UNCLE SAM GETS THE GOLDMINE— STUDENTS GET THE SHAFT: FEDERAL TAX TREATMENT OF STUDENT LOAN INDEBTEDNESS

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I. Introduction

Financing of higher education costs has become an increasingly prominent issue in the past several years,[1] as increases in the price of higher education have outstripped the general inflation rate.[2] A prior article considered the federal tax treatment of plans designed to ease the financing burden in advance of attend-

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[1] *See, e.g.*, Kenny, *Establishing a Program to Provide for College Cost Requires Careful Planning after TAMRA*, 18 TAX'N FOR LAWYERS 56 (July/August 1989); Knight & Knight, *New Ways to Arrange Tuition Costs*, J. ACCT. 46 (March 1989); McPherson & Skinner, *Paying for College: A Lifetime Proposition*, 4 BROOKINGS REV. 29 (Fall 1986); Hanna, *GSL, SLS, LAL Mean SOS for JD: Confused?*, Chicago Daily Law Bulletin, Sept. 8, 1988, at 3, col. 1; Knutson, *As Tuition Rises, Law Students Face More Money Problems*, Chicago Daily Law Bulletin, Sept. 9, 1987, at 1, col. 2; Krug, *Paying for College After Tax Reform Act Changes*, Chicago Daily Law Bulletin, July 8, 1987, at 2, col. 2.

[2] The cost of higher education tuition went up faster in the 1980s than the cost of any other good or service, including medical care. Statement of Arthur Hauptman, Educational Consultant, American Council on Education, *Invitational Conference on College Prepayment and Savings Plans* 21 (1989). The College Board estimated the increase in college costs for the 1989-90 school year to be about nine percent for private four year colleges, and eight percent for public four year colleges. This compares to a rise in the consumer price index of 5.2 percent for the 12 months ending in June, 1988. *Cost of College Still Outpacing Inflation Rate*, Washington Post, Aug. 8, 1989, at a-1, (citing THE COLLEGE BOARD ANNUAL SURVEY OF COLLEGES (1989)); Blumenstyk & Myers, *For Most Cost of Going to College Outpaces Inflation Again*, Chronicle of Higher Education, Aug. 16, 1989 at a-1, a-26 to a-31. For the 1990-91 school year, the average tuition increase for private colleges was about eight percent for private four year colleges and seven percent for public four year colleges, with the general inflation rate remaining at about five percent. *Private Colleges Tem-*

ance at college.[3] These plans, generally called prepaid tuition plans or tuition futures, provide a mechanism whereby a participant can pay a predetermined amount in advance of the receipt of educational services to guarantee that a student's college tuition is fully paid up when that student enters college. An overwhelmingly more prevalent financing method is to pay for educational services after receiving them by borrowing. Many students help finance their education by taking out student loans, in effect mortgaging their future prospects for current receipt of educational services.

This article examines the federal income tax treatment of student loan indebtedness. Current law impedes student loan financing in two ways. The first impediment involves potential inclusion in gross income on account of debt cancellation or deferral under Loan Repayment Assistance Programs (LRAPs) currently being developed by higher education institutions, particularly law schools. It is likely that amounts of loan cancellation under LRAPs are includible in gross income as discharge of indebtedness income.[4] Second, except for education financed through home equity loans, interest paid on loans used to finance education is no longer deductible after enactment of the 1986 Tax Reform Act.[5]

This article will first discuss the general situation with respect to student debt burden and loan repayment assistance with a focus on law student debt burden. Student loan repayment assistance is a concept that can be applied in both the undergraduate and graduate contexts. Nevertheless, it is mainly law schools that have established LRAPs. For that reason this article focuses initially on law student debt burden and on law school

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per Their Increases in Tuition, Wall St. J., Sept. 27, 1990 at B1, col. 1 (citing the COLLEGE BOARD ANNUAL SURVEY OF COLLEGES (1990)).

Another way to view the situation is to compare the rise in college costs to the rise in disposable income. Between 1980 and 1987, disposable income grew at an average annual rate of 6.5 percent. MINNESOTA HIGHER EDUCATION COORDINATING BOARD, STATE SAVING INCENTIVE AND PREPAID TUITION PLANS 4 (1988). For the same period tuition and fees increased at a rate of 9.8 percent. *Id.* This contrasts with the trend prior to the 1980s, when disposable income increased more rapidly than the cost of attending college. *Id.*

[3] Philipps, *Federal Taxation of Prepaid College Tuition Plans*, 47 WASH. & LEE L. REV. 291 (1990).

[4] *See infra* text accompanying notes 55-61.

[5] *See infra* text accompanying notes 157-71, 177-86.

LRAPs. The article will analyze the potential tax treatment under current law of students who benefit from LRAPs and argue that these benefits should be given tax favored treatment. Finally, the article will discuss the nondeductibility of interest paid on student loans and argue that student loan interest should be deductible under general principles of equity and incentive. This part of the article departs from the focus on law student debt and considers student indebtedness in general, because the arguments for allowing deductibility are basically applicable to higher education at all levels.

II. Law Student Debt

Student loans have become a primary vehicle for financing higher education, especially at the graduate and professional studies level.[6] Law students are among the heaviest borrowers.[7] Law student debt has risen dramatically in the past five years. Moreover, the best predictions are that law student debt will continue to rise.

A. *Rise in Debt Burden*

The Higher Education Act of 1986,[8] along with the 1987 amendments to the 1986 Act,[9] made several changes in the existing need-based federal student loan programs by increasing the capacity for student borrowing and indebtedness. This legislation raised the annual and aggregate loan limits for both undergraduate and graduate students. Graduate and professional students can now borrow up to $7,500 per year under the Stafford loan program[10] (formerly GSL) and up to $4,000 per year under the Supplemental Loan for Students program (SLS).[11]

The aggregate loan limits were also increased. Graduate and professional students may now accumulate a maximum ag-

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6 *See* Kramer, *Will Legal Education Remain Affordable, By Whom, and How?*, 1987 DUKE L.J. 240. "Law students are, pound-for-pound, the most vigorous loan program users. . . . Law student use of the loan programs is disproportionate because of the high cost of attending law school compared to other forms of higher education." *Id.* at 253-54.

7 *Id.*

8 Pub. L. No. 99-498, § 402(a), 100 Stat. 1359 (1986).

9 Pub. L. No. 100-50 § 10(a), 101 Stat. 341 (1987).

10 20 U.S.C. § 1075(a)(1)(A)(iii) (1988).

11 20 U.S.C. § 1078-1(b)(1) (1988).

gregate debt level of $54,750 in Stafford loans[12] and $20,000 in SLS loans.[13] Students borrowing all the funds available under just the federal programs during the course of their undergraduate studies and law school find $74,750 in principal alone awaiting repayment following graduation. This does not even consider the possibility that the student may have taken out additional loans from other sources such as the university or from commercial programs such as Law Access Loans (LAL).

The same legislation also made a more subtle change that has had a significant impact on overall graduate indebtedness. The definitions of "independent" and "dependent" student were altered resulting in a larger number of students falling into the independent category. When they are classified as independent, students become eligible for greater levels of assistance. On the graduate and professional studies level this assistance is in the form of loans.

Loan consolidation is available to graduates to ease their monthly payments. Consolidation allows a graduate to combine the outstanding loan indebtedness and stretch out the payments beyond the ten year limit imposed on the original loans. The repayment period may be extended up to twenty-five years for students with outstanding principal equal to or greater than $45,000 at an interest rate of not less than nine percent.[14]

This legislation, in conjunction with the ever-rising cost of tuition,[15] is generating greater student loan indebtedness. Law school attendance can easily create the need for students to borrow large sums to pay for their educations. Moreover, such borrowing now seems to be the norm.[16]

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12 20 U.S.C. § 1075(a)(2)(A)(ii) (1988).

13 20 U.S.C. § 1078-1(b)(2) (1988).

14 20 U.S.C. § 1078-3(c)(1)(C), -(2)(A)(v).

15 *See supra* note 2. Between fiscal years 1977-78 and 1987-88, "[t]he CPI [Consumer Price Index] did not quite double. Law school charges almost trebled." Kramer, *Who will Pay the Piper or Leave the Check on the Table for the Other Guy*, 39 J. LEGAL EDUC. 655, 659 (1989).

"From 1978 to 1988, public school tuition has increased an average of 149 percent for resident and 156 percent for non-resident students. Private school tuition increased an average of 158 percent over the same period." White, *The Impact of Law Student Debt Upon the Legal Profession*, 39 J. LEGAL EDUC. 725, 727 (1989).

16 *See* McPherson & Skinner, *Paying for College: A Lifetime Proposition*, 4 BROOKINGS REV. 29 (Fall 1986). The title of the article is self-explanatory. With the costs of higher education and the existing financing means available, a student may reason-

The average 1989-90 tuition levels of the 175 law schools accredited by the American Bar Association are $11,036 for private schools and $2,936 for state residents and $6,714 for nonresidents at public institutions.[17] These are only the expenses for tuition; when books, living and other expenses are added, the total cost of attending law school necessarily increases. One reasonable estimate of a moderate budget for these items is $22,000 over three years.[18]

Actual data and statistics on the number of students borrowing, the amounts they are borrowing, and the manageability of that debt are scant.[19] Several studies are currently under way that attempt to calculate these amounts.[20] Despite the scarcity of data, there are assumption-based calculations that help to assess

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ably expect to be paying for college for a significant portion of the student's lifetime. "It is not unusual for students at high-cost law schools to have $40,000, or more in educational debts by the time they graduate." Law School Admission Council/Law School Admissions Services, *The Official Guide to U.S. Law Schools 1990-91* 33 (1990).

17 American Bar Association, Section of Legal Education and Admissions to the Bar, *A Review of Legal Education in the United States Fall, 1989 Law Schools and Bar Admission Requirements*, (1990). The range for private schools was from $4,536 at Regent University in Virginia Beach, Virginia to $15,864 at Columbia University in New York City. The range for public school tuition for residents was from $952 at North Carolina Central University in Durham, North Carolina to $7,046 at the University of Pittsburgh. The range for public school tuition for nonresidents was from $3,039 at the University of Wyoming to $12,228 at George Mason University in Arlington, Virginia. *Id.*

18 Kramer, *supra* note 15, at 657.

19 Hansen & Rhodes, *Student Debt Crisis: Are Students Incurring Excessive Debt*, 7 ECONOMICS EDUC. REV. 101 (1988) (focusing on undergraduate student debt using a 1982-83 database, but noting the absence of hard data); telephone interview with Dan Lau, Vice President of Law School Admission Services, Inc. (July 28, 1990). Lau confirms that the only comprehensive sources of information are the individual financial aid offices, and they do not all keep totals on average student debts accumulated or similar statistics. Telephone interview with Dan Lau, Vice President of Law School Admission Services, Inc. (July 28, 1990). There are so many unofficial sources of assistance that, even if the statistics were kept by all institutions, the totals would be inaccurate.

20 David L. Chambers, Professor of Law at the University of Michigan Law School, is beginning a study for the Association of American Law Schools, the American Bar Association (ABA), and the Law School Admissions Council (LSAC). The project involves a pilot study of the class of 1989 at ten schools that will attempt to assess debts of persons in various work settings. Chambers, *Educational Debts and the Worsening Position of Small-Firm, Government, and Legal-Services Lawyers*, 39 J. LEGAL EDUC. 709, 712 (1989).

LSAC is preparing a long range study of student attitudes and borrowing practices while in school and will attempt to track the students following graduation as

and understand the general debt burden many students face. If a student borrowed the maximum amount of federally guaranteed student loans while in law school, and had no other loans outstanding from law school or undergraduate work, that student would owe $37,090 after three years; other loans could easily raise that amount to between $50,000 and $60,000 or even higher.[21]

B. *Effect on Law Students*

The rise in student loan indebtedness adversely affects law students in at least two major ways. First, it creates increased pressure to obtain employment at the highest end of the compensation scale. Second, as a corollary, it impedes the ability of graduates to take employment in public interest organizations, in government, and in smaller firms, even if they would otherwise be willing to make the financial sacrifice currently associated with employment in these areas.

1. Need for Higher Compensation

As educational debt increases, graduates will ultimately require greater monthly payments to service that debt. When the normal living expenses of food, clothing, housing, and transportation are added to monthly loan payments, the difficulty of making ends meet becomes significant. Some commentators have attempted to determine what constitutes manageable debt levels and the maximum indebtedness an individual can carry. The leading studies indicate that borrowers cannot afford to repay educational debt in excess of fifteen percent of pre-tax income (some studies suggest that as little as six percent might be too much) or eight percent of post-tax income.[22]

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they find jobs and cope with their debt burdens. Telephone interview with Dan Lau, Vice President of Law School Access Services, Inc. (July 28, 1990).

