Student Loan Debt and Default: Don't Sacrifice Your Credit

Earning a college degree used to be the default route to a secure future. However, the financial crisis of the last five years has thrown a wrench into the works. Parents have found themselves unable to assist with tuition, cuts in state funding mean fewer grants and scholarships available, and students are turning to government-backed student loans to finance tuition and make ends meet.

New graduates are also discovering jobs are scarce. As a result, student loan debt and default are at historic highs. The average college student who graduated in 2011 had $26,600 in student loans, according to the Institute for College Access and Success.

There are many factors that have caused this high student loan debt and default scenario. Students and their parents need to understand the ramifications of defaulting on a student loan. In addition, parents need to think carefully about co-signing for a student loan and what that could mean to their own financial future.

Should You Co-Sign?

Your child has admirable goals: to attend a four-year college. However, your child also wants you to co-sign for their student loan. How do you say no to that? Before you say yes or no, you need to educate yourself. If your son or daughter ultimately can't keep up with their loan payments, their loan will become your loan. If you can't afford to make the payments, your credit report is going to take the hit.

Only private student loans, such as those through a financial institution, can require co-signers. Federal student loans – 93 percent of student loans are now issued by the government – do not require co-signers. These government-backed student loans typically offer lower interest rates and more flexible repayment plans. Investigate all of your options available before co-signing anything.

Defaulting on a Student Loan

If you or your child does default on a student loan, the government isn't just going to let either of you walk away. There are many steps they can take to recoup their losses:

• Tax Refund Offsets: The IRS can hold onto any income tax refund you may be entitled to until your student loans are paid in full.

• Garnishment of Wages: The government can garnish (take) a limited portion of the wages of a student loan debtor who is in default. It can take up to 15 percent of your disposable income. However, it cannot take more than the equivalent of 30 times the current federal minimum wage.

• Your Federal Benefits The government can take some federal benefit payments (including Social Security retirement benefits and Social Security disability benefits, but not Supplemental Security Income) as reimbursement for student loans. The government cannot take any amount that would leave you with benefits less than $9,000 per year or $750 per month. And, it cannot take more than 15 percent of your total benefit.

• Legal Action The government and private lenders can sue you to collect defaulted student loans. Unlike other debts, there is no time limit on suing to collect student loans – you can be sued indefinitely.

In the Event of Bankruptcy

If you're having trouble repaying your loan, the first thing you should do is contact your student loan lenders to see if you can arrange an easier repayment plan.

If you're having serious trouble paying back your debt, bankruptcy isn't going to be an easy alternative. Unlike credit card debt or automobile loans, student loans are virtually impossible to discharge in bankruptcy, even after declaring bankruptcy. Unless you can show that your education loan payment is an "undue hardship" on you, your family, and your dependents, your student loans are ineligible for cancellation (discharge) in bankruptcy. It is difficult to prove "undue hardship" unless you are physically unable to work and there is no chance of your making money. To discharge your student loans under this special case, you must file a separate motion with the bankruptcy court and present your situation before a judge.

If your student loans are the largest part of your debt, you are better off not filing for bankruptcy because courts are very reluctant to discharge student loans.

Dollars & $ense is a regular column on personal finance prepared and distributed by certified public accountants from the Oregon Society of CPAs (www.orcpa.org). For more money tips from CPAs, read the Oregon Saves blog at oregonsaves.orcpa.org

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How Did the Fiscal Cliff Deal Affect Your Taxes?

Remember all the talk about the impending fiscal cliff a couple of months ago? The fiscal cliff problems involved a list of expiring tax issues and congressionally mandated spending cuts. The expiring tax issues, at least, were mostly addressed in a new law, the American Taxpayer Relief Act of 2012, which made a number of changes in existing tax rules, while also maintaining some important rules that have an impact on many taxpayers. The Oregon Society of CPAs offers a rundown of what you need to know about the new rules this year.

As of January 1, you may have noticed a slight drop in your take-home pay. That's due to the expiration of an existing two-percentage-point cut in the employees' portion of the Social Security payroll tax, returning it to 6.2 percent on income up to $113,700 in 2013. A couple with each spouse earning $50,000 will see their total taxes go up $2,000 a year as a result. In addition, some taxpayers may also be paying a new .9 percent Medicare surtax on income in excess of $250,000.

Most Americans' tax rates remain the same under the law for 2012, but, beginning in 2013, there is now a new 39.6 percent rate for many high-income individuals, as well as a higher rate on capital gains and dividends, plus a new 3.8 percent addition to income tax rates on Net Investment Income. In addition, the phase-out levels for personal exemptions and itemized deductions have gone up for some higher-income taxpayers.

Many middle income taxpayers have increasingly been threatened by the alternative minimum tax—or AMT—an alternate tax that was actually created to prevent high income individuals from avoiding taxes. The problem was that the AMT threshold was never adjusted for inflation, even as inflation pushed more middle income people into its range. Congress has generally passed last-minute patches addressing the problem every year, but the new law permanently indexes the AMT to inflation.

The new law brought at least some temporary stability to estate and gift taxes, but long-term planning is still necessary. Under the law, the estate and gift tax exclusion remains at an inflation-adjusted $5 million indexed for inflation ($5.12 million in 2012 and $5.25 million this year). The top tax rate was raised to 40 percent from 35 percent as of January 1, 2013. However, those rules are set to expire at the end of this year.

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