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UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE CHIEF FINANCIAL OFFICER

THE CHIEF FINANCIAL OFFICER

AUG - 2 1994

MEMORANDUM

TO: Addressees

FROM: Maureen A. McLaughlin *Maureen A. McLaughlin*
Policy Advisor to the Assistant Secretary
for Postsecondary Education

Donald R. Wurtz
Chief Financial Officer *Don Wurtz*

SUBJECT: White Paper on the Role of IRS in Student Loan Programs

Attached is the subject paper that will be discussed at the August 3 meeting at the Department of the Treasury. It is the result of a team effort by the Departments of Education and Treasury and the Internal Revenue Service.

The paper analyzes six alternative roles for the IRS in student loan programs and it also addresses the issue of wage withholding by employers as a mechanism to collect student loan repayments. The concept of employer wage withholding is examined with both mandatory and voluntary options presented. In either case, borrowers will be able to choose whether to repay their loans using wage withholding or another repayment method.

Significant progress has been made on this subject since the June 15 meeting. We anticipate that the meeting on August 3 will result in closure on outstanding issues and agreement on next steps that need to be taken in order to complete a report to Congress on this matter.

Attachment

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WHITE PAPER

An Approach to Managing the Student Loan Portfolio

U.S. Department of Education
U.S. Department of Treasury
Internal Revenue Service
August 1994

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SUMMARY and RECOMMENDATION

Serving Students Better

A centerpiece of the Administration's efforts to promote national service and make paying for college easier was fulfilled through the enactment of the Student Loan Reform Act of 1993 (Title IV of the Omnibus Budget Reconciliation Act of 1993—OBRA '93), and its companion legislation, the National and Community Service Trust Act of 1993. Under President Clinton's new Direct Loan program, all aspects of the loan process are simplified and streamlined to better serve the needs of students and postsecondary education institutions, while saving taxpayer dollars. Specifically, under the Direct Loan program the complex array of lenders, servicers, secondary markets, and guaranty agencies are eliminated and consumers are provided with a variety of repayment plans to allow students to make career choices without undue concern over the level of post-graduate income.

Easing Loan Repayment

The section that follows describes 1) the repayment plans available under the Direct Loan program and 2) various repayment methods borrowers can use to repay their student loans.

Repayment plans

To ease the financial burden of repaying a loan, borrowers will be given the chance to tailor their loan repayments to meet their career needs. Flexible repayment options will give borrowers the chance to reap the benefits of their investment in their education and pay according to their ability.

- Borrowers will be given maximum flexibility to choose from four repayment plans: the income contingent repayment plan, a fixed term standard plan, a graduated plan, an extended repayment plan. Additionally, alternative repayment plans will be created on a case-by-case basis when other repayment plans do not suit a borrower's unusual circumstances. (Appendix 1)
- Borrowers will be able to change plans as their financial needs and circumstances change.
- Under the income contingent plan, borrowers repay their loans as a percent of their incomes. It provides for reasonable monthly payments for borrowers with varying amounts of debt and income.
 - Income contingent repayments enable borrowers to pursue public service careers in fields such as health care, law enforcement, teaching, or social work, without undue concern over the affordability of loan payments.

- Under the income contingent repayment plan, borrowers who cannot afford loan payments will be able to avoid defaulting on their loans.

Repayment methods

To further ease loan repayment, borrowers will be able to choose the most convenient method for paying their monthly loan payments, such as:

- Borrowers can use several versions of electronic funds transfer, normally through their bank or credit union.
- Borrowers may request their employer to withhold payments from their wages and pay their loans through electronic funds transfer.
- Borrowers can write monthly checks.

Any pre-authorized electronic funds transfer, whether through the borrower's bank or employer, will reduce burden for borrowers by making loan repayment an automatic process. (A full discussion of repayment collection options can be found at Appendix 4).

NOTE: One question concerning repayment methods is whether employers should be required to establish a withholding system, separate from tax withholding, so that borrowers, if they choose, can have their student loans automatically deducted from their wages through electronic funds transfer. Alternatively, employer participation would be voluntary. In order to reach a decision on whether employer withholding should be voluntary or mandatory, the following section outlines the pros and cons for each option. This part of the paper will be revised once a decision is made.

Employer withholding - Education can offer borrowers a variety of convenient and easy ways to automatically repay their loans. One method is withholding loan payments from the borrower's salary. In addition to fulfilling the President's goal and the customer's expressed preference for ease of repayment, salary withholding promotes reliability and efficiency. As many commenters observed in Education/IRS sponsored customer focus groups, automatic deductions from salary have the advantage of being taken for granted and thus withheld funds are not considered available when it comes time for borrowers to budget for personal expenses. For cost projections, we estimated that 30% of the borrowers would select employer withholding as the preferred repayment method.

Mandatory withholding for employers - Employers would be required to establish an additional withholding system for student loan repayments that would be similar to the current tax withholding system, but would require more detailed and frequent reporting. Although the withholding system would be mandatory for employers, borrowers would

always have the option to select this repayment method or another that best suits their individual circumstances.

Pros:

- o Offers an easy and convenient repayment method for borrowers who want to take advantage of wage withholding through their employer.
- o Reduces defaults by providing an appealing and automatic repayment method for many borrowers.
- o Impacts minimally on large employers who now offer wage-withholding allotments.
- o Because employer participation is mandatory, eliminates the need for U.S. Government to offer incentives or subsidies to employers.

Cons:

- o Requires legislation and a related enforcement mechanism.
- o Burdens businesses, especially small businesses, that would have to create necessary accounting systems.
- o Could discourage some businesses from hiring student loan borrowers.
- o Burden on employer (Cost estimate--\$5.8 billion annually). (See Appendix 6 for methodology).

Voluntary withholding - Under this option, employers would not be required to set up a system to withhold student loan repayments. Participation by employers would be voluntary, similar to the current system of employer allotments for charitable deductions. As with mandatory withholding, borrowers would have the option to select wage withholding or another repayment method to repay their student loans.

Pros:

- o Since no legislation is required, borrower can take advantage of withholding method immediately upon entering the job market, if employed by a company that participates in the program.
- o Imposes less burden on employers than mandatory withholding.
- o Voluntary participation may meet less resistance from employers than

mandatory participation.

- o Reduces defaults by providing an easy and convenient method for borrowers to repay their loans.

Cons:

- o May not be widely available to all employed borrowers if employers do not voluntarily establish wage withholding systems.
- o To increase participation of employers, would require an extensive PR campaign by the Administration to convince employers to participate.
- o Will involve costs to employers. (Estimate—\$1.5 billion annually. See Appendix 6 for cost estimate methodology). [NOTE: A decision is necessary concerning whether to reimburse the employer as an incentive to participate].

OBRA Required Loan Collection Study

While the Student Loan Reform Act addressed many of the problems plaguing the existing student loan program, the Clinton Administration and the Congress wanted to explore whether there would be additional efficiencies and improved benefits to borrowers and the Federal government by involving the IRS in the servicing and collection of student loans. The Conference Report accompanying OBRA '93 directed the Secretaries of Treasury and Education to study the feasibility of implementing a system of withholding from a borrower's wages or using other means that would involve the IRS in the servicing and collection of student loans. A summary of the analysis is attached at Appendix 5.

In summary, IRS could collect student loans but tax collections from delinquent accounts would suffer without additional resources. Legislation would be required for IRS to use the tax collection system for other than tax collection and a separate organization within IRS would need to be established. Moreover, IRS believes that non-tax collection activities could affect voluntary tax compliance. A preferable application of IRS resources would be to use them to provide increased assistance to ED's collection efforts.

Recommendation

Using the Department of Education to administer all aspects of the Direct Loan program best fulfills the Administration's desire for a student loan program that is characterized by a high level of customer service, ease of repayment, minimal burden, simplicity with accountability,

and reduction in defaults. Therefore, the Departments of Treasury and Education along with the Internal Revenue Service recommend:

- An option that provides for continued Education administration of the entire Direct Loan program, including servicing and collecting, assisted by increased IRS information sharing (option 2) and legislation to authorize IRS to disclose to Education additional income and employment information on borrowers.
- Use of wage withholding to make it easier for borrowers to repay their student loans.

The following chart displays the factors considered to determine the optimal level of IRS involvement. Option 1 represents a minimal role for IRS, with increasing IRS involvement up to option 6.

ATTRIBUTES	OPTION NUMBER					
	1*	2*	3	4	5	6
SIMPLICITY AND ACCOUNTABILITY	2	2	0	0	0	1
CUSTOMER SERVICE	2	2	0	0	0	1
EASE AND FLEXIBILITY OF REPAYMENT	2	2	1	1	1	1
MINIMIZE BURDEN	2	2	2	2	2	0
REDUCE DEFAULTS	1	2	2	2	2	2
COST EFFICIENCY	0	0	1	1	1	2
FTE USAGE	2	2	1	1	1	0
TOTAL SCORE	11	12	7	7	7	7

* WITH VOLUNTARY WITHHOLDING

LEGEND: 2 = FULLY SATISFIES ATTRIBUTE
1 = PARTIALLY SATISFIES ATTRIBUTE
0 = DOES NOT SATISFY ATTRIBUTE

Summarized below are six options that were developed by the Department of Education and IRS. and analyzed in terms of the Administration's goals for servicing and collecting student loans. A full description of these options can be found in Appendix 5.

- o Option 1 - Education would administer the student loan program to include servicing and collecting the loans. IRS would perform address matches, income tax refund offsets for defaulters, and provide to Education adjusted gross income and filing status information.

- o **Option 2 - (Recommended option)** The same functions as in Option 1 apply and IRS would share with Education additional employment and income information for implementing the income contingent loan repayment plan and resolving problem cases.
- o **Option 3** - The same functions as in options 1 or 2 apply and IRS would collect defaulted student loans.
- o **Option 4** - The same functions as in option 3 apply and the IRS would collect all income contingent Direct Loan payments.
- o **Option 5** - IRS would collect, but not service, all Direct Loans.
- o **Option 6** - The IRS would collect and service all student loans.

Under the recommended option, the Administration will realize the President's desire to make paying for college easier by simplifying the loan program, affording students several repayment options, and permitting them to repay their loans by withholding from their salaries. Education's administration of the program with IRS's support will accomplish the following objectives of a model system:

- o ***Customer service.*** Because one agency, with significant experience in student loan programs, would be responsible for all aspects of the program, it could provide the best possible customer service to the student—its principal customer, and to other program participants. It will be in the best position to counsel a borrower on repayment plans as well as options for making payments.
- o ***Ease and flexibility of repayment.*** Education can provide borrowers with a choice of repayment methods building upon the overall Direct Loan program system, relationships with the borrowers, and well established relationships with the schools and the financial aid community.

Education will provide borrowers with a choice of repayment methods, based on the Department's experience with the choice-driven Direct Loan program. New repayment methods, including wage withholding by employers and automatic debits from bank accounts, will be offered to borrowers. Borrowers can still choose to pay by check.

- o ***Minimize burden.*** All forms of repayment impose minimal burden on the borrower; however, burden in conjunction with wage withholding becomes a factor to employers. Under option 2's voluntary wage withholding system administered by Education, having employers withhold the payments and forwarding them to Education would be no more difficult than the common practice of withholding charitable contributions or payments to a credit union. The employer would simply

prepare electronic funds transfer-type payment transactions and forward them to a Department of Education account.

- o ***Simplicity in administration, clear lines of accountability and improved quality control.*** Having Education administer the entire Direct Loan program greatly benefits the borrower because Education controls all aspects of the program from application to repayment for a seamless operation from the borrower's perspective.

The Department of Education has developed the infrastructure necessary to administer a centralized loan program. Moreover, through its experience with the Federal FFEL and the Perkins Student Loan program, Education has gained the institutional knowledge that would support effective administration.

With Education retaining control over the collection and servicing of student loans, all aspects of loan administration would reside in one agency. The program would be easier to administer, accountability would be clear, and quality could be assured through uniform management systems.

- o ***Reduce defaults.*** In addition to the new repayment plans under the Direct Loan program, Education will now provide a variety of ways for students to repay, minimizing the likelihood that borrowers will default.

Most defaults have been attributed to two factors: insufficient income to service debt and lack of borrower commitment exacerbated by poor loan servicing. Defaults caused by insufficient income should be reduced by the availability of several repayment options.

Defaults caused by poor loan servicing should be reduced with Education as the single servicer throughout the loan cycle. Also, the additional income and employment information on problem loan cases will help Education intervene to help a borrower from defaulting. Having Education responsible for all aspects of the program will allow for effective administration, good quality control and good customer service.

In addition, Education and IRS have evaluated cost factors in arriving at their recommendation.

- o ***Cost efficiency/Use of Federal employees.*** Costs for Education's administration of the loan servicing and collecting aspects are primarily contractor costs. However, reliance on contractors for operational aspects provides cost efficiency by permitting Education to continuously adjust the level of resources dedicated to administration. This will minimize the increased need for Federal FTEs. At the same time, using a single integrated system distributed among several contractors will provide flexibility to help control costs through competition.

The benefit of using IRS to collect student loans results from efficiencies in collections. To realize these efficiencies, however, IRS would have to structure the loan collection system similar to the current tax system. Because the law requires that IRS use only Federal employees for processing tax information, IRS would need to increase its FTE levels significantly. However, it would be difficult to decrease staffing during periods of decreased loan volume, or as a result of processing efficiencies. In addition, use of IRS collection resources to collect student loan debt would have a negative effect on the collection of tax liabilities. (Details of this analysis are in Appendix 6).

Option 2 does a far superior job in meeting the customer service objectives of a model loan servicing and collection system, compared to other options. Although projections indicate that option 2 costs more than options 3 through 6, it provides flexibility and does not require a large increase in full-time equivalent employment. Thus option 2 is clearly the preferable choice.

-END OF SUMMARY AND RECOMMENDATION-

Model Student Loan Servicing and Collection System

Goal

The Administration is committed to the goal of creating a model student loan servicing and collecting system that is cost efficient, user friendly, provides choices for borrowers, improves the accountability of the lending system and saves taxpayer dollars. To better understand the steps necessary to achieve the Administration's goal, the Department of Education and the Internal Revenue Service convened nine focus groups with students, borrowers, and members of the public involved in financial aid to explore the range of possible repayment plans and the extent of IRS involvement in collecting student loans.

Overall, participants favored flexibility in repayment options and control over the means of repayment. They principally valued customer service and efficiency, believing that Education would provide these more effectively than the IRS. At the same time, some participants believed that IRS involvement would ensure a higher level of accountability with commensurate savings due to increased collections. (Appendix 3).

Based upon its assessment of the Administration's goal and considering its experience with student loans over the years, the Department of Education developed a framework or model for measuring the adequacy of a student loan servicing and collection system.

Elements of a model system

To achieve an efficient servicing and collection system that is user friendly, provides a range of choices to borrowers, improves accountability, and saves taxpayer dollars, the system should have five main attributes:

- **Customer service.** Customer service must be a high priority in the model student loan system. Borrowers must be able to obtain up-to-date information on their student loan accounts on a continuing basis regardless of the number of loans or the place of origination. In addition, all public and private entities, involved in overseeing and administering loans, including, schools, Congress, and the Department of Education, should have access to current loan information to address issues based on changing law and borrower circumstances.

All loans of an individual borrower should be treated as one account for granting deferments, forbearances, cancellations, and other loan servicing purposes. A model student loan system would include a mechanism whereby borrowers with multiple loans could consolidate these loans and would enable the borrower to easily switch among repayment plans. Moreover, the system would provide prompt and accurate amortization schedules that reconcile the repayment plan's requirements with the student's present loan status (balance, capitalized interest, length of time in

repayment, etc.).

Such a student loan system should include a separate problem resolution unit and a toll-free customer service number, where borrowers, employers, and education institutions can obtain information about their own loans or their employees' or students' loans.

- **Ease and flexibility for students to repay.** The repayment methods available to borrowers (regardless of the repayment plan) should make it easy and convenient for borrowers to repay, without placing an undue burden on employers.

Along with various repayment plan options, borrowers should be able to make payments electronically or automatically without having to write a monthly check. Electronic payments could involve electronic funds transfer-type (EFT) transactions from checking accounts or through employer withholding from paychecks.

- **Minimize burden.** The model student loan system would provide an integrated response to the needs of borrowers, schools, and other program participants such as banks and employers. Any one needing details regarding the student loan program should be able to call one central phone number or write to one central address to effect changes in accounts, resolve problems, or obtain information.

Students, schools, accrediting and state agencies, employers and banks would report information only once. At the same time, a one-time report would facilitate efficient administration.

- **Simplicity in administration, clear lines of accountability and provisions for quality control.** For a student loan system to be effective, program complexity should be substantially minimized to benefit the borrower and provide a high level of customer service from loan origination to repayment. The system should permit timely responsiveness to statutory and regulatory change, easy exchange of information, and effective management and control.

Maintaining clear lines of accountability for effective program management requires current, readily available information detailing borrowers' account activity, including payments, defaults, entitlements to forbearances, cancellations, and deferments. The borrower's personal data and loan history should be updated through a real-time/on-line system.

Quality control would result principally from users monitoring and correcting their own input based on a system of edits and automated internal controls that check for accurate and complete management information and report discrepancies to the source and to the entity responsible for program oversight. The program oversight entity would ensure that timely and appropriate correction actions were taken.

- **Reduce defaults.** The model student loan system would reduce default rates, which in turn would lower the program's costs. The system would address the two principal causes of default: insufficient borrower income to service the debt and lack of borrower commitment exacerbated by poor loan servicing.

Debt service problems would be addressed proactively through various repayment, forbearance and deferment options that allow repayment plans to be adjusted with a borrower's changing circumstances. This would be accomplished through a counseling apparatus designed to inform students of their full range of available choices. In addition, borrowers would be advised if their loan obligation were compromised because the schools they attended were determined to have engaged in prescribed practices that void all or part of the loan obligation.

