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CANCELLATION OF STUDENT LOANS: Amend IRC §§ 108(a) and 6050P to Provide That Gross Income Does Not Include, and Creditors Are Not Required to Report, Income from the Cancellation of Certain Student Loans

PROBLEM

Pursuant to a statutory framework in the Internal Revenue Code (IRC), creditors that forgive a debt are generally required to report the forgiveness to the IRS on Form 1099-C, *Cancellation of Debt*.¹ Taxpayers are generally required to include the amount of the forgiven debt in income.² However, there are situations in which canceled debt may be excluded from income, such as where the taxpayer was insolvent.³ Whether a taxpayer is insolvent is a case-by-case determination. Taxpayers claim an exclusion by filing Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*, with their returns.

Pursuant to statutory provisions outside of the IRC, creditors may be required to forgive certain debts.⁴ These required discharges arise in circumstances that strongly suggest the taxpayer is insolvent or otherwise eligible to exclude the forgiven debt from income. However, the IRC does not contain any exclusions that correspond to discharges of debt pursuant to these non-IRC provisions. If the IRC were amended to recognize these limited provisions as exclusions, and clarify that lenders are not required to report these discharges on Form 1099-C, taxpayers who qualified for the exclusion would not be required to file Form 982, and the IRS would not be required to process these forms and make unnecessary facts and circumstances determinations.

The IRS has recognized that the IRC rules, when triggered by debt forgiveness mandated by non-IRC provisions, may create a compliance burden on taxpayers and an administrative burden on the IRS that is excessive in relation to the amount of taxable income that would result. Thus, the IRS has issued guidance that provides relief to taxpayers whose forgiven student loans arose with respect to specific institutions named in the guidance. However, more uniform relief is needed.

EXAMPLE

In 2014, X borrows from the U.S. Department of Education (ED) pursuant to the Direct Loan Program to finance her attendance at an institution of higher learning.⁵ In 2016, when the balance of her outstanding Direct loans is \$20,000, X establishes as a defense against repayment within the meaning of the Higher Education Act of 1965 that the school misled her and that its actions would give rise to a cause of action against the school under applicable state law. ED cancels X's outstanding student loan

1 Internal Revenue Code (IRC) § 6050P(a); Treas. Reg. § 1.6050P-1(a).

2 IRC § 61(a)(12).

3 IRC § 108(a)(1)(B).

4 Higher Education Act of 1965, Pub. L. 89-329, 79 Stat. 1219, as amended (HEA), implemented in various provisions of Title 20 of the U.S. Code and Title 34 of the Code of Federal Regulations, discussed below.

5 According to the U.S. Department of Education (ED), “the largest federal loan program is the William D. Ford Federal Direct Loan Program, established in 2010, for which the federal government is the lender. Interest on the loans provided under the Direct Loan Program may be subsidized, based on need, while the recipient is in school.” *Loans for Undergraduate Students*, https://nces.ed.gov/programs/coe/pdf/coe_cub.pdf (last visited Nov. 20, 2017).

and reports the discharge to the IRS on Form 1099-C. Because X is insolvent at the time of discharge, she will not be required to include the forgiven debt in income, but if she does not file a return and claim the exclusion, the IRS will treat the amount of debt cancellation as income, and X may receive a Notice CP 2000, *Notice Proposing Adjustments to Income, Payments, or Credits*, which is the IRS's first step toward assessing the tax.

RECOMMENDATION

To reduce the administrative burden of both the taxpayer and the IRS, the National Taxpayer Advocate recommends that Congress amend IRC §§ 108(a) and 6050P to provide that gross income does not include, and creditors are not required to report, income from forgiveness of student loans discharged under the following provisions of the Higher Education Act of 1965 (HEA) as amended and related regulations:

- The Defense to Repayment process of 20 U.S.C. § 1087e and 34 C.F.R. §§ 685.206 and 682.209; or
- The income-driven repayment provisions of 20 U.S.C. § 1087e and 34 C.F.R §§ 685.209 and 685.221.