[21] *See* Hanna, *supra* note 1, at 3; Kramer, *supra* note 6, at 263. Hanna reports that in 1988, the average law graduate at Loyola, Chicago will owe $48,000 over a ten-year period. This article is also a very good overview of the financial aid system in today's law schools. Hanna, *supra* note 1.

[22] *See* Kramer, *supra* note 6, at 263-64. The article examines several published studies, particularly one by Dwight Horch of Educational Testing Service. Horch found that "given a repayment schedule of ten years with equal monthly installments, a law student graduating in 1988 could not readily manage a loan principal in excess of $10,000—an amount from $27,000 to $37,000 less than the amount

When the repayment period is restricted to ten years, a beginning attorney earning as high as $36,000 per year cannot sustain high debts.[23] The economic outlook for future graduates suggests that the situation will not improve in coming years. If law school tuition and costs continue to rise over the next decade at their average annual rate of about eight percent, government and public interest salaries continue to rise at the rate of three percent, and the cost of living increases by 4.5 percent yearly, the starting lawyer will be substantially worse off in 1997 than in 1987.[24]

Pressure created by the debt burden may cause the graduate to seek a higher paying job or face insolvency, as well as have a negative impact on the profession as a whole.[25] In the absence of a family member or other benefactor willing to subsidize monthly payments, a highly indebted graduate has little choice but to seek the highest paying employment available. Even if a graduate were otherwise willing to make the financial sacrifice associated with a lower paying position, the graduate simply may be unable to do so in the face of a large student debt.

Salary levels generally depend on the market where they are

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borrowed by the hypothetically fully loaned-out student." *Id.* at 264, (citing D. HORCH, STUDENT LOAN LIMITS: ESTIMATED MANAGEABLE STUDENT LOAN LIMITS FOR THE CLASS GRADUATING IN 1984 AND THE CLASS ENTERING IN 1985, Table B at iii (1984)). *But see* Hansen & Rhodes, *supra* note 19. Hansen and Rhodes concluded that excessive indebtedness is a problem for less than five percent of all borrowers. Their data, however, is of undergraduate borrowing in a two-year period in the early 1980s and ignores possible effects on job selection.

23 Kramer, *supra* note 6, at 263.

24 *See* Chambers, *supra* note 20, at 722.

25 Some have forecast negative effects on the profession, even beyond the inability to fill public interest positions. Heavy debt burdens can result in unbearable pressure to "milk the profession for all it is worth in order to be able to pay retrospectively for their legal education," or less drastically, "to seek out a job in one of the highest paying law firms, failure to save, or outright default." Kramer, *supra* note 6, at 241, 262. Another leading legal educator maintains that,

> [c]areer choices are not the only decision debt burden may influence. . . . [E]xcessive debt burden has a potential to affect adversely decisions law graduates make on behalf of their clients. Demands of debt payment may increase already existing pressures on young lawyers to opt to maximize their own return from a case rather than that of the client. . . [and] may also deter graduates not engaged in public-interest/service from assuming appropriate pro bono obligations.

Vernon, *Educational Debt Burden: Law School Assistance Programs and a Proposed New Approach*, 39 J. LEGAL EDUC. 743, 759 (1989).

located, but the following data are generally indicative. The National Association for Law Placement (NALP) study of the class of 1987[26] is the most recent comprehensive survey of employment and salaries. The average 1987 law graduate's annual income was $35,814, with firms of less than ten attorneys averaging $26,679 and firms with over 100 attorneys averaging $53,683.[27] In other sectors, the average salaries broke down as follows: business and industry—$37,985, federal government—$28,054, state government—$24,938, and local government—$25,169.[28] The average public interest organization position paid $23,199 annually.[29] As long as earnings systematically vary with the type of law being practiced,[30] indebted graduates will be impeded from considering employment in the lower paying end of the job spectrum.

An alternate, though less comprehensive, source of salary and employment data is the annual survey conducted by the ABA's *Student Lawyer*.[31] The average salary surveyed for 1989 graduates was $40,450 in law firms sampled from twenty-one cities and $35,450 for corporations in the sample. The range extended from a low of $20,000 in Minneapolis/St. Paul law firms and $21,000 in Milwaukee corporations, to highs of $79,000 in New York City law firms and $55,000 for corporations in the same city. These figures are not determinative for the nation, but they present a reasonable impression of the prospects for the new graduates. When these salaries are compared with the $15,000 to $25,000 salaries associated with public interest law and government positions the disparity becomes clear.

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26 National Association for Law Placement, *Class of 1987 Employment Report and Salary Survey* (14th ed. 1989) [hereinafter *1987 Salary Survey*].

27 *Id.* at 45.

28 *Id.* at 46.

29 *Id.* at 47.

30 *See* Ehrenberg, *An Economic Analysis of the Market for Law School Students*, 39 J. LEGAL EDUC. 627, 628 (1989): "[l]awyers' earnings systematically vary with the type of law they are practicing (e.g., private practice, corporate, judicial clerkship, government, public interest)."

31 *The Fifteenth Annual Salary Survey*, 18 STUDENT LAWYER 22 (compiled by White & Assocs. Nov. 1989). The survey sampled only non-patent law firms and corporations in the larger cities and legal markets. If rural areas were included in the tally, the resulting national averages would undoubtedly be lower. The article presents its survey data in three ranges: low, middle and high average starting salaries for each city. The salaries tallied here are averages of all the cities in the survey.

2. Impediment to Government, Public Service, and Small Firm Employment

The average indebted law graduate will not have the luxury of working for employers whose salaries are insufficient to pay the graduate's monthly bills. Government, public service, and smaller law firms typically cannot afford or do not provide sufficient salaries to support the graduates.[32] The most current NALP report found the average public interest salary to be $23,199,[33] while the general salary was $35,814 derived from a range of $10,000 to $125,000 per year.[34] The study also reported 2.9 percent of the 1987 graduates entering into legally oriented public interest work and .2 percent entering into nonlegal work in the same field.[35] While it is true that millions of Americans are earning less than $10,000 per year working full-time, and that a public interest attorney will probably earn twice that amount,[36] the $20,000, $30,000 or $40,000 of educational debt tends to place a severe strain on an indebted graduate's ability to meet obligations.

Some observers contend that the recruiting problem is not salary driven. They cite alternate causes, such as lack of sufficient public interest positions and the social attitudes of today's graduates.[37] These may well be contributing factors, yet stories of

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[32] *See* Bortolan, *Loan Forgiveness Report Highlights Problems of Educational Debt*, 23 CLEARINGHOUSE REV. 1523 (Apr. 1990).

> Public interest legal practice is becoming increasingly inaccessible to young attorneys struggling to pay off their tuition loans and other costs incurred during law school. While a large number of law graduates express an interest in public service, they are unable to work for organizations that cannot afford to provide them with a basic standard of living.

Id. Cf. Miller, *Debt Trap*, 16 STUDENT LAWYER 22 (Sept. 1987). Miller's article begins with the premise that money is keeping law students out of public interest law and conducts a journalistic survey of the status and needs of the public interest law sector.

[33] *1987 Salary Survey*, *supra* note 26, at 47, 181. There is a discrepancy in the report as typed. $23,199 is listed on page as the average annual public interest organization salary, but $23,122 is the average listed on page 181.

[34] *Id.* at 51.

[35] *Id.* at 181.

[36] The median public interest attorney's salary is $21,080. Chambers, *supra* note 24, at 709-10.

[37] *See* Kramer, *Who will Pay the Piper or Leave the Check on the Table for the Other Guy*, 39 J. LEGAL EDUC. 655 (1989).

graduates who cannot take existing positions and positions going unfilled are common.[38]

3. Indebtedness Survey

An informal survey of 172 students at Washington and Lee University confirms the effect of indebtedness on employment expectations outlined above.[39] When asked to estimate their total indebtedness at graduation, 139 students reported an average anticipated indebtedness at graduation of $38,000: $33,500 from law school and $4,500 in undergraduate loans.[40] In each of the classes, educational debt ranked fourth among factors influenc-

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> [A]ll of the incentives to choose public interest work can [n]ever address the crucial factor of an inadequate supply of public interest job opportunities . . . . Incentives are not the issue. Job creation is.

Id. at 690.

> [I]t appears that individual lawyers' occupational decisions, in particular the decision whether to enter private or public interest law practices, depend on differences in their expected earnings in the two types of practices, as well as their underlying political and social attitudes.

Ehreneburg, *supra* note 30, at 628.

[38] *E.g.*, Bortolan, *supra* note 32, at 1523-24; *Student Loans; Be Good*, 313 THE ECONOMIST 36 (Nov. 11, 1989); Miller, *Debt Trap*, 16 STUDENT LAWYER 22 (Sept. 1987).

[39] The survey was conducted by the authors in the Fall of 1990 and included about half the members of each of the three classes enrolled. Washington and Lee is a private school with a national student body drawn from all areas of the country. For an extensive review of law student attitudes toward public interest law, see R. STOVER, MAKING IT OR BREAKING IT: THE FATE OF PUBLIC INTEREST COMMITMENT DURING LAW SCHOOL (H. Erlanger 1989) (reviewed by Schacter at 88 MICH. L. REV. 1874 (1990)).

[40] Thirty-three respondents either reported no indebtedness from law school and their undergraduate studies or declined to provide this information. When these responses are included, as indicating no anticipated debt burden, the average graduate's debt becomes $30,600: $27,000 from law school and $3,600 from undergraduate studies. There was a noticeable variation by year in school. The reported debt levels are as follows:

Class of 1991:
$35,600—law, $4,000—undergraduate.
Including non-reporters: $27,500—law, $3,000—undergraduate.
Class of 1992:
$34,000—law, $2,750—undergraduate.
Including non-reporters: $27,500—law, $2,250—undergraduate.
Class of 1993:
$31,500—law, $6,000—undergraduate.
Including non-reporters: $26,500—law, $5,000—undergraduate.

The decrease in estimated indebtedness by class is surprising in the face of increasing tuition. The greater indebtedness reported by third year students may indicate

ing employment choices.[41] Twenty-eight percent of those interested in employment in public interest, government or small firm positions indicated that debt considerations had affected their choice of law schools. More than a third of those surveyed indicated that they would pursue employment in public interest, government or small firm positions if their debt levels were lower or if a Loan Repayment Assistance Program (LRAP) were available.[42] The survey also suggested a trend in each of the three classes for students to change their preferences from employment in public interest, government, and small firms to pursuit of large firm employment as they progressed through law school.[43]

The debt problem did not suddenly appear without warning. It is the product of a decade or more of rising tuition, cost of

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that actual debt levels will be greater than the students estimate or anticipate in their first year.

41 The three most common factors were: the type of law practiced, location and salary level, in that order. Educational debt was a more frequent factor than ideological, ethical and moral concerns, workload, opportunity for advancement, size of practice, other factors and other debt.

42 Respondents indicating that debt reduction or LRAP assistance would affect their employment pursuits were: 52 percent for government employment; 35 percent for public interest work; and 42 percent for small firm positions.

43 The change in career pursuits from the time students enter law school, even for first year students, was noticeable. Examining all three classes as a whole, pursuit of positions in large firms increased seven percent, while pursuit of positions in the government, public interest and small firms decreased 18 percent. Twenty-two percent of those who originally intended to pursue employment in government, public interest, and small firms no longer plan to do so, and 28 percent of all respondents changing their pursuits switched to large firm employment. Only eight percent of those originally seeking large firm positions altered their plans, and only ten percent of all respondents who changed their pursuits are seeking employment in government, public interest and small firms. Overall, 49 percent of the respondents reported no change in their expected career paths after entering law school.

Student comments on the surveys confirmed the debt barrier to public interest recruitment. A first year student declared:

> I would really like to work for . . . some sort of public interest group and still have hopes of this, but *realistically* I am beginning to think that I will be forced [by financial needs] to go for the 'big dollars' and go into a field which would not be as service oriented.

