

# Congress's Tax Bomb: Income-Based Repayment and Disarming a Problem Facing Student Loan Borrowers

Jonathan A. LaPlante

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### Recommended Citation

Jonathan A. LaPlante, *Congress's Tax Bomb: Income-Based Repayment and Disarming a Problem Facing Student Loan Borrowers*, 100 Cornell L. Rev. 703 (2015)  
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# NOTE

## CONGRESS'S TAX BOMB: INCOME-BASED REPAYMENT AND DISARMING A PROBLEM FACING STUDENT LOAN BORROWERS

*Jonathan A. LaPlante*<sup>†</sup>

INTRODUCTION: THE SCALE OF STUDENT LOANS AND THE NEED FOR A SOLUTION .....	704
I. BACKGROUND: INCOME-BASED REPAYMENT AND ISSUES WITH ITS MECHANICS .....	707
A. Existing Solutions to Prevent Default and Allow Repayment .....	707
B. The Tax Bomb .....	710
C. Current Cost Projections and Enrollment Data in IBR.....	715
II. ANALYSIS .....	717
A. Legislative History of § 1098e .....	717
B. Proposed Solutions for 20 U.S.C. § 1098e's Tax Bomb .....	721
C. A Policy Proposal to Address the Tax Bomb Without Forgoing Revenue .....	723
D. Mechanical and Conceptual Issues with This Proposal.....	727
CONCLUSION .....	731

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<sup>†</sup> B.A., Duquesne University, 2012; J.D. Candidate, Cornell Law School, 2015; Articles Editor, *Cornell Law Review*, Volume 100. Special thanks to Professor Leo Martinez and Professor Robert Green for their excellent instruction in the tax law. Thanks also to friends and family that have supported me throughout law school.

INTRODUCTION: THE SCALE OF STUDENT LOANS AND  
THE NEED FOR A SOLUTION

The landscape of higher education in the United States has shifted greatly in the past few years. More Americans are enrolling in college: the short span between 2001 and 2011 saw an increase of 37% in undergraduate enrollment.<sup>1</sup> Correlatively, more Americans are borrowing from the federal government to finance an education.<sup>2</sup> Partly due to higher undergraduate enrollment, a lower percentage of college graduates report that they are getting jobs that actually require a college degree.<sup>3</sup> This in turn means lower earnings for college graduates.<sup>4</sup> The confluence of these trends has led to more college graduates, with more debt, who default more on their student loans due to a lack of lucrative jobs, all of which translates to millions of struggling borrowers who would be greatly aided by a solution from the federal government.

Solutions for student loan borrowers have not been as forthcoming as solutions in other areas of consumer finance, such as credit cards and mortgages, which have been a critical goal of federal and state governments for decades. Several notable pieces of legislation, such as the Federal Truth in Lending Act,<sup>5</sup> the Credit CARD Act of 2009,<sup>6</sup> and portions of the Dodd-Frank Wall Street Reform and Consumer Protection Act,<sup>7</sup> have sought to provide protections to consumers of credit cards, mortgages, auto loans, and other consumer finance products. However, student loans are no less deserving of attention, especially considering that credit cards and auto loans are no longer the largest source of consumer debt: student loans have sur-

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<sup>1</sup> Inst. of Educ. Scis., *Fast Facts*, NAT'L CTR. FOR EDUC. STATISTICS, <http://nces.ed.gov/fastfacts/display.asp?id=98> (last visited Jan. 17, 2015).

<sup>2</sup> SANDY BAUM & KATHLEEN PAYEA, COLLEGE BOARD, *TRENDS IN STUDENT AID 2013*, at 4 (2013), available at <http://trends.collegeboard.org/sites/default/files/student-aid-2013-full-report.pdf>.

<sup>3</sup> Brad Plumer, *Only 27 Percent of College Grads Have a Job Related to Their Major*, WASH. POST (May 20, 2013), <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/05/20/only-27-percent-of-college-grads-have-a-job-related-to-their-major/> (discussing that 38% of graduates state that their job does not require a college degree).

<sup>4</sup> Alana Semuels, *College-Educated Workers Are Taking Jobs that Don't Require Degrees*, L.A. TIMES (Sept. 20, 2013, 5:00 AM), <http://www.latimes.com/business/la-fi-college-grads-20130920story.html> (noting that the average starting salary for college graduates has slipped 13% in the last decade).

<sup>5</sup> Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified at 15 U.S.C. § 1601 (2012)).

<sup>6</sup> Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (2009) (codified in scattered sections of U.S.C.).

<sup>7</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of U.S.C.).

passed both,<sup>8</sup> accounting for over \$1 trillion.<sup>9</sup> Reform of the student loan market is required immediately: student loans are already in a state of crisis, with 10% of student loans currently in default,<sup>10</sup> representing over \$85 billion in loans,<sup>11</sup> a number that has climbed significantly since 2010.<sup>12</sup>

There have been many proposals on the most effective way to fix student loans going forward. One proposal is to make student loans risk based like most other areas of consumer finance, taking into account the school's placement record.<sup>13</sup> The ultimate aim of risk-based student loans is to bring the maximum amount lenders will give for a student attending a particular school in line with the average employment results for graduates of that school, thereby incentivizing the selection of more employable courses of study by students.<sup>14</sup> This differs from the status quo, where a certain level of student loan funding is guaranteed to any student, regardless of creditworthiness, school, or major choice.<sup>15</sup> Other proposals involve penalizing colleges with high default rates or low graduation rates by lowering the ceiling of federal aid allowed to individual schools based on default rates after graduation,<sup>16</sup> which act as a proxy for student employment outcomes.<sup>17</sup>

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<sup>8</sup> Daniel de Vise, *Student Loans Surpass Auto, Credit Card Debt*, WASH. POST (Mar. 6, 2012, 10:54 AM), [http://www.washingtonpost.com/blogs/college-inc/post/student-loans-surpass-auto-credit-card-debt/2012/03/06/gIQARFQnuR\\_blog.html](http://www.washingtonpost.com/blogs/college-inc/post/student-loans-surpass-auto-credit-card-debt/2012/03/06/gIQARFQnuR_blog.html).

<sup>9</sup> Janet Lorin, *Student-Loan Debt Reaches Record \$1 Trillion*, REPORT SAYS, BLOOMBERG (Mar. 22, 2012, 11:17 AM), <http://www.bloomberg.com/news/2012-03-22/student-loan-debt-reaches-record-1-trillion-u-s-report-says.html>.

<sup>10</sup> Press Release, U.S. Dep't of Educ., *Default Rates Continue to Rise for Federal Student Loans* (Sep. 30, 2013), available at <http://www.ed.gov/news/press-releases/default-rates-continue-rise-federal-student-loans>.

<sup>11</sup> De Vise, *supra* note 8.

<sup>12</sup> See Megan McArdle, *The High Cost of College*, THE ATLANTIC (Sept. 23, 2010, 10:57 AM), <http://www.theatlantic.com/business/archive/2010/09/the-high-cost-of-college/63445/> (stating that the default rate on student loans in 2010 was 7%).

<sup>13</sup> See Michael Simkovic, *Risk-Based Student Loans*, 70 WASH. & LEE L. REV. 527, 637 (2013) (proposing risk-based pricing of student loans based on long-term data that matches schooling records with student loan performance, federal income tax, and Social Security Administration records).

<sup>14</sup> See *id.* at 529–30 (arguing that risk-based loans would make students more aware of which majors lead to better employment outcomes, resulting in a more productive workforce and lower graduate underemployment).

<sup>15</sup> Federal Stafford loans are available regardless of creditworthiness. The current amount guaranteed ranges from \$5,500 to \$7,500 for undergraduates and to \$20,500 for graduate students. See *Subsidized and Unsubsidized Loans*, U.S. DEP'T OF EDUC., <http://studentaid.ed.gov/types/loans/subsidized-unsubsidized> (last visited Jan. 17, 2015).

<sup>16</sup> See McArdle, *supra* note 12 (discussing the impact of penalizing colleges for high dropout rates and limiting loan amounts on the loan system).

<sup>17</sup> Comprehensive employment data is not available for undergraduate schools. This leaves default rates the best measure for student employment outcomes because more students in default is a signal for more students that are unable to find a job. See *College Scorecard*, COLL. AFFORDABILITY & TRANSPARENCY CTR., U.S. DEP'T OF EDUC., <http://>

The main issue with these proposals is that they may incentivize universities to avoid servicing populations that are more prone to default and dropping out, especially low-income students.<sup>18</sup> This potential problem of discrimination that would occur in a risk-based student loan regime is worsened by universities having a pretense of admitting students holistically: schools may consciously not admit low-income or minority populations and attribute it to a lack of extracurricular activities, student involvement, or other unquantifiable factors. Since college admissions are not based solely on test scores,<sup>19</sup> a risk-based student loan regime would require built-in safeguards in order to prevent potential discrimination by universities, which would have a financial disincentive by admitting students who may struggle to ultimately find jobs.

It is practically inarguable that the federal government must reform student loans and the way that they are distributed in some meaningful way, and risk-based student loans or similar programs would be a meaningful step in the right direction. The difficulty with such far-reaching proposals lies in their chances of implementation and the likely long wait for reform. While risk-based student loans and others proposals may be effective at solving issues surrounding student loans in the long run, something must be done to address issues relating to the \$1.2 trillion of student loans already in existence, including the large portion of loans that are in default.<sup>20</sup> Eventually Congress will likely address student loans in a comprehensive way, but Congress must act now to address those who are already struggling.

This Note examines Income-Based Repayment (IBR), a repayment program that allows borrowers to pay a fixed share of their discretionary income over twenty-five years instead of the standard ten-year plan that has fixed monthly payments designed to fully repay the loan in 120 installments.<sup>21</sup> Part II details the mechanics of IBR and how it works for most borrowers; explores one of the largest issues with the program, the one-time tax liability that borrowers face at the

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[collegecost.ed.gov/scorecard/UniversityProfile.aspx?org=s&id=19045](http://collegecost.ed.gov/scorecard/UniversityProfile.aspx?org=s&id=19045) (last visited Feb. 20, 2015).

<sup>18</sup> See McArdle, *supra* note 12 (noting these issues and other issues, in addition to proposing school sanctions as solutions to fix the loan system).

<sup>19</sup> See, e.g., *We Are Looking For . . .*, CORNELL UNIV., COLL. OF ARTS & SCIENCES, <http://as.cornell.edu/admissions/good-candidates.cfm> (last visited Jan. 17, 2015) (stating that admissions looks at “what activities, jobs and interests you have outside the classroom” in addition to SAT and ACT scores).

