THE (NON)TAXATION OF STUDENT DEBT CANCELLATION: STATUTORY MISINTERPRETATION AND NORMATIVE CONFLICT

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Student debt cancellation is an increasingly important form of subsidy for higher education and reflects a shift toward financing higher education with income-contingent loans. But the legal formalities of debt cancellation expose borrowers to the risk of taxation, especially after 2025. This paper shows that the Internal Revenue Service and the Treasury's position that student debt cancellation is sometimes taxable is based on a misreading of the tax code and its history. It is further argued that this misreading arises in part because of the conflicting norms of tax policy and nontax social policy, a conflict that arises in other transfer contexts as well.

Keywords: student loans, student debt, tax law, higher education finance, statutory interpretation, general welfare exclusion

JEL Codes: H52, I22, K34

I. INTRODUCTION

The federal student loan program is the largest single source of government funds for higher education. In 2023, the federal student debt program injected about $88 billion per year into the higher education sector (expected to rise to $93 billion in fiscal year 2025) (US Department of Education, 2024), larger than any other single government funding source for higher education, including state direct spending and federal grants and financial aid (Laderman et al., 2023). The relative importance of student debt in higher education finance can sometimes be missed because loan proceeds are subsumed within student tuition payments when looking at higher education sources of revenue. But today about half of

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Electronically published August 1, 2024

National Tax Journal, volume 77, number 3, September 2024.
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tuition and fee revenue is financed by the federal student loan program.[1] And because so much money is running through the federal student loan program, benefits and relief for students have increasingly also been directed through the student loan program — especially through debt cancellation programs such as Income-Driven Repayment (IDR) and Public Service Loan Forgiveness (PSLF).

In the last decade or so, student debt cancellation has grown to become a major form of student aid, with expected annual transfers to students approaching Pell Grant numbers[2] — and that is just under current policy, without considering the Biden Administration's proposals for one-time, lump-sum forgiveness. While those one-time proposals have been tied up in court, debt cancellation under other programs has continued and grown to become a central part of the overall federal student loan system — or indeed, of higher education finance generally.

These IDR programs allow borrowers to pay a fixed percentage of their income (generally 10 percent, though dropping to as low as 5 percent beginning in 2024[3]) above a threshold (as high as 225 percent of the relevant poverty level) for a fixed number of years (10–25, depending on the program),[4] after which any remaining debt is canceled. At a high level of generality, these programs supplement or replace ex ante aid based on student or family need (such as grants and tuition tax credits) with ex post aid based on the income of graduates and former students; higher-income former students pay the full cost (plus interest), while others receive some graduated relief, and some pay back nothing at all (Brooks, 2016a).[5] Indeed, one could conceive of IDR-based student loans as a combination of an up-front government grant followed by a "graduate tax" on the income of those grantees (Brooks, 2016a; Brooks and Levitin, 2020). But that idealized model has struggled against implementation problems and administrative complexity. And one of those problems is confusion and misunderstanding around the tax and legal status of student debt cancellation.

The Internal Revenue Service (IRS) has taken the position that, absent a clear statement by Congress, canceled student debt should be added to the borrower's gross income for tax purposes — effectively canceling out a portion of the debt cancellation. This is not a theoretical concern; the IRS has imposed tax on this basis

[1] According to the National Center for Education Statistics, total tuition and fee revenue (net of allowances) for public, private nonprofit, and private for-profit postsecondary education schools was about $163 billion in 2021–2022 (NCES, 2022).

[2] The Education Department estimates that the "net subsidy" (more on that later) for new loans made in 2024 is $33 billion (US Department of Education 2024), and the 2024 outlay for Pell Grants was $35 billion (US OMB, 2024).

[3] The Saving on a Valuable Education (SAVE) Plan, which replaced the old REPAYE Plan, will lower payment to as little as 5 percent of discretionary income beginning July 2024.

[4] For PSLF, borrowers can enroll in one of the other IDR programs but can have their debt canceled after 10 years, rather than then 20–25 years of payments that apply to the other programs. PSLF requires that the borrower work in a designated "public service" field for those 10 years.

[5] In 2024, a single person making $32,800 a year or less would have a monthly payment of $0.

in the recent past.[6] However, this imposition of tax is based on an error of statutory interpretation; Congress has in fact long intended for student debt cancellation to be excluded from income, just like most other kinds of student financial aid. More broadly, the erroneous tax treatment of student debt also reveals some under-appreciated risks from the interaction of tax and nontax law and policy. The legal error that has resulted in the belief by the IRS that canceled student debt is taxable arises in part from the typical application of tax law norms and logic colliding with the nontax social policy concerns of debt cancellation — and that conflict could and does arise in other areas of social policy, with the law on point being surprisingly weak.[7]

This paper explains how student debt cancellation grew to become central to higher education finance — including some important steps in the budget treatment of federal credit programs. It also explains the confusing current tax treatment of student debt cancellation. But more importantly, this paper also argues that taxing any sort of student debt cancellation is based on a misunderstanding and misreading of relevant tax law. The key error is that the IRS and Treasury interpreted section 108(f) of the tax code prior to 2018 as providing a *limited* tax exclusion only for PSLF, when Congress intended 108(f) originally as a small fix to ensure a continued *general* exclusion for student debt cancellation as a subset of the section 117 scholarship exclusion. Congress has added a temporary patch to explicitly exclude all student loan cancellation from taxation, but that patch is set to expire at the end of 2025,[8] long before most debt cancellation under IDR (or other cancellation provisions) will occur. This error thus has the potential to be a major drag on the potential policy and social benefits from student loan cancellation; it de facto means that canceling 100 percent of a student's remaining debt is really just canceling as little as 63 percent but substituting the Treasury Department for the Education Department (ED) as the creditor.

While Congress could fix this problem by making its temporary patch permanent, the story of how we got here reveals some perhaps under-appreciated risks of the collision of tax policy and nontax social policy, particularly when social policy is run through federal credit programs like the student debt system. The normative questions raised by tax policy and the interpretation of tax law — What is income? Should it be taxable? What costs should be deductible when calculating income? — are unrelated to and even counterproductive in thinking about the burdens and benefits of higher education, a fundamentally social good with byzantine layers of direct and cross-subsidization, some of which are obscured by the student

[6] Putnam, Judy, "Putnam: Wounded Army Vet Wins the Battle But Loses the Tax War," *Lansing State Journal*, October 20, 2017, https://www.lansingstatejournal.com/story/opinion/columnists/judy-putnam/2017/10/20/putnam-wounded-army-vet-wins-battle-but-loses-tax-war/781458001.

[7] Raghavan (2022) argues that the taxation of canceled debt (student or otherwise) is not solely a product of tax norms but also of political, social, and racial factors that punish those who must rely disproportionately on credit.

[8] I.R.C. § 108(f)(5).

loan program. A student's net tuition payment — debt-financed or otherwise — has become so disconnected from the cost of the education provided that trying to determine whether canceled student debt is "income" or not is not even a coherent question. While this problem is most acute in the context of higher education and the student loan program, aspects of it exist in other areas of social policy as well, and those problems may only increase as federal and state governments explore new models of social and redistributive spending.

II. STUDENT LOANS AND STUDENT AID

The student loan program is both a massive source of funds for higher education and, increasingly, the site for the delivery of large amounts of student aid in the form of debt cancellation. This part briefly describes the process by which the student loan program grew into something more akin to a progressive social program, but it is worth first noting that one reason the student loan program has grown is because of its efficacy in driving higher education outcomes relative to some other kinds of extant aid or interventions. For example, the empirical literature generally concludes that higher education tax incentives, such as tuition or student loan interest deductions and education tax credits, have negligible effects on attendance, graduation, or other measures of college success (LaLumia, 2012; Turner, 2012; Bulman and Hoxby, 2015; Hoxby and Bulman, 2016; Dynarski and Scott-Clayton, 2016; Page and Scott-Clayton, 2016). Moreover, the problem does not seem to be one of lack of information about the availability or effect of the tax incentives (Bergman, Denning, and Manoli, 2019). At most, the tax incentives act as a partial transfer to middle-class families (Dynarski and Scott-Clayton, 2016), though not a very effective one, particularly if schools end up capturing some of the benefits (Turner, 2012).

On the other hand, research shows that interventions that lower the up-front cost of higher education are more successful. State funding or direct financial aid would likely be the most effective. But given the decline in state funding and the corresponding rise in net tuition (Dynarski and Scott-Clayton, 2016; Laderman et al., 2023), access to credit through student loans also appears to positively influence measures of college attainment (Yannelis and Tracey, 2022).

A reasonable conclusion from this body of research is that the most effective interventions are those that lower the immediate, salient financial barriers of higher education that students face ex ante. Financially equivalent interventions that reduce costs through tax savings do not appear to matter, suggesting that students are driven by some combination of up-front liquidity constraints and reasonable behavioral biases when making enrollment and re-enrollment decisions. Direct aid, at either the institutional or student level, that reduces costs would likely be the most effective tool (even if costly), but the availability of student loans may be the next best option. But that, of course, raises the question of whether the longer-term negative effects of excessive personal debt might counteract the positive effects of human capital formation. Some studies have suggested that student loans might reduce, for example, homeownership (Mezza et al., 2020) and retirement savings (Rutledge, Sanzenbacher, and Vitagliano, 2016).