Two second year students agreed with this sentiment. One wrote, "[h]ow can anyone take a low paying position in any area of practice if they must pay out $700 - $800 per month in loan payments." Commenting on whether a reduction of loan debt or LRAP assistance would encourage the student to pursue public interest employment, one student emphatically answered "absolutely." A third year student simply stated that, "[i]f I had debt, I would not be able to work a public interest job."

living, increased availability of loan funds, and a low growth rate for already below-market salaries in certain sectors of the legal community. The problem has received a great deal of attention and many solutions have been proposed.[44] The LRAPs, administered directly by the law schools, seem to be the highest profile and most common means of addressing the problem.

III. Loan Repayment Assistance Programs

The ominous financial realities of the public interest law sector for recent graduates has prompted the adoption of LRAP's in increasing numbers, especially at the higher priced private law schools.[45] In 1988, the American Bar Association adopted a resolution encouraging all law schools to form LRAP's for low-paying public interest jobs.[46] LRAPs began as attempts to make employment in these lower-paying sectors a feasible option for

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[44] An innovative recent proposal by economists at the Economic Policy Institute would create a revolving loan fund out of the Social Security surplus to allow any American to borrow up to $40,000 to finance a college education, apprenticeship, or job training. Eligibility would not be need-tested. Loans would be repaid over 25 years. Payments would vary with a person's earnings and would be made to the IRS via payroll deductions. This program would replace the Perkins and Stafford loan programs. *See* Cooper, *Hitting Up the Sacred Cow for a Loan*, Wash. Post, July 5, 1990 at A-17.

The federal government currently administers some loan forgiveness programs. One such program cancels loans at rates of 15-30 percent each year, up to 50 percent of total indebtedness, for certain public service, such as full-time teachers in impoverished school districts, VISTA volunteers, Peace Corps volunteers, and members of the armed forces in certain situations. 20 U.S.C. § 1087ee (1988). Another Proposal for Federal Loan forgiveness is contained in the Educational Excellence Act of 1990, S. 695, 101st Cong., 2d Sess., 136 CONG. REC. H 5697 (1990).

One might argue that prospective students can opt to go to a state school where tuition is more reasonably priced, and, thereby, avoid the debt problem altogether. This is undoubtedly true in some instances. This solution assumes that all incoming students are aware of the tuition differentials and the salary prospects for the field they have chosen, and that they have chosen their field prior to enrollment. Ehrenberg, *supra* note 30, at 639. Moreover, "graduates from higher rated law schools and private law schools were less likely to be employed in public sector, public service, or public interest positions." *Id.*

[45] There are 19 active LRAP's at private law schools, two at public institutions and one operated by the state of Maryland. Other programs exist, including one offered by the Federal government. NATIONAL ASSOCIATION FOR PUBLIC INTEREST LAW, LOAN REPAYMENT ASSISTANCE PROGRAM REPORT 1989, 7-12.

[46] THE AMERICAN BAR ASSOCIATION HOUSE OF DELEGATES, REPORT NUMBER 123 (adopted Aug. 10, 1990) (endorsing loan repayment assistance programs generally).

the indebted graduate. Their purpose is to offer the graduates a choice and to promote employment in public service which is deprived of skill and talent by financial pressures.

While each LRAP is unique and institution-specific, as a group LRAP's share common elements and the goal of making traditionally lower-paying positions a realistic option for highly indebted graduates.[47] The programs break down into elements of eligibility and administration. A graduate's eligibility for program assistance is the first concern. The eligibility determination depends upon 1) alumni status; 2) employment; and 3) income. Once a graduate's eligibility has been established, the administration element determines 1) the loans the program assists; 2) the form the assistance takes; and 3) the potential forgiveness of the graduate's indebtedness. The following section describes the most common features of the existing programs by presenting them as parts of a typical LRAP.

A. *Description of a Typical LRAP*

A typical LRAP has the following characteristics. The law school sponsoring the program administers it for the benefit of students entering public interest law or government employment upon graduation. The LRAP makes an initial determination of eligibility for assistance and then determines issues of administration.

The eligibility determination is straightforward. The graduate must have received a degree from the institution offering the assistance and must have graduated after the program began. The nature of the graduate's employment must conform to the program's specifications. Any full-time employer falling under I.R.C. section 501(c)(3), (4) or (5) is an eligible employer under the typical program. Program eligibility basically depends on income, because the income disparity between the eligible employers and the rest of the legal market initially created the need to

[47] The primary source for actual data and statistics on the LRAPs is from NATIONAL ASSOCIATION FOR PUBLIC INTEREST LAW (NAPIL), LOAN REPAYMENT ASSISTANCE PROGRAM REPORT 1989. Unless otherwise noted, the generalizations about a typical LRAP program, discussed *infra* are drawn from a combination of the NAPIL information and the proposed LRAP being considered by the School of Law at Washington and Lee University.

establish an LRAP. To participate in the typical program, a graduate's annual salary must fall below $27,500.

After resolving eligibility issues, the LRAP addresses administrative issues concerning the amount, form, and method of assistance. The LRAP determines the graduate's assistance level by use of a set scale comparing debt to income. The typical program always requires graduates to contribute some of their own income toward debt repayment, and the amount of program assistance varies based upon need. The LRAP will not assist the graduate in the repayment of loans other than need-based loans accrued while in law school. Outstanding undergraduate loans will be factored into the adjusted gross income calculations that determine if the graduate is eligible for assistance under the program and the amount of that assistance, but the law school will not assist in the repayment of these loans.

The LRAP assists the graduate by lending to the student interest free funds to help make the monthly debt payments. The assistance loans are between the graduate and the LRAP, and the LRAP does not interact with the graduate's lender. If the graduate remains in the program for three years, the LRAP will begin to forgive its loans to the graduate at a rate of 15 to 25 percent each year. At this rate, the debt to the LRAP will be completely forgiven in six to ten years, provided the graduate remains active in the program. The program will not penalize the graduate for leaves of absence or temporary unemployment due to relocation, child care, hospitalization, additional education, or other acceptable situations. Maternity/paternity leaves of up to six months are allowed and a maximum two years absence may be excusable. The graduate must then resume and maintain active status in the program.

B. *Variations Among LRAPs*

All LRAP's are not created equal. As a group, they resemble the typical program described above. But significant differences and splits in format are common. This section will present the general variations that exist between the typical program and those currently in operation in terms of their eligibility criteria and administration.

The requirement of alumni status is universal and practical

since program funds are limited. Every LRAP in place today requires that the participants be graduates of the institution offering assistance.[48] In contrast with the typical program, some LRAP's offer access to all graduates, past as well as future. The typical program applies only to current and future graduates.

When determining the eligibility of the graduate's work, the type of work performed by the graduate is equally as important as the identity of the employer.[49] All LRAP's provide assistance for public interest employment, most assist government positions, and others will consider any position that is law-related.[50] Some programs also offer assistance for private firm employment, so long as the work is in the public interest. Very few programs will support graduates working in judicial clerkships. This is attributible to the fact that these graduates, who are earning comparatively less than their peers now, will likely enter much more lucrative positions following their clerkships. Little consideration has been given to including solo practitioners or military employment.

Variations in eligibility also occur when part-time employment is considered for potential assistance. Unlike the typical program, some programs provide assistance for part-time employment on a proportionate basis, however, this is rare.

Graduates earning more than a maximum salary are generally excluded from participation on the basis that they do not need assistance. Nevertheless, there are some programs that do not set income caps. These LRAP's consider only the eligibility of the employment and offer assistance to all based on a scale of debt to income. After a certain level of adjusted gross income is reached, however, this scale has the same effect as an income cap. Other programs opt to work from a formula such as the average starting salary of its graduates or an external benchmark, such as the GS-9 federal employee income bracket, and determine eligibility by comparing the graduate's income to these levels.

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48 With the exception of medical doctors, even the Maryland state-wide program requires that the participant be a graduate of a Maryland school of higher education.

49 A notable exception is Harvard; eligibility for its program is determined strictly by income level so long as the graduate is engaged in law-related work.

50 Some programs consider employment that is not law-related, provided that it is in the public interest and requires the types of skills acquired in law school.

After establishing a graduate's eligibility to participate in the LRAP, attention focuses on the administration of the program. The fundamental differences between the various LRAP's in terms of their administration are in the loans covered, the form the assistance takes, and the potential forgiveness of the graduate's indebtedness.

There is a significant split on the inclusion or exclusion of assistance for undergraduate debts. The typical program excludes undergraduate debts. In the programs that assist in the repayment of undergraduate loans, assistance will be extended for the same types of undergraduate loans as law school loans, for example, federal program loans, such as Stafford (GSL), Perkins (NDSL) and SLS (ALAS), Law Access Loans (LAL), and loans from the institution itself. Undergraduate debts are not ignored by those programs that do not assist in their repayment. Undergraduate debts are considered when determining the graduate's adjusted gross income (AGI).[51]

The method of calculating the graduate's AGI is the greatest source of diversity among LRAPs. Determining the AGI which will be used is important, because the amount of assistance the graduate will receive is directly dependent upon it. The typical program includes the graduate's personal income, spouse's income and the presence of dependent children in calculating AGI. Some programs will also consider additional factors such as medical expenses, student loan indebtedness of a spouse, and assets in calculating the availability and amount of assistance the graduate may receive.

The typical programs transfer their assistance funds directly to the graduate. The graduate is then responsible for making the monthly debt payments to his lender. Some programs may transfer the funds directly to the graduate's lender. Most avoid this practice simply because of the added administrative nuisance associated with it.

All LRAP's transfer their assistance funds in the form of either a grant or a loan. The typical program issues funds directly to the graduate in the form of interest-free loans. Many

[51] This may result in indirect assistance, because the AGI considered available for the graduate to repay his law school debts is adjusted downwards by the amount of the undergraduate repayment expense.

programs issue the funds as outright grants. The use of grants rather than loans is very common and becoming more popular. Since most programs eventually forgive the loans, issuing grants reduces the administrative burden early in the program.

Most LRAP's forgive the graduate's indebtedness if the graduate remains an eligible participant for a sufficient period of time. Some programs begin to do so immediately by issuing grants instead of loans. Other programs forgive graduate indebtedness at a later time. The loans which are forgiven are those between the law school LRAP and the graduate. The graduate's debt with the initial lender is wholly separate from the debt to the LRAP. Once loan forgiveness begins, the loans are forgiven at a rate of ten to thirty percent each year for as long as the graduate remains eligible for assistance. LRAP participants will achieve complete loan forgiveness within six to ten years, possibly earlier depending on the particular program. It is imaginable that a graduate may consolidate the outstanding debt and extend the repayment period beyond ten years. But none of the published programs address this concern and it may be rare or simply not yet considered.

C. *Income Tax Consequences*

It is surprising that there has been little written discussion pertaining to the tax consequences of LRAP's, despite the growing number of schools that are establishing or considering these programs.[52] This is especially so when one considers that approximately one-third of any LRAP loan repayment assistance to an individual is ultimately likely to benefit the state and federal governments, rather than to the LRAP recipient personally.[53] Only two-thirds of LRAP assistance from a law school to a recipient would actually benefit the recipient. The other one-third

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[52] In a recent survey of law schools that have established LRAPs, only one, Georgetown, mentioned the possible tax consequences of its program. NATIONAL ASSOCIATION FOR PUBLIC INTEREST LAW, LOAN REPAYMENT ASSISTANCE REPORT SURVEY 1989.

[53] A single individual reaches the 28 percent federal marginal tax bracket at $19,450 taxable income in 1990 ($32,450 for a married couple filing jointly). 1 P-H Federal Taxes 2d ¶14.17 (1990). A five percent state marginal tax rate added to the federal rate would put the overall marginal rate at 33 percent. If LRAP assistance is includible in gross income, many if not most LRAP recipients would be at this 33 percent marginal rate after the LRAP income is added into their other income.

would have the effect of a tax payment from the sponsoring law school to the state and federal governments. This is a perverse result in view of the tax exempt status of law schools. The law schools would be paying taxes in order to assist public interest programs, such as legal aid, that the state and federal governments have chosen to support in such a niggardly manner that they cannot pay market level compensation.

LRAP assistance takes two basic forms. The most obvious is debt cancellation. Prior to outright cancellation of debt, however, many programs provide for deferral of debt on an interest-free basis. A school either lends money on an interest-free basis to a borrower to make loan payments to a third party or forgoes repayment of its own loans, also interest-free.[54] If the borrower remains eligible for LRAP assistance for a certain period of time, for example by remaining in public interest employment, these debts are ultimately cancelled. Therefore, analysis of the tax consequences of LRAP's requires consideration of both loan cancellation and deferral.

