FORGIVEN BUT NOT FORGOTTEN: TAXATION OF FORGIVEN STUDENT LOANS UNDER THE INCOME-BASED-REPAYMENT PLAN

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I. INTRODUCTION

Most agree that there are few things as valuable in life as a quality college education.[1] A strong education expands minds and opens doors to a wide variety of career options not available to those lacking a degree.[2] However, a quality college education is also extremely expensive and frequently results in large quantities of student loan debt that may stay with the student throughout much of his or her life.[3]

In order to encourage higher education, the Federal Government has created several loan programs to help students pay the high cost of college and graduate school.[4] To further assist students participating in these student loan programs, the Federal Government established loan forgiveness programs under which there is no tax liability incurred as a

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[1] *See* Uri Dothan & Joseph Williams, *Education as an Option*, 54 J. BUS. 117, 117 (1981); *see also* Catherine E. Ross & Marieke Van Willigen, *Education and the Subjective Quality of Life*, 38 J. HEALTH & SOC. BEHAV. 275 (1997) (discussing a social study on how education affects a person's well-being both in regards to relationships and work environment).

[2] *See* T. Brooke Benjamin, *Public Perceptions of Higher Education*, 19 OXFORD REV. EDUC. 47, 49 (1993); Ross, *supra* note 1, at 276–77.

[3] *See* Jennifer Ma & Sandy Baum, *Trends in College Pricing*, TRENDS IN HIGHER EDUC. SERIES (College Board, Wash., D.C.), 2008, at 2, *available at* http://professionals.collegeboard.com/profdownload/trends-in-college-pricing-2008.pdf; Kathleen Payea & Sandy Baum, *Trends in Student Aid*, TRENDS IN HIGHER EDUC. (College Board, Wash., D.C.), 2008, at 2, *available at* http://professionals.collegeboard.com/profdownload/trends-in-student-aid-2008.pdf.

[4] *See* 34 C.F.R. § 682.100 (2009).

consequence of the cancellation of indebtedness income resulting from the forgiveness.[5]

There is an anomaly, however, in Congress's approach to student loans and cancellation of indebtedness income. In 2009, a new income-based-repayment plan became available to persons with federally backed student loan debt.[6] Unfortunately, Congress failed to implement any new provisions in the Internal Revenue Code to prevent loans forgiven under the new income-based-repayment plan from being taxed as cancellation of indebtedness income when the taxpayer completes the plan and is absolved of any remaining debt.[7] This omission appears to be at odds with the goal of making higher education affordable for students who might otherwise be unable to afford such an education.

This comment provides a comprehensive review of the law of cancellation of indebtedness income and also describes several Federal Student Loan programs and how such programs address the cancellation of indebtedness issue. Using this background, the comment discusses the apparent inconsistency in the law that exempts cancellation of indebtedness income under some student loan programs but not others. Finally, the comment argues for a change in the law to exempt cancellation of indebtedness income from loans forgiven under the income-based-repayment plan. The author hopes that this comment will provide the reader with a greater understanding of the tax consequences of forgiven debt as well as an appreciation of the need to implement new legislation protecting taxpayers who participate in the income-based-repayment plan from potentially massive tax liability in a single year.

II. BACKGROUND

A. The Price of Education

The cost of college education is high and has risen continuously for decades.[8] The average price for in-state tuition, room, and board at public universities in the United States for the school year beginning in 2008 was \$14,333.[9] The average cost of tuition, room, and board for out-of-state

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[5] *See, e.g.*, 20 U.S.C. § 1078 (2006).

[6] *Id.* § 1098(d)(8) (Supp. 2009).

[7] I.R.C. § 108(f)(1) (2009).

[8] See Ma & Baum, *supra* note 3, for a comprehensive report on college pricing in the United States.

[9] *Id.* at 2.

students was much higher at $25,200.[10] In the same year, students at private universities paid yet a higher average of $34,123.[11] Perhaps even more alarming than the above average prices is the fact that these already high costs have outpaced inflation for many years and are currently increasing at annual rates of 5.7%, 5.2%, and 5.6% for in-state, out-of-state, and private schools respectively.[12]

Clearly, it is not reasonable to expect that most students and their families will be able to pay these costs up front without some kind of financial assistance or loans. In spite of the availability of a wide range of grants and scholarships, many students are forced to turn to student loans for a large portion of their educational funding.[13] In the school year ending in 2007, 60% of students graduating with a bachelor's degree had some amount of student loan debt.[14] Of those students who had at least some debt upon graduation, the average student graduated with $22,700 in student loan debt.[15]

Graduates of law schools and other post-graduate programs may incur an even greater burden. According to the American Bar Association, the average student of a public law school in 2008 graduated having borrowed $59,324.[16] Law students graduating from private law schools borrowed an average of $91,506.[17] These numbers represent increases of $12,825 and $21,359 for state and private law schools respectively since 2002.[18]

Much of this borrowing is directly or indirectly financed or guaranteed by the Federal Government.[19] For the school year ending in 2008, the total amount of federal student lending from all federal programs combined amounted to the staggering sum of $66.8 billion.[20] Compensating for inflation, this amount represented a 70% increase over just the past ten

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[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] See Payea & Baum, *supra* note 3, for a comprehensive report on the state of student aid in the United States.

[14] *Id.* at 3.

[15] *Id.* at 2.

[16] *Average Amount Borrowed for Law School*, AMERICAN BAR ASSOCIATION, http://www.abanet.org/legaled/statistics/charts/stats%20-%2020.pdf (last visited Nov. 30, 2010).

[17] *Id.*

[18] *Id.*

[19] Payea & Baum, *supra* note 3, at 2.

[20] *Id.* at 6.

years.[21] Obviously, student loan debt is a serious financial issue for students and their families and will continue to be an issue many years after graduation.

B. Federally Backed Student Loans

1. Types of Federal Student Loans

In order to avoid cancellation of indebtedness income from a forgiven student loan, the taxpayer must satisfy two key requirements. First, the terms of the forgiveness must meet the requirements of I.R.C. § 108(f).[22] Second, the forgiven loan must have been a federally backed student loan.[23] There are several different types of federally backed student loans available to students including Perkins Loans,[24] Stafford Loans, and PLUS Loans.[25] These programs are described briefly below.

