Exploring Ways to Enhance FAFSA Efficiency:

Applying for Student Aid: Can Federal Tax Returns Take the Place of the FAFSA?

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NASFAA
NATIONAL ASSOCIATION OF STUDENT FINANCIAL AID ADMINISTRATORS

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Overview

The idea of relying on information from the Internal Revenue Service (IRS) instead of requiring federal financial aid applicants to provide detailed financial information on the Free Application for Federal Student Aid (FAFSA) has long been central to proposals for simplifying the student aid system. The need for simplification is clear. The complicated financial aid application process presents a significant barrier to some would-be college students. Many students choose not to apply for aid even if they would qualify for assistance. And often, students who do not apply for aid ultimately choose not to attend college. This deterrent effect is especially acute for students from lower-income families, Black and Latino students and for potential students who would be the first generation of a family to attend college.[1]

Implementation of the Data Retrieval Tool (DRT) in 2009-10, allowing applicants to transfer some information from their tax forms to the FAFSA, was a major step toward simplifying the financial aid process using the tax system. However, concerns remain about the adequacy of tax data for allocating need-based student aid. Moreover, the changes to tax forms brought about by the 2017 Tax Cut and Jobs Act (TCJA) may raise new questions about the feasibility of this strategy. This paper summarizes some of the proposals for using tax information in the financial aid system and examines both the potential contributions and likely hurdles that such a transition would involve, including the problems that would arise from eliminating all information not included on tax forms. An important premise for the discussion is that it should be feasible to make distinctions between determining eligibility for Federal Pell Grants and measuring ability to pay for students from more affluent families applying for other forms of aid.

This discussion considers challenges posed by recent changes to the federal tax system, changes that must be made to the current need analysis system if IRS data are to play a larger role, and factors that would create an ongoing need for additional data to ensure an equitable distribution of aid. We conclude that information from federal tax forms or certification of not being required to file income taxes would be sufficient for awarding Pell Grants. However, for students whose families are too affluent to qualify for Pell, calculating ability to pay in a way that would facilitate an equitable allocation of institutional and state aid would still require more detailed financial information. These concerns are most acute for students who are still dependent on their parents for support. If the FAFSA were eliminated, aid applicants would likely, at a minimum, have to submit a simple form with information about their household structures, but we would also propose requiring more information on the composition and size of assets for applicants whose tax returns indicate significant assets.

[1] Steven Bahr, Dinah Sparks, and Kathleen Mulvaney Hoyer, "Why Didn't Students Complete a Free Application for Federal Student Aid (FAFSA)? A Detailed Look," (National Center for Education Statistics, 2019): https://nces.ed.gov/pubs2018/2018061.pdf.

Proposals for Simplification

In 2007, Susan Dynarski and Judith Scott-Clayton published their analysis of the cost of complexity in the student aid system, arguing that relying on only a few data elements from the IRS would have little impact on targeting aid and would save billions of dollars in administrative costs each year.[2]

In 2008, the Rethinking Student Aid Study Group recommended eliminating the FAFSA and replacing it with a new form that would collect simple demographic information and include an authorization for the IRS to release tax information to the U.S. Department of Education (ED). Eligibility for Pell Grants would be based on Adjusted Gross Income (AGI) and family size (number of income tax exemptions). Families receiving means-tested public benefits, such as Temporary Assistance for Needy Families (TANF), would be eligible for the maximum Pell Grant without use of IRS data. Non-tax filers would fill out simple tax forms (or an alternative simple form) to apply for student aid. Because more information would likely be necessary to determine eligibility for types of aid other than Pell Grants, states and institutions designated by the student would have access to additional IRS data and a centrally computed expected family contribution (EFC) based on tax data. The group's report included data indicating that very small shares of tax units with AGI between $0 and $40,000 reported either business losses or capital gains or losses, although a much larger share of those with negative AGI reported these circumstances.[3]

