



Children's Defense Fund

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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.



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Keeping What They've Earned: Working Families and Tax Credits

As the height of tax-filing season approaches, Americans are being bombarded with advertisements from commercial tax preparers on high-cost options for getting their taxes prepared. Many of these commercial tax preparers focus on low-income neighborhoods and lure their clients with the promise of "Fast Money," "Money Now" or "Rapid Refunds."

Two out of every three people nationwide who claim the Earned Income Tax Credit (EITC) use commercial tax preparers to prepare their returns. These low-income families end up paying high preparation fees and many of them take out high-interest loans against their expected refund. Unfortunately, many of these low- to moderate-income working Americans are unaware of other options—including free tax preparation through Volunteer Income Tax Assistance (VITA) sites.

Enacted in 1975, the EITC is our nation's largest and most effective anti-poverty program, generating billions of dollars to help families meet their most basic needs. Research shows families use their refunds to pay bills such as utilities and rent, to purchase basic household commodities and clothing, to cover the costs of tuition, and some even reserve parts of their EITC for savings. In sum, EITC helps low- to moderate-income families make ends meet while stimulating the local economy.

The Full Value of the Program Is Not Reaching Working Families

Unfortunately, low-income taxpayers lost over \$690 million in loan charges in 2003 and a total of \$2.3 billion if the cost of commercial tax preparation is included¹. These costs can include tax preparation, documentation preparation or application handling fees, electronic filing fees and Refund Anticipation Loan (RALs). The RALs are loans secured by the tax-payer's tax refund, including the EITC.

In middle and upper income communities, consumers have access to loans and credit cards at competitive rates, and branch offices of mainstream banks and savings and loans offer a full array of banking services. Low-income consumers are forced to patronize fringe financial service providers that charge exorbitant rates for personal loans and limited banking services².

RALs Target High Poverty Areas

Recent research has shown that low-income taxpayers who claim the EITC represent the majority of the marketplace for RALs. The product's popularity varies substantially across the U.S., but the most recent Internal Revenue Service figures indicate

that 79 percent of RAL recipients in 2003 had adjusted gross incomes of \$35,000 or less³. Minority consumers are heavier RAL users. Twenty-eight percent of African Americans and 21 percent of Latino taxpayers told surveyors they received RALs compared with 17 percent of White consumers⁴.

The Children's Defense Fund's review of eight states and the District of Columbia reveals that almost \$960 million dollars has been siphoned away from low-income tax payers in these states, because of tax preparation and high-interest loan fees.

California lost an estimated \$236.5 million.

Minnesota lost an estimated \$5.1 million.

Mississippi lost an estimated \$54 million.

New York lost an estimated \$182 million.

Ohio lost an estimated \$82.6 million.

South Carolina lost an estimated \$57 million.

Tennessee lost an estimated \$57 million.

Texas lost an estimated \$251 million.

Washington, D.C. lost an estimated \$5.8 million.

The Appeal of RALs and What Taxpayers Aren't Told

Many low-income families may feel they have little choice but to take out a RAL. First, many are unlikely to have \$100 on hand to pay for tax preparation fees. In setting up the loan, the commercial tax preparers deduct these fees first, relieving the families from the need to find alternative resources. Second, and probably more significantly, RALs enable families to access the amount of money they expect from their refunds within 48 hours, rather than having to wait for the IRS to process their returns. This wait could last 6-8 weeks if the family does not file electronically and does not have a bank account to accept an electronic transfer of the refund. Indeed, many low-income families lack bank accounts. According to the Federal Reserve, one out of four families with incomes less than \$25,000 do not have a bank account of any kind⁵.

Recommendations

- **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, especially those that govern working families' income taxes, need to be simplified and federal and state tax credit programs need to be coordinated.
- **Ensure that free tax assistance for EITC families is available, accessible and well-publicized.** Very few people know that free tax assistance for low-income families is available at Volunteer Income Tax Assistance sites, from Tax Counseling for the Elderly, AARP and other free tax preparation sites in many communities. The community groups and nonprofit organizations that operate many of these sites need help. 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 also should be made aware that there are free or low-cost tax filing Web sites available that they can access through the IRS and other Web sites.

- **Strengthen consumer protection and education.** There is little regulation of tax preparers even though 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 the national banks with which they partner to offer RALs. 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) legislation introduced by Senators Akaka (D-HI) and Bingaman (D-NM) and Representative Schakowsky (D-IL) would prohibit the use of RALs against the EITC.
- **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 does not have a bank account. Recent efforts to partner free tax assistance with financial institutions have been successful.

Children Need Adequate Family Income If They Are to Meet Their Most Basic Needs, from Diapers to Doctors to Healthy Food and Safe Housing.

Whether a child will flounder or flourish can hinge on things that money buys: good quality child care, eyeglasses to read the chalkboard, a little league fee, a musical instrument, or simply the peace of mind that lets parents create a warm and nurturing family life free from worries about eviction or hunger.

Yet almost 13 million children are poor and millions more live in struggling families with incomes just above the official poverty line. Giving children economic security means providing stronger tax credits for low-paid working families and a more reliable safety net when jobs fall short. It also means making more effective use of available programs and ensuring that families have access to the tax credits and food, health, and other benefits that already exist.

The millions of dollars lost by working families to commercial tax preparers is 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 lift themselves 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 working poor.



¹ Children's Defense Fund calculations based on IRS SPEC Return Data Base, Tax Year 2002 Return Information (July 2004). The \$2.3 billion figure includes tax prep costs for 67 percent of EITC recipients and RAL costs for 34.6 percent of EITC recipients.

² Enterprise Foundation (1999), Building Individual Assets; Individual Development Accounts (IDA's) and Community Development Financial Institutions.

³ Wu, Chi Chi with Fox, Jean Ann, "Picking Taxpayer Pockets, Draining Tax Relief Dollars," The NCLC/CFA 2005 Refund Anticipation Loan Report, January 2005. Retrieved from www.consumerlaw.org

⁴ Ibid.

⁵ Kennickell, A.B., Starr-McCluer, M., & Surette, B.J., Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances, Federal Reserve Bulletin, January 2000.