This personal communication between the servicer and the borrower should lower default rates and improve the collection of those loans already in default. To reduce defaults, borrowers must initially be educated regarding their loan obligations. When the loan becomes due, borrowers should receive timely billings and have easy access to information concerning repayment options from knowledgeable loan counselors.

ACTIONS UNDERWAY TO REALIZE THE MODEL SYSTEM

Model realized or underway

To meet the statutorily mandated July 1, 1994 date to begin implementation of the Direct Loan program, to plan for its continued operation, and to plan the scaling back of the FFEL program, Education has already completed some projects and begun work on others to achieve the model student loan servicing and collection system. The Omnibus Budget Reconciliation Act of 1993 provided a permanent, definite appropriation of \$2.5 billion in administrative funds to the Department of Education to be used from 1994 through 1998: \$.8 billion for FDSLPI implementation and \$1.7 billion for transition from the FFEL to the Direct Loan program.

In planning for and developing the operational aspects of the Direct Loan program, the Department of Education has benefited from years of experience in managing all aspects of the FFEL program. This long history has enabled the Department of Education to avoid past mistakes, to identify program needs, and to build upon past successes. Following are the details of the Department's actions that are underway or being planned.

Status of model system

- **Customer Service.** Every phase of the Direct Loan program has been planned to ensure the highest levels of customer service. While its principal customer is the student, Education has also considered the needs of schools, and third parties, such as employers and banks, who may help with the mechanics of repayment.

Access is the main feature of the customer service system Education has developed. The FFEL program established that a principal cause of frustration with the system has been confusion resulting from the division of program responsibilities. In the past, the history, status, or even the location of loans could not always be tracked. Education has resolved this problem by using a single servicer concept, whereby a servicer operating as Education's agent will have information on the entire loan history of every borrower. This information base should enable the servicer to deal with any situation likely to arise.

Every student or school contact concerning any aspect of a direct loan, except those handled directly by the school, will be with Education. The contractor will serve only as ED's agent. The system will continue even as servicers change ensuring that interested parties will always have a contact with Education.

Education's contracted servicer is required to maintain a staff that meets high performance standards governing the timeliness and accuracy of responses concerning all aspects of loan administration. A contractor must provide a toll-free customer

service number that is available from 8:00 am to 8:30 pm EST, along with other services.

Because the servicer will possess the loan history of each borrower, it will be in the best position to counsel a borrower on repayment options and to process changes in repayment plans, deferments, and forbearances according to the latest provisions of law and Education's administrative directives. The contractor has developed a system that will track all obligations of an individual borrower and treat them as one debt. The system will adjust the repayment schedule as circumstances change, reconcile accounts, and send appropriate notices to the borrower informing him or her of every impact of the change. The servicer will resolve borrowers' questions promptly by reviewing their entire loan history, if necessary.

Finally, Education has developed a system that will use up to 10 essentially interchangeable servicers. To ensure a high level of customer service, Education will assign additional work on the basis of satisfactory performance. Moreover, Education will permit a school to change from a servicer who has not provided a satisfactory level of service.

- **Ease and flexibility for students to repay.** Education has organized much of its Direct Loan program around making it easy for students to make their monthly loan payments. As part of the servicer contract, payments will be remitted to a commercial lockbox, which will process the payments and remit them to the Federal Reserve Bank the same day. At the same time, individual payments will be posted to the borrower's account and appropriate accounting transactions will be made. The updated payment information will be readily available to Education and to the borrower through the toll free customer service telephone number.

Education has simultaneously been developing the capability to use Automated Clearing House (ACH) processes to collect loans, either through the use of pre-authorized debits or ACH credits. ACH credits may include an employer's withholding pre-authorized amounts from the borrower's salary. In any case, the borrower would retain complete control over the authorization and continuation of the process, similar to repayment by check. (Appendix 4)

- **Minimize burden.** The same integrated design that will provide a high level of customer service will serve to minimize burden on students, schools, employers, banks, state and accrediting agencies and other parties involved in the Direct Loan process. A principal cause of burden has been the multiplicity of players, duplication of information, inaccurate data, lack of systems interfaces, and uncertainty about who to contact concerning the loan. The current system eliminates these concerns through the use of an integrated design.

The Direct Loan system is designed so that the Department of Education is the single

point of contact to answer any question and resolve any problem. All borrowers will have only one place to write to or one number to call. Participating schools will have their own toll-free telephone number connecting them with a special School Relations staff. Because the Department is responsible for the daily operation of the student loan program and for maintaining current and reliable data on each student account, duplication will be avoided and data will be accurate and timely.

Finally, the efficiency of the Direct Loan processing system and the accuracy of record systems and data are intended to provide quality management information that will make unnecessary the many checks and balances put in place as the means to monitor performance under the multi-faceted FFEL program.

- **Simplicity in administration, clear lines of accountability, and provisions for quality control.** Unlike the multi-party, multi-layer FFEL system, the Direct Loan system is fully automated and designed with Education controlling all aspects of the student loan program, including loan application, origination and repayment. In order to effectively implement the program, Education will continue to use some services provided by schools and others provided by contracted agents. A contract is already in place for determining borrower eligibility. Schools have been selected for the first and second years (1994-1995 and 1995-1996) of the Direct Loan program, and the contract is in place for servicing and collecting Direct Loans, with options to extend through FY 2000. Schools have either been provided software packages or specifications to allow the interfacing of the schools' records with the loan servicer.

Education has placed the servicer contract with a first-rate experienced provider that will process electronic origination records; receive, process, and image promissory notes; interface with Education's Payment Management System to account for drawdowns; process electronic disbursement records from schools; book loans as obligations to the U.S.; and interface with Education on reconciliations of cash with Treasury--all on an individual loan basis.

The centralization and currency of the data will permit prompt and accurate account reconciliations and facilitate Education oversight and program management, specifically related to the implementation of the Credit Reform Act of 1990 and the Chief Financial officer's Act of 1990.

The servicing and collection contract is pivotal to achieving simplicity and accountability. Once loan eligibility is determined, the student and the school will deal with the single servicer in a minimal way. At the same time, the servicer will gather and maintain the necessary information for timely accountability and quality control purposes.

The plan provides that the same servicing system will maintain all data on a student's loans from origination through final repayment. This servicing system will ensure the

completeness and integrity of the system, as well as facilitate effective management. It will include information such as interest rates, choice of repayment option, and deferments. The system is designed with numerous checks, balances and reporting requirements to ensure quality and permit constant oversight by Education. All data will be maintained on a real-time/online system that connects Education with both the schools and the servicer.

Education is obligated to the current loan servicing and collection contract for 21 months with options to extend through FY 2000. Education is also developing proposals for additional or replacement contracts for the second and subsequent years. Education expects to operate the Direct Loan program using up to 12 contracts. The use of contractors will provide Education the flexibility to expand or contract program requirements and stay abreast of the most current technology available.

Education has obligated \$16.7 million for the initial 9 months of the existing servicing contract.

- **Reduce defaults.** The Department of Education has published initial regulations governing the Direct Loan program and provided an array of repayment plans, including an option allowing borrowers to repay a small percentage of their income each year. With the new repayment options fewer borrowers will default due to insufficient income. Education has contracted with the servicer to provide students the option to repay their student loans in a variety of ways to meet their special circumstances. Further, borrowers under the FFEL program can under certain circumstances consolidate their FFEL loans under a new Direct Loan program loan, affording them the same repayment options designed to help a Direct Loan borrower avoid default. Moreover, economic hardship deferments and forbearance provisions are available to assist borrowers through circumstances that the repayment plans do not address.

Education has taken every step possible to ensure that there will be consistent and continual contact with each borrower from the moment of application for a loan to the last payment. All servicer contracts will be written to provide a constant interface. At each loan disbursement, the borrower will be advised of the transaction and its subsequent effect on the borrower's obligation. The borrower will be given pre-disbursement and pre-repayment loan counseling and will be provided information on rights and responsibilities, especially the many options available to repay his or her loans. Throughout the repayment period, be it 10 or 30 years, the borrower will be sent annual account statements. The borrower will also be advised regarding the best repayment options based on the borrower's individual circumstances.

Further, the borrower will be continuously provided with information on who to call or where to write for current and accurate information on any aspect of his or her loan at any phase from application onward.

Finally, Education will continue its computer matching projects with the IRS. These projects include address matching to locate delinquent and defaulted debtors and offsets of tax refunds from borrowers who have defaulted. In addition, the Department is working with the IRS to exchange adjusted gross income and filing status data in order to verify income levels under certain repayment options. These projects, coupled with improved administration under the Direct Loan program will greatly aid in the identification and tracking of problem loans.

This accessible and responsive system should reduce the cost of defaults, while it relieves borrowers from the burdens resulting from delinquencies, default and subsequent enforcement actions.

Options for IRS Involvement in the Collection and Servicing of Direct Student Loans

Introduction

The Departments of Treasury and Education along with the Internal Revenue Service studied the feasibility of IRS involvement in the collection of Direct Loans through wage withholding or other means. A total of six options was developed ranging from minimal IRS involvement to IRS assuming responsibility for the collecting and servicing Direct Loans. These options can be grouped into the following three categories:

1. **Information sharing/voluntary withholding**
 - As currently authorized (Option 1)
 - With additional information sharing (Option 2)
2. **Use of the current tax system**
 - IRS collects defaulted debt (Option 3)
 - IRS collects payments through wage withholding and all defaulted debt (Option 4)
 - IRS collects all Direct Loan payments and all defaulted debt (Option 5)
3. **Separate from the tax system**
 - IRS develops a withholding system separate from the tax system and collects all defaulted debt (Option 6)

Appendix 5 contains detailed descriptions and analyses of each of the six options considered.

Description of the three categories of options

Information sharing/voluntary withholding. Under this category of options, the Department of Education would retain control over the student loan program; overseeing the policy and regulatory process, and originating, servicing, and collecting Direct Loans. Also, under this category of options, the IRS would share individual income tax information with Education. Under Option 1, the IRS would share Adjusted Gross Income (AGI) and filing status information to establish income-contingent repayments. Under Option 2, the IRS would provide additional tax return information to support the income-contingent repayment plan and aid Education in collecting defaulted debt.

Also under Option 2, borrowers would be able to choose among a variety of repayment methods (including voluntary withholding) making it easy and convenient for them to repay their loans. In addition, the IRS could provide consulting services to Education regarding wage garnishment issues and payment processing systems.

Use of the current tax system. This category of options uses the current tax system to collect student loan debt. In order to effectively use the current tax system, student loan liabilities would be treated as tax liabilities. Because student loans would be collected through the tax system, borrower account information would not be available until after the borrower's tax return has been filed and processed. Under Option 3, the Department of Education would collect and service student loans until borrowers default. Upon default, the IRS would collect defaulted debt using its enforcement powers available under the current tax system.

Option 4 requires that the IRS collect all income contingent Direct Loan payments through the tax system in addition to the IRS's collection of defaulted debt outlined above. All other Direct Loan payments would continue to be handled by Education.

The IRS would collect all Direct Student Loan repayments, regardless of the repayment plan (standard, extended, graduated, income-contingent, and alternative) under Option 5. In addition, the IRS would collect defaulted debt as outlined above.

Separate from the tax system. Under Option 6, the IRS would develop a system separate from its current tax system to service and collect Direct Loan repayments and defaulted debt. While the Department of Education would continue to originate direct student loans, the IRS would be responsible for servicing those loans after they are posted as Federal obligations. To implement this option effectively, employer participation in a non-tax withholding program must be mandatory.

Analyses of IRS Options for Involvement

The Administration is committed to creating a model student loan servicing and collection system which has the following five attributes: customer service; ease and flexibility of repayment; minimal burden; simplicity in administration and clear lines of accountability, and improved quality control; and lower default rates. Each option for IRS's involvement in the Direct Loan Program was analyzed within the context of these attributes.

- **Customer service.** To meet the Administration's goal of implementing the model student loan system, customer service must be a high priority in any option under consideration. Borrowers must be able to; (1) access up-to-date information on their student loan accounts, (2) easily switch between repayment plans, (3) consolidate multiple loans, and (4) obtain information on (and receive) deferments, forbearance, and cancellations.

The Information Sharing/Voluntary Withholding category of options (Options 1 and 2) is designed with customer service as its centerpiece. The Department of Education has developed the information systems infrastructure necessary to access up-to-date information on a borrower's account. Through its experience in administering the FFEL, Education has gained the experience to identify the circumstances that entitle

borrowers to deferments, forbearances, or cancellations. Furthermore, Education has developed dispute resolution procedures which were designed to keep borrowers from defaulting. Thus, Options 1 and 2 meet the first goal of the model system.

Use of the current tax system (Options 3, 4, and 5) involves the Department of Education issuing and servicing student loans with the IRS collecting these loans in varying degrees. Borrowers would have to interact with both Education and the IRS under this category of options. The experience Education has gained managing the student loan programs has taught it that borrowers do not distinguish between servicing and collecting loans. Borrowers do not hesitate to contact the entity which sends the bills, even though there are clear instructions to do otherwise.

Furthermore, the IRS would not be able to provide timely program information to Education. Because the reconciliation between withholding and liabilities occurs when tax returns are filed, the IRS would not be able to provide information to Education until after the borrower's return has been filed and processed. The lack of real-time information restricts Education's ability to provide quality customer service. For example, if a borrower using wage withholding chooses to switch to a standard repayment plan, Education would not know the remaining principal until after the next tax return has been filed. Also, if either the tax liability or student loan liability is underpaid, then the borrower's actual payments must be artificially allocated between student loan payments and tax payments, regardless of borrower's intent. Therefore, Options 3, 4, and 5 do not fully satisfy the second goal of providing high quality customer service.

Option 6 involves Education issuing student loans with the IRS servicing and collecting them separate from the tax system. Unlike Options 3, 4, and 5, this option enables the IRS to have access to real-time program information. Because student loans would be collected through a separate withholding system from taxes, the IRS would be able to distinguish loan payments from tax payments. However, like Options 3, 4, and 5, a layer of administrative complexity is added to the student loan program because more than one agency is involved. Thus, Option 6 does not fully meet the goal of providing quality customer service.

- **Ease and flexibility of repayment.** To meet the Administration's goal of implementing a model student loan system, any option considered should provide flexible repayment plans and offer borrowers easy and convenient methods of repayment. Not only should borrowers be able to choose between the five repayment plans, but borrowers should be able to choose between a number of repayment methods.

The Information Sharing/Voluntary Withholding category of options (Options 1 and 2) provides borrowers with five repayment plans as well as several means by which payments can be made. By statute, the Direct Loan Program allows borrowers to

choose between five repayment plans; (1) standard, (2) extended, (3) graduated, (4) income-contingent, and (5) alternative. In addition, borrowers have the opportunity to change repayment plans. The ability to choose and change plans enables borrowers to customize student loan payments to meet their financial circumstances.

This category of options also provides borrowers with a choice in how they can repay their student loans. Borrowers could elect to repay in the traditional way through method monthly checks. Borrowers could also elect to participate in a number of voluntary withholding plans. Large businesses may set up employee withholding programs similar to Christmas clubs or savings bond programs. Most banks and other financial institutions allow bills to be repaid through automatic debiting of bank accounts. All borrowers would have to supply the necessary information to the appropriate institution similar to the direct deposit payment system used by many banks today. Thus, Options 1 and 2 fully meet the goal of providing ease and flexibility in making payments.

Using the current tax system (Options 3, 4, and 5), borrowers would have flexibility regarding repayment plans, but the flexibility available to borrowers regarding repayment methods would be limited. Borrowers could elect to repay through monthly checks, wage withholding, estimated payments, or in a lump-sum on their tax returns. Borrowers would adjust their tax withholdings or estimated payments to meet both tax and student loan liabilities.

However, using the current tax system means that loan payments would be posted annually rather than monthly. If a borrower chooses to change from income-contingent to any other repayment plan, the borrower, the IRS, and Education would not know the remaining balance on the loan until after the borrower files the income tax return. The inability of this category of options to provide real-time data on loan accounts severely hampers the Administration's goal of providing borrowers with ease and flexibility to repay loans. Thus, Options 3, 4, and 5 do not fully satisfy the goals of the model student loan program.

Option 6 involves Education issuing student loans with the IRS collecting and servicing these loans in a system to be developed separate from the tax system. Unlike Options 3, 4, and 5, this option enables the IRS to have access to real-time program information. Borrowers would have the opportunity to choose between repayment plans and be able to switch plans. The borrower, the IRS, and Education would have the up-to-date information necessary to permit the borrower to easily change repayment plans. Like Options 1 through 5, borrowers may elect to repay through monthly checks. Unlike Options 3, 4, and 5, borrowers may also repay their loan through employer withholding which would be separate from tax withholding.

Unlike options 1 and 2, wage withholding under option 6 would have to be accomplished through a mandatory fixed system of salary withholding, similar to tax

withholding. While this option meets the ease of repayment goals of the model student loan system, it does so in a way that may be difficult for some employers, especially small businesses.

- **Minimize Burden.** To meet the Administration's goal of implementing a model student loan system, any option considered should create minimal additional burden on employers. Burden represents the time and expense necessary for employers to implement wage withholding.

The Information Sharing/Voluntary Withholding category of options works through private sector mechanisms (already in place) to collect and service Direct Loans. Instead of being forced to participate, financial institutions and employers could participate through incentives. Some firms may be willing to establish employee allotment programs similar to savings bond or charitable contribution campaigns. Small businesses could establish similar programs, in which employers electronically transfer funds withheld from wages to a Department of Education account. This payment option provides all the conveniences of wage withholding and is available to all borrowers whose employers participate in the system. While options 1 and 2 could cost employers \$1.5 billion, employers have the choice of whether they want to participate. Thus, Options 1 and 2 fully meet the goal of minimizing burden.

