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*From the desk of...*

**Robert Weirnerman | Director of Training**

## **GEN-24-29, GENERAL-24-34, and You, or *The Loss of FAFSA Data Integrity***

You don't need me to join the chorus of financial aid administrators (FAAs) who are outraged by the Department of Education's (ED's) launch of the 2024-2025 FAFSA. I'm outraged too. But what I want to do here is try to interpret their confusing April 1<sup>st</sup> [Announcement](#) and their frustrating April 4<sup>th</sup> [Announcement](#) to help FAAs figure out what is going on.

Note that I have no more information from the Department than you do. I've read the April 1<sup>st</sup> Announcement many times and watched the April 3<sup>rd</sup> webinar on the topic. The Department has not answered a single question I've submitted through the various portals since early in the Summer of 2023, so I don't have any secret back doorway to get information.

Let's start with a question that strikes me as a core issue here:

### **What Happened and How Has ED Addressed It?**

On April 1<sup>st</sup>, ED announced that it has identified three issues with tax data in the 24-25 ISIRs.

- 1) The FA-DDX was bringing in incorrect values for the education credits. ED did not disclose in what manner the data were incorrect.

“Solution”: This has been corrected for ISIRs processed on and after March 30, 2024. Note though that a different problem with education credits is identified for people who completed the FAFSA manually. See item 3 (below). I do not know if the two issues are related, but I do not think that they are.

- 2) If a taxpayer amended their tax return or if the IRS made a change to a taxpayer's return after processing the original filing, the FA-DDX was bringing in only the AGI and the filing status from the changed return. All other data were from the original return.

“Solution”: The IRS will be updating the FA-DDX to bring in the original tax data (as the IRS DRT did in past years) and FAAs will have to collect 1040-Xs or other documentation to manually correct ISIRs if they learn that a contributor to the FAFSA amended their tax return. This means that promised verification savings related to applicants and contributors who amended their tax returns will not be realized.

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3) The FAFSA instructions for “Income Tax for 2022” and “Education Credits” refer to different tax lines than the FA-DDX used to push these items into the FAFSA. The FA-DDX is bringing in Form 1040, line 24, while the FAFSA asks for Form 1040, line 22 minus Schedule 2, line 2. The FA-DDX is also bringing in the total education credit reported on the tax return (Schedule 3, line 3 plus Form 1040, line 29, which it is pulling from Schedule 8863, lines 8 and 19), instead of just the non-refundable portion of the credits (Schedule 3, line 3), which is asked for on the FAFSA. Anyone manually entering tax data into the ISIR was using different lines from the FA-DDX.

“Solution”: the FAFSA and other publications will be updated to reflect the values the FA-DDX has been using, instead of the values ED assumed it was using.

### **Wait, What? FAFSA Tax Item Definitions are Changing? In April?**

It appears so. The language that ED uses in the announcement for item 3 (above) is:

...[t]he third identified inconsistency has to do with **inaccurate instructions on the FAFSA form** [highlighting is the author’s].

After years of using specific lines from the tax forms in the FAFSA, that were carefully considered based on how data are used in the formula, ED has decided that rather than ask the IRS to update the FA-DDX so that the data brought into the FAFSA by the FA-DDX made sense, they are changing the data definitions to fit the FA-DDX. See below for more commentary on this.

It appears that rather than correct the FA-DDX to bring in the values for Education Credits and Income Tax for 2022 that we are familiar with, ED has decided that the old values are wrong, and the FAFSA instructions were “inaccurate”. It appears that we will be using:

- Form 1040, line 24 for “Income Tax for 2022”
- Form 8863, line 8 plus Form 8863, line 19 for Education Credits.

I keep hoping for some clarification or a direct statement about ED’s intention here. But the language is pretty compelling – they have stated clearly that ***inaccurate instructions on the FAFSA form*** are responsible for the errors in the Education Credits and Income Tax Paid fields.

### **ISIR Reprocessing**

ED had initially proposed reprocessing ISIRs only if the student would benefit from it – and leaving the incorrect information in the ISIRs of other students. ED received a lot of push back from Institutions (and, perhaps, Congress) and announced on April 4 that all incorrect ISIRs would be reprocessed. They state, though, that “Schools and states will still have the ability to use their judgment to rely on the original ISIR sent—not the reprocessed record—if the original ISIR results in greater financial aid eligibility for students.”

