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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)

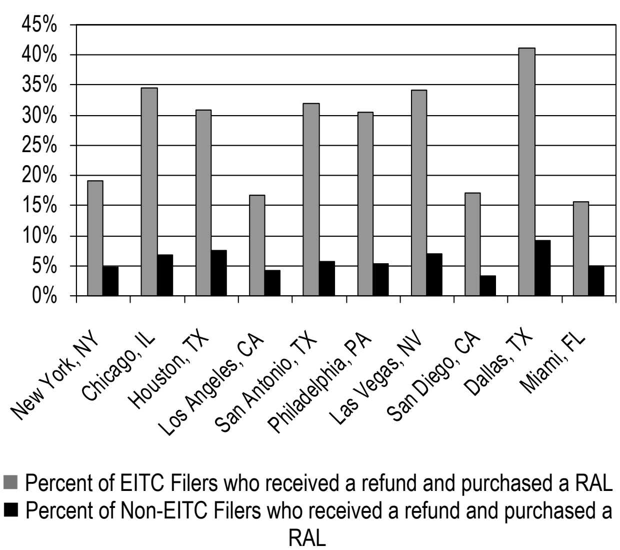

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Figure 2: Total Dollars Lost to Tax Preparation and the Purchase of RALs in U.S. Cities with the Highest Total Number of Returns Filed, Tax Year 2004

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%
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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.