It appears likely, but not certain, that LRAP debt cancellation assistance is includible in gross income, while loan deferral assistance is not includible. The next sections of this article analyze the tax treatment of LRAP assistance and propose that legislation be enacted to exclude all such assistance from gross income.

1. Debt Cancellation

LRAP debt cancellation assistance from a school fits into either of two categories. First, the assistance can be a payment from the school to or on behalf of the borrower to pay off the debt. Second, the school simply may forgive a debt owed by the borrower to the school itself. The tax consequences of either category are similar.

a. *General Rule of Inclusion*

The often stated general rule of I.R.C. section 61 is that all realized economic gain is includible in gross income except that

54 *See supra* text in part III, A.

which is specifically exempted.[55] Gain includible under this principle encompasses all "accessions to wealth, clearly realized."[56] LRAP debt cancellation assistance is undoubtedly an "accession to wealth clearly realized," whether it takes the form of payment to or on behalf of the borrower, or forgiveness of a loan owed directly to the school sponsoring the LRAP.[57] Consequently, LRAP debt cancellation assistance is includible in gross income, unless some specific provision excludes it.

There are several provisions that might support exclusion. The assistance might be characterized as a scholarship under section 117[58] or a gift under section 102.[59] The assistance might also be excluded under the insolvency exception to discharge of indebtedness income under section 108,[60] or the special provision of section 108(f) covering certain student loan forgiveness.[61]

b. *Scholarship*

LRAP assistance plausibly might be characterized as a deferred scholarship, excludible under IRC section 117. Similar loan forgiveness provisions of the National Defense Student Loan Program (the predecessor of the National Direct Student Loan program) were originally treated by the Internal Revenue Service (IRS) as resulting in non-taxable scholarship income.[62] This was true, even though the loan cancellation took place subsequent to the related schooling, and the borrower had to follow

55 *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955) (intent of Congress to "tax all gains except those specifically exempted").

56 *Id.* at 431.

57 In the latter case, the amount of debt forgiveness would be includible as discharge of indebtedness income. *See* Treas. Reg. § 1.61-12.

58 I.R.C. § 117(a).

59 I.R.C. § 102(a).

60 I.R.C. § 108(a)(1)(B).

61 I.R.C. § 108(f).

62 Myers and Hopkins, *IRS Is Limiting the Scope of the Exclusion for Fellowship and Scholarship Grants*, 42 J. TAX'N 215-16 (1975). In 1961, the IRS advised the Department of Health, Education and Welfare (now split into the Department of Education and the Department of Health and Human Services) that loan cancellations under the National Defense Student Loan Program could be treated as scholarships and the Department of Health Education and Welfare manual so advised prospective borrowers. *Id.* Loan cancellations were awarded under this program if borrowers did certain things such as teach in public schools. *Id. Cf.* Rev. Rul. 61-53, 1961-1 C.B. 21 (National Defense Student Loan stipends excludible as scholarships).

certain courses of action, such as teaching in public school, to qualify for the loan cancellation.[63] In 1973, however, the Service reversed this position and ruled in Revenue Ruling 73-256 that medical school loan cancellations given by a state on condition that the recipients practice medicine for a given period of time within certain rural areas of the state were not excludible scholarships.[64]

The Service based its position on its definition of a scholarship. In order for an amount to be excludible under I.R.C. section 117, the amount must be a "scholarship or fellowship."[65] The regulations define the term scholarship as "an amount paid or allowed to, or for the benefit of, a student, . . . to aid such individual in pursuing his studies."[66] The regulations consider this definition to express merely necessary, but not sufficient, characteristics of a scholarship. The regulations add an additional requirement. Section 1.117-4(c) states that an amount is not a scholarship if it is:

> (1) [A]ny amount . . . [that] 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.[67]

Hence, the regulations essentially add a condition that a scholarship cannot be compensatory.

The validity of this regulatory embellishment of the definition of scholarship was upheld by the United States Supreme Court in *Bingler v. Johnson*.[68] The court held that the essence of the regula-

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63 *See* Myers and Hopkins, *supra* note 62, at 215-16.

64 *See* Rev. Rul. 73-256, 1973-1 C.B. 56 (modified by Rev. Rul. 74-540, 1974-2 C.B. 38) (applying Commissioner's authority under I.R.C. section 7805(b) to make Rev. Rul. 73-256 prospective only in application).

65 *See* I.R.C. § 117(a). For ease of expression, this article will simply refer to scholarships to include scholarships and fellowships. A fellowship is "an amount paid or allowed to, or for the benefit of an individual to aid him in the pursuit of study or research." Treas. Reg. § 1.117-3(c). Grants for graduate level education are generally called fellowships.

66 Treas. Reg. § 1.117-3(a).

67 *Id.* § 1.117-4(c)(1), (2).

68 Bingler v. Johnson, 349 U.S. 741 (1969). The facts of *Bingler* strongly suggest that the taxpayer was simply being paid for doing a job: the taxpayer was an em-

tion was a requirement that a scholarship cannot be granted in exchange for a *quid pro quo*.[69] It stated:

> 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 excludible from income as "scholarship" funds.[70]

The Court went on to say in a footnote that the second paragraph of the quoted regulation, which deals with a grant for the primary benefit of the grantor, was merely supplementary to the first paragraph.[71] Consequently, a grant that is not primarily for the benefit of the grantor can still be compensatory and, hence, outside the definition of scholarship.

In line with the *Bingler* decision, Revenue Ruling 73-256 held that for a receipt to be excludible as a scholarship, it is not enough that the purpose of the grant be to further an individual's education. It must, in addition, *not* be in exchange for a *quid pro quo*.[72] The Service ruled that the condition requiring borrowers to practice medicine in certain rural areas of the state in order to qualify for debt cancellation was the extraction of a substantial *quid pro quo*.[73] This was true, even though no employment relationship existed between the state and the borrowers.[74] The services required did not further a substantial educational objective, but rather were "designed to accomplish a basic objective" of the state — to assure an adequate supply of medical care for the state's rural areas.[75] Therefore, the loan cancellations did not qualify as excludible scholarships, and were includible in gross income under the general definition of I.R.C. section 61.

Loan cancellations under the conditions of most LRAP's seem to fall under the rationale of *Bingler* and Revenue Ruling 73-256.

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ployee of the grantor, Westinghouse Corporation; the amount of the stipend was based on the taxpayer's former salary; Westinghouse withheld employee taxes; the taxpayer retained seniority and benefits; and the taxpayer was obligated to return to employment with Westinghouse after the completion of studies. *Id.* at 743-44.

69 *Id.* at 757-58.

70 *Id.*

71 *Id.* at 758 n.32.

72 Rev. Rul. 73-256, 1973-1 C.B. 56.

73 *Id.*

74 *Id.*

75 *Id.*

The typical LRAP requires that the beneficiaries serve in certain categories of employment such as public service or government to qualify for assistance.[76] This arguably amounts to extraction of a *quid pro quo* sufficient to exclude the assistance from the concept of a scholarship. In contrast, an LRAP whose eligibility criteria merely requires that income be below a certain level[77] would not seem to be subject to this same argument. Merely having a low income does not amount to a substantial *quid pro quo*. One does not have to *do* a thing in order to have a low income — merely be unfortunate, inept, or unacquisitive.

A taxpayer could argue that the Revenue Ruling 73-256 situation is sufficiently different from LRAP assistance to justify an opposite tax result. The interest of a law school in a supply of public interest lawyers, while present, is not as direct as the interest of a state in an adequate supply of medical services for the state's rural areas. Hence, there is no primary direct benefit to the grantor law school present in the LRAP situation. Any benefit to the grantor law school is remote at best. However, *Bingler* is explicit that the thrust of the regulation is prohibition of a *quid pro quo*,[78] and most LRAP's definitely do require a *quid pro quo* in the form of required service in certain categories of employment.

Nevertheless, a taxpayer might, in some instances, sufficiently distinguish the LRAP loan cancellation assistance from the loan cancellation in Revenue Ruling 73-256. For example, an LRAP that awards assistance based only on a low income level, could probably establish a lack of *quid pro quo*. Other arguments, however, still present obstacles to application of section 117. LRAP loan cancellation assistance is awarded *after* the schooling has taken place. The Service could argue that the LRAP assistance is not "an amount paid . . . for the benefit of a student . . . to aid such individual in his studies."[79] The recipient is not a *student* when the award is made. Nor is the assistance awarded to aid the recipient in his studies, since the studies have already taken place. The Service did not

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76 *See supra* part III,A.

77 Harvard's LRAP is apparently the lone program that has only an income requirement. NATIONAL ASSOCIATION FOR PUBLIC INTEREST LAW, LOAN REPAYMENT ASSISTANCE REPORT (1989).

78 394 U.S. at 757.

79 Treas. Reg. § 1.117-3(a).

make this contention in Revenue Ruling 73-256,[80] but there seems to be no reason why the Service could not raise the argument if the taxpayer could distinguish that ruling.

Similar arguments can be made based on the wording of the post-1986 version of I.R.C. section 117. The statute now excludes only amounts received as a "qualified scholarship."[81] A qualified scholarship encompasses only amounts used for "qualified tuition and related expenses."[82] The latter term is restricted to required tuition, fees, books, supplies, and equipment.[83] LRAP assistance is not by its terms granted to be expended for tuition and books. Those expenditures have long since been made by the time a taxpayer receives LRAP assistance. The taxpayer would have to establish that the section is intended to encompass a "deferred scholarship." In addition, the taxpayer would have to establish that the loaned "amount was used for qualified tuition and related expenses" in order to qualify for exclusion.[84] Hence, even if the taxpayer succeeded in gaining acceptance for the concept of a deferred scholarship,[85] the taxpayer would still have the difficult task of relat-

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80 *See* Rev. Rul. 73-256, 1973-1 C.B. 56.

81 I.R.C. section 117(a) states:

> **(a) General rule.** — Gross income does not include any amount received as a *qualified scholarship* by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii).

(Italics added).

82 *Id.* section 117(b)(1) states:

> **(1) In general.**— The term "qualified scholarship" means any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for *qualified tuition and related expenses.*

(Italics added).

83 *Id.* section 117(b)(2) states:

> **(2) Qualified tuition and related expenses.** — For purposes of paragraph (1), the term qualified tuition and related expenses means —
>
> **(A)** tuition and fees required for the enrollment or attendance of a student at an educational organization described in § 70(b)(1)(A)(ii), and
>
> **(B)** fees, books, supplies, and equipment required for courses of instruction at such an educational organization.

84 *See* Prop. Reg. § 1.117-6(c)(1) (1988).

85 In a letter ruling, the Service refused to classify loan repayment assistance as a scholarship, partially on the ground that such assistance was not given to aid the recipient in current studies since the studies had been completed. Priv. Ltr. Rul.

ing the loan cancellation to payment of qualified expenses by some sort of tracing procedure.

All the foregoing presents a formidable obstacle to treatment of LRAP loan cancellation assistance as an excludible scholarship under I.R.C. section 117. The likelihood is that LRAP assistance will not be found to be excludible under that section.

c. *Gift*

Another possibility is that the LRAP assistance might be excludible under I.R.C. section 102 as a gift.[86] Assistance received under LRAP's that require service in certain categories of employment as conditions of receiving the assistance would meet the same *quid pro quo* arguments for gift classification as they do for scholarship classification.[87] LRAP's which do not have a service requirement might fare better.

A taxpayer could bypass I.R.C. section 117 altogether, and thus avoid the requirements of the "qualified scholarship" definition discussed above.[88] In that event the question would be a factual one whether the law school gave the assistance out of motives of "detached and disinterested generosity" required by the *Duberstein* test.[89] The taxpayer would have at least a plausible argument in this regard, because of the absence of any substantial direct benefit to the law school granting the LRAP assistance. A law school might derive some indirect public relations benefit from having an LRAP program. This is no different, however, from the benefit a charitable donor derives from being known for philanthropy and should not remove the granting of assistance from the category of "detached and disinterested generosity."

d. *Insolvency Exception*

Another possible route to nontaxability of LRAP loan cancellation assistance is the insolvency exception to the discharge

87-14-035 (Jan. 2, 1987). This reasoning would exclude the concept of a retroactive or deferred scholarship.

86 I.R.C. section 102(a) states: "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."

87 *See supra* text accompanying notes 68-80.

88 *See supra* text accompanying notes 81-84.

