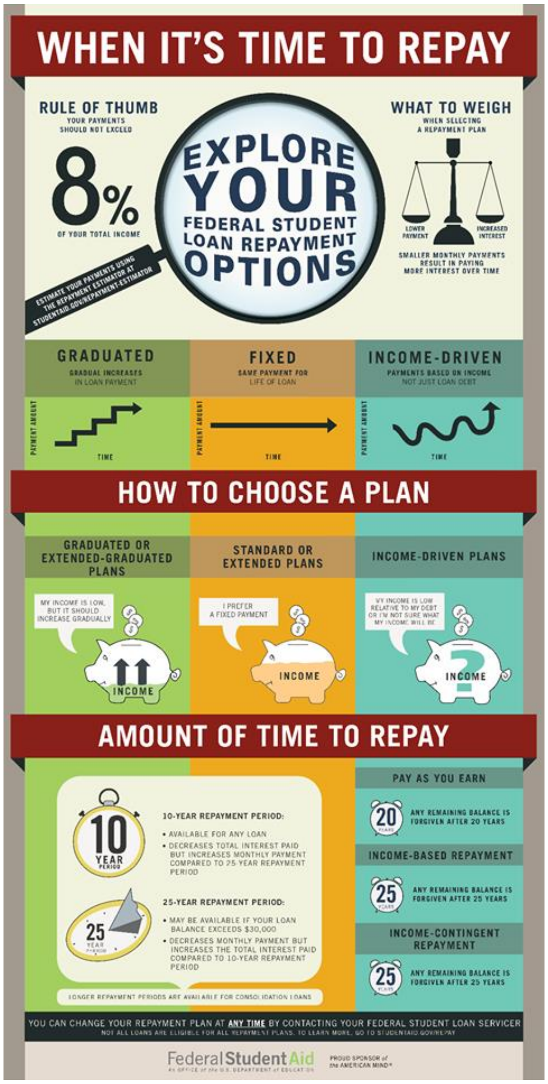

Financing a Legal Education * **

Students must make decisions about financing their education well in advance of securing post-graduate employment. The cost of legal education, indebtedness upon graduation, and starting salaries for law school graduates are all frequently expressed as "average" amounts. In reality, tuition varies across programs, individuals enter law school with diverse financial resources, and entry-level legal salaries range across the board.[1] Each student must navigate his or her particular financing options within the context of anticipated employment options, which likely will change over the course of one's career. As a result, it is important for prospective and current law students to familiarize themselves with the tools available for managing student loan debt. These include a variety of repayment plans as well as loan forgiveness programs.

Currently, the Standard repayment period for student loans is ten years. Borrowers may elect a repayment plan that allows them to extend that period. Several of these—including the *Income-Based Repayment*,[2] *Income-Contingent*,[3] and *Pay as You Earn*[4] programs—link monthly payments to the borrower's annual income. Extending the repayment timeline reduces the amount due each month, but also results in more interest accruing on the loan. There are various *Loan Repayment Assistance Programs* (LRAP) sponsored by institutions, government and employers that offer loans or grants to help borrowers make their monthly payments. Each LRAP has its own eligibility criteria. In general, LRAP funds are reserved for law graduates working in particular employment settings.

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* Ayana Detweiler provided research assistance for this piece.

** Source of chart: www.studentaid.ed.gov.

1 NALP annually reports salary data for recent law school graduates. The most recent data—for the class of 2012—exemplifies how the "average" starting salary does not reflect the reality for most graduates. While the mean salary for 2012 was $80,789, 51% of the class earned $40,000 to $65,000. At the other end,16% earned $160,000 or more.