Perkins Loans are intended for "financially needy" students who need help financing their higher education.[26] Eligible undergraduate students may borrow up to $4,000 per year but may not exceed a total of $20,000 over the course of their program of study.[27] Graduate students may borrow up to $6,000 per year but may not exceed a total of $40,000.[28] Students enrolled in any other type of program, such as those enrolled in trade schools or nontraditional programs, may not exceed a total of $8,000.[29]

The Stafford Loan program is a general federally backed student loan program intended for all undergraduate, graduate, and professional students.[30] Undergraduate students may not exceed an aggregate of $46,000 in federal Stafford Loans over the course of their program.[31] Graduate students are permitted to borrow up to an aggregate of $138,500.[32]

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[21] *Id.*
[22] I.R.C. § 108(f) (2009).
[23] *Id.*
[24] 34 C.F.R. § 674.1 (2006).
[25] *Id.* § 682.100 (2009).
[26] *Id.* § 674.1(a) (2006).
[27] *Id.* § 674.12.
[28] *Id.*
[29] *Id.*
[30] *Id.* § 682.100(a)(1) (2009).
[31] *Id.* § 682.204(e).
[32] *Id.*

The intent of the PLUS Loan program is to promote private lending to the parents of undergraduate students.[33] A 2006 amendment to this program permits graduate students to obtain PLUS Loans independent of their parents.[34] There is no mandatory cap on the amount a student can borrow under the PLUS program other than the requirement that "[t]he total amount of all PLUS program loans that a parent or student may borrow for any academic year of study may not exceed the student's cost of education minus other estimated financial assistance for that student."[35] In other words, a student may only borrow as much as is needed for his or her legitimate educational expenses. As a clear example of the complexity of the system of federally backed student loan programs, I.R.C. § 108(f), which is discussed more fully below, applies to PLUS Loans made directly to graduate students but not to PLUS Loans made to parents of college students.[36]

Federally backed student loans are further subdivided into loans made directly by the Federal Government and loans made by other entities but guaranteed by the Federal Government under the Federal Family Education Loan (FFEL) program.[37] Loans made under the FFEL program are generally made by banks, nonprofits, and other private lenders.[38] These lenders insure themselves against the possibility of the borrower's default by enrolling in a variety or state and nonprofit loan insurance programs.[39] The Federal Government guarantees these loan insurance programs.[40] Thus, FFEL Loans, like direct loans, are ultimately backed by the financial resources of the Federal Government and all American taxpayers.[41]

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[33] *Id.* § 682.100(a)(3).

[34] *Id.* § 682.201(b).

[35] *Id.* § 682.204(h).

[36] I.R.C. § 108(f) (2006).

[37] Letter from Eric Solomon, Assistant Sec'y for Tax Pol'y, to Sander Levin, U.S. Representative 1 (Sept. 19, 2008), http://www.final.org/loans/ 20080919treasurylevinforgiveness.pdf.

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *See id.*

On March 30, 2010, President Barack Obama signed the Health Care and Education Reconciliation Act into law.[42] This legislation made significant changes to the current system of student lending. Most significantly, all future federal student loans will be direct loans.[43] However, FFEL Loans issued prior to the enactment will likely continue to exist for many years to come.

2. Bankruptcy

Understandably, the Federal Government has taken certain precautions to avoid having to repay guaranteed student loans unless absolutely necessary. Under section 523 of the Bankruptcy Code, federally backed student loans cannot be discharged in bankruptcy except in some rare cases of extreme financial hardship.[44] The Code does a thorough job of excepting all types of federally backed loans from discharge by excepting any loans made:

> for an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution, or for an obligation to repay funds received as an educational benefit, scholarship or stipend, unless excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependants.[45]

It is important to note that this rule does not apply to student loans from private financial institutions made outside the federal student lending system.[46] Because the Federal Government has no ultimate responsibility for these loans, banks are permitted to make these loans at their own peril based on the student or his or her parents' credit risk.[47]

In addition to the Federal Government's concern for having to pay on guaranteed loans, there are additional reasons for disallowing the discharge of federally backed student loans in bankruptcy. First, there is the practical

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[42] Tracey Samuelson, *Student Loan Reform: What Will It Mean for Students?*, THE CHRISTIAN SCIENCE MONITOR (Mar. 30, 2010), http://www.csmonitor.com/Money/2010/0330/Student-loan-reform-What-will-it-mean-for-students.

[43] *Id.*

[44] 11 U.S.C. § 523(a)(8) (2006).

[45] *Id.*

[46] 2 DANIEL R. COWANS, BANKRUPTCY LAW AND PRACTICE § 6.20 (7th ed. 1998).

[47] *See id.*

concern that if student loans were dischargeable in bankruptcy, the amount of credit available to future students would be diminished.[48] Second, it would be profoundly unfair for a graduate about to enter a highly lucrative career to file bankruptcy to discharge his or her educational debts just prior to starting a high wage job; as such, an act would unfairly shift the cost of his or her education onto the American taxpayer.[49]

Although an exception for cases of true hardship exists, the difficult burden of producing sufficient evidence of the alleged undue hardship is on the debtor.[50] Although there is no prescribed test in the Bankruptcy Code for proving undue hardship, case law has established that a debtor must show:

> (1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for herself and her dependents if forced to repay the loans; (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and (3) that the debtor has made a good faith effort repay the loans.[51]

These requirements, in conjunction with the debtor carrying the burden of proof, make it unlikely that anyone without a true case of undue hardship will be able to rid themselves of federal student loan debt through bankruptcy.[52]

3. *Federal Programs Forgiving Student Loans*

Although federal student loans cannot be discharged in bankruptcy, Congress enacted several programs to allow for the forgiveness of federal student debt for graduates who meet certain desirable criteria, such as teaching or serving in an area of national need.[53] For example, under 20

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[48] *Id.*

[49] *Id.*

[50] *See, e.g.*, *In re* Pelkowski, 990 F.2d 737, 742 (3d Cir. 1993).

[51] Brunner v. N.Y. State Higher Educ. Servs. Corp., 831 F.2d 395, 396 (2d Cir. 1987).

[52] *See, e.g.*, *id.* In one extreme example of how unwilling the courts have been to allow for the discharge of student loans in bankruptcy without true hardship, a young medical school dropout with monthly income of $693.55 and personal monthly expenses of $683.36 who had devoted his life to helping autistic children in a nursing home was denied a discharge of his approximately $90,000.00 student loan. *See In Re* Malloy, 155 B.R. 940 (E.D. Va. 1993).

[53] 20 U.S.C. § 1078 (2006).

U.S.C. § 1078, a graduate who serves as a teacher for five consecutive years at a qualified educational institution and does not default on any loans during that time may have up to $5,000 of federal student loan debt forgiven.[54] In the case of graduates serving as math or science teachers, this amount increases dramatically with up to $17,500 of qualified student loan debt eligible for forgiveness.[55] Under normal circumstances, these forgiven amounts would be included in the teacher's income for purposes of taxation as cancellation of indebtedness income.[56] However, Congress specifically exempted the forgiveness of these loans from taxable income under the Internal Revenue Code in an attempt to prevent financial hardship to participants in these programs and to encourage participation in the programs.[57] The instances in which forgiven student loans will not be included in income are specified in I.R.C. § 108(f), which states in its pertinent part:

> **(1) In general**
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> 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 cancellation (in whole or in part) of any student loan if such cancellation was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be forgiven if the individual worked for a certain period of time in certain professions for any of a broad class of employers.
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> **(2) Student loan**
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> For purposes of this subsection, the term "student loan" means any loan to an individual to assist the individual in attending an educational organization described in section 170(b)(1)(A)(ii) made by—
>
> (A) the United States, or an instrumentality or agency thereof,

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[54] *Id.* §§ 1078–10.
[55] *Id.*
[56] I.R.C. § 61 (2006).
[57] *Id.* § 108.