89 Commissioner v. Duberstein, 363 U.S. 278, 285 (1960).

of indebtedness income doctrine.[90] The discharge of indebtedness doctrine states that when a debtor is relieved of debt, the debt relief results in income to the debtor.[91] The IRS maintained, as early as 1918, that discharge of indebtedness is includible in gross income,[92] but the doctrine was first firmly established in *United States v. Kirby Lumber Co.*[93] In that case, the Court found that the taxpayer corporation had realized discharge of indebtedness income when it repurchased its own bonds for less than their issue price.[94] Justice Holmes summed up the Court's rationale in two pithy sentences:

> Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct.[95]

The corollary to Justice Holmes' rationale was that if no assets were freed up, because the debtor was insolvent at the time of the discharge, there was no income to be included in the tax base.[96] Although this reasoning for an insolvency exception to discharge of indebtedness income has been justly criticized,[97] the exception does serve a useful practical purpose. It frees financially distressed debtors who work out debt relief arrangements with their creditors from

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90 I.R.C. section 108(a)(1)(B) states:

> **(1) In General.** — 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 indebtedness of the taxpayer if . . . .
>
> **(B)** the discharge occurs when the debtor is insolvent. . . .

91 *See* I.R.C. § 61(a)(12); Treas. Reg. § 1.61-12; United States v. Kirby Lumber Co., 284 U.S. 1 (1931); Witt and Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. TAX REV. 1 (1990); Heinlen, *The ABCs of Indebtedness Income and Attribute Reduction*, 2 N.Y.U. FORTIETH INST. FED. TAX'N § 42.01, at 42-2 (1982).

92 *See* Treas. Reg. 45, Art. 51 and 54 (1920); Heinlen, *supra* note 91, at 42-2.

93 284 U.S. 1 (1931). The classic article on the discharge of indebtedness doctrine is Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959).

94 284 U.S. at 3.

95 *Id.*

96 *See* Dallas Transfer and Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934); Astoria Marine Const. Co. v. Commissioner, 12 T.C. 798 (1949); *see* Bittker & Thompson, *Income from the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 CALIF. L. REV. 1159, 1165 (1978).

97 *See* Eustice, *supra* note 93, at 246-48; Bittker & Thompson, *supra* note 96, at 1165.

the additional burden of an income tax on the debt relief arrangement itself.[98]

The insolvency exception, originally a judicial creation,[99] is now based exclusively in the statute.[100] For the insolvency exception to apply, the debtor must be insolvent at the time of the debt discharge.[101] If the debtor is insolvent at time of discharge, the discharge results in gross income only to the extent that the debtor is solvent after the discharge.[102] If the debtor is insolvent both before and after the discharge, the debtor has no discharge of indebtedness income.

The statute prescribes a net worth test for insolvency. A taxpayer is insolvent to the extent that the taxpayer's liabilities exceed the fair market value of the taxpayer's assets.[103] A recently graduated student debtor with upwards of $50,000 in student debt may well be insolvent under this definition of insolvency. The student is unlikely to have equity in assets that exceed a fair market value of $50,000. Any major assets such as a house and car probably have large accompanying liabilities.

Would such a student be eligible for the statutory insolvency exception? Nothing in the statute states otherwise. Congress prob-

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98 *See* Eustice, *supra* note 93, at 248. The financial distress must, of course, reach the level of insolvency for the insolvency exception to apply. *See* I.R.C. § 108(a)(1)(B), (3), (e)(1).

99 *See* Heinlen, *supra*, note 91, at § 42.03[1], at 42-8; Bittker & Thompson, *supra*, note 96, at 1165; Eustice *supra*, note 93, at 246-48.

100 I.R.C. section 108(e)(1) states:

> **(1) No Other Insolvency Exception.** — Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

101 *See* I.R.C. § 108(a)(1)(B).

102 I.R.C. section 108(a)(3) states:

> **(3) Insolvency exclusion limited to amount of insolvency.** —In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

103 Section 108(d)(3) states:

> **(3) Insolvent.** — For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

See Witt and Lyons, *supra* note 91, at 54-7.

ably did not have student debtors in mind when it enacted the insolvency exception. Nevertheless, a student debtor with minimal fair market value of assets literally fits the statutory definition of insolvency.[104] The Commissioner would have to argue that application of the statutory insolvency exception to student debt violates the purpose of the statute to such an extent that the exception should not apply in that situation.

This argument is not likely to prevail. There is nothing in the statute to indicate that the insolvency exception is inapplicable to student debt. If application of the insolvency exception to student debt were determined to be abusive, then legislation, not administrative or judicial action, would be the appropriate remedy. Moreover, there is a counter-argument that a student debtor receiving LRAP loan cancellation assistance is precisely the kind of distressed debtor for whom Congress enacted the insolvency exception. By definition, only those in financial need receive LRAP assistance. Therefore, it appears that the insolvency exception does provide a possible route to non-taxability of LRAP assistance.[105]

The insolvency exception can afford tax relief only in certain situations, however. The insolvency provision is an exception to inclusion of discharge of indebtedness income. This requires that the underlying transaction be forgiveness or cancellation of debt. The cancellation of debt by a law school to whom the student owes the debt would certainly fall under this rubric; but LRAP assistance that takes the form of payment by the school to or on behalf of the debtor to assist the debtor in paying a third party loan would not strictly be loan forgiveness or cancellation. The Commissioner might contend that the school is simply making a payment to (or on behalf of) the student debtor that the debtor uses to pay the debt. Since the underlying transaction is a direct payment not a discharge of indebtedness, the insolvency exception would be inapplicable.

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104 In the 1970's some student debtors used the bankruptcy laws to discharge recently acquired student debt, arguing that they were insolvent under the bankruptcy definition of insolvency. *See, e.g., In re* Lawson, 10 Bankr. 477 (E.D. Tenn. 1981). Congress considered this an abuse of the bankruptcy law and enacted legislation limiting the availability of bankruptcy discharge for student debts. *See* 11 U.S.C. § 523(a)(8) (1988).

105 Of course, this would require the student debtor to surrender the tax attributes set out in I.R.C. section 108(b). This would not be burdensome since, in most instances, the debtor would have few if any such attributes (for example - net operating loss carryovers) to reduce.

The latter argument would not apply to the situation where the LRAP lends money to the student debtor that the debtor, in turn, uses to make payments on third party loans. In that case the LRAP converts the third party debt into a debt owed directly to the school. A later cancellation of that loan would be a discharge of debt owed directly to the school itself, and I.R.C. section 108 then could apply to the loan cancellation. Most student debt is owed initially to third party creditors, not directly to law schools.[106] Consequently, whatever opening the insolvency exception may provide for tax relief to recipients of LRAP loan cancellation assistance is probably limited to debt that is owed initially to the school or to third party debt that is subsequently converted by the LRAP to debt owed directly to the school.

e. *I.R.C. Section 108(f)*

The Code currently contains a provision, I.R.C. section 108(f), that excludes from income on account of discharge from student debt in certain restricted circumstances.[107] The predecessor of section 108(f) was originally enacted as section 2117 of the Tax Reform Act of 1976.[108] Its purpose was to reverse the holding of Revenue Ruling 73-256[109] in limited circumstances. Congress first enacted the provision with an automatic expiration date, but later extended it and finally made it a permanent part of the Code in 1984.[110]

Section 108(f) requires as a condition of loan forgiveness that the debtor work "for a period of time in certain professions for any of a broad class of employers."[111] Most LRAP's would fit this initial standard, since the vast majority require some form of

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106 39 J. LEGAL EDUC. *passim* (No. 5 1989).

107 Section 108(f)(1) states:

> **(1) In general.** — 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.

108 Tax Reform Act of 1976, § 2117, 90 Stat. 1911 (1976).

109 Rev. Rul. 73-256, 1973-1 C.B. 56. *See supra* text accompanying notes 63-67.

110 Revenue Act of 1978, Pub. L. No. 95-60 § 162, 92 Stat. 2810 (1978); Deficit Reduction Act of 1984, Pub. L. No. 98-369 § 1076, 98 Stat. 1053 (1984).

111 I.R.C. § 108(f)(1).

government or public service employment. But the section also requires that the loan be a loan from 1) a governmental unit; 2) certain hospital units; or 3) a school, provided the funds come from a governmental entity.[112] An example of a loan to which section 108(f) applies is a Perkins Loan authorized under the Higher Education Act of 1965 that is forgiven for teaching in certain schools, performing military service, or serving in the Peace Corps or VISTA.[113] LRAP assistance for loans that do not come from governmental units or hospital units would not qualify for tax relief under section 108(f). Since the vast majority of LRAP assisted loans do not come from these sources, section 108(f) is of little use to taxpayers receiving LRAP loan cancellation assistance.

2. Loan Deferral

Many LRAP's provide an interim mode of assistance that has the effect of deferring rather than cancelling the student indebtedness. The law school makes a non-interest bearing loan to the student borrower for the purpose of making payments due on the borrower's student loan.[114] The question arises whether the interest-free element of these loans has tax consequences under I.R.C. section 7872.

I.R.C. section 7872 imposes income tax when a lender lends a borrower money at no interest or at a below-market interest rate. The provision accomplishes this result by imputing a transfer of the foregone interest from the lender to the borrower and then imputing a retransfer of the same amount from the borrower to the lender as an interest payment.[115] For example, applied to the LRAP situation, I.R.C. section 7872 would impute a transfer by the law school lender to the student borrower of an amount equivalent to the foregone interest, and a retransfer of that same amount from the borrower to the law school. If section 7872 applied, the imputed transfer by the law school to the bor-

112 *See* I.R.C. § 108(f)(2).

113 *See* Higher Education Act of 1965, Pub. L. No. 89-329 § 465, 79 Stat. 1253 (1965); Cong. Research Serv., *Extent to Which Postsecondary Student Financial Aid is Subject to Federal Taxation* at CRS-8 to CRS-9 (1990).

114 *See supra* part III, A. If the law school, itself, is the lender on the student debt, the school simply defers loan repayment on an interest-free basis.

115 *See* I.R.C. § 7872(a).

rower might be characterized as taxable income, unless it came within some exclusion section, such as scholarship or gift.[116] The imputed retransfer from the borrower to the law school would be characterized as a payment of interest income from the borrower to the law school. The latter imputed interest payment would likely have no effect on the law school, since it is presumably a section 501(c)(3) organization, exempt from tax on its interest income.[117]

I.R.C. section 7872, however, does not appear to be applicable to the LRAP situation. First, the words of the statute simply do not fit the case. I.R.C. section 7872 applies to three specific categories and to two broad residual classes of loans: 1) gift loans, for example, loans from a parent to a child; 2) employment related loans, for example, loans from an employer to an employee; 3) corporation-shareholder loans, for example, loans from a corporation to a shareholder; 4) loans one of the principal purposes of which is the avoidance of any federal tax; and 5) to the extent provided in regulations, any below-market loan not included in one of the first four categories, to the extent that the interest arrangements have a significant effect on the federal tax liability of the lender or borrower.[118]

Of these five categories, the third and fourth are patently inapplicable. The law school and borrower are not in a corporation-shareholder relationship, and there is no principal purpose to avoid taxes. The first and second categories are more troublesome, but also appear inapplicable. If the IRS attempted to characterize the foregone interest as a gift under the first category (gift loan), the taxpayers could counter with the argument that under Revenue Ruling 73-256,[119]the condition of working in certain categories of employment constitutes a *quid pro quo* that negates gift characterization.[120]

For LRAP's that do not have an employment requirement

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116 *See supra* text accompanying notes 62-89.

117 There is a very remote possibility that a school could be considered as being in the trade or business of lending money and, consequently, subject to the unrelated business income tax on the imputed interest income. *See* I.R.C. §§ 511-513.

118 I.R.C. § 7872(c)(1)(A), (B), (C), (D), (E). A sixth category, irrelevant to this discussion, includes certain loans to continuing care facilities. *See* I.R.C. § 7872(c)(1)(F).

119 1973-1 C.B. 56.

120 *See supra* text accompanying notes 68-73.

this argument would not apply. Even if gift characterization held, there would still seem to be no adverse tax effects on either the student borrower or the law school. As for the student, the gift of foregone interest would be excludible from gross income under I.R.C. section 102.[121] With respect to the lender law school, the imputed interest income would likely be tax exempt under section 501(c)(3).[122]

The fourth category is compensation related loans.[123] This category applies specifically to: 1) loans between an employer and employee; and 2) loans between an independent contractor and a person for whom the contractor performs services.[124] Patently, LRAP assistance would not fall under the employer-employee classification. There is no employment relationship between the law school and the student borrower.

