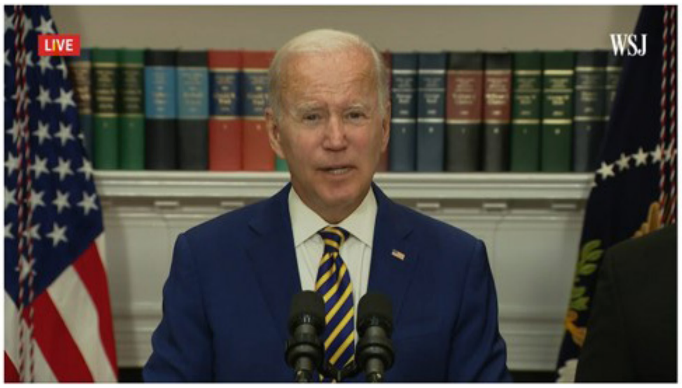
PALLAS
CAPITAL ADVISORS

Declaring Student Debt [Partially] Forgiven

August 2022

Back to School

Like thousands of parents across the country, my wife and I are just returned from a whirlwind trip down to South Carolina, where we said a (temporary) goodbye to a couple of our children – one who is now a college freshman. With a large family, we've done this several times now, and I always come back thinking that I don't remember college being that exhausting. Perhaps that's because it was nearly 30 years ago when I first stepped foot onto campus myself. College is an exciting time for students and parents alike, as each may be entering a new phase of life – full of questions, and maybe even a little bit of worry about what lies ahead, but also full of potential. Of course, one of the less-than-exciting aspects of college is funding this wonderful 4-year experience.



President Biden announcing the education loan forgiveness plan on April 24, 2022. Source: Wall Street Journal

At Pallas Capital, we work with scores of clients helping them plan ahead and save for this expensive endeavor. The reality though, is that not everyone has the means to set aside significant funds each month for future college tuition, room, and board. The cost of higher education hasn't cooperated either. According to some research, the total cost of 4-year public and private college has nearly tripled since 1980, even after accounting for inflation. According to the Department of Education, the typical undergraduate student with loans now graduates with nearly $25,000 in debt. Add on a couple more years of graduate school, and it's not unusual to talk with young people, just starting careers, who have accumulated $75,000 to $100,000 in student loans. This amount of debt can be crippling when one is just starting to "leave the nest", so-to-speak.

Public Service Announcement

As if right on cue, on August 24, 2022, President Biden announced his three-part plan that includes significant student debt cancellation. Over the last 24 hours, one would have to have been stuck on a remote island with no access to news in any form to not feel inundated with hot takes from both sides of the political isle on the merits (or lack thereof) of the President's plan.

The President's administration is basing its legal authority for cancellation in part on the Covid-19 national emergency, citing financial harms suffered by borrowers. The administration also rescinded a Trump administration memo that had concluded that legal authority doesn't exist for mass cancellation.

The purpose of this brief newsletter is not to argue one side or the other (we can do that offline), but rather to summarize the key components of the President's plan.

President Biden's Student Debt Relief Plan

Based on information from www.whitehouse.gov, the Department of Education will:

A. **Provide up to $20,000 in debt cancellation to Pell Grant recipients** with loans held by the Department of Education, and **up to $10,000 in debt cancellation to non-Pell Grant recipients.**

- Borrowers are eligible for this relief if their individual income is less than $125,000 ($250,000 for married couples).
- Forgiveness of indebtedness is normally taxed as income, but notably, the amount of student debt forgiven under this plan will be exempt from federal income taxation. *However, student loan forgiveness could count as taxable income on state income tax returns in several states.*
- The Education Department has promised more details in the weeks ahead, but at least no later than before student loan repayments begin in January 2023.
- This forgiveness does not apply to private student loans. Only federal loans are forgivable.
- Loan forgiveness does not apply to loan balances that have already been paid off.

B. Extend the **pause on federal student loan repayment one final time through December 31, 2022.** Borrowers should expect to resume payment in January 2023.

C. Protect future students and taxpayers by **reducing the cost of college and holding schools accountable** when they hike up prices. The administration's commentary on this point was a bit vague, so it remains to be seen what accountability requirement may be put into place.

Additionally, the Department of Education is proposing:

D. A new income-driven repayment plan that **caps monthly payments for undergraduate loans at 5% of a borrower's discretionary income**—half of the rate that borrowers must pay now under most existing plans.

E. "Fixing" the Public Service Loan Forgiveness (PSLF) plan with a rule that borrowers who have worked at a non profit, in the military, or in federal, state, tribal, or local government, receive appropriate credit toward loan forgiveness.

Resistance is Foreseeable

President Biden is fully aware that at least the loan forgiveness part of this plan will not be embraced by many, if not most, of those in the Republican party. He said as much during the announcement: "I understand that not everything I'm announcing today is going to make everybody happy, but I believe my plan is responsible and fair."