> (B) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof,
>
> (C) a public benefit corporation . . . .[58]

On July 1, 2009, a new income-based-repayment plan became available to many Americans struggling under the burden of student loan debt.[59] Under this new plan, a graduate with federal student loan debt is permitted to make payments based on a percentage of his or her income with no requirement that the graduate work in any particular socially desirable field.[60] After twenty-five years of timely payments under the plan, the balance of the loans is eligible to be forgiven regardless of the remaining balance.[61] Unfortunately, Congress has not yet made any amendments to the Internal Revenue Code to prevent this forgiven debt from being included in taxable income.[62] Unless Congress acts to exempt debt forgiven under the income-based-repayment plan from taxable income or alters the way in which this income is treated, many graduates may receive an immense tax bill in a single year as a consequence of their student loans a quarter century after graduating from college.

C. When and Why Are Canceled Debts Considered Income?

The concept of income arising from cancellation of indebtedness was first established in *United States v. Kirby Lumber Co.*,[63] prior to the implementation of the current Internal Revenue Code.[64] In that well known case, a corporation, Kirby Lumber Co., issued $12,126,800 in bonds and subsequently repurchased the bonds from the bondholders later in the same year at a discount of $137,521.[65] By selling the bonds back to Kirby Lumber at less than their par value, the bondholders effectively canceled $137,521 of the corporation's outstanding debt, and the

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[58] *Id.* § 108(f).

[59] 20 U.S.C. § 1098(e) (2006).

[60] *See* 34 C.F.R. § 682.215(b)(1) (2009) (stating that the only requirement to qualify is partial financial hardship).

[61] *Id.* § 682.215(f)(i–v).

[62] *See* I.R.C. § 108.

[63] 284 U.S. 1 (1931).

[64] *Compare id.* at 1, *with* I.R.C § 108 (showing that *United States v. Kirby Lumber Co*. was decided in 1931 and this section of the tax code was not implemented until 2006).

[65] *Kirby*, 284 U.S. at 2.

corporation became wealthier as a result.[66] In an opinion authored by Justice Holmes, the Court noted, "gross income includes 'gains or profits and income derived from any source whatever'"[67] and held that the corporation had "realized within the year an accession to income" and could be taxed on that income.[68]

Today, the Internal Revenue Code embraces the concept of income including all accessions to wealth and broadly defines gross income as "all income from whatever source derived."[69] This definition is followed by a list of specifically includible items but also includes other types of income not specifically listed in the code as being taxable.[70] In accordance with the holding in *Kirby*, one of the enumerated items specifically included in gross income is "[i]ncome from discharge of indebtedness."[71]

At first glance, it may seem counterintuitive to include canceled or forgiven indebtedness in income because the taxpayer has not received any new money he or she did not already have in his or her possession prior to the cancellation. However, by becoming less indebted the taxpayer has simultaneously become wealthier, and therefore, should be taxed on his or her accession to wealth just as though the wealth had come from any other source.[72]

Additionally, it is important to note that because income from loans is not included in gross income, a taxpayer whose loan has been forgiven has not yet paid tax on that money.[73] As the Court held in *Commissioner of Internal Revenue v. Tufts*:[74]

> When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the

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[66] *Id.*

[67] *Id.* at 3 (quoting The Revenue Act of 1921, ch. 36, § 213, 42 Stat. 238 (1921)). Note that the wording of this provision is similar to what is now codified in the current Internal Revenue Code at I.R.C. § 61(a). *Compare* The Revenue Act of 1921, ch. 36, § 213, 42 Stat. 238 (1921), *with* I.R.C. § 61(a) (2006).

[68] *Kirby*, 284 U.S. at 3.

[69] I.R.C. § 61(a).

[70] *Id.*

[71] *Id.*

[72] *See, e.g.*, Comm'r v. Glenshaw Glass, 348 U.S. 426, 431 (1954) (stating that income is viewed as an accession to wealth).

[73] Comm'r v. Tufts, 461 U.S. 300, 307 (1983).

[74] 461 U.S. 300.

> repayment of the loan likewise has no effect on his tax liability.[75]

If it were otherwise, taxpayers might be able to easily evade tax liability by structuring payments as loans followed by cancellation of the indebtedness at no cost. Clearly, including canceled indebtedness in taxable income is not only proper but also necessary if the tax system is to function fairly for all taxpayers.[76]

Although the most obvious way to incur debt is through loans, there are many other ways to incur debt, not all of which will be included in income if forgiven.[77] The key question in determining whether the cancellation of a debt will give rise to cancellation of indebtedness income is whether the debtor experienced an increase in assets as a result of the cancellation.[78] For this reason, the cancellation of certain debts, such as promises to pay someone else's debt, unpaid rents, and binding promises to donate money, do not ordinarily produce cancelation of indebtedness income.[79] However, if the liability has been used to produce a tax benefit, such as the deduction of rent as a business expense although it has not yet been paid, the cancellation of the debt will create cancellation of indebtedness income.[80]

D. Canceled Indebtedness Not Subject to Taxation

Fortunately for the indebted taxpayer, although canceled indebtedness is income to the taxpayer in many situations, that income may not be taxable.[81] In fact, the Internal Revenue Code has specifically exempted several categories of canceled indebtedness from taxable income.[82]

1. Invalid or Unenforceable Debts

Before a taxpayer may realize taxable income from cancellation of indebtedness, the taxpayer must first show that the debt was a valid obligation and that it was enforceable against the taxpayer prior to the

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[75] *Id.* at 307.

[76] *See supra* notes 63–75 and accompanying text.

[77] Federick R. Parker, Jr., *A Primer on Income Taxes and the Cancellation of Debt*, 39 L.A. BUS. J. 567, 567–68 (1992).

[78] *Id.*

[79] *Id.*

[80] *Id.* at 568.

[81] Robert Willens, *The Elusive Notion of "Income from Discharge of Indebtedness*,*"* 18 J. BANKR. L. & PRAC. 1, 89 (2009).

