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From the desk of…

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An Early Look at Recently Enacted Changes to the Tax Code and How They May Impact Financial Aid

Congress passed and the President signed a reconciliation bill on July 4, 2025, which, as you know, made significant changes to student and parent borrowing and repayment, and technical changes to need analysis and Pell Grant eligibility. Less discussed among financial aid administrators (FAAs), but certainly impactful, are changes to the income tax code that are effective this calendar year (2025), which is the base year for the 2027-2028 academic year. Given all that is on every FAA's plate right now, you might think it's about a year too early to look at these tax changes. But these changes may impact the way you consider professional judgments (PJs) based on reduced income in 2025-2026 and 2026-2027, so please read on.

In situations where an applicant or contributor has less income in a post-base year than in the base year (for example, for 2025-2026 or 2026-2027, which use 2023 or 2024 as the base years respectively), many FAAs will use more current tax returns (i.e. 2025) as documentation of changes to the contributor's income. In such cases, these changes may require us to think a bit differently than in the past.

Please note that this discussion is taking place before any 2025 draft tax forms have been released that incorporate these changes, and some of the details of this analysis may not pan out as I expect. Still, as I have in the past, I will include these changes in the "What's Changed" section of each of my upcoming webinars and in-person trainings and conference session and will follow up with LinkedIn posts as well.

The two tax breaks that I am most concerned about from an aid processing point of view are the tax deduction for overtime work and the tax deduction for cash tips (though the tax deduction for car loan interest may have the same impacts). I discuss each of these toward the end of this document. Each of these is a "above-the-line" deduction. Above-the-line deductions usually appear as adjustments on page 2 of Schedule 1 and reduce a taxpayer's Adjusted Gross Income (AGI). To get an idea of how this works, take a look at the IRA deduction, which is a FAFSA item, and note how it is subtracted from the taxpayer's total income, reducing the AGI. Since these new deductions are likely to reduce a taxpayer's AGI as well, taxpayers who claim them in 2025 will have lower AGIs than they did in 2024 or 2023, all other things being equal.[1]

This means that if your institution's practice is to use post-base year income for your income adjustment PJs, and you don't make any changes to your approach, you will not only be removing income from the calculation that is specific to the reason for the appeal, but also the income protected from taxation by these new deductions. Let's look at an idealized example to help me make my point.

Let's consider a situation where an applicant has submitted a 2026-2027 FAFSA, which collects 2024 tax information, and has submitted a formal request for an adjustment based on one-time income. They have asked you to remove a $30,000 taxable IRA distribution from their income. They have provided documentation that shows that the $30,000 was withdrawn to cover repairs to the foundation of their house, and this documentation shows that this repair was required by their town's building inspector and could not be postponed. You have asked the contributor to send you their 2025 income tax return so you can confirm that they did not withdraw funds from the IRA in 2025 as well (your professional judgment policy limits PJs based on one-time income increases to one adjustment per event[2]). You have decided that this request, in this specific case, warrants a PJ, and is adequately documented.

Let's say that they filed a 2024 tax return using the married filing jointly status, and tax return shows these (idealized) data:

Wages (both taxpayers)	$70,000
Taxable IRA distribution	$30,000
Adjusted Gross Income	**$100,000**.

You ask them for their 2025 tax return, per your institution's approach to income adjustment PJs, and the return shows this data (again, this is an idealized case to drive the point of this issue home):

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[1] Because FAFSA Simplification Act specifies the tax items that are treated as untaxed income in the SAI formula, and the overtime and tip deduction were not part of the tax code when the Act was enacted, these new deductions will not count as untaxed income in the SAI formula unless new legislation including them is enacted.

[2] For simplicity's sake, I have used an example of a one-time income event. Many schools I work with and many FAAs I've talked to have policies that they will only do an income adjustment professional judgment once and often cite language in the *Application and Verification Guide* to suggest that Federal Student Aid imposed this limit. I do not agree with this interpretation and am not suggesting, in my example, that the professional judgment would be unwarranted had an IRA withdrawal been reported in the 2025 tax return.

