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Student Loan Income Contingent Repayment Plans: An Alternative?

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Student loan obligations are becoming not only more prevalent but also significantly larger. There is no doubt that several factors are driving this situation—*e.g.,* the ever-increasing cost of post-secondary education and the decreasing value of a baccalaureate degree in many fields, which require an advanced degree. As a consequence, the number of individuals experiencing severe financial difficulties in repaying student loan obligations appears to be increasing exponentially. A contributing factor to the difficulties being faced by many is the fact that in most cases the individual has multiple loans with varying interest rates and varying repayment periods.

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When representing a debtor experiencing difficulty in repaying multiple student loans, the first thought is usually to seek discharge of the student loans. But is that really the solution? As anyone who has dealt with student loan obligations in the context of a bankruptcy proceeding knows, under the "undue hardship" requirement of 11 U.S.C. §523(a)(8), it is difficult to discharge a student loan. The problem is exacerbated in those circuits in which a student loan discharge is an "all or nothing" situation. Fortunately, there may be an alternative: the William D. Ford Direct Loan Program administered by the U.S. Department of Education (DOE). The Ford Program offers consolidation loans with four repayment options: standard, extended, graduated and an Income Contingent Repayment Plan (ICRP).[2]

This article discusses the ICRP, in part because courts are focusing on it as a bellwether factor to be considered in connection with the third prong of the *Brunner* test applied in most districts: a "good-faith effort to repay." At least one court has held that the refusal to consider an ICRP is sufficient in itself to establish that the third prong has not been met. All other courts that have directly addressed the issue have held that consideration of the ICRP program is a significant, if not critical, factor. It is therefore advisable for counsel representing consumer debtors having student loans to consider the ICRP program before filing a complaint seeking discharge.

How does an ICRP work? The amount of the monthly payment under an ICRP is calculated based on the borrower's adjusted gross income (AGI) determined from the debtor's tax returns, total amount borrowed and family size. The monthly payment is calculated as *the lesser* of the amount that would be paid if the borrower repaid the loan in 12 years, multiplied by an annual income percentage factor that varies based on the borrower's annual AGI, or 20 percent of the borrower's discretionary income. Discretionary income is defined as the borrower's AGI minus the poverty level for the borrower's family size (family size greater than one must be established by documentation satisfactory to the Secretary of Education). This payment may be adjusted annually depending on changes to the AGI reported on the debtor's tax return for the preceding year and the national poverty level. The combined income of a married couple is used to determine AGI.

If that calculation yields a monthly payment between $0 and $5, the monthly payment is $5 unless the borrower's income is less than or equal to the poverty level, in which case the monthly payment is zero. If the monthly payment is less than the amount of the interest that accrues on the loans, unpaid interest is capitalized once a year until the principal balance reaches 10 percent more than the original principal balance. At that point, interest continues to accrue but is not added to the principal balance. A debtor who is able to pay little or nothing on student loans will carry the ever-increasing debt for a maximum of 25 years, after which the remaining loan balance is canceled. The downside is that the unpaid amount is treated as taxable income to the debtor, which may result in a large non-dischargeable tax debt.[3]

To determine the estimated payment under ICRP is a five-step process. First, one must determine the interest rate for a consolidated loan, which is the weighted average of the interest rates on the loans being consolidated (as of the date the application is received) rounded to the nearest higher one-eighth of one percent. This rate is fixed for the life of the loan and cannot exceed 8.25 percent.[4] Once the interest rate is calculated, the next step is to determine the amount that would be paid over a period of 12 years in equal monthly installments. (The *Repayment Book* provides a table with the factors to be utilized for various interest rates.) In the third step, the amount determined from the second step is multiplied by an income percentage factor developed by the Ford Program; this is also contained in a table in the *Repayment Book*. Fourth, subtract the poverty level for the family size from AGI, multiply by 20 percent and divide the result by 12.[5] Finally, compare the result in the fourth step to the result in the third step. The initial ICRP payment is *the lesser of the two.*[6]

Example 1: Married couple, no children. Amount of loan to be refinanced: $35,000 at

1 Board Certified in Business Bankruptcy Law and Consumer Bankruptcy Law by the American Board of Certification.

2 Detailed information on the four Ford Loan Consolidation Program plans is contained in a *Repayment Book* published by DOE, accessible online at www.ed.gov/DirectLoan/pubs/repaybook.pdf and in 34 C.F.R. Part 685.

3 If the debt is discharged in the bankruptcy, the debtor does not realize and recognize any debt forgiveness income, a fact that should not be overlooked in the analysis.

4 DOE provides an online calculator to estimate the weighted average interest rate, accessible at loanconsolidation.ed.gov/rate.shtml.

5 Poverty levels may be accessed online at aspe.hhs.gov/poverty/index.shtml. When projecting AGI, keep in mind that the interest paid on the consolidated loan is probably deductible to a maximum of $2,500 per year. As an "above the line" deduction, it will reduce AGI even if the debtor does not itemize.

8.0 percent. AGI: $30,000.