CURRENT LAW

IRC § 61(a)(12) generally requires a taxpayer whose debt is canceled to include the amount canceled in his or her income when filing a tax return.⁶ IRC § 108(a) provides exceptions to this general rule.⁷ For example, pursuant to IRC § 108(a)(1)(B), canceled debt may be excluded from income if the taxpayer is insolvent when the debt is canceled.⁸

Other bases for excluding canceled debt from income include:

- IRC § 108(f), where student debt is forgiven contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers, or pursuant to a loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas;⁹
- IRC § 108(f), where student debt is discharged after December 31, 2017, and before January 1, 2026, on account of a borrower's death or disability;¹⁰

6 IRC § 61(a)(12).

7 IRC § 108(a) provides:

(a) Exclusion from Gross Income.—

(1) In general.—Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent,

(C) the indebtedness discharged is qualified farm indebtedness,

(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or

(E) the indebtedness discharged is qualified principal residence indebtedness which is discharged—

(i) before January 1, 2017, or

(ii) subject to an arrangement that is entered into and evidenced in writing before January 1, 2017.

8 The term “insolvent” means the excess of liabilities over the fair market value of assets. IRC § 108(d)(3).

9 IRC § 108(f)(2), (4).

10 IRC § 108(f)(5), added by Pub. L. No. 115-97, § 11031 (2017).

- HEA provisions pursuant to which an educational institution forgives certain student loans for certain public service;¹¹ and
- HEA provisions pursuant to which ED forgives student loans under the Closed School discharge procedure.¹²

Non-statutory grounds for excluding canceled debt in income may also be available. For example, taxpayers who demonstrate that a “debt” was invalid at inception or is otherwise unenforceable under state law may exclude its forgiveness from income.¹³

Ascertaining Whether Forgiven Student Loan Is Excludible From Income May Require a Case-by-Case Determination

In addition to the HEA provisions discussed above, other HEA provisions authorize or require ED to cancel student loans under circumstances that suggest the forgiven debt would be excludible from income under IRC § 108(a) or other authority, but do not explicitly exclude such cancellation from income. For example, under the HEA, the Defense to Repayment process requires ED to discharge certain loans if the borrower establishes, as a defense against repayment, that a school’s actions would give rise to a cause of action against the school under applicable state law.¹⁴ To assist it in making this determination, ED’s *Application for Borrower Defense to Loan Repayment* asks, in a series of questions: “Did the school mislead you (or fail to tell you important information)” in matters such as:

- Promises of future employment, likelihood of finding a job, eligibility for certification or licensure in your field of study, how many students graduate, and/or earnings after graduation;
- How much your classes would cost, how you would pay for your education, the terms of loan repayment, and/or other issues about the cost of your education;
- Transferring your credits from this school to other schools; or

11 See 20 U.S.C. § 1087ee(a)(5), dd(g)(4), applicable to Federal Perkins Loans. ED describes the Perkins Loans Program as “a school-based loan program for undergraduates and graduate students with exceptional financial need. Under this program, the school is lender.” Federal Student Aid, ED, *Loans* <https://studentaid.ed.gov/sa/types/loans> (last visited Nov. 20, 2017).

12 See 20 U.S.C. § 1087(c)(4) (providing for loan discharge if the borrower (or the student on whose behalf a parent borrowed) could not complete the program of study at the school because the school closed while the borrower (or student) was enrolled, or if the borrower (or student) withdrew from the school no more than 120 days before the school closed and incorporating 20 U.S.C. § 1087ee(a)(5) with respect to forgiven Federal Family Education Loans (FFEL)), and 20 U.S.C. § 1087e(a)(1) (making FFEL terms applicable to Direct Loans). FFEL loans are made by non-federal entities and are generally insured by a state or private nonprofit loan insurance program. The federal government guarantees a portion of the amount a loan insurance program pays a lender for a loss due to a borrower’s default. See 20 U.S.C. §§ 1085(d), 1078(c)(1). ED notes that loans are no longer being made under this program. ED, <https://www2.ed.gov/programs/ffel/index.html> (last visited Nov. 20, 2017).

