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Camp Reform Draft Might Spell Trouble for Student Loan Exemptions.

The tax reform draft of House Ways and Means Committee Chair Dave Camp, R-Mich., proposes to eliminate tax breaks for student loans, and student loan relief advocates are concerned about the potential regressive effects of eliminating the breaks, as well as the potential retroactive application of such a move.

With House Ways and Means Committee member Kevin Brady, R-Texas, saying February 25 that the “student loan crisis” is a hindrance on “the future growth of the country” that must be rectified, student loan relief advocates were likely disappointed the next day to discover that committee Chair Dave Camp, R-Mich., was proposing to eliminate tax breaks for student loans in his tax reform discussion draft.

The Camp draft proposes to eliminate the student loan interest deduction and the exclusion of discharge of student loan indebtedness, among other student tax benefits. Advocates for student loan relief who were contacted by Tax Analysts are concerned about the potential regressive effects of eliminating the breaks, as well as the potential retroactive application of such a move.

“This is baffling to me,” Isaac Bowers of public service lawyers group Equal Justice Works said of Camp’s student loan proposals. “The [Congressional Budget Office] projects that the Department of Education is going to make about \$174 billion in profits through 2023, so I just don’t see a huge need to cut back on these education provisions that by and large help middle- and lower-class Americans.”

Under current law, gross income generally includes the taxpayer’s discharge of indebtedness, with some exceptions. Camp’s bill would eliminate section 108(f), which exempts from cancellation of indebtedness income student loans discharged after the individual worked for a predetermined period of time in professions involving education or other public benefits.

Congress in 1984 codified under section 108(f) temporary tax provisions that had been enacted in 1976 and 1978, because it believed that the tax break served an important purpose in encouraging doctors, nurses, and teachers to serve in rural and low-income areas. Concerned that the rule would apply too broadly, Congress tightened the exclusion to only loans canceled on the condition of performance of services for a specified, broad class of employers.

In 1984 the Joint Committee on Taxation estimated that section 108(f) would reduce budget receipts by less than \$5 million per year. According to a JCT analysis of Camp’s reform draft, eliminating the exclusion for discharge of student loan indebtedness is expected to increase revenues by \$1.1 billion from 2014 through 2023.

The repeal of section 108(f) would mean large tax bills for the many recent college graduates taking advantage of one of the many loan forgiveness programs. Under the proposal, they would have to include the amount of the discharged loan in gross income.

Two popular programs under section 108(f) are the teacher loan forgiveness and public service loan forgiveness (PSLF) programs.

The teacher loan forgiveness program applies to borrowers who are employed as full-time teachers for five consecutive years in elementary and secondary schools that serve low-income families, after which they may be eligible to have up to \$17,500 in student loan debt forgiven. PSLF borrowers must make 120 payments while employed by some public interest employers, including state and local governments, the federal government, and nonprofit organizations, after which the remaining balance of their federal direct student loans may be forgiven.

Bowers said that if discharge of indebtedness under PSLF becomes taxable, it will prevent many people from being able to use the program.

Someone who begins with \$80,000 in federal loans and takes a public service job making about \$40,000 a year could end up with a \$93,000 tax bill once the loan is forgiven, assuming a 3 percent annual salary raise, Bowers said. "Basically nobody would do that unless the amount they borrowed was low enough compared to their discretionary income so they would pay it off by the time of forgiveness," he said.

"People would have to do some fine-grain calculations over a long period of time to figure out if this would work for them," Bowers said. "And people's circumstances change."

Income-based repayment (IBR) and "pay as you earn" programs are not exempt from cancellation of indebtedness income, Bowers said, adding, "If the same thing happens to PSLF, many people will find that this is not a program that will help them, but in fact will hurt them."

Bowers said the purpose of PSLF was to allow people to take lower-paying public service jobs and manage their student debt. If section 108(f) is repealed, they'll just end up owing a huge amount to Treasury and "a lot of people are going to be dissuaded from doing public service work," Bowers said, adding, "People are going to look at this and say, 'I'm better off going to the private sector.'"

Retroactive?

John Buckley, former chief tax counsel for House Ways and Means Democrats and a member of Tax Analysts' board of directors, said he is concerned about the retroactive application of Camp's proposed repeal of the student loan indebtedness exclusion.

Under the draft bill, the repeal of section 108(f) would apply to all amounts discharged after December 31, 2014, regardless of when the loan or discharge agreement was entered into by the taxpayer.

Buckley said that although the effective date is not explicitly retroactive because it applies only to future discharges, it would have a retroactive effect "because people who are currently doing something to do loan discharge will find their expectations substantially disturbed." He added that it would be unfair to have program participants change their plans midstream.

But Buckley is hopeful that if Congress passes the bill, it will exempt existing contracts, despite the current proposal's retroactive effect. "Quite often, when Congress passes something like this, they exempt existing contracts," he said.

"In a commercial setting, [Congress] would generally exempt existing contracts. This is the result of a sense of fairness," Buckley added. "If you are changing the tax treatment of a contract, it is almost always prospective. You don't disturb existing contracts."

Obama Proposal

The Obama administration's fiscal 2015 budget plan proposes a broadening of section 108(f) to exclude from gross income those amounts forgiven at the end of the repayment period for some borrowers using the income-based or income-contingent repayment (ICR) options. The proposal would be effective for loans forgiven after December 31, 2014.

Under IBR and ICR, loans are discharged after the taxpayer makes payments contingent on income for 25 years.

The Obama administration reasoned that individuals meeting the forgiveness requirements will have had low incomes relative to their debt burden and that for many of those individuals, paying the tax on the forgiven amounts will be difficult.

However, the Obama budget also proposes limiting the PSLF amount to \$57,500, the undergraduate loan limit. Bowers said that proposal would almost certainly make PSLF untenable for professionals such as doctors, lawyers, and teachers who get advanced degrees and often incur debt in excess of the proposed cap.

New Bill of Hope?

On January 15, Rep. Frederica S. Wilson, D-Fla., introduced a bill that would exempt student loan forgiveness under the IBR and pay as you earn programs from cancellation of indebtedness income. The Student Loan Borrowers' Bill of Rights Act of 2013 (H.R. 3892) would amend section 108(f) to include all student loan discharges, regardless of circumstances surrounding them. The bill is currently pending before four House committees, including Ways and Means.

Bowers expressed support for Wilson's bill, saying, "This is the way we think things should be going."

Bowers added that nobody wants to be on IBR for 25 years but that people will be because of the high unemployment rate and inability of people to find jobs that will help them pay off their loans. And under current law, "those people are going to potentially face a humungous tax bill," he said.

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