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Work Incentive Support Center

Policy and Practice Brief:

Effect of Defaulted Student Loans on Return to Work Efforts

Prepared by

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This is one of a series of articles written for benefits specialists employed by Benefits Planning, Assistance and Outreach projects and attorneys and advocates employed by Protection and Advocacy for Beneficiaries of Social Security programs. Materials contained within this policy brief have been reviewed for accuracy by the Social Security Administration (SSA), Office of Employment Support Programs. However, the thoughts and opinions expressed in these materials are those of the authors and do not necessarily reflect the viewpoints or official policy positions of the SSA. The information, materials and technical assistance are intended solely as information guidance and are neither a determination of legal rights or responsibilities, nor binding on any agency with implementation and/or administrative responsibilities.

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I. Introduction

Many individuals with disabilities may have attempted college either before or after they became disabled. If prior college attempts were unsuccessful, the student may have defaulted on student loans. When the loans are secured by the federal government, the individual will not be eligible for further financial assistance, including all federal grants and loans, for college until the prior loans are no longer in default. Many state vocational rehabilitation (VR) agencies may also be reluctant to provide VR funding for higher education in this event. Moreover, the Debt Collection Improve-ment Act of 1996 (Debt Collection Act),[1] and other federal changes, allow for expanded collection of delinquent student loans.

For individuals with disabilities who are attempting to go to work, the dual impact of not being eligible for additional federal aid to obtain higher education and the potential drain on income to repay the defaulted loans can be devastating. It is, therefore, very important for both Benefits Planning, Assistance and Outreach (BPA&O) counselors and Protection and Advocacy for Beneficiaries of Social Security (PABSS) advocates to be aware of the effects of defaulted student loans, the increased federal efforts to collect on those loans, and some of the remedies that are available to debtors. This article will explore each of these issues in some detail. There is also an extremely well written and well-documented resource available from the National Consumer Law Center for those who may be interested in a more in-depth treatment of this subject.[2]

II. Types of Student Loans

For anyone working with individuals with defaulted student loans, it is important to first determine the precise type of loan as well as the effective date of the loan. Over the years, the names of the different types of loans, as well as the rules applicable to those loans, have changed a number of times. Currently, there are three basic types of federally guaranteed student loans: Federal Family Education Loans (FFEL), which are between the student and private financial institutions;[3] Direct Loans, which are between the federal government and the student;[4] and Perkins Loans, which are between the school itself and the student.[5] A good place to start to find the status of a borrower's student loans is www.studentclearinghouse.org.

It can then get very confusing, because within each of these three basic families of loan programs are specific types of loans. A loan with the same name can be from two different families. For example, there can be a Stafford Loan, subsidized or unsubsidized, under both the FFEL or Direct Loan programs. This article will not attempt to differentiate between each of the specific types of loans, but will try to give the basic rules, with citations, which are applicable as broadly as possible. The reader interested in more specific information is referred to Student Loan Law by the National Consumer Law Center.[6]

[1] Pub.L.No. 104-34, 31 U.S.C. § 3716.

[2] Loonin, Deanne, John Rao and Alan White, Student Loan Law, *The Consumer Credit and Sales Legal Practice Series*, National Consumer Law Center, Inc. (Boston, MA 2001). Much of the basic information in this article came from this resource.

[3] Governing regulations are found at 34 C.F.R. Part 682.

[4] *Id.* Part 685.

[5] *Id.* Part 674.

[6] *See* note 2, above.

III. Effects of a Defaulted Student Loan

A. Introduction

Currently, a loan will be "in default" if there have been no payments for 270 days (about nine months) and there is a reasonable finding that the borrower no longer intends to repay.[7] Defaulting on a federally-guaranteed student loan has serious consequences. The loan will most likely be given to a collection agency, which will add collection fees onto the outstanding principle, interest will continue to accrue on the loan, the borrower's credit rating will be affected and wages can be garnished. Additionally, new offset provisions, which will be discussed below, allow the federal government to seize tax returns and, for Social Security Disability Insurance (SSDI) beneficiaries, a portion of the SSDI check to repay the loan. Therefore, it is extremely important to avoid going into default in the first place.