With all that in mind, we can perhaps see why higher education finance has tended to converge on discounted — but debt-financed — tuition as a major piece of higher education finance. And, furthermore, why the student loan system is a particularly attractive vehicle for delivering additional student aid in the form of debt reduction or cancellation. It took many incremental steps to arrive at this place, however.

A. Evolution of Student Loans

The federal student loan program started as a more-or-less conventional credit program (though one still suffused with public purposes) but has evolved today into a program that more resembles an ex ante government grant program coupled with ex post progressive income surtax on loan recipients (something akin to a "graduate tax").[9] Since 2010, all federal student loans were made by the federal government itself (rather than subsidized private lenders) and since 2012, those loans were eligible for one of the IDR programs, which combine a monthly income-based loan payment (i.e., something approximating a tax on income) for a fixed number of years with cancellation of any remaining debt at the end of that period. But getting to this system has been an incremental process over decades, and that narrative shows how, at each major step, loans shifted further toward being a vehicle for progressive social funding of higher education. That process also shows, however, the accumulation of administrative complexity that ends up limiting the efficacy of that progressive social funding model. The taxation story this paper focuses on is one example of that damaging complexity, but not the only one.

Starting in the post–World War II period, there was even then an understanding that high student fees were a major barrier to college access, which was an issue of great concern with a generation of GIs returning home (and with the beginnings of the baby boom starting to appear). Some loan products were available, but they were little used, in part because the terms were so onerous (Truman Commission, 1947). The market failure around student lending — especially the lack of collateral — was well understood as early as the 1930s (Walsh, 1935).

The first major government intervention in student loans was in the National Defense Student Loan (NDSL) program, created by the National Defense Education Act of 1958. In its first incarnations, that program provided loans capped at $1,000 per year, $5,000 per student, and a total of $250,000 per institution per fiscal year. Schools themselves were also supposed to provide 10 percent of the loan funds, and technically the school itself was the creditor, even though the bulk of the funds came from the federal government. Furthermore, the NDSL program (which later became the Perkins Loan program) also had a limited form of debt cancellation; teachers could cancel 10 percent of their loan balance for each year of

[9] This review relies largely on Brooks and Levitin (2020).

service, up to a maximum of 50 percent. So, from the earliest stages we see elements of using loans as grants.

By the 1960s, it was clear that the NDSL program and other existing higher education programs were insufficient and that the public interest in higher education had evolved beyond narrow national defense–related topics. The Higher Education Act (HEA) of 1965 created the Guaranteed Student Loan (GSL) program, the predecessor to today's federal student loan program, but quite different in its operation. In particular, the GSL program relied on subsidized private lending; private lenders would put up the capital, but with the federal government subsidizing the interest payments (for low-income borrowers) and guaranteeing a portion of the principal in the case of default.

Although the GSL program was, in a formal sense, a private lending program, the move from the NDSL program to the GSL program shows a shift toward an increasing public financing role. The NDSL program was relatively small and targeted, and it appeared to be mostly an attempt to kick-start school-based lending. The GSL program, by contrast, was massively larger, incorporated interest subsidies, and had the federal government carrying most or all of the credit risk. The rollout of the GSL program coincided with similar government interventions into credit markets, especially home mortgages, such as direct or guaranteed mortgages for veterans through the Department of Veterans Affairs and the creation of Fannie Mae, to provide for a secondary market in mortgages. The 1972 amendments to the Higher Education Act created a similar secondary market for student loans through the Student Loan Marketing Association, or Sallie Mae, which financed student debt purchases with bonds backed by the full faith and credit of the United States government. And the size and reach of the GSL program continued to expand throughout the 1970s and 1980s, including especially the creation of the Parent Loan for Undergraduate Student (or "PLUS") loan product in 1980, which after 1992 was not subject to the lending caps that applied to loans made to students, and thus became a major source of the growth in student debt.[10]

The 1990s saw two key moves in the shift of student loans from private credit to social program: the creation of Direct Loans (as a pilot program) in 1992, and the first IDR program in 1993. Direct Loans, as the name implies, are loans directly from the federal government and held on its balance sheet, unlike the subsidized private lending under the renamed Federal Family Education Loan (FFEL) program. (The next section will say more about the importance of this shift.) The first IDR program, Income-Contingent Repayment, followed the basic model of today's IDR programs — income-based caps on monthly payments and cancellation of the loan after a period of payment — but the terms were not attractive and the program was little used.

[10] Federal student loans for undergraduate education are capped at a total (for all years) of $31,000 (for dependent students) or $57,500 (for independent students). Graduate students, however, can borrow up the full "cost of attendance" per year. 34 C.F.R. § 685.203.

Direct Loans and IDR thus began as relatively minor pieces of the overall student loan program, but in the 2000s, they became dominant. Both Direct Loans and IDR expanded somewhat gradually at first — for example, with the creation of PSLF and the Income-Based Repayment (IBR) plan in 2007 — but the explosive moment was in 2010. Following a series of lending scandals and the 2008 financial crisis (in which student loan lenders had to be bailed out like other lenders) — and also in search of revenue to help pay for Obamacare[11] — Congress essentially nationalized the student loan program. It ended the FFEL program of subsidized private lending and made Direct Loans the only loan product going forward. After 2010, the federal government itself was the source for all loans under the student loan program, and it quickly became the largest federal direct loan program by nearly an order of magnitude.[12]

In addition, Congress made IBR more generous for borrowers — though the biggest changes in the IDR program came through regulation, with the Obama Administration creating the Pay As You Earn (PAYE) and Revised Pay As You Earn (REPAYE) plans with more generous terms to be more attractive to borrowers, particularly on interest accruals and capitalization. REPAYE has now been reformulated in the SAVE program, with yet more generous terms (discussed in more detail later). And, importantly for the story of the shift from private lending to social spending, REPAYE and SAVE use an income-based payment *regardless of income*, whereas earlier programs, like IBR and PAYE, use an income-based cap but otherwise default to a standard amortizing loan payment once incomes get high enough.[13]

According to ED's Student Loan Portfolio, as of the end of 2023, $1.4 trillion of the student loan portfolio are Direct Loans, with only $185 billion under the legacy FFEL program (FSA, 2024a).[14] And of the roughly $1.2 trillion of debt that is currently in repayment, about half — $603 billion, representing about one-third of

[11] The Student Aid and Fiscal Responsibility Act (SAFRA) was passed as a provision of the larger Health Care and Education Reconciliation Act of 2010, better known as the bill that resolved the final tweaks to the Affordable Care Act and allowed its passage. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §§ 2001–2303, 124 Stat. 1029, 1071 (2010). The revenue generated from the student loan reforms was scored as part of that health care bill, allowing it to pass through reconciliation procedures (CBO, 2010).

[12] According to the 2025 Budget of the United States, the government issued around $145 billion in student loans in 2024 (combining new loans and consolidated pre-existing loans). The next largest direct loan program was under the new CHIPS technology subsidization program, at $25 billion (US OMB, 2024).

[13] In other words, under IBR and PAYE, a borrower would pay 10 percent of discretionary income until that amount exceeded what would have been the standard loan repayment amount on a typical amortizing loan, at which point a borrower would switch to that payment. Under REPAYE/SAVE, however, once a borrower is enrolled, they will make the income-based payment for the duration of the loan, regardless of how high their income goes.

[14] Of that $185 billion, about $40 billion is actually owned by ED (largely because of the 2008-era bailouts), $37 billion is in ED's default management system, and $20 billion is held by a state or nonprofit guaranty agency (FSA, 2024b). Thus even of the tiny bit of nominally private loans that make up the current portfolio, a good chunk of that debt is nationalized in some way. The debt that is

borrowers in repayment — is enrolled in one of the IDR plans, the largest being SAVE/REPAYE. With the Biden Administration's continuing push to enroll borrowers in SAVE and its substantially more generous terms compared to prior IDR plans, it is not hard to imagine that soon student loans will de facto all be income-contingent, with borrowers paying between 5 and 10 percent of their discretionary income for 10–25 years.

