



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

For millions of hardworking Americans, tax season means another trip to the commercial tax preparer to have their returns completed and filed. Many of these same taxpayers will be eligible for the Earned Income Tax Credit (EITC)—a federal tax credit designed to supplement the earnings of low- to moderate-income workers—and will opt to receive their refund sooner by purchasing a Refund Anticipation Loan (RAL). The growth of free tax preparation sites in recent years, however, has given taxpayers more options at tax time. These sites offer electronic filing and direct deposit of refunds, allowing taxpayers to get their money in about 10 days without fees. With the money saved, families can work towards financial stability by paying bills, investing in a house, and increasing savings.

Throughout the country this tax season, millions of low- to moderate-income families will claim billions of dollars in EITC refunds. A large percentage of these taxpayers will pay outrageous fees to have their taxes prepared and to receive their refund more quickly. According to data from the Internal Revenue Service (IRS), recent success in promoting the EITC has been accompanied by losses to commercial tax preparers and RAL lenders:

- More than 21.7 million taxpayers received the EITC in 2004, representing a \$39.8 billion investment in children, families, and the communities in which they live, work, and play. Still, tax preparation fees and RALs drained nearly \$2.9 billion from this investment.¹

Support for Working Families

Each year, the EITC lifts nearly 5 million Americans above the poverty line.² Its contribution to the well-being of lower-wage, working families is significant—giving working parents an opportunity to support their families and infusing money into the local economy.³ For tax year 2006, this federal tax credit is worth up to:

- \$4,536 for families with two or more children;
- \$2,747 for families with one child; and,
- \$412 for individuals between the ages of 25 and 64 with no children.

In addition, many EITC recipients are also eligible for other tax credits such as the Child Tax Credit (CTC). The CTC is a federal tax credit for working families with children and incomes above \$11,300. It is worth up to \$1,000 for each child claimed. In 2004, the average total refund for taxpayers claiming the EITC who also received other tax credits was \$2,989.

Costs of Using Commercial Tax Preparers and RALs

In order to claim the EITC and CTC, taxpayers must file their federal and state tax returns. This task can be quite challenging,

as large numbers of EITC-eligible families hire commercial preparers to complete their returns. In 2004, almost 71 percent of EITC recipients in the U.S. paid to have their return completed professionally. Tax preparation fees drained nearly \$2.3 billion from the pockets of working families.

In addition to paying high fees to commercial tax preparers, many working families also use Refund Anticipation Loans to get their refund money on the same day or within a few days. These short-term, high-interest loans are based on the filer's expected tax refund and can end up costing the client a large percentage of their refund. In 2004, the average family in the U.S. purchasing a RAL paid \$100 just to get their refund sooner—meaning that hardworking families lost \$597 million in RAL fees. What's more troubling is that EITC recipients are approximately six times as likely to purchase a RAL than taxpayers who did not file for the credit. According to IRS data, an estimated 6 million—almost 29 percent—of EITC tax filers receiving refunds for 2004 also took out RALs, whereas only 4.5 percent of non-EITC taxpayers who received refunds purchased RALs for the same year. Figure 1 illustrates the disproportionate usage of RALs by EITC families in the country's largest metropolitan areas. Between the costs of tax preparation and RAL fees, the typical EITC family in the U.S. getting a RAL loses an estimated 4.7 percent of its federal refund.

Although RAL usage dropped significantly in 2004, new industry developments put lower-wage families at greater financial risk.⁴

Figure 1: EITC v. Non-EITC Filers who Purchased Refund Anticipation Loans (RALs)

