Paving the Way to Student Debt Cancellation: Tax Forgiveness in the American Rescue Plan

Last Updated: April 21, 2021

Forty-six million student loan borrowers in the U.S. carry $1.67 trillion in debt. Cancelling student debt would remove this burden and could significantly boost the economy. However, the potential threat of surprise tax bills on borrowers has been a concern for student debt cancellation efforts.

The American Rescue Plan Act put that concern to rest by making student debt cancellation tax-free through 2025. This change, while it got little attention at the time, could significantly ease student debt cancellation over the next four years.

**American Rescue Plan**

If a student loan borrower’s debt is cancelled, the Internal Revenue Service generally considers that cancelled debt as taxable income. Prior to 2021, federal law provided exceptions for a few student debt cancellation programs, such as the Public Service Loan Forgiveness program. However, most borrowers could have potentially still faced a big tax bill if either President Biden or Congress cancelled their student debt.

Advocates argued that existing law could be interpreted to exempt student debt cancellation. Section 9675 of the American Rescue Plan Act settled the matter by clearly exempting debt cancellation for both public and private student loans from federal taxes through 2025. Student loan borrowers can now benefit from student debt cancellation provided under current law or by executive or congressional action without facing a surprise tax bill at the end of the year.

**Recent Student Debt Cancellation by Biden Administration**

**Defrauded borrowers**

In mid-March, the Department of Education announced that it would provide full debt cancellation for approximately 72,000 borrowers who were defrauded by their for-profit college. It did so by rescinding the less generous borrower defense partial relief formula under former Education Secretary Betsy DeVos. In total, these defrauded borrowers will receive $1 billion in debt cancellation.

When the Obama Administration first cancelled debt for students defrauded by Corinthian Colleges, it had to tackle the issue of tax liability. At the urging of Sen. Warren (MA) and others, the Obama Administration determined that the borrowers qualified for an exclusion from income in the tax code, which meant that they did not have to pay taxes on the cancelled debt.
**Borrowers with disabilities**

The Department of Education has also announced that it will cancel the debt of borrowers with total and permanent disability who failed to submit their earnings documentation during the COVID-19 pandemic. This action will lead to over $1.3 billion in relief to more than 41,000 student loan borrowers. Another 190,000 borrowers will no longer be required to submit their earnings information for the duration of the pandemic. The current process for a total and permanent disability discharge normally requires borrowers to submit three years of earnings information, but this action means that documentation will not be required for the duration of the COVID-19 pandemic. The time during the pandemic will automatically count toward the required three years.

Advocates were disappointed, however, as they preferred that the Department of Education work with the Social Security Administration to automate this process, which would lead to approximately 400,000 borrowers receiving relief.

**Additional Opportunities for Student Debt Cancellation**

**Legislation**

As a candidate, President Biden indicated that he supported legislation to cancel $10,000 of student debt for every borrower. In 2019, Rep. Ilhan Omar (MN) introduced the Student Debt Cancellation Act to cancel all student loan debt. Last year, Rep. Ayanna Pressley (MA) introduced the Student Debt Emergency Relief Act to cancel $30,000 in student debt per borrower and pushed for this legislation as part of broader COVID-19 relief. Both bills included exclusion of student debt cancellation from borrowers' taxable income. Those provisions would no longer be necessary if those bills are reintroduced in the 117th Congress.

The committee jurisdiction in Congress for student debt cancellation is complicated. In the House, federal loans fall under the Education and Labor Committee, private loans fall under the Financial Services Committee, and taxes on debt cancellation fall under the Ways and Means Committee. Similarly, in the Senate, federal loans fall under the Health, Education, Labor, and Pensions Committee; private loans fall under the Banking Committee, and taxes fall under the Finance Committee. With tax liability addressed, one fewer committee is involved in each chamber, which could be especially helpful if student debt cancellation advances through the budget reconciliation process.

**Executive action**

The benefits of tax forgiveness already being on the books is even greater for executive action. Executive action cancelling debt, and the associated increase in debt cancellation exempt from taxation, is not subject to congressional or statutory pay-as-you-go (PAYGO) requirements.

In February, President Biden asked the Department of Justice to review his legal authority to cancel student loan debt through executive action. In early April, White House Chief of Staff Ron Klain indicated that President Biden is undecided on the
total amount of student loan cancellation. Klain also stated that President Biden has asked the Department of Education to also compile a memo on the President’s legal authorities and that President Biden expects to review both the Department of Education memo and the Department of Justice memo in the next few weeks.

Sens. Warren and Schumer (NY) in the Senate and Reps. Pressley, Omar, Waters (CA), Adams (NC), Bowman (NY), Jones (NY), and Torres (NY) in the House are leading a resolution calling on President Biden to use executive authority to cancel up to $50,000 in student loans for each student loan borrower. The pending memos will answer the question of whether he, in fact, has the authority to do so. By ensuring that debt cancellation is on strong legal footing, the Administration will make it less likely that student debt cancellation is delayed or blocked by a legal challenge.

While the Justice and Education Departments examine the legal basis for broad student debt cancellation, the Biden Administration can take immediate action to provide additional relief under well-established authorities. These authorities include cancelling additional student debt under borrower defense, expanding closed school discharges and making those automatic, and addressing the myriad issues with the Public Service Loan Forgiveness program.

**Conclusion**

Nearly two-thirds of Americans support cancelling all or some student debt, including 90 percent of Americans who currently have student debt. It would generate broad economic benefits, including a reduction in wealth inequality. Congress and the Biden Administration have many options on the table for realizing these gains. Whatever path the Biden Administration takes, the road to full student debt cancellation is easier with the American Rescue Plan enacted into law.