Use of the current tax system (Options 3, 4, and 5) involves Education issuing and servicing student loans with the IRS collecting these loans in varying degrees. Because borrowers could repay their student loans through an adjustment to their income tax withholdings or estimated payments, no additional burden would be imposed on employers. Employers would not know, or even need to know, that employees were repaying student loans. Thus, this category of options meets the model student loan system goal of minimizing burden.

Option 6 involves Education issuing student loans with the IRS servicing and collecting student loans separate from the tax system. Because employers would be required to withhold and report student loan payments separately from tax withholdings, there is a substantial increase in the employer's burden under Option 6. Employers would be required to deposit each borrower's student loan payment each pay period. An estimated \$ 5.8 billion in additional costs would be imposed on employers. Thus, Option 6 does not fully meet the goal of minimizing burden.

- **Simplicity in administration, clear lines of accountability and improved quality control.** To meet the Administration's goal of implementing a model student loan system, any option considered should be simple to administer and have clear lines of accountability. The system should provide for centralized management and control. It should also have access to current program information in order for management to measure program performance. Finally, the system should provide real-time

borrower account information and be able to timely respond to changes in the program.

The Information Sharing/Voluntary Withholding category of options (Options 1 and 2) is simple to administer and has clear lines of accountability. Because the Department of Education would administer all facets of the Direct Loan Program, it would have centralized management and control of the program. The Department of Education also has developed the infrastructure necessary to administer a centralized program. Through its experience in administering the FFEL Program, Education has gained the institutional knowledge essential to effectively administer the Direct Loan program. Thus, Options 1 and 2 meet the first goal of the model system.

Use of the current tax system (Options 3, 4, and 5) involves Education issuing and servicing student loans with the IRS collecting these loans in varying degrees. Because two agencies would be involved, added complexity would be introduced. While two agencies would be involved in the first category of options, using the current tax system to collect student loans increases the interdependencies between the IRS and Education. To ensure the efficient operation of the program, clear lines of communications would have to be maintained at all times.

Furthermore, the IRS would not be able to provide timely program information to Education. Because the reconciliation between withholding and liabilities occurs when tax returns are filed, the IRS would not be able to provide information to Education until after the borrower's return has been filed and processed. The lack of real-time information restricts Education's ability to effectively manage the program. Thus, Options 3, 4, and 5 do not fully satisfy the goal of simplicity with clear accountability and improved quality control.

Option 6 involves Education issuing student loans with the IRS servicing and collecting student loans separate from the tax system. Unlike Options 3, 4, and 5, this option enables the IRS to share real-time program information with Education. However, like Options 3, 4, and 5, a layer of administrative complexity is added to the student loan program because more than one agency is involved. Thus, Option 6 does not fully satisfy the first goal of the model student loan system.

- **Reduce Defaults.** To meet the Administration's goal of implementing the model student loan system, any option considered should address the two principal causes of defaults: insufficient borrower income and lack of borrower commitment accentuated by poor loan servicing practices.

Both the Information Sharing/Voluntary Withholding Category of options (Options 1 and 2) and Option 6, (development of separate system within the IRS) address these concerns through the maintenance of current borrower information. This current information enables program managers to proactively intervene in problem loan

situations allowing them to reduce borrower default.

Options 3, 4 and 5 do not provide current information due to the lag in reporting tax return information. Thus, these options will not provide the program manager with the information necessary to proactively address problem accounts.

Issues Unique to IRS Involvement

Under the Information Sharing/Voluntary Withholding category of options (Option 1 and 2), the IRS would share individual income tax information with the Department of Education. Under Option 1, the IRS would share Adjusted Gross Income (AGI) and filing status for the purpose of establishing income-contingent repayments. Under Option 2, the IRS would provide additional tax return information to support the income-contingent repayment plan and aid Education in collecting defaulted debt. Option 2 would require the Congress to amend the Internal Revenue Code to authorize the IRS to share additional tax return information.

Use of the current tax system (Options 3, 4 and 5) would also require additional legislation. In order to effectively use the current tax system, legislation would be required to enable the IRS to treat student loan liabilities as if they were tax liabilities. Such legislation would facilitate the use of the IRS's enforcement powers not only in the collection of defaulted debt, but in the day-to-day administration of loans. Instead of having to create a separate system to handle student loan servicing and collecting, the IRS would be able to maximize the use of its current systems.

In addition, using the current tax system would require additional legislation to allow the IRS to share collection data with Education. Because student loans would be collected as taxes, information regarding such collections would be subject the IRS's disclosure provisions. This disclosure of collection information is required for effective program management.

Option 6 would require the Congress to authorize the collecting and servicing of student loans by the Internal Revenue Service. The IRS would collect student loans separately from the tax system; however, the IRS should also be given the legislative authority to collect defaulted student loans using all of the collection techniques used to collect delinquent taxes.

Cost Estimates. Exhibit A summarizes the estimated program costs for each of the six options developed. For each option, costs were estimated with and without the IRS collecting Education's current inventory of defaulted loans from the FFEL. Exhibit B summarizes the full-time equivalents required by the IRS to fully implement Options 3, 4, 5, and 6 (Appendix 6 contains the IRS's cost methodology).

Under Options 1 and 2, the IRS would provide the information to Education using existing resources. The IRS already offsets the refunds of defaulted borrowers referred by the Department of Education. IRS also provides Education with basic information (name and

address) to aid in the collection of defaulted debt. Options 1 and 2 expand the scope of the information provided to Education. Options 3, 4, and 5 use the existing tax system to collect student loans. The cost estimates for these options are extremely sensitive to obtaining funding for the Tax Systems Modernization Program. Finally, Option 6 requires that the IRS develop a withholding and information processing system separate from its tax system.

Impact on Voluntary Compliance. Historically, IRS has been concerned about the impact of nontax debt collection on voluntary compliance. With the exception of the refund offset program, where the IRS offsets the refunds of taxpayers who have defaulted on Federal debts, the IRS has had minimal experience in nontax collection. However, extensive studies by both IRS and the General Accounting Office concluded that the refund offset had a negative impact on taxpayer compliance following the offset.

Ability of the IRS to Collect Defaulted Student Loans. Greater IRS involvement in the collection of student loans may or may not increase the collection of student loans. While it is true that the IRS is successful in collecting delinquent taxes, these taxes are based on income a taxpayer has earned, an indication of ability to pay. Student loan debt is not related to income a borrower has earned, rather loans are granted to students who need financial support to afford an education. Because student loans are based on the borrower's needs and not on income earned, it is unclear whether the IRS could collect student loan liabilities at the same rate it collects delinquent taxes (See Appendix 5).

Recommendation

Using the Department of Education to administer all aspects of the Direct Loan program best fulfills the Administration's desire for a student loan program that is characterized by a high level of customer service, ease of repayment, minimal burden, simplicity with accountability, and reduction in defaults. Therefore, the Departments of Treasury and Education along with the Internal Revenue Service recommend:

- An option that provides for continued Education administration of the entire Direct Loan program, including servicing and collecting, assisted by increased IRS information sharing (option 2) and legislation to authorize IRS to disclose to Education additional income and employment information on borrowers.
- Use of wage withholding to reduce the burden for borrowers to repay their student loans.

The chart on the next page displays the factors considered to determine the optimal level of IRS involvement. Option 1 represents a minimal role for IRS, with increasing IRS involvement up to option 6.

ATTRIBUTES	OPTION NUMBER					
	1*	2*	3	4	5	6
SIMPLICITY AND ACCOUNTABILITY	2	2	0	0	0	1
CUSTOMER SERVICE	2	2	0	0	0	1
EASE AND FLEXIBILITY OF REPAYMENT	2	2	1	1	1	1
MINIMIZE BURDEN	2	2	2	2	2	0
REDUCE DEFAULTS	1	2	2	2	2	2
COST EFFICIENCY	0	0	1	1	1	2
FTE USAGE	2	2	1	1	1	0
TOTAL SCORE	11	12	7	7	7	7

* WITH VOLUNTARY WITHHOLDING

LEGEND: 2 = FULLY SATISFIES ATTRIBUTE
1 = PARTIALLY SATISFIES ATTRIBUTE
0 = DOES NOT SATISFY ATTRIBUTE

Below are summaries of the six options that were developed by the Department of Education and IRS and analyzed in terms of the Administration's goals for servicing and collecting student loans. A full description of these options can be found in Appendix 5.

- o Option 1 - Education would administer the student loan program to include servicing and collecting the loans. IRS would perform address matches, income tax refund offsets for defaulters, and provide adjusted gross income information.
- o Option 2 - (Recommended option) The same functions as in Option 1 apply and IRS would share with Education additional employment information and additional income information.
- o Option 3 - The same functions as in options 1 or 2 apply and IRS would collect defaulted student loans.
- o Option 4 - The same functions as in option 3 apply and the IRS would collect all income contingent Direct Student Loan payments.
- o Option 5 - IRS would collect, but not service, all Direct Student loans.
- o Option 6 - The IRS would collect and service all student loans.

Under our recommended option, the Administration will realize the President's desire to make paying for college easier by simplifying the loan program, affording students several repayment options, and permitting them to repay their loans by withholding small amounts from their salaries. Education's administration of the program with IRS's support will accomplish the following objectives of a model system:

- o ***Customer service.*** Because Education would be responsible for all aspects of the program, Education can provide the best possible customer service to the student—its principal customer, and to other program participants. It will be in the best position to counsel a borrower on repayment plans as well as options for making payments.
- o ***Ease and flexibility of repayment.*** Education can provide borrowers with a choice of repayment methods building upon the overall Direct Loan program system, relationships with the borrowers, and well established relationships with the schools and the financial aid community.

Education will provide borrowers with a choice of repayment methods, based on the Department's experience with the choice-driven Direct Loan program. New repayment methods, including wage withholding from employers and automatic debits from bank accounts, will be offered to borrowers. Borrowers can still choose to pay by check.

- o ***Minimize burden.*** All forms of repayment provide minimal burden for the borrower. Burden becomes a factor in conjunction with wage withholding. Under option 2's voluntary wage withholding system administered by Education, having employers withhold the payments and forwarding them to Education would be no more difficult than the common practice of withholding charitable contributions or payments to a credit union. The employer would simply prepare EFT-type payment transactions and forward them to a Department of Education account.
- o ***Simplicity in administration, clear lines of accountability and improved quality control.*** Having Education administer the entire Direct Loan program greatly benefits the borrower because Education controls all aspects of the program from application to repayment for a seamless operation from the borrower's perspective.

The Department of Education has developed the infrastructure necessary to administer a centralized loan program. Moreover, through its experience with the FFEL program and the Perkins Student Loan program, Education has gained the institutional knowledge that would support effective administration.

With Education retaining control over the collection and servicing of student loans, all aspects of loan administration would reside in one agency. The program would be easier to administer, accountability would be clear, and quality could be accurately assessed through uniform management systems.

- o ***Reduce defaults.*** In addition to the new repayment plans under the Direct Loan program, Education will now provide a variety of ways for students to repay, minimizing the likelihood that borrowers will default.

Most defaults have been attributed to two factors: insufficient income to service debt and lack of borrower commitment exacerbated by poor loan servicing. Defaults caused by insufficient income should be reduced by the availability of several repayment options.

Defaults caused by poor loan servicing should be reduced with Education as the single servicer throughout the loan cycle. Having Education responsible for all aspects of the program will allow for effective administration, good quality control and good customer service.

In addition, Education and IRS have evaluated cost factors in arriving at their recommendation.

- o ***Cost efficiency/Use of Federal employees.*** Costs for Education's administration of the loan servicing and collecting aspects are primarily contractor costs. However, reliance on contractors for operational aspects provides cost efficiency by permitting Education to adjust the level of resources for administration. This will especially control the increased use of Federal FTEs. At the same time, plans to use several contractors along systems integration will help control costs through competition.

The benefit of using IRS to collect student loans results from efficiencies in collections. To realize these efficiencies, IRS would have to structure the loan collection system similar to the current tax system. Sensitivity to the use of tax information legislatively requires that IRS use only Federal employees for processing tax information. Therefore, IRS would need to increase its FTE levels significantly during years of loan growth. However, it would be difficult to decrease staffing during periods of decreased loan volume, or as a result of processing efficiencies. In addition, use of IRS collection resources to collect student loan debt would have a negative effect on the collection of tax liabilities.

Option 2 does a far superior job in meeting all aspects of the customer service objectives of a model loan collection system, compared to other options. Although projections indicate that option 2 costs more than options 3 through 6, it provides flexibility and does not require a large increase in full-time equivalent employment. Thus option 2 is clearly the preferable choice.

APPENDICES

Appendix

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Exhibits

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Appendix 1

DIRECT LOAN REPAYMENT OPTIONS

Under the Direct Loan Program, borrowers may choose between the following four repayment plans:

1. THE STANDARD REPAYMENT PLAN -- Under the standard repayment plan, borrowers make fixed monthly payments of at least \$50 per month for up to ten years.
2. THE EXTENDED REPAYMENT PLAN -- Under the extended repayment plan, borrowers make fixed monthly payments for an extended period of time. The maximum number of years that a borrower may repay a loan under this plan depends on the amount of the loan as follows:

<u>LOAN AMOUNT:</u>	<u>YEARS OF REPAYMENT:</u>
Less than \$10,000	12 years
\$10,000 - \$19,999.99	15 years
\$20,000 - \$39,999.99	20 years
\$40,000 - \$59,999.99	25 years
\$60,000 or more	30 years

3. THE GRADUATED REPAYMENT PLAN -- Under the graduated repayment plan, a borrower's required repayment is small at the beginning of the repayment period and gradually increases over time. The maximum number of years of repayment under this plan is the same number of years that is permitted under the extended repayment plan. (See table above.)
4. THE INCOME CONTINGENT REPAYMENT PLAN -- Under the income contingent repayment plan, borrowers repay between four and fifteen percent of their income each year depending upon the amount of their debt. Specifically, a borrower repays four percent plus 0.2 percent for each \$1,000 borrowed over \$1,000. If a borrower does not fully repay a loan after 25 years of payment under the income contingent repayment plan, the unpaid portion of the loan is forgiven.

If a borrower is married and filed a joint Federal income tax return, the couple's joint income is used to calculate the borrower's monthly payment. Seven dollars is subtracted from a borrower's monthly repayment for each dependent, other than a spouse, for up to five dependents. If a borrower's monthly repayment amount is less than \$25, the borrower is not required to make a payment. Borrowers may choose to cap the amount of their payments at the amount that they would be required to repay under a 12-year fixed-payment repayment plan.

If none of the above repayment plans suits a borrower's exceptional circumstances, the Department may, on a case-by-case basis, establish an alternative repayment plan for that borrower.

App. 2

OMNIBUS BUDGET RECONCILIATION ACT REQUIREMENTS FOR A REPORT TO CONGRESS

*Note that the report to Congress is mandated by two separate sections of OBRA. The conference agreement requirements are similar.

CONFERENCE AGREEMENT LANGUAGE

Department of Treasury Section of OBRA

The conferees direct the Treasury Department, in consultation with the Department of Education, to conduct a study of the feasibility of implementing a system for the repayment of Federal student loans through wage withholding or other means involving the IRS. Such study should include an examination of:

(1) whether the IRS could implement such a system of student loan repayment with its current resources and without adversely affecting its ability to collect tax revenues,

(2) the cumulative impact of increased disclosure of tax information and increased IRS involvement in nontax collection activities on voluntary compliance with the tax laws,

(3) the ability of the IRS to enforce collection of student loans using an alternate system of dispute resolution, penalties, and collection devices,

(4) the effect of separating loan collection from other loan servicing functions, and

(5) the anticipated effect on the management of Federal student loan collections and on borrower repayment of such loans.

If the study concludes that IRS collection is feasible, the Treasury Department and the Department of Education should develop a plan to implement such a collection system. The feasibility study and any plan that is developed, together with any legislative recommendations that the Secretaries may deem advisable, should be submitted to the Congress within six months of the date of enactment.

Department of Education Section of OBRA

The managers request that the Secretaries of Education and Treasury jointly develop a plan for the involvement of the Internal Revenue Service in the collection of student loans:

- o including an analysis of its feasibility,
- o the additional resources that would be required for the IRS,
- o the enforcement procedures that should be used, and
- o the effect on the collection of ordinary income taxes, and the effect on the management of Federal student loan collections and on borrower repayment of such loans.

The Secretaries are further requested to submit the Congress the plan for implementing such a collection system, together with the results of the feasibility analysis and any legislative recommendations they may deem advisable, no later than six months after the date of enactment of this bill.

...

Appendix 3

Student Loan Options and IRS Involvement in Collecting Student Loans

Focus Group Report

January 21, 1994

Price Waterhouse



CITY	PARTICIPANT GROUP
Washington, DC	(Pre-test) Current students, two-year, proprietary, four-year and graduate schools Current students, proprietary & 2-year schools Former students, proprietary & 2-year schools
Atlanta, GA	Current students, proprietary & 2-year schools Financial aid advisors representing two-year, proprietary, four-year and graduate schools
Columbus, OH	Current students, 4-year colleges Former students, 4-year colleges and graduate programs
Los Angeles, CA	Current students, graduate schools Defaulters

B. Key Findings

Repayment Schedules

Participants seek flexibility and a variety of options to choose from when it comes to repaying their student loans. Their choice of repayment schedules seems to depend mostly on the amount borrowed, their anticipated income and their general outlook for the future. Many are concerned about potential financial problems and would like to choose the plan that they think can best help them to endure their difficulties.

The least favored repayment plan was the extended plan, with participants seeing twenty years as too long a period of time to repay a student loan. This option was also perceived as very costly in terms of interest paid. It may have some appeal to students with very large debts.

The standard repayment plan was appealing to participants because it makes the task of budgeting easier, and payments are perceived to be manageable in most cases. However, if financial hardships occur, participants believe this repayment plan could be burdensome. Many former students are currently repaying their loans on this plan. Ten years may actually be too long a period of time for those with small debts.