13 See, e.g., *Zarin v. Comm’r*, 916 F.2d 110 (3d Cir. 1990), rev’g 91 T.C. 1084 (1989) (cancellation of a gambling debt that was unenforceable as a matter of state law was not required to be included in income).

14 See generally 20 U.S.C. § 1087e(h), 34 C.F.R. § 685.206(c) (applicable to Direct Loans) and 34 C.F.R. § 682.209(g) (applicable to FFEL loans). See *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*, 81 Fed. Reg. 75926 (Nov. 1, 2016), final regulations promulgating 34 C.F.R. § 685.222, which includes breach of contract or material misrepresentation by the school as potential bases for discharging a student loan. These provisions of the final regulations were suspended until further notice pending judicial review. See 82 Fed. Reg. 27621-01 (June 17, 2017).

- The availability or quality of job placement, career services assistance, or the school's connections to employers within your field of study.¹⁵

Once a claimant's application and supporting documents are reviewed, the claimant is notified of whether the loan will be discharged.

As the IRS recognized:

[D]etermining whether one or more of these exceptions [the Defense to Repayment discharge process, the insolvency exclusion, or another tax law authority] is available to each affected borrower would require a fact intensive analysis of the particular borrower's situation to determine the extent to which the discharged amount is eligible for exclusion under each of the potentially available exceptions.¹⁶

In guidance issued in 2015 applicable to forgiven student loans involving a specific institution, the IRS concluded that this 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."¹⁷ Thus, the IRS determined that affected taxpayers were not required to include the forgiven loans in income.¹⁸ The IRS subsequently issued similar guidance applicable to forgiven student loans involving a different institution.¹⁹

These Revenue Procedures provide much-needed *ad hoc* guidance, but do not address the needs of similarly situated taxpayers whose forgiven loans did not involve the specified institutions. Thus, taxpayers not within the ambit of the revenue procedures have no alternative but to shoulder a compliance burden "excessive in relation to the amount of taxable income that would result."²⁰

Another example of a situation in which it appears an exception would likely apply to exclude forgiven student debt from income is where an income-driven repayment plan is in place. These plans allow certain student loan borrowers to repay their loans by remitting to ED a specified percentage of their

15 See Federal Student Aid, ED, *Application for Borrower Defense to Loan Repayment*, <https://studentaid.ed.gov/sa/sites/default/files/borrower-defense-application.pdf> (last visited Nov. 20, 2017). Each of these questions includes a follow-up question: "Did you choose to enroll in your school based in part on the issues describe [sic] above?" The application also asks: "Do you have any other reasons relating to your school that you believe qualify you for borrower defense, such as your school failing to perform its obligations under its contract with you, or that there is a judgment against your school in a Federal court, a State court, or in front of an administrative board or that you believe that you have a state law cause of action against the school? Is there some other reason you feel your school misled you?"

16 Rev. Proc. 2015-57 § 2.03.

17 *Id.* (providing that students who attended a school owned by Corinthian Colleges whose loans were forgiven by ED are not required to report the forgiven loans as income).

18 Rev. Proc. 2015-57 § 4.01.

19 *Id.* at § 2.03 (noting "[t]he Treasury Department and the IRS conclude that most borrowers whose Federal student loans taken out by taxpayers to finance attendance at a school owned by ACI [American Career Institutes] that are discharged under the Defense to Repayment discharge process would be able to exclude from gross income all or substantially all of the discharged amounts based on fraudulent or material misrepresentations made by the schools owned by ACI to the students or based on the insolvency exclusion or another tax law authority." The guidance provides that ACI students whose loans were forgiven by ED are not required to report the forgiven loans as income and notes that ED will not issue Form 1099-C for the forgiveness of ACI's student loans).