B. Steps to take prior to going into default

1. Repayment Plans

For low-income borrowers, there are repayment options in addition to the traditional repayment plans. FFELs have income-sensitive repayment plans (ISRP) where the borrower's payments are adjusted each year based on their expected monthly gross income. However, monthly payment must be large enough to at least cover accruing interest.[8] Direct Loans have Income Contingent Repayment Plans (ICRP), which allow payments to be reduced for low income borrowers as well. Payments under an ICRP need not cover accruing interest and can even be zero for borrowers below the poverty level.[9] Under Perkins Loans, schools may extend the repayment period for low-income borrowers for up to an additional ten years. But, as with the repayment plans under the other programs, interest continues to accrue.[10]

2. Deferments

Another option for borrowers finding it difficult to make payments, prior to default, is to seek a deferment. A deferment allows the borrower to postpone paying the loan back and, during that period, interest does not continue to accrue. The rules for obtaining a deferment changed for any loan issued after July 1, 1993.

Deferments are now available under the FFEL and Direct Loan programs for: students in at least half-time study, graduate fellowships, or rehabilitation programs; unemployment, with the loan deferment for no more than three years; economic hardship, determined one year at a time for no more than three years; and Peace Corps service.[11]

For Perkins Loans, the following deferments are now available: student; unable to find full-time employment, for no more than three years; economic hardship, for no more than three years. In addition, in certain specified circumstances, these deferments are also available: full-time teaching, full-time law enforcement, military service, and volunteer service, such as the Peace Corps.[12]

[7] 34 C.F.R. §§ 682.200(b)(FFEL) and 685.102(b) (Direct).
[8] *Id.* § 682.209(a)(7)(iv).
[9] *Id.* § 685.208(f).
[10] *Id.* § 674.33(c)(3).
[11] *Id.* § 682.210(s) (FFEL) and 685.204(b) (Direct).
[12] *Id.* § 674.34.
[13] Student Loan Law, p. 12.

3. Forbearances

A forbearance is another option for borrowers who cannot make their loan payments. Under the FFEL and Direct Loan programs, unlike a deferment, it is available both before and after a borrower goes into default. The forbearance will put a halt to collection actions.[13] The forbearance allows a borrower to temporarily stop making payments altogether, reduce the amount of the payments, or extend the length of time over which payments will be made.[14] However, also unlike a deferment, interest will continue to accrue during the forbearance period, so it is actually likely that the amount owed on the loan will increase during this time.[15]

Forbearances are available for borrowers who cannot make loan payments because they are in poor health or have other personal problems.[16] Administrative forbearances are also available while applications are being processed for, among other things, changes in payments, requests for deferments, loan consolidation or discharge.[17]

Under the Perkins Loan program, for students who are already paying the $30 monthly minimum and still unable to make payments because of hardship, the school may further reduce the minimum payments for up to a year.[18] Additionally, a borrower's repayment period can be extended for up to ten more years for families with income up to 150 percent of poverty.[19]

C. Effect of Defaulted Student Loans on VR Agency Funding for College

What if the individual now seeks to return to college, with state VR agency support, and does not have the financial ability to get the loan out of default? Must the VR agency consider, as a comparable benefit, the value of any grants for which the individual would have been eligible, and reduce its support to the individual by that amount?

VR agencies may fund higher education, if needed to meet an employment goal. However, the VR agency cannot use federal VR funds "unless maximum efforts have been made . . . to secure grant assistance, in whole or in part, from other sources to pay for that training."[20] The Rehabilitative Services Administration (RSA), which oversees the VR program, has issued a Policy Directive to reconcile the requirement to use "maximum efforts" to secure outside grant assistance and the problem for individuals with defaulted student loans, where that assistance is unavailable.[21]

RSA's Policy Directive provides that if an individual with the financial means to do so fails to repay a loan, the VR agency may determine that the grant assistance for which the student is ineligible is, in any event, "available" to that person. Accordingly, the VR agency would deduct from the amount of assistance it will provide the value of the grants for which the student would have been eligible. On the other hand, when a student with limited financial means cannot make repayment arrangements with the

[14] 34 C.F.R. §§ 682.211(a)(1)(FFEL) & 685.205(a) (Direct).
[15] Student Loan Law, p. 12.
[16] 34 C.F.R. §§ 682.211(a)(2)(i) (FFEL) & 685.205(a)(1) (Direct).
[17] Student Loan Law, p. 13.
[18] 34 C.F.R. § 674.33(b)(5).
[19] *Id.* § 674.33(c)(2).
[20] 29 U.S.C. § 723(a)(5); 34 C.F.R. § 361.48(f)(6)(emphasis added).
[21] RSA Policy Directive, RSA-PD-92-02 (11/21/91).
[22] *Id.*
[23] 20 U.S.C. § 1091a.

lender, or otherwise take the loan out of default as discussed below, the VR agency may conclude that "maximum efforts" have been made and full VR assistance would be appropriate. When confronted with this question, VR counselors must make individualized determinations, based on all of the circumstances involved.[22]