More recently, the federal government made cooperation between the IRS and ED a reality by implementing the DRT process that allows data from tax forms to supply some of the information needed for the calculation of EFCs. Since then, proposals for simplifying the student aid system have focused more on which data elements are necessary, rather than on the broader question of the feasibility of using tax data. According to Lindsay Page and Judith Scott-Clayton, simplification efforts have helped, with FAFSA completion rates increasing from 50% to 70% of undergraduates between 1999 and 2011, but many students still do not file the application even if they would qualify for financial aid. They found roughly one in three students who did not file a FAFSA would have been eligible to receive a Pell Grant.[4]

In 2015, the National Association of Student Financial Aid Administrators (NASFAA) proposed expanding the DRT to include all line items from the 1040 form and the W-2, but not information from tax schedules. Under NASFAA's proposal, many applicants not eligible for need-based income-support programs would have to provide some financial information to supplement data available from the IRS. The argument is that without additional information, the system cannot appropriately distinguish different financial circumstances among households with similar income levels.[5] Similarly, in 2015 the Gates Foundation proposed asking applicants who had reported information on tax schedules additional questions about their assets.[6]

[2] Susan Dynarski and Judith E. Scott-Clayton, *College Grants on a Postcard: A Proposal for Simple and Predictable Federal Student Aid,* (Washington, DC: The Brookings Institution, 2007): https://www.brookings.edu/research/college-grants-on-a-postcard-a-proposal-for-simple-and-predictable-federal-student-aid/.

[3] *Rethinking Student Aid Study Group, Fulfilling the Commitment: Recommendations for Reforming Federal Student Aid,* (College Board, 2008): https://secure-media.collegeboard.org/digitalServices/pdf/advocacy/homeorg/rethinking-student-aid-fulfilling-commitment-recommendations.pdf.

[4] Lindsay Page and Judith Scott-Clayton, "Improving College Access in the United States: Barriers and Policy Responses." *Economics of Education Review*, 51, (2016): 4-22, https://www.nber.org/papers/w21781.pdf.

[5] NASFAA FAFSA Working Group, *FAFSA Simplification,* (National Association of Student Financial Aid Administrators, 2015): http://www.nasfaa.org/uploads/documents/fafsa_report_1.pdf.

[6] Bill & Melinda Gates Foundation, *Better for Students: Simplifying the Federal Financial Aid Process,* (2015): http://postsecondary.gatesfoundation.org/wp-content/uploads/2015/07/FAFSA-Approach_FINAL_7_7_15.pdf.

In the same year, researchers at the Urban Institute (including two of the authors of this paper) proposed a system that would separate Pell Grant calculations from the rest of the financial aid application process. They recommended determining Pell Grant eligibility with a look-up table based on simple data available from the IRS but requiring additional information for applicants whose tax returns suggest they have significant assets and therefore less need than their income levels alone suggest.[7]

Members of Congress are receptive to the idea of simplifying the process of applying for federal student aid, and a number of bills introduced in the current session would move in that direction. Some would make it easier for the IRS to share data with ED. The FAFSA Simplification Act of 2019, sponsored by Sen. Lamar Alexander, would make Pell Grant eligibility a function of just two variables: AGI and household size. Another bill, the HOPE (Heightening Opportunities for Pathways to Education) for FAFSA Act, would create three pathways along the lines proposed by NASFAA. In that bill, participants in federal need-based programs would be eligible for an auto-zero EFC (where the student's EFC is automatically set to zero), and those who have income below $60,000 and are not required to file lettered tax schedules would be able to rely solely on data provided by the IRS to calculate the EFC.[8] Only applicants not meeting these criteria would be required to provide information about income and assets. Other proposals would limit the amount of information required about assets.[9]

Changes in FM and the Federal Income Tax System

The Fostering Undergraduate Talent by Unlocking Resources for Education (FUTURE) Act of 2019, signed into law in December 2019, simplifies the financial aid application and verification processes. The FUTURE Act allows the IRS to disclose tax return information directly to authorized ED officials for the purpose of determining eligibility for federal student aid. In addition to the information currently included in the DRT, this information includes whether an individual filed a federal income tax return, their filing status, and whether the return includes any tax schedules required for more complicated financial circumstances.