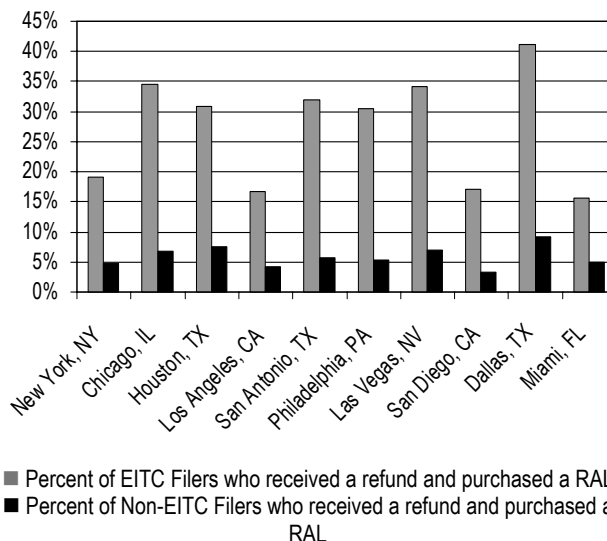


Figure 2: Total Dollars Lost to Tax Preparation and the Purchase of RALs in U.S. Cities with the Highest Total Number of Returns Filed, Tax Year 2004

| City | Total Returns | EITC Returns | % of EITC Filers who used Paid Preparers | % of EITC Returns with a RAL* | % of Non-EITC Returns with a RAL* | Dollars Lost to Tax Prep and RALs** | Child Poverty Rate |
|------------------|---------------|--------------|--|-------------------------------|-----------------------------------|-------------------------------------|--------------------|
| New York, NY | 3,344,740 | 814,991 | 76.0% | 19.1% | 4.8% | \$107,049,570 | 30.3% |
| Chicago, IL | 1,123,286 | 277,885 | 73.1% | 34.5% | 6.8% | \$39,593,220 | 28.5% |
| Houston, TX | 1,075,839 | 282,217 | 75.4% | 30.9% | 7.6% | \$40,231,770 | 26.4% |
| Los Angeles, CA | 873,837 | 239,710 | 81.7% | 16.8% | 4.3% | \$33,082,200 | 30.7% |
| San Antonio, TX | 598,819 | 158,611 | 67.0% | 32.0% | 5.7% | \$20,889,120 | 24.6% |
| Philadelphia, PA | 591,650 | 160,291 | 64.0% | 30.5% | 5.4% | \$20,164,680 | 31.6% |
| Las Vegas, NV | 534,710 | 89,387 | 73.0% | 34.2% | 6.9% | \$12,736,950 | 15.9% |
| San Diego, CA | 532,294 | 71,342 | 71.7% | 17.0% | 3.3% | \$8,803,140 | 20.3% |
| Dallas, TX | 499,983 | 123,858 | 75.9% | 41.2% | 9.1% | \$19,021,470 | 25.5% |
| Miami, FL | 487,205 | 126,350 | 73.3% | 15.6% | 5.0% | \$15,688,350 | 38.5% |
| US Totals | 128,599,631 | 21,721,218 | 70.6% | 28.8% | 4.5% | \$2,896,229,700 | 16.6% |

Source: Internal Revenue Service SPEC Information Database, Tax Year 2004 (December 2006). Poverty figures from US Census Bureau 2000 Census. CDF calculations.

*Of those who received a refund

**Calculated based on a \$150 average tax preparation fee and a \$100 average RAL fee.

Vendors introduced the pay stub or holiday RAL, which is available to taxpayers prior to receiving their W-2s and is taken out against their expected refund. As advocates educate taxpayers about the dangers of purchasing RALs, lenders are finding more ways to reach taxpayers earlier. These developments hurt community efforts to encourage the use of free tax filing sites because loans are now accessible before the tax season begins. To complicate matters, some preparation businesses require pay stub and holiday RAL users to return to the same office to have their tax returns completed.⁵

Effects on Economic Activity

RAL fees and tax preparation costs represent a significant drain on local economies across the country. Figure 2 summarizes the total dollars lost in the country's largest urban areas while Figure 3 highlights the losses endured by counties with the highest percentage of RAL purchases among EITC claimants. Of note, counties with high rates of RAL usage tend to have higher rates of child poverty than the national average. The average child poverty rate in the 25 counties with the highest percentage of RALs was 36.7 percent, significantly higher than the national rate of 16.6 percent. Areas of the country hit hardest by RALs include North and South Dakota and states in the Deep South such as Mississippi, Georgia, and South Carolina. Lastly, Figure 4 provides an overview of the total dollars lost across all fifty states and the District of Columbia.