The plan will test the legal limits of the federal government's authority to cancel student debt. Its success could depend on how courts would interpret the education secretary's powers under the 1965 Higher Education Act, which allows the secretary to "consent to modification" of loans, and "compromise, waive, or release" unspecified amounts of student debt.

Finally, in what must be assumed to be a calculated risk just prior to the November mid-term elections, the President's plan will certainly drive some of the political winds that will soon begin to blow hard. Politicians on both sides of the aisle seem to be concerned about the long-term impact such a plan will have on inflation – particularly the inflation of education costs – which lie close to the very heart of the problem in the first place.

Repaying the Balance of Your Student Loans

Many individuals will still have significant education loan balances, even assuming the President's plan withstands anticipated resistance from those in the right side of the political isle. Whether you have a small sum or a small fortune to pay off, it's helpful to brush up on some student loan basics.

Remember the Grace Period

After you graduate, you'll likely get anywhere from six to nine months before you need to start repaying your loans. This gives you some breathing room to get financially settled.

Understand Your Repayment Options

The federal government offers several flexible repayment plans to help students manage this large financial responsibility. (Private student lenders may or may not offer the following plans — check with your lender.)

- **Standard repayment plan**: This is the original repayment plan. With a standard plan, you generally pay a fixed amount each month for up to 10 years.

- **Graduated repayment plan:** With a graduated plan, your payments start out low in the early years of the loan but increase in later years (the term is still 10 years). This plan is tailored to individuals with relatively low current incomes (e.g., recent college graduates) who expect their incomes to increase in the future. However, you'll ultimately pay more for your loan than you would under the standard plan, because more interest accumulates in the early years of the plan when your outstanding loan balance is higher.

- **Extended repayment plan:** With an extended plan, you extend the time you have to repay your loan, usually from 12 to 30 years, depending on the loan amount. Your fixed monthly payment is lower than it would be under the standard plan, but again, you'll ultimately pay more for your loan because of the interest that accumulates under the longer repayment period. Note: Many lenders allow you to combine an extended plan with a graduated plan.

- **Income-based repayment plan:** With an income-based repayment (IBR) plan, your monthly loan payment is based on your annual discretionary income. The federal government offers a PAYE plan (Pay As You Earn) and a REPAYE plan (Revised Pay as You Earn). Generally, undergraduate borrowers who qualify will pay 10% of their discretionary income toward their student loans each month, and after 20 years of on-time payments, the remaining balance may be forgiven (payments may be forgiven after 10 years for those in certain public interest jobs and after 25 years for graduate school borrowers). For more information, visit the federal government's student aid website at studentaid.ed.gov.

- **Loan consolidation:** Loan consolidation is technically not a repayment option, but it does overlap. With loan consolidation, you combine several student loans into one loan, sometimes at a lower interest rate. Thus, you can write one check each month. You need to apply for loan consolidation, and different lenders have different rules about which loans qualify for consolidation. However, with most loan consolidations, you can choose an extended repayment and/or a graduated repayment plan in addition to a standard repayment plan.

In addition to inquiring about repayment options, ask whether your lender offers any special discounts for prompt loan repayment. For example, some lenders may shave a percentage point off your interest rate if you allow them to directly debit your checking account each month. Or, they may waive some monthly payments after receiving on-time payments for a certain length of time.

Investigate the Student Loan Interest Deduction

You might be able to deduct some or all of the student loan interest you pay on your federal tax return.

- In 2022, if you're a single filer with a modified adjusted gross income (MAGI) under $70,000 or a joint filer with a MAGI under $145,000, you can deduct up to $2,500 of student loan interest that you pay during the year.
- A partial deduction is available to single filers with a MAGI between $70,000 and $85,000 and joint filers with a MAGI between $145,000 and $175,000.

There are a couple of hurdles, though. You must have incurred the loans when you were at least a half-time student, and you can't take the deduction if you're claimed as a dependent on someone else's tax return.

If you paid $600 or more of interest to a single lender on a qualified student loan during the year, you should receive Form 1098-E at tax time from your lender, showing the amount of student loan interest you've paid for the year. For more information, see IRS Publication 970.

Do You Have Leftover 529 Plan Funds?

If you have funds available in a 529 plan, you can use them for student loan repayment. There is a lifetime limit of $10,000 per 529 plan beneficiary and $10,000 for each of the beneficiary's siblings. Keep in mind that any portion of student loan interest that is paid for with tax-free 529 plan funds is not eligible for the student loan interest deduction.

Conclusion

We've enjoyed the company and have benefited from the work of several college interns at our firm over the past couple of years. For most reading this newsletter, I'd venture to say that each new phase of life brings with it the promise of a fresh start and the hope of a bright future. The college experience is certainly no exception. Students, apply the valuable attributes of diligence and attention to detail to whatever endeavor you pursue. To all those families that are beginning or continuing that experience, we wish you much success!

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