Another relevant change is the recent shift to relying on "prior-prior-year" data for the Federal Methodology (FM), allowing aid applicants to use information already available from the IRS at the time they complete the FAFSA. Eligibility for aid for the 2020–21 academic year now relies on tax data from 2018 instead of 2019.

As momentum continues to build to further simplify the federal student aid application process and the formula for determining aid eligibility, it is important to probe the viability of further moves in this direction as well as the implications for both students and taxpayers.

One aspect of this inquiry involves asking whether the changes to the federal tax forms resulting from the 2017 TCJA have any impact on how relying on tax data would affect the need analysis system. Potentially relevant changes include the following:

[7] Kim Rueben, Sarah Gault, and Sandy Baum, *Simplifying Federal Student Aid: An Overview of Eight Plans,* (Urban Institute, 2015): https://www.urban.org/research/publication/simplifying-federal-student-aid-overview-eight-plans.

[8] U.S. Congress, House, *HOPE (Heightening Opportunities for Pathways to Education) for FAFSA Act of 2019,* HR 4245, 116th Cong., 1st sess., introduced in House September 9, 2019, https://www.congress.gov/bill/116th-congress/house-bill/4245.

[9] U.S. Congress, Senate, *Student Aid Improvement Act of 2019,* S 2557, 116th Cong., 1st sess., introduced in Senate September 26, 2019, https://www.congress.gov/bill/116th-congress/senate-bill/2557.

The standard deduction: The TCJA nearly doubled the standard deduction from $6,500 for individuals in 2017 to $12,000 in 2018 ($12,400 in 2020) and from $13,000 in 2017 to $24,000 in 2018 ($24,800 in 2020) for joint returns. Because of this change, combined with a cap on the amount of state and local taxes that can be deducted, a much smaller percentage of filers now itemizes deductions. The share of filers itemizing declined from about 30% in 2017 to about 13% in 2018.[10] As a result, much less information is available about mortgage interest and property taxes paid, charitable contributions, and other deductible expenses. However, the information available from tax forms has never been sufficient to measure the value of filers' homes, and it is not clear that this change has significant implications for the allocation of financial aid.

Personal exemptions and credits for dependents: In 2017, tax filers subtracted a personal exemption of $4,050 from their incomes for themselves and each of their dependents. Only one filer could claim each dependent. For 2018 and beyond, the TCJA eliminated personal exemptions, so taxpayers do not get a specific deduction from income for each dependent. TCJA replaced the exemption with a partly refundable child credit, up to $2,000 for dependents under the age of 17, which phases out for taxpayers with income of $200,000 (or $400,000 for joint filers). Because of the age limit, this credit is not generally available to students applying to college.

Dependents who are under age 24 and are also full-time students at least five months of the year can be qualifying children for the Earned Income Tax Credit (EITC). The EITC is available to taxpayers with earned income of roughly less than $50,000 (limits depend on filing status and the number of children in the household). The EITC is often more valuable to families than the new Credit for Other Dependents (discussed below), because it is refundable and often more substantial.

The TCJA introduced a non-refundable Credit for Other Dependents, allowing taxpayers to claim up to $500 for qualifying dependents over age 17. The requirements for claiming a dependent for this credit remain consistent with pre-TCJA law, and dependents are still listed on the 1040, but the Credit for Other Dependents is much smaller than the value of the pre-TCJA personal exemption. Taxpayers have more incentive to avoid claiming their college students if this might increase their eligibility for financial aid by preventing them from being linked to a parent with significant resources.

In other words, the elimination of the personal exemption makes it less feasible to base dependency status for financial aid purposes on dependency status for tax purposes. While the IRS has set rules for who should be counted as a dependent based on the provision of support, for some taxpayers, the benefits of claiming dependents on their tax returns may no longer be large enough to make it worth giving up the financial aid the students might receive if they were either attached to a lower-income parent or deemed independent.

