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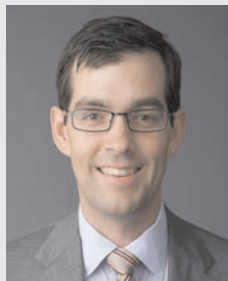
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## Treasury Should Exclude Income From Discharge of Student Loans

by John R. Brooks



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In this article, Brooks argues that Treasury has sufficient statutory authority to exclude from gross income the amount of any discharged federal student loans and that it should do so.

In June the Education Department proposed regulations that would streamline the process for student loan discharge for situations in which an institution deceived or defrauded its students.<sup>1</sup> This follows other recent student loan discharge actions, including discharging the loans of students who attended Corinthian College schools<sup>2</sup> and publicizing the availability of loan discharge for disabled former students.<sup>3</sup> Also, late last year the new Revised Pay As You Earn (REPAYE) student loan repayment program became available, expanding the number of borrowers who can limit their loan

payments to 10 percent of discretionary income<sup>4</sup> and be eligible for loan forgiveness.<sup>5</sup>

The relatively fevered pace of activity around student loans brings to the fore, yet again, the tax issues related to student loan forgiveness. In many cases student loan forgiveness creates what Greg Crespi has called a “tax bomb” — taxable income from the cancellation of student debt (COSD).<sup>6</sup> While the logic for taxing typical cancellation of debt (COD) income is sound, the policy and moral implications of taxing COSD income are more dubious. Consider a debtor who has \$50,000 of student loan debt forgiven — if that COSD income fell in the 25 percent bracket, he would still owe the government a quarter of the debt, \$12,500. On one hand, the government-as-lender says that a borrower should not have to repay the loan; on the other hand, the government-as-tax-collector says, pay me a portion of that loan anyway. Creating taxable income in that situation undermines the policy behind loan forgiveness, while likely not raising much revenue.

Congress and Treasury have created an odd patchwork of tax treatment of COSD income — exclusion in some situations and not others — sometimes by statute and sometimes not. It is past time to clean it up and provide a clear rule that the cancellation of student loan debt through these various government programs does not create taxable income. On July 15 Senate Finance Committee member Robert Menendez, D-N.J., and Sen. Elizabeth Warren, D-Mass., introduced the Student Loan Tax Relief Act, which would do precisely that by amending section 108 to exclude all COSD income.<sup>7</sup>

<sup>1</sup>Student Assistance General Provisions, Federal Perkins Loan Program, Federal Family Education Loan Program, William D. Ford Federal Direct Loan Program, and Teacher Education Assistance for College and Higher Education Grant Program (notice of proposed rulemaking), 81 F.R. 39329 (proposed June 16, 2016) (to be codified at 34 CFR parts 30, 668, 674, 682, 685, and 686), available at <http://federalregister.gov/a/2016-14052>.

<sup>2</sup>Department of Education, “Fact Sheet: Protecting Students From Abusive Career Colleges” (June 8, 2015), available at <http://www.ed.gov/news/press-releases/fact-sheet-protecting-students-abusive-career-colleges>.

<sup>3</sup>Department of Education, “Department of Education Acts to Protect Social Security Benefits for Borrowers With Disabilities” (Apr. 12, 2016), available at <http://www.ed.gov/news/press-releases/us-department-education-acts-protect-social-security-benefits-borrowers-disabilities>; and “Total and Permanent Disability (TPD) Discharge,” available at <http://www.disabilitydischarge.com>.

<sup>4</sup>Discretionary income is adjusted gross income less 150 percent of the relevant poverty line. 34 CFR sections 685.209(a)(2)(i) (PAYE), 685.209(c)(2)(i) (REPAYE), and 685.221(b)(1) (IBR).

<sup>5</sup>See “Revised Pay As You Earn Plan,” 34 CFR section 685.209(c); “Income-Driven Plans,” available at <http://www.studentaid.gov/idr>.

<sup>6</sup>Gregory S. Crespi, “Should We Defuse the ‘Tax Bomb’ Facing Lawyers Who Are Enrolled in Income-Based Student Loan Repayment Plans?” SMU Dedman School of Law Legal Studies Research Paper No. 225 (May 8, 2016), available at <http://ssrn.com/abstract=2615561>.