The graduated repayment plan gives students some time to get established before having to make large loan payments. While some participants believe they will be in a better position to make larger payments later, others aren't so optimistic about the future, or believe their expenses will increase along with their income as they take on family obligations. They are concerned that payments at the end may become too large, and a large amount may be spent on interest because of the smaller payments in early years.

The income contingent plan allows borrowers to pay off their loan as they can afford to do so. However, most participants object strongly to the inclusion of a spouse's income in the equation, and believe repayment amounts should be based solely on their individual income. Participants would also like this repayment plan to be based on current income, not last year's income, anticipating that less income this year than last could result in economic hardship. They would also like this repayment plan to take into account current expenses, and be based on discretionary income rather than gross income. Participants recognize that determining borrower's income could add to administrative expenses for this option. They also believe this option has the greatest potential for fraud. When asked if they would voluntarily report their income to the Department of Education under this option, they note that people might voluntarily report their income, but it would probably not be their whole income.

Participants would like to see the option of repaying loans through work or community service programs, particularly for those who are unemployed.

Repayment Methods

Participants are most concerned with control and convenience in selecting a repayment method. Although many are wary about letting a bank or employer make their loan payment for them, they like the convenience associated with having one less bill to pay.

Writing a monthly check and employer withholding were the most popular payment methods. Those who prefer to write a check every month feel they maintain more control over their finances that way. More specifically, they can pay more when they are able and withhold payment when necessary. The check also serves as documentation that a payment was made, should a question ever arise. Those who dislike the idea of writing a check every month find they may forget to do it, or see it as just one more thing they have to do.

Employer withholding was perceived as an easy and convenient payment method by many participants. The payment is made without any thought or effort on the borrower's part, once withholding is set up. Also, payments are much less painful than writing a check. That is, the borrower feels that money was never theirs so they don't miss it. Participants would particularly like this method of withholding if it were done on a pre-tax basis. Concerns about this method center on employer fraud and mistakes, and privacy issues. Some participants worry employers would withhold the money, but not pay the government. Others worry that mistakes made by the employer would be difficult to trace and correct, while they would still be responsible for the payment. Some participants object to their

employer knowing about their financial obligations. Participants also wonder how they would know what their outstanding balance is with this method.

While electronic transfers are also seen as an easy and automatic method of payment by some, the majority of participants don't like the loss of control over their finances envisioned with this method. While they wouldn't forget to make the payment with this method, they worry that they wouldn't know exactly when the money would be taken out of their account, and they would have to remember to have the funds in the account to cover the payment. This method was also seen as making it difficult to keep track of their account balance. They are also afraid of mistakes being made with this method, and of having no way of documenting that payments were made.

Loan Processing/Service Agency

Participants felt that customer service and efficiency are the most important qualities that a loan processing agency should have. They expressed concerns about poor customer service received in the past from the different organizations that they have dealt with, as well as some apprehension about what organization could administer the program most efficiently.

Organizations mentioned by participants as possible contenders for loan processing and servicing were the Department of Education, the Internal Revenue Service, private contractors (such as banks), Sally Mae, the Federal Credit Union, and educational institutions. While the Department of Education was mentioned most frequently and was thought to be most empathetic to the student perspective, some participants do not see loan processing as the Department's area of expertise. Some participants also think the Department of Education has more important responsibilities on which it should focus its attention. And while the Department of Education was expected to be the most knowledgeable of the student perspective, those who have had direct experience with the Department (including financial aid advisors) do not necessarily find its staff knowledgeable or accommodating.

Private industry was the second most often mentioned loan processing and servicing agency. Private contractors were thought to be more customer service oriented than governmental agencies, although some participants were skeptical about having only one organization provide the services. Rather, they would like to see several private contractors provide services so that the element of competition is not removed from the mix. Banks in particular are thought to have the appropriate expertise.

Those who favor the IRS as the loan processing and servicing agency see it already having the necessary expertise, infrastructure and access to information. Participants predict default rates would decline if the IRS were involved, and that they would be effective at collecting from defaulting borrowers. On the down side, many participants perceive the IRS as a strong arming organization that would not understand a late payment or do much to renegotiate loan terms if necessary. The IRS is also seen by some as inefficient, difficult to navigate, and lacking in a customer service orientation. Some participants suggest if the IRS

is to be involved, that a separate division be created specifically for dealing with student loans, and that personnel be trained specifically for dealing with student loan issues. Some suggest the IRS should only be involved with late payers and defaulters.

Most participants say that the loan processing and servicing agency which is chosen will not affect their choice of loan repayment plan.

Pursuing Those Who Do Not Repay Their Student Loan/IRS Involvement

Participants vacillate between harshness and leniency when asked how the government should handle those who do not repay their loans. While on the one hand, the vast majority of participants want to see the loans repaid, they also believe leniency is in order for those who are communicating with the government and letting them know if they are having financial difficulty. Little or no leniency was suggested for those who have the means to repay their loans and simply refuse to do so, with renegotiation of loan terms being the first choice, but seizing assets acceptable in "hard core" cases. Reporting late payments and non-payment to credit bureaus was seen as particularly harsh, especially for those having financial difficulties or those who may be applying for a deferment that may take many months to obtain.

Many participants believe that not repaying a student loan is just as serious as, or more serious than, not paying taxes, although they believe the consequences for non-payment of taxes are much more severe than for non-payment of student loans. They believe more stringent IRS enforcement of student loan payments would decrease the default rate, but it may also discourage some students from taking loans and pursuing an education or as much education as they might like. Some participants believe IRS enforcement would cause students to take the loans more seriously in the first place, and those who are unlikely to repay them might also be less likely to accept them. Participants believe IRS enforcement would have a limited impact on tax filing behavior, with most participants conveying that filing a tax return is something that they just have to do.

Appendix 4

DIRECT FEDERAL STUDENT LOANS

REPAYMENT: FUNDS COLLECTION METHODS

**RECOMMENDATIONS FOR THE DEPARTMENT OF
EDUCATION**

**FROM FINANCIAL MANAGEMENT SERVICE,
DEPARTMENT OF THE TREASURY**

JUNE 1994

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Funds Collection Options for Repayment of Direct Federal Student Loans

Background

The Financial Management Service supports the Department of Education in their initiative to offer a variety of ways for Direct Federal Student Loan borrowers to remit payments, especially using electronic funds transfer.

Just as with the "repayment plan" options, there are several convenient and appealing funds collection options which can be offered to borrowers for initiating their loan repayment remittances.

AUTOMATED CLEARING HOUSE (ACH)

The Automated Clearing House network is a funds transfer system which provides for the interbank clearing of electronic entries for participating financial institutions. There are 26,522 participating financial institutions.

ACH is inexpensive, reliable and improves funds availability. Also, once the borrower sets up the ACH service, the chances of full collection are improved since the borrower doesn't have to write a check each month. ACH transactions can be originated by a borrower directly, or can be originated by a borrower's employer, and then deducted out of the employee's pay, using common wage-withholding practices.

Borrowers and bill payers have been demonstrating a rapidly growing interest in making payments automatically and electronically. Automatic electronic payments (using ACH) are easy, save time, and are not dependent on the borrower being at a certain place or having to write a check, address and envelope and get it into the postal system. Some borrowers perceive ACH payments involving degree of lost control over their money. This is a perception issue which has no basis in fact, since the consumer must authorize any electronic activity occurring through their bank account. The ACH network has made a lot of progress overcoming the perception; however, some still remains.

Because of the savings derived from using ACH, the agency should either mandate its use or offer borrowers incentives to sign up for ACH. Mandates are generally used in conjunction with other actions, such as a non-payment judgment. For the majority of cases, where repayment is expected, a voluntary program is recommended, with incentives offered to increase enrollments. Incentives for repayment by electronic funds, normally ACH, are common in the consumer loan industry. Three suggestions for incentives are:

- Interest rate concessions, such as 25 or 50 basis point reductions, are offered if the borrower uses ACH for repayment. (Rate concessions would need to be evaluated to determine at what point they lose cost effectiveness. They may also require legislation).
- Later payment due dates, such as one or two day delays in the monthly due date (which is when the ACH transaction would settle against the borrower's bank account).
- Multiple payments during a month, such as twice-monthly when the borrower is paid by their employer. The amount paid during a given month equals the monthly payment, but by splitting it into increments, consistent with the way the borrower's wages are paid, the loan is paid down faster.

ACH Options

ACH payments can take two general forms:

ACH Debit - is originated by the agency (based upon the borrower's authorization) and settles through the Federal Reserve system as a credit to the agency (through the Treasury General Account, or TGA) and a debit against the borrower's bank (account). If there are insufficient funds in the borrower's bank account, the bank will return the entry to the Federal Reserve, where it will be debited to the agency (through the TGA) with information provided back to the agency, for further collection action.

ACH Credits - is originated by the borrower, their employer, or their bill-payment servicer, and settles through the Federal Reserve as a debit against the borrower's bank (account) and a credit to the agency (through the TGA). Since the borrower originated the entry, the bank will only send it if funds are available in the borrower's account.

In addition to accelerated availability of funds (when compared to checks), ACH also enables the agency to automatically update accounts receivable and accounting records from the electronic payment records which are originated into or received from the ACH network. This fact is one of the primary reasons that ACH brings so much cost savings to an organization.

FMS will assist the agency in developing a marketing program using an appealing name, like "Easy Payment", for the ACH programs. This might include a public service television campaign, similar to Social Security's Direct Deposit campaigns,

to promote ACH as an "easy and convenient" method of repaying student loans.

The debit and credit forms of ACH are discussed below, with proposed uses by the Department of Education in offering an array of "Easy Payment" services to Direct Federal Student Loan borrowers.

ACH Pre-Authorized Debits

Pre-authorized debits, or PADs are electronic debits to a receiver's (borrower's) bank account. They must be authorized by the receiver (borrower) in writing, normally as part of the loan repayment set-up process. PADs are best suited for recurring, fixed dollar amount transfers, such as loan repayments, because, once the authorization is established, the lender can automatically generate the ACH debits each month, without the remitter needing to take further action.

At the time the loan repayment agreement is negotiated, Department of Education, or its servicing agent, would obtain a signed authorization from the student allowing the agency to directly debit the loan repayments from the student's bank account. In the near future, the agency may also be able to avail themselves of an "Automated Enrollment" method, whereby the borrower would request his/her financial institution to initiate a zero-dollar ACH transaction to Department of Education coded to notify the agency to establish the borrower as a pre-authorized debit remitter. The financial institution would be responsible for maintaining a record of the written authorization. The Social Security Administration has been testing Automated Enrollments and has enrolled over 150,000 recipients in Direct Deposit using that method. The operating rules for the transaction, necessary for nationwide application, should be finalized later this year.

The Department of Education will need to maintain a database of pertinent information on borrowers enrolled in the pre-authorized debit option, including the borrower's bank account information (the routing and transit number of the bank and the account number). The agency will also need to establish a method for ensuring that borrowers provide updates whenever they change bank accounts. Under income-contingent repayment plans, the borrowers can take up to 25 years to repay loans. The transient nature of recent graduates will also create complications. Automated Enrollment services, discussed in the paragraph above, may provide solutions.

On a pre-established schedule, the agency will originate a file of debit transactions, for processing by FMS or an agent bank. This file will be converted into ACH transactions and processed through the ACH network, to the student's bank account. ACH debits must be originated into the ACH network one day prior to the settlement date.

Pre-authorized debits can also be originated on a "single-entry" basis. An authorization system would need to be established using voice response or PC technology. The Department of Education could even utilize a public access network, such as Internet, to provide access to the authorization system. A standing written agreement and password-security would be established in advance. The borrowers access the authorization system each time they are making a payment and provide authorization for Department of Education to debit their bank account for the full or partial amount of the loan. Pre-formatted screens can be created for the borrower to "fill-in-the-blanks" with bank instructions, amount, etc. The agency would use the authorization to generate ACH pre-authorized debit entries.

ACH Credits

Wage-withholdings from employers - The agency provides the borrower with information to take to their employer to set up a payroll-deduction. The employer automatically deducts payment amounts from the employee's wages and originates ACH credits through the ACH network to the Treasury/Department of Education, for benefit of the borrower. (It could be compared to a "Christmas Club" arrangement.) This is certainly one of the easiest ACH collection methods, and employer participation could be voluntary or mandatory.

Mandatory wage-withholding would place an additional burden on businesses and could make the prospective employee with a student loan a less desirable job candidate.

FMS recommends voluntary employer compliance and believes if the Department of Education offers borrower incentives, as discussed on page 2, that employers will also have an incentive to volunteer. Employers will want to support their employees' opportunity to take advantage of incentives, especially something like a rate concession.

To further incent voluntary participation by employers, the Department of Education might allow employers to charge employees a nominal fee per transaction to cover the cost of handling the payments for the employee.

Wage-withholding is being used successfully by the Administration for Children and Families for collecting child support payments. They had legislation passed to mandate employer participation to withhold from wages of delinquent obligors. However, many obligors participate voluntarily, requesting their employer to deduct and send the support payments for them. If Department of Education elects to implement a wage-withholding program, a working relationship should be developed with the Administration for Children and Families to learn from their efforts.

Bill Payment Services

Again, the agency would provide borrowers with information, which would be required to set up their student loans on a bill payment service that might be offered through the borrowers' bank or bill payment service. On a monthly, or recurring basis, the borrowers authorize payments through their bill-payment servicer using a touch-tone phone or PC access. The servicers use the authorizations to debit borrowers' bank accounts and originate ACH credits to the Department of Education, for benefit of the borrower. In addition, most servicers allow for standing orders for payments which occur automatically unless their customer intervenes. This is appealing to many remitters because they can exercise a greater degree of control.

The Department of Education should establish "strategic alliances" with the major bill payment service providers and large regional banks where concentrations of borrowers are located. Such alliances can be beneficial to both parties for at least these two reasons:

- (1) The Department of Education can provide bill payment servicers with billing files, which are used to create messages/reminders to borrowers and request authorization for making payments. This enhances the bill payment servicers' offering and will encourage prompt payment to Department of Education.
- (2) Joint marketing campaigns can be initiated with the agency and the bill payment servicer/banks to get the word out that student loan payments can be made through these services.

PAPER CHECKS INTO A LOCKBOX

A lockbox is a post office box which is maintained for the Government by a Treasury designated financial institution (FI) for the purpose of accelerating the receipt and clearing of paper check remittances on behalf of a Federal agency. The FI receives the remittances by mail from the post office frequently during the day. The FI opens the envelope, extracts the check and any accompanying documentation, records the amount of the check, processes the check for clearing in the banking system, and reports the deposit information to Treasury. The funds are transferred to Treasury's account at the Federal Reserve Bank of New York via ACH the next business day, and the agency's ALC is credited the next business day following the date the deposit is reported to Treasury. The FI also captures the accounting information, and passes this, along with a record of the check payment to the agency. The agency updates its accounting records from the information supplied by the Lockbox bank.

Checks are not the preferred method of collection, but unless the Department of Education is going to mandate EFT in the Direct Student Loan Program, collection arrangements must accommodate checks. To effect the payment, the student writes out a check and sends it, along with a scannable remittance document, to a post office box address supplied by the agency. The agency supplies the remitter with a monthly notice or a coupon (book) to return with the remittance. Whether a monthly bill or a coupon is used, the return document must be machine scannable, since the volumes will be high.

SUMMARY

The Financial Management Service (FMS) recommends that ACH be cited as the "preferred payment method". This infers that, unless requested otherwise, the borrower will be expected to pay by ACH. This approach is used by the Social Security Administration under a plan called "Preferred Direct Deposit". Unless the beneficiary requests otherwise, an application for benefits is handled assuming Direct Deposit will be the payment mechanism.

Many of the recommended ACH collection options can be established very easily through use of arrangements already in place under the FMS umbrella of services. Some of the steps involved are outlined below:

- Education provides data on the volume and dollar amount of the collections to FMS.
- FMS and Education meet to discuss Education's requirements for additional data and remittance processing.
- FMS selects the optimal processor(s) for the collection methods chosen as the most viable.
- FMS, Education and the collections processor(s) meet to discuss Education's collections needs and design information interfaces.
- Education and the collections processor(s) establish testing schedule and conduct testing.
- Education and collections processor(s) develop standard procedures for operating the collection systems.
- FMS prepares a memorandum of understanding and signs it along with Education and the collections processor(s).
- FMS sets up the Department of Education program into its deposit reporting system.
- Education provides information to borrowers on the various collection options, and has the borrowers decide on a repayment plan. Education also obtains a signed authorization form for ACH debits, if necessary.
- For ACH preauthorized debits, Education creates a database of financial institution information on borrowers paying by ACH debits. Education must send prenotifications on ACH preauthorized debits 10 days before sending live entries.

Appendix 5

Feasibility of IRS Involvement in the Collection and Servicing of Federal Student Loans

Introduction

The Clinton Administration and the Congress wanted to explore whether there would be increased efficiencies and improved benefits to borrowers and the Federal government by involving the IRS in the servicing and collecting of student loans. The conference report accompanying OBRA '93 directed the Secretaries of Treasury and Education to conduct a study of the feasibility of implementing a system for the repayment of Federal student loans through wage withholding or other means involving the IRS. The conference report specifically required the following analyses:

1. Whether the IRS could implement a student loan repayment system with its current resources and without adversely affecting its ability to collect tax revenues.
2. The cumulative impact of increased disclosure of tax information and increased IRS involvement in nontax collection activities on voluntary compliance with the tax laws.
3. The ability of the IRS to enforce collection of student loans using an alternative system of dispute resolution, penalties, and collection devices.
4. The effect of separating student loan collection from other servicing functions.
5. The anticipated effect of IRS involvement on the management of Federal student loan collections and on borrower repayment of such loans.