It might be necessary to define specific financial aid rules for establishing which parent's information is the basis for determining financial aid eligibility and to access the tax returns of parents even if the applicant is filing as an independent tax unit.[11] In addition, if eligibility for financial aid continues to be a function of the number of children in the family who are in college at the same time,[12] the application will need to request this information separately from information included on the tax forms, as is currently done on the FAFSA.

[10] Robert McClelland, "Anybody Can Itemize Their Deductions. But Most Don't Want To," (Urban-Brookings Tax Policy Center, (September 15, 2019): https://www.taxpolicycenter.org/taxvox/anybody-can-itemize-their-deductions-most-dont-want.

[11] Elaine Maag, "Shifting Child Tax Provisions in the TCJA Left Most Families About the Same," (Urban-Brookings Tax Policy Center, August 16, 2019): https://www.taxpolicycenter.org/publications/shifting-child-tax-benefits-tcja-left-most-families-about-same.

[12] For a discussion of the problems with this aspect of the current formula, see the paper in this series, "The Federal Methodology: Is It a Good Measure of Ability to Contribute Toward Educational Expenses?"

Pass-through income: The TCJA introduced a new deduction available to some owners of sole proprietorships, partnerships, and S corporations. This deduction from pass-through income will reduce income and taxes for those eligible, but it will affect only taxable income, not AGI.[13] As a result, it would not appear to complicate estimation of financial aid eligibility. However, if the ability to deduct some of this pass-through income changes the type of income earned, it might be more important to include information on noncorporate businesses in any aid calculations.

Elimination of 1040A and 1040EZ forms: FM historically linked the simplified application process for students from low-income households to eligibility to file the 1040A or 1040EZ tax forms. The 1040A was limited to filers with income from certain sources (including interest, dividends, and capital gains), with taxable income below $100,000, claiming a limited subset of credits.[14] Eligibility for the 1040EZ was even more limited. Only aid applicants eligible to file one of these simple tax forms could qualify for the simplified needs test, which relieves applicants of the requirement to report assets, or the auto-zero EFC, which assigns an EFC of $0 to applicants with income below $26,000 without requesting any financial information.

Now that these forms do not exist, the requirement has changed to not filing Schedule 1. This schedule includes income other than bank interest, investment dividends, or wages reported on an IRS Form W-2, such as business income, rental income, or unemployment compensation. It also includes certain adjustments to income that can reduce taxable income. The conditions are complicated by the fact that some Schedule 1 filers can still take advantage of the simplified needs test or auto-zero EFC, depending on which types of income they report there.

It remains true that filers with some financial assets can qualify for the simpler aid application process, but the income limits on these FM provisions remain quite strict.

Pell Eligibility Versus EFC

Our earlier work confirmed the finding of other researchers that a simple Pell eligibility formula based on AGI and information about family composition would have minimal impact on the distribution of Pell Grants and could be revenue neutral. In a 2015 study, we tested the impact of ending the practice of dividing the EFC by the number of students in a family who are in college in order to eliminate the need to know about the college enrollment of applicants' siblings and ease early notification of Pell eligibility.[15] We found that this change would lead to the loss of eligibility for students from higher-income families.

The study concluded that the best approach would be splitting out the Pell Grant calculation from the rest of the federal aid application process. This would create a simple and predictable Pell Grant system while allowing states and institutions that distribute aid farther up the income scale to equitably differentiate among applicants.

[13] William Gale and Aaron Krupkin, "Navigating the New Pass-Through Provisions: A Technical Explanation," (Urban-Brookings Tas Policy Center, January 31, 2018): https://www.taxpolicycenter.org/publications/navigating-new-pass-through-provisions-technical-explanation/full.

[14] StudentAid.gov, "Were you eligible to file a 1040A or 1040EZ?", accessed May 26, 2020, https://studentaid.gov/1920/help/student-eligible-1040a-1040ez.