While only a handful of studies have measured the economic impact of the Earned Income Tax Credit on local economies, their results are telling. An analysis of EITC population and participation rates by researchers in San Antonio concluded that increasing the number of EITC claims would benefit the city's economy. Not only would two-thirds of additional EITC dollars be spent locally on retail, general services and utilities, but each additional dollar received would generate roughly \$1.58 in local economic activity.⁶ Unfortunately, cities such as San Antonio do

not benefit fully from increasing EITC participation rates because money that was intended for working families is diverted into the portfolios of commercial tax preparers and lending institutions. Communities across the United States are similarly affected because fewer dollars in the hands of working families means less economic activity.

Recommendations

Families across the country lost an estimated \$2.9 billion because of tax preparation fees and RALs in 2004. Government officials and community leaders are in a unique position to develop public policies that address the cause and mitigate the effect of RALs and costly tax preparation on lower-income communities. To that end, Children's Defense Fund recommends the following:

1. **Strengthen consumer protections.** In past sessions of Congress, EITC and RAL legislation has failed to gain traction. This year lawmakers must again consider adopting policies that protect consumers, such as establishing licensing requirements for commercial tax preparers, ensuring full disclosure of RAL fees and interest rates, prohibiting the sale of RALs to EITC recipients, and placing a cap on the interest rates that banks can charge for RALs.
2. **Expand access to free tax assistance.** Large numbers of taxpayers pay to have their taxes completed and filed. Elected officials and community leaders must find ways to build and maintain free tax preparation networks across the country by investing in the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs and other free tax assistance centers.
3. **Connect working families to mainstream financial services.** Free or low-cost checking and savings accounts, credit counseling opportunities, and financial education programs offer working families the tools to

Figure 3: U.S. Counties with the Highest Percentage of Refund Anticipation Loan Purchases, Tax Year 2004