[82] I.R.C. § 108 (2006).

cancellation.[83] This principle is well illustrated by *Zarin v. Commissioner of Internal Revenue*.[84]

Mr. Zarin was a high rolling, compulsive gambler who was sued by a New Jersey casino for $3,435,000 and settled his debt for only $500,000.[85] The Internal Revenue Service argued that the $2,935,000 difference between what was owed and what was paid should have been included in Mr. Zarin's gross income and taxed accordingly.[86] Unfortunately for Mr. Zarin, he was in the 70% tax bracket at the time, and the total tax due, including several years worth of interest, came to $5,209,033.[87]

The debt Mr. Zarin owed to the casino was the result of a series of loans taken out over a period of months to fuel his ever-worsening gambling addiction.[88] Prior to the extension of the credit that became the subject of the lawsuit, the casino was ordered by the Casino Control Commission to stop making loans to Mr. Zarin due to allegations of abusive practices regarding the financing extended to Mr. Zarin.[89] The casino simply ignored the Casino Control Commission and continued making loans to Mr. Zarin in direct violation of the order.[90]

The court reasoned that I.R.C. § 61 does not define the term indebtedness, and I.R.C. § 108(d)(1) defines it as "(A) any indebtedness for which the taxpayer is liable, or (B) subject to which the taxpayer holds property."[91] The court determined that the gambling chips Mr. Zarin received should not be considered property because the chips were merely a medium of exchange.[92] Because the loans were made illegally, the court determined that Mr. Zarin could not have been liable for them, and therefore, did not have any income or tax liability as a result of their cancellation.[93] Thus, the cancellation of illegal or otherwise invalid obligations does not result in cancellation of indebtedness income for the taxpayer.[94]

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[83] Zarin v. Comm'r., 916 F.2d 110, 113 (3d Cir. 1990).
[84] 916 F.2d 110.
[85] *Id.* at 112.
[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] *Id.*
[90] *Id.*
[91] *Id.* at 113 (quoting I.R.C. § 108(d)(1) (1990)).
[92] *Id.* at 113–14.
[93] *Id.* at 114.
[94] *See id.*

2. *Cancellation of a Contingent Obligation*

Like the cancellation of an invalid or unenforceable obligation, the cancellation of a contingent obligation does not produce taxable income.[95] The reasoning behind this rule centers on the concept of looking at whether the taxpayer has experienced an increase in available assets because of cancellation.[96] If the obligation to repay the debt was never certain, it would be difficult to determine to what extent the release of the obligation may have freed previously committed assets for use.[97] Although it might be possible to attempt to make a determination as to the likelihood that the taxpayer would have had to pay the debt, canceled contingent obligations are not taxed.[98]

3. Cancellation of Indebtedness as a Gift

It is well established that gifts are not included in the gross income of the recipient, and therefore, are not taxed.[99] However, it is sometimes difficult to determine whether a payment is a gift or merely a payment disguised as a gift to avoid taxation on the income.[100] Additionally, there has been some difficulty in determining exactly how "gift" should be defined.[101]

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[95] *See* Hunt v. Comm'r, 59 T.C.M. (CCH) 635, 650 (1990).

[96] *See* Parker, *supra* note 77, at 567–68.

[97] Corporacion de Ventas de Salitre Y Yoda de Chile v. Comm'r, 130 F.2d 141, 143 (2d Cir. 1942).

[98] *Id.*

[99] I.R.C. § 102(a) (2006) ("Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."). This exclusion is not to be confused with the gift tax provided for in I.R.C. § 2501. *See* I.R.C. § 2501 (2006). The exclusion of I.R.C. § 102 applies to the amount received by a taxpayer. *See* I.R.C. § 102(a). The tax created in I.R.C. § 2501 is a tax on money given by a taxpayer. *See* I.R.C. § 2501(a)(1). Thus, gifts are taxed under the Internal Revenue Code, but gifts are never included in the income of the recipient. *See* I.R.C. § 102(a); I.R.C. § 2501(a)(1). Additionally, if the recipient of the gift attempts to compensate the donor for the tax liability imposed by I.R.C. § 2501, the donor will have to pay taxes on that amount as well because that payment itself constitutes income pursuant to I.R.C. § 61(a). Diedrich v. Comm'r, 457 U.S. 191, 198 (1982) (gift was given subject to the condition that the donees pay the resulting gift taxes).

[100] *See* William A. Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word "Gift,"* 48 MINN. L. REV. 215, 216–17 (1963).

[101] *Id.* at 216.

In *Commissioner v. Duberstein*,[102] the Court knitted together several previous decisions to clearly define what constitutes a gift for purposes of taxation.[103] The Court freed the term "gift" from the baggage of any previous case law by summarily determining that the Internal Revenue Code "does not use the term 'gift' in the common law sense, but in the more colloquial sense."[104] The Court went on to say that what differentiates a gift from a taxable payment is primarily donative intent or the mindset of the party making the payment.[105] The Court stated that a gift is given with a "detached and disinterested generosity"[106] and is marked by "affection, respect, admiration, charity or like impulses."[107]

Although gifts are generally thought of as transfers from one party to another, discharging the indebtedness of another out of generosity may also constitute a gift for tax purposes.[108] As with ordinary gifts, the key element in determining if a cancellation of indebtedness is a gift is donative intent.[109] A cancellation is not likely to be considered a gift when the creditor intends to derive a benefit from the cancellation.[110]

4. Cancellation of Indebtedness when Insolvent

Sometimes, the taxpayer may be wholly or partially insolvent at the time their debt is forgiven.[111] When a taxpayer is insolvent at the time

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[102] 363 U.S. 278 (1960).

[103] *Id.* at 285–86.

[104] *Id.* at 285.

[105] *Id.*

[106] *Id.* (citing Comm'r v. LoBue, 351 U.S. 243, 246 (1956)).

[107] *Id.* (citing Robertson v. United States, 343 U.S. 711, 714 (1952)).

[108] Helvering v. Am. Dental, 318 U.S. 322, 331 (1943) (stating that because the donor did not receive anything of value in return for the discharge of the debt, the discharge was presumed to have been a gift).

[109] Sutphin v. United States, 14 Cl. Ct. 545, 548–49 (1988) (noting that because the alleged donor acted for economic reasons the discharge in question was likely not intended as a gift). The reader should take note of the fact that *Helvering* was decided prior to *Duberstein* while *Sutphin* was decided after *Duberstein*. *See Helvering*, 318 U.S. 322 (1943); *Duberstein*, 363 U.S. 278 (1960); *Sutphin*, 14 Cl. Ct. 545 (1988). *Sutphin* focused on the concept of donative intent of the donor as opposed to what was or was not received in exchange for the forgiveness of indebtedness. *See Sutphin*, 14 Cl. Ct. at 548–49.

[110] *See id*.

[111] *See* Carlson v. Comm'r, 116 T.C. 87, 89 (2001) (showing that the taxpayer in question alleged he was insolvent at the time of the discharge of indebtedness because the value of his commercial fishing license should not have been included as an asset).

their debt is canceled, the canceled debt is excluded from income to the extent of the indebtedness in spite of the taxpayer's accession to wealth.[112]

When *Kirby Lumber* was decided in 1931, the taxpayer in question was a solvent corporation, and there was no mention made of what tax liability the taxpayer might incur if they were insolvent at the time the debt was canceled.[113] However, the courts quickly filled this gap in the *Kirby* rule with subsequent back-to-back rulings in *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*[114] and *Lakeland Grocery Co. v. Commissioner*.[115]

In *Dallas Transfer*, the taxpayer corporation found itself indebted to the lessor of a building in the amount of $107,880 and simultaneously insolvent by $226,470.[116] The corporation was able to negotiate a deal with the landlord to have all of the debt canceled in exchange for the conveyance of a building owned by the corporation.[117] As part of the deal, the landlord assumed the balance of the mortgage on the building.[118] However, the depreciated cost of the building offset by the balance of the mortgage was only $14,513, and the Commissioner of Internal Revenue assessed a deficiency of $93,367, representing cancellation of indebtedness income on the difference between the amount of the debt and the value of the property conveyed in exchange for the forgiveness of the debt.[119]

The court held that the corporation should not have been subject to taxation on any amount of cancellation of indebtedness income because it was insolvent at the time of the cancellation.[120] The court likened the transaction to what occurs in a bankruptcy proceeding[121] and held that

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[112] I.R.C. § 108(a)(1) (2006).

