



Children's Defense Fund

## Children's Defense Fund - Southern Regional Office

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# Keeping What They've Earned: Working Mississippians 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 sites such as the Volunteer Income Tax Assistance (VITA) program.

The story is consistent across the country. Although approximately 356,000 of Mississippi's working taxpayers received about \$736 million in EITC refunds, they lost an estimated \$54 million<sup>1</sup> 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.<sup>2</sup> 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. Nationally in 2002, the EITC lifted 4.9 million people, including 2.7 million children out of poverty.<sup>3</sup> 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 \$54 million dollars in EITC refunds statewide through tax preparation and high cost loans has an adverse effect on the state and local economy.

The EITC can mean 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 Mississippi who claimed the EITC during the 2002 tax year received an average refund of \$2,069.





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A woman came into one of Mississippi's VITA sites with her husband and two children to get their taxes prepared. The family's annual income was \$12,000, so money was tight and every dollar counted. They first experienced some problems claiming the EITC because her husband had claimed her two children on a past return before they were married. She had been reluctant to admit any past problems with the EITC, but she eventually felt comfortable disclosing this information with the volunteers at the VITA site. The proper forms were filed and



## 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 state 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 Mississippi - approximately 69 percent - hire a professional to prepare their taxes. The estimated cost of having their taxes prepared and electronically filed is about \$120.<sup>4</sup> This is a particularly large amount for Mississippi families that live paycheck to paycheck. Essentially, most of these working Mississippi families are paying almost 6 percent of their EITC just to claim it.<sup>5</sup> Statewide costs for tax preparation represent close to \$30 million dollars lost to poor working families.<sup>6</sup>

## Use of Refund Anticipation Loans (RALs)

More than 76 percent 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.<sup>7</sup> 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.<sup>8</sup> 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 Mississippi with a refund of \$2,069 paid an estimated \$130 just to get a RAL. This translates into a shockingly high APR - about 245 percent.<sup>9</sup> Mississippi's typical EITC family loses an additional six percent of their refund just to get their money one or two weeks sooner with a RAL. This represents an additional \$25 million dollars in RAL fees lost to poor working families statewide.<sup>10</sup> When tax preparation fees are included the typical family that gets a RAL loses almost 12 percent of its refund, or about \$250.

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 Mississippi

Based on IRS data, it is estimated that 192,000 EITC tax filers, more than half of Mississippi's EITC families (54 percent), who received refunds for tax year 2002 also took out a RAL. RAL vendors continue to target EITC families. As a comparison, only about 11 percent of Mississippians who did not claim the EITC received a RAL for tax year 2002.

As Table 1 indicates, the 54 percent figure in Mississippi is much 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. For instance, in more than 90 percent of the zip codes in Mississippi, more than one-third of EITC claimants got their refunds with a RAL.

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These zip codes also have much higher rates of poverty than the state average. The average poverty rate in the 25 zip codes in which the highest percentage of EITC families purchased RALs was 34 percent compared to the statewide poverty rate of 19.9 percent and the national poverty rate of 12.4 percent.<sup>11</sup> 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.<sup>12</sup> 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, Tax Counseling for the Elderly, AARP and other free tax preparation sites in many Mississippi 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

Mississippi's low- to moderate-income working families lost an estimated \$54 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 Mississippi'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®.

the EITC claim was approved. The family received an EITC refund of \$4,332. They were also able to amend past tax returns and get an additional EITC refund for the previous year. The family was very grateful for all the assistance. If this family had gone to a commercial tax preparer, they would have paid about \$120 just to have their taxes prepared and an additional \$130 to take out a RAL if they wanted their money right away. When every dollar counts, losing \$250 from their tax refund would have really hurt this family.

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





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

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

Zip Code	City	County	Number of EITC Returns with a Refund	Percent of All Returns With EITC	Percent of EITC Returns with RALs	Percent of Non-EITC Returns with RALs	1999 Poverty Rate
38731	Chatham	Washington	33	68.8%	79.1%	0.0%	*
38638	Independence	Tate	37	55.2%	75.4%	30.0%	*
38802	Arkabutla	Tate	28	42.4%	73.9%	18.9%	*
39179	Vaughan	Yazoo	212	59.2%	72.2%	19.5%	42.5%
38778	Sunflower	Sunflower	427	72.6%	72.1%	18.2%	33.9%
38765	Panther Burn	Sharkey	64	82.1%	71.7%	19.3%	21.5%
38670	Sledge	Tunica	358	69.8%	71.1%	23.8%	31.8%
38649	Mount Pleasant	Marshall	19	55.9%	71.1%	6.0%	11.8%
38621	Crenshaw	Panola	445	64.2%	71.0%	20.4%	32.1%
39177	Valley Park	Issaquena	23	48.9%	70.4%	7.5%	21.8%
38664	Robinsonville	Tunica	409	50.4%	69.5%	18.1%	*
38760	Metcalfe	Washington	292	72.9%	69.0%	19.6%	44.4%
39144	Pattison	Claiborne	264	66.4%	68.9%	15.7%	34.1%
39113	Mayersville	Issaquena	134	76.6%	68.5%	15.4%	44.8%
39054	Cary	Sharkey	196	68.3%	68.4%	14.4%	37.0%
38825	Becker	Monroe	29	29.8%	68.3%	15.6%	*
39166	Silver City	Humphreys	138	70.7%	67.8%	7.5%	35.0%
38761	Moorhead	Sunflower	605	73.4%	67.5%	21.2%	40.5%
39203	Jackson	Hinds	1,484	69.8%	67.3%	21.8%	46.6%
39194	Yazoo City	Yazoo	3,197	56.7%	67.2%	13.8%	34.2%
39097	Louise	Humphreys	240	70.1%	67.1%	6.3%	49.3%
39159	Rolling Fork	Sharkey	641	63.5%	66.8%	10.4%	36.4%
38676	Tunica	Tunica	1,725	66.5%	66.5%	19.5%	35.2%
38701	Greenville	Washington	4,380	54.5%	65.8%	13.9%	28.3%
38962	Tippo	Tallahatchie	119	80.1%	65.8%	14.1%	33.4%
Mississippi Totals			355,808	38.8%	53.9%	11.2%	19.9%
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](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](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>.

The mission of the Children's Defense Fund is to Leave No Child Behind® and to ensure every child a Healthy Start, a Head Start, a Fair Start, a Safe Start, and a Moral Start in life and successful passage to adulthood with the help of caring families and communities.