20 Rev. Proc. 2015-57 § 2.03.

discretionary income (10, 15, or 20 percent, depending on the plan) over a period of 20 or 25 years.²¹ Discretionary income is the excess of the student's income over the federal poverty level or 150 percent of the federal poverty level, depending on the plan.²² At the expiration of the repayment period, ED forgives the borrower's remaining loan balance. ED provides this example:

- You are single and your family size is one, your adjusted gross income (AGI, as reported on your federal income tax return) is \$40,000, and you have \$45,000 in eligible federal student loan debt.
- 150 percent of the 2016 federal poverty level for a family of one is \$17,820. The difference between your AGI and 150 percent of the federal poverty guideline amount is \$22,180. This is your discretionary income. Ten percent of your discretionary income is \$2,218. Dividing this amount by 12 results in a monthly payment of \$184.83.²³

There is no statutory provision (other than IRC § 108, as discussed above) allowing taxpayers to exclude these forgiven loans from income, and the IRS has not issued any guidance analogous to Revenue Procedure 2015-57 or Revenue Procedure 2017-24 that would allow creditors and taxpayers to treat the canceled debt as excludible from income.

Even When Forgiven Student Loan Is Clearly Excluded From Income, Claiming the Exclusion Is Burdensome

A creditor that cancels a debt is generally required to report that amount to the IRS on Form 1099-C, and provide a copy to the taxpayer.²⁴ Form 1099-C does not indicate the extent to which the canceled debt is subject to an exception under IRC §108(a) or excludible from the debtor's income under IRC § 108(f). Form 1099-C does not show, for example, that a debtor was insolvent when the debt was canceled, because it would be difficult if not impossible for the creditor to determine whether that condition was met. The form also does not indicate when non-IRC statutory provisions may make a canceled student loan excludible from income, even though the creditor is able to identify those provisions. Thus, the IRS generally treats forgiven student loans reported on Form 1099-C as required to be included in income.²⁵ Taxpayers who wish to exclude canceled debt from income must generally claim the exclusion by filing Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness* with their returns. The National Taxpayer Advocate has for years described the difficulty taxpayers encounter in understanding Form 1099-C and preparing Form 982.²⁶ A recent TAS survey shows that

21 For a description of various aspects of income-driven repayment plans (e.g., Pay As You Earn Repayment Plans (PAYE), Revised Pay As You Earn Repayment Plans (REPAYE), Income-Based Repayment Plans (IBR), and Income-Contingent Repayment Plans (ICR)), see Federal Student Aid, ED, Income Driven Plans, <https://studentaid.ed.gov/sa/repay-loans/understand/plans/income-driven> (last visited Nov. 20, 2017).

22 20 U.S.C. § 1087e(d)(D); 34 C.F.R. §§ 685.209(a)(2)(i) (PAYE), 685.209(c)(2)(i) (REPAYE), and 685.221(b)(1) (IBR).

23 Federal Student Aid, ED, *Income-Driven Repayment Plans: Questions and Answers*, Q. 17, <https://studentaid.ed.gov/sa/sites/default/files/income-driven-repayment-q-and-a.pdf> (last visited Nov. 20, 2017).

24 IRC § 6050P(a). Treas. Reg. § 1.6050P-1(a) requires creditors that discharge an indebtedness of at least \$600 during any calendar year to file a Form 1099-C information return with the IRS.

25 For a description of the IRS's reliance on Form 1099-C, which may be inaccurate and may not actually signal that a taxable event has occurred, see National Taxpayer Advocate 2010 Annual Report to Congress 149 (Most Serious Problem: *Third-Party Reporting of Cancellation-of-Debt Events is Not Always Accurate, and the IRS's Reliance on Such Reporting May Burden Taxpayers*).

