

December 10, 2015

Via EMAIL

Internal Revenue Service
Office of Pre-filing and Technical Services
Large Business and International Division SE:LM:PFT
Mint Building 3rd Floor M3-420
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Revenue Procedures 2003-36 – Application for Industry Issue or Resolution Program – Information Reporting for Accrued but Unpaid Interest With Respect to Qualified Student Loans that Enter the Repayment Phase

Dear Sir or Madam:

I hereby submit the following issue for Internal Revenue Service (IRS) guidance under the Industry Issue Resolution (IIR) Program. The issue is important to the millions of Americans repaying student loans for costly college tuition, as well as lenders and servicers who finance such costs. The following information is submitted in accordance with Revenue Procedure 2003-36.

Issue Statement:

Pursuant to Section 6050S of the Internal Revenue Code (IRC), a lender or party servicing a loan who receives \$600 or more of student loan interest from a borrower in the course of its trade or business must report the amount received to both the borrower and the IRS on *Form 1098-E Student Loan Interest Statement*. The reporting issue presented for your consideration relates to the accrued but unpaid interest that becomes part of the loan's principal when the loan enters the repayment phase from the deferment phase.

Statement as to Whether the Issue is Appropriate for the IIR Program:

1. *The proper tax treatment of a common factual situation is uncertain.* There is ambiguity regarding how accrued but unpaid interest that becomes a part of a student loan's principal upon the loan entering the repayment phase should be reported. There is no guidance addressing this scenario under Section 6050S of the IRC or the Regulations and interpretations thereunder.
2. *The issue is significant and affects a large number of taxpayers either within an industry or across industry lines.* According to the Federal Reserve¹, student loan debt grew to a record level of approximately \$1.2 trillion as of March 2015. Additionally, student loan debt in the United States has increased by 87% between 2007 and 2013, as the significant unemployment

¹ <http://www.federalreserve.gov/econresdata/notes/feds-notes/2015/how-much-student-debt-is-out-there-20150807.html>

caused by the *Great Recession* led many then unemployed individuals to go back to school and increase their marketability for jobs. Under the terms of the majority of student loans, and all student loans originated by the US Department of Education,² no payment of interest and principal becomes due on a student loan while the borrower remains in school (“deferment phase”). However, during the deferment phase of the loan, interest still accrues at the loan’s stated interest rate. At the end of the deferment phase, all accrued but unpaid interest becomes part of the principal balance of the loan³ (“capitalization”). Because borrowers are most often full-time students during the deferment period, substantially all interest accrued during the deferment period remains unpaid when the loan enters the repayment phase for the majority of borrowers. Thus, the issue under review herein affects a large segment of American taxpayers, including both borrowers and student loan servicers.

3. *The issue requires extensive factual development, and an understanding of industry practices and views concerning the issues would assist the IRS in determining the proper tax treatment.* The information reporting regulations require separate reporting of student loan interest with respect to individual student loans. By working with the industry in the IIR program, there is significant knowledge regarding current and recommended practices that can be leveraged, which will avoid differing practices in the industry.

Explanation of the Need for Guidance

As stated above, Section 6050S of the IRC requires lenders or servicers of student loans to report the amount of interest received from borrowers on student loan obligations on an annual basis on IRS Form 1098-E to both borrowers and the IRS. Normally, such a requirement is straight forward and does not require further interpretation or guidance. However, in instances in which loans move from the deferment phase to the repayment phase after students leave college, the requirements for reporting accrued interest that is transferred to the principal balance of the loan are ambiguous.

For instance, consider for illustrative purposes a borrower with \$10,000 (principal) in outstanding student loans and \$1,000 of accrued, unpaid interest who graduates from college and enters the workforce. This borrower, like most student loan borrowers, did not make payments during the deferment period of the loan while attending college. At the outset of the repayment period of the loan, the \$1,000 of accrued, unpaid interest becomes part of the principal balance. Now, the reported outstanding principal balance on the loan is \$11,000, and interest begins to accrue on this amount. In the absence of guidance directly on point under Section 6050S of the IRC, there are differing views by industry participants on if, or when to report this accrued interest that became part of principal to borrowers and the IRS.