[113] Kirby Lumber Co. v. Comm'r, 284 U.S. 1, 1 (1931).

[114] 70 F.2d 95 (5th Cir. 1934).

[115] 36 B.T.A. 289 (1937).

[116] *Dallas Transfer*, 70 F.2d at 95.

[117] *Id.*

[118] *Id.*

[119] *Id.* at 95–96.

[120] *Id.* at 96.

[121] *Id*. I.R.C. § 108 specifically exempts from gross income any discharge of indebtedness occurring as a result of bankruptcy. I.R.C. § 108(a)(1)(A) (2006). However, because student loans cannot normally be discharged in bankruptcy, this exemption is not overly relevant to this paper. 11 U.S.C. § 523(a)(8).

because the corporation had not received any increase in assets it should not have been subject to taxation on the cancellation of indebtedness.[122]

Not long after the decision in *Dallas Transfer*, *Lakeland Grocery Co. v. Commissioner* addressed the situation of a debtor who is insolvent by less than the amount of the debt forgiven.[123] The court extended the rule from *Dallas Transfer* and held that the canceled indebtedness should be excluded from income only to the extent of the indebtedness.[124] The balance of the canceled indebtedness is included in taxable income as usual.[125]

Under the current Internal Revenue Code, canceled indebtedness continues to be excluded from income to the extent of the taxpayer's insolvency in accordance with the case law established prior to the code's enactment.[126] Section 108(d)(3) of the Internal Revenue Code clearly defines insolvency:

> 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.[127]

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[122] *Dallas Transfer*, 70 F.2d at 96. In coming to the conclusion that discharge of indebtedness should not be taxed when the debtor is insolvent, the court relied on the concept of income set forth in *Eisner v. Macomber*. *Id*. In *Macomber*, the Court conceived income as a "gain derived from capital, from labor, or from both combined." *Macomber*, 252 U.S. 189, 207 (1920) (quoting Stratton's Independence v. Howbert, 231 U.S. 399, 415 (1913) and Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918)). This notion of what constitutes income is rather narrow and very different from the one found today in I.R.C. § 61(a). *Compare Macomber*, 252 U.S. at 207, *with* I.R.C. § 61(a) (2006). In accordance with the modern concept of what constitutes income found in I.R.C. § 61(a), it would seem that discharged indebtedness should be included in income regardless of the debtor's solvency. Nonetheless, indebtedness discharged while insolvent remains exempt from taxation. I.R.C. § 108(a)(1)(B).

[123] *Lakeland Grocery Co. v. Comm'r*, 36 B.T.A. 289, 292 (1937).

[124] *Id.* As in *Dallas Transfer*, the court's analysis focused on what constitutes income under the conception of income from *Macomber*. *Id.*

[125] *Id.*

[126] I.R.C. § 108(a).

[127] *Id.* § 108(d)(3).

Although canceled indebtedness is not included in income to the extent of the debtor's insolvency, this exemption does not come without a cost to the debtor.[128] I.R.C. § 108(b) recoups any amounts of canceled indebtedness not included in income due to insolvency by reducing the debtor's beneficial tax attributes for the year in which the cancellation occurs as well as the next year if any of the attributes carry over.[129] Additionally, the basis of any property owned by the debtor will be reduced to account for the canceled indebtedness not included in income.[130] This reduction in basis may be thought of as a means of pushing the tax liability on the canceled indebtedness into the future until the time when the reduced basis asset is sold. At that time, the taxpayer will have to pay tax on the difference between the sale price and the now reduced basis, thereby, recouping some of the income from the canceled indebtedness.[131]

E. Forgiveness of Indebtedness from Student Loans

Student loans are a major source of long-term debt for many Americans.[132] As described above, I.R.C. § 108 specifically exempts some canceled student loans from income in an attempt to encourage certain career choices that the government deemed to be desirable.[133] However, with the exception of those instances specifically exempted from taxation, canceled student loans are subject to taxation as cancellation of indebtedness income.[134]

1. Are Canceled Student Loans Gifts Because the Creditor Receives Nothing in Exchange for the Cancellation?

In *Plotinsky v. Commissioner*,[135] a recent graduate of law school attempted to argue that his forgiven student loan indebtedness was a gift, and therefore, not includable in his taxable income.[136] After graduating from law school, Mr. Plotinsky consolidated his student loans with

[128] *See id.* § 108(b).
[129] *Id.* § 108(b)(2)(A).
[130] *Id.*
[131] *Id.* § 1001(a).
[132] Payea & Baum, *supra* note 3, at 2.
[133] I.R.C. § 108(f)(2)(D)(ii).
[134] *Id.* § 108(f)(3).
[135] 96 T.C.M. (CCH) 292 (2008).
[136] *Id.* at 292.

American Education Services, a division of Key Bank.[137] As an incentive, the bank offered to cancel a portion of the loan if he were to make thirty-six consecutive, on-time payments.[138] Mr. Plotinsky made the thirty-six on-time payments and received the promised cancellation of $3,043.28.[139] When he filed his annual income tax return for that year, he omitted the canceled indebtedness from income and attached an explanation that the cancellation was a gift, and therefore, was not taxable income.[140] The Commissioner of Internal Revenue disagreed and issued a notice of deficiency.[141]

Mr. Plotinsky relied on the holding in *Helvering v. American Dental*[142] to argue that because American Education Services did not receive anything in exchange for the forgiveness of the debt, the cancellation was a gift.[143] Unfortunately for Mr. Plotinsky, this reasoning ignored the later holding in *Duberstein*, which found that the determinative factor in ascertaining whether a payment is a gift is the mindset of the creditor.[144] The court held that the bank acted out of a desire for timely payments and not out of disinterested generosity as required by *Duberstein*.[145] Although there may be some occasions in which the cancellation of a student loan truly is a gift, the majority of cases seem unlikely to satisfy the requirements of *Duberstein*.[146]

2. *Are Forgiven Student Loans Nontaxable Scholarships?*

Another possible argument in favor of the taxability of canceled student loans is that the canceled loan should be regarded as a qualified scholarship or tuition reduction.[147] As a matter of horizontal equity it would seem money given to a student so that he or she may pursue an

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[137] *Id.*

[138] *Id.*

[139] *Id.*

[140] *Id.* at 292–93.

[141] *Id.*

[142] 318 U.S. 322 (1942).