Wages (both taxpayers)	$70,000
Taxable IRS distribution	$0
Tips deduction	($15,000)
Overtime deduction	($10,000)
Adjusted Gross Income	**$45,000**.

From the professional judgment standpoint, the goal is to remove the IRA deduction from the SAI income to get to a total income of $70,000.00, eliminating the income impact of the one-time IRA distribution. But since the AGI is reduced in 2025 by these new deductions, the 2025 AGI is lower than that anticipated figure.

You'll want to review the professional judgment section of your Policies and Procedures Manual to make sure your policy does not lock you into using the 2025 AGI and gives you the flexibility to include these deductions in the income that is assessed when using 2025 income in 2025-2026 or 2026-2027 PJs. You'd include it in the AGI, as was done in 2023 and 2024; it would not make sense to add it to one of the untaxed income fields.

Now, I acknowledge that without additional legislation, when 2027-2028 comes around, the real AGI, which has been reduced by these new deductions, will drive both the SAI calculation and Pell Grant eligibility. This means that in the absence of a change to the Higher Education Act that allows for the collection of these deductions as untaxed income, SAIs will be lower and Pell eligibility may be higher when contributors claim these deductions. But in my opinion, that should not apply in 2025-2026 or 2026-2027. All tip and overtime income are included in the AGI in 2023 and 2024, and we should be creating an alternative PJ AGI based on the base year's tax code rules, not future rules, when determining eligibility for financial aid.

Let's leave professional judgment for now and look at these changes to the tax code more specifically.

The **Limited Tax Deduction for Overtime Pay** is in effect for tax years 2025 to 2028, so people who are earning overtime in these years may be able to deduct all or a portion of it on their 2025 to 2028 tax returns. The deduction is retroactive to January 1, 2025, so overtime pay earned in 2025 before the deduction was enacted is eligible for the deduction. The deduction is capped at $12,500 ($25,000 for joint filers) of the taxpayer's overtime pay. This deduction begins to phase out at a modified Adjusted Gross Income (mAGI) of $150,000 ($300,000 for joint filers), at a rate of $100 for each $1,000 of income above these mAGI levels.

The definition of overtime is based on Section 7 of the Fair Labor Standards Act of 1938, which means people cannot redefine their pay to include overtime if their employers are not required to pay them for overtime based on this Act. Only the portion of the overtime pay that exceeds the employee's base earnings rate is eligible for the deduction (for example, if a worker earns $25.00 per hour for the first 40 hours of work in a week, and $37.50 an hour for work after the 40th hour, only the $12.50 per hour increase is eligible for the deduction).

In order for the overtime to be deductible, employers must report the deduction eligible pay to the employee as qualified overtime on their W-2, which means that if we needed to know that a contributor had overtime pay, their W-2 will tell us. In addition, the deduction is not available to taxpayers who use the married-filing-separately status[3].

Overtime income, even if deducted for income tax purposes, remains subject to social security and Medicare taxation, and state income taxation in most cases.

The **Limited Tax Deduction for Cash Tips** is also in effect from 2025 to 2028. During these tax years, workers whose compensation includes tips may be able to deduct up to $25,000 of their tips as an above-the-line deduction. The deduction is retroactive to January 1, 2025, so tips earned in 2025 before the deduction was enacted are eligible for the deduction. This tips deduction, like the overtime pay deduction, begins to phase out at an mAGI of $150,000 ($300,000 for joint filers), at a rate of $100 for each $1,000 of income above these mAGI levels, and is not available to married taxpayers who use the married filing separately filing status (see footnote 3).

Unlike the overtime deduction, the tips deduction applies not only to employees, but also self-employed workers, and will apply to gig workers (i.e., Uber/Lyft drivers, DoorDash and other delivery people, etc.) and others who file a Schedule C, partners, and others reporting tips who did not receive them as wages.

Taxpayers may deduct only "cash tips received by an individual in an occupation which customarily and regularly received tips on or before December 31, 2024, as provided by the Secretary". The Secretary of Labor is required to compile a list of "occupations traditionally receiving tips" by October 2, 2025 – only tips paid to workers in these occupations will be eligible for the tips deduction.

