

Partial Public Service Loan Forgiveness Loophole Will Yield Substantial Financial Benefits to Some Medical School Graduates

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A loophole in the public service loan forgiveness program will provide substantial financial benefits to some medical school graduates due to the forgiveness that can accrue during the medical internship, residency and fellowship. This partial forgiveness may cost the federal government as much as \$500 million to \$1 billion a year on a net present value basis.

Congress is likely to take action to eliminate this loophole, just as it has eliminated other benefits to graduate and professional students. The College Cost Reduction and Access Act of 2007 repealed the 20/220 rule, which enabled medical school graduates to qualify for the economic hardship deferment during the internship, residency and fellowship, effective October 1, 2007.¹ The Budget Control Act of 2011 eliminated subsidized interest benefits to graduate and professional students on new subsidized Stafford loans made on or after July 1, 2012.

There are several ways Congress could address this loophole:

- by blocking the accrual of forgiveness during the internship, residency and fellowship,
- by making doctors ineligible for public service loan forgiveness (except perhaps for primary care physicians) or
- by requiring doctors to participate in the income-contingent repayment plan if they want to have their debt forgiven under public service loan forgiveness.

The last option allows the payments that exceed the standard payment to offset some of the forgiveness that accrues during the internship, residency and fellowship.

INTRODUCTION

Statutory changes since 2007 have eliminated some student aid subsidies to graduate and professional students, especially to medical school graduates. The College Cost Reduction and Access Act of 2007 repealed the 20/220 rule effective October 1, 2007. The 20/220 rule allowed many medical school graduates to qualify for the economic hardship deferment during their residencies and internships. The Budget Control Act of 2011 eliminated subsidized interest on new subsidized Stafford loans to graduate and professional students starting July 1, 2012.

Proponents of these changes justified them, in part, by arguments against subsidizing the education of graduate and professional students who will ultimately be much wealthier than most other college graduates. Eliminating subsidized interest benefits increases the total amount of debt because most students defer repayment during in-school and internship/residency/fellowship periods. If the interest is

¹ The US Department of Education allowed the 20/220 rule to remain in effect until the issuance of final regulations for the College Cost Reduction and Access Act of 2007. Those regulations became effective on July 1, 2009.

not paid as it accrues, the interest is capitalized, adding it to the loan balance. This increases the overall loan balance by about 6% when the loans enter repayment and by about an additional 8% to 12% by the end of the residency or fellowship. Most doctors earn enough income to enable them to repay their federal student loans despite the added cost of interest capitalization.

A loophole in the public service loan forgiveness program, however, will allow doctors to receive partial forgiveness based on the internship, residency and fellowship. This loophole may ultimately cost the federal government much more than the subsidized interest benefits that were eliminated.

PUBLIC SERVICE LOAN FORGIVENESS

Public service loan forgiveness works in conjunction with the income-based repayment plan (IBR). Income-based repayment bases the monthly loan payments on a percentage² of the borrower's discretionary income, as opposed to the amount they owe.³ Any remaining debt, including accrued but unpaid interest, is forgiven after 25 years (current IBR) or 20 years (new IBR) in repayment. Public service loan forgiveness reduces the forgiveness period to 10 years for borrowers who work full-time in a public service job for 10 years while repaying their federal student loans in the Direct Loan program under the income-based repayment, income-contingent repayment or standard 10-year repayment plans. Under current law, the amount forgiven under public service loan forgiveness is tax-free,⁴ unlike the 20-year or 25-year forgiveness available under income-based repayment. Eligible public service jobs include public health, working for city, state or federal medical facilities (e.g., VA hospitals), EMT, and working for any 501(c)(3) organization, in addition to a variety of non-medical occupations (e.g., police, fire, military, public school teachers, prosecutors, public defenders, public librarians, etc.).

Income-based repayment functions as a cap on the monthly loan payment. Most borrowers who qualify for income-based repayment will have total federal student loan debt that exceeds their annual income. If a borrower's circumstances change, the borrower's income might increase enough that the borrower will no longer qualify for income-based repayment. When the monthly payment under income-based repayment exceeds the monthly payment under standard 10-year repayment, the borrower will no longer qualify for income-based repayment and will begin repaying their loans under the standard repayment plan. The monthly payments, however, will be based on the monthly payment the borrower would have received before switching into income-based repayment.⁵

Borrowers can also choose to switch into a different repayment plan, but only payments made under income-based repayment, income-contingent repayment and standard repayment count toward public service loan forgiveness.