| County | Total Returns | EITC Returns | % of EITC Filers who used Paid Preparers | % of EITC Returns with a RAL* | % of Non-EITC Returns with a RAL* | Dollars Lost to Tax Prep and RALs** | Child Poverty Rate |
|----------------|---------------|--------------|--|-------------------------------|-----------------------------------|-------------------------------------|--------------------|
| Todd, SD | 2,802 | 1,620 | 93.0% | 67.2% | 22.2% | \$334,320 | 57.7% |
| Shannon, SD | 3,716 | 2,285 | 92.0% | 67.1% | 33.7% | \$468,000 | 61.0% |
| Sioux, ND | 1,362 | 643 | 90.0% | 61.6% | 22.3% | \$125,820 | 45.2% |
| Yazoo, MS | 9,539 | 4,200 | 71.2% | 61.4% | 12.0% | \$702,240 | 43.1% |
| Thurston, NE | 2,662 | 1,017 | 91.0% | 61.1% | 15.9% | \$199,950 | 33.1% |
| Buffalo, SD | 533 | 309 | 75.4% | 60.8% | 21.1% | \$53,670 | 61.8% |
| Lake, TN | 2,233 | 752 | 85.4% | 60.7% | 13.4% | \$141,030 | 35.7% |
| Emporia, VA | 5,636 | 1,855 | 79.1% | 60.4% | 12.9% | \$330,900 | 21.9% |
| Dillon, SC | 12,256 | 5,279 | 76.2% | 60.1% | 15.6% | \$915,450 | 33.4% |
| Stewart, GA | 1,977 | 896 | 72.2% | 59.9% | 12.1% | \$150,150 | 30.5% |
| Scotland, NC | 13,728 | 5,015 | 84.4% | 59.3% | 12.8% | \$928,860 | 30.3% |
| Hancock, GA | 3,422 | 1,643 | 81.6% | 59.2% | 16.0% | \$297,720 | 45.4% |
| Anson, NC | 9,764 | 3,577 | 91.5% | 58.2% | 14.7% | \$694,770 | 24.0% |
| Marlboro, SC | 11,319 | 4,937 | 80.6% | 57.9% | 14.8% | \$879,690 | 29.4% |
| Webster, GA | 746 | 291 | 80.1% | 57.9% | 9.4% | \$51,510 | 26.0% |
| Kenedy, TX | 160 | 74 | 71.6% | 57.2% | 18.0% | \$12,180 | 15.6% |
| Cook, GA | 6,304 | 2,287 | 77.1% | 56.8% | 11.9% | \$391,770 | 28.5% |
| Bamberg, SC | 5,771 | 2,303 | 67.6% | 56.5% | 13.9% | \$360,090 | 35.4% |
| Benson, ND | 2,613 | 967 | 87.1% | 56.4% | 10.8% | \$178,950 | 39.2% |
| Mitchell, GA | 8,366 | 3,484 | 79.7% | 56.3% | 10.7% | \$609,390 | 38.8% |
| Greene, AL | 3,488 | 1,747 | 67.9% | 56.2% | 13.7% | \$275,280 | 44.1% |
| Marion, MS | 9,852 | 3,713 | 73.7% | 56.1% | 15.6% | \$611,820 | 32.6% |
| Early, GA | 4,460 | 1,928 | 89.2% | 56.1% | 10.2% | \$364,590 | 37.3% |
| Jasper, MS | 7,282 | 2,961 | 79.7% | 55.8% | 12.4% | \$516,120 | 28.9% |
| Washington, MS | 22,013 | 10,578 | 79.0% | 55.6% | 12.3% | \$1,836,000 | 38.5% |
| US Totals | 128,599,631 | 21,721,218 | 70.6% | 28.8% | 4.5% | \$2,896,229,700 | 16.6% |

Source: Internal Revenue Service SPEC Information Database, Tax Year 2004 (December 2006). Poverty figures from US Census Bureau 2000 Census. CDF calculations.

*Of those who received a refund

**Calculated based on a \$150 average tax preparation fee and a \$100 average RAL fee.

- build for a better financial future, and public – private partnerships should be explored and established to ensure that working families have easy access to these resources.
4. **Create state EITCs.** Most poor children live in families with a working parent, and the creation of state EITCs could supplement wages and help lift a family out of poverty. Only nineteen states, including the District of Columbia, currently have a state EITC in effect. In addition, three localities—New York City, San Francisco, and Montgomery County, Maryland—offer local Earned Income Tax Credits. Research indicates that tax refunds can be used to help families build assets while stimulating local economies.

ENDNOTES

1. IRS SPEC Return Information Database, Tax Year 2004 (December 2006). All figures contained in this report have been retrieved from the 2004 SPEC database unless otherwise noted. CDF calculations.
2. Alan Berube, *Using the Earned Income Tax Credit to Stimulate Local Economies* (The Living Cities Policy Series, 2007).
3. Steve Holt, *The Earned Income Tax Credit at Age 30: What We Know* (Washington: Brookings Institution, 2006).
4. The number and cost of RALs purchased declined significantly in the 2004 tax year, possibly due to more education and awareness, advocacy, and changes to IRS reporting. Chi Chi Wu, *One Step Forward, One Step Back: Progress Seen in Efforts Against High-Priced Refund Anticipation Loans, but Even More Abusive Products Introduced* (Boston: National Consumer Law Center, 2007).
5. Chi Chi Wu, *One Step Forward, One Step Back*.
6. *2004 Update: Increased Participation in the Earned Income Tax Credit in San Antonio* (Austin: Texas Perspectives, 2004). CDF calculations.

