Student Loan Forgiveness Creates New Tax Trap

There's a new student loan repayment program that forgives some student loan debt if other payments are made. This new debt forgiveness is creating a tax surprise for the unsuspecting student. Here is what you need to know.

The debt forgiveness program dilemma

To combat the hardship of high student loan debt, a popular new repayment option is the income-based repayment plan. These plans limit monthly payment amounts to a percentage of discretionary income. They also limit the number of repayment years. If your loan is not paid by a pre-determined future date and you've been making the payments as agreed, the balance of the loan is forgiven.

While the prospect of having a portion of the debt canceled is enticing, it can create an unexpected tax burden if you are not prepared. Here's why it may be a problem:

- **Canceled debt is considered taxable income.** When a portion of a loan is forgiven, that amount is considered taxable income in the year in which the debt is cancelled. While there are exceptions, this is the general tax rule.
- **A 1099-C is issued to you and the IRS.** Upon the forgiveness of the student loan debt, the loan servicing company will issue a Form 1099-C titled "Cancellation of Debt". A copy of the form will be delivered to both you and the IRS informing both parties of the amount of forgiven debt. This amount needs to be included on your Form 1040.
- **Taxes are due at filing.** The entire amount will likely be taxed at the taxpayer's highest marginal tax rate. This amount is due in its entirety at the annual tax-filing deadline. If a large amount is due, there may also be additional underpayment fees tacked on by the IRS.

Some exceptions apply

Before you begin to worry about a surprise tax bill, consider your other options:

- **Tax-exempt debt forgiveness programs:** There are a few programs that consider the student loan canceled debt tax-exempt. The two most common are for students that become public service employees and teachers. So when you have canceled debt, conduct a review to see if your employment complies with the possible tax exclusion.
- **Insolvency exclusion:** The IRS provides a way to exclude a forgiven debt from taxable income if you can prove you are financially insolvent. The IRS defines "insolvency" as when a taxpayer's total liabilities exceed his or her total assets. To claim this exclusion, an additional form is filed with your tax return. Make sure you can back up any claims you make, because the IRS may request to see proof.

- **IRS repayment plan:** If you have a balance due as a result of the canceled debt and cannot pay it in full by the deadline, the IRS has payment plans available. There will be additional penalties, interest and possibly setup fees that will be added to the amount due. This is not a great option, but it is better than not paying the balance at all.

Even with the additional tax liability that is realized, debt relief is generally a good deal for most. The hardship comes if you are not prepared for how to handle the tax payment that becomes due. Before signing an agreement that relieves debt, it makes sense to review your situation to avoid any surprises on your tax bill.