



## Keeping What They've Earned: Tax Credits for Working Families in the District of Columbia

As a single father of a preschool son and a grandfather to several other children, learning that he qualified for the Earned Income and Child Tax credits and would receive a sizeable refund was a welcome surprise for Bill.<sup>1</sup> Last year, he visited a commercial tax preparer and paid several hundred dollars to have his return completed and filed. It was an experience he would rather forget, and finding a Volunteer Income Tax Assistance (VITA) site near his home has helped. In addition to the kind and courteous treatment he received when having his return prepared, Bill avoided the high fees he had become accustomed to paying.

Throughout the country this tax season, millions of low- to moderate-income families will claim billions of dollars in Earned Income Tax Credit (EITC) refunds. A large percentage of these taxpayers will pay outrageous fees to have their taxes prepared and to receive their refund more quickly with a Refund Anticipation Loan (RAL). 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. Tax preparation fees and RALs drained nearly \$2.9 billion from this investment.<sup>2</sup>
- In the District, almost 48,000 taxpayers claimed an estimated \$83.3 million in Earned Income Tax Credits. Still, District residents lost an estimated \$6.7 million to tax preparation fees and high interest loans.

### Support for Working Families

Each year, the EITC lifts nearly 5 million Americans above the poverty line.<sup>3</sup> 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.<sup>4</sup> 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 workers between 25 and 64 with no children.

The District of Columbia also offers an EITC to its taxpayers. DC residents who claim the EITC on their federal taxes can get an additional credit valued at 35 percent of their EITC when they file their city taxes. Additionally, 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 tax year 2006. In 2004, the average total refund

for District of Columbia taxpayers claiming the EITC who also received other tax credits was \$2,917.

### Costs of Using Commercial Tax Preparers and Refund Anticipation Loans

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 65 percent of EITC recipients in Ohio paid to have their return completed professionally. Tax preparation fees drained nearly \$76 million 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 a taxpayer a large percentage of what they are owed. In 2004, the average family in the District of Columbia purchasing a RAL paid \$100 just to get their refund one or two weeks sooner—meaning that hard-working families lost \$1.7 million in RAL fees. What's more troubling is that EITC recipients are almost seven times as likely to purchase a RAL than taxpayers who did not file for the credit. According to IRS data, almost 17,000—or 36 percent—of the District's EITC tax filers receiving refunds for 2004 also took out RALs, whereas only 5.3 percent of non-EITC taxpayers who received refunds purchased RALs for the same year. Figure 1 illustrates the

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

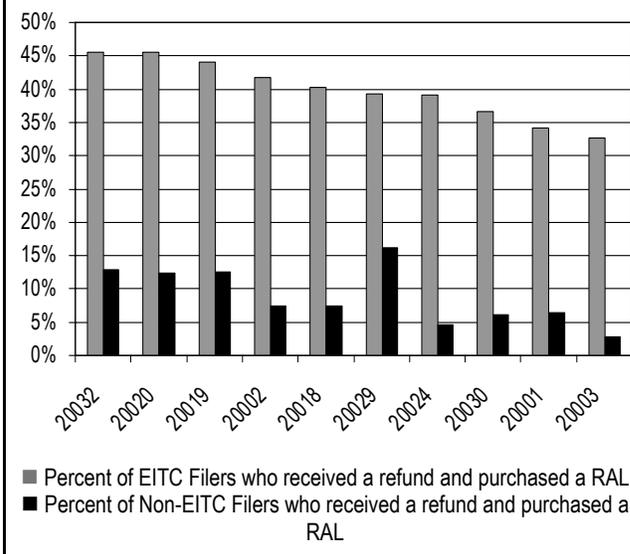


Figure 2: Total Dollars Lost to Tax Preparation and the Purchase of RALs in DC Zip Codes with the Highest Total Number of Returns Filed, Tax Year 2004

