

Date: March 11, 2016
To: Department of Education Negotiators
Cc: Non-department of Education Negotiators

From: Margaret Reiter

Re: Language to include to facilitate non-taxable treatment of successful borrower defense

In the first and second sessions of negotiated rulemaking, the concern was raised that students who had been harmed by school misconduct and who successfully defended against repayment might have any recovery considered as taxable income. Various negotiators expressed the view that this would be unfair because a successful defense should be based on misrepresentations or other unlawful, unfair, deceptive or abusive acts or omissions. It was proposed to include language that would make clear that a successful borrower defense does not fit the definition for a taxable event.

I said I would provide language which might be useful to make clear that any recovery should be non-taxable. The language should apply to successful borrower defenses under both the FFEL and the Direct loan programs. I propose the following language could be inserted at the end of 685.222(g) (based on the Department's proposed language before the second session of the negotiated rulemaking:

685.222(g)(6?) The Secretary considers that any reduction in a borrower's obligation to repay determined under this section has been reduced because of a legal infirmity that relates back to the original transaction for enrollment or continued enrollment or to the financing of that enrollment or continued enrollment.

This proposed language is drawn from the Treasury Department statement regarding borrowers who attended Corinthian Colleges:

For example, a borrower that has a liability reduced because of a legal infirmity that relates back to the original sale transaction (for example fraud) may not have gross income to the extent of the debt reduction.

Rev. Proc. 2015-57, p. 3, available at <https://www.irs.gov/pub/irs-drop/rp-15-57.pdf>

Although a statement from the Secretary may not guarantee recovery will be a non-taxable event, including this language should be influential, if not dispositive.