rural medical clinic or school—were not for the lender, the loan cancellation was better described as a condition for receiving a scholarship grant, the IRS ruled.³⁹

The Supreme Court complicated the issue in 1969 by ruling in *Bingler v. Johnson*⁴⁰ that an employee on paid leave while pursuing a graduate degree could not exclude that payment as a “scholarship” under section 117, because he was required to return to work for two years after receiving his degree. The Court held that section 117 applied only to “no-strings

³⁶ See, e.g., I.R.S. Priv. Ltr. Rul. 5604265200A (Apr. 26, 1956) (describing a typical state program).

³⁷ National Defense Education Act of 1958, Pub. L. No. 85-864, § 205(b)(3), 72 Stat. 1580, 1585 (1958).

³⁸ I.R.S. Gen. Couns. Memo 31,871 (Jan. 19, 1961). I.R.S. Priv. Ltr. Rul. 6004275330A (Apr. 27, 1960); I.R.S. Priv. Ltr. Rul. 5807039700A (July 3, 1959) (reversing I.R.S. Priv. Ltr. Rul. 5604265200A (Apr. 26, 1956)); I.R.S. Gen. Couns. Mem. 30,700 (May 27, 1958).

³⁹ See, e.g., I.R.S. Priv. Ltr. Ruling 6004275330A.

⁴⁰ 394 U.S. 741 (1969).

educational grants, with no requirement of any substantial quid pro quo from the recipients.”⁴¹ Although the facts of that case were still consistent the IRS’s prior interpretation—that a scholarship does not include payments contingent on providing services *to the grantor*—the IRS used *Bingler* to reverse its earlier loan cancellation rulings. In 1973 the IRS ruled instead that loan cancellation dependent on, for example, the borrower working in rural medicine was “primarily for the benefit of the grantor” and therefore could not qualify as a non-taxable scholarship.⁴² Congress quickly responded to overrule the IRS legislatively,⁴³ ultimately adding the section 108(f) exclusion mentioned above for PSLF-type loan cancellation.⁴⁴

But regardless of whether the IRS was correct to read *Bingler* as applying to PSLF-type loans, that issue is irrelevant to the question of whether IDR or other loan cancellation should be taxable. Loan cancellation under income-driven repayment or settlement and compromise does *not* require any sort of quid pro quo—no one is required to work in a particular field or geographical area, or really do anything other than make their required payments. In those circumstances, we should default to the IRS’s original treatment of student loan cancellation as a non-taxable scholarship. In passing section 108(f), Congress was not indicating that all other forms of student debt cancellation should be taxable; instead, it was plugging a hole in order to keep the general policy of non-taxability intact. Section 108(f) was only needed to cover loan cancellation that section 117 did not cover.⁴⁵

Student loans and section 117 have both changed somewhat in ways that complicate this argument today, but do not contradict the core point. At the time section 108(f) was added, PSLF-type forgiveness was the dominant

⁴¹ *Id.* at 750.

⁴² Rev. Rul. 73-256, 1973-1 C.B. 56.

⁴³ See Tax Reform Act of 1976, Pub. L. No. 94-455, § 2117, 90 Stat. 1520, 1911–12; Revenue Act of 1978, Pub. L. No. 95-600, § 162 92 Stat. 2763, 2810. In its report on the 1976 Act, Congress specifically stated that the statutory exception was in response to Rev. Rul. 73-256. See S. Rep. No. 94-938, at 430.

⁴⁴ See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1076(a), 98 Stat. 494, 1053; Joint Committee on Tax’n, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84, at 1199–1201 (1984), <https://www.jct.gov/publications/1984/jcs-41-84/>.

⁴⁵ Richard Beck has argued persuasively that the language of 108(f) explicitly acknowledges that other kinds of student debt cancellation outside of 108(f) could also be non-taxable, and that “Congress did not intend to change the law by enacting I.R.C. § 108(f), but rather to clarify it by purging the IRS’ erroneous interpretation in Revenue Ruling 73-256.” Beck, *supra* note 35, at 279–83. See also S. Rep. No. 94-938, at 430 (a reason for the statutory change was to make debt cancellation “consistent with the treatment of scholarships and fellowship grants which are not contingent upon the performance of needed services by the recipient”).

form of cancellation; IDR did not appear until 1994⁴⁶ and did not really take off until after 2010.⁴⁷ So the tax code's silence on IDR should not be given much weight. Section 117 also changed somewhat in 1986,⁴⁸ especially by making it inapplicable to those who are not "candidate[s] for a degree."⁴⁹ While that might seem at first glance to foreclose scholarship treatment for those who have completed their degree or left school, the legislative history makes clear that the intent was only to remove scholarship treatment for nondegree *programs*.⁵⁰ This is further supported by the fact that the scholarship exclusion appears to be the reason interest subsidies are not taxable,⁵¹ even though they also occur after the borrower leaves school.