<sup>20</sup> See Lorin, *supra* note 9. Default rates are higher for some schools, with the rate being 12.9% for public colleges and 19.1% for for-profit institutions. Allie Bidwell, *Student Loan Default Rate Drops 7 Percent in One Year*, U.S. NEWS & WORLD REP. (Sept. 24, 2014, 11:00 AM), <http://www.usnews.com/news/articles/2014/09/24/student-loan-default-rate-decreases-but-some-question-federal-free-passes>.

<sup>21</sup> 20 U.S.C. § 1098e(a)(3) (2012); see also *infra* text accompanying note 30.

end of the repayment period; and then examines the federal government's cost projections for the program and current enrollment rates in the program. The one-time tax liability is often a significant liability, and borrowers may be unable to pay unless they were saving a large sum of money for the express purpose of repayment. Part II.A analyzes the extensive legislative history surrounding 20 U.S.C. § 1098e, the IBR statute, as well as other student loan and taxation provisions. Part II.B evaluates current solutions that have been offered to fix this one-time tax liability, and ultimately Parts II.C and II.D propose a solution to eliminate the large one-time liability without resulting in a vastly increased cost for the federal government.

## I

### BACKGROUND: INCOME-BASED REPAYMENT AND ISSUES WITH ITS MECHANICS

#### A. Existing Solutions to Prevent Default and Allow Repayment

In order to address the problems with current borrowers who are struggling, Congress has instituted several programs to assist with the repayment of student loans. Repayment of student loans defaults to a standard repayment schedule, which requires the full payment of the loan in 120 payments or ten years.<sup>22</sup> This is a fixed-payment amount, and it is not adjusted for changes in borrower income.<sup>23</sup> Since the standard repayment amount is the same right after graduation as several years after graduation, many borrowers struggle to make payments at the beginning of their careers.<sup>24</sup>

To counter this, new repayment programs have been introduced that are linked to borrower income and increase the repayment time of the loan. These programs include IBR<sup>25</sup> and Pay As You Earn (PAYE).<sup>26</sup> These programs allow graduates to pay a fixed share of

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<sup>22</sup> *Repayment Plans*, U.S. DEP'T OF EDUC., <http://studentaid.ed.gov/repay-loans/understand/plans> (last visited Jan. 19, 2015).

<sup>23</sup> *See id.*

<sup>24</sup> Cohort default rates (CDR) measure the number of borrowers who default within a certain period time. The Department of Education announced that the national two-year CDR rose from 9.1% in fiscal year 2010 to 10% in fiscal year 2011 and that the national three-year CDR rose from 13.4% in 2009 to 14.7% in 2010. *See, e.g.,* Allie Bidwell, *Student Loan Default Rates Rise for Sixth Year*, U.S. NEWS & WORLD REP. (Oct. 1, 2013, 1:49 PM), <http://www.usnews.com/news/articles/2013/10/01/student-loan-default-rates-rise-for-sixth-year> (explaining that the number of borrowers defaulting two years into repayment has increased six years in a row); Press Release, Bill Swindell et al., The Inst. for Coll. Access & Success, New Data Confirm Troubling Student Loan Default Problems (Sept. 30, 2013), *available at* [http://www.ticas.org/files/pub/CDR\\_2013\\_NR.pdf](http://www.ticas.org/files/pub/CDR_2013_NR.pdf) ("More than 600,000 federal student loan borrowers who entered repayment in 2010 defaulted on their loans by 2012, new federal data show.").

<sup>25</sup> 20 U.S.C. § 1098e.

<sup>26</sup> *Income-Driven Repayment Plans for Federal Student Loans*, U.S. DEP'T OF EDUC. (July 2014), <http://studentaid.ed.gov/sites/default/files/pay-as-you-earn.pdf>.

their income for a longer period of time than the standard repayment period. Under IBR, students that borrowed their first student loan before 2014 pay 15% of their discretionary income for twenty-five years, and students that borrow their first loan after January 1, 2014, pay 10% of their discretionary income for twenty years.<sup>27</sup> However, because the amount of the payment is linked to borrower income and not the outstanding amount of the loan, part of the loan balance often remains, which is forgiven at the end of the repayment period.<sup>28</sup> In order to ensure that only borrowers that need relief can use the program, eligibility for IBR students is limited to those that are suffering from a partial financial hardship, which is determined by a formula.<sup>29</sup>

The formula to assess a borrower's partial financial hardship is a binary standard: if the amount of the student's loan payment using the standard repayment calculation in 20 U.S.C. § 1078(b)(9)(A)(i) or 20 U.S.C. § 1087e(d)(1)(A) would exceed 15% of the borrower's discretionary income, the borrower is eligible for IBR.<sup>30</sup> Discretionary income is defined by the statute as the amount by which the borrower's adjusted gross income exceeds 150% of the poverty line.<sup>31</sup> This formula can be simplified by mathematical representation:  $\text{Standard Payment} > 0.15(\text{AGI} - 1.5 \times \text{Poverty Line})$ .<sup>32</sup> If that equation is true, then the borrower has partial financial hardship and is able to take advantage of IBR.

By way of illustration, assume there is a borrower with \$125,000 of student loan debt, the average for graduates of private law schools.<sup>33</sup> This loan would have a \$17,262 annual payment under the standard repayment method, which involves 120 monthly payments.<sup>34</sup> The

<sup>27</sup> 20 U.S.C. § 1098e.

<sup>28</sup> See *Income-Driven Plans*, U.S. DEP'T OF EDUC., <http://studentaid.ed.gov/repay-loans/understand/plans/income-based> (last visited Jan. 18, 2015) ("Under all three [income-driven repayment] plans, any remaining loan balance is forgiven if [the] federal student loans are not fully repaid at the end of the repayment period.").

<sup>29</sup> 20 U.S.C. § 1098e(b)(1).

<sup>30</sup> *Id.* § 1098e(a)(3) (defining partial financial hardship).

<sup>31</sup> *Id.* § 1098e(a)(3)(B).

<sup>32</sup> As a note, the calculations throughout this Note assume the borrower's first loan was distributed before 2014, which means that the 15% rate still applies, instead of the new lower 10% rate. See *Ensuring that Student Loans are Affordable*, WHITE HOUSE, <http://www.whitehouse.gov/issues/education/higher-education/ensuring-that-student-loans-are-affordable> (last visited Jan. 18, 2015) (explaining the new law limiting IBR plan repayments to 10% of income).

<sup>33</sup> Debra Cassens Weiss, *Average Debt of Private Law School Grads Is \$125K; It's Highest at These Five Schools*, A.B.A. J. (Mar. 28 2012, 10:29 AM), [http://www.abajournal.com/news/article/average\\_debt\\_load\\_of\\_private\\_law\\_grads\\_is\\_125k\\_these\\_five\\_schools\\_lead\\_to\\_m/](http://www.abajournal.com/news/article/average_debt_load_of_private_law_grads_is_125k_these_five_schools_lead_to_m/).

<sup>34</sup> This monthly payment is calculated using present figures for interest on Stafford Loans and Graduate Plus Loans, which are the types of loans most commonly used for graduate school. See *Subsidized and Unsubsidized Loans*, U.S. DEP'T OF EDUC., <http://studentaid.ed.gov/types/loans/subsidized-unsubsidized> (last visited Jan. 19, 2015).

Department of Health and Human Services currently has the poverty line set at \$11,490 for an individual and \$15,510 for a family of two, making 150% of the poverty line \$17,235 and \$23,265, respectively.<sup>35</sup> All single borrowers with income less than \$132,315<sup>36</sup> are qualified to use IBR.<sup>37</sup> The amount for married borrowers will depend on the spouse's income.<sup>38</sup> While it may be difficult to conceptualize a six-figure income resulting in partial financial hardship, the correlating debt load for this hypothetical borrower is also high, and is close to the maximum amount experts recommend borrowing: no more than the borrower's expected first-year salary.<sup>39</sup>

This example helps to illustrate the importance of the initial principal borrowed and is especially demonstrative when paired with a lower figure: when the principal of the above example is changed to \$26,600, the average amount of student loan debt incurred by undergraduates that borrow student loans, the point where borrowers become ineligible for IBR is reduced considerably.<sup>40</sup> This annual loan

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<sup>35</sup> Annual Update of the HHS Poverty Guidelines, 78 Fed. Reg. 5,182, 5,183 (Jan. 24, 2013).

<sup>36</sup> Calculated using the above formula of Standard Payment  $> 0.15(\text{AGI} - 1.5 \times \text{Poverty Line})$ . The standard annual payment is \$17,262, and 150% of the poverty line is \$17,235. With these figures inserted, the equation becomes  $17,262 > 0.15(\text{AGI} - 17,235)$ . When the variable AGI is solved for, it equals \$132,315. Solving for AGI in this context means finding the threshold where the borrower is no longer able to use IBR.

<sup>37</sup> This assumes no above-the-line deductions, such as those that appear in 26 U.S.C. § 165. This calculation also uses the interest rates for federal Stafford Loans when determining the amount the borrower owes under the standard payment schedule and also assumes that borrowers are paying origination costs at the time of borrowing instead of adding them to the loan. The annual standard payment could be even larger with other types of loans, such as private student loans, which typically carry higher interest rates and higher origination fees. See Karen Weise, *Why Your Student Loan Interest Rate Is So High*, BLOOMBERG BUS. WK. (Apr. 4, 2013), <http://www.businessweek.com/articles/2013-04-04/why-your-student-loan-interest-rate-is-so-high> ("Private loans historically have been more expensive than federal ones.")

<sup>38</sup> 20 U.S.C. § 1098e(d) (2012). In this way, § 1098e arguably imposes a marriage penalty in the case of a borrower with significant student loan debt and a spouse with income but no or little student loan debt.

<sup>39</sup> See, e.g., Kim Clark, *How Much Money Should I Borrow for College?*, U.S. NEWS & WORLD REP. (June 9, 2009, 10:51 AM), <http://www.usnews.com/education/best-colleges/paying-for-college/articles/2009/06/09/how-much-money-should-i-borrow-for-college> ("Another rule of thumb that experts . . . often suggest: Cap total student debt below the first year's expected salary . . . ."); Kathleen Pender, *Students Should Limit Borrowing, Pay Loans Off Quickly*, SF GATE (May 17, 2014, 2:51 PM), <http://www.sfgate.com/business/networth/article/students-should-limit-borrowing-pay-loans-off-5486344.php> ("Total student loan debt at graduation should be less than your expected annual starting salary, and ideally a lot less." (quoting an expert on financial aid)).

