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Tax Consequences of Loan Discharges for Borrowers in Income-Driven Repayment Plans

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Income-driven repayment (IDR) plans help federal student loan borrowers manage their debt by setting loan payments as a share of income and limiting how long they must repay. These plans provide relief when borrowers' incomes are low or drop, and increase their payments when incomes rise. One IDR plan (Original Income-Based Repayment, or Original IBR) caps monthly loan payments at 15% of discretionary income and discharges any remaining debt after 25 years of payments, while two other plans (Pay As You Earn, or PAYE, and 2014 IBR) cap monthly payments at 10% of discretionary income and discharge remaining balances after 20 years of payments.[1]

Many borrowers in IDR will repay their loans in full, and many will *pay more* interest in IDR than under a 10-year standard repayment plan because they will make lower monthly payments over a longer period of time. However, those who do receive a discharge of remaining debt after 20 or 25 years of responsible payments may face an unaffordable tax liability, because these discharged amounts are treated as taxable income under current law. Concern about this potential tax liability, which could run into the many thousands of dollars, discourages some borrowers from enrolling in IDR—including the struggling borrowers it was specifically designed to help. In contrast, loan balances discharged after 10 years of payments under the Public Service Loan Forgiveness program (PSLF) are *not* treated as taxable income. This disparity is highly inequitable and should be corrected so that discharged student loans are not taxed after either 10 years in PSLF *or* 20 or 25 years in IDR. Regardless of the reason, discharged student loan debt should not be treated as taxable income.

The table below and Examples 1 and 2 on the next page illustrate the many borrowers who will repay their loans in full in IDR. Examples 3, 4, and 5 show the significant tax consequences for a borrower with debt discharged under IDR. All of the examples compare income-driven plans to fixed-payment 10-year and 25-year repayment plans. For more details about the borrower scenarios and assumptions for Examples 1-5, see page 4.

Borrowers in income-driven repayment plans will repay ***in full*** (including all interest) if they:

Borrowed in federal student loans:	And earn at least:[2]	
	15%/25 years IDR (Original IBR)	**10%/20 years IDR (PAYE, 2014 IBR)**
$29,400 (avg. total debt of 2012 BA recipients who borrowed)[3]	$26,000	$35,250
$100,000	$52,650	$82,650

[1] This document focuses on the two newest IDR plans, IBR and PAYE. For a summary of existing IDR plans, see http://www.ibrinfo.org/existingidr.vp.html. For more information about the IDR plans and the Department of Education's online repayment estimator, visit http://studentaid.gov/idr and http://ibrinfo.org. For information on TICAS' proposal to streamline the multiple current IDR plans into one improved plan, see http://bit.ly/1FL7yrr.

[2] Incomes are adjusted gross incomes (AGI) in current dollars, rounded up to the nearest $50. Calculations conservatively assume a single borrower without dependents.

[3] TICAS. 2013. *Student Debt and the Class of 2012.* http://ticas.org/content/pub/student-debt-and-class-2012.

Example 1: Middle-income family (married with one child)

This family ***repays in full*** under all IDR plans and ***pays more in total*** than under a 10-year standard plan, but their monthly payments are more manageable under IDR.

- $50,000 in combined federal student loans
- $60,000 a year in combined income
- Has a child in year 8

	10-Year Plan	25-Year Plan	15% IDR, 25 Years	10% IDR, 20 Years
Monthly payments	$580	$350	$450 initially, rising to $580[4]	$300 rising to $580
Total payments	$69,050	$104,100	$72,700	$93,200
Amount discharged	n/a	n/a	$0	$0

- After 11 years and 3 months in 15% IDR (Original IBR):
  - They repay the entire loan principal ***plus $22,700*** in interest (no forgiveness)
- After 18 years and 2 months in 10% IDR (PAYE or 2014 IBR):
  - They repay the entire loan principal ***plus $43,200*** in interest (no forgiveness)
- In both 15% and 10% IDR, they ***pay more in total*** than under 10-year standard repayment

Example 2: Lawyers (married with one child)

This family also ***repays in full*** under all IDR plans and ***pays more in total*** than under a 10-year standard plan, but their monthly payments are more manageable under IDR.

- $238,000 in combined federal loans[5]
- $200,000 a year in combined income
- Has a child in year 4

	10-Year Plan	25-Year Plan	15% IDR, 25 Years	10% IDR, 20 Years
Monthly payments	$2,740	$1,650	$2,200 rising to $2,740	$1,470 rising to $2,740
Total payments	$328,650	$495,550	$347,050	$440,400
Amount discharged	n/a	n/a	$0	$0

- After 11 years and 4 months in 15% IDR (Original IBR):
  - They repay the entire loan principal ***plus $109,050*** in interest (no forgiveness)
- After 17 years and 10 months in 10% IDR (PAYE or 2014 IBR):
  - They repay the entire loan principal ***plus $202,400*** in interest (no forgiveness)
- In both 15% and 10% IDR, they ***pay more in total*** than under 10-year standard repayment

[4] Monthly payment amounts in the current IDR plans increase as the borrower's income increases, up to the amount s/he would have paid under a 10-year standard repayment plan.

[5] The average law school graduate in 2012 who borrowed had $119,000 in federal debt from undergraduate and graduate studies. TICAS analysis of data from the U.S. Department of Education, National Postsecondary Student Aid Study (NPSAS), 2011-12.