<sup>7</sup>S. \_\_\_, 114th Cong. (2016). A similar bill was introduced by Rep. Jim McDermott, D-Wash., in the House last year. See Student Loan Tax Debt Relief Act, H.R. 2429, 114th Cong. (2015).

(Footnote continued on next page.)

## COMMENTARY / POLICY PERSPECTIVE

Congress should pass that bill. However, Congress might be unable to act quickly enough for borrowers already seeking discharge, especially disabled borrowers responding to the Education Department's current outreach efforts. I argue here that Treasury likely has the authority to act administratively and that it should do so, especially if congressional dysfunction continues.

### A. Background

The federal government is the dominant student loan lender, directly lending 90 percent of all student loans by value.<sup>8</sup> Before 2010 many student loans were technically made by private lenders through the Federal Family Education Loan (FFEL) program, but with a federal guarantee that meant that the government bore most of the credit risk.<sup>9</sup> But in 2010 Congress repealed the FFEL program,<sup>10</sup> and now the Education Department makes the vast majority of student loans through the Direct Loan and PLUS Loan programs, among others.

Any of these loans can be discharged in some circumstances. The Higher Education Act (HEA) provides for loan discharge in cases of death and disability, school closure, and false certification of loan eligibility.<sup>11</sup> It also provides for "defense to repayment" discharge in cases of school violations of state law, such as fraud.<sup>12</sup>

Moreover, any of those loans, including pre-2010 FFEL loans, qualify for one or more forms of income-driven repayment and possible loan forgiveness. Under these programs, a borrower can pay no more than (typically) 10 percent of her "discretionary income,"<sup>13</sup> and any remaining balances are forgiven after 10, 20, or 25 years of regular payments, depending on the program and other details.<sup>14</sup>

These various programs include Public Service Loan Forgiveness (PSLF), Income-Based Repayment (IBR), Pay As You Earn (PAYE), and REPAYE. There are some important differences between IBR, PAYE, and REPAYE, some of which I covered in an

earlier *Tax Notes* article,<sup>15</sup> but for our purposes here, the key divide is between PSLF on one hand and IBR, PAYE, and REPAYE on the other. (I will refer to these collectively as IBR for simplicity.)

Under PSLF, if a borrower works for the government or a public service organization, he can pay 10 percent of discretionary income and any remaining debt is forgiven after 10 years.<sup>16</sup> For the IBR programs, the borrower also pays 10 percent of discretionary income but forgiveness arrives after 20 or 25 years.<sup>17</sup> No particular career or profession, or even any job at all, is required under IBR, however — it is available to everyone.

The career choices and payment periods are not the only differences between PSLF and IBR. Under Treasury's current interpretation, section 108(f) provides an exclusion of COSD income for student loan forgiveness only under PSLF, not under IBR. In a September 19, 2008, letter to Rep. Sander M. Levin, Eric Solomon, then-assistant secretary for tax policy, confirmed this interpretation.<sup>18</sup> Thus, IBR borrowers potentially face the tax bomb of taxable COSD income just when their outstanding debt is forgiven.

But the tax bomb can also hit other forms of discharge, such as disability and defense to repayment. Like IBR, those discharges do not require work in a specific profession for a specific period, and thus don't fit the language of section 108(f).<sup>19</sup> Oddly, the HEA provides a specific exclusion for COSD income from *closed school* discharge,<sup>20</sup> a fact that Treasury missed in its 2008 letter, but later corrected in Rev. Proc. 2015-57 (discussed below)<sup>21</sup> after receiving a letter from Sens. Warren, Richard J. Durbin, D-Ill., and Sherrod Brown, D-Ohio, and Rep. Maxine Waters, D-Calif.<sup>22</sup> The fact that the exclusion was in the HEA, not the tax code, and that Treasury wasn't aware of it until it was brought to their attention underscores the patchwork nature of the relevant law.

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That bill was referred to the Ways and Means Committee, and no further action has been taken.

<sup>8</sup>See College Board, "Total Federal and Nonfederal Loans Over Time," *Trends in Student Aid 2015*, at 16, Figure 5, available at <https://trends.collegeboard.org/student-aid>.