IV. Increased Federal Efforts to Collect Defaulted Student Loans

A. Elimination of Statute of Limitations

It is important to note that there is no longer a statute of limitations that applies to the collection of student loans.[23] What this means is that no matter how old a loan is, all of the collection actions discussed in this article can be used to seek to recover on a defaulted student loan. For example, the authors have had clients with loans that were 20 years old that were now subject to collection actions.[24]

B. Tax Intercept Program

The tax intercept program applies to a legally enforceable debt owed to the federal government or administered by a third party on behalf of the government.[25] This would, therefore, apply to defaulted student loans. It gives the government the authority to use any tax refunds owed to a borrower toward repaying the defaulted student loan.[26] As long as the loan continues to be in default, with an outstanding balance, any tax refunds owed will simply be used toward paying off the loan. It is called an intercept program because the refund never gets to the borrower. It goes directly from the Internal Revenue Service (IRS) to the Department of Education (DOE), the federal agency that is owed the debt.

Prior to commencing a tax refund intercept, the DOE must give the borrower written notice. The notice must inform them of the right to review the loan records, to obtain a review of the status of the loan, or to enter a repayment agreement.[27] The borrower may request a hearing from the DOE within 65 days of receipt of the notice (if the borrower does not first request to review the file).[28] A timely request for a hearing will stop the intercept until the review is complete.[29] Even though the tax collection under this intercept program is administered by the IRS, any attempts at resolution must be pursued with the DOE.

C. Social Security Offset Program

Federal law generally prohibits anyone, including the federal government, from taking Social Security Disability Income (SSDI) or Supplemental Security Income (SSI) benefits by legal means.[30] This is referred to as the anti-assignment clause. However, because this right was created by Congress, it can be modified by Congress. In certain instances Congress has specifically allowed this protection to be pierced. The Debt Collection Act[31] is one such instance in which Congress specifically indicated its intent to override

[24] In a recent federal district court decision, however, the judge ruled that the DOE could not seek to offset Social Security benefits for loans where their right to pursue a claim is more than 10 years old. This is a very important first step in limiting governmental actions on very old loans.
[25] 31 U.S.C. § 3720A.
[26] *Id.* § 3720A(c).
[27] 34 C.F.R. § 30.33(b).
[28] *Id.* § 30.33(d).
[29] 31 U.S.C. § 3720A(b).
[30] 42 U.S.C. §§ 407 (SSDI) & 1383(d)(a)(SSI).
[31] 31 U.S.C. § 3716.

the anti-assignment clause protection. The law specifically overrides the anti-assignment clauses for both SSDI and SSI.[32] However, the federal regulations implementing the Debt Collection Act provide an exemption for SSI payments,[33] and the Social Security Administration's (SSA) Program Operations Manual System (POMS) also exempts SSI benefits from the offset program.[34] Therefore, this program will not apply to SSI recipients, but it will apply to SSDI recipients. Although the law was passed in 1996, it was not until 2001 that the government began to implement the program.[35]

The DOE initiates collection by providing notice of intent to collect past due student loans to the SSDI recipient.[36] This notice of offset will provide hearing rights and limited remedy information. The recipient has the right to request a hearing[37] to challenge the offset or to set up a repayment plan to avoid offset.[38] Requests for hearings and arrangements for repayment plans must be made with the DOE.

The SSA has no authority to modify or terminate DOE offsets.[39] DOE must certify the debt to the Department of Treasury (Treasury). Once all notice time periods have run and hearings have occurred, Treasury will order SSA to assign a portion of the recipient's monthly SSDI benefits to DOE. Notices from Treasury will come from the Financial Management Service (FMS).

The Debt Collection Act does provide some protections, however. The first $750 of SSDI paid to a recipient cannot be taken. The total amount recouped from each monthly benefit payment must be the lesser of the amount the monthly benefit exceeds $750, if at all, or 15 percent of the total monthly benefit.[40] The implementing regulations give the following examples to clarify how this would work:

(i) A debtor receives monthly Social Security benefits of $850. The amount offset is the lesser of $127.50 (15% of $850) or $100 (the amount by which $850 exceeds $750). In this example, the amount offset is $100 (assuming the debt is $100 or more).

(ii) A debtor receives monthly Social Security benefits of $1250. The amount offset is the lesser of $187.50 (15% of $1250) or $500 (the amount by which $1250 exceeds $750). In this example, the amount offset is $187.50 (assuming the debt is $187.50 or more).