[143] *Plotinsky*, 96 T.C.M. (CCH) at 293 (citing Helvering v. Am. Dental, 318 U.S. 322, 331(1943)).

[144] Comm'r v. Duberstein, 363 U.S. 278, 285 (1960).

[145] *Plotinsky*, 96 T.C.M. (CCH) at 296.

[146] Stevens Bros. Found. v. Comm'r, 39 T.C. 93, 103 (1962); *see also Duberstein*, 363 U.S. at 278.

[147] *See* I.R.C. § 117 (2006).

education should be treated the same as money loaned to a student for the same purpose and then later forgiven.

Unfortunately, this is not the case. The question of what may be considered a scholarship for tax purposes was initially answered by the Supreme Court in *Bingler v. Johnson*.[148] The Court held that a payment cannot be considered a scholarship "where the recipient receives money and in return provides a quid pro quo."[149]

This rule was later expanded in a 1973 Revenue Ruling in which the taxpayer was a graduate of medical school who had a portion of his loan canceled pursuant to a state program, which encouraged medical school graduates to practice in disadvantaged regions.[150] The Revenue Ruling stated that although the government was not directly receiving anything from the taxpayer, the canceled debt was nonetheless taxable because the taxpayer was required to fulfill requirements set by the state.[151] This ruling was quickly repudiated in 1978 when Congress enacted the temporary provisions, which would later be made permanent in I.R.C. § 108(f).[152] Because I.R.C. § 108(f) only applies under limited circumstances, cancellation of indebtedness income from all other canceled student loans remain taxable.[153]

3. All Forgiven Loans Not Explicitly Excepted Remain Taxable

In *Porten v. Commissioner*,[154] the United States Tax Court made it clear that a forgiven student loan that does not meet the requirements of an exception will be considered cancellation of indebtedness income.[155] In 1972, the State of Alaska instituted a student loan forgiveness program in an effort to prevent a "brain drain" from the state.[156] The state granted student loans to Alaska residents for college tuition and fees.[157] After graduation, these loans were partially forgiven for each year the graduate

[148] 394 U.S. 741 (1969).

[149] *Id.* at 758 n.32 (internal citation omitted).

[150] Rev. Rul. 73–256, 1973–1 C.B. 56.

[151] *Id.*

[152] Richard Beck, *Loan Repayment Assistance Programs for Public-Interest Lawyers: Why Does Everyone Think They Are Taxable?*, 40 N.Y.L. SCH. L. REV. 251, 268 (1996).

[153] *Id.*

[154] 65 T.C.M. (CCH) 1994 (1993).

[155] *Id.*

[156] Beck, *supra* note 152, at 274.

[157] *Id.*

remained an Alaskan resident.[158] For seventeen years, the plan operated successfully, and the Internal Revenue Service did not attempt to assess a deficiency for the cancellation of indebtedness income generated by the forgiven loans.[159] This changed in 1989 when the IRS determined that Alaskans participating in the plan would have to include the forgiven loans in income.[160]

The taxability of these forgiven loans was addressed in *Porten*. The court first demonstrated that the forgiven loans could not be construed as scholarships.[161] The petitioners argued that the Alaska statute authorizing the program explicitly referred to the plan as a scholarship.[162] The court disagreed arguing that although the state of Alaska may have considered the program to be a scholarship, states cannot determine federal tax policy by simply characterizing a debt forgiveness program as a scholarship.[163] Instead, the court applied the test from *Bingler v. Johnson* and determined that the forgiveness could not be a scholarship under *Bingler* because Alaska had clearly received the benefit of keeping educated residents in the state.[164]

The court then turned to the possibility that the forgiven loans could have been a gift.[165] This proposition was quickly defeated for the same reasons as the prior possibility. The court held that because Alaska acted out of a desire to keep educated students in Alaska, the state lacked the donative intent required by *Duberstein*; and thus, the forgiven loans could not be categorized as gifts.[166]

Third, the court addressed the possibility that the forgiven loans fit into the exclusion created by I.R.C. § 108(f).[167] The petitioners believed that the apparently broad language of I.R.C. § 108(f) requiring employment "in certain professions for any of a broad class of employers"[168] could be construed to include Alaska's requirement that the program participants

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[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] *Id.*
[162] *Id.*
[163] *See id.*
[164] *Id.* at 274–75.
[165] *Id.* at 275.
[166] *Id.*
[167] *Id.* at 274.
[168] I.R.C. § 108(f) (2006).

work in Alaska.[169] The court disagreed, stating that a requirement that participants remain in Alaska did not fit the clear meaning of the statute.[170]

The final possibility raised by the respondents was the theory that the obligation to repay the loan was contingent from its inception, and therefore, yielded no income when canceled.[171] Again, the court disagreed.[172] The court reasoned that the promissory notes signed by the program's participants were for a fixed amount payable at a fixed time and could not be construed as contingent based on the possibility of future cancellation.[173] The court then held that the petitioners had realized income on the cancellation of their loans.[174]

As demonstrated by *Porten v. Commissioner*, the tax court is not receptive to attempts to squeeze student loan forgiveness programs that are not expressly excludible into an exception.[175] Thus, if a loan forgiveness program has not been clearly included as an exception to the general rule that canceled student loans are taxable, the taxpayer must include the amount of the cancellation in income for that year.[176]

III. THE INCOME-BASED-REPAYMENT PLAN AND ITS CONSEQUENCES

A. The Income-Based-Repayment Plan

The income-based-repayment plan was created in 2007 when Congress added the provisions now codified at 20 U.S.C. § 1098e to the Higher Education Act of 1965.[177] This statute authorized the Secretary of Education to make available an income-based-repayment plan and outlined some basic provisions for inclusion in the plan.[178]

The plan allows taxpayers with federal student loans to make payments of 15% of the difference between the taxpayer's adjusted gross income and

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[169] Porten v. Comm'r, 65 T.C.M. (CCH) 1994, 1969 (1993).

[170] *Id.*

[171] *Id.* at 1997.

[172] *Id.*

[173] *Id.*

[174] *Id.*

[175] *See id.* at 1996.

[176] *Id.*

[177] *See* 20 U.S.C. § 1098e (2006). See *Summary of the College Cost Reduction and Access Act (H.R. 2669)*, N.A.S.F.A.A., http://www.nasfaa.org/publications/2007/G2669 Summary091007.html (last visited Nov. 30, 2010), for an excellent summary of the College Cost Reduction and Access Act.

[178] 20 U.S.C. § 1098e(b).