<sup>9</sup>See "Federal Family Education Loan Program," 34 CFR part 682.

<sup>10</sup>See Health Care and Education Reconciliation Act of 2010, P.L. 111-152, sections 2201-2213, 124 Stat. 1029, 1074-1081 (2010).

<sup>11</sup>20 U.S.C. sections 1087 (FFEL loans) and 1087e(a)(1) (incorporating FFEL terms for direct loans).

<sup>12</sup>See, e.g., 20 U.S.C. section 1087e(h) (direct loans).

<sup>13</sup>See *supra* note 4.

<sup>14</sup>See "Income-Driven Plans," available at <http://www.studentaid.gov/idr>.

<sup>15</sup>See John R. Brooks, "Student Loans as Taxes," *Tax Notes*, Apr. 25, 2016, p. 513.

<sup>16</sup>See "Public Service Loan Forgiveness," 34 CFR section 685.219.

<sup>17</sup>See 34 CFR sections 685.209 and 685.221.

<sup>18</sup>Letter from Eric Solomon, assistant secretary for Tax Policy, to Rep. Levin (Sept. 19, 2008) (on file with author), available at <https://www.edvisors.com/media/files/discharge-forms/20080919-treasury-forgiveness-levin.pdf>.

<sup>19</sup>See *id.*

<sup>20</sup>20 U.S.C. sections 1087ee(a)(5) (PSLF loans), 1087(c)(4) (incorporating section 1087ee(a)(5) for FFEL loans), and 1087e(a)(1) (incorporating FFEL terms for Direct Loans).

<sup>21</sup>2015-51 IRB 863. See *infra* note 24.

<sup>22</sup>Letter from Warren et al. to Jack Lew, Treasury secretary (Aug. 11, 2015).

## B. Recent Moves on Loan Cancellation

In 2015 the Education Department forced the closure of Corinthian Colleges, a chain of poorly performing for-profit colleges that was allegedly abusing the federal student loan program.<sup>23</sup> The Education Department announced that it was allowing discharge of outstanding student loans for these schools under either the closed school or defense to repayment discharge provisions of the HEA, with loose standards for applying those provisions.<sup>24</sup> For example, closed school discharge is generally for students attending the school when it closed or who withdrew within 120 days of the closing, but the Education Department extended that window back nearly a year for the Corinthian borrowers. The Education Department used similarly broad standards for determining if a student had a defense to repayment because of possible fraud by Corinthian. (It appears that the Education Department has not applied these same standards to other discharges, however.)

As noted above, in 2008 Treasury stated as a general matter that closed school and defense to repayment discharges under the HEA still create taxable COD income. However, in the Corinthian case, after prompting from Warren and others,<sup>25</sup> Treasury issued Rev. Proc. 2015-57, which stated that the IRS would *not* assert that any of the Corinthian borrowers affected had taxable income. In the case of closed school discharge, Treasury cited the HEA provisions that state such discharge does not create taxable income, thus reversing the position in the 2008 letter to Levin. In the case of defense to repayment discharge, Treasury instead relied on a combination of the insolvency exclusion in section 108(a)(1)(B) and a general principle that a “legal infirmity” like fraud in the underlying transaction could affect the amount of debt deemed discharged. (The revenue procedure is vague on that point, but presumably Treasury had in mind something like the “contested liability” doctrine at issue in *Zarin v. Commissioner*.<sup>26</sup>)

Rev. Proc. 2015-57 stated that the Corinthian borrowers claiming a defense to repayment were likely victims of fraudulent misrepresentations, insolvent at the time of the discharge, or both but that determining that case by case would require a “fact intensive analysis of the particular borrower’s situation.” It concluded that “such an analysis would

impose a compliance burden on taxpayers, as well as an administrative burden on the IRS, that is excessive in relation to the amount of taxable income that would result. Accordingly, the IRS will not assert that a taxpayer within the scope of this revenue procedure recognizes gross income as a result of the Defense to Repayment discharge process.”