<sup>40</sup> MATTHEW REED & DEBBIE COCHRANE, PROJECT ON STUDENT DEBT, STUDENT DEBT AND THE CLASS OF 2011, at 21 (2012), available at <http://projectonstudentdebt.org/files/pub/classof2011.pdf>. As an important caveat, that figure only includes the average of those who borrowed student loan debt, which excludes a significant number of college students who pay for college through other means, such as parental contributions.

payment is a much more reasonable \$3,672, instead of \$17,262.<sup>41</sup> This in turn means that borrowers with less than \$41,715 of income will qualify for IBR.<sup>42</sup>

IBR is of chief importance in order to ensure that students who pursue careers in public service, such as civil servants, teachers, prosecutors, and police officers are free to choose these careers over more lucrative options.<sup>43</sup> It also, perhaps more importantly, ensures that students who overborrowed are able to have productive economic lives without the constant specter of crushing student loan debt.<sup>44</sup> IBR is also effective in ensuring that there are real consequences to student borrowing without overwhelming the students. One policy justification for not forgiving student loans outright is that students should understand the consequences of borrowing large sums of money for school, or there would be no incentive for students to borrow responsibly.<sup>45</sup> IBR and programs like it reach a middle ground by requiring the repayment of a significant portion of a graduate's income without making the payment onerous enough to be unaffordable.

## B. The Tax Bomb

While the IBR provision allows graduates to pay back their loans by paying a manageable percentage of their income, the provision has a significant shortfall that must be fixed before the first borrowers using IBR have their loans forgiven in 2034.<sup>46</sup> When the borrower's loan is forgiven, it is counted as a discharge of indebtedness.<sup>47</sup> This may sound intuitive because the graduate does not have to pay back the rest of the amount. Unfortunately, this distinction has a downside: a discharge of indebtedness is counted as part of the taxpayer's

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<sup>41</sup> This repayment figure is calculated using the Loan Payment Calculator on FinAid, a resource for information concerning higher education. See *Loan Calculator*, FINAID, <http://www.finaid.org/calculators/loanpayments.phtml> (last visited Jan. 18, 2014).

<sup>42</sup> This once again assumes that a borrower would have no above-the-line deductions in reaching the calculation for adjusted gross income.

<sup>43</sup> *Public Service Loan Forgiveness Program*, U.S. DEP'T OF EDUC. (Dec. 2013), <http://studentaid.ed.gov/sites/default/files/public-service-loan-forgiveness.pdf>.

<sup>44</sup> See, e.g., REED & COCHRANE, *supra* note 40, at 16 (noting how high student debt can limit one's ability to "save for a home, a family, retirement, or one's own children's education").

<sup>45</sup> Arguably IBR and programs like it are ineffective at making students aware of the amount they are borrowing because repayment does not begin until borrowers graduate or drop out of school when it is too late to make any meaningful changes to their borrowing decisions.

<sup>46</sup> IBR went into effect in 2009, and the program at the time had a twenty-five-year repaying period before the forgiveness of loans. This translates into the first borrowers having their loans forgiven in 2034. 20 U.S.C. § 1098e(b)(7)(B) (2012).

<sup>47</sup> See *infra* notes 52–55 and accompanying text.

gross income for the year.<sup>48</sup> This translates into a one-time tax liability, which for borrowers with high amounts of student debt and low income can be greater than the median income in the United States.<sup>49</sup>

The reason for this one-time tax liability has its roots in federal income tax law. Under most circumstances, a taxpayer's gross income does not include borrowed amounts, because borrowing money is linked to an obligation to repay the funds, meaning that the borrower has not gained any wealth through the transaction.<sup>50</sup> This means that when students take out loans for education, those amounts do not need to be reported as income.<sup>51</sup> However, when a loan is forgiven, this corresponding obligation to repay is removed, meaning that the borrower has an acquisition of wealth equal to the amount of the loan.<sup>52</sup> The provision of the Internal Revenue Code that concerns the discharge of indebtedness<sup>53</sup> exempts the discharge of student loans under specific programs from gross income, most notably exempting public sector loan forgiveness programs.<sup>54</sup> However, there is no blanket exemption for the discharge of student loans, meaning that for most borrowers when the loan is forgiven, the balance will be counted as income for the taxable year.<sup>55</sup>

Including discharged indebtedness in gross income makes conceptual sense in the case of purchase of tangible property. For exam-

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<sup>48</sup> 26 U.S.C. § 61(a)(12) (2012).

<sup>49</sup> Ron Lieber, *For Student Borrowers, Relief Now May Mean a Big Tax Bill Later*, N.Y. TIMES (Dec. 14, 2012), [http://www.nytimes.com/2012/12/15/your-money/for-student-borrowers-a-tax-time-bomb.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2012/12/15/your-money/for-student-borrowers-a-tax-time-bomb.html?pagewanted=all&_r=0). The Census Bureau estimates that the median household income in the United States was \$51,939 in 2013. See CARMEN DENAVAS-WALT & BERNADETTE D. PROCTOR, INCOME AND POVERTY IN THE UNITED STATES: 2013, at 5 (2014), available at <http://www.census.gov/content/dam/Census/library/publications/2014/demo/p60-249.pdf>. Depending on student borrowing levels and income, the one-time tax liability could easily exceed this amount. For specific calculations of this one-time liability, see *infra* Part II.D.

<sup>50</sup> While the rule that borrowed amounts do not count as gross income is not codified in the Internal Revenue Code, it was established in the seminal case of *Commissioner of Internal Revenue v. Glenshaw Glass Co.*, 348 U.S. 426, 426 (1955) (giving the definition of gross income as "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion," which loans do not qualify for because the taxpayer does not have complete dominion over the funds).

<sup>51</sup> *Id.*

<sup>52</sup> See 26 U.S.C. § 108(a)(1) (stating that discharge from indebtedness is counted as gross income in certain circumstances).

<sup>53</sup> Stephen J. Dunn, *Discharge of Indebtedness Income? Really?*, FORBES (Feb. 18, 2012, 2:30 PM), <http://www.forbes.com/sites/stephendunn/2012/02/18/discharge-of-indebtedness-income-really-2/>.

<sup>54</sup> 26 U.S.C. § 108(f)(4).

<sup>55</sup> See *id.* § 108(f)(1) (stating that the discharged amount is only excluded "if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers").

ple, if a borrower negotiates with creditors to settle \$4,000 of credit card debt for \$1,000, they will have \$3,000 of discharge from indebtedness income.<sup>56</sup> Presumably, the taxpayer purchased goods and services with that \$4,000 that they consumed or held, giving stronger support to the notion that the taxpayer has benefitted by an amount equal to the forgiveness. The taxpayer received \$4,000 of goods for \$1,000, meaning that the taxpayer had an accession to wealth of \$3,000.<sup>57</sup>

This is a critical difference from discharge of indebtedness in the higher education context. Educational credentials are intangible, and their true values have the propensity to be far out of line with their cost because the market for education is distorted by the availability of non-risk-based, near-unlimited credit and the nebulous value proposition of higher education.<sup>58</sup> This casts doubt that the amount that will

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<sup>56</sup> There will be discharge from indebtedness income unless the forgiveness takes place in the context of bankruptcy. *See id.* § 108(a)(1)(B).

<sup>57</sup> *Cf.* Ray Martin, *Cancellation of Debt Income: How to Exclude from Gross Income*, CBS NEWS, <http://www.cbsnews.com/news/cancellation-of-debt-income-how-to-exclude-from-gross-income/> (last updated Apr. 5, 2011, 9:30 AM) (explaining the mechanics of discharge of indebtedness in a similar case of a credit card settlement).

<sup>58</sup> *Compare* AM. BAR ASS'N SECTION OF LEGAL EDUC. & ADMISSIONS TO THE BAR, UNIVERSITY OF CALIFORNIA, BERKELEY EMPLOYMENT SUMMARY FOR 2013 GRADUATES (2013), *available at* <http://employmentsummary.abaquestionnaire.org/> (last updated Mar. 17, 2014, 2:36 PM) (select "University of California – Berkeley" and "2013" from the "Individual School Summary Reports" section) (stating that 82.5% of 2013 graduates were employed long term in firms of over one hundred lawyers, federal clerkships, public interest, or government), *with* AM. BAR ASS'N SECTION OF LEGAL EDUC. & ADMISSIONS TO THE BAR, CHAPMAN UNIVERSITY EMPLOYMENT SUMMARY FOR 2013 GRADUATES (2013), *available at* <http://employmentsummary.abaquestionnaire.org/> (select "Chapman University" and "2013" from the "Individual School Summary Reports" section) (stating that 12.9% of 2013 graduates were employed long term in firms of over one hundred lawyers, federal clerkships, public interest, or government). These are the categories of jobs that either allow borrowers to earn salaries that they can use to repay large student loan obligations or are eligible for public sector loan forgiveness programs. This measure is imperfect, however. There are some small law firms that pay enough for students to service large debt loads, and some of the public interest or government jobs may be university-funded positions that qualify as "Full Time, Long Term" employment based on how the ABA defines the category. *See New Research on Law School Funded Positions for Law School Graduates*, NAT'L ASS'N FOR LAW PLACEMENT (Sept. 2012), [http://www.nalp.org/sept12research\\_lsfunded](http://www.nalp.org/sept12research_lsfunded) (stating that in the class of 2011 almost 5% of jobs were funded by the graduate's law school). Despite this, the ABA data represents the best available proxy for what represents a good outcome from law school. Given the significantly better outcomes from Berkeley, if the economy for higher education worked efficiently, the cost of a school like Chapman would be considerably less. However, this is not true. *Compare University of California - Berkeley Profile*, LAW SCHOOL TRANSPARENCY, <http://www.lstscoreports.com/schools/berkeley/costs/2013/> (last visited Jan. 19, 2015) (stating that the nondiscounted cost of a degree is \$296,910), *with Chapman University Profile*, LAW SCHOOL TRANSPARENCY, <http://www.lstscoreports.com/schools/chapman/costs/2013/> (last visited Jan. 19, 2015) (stating that the nondiscounted cost of a degree is \$279,419). This information demonstrates the asymmetry in the value proposition of education by school, furthering the argument that the price of the intangible asset that will be forgiven does not reflect the actual value that the borrower has received, making the application of 26 U.S.C. § 108 less rational than in the tangible goods

be counted as gross income at the time of forgiveness will be in line with the long-run, difficult-to-estimate benefits received for many student loan borrowers, such as career advancement or additional salary.<sup>59</sup> Moreover, in the tangible goods context, such as with an auto loan settlement or credit card settlement, the taxpayer can sell these goods in order to address a potential cash shortfall when the tax liability that results from the forgiven amount is counted as part of the borrower's gross income, which cannot be done with a human capital product like education.<sup>60</sup>

Consumers can also more easily assess the relationship between the quality of a tangible asset and its price and do not automatically believe that higher-priced goods are of higher quality.<sup>61</sup> This differs from education, which is a difficult commodity to evaluate, even for experts.<sup>62</sup> The value of education is further clouded by a constant stream of articles and marketing that encourage consumers to pursue higher education, which likely leads to an overvaluing of the benefit of higher education by consumers.<sup>63</sup> As a result of these differences between tangible goods and intangible goods like higher education, the logic behind 26 U.S.C. § 108 is dubious for users of IBR. The

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context. In this particular case, the cost is nearly the same for the two educational institutions, but employment figures suggest that there is a cavernous difference between the two, and there is no mechanism in 26 U.S.C. § 108 to take this into account. The two "products," in this case degrees, are worth vastly different amounts even though they cost nearly the same.

