



Children's Defense Fund

The Children's Defense Fund

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Keeping What They've Earned: Working Families In Washington, DC And Tax Credits

As the height of tax-filing season approaches, Americans are being inundated with advertisements from commercial tax preparers on some high-cost options for getting their taxes prepared. Many of these commercial tax preparers are concentrated in low-income neighborhoods and lure their clients with the promise of "Fast Money," "Money Now" or "Rapid Refunds." A vast number of these consumers, who because of their low incomes are eligible for tax credits such as the Earned Income Tax Credit (EITC), end up paying high preparation fees and taking out high-interest loans against their expected return. More than 67 percent of people nationwide who claim the EITC use commercial tax preparers to prepare their returns. Unfortunately, many low- to moderate-income working Americans are often unaware of all their choices - including free tax preparation such as Volunteer Income Tax Assistance (VITA) sites.

The story is consistent across the country. Although about 49,000 of the District of Columbia's working taxpayers received about \$83 million in EITC refunds, they lost an estimated \$5.8 million¹ of that to tax preparation and high interest loans during the 2002 tax year. Nationally, the annual percentage rate (APR) on these Refund Anticipation Loans (RALs) is estimated to range from 70 to more than 700 percent.² Commercial tax preparers and high interest RALs take money from the tax refunds of poor working families - money that could go toward providing basic needs. We can do better to ensure that working Americans are not losing valuable money to paid preparers and the purchase of RALs by:

- 1) **Simplifying the rules and process** for completing tax returns;
- 2) **Ensuring that free tax assistance** for these families is available, accessible and well-publicized;
- 3) **Strengthening consumer protections and education** through increasing federal and state oversight and regulation of commercial tax preparers and national banks promoting RALs; and
- 4) **Connecting more low-income families** with financial institutions and increasing financial literacy.

An Earned Tax Credit for Working Families

The EITC is a refundable federal tax credit for people who work full or part-time but earn low wages. The EITC is the most effective work support and anti-poverty tool that we have today. In 2002, the EITC lifted 4.9 million people, including 2.7 million children, out of poverty.³ Low-income families spend a disproportionate share of their income on payroll, sales and excise taxes, and the EITC helps to offset these tax burdens. People can use the credit to decrease the amount of money a family owes in income tax, and in most cases even get money back in a refund. This money helps workers cover expenses like rent, utilities, food and childcare - making it easier for people to keep working and improve the lives of their children and families. In addition, because much of the money is spent immediately within the local economy, it boosts local economic development. Conversely, the loss of \$5.8 million dollars in EITC refunds district-wide through tax preparation and high cost loans has an adverse effect on the local economy.

The EITC means real money in the pockets of eligible individuals and families. For the 2004 tax year, the EITC is worth up to \$4,300 for workers who earn less than \$34,458 (\$35,458 if married filing jointly) and have two or more qualifying children, and up to \$2,604 for workers who earn less than \$30,338 (\$31,338 if married filing jointly) and have one qualifying child. Working adults between the ages of 25 and 64 with no children who earn less than \$11,490 (\$12,490 if married filing jointly) are also eligible for an EITC worth up to \$390. In fact, workers in the District of Columbia who claimed the EITC during the 2002 tax year received an average refund of \$1,696.





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A family of six went to a local VITA site and got their taxes prepared for free. They received a refund of more than \$6,000. The father is from California and the mother is from Peru. The children, who are all under 10 years old, have not seen either set of grandparents in years. The family is going to use a portion of the refund money to fly to California to finally see their grandparents



Use of Commercial Tax Preparers

To claim the EITC and other tax credits for which they are eligible, taxpayers need to complete and file their federal and district income taxes - a task that can be very complex. The laws and procedures that govern this area of the tax code in particular are very complicated, and often change from one year to the next. In addition, many low-income families face language and literacy barriers. Consequently, it is not surprising that a high percentage of low-income EITC families in the District of Columbia - 63 percent - hire a professional to prepare their taxes. The estimated cost of having their taxes prepared and electronically filed is about \$120.⁴ This is a particularly large amount for District of Columbia families that live paycheck to paycheck. Essentially, most of these working District of Columbia families are paying almost 7 percent of their EITC just to claim it.⁵ District-wide costs for tax preparation represent about \$3.7 million dollars lost to poor working families.⁶

Use of Refund Anticipation Loans (RALs)

Two-thirds of the EITC claimants who went to a paid preparer also purchased an expensive Refund Anticipation Loan (RAL). RALs are short-term, high interest loans that tax filers take out based on their expected tax return. The loan is repaid from their tax refund, but the fees associated with RALs, including the account set-up fees, surcharge fees and finance fees can end up costing the client a large percentage of their refund.⁷ RALs allow families to get their tax refunds usually within two days, but many families may not be aware that with electronic filing and direct deposit, they can get their refunds back within two weeks without paying any additional loan fees.⁸ Most EITC families need their refund dollars as soon as possible, and many do not have the \$120 necessary just to pay the tax preparation costs up front. Knowing this, many paid tax preparers partner with banks and aggressively market RALs.