This is clearly a massive change from the beginnings of the NDSL program, or even the early GSL program; it starts to approach something more like student loans in Australia[15] or the United Kingdom,[16] which both have only income-based repayment and debt collection through the tax system. With a few additional changes — such as making SAVE the only form of repayment, reducing or eliminating interest,[17] and instituting payroll withholding — the student loan program would become equivalent to a government education grant, followed by an income surtax on graduates and former students keyed to the size of the grant. Brooks and Levitin (2020) argue that certainly by that point, if not already, the student loan program will cease to be a credit program in all but name. But the name still matters; calling these government grants "loans" triggers all sorts of legal and institutional repercussions. Brooks and Levitin (2020) argue that the mismatch of saddling a de facto social spending program with the inappropriate institutional apparatus of debt — and not the size of the overall program or typical loan (grant) — is the source of many of the problems with the student loan program. A particularly egregious example of this mismatch is the tax treatment of loan cancellation. If the program literally followed a grant-and-tax model, there would be no debt to cancel; the deal would simply be that graduates pay an income percentage for some period of time. But by constructing that program through the mechanism of forgivable debt and

still nominally held in private hands does not fit quite as cleanly as the main argument of this paper, but it is small enough (and shrinking) that I have put aside those issues here.

[15] Briefly, Australia's HELP program provides loans for higher education, paid back through graduated income-based payments collected through the tax system, with interest equal to the rate of inflation. The debt is not canceled at any point, except in special circumstances. https://www.studyassist.gov.au/help-loans.

[16] UK student loans operated similar to Australia's: income-based payments collected through the tax system, with inflation-based indexing (though with some variation across the UK). Key differences with Australia are (a) the rates are not graduated based on income but are either 9 percent for undergraduate loans or 6 percent for graduate loans, and (b) the loans will be canceled at some point, though potentially as much as 40 years later. Cassidy, John, and Hazel Shearing, "Student Loans: How Do They Work, What Can I Borrow and When Do I Pay It Back?" *BBC*, August 11, 2023, https://www.bbc.com/news/education-62241512.

[17] The nominal interest rates are set by statute in the Higher Education Act, but the interest subsidization pieces of the IDR programs can lead to effectively a 0 percent interest rate for some borrowers; interest thus becomes a sort of additional cross-subsidization from higher-income former students who do not qualify for the interest subsidies. There may be some logic for helping to fund the program in that way (Brooks, 2016a), but more likely interest just adds confusion, especially because of its association with classic debt instruments, rather than progressive social funding (Brooks and Levitin, 2020).

income-contingent loan payments, we drag in additional legal consequences associated with debt and its cancellation.

B. The Federal Credit Reform Act and Its Impacts on Direct Government Lending

A central piece of this story is the shift in the government accounting treatment of federal credit programs that occurred in 1990. Prior to then, federal credit programs — money loaned by, and then repaid to, the federal government — were treated as on-budget outlays. That is, money loaned was treated as an expenditure, and the interest and eventual principal repayment were budgetary receipts (Stanton, 2002). This made federal government loans highly visible and salient, with direct effects on the nominal size of government. Furthermore, if the loan terms were longer than 10 years, the principal repayment would be outside the budget window, meaning that most of the revenue offsetting the cost of the loan would not be scored at the time the loan was made; in that case, a loan was essentially the same as a grant, for budget purposes.

By contrast, loan *guarantees* prior to 1990 had an almost negligible budgetary footprint; all that showed up on the budget was any incremental interest subsidy paid to the lender during the loan term, and some potential reimbursement of the lender in the case of default. With that context, it is easy to see why so much of the governmental intervention in debt markets — student loans, home mortgage, or otherwise — took the form of loan guarantees or secondary market interventions rather than direct lending.

That budgetary logic changed in 1990 with the passage of the Federal Credit Reform Act (FCRA). The intent of FCRA was to more accurately account for the budget effects of loans and also to equalize the treatment of direct loans and guaranteed loans (Stanton, 2002). Under FCRA, direct loans and loan guarantees are both scored the same way, based on the net present value of the expected difference between the loan outlay and repayment, all in the year of the loan disbursement.[18] In other words, the loaning agency takes the loan principal amount and offsets it with the net present value of the expected receipts — both interest and eventual loan principal repayment, but accounting for risk of default — for the full life of the loan regardless of whether payments extend beyond the 10-year budget window. That difference (the "net subsidy") is treated as a budget outlay (or receipt) in the year the loan is made, dramatically reducing the budget effect of a direct loan. As a result, in many cases loans are treated as net revenue in the year of their issue.[19]

[18] Federal Credit Reform Act of 1990, 2 U.S.C. §§ 661a(5), 661c.

[19] The agency is also required to re-estimate the expected repayments annually to account for things like changes in default risk. Any resulting increase (decrease) in a loan cohort's net subsidy is treated as an additional expenditure (receipt) in the year of re-estimate.

With FCRA in mind, we can see why student Direct Loans first appeared in 1992 — shortly after FCRA — and could then grow substantially with little budgetary pushback even as loan sizes became a more salient political issue. Indeed, for a time, student loans were consistently a source of substantial revenue for the government, and that revenue was used to finance further government spending or tax cuts, even though the bulk of that revenue was mostly uncollected and would not be collected for decades in some instances (Brooks, 2022; US GAO, 2022).

In the first years after the shift to all Direct Loans, ED projected that each loan cohort would bring about substantial profit, peaking with the 2013 loan cohort, which under FCRA was estimated by GAO to have a "net subsidy" of −19.7 percent; that is, it would generate a 19.7 percent profit for the government, or about $27.3 billion (US GAO, 2022). It was not until the 2020 cohort that ED projected a positive net subsidy (i.e., a net outlay) for a loan cohort in the year the loans were made. According to US GAO (2022), ED's original FCRA estimates for all Direct Loans from 1997 through 2021 (the last year of GAO's study) totaled $114 billion in income for the government, or an overall net subsidy of around −6 percent. By 2021, however, ED had re-estimated the net subsidy downward for all loan cohorts, such that it anticipated a net cost to the government of around $197 billion, or an overall net subsidy of around 8.8 percent.[20]

It is important to place these costs in context. First, GAO estimates that of the total $311 billion change as of 2021 in net costs of the student loan program from re-estimates (from net revenue of $114 billion to net outlay of $197 billion), roughly one-third, or about $122 billion, is associated with COVID-related payment pauses and similar modifications, meaning at most $189 billion of the net change in subsidy is due to more generous IDR programs. If correct, then as of 2021, the IDR programs are associated with an overall net outlay of around $75 billion over at least 25 years of loans, relative to an outstanding loan balance of $1.8 trillion. By contrast, Pell Grants have an outlay of around $35 billion per year (US OMB, 2024). That said, the subsidy estimate for the 2024 student loan cohort is $33 billion (about a 21 percent net subsidy rate) — so roughly on par with Pell Grants for the same cohort (US Department of Education, 2024).

Second, these numbers reveal that the largest cost to the government from IDR is a reduction in profit. But the FCRA budget process treats the reduction in profit as an outlay in the year of the reduction. For example, suppose that a given loan is estimated in the year of its outlay (Year 1) to produce $1,000 in net revenue on a present value basis over its life. That would be reported on the national budget as a receipt of $1,000 in Year 1. But suppose in Year 2, there is a re-estimate of the likely repayment on that loan because of a new IDR program, such that the loan is now estimated to generate only $500 in net revenue. That re-estimate would be

[20] The Biden Administration's Fiscal Year 2025 budget contains a similar estimated net cost for all outstanding loan cohorts of $121.8 billion (US OMB, 2024).

reported as a budget *outlay* of $500 in Year 2. Thus, from one standpoint, the "cost" of the new IDR program is treated as $500, even though the loan itself is still profitable to the government.

Third, it is worth noting the source of the potential profit from a non-IDR student loan — high interest rates. The interest rate is set by statute to be well above the government's borrowing rate (and thus its discount rate).[21] This mechanically results in a negative net subsidy from a typical amortizing loan; in essence, the loan value is inflated at the loan interest rate, and then deflated at the government's discount rate, so the rate spread generates net revenue under FCRA. While debt cancellation under IDR is an important part of the change in the net subsidy for student loans, the interest subsidies are also a big portion (though I am not aware of studies or reports that disaggregate the two). Several of the IDR programs, especially SAVE, limit the accrual and capitalization of interest when the income-based payment is insufficient to cover it fully, though in complicated ways. Thus, much of the net subsidy discussed earlier — treated as an outlay on student borrowers — is just a cut in the interest borrowers must pay. Again, as of 2022, the government estimated that it would be paid back nearly 90 percent of the $1.8 trillion it has loaned, with a shortfall of just $197 billion.

C. IDR and Other Debt Cancellation Programs

The prior subsections sketched out how interest subsidies and debt cancellation have transformed the federal student loan program from a mostly typical credit arrangement to a form of progressive social spending on higher education, where the progressivity is based on the income of former students who participate in the program. This section provides a bit more detail on the programs themselves and how they work. It also introduces the details on the tax law treatment of student debt cancellation and interest subsidization.

1. SAVE Program

The SAVE program is the dominant IDR program and, because of its generous terms, is likely to be the only plan going forward. The program began in 2015 as the REPAYE plan.[22] REPAYE began by requiring a payment of 10 percent of discretionary income (i.e., adjusted gross income [AGI] above 150 percent of the relative poverty level),[23] for 20 years (extended to 25 years if a borrower had any graduate school

[21] The Higher Education Act determines the rate by adding a spread of 1–3.1 percent to the federal borrowing rate. 20 U.S.C. § 1087e(b).