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## **How Did the Issue with the Manual Tax Information Happen?**

It's hard to fathom how these errors could have been missed by ED for so long, but it's not hard to understand how it happened. My guess is that ED specked out the data needed for the FUTURE Act Direct Data Exchange (FA-DDX) using words, instead of tax line numbers, and the IRS responded with their interpretations of those words. The IRS is not concerned with only the amount of income tax an individual owes for the year; they are concerned with all the taxes an individual owes for the year. So, if ED asked for "taxes paid" or something similar, the IRS would naturally reply with Form 1040, line 24 (which includes all taxes owed) instead of Form 1040, line 22, which is just the income tax. Similarly, if ED asked for "education credits" instead of Schedule 3, line 3, of course the IRS would reply with the entire education credit, which is a combination of the non-refundable education credit (Schedule 3, line 3) and the refundable credit (Form 1040, line 29). These are calculated on Form 8863, lines 8 and 19. The IRS polices the education credits very carefully and is concerned about both parts of the education credit, not just the non-refundable portion.

## **Why Didn't ED Catch These Issues Earlier?**

Hard to say, but remember, FAAs identified these issues almost immediately after receiving their first set of ISIRs.

## **What Does the Change to the FA-DDX's Treatment of Amended Returns Mean for FAAs?**

The IRS will be updating the FA-DDX so that all tax data *from original tax returns as processed* will be imported into the FAFSA. If a FAA becomes aware that a contributor to a FAFSA amended their return, then the application must be reviewed for conflicting information. Luckily, the FAFSA will not contain an indicator (like the old IRS Request Flag 07 that the IRS DRT used) that the tax return was amended, so FAAs will only need to address amended tax returns if they learn that the return was changed from the applicant or a contributor.

ED has never really understood how the IRS processes amended tax returns and its guidance on them has always been incomplete and incorrect. If you participated in any of my Verification training sessions this year, you may have heard me state that "The Department thinks the FA-DDX will bring in data from the amended tax returns, but they are wrong. It won't." Form 1040-X does not include all data that goes into the FAFSA, and the IRS has never been able to produce a transcript that includes anything from the amended tax return except for AGI, exemptions, filing status, and total tax (Form 1040, line 24). Of course, they couldn't extract a full set of FAFSA data from an amended or changed return. If they can't put an item on a transcript, they can't put it anywhere else.

## **How will the Change in the Definition of "Income Tax Paid" Impact Applicants?**

The move from Form 1040, line 22 minus Schedule 2, line 2 to Form 1040, line 24 will decrease the SAI for three sets of students:

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- 1) Those who underestimated their incomes when they applied for Affordable Care Act Health Insurance subsidies and had to repay a portion of the subsidy due to having higher income (when we subtract Schedule 2, line 2 from Form 1040, line 22, we are removing this repayment from the formula). It will remain in the formula if we move solely to Form 1040, line 24.
  - 2) Those with contributors who own businesses and pay self-employment taxes, face penalties for early withdrawals from IRAs and pensions, or owe various other taxes unrelated to the income tax. For those who pay self-employment tax, they will get an effective allowance for their self-employment tax in the formula that is *three times larger* than a wage earner gets for their payroll tax deduction.
  - 3) People who earn their income as partners in a partnership. The 2024-2025 definition of income earned from work excluded “Schedule K-1, Form 1040, Box 14, Code A”, which is a partner’s self-employment income. So, a partner’s earned income is no longer reported on the FAFSA and does not get included when the earned income-based allowances are calculated. The move from line 22 to line 24 will give partners a deduction for their self-employment tax – that is two times larger than it would have been had they been employees.

I am often asked why we (used to) use Form 1040, line 22 and not Form 1040, line 24. The answer (used to be) that most of the tax we see on line 24 that is not also on line 22 is self-employment tax, and we make an allowance for self-employment tax based on the contributor’s income earned from work. The allowance was often bigger than the actual self-employment tax, because the income earned from work definition (used to) include a rule that negative values for any component of the income earned from work question be treated as 0 when determining the value of income earned from work. The move to line 24 *triple counts self-employment tax* for Schedule C business owners and Schedule F farmers and will provide an inequitable benefit to applicants who have self-employed contributors.

### **What is the Impact of the Change in the Definition of the “Education Credits”?**

The Higher Education Act contained a provision that prohibited the receipt of education credits, need-based financial aid, etc. from impacting a student’s eligibility for Title IV aid. The need analysis included a way to make sure that a student would receive the same amount of aid whether or not they received these items. For example, if the student received taxable grants or scholarships (which would be included in their AGI), we subtract them from their income so that a student with taxable scholarships will receive the same amount of aid they would have if they had not received the taxable scholarships.

Similarly, since receiving an education credit can reduce the amount of income tax a taxpayer owes, and we subtract the income tax from total income in the need analysis, we also must subtract any portion of the education credit that reduced the tax.