Figure 4: Total Dollars Lost to Tax Preparation Fees and Refund Anticipation Loans in U.S. States, Tax Year 2004

| State | Total Returns | Total EITC Returns | % of EITC Filers who used Paid Preparers | % of EITC Returns with RAL* | % of Non-EITC Returns with RAL* | Dollars Lost to Tax Prep and RALs** | Child Poverty Rate |
|----------------|---------------|--------------------|--|-----------------------------|---------------------------------|-------------------------------------|--------------------|
| Alabama | 1,861,058 | 481,479 | 75.4% | 41.9% | 7.5% | \$74,079,120 | 21.5% |
| Alaska | 329,863 | 38,649 | 52.7% | 20.1% | 4.2% | \$3,797,490 | 11.8% |
| Arizona | 2,288,969 | 393,222 | 68.8% | 25.6% | 4.0% | \$50,268,630 | 19.3% |
| Arkansas | 1,109,117 | 275,910 | 77.3% | 40.7% | 7.4% | \$42,845,970 | 21.8% |
| California | 14,593,144 | 2,378,899 | 75.4% | 17.3% | 3.2% | \$307,233,570 | 19.5% |
| Colorado | 2,038,858 | 259,580 | 63.3% | 21.1% | 2.9% | \$29,823,210 | 11.3% |
| Connecticut | 1,632,368 | 165,216 | 68.3% | 23.0% | 2.7% | \$20,553,120 | 10.4% |
| Delaware | 384,871 | 56,346 | 61.9% | 30.0% | 4.0% | \$6,872,250 | 12.3% |
| DC | 265,859 | 47,875 | 69.9% | 36.0% | 5.3% | \$6,687,960 | 31.7% |
| Florida | 7,838,432 | 1,556,443 | 69.5% | 27.5% | 5.1% | \$202,998,000 | 17.6% |
| Georgia | 3,693,890 | 842,836 | 74.7% | 39.1% | 6.8% | \$126,351,570 | 17.1% |
| Hawaii | 587,556 | 85,250 | 62.5% | 16.7% | 2.9% | \$9,338,760 | 14.1% |
| Idaho | 579,034 | 99,770 | 60.7% | 17.0% | 2.5% | \$10,700,880 | 14.3% |
| Illinois | 5,606,496 | 843,346 | 70.9% | 30.2% | 4.3% | \$113,917,590 | 14.3% |
| Indiana | 2,792,173 | 425,032 | 69.3% | 33.2% | 5.6% | \$57,905,760 | 12.2% |
| Iowa | 1,311,323 | 168,313 | 72.8% | 20.6% | 2.9% | \$21,693,270 | 11.0% |
| Kansas | 1,195,266 | 173,164 | 67.7% | 24.2% | 3.2% | \$21,616,320 | 12.0% |
| Kentucky | 1,722,549 | 338,311 | 75.6% | 34.5% | 6.6% | \$49,591,200 | 20.8% |
| Louisiana | 1,763,306 | 509,929 | 72.2% | 40.4% | 7.1% | \$75,349,830 | 26.6% |
| Maine | 609,600 | 85,287 | 59.0% | 18.2% | 2.9% | \$8,991,150 | 13.7% |
| Maryland | 2,543,846 | 337,548 | 65.8% | 28.6% | 3.9% | \$42,567,450 | 10.7% |
| Massachusetts | 2,981,033 | 304,132 | 65.3% | 15.6% | 2.1% | \$34,261,950 | 12.0% |
| Michigan | 4,429,574 | 640,123 | 69.1% | 27.0% | 3.9% | \$82,997,490 | 13.9% |
| Minnesota | 2,357,454 | 255,346 | 65.4% | 16.6% | 1.5% | \$29,045,850 | 9.6% |
| Mississippi | 1,132,124 | 367,122 | 73.2% | 47.0% | 9.5% | \$57,155,220 | 27.0% |
| Missouri | 2,525,625 | 432,291 | 71.0% | 29.9% | 4.0% | \$58,448,550 | 15.7% |
| Montana | 430,008 | 72,283 | 64.9% | 21.8% | 3.0% | \$8,526,720 | 19.0% |
| Nebraska | 789,870 | 108,231 | 68.1% | 20.4% | 2.6% | \$13,156,500 | 12.3% |
