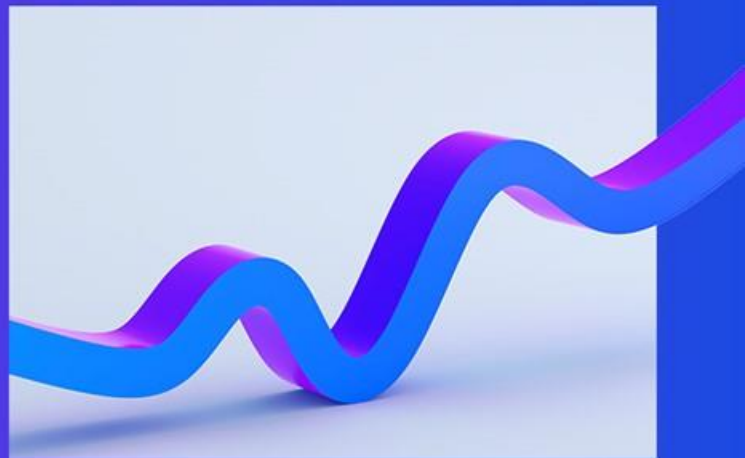


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Is Forgiveness Free? Student Loans and State Reporting

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President Biden recently announced a plan that will provide student loan forgiveness, up to \$20,000, for certain borrowers. As an added benefit, borrowers will not be subject to federal taxation on amounts forgiven under this plan. Although a handful of states have not indicated whether state taxation will be required, one has stated that it will. However, due to a recent IRS notice, federal reporting is not required by entities granting the relief, nor will state reporting be required due to tack-on laws in place for most states. Thus, it is unclear how states will identify the amounts forgiven, raising the issue of potential state penalties for taxpayers which do not self-report, even if they are unaware that self-reporting is required.

Background

The first federal student loan program was not established until 1958, four years after discharge of indebtedness was officially codified as gross income in the Internal Revenue Code of 1954 (amendments to the Internal Revenue Code of 1939 previously carved out gross income exclusions for specific types of discharge of indebtedness). However, the IRS generally held the view that cancelation of student loans was non-taxable, as a form of scholarship. As college costs increased, lending rose through the 1970s, leading to more delinquent payments and more public scrutiny. Although defaults remained low, public pressure forced the IRS to reevaluate its stance. In 1973, under Rev. Rul. 73-256, the IRS ruled that loan scholarship payments conditioned upon a student practicing medicine in a state-selected area constituted taxable income, as the payments were designed to accomplish the state's objective in boosting the number of doctors in rural areas.

In 1976, Congress enacted the Tax Reform Act of 1976, [here](#), excluding certain discharge of indebtedness on student loans made before January 1, 1979, from being included in gross income. Specifically, the act excluded amounts discharged when the “discharge was pursuant to a provision of such loan under which all or a 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.” As noted in the Joint Committee of Taxation Blue Book, [here](#), this provision was made in part to reverse the former IRS ruling. The Revenue Act of 1978, [here](#), extended this treatment through 1982. Thus, the earlier versions of gross income exclusions for student loan forgiveness focused on prior, unofficial forms of the Public Service Loan Forgiveness (PSFL) program. Blanket exclusion for forgiveness would not come until much later.

The American Rescue Plan Act of 2021 (ARPA), [here](#), was enacted on March 11, 2021, as a way to provide further relief to Americans impacted by COVID-19. The \$1.9 trillion stimulus package extended relief previously provided under the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 and the Consolidated Appropriations Act of 2021, and included several new provisions designed to speed up the economic recovery from the pandemic. In particular, one provision modified the treatment of student loan forgiveness under section 108(f), excluding from gross income discharges occurring during calendar years 2021 through 2025 for certain educational expenses. On December 21, 2021, the IRS issued an advance version of Notice 2022-1, [here](#), notifying lenders of student loans that they “should not file information returns or furnish payee statements...to report the discharge of student loans when the discharge is excluded from gross income under section 108(f)(5).” Thus, Form 1099-C is not required for student loan forgiveness occurring under ARPA for calendar years 2021 through 2025.

On August 24, 2022, President Biden announced a three-part plan aimed at providing student loan relief to low- to middle-income taxpayers (see the White House Fact Sheet, [here](#)), including forgiveness of student loans for certain borrowers. Specifically, borrowers with individual income lower than \$125,000 (\$250,000 for married couples) are eligible for forgiveness up to \$10,000, and Pell Grant recipients are eligible for forgiveness up to \$20,000. Under the current plan, eligible borrowers may apply for one time forgiveness through December 31, 2023. The announcement was a welcome relief to borrowers but caused immediate questions on taxation and reporting at the state level.

State Taxation and Reporting Issues

At a high level, states determine how much of the Internal Revenue Code (IRC) to adopt in order to carry out state functions and are generally labeled as rolling or static conformity states. However, rolling conformity states are not required to adopt all provisions, and static conformity states may adopt specific provisions even if they have not updated to the current version of the IRC. The Tax Foundation provides a great summary of the nuanced issues this presents, [here](#).

The initial issue is whether states will adopt the ARPA amendments to section 108(f), rendering discharge of indebtedness non-taxable at the state level. The Tax Foundation article above has tracked down each state's position, updating as states have provided confirmation whether they will tax student loan forgiveness. As of the writing of this article, the following states are currently silent on the issue, but are posed to tax loan forgiveness unless subsequent guidance is issued: Arkansas, Minnesota, Mississippi, North Carolina, and Wisconsin. California is also listed, but bicameral members of the state legislature have since issued an informal release stating that they will work to ensure California does not tax student debt relief.

Conversely, Indiana has definitively stated that it will tax student loan relief. As noted by the Indiana Department of Revenue (DOR), [here](#), the Indiana General Assembly updated its IRC conformity date to the post-ARPA version in effect on March 31, 2021, but decoupled from the student loan forgiveness provision and will require the relief to be added back for state tax purposes. Due to Indiana's flat 3.23% rate, this means up to \$323 in state taxation (\$646 for Pell grant recipients) for borrowers, potentially more depending on the county they live in. Indiana has indicated that it will include a line on *Schedule 1: Add-Backs* of the individual

income tax return for federal student loan forgiveness to be included to state income. The trickier issue is how Indiana will gather this information, and how compliance will be enforced. Even if federal reporting was required, Indiana does not require lenders to submit Form 1099-C to the state. Thus, Indiana is relying on individuals to self-report, which is problematic in the absence of recipient statements. This raises the question whether Indiana will assess penalties for borrowers who may not fully understand their state tax obligations, or how Indiana would even determine which borrowers took advantage of the forgiveness.

Similarly, many of the states that are currently silent on the issue do not require Form 1099-C, or only require it when the payor is required to submit for federal purposes. Thus, the same issue is presented across the spectrum, that payees will not necessarily know what to report, and state agencies will not have access to information in order to determine noncompliance. Perhaps with additional consideration, the remaining states will determine that the burden imposed on borrowers, and indeed the burden imposed on its own state agents, is not worth the negative public backlash. This is particularly true if state agencies turn to public audits to enforce collection of the minimal tax amounts that would be due. In either case, this is certainly an issue worth monitoring for those involved.

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