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
20011	28,428	5,588	70.8%	25.6%	6.4%	\$730,620	18.7%
20009	25,479	2,877	66.3%	19.9%	2.1%	\$339,390	34.2%
20002	22,595	5,361	70.1%	41.7%	7.5%	\$783,240	35.6%
20019	21,463	7,661	71.2%	44.1%	12.5%	\$1,152,720	40.5%
20020	19,683	7,112	73.9%	45.5%	12.3%	\$1,109,430	47.4%
20008	16,187	445	49.9%	3.5%	0.4%	\$34,650	2.2%
20016	14,227	371	54.4%	3.4%	0.4%	\$31,380	1.4%
20001	13,830	3,263	68.6%	34.1%	6.4%	\$443,460	34.5%
20010	13,350	2,938	72.6%	21.1%	4.7%	\$378,360	31.0%
20032	12,906	5,248	71.5%	45.6%	12.8%	\$799,920	46.9%
20007	12,394	352	48.6%	3.2%	0.5%	\$26,640	8.1%
20003	10,468	1,076	66.9%	32.7%	2.8%	\$142,110	42.7%
20017	7,796	1,183	66.4%	30.8%	6.0%	\$153,120	15.4%
20015	7,623	170	55.3%	8.1%	0.3%	\$15,270	0.9%
20018	7,261	1,453	71.1%	40.2%	7.4%	\$212,190	23.5%
DC Totals	265,859	47,875	69.9%	36.0%	5.3%	\$6,687,960	31.7%
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.

disproportionate usage of RALS by EITC families in the District's largest zip codes. Between the costs of tax preparation and RAL fees, the typical EITC family in the District of Columbia getting a RAL loses an estimated 4.9 percent of its federal refund.

Although RAL usage dropped significantly in 2004, new industry developments put lower-wage families at greater financial risk.<sup>5</sup> 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.<sup>6</sup>

#### Effects on Economic Activity

RAL fees and tax preparation costs represent a significant drain on local economies across the District. Figures 2 and 3 summarize the total dollars lost to tax preparation fees and Refund Anticipation Loans by zip code. Of note, the three zip codes with the highest percentage of RAL purchases are located along the southeast edge of the District and have an average child poverty rate of 45 percent—significantly higher than the District-wide rate of 31.7 percent and the national rate of 16.6 percent.

While only a handful of studies have measured the economic impact of the Earned Income Tax Credit on local communities, 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.<sup>7</sup> 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. District of Columbia communities are similarly affected because fewer dollars in the hands of working families means less economic activity.

#### Recommendations

District of Columbia families lost an estimated \$6.7 million 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.** District of Columbia lawmakers must consider adopting policies that establish licensing requirements for commercial tax preparers, ensure full disclosure of RAL fees and interest rates,

Figure 3: Total Dollars Lost to Tax Preparation and RALs in DC Zip Codes with the Highest Percentage of RAL 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
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20018	7,261	1,453	71.1%	40.2%	7.4%	\$212,190	23.5%
20029	268	85	69.4%	39.2%	16.2%	\$12,180	n/a
20024	5,756	834	66.9%	39.1%	4.7%	\$114,840	42.4%
20030	248	81	71.6%	36.7%	6.1%	\$11,670	n/a
20001	13,830	3,263	68.6%	34.1%	6.4%	\$443,460	34.5%
20003	10,468	1,076	66.9%	32.7%	2.8%	\$142,110	42.7%
20017	7,796	1,183	66.4%	30.8%	6.0%	\$153,120	15.4%
20012	6,360	734	70.0%	26.5%	4.8%	\$95,460	10.4%
20011	28,428	5,588	70.8%	25.6%	6.4%	\$730,620	18.7%
20010	13,350	2,938	72.6%	21.1%	4.7%	\$378,360	31.0%
20013	529	67	53.7%	20.7%	5.4%	\$6,660	n/a
DC Totals	265,859	47,875	69.9%	36.0%	5.3%	\$6,687,960	31.7%
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prohibit the sale of RALs to EITC recipients, and place a cap on the interest rates that banks can charge for RALs.

2. **Expand access to free tax assistance.** Large numbers of District of Columbia residents pay to have their taxes completed and filed. The District of Columbia City Council recently committed \$150,000 to community groups providing EITC outreach, education, and free tax preparation services. Elected officials and community leaders must find additional ways to build and sustain free tax preparation networks throughout the District by continuing to invest 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 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.

#### ENDNOTES

1. A pseudonym was used to protect his identity.
2. 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.
3. Alan Berube, *Using the Earned Income Tax Credit to Stimulate Local*

*Economies* (The Living Cities Policy Series, 2007).

4. Steve Holt, *The Earned Income Tax Credit at Age 30: What We Know* (Washington: Brookings Institution, 2006).
5. 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).
6. Chi Chi Wu, *One Step Forward, One Step Back*.
7. *2004 Update: Increased Participation in the Earned Income Tax Credit in San Antonio* (Austin: Texas Perspectives, 2004). CDF calculations.

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](http://www.childrensdefense.org/healthychild).