Moreover, LRAP assistance does not fit easily into the independent contractor classification. Although the student borrower might possibly be characterized as performing a *quid pro quo* in return for the LRAP assistance,[125] the borrower does not perform that *quid pro quo* as an independent contractor *for* the law school lender. The borrower performs no services *for* the law school as the statute requires.[126] More than a mere *quid pro quo* must be present. There also must be some relationship (employer-employee or independent contractor-service recipient) that produces a benefit to the lender.[127] Therefore, none of the

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121 *See supra* text accompanying notes 86-89.

122 *See supra* text accompanying note 117.

123 I.R.C. section 7872(c)(1)(B) states that the section applies to,

> **(B) Compensation-related loans.** — Any below-market loan directly between —
>
> (i) an employer and an employee, or
>
> (ii) an independent contractor and a person *for* whom such independent contractor provides services.

(Italics added).

124 *Id.*

125 *See supra* text accompanying notes 78, 83.

126 *See* I.R.C. § 7872(c)(1)(B)(ii).

127 *See* Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984*, 98th Cong., 2d Sess., 529-30 (1984) (section 7872 applicable if there is in substance a compensatory element arising from the transaction); B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, GIFTS AND ESTATES ¶58 (I.R.C. section 7872(c)(1)(B) definition should be interpreted *in pari materia* with I.R.C. section 83).

first four categories appears to be applicable to LRAP interest-free loan assistance.

The fifth category is a catch-all provision that authorizes the Treasury to issue regulations applying section 7872 to "any below-market loan . . . if the interest arrangements of such loan have a significant effect on any Federal tax liability of the lender or the borrower."[128] The Treasury has issued temporary regulations under this provision which exempt several classes of transaction from application of I.R.C. section 7872.[129] Among the transactions exempted from section 7872 by these regulations are:

> Loans made by a private foundation or other organization described in section 170(c), the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B).[130]

To come within this exemption a loan must meet two conditions. First, the lender must be an organization described in I.R.C. section 170(c). Most law schools should easily come within the description in section 170(c), because law schools are normally "organized and operated exclusively for religious, charitable, scientific, literary, or *educational* purposes."[131] Second, the purpose of the loan must be to "accomplish one or more of the purposes described in section 170(c)(2)(B)."[132] The purposes described in section 170(c)(2)(B) are the purposes listed above: "religious, charitable, scientific, literary, or educational."[133]

The regulations interpreting I.R.C. section 4944 provide guidance for the application of the second condition required by regu-

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128 I.R.C. § 7872(c)(1)(F).

129 Temp. Treas. Reg. § 1.7872-5T (1985).

130 *Id.* § 7872-5T(b)(11).

131 I.R.C. § 170(c)(2)(B) (emphasis added).

132 Temp. Treas. Reg. § 1.7872-5T. The wording of the regulation is ambiguous on the question of whether it is the *lending organization* or the *loan* that must further section 170(c)(2)(B) purposes. In letter rulings the Service has consistently held that the *loan* itself must further section 170(c)(2)(B) purposes. *See* Priv. Ltr. Rul. 89-10-027 (1989); Priv. Ltr. Rul. 88-10-026 (1988); Priv. Ltr. Rul. 87-31-040 (1987); Priv. Ltr. Rul. 86-39-064 (1986). This appears to be a correct interpretation, since, otherwise, the section 170(c)(2)(B) requirement would be redundant: any organization that furthered section 170(c)(2)(B) purposes (assuming it is also organized for those purposes) automatically would be described in I.R.C. section 170(c) — the regulation's first requirement.

133 *See* I.R.C. § 170(c)(2)(B).

lations section 1.7872-5T(b)(11). I.R.C. section 4944(c) establishes an exception for "program-related investments" to the excise tax on private foundation investments which jeopardize the organization's charitable purpose.[134] To qualify for this exception from the excise tax, the investment must be one, "the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B)"[135] This is the same phrase that appears in regulations section 1.7872-5T(11). Accordingly, the regulations interpreting I.R.C. section 4944(c) are useful in applying the second condition required by regulations section 1.7872-5T(b)(11).

The regulations interpreting I.R.C. section 4944(c) state that an investment:

> shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) if it significantly furthers the accomplishment of the [organization's] exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the [organization's] exempt activities.[136]

The regulations go on to state that the condition is fulfilled regardless of whether or not the section 170(c)(2)(B) purposes are carried out by organizations described in I.R.C. section 170(c).

Law schools establish LRAP's as part of their broad mission to advance the legal profession. LRAP's advance the legal profession by broadening the alternatives available to law school graduates to enter government and public interest employment. LRAP's have the effect of supplementing the compensation paid for government and public interest employment, thereby making it economically more feasible for graduates to take positions in these areas. Moreover, LRAP's may make it more attractive for public service oriented and financially needy students to borrow and attend law school. In this regard, LRAP's serve a function similar to scholarships. Certainly, scholarships further a law school's section 170(c)(1)(B) purposes. Consequently, LRAP's probably satisfy the requirements of regulations section 7872-5T(b)(11) for exemption from I.R.C. section 7872.

LRAP's do not fit easily into any of the categories covered by

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134 *See* I.R.C. § 4944(c).

135 *Id.*

136 Treas. Reg. § 53.4944-3(a)(2)(i).

I.R.C. section 7872. Hence, it appears likely (but not absolutely certain) that the interest-free loan component of LRAP assistance will not have adverse tax impact on either the lender law school or the student borrower.

3. Proposed Legislation

Congress should enact legislation expressly to exclude LRAP assistance from gross income. The exclusion should apply to both debt cancellation and debt deferral. This would be only a modest departure from existing law. The code currently excludes income from discharge of student debt in analogous circumstances.[137] Moreover, LRAP assistance closely resembles traditional scholarship assistance, currently excluded from gross income under I.R.C. section 117.

a. *Similarity to I.R.C. section 108(f) Debt Discharge*

One can argue plausibly that exclusion of income resulting from discharge of student debt traditionally has been the rule rather than the exception under the federal income tax. It was not until Revenue Ruling 73-256,[138] issued in the wake of *Bingler v. Johnson*,[139] that the Service began serious attempts to include income from discharge of student loan indebtedness in income.[140] In response, Congress enacted the predecessor of I.R.C. section 108(f) to counter the specific holding of Revenue Ruling 73-256.[141]

I.R.C. section 108(f) currently excludes student debt discharge income when the loan forgiveness is granted by a government or related entity on account of the taxpayer's engaging in certain professions for any of a broad class of employers.[142] LRAP's generally have the same kind of requirement. LRAP assistance currently is not excluded from gross income under I.R.C. section 108(f), because it does not meet that section's requirements concerning the source and timing of the loans.[143]

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137 *See* I.R.C. § 108(f); *supra* text accompanying notes 107-13.
138 Rev. Rul. 73-256, 1973-1 C.B. 56. *See supra* text accompanying notes 63-67.
139 349 U.S. 741 (1969).
140 *See supra* text accompanying notes 72-77.
141 *Id.*
142 I.R.C. § 108(f)(1).
143 *See supra* text accompanying notes 112-14.

Nevertheless, LRAP assistance follows the same general lines as section 108(f). Under most LRAP programs the student must engage in public service oriented employment in order to be eligible for LRAP assistance. This closely parallels the I.R.C. section 108(f) requirement that the student debt be discharged on account of employment "in certain professions for any of a broad class of employers."[144]

Broadening the exclusion of section 108(f) to encompass LRAP loan cancellation assistance would further the purpose of that section to give relief to needy student debtors whose loans are cancelled on account of their employment in public service oriented activities. At the same time, extending the coverage of section 108(f) to LRAP loan cancellation assistance would work only a minor change in existing law. Finally, it would be in keeping with the practice prior to Revenue Ruling 73-256 of not requiring inclusion of student loan forgiveness in income.[145]

b. *Resemblance to Traditional Scholarships*

LRAP assistance is essentially a form of deferred scholarship. Instead of awarding the scholarship in advance of educational services, the school chooses to target its aid more precisely by awarding the aid subsequent to the education. The criteria for awarding LRAP assistance are similar to the criteria used in awarding traditional scholarships — financial need and achievement. The income level requirements of LRAP programs address the financial need aspect and the requirements for certain kinds of employment address the achievement aspect. Likewise, the school's purpose of assisting needy and deserving students is similar for both scholarship and LRAP assistance.

The federal income tax law historically has given scholarships tax-favored treatment.[146] The only real difference between a currently tax-exempt scholarship and LRAP assistance is the timing of the assistance. A scholarship is generally awarded prior

144 § 108(f)(1).

145 *See supra* note 138-40 and accompanying text.

146 *See* I.R.C. § 117; B. BITTKER & L. LOKKEN, *supra*, note 127, at ¶11.2; Myers, *Tax Status of Scholarships and Fellowships*, 22 TAX LAW. 391 (1969); Gordon, *Scholarship and Fellowship Grants as Income: A Search for Treasury Policy*, 1960 WASH. U.L.Q. 144; Huberman, *Scholarships, Fellowships and Prizes*, 3 HAST. L.J. 116 (1952); Note, *Taxation of Forgiven Student Loans*, 62 GEO. L.J. 1243 (1974).

to (or during) the recipient's school attendance. LRAP assistance is rendered subsequent to the recipient's school attendance. The same policy reasons that support the exclusion of scholarships from gross income also support the exclusion of LRAP assistance.

Congress reached a similar conclusion when it enacted the predecessor of I.R.C. section 108(f). The Senate Finance Committee explained the rationale for excluding from gross income student loan forgiveness under programs designed to encourage student debtors to perform services in especially needed areas of employment. The Finance Committee Report stated:

> A provision in student loan programs for loan cancellation in certain circumstances is intended to encourage the recipients, upon graduation, to perform services needed in such areas. Proponents of these programs believe that loan cancellation is not primarily for the benefit of the 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.[147]

Student loan forgiveness under LRAP's likewise benefits the whole community and is not primarily for the benefit of the grantor. Excluding student loan assistance provided under LRAP programs is entirely "consistent with the treatment of scholarships and fellowship grants"[148] under current law.

The revenue cost of excluding LRAP assistance from gross income would be minimal in relation to the benefits.[149] Students, especially low income students, would be encouraged to seek employment in areas other than the highest paying in the private sector. The very fact that LRAP's have sprung up without govern-

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147 S. REP. No. 938, 94th Cong. 2d Sess., 430 (1976) (emphasis added).

148 *Id.*

149 The 1984 Tax Act Bluebook estimated that the enactment of section 108(f) would, on a static estimate, cost less than $5,000,000 in revenue annually. Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 98th Cong., 2d Sess., 1201 (1984). Presumably, excluding LRAP assistance would result in comparable revenue loss.

ment assistance at so many institutions is itself evidence of their need.

Non-federal initiatives such as LRAP's should be encouraged by the federal government. At present the federal government actually *discourages* creation of LRAP's through the tax system. For every dollar of LRAP assistance granted by an LRAP, the federal government may claim about twenty-eight cents in income tax.[150] A state or local tax of as little as six percent would raise the total tax cost to over one third of the loan forgiveness amount. This is, in effect, a tax on the institution sponsoring the LRAP (presumably an institution that is normally tax-exempt under IRC section 501(c)(3)). Of every dollar in LRAP assistance granted to the student debtor, only sixty-seven cents actually benefits the recipient. It makes little sense to burden the grant programs of tax-exempt institutions with such a tax cost, especially when those programs so closely resemble the same institutions' other grant programs that are tax-exempt. An institution faced with a choice of expending funds for either a worthwhile taxable program or an equally worthwhile non-taxable one is likely to opt for the non-taxable program on cost efficiency grounds. Hence, the current tax laws stack the odds against LRAP's.

c. *Tax Expenditure*

Some may argue that an exclusion for LRAP assistance would be an unwise "tax expenditure". There are two responses to this argument.

First, the tax expenditure concept, itself, is not without flaws. The idea is based on the notion that in an ideal income tax, all economic income — defined as personal consumption plus wealth accumulation — should be taxed.[151] The next step is to assert that deviations from this ideal income tax base represent indirect subsidies or tax expenditures for those who pay less tax because of the deviation.[152]

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150 The student debtor would be in the 28% federal marginal tax bracket at $19,450 ($32,450 for married couples filing jointly) taxable income in 1990. *See* 1 P-H Federal Taxes 2d ¶14.17 (1990).

151 This is the Haig-Simons definition of income. *See infra* text accompanying note 174.

152 A classic exposition of the tax expenditure concept is Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970). This article was amplified in Surrey and McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. IND.