The average EITC family in the District of Columbia with a refund of \$1,696 paid an estimated \$100 just to get a RAL. This translates into a shockingly high APR - about 229 percent.⁹ The District of Columbia's typical EITC family loses an additional 6 percent of their refund just to get their money one or two weeks sooner with a RAL. This represents an additional \$2.1 million dollars in RAL fees lost to poor working families district-wide.¹⁰ When tax preparation fees are included the typical family that gets a RAL loses 13 percent of its refund, or about \$220.

Another disturbing aspect of RALs is that because they are loans, they can actually place families at risk of greater financial crisis. Usually, a RAL is paid off once the IRS processes the tax return and transfers the funds. However, if the IRS denies part of the refund for any reason or even withholds it temporarily for audit purposes (which is very likely to happen more frequently with EITC returns this tax season), interest continues to accrue and the family is responsible. Given their often pressing financial needs, it is unlikely that EITC families budget for this possibility. There is also ample anecdotal evidence that some families, especially those with limited English proficiency, do not fully comprehend that they are taking out a loan. Ironically, families could end up in debt due to their efforts to claim the EITC and other tax benefits that are intended to assist them in becoming more financially secure.

RALs in Washington, DC

Based on IRS data, more than 21,000 EITC tax filers, 43 percent of the District of Columbia's EITC families who received refunds for tax year 2002, also took out a RAL. RAL vendors continue to target EITC families. As a comparison, only 8.5 percent of people in the District of Columbia who did not claim the EITC received a RAL for tax year 2002.

As Table 1 indicates, the 43 percent figure in the District of Columbia is higher than the national average of 35 percent of EITC families that get their refunds with a RAL. And the percentage is even higher in certain zip codes.

These zip codes also tend to have much higher rates of poverty than the state average. The average

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poverty rate in the 25 zip codes in which the highest percentage of EITC families purchased RALs was 20.3 percent, the same as the average for the District of Columbia as a whole, but almost twice the national rate of 12.4 percent.¹¹ In fact, research indicates that commercial tax preparers target low-income neighborhoods for their services. Neighborhoods across the nation with high percentages of EITC filers have 50 percent more electronic tax filing and preparation services than neighborhoods with low percentages of EITC filers.¹² Clearly, the collective economic impact of RALs is higher in these poverty-stricken areas of the state.

Recommendations

1. Simplify the rules and process. Working families should be able to complete their own taxes, without having to pay for professional assistance. Federal and state laws that govern working family's income taxes need to be simplified, and federal and state tax credit programs need to be coordinated.

2. Ensure that free tax assistance for EITC families is available, accessible and well publicized. Free tax assistance for low-income families is available at Volunteer Income Tax Assistance sites, Tax Counseling for the Elderly (TCE), AARP and other free tax preparation sites in many District of Columbia communities, but very few people know this. In fact, these sites serve less than 2 percent of the EITC-eligible taxpayers nationwide. Different levels of government, employers, foundations, churches and other community groups can all provide financial assistance, make site locations available, donate computers for electronic filing, help recruit volunteers and conduct outreach with potential EITC families. EITC families should also be made aware that there are free or low-cost tax filing websites available that they can access through the IRS and other websites.

3. Strengthen consumer protection and education. There is extremely little regulation of tax preparers - they are not even required to have a high school education. Yet, they are entrusted with personal information and expected to stay abreast of many complex tax laws. The federal and state governments could do more to regulate and monitor the practices of paid preparers as well as their partner banks. Families need to understand what they can expect of their tax preparer, as well as the drawbacks and hidden costs of RALs. On the federal level, the Taxpayer Abuse Prevention Act (TAPA) is being re-introduced in Congress on February 8, 2005 by Senator Daniel Akaka. Among the many issues that TAPA addresses, it prohibits the use of RALs against the Earned Income Tax Credit.

4. Connect more low-income families with financial institutions and increase their financial literacy. Having a tax refund electronically deposited directly into a bank account speeds up the turnaround time significantly, but one out of four families with incomes less than \$25,000 do not have a bank account. Recent efforts to partner free tax assistance with financial institutions are proving successful.

Conclusion

The District of Columbia's low- to moderate-income working families lost an estimated \$5.8 million dollars to commercial tax preparers in tax year 2002 - money that could have been used to help provide their children with a safe home, nutritious meals and a good education. These hardworking families are trying to rise out of poverty but are falling victim to targeted marketing tactics that are taking their hard-earned money. The Children's Defense Fund's efforts to educate and assist families that may otherwise fall prey to these unconscionable sales tactics can make a difference in the lives of the District of Columbia's working poor. Only when every eligible working family has access to free and fair tax preparation services can we truly Leave No Child Behind®.