(iii) A debtor receives monthly Social Security payments of $650. No amount will be offset because $650 is less than $750.[41]

[32] *Id.* § 3716(c)(3)(A)(i).
[33] 31 C.F.R. § 285.4(a)(1).
[34] POMS GN 02410.300 B.1.a.
[35] Tarantino, Louise, "Social Security Benefits Subject to Increased Debt Collection," p. 16, *Legal Services Journal* (Greater Upstate Law Project, December 2001).
[36] 31 C.F.R § 285.4(f).
[37] 31 U.S.C. § 3716(a).
[38] 34 C.F.R. § 30.22(b)(3)(iii).
[39] *See* POMS GN 02410.300 A.5.
[40] 31 C.F.R. § 285.4(e).
[41] *Id.* § 285.4(e)(3).

V. Remedies to Take a Loan out of Default

A. Bankruptcy

While severe limitations have been placed on the discharge of student loans through bankruptcy, it is still possible to discharge a student loan based on "undue hardship."

There must have been a "good faith" effort to pay the debt in the past together with no prospect for future income for a significant period of time.[42] Although this is a very high hardship standard, it may warrant exploration in appropriate cases. For example, even if the hardship standard cannot be met, some bankruptcy courts have discharged collection fees and interest for the student loan debt. In addition, a Chapter 13 bankruptcy plan will determine how much the borrower pays each month. In many instances, this could mean a significantly lower monthly payment on the outstanding loan.

B. Disability Discharge

Under the federal guaranteed student loan programs, there are provisions for discharging a student loan, if a person becomes "totally and permanently disabled."[43] To be considered "totally and permanently disabled," the individual must be "unable to work and earn money or attend school because of an injury or illness that is expected to continue indefinitely or result in death."[44]

Beginning in July 2002, a new process for disability discharges exists.[45] The DOE will issue a "conditional discharge" for a period of three years.[46] During this period the DOE will review the borrower's ability to work (most likely by reviewing SSA income reports) in order to determine whether the "conditional discharge" remains appropriate. The borrower also has an affirmative duty to report to the DOE earnings that are more than the federal poverty level.[47] During the three year period the borrower will be allowed earnings up to the poverty level. If earnings exceed the poverty level, the loan will again become due and owing. If earnings remain below poverty during the three year period, the loan will be permanently discharged. During the period of the conditional discharge, the borrower is not required to make any loan payments, nor does interest accrue.[48]

C. Debt Cancellation Through Discharge Procedures

First, there is a discharge of the loan based on the death of the borrower.[49] Additionally, based upon "hardship," debt cancellation, through a number of discharge options, which will be discussed below, is one of the most effective ways for a borrower to obtain relief from the DOE's collection efforts. While there is no time limit associated with filing a discharge request, the student loan in question must have been made in 1986, or later. Discharge will result in the complete elimination of the student loan debt and the reimbursement of all monies paid out by the borrower, including tax refunds seized by the IRS and payments made by the borrower. The DOE will also be required to assist in "cleaning up" the credit report of the borrower after discharge. Upon the denial of a discharge there exists an informal DOE review process, a second discharge request can be submitted, or the borrower can seek review in federal court.

Many states have their own tuition recovery funds for students who have been defrauded but do not qualify for one of the federal discharge options.[50]

[42] *Brunner v. New York State Higher Ed. Services Corp., 831 F.2d 395 (2d Cir. 1987).*
[43] 20 U.S.C. § 1087(a).
[44] 34 C.F.R. §§ 682.200(b) (FFEL) & 685.102(a)(3) (Direct).
[45] 65 Fed. Reg. 65, 687-79.
[46] 34 C.F.R. §§ 674.61(b) Perkins, 682.402(c)(1) (FFEL) and 685.213(a)(i) Direct) 411.530.
[47] *Id.* §§ 674.61(b)(7)(iv) (Perkins), 682.402(c)(14)(iv) (FFEL) and 685.213(d)(4) (Direct).
[48] *Id.* §§ 674.61(b)(7)(i) (Perkins), 682.402(c)(14)(i) (FFEL) and 685.213(d)(1) (Direct).
[49] *Id.* § 374.61(a).
[50] *Id.* See Student Loan Law, p. 113, n. 179, for a list of available state programs.

1. Closed School Discharge

A closed school discharge is available for FFELs, Direct Loans and Perkins Loans received, at least in part, after January 1, 1986.[51] The discharge is available if the borrower was unable to complete the program because the school closed.[52] The student must have either been enrolled at the time of the school's closure, or if the student withdrew, the withdrawal must have occurred within 90 days of the school's closure.[53] The DOE maintains a list of official school closing dates at www.ed.gov/offices/OSFAP/Students/closedschool/search.html.