<sup>59</sup> To illustrate in the undergraduate degree context, a liberal arts degree at most schools is the same price as a business degree, even though the two have asymmetric outcomes. From a purely economic perspective, it seems impossible that the two could truly be worth the same amount. See *infra* note 168 and accompanying text (stating the average starting salary of a business degree holder is \$55,635, compared with \$37,791 for the humanities and social science).

<sup>60</sup> Consumers may purchase goods that are worth well less than the purchase amount, or interest or finance charges may make up a significant portion of the debt that is ultimately forgiven. Despite this, consumers of tangible goods still have an advantage over the consumers of education, who receive no tangible assets in return for the additional gross income that accompanies the discharge of indebtedness.

<sup>61</sup> See, e.g., Valarie A. Zeithaml, *Consumer Perceptions of Price, Quality, and Value: A Means-End Model and Synthesis of Evidence*, J. MARKETING, July 1988, at 10–13 (stating that many different studies that have examined the link between consumer perception of quality and price have not found definite links, meaning that consumers do not automatically believe that higher-cost goods are higher quality and, thus, are likely to make better buying decisions regarding tangible goods).

<sup>62</sup> See, e.g., Melissa Korn, *Is an M.B.A. Worth it?*, WALL ST. J. (Oct. 6, 2011), <http://online.wsj.com/news/articles/SB10001424053111904060604576574963215607744> (discussing the problems with assessing the value of an MBA).

<sup>63</sup> See, e.g., Robert Pearigen, *Cost and Value in Higher Education*, MILLSAPS COLL., [http://www.millsaps.edu/about\\_millsaps/cost\\_and\\_value\\_in\\_higher\\_education\\_pearigen.php](http://www.millsaps.edu/about_millsaps/cost_and_value_in_higher_education_pearigen.php) (last visited Jan. 17, 2015) (representing the typical value proposition of higher education that colleges publish to prospective students). This is not to say that higher education is unimportant; indeed, it is critical in today's economic climate. However, the notion that the pursuit of higher education at any cost is per se a wise decision is seriously misguided.

notion that student loan borrowers are truly benefitting from their higher education in the amount of the balance left after twenty-five years of payment and capitalization on a student loan is troubled, and Congress needs to refine the mechanics of the statute.

The one-time tax liability in 20 U.S.C. § 1098e does not appear to be a provision purposely designed for IBR but rather a consequence of applying long-standing tax law to the mechanics of the program.<sup>64</sup> The examination of the one-time tax liability is especially vital because it does not appear to be the result of calculated planning but rather the passive outcome of applying old law to a new program. This provision in § 1098e has been referred to in the popular media as a “tax bomb,” since it has the potential to cause significant financial harm to unassuming borrowers.<sup>65</sup> This liability supplements the 300 monthly payments that a student loan borrower has already paid by the time of “forgiveness.”

A borrower goes from paying no additional income tax for their student loans to paying one large liability in a single year, requiring well-thought-out financial planning by borrowers in the years leading up to forgiveness. If the borrowers cannot pay back this potentially substantial tax immediately, the Internal Revenue Service (IRS) has the authority to levy additional fines, thus further increasing the cost of education.<sup>66</sup> As one commentator dryly noted, “[t]he Internal Revenue Service, alas, does not have an income-based repayment program.”<sup>67</sup>

There are several reasons why there may not be popular demand for changing the mechanics of IBR. First, IBR is a relatively new provision.<sup>68</sup> There have yet to be any students that have had their loans forgiven at the end of the repayment period, which means that there have not been any correlating tax bombs. Once these start to occur, there will presumably be more popular demand to fix the problem, but lack of awareness is the critical issue today. Second, despite the program being in place for several years, a significant percentage of students still are not taking advantage of IBR, despite continued growth.<sup>69</sup> There may not be enough graduates using IBR to make finding a solution a congressional priority. Third, even if Congress is aware of the problem, they may not have yet developed an adequate

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<sup>64</sup> See *infra* Part II.A.

<sup>65</sup> Lieber, *supra* note 49.

<sup>66</sup> *Topic 653 – IRS Notices and Bills, Penalties and Interest Charges*, IRS, <http://www.irs.gov/taxtopics/tc653.html> (last updated Jan. 8, 2015).

<sup>67</sup> Lieber, *supra* note 49.

<sup>68</sup> College Cost Reduction and Access Act, Pub. L. No. 110-84, 121 Stat. 784 (2007).

<sup>69</sup> Tamar Lewin, *U.S. to Contact Borrowers with New Options for Repaying Student Loans*, N.Y. TIMES (Sept. 24, 2013), [http://www.nytimes.com/2013/09/25/education/us-to-contact-borrowers-with-new-options-for-repaying-student-loans.html?\\_r=0](http://www.nytimes.com/2013/09/25/education/us-to-contact-borrowers-with-new-options-for-repaying-student-loans.html?_r=0).

alternative to the current mechanics of IBR, including the tax time bomb.

Simply forgiving the loans without the tax consequences would be seen as problematic. The federal government stands to lose a large amount of money through loan forgiveness, and wholesale loan forgiveness at the end of the repayment period results in potentially significant forgone revenue, increasing the cost of IBR. The tax bomb could also be an incentive for students to avoid committing to student loan debt that they will later be unable to repay. In other words, it is possible that Congress has not discovered an alternative that maintains borrower "skin in the game" while still allowing for an equitable outcome for the borrower at the end of the repayment period.

### C. Current Cost Projections and Enrollment Data in IBR

The Congressional Budget Office (CBO) admits that the program will result in significant federal costs: \$1.8 billion from 2008 to 2017.<sup>70</sup> In arriving at this cost estimate, a House Report by the Committee on Education and Labor before the legislation went into effect estimated that costs would be kept down by low student participation "because of the required capitalization of interest and the seeming reluctance of borrowers to apply for similar relief elsewhere . . . ."<sup>71</sup> For the first few years after IBR went into effect, it seemed that the CBO was correct. In 2012, the Federal Reserve Bank of New York estimated that only 630,000 borrowers were enrolled in IBR, while more than 5 million had at least one loan past due.<sup>72</sup> These 5 million borrowers fit the exact profile of those that ought to be on IBR.<sup>73</sup>

However, enrollment figures have changed significantly since the 2012 report. One year later, 1.6 million borrowers are using income-linked debt-relief programs, including IBR.<sup>74</sup> The amount of borrowers using IBR and other similar programs is just poised to grow: the Department of Education is taking steps to address the lack of awareness of IBR by both contacting borrowers that are unable to repay their student loans on the current payment plan and informing graduates of options to pay their loans.<sup>75</sup> The federal government has prioritized spreading the word about IBR in other ways as well; the White

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<sup>70</sup> H.R. REP. NO. 110-210, at 71 (2007).

<sup>71</sup> *Id.*

<sup>72</sup> Kayla Webley, *Why Have So Few Student-Loan Borrowers Taken Advantage of Income-Based Repayment?*, TIME (June 12, 2012), <http://business.time.com/2012/06/12/why-have-so-few-student-loan-borrowers-have-taken-advantage-of-income-based-repayment/>.

<sup>73</sup> *See id.*

<sup>74</sup> Lewin, *supra* note 69.

<sup>75</sup> *See id.*

House,<sup>76</sup> the Department of Education,<sup>77</sup> and even the Consumer Financial Protection Bureau<sup>78</sup> have released information about IBR on their respective websites to encourage additional enrollment in the program. As initially identified by the Committee on Education and Labor report, there is currently “seeming reluctance” of struggling borrowers to enter the program,<sup>79</sup> though proactive government marketing may mitigate this and lead to additional enrollment. As more borrowers enroll in these programs, the federal government may spend billions more than Congress originally expected.

More importantly, the true crisis has not yet come. Graduates could not use IBR until 2009, meaning that the first wave of student loan forgiveness will not come until 2034.<sup>80</sup> The federal government stands to lose a significant amount of money when it begins to forgive loans. Even though the federal government stands to recoup a portion of the loans from the one-time tax liability, the government will end up writing off significantly more through loan forgiveness.<sup>81</sup> The Office of Management and Budget estimates that the average student loan balance of an IBR user is \$39,500, which after payments for twenty-five years will leave behind \$41,000 to be forgiven.<sup>82</sup> The cost that forgiveness will eventually create is not included in the initial cost-projection numbers, which only stretch to 2021, before the first wave of forgiveness will occur in 2034.<sup>83</sup>

The report estimates that the average tax liability for the borrower for this discharge from indebtedness may be over \$10,000, depending on the borrower’s tax bracket.<sup>84</sup> Since the average loan balance at time of forgiveness is projected to be \$41,000, even with the tax collection from borrowers, the federal government stands to lose close to \$30,000 on each individual borrower who uses loan forgiveness.<sup>85</sup> When this loss is extrapolated over the millions of borrowers

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<sup>76</sup> Megan Slack, *Income Based Repayment: Everything You Need to Know*, THE WHITE HOUSE BLOG (June 7, 2012, 10:59 AM), <http://www.whitehouse.gov/blog/2012/06/07/income-based-repayment-everything-you-need-know>.

<sup>77</sup> *Income-Driven Plans*, *supra* note 28.

<sup>78</sup> *What is Income-Based Repayment (IBR)?*, CONSUMER FIN. PROT. BUREAU, <http://www.consumerfinance.gov/askcfpb/633/what-income-based-repayment-ibr.html> (last updated June 17, 2013).

<sup>79</sup> See H.R. REP. NO. 110-210, at 71 (2007) (identifying borrower reluctance to enter into similar programs).

<sup>80</sup> See 20 U.S.C. § 1098e(b)(7)(B) (2012) (specifying a twenty-five-year repayment period before forgiveness for borrowers who received their first loan before July 1, 2014).

<sup>81</sup> See Lieber, *supra* note 49.

<sup>82</sup> See *id.* (discussing projected estimates from 2012 through 2021). It is especially important to note that the projected amount to be forgiven will actually exceed the initial amount borrowed, even after 300 monthly payments.

