



Children's Defense Fund

## Children's Defense Fund - Texas

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### Keeping What They've Earned: Working Texans 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 nearly two million of Texas' working taxpayers received about \$3.8 billion in EITC refunds, they lost an estimated \$251 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. 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 \$251 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 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 Texas who claimed the EITC during the 2002 tax year received an average refund of \$1,945.





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Rosemary Valdez works for a local community-based organization in the Rio Grande Valley. She discovered, through the efforts of the CDF-TX office, that this year she and her family will qualify for the Earned Income Tax Credit. She specifically said that it was through CDF-TX office's publicity that she was able to find out about the credit and take advantage of the information and possibly the FREE VITA sites. Ms. Valdez's car was stolen the same day she found out



## 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 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 Texas - more than 70 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 Texas families that live paycheck to paycheck. Essentially, most of these working Texas families are paying more than 6 percent of their EITC just to claim it.<sup>5</sup> Statewide costs for tax preparation represent about \$166 million dollars lost to poor working families.<sup>6</sup>

## Use of Refund Anticipation Loans (RALs)

More than 59 percent of the EITC claimants who 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 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 Texas with a refund of \$1,945 paid an estimated \$100 just to get a RAL. This translates into a shockingly high APR - about 198 percent.<sup>9</sup> Texas' typical EITC family loses an additional 5 percent of their refund just to get their money one or two weeks sooner with a RAL. This represents an additional \$85 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 more than 11 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 Texas

Based on IRS data, it is estimated that 850,000 EITC tax filers, just less than half of Texas' EITC families (43.2 percent), who received refunds for tax year 2002 also took out a RAL. RAL vendors continue to target EITC families. As a comparison, just more than 10 percent of Texans who did not claim the EITC received a RAL for tax year 2002.

As Table 1 indicates, the 43.2 percent figure in Texas 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. For instance, in nearly 60 percent of the zip codes in Texas, more than one-third of EITC claimants got their refunds with a RAL.

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These zip codes also tend to 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 30.2 percent compared to the statewide poverty rate of 15.4 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 (VITA) sites throughout many Texas communities. For example, CDF-TX coordinates two VITA sites in the Rio Grande Valley and partners with the Houston Asset Building Coalition to promote 45 VITA sites throughout Houston and Harris County. While these VITA sites serve a small percentage of EITC-eligible taxpayers our offices are working diligently to increase the numbers of EITC-eligible filers through coordinated outreach efforts with the help of state and federal government, employers, faith organizations and community groups. Different levels of government, employers, foundations, churches and other community groups can make site locations available, donate computers for electronic filing, help recruit volunteers and conduct outreach with potential EITC families.

**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 the national banks with which they partner to offer RALs. Texas State Representative Mike Villarreal proposed HB No. 398, "Refund Anticipation Loan Act," in the 79<sup>th</sup> session to protect consumers. The Act prohibits RAL interest rates from exceeding the state's market competitive rate ceiling; regulates RAL facilitators and requires them to register with the state; and requires full disclosure of the nature, costs and risks 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. TAPA, among other things, 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.** For example, CDF-TX coordinates free tax assistance with financial education and literacy services. By collaborating with institutions like IBC Bank and other local banks, families are provided information on how to open and maintain bank accounts.

## Conclusion

Texas' low- to moderate-income working families lost an estimated \$251 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 who may otherwise fall prey to these unconscionable sales tactics can make a difference in the lives of Texas' working poor. Only when every eligible working family has access to free and fair tax preparation services can we truly Leave No Child Behind®.

about qualifying for the EITC. She got back more than \$2,600 in her refund and she said that it will be used to purchase a new car. If Ms. Valdez had gone to a commercial tax preparer, it would have cost her about \$120 just to file her taxes and an additional \$100 if she took out a RAL to get her money right away - a total cost of \$220 that would have made her refund much smaller.





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

Includes the 25 Texas 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
77852	Deanville	Burleson	18	26.7%	75.0%	9.5%	*
76686	Tehuacana	Limestone	44	36.0%	71.6%	20.0%	11.1%
78142	Normanna	Bee	29	35.4%	65.2%	8.5%	5.7%
77467	Pierce	Wharton	18	41.9%	65.0%	10.8%	4.3%
75237	Dallas	Dallas	2,355	52.0%	64.8%	27.9%	20.2%
75210	Dallas	Dallas	1,330	59.6%	64.8%	29.6%	48.0%
78292	San Antonio	Bexar	14	31.9%	64.3%	19.1%	*
78674	Weir	Williamson	30	20.1%	63.0%	12.1%	*
75641	Easton	Gregg	79	59.8%	62.7%	22.1%	9.5%
75153	Powell	Navarro	65	31.6%	62.3%	22.5%	15.0%
76564	Pendleton	Bell	26	27.8%	62.3%	10.1%	*
77436	Egypt	Wharton	38	44.7%	61.6%	11.5%	*
77443	Glen Flora	Wharton	38	36.3%	61.6%	9.6%	21.3%
78295	San Antonio	Bexar	22	59.0%	61.4%	10.6%	*
79839	Fort Hancock	Hudspeth	455	74.2%	61.1%	17.9%	45.0%
75157	Rosser	Kaufman	59	40.3%	61.0%	18.0%	*
76005	Arlington	Tarrant	37	19.1%	60.8%	12.4%	*
76667	Mexia	Limestone	1,449	40.2%	60.7%	18.3%	18.3%
78401	Corpus Christi	Nueces	607	51.9%	60.5%	13.1%	50.4%
79855	Van Horn	Culberson	530	53.3%	60.3%	15.1%	26.2%
75215	Dallas	Dallas	3,180	55.7%	60.3%	24.0%	44.2%
75241	Dallas	Dallas	4,231	46.4%	60.0%	23.3%	22.8%
78293	San Antonio	Bexar	15	37.5%	60.0%	18.0%	*
77091	Houston	Harris	4,314	51.0%	59.7%	19.0%	27.4%
78935	Alleyton	Colorado	38	20.9%	59.2%	10.3%	5.5%
Texas Totals			1,965,557	28.1%	43.2%	10.4%	15.4%
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 Llobera 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/5-14-04sf.htm#\\_ednref1](http://www.cbpp.org/5-14-04sf.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/hirl\\_express\\_refund\\_loan.jsp](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>.

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

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.