2. False Certification Discharge

A false certification discharge also applies to student loans received, at least in part, after January 1, 1986.[54] Perkins Loans are not eligible for this type of discharge. The student must prove that the school falsely certified to the DOE his or her ability to benefit from the program. In most cases, students with high school diplomas or General Equivalency Diplomas at the time of admission will not be eligible.[55] However, if the student is unable to meet minimum state employment requirements for the job for which the student was being trained,[56] or if the school forged or altered the loan note or check endorsements,[57] a false certification discharge still may be available.

3. Unpaid Refund Discharge

An unpaid refund discharge also applies to loans obtained, at least in part, after It will allow a borrower to discharge any part of loan liability that is directly due to the school's failure to pay tuition refunds to the student. They will be able to reduce their debt by the amount of the refund that was owed, as well as interest and related charges.[58]

D. Repayment of Defaulted Student Loans

If an individual with a disability is not eligible to have a student loan discharged, the law makes it relatively easy to develop a repayment plan, which will take the loan out of default. Each guaranty agency under the federal student loan program must establish a program, which allows a borrower with defaulted loans to renew eligibility for all federal financial assistance. The borrower must make six consecutive monthly payments to bring the loan out of default. The guaranty agency cannot demand from a borrower a monthly payment amount that is "more than is reasonable and affordable based upon the borrower's total financial circumstances."[59] A borrower may only obtain the benefit of this provision once.[60]

The payments must be voluntary and on-time. "On-time" means payments are made within 15 days of the scheduled due date. "Voluntary payments" "do not include payments obtained by income tax offset, garnishment, or income or asset execution."[61]

[51] 34 C.F.R. §§ 682.402(d)(1)(i) (FFEL), 685.214(c)(1)(ii) (Direct) & 674.22(g) (Perkins).
[52] 20 U.S.C. § 1087(c)(1).
[53] 34 C.F.R. § 682.402(d)(1)(i) (FFEL) & 685.214(c)(1)(ii) (Direct).
[54] 34 C.F.R. § 682.402(e)(1)(i)(A).
[55] *Id.* § 682.402(e)(1)(i)(A).
[56] *Id.* § 682.402(e)(13)(iii)(B).
[57] *Id.* § 682.402(e)(1)(i)(B), (e)(1)(ii).
[58] Student Loan Law, p. 58.
[59] 20 U.S.C. § 107-6(b) (emphasis added).
[60] *Id.*
[61] 34 C.F.R. § 685.102(b).

A borrower can also cure a default by "rehabilitation." To get rehabilitation, the borrower must make twelve timely monthly payments. Once a loan is rehabilitated, the borrower is eligible for new federal financial assistance.

E. Loan Consolidation

Loan consolidation may also be available and can be a great alternative. It is available both before and after a loan goes into default. One disadvantage of consolidating a loan after it has gone into default is that an 18.5 per cent collection fee is added to the amount due.

Consolidation plans should be treated as a refinancing agreement and payment plans are set by the DOE. There is both a Direct Consolidation Loan and a FFEL Consolidation Loan. As long as a borrower has at least one outstanding Direct Loan or FFEL, the borrower can apply for a Direct Consolidation Loan and consolidate all outstanding loans, including Perkins Loans.[62]

Generally speaking, for low income borrowers, the Direct Consolidation Loan will be preferable to a FFEL Consolidation Loan, because under the FFEL program, payments must at least cover accruing interest.[63] However, for a Direct Consolidation Loan, the payment level of a borrower with income at, or below, poverty is $0 per month.[64] The consolidation plan will remove any default that was outstanding prior to the adoption of the plan and a re-evaluation of the borrower's financial situation will occur each year to adjust the payment level accordingly. After 25 years of compliance with the consolidation plan the entire loan is considered paid in full, even if the payments were zero each year,[65] and the borrower's credit report must be corrected.

Consolidation applications can be found on-line at www.ed.gov/directloan. An on-line calculator will allow the student to determine monthly repayment levels before completing the consolidation application. The calculator can be found at www.ed.gov/DirectLoan/Repay/Calc/dlentry2.html.

VI. Conclusion

While defaulted student loans can be a huge barrier to financial independence, there are a number of options available to the borrower. The borrower can either seek to have a loan discharged completely or develop an affortable repayment plan to take the loan out of default. This is an emerging area of law which the BPA&O and PABSS projects need to be aware.

[62] Student Loan Law, p. 84.
[63] 34 C.F.R. § 682.209(a)(7)(iv).
[64] *Id.* § 685.209(a)(2).
[65] *Id.* § 685.209(c)(4) (iv).

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