Additionally, there does not appear to be any clarifying regulatory guidance on this topic in IRC Section 6050S or other regulatory interpretation outside of the IRC. Accordingly, industry participants may take differing approaches in their treatment of this accrued interest that becomes part of the principal balance of the loan. Given that the intent of the deduction for student loan interest was to ease the financial burden on student debt-laden taxpayers, it does not follow that this, often substantial, accrued interest transferred to principal would not be eligible to receive a tax deduction by the borrowers. However, for a substantial number of borrowers, such accrued interest becomes part of the loan’s

² <https://studentaid.ed.gov/sa/glossary#Deferment>

³ https://www.nelnet.com/interest_capitalization/

principal balance, and the tax deduction for this student loan interest is lost. Taxpayers often do not - or are not able - to make interest payments during the deferment period, and even if they did, the tax deduction for such interest payments would not serve to reduce the borrowers' tax burdens, as such taxpayers in school often do not have income against which this deduction can be taken.

It is worth noting that the ultimate determination of the student loan interest paid is the individual borrowers' responsibility, and the information provided in Form 1098-E is not determinative of the deduction of the borrower. That said, such discrepancies should be clarified to promote uniform reporting of such deductions by borrowers. Additionally, many borrowers lack the expertise necessary to go beyond deducting what is reported by the loan servicer in the Form 1098-E, and borrowers may be hesitant to report a student loan interest deduction that differs from the student loan interest paid reported by the loan servicer, especially one greater than the amount reported on Form 1098-E.

On a related note, additional evidence supporting my claim of ambiguity in this area relates to a number of recent court cases where borrowers on home mortgage loans brought legal action against lenders who had rolled accrued interest into the principal balance of a mortgage loan upon the loan's modification or refinance, stating that lenders had provided inaccurate or incomplete information reporting documents, resulting in alleged damages. The courts have generally dismissed or ruled against plaintiffs in such actions, citing that existing rules do not address the issue and the IRS has primary jurisdiction to address and resolve the question. While mortgage loans are not the loan product in question here, I believe such cases are intimately related to the student loan interest question at hand. That is, what is the treatment of accrued but unpaid interest on student loans and residential mortgages loans - both with significant tax consequences - that becomes part of the principal balance of the loan.

Estimated Number of Taxpayers Affected by the Issue:

While an exact accounting of the number of taxpayers affected is difficult, as reported above, student loans of \$1.2 trillion were outstanding at March 2015. Additionally, as new graduates are the most affected by the question at hand (as they are the ones soon to enter the repayment phase of their loans), observe that over 70% of college students who graduated in 2015 received financial aid through student loans⁴. Additionally, the average debt per borrower who graduated in 2015 was over \$35 thousand⁴. Thus, the answer to this question stands to have a profound effect on a large proportion of the taxpaying population.

Issue Resolution:

For these aforementioned reasons, I believe this issue is of high importance and is appropriate for acceptance into the IIR program. I look forward to any opportunity afforded to me to assist in bringing sufficient resolution to the question at hand. I would suggest reporting guidance be based on at least the following tenets:

1. Any reporting guidance should be applied prospectively. However, clarifying guidance should be provided by the IRS to taxpayers regarding the treatment of this accrued interest for tax purposes, so that taxpayers have sufficient information to report their income tax returns in accordance with the IRC and related IRS rules and regulations.

⁴ <http://blogs.wsj.com/economics/2015/05/08/congratulations-class-of-2015-youre-the-most-indebted-ever-for-now/>

2. Relatedly, consideration should be given to borrowers who may need to make changes in interest deductions taken on previously filed returns with a view to avoid significant levels of amended tax returns.
3. Finally, as indicated above, it does not follow that the accrued but unpaid interest at the outset of a student loan's repayment phase would not be eligible for a tax deduction for the borrower. These expenses are incremental to those incurred in paying the cost of qualified tuition and fees and are clearly aligned with the interest expense that congress intended to be deductible for federal income tax purposes. It is logical that such expenses should be deductible for federal income tax purposes, even if rolled into the principal balance of the loan for the servicer's operational ease. Perhaps such accrued but unpaid interest expense could be recognized ratably over the remaining term of the loan. This would allow student loan borrowers to realize the full tax benefits on their student loans that congress intended in creating this deduction.

Contact Information:

If you have any questions or need additional information, please contact me at (806) 679-8358 or brad.bowen@gmail.com.

Thank you for your consideration of this matter.

Sincerely,

A handwritten signature in black ink that reads "Brad Bowen". The signature is written in a cursive, slightly slanted style.

Brad Bowen, CPA

Cc: The Honorable Elizabeth Warren
The Honorable Pete Sessions