150% of the poverty line for the taxpayer's family size.[179] After twenty-five years of timely payments, any outstanding balance, including all interest, is to be canceled.[180]

Loans made after July 1, 2014 will qualify for even more generous terms.[181] Payments will be capped at 10% of the difference between the taxpayer's disposable income.[182] Additionally, the loans will be eligible for cancellation after twenty years instead of the current twenty-five.[183] However, these changes will only be applicable to new loans and will not affect existing loans made prior to July 1, 2014.[184]

The regulations created by the Department of Education at the request of Congress describe the plan in greater detail.[185] The regulations broadly define which types of loans are eligible for the plan and clearly include both direct loans from the Federal Government and federally backed loans made by private entities under the FFEL.[186] The only federal student loans clearly not eligible for the plan are those loans made to the parents of students under the PLUS program.[187]

A borrower is eligible for the plan if the total amount due on his or her loan in a given year exceeds 15% of the difference between the borrower's adjusted gross income and 150% of the poverty line for the borrower's family as established by the United States Department of Health and Human Services.[188] In 2009, the federal poverty line for a single adult in the contiguous forty-eight states was $10,830.[189] Using this statistic, a

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179 *Id.* § 1098e(a)(3)(B).

180 *Id.* § 1098e(b)(7).

181 Samuelson, *supra* note 42.

182 *Id.*

183 *Id.*

184 *Id.*

185 34 C.F.R. § 682.215 (2009).

186 *Id.* § 682.215(a)(2).

187 *Id.*

188 *Id.* § 682.215(a)(4).

189 Department of Health and Human Services, Annual Update of the HHS Poverty Guidelines, 74 Fed. Reg. 4200 (January 23, 2009). The Department of Health and Human Services has established separate poverty guidelines for persons living in the states of Alaska and Hawaii. *Id.* The Department of Health and Human Services does not publish poverty guidelines for other United States territories such as Puerto Rico and the U.S. Virgin Islands. *Id.* However, the regulations regarding the income-based-repayment plan indicate that borrowers in jurisdictions not covered by the Department of Health and Human Services guidelines should use the guidelines for the contiguous forty-eight states in determining their eligibility. 34 C.F.R. § 682.215(a)(5).

single adult earning $40,000 would need to have an annual student loan payment greater than $3,563 in order to be eligible.[190] This works out to a monthly payment of just $297 per month. In the case of a family of four, the federal poverty line is $20,050,[191] and a borrower earning $40,000 per year would qualify for the program if his or her monthly payment were greater than $124.[192]

Once enrolled in the income-based-repayment plan, the borrower's maximum monthly payment is calculated using the same formula as that used to qualify for the program.[193] Thus, the borrowers described above would have monthly payments of $297 and $124 per month respectively, regardless of the amounts due on their loans. If the borrower's income is such that the calculated payment due is less than $5.00, the payment is reduced to zero.[194] Months in which the payment is calculated to be zero still count toward the time necessary to receive a total discharge.[195]

In the case of Subsidized Stafford Loans, if the monthly payments made under the plan prove to be insufficient to cover the interest accruing on the loan, as may well be the case for many participants, the Secretary must pay the holder of the loan the difference between the payment and the accrued interest for "a period not to exceed three consecutive years from the established repayment period start date on each loan repaid under the income-based repayment plan."[196] After three years have elapsed, or in the case of loans other than Subsidized Stafford Loans, the Secretary will not be responsible for paying the borrower's interest.[197] Unpaid interest accrues but does not compound.[198] This means the participant will only ever pay interest on the principal of the loan.[199]

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[190] *See id.* One-hundred and fifty percent of 10,830.00 is $16,245.00. The difference of $40,000.00 and $16,245.00 is $23,755.00. This amount multiplied by 0.15 is $3,563.25.

[191] *Id.*

[192] *Id*. See *Income-Based Repayment (IBR) Worksheet – 2009*, EQUAL JUSTICE WORKS, http://www.equaljusticeworks.org/files/ibr_worksheet_09.pdf (last visited Dec. 5, 2010), for an excellent worksheet for determining whether or not a person will be eligible for the income-based-repayment plan.

[193] 34 C.F.R. § 682.215(b).

[194] *Id.* § 682.215(b)(1)(ii).

[195] *Id.* § 682.215(f)(1)(i).

[196] *Id.* § 682.215(b)(4).

[197] *Id.*

[198] *Frequently Asked Questions*, IBR INFO, http://www.ibrinfo.org/faq.vp.html (last visited Dec. 5, 2010).

[199] *Id.*

Borrowers are eligible to have their entire balance canceled after twenty-five years.[200] Payments made during the twenty-five year period may include payments made under a variety of other qualified payment plans:[201]

> (1) To qualify for loan forgiveness after 25 years, the borrower must have participated in the income-based repayment plan and satisfied at least one of the following conditions during that period—
>
> (i) Made reduced monthly payments under a partial financial hardship as provided under paragraph (b)(1) of this section. Monthly payments of $0.00 qualify as reduced monthly payments as provided in paragraph (b)(1)(ii) of this section;
>
> (ii) Made reduced monthly payments after the borrower no longer had a partial financial hardship or stopped making income-based payments as provided in paragraph (d)(1) of this section;
>
> (iii) Made monthly payments under any repayment plan, that were not less than the amount required under the FFEL standard repayment plan described in § 682.209(a)(6)(vi) with a 10-year repayment period;
>
> (iv) Made monthly payments under the FFEL standard repayment plan described in § 682.209(a)(6)(vi) based on a 10-year repayment period for the amount of the borrower's loans that were outstanding at the time the borrower first selected the income-based repayment plan; or
>
> (v) Received an economic hardship deferment on eligible FFEL loans.[202]

Borrowers who have participated in the income-based-repayment plan and made twenty-five years worth of payments under any combination of the options listed above are eligible for a total discharge of any balance

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[200] 34 C.F.R. § 682.215(f)(1) (2010).
[201] *Id.*
[202] *Id.*

remaining on their loans.[203] Unfortunately, because the discharge is not contingent upon employment in any specific profession, the requirements of § 108(f) are not met and the taxpayer is subject to taxation on the resulting cancellation of indebtedness income.[204]

Another serious defect in the income-based-repayment plan as currently enacted is the plan's failure to accurately account for the income and debts of married participants' spouses.[205] As currently interpreted, a married taxpayer who chooses to file a joint tax return with his or her spouse will have to include the spouse's income for purposes of computing eligibility and payments but will not be permitted to include the spouse's own student loan debts.[206] Thus, a married couple who has the same amount of income and debt and would both otherwise be eligible may find that neither partner is eligible due to the other's income even though most of that income is used to pay his or her own student loan debts.[207]

Fortunately, there is a way around this conundrum. Married taxpayers may avoid the entire problem by electing to file separate tax returns.[208] However, this decision may have other adverse implications and participants should carefully consider the pros and cons of both options.[209] Although the Department of Education has agreed to revisit this rule,[210] for the time being participants should be mindful of their spouse's income to student loan debt ratios when choosing whether to file a joint tax return.

The income-based-repayment plan as outlined in the Code of Federal Regulations appears to be a broad and flexible plan for allowing borrowers to repay their student loans, to the extent they are able, while ensuring that families have sufficient income to meet their needs.[211] It is hoped that the Internal Revenue Code can be amended to do likewise.

IV. TAXATION WITHOUT HARDSHIP

The author proposes an amendment to I.R.C. § 108 to prevent taxpayers who have made a quarter century of payments from incurring massive tax liability in a single year. This could be accomplished in one of

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[203] *Id.* § 682.215(f)(2) (2010).