Options for IRS Involvement

An oversight group with representatives from the Internal Revenue Service, the Office of the Secretary of the Treasury and the Department of Education was established to coordinate the study. While the conference report language suggests that the study should concentrate on the use of the withholding system in repaying student loans, the oversight group expanded the scope of the study to include an examination of the range of possible involvement by the IRS.

IRS involvement in the administration of Federal student loans can be grouped into 3 categories:

1. Information Sharing
 - As Currently Authorized (*Option 1*)
 - Increased Information Sharing (*Option 2*)
2. Use of the Current Tax System
 - IRS Collects Defaulted Debt (*Option 3*)
 - IRS Collects Income-Contingent Loans & Collects Defaulted Debt (*Option 4*)
 - IRS Collects All Direct Loans & All Defaulted Loans (*Option 5*)

3. **Development and Use of a Separate System by the IRS**
 - **IRS Collects and Services all Direct Loans and Collects Defaulted Debt in a Newly Developed System, Separate from the Current Tax System (*Option 6*)**

Category 1 - Information Sharing/Private Withholding

Under this category of options, the Department of Education would retain control over the student loan program; overseeing the policy and regulatory process, and originating, servicing, and collecting Direct Loans. Also, under this category of options, the IRS would share individual income tax information with the Department of Education.

This category of options also incorporates private withholding as a method to repay student loans. Wage withholding is not dependent on the tax system (See Appendix 4). Employers could participate in nontax withholding similar to allotments for charitable contributions and retirement plans. Borrowers also could elect to repay their student loans by authorizing electronic transfers of funds from their bank accounts to the Department of Education. These private withholding plans enable borrowers to choose method of repayment that best serves their needs.

Option 1 - Information Sharing as Currently Authorized

Currently, the Direct Loan Program provides five student loan repayment options; (1) standard repayment, (2) extended repayment, (3) graduated repayment, (4) income-contingent repayment, and (5) alternative repayment. Of these five repayment options, the income-contingent repayment option bases repayment obligations, at least in part, on the borrower's ability to pay.

Under Option 1, the Department of Education would administer the income-contingent method by determining borrowers repayment based on the prior year's adjusted gross income (AGI) and the amount borrowed. The Omnibus Budget Reconciliation Act of 1993 authorized the Internal Revenue Service to share limited individual income tax information with the Department of Education for the purpose of establishing income-contingent repayments. The IRS, through this limited information sharing, supports the Department of Education in administering the Federal Direct Student Loan Program. This information sharing option, requires the least involvement by the IRS.

Option 1 meets the goals of the ideal student loan system. A centralized program permits the Department of Education to manage student loan servicing and repayment issues in a more coordinated and cost-effective manner. Because program responsibilities are not divided between multiple agencies, the Department of Education can ensure that policy objectives are achieved, borrowers are treated fairly and consistently, and that a high standard of quality is maintained. In addition, because only one agency would be involved, the lines of accountability are very clear.

Option 2: Increased Information Sharing

As in the first option, under Option 2 the Internal Revenue Service would continue to play a supportive role in the Federal Direct Student Loan Program. While the role of the IRS would be limited to sharing borrowers' tax return information and offsetting refunds for defaulted student loans, the amount of tax return information that could be shared with Education by the IRS would be increased.¹ This increased information would aid the Department of Education in both developing a more equitable income-contingent formula and in more effective debt collection.

In terms of structure and organization, Option 2 is identical to Option 1. The Department of Education retains control over the student loan program. The exact information that would be included in the enhanced program would be determined by both Education and the IRS based on the intended use. In addition to providing Education with additional information to support the income-contingent repayment plan, Option 2 also may be beneficial to Education in collecting defaulted debt. Although Education uses contractors for much of their debt collection activities, the IRS and Education could work together to determine if additional information could be used to determine a defaulter's financial situation prior to establishing an installment agreement.

Furthermore, as part of Option 2, IRS could provide consulting services to the Department of Education. The Department of Education recently was provided with additional collection tools such as administrative wage garnishment. The IRS could assist Education in the implementation of wage garnishment to improve defaulted student loan collections. The IRS may be able to assist Education and its contractor in improving their payment processing system.

Option 2 meets the goals of the ideal student loan system. A centralized program permits the Department of Education to manage student loan servicing and repayment issues in a more coordinated and cost-effective manner. Because program responsibilities are not divided between multiple agencies, the Department of Education can ensure that policy objectives are achieved, borrowers are treated fairly and consistently, and that a high standard of quality is maintained.

The additional tax return information that will be shared under Option 2 will allow Education to develop a repayment plan that better reflects a borrower's ability to pay and should increase the effectiveness of Education's defaulted debt collection efforts. Also under this option the IRS could assist Education in implementing its administrative wage

¹ While the appropriate authority to provide Education additional information under IRS disclosure provisions needs to be worked out between Education and IRS, three potential means are to amend §6103 of the Internal Revenue Code, to expand the scope of the borrowers' consent, or to develop a joint IRS/Education system to completely mask tax return information.

garnishment powers.

Category 2 - Use of the Current Tax System

This category of options uses the current tax system to collect student loan debt. In order to effectively use the current tax system, student loan liabilities would be treated as tax liabilities under these options. Because student loans would be collected through the tax system under these options, borrower's account information would not be available until after the borrower's tax return has been filed.

Because this category of options divides the collection of direct loans from the servicing of direct loans as well as uses the current tax system, IRS disclosure laws would have to be amended to enable the IRS to share any collection information with the Department of Education. All payments and enforcement (collection) information would be considered tax information under the Internal Revenue Code. However, to effectively manage the Direct Student Loan Program, the Department of Education would need to know the most basic information. For example, to determine loan eligibility, the Department of Education must determine whether a prospective borrower has had a student loan and the status of that loan. Education needs access to the most current borrower information available; therefore, the Internal Revenue Code would have to permit the disclosure of all relevant information.

Option 3: IRS Collects Defaulted Debt

Under Option 3, the Department of Education retains control over all aspects of the student loan program, including collecting and servicing the debt, until a borrower defaults. Once a borrower defaulted, the Secretary of Education would declare the entire outstanding principal to be payable on demand and would refer the remaining balance to the IRS *using an administrative judgement that would allow IRS to treat the defaulted debt as if it were a tax*. The IRS would collect the defaulted debt using the enforcement powers available under the current tax system.

As a tax, a defaulted student loan would be subjected to the same collection procedures used to collect delinquent individual income taxes. The first step in the IRS collection process consists of a series of computer generated notices requesting payment. If taxpayers do not respond to the notices, their cases would enter Tax Delinquent Account (TDA) status.

Resolution of TDAs begins at the Automated Collection Service (ACS) call sites. A series of phone calls are made at the ACS call sites to taxpayers requesting payments. If these phone calls do not resolve the TDAs, the cases enter a queue and are electronically prioritized. Cases with the highest priority are assigned to a Revenue Officer (RO). Those cases not assigned to an RO remain in the queue until all cases with a higher priority have been assigned. Revenue Officers use a variety of activities from phone calls to personal

interviews to resolve the TDAs and are responsible for the cases until they close.

For this option to work effectively, prior to referring defaulted accounts to the IRS for collection, the Department of Education should enter into a dispute resolution process with individual borrowers, as it currently does prior to refund offset referrals. While the IRS does have a problem resolution program and an appeals process, these programs are geared towards tax collection, not debt collection.² Under this option, the avenues available to resolve problems after referral would be identical to the mechanisms used to resolve tax disputes. While the dispute resolution mechanisms for taxes would be used to solve defaulted student loan problems, borrowers, Education and IRS would be better served if disputes were resolved prior to referral.

Depending on the year of implementation, the IRS would ultimately take over 7 to 10 million defaulted accounts (\$22 billion in accounts receivables) from the Federal Family of Education Loan Program. The IRS's accounting routines should track student loan collection efforts separately from normal tax collection. To effectively administer and ensure program integrity in the Direct Loan Program, the Department of Education must know when the defaulted debt has been fully paid since borrowers in default are not eligible to receive further assistance from Education until all prior debts are paid. However, the Internal Revenue Service may not be able to provide this information. Defaulters, who also have tax problems, would not be able to have their payments credited to the student loan and tax accounts. When a loan has assessed a tax, it would be included with all the other tax delinquencies.

While defaulted student loans would be collected as delinquent tax liabilities, the IRS Collection function would have to develop an effective collection strategy. The average defaulted student loan balance is approximately \$3,700. The average value of tax collection cases referred to the field for collection is much higher. If defaulted student loan cases are not assigned priority, which in turn would limit the IRS's ability to collect higher tax liabilities, many of the cases would remain in the queue until the 10 year statute of limitations for delinquent taxes expires.³

Defaulted student loans would be added to delinquent taxes. The coupling of student loans and delinquent taxes would serve to increase the priority of the collection effort. From an IRS Revenue Officer's perspective, student loans would be indistinguishable from delinquent taxes. However, from a program accountability perspective, student loan collections should be tracked separately from tax collections. Therefore, in cases where a taxpayer has both a defaulted student loan and delinquent taxes, payments will have to

² The type of disputes arising in connection with the collection of a delinquent student loans will be distinctly different from the type of disputes normally handled by IRS.

³ The queue is a holding place for tax cases waiting to be assigned to a Revenue Officer. There is no Statute of Limitation on defaulted student loans.

artificially allocated between taxes and student loans. If taxes are paid first, then the borrower would not be eligible for another student loan until all delinquent taxes and student loans are paid. If student loan accounts are credited first, then borrowers would be eligible for additional loans even though they have delinquent tax accounts. The prioritization of defaulted student loan or delinquent tax payments needs to be determined prior to IRS involvement in defaulted student loan collection. However, because loans would be indistinguishable from taxes, full program accountability cannot be attained.

Based on historical tax collection data, the Service collects approximately 70% of the original assessed dollars in tax cases within the first three years. Approximately 70% of eventual collections are received during the first year. Between the banks, guaranty agencies and the Department of Education, approximately 60% of defaulted student loans eventually are collected.⁴ Between the guaranty agencies and the Department of Education, approximately \$22 billion in student loans are currently in default. Student loans are different from taxes; therefore, IRS' ability to collect defaulted student loans may not match its ability to collect delinquent taxes. Tax liabilities are based on income, so the probability of eventual collection should be high. On the other hand, defaulted student loans are not income dependent. Therefore, expected collections for defaulted loans should be lower than expected tax collections.

Based on studies conducted by the General Accounting Office and various guaranty agencies, defaults are more likely among those attending proprietary schools and community colleges, independent students, freshman, dropouts, students with meager financial resources, and those who do not receive loan counseling. In 1989, the Department of Education analyzed the effects of five variables on default status: type of institution attended, AGI, independent / dependent status, years of schooling completed, and enrollment status (i.e., graduated, withdrawn). Statistical analyses indicated that AGI, type of institution, and years of schooling were highly correlated with default. Because the correlation between AGI and default status was negative and the propensity to repay increases with the amount borrowed, the probability of increased collection of defaulted debt by IRS is highly speculative.

Since the majority of loans currently in default are held by guaranty agencies, the cost analysis assumes that IRS would not receive the entire portfolio at once. Instead, IRS estimated costs under the assumption that it would receive one-fifth of the current defaulted account inventory each year for the first five years. To work these cases, IRS would require a substantial increase in resources. The estimate of collection resources required for active work beyond the notice stream and refund offset were increased substantially to make the IRS's default collection efforts comparable to the collection effort expended by the Department of Education and the guaranty agencies.

⁴ This includes collections from the refund offset program administered by the Internal Revenue Service.

There would be large opportunity costs associated with IRS collecting defaulted student loans. To handle the increased workload, the IRS would require additional resources. It should be noted, however, instead of applying the additional resources to student loan cases, if the IRS could use the resources to collect delinquent taxes. On average, student loans balances are lower than delinquent taxes. If the additional resources were applied to outstanding taxes cases currently in IRS' inventory instead of defaulted student loans, approximately \$1,200 million per year in tax revenues could be collected.

Furthermore, regardless of how payments are divided between defaulted loans and delinquent taxes, the prioritization scheme would be artificially derived. While treating defaulted student loans as if it were a tax for collection purposes minimizes problems for IRS' collection personnel, it does not allow the Service to accurately separate collections from individuals who defaulted on a student loan and have outstanding tax liabilities.

Option 4: IRS Collects Income-Contingent Direct Student Loans

In addition to the IRS's collection of defaulted debt outlined above, Option 4 requires that the IRS collect all income contingent Direct Student Loan payments through the tax system. All other Direct Loan payments would continue to be handled by the Department of Education. Like option 3, this option requires that the Congress authorize the Internal Revenue Service to collect student loan repayments as if they were taxes.

Income-contingent repayment is based on the borrowers' ability to pay. Borrowers would estimate the additional wage withholdings or estimated quarterly payments necessary to meet their required repayments. The estimated withholding or quarterly payment for student loan repayment would be based on a worksheet or formula provided to the borrower by the Department of Education. Wage earning borrowers could either specify the additional withholdings or adjust their allowances on Form W-4, Employee's Withholding Allowance Certificate. Self-employed borrowers/taxpayers would have to increase their quarterly estimated tax payments.

The reconciliation between required and actual payments and liabilities would occur on the individuals' annual income tax returns. In principle, this reconciliation would be similar to the reconciliation between tax payments and tax liabilities. The most likely method for handling student loan reconciliations would be through the creation of a new schedule and the addition of new lines on Form 1040.

Because the Department of Education would retain responsibility for overseeing the entire Direct Loan program and would maintain and service accounts, IRS would have to be notified on an annual basis to expect student loan repayments. IRS would then:

- Compare the sum of required loan payments and tax liabilities to total actual payments (the sum of withholding, estimated payments and remittances with the return)
- Issue notices and notify Education of underpayments (nonpayments)

- Refund overpayments or credit the overpayment to next years liability

If a borrower fails to pay or underpays the required repayment for that year, the IRS would issue a balance due notice and attempt to collect the delinquent amount through normal tax collection procedures. However, the Department of Education, not the IRS, would make the determination of when the debtor entered default status. Education would then accelerate the outstanding loan balance and refer it to the IRS for collection as if it were a tax (see Option 3).

This option imposes no additional burden on employers because there would be no changes to the withholding system. In fact, the burden and responsibility rests with the borrower. Employers would not be able to, nor would they be required to, separate withholdings for student loans from withholdings for taxes. While there will have to be some changes to the existing individual income tax forms as well as the addition of another schedule, employers would not have to develop or change existing accounting systems to handle income-contingent repayments.

Because Option 4 uses the existing tax collection system to collect income-contingent student loans, the Direct Loan Program goal of accountability would not be met. Payments will not be separated by account category; *loan payments* for individuals' choosing income-contingent repayment will be indistinguishable from *tax payments*. If either the loan or the tax is underpaid, it will be difficult to determine which liability account should be credited for the amount withheld. Resolution of this issue is necessary for the Option to be implemented.

While spousal income is included as a basis for income-contingent student loan repayment under all options, it becomes a particularly significant problem when IRS is involved in collection. The individual income tax system is a progressive tax system which means that the marginal tax rate increases as income increases. Tax withholdings are based in part on filing status; however, the potential exists that married borrowers could have taxes withheld at a lower marginal rate and then be liable at the higher marginal tax rate. Therefore, even though a married borrower could have adjusted withholdings to account for the income-contingent student repayment, the borrower (and spouse) may be underwithheld for taxes. Therefore, the amount that was intended to be student loan payments may be used to offset the delinquent tax

Because, the Department of Education will not have account information for the year until loan and tax withholdings have been reconciled on an individual's income tax return, it will not be able to provide quality customer service to borrowers or third parties or to effectively manage the program.

Since reconciliation would occur on an annual basis and payments are posted only once a year, the frequency of payment would not impact the term of the loan. On a conventional loan, the amount borrowed is amortized over a fixed period at a fixed interest

rate. An increase in the frequency of payments would greatly reduce the total interest paid and shorten the term of the loan. Even though borrowers would be making payments (via withholding or estimated payments) on a regular basis, their payments only would be posted annually. Payments based on bimonthly, biweekly, or weekly earnings would reduce the total interest paid over the life of the loan and significantly reduce the term of the loan. However, using the existing tax collection system prevents the IRS from crediting individual borrowers' accounts during the course of the year.

Finally, neither the IRS or the Department of Education would be able to provide stakeholders with timely information on individual borrowers or on the loan program. Because account reconciliation occurs only once a year, reports to Schools, Congress, Education, and credit bureaus could not be based on the most up-to-date information. The lack of current information would hamper the Department of Education's ability to effectively service student loans. Under this option, borrowers would be able to determine their outstanding principal only after their tax return had been filed. Furthermore, borrowers, wishing to change repayment plans, would only be allowed to change repayment plans at the time that their tax returns are filed.

Option 5: IRS Processes All Federal Direct Student Loans

The IRS would collect all Direct Student Loan repayments, regardless of the repayment plan (standard, extended, graduated, income-contingent, and alternative) under Option 5. In addition, the IRS would collect defaulted debt as outlined above.

To implement Option 5, the Congress would pass legislation which would allow the Internal Revenue Service to:

- use its enforcement functions to collect defaulted or delinquent student loans
- use the tax system (wage withholding, estimated payments) to collect direct student loans
- process all other direct student loan payments (e.g., standard, extended or graduated repayments)

The underlying assumptions that were discussed in Options 3 and 4 apply to this option, as well. The Department of Education retains overall responsibility for the Federal Direct Student Loan Program (FDSLPP). Included with this responsibility is the maintaining and servicing of student loan accounts. Furthermore, the Department of Education is responsible for determining when borrowers enter default status. For payment processing and default collection purposes, the Internal Revenue Service would treat loan repayments like a tax.