² The income-based repayment plan was established by the College Cost Reduction and Access Act of 2007 with an initial percentage of discretionary income set at 15%, effective July 1, 2009. The Health Care and Education Reconciliation Act of 2010 reduced the percentage to 10%, effective for new borrowers on or after July 1, 2014. President Obama took executive action in fall 2011 to make the 10% version of income-based repayment available two years earlier to new borrowers as of 2008 who have at least one loan in 2012 or a subsequent year.

³ Discretionary income in IBR is the amount by which adjusted gross income exceeds 150% of the poverty line.

⁴ See Chapter 5 of IRS Publication 970 (www.irs.gov/pub/irs-pdf/p970.pdf) for a summary of the requirements for tax-free treatment of the loan forgiveness. The forgiveness is tax-free because it is restricted to borrowers who work in a specific (albeit broad) set of occupations.

⁵ This monthly payment may be lower than the monthly payment under a re-amortization of the student's debt, since borrowers can be negatively amortized under income-based repayment, causing the debt to increase. Any accrued but unpaid interest is capitalized when the borrower no longer qualifies for income-based repayment.

PARTIAL PUBLIC SERVICE LOAN FORGIVENESS

The forgiveness from public service loan forgiveness is all-or-nothing, in that the borrower must work full-time in a public service job for the full ten years. If the borrower stops working in a public service job after nine years, the remaining debt is not forgiven. However, partial loan forgiveness is possible if the borrower works full-time in a public service job for ten years but doesn't qualify for income-based repayment for some of those years because of an increase in income. The borrower earns forgiveness during the years in the income-based repayment plan and this forgiveness is preserved by the years in standard repayment until the borrower fulfills the 10-year service requirement.

For example, most doctors earn too much to qualify for income-based repayment even with six figure debt. However, a typical medical school graduate will spend 3-5 years in an internship, residency and fellowship. During the internship, residency and fellowship the salaries are much lower, typically \$40,000 to \$60,000 a year. Because the typical medical school graduate has more than \$100,000 in debt and debt-to-income ratios of 2:1 to 7:1 are common, many doctors will rely on income-based repayment during this period to reduce the monthly loan payments to an affordable level, since they are no longer eligible for the economic hardship deferment due to the repeal of the 20/220 rule.⁶

The lower income during an internship, residency and fellowship may enable a medical school graduate to qualify for partial forgiveness under the public service loan forgiveness program. The internship, residency and fellowship must be located at a public or non-profit hospital. The forgiveness earned during the residency, internship and fellowship is preserved so long as the doctor continues to work for a public or non-profit hospital for the remainder of the 10-year period. The doctor must also repay his or her federal student loans using the standard repayment plan (or income-based repayment, if they qualify) during the remainder of the 10-year period. Most doctors will lose eligibility for income-based repayment after they complete the internship, residency and fellowship because of the typical increase in annual income.

FINANCIAL IMPACT OF PARTIAL LOAN FORGIVENESS

This partial loan forgiveness can yield a substantial financial benefit to the borrower, forgiving tens of thousands or even hundreds of thousands of dollars of debt, depending on the amount borrowed and the duration of the internship, residency and fellowship program. The tax-free forgiveness may be the equivalent of as much as a 20% to 50% increase in income and at least a 5% to 10% increase in income during the remainder of the 10-year period. That's enough of an incentive to encourage medical school graduates to temporarily work in a public or non-profit hospital until they receive the forgiveness.

The next table illustrates several typical scenarios. The scenarios involve \$50,000, \$100,000 and \$160,000 in debt, and an initial salary of \$50,000 increasing to \$100,000, \$200,000 or \$400,000 after 3-5 years in an internship, residency and fellowship. Borrowers are assumed to repay their debt using the 15% version of income-based repayment during the internship, residency and fellowship. Figures are rounded to nearest \$1,000. The doctor is assumed to work in a public or non-profit hospital during the internship, residency and fellowship, and to continue working in a public or non-profit hospital for the remainder of the 10-year period. In each case except for the lowest debt scenario, the doctor will qualify for a significant amount of loan forgiveness under the public service loan forgiveness program.