However, it is also clear that section 117 can apply only to "qualified tuition and related expenses," i.e., only money to cover tuition and fees, not room, board, and other living expenses.⁵² That could pose a problem especially for Grad PLUS Loans, which can cover up to the full cost of attendance. So while we should not read any of this as clear Congressional intent to tax student debt cancellation, these provisions do mean that Treasury and the IRS may need to take more affirmative steps to ensure that the promise of student debt cancellation is fulfilled.

As I lay out below, there are several overlapping legal arguments and regulatory steps that can ensure that cancelled debt is truly 100% cancelled. (Several of these arguments were first laid out in more detail in a letter from Sens. Warren, Brown, and Durbin, and Rep. Waters to the Treasury in 2015.⁵³ I also cover them in some

⁴⁶ See Student Loan Reform Act of 1993, Pub. L. No. 103-66, § 4021, 107 Stat. 312, 341 (creating Income-Contingent Repayment Program).

⁴⁷ For more on the history and expansion of the IDR programs and Direct Loans, see John R. Brooks and Adam J. Levitin, *Redesigning Education Finance: How Student Debt Outgrew the "Debt" Paradigm*, 109 Geo. L.J. 5, 27–33 (2020).

⁴⁸ Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 123(a), § 117, 100 Stat. 2085, 2112–13.

⁴⁹ I.R.C. § 117(a).

⁵⁰ See, e.g., H. Rep. No. 99-841, at II-15 (distinguishing between "degree candidates" and "nondegree candidates"). The prior version of section 117 could apply to candidates who were "not . . . candidate[s] for a degree at an educational institution (as defined in section 151(e)(4))" only if the grantor otherwise qualified as a section 501(c)(3) tax-exempt organization. See I.R.C. § 117(b)(2) (1958). In other words, the emphasis was on whether the institution was an educational institution that could grant degrees, not on whether the student was currently enrolled. As noted above, the IRS used this version of section 117 to rule that early loan forgiveness programs should be excluded from income. See *supra* note 38. Furthermore, cancelling a loan essentially transforms part of the original loan into a grant—one that was made at the time at the time of the original loan, i.e., when the borrower was still a "candidate for a degree."

⁵¹ See "Interest Subsidies," *supra*.

⁵² I.R.C. § 117(b); Prop. Treas. Reg. § 1.117-6(c)(1).

⁵³ Letter from Senator Elizabeth Warren et al. to Jack Lew, Sec'y of the Treasury, and John Koskinen, Comm'r of the Internal Revenue Service (Aug. 11, 2015),

more detail in a 2016 *Tax Notes* article.⁵⁴) Some of these arguments apply with more force than others or apply to some situations better than others. But like for the borrower defense safe harbor, the sum total of these approaches is more than sufficient to empower the IRS either to affirmatively rule that student debt cancellation is not taxable, or at a minimum to decline to assert taxation for administrative reasons.

- **General Welfare Exclusion.** Treasury and the IRS have the clear authority to conclude “that payments to individuals by governmental units under legislatively provided social benefit programs for the promotion of the general welfare are not included in a recipient’s gross income.”⁵⁵ This exclusion applies to payments (1) made from a governmental fund, (2) for the promotion of the general welfare, and (3) that are not compensation for services.⁵⁶ The IRS has applied the general welfare exclusion to, *inter alia*, payments to the blind,⁵⁷ mortgage assistance payments,⁵⁸ replacement housing subsidies,⁵⁹ vocational training payments,⁶⁰ stipends to under-employed individuals under probation,⁶¹ disaster relocation payments,⁶² and payments to crime victims.⁶³ The primary justification for the general welfare exclusion is that taxing these benefits would undermine their social purpose—that the government would be giving with one hand and

The primary justification for the general welfare exclusion is that taxing these benefits would undermine their social purpose—that the government would be giving with one hand and taking with the other.