26 The National Taxpayer Advocate has long identified cancellation of debt as a serious problem faced by taxpayers (National Taxpayer Advocate 2007 Annual Report to Congress 13 Most Serious Problem: *Tax Consequences of Cancellation of Debt Income*; National Taxpayer Advocate 2008 Annual Report to Congress 39 Most Serious Problem: *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income*), and recommended simplifying the tax treatment of cancellation of debt income (National Taxpayer Advocate 2008 Annual Report to Congress 391, Legislative Recommendation: *Simplify the Tax Treatment of Cancellation of Debt Income*).

taxpayers who seek information on the IRS's website for information about an IRS notice frequently do not find it.²⁷

Compounding the difficulty, the IRS no longer assists taxpayers with return preparation at its walk-in sites and no longer answers tax law questions outside of the tax filing season, which runs from January to April.²⁸ Student loan cancellation of debt is “out of scope” for both the Volunteer Income Tax Assistance (VITA) program (which provides free basic income tax return preparation to taxpayers who generally make \$54,000 or less) and the Tax Counseling for the Elderly (TCE) program (which offers free tax help for taxpayers 60 years of age and older).²⁹

REASONS FOR CHANGE

Student loans may be forgiven under circumstances that suggest the taxpayer would not be required to include the amount discharged in income. The IRS has already identified two instances in which students whose loans were forgiven pursuant to the Defense to Repayment discharge process were likely eligible to exclude the forgiven debt from income; the IRS determined not to assert that those taxpayers recognized gross income from the debt cancellation. Providing a uniform exclusion when student loans are forgiven pursuant to the Defense to Repayment process would treat similarly situated taxpayers alike without taxpayers being forced to seek guidance on an *ad hoc* basis.

In order for student loans to be forgiven pursuant to income-driven repayment provisions, the student must have made payments over a long period (at least 20 years).³⁰ Those payments, calculated on the basis of disposable income, which is in turn determined with reference to the federal poverty level, must have been insufficient to fully repay the debt at the end of that period. A taxpayer in this situation may be unlikely to have acquired assets in excess of liabilities, *i.e.*, he or she may qualify for the insolvency exception, but will be burdened by the requirement to file Form 982. Consuming IRS resources in the ensuing case-by-case determinations appears inefficient in relation to the amount of taxable income that would likely result.

27 See Research Study: *A Further Exploration of Taxpayers' Varying Abilities and Attitudes Toward IRS Options for Fulfilling Common Taxpayer Service Needs* vol. 2, *infra*, noting that about 60 percent of taxpayers who used the web to get information about an IRS notice did not get full resolution, and of those, around half stated they did not find the information or service they were looking for.

28 See Most Serious Problem: *Taxpayer Assistance Centers (TACs): Cuts to IRS Walk-In Sites Have Left the IRS With a Substantially Reduced Community Presence and Have Impaired the Ability of Taxpayers to Receive in-Person Assistance*, *supra*.

29 See IRS, *Free Tax Return Preparation for Qualifying Taxpayers*, <https://www.irs.gov/individuals/free-tax-return-preparation-for-you-by-volunteers> (last visited Sept. 23, 2017). The income eligibility threshold for Volunteer Income Assistance Tax Assistance (VITA) assistance changes each year. See IRS Publication 5220, *VITA/TCE Volunteer Site Scope & Referral Chart* (Dec. 2016). See also Most Serious Problem: *VITA/TCE Programs: IRS Restrictions on Volunteer Income Tax Assistance (VITA) and Taxpayer Counseling for the Elderly (TCE) Programs Increase Taxpayer Burden and Adversely Impact Access to Free Tax Preparation for Low Income, Disabled, Rural, and Elderly Taxpayers*, *supra*.

30 See <https://studentaid.ed.gov/sa/repay-loans/understand/plans/income-driven>.

EXPLANATION OF PROVISION

The proposal would not create a general exclusion for student loan discharges. The proposed amendment to IRC § 108(a) would apply in three situations in which the taxpayer may already qualify to exclude the forgiven debt in income and is thus consistent with the existing insolvency exclusion. These circumstances are where a student loan is forgiven under the Defense to Repayment process; or pursuant to income-driven repayment provisions. Amending IRC § 6050P to clarify that creditors are not required to report the canceled debt in these circumstances would eliminate the inefficiencies that arise when creditors issue unnecessary Forms 1099-C.