2 http://studentaid.ed.gov/repay-loans/understand/plans/income-based

3 http://studentaid.ed.gov/repay-loans/understand/plans/income-contingent

4 http://studentaid.ed.gov/repay-loans/understand/plans/pay-as-you-earn

Finally, the federal *Public Service Loan Forgiveness*[5] (PSLF) program provides an additional tool for borrowers to discharge their debt. Under this program, graduates who devote at least ten years of their career to full-time work at a public service organization have any remaining loan balance forgiven. While each repayment option discussed below is currently available to student borrowers, not all types of loans are eligible for all programs. Furthermore, the tax consequences of each choice vary. Law students and graduates should carefully select the loan repayment option that best matches his or her individual situation. Finally, President Obama recently proposed changes to the *Pay as You Earn* repayment program, as well as the *Public Service Loan Forgiveness Program,* that may affect the availability of those debt management tools in the future.

TYPES OF STUDENT LOANS

Federal Direct Loans

Through the Federal Direct Loan program, the U.S. Department of Education provides educational loans to students.[6] Depending on their need and borrowing history, law students may be eligible for Subsidized and Unsubsidized Stafford loans, PLUS loans, or Perkins loans.

The Federal Family Education Loan (FFEL) Program that once offered loans to students' parents was terminated with the Healthcare and Education Reconciliation Act of 2010, and now all federal loans are made as Federal Direct Loans. Outstanding FFEL Loans are generally ineligible for loan forgiveness programs, unless consolidated into a student's own Direct Loan.[7]

Other Options

Law students unable to cover their cost of attendance and living expenses with federal loans often look for other sources to finance their education, which may include private loans, institutional loans, or family loans. These types of loans are generally ineligible for all of the repayment tools discussed here.

The Federal Work Study program offers students a way to receive a portion of their financial aid package as wages, thus reducing their ultimate loan balance. Some students may be eligible for the Veterans Educational Assistance Program, which includes the Montgomery GI Bill, as well as the Post-9/11 GI Bill. In addition, many organizations offer scholarships that can help finance a legal education.

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[5] http://studentaid.ed.gov/repay-loans/forgiveness-cancellation/charts/public-service

[6] For more information about each type of Federal Direct loan, visit http://studentaid.ed.gov/types/loans. Federal Direct loans are only available to U.S. citizens. Foreign students are ineligible and must find alternate sources to finance their legal education.

[7] http://studentaid.ed.gov/sites/default/files/public-service-loan-forgiveness-employmentcertification-borrower-letter.pdf

REPAYMENT PLANS: FEDERAL LOANS

Traditional Repayment

The Standard Repayment Plan for federal education loans consists of monthly payments of at least $50, made over 10 years.[8] Student loan interest payments may be tax deductible.[9]

Consolidation—Extended & Graduated Repayment

Upon graduating, student borrowers may elect to consolidate their loans, and elect for an Extended or Graduated repayment plan. Under the Extended plan, the timeline for repayment is extended from 10 years to up to 30 years, thus reducing the size of each monthly payment. However, all plans that extend the repayment timeline will result in more interest accruing on the loan, thus increasing the total amount that a borrower must repay. Under the Graduated plan, monthly payments increase over the course of the loan repayment period.

Payments made under this type repayment plan are generally not eligible for the PSLF program. However, it is possible that at least some of the monthly payments made towards the end of a Graduated Repayment plan may qualify. Borrowers who opt for a consolidation loan may also lose any other borrower benefits attached to the original loan.

As with Traditional Repayment, the amount paid towards the loan's interest balance may be tax deductible, even for those who do not itemize.

Income-Based Repayment

The Income-Based Repayment (IBR) plan is available to student borrowers who can demonstrate *partial financial hardship*. A borrower demonstrates partial financial hardship when the annual amount due under the Standard (10-year) repayment plan is greater than 15% of the borrower's *discretionary income*. Discretionary income is defined as the difference between the borrower's adjusted gross income and 150% of the poverty line for his or her family size in the state where the taxpayer lives. Once a borrower qualifies for IBR, he or she may continue

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[8] https://studentloans.gov/myDirectLoan/mobile/repayment/repaymentEstimator.action (link to Department of Education student loan repayment calculator)