<https://www.brown.senate.gov/imo/media/doc/2015.8.11%20Letter%20to%20Treasury%20and%20IRS%20re%20Corinthian%20student%20loan%20debt1.pdf>.

⁵⁴ Brooks, *supra* note 19. Other extended treatments of the question include Beck, *supra* note 35; Herrine, *supra* note 31, at 402–10.

⁵⁵ Rev. Rul. 2005-46, 2005-2 C.B. 120.

⁵⁶ *Id.*

⁵⁷ Rev. Rul. 57-102, 1957-1 C.B. 26.

⁵⁸ Rev. Rul. 75-271, 1975-2 C.B. 23.

⁵⁹ Rev. Rul. 74-205, 1974-1 C.B. 20.

⁶⁰ Rev. Rul. 68-38, 1968-1 C.B. 446.

⁶¹ Rev. Rul. 72-340, 1972-2 C.B. 31.

⁶² Rev. Rul. 98-19, 1998-1 C.B. 840.

⁶³ Rev. Rul. 74-74, 1974-1 C.B. 18.

taking with the other. That concern applies with equal force to student loan cancellation. This exclusion would be particularly relevant for IDR debt cancellation, as it is a legislatively provided program intended to support low-income borrowers, and the exclusion could possibly apply to settlement and compromise, since that power is also granted to ED by legislation.

- **Qualified Disaster Relief Payment.** The general welfare exclusion is also partially codified in the case of payments made by the government “in connection with a qualified disaster in order to promote the general welfare.”⁶⁴ Because the COVID-19 pandemic has been declared a “qualified disaster” for tax purposes,⁶⁵ this provision would be particularly relevant for any one-time cancellation by the new administration under settlement and compromise.⁶⁶

Because the COVID-19 pandemic has been declared a “qualified disaster” for tax purposes, this provision would be particularly relevant for any one-time cancellation by the new administration under settlement and compromise.

- **Scholarship Exclusion.** As discussed above, student debt cancellation should still be considered to fall within the general definition of a non-taxable “scholarship” under section 117. That said, the exclusion likely covers only loans for degree programs at educational institutions, which would leave out other types of programs for which federal student loans are available. It would also cover cancellation only to the extent the loans covered tuition and fees, not other living expenses. It would be fair to assume that undergraduate loans largely go to tuition and fees, given the relatively low borrowing limits,⁶⁷ but not graduate loans, which can be up to the full cost of attendance.⁶⁸ That said, a relatively small one-time cancellation, such as \$10,000 per borrower, might be safely assumed to

cover only tuition and fees.

⁶⁴ I.R.C. § 139(a), (b)(4).

⁶⁵ The White House, Proclamation on Declaring a National Emergency Concerning the Novel Coronavirus Disease (COVID-19) Outbreak (March 13, 2020), <https://www.whitehouse.gov/presidential-actions/proclamation-declaring-national-emergency-concerning-novel-coronavirus-disease-covid-19-outbreak>.

⁶⁶ Calling debt cancellation a “qualified disaster relief payment” is particularly useful, since the more common-law general welfare exclusion might not apply, if, e.g., cancellation under settlement and compromise is not considered to be “legislatively provided.”

⁶⁷ See 20 U.S.C. §§ 1078-8(d)(1) (limit of \$31,000 for undergraduate dependent students and \$57,000 for undergraduate independent students).

⁶⁸ See 34 C.F.R. §§ 685.203(f), (g).