Based on projections provided by the Department of Education, approximately 15% of all direct loans will be repaid through the income-contingent plan. However, because the tax system can be used under all repayment plans, IRS assumed that 30% of all direct loan

payments would be received through wage withholdings or estimated payments. Paying through the tax system would be accomplished according to the method described under Option 4. As in Option 4, the IRS could not distinguish loan payments from tax payments if they were received through wage withholding or estimated payments.⁵

The remaining 70% of student loans would repay via "normal" payment processing methods. From a processing point of view, there is virtually no difference between standard, extended, graduated, or alternative payments—they are all variations of a fixed payment plan. Since the Department of Education would remain responsible for maintaining and servicing accounts, Education would notify IRS of the total payment required for the coming year. Payments would be received either through additional withholdings or estimated payments, similar to the income-contingent repayment option, or IRS would issue coupon books to borrowers with the monthly payments for the coming year. By using coupon books, IRS would then be in a position to track payments and issue reminder notices when payments are behind schedule.⁶

For borrowers choosing not to repay through the tax system, IRS would be able to identify student loan payments. IRS would be able readily distinguish student loan payments from tax receipts. Since payments would be already separated from tax collections, IRS could track payments. For example, if a borrower missed a payment, IRS would issue a reminder notice and notify Education of the account status. For those borrowers who repay through wage withholding or estimated payments, it would be impossible to identify underpayments or nonpayments until the tax return is filed and the payments are reconciled with the liabilities.

Because there are no planned changes to the withholding system, this option does not affect the burden on employers. The burden and responsibility rests with the borrower. Employers would not be able to, nor would they be required to, separate withholdings for student loans from withholdings for taxes. While there will have to be some changes to the existing individual income tax forms as well as the addition of another schedule, employers would not have to develop or change existing accounting systems to handle income-contingent repayments.

Borrowers who elect to repay through the tax system will be treated differently from borrowers who use more conventional repayment methods. Under the tax system, borrowers who underpay or don't pay taxes may end up defaulting on the student loan. Borrowers using the tax system will have payments artificially allocated between taxes and student loans. On the other hand, borrowers' payments, for those who repay using more traditional

⁵ This means that the IRS would treat nonpayment or underpayment of student loans identically to nonpayment or underpayment of taxes.

⁶ The cost estimates for Option 5 assume that IRS would provide borrowers with payment coupon books on an annual basis.

methods, would already be separated from tax receipts. A balance due tax account would not affect the student loan at all. IRS can track payments using coupon books. The only way tax accounts and student loan accounts would be mixed would be if the borrower defaulted. While this unequal treatment of borrowers exists under Option 4, Option 5 centralizes it within one processor.

Category 3 - Separate From the Tax System

Option 6: IRS as the Student Loan Collection and Servicing Agency

Under Option 6, the IRS would develop a system, separate from its current tax system, to service and collect Direct Student Loan repayments and to collect defaulted debt. While the Department of Education would continue to originate direct student loans, the IRS would be responsible for servicing those loans after they are posted as Federal obligations. To implement this option effectively, employers must participate in a non-tax withholding program.

Under Option 6, the Internal Revenue Service would become the Student Loan Collection and Servicing Agency for the Federal government. While the Department of Education would continue to originate direct student loans, IRS would be responsible for servicing those loans after they are posted as Federal obligations. Once borrowers are no longer eligible for deferment, the schools would notify the IRS. At that time, IRS would contact the borrowers and finalize arrangements concerning repayment.

For both the Service and the borrowers, student loans be treated differently from tax liabilities. Unlike Options 3, 4, and 5, which use the current tax system to collect student loan payments, Option 6 requires the IRS to do much more than processing payments and collecting defaulted accounts. Loan collection and service requires quality customer service. Not only should IRS be able to access account information, but borrowers must be able to access up-to-date information about loan balances, repayment schedules, and other related issues. IRS must promptly reconcile payments with debts in order to deliver timely customer service to borrowers. By providing time, accurate customer service through the prompt posting of payments and providing up-to-date information to borrowers, IRS would be able to identify potential problems earlier, thereby allowing timely corrective actions.

To treat student loans differently from individual income tax liabilities, the IRS would have to develop a parallel withholding system⁷. A separate division within the IRS would be dedicated to student loan collection and servicing. The development of a separate withholding system for the repayment of student loans eliminates much of the disclosure issues encountered under Category 2, Use of the Current Tax System. However, the IRS's

⁷ Since student loans are not taxes, separate withholding and reporting is necessary to distinguish underpayment of tax deposits from underpayment of student loan payments.

disclosure provisions, §6103 of the Internal Revenue Code, would have to be amended to allow the tax side of the IRS to share return information with the student loan side of the IRS for the purposes of determining income-contingent payments and collecting from defaulters (including refund offset).

Employers would report each employee's withholding for student loans each pay period based on the allotment indicated on Form W-4SL. Similarly, Self-employed taxpayers would be required to report student loan payments on Form 1040ES-SL. By using a separate withholding system to keep tax deposits separate from student loan payments, the IRS would be able to reconcile payments with liabilities on an ongoing basis and time loan payments with pay cycles.

Borrower inquiries would be routed through the Student Loan Customer Service Center. This center would serve as the primary point of contact for all borrower inquiries. Borrowers would be able to expect service for:

- account inquiries, account status, remaining principle, payment information
- information concerning repayment options
- changing repayment option
- response to the IRS's student loan correspondence

In addition, the Customer Service Center would be the conduit for the Service's business with the borrower and other oversight agencies. Other responsibilities of the Customer Service Center would be to:

- act as the conduit for dispute resolution and the problem resolution program
- provide referral to appeals and litigation
- issue correspondence
- certify accounts for refund offset
- issue periodic reports to Education, IRS, Treasury, and OMB
- issue credit reports to credit bureaus

While borrowers would have a number of repayment options (e.g., standard, extended, graduated, income-contingent, and alternative), they also would have several options in how they repay. Since borrowers can specify the amount to be withheld on Form W-4SL, withholding potentially can be used by all borrowers as the repayment vehicle.

While the combination of the income-contingent repayment plan and wage withholding should reduce the default rate on direct student loans, there are approximately 7 million accounts currently in default (\$22 billion) and students still would be able to obtain loans under the older program, Federal Family Education Loan Program (FFEL). Under Option 6, the IRS would be responsible for collecting defaulted FFEL accounts. The IRS' reputation as the premier collection agency is based on its efficient tax collection system and its powerful enforcement functions. However, the IRS's enforcement tools are predicated on being used for the collection of taxes, not student loans. Therefore, under Option 6, Congress would grant the IRS the authority to use its tax collection enforcement tools to collect defaulted student loans. Unlike Option 3 where the IRS would collect defaulted student loans as if they were delinquent taxes, the IRS would use its enforcement powers, unique to tax collection, to collect defaulted debt under Option 6.

Finally, employer participation in this program must be mandated. For the first several years of the direct loan program, only a small percentage of the population will be repaying their student loan. If employers participation is voluntary, then businesses may discriminate between potential employees with student loans and potential employees without student loans. The decision to hire a qualified individual should not be dependent on the existence of a student loan. Furthermore, borrowers' choice of repayment method should not be dependant on whether their employer allows withholding.

OBRA '93 Conference Report Issues

Whether IRS could implement a student loan repayment system with its current resources and without adversely affecting its ability to collect tax revenues?

Under the information sharing alternatives (Options 1 and 2), the IRS will support the Department of Education's implementation of the Direct Student Loan Program by providing the data necessary to implement the President's vision of linking loan payments with the borrower's ability to pay. In addition, a system of private withholding, similar to Christmas clubs and charitable contributions fullfills the administrations goal of a student loan program that provides borrowers with an easy, convenient repayment method. Option 2 also provides the Department of Education with additional tax return information which would greatly enhance its defaulted debt collection mechanisms.

Education was recently granted the authority to use administrative wage garnishing to collect defaulted debt. Employment and bank account information from the IRS would make wage garnishment, as a method of defaulted debt collection, more effective. Options 1 and 2 would be reimbursable programs for IRS. In developing its cost estimates for the Direct Loan Program, the Department of Education assumed that the IRS costs (FY94-FY98) would be approximately \$200 million.

The second category of IRS involvement, use of the current tax system (Options 3, 4, and 5), also meets the President's vision of linking loan payments with a borrower's ability to pay, and also provides borrowers with a convenient method of repaying student loans while increasing the consequences to borrowers failing to meet their obligations. Depending on the option, borrowers would be able to repay their student loan through the tax system.

While loans would be collected through the tax system, Options 3, 4, and 5 represent significant new activity for the IRS in nontax debt collection. While the IRS has been involved in the refund offset program, its role has always been the collector of last resort. In Options 3, 4, and 5, the IRS becomes the Federal government's primary student loan collector. This transformation significantly increases the IRS's costs. Cost estimates for all options are summarized in Exhibit A.⁸ Exhibit B summarizes staffing level required by the

⁸ The detailed cost analyses are presented in Appendix 6.

IRS to develop and implement these options. These cost estimates are extremely sensitive to:

- **Status of the Tax Systems Modernization Program (TSM)** - IRS involvement in the student loan program would represent a marginal increase in planned capacity under TSM. Student loan processing and collection activities would represent an extension of planned tax processing and collection activities. Student loan cost estimates for Options 3, 4, and 5 are sensitive to the implementation of TSM.
- **Student Loan Volumes** - IRS cost estimates are based on estimates of the number borrowers who are in repayment each year. To the extent that estimates of loan volumes are under estimated, IRS cost estimates will be under estimated.
- **Collection of Defaulted Debt** - IRS cost estimates for defaulted student loans assume that the Service will receive the entire inventory of 7 to 10 million defaulted loans over a five year period. Since these cases have been extensively worked, IRS assumed that a high percent of cases would have to be resolved through the Automated Collection System and through Revenue Officers in IRS' District Offices.

In addition to the direct costs, there are substantial opportunity costs associated with use of the current tax system. Without additional resources, tax collections from delinquent tax accounts would suffer. If the additional resources were applied to outstanding tax cases currently in the IRS's queue instead of defaulted student loans, approximately \$1,200 million per year in tax revenues potentially could be collected. Given the size and distribution of IRS' accounts receivables as compared with Education's portfolio of defaulted debt, collecting defaulted student loans may be a poor allocation of the IRS' resources because the marginal yield-to-cost ratio will be higher for collecting tax delinquencies than for collecting defaulted student loans.

The third category of IRS involvement in the student loan program requires the IRS to collect and service all direct loans separate from the tax system and to collect (using an enforcement function) all defaulted student loans (Option 6). The primary difference between this alternative and the use of the current tax system is that student loans would continue to be loans and not treated as tax liabilities. This alternative addresses the fact that loan service and collection is fundamentally different from the service and collection of income tax obligations.

Under this option, the IRS would develop a system separate from the current tax system to accommodate the level of service required for servicing student loans. Employers would be required to withhold student loans separately from taxes and provide the IRS detailed information with each student loan deposit. In order to service student loans effectively, Option 6 requires that employers provide the IRS with the earnings and student loan withholdings for each employee that elects to repay via wage withholding. Only with this type of detailed information can the IRS properly track payments.

Option 6 positions the IRS to be the Federal government's primary loan collection agency. Because this option requires the development of a separate system to service and collect student loans, the costs of developing and implementing this system are significant. In essence, a separate system within the current IRS would be developed to service and collect student loans. The cost estimates for this option are included in Exhibits A and Exhibit B.⁹ These estimates are sensitive to:

- **Student Loan Volumes** - IRS cost estimates are based on estimates of the number borrowers who are in repayment each year. To the extent that estimates of loan volumes are under estimated, IRS cost estimates will be under estimated.
- **Collection of Defaulted Debt** - IRS cost estimates for defaulted student loans assume that the Service will receive the entire inventory of 7 to 10 million defaulted loans over a five year period. Since these cases have been extensively worked, IRS assumed that a high percent of cases would have to be resolved through the Automated Collection System and through Revenue Officers in IRS' District Offices.
- **Legislative changes** -
 - ability to apply tax enforcement powers to student loan collections (liens, levies, refund offset, etc.)
 - back-up withholding for defaulters (ability to require employers to withhold from borrowers who are in default on their student loans)
 - amend IRS disclosure provisions to allow IRS to share tax return information with itself for the purposes of servicing and collecting student loans
 - authority to require employers to offer employees the opportunity to repay student loans through wage withholding

Finally, these estimates assume that IRS would receive the additional resources necessary to develop, implement, and operate under Option 6.

The cumulative impact of increased disclosure of tax return information and increased IRS involvement in nontax collection activities on voluntary compliance with the tax laws.

The Internal Revenue Service is authorized to disclose limited tax return information to other agencies as specified by §6103 of the Internal Revenue Code. To protect taxpayer privacy and ensure the integrity of the tax system and voluntary compliance, the IRS strictly administers these disclosure provisions.

Options 1 and 2 consist primarily of increased information exchanges of tax return information with the Department of Education. Thus, the impact of increased disclosure on voluntary compliance is of significant concern. Under the program being implemented by

⁹ The detailed cost analyses are presented in Appendix 6.

the Department of Education currently (Option 1), §6103 allows the IRS to disclose to the Department of Education, taxpayer entity information, adjusted gross income, and filing status of certain borrowers.

The Department of Education is currently relying on contractors to administer the Direct Loan Program. Because §6103 does not authorize disclosure of tax return information to these third parties, the income-contingent repayment option will be offered to borrowers on a conditional basis. Borrowers requesting income-contingent repayments will be required to sign a consent at the time of repayment which would permit the IRS to provide the contractor with AGI, filing status, and entity information of borrowers for the purposes of determining the required repayment amount.

While requiring a consent legally allows IRS to release limited return information, it does expand the universe of individuals with access to information that is considered confidential and potentially sensitive. This increased inter-agency information sharing may decrease voluntary compliance.

In addition to increased information sharing, increased IRS involvement in non-tax collection activities may impact negatively on voluntary compliance with the tax laws. This risk is most prevalent in Options 3, 4, and 5 (use of the current tax system to collect student loans) and Option 6 (creation of a separate system within the IRS). Historically, the Internal Revenue Service has been concerned that its involvement in non-tax debt collection may impair its ability to carry out its mission to collect the tax revenues owed to the Federal government. The IRS is concerned that increased non-tax debt collection activity eventually could undermine taxpayers' confidence in the tax system, resulting in an erosion of voluntary compliance.

In the Omnibus Budget Reconciliation Act of 1981, Congress authorized IRS to offset refunds for taxpayers owing support debt to families receiving Aid to Families with Dependent Children. Since then, Congress expanded the refund offset program to encompass all Federal nontax debt. In order to determine whether refund offsets negatively influence voluntary compliance, IRS conducted a comprehensive long-term study. The final results of that study, released in February 1993, concluded that the program did have a long-term negative impact on compliance. In that situation, however, the study concluded that the program benefits outweighed the costs.¹⁰ The dollars offset for delinquent debt were greater than the estimated loss in tax revenues.

¹⁰ Between 1986 and 1991, a total of approximately \$719 million in tax revenue was lost due to the decreased compliance for taxpayers offset for the first time in 1985, 1986, 1987 and 1988. Of that \$719 million, \$621 million was attributed to the increase in nonfilers and approximately \$98 million was attributed to the increase in balance due filers. Over the same period, about \$1.3 billion was offset from the same population.

The same not be true of a program that relies on the IRS to be the sole collector of student loan repayments. Currently, the IRS works with the Department of Education to collect defaulted debt through the refund offset program. Increased IRS involvement in the collection of student loan will be costly. It is unclear, however, if significantly greater collection than is already being realized through the refund offset program can be accomplished by greater IRS involvement.

The General Accounting Office also studied the impact of refund offsets on voluntary compliance. In a study of guaranteed student loan defaulters, GAO agreed with IRS's general conclusion that there is a decline in compliance in the year immediately following an offset; however, the decline was short-term (one year). Both IRS and GAO agreed that the refund offset program has yielded a net benefit to the Federal government despite the decline in compliance. However, if the impact on compliance is long-term, as indicated by IRS research, then the decline in compliance eventually could result in a net loss to the Federal government.¹¹ Because compliance is affected by IRS involvement in the collection of Federal debt, Options 3 through 6 should further reduce voluntary compliance.

The ability of the IRS to enforce collection of student loans using an alternative system of dispute resolution, penalties, and collection devices.

The ability of the IRS to enforce collection of student loans using an alternative system of dispute resolution, penalties, and collection devices is implicated only in considering Option 6 (development of a separate tax system). Under the separate system provided in Option 6, student loans would be serviced and collected as loans, not taxes. IRS cost estimates for Option 6 included the development of an alternative dispute resolution mechanism. However, IRS assumed that it would be allowed to use collection techniques that are currently unique to taxes (liens, levies) to improve defaulted debt collection. With these collection powers, the cost estimates assumed that the IRS and the Department of Education (under Option 2) would be equally effective in collecting defaulted debt.

The Internal Revenue Service eventually collects approximately 70% of originally assessed tax liabilities. The Department of Education (including the banks and guaranty agencies) eventually collect 60% of the originally defaulted loan. Under Option 2, Increased Information Sharing and Private Withholding, the Department of Education would be able to

¹¹ For further information concerning the impact of the refund offset program on voluntary compliance see:

United States General Accounting Office, Tax Policy: Refund Offset Program Benefits Appear to Exceed Costs, GAO/GGD-91-64, May 1991.

Internal Revenue Service, Research Division, The Impact of Nontax Refund Offsets on Voluntary Compliance, October 1992 (Revised February 1993).

use tax return information to identify the employers of defaulters. With this information, Education would be able to use more effectively its administrative wage garnishment authority. Fully using administrative wage garnishment as a collection tool would make the Department of Education as capable as the Internal Revenue Service would be in collecting defaulted loans.

The effect of separating loan collection from other loan servicing functions.

One of the primary reasons Congress and the Administration support the Federal Direct Student Loan Program is that it is less complex than the Federal Family Education Loan Program (FFEL). The FFEL, with its array of loan holders, presents a customer service nightmare for a very large number of borrowers who get lost between lenders, secondary markets, servicers, guaranty agencies, and the Federal government. Ideally, borrowers should always know which entity is servicing their loans, who to go to for questions about the programs, payment plans, individual loan records, etc. Ideally, this should be one and the same entity whether the borrower is in school, in grace period, in repayment status, or in default status. The Federal government should be in the business of minimizing burden on borrowers and not in the business of creating barriers to repayment.