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For example, if a taxpayer would owe \$5,000 in income tax without an education credit, we'd subtract \$5,000 from their income in the need analysis. If instead, they received a \$2,500 American Opportunity Tax Credit (AOTC), of which \$1,500 is a non-refundable credit that reduces the income tax only (Form 1040, line 22) and \$1,000 is a refundable credit that does not reduce Form 1040, line 22, then their Form 1040, line 22 would be \$3,500 (\$5,000 total tax minus \$1,500 non-refundable AOTC). To make sure that the student with an education credit received the same amount of aid as a student who did not receive a credit, we must subtract both Form 1040, line 22 (\$3,500) plus the education credit (Schedule 3, line 3, or \$1,500) for a total of \$5,000.

The change in the definition of Education Credit from Schedule 3, line 3 to Form 8863, lines 8 and 19 means that many students will be getting a larger credit in the need analysis than before, bringing their SAIs down. This is a net positive change for many students with education credits.

Note: Honestly, I am not sure if the Higher Education Act still contains the provision I mentioned above. Form 8863, line 8 does not reduce the taxpayer's Form 1040, line 22 (or line 24), so it has no impact on the EFC or SAI calculation. But bringing it into the formula, a student receiving a refundable education credit may show a different amount of Title IV aid eligibility than a student without it. This would violate the prohibition of education credits impacting a student's Title IV aid.

### **What Does the Mean for Program Integrity?**

Financial aid administrators spend an enormous amount of time making sure that students are awarded all the financial aid they are eligible for, and not more or less. They are required to verify the FAFSA data of large numbers of students. They are required to tell a parent who is married to an undocumented spouse who use the head of household filing status that their child's FAFSA cannot be processed until they amend their return and use a married status. They are required to hold off on processing a FAFSA if a contributor earned certain amounts of income but did not file a tax return. It does not matter whether the corrected information will increase or decrease the applicant's aid eligibility. Program integrity requires that a school can only disburse aid to a student if the data in the student's application is correct.

But this appears to apply only to institutions. It's hard to believe that with all the work ED expects schools to do to protect the integrity of the Title IV programs, ED can come out with a policy to only correct data if the correction will afford the student more aid, or later, to correct all ISIRs, but encourage schools to use the ISIR that provides the student with the most aid, even if the data is known to be incorrect.

### **There's an Equity Issue Here, and It Impacts Low Income Students the Most**

As mentioned above, ED is giving schools the option to use an ISIR with incorrect data if the student will receive more financial aid than if they use the ISIR with accurate data. Not only does this undermine ED's goal of maintaining confidence and integrity in its programs, it is inequitable.

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The amended tax return issue has been resolved. The other issues will soon be resolved. And so, at some point, FAFSAs will be processed with the newly defined correct information and schools will have one ISIR to use. At that point, any applicant who might have gotten more financial aid if their ISIR has been processed before the issues were resolved will be ineligible for this increase in aid.

**This means that applicants who were able to submit their application before the IRS updated the FA-DDX or ED changed the instructions in the FAFSA may get more financial aid than people who submitted their application later.** I might not be concerned about this if the issue were simply a matter of timing, but it's not just a matter of timing. Remember, 20% of ISIRs are sitting out there rejected – and there is no way for the student to correct the issue and have the FAFSA processed at this time. Remember, students with contributors who do not have social security numbers are unlikely to have had their FAFSAs processed early. Students who were lucky enough to get into the FAFSA on December 30th and were prepared to complete the FAFSA on that date may not have been functionally able to complete their application as of today if one of their parents did not have a social security number. It is ED's fault that these students' FAFSA will be processed months later than the students intended.

ED stated in the announcement that 10% of current applicants have one of these errors and the error produced an SAI lower than it should be, but that schools can use this incorrect ISIR to package aid. Also consider that this 10% does not include students who reported assets that were not assessed in the original calculations – so a significantly larger percentage of applicants than 10% may get more aid than they should have had the FAFSA worked properly from the beginning.

If FAFSA patterns remain constant through the processing cycle, then significantly more than 10% of future applicants will miss out on the opportunity to get more financial aid, solely because of ED's inability to process their applications in a timely manner. I find this shocking. Shouldn't FAAs be given the opportunity to use professional judgment to force SAI calculations for students who were unable to complete the application before mid-April that are based on the old, incorrect datasets? Shouldn't all students have equal access to the same SAI calculation as other students? Wouldn't that be equitable, and how professional judgment should be used?

### **Is this the End? Will there be More Errors Identified, ISIRs Reprocessed, Nonsense?**

I am not surprised that ED changed its mind and decided to reprocess all ISIRs, not just those that benefited the student. To do otherwise would be to bring the integrity of the entire Title IV aid program into jeopardy, it just didn't make sense. And I won't be surprised if we learn that there are other ISIR issues and other changes still to be found.

### **Questions, Comments, Thoughts, Errors?**

Please let me know!