[22] See 80 Fed. Reg. 67,204 (October 30, 2015).

[23] 34 C.F.R. § 685.209(c)(2)(i) (2023).

debt, but reduced to 10 years for PSLF).[24] REPAYE also subsidized interest, first by forgiving a portion of any unpaid interest (because the income-based payment is too low to cover it) and second by *not* capitalizing any of the remaining accrued, but unpaid, interest into the loan balance unless the borrower left the REPAYE program[25] (a significant change from earlier IDR programs, which capitalized some or all interest, resulting in negative amortization).

Beginning July 1, 2024, REPAYE becomes SAVE, with more generous repayment terms.[26] First, the exemption amount rises from 150 percent of the poverty level to 225 percent of the poverty level.[27] Second, the monthly payment is reduced from 10 percent of discretionary income to 5 percent for payment of undergraduate debt.[28] (The rate remains 10 percent for graduate debt, with a prorated mixed rate for those with a combination of undergraduate and graduate debt.[29]) Third, all accrued, but unpaid, interest is uncharged and forgiven (which makes the question of capitalization moot).[30] The 20- or 25-year repayment period before cancellation is unchanged.[31]

2. The Pre-SAVE IDR Programs

The other IDR programs — Income-Contingent Repayment (ICR), Income-Based Repayment (both "old" IBR and "new" IBR), and PAYE[32] — will be obsolete going forward, particularly because borrowers now in those repayment plans can (and should) switch to SAVE.[33] But some of their details are worth noting, to contrast them with the current SAVE program. First, these programs had some combination of higher income percentages (15 percent for ICR and "old" IBR, 10 percent for the others) and lower exemption thresholds (100 percent of the poverty level for ICR, 150 percent for the others). Second, until recently, some or all unpaid interest accrued and was capitalized into the loan principal (in detailed ways not worth covering here), which meant that unpaid balances might grow while a borrower had low income-based payments. That affects how much nominal debt is ultimately canceled after 20 years (or reimposed if a borrower leaves the program). (New regulations eliminated interest capitalization for all programs except

[24] 34 C.F.R. § 685.209(c)(5) (2023).

[25] 34 C.F.R. § 685.209(c)(2)(iii) (2023).

[26] The SAVE program has been recently challenged in court as exceeding ED's authority under the HEA, but the case has not progressed as of this writing. Tara Siegel Bernard, "Biden's Student Loan Repayment Plan Is Being Challenged. Here's What to Know," *New York Times*, April 13, 2024, https://www.nytimes.com/2024/04/13/business/biden-save-student-loans-courts.html.

[27] 34 C.F.R. § 685.209(b)(1) (2024).

[28] 34 C.F.R. § 685.209(f)(1)(i) (2024).

[29] 34 C.F.R. § 685.209(f)(1)(i) (2024).

[30] 34 C.F.R. § 685.209(h)(1) (2024).

[31] 34 C.F.R. § 685.209(k) (2024).

[32] For fuller descriptions of these programs, see Brooks (2018).

[33] *See* 34 C.F.R. § 685.209(i) (2024).

IBR, beginning July 2023,[34] and the Biden Administration is proposing to cancel some past accrued interest.[35]) Finally, these programs all reverted back to a standard amortizing loan payment once a borrower's income got high enough. In other words, a borrower would pay the *lesser* of the standard payment or the income-based payment. In contrast, under SAVE (and REPAYE), a borrower pays the income-based percentage *regardless* of income, even if that is higher than what a standard loan payment would be — which makes those payments closer to a true income surtax.

3. Other Debt Cancellation Programs

Although IDR is the primary tool for delivering student debt cancellation, other tools exist and have been used by the ED and others, in some cases to relieve large amounts of debt. An understanding of the overall policy landscape for student debt cancellation requires an understanding of these programs. Briefly, these include:

- *Death and Disability Discharge*. Student debt can be canceled in the case of a borrower's death[36] or "total and permanent disability."[37] This has been an important tool especially for disabled veterans, and new regulations make discharge automatic when disability thresholds are met for Social Security or Veteran's Administration purposes.[38]
- *Closed School Discharge*. A student's debt can be canceled if their school closes while they are attending it or if they withdrew from the school less than 180 days before the school's closure,[39] though the tool can be applied to borrowers outside that window.[40] New regulations also make this cancellation automatic in some circumstances, though these regulations are currently under court challenge and an injunction as of this writing.[41]
- *Borrower Defense Discharge*. Loans can be canceled in circumstances where the borrower has a "defense to repayment," which encompasses a

[34] 87 Fed. Reg. 65904 (November 1, 2022).

[35] "President Joe Biden Outlines New Plans to Deliver Student Debt Relief to Over 30 Million Americans Under the Biden-Harris Administration," White House Press Release, April 8, 2024, https://www.whitehouse.gov/briefing-room/statements-releases/2024/04/08/president-joe-biden-outlines-new-plans-to-deliver-student-debt-relief-to-over-30-million-americans-under-the-biden-harris-administration.

[36] 34 C.F.R. § 685.212(a).

[37] 34 C.F.R. §§ 685.212(b), 685.213.

[38] 34 C.F.R. § 685.213(d), added by 86 Fed. Reg. 46972, 46982 (August 23, 2021).

[39] 34 C.F.R. §§ 685.212(d), 685.214(d).

[40] 34 C.F.R. § 685.214(h).

[41] *Career Colleges and Schools of Texas v. U.S. Department of Education*, 98 F.4th 220, 251–54 (5th Cir. 2024).

range of fraud-like behavior, like misrepresentation and breach of contract.[42] This is a powerful tool for the government to use especially for students who attended predatory schools, and the Biden Administration especially has been applying it aggressively.[43] The rules themselves have been in flux across multiple administrations and have been the subject of several rounds of litigation. The newest regulations, like the closed school discharge regulations, are currently under court challenge and injunction.[44]

- *False Certification Discharge*. Student debt can be canceled in cases where the school falsely certified the eligibility of the borrower to receive a student loan,[45] a provision that has some overlaps with borrower defense, for example, where a school signed a student's name on a loan application without authorization.[46]
- *Bankruptcy*. There is a widespread belief that student loans cannot be discharged in bankruptcy, but that is not accurate. Rather, a student debt can be discharged only in the case of "undue hardship,"[47] but that standard is met frequently when debtors actually seek discharge (Iuliano, 2012).
- *Settlement and Compromise*. Finally, the Secretary of Education simply has the ability under the Higher Education Act to "compromise, waive, or release any right, title, claim, lien, or demand, however acquired" (Herrine, 2020).[48] This is the authority ED is invoking in its most recent proposal for one-time, lump-sum cancellation.[49]

4. Current Tax Treatment of Student Debt Cancellation

As of this writing, the tax code excludes all canceled student debt from gross income for tax purposes. However, that provision is set to expire at the end of 2025. Unless it is extended, the tax treatment of student debt will revert to the pre-2018 status quo. I summarize the IRS's view of that baseline law here.

[42] 34 C.F.R. § 685.222.

[43] "President Joe Biden Outlines New Plans to Deliver Student Debt Relief to Over 30 Million Americans Under the Biden-Harris Administration," White House Press Release, April 8, 2024, https://www.whitehouse.gov/briefing-room/statements-releases/2024/04/08/president-joe-biden-outlines-new-plans-to-deliver-student-debt-relief-to-over-30-million-americans-under-the-biden-harris-administration.

[44] *Career Colleges*, 98 F.4th at 239–51.

[45] 34 C.F.R. §§ 685.212(e), 685.215.

[46] 34 C.F.R. § 685.215(a)(1)(iii).

[47] 11 U.S.C. § 523(a)(8).

[48] 20 U.S.C. § 1082(a)(6).

[49] Lieber, Ron, "How Biden Might Try to Cancel Student Debt Next," *New York Times*, July 10, 2023, https://www.nytimes.com/2023/07/10/your-money/biden-student-loans-cancellation.html.

- *IDR Other Than PSLF*. The Treasury Department has taken the position that debt canceled under an IDR program (other than PSLF) is **taxable**.[50]
- *PSLF*. Because of the explicit exclusion by section 108(f), debt canceled under PSLF is **nontaxable**, even if the borrower was enrolled in an IDR plan.
- *Death and Disability Discharge*. Because there was no clear exclusion in the tax code, the IRS treated this discharge as **taxable** and has imposed tax on that basis.[51] In 2018, Congress added a temporary exclusion to section 108(f) just for death and disability, but that provision was set to expire in 2025 and was subsequently subsumed by the 2021 temporary exclusion for all student debt cancellation.
- *Closed School Discharge*. The Higher Education Act (rather than the tax code) states that canceled debt under the closed school discharge is **nontaxable**,[52] but that provision was so little known, that the IRS for a period was not aware of its existence and had stated erroneously that such discharge was taxable (Brooks, 2016b).[53]
- *Borrower Defense Discharge*. There is no clear statutory exclusion for borrower defense discharge and so the default position is that it should be **taxable**. However, the IRS is operating under a Revenue Procedure that says that it will apply "safe-harbor" relief to such borrowers, making this cancellation **nontaxable**.[54] The IRS and the Treasury Department claim authority for this on the basis that all or most of the relevant debt would be excludable either under the insolvency exclusion, because of fraudulent actions by the school, or because of "other tax law authority." To be clear, this is an exercise of discretion by the Treasury; even if some debt falls outside these other exclusions, the IRS will not assert taxation because doing so "would impose a compliance burden on taxpayers, as well as an administrative burden on the IRS that is excessive in relation to the amount of taxable income that would result."[55]

[50] Letter from Eric Solomon, Assistant Secretary for Tax Policy, to Rep. Levin (September 19, 2008) (on file with author).