The tax expenditure is measured by the revenue foregone by the government on account of deviation from the ideal. For example, the tax expenditure from excluding LRAP assistance would be measured by the amount of excluded income multiplied by the applicable tax rate. As presently formulated, the measurement of foregone revenue is inaccurate, because it fails to take into account changes in taxpayer behavior that will occur if a deviation from the ideal income tax base is eliminated. Consequently, it is incorrect to assert that excluding LRAP assistance from income will decrease government revenue by an amount equivalent to the product of the excluded income times the applicable tax rate.[153] The existence or not of the exclusion will, in itself, affect the amount of foregone revenue.

The tax expenditure concept also fails to take a long view. Perhaps granting an exclusion to LRAP loan forgiveness may result in short-term revenue loss. Nevertheless, it will also result in long-term revenue gain, if the exclusion fosters a better educated and, hence, higher earning work-force. If Congress considers the short-term revenue loss to be too great a problem, it might consider recovering offsetting revenue by repealing the current law interest deduction for mortgages on second homes.[154]

Finally, the lavish devotion to the tax expenditure concept that some tax theorists display reveals a slavish adherence to economic concepts to the exclusion of other disciplines. The fact is "we live in a society not an economy."[155] In the words of Oliver Wendell Holmes, Jr., "[t]he income tax laws do not profess to

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& COM. L. REV. 225 (1979). *See generally*, S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973). Congress has enacted the tax expenditure concept into law. The statute requires Congress to examine tax expenditures as part of budgetary policy. *See* Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, §§ 3(a)(3), 101(c), 102(a), 88 Stat. 297, 299, 300, 300-01 (codified at 2 U.S.C. § 622(a)(3) (1988)). The statute also requires the President to include tax expenditures as an item in his recommended budget. *See id.* § 601, 88 Stat. 297, 323-24 (codified at 31 U.S.C. § 1105(a)(16) (1988)). For a brief history of the tax expenditure concept, *see* Karzon & Coffin, *Extension of the At-Risk Concept to the Investment Tax Credit: A Shotgun Approach to the Tax Shelter Problem*, 1982 DUKE L.J. 847, 850 n.13.

153 *See* Stiglitz & Boskin, *Impact of Recent Developments in Public Finance Theory on Policy Decisions*, 67 AM. ECON. REV. 295 (1977).

154 *See infra* text accompanying notes 178-97.

155 Avorn, *Benefit and Cost Analysis in Geriatric Care*, 310 NEW ENG. J. MED. 644 (1984) (quoting Fein, *On Measuring Economic Benefits of Health Programmes*, in MEDICAL HISTORY AND MEDICAL CARE: A SYMPOSIUM OF PERSPECTIVES 179-220 (1971)).

embody perfect economic theory."[156]

IV. Nondeductibility of Student Loan Interest

The 1986 Tax Reform Act eliminated the income tax deduction for interest on student loans.[157] Under prior law, taxpayers were entitled to deduct almost all of their interest paid without regard to the use to which the loan proceeds were put.[158] The interest deduction has a long and venerable history. A deduction for interest had been in the tax law as early as the Civil War Income Tax Act.[159] The interest deduction was among the original itemized deductions allowed by the 1913 Revenue Act.[160]

The 1986 Act, nevertheless, generally eliminated the deduction for "personal interest."[161] Personal interest encompasses interest on any indebtedness the proceeds of which are used for personal consumption purposes.[162] Hence, the disallowance embraces interest on student loans, because educational expense is generally treated as a personal consumption expense under the federal income tax.[163]

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156 Weiss v. Weiner, 279 U.S. 333, 335 (1929).

157 Tax Reform Act of 1986, Pub. L. No. 99-514 § 511(b), 100 Stat. 2246 (codified at I.R.C. § 163(h)).

158 *See* I.R.C. of 1954 § 163. There were limitations with regard to certain investment interest (*see* I.R.C. of 1954 § 163(d)) and interest on indebtedness paid or incurred to purchase or carry tax exempt bonds. *See* I.R.C. of 1954 § 265(2). These provisions affected only a small number of taxpayers.

159 Act of March 3, 1865, ch. 78, 13 Stat. 479. The 1894 Income Tax Act also contained a provision allowing a deduction for personal interest. *See* Act of August 27, 1894 ch. 349, § 28, 28 Stat. 553.

160 Act of October 13, 1913, ch. 16, § 2(B), 38 Stat. 167 (1913).

161 I.R.C. § 163(h). The 1986 Act did phase in the disallowance over a five year period. By 1991 this phase-in has been completed and all personal interest is disallowed for 1991 and thereafter. *See* I.R.C. § 163(d)(6), (h)(5).

162 *Id.*

163 *See* Treas. Reg. § 1.162-5(b)(1) which states that, "[e]ducational expenditures . . . are personal expenditures or constitute an inseparable aggregate of personal and capital expenditures."; Toner v. Commissioner, 623 F.2d 315, 317 (3d Cir. 1980); Krist v. Commissioner, 483 F.2d 1345, 1347 n.2 (2d Cir. 1973); Carroll v. Commissioner, 418 F.2d 91, 94 (7th Cir. 1969); M. CHIRELSTEIN, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE ¶6.02(c) (4th ed. 1985); Shaw, *Education as an Ordinary and Necessary Expense in Carrying on a Trade or Business*, 19 TAX L. REV. 1 (1963); Note, *Section 163: Interest Paid on Educational Indebtedness—Past, Present, and Future*, 43 Tax Law. 1007 (1990).

In Welch v. Helvering, 290 U.S. 111, 115 (1933), Justice Cardozo referred ironically to a taxpayer who,

> conceives the notion that he will be able to practice his vocation with

A. *Education as Investment*

The necessity for borrowing as a means to accumulate the intellectual capital necessary for the student to earn a living differentiates student loan interest from other personal interest. Education is an investment in one's own human capital.[164] Indeed, the idea that higher education is an investment was one of the original grounds for creation of student loan programs.[165] As early as 1953, a group of legal educators made the following statement supporting creation of a law student loan program:

> [e]ducation is a long term capital investment capable of returning high yields. The difference between the cost of a legal education and its value in terms of lifetime earnings is proportionately much greater than the returns ordinarily experienced on invested capital. . . . This annual return makes legal education a sound investment.[166]

Educators and economists regard higher education as a sound investment.[167] Certainly, private lenders would be much less willing than they are to make student loans if higher education were not a good investment. As matters now stand, student loans are looked upon as investments by educators, economists, lenders and the Department of Education, but not by the tax law. Legally trained minds may easily grasp this subtle distinction, but less honed intellects will surely find it difficult.

A college education provides benefits under two aspects: 1) personal cultural enrichment and 2) enhanced earning power.[168]

> greater ease and profit if he has an opportunity to enrich his culture. Forthwith the price of his education becomes an expense of the business, reducing the income subject to taxation.

164 Various commentators have elaborated on the idea of investment in human capital. *See e.g.*, E. COHN, THE ECONOMICS OF EDUCATION 13-20 (1979); G. BECKER, HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS WITH SPECIAL REFERENCE TO EDUCATION (1975); L. THUROW, INVESTMENT IN HUMAN CAPITAL (1970); Gross, *Tax Treatment of Education Expenses: Perspectives for Normative Theory*, 55 U. CHI. L. REV. 916, 930-34 (1988); Stephan, *Federal Income Taxation and Human Capital*, 70 VA. L. REV. 1357 (1984); Schultz, *Investment in Human Capital*, 51 AM. ECON. REV. 1 (1961).

165 *See* Kramer, *supra* note 6, at 249-50.

166 *Id.* at 250 (*quoting Loans for Law School Students*, 5 J. LEGAL EDUC. 312, 314 (1953)).

167 *See* McPherson & Skinner, *supra* note 1. "College is in fact a long-term investment returning financial and personal benefits that extend over a lifetime." *Id.* at 29

168 *See* Gross, *supra* note 164, at 930.

Although the first aspect may come under the heading of personal consumption, the second most certainly does not. The explanation usually offered for denying a deduction for higher education expense is that the two aspects cannot be separated adequately for accounting purposes. The regulations speak of education expenses in terms of an "inseparable aggregate" of personal and investment expenditures.[169] Denying any tax benefit at all unfairly disadvantages the investment aspect because it is difficult to separate the personal and investment aspects of higher education expenses.

A better result would be to recognize the investment aspect by providing a deduction of some kind, even if the deduction only approximates the actual allocation between personal consumption and investment. This would be but another application in the real world of the principle of second best.[170] Allowing a deduction for student loan interest would at least recognize for tax purposes the substantial investment element in higher education, especially professional education.[171]

B. *Ability to Pay*

One of the fundamental rationales for an income tax is that taxes should be exacted in accordance with ability to pay.[172] The

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169 Treas. Reg. § 1.162-5(b)(1).

170 The principle of second best is an economic concept. It states that when a market contains an imperfection, the addition of a second imperfection may actually improve efficiency, thereby resulting in a second best, albeit imperfect, outcome. In effect, two wrongs may result in "the next best thing to a right." Schmallbeck, *The Uneasy Case for a Lower Capital Gains Tax*, 48 TAX NOTES 195, 199 (July 9, 1990). Although the principle of second best has its genesis in economics, it is applicable to other systems such as law, including tax law. *Id.*; Hirsch, *The Problem of the Insolvent Heir*, 74 CORNELL L. REV. 587, 616-17 (1989); Leff, *Economic Analysis of Law: Some Realism about Nominalism*, 60 VA. L. REV. 451, 476 (1974). For a general discussion of the principle of second best, see Markovits, *A Basic Structure for Microeconomic Policy Analysis in Our Worse-Than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the Study of Law and Economics*, 1975 WIS. L. REV. 950.

171 See Gross, *supra* note 164, at 934-41 for a similar proposal to allow an amortization deduction over the repayment period for student loan interest costs. Even assuming that amortization is a more accurate method of measuring net income, increased administrative costs would likely outweigh any resultant gain in accuracy an amortization system would bring about.

172 *See generally* H. ARRON AND H. GALPER, ASSESSING TAX REFORM 20-29 (1985); P. SAMUELSON, ECONOMICS 154-66 (11th ed. 1980); Bankman & Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CALIF. L. REV. 1905 (1987); Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309

term ability to pay is itself vague and in need of specificity. One way to measure ability to pay is by the amount of a person's income.[173] Tax theorists, in turn, frequently define income as a person's personal consumption plus wealth accumulation or saving during a given time period.[174]

The income tax attempts to measure a person's net income as a measure of that person's ability to pay. Obviously, business and other income related deductions contribute to the measurement of net income. In addition, personal deductions are a part of the income tax. One rationale for the presence of personal deductions in the income tax is that personal deductions are refinements of the concept of personal consumption in the Haig-Simons definition of income.[175] The goal is to tax "personal consumption and accumulation of real goods and services."[176] Higher education expenses do not represent pure personal consumption because of their investment aspect.[177] In the latter aspect, education expenses are in the nature of capital expenditures to acquire an income producing asset.

If it is necessary for students to borrow in order to finance their education, and if higher education contains a substantial investment component, it is obvious that interest paid on student loans reduces the income that student borrowers have available for consumption and saving and, hence, reduces their ability to pay income taxes. Therefore, a deduction for student loan interest conforms to the ability-to-pay rationale of the income tax.

(1972). The classic article on the concept of ability to pay applied to a progressive income tax remains Blum & Kalven, *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952).

173 Another measure might be a person's net worth or total wealth accumulation. *See* Andrews, *supra* note 172, at 327.

174 *Id.* at 326-27. This is a version of the familiar Haig-Simons definition of income as,

> the algebraic sum of 1) the market value of rights exercised in consumption and 2) the change in the value of the store of property rights between the beginning and end of the term in question.

See R. Haig, *The Concept of Income — Economic and Legal Aspects*, (*reprinted* in THE FEDERAL INCOME TAX 7 (R. Haig ed. 1921)) ("money value of the net accretion to one's economic power"); H. SIMONS, PERSONAL INCOME TAXATION 50 (1938) (consumption plus net change in wealth); Andrews, *supra* note 172, at 320-25. *See generally*, A. ATKINSON, THE ECONOMICS OF INEQUALITY 35-60 (1983).

175 *See* Andrews, *supra* note 172, at 312-14.

176 *Id.* at 313.

177 *See supra* text accompanying notes 165-71.