<sup>83</sup> *Cf. id.* (explaining projections based on data through 2021).

<sup>84</sup> See *id.*

<sup>85</sup> See *id.* The federal government obviously recoups part of the loan balance through twenty-five years of payment, but that amount often only covers interest or part of the

who will use IBR, the income shortfall for the federal government will well exceed the initial cost estimates, which relied on projected non-participation by borrowers.<sup>86</sup> Despite the potentially dire consequences of inaction, Congress has not changed the mechanics of IBR, perhaps due to the far-off nature of the one-time tax liability for borrowers. The Office of Management and Budget figures also demonstrate the problem of continued interest capitalization during the repayment period. At the current student loan interest rate, the forgiven amount often exceeds the initial loan principal.<sup>87</sup>

## II

### ANALYSIS

#### A. Legislative History of § 1098e

IBR came into existence as part of the College Cost Reduction and Access Act.<sup>88</sup> This act includes several other notable provisions, including an additional public sector loan forgiveness program that forgives loans after ten years in public service, reduced interest rates for certain undergraduate loans, student loan deferment for members of the armed forces, and other similar programs.<sup>89</sup> This public service loan forgiveness program can be combined with IBR, so that a borrower can pay 15% of his or her discretionary income under IBR and have the remainder of the balance forgiven in ten years instead of twenty-five years.<sup>90</sup>

In available legislative history of the College Cost Reduction and Access Act, Congress seems to be aware that a one-time tax liability will occur, but it is never explicitly discussed. One House Conference Report states that “[u]nder [IBR], unpaid interest and principal are capitalized and any outstanding loan balance is forgiven after twenty years of repayment.”<sup>91</sup> This suggests that Congress is aware of the two major issues with IBR: that the interest continues to capitalize, which results in a larger amount that is forgiven, and that a discharge of indebtedness occurs at the end of the payment period.<sup>92</sup> However,

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interest, leading to a loss when the capitalized interest is considered. Even if most of the initial principal is recovered, the government has still lost the use of that capital for twenty-five years.

<sup>86</sup> The flaw of the cost estimates is the assumption that not many students would sign up for IBR. The combination of borrower-student awareness and lower-than-expected employment prospects for college graduates will likely result in millions more using IBR. See Plumer, *supra* note 3; Semuels, *supra* note 4.

<sup>87</sup> See Lieber, *supra* note 49.

<sup>88</sup> Pub. L. No. 110-84, 121 Stat. 784 (2007).

<sup>89</sup> See *id.*

<sup>90</sup> *Income-Driven Plans*, *supra* note 28.

<sup>91</sup> H.R. REP. NO. 110-317, at 44 (2007) (Conf. Rep.).

<sup>92</sup> See *id.*

there is no further discussion of the consequences of IBR in that report.

There is a voluminous legislative history record of IBR and the other provisions of the College Cost Reduction and Access Act. In one of the first Senate floor debates for the act, IBR is discussed briefly, but the focus is mainly on pairing it with public service loan forgiveness: “[o]ur income-based repayment plan . . . when it’s combined with our public service loan forgiveness plan, the help we’ll provide to students will be truly remarkable.”<sup>93</sup> The speech then goes on to exclusively discuss the impact on public sector employees, including teachers, members of the armed services, legal aid lawyers, and social workers.<sup>94</sup> Throughout the speeches, IBR is exclusively mentioned in conjunction with the public sector loan forgiveness program or the discussions of public sector workers.<sup>95</sup> While the focus on public sector employees is admirable, it completely ignores the mechanics of IBR for graduates that are using IBR because they are struggling in the private sector or unable to secure any meaningful employment.

This exclusive focus on how IBR works in conjunction with public sector loan forgiveness continues in other House and Senate debates and reports. In a House floor proceeding, the chairman of the committee that was in charge of the legislation, the Education and Labor Committee, states that under IBR, graduates “will not be required to pay any more than 15 percent of their income . . . . That means they can start a career in nursing, in health care, in law enforcement, as a first responder, and they know that if they stay in that field for ten years, that loan will be forgiven.”<sup>96</sup> A House speech from a few days later states that IBR is needed because “too many student[s] interested in public service careers cannot pursue them because of the debt to salary ratio after graduation.”<sup>97</sup> Another House report by the chair of the committee states that IBR “serve[s] to expand rather than restrict educational and economic opportunities for graduates who would otherwise be unable to afford to work as teachers or social workers.”<sup>98</sup>

It is difficult to see this focus on public sector loan forgiveness as anything but myopic, as it ignores the more severe structural problems lurking within § 1098e. The program works much better for public sector employees because the balance after ten years that is forgiven is expressly not included in the borrower’s gross income.<sup>99</sup>

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<sup>93</sup> 153 CONG. REC. 11,260 (2007).

<sup>94</sup> *See id.* at 11,260–63.

<sup>95</sup> *See id.* at 11,241–63.

<sup>96</sup> 153 CONG. REC. 10,256 (2007).

<sup>97</sup> 153 CONG. REC. 1847 (2007).

<sup>98</sup> H.R. REP. NO. 110-210, at 44 (2007).

<sup>99</sup> 26 U.S.C. § 108(f)(1) (2012).

There is no similar concession for borrowers working in the private sector, which will be the vast majority of borrowers.<sup>100</sup> The same report notes that under IBR, “unpaid interest and principal are capitalized.”<sup>101</sup> However, the report fails to analyze the consequences of this fact. Capitalizing interest and principal over twenty-five years at current interest rates can often make the loan balance larger at the time of forgiveness than the initial balance of the loan, despite twenty-five years of payments.<sup>102</sup>

There were also several proposed amendments and changes to § 1098e.<sup>103</sup> One member of a House committee attempted to eliminate IBR from the College Cost Reduction and Access Act, but he failed.<sup>104</sup> This could be seen as a ratification of House support for IBR. Congress also further modified § 1098e after the law was enacted. A provision of the Health Care and Education Reconciliation Act of 2010 changed the mechanics of IBR for borrowers that took out their first student loan after July 1, 2014.<sup>105</sup> After the change, these first-time borrowers have had their repayment period under IBR shortened from twenty-five years to twenty years, and the standard for having partial financial hardship, and hence qualifying for IBR, was cut from 15% to 10% of discretionary income.<sup>106</sup> These actions are an even more decisive show of support by Congress and are further evidence of Congress's recognition of the current crisis in student loans. However, the legislative history of the Health Care and Education Reconciliation Act still does not include any detailed analysis of the tax bomb and its consequences for borrowers.<sup>107</sup>

More recent legislative history not only continues the trend of apparent nonawareness of the tax bomb but also considers reducing the benefit of IBR to borrowers. In a House committee report accompanying his proposed 2014 budget, Congressman Paul Ryan suggested changing the classification of partial financial hardship back to 15% of discretionary income, which was reduced to 10% in 2010 to help struggling graduates who made enough to not qualify for IBR but not

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<sup>100</sup> See Catherine Rampell, *More College Graduates Take Public Service Jobs*, N.Y. TIMES (Mar. 1, 2011), <http://www.nytimes.com/2011/03/02/business/02graduates.html?page-wanted=1&adxnml=1&adxnmlx=1385002087-zkgqFXzMtgbZVCfDirmd9w> (discussing that, while more graduates are taking public sector jobs, most graduates are still pursuing private sector jobs).

<sup>101</sup> H.R. REP. NO. 110-210, at 54.

<sup>102</sup> Cf. Lieber, *supra* note 49 (demonstrating instances where an individual's repayment value becomes more than the principal balance due to low payments attributed to the income-based repayment plan).

<sup>103</sup> See H.R. REP. NO. 110-224 (2007).

<sup>104</sup> See *id.* at 3 (motion of Representative Diaz-Balart).

<sup>105</sup> Pub. L. No. 111-152, § 2213, 124 Stat. 1029, 1081 (2010).

<sup>106</sup> *Id.*

<sup>107</sup> See 124 Stat. 1029.

enough to comfortably service their student loan debt on the standard plan.<sup>108</sup> This was partially motivated by “concerns that the expansions [of IBR] could disproportionately benefit graduate and professional students.”<sup>109</sup> While the income ceiling borrowers must have to qualify for IBR is relatively high,<sup>110</sup> this argument assumes that borrowers will want to be on IBR when they could otherwise afford the standard repayment plan, even if it costs more than 10% of their discretionary income, a proposition that is very difficult to support.<sup>111</sup> It is also possible that this argument is not representative of the current political climate surrounding student loans, and no amendment to IBR has been made.<sup>112</sup>

Overall, the dearth of legislative history surrounding the tax bomb is surprising, given the potential damage it presents to many taxpayers. Available legislative history demonstrates that members of the Education and Labor Committee were aware that interest would capitalize and that the amount that will be forgiven will be counted as gross income in the final year of repayment.<sup>113</sup> However, the lack of analysis after this acknowledgement suggests that the committee was either not aware of the problems that this would create for borrowers or that the committee saw no alternative to the mechanics of IBR in the College Cost Reduction and Access Act. Instead, Congress focused unblinkingly on public service loan forgiveness and all the graduates who will become police officers, prosecutors, and social workers because of the bill.<sup>114</sup> Meanwhile, the record is devoid of significant concern for the ever-increasing percentage of loan holders who work in the private sector who are defaulting.<sup>115</sup> Of course, available legislative history does not tell the whole story, instead only allowing a glimpse of congressional thought through officially available committee reports and speeches. While not complete, this snapshot still suggests a lack of congressional awareness, at the time IBR was initially put into place, of the issues facing borrowers.

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<sup>108</sup> H.R. REP. NO. 113-17, at 83 (2013).

<sup>109</sup> *Id.*

<sup>110</sup> See *supra* notes 33–37 and accompanying text (calculating that the average private law school graduate must make more than \$132,315 in order to lose eligibility for IBR).

<sup>111</sup> Graduates that are on IBR face difficulty getting approved for other loans, including mortgages, auto loans, and other installment loans. It is doubtful that many borrowers would put themselves in such a precarious financial situation unless they had no alternatives.

<sup>112</sup> See Ezra Klein, *Paul Ryan's Budget: Social Engineering with a Side of Deficit Reduction*, WASH. POST (Mar. 12, 2013), <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/03/12/paul-ryans-budget-isnt-about-the-deficit/> (calling the ideas that underlie the Ryan budget to be “deeply unpopular, and considered quite radical,” even by fellow Republicans).

<sup>113</sup> See H.R. REP. NO. 110-317, at 44 (2007) (Conf. Rep.).

<sup>114</sup> H.R. REP. NO. 110-210, at 36 (2007).

<sup>115</sup> See McArdle, *supra* note 12 (noting that the current rate of default is 7%).