Earlier this year, the Education Department also made a push to publicize the availability of disability discharge, including sending letters to 387,000 borrowers that it believes are eligible, based on disability information from the Social Security Administration.<sup>27</sup> On its website for handling applicants for disability discharge, the Education Department states that “the amount of the discharged debt will be considered income for federal tax purposes and possibly for state tax purposes” and that it will send Forms 1099-C to those whose debts are discharged.<sup>28</sup> Considering that those borrowers were identified as unable to work because of disability, they are even more likely to qualify for the insolvency exclusion in section 108(a)(1)(B) than the Corinthian borrowers, but Treasury has not yet ruled.

Finally, in June the Education Department proposed new regulations to change the process for defense to repayment discharge, among other changes.<sup>29</sup> It would expand the definition of a “misrepresentation” by the school to include statements that would “mislead under the circumstances,” rather than just “deceive,” and “any statement that omits information in a way as to make the statement false, erroneous, or misleading.”<sup>30</sup> The proposed regulations also clarify the process for demonstrating a defense to repayment, which would include contract-based claims for the failure to provide education or other services.<sup>31</sup> The proposed regulations do not address the tax treatment of COSD income, noting that the Education Department does not have that authority.<sup>32</sup>

## C. Congress Should Act

To summarize the patchwork tax treatment of student debt forgiveness: Borrowers will not have taxable COSD income for closed school discharge, but will have taxable COSD income for death and

<sup>23</sup>See *supra* note 2.

<sup>24</sup>See *id.*; Department of Education, “Federal Student Aid, Information About Debt Relief for Corinthian College Students,” available at <http://studentaid.ed.gov/sa/about/announcements/corinthian>.

<sup>25</sup>See Warren et al., *supra* note 22.

<sup>26</sup>*Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990).

<sup>27</sup>See *supra* note 3.

<sup>28</sup>Department of Education, “Total and Permanent Disability (TPD) Discharge,” available at <http://www.disabilitydischarge.com>.

<sup>29</sup>See notice of proposed rulemaking, *supra* note 1.

<sup>30</sup>*Id.* at 39409-39410 (to be codified at 34 CFR section 668.71).

<sup>31</sup>*Id.* at 39417-39418 (to be codified at 34 CFR section 685.222).

<sup>32</sup>*Id.* at 39352.

disability, false certification, and defense to repayment discharge. Borrowers will not have taxable COSD income for student debt forgiveness under PSLF (or Teacher Loan Forgiveness and similar public service oriented programs), but will have taxable COSD income for IBR, PAYE, and REPAYE forgiveness. There is clearly no underlying logic for this varied treatment.

The right policy here is to exclude all COSD income. In a typical case of COD, creating taxable income in the amount of the cancellation makes sense. The canonical case here is *Kirby Lumber*,<sup>33</sup> in which a business bought back its bonds for below face value, creating a net benefit to itself. Taxing that benefit provided by a third party is appropriate. But in the student loan case, extracting a portion of the debt from borrowers who had just had their debt forgiven violates the policies underlying student debt forgiveness in the first place. Unlike the *Kirby Lumber* situation, the lender and the tax collector are the same party, so taxing forgiveness is tantamount to allowing only *partial* rather than *full* forgiveness — the government collects a portion of the debt regardless. To tack such balloon payments onto the discharge programs undermines their purposes.

The best way to fix that anomaly is for Congress to pass the Student Loan Tax Relief Act or similar legislation to amend section 108. And Congress should do this sooner rather than later. Current discharges are focused on disabled borrowers or borrowers who are likely insolvent, whereas IBR discharges may not come until around 2028, when the first borrowers to use IBR and PAYE have their loans forgiven.<sup>34</sup> Amending the code now will have a relatively low revenue score because the big forgivenesses under IBR will be outside the budget window, and the current discharges for disability and defense to repayment are unlikely to lose much revenue. Passing a law now that has a revenue effect outside the budget window is a somewhat cynical strategy, but hardly rare. Congress still has a few more years to have this free lunch, but the clock is ticking.

#### D. If Congress Doesn't Act, Treasury Should

Assuming the anti-Trump wave doesn't leave the Democrats controlling both houses of Congress, Treasury may have to consider acting unilaterally to exclude COSD income created by IBR, PAYE, and

REPAYE. While its legislative authority is weaker than Treasury might prefer, there is nonetheless sufficient authority for it to act.