- **Insolvency Exclusion.** The tax code excludes income from the cancellation of debt to the extent that the borrower is insolvent at the time of the discharge, i.e., to the extent that their liabilities (including the liability about to be discharged) exceed their assets.⁶⁹ This was one of the theories for non-cancellation of debt for borrower defense.⁷⁰ For IDR, insolvency is less certain, but still likely, since by definition the borrower is not earning sufficient income to pay down his or her student debt. It would likely apply with the least coverage in the case of a broad one-time cancellation, but would still apply to many borrowers. To make this exception more likely to apply to more borrowers, Treasury and the IRS could issue regulations defining “insolvency” for purposes of student debt in a way that excludes some assets, such as a personal residence, tax-preferred retirement accounts, and assets exempt from creditors under state law.⁷¹ This would be consistent with the Bankruptcy Code’s definition of insolvency,⁷² and there is evidence that Congress intended the section 108 insolvency exclusion to mirror bankruptcy law.⁷³
- **Contingent Liabilities.** All student loans carry with them by law the right to cancellation under certain circumstances, whether because of income, disability, borrower defense, and so on. For example, if we view IDR not as some discretionary cancellation of debt by the lender, but rather as a fulfillment of the terms of the loan, then debt isn’t really “forgiven” in a formal sense. The implicit terms of every student loan include the option to, instead of paying a fixed amount of principal and interest, pay a percentage of one’s income for 20–25 years. Seen that way, the IDR debt instrument is really a contingent liability, where the amount that will be paid is not fully clear at the time the debt is entered into, and the borrower

⁶⁹ I.R.C. § 108(a)(1)(B), (d)(3).

⁷⁰ See Rev. Proc. 2020-11.

⁷¹ See, e.g., *Cole v. Comm’r*, 42 B.T.A. 1110 (1940); *Marcus Estate v. Comm’r*, T.C. Memo. 1975-9. *But see* *Carlson v. Comm’r*, 116 T.C. 87, 101 (2001) (holding that the section 108(d)(3) definition precludes the application of *Cole* and other earlier cases).

⁷² 11 U.S.C. §§ 101(32)(A) and 522.

⁷³ S. Rep. No. 96-1035, at 10 (1980) (“The rules of the bill concerning income tax treatment of debt discharge in bankruptcy are intended to accommodate bankruptcy policy and tax policy The bill provides that . . . a debtor coming out of bankruptcy (or an *insolvent debtor outside bankruptcy*) is not burdened with an immediate tax liability.”) (emphasis added).

does not ever legally “owe” the cancelled amount.⁷⁴ If there is no unconditional obligation to repay, then release of that obligation should not constitute income.⁷⁵

- **Significant Debt Modification.** If, alternatively, entering into IDR is considered a change in the terms of the loan, then arguably tax should have been imposed at the time of opt-in, because a “significant debt modification” should be treated as a taxable exchange of one debt instrument for another.⁷⁶ In the case of cancellation under settlement and compromise, if the borrower still has debt remaining the cancellation could also be considered a significant debt modification under some circumstances.⁷⁷ Under this view, the proper measure of how much debt is cancelled is actually the difference in the fair market values of the two instruments at the time of that exchange.⁷⁸ But because the IDR options would be included in the both the old and new loan, the loan values would be so speculative and contingent that it would be effectively impossible to measure that difference and impose taxation.⁷⁹ Furthermore, the insolvency exclusion in section 108(a)(1)(B) would be *much more* likely to apply at the time of opt-in than on final discharge.⁸⁰

⁷⁴ See, e.g., *Central Paper Co., Inc. v. Comm’r*, 158 F.2d 131, 133–34 (1946); *Corporacion de Ventas Etc. v. Comm’r*, 130 F.2d 141, 143–144 (2d Cir. 1942) (no income for cancellation of payments that were contingent on future profits); I.R.S. Priv. Ltr. Rul. 201027035 (July 9, 2010) (prepayment to satisfy liabilities contingent on future profits does not give rise to cancellation of indebtedness income).

⁷⁵ This argument likely has relatively little purchase in the case of debt cancellation under settlement and compromise.

⁷⁶ Treas. Reg. § 1.1001-3(b), (e). Some additional IRS action would be helpful in shoring up this theory, since under current regulations, some alterations occurring by operation of the terms of the debt instrument are not considered “modifications,” Treas. Reg. § 1.1001-3(c)(ii), which might describe entering IDR. Such an alteration would still be considered a “modification” if it were pursuant to exercising an option that is not unilateral, i.e., one that is subject to the other party’s approval. Treas. Reg. § 1.1001-3(c)(2)(iii) & -3(c)(3). The Education Secretary ultimately has to approve the borrower entering IDR, at a minimum through determination of the borrower’s income. See, e.g., 34 C.F.R. 685.209(a)(5)(i) (income documentation must be “acceptable to the Secretary”). The IRS should make clear that this power of the Secretary is sufficient to make the option to enter IDR not unilateral (a fact which is also supported by the many accounts of the challenges borrowers have in getting approved for IDR).