## B. Proposed Solutions for 20 U.S.C. § 1098e's Tax Bomb

It may seem as though there is no politically viable solution for the problems of IBR. After all, the tax bomb does some good for the Treasury by recouping part of the amount that is forgiven by the federal government. There are existing proposals to address the issue. Representative Sander Levin of Michigan introduced a bill to the House Ways and Means Committee<sup>116</sup> that excludes the taxation of loan discharges from IBR by amending the tax code.<sup>117</sup> The relevant provision of the tax code, 26 U.S.C. § 108(f), already excludes certain types of student loan forgiveness from inclusion in gross income, including public service loan forgiveness as part of the College Cost Reduction and Access Act<sup>118</sup> and teacher loan forgiveness under the Higher Education Act of 1965.<sup>119</sup>

However, nothing was done with Representative Levin's legislation after being introduced to the committee in 2009.<sup>120</sup> The reason may be the cost: allowing the loans to be forgiven wholesale would not allow the IRS to recapture any amount of the student loan at the end of the repayment period, which may be on average more than the initial balance of the loan.<sup>121</sup> Given that some members of Congress wanted to eliminate IBR entirely due to cost concerns,<sup>122</sup> the recovery of some revenue is likely a requirement for the continued existence of the program.

A more radical proposal is to allow student loans to be dischargeable in bankruptcy, bringing student loans in line with other forms of consumer debt. This would eliminate the tax bomb because the tax code already excludes discharges of indebtedness resulting from a bankruptcy proceeding from a taxpayer's gross income.<sup>123</sup> The problem with this proposal is the vast revenue the federal government would have to forgo, especially because this solution covers all loans, not just those that are being repaid via IBR.

This would be a stark departure from current bankruptcy law concerning student loans.<sup>124</sup> In most jurisdictions, borrowers can only discharge student loans in bankruptcy with a showing of undue

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<sup>116</sup> H.R. 2492, 111th Cong. (2009).

<sup>117</sup> This is done by an amendment of 26 U.S.C. § 108(f) (2012).

<sup>118</sup> Pub. L. No. 110-84, § 401, 121 Stat. 784, 800 (2007).

<sup>119</sup> Pub. L. No. 89-329, § 465, 79 Stat. 1219, 1253 (1965).

<sup>120</sup> H.R. 2492 (stating legislation died in previous session).

<sup>121</sup> See Lieber, *supra* note 49 (discussing that Office of Management and Budget estimates project that the average loan amount that will be included is \$41,000 even though the average initial balance was \$39,500).

<sup>122</sup> See H.R. REP. NO. 110-224, at 3 (2007) (motion of Representative Diaz-Balart).

<sup>123</sup> 26 U.S.C. § 108(a) (2012).

<sup>124</sup> See, e.g., Equal Justice Works, *Bankruptcy Case Offers Hope for Student Borrowers*, THE STUDENT LOAN RANGER, U.S. NEWS & WORLD REP. (June 12, 2013, 10:00 AM), <http://www.usnews.com/education/blogs/student-loan-ranger/2013/06/12/bankruptcy-case-offers->

hardship, established in the foundational case of *Brunner v. New York State Higher Education Services Corp.*<sup>125</sup> *Brunner* gives a three-part test to determine if the borrower is suffering undue hardship and is therefore eligible for discharge of student loans in bankruptcy: the debtor must not be able to maintain a minimal standard of living, that minimal standard of living must be likely to persist, and the debtor must make good faith efforts to repay the loan.<sup>126</sup> This standard has been accepted by nine U.S. courts of appeals.<sup>127</sup> Any solution making student loans dischargeable in bankruptcy on a wide scale would require Congress to direct courts to abandon the undue hardship standard, which is currently very lender friendly.<sup>128</sup>

While many have suggested allowing student loans to be dischargeable in bankruptcy,<sup>129</sup> Daniel A. Austin suggests an innovative and thoughtful approach.<sup>130</sup> Under his proposal, bankruptcy courts would evaluate the fair market value of a borrower's loans.<sup>131</sup> Fair market value is defined as the amount that an "investor would pay to purchase the respective student loan obligation."<sup>132</sup> After evaluating the fair market value of the student loan, this amount is nondischargeable by the borrower.<sup>133</sup> The excess of the loan balance above that amount is then forgiven in bankruptcy.<sup>134</sup> In order for this solution to be effective, federal courts would have to change their standard in allowing discharge of indebtedness, or, alternatively, Congress would have to amend the Bankruptcy Code to direct courts to change their standard.

This proposal would allow the federal government to still recover a component of the loans due while not overburdening borrowers. However, a reform on a scale that deals with student loans in a whole-

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hope-for-student-borrowers (explaining the difficulty of getting student loans discharged in bankruptcy and focusing on a notable case where discharge was actually allowed).

<sup>125</sup> 831 F.2d 395, 396 (2d Cir. 1987).

<sup>126</sup> *Id.*

<sup>127</sup> Daniel A. Austin, *The Indentured Generation: Bankruptcy and Student Loan Debt*, 53 SANTA CLARA L. REV. 329, 373 (2013).

<sup>128</sup> See Natalie Kitroeff, *Loan Monitor Is Accused of Ruthless Tactics on Student Debt*, N.Y. TIMES (Jan. 1, 2014), <http://www.nytimes.com/2014/01/02/us/loan-monitor-is-accused-of-ruthless-tactics-on-student-debt.html> (discussing a company that fights bankruptcy claims relating to student loans that is very successful in preventing the discharge of most student loan debt).

<sup>129</sup> See Devon Merling, *How Bankruptcy Could Help Solve the Student Loan Crisis*, DESERET NEWS (Aug. 23, 2013, 6:35 PM), <http://www.deseretnews.com/article/print/865585172/how-bankruptcy-could-help-solve-the-student-loan-crisis.html>.

<sup>130</sup> Austin, *supra* note 127, at 417.

<sup>131</sup> *See id.*

<sup>132</sup> *Id.* at 418.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

sale manner would be unlikely to pass in today's political climate.<sup>135</sup> It also would be a significant expense for taxpayers: if any borrower could discharge his or her student loans in bankruptcy without waiting for twenty-five years, it might lead to mass participation by borrowers. That is not to say that industry reform is not required, and in fact it will likely someday be necessary to face the coming education bubble, but the IBR gap must be filled in the short term in order to help current borrowers. This is especially true because the current Congress is anemic toward any provisions that result in significantly more spending for the federal government.

Though the first IBR tax bomb will not occur for many years, solutions put in place now may still affect current borrower treatment by the IRS,<sup>136</sup> and knowing how the federal government will ultimately treat IBR borrowers will certainly affect borrowers' financial planning.<sup>137</sup> A solution specifically designed for IBR could be more narrowly tailored and less costly in its implementation and thus would be less controversial and more likely to be implemented by Congress. Since there are already close to two million users of IBR, swiftness of implementation is key to assure that borrowers that are struggling now are able to benefit from the eventual solution.

### C. A Policy Proposal to Address the Tax Bomb Without Forgoing Revenue

Though current proposals to fix IBR all have some merit, they each have implementation issues that make them unlikely to succeed politically. A proposal simply adding loan debt forgiven under IBR to current exclusions in 26 U.S.C. § 108(f) would be simple and not require any notable overhaul of current procedures.<sup>138</sup> While this proposal certainly has appeal for taxpayers currently using IBR, it would result in a substantial loss of revenue to the federal government.<sup>139</sup> While other programs currently allow loan forgiveness to be excluded from gross income, these programs are targeted at small, discrete sec-

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<sup>135</sup> Cf. Chris Cillizza, *The Least Productive Congress Ever*, WASH. POST (July 17, 2013), <http://www.washingtonpost.com/blogs/the-fix/wp/2013/07/17/the-least-productive-congress-ever/> (discussing that the current Congress is one of the least productive in terms of the number of laws passed); Morgan Little, *Congress Set to Pass Historically Few Laws in 2013*, L.A. TIMES (Dec. 11, 2013), <http://articles.latimes.com/2013/dec/11/news/la-pn-congress-few-laws-2013-20131211> (focusing on similar legislation numbers).

<sup>136</sup> For example, if the IRS began collecting a pro rata portion of the borrowers' projected tax liability upon forgiveness as suggested by this Note, the IRS would have to change its collection tactics for the millions of borrowers already using IBR.

<sup>137</sup> See Lieber, *supra* note 49 (discussing how there are already financial firms that offer services to help borrowers on IBR plan their financial future).

<sup>138</sup> See Austin, *supra* note 127, at 417.

<sup>139</sup> See *id.*

tions of the population, such as those that work in public service for ten years after graduating.<sup>140</sup>

A universal exclusion from gross income for all IBR recipients is unlikely to come to fruition.<sup>141</sup> It also endangers the incentives to enter government service, education, and other underserved areas that Congress targeted with existing exemptions;<sup>142</sup> making the exclusion available to all does not encourage new graduates to enter any particular field. At the same time, while there is significant merit to Austin's proposal of allowing loans to be partially discharged in bankruptcy,<sup>143</sup> this would require a significant overhaul of laws surrounding student loans that may be difficult to reach in the current political climate. Additionally, Austin's proposal covers all student loans, and not just the borrowers that are using IBR,<sup>144</sup> which could result in even more significant write-offs of student debt by the federal government.<sup>145</sup>

This Note proposes a more moderate solution that allows the federal government to recoup part of the funds being forgiven without requiring systemic change in the way that student loans are handled in bankruptcy and without crippling the taxpayer at the point of forgiveness. The IRS could treat the amount that would be forgiven at the end of the twenty-five-year period conceptually similarly to capital expenditures, prorating the total amount over the twenty-five-year period.<sup>146</sup> However, instead of a percentage of a deduction being allowed each year, a percentage of the projected eventual liability will be assessed against the borrower. For the borrower, this means that there is no single crushing payment but rather manageable installments. For the federal government, this means that most of the

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<sup>140</sup> See, e.g., Letter from Eric Solomon, Assistant Secretary of Tax Policy, to Representative Sander Levin (Sept. 19, 2008) (on file with author) (discussing current loan forgiveness programs, such as those for teachers under the Higher Education Act of 1965).

<sup>141</sup> Cf. 156 CONG. REC. H7,453–503 (daily ed. Nov. 15, 2010) (showing the last activity on H.R. 2492, a bill to exclude IBR loan forgiveness from gross income: a single sponsor attaching to the bill in 2010); *H.R. 2492 – To Amend the Internal Revenue Code of 1986 to Exclude from Gross Income Discharges of Student Loans the Repayment of Which is Income Continuing or Income Based*, CONGRESS.GOV, <https://www.congress.gov/bill/111th-congress/house-bill/2492/cosponsors> (last visited Jan. 19, 2015) (showing no further movement on H.R. 2492 since November 15, 2010).