[51] Putnam, Judy, "Putnam: Wounded Army Vet Wins the Battle But Loses the Tax War," *Lansing State Journal*, October 20, 2017, https://www.lansingstatejournal.com/story/opinion/columnists/judy-putnam/2017/10/20/putnam-wounded-army-vet-wins-battle-but-loses-tax-war/781458001.

[52] The Higher Education does this by incorporating terms that apply to PSLF loans by a complicated embedded cross-reference, so it's a bit obscure and roundabout. See 20 U.S.C. § 1087ee(a)(5) (exclusion for PSLF loans); 20 U.S.C. § 1087(c)(4) (incorporating § 1087ee(a)(5) for FFEL loans); 20 U.S.C. § 1087e(a)(1) (incorporating FFEL terms for Direct Loans).

[53] This position was also taken by Solomon in the letter cited earlier; see note 50.

[54] Rev. Proc. 2020-11, 2020-6 I.R.B. 406.

[55] Rev. Proc. 2020-11, 2020-6 I.R.B. 406.

- *False Certification Discharge*. This debt should be **nontaxable** for the same reason as closed school discharge,[56] but I am not aware of clear rulings or statements on this.
- *Bankruptcy*. All debts discharged in bankruptcy, or because a taxpayer is insolvent, are **nontaxable**.[57]
- *Settlement and Compromise*. Prior to 2021, student debt canceled through direct negotiation with ED was considered **taxable** because no clear exclusion was applied.[58] If Biden's current one-time, lump-sum debt cancellation proposal goes through, that relief may extend beyond the 2025 sunset of the current exclusion, in which case Congress will likely have to act or else much of that debt will be taxable.

III. THE STUDENT DEBT CANCELLATION ERROR

The patchwork and confusing tax treatment of student debt cancellation, with some types of cancellation taxable but others not (after 2025), derives from a series of errors and misunderstandings in interpreting the tax law, which over time have calcified into effectively a change in the law itself, even though, as we will see, that change is at odds with what Congress intended. This is a legal process not unique to this provision or even to tax law generally but occurs with some regularity throughout the law. In this case, however, the error arguably arose as a result of the misapplication of tax norms to a nontax issue.

A simple application of tax law to student debt cancellation might go something like this: "Gross income" includes "discharge of indebtedness," under section 61(a)(11), unless there is an explicit exclusion. Section 108, where most of the exclusions for debt discharge live, provided (prior to 2018) an explicit exclusion only for PSLF.[59] Therefore, all other forms of student debt cancellation must generate taxable income under section 61(a)(11). In 2018, Congress amended section 108 to also apply to discharge due to death or disability, but only through 2025,[60] and in 2021, Congress extended the section 108 exclusion to all student debt cancellation, but again only through 2025.[61] But the baseline interpretation remains;

56 20 U.S.C. § 1087(c)(1), see note 47.
57 I.R.C. § 108(a)(1)(A), (B).
58 For example, Minsky, Adam, "Is Student Loan Forgiveness Taxable? It Depends," *Forbes*, January 27, 2020, https://www.forbes.com/sites/adamminsky/2020/01/27/is-student-loan-forgiveness-taxable-it-depends/?sh=1d2d726d1b93.
59 The 108(f) (now 108(f)(1)) exclusion applied only to discharge of debt "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." I.R.C. § 108(f)(1).
60 Pub. L. No. 115-97, § 11,031, 131 Stat. 2054, 2081 (2017).
61 I.R.C. § 108(f)(5).

unless section 108 says otherwise, student debt cancellation is taxable, according to the IRS, and if nothing else happens, student debt cancellation other than PSLF will revert to being taxable in 2026.

Almost anyone who has looked at this probably wonders: Why did section 108(f) only exclude PSLF? Congress could have extended the exclusion to all student debt cancellation — Why carve PSLF out specially? Did Congress affirmatively *want* to tax other forms of student debt cancellation? No — the intent of 108(f) was actually the opposite, to ensure the *nontaxation* of all student debt cancellation. But understanding why requires unpacking errors the IRS made decades ago.

A. Student Loans and the Scholarship Exclusion

Federal student loan and loan cancellation programs go back at least to the NDSL program in 1958, which included a form of loan cancellation for teachers.[62] Around the same time, some states also introduced loans and cancellation programs, especially for medical students; the state would make a loan for paying medical school tuition but would gradually cancel the loan while the new doctor worked in an underserved community.

In the 1950s and 1960s, the IRS was asked to rule several times on the proper tax treatment of these medical school debt cancellation programs. In one early ruling (perhaps the first) from 1956, the IRS stated that because loans were not scholarships, discharged amounts did not qualify as excluded scholarships and thus were taxable gross income.[63] But in 1959, the IRS reversed that 1956 ruling, finding that loan cancellation did fall within the definition of a "scholarship" excluded from taxation under section 117.[64]

Scholarships — which more typically refer to direct grants or tuition reductions — have been explicitly excluded from "gross income" by the tax code since 1954,[65] and because student loan cancellation is essentially an ex post tuition reduction, section 117 covered that as well. The then-applicable regulations defined a scholarship as any payment of tuition and related fees on behalf of an undergraduate *or a graduate*, that is, someone already out of school. A canceled student loan essentially becomes a scholarship grant retroactively.[66] The only potential catch, the IRS said in the 1959 ruling, was if the loan cancellation was a quid pro quo tantamount to employment. If a scholarship payment was essentially a form of compensation for services, then a taxpayer could not exclude it under section 117. The

[62] Pub. L. No. 85-864, § 205(b)(3), 72 Stat. 1580, 1585.

[63] I.R.S. Priv. Ltr. Rul. 5604265200A (April 26, 1956).

[64] Tech. Adv. Memo. 5807039700A (July 3, 1959).

[65] Prior to 1954, scholarships were excluded if they qualified as "gifts" under section 102, which would generally apply if there was no quid pro quo, such as services being provided in exchange for the scholarship (Bittker and Lokken, 2024). That same principle was thus carried into the interpretation of section 117.

[66] Treas. Reg. § 1.117-3(a) (1959).

key test, therefore, was whether the cancellation program created "an employment relationship" with the state or if any services were "subject to the direction or supervision of the [scholarship] grantor" (i.e., the state), which in these cases they were not.[67] While the doctor had to work in a particular community to qualify for loan cancellation, the "manner in which recipients under the program practice medicine subsequent to graduation is in no way subject to direction and supervision by the State Medical Education Board."[68] In 1960, the IRS made the same ruling for a federal teacher loan cancellation program under the National Defense Education Act.[69]

That was the state of play for the 1960s and early 1970s; loan cancellation programs were essentially ex post scholarship grants, and the fact that a graduate had to work in a particular field or in a particular geographic area did not transform that grant into compensation for services.

Then, in 1969, the Supreme Court ruled in *Bingler v. Johnson*[70] that an employee on paid leave from his job while pursuing a graduate degree could not exclude his salary payment as a "scholarship" under section 117 because he was required to return to and work for his employer for two years after graduating. Such a payment clearly fell within the then-applicable regulations section 1.117-4(c) exception cited earlier, as compensation for work subjects to the direction of the grantor. But the taxpayer challenged the validity of the regulation, saying that it went beyond what Congress intended in section 117. The Supreme Court held, however, that the regulations in question were valid in part because they "comport[ed] with the ordinary understandings of 'scholarships' and 'fellowships' as relatively, disinterested, 'no-strings' education grants, with no requirement of any substantial *quid pro quo* from the recipients."[71]

Bingler, properly read, was thus not adding anything new to the definition of "scholarship" but was merely upholding the validity of the existing regulation. Furthermore, the facts of the case — where the taxpayer worked *for the grantor* — were easily distinguishable from the loan cancellation cases, where the employer and the grantor were different entities. Nonetheless, in response to *Bingler*, the IRS reversed course again in 1973 and ruled in Revenue Ruling 73-256 that because of *Bingler*'s emphasis on "no strings" versus "*quid pro quo*," medical school loan cancellation programs *did* generate gross income for tax purposes after all.[72] The IRS said in the same Revenue Ruling that "no employment relationships exists between the grantor and the grantees, the services required . . . are designed to accomplish a basic objective of the grantor" and that was sufficient to make the loan cancellation not a "scholarship."