[3] This is my interpretation of this clause in the "No Tax on Overtime" section of the Act: "Married Individuals.--If the taxpayer is a married individual (within the meaning of section 7703), this section shall apply only if the taxpayer and the taxpayer's spouse file a joint return for the taxable year."

The law states that cash tips “includes tips received from customers that are paid in cash or charged, and, in the case of an employee, tips received under any tip-sharing arrangement.” There has been a lot of discussion about the term “cash tips”, and many online pundits have incorrectly posited that this change to the tax code will have minimal impact because either most workers were not reporting cash tips on their tax return anyway, so they weren’t being assessed anyway, or because most payments are made electronically and few people receive a lot of cash tips. This is a misread of the law. The IRS has always considered “cash tips” to include cash tips, tips from credit or debit card transactions, and tips received indirectly through a tip pool. The only tips that are considered non-cash tips (and are ineligible for the new tip deduction) are non-currency-based items of value like tickets, passes, or services.

Tip income, even if deducted for income tax purposes, remains subject to employment taxes (social security and Medicare, or self-employment taxes, as relevant), and in most cases, will be subject to state income taxation.

Deduction for Car Loan Interest: I don’t think we will see many people claiming this deduction, but since it appears to be an above-the-line deduction that might reduce the taxpayer’s AGI, I am including it with the tips deduction and overtime deduction in this discussion. Interest on car loans taken out on cars purchased in 2025 to 2028 will be tax deductible if, among other things, the final assembly of the car took place in the United States. Up to $10,000.00 of such interest is deductible. This is an above-the-line deduction (similar to the IRA deduction, tip deduction, and overtime deduction) and is subject to an AGI based phaseout starting at $100,000 ($200,000 for joint filers).

The Impact on the Student Aid Index (SAI) and Maximum and Minimum Pell Grant Eligibility Starting in 2027-2028.

I mentioned this before, but in case you are skipping around this article looking for specific information, I’ll state it again here. Both the Overtime Deduction and the Tip Deduction (and possibly the car interest deduction) are above-the-line deductions, which means they will reduce the taxpayer’s Adjusted Gross Income (AGI). Barring any future changes to the SAI formula and Pell Grant eligibility rules, students with contributors to the 2027-2028 FAFSA who claim these deductions on their 2025 tax returns may have lower SAIs and a greater likelihood of receiving Maximum Pell or Minimum Pell Grant eligibility based on the poverty guidelines than they would have had in earlier years, because their AGI will be lower than it would have been had the overtime or tips not been deductible. Since the FAFSA Simplification Act defines the income that the Department of Education can ask about, treating the deduction tips and overtime pay as untaxed income would require, as they say, an Act of Congress.

A Note about the Charitable Contribution for Non-itemizers: Starting in tax year 2026 (not 2025), taxpayers who do not itemize their deductions will be allowed to deduct up to $1,000.00 ($2,000.00 for joint filers) of their total charitable contributions “below the line”, which means the deduction will reduce their taxable income, but not their AGI. This is really just a restoration of the COVID era charitable contribution deduction of $300.00 ($600.00 for joint filers in the second year). This deduction does not phase out at higher incomes and does not expire – it is a permanent feature of the tax code unless repealed or changed by legislation.

There are other changes to the tax code, but I am not mentioning them here as they should not have an impact on the processing of Title IV aid. I’ll cover changes to the individual and business tax codes that may impact institutional aid reviews in my Business and Real Estate Tax Returns webinars and in-person trainings this fall.

Again, there is a bit of speculation here and as soon as the IRS issues regulations and filing instructions, some of this speculation may prove to be inaccurate. However, given the change to the tax code, reviewing your institution’s professional judgment policies and procedures, in case they are not compatible with the tax code changes, would be a good practice.

Have you come to a different conclusion than I have about how the changes to the tax code may impact financial aid? As always, please let me know by emailing me at robert@ironbridgeresources.com, or, if you are reading this through LinkedIn, in the comments section below.