[9] Borrowers who pay more than $600 interest on a qualified loan receive a Form 1098-E (Student Loan Interest Statement) that allows him or her to take a tax deduction equal to the lesser of the amount of interest actually paid that year or $2,500. A student loan interest deduction is claimed as an adjustment to income, meaning that it is not subject to the same limits as itemized deductions (e.g., home mortgage interest) are. Furthermore, a taxpayer may elect to take the student loan interest deduction while still claiming the standard deduction. However, the amount that may be taken as a deduction is subject to a phase-out depending on the taxpayer's income and filing status.

to make payments under the plan, even if partial financial hardship no longer applies.

Both Direct and FFEL loans are eligible for IBR. Unlike *Income-Contingent Repayment*, the total loan amount has no impact on eligibility for IBR participation. However, special rules apply to borrowers whose spouses are also repaying student loans under IBR.[10]

A borrower making payments under IBR also receives benefits regarding the loan's interest. If the monthly payment does not cover the accrued interest on a Direct Subsidized loan,[11] the federal government will pay the difference for up to 3 consecutive years. After 3 years, any interest that accrues but is not covered by the monthly payment does <u>not</u> capitalize, unless the borrower no longer demonstrates partial financial hardship.

After 25 years, any remaining loan balance is cancelled. Forgiveness of debt under IBR is a taxable event; as a result, the cancelled balance is included in the taxpayer's ordinary income for that year.[12]

Income-Contingent Repayment

Unlike the Income-Based plan, student borrowers do not need to meet a partial financial hardship threshold to participate in Income-Contingent Repayment (ICR). Under ICR, monthly payments are calculated by adjusted gross income, family size, and the borrower's total Direct Loan debt.
The monthly amount due is the <u>lesser</u> of:

- The amount equal to the monthly payment due if the loan was paid over 12 years multiplied by an income factor (which varies annually with the borrower's income); or
- 20% of monthly *discretionary income*.[13]

While a borrower makes payments under ICR, interest on the loan only capitalizes until it equals 10% of the original loan balance when the borrower entered repayment. After that date, interest continues to accrue but does not capitalize. This means borrowers do not pay interest on the interest.

ICR is available <u>only</u> for Federal Direct loans. Like IBR, any portion of the loan forgiven after the 25-year period is taxable.

[10] Borrowers in this position should refer to: http://studentaid.ed.gov/sites/default/files/incomebased-repayment-q-and-a.pdf for more detailed information.
[11] The interest payment benefit is also available for the subsidized portion of a Consolidated loan.
[12] As a general rule, any forgiveness of debt is characterized as taxable income under § 61(a)(12) of the Internal Revenue Code. Congress created an exception to this rule for student loans forgiven under some Loan Repayment Assistance Programs and the federal Public Service Loan Forgiveness program. IRC § 108(f).
[13] Discretionary income is defined as: Income minus the poverty guidelines for the borrower's family size.

Pay as You Earn (PAYE)

Established in 2012, the PAYE plan is restricted to "new borrowers," defined as students who borrowed for the first time after October 1, 2007.[14] In addition, the borrower must have received a Direct Loan disbursement on or after October 1, 2011.

Furthermore, to be eligible for PAYE a borrower must meet a *partial financial hardship* threshold. Under PAYE, this is met when the annual amount due under the Standard (10-year) repayment plan is greater than 10% of the borrower's *discretionary income*. Like IBR, discretionary income for PAYE is defined as the difference between the borrower's adjusted gross income and 150% of the poverty line for his or her family size in the state where the taxpayer lives. Loans eligible for PAYE include Subsidized and Unsubsidized Stafford loans, graduate PLUS loans, and federal Consolidation loans.[15]

Under the PAYE plan, monthly payments are determined by income and family size, which requires annual documentation. Once a borrower qualifies for PAYE, he or she may continue to make payments under the plan, even if partial financial hardship no longer applies.