⁶ Graduate and professional students remain eligible for forbearances at the discretion of the lender. Most medical school graduates will prefer income-based repayment because it bases the monthly payment on the borrower's income, not the amount they owe. Forbearances increase the debt by capitalizing the interest.

6.8% Debt	7.9% Debt	Initial Salary	Income Jump	Jump Delay	Total Forgiveness (IBR 15%)
\$80,000	\$20,000	\$50,000	\$100,000	5 years	\$72,000
\$80,000	\$20,000	\$50,000	\$200,000	5 years	\$69,000
\$80,000	\$20,000	\$50,000	\$400,000	5 years	\$69,000
\$80,000	\$20,000	\$50,000	\$100,000	3 years	\$49,000
\$80,000	\$20,000	\$50,000	\$100,000	4 years	\$61,000
\$80,000	\$80,000	\$50,000	\$100,000	5 years	\$183,000
\$80,000	\$80,000	\$50,000	\$200,000	5 years	\$139,000
\$80,000	\$80,000	\$50,000	\$400,000	5 years	\$139,000
\$80,000	\$80,000	\$50,000	\$100,000	3 years	\$160,000
\$80,000	\$80,000	\$50,000	\$200,000	3 years	\$93,000
\$80,000	\$80,000	\$50,000	\$400,000	3 years	\$93,000
\$50,000	None	\$50,000	\$100,000	5 years	\$12,000
\$50,000	None	\$50,000	\$100,000	3 years	\$9,000
\$50,000	None	\$50,000	\$200,000	3 years	\$9,000

Notice how the forgiveness does not decrease after the salary reaches a certain level. That's because at this point the forgiveness is based entirely on the years in an internship and residency. There are essentially two components to the forgiveness: (1) forgiveness due to the years in an internship, residency and fellowship and (2) forgiveness due to years in the main job with salary low compared with the debt. In most cases the forgiveness earned during the internship, residency and internship will contribute the majority of the forgiveness.

The partial forgiveness from public service loan forgiveness yields a much better financial benefit to the borrower than the economic hardship deferment ever granted.

The previous table illustrated the amount of forgiveness based on the current 15% version of income-based repayment. The next table shows the amount of forgiveness under the new 10% version of income-based repayment, which cuts the monthly payments by a third.

6.8% Debt	7.9% Debt	Initial Salary	Income Jump	Jump Delay	Total Forgiveness (10% IBR)
\$80,000	\$20,000	\$50,000	\$100,000	5 years	\$106,000
\$80,000	\$20,000	\$50,000	\$200,000	5 years	\$82,000
\$80,000	\$20,000	\$50,000	\$400,000	5 years	\$82,000
\$80,000	\$20,000	\$50,000	\$100,000	3 years	\$91,000
\$80,000	\$20,000	\$50,000	\$100,000	4 years	\$99,000
\$80,000	\$80,000	\$50,000	\$100,000	5 years	\$215,000
\$80,000	\$80,000	\$50,000	\$200,000	5 years	\$153,000
\$80,000	\$80,000	\$50,000	\$400,000	5 years	\$152,000
\$80,000	\$80,000	\$50,000	\$100,000	3 years	\$202,000
\$80,000	\$80,000	\$50,000	\$200,000	3 years	\$108,000
\$80,000	\$80,000	\$50,000	\$400,000	3 years	\$102,000
\$50,000	None	\$50,000	\$100,000	5 years	\$27,000
\$50,000	None	\$50,000	\$100,000	3 years	\$18,000
\$50,000	None	\$50,000	\$200,000	3 years	\$18,000

The next table shows the maximum possible amount of partial forgiveness under the public service loan

forgiveness program based on the number of years in income-based repayment. It assumes that the borrower's income was less than 150% of the poverty line, yielding a zero monthly loan payment.⁷ The amount of forgiveness exceeds the amount borrowed with 5 or more years in income-based repayment because it includes accrued but unpaid interest in addition to the principal balance of the loan.