<sup>142</sup> See 153 CONG. REC. H10,255–301 (daily ed. Sept. 7, 2007) (stating that public sector loan forgiveness will allow more people to pursue careers in public service by allowing loan forgiveness after ten years).

<sup>143</sup> Austin, *supra* note 127, at 417.

<sup>144</sup> See *id.*

<sup>145</sup> Cf. McArdle, *supra* note 12 (noting that 7% of student loan borrowers are currently in default, which suggests that there may be widespread participation in Austin's proposed bankruptcy overhaul).

<sup>146</sup> See 26 U.S.C. § 68 (2012) (giving guidelines for deductions of capital expenditures over an item's class life, a conceptually similar idea to a pro rata contribution of the projected one-time tax liability).

money recouped via the old one-time tax liability will be received years earlier.

For example, if a borrower's tax liability would be \$25,000 at time of repayment, the borrower could pay \$1,000 of additional federal income tax each year for twenty-five years. From the perspective of the Treasury, the same amount of money is being received from the borrower as would have been received in the year of forgiveness, though the money is collected in a way that is significantly friendlier to borrowers. Currently, borrowers have to plan for the one-time tax liability years in advance and save to eventually make the payment.<sup>147</sup> This financial planning is unnecessary for the borrower if the pro rata portion is due on a yearly basis, leading to less risk of improper planning and the borrower being assessed fines from the IRS for not being able to pay the liability.<sup>148</sup>

This solution of pro rata collection of the eventual tax bomb is a better option for the federal government than simply collecting funds in year 25 for two reasons. First, it is likely that many borrowers will not have the cash on hand to repay the tax bomb amount because the one-time tax liability will be very large to most borrowers relative to their income, especially considering that the average user of IBR will not have a high-paying job.<sup>149</sup> A borrower's potential unpreparedness for repayment is problematic because the IRS imposes stiff penalties on taxpayers who do not pay their tax liabilities on time.<sup>150</sup> Repayment may be further protracted because even the stiffest penalties cannot force borrowers to repay money that they do not have, resulting in many borrowers having to settle their tax debt over a period of years, further worsening the impact of loan forgiveness for borrowers.<sup>151</sup>

As a result, the repayment to the federal government may end up coming in years 25 through 30 instead of year 25, for example, or the government may ultimately only be able to recover a portion of the borrower's tax liability, resulting in forgone revenue. The relative security of pro rata collection in years 1 through 25 avoids the logistical headaches associated with collecting a lump sum from borrowers who may not have properly planned for repayment. Second, the Treasury would benefit by receiving the money earlier due to the time value of

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<sup>147</sup> See Lieber, *supra* note 49 (discussing how private financial firms are assisting borrowers using IBR who must plan their financial futures to account for loan forgiveness).

<sup>148</sup> See *Topic 653 – IRS Notices and Bills, Penalties and Interest Charges*, IRS, <http://www.irs.gov/taxtopics/tc653.html> (last updated Jan. 8, 2015).

<sup>149</sup> Moreover, IBR users who have high-income jobs will also have high student loan debt loads, or they would not have been eligible for IBR in the first place.

<sup>150</sup> See Lieber, *supra* note 49.

<sup>151</sup> See IRS, *THE IRS COLLECTION PROCESS: PUBLICATION 594* (2012), available at <http://www.irs.gov/pub/irs-pdf/p594.pdf>.

money.<sup>152</sup> If the Treasury has to take a loss on the loan because of forgiveness, which it does under the current IBR system, it would be more beneficial to the federal government if the money is received before the final year of the plan.

While making this change to IBR, other more minor changes ought to be made as well, reflecting the need for disclosure-based regulations in addition to the structural change of pro rata collection. As part of this proposal, Congress should require the Department of Education to increase disclosures made to borrowers who are repaying their loans. Student loan statements currently inform borrowers not just what their monthly payment is but also how much of the loan principal has been paid. In theory, this incentivizes borrowers to make higher-than-minimum payments: when borrowers see how much of the minimum payment goes to interest alone, they are incentivized to pay more than the minimum to minimize the cost of the loan over the course of repayment.<sup>153</sup>

For users of IBR, student loan statements should state the current projected loan balance at the time of forgiveness, as well as the projected tax consequences to the borrower. In other words, borrowers should see their total projected tax bomb every month upon receiving the statements. Consumer awareness about the one-time tax liability at the time of loan forgiveness should also be increased, by putting this information in monthly statements as suggested or clearly indicating the consequences of IBR to borrowers at the time they sign up for the payment plan. This would have two beneficial effects: it would disincentivize those who do not truly need to be on IBR by demonstrating the consequence of carrying student loans for twenty-five years,<sup>154</sup> and it would also incentivize those who genuinely need IBR to make larger-than-minimum payments to the extent that they are able to minimize the tax fallout from loan forgiveness.

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<sup>152</sup> See, e.g., *A Primer on the Time Value of Money*, N.Y.U. STERN SCH. OF BUS., [http://pages.stern.nyu.edu/~adamodar/new\\_home\\_page/pvprimer/pvprimer.htm](http://pages.stern.nyu.edu/~adamodar/new_home_page/pvprimer/pvprimer.htm) (last visited Jan. 17, 2015) (“The notion that a dollar today is preferable to a dollar some time in the future is intuitive enough for most people to grasp without the use of models and mathematics.”).

<sup>153</sup> The idea behind these disclosures is conceptually similar to those used in the credit card industry as part of the Federal Truth in Lending Act and the Credit CARD Act of 2009. See CARD Act Factsheet, CONSUMER FIN. PROT. BUREAU (Feb. 2011), <http://www.consumerfinance.gov/credit-cards/credit-card-act/feb2011-factsheet/> (“Each monthly statement must include how long it will take to pay off the bill and the total cost to the consumer as a result of paying only the minimum amount due.”).

<sup>154</sup> H.R. REP. NO. 113-17, at 77 (2013) (noting that one concern with IBR is the potential for graduate and professional students with high income to use the program when they are actually able to repay their loans on a normal repayment schedule).

#### D. Mechanical and Conceptual Issues with This Proposal

There are mechanical difficulties in implementing this proposal, most notably issues relating to the calculating of the pro rata amount that taxpayers will owe and how to deal with borrowers who elect out of IBR.<sup>155</sup> First, the borrower's income will change over the course of twenty-five years, which in turn means that the amount the borrower will pay using IBR will fluctuate as the borrower's discretionary income increases or decreases.<sup>156</sup> The difficulty here is projecting the loan forgiveness amount with relative precision. If a borrower makes a larger payment due to increased income, the principal of the loan will be affected, and, as a consequence, the amount forgiven at the end of the repayment period will change. Unless the IRS adjusts for this, projections would assume the same income for twenty-five years, which would in turn lead to a higher projected tax bomb than will actually occur and a pro rata payment higher than it ought to be. Put simply, the borrower would be paying for a tax liability that, in most cases, will end up being far lower.

To elaborate, if IRS projections used to calculate the borrower's pro rata portion of tax bomb repayment assume that the borrower will have income of \$60,000 for twenty-five years, the projected loan balance forgiven at year 25 will be significant because discretionary income payments with a salary of \$60,000 for the total loan amount of average debt will barely affect the principal. However, in the most likely scenario to occur in reality, the borrower's salary will increase over time as he or she receives raises and promotions, which in turn increases his or her discretionary income and the amount being paid under IBR. This results in a smaller projected loan balance that will be forgiven at the end of the repayment period.

To illustrate, assume a borrower with \$60,000 of income and \$125,000 of student loan debt.<sup>157</sup> This borrower has partial financial

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<sup>155</sup> Borrowers are allowed to change their repayment schedule or they may become ineligible for IBR due to rising income. See 20 U.S.C. § 1098e(b)(6) (2012).

<sup>156</sup> See *Income-Driven Plans*, *supra* note 28 ("Your required monthly payment amount may increase or decrease if your income . . . changes from year to year.")

<sup>157</sup> This example uses the average indebtedness upon graduation for a law student at a private university and a median entry-level salary figure. See *supra* note 33 (stating that the average indebtedness for a private law school graduate is \$125,000). The National Association for Law Placement (NALP) estimates that the median starting salary for law school graduates in 2011 was \$60,000. See *Starting Salaries – Class of 2011*, NAT'L ASS'N FOR LAW PLACEMENT (Jan. 2013), [http://www.nalp.org/starting\\_salaries\\_class\\_of\\_2011](http://www.nalp.org/starting_salaries_class_of_2011). While NALP did not furnish the median salary for 2013, it released data that show the median salary still hovering around \$60,000. As an important caveat to "average" starting salary data: the salary distribution for graduates is bimodal, with one end of the distribution at \$160,000—the starting salary at many large law firms, and the other end of the curve between \$40,000 and \$65,000—the starting salary at many smaller law firms and public interest organizations. See *Salary Distribution Curves – Class of 2013*, NAT'L ASS'N FOR LAW PLACEMENT, <http://www.nalp.org/salarydistrib> (last visited Jan. 19, 2015). Notably, the ad-

hardship and will have a monthly IBR payment of \$534.<sup>158</sup> Such a relatively small monthly payment will not even cover the interest for the month, and at the end of the repayment period the loan will have a balance of \$253,663.<sup>159</sup> If this amount was included in the borrower's projected gross income for year 25, it would change the borrower's estimated tax bill from \$8,435 to \$86,032.<sup>160</sup> This would make the borrower's tax bomb \$77,597,<sup>161</sup> and the pro rata share would be \$3,103.<sup>162</sup> Compare this to the same borrower profile but with income adjusted upward each year to reflect a raise approximately tracking the rate of inflation. If the borrower's projected income were increased by 2% each year during the twenty-five-year period, the projected tax bomb will be approximately half of the original projection, because there would be a gradually larger amount being paid each repayment period.<sup>163</sup>

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justed mean salary of \$78,205 only represents 2%–4% of total graduates, and half of all graduates are in the relatively narrow cluster of \$40,000 to \$65,000. *See id.* (“[A]s both the arithmetic mean and the adjusted mean show, relatively few salaries are close to either mean.”). The 18% distribution at \$160,000 throws off the mean calculation, artificially making the average law school employment result better than it actually is. This is important because it demonstrates that the median starting salary number, which is lower, is a better indicator than the mean for the purpose of modeling real world results.

<sup>158</sup> Borrower's monthly payment assumes borrower is single with no above-the-line deductions. To calculate monthly payment:  $(60,000 - 17,235) \times 0.15 / 12 = 534$ . Here: 60,000 is the AGI, 17,235 is 150% of the poverty line, 0.15 is for 15% of discretionary income, and 12 adjusts from annual payment to monthly payment.