[67] Treas. Reg. § 1.117-4(c)(1).
[68] Tech. Adv. Memo. 5807039700A.
[69] I.R.S. Priv. Ltr. Rul. 6004275330A (April 27, 1960).
[70] 394 U.S. 741 (1969).
[71] *Bingler*, 394 U.S. at 751.
[72] Rev. Rul. 73-256, 1973-1 C.B. 56.

Revenue Ruling 73-256 was thus a misreading of both section 117 and *Bingler*; *Bingler* merely upheld the regulation already being applied, which by its terms should not have applied to student loan cancellation. And Congress agreed. In the Tax Reform Act of 1976, Congress included language that roughly tracks the current section 108(f)(1): "[N]o amount shall be included in gross income . . . by reason of discharge of all or part of the indebtedness of the individual under a student loan 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 geographical areas or for certain classes of employers."[73] In the legislative history, Congress said that this provision was specifically in response to Revenue Ruling 73-256 and that its intent was to return to the status quo treatment of student loan cancellation — not taxable by reason of the section 117 scholarship exclusion.[74] The report added that one reason for the change was to make the treatment of this form of debt cancellation "consistent with the treatment of scholarships and fellowship grants which are not contingent upon the performance of needed services by the recipient." In other words, the noncontingent scholarship and cancellation programs remained tax-free, and Congress wished to return PSLF-type debt cancellation to that broader category, where it had been prior to 1973.

The 1976 provision was not codified into the tax code and applied only to cancellation before 1979, but Congress extended it further in 1978,[75] before finally adding the exclusion permanently to the tax code in 1984, as section 108(f).[76] The Joint Committee on Taxation's General Explanation of the 1984 Act (the "Bluebook") reiterated Congress's intent to overrule Revenue Ruling 73-256 (US JCT, 1984).

This background to section 108(f) reveals a few important points. First, the reason section 108(f) only referred to PSLF-type cancellation is because the predecessors to section 108(f) were passed specifically to plug the PSLF hole created by the IRS. This explains its narrow language and the failure to mention other kinds of loans; it was not necessary to do so.

Second, even under the most conservative reading of *Bingler*, a quid pro quo was still needed for loan cancellation to fail the scholarship test. At a minimum, according to the IRS in Revenue Ruling 73-256, the loan cancellation must be "to accomplish a basic [employment] objective of the grantor." Where there is no plausible quid pro quo — such as for IDR or any of the other forms of discharge — the scholarship theory should therefore be intact, and there is no need for a separate statutory

[73] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2117, 90 Stat. 1520, 1911–12. The language about "certain classes" of employers was to distinguish these cases from those like *Bingler*, where someone was required to work for one specific employer.

[74] S. Rep. No. 94-938, at 430 (1976).

[75] Revenue Act of 1978, Pub. L. No. 95-600, § 162 92 Stat. 2763, 2810.

[76] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1076(a), 98 Stat. 494, 1053.

exclusion. One could perhaps argue that this was all happening in the 1960s and 1970s and early 1980s, when PSLF-type cancellation was the only game in town. Moreover, it was during a period when most other loans were coming largely from private lenders, so there was perhaps less of a concern with cancellation undermining a social program, at least optically. It is unclear how those Congresses would have treated IDR, which began in the 1990s and did not really have wide applicability until the 2010s. But the logic of the early rulings and Congress's response is that the connection between loans and tuition brought loan cancellation within the definition of "scholarship," and it was only the potential quid pro quo that violated that logic. If no quid pro quo, then no problem.

Finally, the episode also underscores the irrationality of being overly formalistic about the form in which a benefit is delivered. For example, in many cases, students consider different financial aid packages with different combinations of grants and loans and often negotiate with a school over that mix.[77] A school could decide to grant further aid so that the student's loan amount is less — in effect, transferring additional aid to "cancel" some of the debt. Or a student could simply choose a school with a higher grant and a lower loan offer. But there would be no question in those instances that the additional grants would be excluded from scholarships. Why should the answer be different just because the grant comes later in time? The tax law does something like this in the context of purchase-money debt; the cancellation of debt to a seller of a good is treated as a nontaxable reduction in the original price of the good rather than a cancellation of indebtedness.[78] When we recall that the college net tuition charge is already highly negotiable largely based on a student's family income, an income-based reduction in student debt starts to look like a very similar renegotiation in price.[79]

B. The Current State of the Debt Cancellation and the Scholarship Exclusion

This issue mostly lay dormant for the 1990s and 2000s. Loan cancellation, other than for public service, was just a footnote, so it caused little harm to misread section 108(f) and misinterpret the original connection to the scholarship exclusion. Unfortunately, during this time, section 117 was amended in a way that challenges, but does not entirely remove, its applicability to student debt cancellation. For example, in 1986, Congress amended section 117 to make it only applicable to "candidate[s] for a degree," which a graduate is not. However, the legislative history

[77] Kantrowitz, Mark, "How to Negotiate a Better Financial Aid Offer," *Forbes*, August 19, 2021, https://www.forbes.com/sites/markkantrowitz/2021/04/19/how-to-negotiate-a-better-college-financial-aid-offer/.

[78] I.R.C. § 108(e)(5).

[79] Bittker (1972) makes a similar point about the fungibility of a charitable contributions deduction versus a government matching grant program.

makes clear that Congress intended by this language to distinguish between degree and nondegree *programs*, not between graduates and nongraduates.[80]

Furthermore, it cannot be the case that the scholarship exclusion is inapplicable to graduates (or others who have left school) because section 117 appears to be the basis for the exclusion of student loan *interest subsidies* from taxation. For Subsidized Stafford Loans and for some of the IDR programs, the government agrees to cover some of the accrued interest that would otherwise be covered. Why is that not taxed, as either a form of loan cancellation or perhaps as payment of the debt of another, under *Old Colony*?[81] The law here is thin, but it seems that the main (perhaps only) authority is Revenue Ruling 75-537, which held that interest subsidies paid to private lenders under the old FFEL program were excluded as scholarships under section 117.[82] While that ruling predates the section 117 amendments in 1986, the lack of any substantive change to the treatment of interest subsidies is strong evidence that neither the IRS nor Congress intended the scholarship exclusion only to apply prior to receiving a degree. Indeed, what this actually shows is that the scholarship exclusion as applied to student debt cancellation is alive and well today.

More problematic, perhaps, is the current limitation of section 117 to "qualified tuition and related expenses," which clearly excludes room, board, and similar living expenses.[83] Many loans today cover expenses beyond that, especially PLUS loans to graduate students because they allow borrowing up to the full cost of attendance. PLUS loans were created in 1980 for parents and were extended to graduate students in 2005 (the "Grad PLUS" loan). So even if the Congresses that added section 108 and its predecessors likely would not have objected to treating all loan cancellation as scholarships, the subsequent changes to both the loan program and section 117 may supersede that, at least with respect to loans that cover more than tuition and related expenses.

There are several technical arguments available that could apply to that residual canceled debt, but they are beyond the scope of this paper.[84] The next section

[80] See, for example, H.R. Conf. Rep. No. 99-841, at II-15. The report distinguishes between "degree candidates" and "nondegree candidates," meaning that the distinction is between students who are candidates for a degree (i.e., at a degree-granting educational institution) versus students who are not candidates for a degree. The prior version of section 117 could apply to candidates who were "not . . . candidate[s] for a degree at an educational institution" provided that the grantor otherwise qualified as a section 501(c)(3) tax-exempt organization. See I.R.C. § 117(b)(2) (1958). But the revised version of section 117 removed that exception for those who were not candidates for a degree. In other words, the distinction was on the type of institution, not on whether the student had already graduated or not.

[81] *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), in which the Supreme Court held that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed," that is, that someone paying your debt is paying you.

[82] Rev. Rul. 75-537, 1975-2 C.B. 32.

[83] I.R.C. § 117(b)(2).

[84] For example, the debt could also be excluded from gross income for insolvency, as a contingent liability, or as a "significant debt modification" (Brooks, 2016b).

provides some observations about how this problem illustrates the challenges that can arise when tax policy and social policy collide.

IV. A CHALLENGE OF THE INTERACTION OF TAX AND SOCIAL POLICY

The general failure of tax credits and deductions to meaningfully affect any college-related outcomes, plus the likely harm caused by the misinterpretation of section 108, illustrates some of the risks and challenges when tax policy and social policy collide, particularly in higher education. The small effects of tax credits and deductions on enrollment and attainment outcomes are likely due to the combination of complexity, delayed benefits, and the limited salience of after-tax tuition to students. But the section 108 problem is different; it seems to result more from the conflicting normative goals and interpretive frames of tax and higher education policy, respectively.