[204] I.R.C. § 108(f) (2006).

[205] *Id.*

[206] *Id.*

[207] *Id.*

[208] *Id.*

[209] *Id.*

[210] *Id.*

[211] *See* 34 C.F.R. § 682.215 (2010).

several ways to alleviate the burden on the taxpayer while simultaneously allowing the taxpayer to be taxed fairly on his or her increase in wealth resulting from the cancellation of indebtedness.

A. Exempt Indebtedness Discharged Under the Income-Based-Repayment Plan from Taxable Income

The simplest and most easily implemented option for dealing with the problem of cancellation of indebtedness income from student loans canceled under the income-based-repayment plan may be to simply amend I.R.C. § 108 to exempt such income from taxation.

This is the approach taken by a bill, H.R. 2492, currently under consideration in the House of Representatives.[212] This bill was introduced by Congressman Sander Levin in May 2009 and reads in its pertinent section:

> (a) IN GENERAL.—Paragraph (1) of section 108(f) of the Internal Revenue Code of 1986 is amended by striking "any student loan if" and all that follows and inserting []any student loan if—
>
> [](A) 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, or
>
> "(B) such discharge was pursuant to subsections (d)(1)(D) and (e)(7) of section 455, or section 493C(b)(7), of the Higher Education Act of 1965 (relating to income contingent and income based repayment, respectively)." [sic]
>
> (b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to discharges of loans after June 30, 2009.[213]

If enacted, the effect of this bill would be to amend I.R.C. § 108(f) to exclude from income any cancellation of indebtedness under the Higher Education Act of 1965 "relating to income contingent and income based

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[212] H.R. 2492, 111th Cong. (2009) (enacted).
[213] *Id.*

repayment."[214] Although simple and easy to implement, this approach fails to prevent abuse by a minority of taxpayers who may have significant assets but little income.[215] As written, the bill permits these asset rich, income poor taxpayers to obtain a total discharge free from taxation despite having the ability to comfortably pay the tax.[216] Before rushing to enact this broad legislation, Congress should consider some other options for dealing with the problem to ensure that all taxpayers are treated fairly and pay the appropriate amount of tax for their financial situation.

B. Exempt Any Amount Above the Principal Amount of the Loan from Taxable Income

One possibility for ensuring that all taxpayers pay an appropriate amount of tax for their financial situation would be to exempt from taxable income all interest and penalties that may have accrued during the life of the plan while forcing solvent taxpayers to pay tax on any unpaid principal. This approach would prevent taxpayers who made only insignificant progress towards repaying their loan balance from paying tax on twenty-five years of interest while requiring them to pay tax on the balance of the principal, which they actually received and spent on the cost of their education.

Such an approach prevents taxpayers with little income and significant assets from discharging their loan without paying any taxes. At the same time, taxpayers who are genuinely in a state of hardship would not be unduly burdened because the cancellation would not be taxable to the extent of their insolvency as explained above.[217]

Unfortunately, because payments made under the income-based-repayment plan are applied to interest, collection costs, and late charges before being applied to principle, many taxpayers receiving a discharge are likely to have large amounts of unpaid principal.[218] However, this hurdle could be eliminated by re-calculating the balance due for tax purposes such that all payments would be treated as though they were applied to principal before interest. Thus, a solvent taxpayer who made $50,000 in payments towards a principal balance of $70,000 over the twenty-five year plan would have to pay tax on $20,000. Any interest, fees, or costs above that amount would be discharged and exempted from taxable income. Under

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[214] *Id.*
[215] *See id.*
[216] *See id.*
[217] *See* I.R.C. § 108(a)(1) (2006).
[218] 34 C.F.R. § 682.215(c) (2006).

this plan, a solvent taxpayer who made payments equal or greater to the original principal of the loan would pay no tax regardless of the size of the discharged balance.

C. Expand Insolvency Exception for Canceled Indebtedness from Student Loans

Another possibility for softening the impact of cancellation of indebtedness income from student loan debt would be to expand the insolvency exception in cases where the canceled indebtedness was a student loan. This approach would allow taxpayers who are solvent by only a small amount to avoid taxation on forgiven student loans while requiring taxpayers with significant assets to pay tax on any forgiven student loans.

I.R.C. § 108(a)(3) currently excludes canceled indebtedness from gross income up to "the amount by which the taxpayer is insolvent."[219] A new section, 108(a)(3)(B), could be created to exempt from gross income any cancellation of indebtedness income from forgiven federal student loans under the income-based-repayment plan if the taxpayer is solvent by less than $100,000. This would have the effect of forcing wealthy taxpayers to pay tax on their cancellation of indebtedness while preventing taxpayers with only insignificant assets from being burdened with a large tax.

Additionally, because the basis of an exempt taxpayer's depreciable property would be adjusted,[220] some taxpayers exempted from paying tax on their canceled indebtedness would eventually have to make payments if they were to sell the depreciable asset.[221]

D. Spread Out the Tax Liability

A final suggestion for easing the impact of cancellation of indebtedness income from forgiven student loans would be to allow taxpayers to spread the tax liability out over a period of several years. If taxpayers were able to spread the tax liability for their forgiven student loan out over several years, they would be able to pay the full amount of the tax without being confronted with the problem of a large tax bill and no liquid assets with which to pay. Additionally, if liability were to be spread out over a period of several years, the liability could be offset by the various other credits and deductions available to the taxpayer.

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[219] I.R.C. § 108(a)(3).
[220] *Id.* § 108(b)(2)(E).
[221] *See id.* § 108(b)(5)(B).

Such a plan could be accomplished by creating an option under which the taxpayer's student loan debt is forgiven in equal installments over a period of several years after the completion of the plan. During this period, the taxpayer could be required to continue to make his or her required income-based payments.

V. CONCLUSION

This comment shows the extent of the problem of student loan debt in the United States and the consequences of discharging that debt for less than the full amount due. Further, this comment shows how this problem will be exacerbated by the newly available income-based-repayment plan. Finally, some suggestions are made for remedying the problem. Although the plan currently under consideration in the United States Congress would be preferable over taking no action, Congress is encouraged to look at some other options before rushing to enact such broad legislation.

The author hopes that the public will call upon Congress to enact legislation to lessen the tax consequences of discharging student loans under the income-based-repayment plan while ensuring that taxpayers with the ability to pay the tax on their canceled indebtedness are subject to a fair tax on their accession to wealth. Students who receive student loans and are later absolved from repayment undoubtedly receive income and should be required to pay tax on that income if they are able.[222] However, students should also be able to borrow responsibly for their education without worrying about being bankrupted by tax consequences far in the future. The suggestions in this comment are designed to resolve the conundrum created by the clash of these two competing interests.

Without legislation to address this problem, many Americans who choose to participate in the income-based-repayment plan will find themselves subject to burdens far beyond anything they could have imagined the day they chose to pursue a college education.

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[222] *See* I.R.C. § 61.