For additional information concerning the methodology of this report, contact the Children's Defense Fund at (202) 662-3542.

again. If the family had gone to a commercial tax preparer, they would have paid approximately \$120 just to get their taxes completed and an additional \$100 if they wanted to take out a RAL and get their money right away. The family would have lost a total of \$220 from their tax refund.





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Table 1: Percent of EITC and Non-EITC Returns with RALs

Includes the 25 District of Columbia Zip Codes with Highest Percentage of EITC Filers Taking Out RALs (Refund Anticipation Loans), Tax Year 2002

Zip Code	Number of EITC Returns with a Refund	Percent of All Returns With EITC	Percent of EITC Returns with RAL	Percent of Non-EITC Returns with RAL	1999 Poverty Rate
20032	5,646	47.3%	54.6%	18.5%	35.2%
20020	7,456	42.6%	53.7%	17.3%	32.4%
20019	7,402	40.3%	52.0%	16.6%	28.5%
20039	18	21.3%	50.0%	15.2%	*
20002	5,680	30.0%	48.0%	11.7%	22.0%
20030	91	39.6%	46.5%	18.1%	*
20003	1,294	15.9%	45.4%	6.6%	21.1%
20018	1,436	24.6%	45.3%	11.4%	16.8%
20024	867	20.2%	44.7%	8.2%	22.0%
20029	121	39.2%	42.4%	16.2%	*
20017	1,143	19.0%	40.7%	10.2%	14.7%
20001	3,391	33.2%	39.8%	12.3%	29.6%
20090	38	23.1%	35.5%	10.3%	*
20013	122	23.4%	35.4%	9.7%	*
20011	5,605	25.1%	31.8%	10.1%	13.5%
20012	657	14.4%	30.8%	7.4%	8.9%
20009	3,039	16.7%	27.3%	5.1%	18.0%
20010	3,190	30.0%	25.0%	7.2%	21.8%
20005	447	12.1%	17.9%	4.9%	24.0%
20037	76	3.1%	15.4%	2.0%	22.6%
20015	141	3.1%	11.5%	1.4%	4.3%
20036	87	3.9%	11.4%	2.6%	9.6%
20016	284	3.6%	9.5%	1.5%	6.7%
20008	338	3.5%	8.0%	1.7%	5.6%
20007	286	3.9%	4.4%	2.1%	14.1%
DC TOTALS	48,980	23.9%	43.0%	8.5%	20.2%
USA TOTALS	19,963,434	20.7%	34.6%	6.4%	12.4%

*There is no data available for this zip code in Census 2000.

SOURCE: IRS SPEC Return Data Base, Tax Year 2002 Return Information (July 2004). Poverty figures are from U.S. Census Bureau, 2000 Census. Calculations by CDF.

Endnotes

1. IRS SPEC Return Data Base, Tax Year 2002 Return Information (July 2004). Calculations by CDF.

2. Chi Chi Wu and Jean Anne Fox. "All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low Income Americans," NCLC/CFA 2004 Refund Anticipation Loan Report, January 2004, page 5-6.

3. Joseph Llobrera and Bob Zahradnik, "A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2004," Center on Budget and Policy Priorities, May 14, 2004. Pulled from http://www.cbpp.org/5-14-04sfp.htm#_ednref1.

4. H&R Block, Q4 2002 H&R Block Earnings Release Conference Call, June 12, 2002, available at 2002 WL 26337229. Cited in, Ibid., Chi Chi Wu and Jean Anne Fox, 2004, page 5.

5. These values are based on all EITC claimants, including the small minority that does not receive a refund.

6. IRS SPEC Return Data Base, Tax Year 2002 Return Information (July 2004). Calculations by CDF.

7. "2004 Season Express Refund Loan Pricing," pulled from: http://www.household.com/corp/hir/express_refund_loan.jsp.

8. IRS e-file 2005 Refund Cycle Chart, Publication 2043. Pulled from: <http://www.irs.gov/pub/irs-pdf/p2043.pdf>.

9. Ibid., IRS Publication 2043. Based on this publication, the IRS direct deposits refunds in eight to 15 days. APR calculations are based on a 10-day loan period and are based on the full RAL cost, including all fees and surcharges.

10. IRS SPEC Return Data Base, Tax Year 2002 Return Information (July 2004). Calculations by CDF.

11. U.S. Census Bureau, 2000 Census. Calculations by CDF.

12. A. Berube, A. Kim, B. Forman, & M. Burnes. "The Price of Paying Taxes," The Brookings Institution, May 2002, pulled from <http://www.brookings.edu/dybdocroot/es/urban/publications/berubekimeitc.pdf>.