One way some of these contradictions between tax and nontax policy have been expressed is through the concept of tax expenditures. Early tax expenditure critics, especially Stanley Surrey, were motivated largely by a desire to keep tax and nontax policies in their separate domains (Surrey, 1973). That view has been regularly challenged and contextualized over the years. One prominent rebuttal is Weisbach and Nussim (2004), which argued that agency competence and expertise should be relevant. For example, administering cash grants like the Earned Income Tax Credit (EITC) through the IRS may be a wise choice because the IRS has expertise in income measurement and is more likely to reach all or most American families than a welfare agency. That argument applies less strongly to, say, the low-income housing tax credit, which depends on, for example, what the credit funds are spent on, what fraction of a building is occupied by low-income residents, what their rent is, whether the project is funded with tax-exempt bonds, and more.[85]

I suggest a related but different problem, focusing not on agency expertise but rather on the norms and methodological frames of different legal systems. The core of the misinterpretation problem with section 108 is that a primary concern for the tax system is defining income, and tax lawyers are trained to look for it. And deductions and exclusions are seen through this frame: How do they affect the measurement and taxation of income? Measurement of income is relevant to student debt cancellation, of course, especially under IDR. But that income-based calculation happens outside of the tax law; all tax law sees in the first instance is the "income" of canceled debt. In this way, the norms of tax law can undermine the norms of nontax social policies like promoting affordable higher education.

This normative conflict between tax policy and social policy is not unknown, and tax law has developed some tools to address it. I describe two — the general welfare exclusion and the specific tax treatment of refundable tax credits — before returning to the issue of forgivable federal loans. What these two examples show is

[85] See I.R.C. § 42.

that the different types of welfare transfer payments may require different tax law solutions and that the tax law solutions on offer are perhaps not as solid as one might want.

A. The General Welfare Exclusion

The IRS developed the administrative doctrine, known today as the "general welfare exclusion," to address the tax treatment of welfare payments. The doctrine goes back at least to 1938, when the IRS ruled that payments under the new Social Security program were not subject to federal income tax (Brunson and Johnson, 2022; Ball, 2023). The current articulation of the exclusion states that "[t]o qualify under the general welfare exclusion, payments must (i) be made from a governmental fund, (ii) be for the promotion of the general welfare (i.e., generally based on individual or family needs), and (iii) not represent compensation for services."[86] The exclusion has been applied to a large set of transfer payments, such as payments to the blind,[87] mortgage assistance,[88] replacement housing subsidies,[89] vocational training programs,[90] disaster relocation payments,[91] and more. But as Brunson and Johnson (2022) show, the IRS has always been a bit skittish about applying the exclusion and has thus usually applied it only to means-tested benefits,[92] though somewhat inconsistently and without clear guidance for what constitutes need. Current practice seems to include an insistence that beneficiaries have low or moderate income, a status that may not apply to some student borrowers with debt cancellation, including under IDR.[93] The 2024 proposal by the Biden Administration for one-time, lump-sum cancellation will apply to those who are "experiencing hardship,"[94] but it is not clear how that will be determined.

Furthermore, the use of the exclusion is at the discretion of the IRS, without clear statutory authority from Congress, meaning that it is not often applied or even well known. In theory, the general welfare exclusion could play a gap-filling role, addressing situations for which Congress has not provided an explicit exclusion

[86] Rev. Rul. 2005-46, 2005-2 C.B. 120.
[87] Rev. Rul. 57-102, 1957-1 C.B. 26.
[88] Rev. Rul. 75-271, 1975-2 C.B. 23.
[89] Rev. Rul. 74-205, 1974-1 C.B. 20.
[90] Rev. Rul. 68-38, 1968-1 C.B. 446.
[91] Rev. Rul. 98-19, 1998-1 C.B. 840.
[92] Two key exceptions to means-testing are disaster relief payments and Indian general welfare payments, for which the exclusions are now codified. See I.R.C. §§ 139, 139E.
[93] For example, a borrower with a large graduate student debt might still qualify for income-based payments and ultimate cancellation after 25 years, even if their income is relatively high at that time.
[94] "President Joe Biden Outlines New Plans to Deliver Student Debt Relief to Over 30 Million Americans Under the Biden-Harris Administration," White House Press Release, April 8, 2024, https://www.whitehouse.gov/briefing-room/statements-releases/2024/04/08/president-joe-biden-outlines-new-plans-to-deliver-student-debt-relief-to-over-30-million-americans-under-the-biden-harris-administration.

but which are close in spirit to situations where it has. But one can easily imagine the discomfort this creates for IRS and Treasury lawyers, who are asked essentially to guess what Congress might have wanted when their training tells them that Congress generally needs to be explicit about that sort of thing. Indeed, as the student debt situation shows, the more explicit exclusions Congress adds to the code — such as section 108(f) — the more likely it is that Congress's silence on other transfers will be read as intentional.[95]

B. Refundable Tax Credits

The general welfare exclusion applies mostly to traditional welfare and social insurance programs. But more and more, cash transfers are now made through refundable tax credits, such as the EITC, the Child Tax Credit, or the Premium Assistance Tax Credit (i.e., the Obamacare subsidies), rather than direct payments. And for some of these, the general welfare exclusion would not be available because the credits can apply at relatively high levels of income. For years 2018–2025, the Child Tax Credit does not phase out until the taxpayer has AGI over $200,000 for an individual or $400,000 for a joint return;[96] for years 2021–2025, the Premium Assistance Tax Credit has no income threshold at all.[97]

At first glance, it might seem that these tax credits ought to be immune from being considered "income," if only because tax law should not take away what it itself has given. But for *refundable* tax credits, the issue is more complicated because in those cases, there is no tax to credit; the credits are just cash transfers from the government. And the issue is not entirely theoretical; the Tax Court has ruled in recent years that the refundable portion of *state* business tax credits must be included in gross income for federal tax purposes.[98]

Federal refundable tax credits avoid this problem by being deemed by the tax code to be refunds of "overpayments" of tax.[99] In other words, the tax refund fiction is taken to the extreme; a tax credit is deemed to be the return of tax overpayments, even if no tax was actually collected,[100] and thus would not be taxable gross income on its own.[101] The state tax credits at issue in the Tax Court cases mentioned earlier were similarly deemed "overpayments" for state tax purposes, but the Tax

[95] Galle and Pancotti (2021) describe a similar problem with the COVID-era expanded Unemployment Insurance (UI) benefits, for which the IRS chose to apply standard UI taxability rules rather than the section 139 disaster relief payment exclusion.

[96] I.R.C. § 24(h)(3).

[97] I.R.C. § 36(c)(1)(E).

[98] See *Maines v. Commissioner*, 144 T.C. 123 (2015); *Rivera v. Commissioner*, T.C. Memo 2016-25.

[99] I.R.C. § 6401.

[100] I.R.C. § 6401(c) ("An amount paid as tax shall not be considered not to constitute an overpayment solely by reason of the fact that there was no tax liability in respect of which such amount was paid.").

[101] Moreover, any tax refund (because of a refundable tax credit or otherwise) cannot be considered "income" for purposes of determining eligibility for any other government program. I.R.C. § 6409.

Court held that federal tax law was not required to follow that state tax law determination.[102]

But both the tax code and the Tax Court distinguish between the refundable and nonrefundable portions of a tax credit. Section 6401 of the tax code only deems refundable credits to be "overpayments," and the Tax Court in *Maines v. Commissioner* only treated as taxable the refundable portion of the state tax credit. But it is not obvious why the *nonrefundable* portion should be treated differently; in both cases, the credit is a cash transfer, and delivering some of that transfer via a reduction in a tax bill is just a convenient delivery device, not literally the refund of an "overpayment." Why is not, for example, a nonrefundable tax credit to subsize energy-efficient windows[103] just as much a cash transfer as the refundable portion of the EITC? Or, to put it another way, if the IRS or the Tax Court can ignore a nonrefundable tax credit without clear statutory authority, why does it need statutory authority to ignore a refundable one?

C. Federal Debt Cancellation

The earlier sections show that the nontaxation of traditional forms of social policy transfer payments is built on a somewhat shaky foundation of weak legal precedent and long-established practice by the IRS. Indeed, a large share of transfer payments go untaxed either by applying the administrative general welfare exclusion or, in the case of nonrefundable credits, simply ignoring them. That system is unlikely to be poked too hard, however, and it does a decent job of covering the spaces of direct transfers and tax credits. But those are not the only ways the government transfers money, and those existing tax law solutions may not apply well in other settings. For debt cancellation in particular, the IRS must search for other solutions, with the obvious being section 108, where exclusions of cancellation of indebtedness income reside. But for student debt cancellation, that solution is both erroneous — because the IRS should instead be looking at section 117 — and inadequate.

The problem with section 108 and student debt cancellation comes in large part from the way tax law frames these questions: Is canceled student debt "income"? If so, how should it be taxed? If not, why? But higher education policy asks a different normative question: How much of a student loan should a borrower be required to pay? Or, more deeply, how much should an individual contribute toward their own higher education? And what systems should we design to accomplish that goal? If higher education policymakers judge that 100 percent of a student's debt should be canceled after some triggering event, taxing that cancellation in effect means that tax policy is overruling that social policy judgment, saying that maybe

[102] *Maines*, 144 T.C. at 132.
[103] See I.R.C. § 25C.

only 63 percent of the debt is canceled (if the borrower pays 37 percent of the canceled amount in taxes). ED cancels the debt, but the Treasury Department reimposes some of it.