⁷⁷ See Treas. Reg. § 1.1001-3(g), Example 3 (lowering of principal due at maturity can a “significant modification” if it causes a large enough change in the yield of the debt instrument).

⁷⁸ I.R.C. § 108(e)(10).

⁷⁹ See *Ventas*, 130 F.2d at 143 (“Whether the taxpayer made a profit or loss in buying up debentures at 45 percent discount from face value is as yet pure speculation.”). Under I.R.C. section 108(e)(10), we value the loans for this purpose based on their “issue price” as defined in section 1273. The regulations under that section introduce a number of valuation complexities and uncertainties in cases of contingencies and situations where debt (and interest) is not unconditionally payable, etc. See I.R.C. § 1273(b)(4) (“issue price” is “stated redemption price at maturity”); Treas. Reg. § 1.1273-1(b) (“stated redemption price at maturity” is determined using payment schedule); *id.* § 1.1273-1(c) (determining a payment schedule if subject to contingencies).

⁸⁰ In addition, for many borrowers currently in IDR, the implied exchange may be outside the three-year statute of limitations. I.R.C. § 6501(a).

- **Statutory Fixes.** Of course, the cleanest and simplest solution would be for Congress to step in. Congress could expand the tax exclusion in section 108(f) or the definition of “scholarship” in section 117. Alternatively, Congress could provide for an exclusion in the Higher Education Act (as it did for closed school discharge). Because the Higher Education Act is overdue for reauthorization anyway, changes there may actually be feasible.

The sum total of these arguments, in addition to providing sufficient authority to Treasury and the IRS, also illustrates why the entire logic of applying cancellation of indebtedness principles to student debt is flawed. Ultimately, many of these arguments come down to the fact the student debt in its current form is so unlike any other kind of debt that our standard approaches just do not fit well.⁸¹ From its very beginnings, the student debt system has been primarily in service of the public good of expanding educational access and affordability.⁸² In its current form, that system uses income-contingent government credit with no underwriting, statutory interest rates, baked-in interest subsidies, and multiple types of discharge and cancellation enshrined by law.⁸³ And that debt is used largely as a vehicle for the quasi-public funding of the higher education sector,⁸⁴ by paying schools a nominal tuition amount that is itself highly variable and contingent. The tax treatment of cancellation of indebtedness is based on a model of someone borrowing cash but not having to pay it back. That is emphatically not what is going on here.

⁸¹ See Brooks & Levitin, *supra* note 47, at 33–47.

⁸² See Jonathan D. Glater, *Debt, Merit, and Equity in Higher Education Access*, 79 Law & Contemp. Probs. 89, 91–95 (2016).

⁸³ See Brooks & Levitin, *supra* note 81.

⁸⁴ See John R. Brooks, *Income-Driven Repayment and the Public Funding of Higher Education*, 104 Geo. L.J. 229, 230–32 (2016).

Conclusion

Providing student debt relief should be a top priority of the incoming administration and the incoming Congress. But the tax consequences of providing relief must be addressed at the same time. Policymakers will be forced to take a position on whether current law necessitates a tax bill in the event of student debt relief. Should this debt relief be treated as a tax liability, the consequences are substantial. And ironically, the greater the relief, the greater the tax bill. Furthermore, while that tax bill would certainly be less than the amount of debt discharged, the full bill would come due immediately. And the problem is not limited to immediate debt relief. Income-driven repayment has quickly become a backbone of the student debt system and is the primary tool to help low-income borrowers, but its effectiveness is undermined by the “tax bomb” looming at the end of the payment period. Tax law could impose substantial economic hardship at exactly the point when education law determines that relief is most necessary. That would be a perverse result.

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It would also be a result contrary to the historical view of how to treat student loan cancellation—that it should be considered like a scholarship, a non-taxable grant with the purpose of funding higher education. That purpose also dovetails with the general welfare exclusion, which applies to government payments for the promotion of the general welfare, particular in the context of disaster like the COVID-19 pandemic. Furthermore, other parts of the tax law that apply to debt instruments raise substantial questions of whether student debt cancellation would be taxable anyway. In these circumstances, the IRS should, at a minimum, use its discretion to extend the safe harbor in Revenue Procedure 2020-11 and announce that it will not assert taxation for any cancellation of student debt.

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