A borrower making payments under PAYE also receives benefits regarding the loan's interest. If the monthly payment does not cover the accrued interest on a Direct Subsidized loan,[16] the federal government will pay the difference for up to 3 consecutive years. After 3 years, any interest that accrues but is not covered by the monthly payment does not capitalize, unless the borrower no longer demonstrates partial financial hardship. Once interest begins capitalizing, it is capped at 10% of the original principal balance as of the date the borrower entered PAYE.

As with IBR and ICR, any debt forgiven under PAYE is taxable.

LOAN FORGIVENESS

Loan Repayment Assistance (LRAP)

Loan Repayment Assistance programs provide financial assistance to borrowers working in particular settings to help pay their monthly loan payments.

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[14] Those who received a Direct of FFEL loan prior to October 1, 2007 may still be considered a "new borrower" if there is no outstanding balance on that loan, *and* the borrower receives a new loan after October 1, 2007.

[15] Provided the Consolidation loan was not used to repay any Parent PLUS loan. Parent PLUS loans, FFEL loans, and private education loans are not eligible for PAYE. Low-income borrowers with FFEL loans may be eligible for reduced monthly payments under the *Income-Sensitive Repayment* plan.

[16] The interest payment benefit is also available for the Subsidized portion of a Consolidated loan.

[17] The Internal Revenue Service clarified that forgiveness of debt under law school LRAP programs is tax-exempt in Revenue Ruling 2008-34. The IRS noted that the policy and requirements governing LRAP programs is consistent with the policy granting tax exemption for debt forgiven under the Public Service Loan Forgiveness Program. In contrast, LRAP programs that provide grants may increase the borrower's taxable income.

LRAP programs are typically structured to provide a loan, while a minority of LRAP programs provide grants. LRAP loans are disbursed and then forgiven, provided the borrower remains in a qualifying position. Like the forgiveness of debt granted by the Public Service Loan Forgiveness Program, loans cancelled under LRAP do not give rise to any tax liability.[17] LRAP funds may come from several different sources:

- Institutional ○ Many law schools provide loans to their graduates through their own LRAP programs. These programs are typically structured as forgivable loans, which are then cancelled without tax consequences for the borrower.
- Federal ○ Several federal agencies—including the Department of Justice, SEC, and State Department—offer loan repayment assistance as an employee recruitment and retention tool. Unlike law school LRAP programs, employer-funded LRAP loans are typically not tax-free.
- State ○ LRAP programs funded by State governments are typically tied to employment within that state. Currently, 25 states offer LRAP programs;[16] some are funded by the state, and others by organizations such as the state bar foundation. State LRAP programs tend to be a mix of loans and outright grants.

Although the borrower requirements for many LRAP programs overlap with the PSLF requirements, borrowers planning to participate in both should familiarize themselves with any eligibility distinctions.[17]

Public Service Loan Forgiveness (PSLF)

The PSLF program was created in 2007 as part of the College Cost Reduction and Access Act. Its purpose is to allow student borrowers to pursue public interest careers despite their debt at graduation. To be eligible for PSLF, borrowers must work full-time[18] at a "public service organization" for at least 10 years. Qualifying employers include federal, state, local, or tribal governments;[19] nonprofit 501(c)(3) organizations; AmeriCorps and Peace Corps; and other organizations that provide "specified public services" (e.g., public interest legal services). After making 120

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[16] States with current LRAP programs are: AZ, DC, FL, IL, IN, IA, LA, MA, ME, MD, MN, MS, NY, NC, OH, OR, PA, TX, VT and VA. Four states—KY, MO, NE, and WA have suspended LRAP programs.

[17] Borrowers thinking about participating in an LRAP program should visit: http://equaljusticeworks.org/ed-debt/students/loan-repayment-assistance-programs/any-lrapquestions.

[18] "Full-time" is defined as at least 30 hours per week (with an exception for teachers). A borrower who works for two qualifying employers for a combined total of 30 hours per week is also eligible. The term "full-time" includes periods of leave covered by law, such as the Family & Medical Leave Act of 1993.