Years in IBR	Amount of Forgiveness Per \$1,000 Borrowed	
	6.8% Interest	7.9% Interest
1	\$258	\$298
2	\$490	\$562
3	\$700	\$795
4	\$889	\$999
5	\$1,058	\$1,179
6	\$1,211	\$1,336
7	\$1,348	\$1,473
8	\$1,470	\$1,593
9	\$1,579	\$1,696
10	\$1,680	\$1,790

A primary care physician working in a private practice, on the other hand, does not qualify, not even if they are working in a national need area, because they do not work for a public hospital or a non-profit 501(c)(3) organization.

However, a primary care physician (or even an orthopedic surgeon or cardiologist) could incorporate their practice as a non-profit 501(c)(3) organization⁸ and then qualify for public service loan forgiveness. They could even pay themselves a very low salary during the remainder of the 10-year period in order to maximize the amount of loan forgiveness. The non-profit practice would retain the income, presumably to be paid to the doctor as a big bonus after qualifying for public service loan forgiveness. But even if the doctors don't manipulate their income, the previous tables demonstrate that they will qualify for tens of thousands of dollars of loan forgiveness from the years at low pay during the internship and residency.

POSSIBLE WAYS OF CLOSING THE LOOPHOLE

There are several possible ways of closing this loophole in the public service loan forgiveness program.

Blocking the accrual of forgiveness during internships, residencies and fellowships. One method would involve specifying that working in an internship, residency or fellowship does not qualify as full-time employment in a public service job. Even though these activities occur after completion of medical school, they are still part of the educational program.

Exclude doctors from public service loan forgiveness. Another method would involve specifying that doctors, except perhaps for primary care physicians, are ineligible for public service loan forgiveness.

⁷ Note that the total forgiveness in the previous tables may exceed these figures if the borrower still qualifies for income-based repayment after the increase in income. Income is assumed to grow at a 4% annual rate and the poverty line at a 3% annual rate.

⁸ The choice between incorporating as a non-profit or as a for-profit organization does not otherwise matter much, because most of the income to the practices will eventually be paid to the doctor as salary.

Allow higher income after the end of income-based repayment to offset the accrued forgiveness.

Another method would involve allowing the monthly payments to exceed standard repayment, so that the higher payments reduce the forgiveness earned during the internship, residency and fellowship. The forgiveness earned during the internship, residency and fellowship is based on the difference between the payments under income-based repayment and standard repayment. When the monthly payment under income-based repayment equals or exceeds the standard repayment, the borrower no longer qualifies for income-based repayment and switches to standard repayment. The forgiveness earned during the low-income years is preserved by the switch to standard repayment. While standard repayment doesn't add any new forgiveness (i.e., 10 years of payments under standard repayment would leave no remaining balance to forgive), it also doesn't allow the higher earnings during those years to offset some of the forgiveness earned during the internship, residency and fellowship. If the monthly payment were allowed to increase beyond the standard repayment amount it would offset some of the previously accrued forgiveness.

Unlike income-based repayment, eligibility for income-contingent repayment doesn't terminate when the monthly payment under income-contingent repayment exceeds the monthly payment under standard repayment.⁹ As the borrower's income grows, the excess over the standard payment amount will pay down the balance more aggressively, offsetting some of the forgiveness that was earned during the internship, residency and fellowship. (In addition, income-contingent repayment bases the monthly payment on a greater percentage of discretionary income, yielding a smaller amount of loan forgiveness.) However, under current law a doctor who no longer qualifies for income-based repayment can switch to standard repayment, which preserves the forgiveness earned during the internship, residency and fellowship. So a possible solution would involve restricting doctors to the income-contingent repayment plan if they want to obtain public service loan forgiveness.

The following table summarizes the differences between the three repayment plans:

Repayment Plan	Monthly Payment	Definition of Discretionary Income	Termination
Income-Contingent Repayment	20% of discretionary income	AGI – 100% Poverty Line	None
Income-Based Repayment (2009)	15% of discretionary income	AGI – 150% Poverty Line	IBR > Standard Repayment
Income-Based Repayment (2012)	10% of discretionary income	AGI – 150% Poverty Line	IBR > Standard Repayment

The next table compares the amount of forgiveness under income-contingent repayment (ICR 20%) with the forgiveness under income-based repayment (IBR 15%). The forgiveness under income-contingent repayment is much smaller, but there is still some forgiveness for doctors earning \$100,000 a year or who happen to have above-average debt.