By assigning loan collection responsibility to IRS and loan responsibility to the Department of Education under the second policy alternative, the Federal government would be introducing added complexity to a program which was created in response to the real need to simplify the process for the Government's primary customer--the students and the schools.

Loan servicing and loan collection functions are intertwined. Student loan borrowers, in particular, do not tend to draw distinctions between the two processes. The experience the Department of Education has gained managing the student loan programs has taught it that borrowers do not hesitate to contact the entity which sends the bills, even though there are clear instructions to do otherwise. The vast majority of student loan borrowers have demonstrated financial need to obtain their loans. The Federal government should not underestimate the student loan borrowers' greater need for counseling and advice.

The anticipated effect on the management of Federal student loan collections, and on borrower repayment of such loans.

The advantage the IRS has in the collection of taxes is that it essentially collects taxes throughout the year, but does the "bookkeeping" once a year when taxpayers file their returns. If IRS were to assume a role greater than just sharing information, it is clear that the Federal government would either need to make student loan payments a tax by law or would need to create an IRS system student loan collection system. If the IRS were to create a new system for collecting student loans (Option 6), then a significant aspect of this new IRS entity would be whether it could demonstrate an economic advantage over the present system.

... If student loans are to be treated as taxes, it than should be expected that IRS would not have the flexibility that Education currently has to deal with defaulters. The Department of Education and guaranty agencies offer borrowers the opportunity to resolve their defaulted loans by making reasonable and affordable payments and by rehabilitating their loans. Furthermore, the average value of a defaulted student loan account is approximately \$3,700. To place a high collection priority on these low balance accounts would require the Service

either to modify its workload prioritization program significantly (diversion of resources from tax cases) or to add the resources necessary to work defaulted loans.

With the assistance of IRS, the Department of Education has made great strides in collecting defaulted student loans. About one-third of all defaulted student loan collections are accomplished through the refund offset program. IRS also provides Education with the most recent tax filing addresses for use in collecting student loans. Further assistance by IRS through the sharing of information (and possible resources) could allow the Department of Education to expand its proficiency in collecting defaulted debt while offering "normal" borrowers a wide range of repayment options and methods of repayment.

Appendix 6

IRS Cost Methodology

Summary

This study examined six options for IRS involvement in the collection of student loans. These options range from continuation of current procedures (Option 1) to the IRS servicing, processing and collecting student loans (Option 6). As part of the study, cost estimates were developed for each option which imposed significant new operating cost burdens on the Service.

Costs were not estimated for Options 1 and 2, since these options would not lead to major new processing or staff expenditures. Detailed cost estimates were developed for:

- Option 3, the IRS collects defaulted debt from both the Federal Family Education Loan Program (FFEL) and the Federal Direct Student Loan Program (FDSLP)
- Option 4, Option 3 and the IRS processes income-contingent payments for FDSLP
- Option 5, the IRS collects FFEL/FDSLP defaults and processes all FDSLP payments
- Option 6, the IRS services and collects all FDSLP loans as well as all defaulted loans

Each of these options were prepared under two scenarios: one assuming that the IRS collects FFEL defaults and the other scenario assuming IRS would not collect FFEL defaults. Major operational cost impacts for the IRS will be felt in the following areas:

- Information Systems, for development and operation of new student loan databases
- Returns Processing (Options 4, 5 and 6 only), for processing of loan payments and posting of payments
- Taxpayer Service (Options 5 and 6 only)
- Collection (Options 3, 4, 5 and 6), for the collection of defaulted loans.
- Chief Counsel/Appeals (Option 6 only)

For the first few years, the most significant cost would be incurred by Collection if the Service assumed responsibility for collecting the existing defaults under the FFEL program. Estimates are that this effort will require an increase of approximately 2,800 Collection FTE per year in the FY 1998-2002 period. Under Options 5 and 6, Returns Processing costs eventually become the most significant cost, requiring an increase of 1,800 FTEs for FY 2000 and 7,500 FTEs when the program reaches a capacity of 20 million loans in repayment. To meet the servicing goals of Option 6, Customer Service costs

become significant.

Total IRS costs for FY99 range from \$303.8 million (Option 3) to \$580.8 million (Option 6); FTE resource requirements will range from 3,655 (Option 3) to 6,936 (Option 6). Option 5 and 6 costs significantly increase over time. FY00 program costs are projected to range from \$307.5 million to \$670.4 million, with FTE requirements ranging from 3,544 to 7,823. At 20 million loans, Option 5 costs reaching \$469.5 million (5,527 FTEs) and Option 6 costs reaching \$1,002.2 million (13,182 FTEs).

It should be emphasized that major operational and design decisions have not been made; therefore, these costs estimates should be regarded as preliminary and subject to modification.

Limitations and Assumptions

Costs were developed for the FY98-FY00 period. Extrapolations were made for FY05, at which time it was assumed that there would be 20 million direct loans in repayment. In creating these estimates, it was assumed that major operational involvement by the Service would not begin before the start of FY98, although systems development would begin in FY95.

Costs were developed for the key IRS functions that would be involved in these options--Information Systems, Returns Processing, Taxpayer Service, and Collection. Additional administrative costs imposed on such support functions as Finance or Human Resources were not considered.

Costs for each key function were developed separately. Wherever possible, staff costs were converted into dollars by use of the 1995 Unit Cost Rate handbook. Out-year costs were adjusted by the use of OMB Gross Domestic Product (GDP) inflator percentages for the FY94-99 period. Since no official inflator percentage has yet been set for FY00, the FY99 inflator percentage was also used for that year.

Department of Education figures, as of mid-March, were used to estimate overall loan volumes for the Direct Loan program, as well as the total number of FFEL defaults. The Department of Education does not track defaults or provide estimates on the basis of borrowers. For IRS purposes, it was necessary to determine the number of individual borrowers rather than overall numbers of loans. Therefore, Education department projected loan volumes were converted into number of borrowers (taxpaying entities) based on analyses performed by IRS. The estimates could not be validated for the purposes of these projections.

The projected percentage of total Direct Loan borrowers who will request the income-contingent repayment option (15%) was also based on Department of Education projections. Changes in these estimates would have a significant impact on these cost estimates.

Collection estimates were based on data from the Department of Education that approximately 7 million FFEL cases are currently in default, and that the current FFEL default rate is about 900,000 cases per year. This rate was projected to slowly drop beginning in the late 1990's. Two major assumptions used in developing these estimates are that the current FFEL backlog of approximately 7 million loans will still exist at approximately its current levels in FY98, and that the Service would absorb this backlog into five annual classes to be worked beginning in FY98.

These estimates also assume that the default rates for the new Direct Loan program would be equivalent to FFEL during the period in question. These estimates also assume neutrality in the ability to collect defaults. These assumptions should be treated with caution and represent major risk factors in this analysis.

Approach

Information Systems

Although the specific architectures and processing requirements have not yet been defined for this potential program, cost estimates were developed on the following assumptions:

Options 3, 4 and 5:

- A separate "Student Loan Master File" (SLMF) would be created, linked to IDRS and other master-file processing.
- The Department of Education would be responsible for case creation and data feeds to the SLMF.
- Data would be retained in the SLMF for at least 10 years after repayment.
- The average record size would be 14 kilobytes.
- The SLMF would initially be sized to contain 20 million records, with a total storage requirement of 280 gigabytes.
- Development (information engineering design and programming) would require a total of 3 fiscal years. During the initial year a total of 40 FTE would be needed for design and programming support, plus 10 non-programming IS staff, plus 8 FTE for Resource Management support (total of 58 FTE). This number would increase to 72 FTE in Year 2, and decline to 43 FTE in Year 3. These estimates are tentative and depend on scheduling and design decisions that have not yet been made. The estimates also assume that the programming effort needed to develop the SLMF will be identical regardless of the Option finally chosen.

- Hardware costs also depend on future design decisions. For estimation purposes it is assumed that FY 94-00 mainframe processing costs will range from \$5 million to \$15 million, depending on the availability of existing hardware capacity, and lifecycle connectivity/ telecommunications costs will range from \$1 to \$3 million.

Option 6:

- Costings were based on purchasing the equivalent computing capacity used by the Department of Education's current contractor's system. Besides the capabilities outlined for Options 3, 4 and 5, the computing system would be able to provide complete account information.
- Development (information engineering design and programming) would require a total of 2 fiscal years. During the initial two years (FY 95 and 96), 329 FTEs per year would be needed for design and programming support. Afterwards, maintenance programming has been estimated at a rate of 40% of the development effort (263 FTEs). These estimates are tentative and depend on scheduling and design decisions that have not yet been made. The estimates also assume that the programming effort needed to develop the SLMF will be identical regardless of the Option finally chosen.

Returns Processing

Options 3, 4 and 5

Costs are based upon current processing costs. Volumes for processing payments/returns based upon borrowers in repayment status. Since the Department of Education does not possess this statistic (it measures volumes by loans rather than by individuals), the IRS converted loan volumes to volumes of individuals using formulas on the percentage of individuals from a cohort who takes 1, 2, 3, etc. loans. The conversion formulas assume 1) that individuals receiving direct loans will only receive direct loans and 2) that individuals receiving multiple loans will do so in consecutive years. Volumes and percentage rates for defaults were also based on Department of Education statistics of defaults.

- 70% of individuals assumed to make monthly payments via a coupon book, 30% via wage withholding, with reconciliation made on the tax return.
- Coupon book payments to be sent to a lockbox and processed at a cost of \$0.75 per payment.
- Data entry assumed to be at the same production rates as the processing of individual income tax returns.

- Error rate for error correction assumed to be same as average for Form 1040 (20%).
- Correspondence/adjustment volume assumed to be at 40% of borrowers in repayment status at average production rate of 2.7 per hour.
- Reminder notices of late payment assumed to be necessary for 10% of borrowers at a rate of one per individuals (this does not include defaulters).
- For Direct Loan borrowers who default, six notices, including the default notice, would be sent. For FFEL defaulters only, the default notice will be sent.

Option 6

- Generally the same assumptions for Option 3, 4, and 5 were used for Option 6, with the following exceptions:
- Monthly notices showing balance due and repayments would be sent rather than a coupon book.
- Employers of individuals using wage withholding would file a form similar to Form 945. It was assumed that the average employer would have 3 employees, and that payment would be sent on the average of once each two weeks.
- A 12% error rate was assumed for processing the employer withholding form.
- Advance staffing was assumed necessary for training and piloting purposes. One half of anticipated first year processing FTEs would be hired in FY96; the rest in FY 97.

Collection

- The total default caseload was based on Department of Education estimates and include two major elements: a backlog of approximately 7 million cases and an annual increment of 900,000 cases. It was assumed that the annual increment would slightly increase during the FY 1998-2005 period, although the mix of defaults would change as the Direct Loan program expands. Different workload assumptions would have a dramatic impact on Collection costs.
- Since Options 3 through 6 involve collection of defaulted loans, collection costs remain constant for these options. The same applies when FFEL loans are excluded. Collection costs remain constant across options, but at a much lower level than if the FFEL defaults are included.

- Collection cases are assumed to proceed through the Collection process in the normal way—notice stream, with Service Center Collection Branch (SCCB) answering any correspondence, followed by attempted telephone contacts through the Automated Call System (ACS) and finally, if the case is still unresolved, personal contact by Revenue Officers in the Collection Field Function (CFf).
- All scenarios assume that internal IRS resources will be used for collection.
- Fallout rates—the percentage of cases which are not resolved at each point and therefore pass to the next stage—these rates are higher than the rates generally used for tax cases, since the FFEL cases are all already in default (*Note: this is an unverified assumption*). It is assumed that IRS would have to expend a higher level of effort to collect student loans than taxes because of the differences between defaulted debt and taxes. The scenario used for overall cost estimates assumes that 45% of all the cases receiving initial notices will require additional correspondence work by SCCB, 40% of all cases will go to ACS, and 15% will require work by the Collection field function. In this scenario, the 7 million FFEL-case backlog would be allocated over 5 years. Other, equally plausible, assumptions would significantly impact estimated costs.
- This scenario anticipates the following FTE requirements:
 - FY98: 2,797 (including 2,292 in CFf)
 - FY99: 2,800 (including 2,295 in CFf)
 - FY00: 2,793 (including 2,289 in CFf)
 - FY05: 1,340 (including 1,098 in CFf)
- The lower amount for FY 2005 assumes that the current FFEL backlog will be resolved by the end of Year 5 (FY 2002).
- If FFEL defaults are not included, the Collection FTE requirements are:
 - FY98: 22
 - FY99: 30
 - FY00: 37
 - FY05: 97
- Dollar costs were derived by using the 1995 UCR handbook "Tax Examiner" expansion rates for SCCB employees, "Other Permanent" expansion rates for ACS, and "Revenue Officer" expansion rates for CFf. All rates were adjusted for inflation. However, no additional costs were built in for administrative or HR support, or for additional facilities, since these factors will depend on management decisions not yet made. A conservative approach would be to add 15% to listed dollar costs for these factors, increasing the Collection FY

1998-2000 estimate by \$37 million a year, and FY 2005 by about \$22 million a year.

- Most Collection costs would be incurred in CFf. Regardless of the assumptions used, however, a large percentage of cases would inevitably end up queued into currently not collectable status. We have not attempted to deal with the consequences of this situation for ARDI, etc.
- Revenue neutrality was assumed across all six options.

Opportunity Costs

- With FFEL
 - Average Collection per FTE: \$430,000
 - Average Number of FTEs per year (FY98-FY99) : 2,800
 - Opportunity Cost: \$1.2B per year
- Without FFEL
 - Average Collection per FTE: \$430,000
 - Average Number of FTEs per year (FY98-FY99): 26
 - Opportunity Costs: \$11.8M per year

Note: Given the size of the IRs's Accounts Receivables, the marginal gain in revenue from adding an FTE is equal to the average gain in revenue.

Taxpayer Service

- Both default-collection and loan servicing will generate additional workload for the Taxpayer Service function. Although current policy options call for the Department of Education to retain an important role in customer contact and dispute resolution, some borrowers will call the IRS for information or initial contact.
- In developing Taxpayer Service estimates, the following assumptions were used:
 - FFEL default cases:
 - 15% will make telephone contact each year
 - 1% will have written correspondence each year
 - 5% will generate walk-in traffic each year
 - New Direct Loans:
 - 15% will make telephone contact each year
 - 1% will have written correspondence each year

- 5% will generate walk-in traffic each year
- Repayment cases:
 - Income Contingent--
 - 5% will make telephone contact each year
 - 0.5% will have written correspondence each year
 - 1.7% will generate walk-in traffic each year

All Other Repayment Plans--

- 10% will make telephone contact each year
- 1% will have written correspondence each year
- 3.4% will generate walk-in traffic each year
- Current TPS norms were used to estimate contact time:
 - Telephone: 0.22 hours
 - Correspondence: 0.44 hours
 - Walk-Ins: 0.29 hours
- 1995 Unit Cost Rate Taxpayer Service Representative (Permanent) expansion rate numbers were used to convert workload to dollar costs. Rates were adjusted in the out-years using GDP inflators. A 15% RM overhead factor was added to final cost projections.
- For Option 6, additional costs would be incurred for correspondence and notices required while loan recipients remain in school or otherwise in deferral status (i.e. contacts with the schools and students, additional inquiries by students and schools). Per estimates provided by the Department of Education, the cost of these customer services would be \$10 per individual in deferral status. While FTEs were not determined, if the production rate for these services were equivalent to those for Taxpayer Services, the FTEs required would range from approximately 1100 in FY98 to 2800 in FY05.

Estimates of the Burden on Employers

Options 1 and 2 assume that employer withholding for the repayment of student loans would be voluntary. Under these options, large businesses or businesses that contract out their payroll operations would be the most likely participants. These businesses would view this as an employee benefit. Therefore, voluntary employer withholding would not be offered by all employers. For these burden estimates, it was assumed that 33% of the employers (approximately 2 million employers) would allow their employees to participate.

It was further assumed that each employer participating would have an average of 3 employees who elect to repay through wage withholding.

Options 3, 4, and 5 do not add any burden to employers. Under these options, student loans would be collected through the tax system. Employers would not know, nor would they be required to know, that employees had student loans. The burden for withholding would fall on the employee through the adjustment to their W-4 (Employee Withholding Form) and the reconciliation of student loan/tax liabilities with the total amount withheld.

Option 6 mandates that employers offer employees the opportunity to repay student loans through withholding. This option affects all employers. All employers would be required to develop the accounting and reporting systems necessary to withhold and report to the Internal Revenue Service. For the following burden estimates, it was assumed that all 6 million employers would be affected and that an average of one employee per employer would elect to repay student loans through wage withholding.

Voluntary Withholding

Data

- Payroll Frequency
 - Biweekly: 36.3%
 - Weekly: 31.5%
 - Bimonthly: 25.2%
 - Monthly: 7.0%
- Monthly fee charged to employers for wage garnishment: \$42.00
- Transaction fee charged to employers: \$2.50 per individual transaction (Noter: the transaction fees vary according to state. The maximum fee allowed is \$5.00 per transaction)

Source: Automated Data Processing, Inc.