**1. Scholarship exclusion.** “Qualified scholarships” are excluded from income by section 117, and proposed regulations under section 117 state that scholarships include “a reduction in the *amount owed* by the recipient to an educational organization for tuition, room and board, or any other fee” [emphasis added].<sup>35</sup> Therefore, the scholarship concept clearly captures loan forgiveness. It would be only a small additional step for Treasury to rule or to issue additional regulations that discharges of federal student loans would also be “scholarships.” I explore some of the wrinkles of this below, but some history first may be helpful.

Congress first added section 108(f) in 1984 to deal with the fact that the section 117 exclusion for scholarships did not apply to early versions of PSLF.<sup>36</sup> Early versions of PSLF were often state-based programs that forgave student loans if graduates worked in specific fields or geographic areas. For example, one state gave medical students a \$10,000 advance to pay for medical school tuition, but it would forgive repayment if the graduates worked in a rural area of the state. In Rev. Rul. 73-256,<sup>37</sup> the IRS ruled that section 117 did not apply to this program because there was a quid pro quo, namely that the graduates work in a particular geographic region. It cited the Supreme Court case of *Bingler v. Johnson*,<sup>38</sup> which held that section 117 applied to “no-strings educational grants, with no requirement of any substantial quid pro quo from the recipients.”<sup>39</sup> Requiring specific actions is akin to paying an employee, not making a scholarship grant, the IRS ruled.

Congress remedied this problem with specific provisions of the Tax Reform Act of 1976<sup>40</sup> and the Revenue Act of 1978,<sup>41</sup> but the exclusions applied only to loans made before January 1, 1983.<sup>42</sup> Congress then added section 108(f) in the Deficit Reduction Act of 1984 to make the exclusion permanent.<sup>43</sup> But because section 108(f) was written to apply to PSLF-type programs that require specific types of

<sup>35</sup>Prop. reg. section 1.117-6(c)(3)(i).

<sup>36</sup>See Joint Committee on Taxation, “General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,” JCS-41-84, at 1199-1201 (Dec. 1984).

<sup>37</sup>1973-1 C.B. 56.

<sup>38</sup>*Bingler v. Johnson*, 394 U.S. 741 (1969).

<sup>39</sup>*Id.* at 750.

<sup>40</sup>P.L. 94-455, section 2117, 90 Stat. 1520, 1911-1912.

<sup>41</sup>P.L. 95-600, section 162, 92 Stat. 2763, 2810.

<sup>42</sup>*Id.* The 1976 act applied only to loans made before 1979, but the 1978 act extended that to loans made before 1983.

<sup>43</sup>P.L. 98-369, section 1076(a), 98 Stat. 494, 1053.

<sup>33</sup>*United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

<sup>34</sup>The bulk of the discharges won't begin until around 2033 because loans disbursed between 2007 and 2011 only qualify for PAYE if the borrower also receives a loan disbursement after October 1, 2011. See 34 CFR section 685.209(a)(iii). In contrast, all loans made after October 1, 2011, qualify.

employment, it doesn't apply on its face to IBR or other kinds of discharge, which have no such requirement.

But going back to the original 1973 revenue ruling, the reason section 117 couldn't apply in the first place is because of the quid pro quo for PSLF-type forgiveness. But there is no such quid pro quo for IBR, disability, or other forms of forgiveness; qualification is based solely on income or other factors, with no particular career, employer, or geography required. Thus, the section 117 exclusion should be available.

Forgiving a student loan may not fit neatly into a conventional idea of scholarship, but the underlying economics are pretty close to a need-based scholarship. A student loan is, after all, just a deferred payment of tuition and related expenses, so forgiving some of that loan based on need is similar to lowering tuition based on need — but with the determination of need based on post-graduate characteristics, rather than pre-matriculation characteristics. (I argue in an article in the *Georgetown Law Journal* that this is actually a more equitable way to determine need.<sup>44</sup>)

The proposed regulation cited above is consistent with this view that loan forgiveness can be a “scholarship,” but unfortunately the regulation probably does not apply by its terms to federal student loans. It refers to loans by an “educational organization,” as defined in section 170(b)(1)(A)(ii),<sup>45</sup> and thus does not include the Education Department or related loan servicers. But the principle is the same, and a new regulation could expand that definition to include amounts owned to the Education Department.

