



Children's Defense Fund

Children's Defense Fund - New York

420 Lexington Avenue, Suite 655, New York, NY 10170

Tel: (212) 697-2323 Fax: (212) 697-0566

www.cdfny.org

February 2005

Keeping What They've Earned: Working New Yorkers 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. An estimated 68 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 1.4 million of New York's working taxpayers received almost \$2.5 billion in EITC refunds, they lost an estimated \$182 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 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 sometimes 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 \$182 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 federal EITC is worth up to \$4,300 for workers who earn up to \$34,458 (\$35,458 if married filing jointly) and have two or more qualifying children, and up to \$2,604 for workers who earn up to \$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. New York State also offers an EITC worth 30 percent of the federal credit and New York City just introduced a local EITC worth 5 percent of the federal credit. Workers in New York who claimed the EITC during the 2002 tax year received an average federal refund of \$1,746.





Children's Defense Fund

Sharon, a 28-year-old single mother, works full time as a home health aid earning about \$20,000 a year. With two growing sons to support, every dollar counts! In the past, she has gone to neighborhood tax sites and paid more than \$100 to have her taxes prepared and an additional \$250 just to take out a loan to get her refund back faster. After subtracting the \$350 in fees paid to the commercial tax preparer, Sharon only got back about \$1,650, almost 18 percent less than her \$2,000 tax refund! Last year Sharon's labor union sent out information about free tax preparation sites in her neighborhood and she decided to give it



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 New York - 64 percent - hire a professional to prepare their taxes. The estimated cost of having their taxes prepared and electronically filed is about \$165.⁴ This is a particularly large amount for New York families that live paycheck to paycheck. On average, working New York families are spending more than 9 percent of their federal EITC refund just to claim the money they have earned.⁵ Statewide, EITC recipients are losing \$149 million on tax preparation fees.⁶

Use of Refund Anticipation Loans (RALs)

Almost 37 percent of the EITC claimants in New York that went to a paid preparer also purchased an expensive Refund Anticipation Loan. RALs are short-term, high-interest loans that tax filers take out based on their expected federal tax return. The loan is repaid from their federal 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 \$165 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 New York with a federal refund of \$1,746 paid \$100 just to get a RAL. This translates into a shockingly high APR - about 222 percent.⁹ New York'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. When tax preparation fees are included the typical family that gets a RAL loses more than 15 percent of its federal EITC refund, or about \$265. This represents an additional \$33 million dollars in RAL fees lost to poor working families statewide.¹⁰

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 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 New York

According to IRS data, 331,000 EITC tax filers, a fourth of New York's EITC families (25.1 percent) who received refunds for tax year 2002, also purchased a RAL. RAL vendors continue to target EITC families. As a comparison, less than 5 percent of New Yorkers who did not claim the EITC received a RAL for tax year 2002.

As Table 1 indicates, 26.1 percent of EITC families in New York requested a RAL, with the percentage being even higher in many zip codes. These zip codes also have much higher rates of poverty than the state average. The average poverty rate in the 20 zip codes in which the highest percentage of EITC

Children's Defense Fund - New York

February 2005

families purchased RALs was 30.5 percent compared to the statewide poverty rate of 14.6 percent and the national poverty rate of 12.4 percent.¹¹ (See Table 1). 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, especially those 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, AARP and other free tax preparation sites in many New York communities, but very few people know this. In fact, these sites serve less than 2 percent of the EITC-eligible taxpayers statewide. 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 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. While some legislation does exist in New York City, 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) is being re-introduced in Congress on February 8, 2005 by Senator Akaka. Among the many issues that TAPA addresses, it prohibits the use of RALs against the Earned Income Tax Credit.