Assumptions

- 20 million loans in repayment, 6 million loans being repaid through wage withholding
- 2 million employers participating in the voluntary withholding program
- 3 employees per employer repaying student loans through withholding

Burden Calculations:

- (1) Fixed Burden Estimate (based on the number of employers participating)
 $2M \times \$42.00 \times 12 = \$1,008M$
- (2) Transaction per year (based on the number of employees)
 - Biweekly: $3 \times 2M \times .363 \times 26 = 56.63M$
 - Weekly: $3 \times 2M \times .315 \times 52 = 98.28M$
 - Bimonthly: $3 \times 2M \times .252 \times 24 = 36.29M$
 - Monthly: $3 \times 2M \times .07 \times 12 = 5.04M$

Total Transactions per year: 196 million

- (3) Transaction Burden
 $196\text{M} \times \$2.5 = \490.6M
- (4) Total Burden
 $\$1,008\text{M} + \$490.6\text{M} = \$1,498.6 \text{ million per year}$

Mandatory Withholding (Option 6)

Data:

- Reporting Burden
 - Form 941 Burden (Employer's Quarterly Filing): 4.36 hours per form
 - Form 8109 Burden (Federal Tax Deposit): .04 hours per form
 - Total Reporting Burden: 4.4 hours per form

Source: Internal Revenue Service: Burden Estimation Models used for the Information Collection Budget

Assumptions:

- Recordkeeping burden represents a marginal increase of 1 hour per form over the current level of recordkeeping
- Employers file student loan deposits on average of 18 times per year
- \$10 per hour labor charge for converting hours to dollars
- 20 million loans in repayment, 6 million loans being repaid through wage withholding
- 1 employee repaying through wage withholding per employer

Calculations

- (1) Recordkeeping Burden
 $6\text{M} \times 1 \times 18 = 108\text{M hours}$
- (2) Reporting Burden
 $6\text{M} \times 4.4 \text{ hours} \times 18 = 475.2\text{M hours}$
- (3) Total Burden
 $108\text{M} + 475.2\text{M} = 583.2\text{M hours}$
- (4) Total Burden (\$M)
 $583.2\text{M hours} \times \$10/\text{hour} = \$5,832\text{M}$

Student Loan Feasibility Study
Estimated Student Loan Volumes and
Estimated IRS Costs: Including FFEL Defaults

Using the Current Tax System: Options 3, 4, and 5

Volumes	FY95		FY96		FY97		FY98		FY99	
Total Direct Loans	1,283,000		2,676,000		3,102,000		3,571,000		4,076,000	
Total New Borrowers	1,209,020		1,982,289		1,619,017		1,838,924		2,148,202	
Loans in Repayment	0		0		0		0		0	
Income Contingent	16,816		74,940		190,628		348,261		535,269	
Fixed Payment	117,710		524,578		1,334,396		2,437,824		3,746,885	
Total	134,526		599,518		1,525,024		2,786,085		4,282,154	
Defaults										
Direct Loans	1,042		12,920		54,011		111,240		155,258	
FFEL	995,470		998,713		960,094		913,836		871,962	
Total	996,512		1,011,633		1,014,105		1,025,076		1,027,220	
Costs w/FFEL defaults	\$M	FTE	\$M	FTE	\$M	FTE	\$M	FTE	\$M	FTE
Option 3: Default Collection										
Information Systems	\$16.8	58.0	\$6.6	72.0	\$4.4	43.0	\$1.5	4.0	\$1.5	4.0
Payment processing	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0
Collection	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$241.9	2,797.0	\$249.4	2,800.0
Customer Services	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$13.1	376.0	\$13.3	378.0
Resource Mgmt @ 15%	\$2.5	8.7	\$1.0	10.8	\$0.7	6.5	\$38.5	476.6	\$39.6	477.3
Total - Option 3	\$19.3	66.7	\$7.6	82.8	\$5.1	49.5	\$295.0	3,653.6	\$303.8	3,659.3
Option 4: Income Contingent										
IS Development	\$16.8	58.0	\$6.6	72.0	\$4.4	43.0	\$1.5	4.0	\$1.5	4.0
Payment processing	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$0.1	5.0	\$9.4	6.0
Collection	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$241.9	2,797.0	\$249.4	2,800.0
Customer Services	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$14.8	428.0	\$16.2	472.0
Resource Mgmt @ 15%	\$2.5	8.7	\$1.0	10.8	\$0.7	6.5	\$38.7	485.1	\$41.5	492.3
Total - Option 4	\$19.3	66.7	\$7.6	82.8	\$5.1	49.5	\$297.0	3,719.1	\$318.0	3,774.3
Option 5: All Direct Loans										
IS Development	\$16.8	58.0	\$6.6	72.0	\$4.4	43.0	\$1.5	4.0	\$1.5	4.0
Payment processing	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$19.2	11.0	\$29.3	12.0
Collection	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$241.9	2,797.0	\$249.4	2,800.0
Customer Services	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$27.5	748.0	\$37.9	1,052.0
Resource Mgmt @ 15%	\$2.5	8.7	\$1.0	10.8	\$0.7	6.5	\$43.5	534.0	\$47.7	580.2
Total - Option 5	\$19.3	66.7	\$7.6	82.8	\$5.1	49.5	\$333.6	4,094.0	\$365.8	4,448.2

Student Loan Feasibility Study
Estimated Student Loan Volumes and
Estimated IRS Costs: Without FFEL Defaults

Using the Current Tax System: Options 3, 4, and 5

Volumes	FY95		FY96		FY97		FY98		FY99	
Total Direct Loans	1,283,000		2,676,000		3,102,000		3,571,000		4,076,000	
Total New Borrowers	1,209,020		1,982,289		1,619,017		1,838,924		2,148,202	
Loans in Repayment	0		0		0		0		0	
Income Contingent	16,816		74,940		190,628		348,261		535,269	
Fixed Payment	117,710		524,578		1,334,396		2,437,824		3,746,885	
Total	134,526		599,518		1,525,024		2,786,085		4,282,154	
Defaults										
Direct Loans	1,042		12,920		54,011		111,240		155,258	
FFEL	995,470		998,713		960,094		913,836		871,962	
Total	996,512		1,011,633		1,014,105		1,025,076		1,027,220	
Costs w/o FFEL defaults	\$M	FTE	\$M	FTE	\$M	FTE	\$M	FTE	\$M	FTE
Option 3: Default Collection										
Information Systems	\$16.8	58.0	\$6.6	72.0	\$4.4	43.0	\$1.5	4.0	\$1.5	4.0
Payment processing	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0
Collection	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$1.5	22.0	\$2.2	30.0
Customer Services	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$2.2	53.0	\$2.8	69.0
Resource Mgmt @ 15%	\$2.5	8.7	\$1.0	10.8	\$0.7	6.5	\$0.8	11.9	\$1.0	15.5
Total - Option 3	\$19.3	66.7	\$7.6	82.8	\$5.1	49.5	\$6.0	90.9	\$7.5	118.5
Option 4: Income Contingent										
IS Development	\$16.8	58.0	\$6.6	72.0	\$4.4	43.0	\$1.5	4.0	\$1.5	4.0
Payment processing	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$0.1	5.0	\$0.1	6.0
Collection	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$1.5	22.0	\$2.2	30.0
Customer Services	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$3.7	102.0	\$5.3	173.0
Resource Mgmt @ 15%	\$2.5	8.7	\$1.0	10.8	\$0.7	6.5	\$1.0	20.0	\$1.4	32.0
Total - Option 4	\$19.3	66.7	\$7.6	82.8	\$5.1	49.5	\$7.8	153.0	\$10.5	245.0
Option 5: All Direct Loans										
IS Development	\$16.8	58.0	\$6.6	72.0	\$4.4	43.0	\$1.5	4.0	\$1.5	4.0
Payment processing	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$19.2	11.0	\$29.3	12.0
Collection	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$1.5	22.0	\$2.2	30.0
Customer Services	\$0.0	0.0	\$0.0	0.0	\$0.0	0.0	\$12.4	376.0	\$21.5	662.0
Resource Mgmt @ 15%	\$2.5	8.7	\$1.0	10.8	\$0.7	6.5	\$5.2	62.0	\$8.2	106.2
Total - Option 5	\$19.3	66.7	\$7.6	82.8	\$5.1	49.5	\$39.8	475.0	\$62.7	814.2

Student Loan Feasibility Study

Option 6: IRS Collection and Servicing of Student Loans

Cost Summary

	FY95	FY 96	FY97	FY98	FY99	FY95-FY99 Total	FY05
Labor - FTEs	378	719	987	6,090	6,739		13,007
Labor and Rental- \$M	\$35.5	\$48.1	\$59.8	\$514.5	\$562.6	\$1,220.5	\$887.0
Information Systems	\$114.0	\$16.2	\$16.8	\$17.5	\$18.2	\$182.7	\$23.1
Total	\$149.5	\$64.3	\$76.6	\$532.0	\$580.8	\$1,403.2	\$910.1

Assumptions:

- a) IRS receives legislative authority to service and collect student loans separate from taxes in FY95.
- b) Systems Development, FY95-FY99
- c) Hardware acquired in FY96.
- d) Assumes maximum capacity of 20 million accounts reached by FY2005

Student Loan Feasibility Study

Option 6: IRS Collection and Servicing of Student Loans

Labor Costs - FTEs / \$M

	FY95	FY96	FY97	FY98	FY99	FY05
Function	FTE	FTE	FTE	FTE	FTE	FTE
Returns Processing						
Billing	****	****	0	348	535	2,498
Pipeline	****	****	0	411	628	2,937
Reminder Notices	****	****	0	8	12	54
Default Notices	****	****	0	34	41	93
Accounting	****	****	0	44	67	317
Customer Service	****	****	0	627	723	2,458
Problem Resolution	****	****	0	17	26	120
Chief Counsel / Appeals	****	****	0	714	708	685
Forms and Publications	****	****	2	1	1	1
Information Systems						
Software Development	****	329	329	0	0	0
Software Maintenance	****	****	0	263	263	263
Customer Service Center	****	****	0	110	110	110
Collection	****	****	0	2,928	2,936	1,065
Total -- FTEs	0	329	331	5,506	6,050	10,601
Total Labor Costs -- \$M	\$38.8	\$48.1	\$59.8	\$514.5	\$562.6	\$887.0

Student Loan Feasibility Study

Option 6: IRS Collection and Servicing of Student Loans

Labor Costs - FTEs / \$M

Function	FY95		FY96		FY97		FY98		FY99		FY05	
	FTE	\$M	FTE	\$M	FTE	\$M	FTE	\$M	FTE	\$M	FTE	\$M
Returns Processing	****	****	****	****	****	****	348	\$31.1	535	\$47.9	2,498	\$223.6
Lockbox billing	****	****	****	****	****	****	409	\$9.6	628	\$14.7	2,935	\$68.8
Processing of Returns	****	****	****	****	****	****	44	\$1.0	68	\$1.6	319	\$7.7
Accounting	****	****	****	****	****	****	****	\$40.0	****	\$46.5	****	\$109.4
Deferral Services	****	****	****	****	****	****	****	****	****	****	****	****
Customer Service	****	****	297	\$11.0	593	\$21.9	593	\$21.9	721	\$27.1	3,039	\$112.5
Problem Resolution	****	****	****	****	****	****	17	\$1.2	26	\$1.8	120	\$8.5
Chief Counsel / Appeals	****	****	****	****	****	****	714	\$58.2	708	\$57.7	685	\$55.8
Forms and Publications	****	****	****	****	2	\$0.2	1	\$0.1	1	\$0.1	1	\$0.1
Information Systems	****	****	****	****	****	****	****	****	****	****	****	****
Software Development	329	\$30.9	329	\$30.9	****	****	0	\$0.0	0	\$0.0	0	\$0.0
Software Maintenance	****	****	****	****	263	\$24.7	263	\$24.7	263	\$24.7	263	\$24.7
Customer Service Center	****	****	****	****	****	****	110	\$7.2	110	\$7.2	110	\$7.2
Collection	****	****	****	****	****	****	2,797	\$241.9	2,800	\$249.4	1,340	\$142.5
Resource Mgmt. @ 15%	49	\$4.6	94	\$6.3	129	\$7.0	794	\$65.5	879	\$71.8	1,697	\$114.1
Service Center rental	****	****	****	****	****	\$6.1	****	\$12.1	****	\$12.1	****	\$12.1
Total	378	\$35.5	719	\$48.1	987	\$59.8	6,090	\$514.5	6,739	\$562.6	13,007	\$887.0

Notes:

**** Development: no costs

Student Loan Feasibility Study

Option 6: IRS Collection and Servicing of Student Loans

Information Systems Equipment Costs (\$M)

	FY95	FY96	FY97	FY98	FY99	Total
Processor Complex	\$33.3	\$1.4	\$1.5	\$1.7	\$1.8	\$39.6
Imaging Complex	\$53.8	\$4.1	\$4.5	\$5.0	\$5.5	\$72.9
Network Complex	\$17.0	\$0.7	\$0.7	\$0.8	\$0.9	\$20.1
Telecommunications	\$10.0	\$10.0	\$10.0	\$10.0	\$10.0	\$50.0
Total	\$114.0	\$16.2	\$16.8	\$17.5	\$18.2	\$182.7

Assumptions:

- a) Hardware acquired in FY95, maintenance contracts for FY95-FY99
- b) One processing center: maximum capacity of 20 million loans
- c) Sizing and capabilities based on CDSI Direct Loan Servicing Contract
- d) 7 year life cycle

Student Loan Feasibility Study

Options for IRS Involvement in the Collecting and Servicing of Direct Loans

Exhibit A: Estimated Program Costs for Options 1 through 6

	With FFEL Defaults		Without FFEL Defaults	
	FY98	FY99	FY98	FY99
Option 1				
Education	\$676.1	\$848.2	\$280.7	\$420.8
IRS	\$0.0	\$0.0	\$0.0	\$0.0
Total	\$676.1	\$848.2	\$280.7	\$420.8
Option 2				
Education	\$676.9	\$848.2	\$280.7	\$420.9
IRS	\$0.0	\$0.0	\$0.0	\$0.0
Total	\$676.9	\$848.2	\$280.7	\$420.9
Option 3				
Education	\$318.9	\$491.1	\$269.8	\$398.6
IRS	\$295.0	\$303.8	\$6.0	\$7.4
Total	\$613.9	\$794.9	\$275.8	\$406.0
Option 4				
Education	\$306.6	\$470.1	\$257.5	\$377.6
IRS	\$297.0	\$318.0	\$7.8	\$10.5
Total	\$603.6	\$788.1	\$265.3	\$388.1
Option 5				
Education	\$235.4	\$349.3	\$186.4	\$256.8
IRS	\$333.6	\$365.8	\$39.8	\$62.7
Total	\$569.0	\$715.1	\$226.2	\$319.5
Option 6				
Education	\$49.0	\$92.5	\$0.0	\$0.0
IRS	\$532.0	\$580.8	\$266.3	\$313.5
Total	\$581.0	\$673.3	\$266.3	\$313.5

Notes:

- a) Options 1 and 2 work within existing resources
- b) Options 3, 4, and 5 use the existing tax system
- c) Option 6 requires IRS to develop a withholding system separate from the tax system

Student Loan Feasibility Study***Options for IRS Involvement in the Collecting and Servicing of Direct Loans*****Exhibit B: Estimated IRS Full-Time Equivalents**

	With FFEL Defaults		Without FFEL Defaults	
	FY98	FY99	FY98	FY99
Option 1	0	0	0	0
Option 2	0	0	0	0
Option 3	3,649	3,655	86	114
Option 4	3,715	3,770	148	228
Option 5	4,089	4,444	470	810
Option 6	6,090	6,739	2,851	3,514

Notes:

- a) Options 1 and 2 work within existing resources
- b) Options 3, 4, and 5 use the existing tax system
- c) Option 6 requires IRS to develop a withholding system separate from the tax system

Exhibit A

Student Loan Feasibility Study**Options for IRS Involvement in the Collecting and Servicing of Direct Loans****Exhibit A: Estimated Program Costs for Options 1 through 6**

	With FFEL Defaults		Without FFEL Defaults	
	FY98	FY99	FY98	FY99
Option 1				
Education	\$676.1	\$848.2	\$280.7	\$420.8
IRS	\$0.0	\$0.0	\$0.0	\$0.0
Total	\$676.1	\$848.2	\$280.7	\$420.8
Option 2				
Education	\$676.9	\$848.2	\$280.7	\$420.9
IRS	\$0.0	\$0.0	\$0.0	\$0.0
Total	\$676.9	\$848.2	\$280.7	\$420.9
Option 3				
Education	\$318.9	\$491.1	\$269.8	\$398.6
IRS	\$295.0	\$303.8	\$6.0	\$7.4
Total	\$613.9	\$794.9	\$275.8	\$406.0
Option 4				
Education	\$306.6	\$470.1	\$257.5	\$377.6
IRS	\$297.0	\$318.0	\$7.8	\$10.5
Total	\$603.6	\$788.1	\$265.3	\$388.1
Option 5				
Education	\$235.4	\$349.3	\$186.4	\$256.8
IRS	\$333.6	\$365.8	\$39.8	\$62.7
Total	\$569.0	\$715.1	\$226.2	\$319.5
Option 6				
Education	\$49.0	\$92.5	\$0.0	\$0.0
IRS	\$532.0	\$580.8	\$266.3	\$313.5
Total	\$581.0	\$673.3	\$266.3	\$313.5

Notes:

- a) Options 1 and 2 work within existing resources
- b) Options 3, 4, and 5 use the existing tax system
- c) Option 6 requires IRS to develop a withholding system separate from the tax system

Exhibit B

Student Loan Feasibility Study

Options for IRS Involvement in the Collecting and Servicing of Direct Loans

Exhibit B: Estimated IRS Full-Time Equivalents

	With FFEL Defaults		Without FFEL Defaults	
	FY98	FY99	FY98	FY99
Option 1	0	0	0	0
Option 2	0	0	0	0
Option 3	3,649	3,655	86	114
Option 4	3,715	3,770	148	228
Option 5	4,089	4,444	470	810
Option 6	6,090	6,739	2,851	3,514

Notes:

- a) Options 1 and 2 work within existing resources
- b) Options 3, 4, and 5 use the existing tax system
- c) Option 6 requires IRS to develop a withholding system separate from the tax system