A bigger challenge under section 117 is that the exclusion is only for “qualified scholarships,” not all scholarships.<sup>46</sup> Qualified scholarships are those that go toward “qualified tuition and related expenses,” and expenses such as room and board, travel, and supplies are not related expenses unless they are “required for either enrollment or attendance of a student at an educational organization”<sup>47</sup> or in a “course of instruction at such an education organization” [emphasis added]. That could exclude most room, board, and other living expenses. That may not be a big problem for undergraduate direct loans, if the schools and the Education Department are smart about how they allocate the

loans and any grants,<sup>48</sup> but it could be a hurdle for graduate students borrowing the full cost of attendance. While my preference is for a full exclusion, a partial exclusion may satisfy some IBR critics who view forgiveness for graduates of professional schools as too generous.<sup>49</sup> That said, the IRS could use its discretion to say it's not worth the effort of figuring out how much of each individual loan went to tuition and related expenses, much as it did in applying the insolvency and fraud exclusions to all Corinthian borrowers in Rev. Proc. 2015-57. Further, it could issue new regulations under section 117 expanding the definition of “related expenses.”

**2. Insolvency exclusion.** Even if section 108(f) does not apply, section 108(a)(1)(B) could — COD income is excluded if the taxpayer is insolvent when the debt is canceled. That was one reason that Treasury excluded the COSD income in the Corinthian case.

Insolvency is defined as the excess of liabilities over the fair market value of assets.<sup>50</sup> The determination is made immediately before the cancellation, and any exclusion is not greater than the amount of the insolvency at that time.<sup>51</sup> The upshot is that, to have a full exclusion for the COSD income, the borrower must be insolvent by at least the amount of the forgiven debt. If a borrower has \$50,000 in student debt forgiven, and immediately before the forgiveness the excess of his liabilities, including that debt, over assets is only \$1,000, then there would still be taxable COSD income of \$49,000.

Just as in the Corinthian case, those seeking discharge for total and permanent disability are likely to be sufficiently insolvent, as are those seeking closed school or defense to repayment discharge. After all, their requests for discharge are driven largely by financial distress. For IBR borrowers, however, that degree of insolvency may be unlikely given that the forgiveness is at least 20 years after leaving school, especially if the borrowers have purchased homes or set up retirement accounts. Indeed, lowering the loan payments to 10 percent of discretionary income is partly to allow borrowers to have more room in their budgets for those types of expenses and savings.

<sup>48</sup>Direct Loans to undergraduates are limited to between \$5,500 and \$7,500 per year for dependent students, with an overall cap of \$31,000.

<sup>49</sup>See, e.g., Jason Delisle and Alex Holt, “Safety Net or Windfall?: Examining Changes to Income-Based Repayment for Federal Student Loans,” New American Foundation, at 14 (Oct. 2012).

<sup>50</sup>Section 108(d)(3).

<sup>51</sup>Section 108(a)(3).

<sup>44</sup>See Brooks, “Income-Driven Repayment and the Public Financing of Higher Education,” 104 *Geo. L.J.* 229, 268-272 (2016).

<sup>45</sup>Prop. reg. section 1.117-6(c)(5).

<sup>46</sup>Section 117(a).

<sup>47</sup>Section 117(b)(1); see prop. reg. section 1.117-6(c)(2).

Treasury could remedy this situation with regulations defining the meaning of “insolvency” for purposes of student debt. For example, Treasury could exclude a personal residence, tax-preferred retirement accounts, and assets exempt from creditors under state law in determining the amount of insolvency. While the statutory language seems clear about the meaning of “liabilities,” cases before the enactment of section 108(a)(1)(B) excluded assets exempt under state law,<sup>52</sup> and the legislative history under section 108(a)(1)(B) is silent on whether the provision was intended to overrule those prior cases. Further, there is some indication that Congress’s intent with section 108(a)(1)(A) and (B) was to be consistent with bankruptcy policy regarding a “fresh start.”<sup>53</sup> The bankruptcy code’s definition of insolvency excludes assets like tax-preferred retirement accounts, property held as a joint tenancy or tenancy by the entirety, and assets exempt under applicable state law.<sup>54</sup> The same policy should apply here.