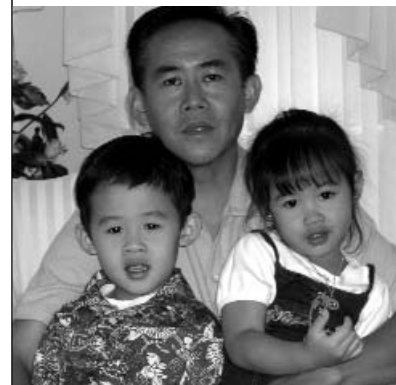
4. Connect more low-income families with financial institutions and increase their financial literacy. Having a tax refund electronically deposited directly into a bank account speeds up the turnaround time significantly, but one out of four families with incomes less than \$25,000 does not have a bank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

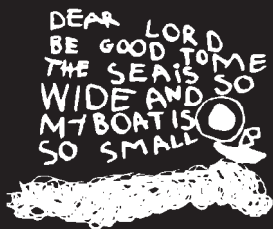
Conclusion

New York's low- to moderate-income working families lost an estimated \$182 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 New York'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 (212) 697-2323.

a try. Now Sharon says that she is "definitely passing the word along to my friends." She went to the site, called Money Central and said "It was wonderful!" She got back almost \$6,000 in her tax refund and didn't have to pay anything to get her taxes prepared. "The extra money that I received will help pay my bills," she said. She will also put some aside in her savings for a down payment on a house.





Children's Defense Fund

Children's Defense Fund - New York

February 2005

Table 1: Dollars Lost to Tax Preparation and RALs by EITC Filers

20 New York Zip Codes & 5 Large Cities with Highest Percentage of EITC Filers Taking Out RALs (Refund Anticipation Loans), Tax Year 2002

Zip Code, City	EITC Dollars Lost to Tax Preparation	Percent Rate of Requested RALs by EITC Filers	EITC Dollars Lost to RAL Fees	Total EITC Dollars Lost (Tax Preparation & RALs)	1999 Poverty Rate
New York State	\$149,283,585	26.1%	\$33,089,220	\$182,372,805	14.6%
12307, Albany	\$146,685	63.4%	\$63,270	\$209,955	43.8%
12206, Albany	\$282,315	57.6%	\$120,960	\$403,275	28.4%
14611, Rochester	\$360,690	56.5%	\$143,550	\$504,240	32.2%
14608, Rochester	\$240,900	55.9%	\$94,500	\$335,400	39.5%
12202, Albany	\$185,955	55.9%	\$79,650	\$265,605	33.7%
12210, Albany	\$137,775	55.1%	\$59,490	\$197,265	27.1%
14605, Rochester	\$312,675	54.9%	\$121,680	\$434,355	45.3%
14211, Buffalo	\$491,040	52.9%	\$195,120	\$686,160	33.0%
14204, Buffalo	\$155,100	51.3%	\$63,360	\$218,460	36.7%
14212, Buffalo	\$232,980	51.3%	\$88,470	\$321,450	36.9%
14208, Buffalo	\$171,930	51.2%	\$68,400	\$240,330	29.4%
12207, Albany	\$33,165	51.2%	\$13,950	\$47,115	50.7%
14621, Rochester	\$677,160	50.9%	\$244,350	\$921,510	31.8%
14619, Rochester	\$243,210	50.5%	\$88,290	\$331,500	14.9%
14613, Rochester	\$258,555	50.5%	\$94,050	\$352,605	24.1%
14215, Buffalo	\$699,930	49.9%	\$267,030	\$966,960	22.6%
12180, Troy	\$454,905	48.3%	\$160,020	\$614,925	15.5%
11212, Brooklyn	\$1,420,980	45.9%	\$559,710	\$1,980,690	38.3%
13202, Syracuse	\$80,850	45.2%	\$28,530	\$109,380	52.4%
13205, Syracuse	\$278,190	45.1%	\$95,940	\$374,130	25.9%
Albany City	\$1,165,395	46.3%	\$432,540	\$1,597,935	21.7%
Buffalo City	\$4,926,405	37.9%	\$1,537,380	\$6,463,785	26.6%
New York City	\$80,808,585	23.8%	\$16,998,120	\$97,806,705	21.2%
Rochester City	\$4,560,765	40.6%	\$1,404,900	\$5,965,665	25.9%
Syracuse City	\$2,207,865	37.4%	\$646,290	\$2,854,155	27.3%

SOURCE: IRS SPEC Return Data Base, Tax Year 2002 Return Information (July 2004). Poverty figures are from U.S. Census Bureau, Census 2000. 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. Calculation based on a price survey of New York preparers and reflects the fact that New York State taxpayers file additional forms.

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/hirl_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.