Example 3: Small business owner (married with two children)

IDR helps keep this family's monthly payments manageable, particularly while building their business. However, taxing the amount discharged after 20 years of payments ***increases the amount of taxes this family owes by more than two-thirds—adding $9,750 to their federal income tax bill for that year.***

- $46,000 in federal loans[6]
- Earns $0 for the first three years, while building a business
- Earns $45,000 per year starting in the fourth year
- Gets married in year 7. Spouse earns $30,000/year
- Has a child in year 9, and spouse begins working part-time, earning $20,000 a year. The couple has another child in year 11

	10-Year Plan	**25-Year Plan**	**15% IDR, 25 Years**	**10% IDR, 20 Years**
Monthly payments	$530	$320	$0 rising to $530	$0 rising to $490
Total payments	$63,500	$95,800	$91,400	$73,700
Amount discharged	n/a	n/a	$0	$32,950
Tax on discharged amount	n/a	n/a	n/a	$9,750

- After 18 years and 11 months in 15% IDR (Original IBR):
  - Repays entire loan principal ***plus $45,400*** in interest (no forgiveness)
- After 20 years in 10% IDR (PAYE or 2014 IBR):
  - Repays entire loan principal ***plus $27,700*** in interest
  - Owes $9,750 in federal income tax on the amount discharged, increasing tax burden ***by more than two-thirds***

Example 4: Engineer (married with two children)

IDR helps keeps this family's monthly payments manageable. However, taxing the amount discharged after 20 years of payments ***increases the amount of taxes this family owes by more than two-thirds—adding $13,000 to their federal income tax bill for that year.***

- $60,000 in combined federal loans
- Earns $60,000 a year as a civil engineer
- Has children in years 2 and 3
- Spouse does not work

	10-Year Plan	**25-Year Plan**	**15% IDR, 25 Years**	**10% IDR, 20 Years**
Monthly payments	$690	$420	$450 rising to $690	$300 rising to $590
Total payments	$82,850	$124,950	$112,400	$89,900
Amount discharged	n/a	n/a	$0	$50,800
Tax on discharged amount	n/a	n/a	n/a	$13,000

- After 18 years and 1 month in 15% IDR (Original IBR):
  - Repays entire loan principal ***plus $52,400*** in interest (no forgiveness)
- After 20 years in 10% IDR (PAYE or 2014 IBR):
  - Repays entire loan principal ***plus $29,900*** in interest
  - Owes $13,000 in federal income tax on the amount discharged, increasing tax burden ***by more than two-thirds***

[6] The average MBA graduate in 2012 who borrowed had $46,000 in federal debt from undergraduate and graduate studies. TICAS analysis of data from the U.S. Department of Education, National Postsecondary Student Aid Study (NPSAS), 2011-12.

Example 5: Social worker (divorced with two children)

IDR helps keep this family's monthly payments manageable, particularly when the borrower is just starting out as a social worker. However, taxing the amount discharged after 20 years of payments in IDR ***more than doubles the amount of taxes the family owes for the year, increasing their federal income taxes by almost $19,000.***

- $55,000 in federal loans from undergraduate and graduate school
- Earns $40,000 per year as a contractor for a State agency (does not qualify for Public Service Loan Forgiveness)
- Children are ages 8 and 10 when the borrower enters repayment

	10-Year Plan	25-Year Plan	15% IDR, 25 Years	10% IDR, 20 Years
Monthly payments	$630	$380	$120 rising to $630	$80 rising to $480
Total payments	$75,950	$114,500	$128,350	$61,350
Amount discharged	n/a	n/a	$7,100	$68,450
Tax on discharged amount	n/a	n/a	$2,000	$18,800

- After 25 years in 15% IDR (Original IBR):
  - Repays entire loan principal ***plus $73,350*** in interest
  - Owes $2,000 in federal income tax on discharged amount, increasing tax burden by 10%
- After 20 years in 10% IDR (PAYE or 2014 IBR):
  - Repays entire loan principal ***plus $6,350*** in interest
  - Owes $18,800 in federal income tax on the amount discharged, ***more than doubling*** the taxes he owes for the year
- In both 15% and 10% IDR, monthly payments are much more manageable than under 10-year repayment
- If the social worker worked directly for the State agency, he could qualify for Public Service Loan Forgiveness (PSLF) after 10 years and his discharged loan amount would not be treated as taxable income.

Details about Examples 1-5:

- All incomes in the examples are Adjusted Gross Incomes (AGIs) and all figures are in current dollars.
- Monthly loan payments are rounded to the nearest $10, and total payments and tax liability are rounded to the nearest $50.
- Unless otherwise noted, calculations assume that the borrower lives in one of the 48 contiguous states, the average interest rate on the borrower's loans is 6.8%, married borrowers file their taxes jointly, and AGI increases 4% a year.
- Calculations are based on 2015 federal poverty levels and 2014 federal income tax brackets and rates, and assume that the poverty level increases annually at the rate of inflation.
- All loan repayment amounts are calculated by TICAS.
- Estimated taxes paid are calculated using the Bankrate online tax calculator, available at http://www.bankrate.com/calculators/tax-planning/1040-form-tax-calculator.aspx.