[15] Kim Rueben, Sarah Gault, and Sandy Baum, *Simplifying Federal Student Aid: An Overview of Eight Plans,* (Urban Institute, 2015): https://www.urban.org/research/publication/simplifying-federal-student-aid-overview-eight-plans.

Earlier studies found similarly small impacts from moving the calculation of Pell eligibility from a complicated EFC-based formula derived from information provided on the FAFSA to a simple AGI-based index. Susan Dynarski and Judith Scott-Clayton found that differences in AGI explained about three-quarters of the variation in Pell awards, and moving to a very simple formula based on tax information would make a significant difference in very few awards.[16]

A 2012 College Board study used 2007–08 FAFSA data from five states to examine the potential impact of FM simplification on EFCs, Pell Grant awards, and state grant eligibility. Simulations indicated that basing eligibility for Pell on AGI and family size would have minimal impact. However, removing assets from the calculations would measurably lower EFCs for higher-income families.[17]

All of these studies confirm the feasibility of simplifying the determination of Pell eligibility and relying on data available from the IRS to allocate this federal grant aid for low- and moderate-income students. They also point to the greater sensitivity of the determination of ability -to -pay among more affluent households. In other words, a few data elements from income tax forms can substitute for the complicated information now required for allocating Pell Grants. However, estimating the financial capacity of households with higher incomes and varying levels of assets is not so simple. AGI is not a sufficient measure. The question is whether other information from income tax forms would make it possible to construct a reasonable EFC, or whether some aid applicants should continue to provide additional information.

Supplementing Financial Data From the IRS

The current FM asks only for information on cash, savings and checking accounts; net worth of investments other than the family home; and some business and farm assets. It excludes all assets, for both dependent students and independent students with dependents, for families with incomes below $50,000. In other words, FM ignores a significant share of the assets held by families eligible for financial aid. It does not ask about either home equity or retirement assets, the most significant assets held by households in the age range of most parents of college students.[18] Information on retirement assets would be difficult to collect for the approximately 30% of households with defined benefit retirement plans.[19] The College Board's profile form does collect information on home equity, but it would not be possible to collect information on either of these types of assets from tax forms.

Information from the IRS could, however, close another loophole in the FM that reduces EFCs for families with significant resources. Currently, negative AGI does not trigger any adjustments in the FM or for Pell eligibility. In contrast, the College Board's Institutional Methodology, which some institutions use to calculate EFCs for the distribution of their own funds, adds losses back to income to avoid this problem. Adopting this strategy would more accurately distinguish among families with different levels of resources.

[16] Susan Dynarski and Judith Scott-Clayton, "The Cost of Complexity in Federal Student Aid: Lessons from Optimal Tax Theory and Behavioral Economics." National Tax Journal, 59, no. 2, (2016): 319–356, https://www.nber.org/papers/w12227.

[17] Sandy Baum, Kathleen Little, Jennifer Ma, Anne Sturtevant, *Simplifying Student Aid: What It Would Mean for States,* (College Board, 2012): https://eric.ed.gov/?id=ED531673.

[18] U.S. Census Bureau, *Wealth, Asset Ownership, & Debt of Households Detailed Tables 2015,* Tables 1 and 2, 2015, https://www.census.gov/data/tables/2015/demo/wealth/wealth-asset-ownership.html.

[19] Monique Morrissey, "Private-sector Pension Coverage Fell by Half Over Two Decades," *Working Economics Blog,* Economic Policy Institute, January 11, 2013, https://www.epi.org/blog/private-sector-pension-coverage-decline/.

As the studies cited above confirm, excluding assets from the calculation of EFC has limited impact on low-income filers.[20] Eliminating filers with negative AGI would further diminish this impact. But asset levels do vary widely among households with similar incomes. Despite the reality that it is far from complete, the asset information provided on the FAFSA has a measurable impact on the EFCs of many aid applicants beyond the Pell Grant range, and the inability to include this information would reduce the equity of the system.