<sup>159</sup> This is assuming interest compounded monthly, 300 monthly payments, an initial loan balance of \$125,000, and a monthly payment of \$534.

<sup>160</sup> Calculated using the IRS's estimated federal withholding calculator, which calculates a taxpayer's anticipated tax liability based on input of gross income and above-the-line deductions (which are 0 here). *See Withholding Calculator, IRS*, <http://apps.irs.gov/app/withholdingcalculator/> (last visited Feb. 13, 2015).

<sup>161</sup> All of the calculations in this Note are modeled in Excel. The following will recreate this calculation:  $=FV(0.0056, 300, 534, -125000)$ . This formula represents the outstanding loan balance at the end of an IBR term starting with the numbers above, using Excel's FV function, which measures how payments affect a balance affected by compound interest over time. The four variables in this formula are (from left to right): interest rate, number of payments, monthly payment, and starting balance. This FV function operates on a monthly basis. Federal student loans have an annual interest rate of 6.7%, which divided by 12 equals 0.0056, the first variable. For number of payments, there are twelve payments a year for twenty-five years, yielding 300, the second variable. The third variable is the monthly payment, and using the formula discussed earlier, the monthly payment is \$534. Finally, the fourth variable is the balance, which this Note assumes to be \$125,000, the average for a graduating private law school student.

<sup>162</sup> This calculates the taxpayer's gross income for year 25 at \$313,663, or \$60,000 + loan balance forgiven. The taxpayer's normal tax liability is subtracted to give the final amount of the tax bomb.

<sup>163</sup> This is due to higher payments reflected by a gradually climbing salary. Eventually, the borrower's payment will be greater than the capitalizing interest and actually decrease the principal of the loan. Using Excel to illustrate the proposed fix of pro rata repayment is more difficult to model due to the changing variables of this alternative. The model assumes the borrower's income will go up at roughly the rate of inflation (1%–3%), in order to reduce the pro rata amount paid on top of normal tax each year. The FV func-

In order to more closely track borrowers' likely salary increases, the IRS could use Bureau of Labor statistics to estimate what the average increase in income over twenty-five years will be for someone in the borrower's occupation and age and downwardly adjust the projected student loan balance forgiveness at the end of the period and the corresponding tax liability.<sup>164</sup> Alternatively, and more simply, the IRS could assume that the borrower's income will rise at the rate of inflation and use that figure to downwardly adjust the borrower's pro rata tax liability, which would be less complicated and result in significantly lower administrative costs, although it would have the drawback of understating many borrowers' future incomes by only adjusting for cost-of-living increases. Either one of these solutions would reduce a borrower's pro rata contributions in the early years after graduating, which will presumably be the years when borrowers have the lowest income of their career.

Second, there are issues with borrowers who begin their repayment on IBR but then transition to the ten-year payment plan when they have the income to be on a normal repayment schedule and are no longer eligible for IBR.<sup>165</sup> The standard repayment schedule does not include any tax liability at the end of the repayment period, because the entire loan balance is paid by the borrower.<sup>166</sup> If a borrower starts out on IBR under this proposal, they would incur pro rata tax liability based on their projected loan forgiveness at the end of the repayment period. Eventually, when the borrower elects to switch to the normal ten-year repayment plan, the borrower would have paid a pro rata portion of a tax liability that does not in fact exist. Congress could simply pay all the pro rata contribution back to the borrower during the year that the borrower elects to switch to the standard re-

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tion requires all four variables to be the same for the life of the loan. To fix this, the model examines each individual year, with the assumption that the borrower's salary was going up by 1%–3% each year, an average estimate for inflation in the United States. That number is then divided by 12 to break down the yearly payment to monthly payments. With a 3% year-over-year salary growth assumption, the ending balance of the loan is \$68,000 instead of \$253,000, making the tax bomb go down from \$77,000 to \$18,000. With a 2% year-over-year salary growth assumption, the ending balance of the loan is \$138,000, making the tax bomb \$37,000. With a 1% year-over-year salary growth assumption, the ending balance of the loan is \$199,000, making the tax bomb \$58,000. The pro rata contribution each year for these loan assumptions would be \$720 (3%), \$1,480 (2%), and \$2,320 (1%), compared to \$3,103 without any assumption of salary growth. These figures would obviously change depending on income due to the progressive taxation system, but the estimates illustrate the ability for salary growth assumption to be a simple and effective fix.

<sup>164</sup> See *Occupational Employment Statistics: May 2013 National Occupational Employment and Wage Estimates*, BUREAU OF LABOR STATISTICS, [http://www.bls.gov/oes/current/oes\\_nat.htm](http://www.bls.gov/oes/current/oes_nat.htm) (last modified Apr. 1, 2014) (providing wage estimates for select professions).

<sup>165</sup> See 20 U.S.C. § 1098e(b)(6) (2012).

<sup>166</sup> See *Repayment Plans*, *supra* note 22 (providing background on the standard ten-year repayment plan).

payment plan. Congress could also elect to keep a portion of the pro rata tax liability as a fee for using IBR.<sup>167</sup>

Third, the proposal's most significant shortcoming is illustrated by the preceding discussion regarding the profile of borrowers who are eligible for IBR and their average debt loads: fixing IBR does little to fix the more systemic issue of the expense of education and a mismatch in the degrees that borrowers pursue and degrees that are employable. Minimizing initial borrowing is the critical step toward lessening financial hardship for borrowers, something that reform for IBR alone are not able to accomplish.

Take the example of a borrower who has an entry-level job salary around the national average for college graduates in the social sciences and humanities, \$38,000, and has undergraduate debt around the average for IBR users, \$26,000.<sup>168</sup> This borrower will actually pay off the loan during year 13, and thus will not have any tax liability that will result in income from the discharge of indebtedness.<sup>169</sup> The key is responsible loan origination by borrowers and meaningful reforms to encourage responsible borrowing. While the tax bomb will certainly have grave consequences to the taxpayers that it affects, it will likely only affect the small subset of borrowers that incur large student loan liabilities relative to the job prospects of their degree.

Accordingly, the borrowers who will be most affected by the tax bomb are college students who do not graduate;<sup>170</sup> professional school students who incur higher-than-average debt without correlating higher-than-average starting salaries, such as veterinary<sup>171</sup> and law students;<sup>172</sup> and students who receive degrees without significant prac-

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<sup>167</sup> This could further reduce congressional concerns that borrowers would use IBR when they do not truly need to in order to reduce the amount they pay.

<sup>168</sup> The figure for social sciences and the humanities is used because the average business graduate will not be eligible for IBR due to high income. See *Salary Survey: Average Starting Salary for Class of 2013 Grads Increases 2.4 Percent*, NAT'L ASS'N OF COLLS. AND EMP'RS (Sept. 4, 2013), <https://naceweb.org/s09042013/salary-survey-average-starting-class-2013.aspx> (providing starting salaries for various disciplines).

<sup>169</sup> This borrower will pay off the loan in month 153 of IBR, assuming that the borrower did not lose eligibility at an earlier time due to higher income.

<sup>170</sup> Note the special problem of students who attend for-profit colleges but do not graduate, who often incur vast student loan liabilities relative to their peers at nonprofit colleges. See John Lauerman, *For-Profit College Costs Surpass Nonprofit Peers in U.S. Study*, BLOOMBERG (May 26, 2011, 12:01 AM), <http://www.bloomberg.com/news/2011-05-26/for-profit-college-costs-surpass-nonprofit-peers-in-u-s-study.html> (showing that from 2007–2008, for-profit schools cost on average \$30,900, while public universities cost on average \$15,600).

<sup>171</sup> See, e.g., David Segal, *The Vet Debt Trap*, N.Y. TIMES, Feb. 24, 2013, at BU1 (providing an overview of the debt veterinary students can face upon graduation).

<sup>172</sup> See, e.g., David Segal, *Is Law School a Losing Game?*, N.Y. TIMES, Jan. 9, 2011, at BU1 (providing accounts of the challenges law students face in paying off debt upon graduation); Jennifer Smith, *Crop of New Law Schools Opens Amid a Lawyer Glut*, WALL ST. J. (Jan. 31, 2013, 8:19 PM), <http://online.wsj.com/news/articles/SB1000142412788732392610457827>

tical application, such as unfunded doctoral or masters programs in the humanities.<sup>173</sup> This stresses that the IBR fix is merely a temporary repair for current borrowers, and systemic reform is necessary in order to align the cost of education to its true value.<sup>174</sup> The solution in this Note is only intended to be a solution for those who have already borrowed too much for an education with a lackluster outcome. That is not to say that a solution for these borrowers is not critical. Instead, this proposal ought to form part of the eventual tapestry of fixes Congress uses to solve the burgeoning student loan crisis.

#### CONCLUSION

The problems of IBR are a microcosm of the problems of student loans: a significant amount of borrowers have borrowed too much from the federal government without a correlating rise in job prospects. If left unchanged, the statutory gap of 20 U.S.C. § 1098e will result in vast tax liabilities for millions of borrowers at the end of the repayment period when the loans are forgiven. Wholesale exclusion of the amount discharged from indebtedness is politically unlikely in a climate that disfavors significant federal expenditures.<sup>175</sup> The solution proposed in this Note achieves both affordability for the borrower and maintains revenue for the federal government by requiring the borrower to contribute a pro rata amount of the projected tax liability as part of the borrower's federal income tax.

At some point in the near future, Congress must engage in a systemic reform of student loans to address the coming crisis. However, there are currently millions of borrowers using IBR, and the amount is only projected to grow. These borrowers need a retroactive solution to avoid being further crippled by student loan debt. Legislative history reveals that the one-time tax liability was not meticulously designed, and it did not demonstrate any policy goal that Congress was attempting to achieve with IBR. Unfortunately, the application of long-standing federal income tax law to loan forgiveness puts millions of student borrowers further at risk. While the first tax bomb will not be dropped for two decades, reform now is critical to eliminate the haze of uncertainty surrounding the tax bomb and to restore financial security to current borrowers.

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6301888284108 (illustrating that the problem of too many law school graduates has continued past the recession).

<sup>173</sup> Thomas H. Benton, *Graduate School in the Humanities: Just Don't Go*, THE CHRONICLE OF HIGHER EDUC. (Jan. 30, 2009), <http://chronicle.com/article/graduate-school-in-the/44846> (explaining the disadvantages of graduate school, one of which is debt).

<sup>174</sup> See, e.g., Simkovic, *supra* note 13 (discussing a proposal for risk-based student loans).

<sup>175</sup> Expenditure here means the amount of income the federal government would forgo by the exclusion of discharged indebtedness from gross income.