Step 1: $35,000 x 0.0108245 = $378.86
Step 2: $425.65 x 0.8871 = $336.09
Step 3: (($30,000 - 12,490) x 0.2) / 12 = $291.83

The initial monthly payment in this example would be $291.83. Assuming no change in discretionary income (payments remain constant), the couple would make payments for 242 months and the loan would be paid in full.[7]

Example 2: Married couple, with eight-year old twins. Amount of loan to be refinanced: $35,000 at 8.0 percent. AGI: $35,000.

Step 1: $35,000 x 0.0108245 = $378.96
Step 2: $378.96 x 0.9628 = $364.86
Step 3: (($35,000 - $18,850) x 0.2) / 12 = $269.17

The initial monthly payment in this example would be $269.17. Assuming that in 10 years, when the twins reach age 18 and they move out of the home, discretionary income would increase by the amount in the reduction in the poverty level, monthly payments would increase to $364.86 (assuming no other change in discretionary income). The couple would make payments for 228 months, at the end of which the loan would be repaid in full.[8]

Example 3: Married couple, with eight-year old twins. Amount of loan to be refinanced: $75,000 at 8.0 percent. AGI: $50,000.

Step 1: $75,000 x 0.0108245 = $811.84
Step 2: $811.84 x 1.0 = $811.84
Step 3: (($50,000 - $18,850) x 0.2) / 12 = $519.17

The initial monthly payment in this example would be $519.17. Assuming that in 10 years, when the twins reach age 18 and they move out of the home, discretionary income would increase by the amount in the reduction in the poverty level, and assuming no other change to discretionary income, *i.e.,* increases in AGI were matched by corresponding increases in the poverty level, monthly payments would increase to $625.16. The couple would make payments for the entire 25-year period, at the end of which they would still owe a principal balance of $20,092. The remaining balance would be forgiven and taxable income in the year forgiven.[9]

Whether any of the Ford Program plans are viable, and which of the four may be the best option for a particular debtor, can get somewhat complex and, because of the potentially lengthy repayment period, requires considerable crystal-ball gazing. Although several factors must be considered, two factors are particularly critical: age of the debtor and projected future income. The older the debtor and the lower the probability that the debtor's income will increase significantly in the future, the less viable a Ford Program plan becomes. This is in actuality the second prong of the *Brunner* test: Additional factors indicate that the inability to repay the student loan and maintain a minimal standard of living will continue for the foreseeable future.

Taking Example 3 and assuming the debtor is 45 years old with little likelihood that income will increase in the future, an ICRP may appear to be viable but may very well be a trap with potentially disastrous consequences at the end. When the 25-year payment period ends, the debtor will be age 70. At that point, the debtor will realize and recognize for tax purposes—but not receive—$20,000 in income. In all probability, that debtor's sole retirement income will be social security (contrary to my usual pessimistic nature, I assume social security will still exist 25 years hence), and it is unrealistic to assume that the debtor would be able to pay the taxes on an additional $20,000 in taxable income and "maintain a minimal standard of living."

Age can be a significant factor even if the debtor has some realistic prospect of a reasonable increase in future income. The graduated repayment program for a individual over the age of 40 with a student loan obligation of $40,000 or more can be problematic because the repayment period extends for 25 years (30 years if the loan is $60,000 or more), with the highest payments in the later years when the peak earning years for most individuals has passed. It is imperative that the consideration of the viability of the Ford Program plans be careful and thorough, not perfunctory—otherwise, the result could be to simply defer the inevitable disaster to a later point in life.

Counsel for consumer debtors with student loans should be familiar with the William D. Ford Direct Loan Program plans, particularly the graduated repayment and income contingent repayment plans. It is perhaps fatal to a favorable outcome if the availability and viability of one of these programs is not considered before initiating a dischargeability action. By carefully considering the Ford Program plans, counsel can either avoid what is more often than not the *pro bono* representation in an adversary action to discharge student loans if one of the plans is a viable alternative or, if it is determined that no Ford Program plan is viable, be in a position to effectively counter the lender's argument when the issue is inevitably raised. In any event, it is an exercise that will provide a better basis upon which to assess the probabilities of prevailing. ■

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6 The DOE provides an interactive repayment calculator accessible at www.ed.gov/offices/OSFAP/DirectLoan/RepayCalc/dlentry2.html that provides a comparison of the payments and repayment period for the four types of direct loans.

7 For comparison purposes, under the standard program, monthly payments would be $424.65 for 10 years; under the extended program, $292.75 for 20 years; and under the graduated program, $233.33 a month increasing every other year to $419.40 for the last two years, for a total repayment period of 20 years.

8 For comparison purposes, the amount and number of monthly payments under the standard, extended and graduated programs and would be the same as in the first example.

9 For comparison purposes, under the standard program, monthly payments would be $909.96 for 10 years; under the extended program, $550.32 for 30 years; and under the graduated program, $500 a month increasing every other year to $676.88 for the last two years, for a total repayment period of 30 years.