An obvious question is whether it is possible to impute assets—or at least financial assets—using only information available on tax forms. This would be true if income and wealth (or at least some reasonable measure of wealth) were highly correlated. If this were the case, the ranking of households by income would be very similar to a ranking based on a combination of income and assets. It would also be possible to impute assets if the interest and dividends reported on tax forms were a reliable indicator of financial wealth. But this turns out not to be the case.

Annual income is a poor predictor of wealth. According to data from the U.S. Census Bureau, there is considerable variation in asset levels among households with similar incomes. In 2015, 29% of households in the lowest income quintile had zero or negative net worth, but 21% had $100,000 or more. Among those in the middle income quintile, 33% had net worth below $25,000; 27% had net worth of $250,000 or more.[21]

Another way of thinking about predicting assets from income information is by asking how correlated the two are. An analysis by Jeff Desjardins of the relationship between income and net worth based on data from the Survey of Consumer Finances suggests only about one-third of differences in wealth are explained by differences in income.[22]

Another perspective on the relatively weak correlation between income and wealth comes from estimates of the correlation between different forms of income and different measures of wealth. After removing the top 1%, a 2018 study by Linda Keister finds a correlation of .61 between net worth and total household income and .56 between financial assets and total household income. Perhaps most relevant for the question of using information from tax forms to impute assets, Keister found a correlation of just .59 between financial assets and dividends.[23] So, imputing the value of financial assets from the investment returns reported on tax forms would not yield accurate results.

Moreover, the taxation of investment income varies dramatically across different types of assets. Interest payments, dividends from corporate stocks and mutual funds, and rents are taxed when earned. Dividends and distributions from pass-through businesses, such as partnerships and S corporations, are not directly taxed, but the owners pay tax on the profits of these businesses as those profits are earned. These earnings are all taxed contemporaneously, and if the rate of return is known, calculating the value of the underlying asset could be possible. However, it seems more direct to have applicants report this income.

[20] The decline in recent years in the education savings and asset protection allowance has increased the assets that contribute to EFC. However, this decline is an artifact of the formula, and there are good arguments for restoring its level. For more detail, see the paper in this series, "The Federal Methodology: Is It a Good Measure of Ability to Contribute Toward Educational Expenses?"

[21] U.S. Census Bureau, *Wealth and Asset Ownership.*

[22] Jeff DesJardins, *Visual Capitalist,* "The Relationship Between Income and Wealth," https://www.visualcapitalist.com/relationship-income-and-wealth/.

[23] Linda Keister, "Income and Wealth Are Not Highly Correlated: Here Is Why and What It Means," *Work in Progress,* October 29, 2018, http://www.wipsociology.org/2018/10/29/income-and-wealth-are-not-highly-correlated-here-is-why-and-what-it-means/.

In contrast, capital gains and losses are taxed only when realized, which generally means when the underlying asset is sold. This deferral of taxes on gains until assets are sold makes these assets invisible on earlier tax returns. Suppose an investor purchases $1 million worth of shares in a non-dividend-paying stock at the beginning of the year, holds them for two years, and then sells them for $1.2 million. The shares are worth $1.1 million at the end of the first year, but that increase in value will not appear on the tax return. Increasing calls to tax individuals' wealth rather than just income flows have garnered attention to different ways to assess underlying assets, but there is currently no reasonable way for the financial aid system to assess accrued—as opposed to realized—capital gains.

Capital gains are also a much more volatile form of income than other financial earnings, in part because of the ability of holders to time when they realize gains or losses. Estimates suggest that since 2009, capital gains have added an average of $3 trillion to investment income each year.[24] Because capital gain or loss realizations depend on the taxpayer's actions, there are incentives to delay or accelerate realizations to minimize AGI in years when tax returns are used for the calculation of financial aid.