Exclusions under section 108(a)(1)(B) are applied to reduce the taxpayers’ tax attributes, though most borrowers seeking student loan forgiveness will not possess many of these attributes. They may be required to reduce their bases in any property under section 108(b), but that reduction is limited by section 1017(b)(2). At any rate, some partial recapture in the future from borrowers with appreciated assets may be appropriate.

**3. Contingent liability.** For IBR in particular, Treasury could simply say that the Education Department was never truly owed the nominal amount of the debt in the first place. Because any student loan borrower can now use IBR, and this is reflected in the terms of the underlying note, the borrower never had a legal duty to pay more than 10 percent of her discretionary income for 20 to 25 years. The loan is in effect a contingent liability, and the forgiveness simply reflects that the contingent conditions did not occur. The borrower has paid no more, and the lender has received no more, than was required.<sup>55</sup> The Education Department has es-

<sup>52</sup>See, e.g., *Cole v. Commissioner*, 42 B.T.A. 1110 (1940); *Marcus Estate v. Commissioner*, T.C. Memo. 1975-9. But see *Carlson v. Commissioner*, 116 T.C. 87, 101 (2001) (holding that the section 108(d)(3) definition precludes the application of *Cole* and other earlier cases).

<sup>53</sup>S. Rep. No. 96-1035, at 10 (1980) (“The rules of the bill concerning income tax treatment of debt discharge in bankruptcy are intended to accommodate bankruptcy policy and tax policy. . . . A debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability” [emphasis added]).

<sup>54</sup>11 U.S.C. sections 101(32)(A) and 522.

<sup>55</sup>See, e.g., *Corporacion de Ventas Etc. v. Commissioner*, 130 F.2d 141, 143-144 (2d Cir. 1942) (no COD income for cancellation of  
(Footnote continued in next column.)

entially labeled as “forgiveness” what is simply the end of the payment period for this contingent obligation.

To see this another way, consider the REPAYE rules, which require a borrower to pay 10 percent of her discretionary income, no matter what her income is, until a notional principal and interest amount are paid off or after 20 years, whichever is sooner. If all student loans started as REPAYE loans by default and were written in that way, would there be COD income as a formal matter? Or would we just say that after 20 years a borrower had met his obligations under the debt instrument?

If this seems like an odd way to think about a loan, that’s true. Student loans in income-driven repayment are very different from traditional loans — they’re more akin to income share agreements or even tax obligations. Trying to impose a *Kirby Lumber*-style idea of COD income is like saying there’s COD income for a corporation that paid less in preferred dividends because it was not as profitable as expected or for an individual who paid less in taxes because his income was lower than expected. As I’ve written here<sup>56</sup> and elsewhere,<sup>57</sup> we need to find a new way to think about student loans in income-driven repayment — treating them as typical loans no longer works.

The contingent debt argument could be applied to disability, closed school, and defense to repayment discharges as well. For closed school and defense to repayment, the argument would be that the debt was contingent on the school performing at some minimum standard. For disability discharge, the debt was contingent on a person being sufficiently able to generate enough income to service the loan. The letter from Warren et al. expands on those points in detail.<sup>58</sup>

**4. Significant debt modification.** Finally, as an alternative to the contingent liability theory, for IBR there is an argument that any COD income should be calculated when the borrower goes into IBR, rather than when the remaining debt is forgiven.<sup>59</sup> Thus, even if the original debt was equal to the face amount, the switch from standard repayment to income-driven repayment is a “significant debt modification,” and therefore a taxable exchange of one debt instrument for another.<sup>60</sup> Under section

payments that were contingent on future profits). For more on this theory, see Warren et al., *supra* note 22.

<sup>56</sup>Brooks, *supra* note 15.

<sup>57</sup>Brooks, *supra* note 44, at 258-263.

<sup>58</sup>See Warren et al., *supra* note 22.

