Three Tax Fixes to Improve the
FEDERAL STUDENT AID PROGRAM

MARCH 2020

1. Stop Taxing Discharged Student Loans as Income. Borrowers who repay their loans under an income-driven repayment (IDR) plan have any remaining debt discharged after 20-25 years of responsible payments (depending on the plan). This forgiven debt is taxed as income. We urge lawmakers to end this taxation and, in doing so, align with recent policy changes that have removed the tax liability formerly associated with other forms of discharged student loan debt.

Long recognized as a policy design flaw — forgiven student debt is not a windfall of income — as well as a looming threat for borrowers in IDR, this unfair tax penalty will become a growing problem for struggling borrowers in the years ahead if it is left unaddressed.

2. Stop Taxing Pell Grants as Income. Currently, Pell Grants are not taxed as income if they are used to pay for required tuition, fees, books, supplies, or equipment, but they are taxed as income if they are used to pay for transportation, food, housing, or other eligible costs of attendance.

Therefore, if students use their Pell Grants to cover fully their tuition, fees, and books, they will have no out-of-pocket qualified expenses for claiming the American Opportunity Tax Credit (AOTC). Meanwhile, if students claim the AOTC for tuition, fees, and books paid for out of pocket, and use their Pell Grants to cover remaining costs of attendance, then they may face a tax liability.

By removing the threat of any tax liability associated with Pell Grants, this complicated, confusing interaction will no longer occur and more students, particularly at low-tuition institutions such as community colleges, will be able to benefit from both Pell Grants and the AOTC, just as students attending higher-cost institutions already do.

The Joint Committee on Taxation estimated that eliminating the taxation of Pell Grants would cost less than half a million dollars per year.

We urge lawmakers to support H.R.3803, the Pell Grant Flexibility Act of 2019, which will resolve this issue. The bipartisan bill is led by Reps. Mark DeSaulnier (D-CA), Lee Zeldin (R-NY), and Peter King (R-NY).

3. End Overly Punitive Tax Offsets for Struggling Borrowers. Borrowers with defaulted loans can have their wages or tax refunds garnished by the Treasury Department through its Treasury Offset Program (TOP), often causing financial hardship for those who can least afford it.

We recommend that offsets be capped at a reasonable level for all borrowers and that certain low-income borrowers, including those who qualify for the Earned Income Tax Credit (EITC) and/or the Child Tax Credit (CTC), be exempted from TOP collections.

We urge lawmakers to support H.R.5114, the Stop EITC and CTC Seizures Act, led by Rep. Sylvia Garcia (D-TX) and H.R.2991, the Protection of Social Security Benefits Restoration Act, led by Rep. Raul Grijalva (D-AZ).