Prior work simulating the effectiveness of using tax information to replace the FAFSA required assumptions about how information reported on tax returns translates into information on assets. Tax data could only reliably estimate the value of assets if interest and dividends earned and capital gains or losses were highly correlated with financial assets. But as the evidence cited above indicates, this is not the case. Including assets in the need analysis methodology will continue to require additional information from households with incomes likely to be associated with significant asset levels.

These realities suggest both that ignoring assets makes it impossible to rank households by their financial capacity and that the limited information on tax forms related to assets is unlikely to provide reliable estimates for relatively affluent households with complex financial circumstances.

As noted in our prior work and as suggested in reform proposals put forth by both the Bill & Melinda Gates Foundation and NASFAA, an option would be to rely on tax return data for the majority of applicants but then require additional information from applicants whose tax forms indicate the presence of assets. Specifically, we would suggest collecting additional information from taxpayers who file Schedule B, C, D, E, or F. In our earlier work, we estimated that using a method like this would involve additional information for about 10% to 14% of applicants, most of whom would be dependent rather than independent students. For example, we estimated that using a system similar to that recommended by NASFAA would involve requiring more asset information from 17% of dependent students and only 2% of independent students.

We estimated that using only IRS data would generate average EFCs for higher-income applicants that are both lower than current levels and lower than under the Gates Foundation and NASFAA proposals. Requiring additional information for this subset of applicants would yield average EFCs much more similar to current EFCs. For example, for applicants with AGIs over $100,000, relying only on IRS data would lead to EFCs that are on average 15% lower than if wealth information were included.

[24] Greg Leiserson, *Taxing Wealth by Taxing Investment Income: An Introduction to Mark-to-Market Taxation,* (Washington Center for Equitable Growth, September 2019): https://equitablegrowth.org/taxing-wealth-by-taxing-investment-income-an-introduction-to-mark-to-market-taxation/.

Table 1: EFC Estimates for 2011–12 NPSAS Sample of Financial Aid Applicants

Adjusted gross income	Weighted count	Average EFC: Baseline	Average EFC: IRS data only	Average EFC: Gates	Average EFC: NASFAA
$100,001 – $200,000	1,316,697	$27,266	$22,757	$25,151	$26,954
>$200,000	222,760	$62,323	$53,256	$69,671	$62,002
All	12,511,096	$7,008	$5,916	$6,432	$6,899

[a] From Kim Rueben, Sarah Gault, and Sandy Baum, *Simplifying Federal Student Aid: How do the Plans Stack Up?* Table 16, (Urban Institute, 2015): https://www.urban.org/sites/default/files/publication/72826/2000507-simplifying-federal-student-aid-how-do-the-plans-stack-up_3.pdf.

How Would Results Vary by Type of Student?

Thus far we have discussed the advantages and disadvantages of eliminating the FAFSA and relying solely on income tax information for all students. But how would these changes vary by type of student?

Because of changes in the tax treatment of dependents who are between ages 17 and 24, it could be the case that parents would stop claiming college-age students or that divorced parents would have incentives to shift which parent claims a child to maximize financial aid awards. In addition, if need were solely determined by income tax returns, the main information from the FAFSA that would be lost would relate to financial and business assets.

As noted above, dependent student EFCs would be more affected than those of independent students if asset information were unavailable. Using estimates for 2012, tax returns including dependent students reported higher incomes and were more likely to include nonwage income than those of independent students. While over one-quarter of dependent students reported AGI over $100,000 only about 6% of independent students reported AGI at this level. Similarly, 20% of tax returns of parents of dependent students reported income from two or more tax schedules while only 12% of tax returns of independent students reported this level of activity.

Defining Household Units

A fundamental question in any need analysis system is whose financial resources are relevant for determining ability to pay. Under what circumstances are students considered independent of their parents, making only their own (and their spouse's if they are married) resources relevant? If a student's parents are divorced, are both still relevant or only one and, if so, which one? What about students who live with their grandparents or other adults who are not their parents? It is important to ask whether relying on IRS data will complicate these choices.