| Nevada | 1,046,445 | 158,030 | 71.4% | 33.3% | 6.4% | \$22,007,610 | 14.0% |
| New Hampshire | 632,975 | 61,815 | 60.8% | 19.7% | 3.2% | \$6,779,640 | 7.8% |
| New Jersey | 4,000,604 | 481,231 | 76.2% | 26.0% | 3.7% | \$66,881,010 | 11.1% |
| New Mexico | 804,208 | 194,694 | 66.2% | 22.9% | 4.1% | \$23,639,550 | 25.0% |
| New York | 8,384,979 | 1,449,615 | 73.8% | 21.5% | 3.7% | \$189,275,280 | 20.0% |
| North Carolina | 3,658,074 | 747,436 | 73.9% | 41.5% | 7.6% | \$112,811,880 | 16.1% |
| North Dakota | 300,549 | 39,060 | 65.4% | 19.8% | 2.5% | \$4,560,570 | 14.0% |
| Ohio | 5,346,738 | 781,499 | 64.8% | 31.9% | 4.3% | \$100,110,660 | 14.4% |
| Oklahoma | 1,428,959 | 307,153 | 68.7% | 31.9% | 5.5% | \$41,061,000 | 19.6% |
| Oregon | 1,545,169 | 219,780 | 54.8% | 17.7% | 2.2% | \$21,745,860 | 14.7% |
| Pennsylvania | 5,710,870 | 765,504 | 64.9% | 25.1% | 3.1% | \$93,043,800 | 14.7% |
| Rhode Island | 489,135 | 64,370 | 74.3% | 21.4% | 3.6% | \$8,491,800 | 16.9% |
| South Carolina | 1,797,085 | 422,511 | 77.6% | 43.7% | 7.2% | \$67,156,260 | 18.8% |
| South Dakota | 356,888 | 54,753 | 70.2% | 28.3% | 3.7% | \$7,237,260 | 17.2% |
| Tennessee | 2,552,768 | 541,580 | 73.9% | 39.3% | 7.6% | \$80,494,110 | 18.0% |
| Texas | 9,145,683 | 2,170,290 | 72.2% | 33.5% | 7.0% | \$305,145,180 | 20.5% |
| Utah | 964,755 | 137,993 | 59.9% | 16.5% | 2.6% | \$14,610,030 | 10.1% |
| Vermont | 303,104 | 37,851 | 58.8% | 14.5% | 2.2% | \$3,842,880 | 11.4% |
| Virginia | 3,379,660 | 485,927 | 66.5% | 33.6% | 4.5% | \$64,151,400 | 12.3% |
| Washington | 2,768,468 | 350,253 | 58.1% | 21.8% | 3.6% | \$37,828,110 | 13.7% |
| West Virginia | 739,951 | 143,747 | 63.8% | 30.5% | 5.7% | \$17,995,680 | 24.3% |
| Wisconsin | 2,578,347 | 292,626 | 66.0% | 18.8% | 1.9% | \$34,255,290 | 11.2% |
| Wyoming | 238,413 | 33,082 | 65.0% | 23.4% | 4.5% | \$3,967,680 | 14.5% |
| US Totals | 128,599,631 | 21,721,218 | 70.6% | 28.8% | 4.5% | \$2,896,229,700 | 16.6% |

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Children's Defense Fund®

Healthy Child Campaign

In addition to the EITC and access to VITA sites, health insurance is critical to financial stability. Health care costs have increased drastically in recent years, leaving an estimated 9 million children uninsured.

Families that lack medical insurance tend to have higher credit card debt because they cannot pay for services, and, as a result, medical expenses account for nearly 50 percent of bankruptcy filings. CDF unveiled a legislative proposal in January that would ensure that all children would receive coverage for all medically necessary care. For more information, visit www.childrensdefense.org/healthychild.