The last column in this table shows the total forgiveness when income-based repayment¹⁰ is tweaked to behave more like income-contingent repayment (i.e., if eligibility for income-based repayment did not terminate when the monthly payment exceeds the payment under standard repayment).¹¹ This yields

⁹ Some doctors who aren't seeking loan forgiveness like this aspect of income-contingent repayment because it helps them pay off their debt quicker, typically in about 7 years.

¹⁰ Note that the tweak was applied to the 15% version of income-based repayment. Changes in the percentage of discretionary income have a big impact on the amount of forgiveness. When the percentage of discretionary income drops to 10%, the amount of forgiveness will increase.

¹¹ This tweaked version was implemented using the policy version of FinAid's income-based repayment calculator, www.finaid.org/calculators/ibr_policy.phtml. The "Use Lower Ceiling" parameter specifies whether eligibility

forgiveness that is between the forgiveness under income-based repayment and the forgiveness under income-contingent repayment. It is closer to the forgiveness under income-based repayment except when the income jumps significantly.

6.8% Debt	7.9% Debt	Initial Salary	Income Jump	Jump Delay	Total Forgiveness (IBR 15%)	Total Forgiveness (ICR 20%)	Total Forgiveness (IBR 15%) Tweaked
\$80,000	\$20,000	\$50,000	\$100,000	5 years	\$72,000	\$22,000	\$71,000
\$80,000	\$20,000	\$50,000	\$200,000	5 years	\$69,000	\$4,000	\$0
\$80,000	\$20,000	\$50,000	\$400,000	5 years	\$69,000	\$0	\$0
\$80,000	\$20,000	\$50,000	\$100,000	3 years	\$49,000	\$9,000	\$45,000
\$80,000	\$20,000	\$50,000	\$100,000	4 years	\$61,000	\$16,000	\$59,000
\$80,000	\$80,000	\$50,000	\$100,000	5 years	\$183,000	\$84,000	\$183,000
\$80,000	\$80,000	\$50,000	\$200,000	5 years	\$139,000	\$34,000	\$99,000
\$80,000	\$80,000	\$50,000	\$400,000	5 years	\$139,000	\$11,000	\$0
\$80,000	\$80,000	\$50,000	\$100,000	3 years	\$160,000	\$61,000	\$160,000
\$80,000	\$80,000	\$50,000	\$200,000	3 years	\$93,000	\$0	\$21,000
\$80,000	\$80,000	\$50,000	\$400,000	3 years	\$93,000	\$0	\$0
\$50,000	None	\$50,000	\$100,000	5 years	\$12,000	\$1,000	\$0
\$50,000	None	\$50,000	\$100,000	3 years	\$9,000	\$0	\$0
\$50,000	None	\$50,000	\$200,000	3 years	\$9,000	\$0	\$0

Clearly, requiring doctors to use income-contingent repayment to qualify for public service loan forgiveness yields the least amount of forgiveness. This would require the US Department of Education to continue to offer income-contingent repayment instead of phasing it out as borrowers switch to income-based repayment or reach the 25-year forgiveness threshold.¹²

Another flaw with this approach to offsetting forgiveness is the potential for moral hazard, where a medical school student might decide incur more debt because it may be forgiven if their internship, residency and fellowship are in a public or non-profit hospital.

Blocking the accrual of forgiveness during the internship and residency seems to be the most effective solution, since it eliminates the loophole without preventing doctors from obtaining public service loan forgiveness for working in a low-wage public service job.

Congress should also consider adding primary care physician to the list of public service jobs. There is a shortage of primary care physicians because the pay is low compared with the debt and the opportunities for better pay in other specialties.

terminates when the monthly payment exceeds the monthly payment under standard repayment (i.e., Use Lower Ceiling = Yes) or whether the eligibility continues even after the monthly payment exceeds the monthly payment under standard repayment.

¹² Borrowers with a zero monthly payment under income-contingent repayment have no incentive to switch from income-contingent repayment to income-based repayment.