It is especially strange to ask whether some of that cancellation is “income,” because in most cases that student has never actually had possession of any of the loaned amounts, and moreover much of the loan proceeds is not even for their benefit. Colleges have massive amounts of cross-subsidization, from full payers to aid recipients, and from higher-tuition schools and departments to other schools and departments (Rose and Sorensen, 1992; Curs and Singell, 2010; Johnstone and Marcucci, 2010; Skiball, 2016). Few students pay the full list-price tuition, and discounted tuition is largely a matter of price discrimination (Martin, 2002, 2004). Moreover, with so much of the money coming from the federal government, the student is more of a conduit for institutional funding. At the end of the day, it is almost certain that the actual cost of a given student’s education is *not* equal to the net tuition that student is charged (Brooks, 2022).

Furthermore, in many cases, some of the canceled debt will consist of accrued interest,[104] which for some borrowers has also been capitalized into the loan principal. If that interest actually reflected some combination of the time value of money and the borrower’s credit risk, perhaps taxation could be argued for, but it does not; interest rates are set by a statutory formula, with some of the lowest-risk loans facing the higher interest rates set for budget scoring purposes. Plus, when monthly interest is canceled or not charged under the interest subsidy rules, that cancellation is not taxed. But when interest instead accrues and becomes part of the loan principal, its later cancellation would be taxable under the IRS’s interpretation of section 108.

But these sorts of nuances are foreign to tax law. Tax law generally does not care about how a canceled debt arises, what it is used for, or whether the borrower ever even got something in exchange for the debt; the “freeing of assets” theory for taxing canceled debt is generally out of favor, on the theory that any lowering of debt increases net wealth (Bittker and Lokken, 2024). And of course a borrower benefits from the cancellation of a loan otherwise owed. Even if their net tuition is unrelated to the cost of their higher education and their capitalized interest is unrelated to their real borrowing costs, they still accrued a legally enforceable debt under those terms, which they would have to pay but for the cancellation. They legally owed $X, and now they owe $X–$Y, so has not the borrower just had an “accession to wealth” of $Y? But that is the problem: the tax system is designed largely to measure benefit in a given tax period, not so much to consider the wider context and policy space in which that benefit arose.

[104] Explicitly so, in the Biden Administration’s recent proposal to cancel some accrued interest. “President Joe Biden Outlines New Plans to Deliver Student Debt Relief to Over 30 Million Americans Under the Biden-Harris Administration,” White House Press Release, April 8, 2024, https://www.whitehouse.gov/briefing-room/statements-releases/2024/04/08/president-joe-biden-outlines-new-plans-to-deliver-student-debt-relief-to-over-30-million-americans-under-the-biden-harris-administration.

Student debt cancellation is the largest and most salient example of using a federal credit program to deliver redistributive transfer payments, but it is not the only one, and this method is likely to be used more in the future. As noted earlier, federal credit programs are administratively attractive because of their light budgetary footprint under FCRA compared to direct transfers,[105] and cancellation of debt is normatively attractive in some circumstances because of the ability to base it on ex post eligibility tests. A simple example of this is the COVID-era Paycheck Protection Program (PPP). PPP payments were understood to be essentially cash transfers to support businesses but were structured as forgivable loans. Because it was expected that almost all the loans would be forgiven, there was not a huge budget scoring benefit under FCRA, though CBO still scored PPP through the FCRA "net subsidy" framework (CBO, 2020a). But this structure allowed the amounts of the loan themselves to be more open-ended, with additional appropriations coming based on revised net subsidy estimates.[106]

As for the tax treatment of the PPP loan forgiveness, the CARES Act included a specific exclusion of any canceled debt from gross income for tax purposes.[107] This shows competent drafting and also illustrates the precise pitfall this paper identifies — the potential that the IRS would treat the canceled debt as taxable income absent some clear order from Congress. Indeed, the case of student debt cancellation shows that risk remains.[108] Debt relief of some kind is likely to be a tool the government keeps using; in recent years, the federal government has also forgiven USDA loans to farmers[109] and other kinds of small business loans other than PPP,[110]

[105] Even if a transfer program had a tax pay-for, such that the deficit is not increased, that would increase both "taxing" and "spending" totals in the budget, whereas under FCRA a credit program would only include the net of the two on the budget.

[106] For example, Paycheck Protection Program and Health Care Enhancement Act, Pub. L. No. 116-139, § 101(a) 134 Stat. 620, 620. See CBO (2020b).

[107] CARES Act, Pub. L. No. 116-136, § 1106(i),134 Stat. 281, 301 (codified as amended at 15 U.S.C. § 636m(i)). Note that, like for closed school discharge, this is a tax exclusion for cancellation of indebtedness that exists outside of the Internal Revenue Code.

[108] My arguments about section 117 apply generally, but closed school discharge shows a narrower example of the same phenomenon — as noted earlier, even when Congress excluded that discharge by statute, the IRS missed it and claimed that such discharge was taxable.

[109] "USDA Provides Payments of nearly $800 Million in Assistance to Help Keep Farmers Farming," USDA Press Release No. 0223.22 (October 18, 2022). The relief was authorized by the Inflation Reduction Act, which did not provide for a tax exclusion, and the press releases refer to the aid as potentially taxable. However, some "qualified farm indebtedness" can be excluded from gross income under I.R.C. § 108(a)(1)(C).

[110] "SBA debt relief," https://www.sba.gov/funding-programs/loans/covid-19-relief-options/sba-debt-relief. Another good example of confusion around taxability. The CARES Act provided that the SBA would cover six months of principal, interest, and fees for certain classes of SBA loan (7(a) loans, 504 loans, and Microloans), and the SBA started making such payments in April 2020. The SBA first determined that this relief was taxable and that lenders should send 1099-MISC forms to affected borrowers (these are guaranteed loan programs operating through third-party lenders). Then in December 2020 Congress passed the Tax Relief Act of 2020, which included a provision excluding such payments from gross income. The SBA quickly reversed its position. See "Updated

for example. Those examples, and others, arose out of the COVID pandemic, and it is telling that the government's use of the debt cancellation tool has become more common; it is likely to be a muscle it continues to flex in the years ahead, and the tax law needs to accommodate this in a better way than it has thus far. Congress has been inconsistent in whether and how it includes a statutory exclusion, and the IRS and Treasury have been inconsistent in whether or not to use their discretion to not assert tax. And even when Congress speaks clearly, the message can become so muddled that the IRS hears the opposite.

V. CONCLUSION

Student debt cancellation has gradually, and then suddenly, become one of the largest sources of financial aid for higher education. And that is so just considering current repayment and discharge plans, not the further court-challenged proposals for one-time, lump-sum forgiveness. Student debt cancellation is now central to the United States' overall scheme of higher education finance and social policy. Furthermore, debt cancellation is increasingly becoming a tool for government redistributive social policy in other policy areas as well.

But the debt cancellation tool reveals some under-appreciated conflicts between tax policy and other social policies. In particular, the norms of taxation generally treat canceled debt as gross income for tax purposes, a position that could undermine the efficacy of using debt cancellation as a policy tool. Those tax norms are strong enough that they have even overridden Congress's statutory commands otherwise, as this paper has shown happened with student debt. Congress long intended for student debt cancellation to be treated as excluded scholarships, but that intent was just buried enough in the history that the IRS and Treasury never sought it out, believing perhaps that section 108(f) spoke clearly enough on its own.

There is not an easy solution to this problem. Even the tools and doctrines that were developed for other social policy areas, such as the general welfare exclusion, are imperfect and inconsistent. It may be that the most effective solution is just for Congress to state clearly its intent for debt cancellation and other transfers to be taxable or not, rather than to leave it to the IRS and Treasury. Indeed, the central story here is one where normative conflict leads to errors in statutory interpretation. We are unlikely to change tax law norms — nor should we necessarily want to — which means the burden may be on Congress to make sure that its legislation cannot be misread.

Information on IRS Information Reporting Related to the Payments Made on Behalf of Borrowers under Section 1112 of the CARES Act Based on Section 278 of the COVID-related Tax Relief Act of 2020," SBA Information Notice No. 5000-20087, https://www.sba.gov/sites/default/files/2021-01/Information%20Notice%205000-20087%20Updated%20Section%201112%20Tax%20Implication%20Reporting%20Requirements-508.pdf.

ACKNOWLEDGMENTS AND DISCLAIMERS

I would like to thank Brian Galle, Luke Herrine, Vijay Raghavan, and the participants in the 2022 NTA Spring Symposium for their helpful comments. All errors are my own.

DISCLOSURES

The author has no financial arrangements that might give rise to a conflict of interest.

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