<sup>59</sup>This argument does not apply as easily to disability, closed school, and defense to repayment discharges.

<sup>60</sup>See reg. section 1.1001-3(b). It’s not certain that entering IBR would be significant modification, however. The change in the  
(Footnote continued on next page.)

108(e)(10), any COD income should be calculated at the time of that exchange based on the difference in value between the two debt instruments. But both the new and the old instruments would be hard to value at that time — the new IBR instrument because it is contingent on future income and the old standard repayment instrument because (a) the borrower had enough financial hardship to need IBR, and (b) IBR was always available. With that degree of uncertainty it would be impossible to determine how much COD income there is, if any.<sup>61</sup> Further, because most borrowers will enter IBR in a period of financial hardship, the section 108(a)(1)(B) insolvency exception is much more likely to apply at that time than 20 years in the future. Thus, the IRS could apply the same reasoning as in Rev. Proc. 2015-57 to ignore the transaction.

### E. Conclusion

In a recent story on the struggles of some law students and law schools, *The New York Times* described a student with substantial amounts of student debt, but relatively low potential income.<sup>62</sup> In past years, that alone would have described a

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terms is clearly economically significant, but under the section 1001 regulations, some alterations occurring by operation of the terms of the debt instrument don't count as "modifications" (the IBR options are included in the Education Department's Master Promissory Note). See reg. section 1.1001-3(c)(1)(ii). For entering IBR to count as a modification, it would have to be considered exercising an option that's not unilateral, that is, one that was subject to the other party's approval. See reg. section 1.1001-3(c)(2)(iii) and -3(c)(3). As a formal matter, the Education Department, the lender, must approve the borrower's entry into IBR, and it has the sole discretion to make the income determination that leads to the lower payments. It's not clear whether this is the sort of approval intended by the regulation — the examples and existing rulings are not on point. But as with the other avenues to excluding COSD income, if the hurdles are regulatory, they are within Treasury's power to amend them — the statute itself does not present a problem.

<sup>61</sup>See *Ventas*, 130 F.2d at 143 ("Whether the taxpayer made a profit or loss in buying up debentures at 45 percent discount from face value is as yet pure speculation.")

<sup>62</sup>See Noam Scheiber, "An Expensive Law Degree, and No Place to Use It," *The New York Times*, June 19, 2016, at BU1. The article has been criticized, especially by Michael Simkovic. See Simkovic, "Why the New York Times Should Correct Remaining Factual Errors in Its Law School Coverage," Brian Leiter's Law School Reports (June 24, 2016).

problem of financial hardship. But since IBR is now available, the description of the problem changed. It was not the debt itself, which the article acknowledged could eventually be forgiven. Rather, the problem was the large potential tax bill due upon forgiveness.<sup>63</sup>

Although there is still a natural reaction when one sees large nominal debt amounts, especially for graduate school, the problem in an IBR era is fundamentally different than in earlier eras. The problem, as presented in the *New York Times* article, is no longer "How can someone pay back \$200,000 over 10 years?" It is "How can someone afford the lump sum \$70,000 tax bill that comes with loan forgiveness?" In lifetime terms, one would rather pay \$70,000 than \$200,000, but it is still a substantial hardship, especially because it falls all in one year. It could turn loan forgiveness from a long-term blessing into a short-term curse.

The problem is easy to fix, however. Congress should pass the Student Loan Tax Relief Act — a small bill, with little to no revenue cost within the budget window. And likely no significant overall revenue cost either, if one believes, as I do, that it's unlikely for the government ever to collect on these tax bills.

But Congress is Congress, and if it continues to fail to act, Treasury should step in to provide an exclusion. Treasury has the authority to act under section 117, section 108, and long-standing regulatory and common law on contingent liabilities and debt modifications. A combination of some minor regulatory changes and IRS discretion should be sufficient to exclude most or all income from COSD, especially for those most in need of relief. ■

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<sup>63</sup>*Id.* ("The government will eventually forgive the loan — in 20 years — if he's unable to repay it, as is likely on his small-town lawyer's salary. But the Internal Revenue Service will probably treat the forgiven amount as income, leaving him what could easily be a \$70,000 tax bill on the eve of retirement, and possibly much higher.")