C. *Inequity with Qualified Residence Loans*

The only exception to disallowance of personal consumption interest is that certain indebtedness secured by a taxpayer's principal residence and one other secondary residence is still deductible.[178] Basically, a taxpayer can deduct (1) interest on up to $1,000,000 of indebtedness secured by and used to acquire, construct, or substantially improve the residences (acquisition indebtedness), plus (2) interest on up to $100,000 additional indebtedness secured by the residences (home equity indebtedness).[179] Home equity indebtedness is deductible regardless of the use to which the proceeds of the indebtedness are put.[180] Thus, the interest is deductible if a parent with sufficient equity in a residence takes out a home equity loan and uses the loan proceeds to pay for a child's educational expenses.[181] But the interest on a student loan that does not qualify as a home equity loan is not deductible.[182]

The deduction applies not only to a taxpayer's principal residence but also to a secondary residence such as a vacation home.[183] In fact, under temporary Treasury regulations, the deduction can extend to a mobile home or boat that is used as a residence by the taxpayer.[184] The regulations require only that the mobile home or boat contain sleeping space and toilet and cooking facilities.[185] Obviously, this gives the taxpayer fairly wide berth in designating a secondary residence.

Consequently, interest secured by a secondary residence and interest on a home equity loan are normally deductible in full, regardless of the use to which the loan proceeds are put, while interest on a student loan is no longer deductible at all. This is

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178 *See* I.R.C. § 163(h)(3).

179 *Id.* The amount of home equity indebtedness is further limited to the fair market value of the residence reduced by any acquisition indebtedness. *Id.*

180 *See* I.R.C. § 163(h)(3), (4). Since there is no limitation on the use to which the proceeds of a home equity loan may be put, a taxpayer can use the proceeds to buy a car, go on vacation, or purchase any other consumer item, and the interest remains deductible so long as the maximum loan limits of I.R.C. § 163(h)(3)(C) are not exceeded.

181 *See* I.R.C. § 163(h)(3), (4).

182 *Id.*

183 *See* I.R.C. § 163(h)(4)(A).

184 Temp. Treas. Reg. § 1.163-10T(p)(3)(ii), (iii).

185 *Id.*

probably one the most egregious results of the 1986 Tax Act because it produces two inequities.

First, there is an inequity between persons able to afford a second home and students who have struggled financially to acquire an education. The former can deduct interest on their second home mortgages, while the latter cannot deduct interest on their student loans. The only explanation for such a gross inequity would seem to be politics in its worst form. Vacation homes are an important industry in many states represented by Congressmen on the tax-writing committees. Or even worse, this result might be explained simply by the fact that most Members of Congress have two residences.[186]

There is no good reason why an interest deduction should be allowed for indebtedness incurred in connection with a second home, while at the same time a deduction is denied for student loan indebtedness. Students who take loans are those who most need help in financing their education. The basic rationale for the mortgage interest deduction is that it provides a tax incentive for persons to own their own homes. One tax-incentive-home for a person should be enough. Higher education provides a more beneficial long-range investment in the economy than do second homes.

The second inequity is that parents with sufficient equity in their residences can take out home equity loans to help their children with college costs, and deduct the interest on those loans. In contrast, students whose parents do not have sufficient home equity, or whose parents refuse to help their children with home equity loans, are unable to deduct any interest at all on their educational loans.[187]

There is no reason in principle why interest on educational loans secured by home equity should be deductible, while interest on other educational loans is not deductible. This is not to

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186 The response of a top Treasury official at the 1986 Virginia Tax Conference on what is the rationale for allowing deductions for second residences while denying a deduction for student loans was that it was simply "politics." Response of Roger P. Mentz, Assistant Secy. of Treas. for Tax Policy 1986 Virginia Tax Conference, Charlottesville, Va. (June 5, 1986) (question from audience). On another occasion, a senior Congressional staffer remarked to one of the authors that this result came about because most members of Congress own two residences.

187 *See* Gross, *supra* note 164, at 924-27.

say that there are not sound practical reasons for Congress to allow a deduction for interest on home equity loans, only that there is no reason in principle why educational loans secured by home equity should be tax favored, while other educational loans are not.

D. *Retroactive Disallowance*

Another problem with the 1986 change is that former students who incurred large amounts of debt in the expectation that interest on it would be deductible now find that this legitimate expectation will not be fulfilled. This is because disallowance of the deduction applies to interest on debts incurred prior to the 1986 Act, as well as to debt incurred subsequent to the Act. These are students who incurred debt with no way of knowing that the interest would not be deductible.

Income tax acts generally provide for the grandfathering of certain completed transactions or for transition periods when the law changes substantially.[188] The 1986 act provided no grandfathering at all and only minimal transition relief for student loan interest.[189] Other considerations apparently overcame the equity considerations that normally support grandfathering.

One can only speculate as to the reasons for not grandfathering already existing student loans. Perhaps it was the need to provide adequate revenues to keep the Act revenue neutral. Or it might have been the administrative difficulty of tracing interest payments to grandfathered loans. If the reason was to

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188 *E.g.*, Tax Reform Act of 1986, Pub. L. No. 99-514 § 203(a), (b), 100 Stat. 2143 (1986) (longer useful lives under modified accelerated cost recovery rules applicable only to property placed in service after December 31, 1986); *Id.* § 633(d), 100 Stat. 2278 (1986) (transition rule for taxing liquidation distributions of certain corporations); *Id.* § 1122(h)(2)(B), 100 Stat. 2470 (changes in section 72 annuity rules applicable only to individuals whose annuity starting date is after December 31, 1986).

189 The deduction for personal interest was phased out over a four year period so that the following percentage of personal interest paid or incurred was allowable in each year of the phaseout period:

Year	Percent deductible
1987	65%
1988	40%
1989	20%
1990	10%

I.R.C. § 163(d)(6), (h)(5). The phaseout obviously has been worth little since 1988.

ease administration, it failed. The interest tracing regulations issued to implement the 1986 Act changes have turned out to be such an administrative nightmare that the necessity to trace interest on grandfathered loans would make little difference.[190] Whatever the reasons, the failure to grandfather already existing loans simply added another inequity to an already ill-advised aspect of the 1986 Tax Act.

E. *A Typical Case*

Disallowance of the deduction is especially hard on graduate and professional students, many of whom face as much as $50,000-$60,000, or even more,[191] of student loan indebtedness upon graduation. The disallowance of the deduction increases the net cost of these loans to the student borrower. This both discourages students from taking loans to further their education and makes it more difficult for students to service the loans they do take out.

Take the tax situation of a typical recent professional school graduate.[192] At 1990 rates, a single individual entered the 33 percent rate bracket at $47,050 ($78,400 for married persons filing jointly) of taxable income.[193] In addition, that same individual would be subject to FICA tax at 7.65 percent on salary up to the 1990 FICA maximum of $53,000. If the state imposes tax at a marginal rate of seven percent, the taxpayer could have a total marginal tax rate as high as 47.65 percent on portions of his salary.[194] Moreover, this calculation does not even take into account the employer's share of FICA taxes which is arguably also a component of employee compensation.

Suppose this individual had debt of $60,000 payable over a

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190 *See* Treas. Reg 1.163-8T (1987).

191 *Restoration of the Deductibility of Interest on Educational Loans: Hearing before the Subcommittee on Select Revenue Measures Of the House Committee on Ways and Means*, 101st Cong., 2d Sess., (1990) [hereinafter *Interest Deduction Hearing*] (statements of Dr. Michael Crete on behalf of the American Dental Society, and Dr. Mark S. Litwin on behalf of the American Medical Association).

192 Thanks to Robert A. DuChemin, Esq., Jacksonville, Fla. for suggesting this example.

193 1 P-H Federal Taxes 2d ¶14.17 (1990).

194 33% federal marginal rate plus 7% state marginal rate plus 7.65% FICA rate = 47.65%.

ten year repayment period at nine percent interest.[195] The monthly payments on this debt would be about $760 and the total interest payable over the ten year period would be $31,207. At a 33 percent marginal federal tax rate and a seven percent marginal state tax rate, denial of the interest deduction would cost the taxpayer $12,483 ($31,207 x 40 percent) over the ten year repayment period. If the repayment period was the twenty-five year maximum period for consolidated loans,[196] the monthly payment would be $504, and the total interest payable over the twenty-five year repayment period would be $91,054, costing the taxpayer $36,422 ($91,054 x 40 percent) additional taxes over the twenty-five year period. Since interest is front-loaded, most of this tax cost will occur in the early years of the repayment period when the borrower is least able to bear it because of lower early year earnings.

Clearly, denial of the interest deduction adds substantially to the already difficult task of repaying student debt.[197] This cost is imposed on those who were the most needy students, since by definition it is the needy student who must borrow the most.[198]

The nondeductibility of student loan interest affects a substantial number of taxpayers. Half of all federal student aid is in loan form.[199] According to a Joint Committee on Taxation study, almost half the graduates of four-year institutions of higher education borrow money for educational expenses.[200] The percentages are even higher for professional schools such as law schools.[201] Moreover, student loans provide a substantial portion of the income of colleges and universities.[202] The denial of the interest deduction for these loans simply means that the net

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195 This is the basic rate chargeable to borrowers for federally insured loans. *See* 20 U.S.C. §§ 1077a(a)(2)(B), 1078-3(c)(1)(C) (1988).

196 20 U.S.C. § 1078-3(c)(2)(A)(v) (1988).

197 For a discussion of the ability of borrowers to repay law school debt *see* Kramer, *supra*, note 15.

198 *See Interest Deduction Hearing*, *supra* note 191.

199 *Hearings Regarding the Impact, Effectiveness, and Fairness of the Tax Reform Act of 1986 Before the House Ways and Means Committee*, 101st Cong., 2d Sess., (1990) (statement of Joe B. Wyatt, Chancellor, Vanderbilt University).

200 STAFF OF JOINT COMMITTEE ON TAXATION, 100TH CONG., 2D SESS., STAFF DATA AND MATERIALS ON TAX INCENTIVES FOR EDUCATION 29 (Comm. Print 1988) [hereinafter STAFF DATA ON TAX INCENTIVES].

201 *See* 39 J. LEGAL EDUC. *passim* (No. 5 1989).

202 *See* STAFF DATA ON TAX INCENTIVES, *supra* note 200, at 37, Table 2.

cost of attending an institution of higher education, already rising more rapidly than the cost of living generally,[203] will be even higher.

Denial of a deduction for student loan interest is inequitable from a tax policy standpoint and imposes a disincentive for higher education. Hearings have been held[204] and legislation has been introduced to reinstate deductibility of student loan interest.[205] The revenue cost of reinstating the student interest deduction fully is estimated to be $700 million for the next five years.[206] This sum is small in relation to the benefits to higher education it would provide.[207] The deduction for student loan interest should be reinstated.[208]

V. Conclusion

The current income tax law treatment of student loan indebtedness unduly burdens the student debtor by likely requiring inclusion of LRAP student debt cancellation assistance in income, and by denying a deduction for interest paid on student loans. This policy is unfair and shortsighted. Moreover, it is inconsistent with the historic tax law policy of fostering education. Congress should enact legislation allowing an exclusion from gross income for all forms of LRAP assistance and permitting a full deduction for interest on student loans.

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203 *See supra* note 2.

204 *See Interest Deduction Hearing, supra* note 191.

205 S. 628, 101st Cong., 1st Sess., (1989); H.R. 747, 101st Cong., 1st Sess., (1989). H.R. 747 was cosponsored by 309 members of the House of Representatives, among whom, 15 are members of the Ways and Means Committee. *Interest Deduction Hearing, supra* note 191 (statement of Rep. Richard Schulze). The cosponsors, undoubtedly, will introduce similar legislation in the 102nd Congress.

206 *Interest Deduction Hearing, supra* note 191 (statement of Student Loan Interest Deduction Restoration Coalition).

207 Moreover, this appears to be a static estimate that does not take into account increased revenues likely to result from higher incomes earned by a more highly educated populace.

208 If Congress considers the short term revenue cost of reinstating the deduction to be too high, it might make up the revenue shortfall by disallowing the deduction for interest on a debt secured by a second residence. *See supra* text accompanying notes 177-87. Another possibility would be to adopt a provision allowing a deduction for all personal consumption interest up to a certain limit. A suggestion along these lines was made recently by the Joint Committee on Taxation as part of a simplification proposal. *See* STAFF OF HOUSE WAYS AND MEANS COMM., 101ST CONG., 2D SESS., STAFF DATA AND MATERIALS ON WRITTEN PROPOSALS ON TAX SIMPLIFICATION (Comm. Print 1990) (letter from Ronald A. Pearlman to Representative Dan Rostenkowski).