It would be possible for a student to fill out a form with the name and social security number of their legal guardian/custodial parent and use that individual's tax records to determine eligibility for financial aid. The alternative would be to use the information on the tax form on which the student is listed as a dependent. The FAFSA currently uses the parent with whom the student lived most during the year preceding the FAFSA application date. Therefore, the question of who contributes most financial support is only determinative if students divide their time equally between two parents. The FAFSA definition of household size is based on providing support, not on age. As a result, using the count of dependents for tax purposes could exclude some individuals currently counted for financial aid purposes or include others (like grandparents) not currently included.

There is no obvious logical advantage to using the IRS definition of custodial parent over the FAFSA definition of custodial parent in cases where the two differ. Moreover, it is not at all clear that it is equitable to use information from only one divorced parent when information from the other is available. The Institutional Methodology asks for information from both the custodial and the noncustodial parent in cases of divorce, and including more information can help illustrate a student's true financial circumstances. And, as noted above, the elimination of personal exemptions makes it more difficult to determine dependency for financial aid purposes using dependency for tax purposes.

Household size is also a relevant variable in the current calculation of EFC, with larger households having smaller estimated contributions for a given income level. Children who receive more than half their support from a parent are considered members of that parent's household for financial aid purposes, regardless of where they reside.

Relying on tax forms for information about household composition is probably as reliable as relying on information provided on the FAFSA but might include a different set of household members. Not associating students with the taxpayers claiming them as dependents would complicate a financial aid system using tax data, but an alternative strategy would likely be necessary to ensure the integrity of the system. However, requesting additional household composition information, if that is necessary, does not significantly diminish the benefits of relying on tax data instead of collecting financial information for all aid applicants through the FAFSA.

Conclusion

There is powerful evidence about the importance of simplifying the process of applying for financial aid and the potential impact of making the availability of aid for college more transparent and predictable for low-income students. Requiring students and parents to complete complicated forms asking for detailed financial information, much of which is already available on tax forms for those required to file them, interferes with the vital agenda of increasing access to college and educational attainment among low-income and first-generation students.

Making better use of tax data is a logical and vital component of solving these problems. The evidence is clear that allocating Pell Grants by relying only on a few data elements from the IRS would have minimal impact on the distribution of these foundational federal grants for low- and moderate-income students. Recent changes in the federal income tax do not substantively change the feasibility of this approach. A simple formula for Pell Grants based on AGI and household size, for example, might be strengthened by using tax information such as negative AGI to exclude students whose financial circumstances are not consistent with the appropriate targeting of Pell Grants. Congress should implement this system in the next reauthorization of the Higher Education Act of 1965, as amended.

However, it is not at all clear that the entire financial aid system can operate effectively by relying only on data collected on tax forms. Excluding any accounting for assets from the Pell Grant system would not significantly affect the allocation of that aid. But ignoring assets in distributing state and institutional grant aid to households with higher incomes and more complicated financial situations would make it more difficult to differentiate among households that are actually in very different circumstances. The current FM already ignores a large share of the assets that make some families much better off than others—particularly home equity. Failing to reliably measure all financial assets would exacerbate the problem, causing aid to go to students who don't really need it and depriving those facing greater constraints of the funds they need to make paying for college feasible.

In addition, a reliable system for determining which students are dependent and, in cases of divorce, who the relevant parent is, is not likely to rely entirely on the tax system.

The idea of collecting additional financial information from families whose tax forms indicate they may have sizeable assets need not compromise the success of integrating the basic federal financial aid system with the tax system. Families who have assets to report are not likely to be intimidated by the application process or to decide not to send their children to college because of this requirement.

Simplifying the aid system, particularly for low-income students, is critical. But it is not possible to reliably differentiate among middle- and upper-income households without a full understanding of their financial situations. Maintaining a system of financial aid that makes attendance at all types of institutions a reasonable possibility for a wide range of students demands simplicity and transparency but also must maintain the ability to equitably evaluate the need for aid across all students.

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