[19] The specific nature of a borrower's employment at a qualifying employer is irrelevant for purposes of eligibility for PSLF, with a few notable exceptions. Elected members of Congress; government contractors; employees of foreign governments or non-governmental organizations (e.g., the United Nations, OECD, NATO, OAS); and employees of 501(c)(3) religious organizations who spend a majority of their time on church-related tasks are not eligible for PSLF.

qualified payments,[20] a borrower is eligible to have any remaining loan balance forgiven. The 120 payments do not need to be made consecutively, however the borrower must be employed full-time at a qualifying employer:

- At the time each payment was made;
- When submitting the PSLF application; and
- When any remaining balance is forgiven.

Only Federal Direct loans are eligible for PSLF. Perkins loans cannot be discharged through PSLF, and any outstanding FFEL loans must be consolidated into a Direct loan to be forgiven through PSLF.

Borrowers do not "enroll" in PSLF as they do with loan repayment plans such as PAYE. Rather, they submit an application after completing their 120 payments. As a result, a borrower's use of PSLF can be combined with participation in IBR, ICR, or PAYE.[21] It may also be available in conjunction with an LRAP program.

In contrast to IBR, ICR, and PAYE, forgiveness of debt under PSLF is not taxable.

Proposed Changes

With his 2015 budget, President Obama recommended substantial changes to the federal loan repayment and forgiveness options available to future student borrowers. First, President Obama proposes that the PAYE program expand to include borrowers who do not qualify as "new borrowers" under the current (October 2007) standard. This would increase the number of borrowers who could participate under PAYE, including those currently repaying their student loans under IBR or ICR. However, the new PAYE program would also two other significant changes:

- *A new formula for calculating a borrower's annual income*.
    - Under the current PAYE plan, monthly payments are calculated in reference to a borrower's own adjusted gross income. The President's proposal would change the calculation for married taxpayers to include the borrower's spouse's annual income. This could potentially increase the monthly payments required of married borrowers whose spouse also earns an income.
- *Removing the current cap on monthly payments*.
    - Currently, under PAYE (as well as IBR and ICR) monthly payments can increase with a borrower's annual income, but cannot exceed the

[20] To qualify for PSLF, a borrower must make 120 separate monthly payments (i.e., no lump sum payment equal to 120 monthly payments). The U.S. Department of Education provides a form to help borrowers track their eligible payments, and obtain employer certification. It can be found at: http://studentaid.ed.gov/sites/default/files/public-service-employment-certification-form.pdf.

[21] A borrower making monthly payments under the 10-year Standard Repayment Plan will not have any remaining balance after 120 payments. Those repaying their loans under an Extended timeline (other than IBR, ICR or PAYE) are likely ineligible for PSLF, which requires monthly payments less than the Standard amount to be linked to annual income.

amount that would be due under the Standard 10-year repayment plan. The President's proposal would remove this cap, and allow a borrower's monthly payments to exceed what would be due under the traditional repayment plan.

More significantly, the President's proposal includes dramatic changes to the Public Service Loan Repayment program. Specifically, President Obama recommends:

- *Limiting the amount of debt that could be forgiven under the current program*.
    - Under the President's proposal, only borrowers with up to $57,500 of Direct loan debt would be eligible for loan forgiveness after 120 payments. The $57,500 cap reflects the current aggregate loan amount available to independent undergraduate borrowers.
    - Student borrowers graduating with more than $57,500 in debt would have their repayment timeline extended from 10 years to 25 years before becoming eligible for loan forgiveness (a 150% increase in the number of payments necessary to participate).

Since $57,500 would not cover three years of tuition at most law schools, there is a very high likelihood that many law graduates will be ineligible for the 10-year timeline. This is especially true if they enter law school with undergraduate debt (because the overall limit is $57,500, not per degree).