



Children's Defense Fund

# The Children's Defense Fund - Tennessee

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

More than 13 million children live in poverty in the United States. Across the country this tax season, millions of their low- to moderate-income families will receive tax refunds through the Earned Income Tax Credit (EITC) program—one of the most effective federal weapons against poverty. More than 21.4 million taxpayers claimed over \$38.3 billion in 2003. The EITC not only helps to alleviate poverty among working families, it also boosts local economies since refunds are often used to pay for rent, utilities, food and child care. Unfortunately, up to 20 percent of eligible low-income taxpayers do not claim the EITC, while others claim the credit but pay exorbitant fees to have their taxes prepared or to receive their refund more quickly. Millions of dollars are lost to families and communities nationwide through Refund Anticipation Loans (RALs), high-interest loans that tax filers take out against their expected tax refunds, commonly marketed as “Rapid Refunds” or “Fast Money.” Approximately 70 percent of families claiming the EITC use commercial tax preparers, unaware of other choices available to them, including free tax preparation at Volunteer Income Tax Assistance (VITA) sites.

In Tennessee, more than 535,000 taxpayers claimed \$973 million in the EITC, but they lost an estimated \$77.5 million to tax preparation and high-interest loans during the 2003 tax year.<sup>1</sup> Much more needs to be done on the national, state, and local levels to ensure that EITC dollars make it into the pockets of the needy recipients who the program was designed to help.

### *Earned Tax Credits for Working Families*

The EITC has wide bipartisan support and has been a part of the federal tax system since 1975. It is the most effective work support tool to assist families who work full- or part-time but earn low wages. EITC refunds received for the 2003 tax year helped to lift 4.4 million people, including 2.4 million children, out of poverty.<sup>2</sup> Recipients can use the credit to help pay income taxes owed or, in most cases, even get money back in the form of a refund.

The EITC means real money in the pockets of eligible individuals and families. For the 2005 tax year, the EITC is worth up to \$4,400 for workers who earned less than \$35,263 (\$37,263 if married and filing jointly) and have two or more qualifying children. Workers earning less than \$31,030 (\$33,030 if married and filing jointly) with one qualifying child may be eligible for up to \$2,662. Working adults between the ages of 25 and 64 with no children, who earned less than \$11,750 (\$13,750 if married and filing jointly) may also qualify for an EITC worth up to \$399.

In addition, many EITC recipients are also eligible for other tax credits such as the Child Tax Credit (CTC). The Child Tax Credit is a federal tax credit for working families with children and incomes above \$11,000 that may be worth up to \$1,000 for each child claimed in 2005. In Tennessee, the average total refund for taxpayers claiming the EITC was \$2,904 in 2003.

### *Costs of Using Commercial Tax Preparers and Refund Anticipation Loans (RALs)*

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 quite complex since tax laws, especially those regarding the EITC, 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 nearly 75 percent of Tennessee low-income families eligible for the EITC hire commercial tax preparers to do their tax returns. It is estimated that these recipients spend an average of \$120 to have their taxes prepared and electronically filed.<sup>3</sup> For EITC families living paycheck to paycheck, this is a significant amount of money—more than four percent of their total refund.<sup>4</sup> Statewide tax preparation costs represent about \$48.1 million lost to poor working families.<sup>5</sup>





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The Children's Defense Fund® (CDF) mission 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. The Children's Defense Fund's national Tax and Benefits Outreach Initiative is entering its third year of working with coalitions across the country during the tax season. CDF has partnered with organizations in local community coalitions to run Volunteer Income Tax Assistance (VITA) sites and provide outreach to working families. These partnerships have resulted in helping families and local communities get an estimated \$170 million in tax refunds during the past two years.

**Elizabeth, a 40-year-old single mother with one grown daughter and two others at home worked as a housekeeper in Newport, Tennessee. She filed her taxes using a commercial tax preparer and took out a Refund Anticipation Loan (RAL) because she needed to pay a large utility bill immediately. Because Elizabeth was not aware of the free tax assistance sites located throughout Tennessee, she wound up paying \$185—nearly 23 percent of her \$794 refund—for tax preparation and RAL fees. Since learning about the Volunteer Income Tax Assistance (VITA) sites through a Children's Defense Fund press conference, Elizabeth has vowed to tell everyone she knows about these free sites.**

In addition to paying high fees to commercial tax preparers, many working families also use Refund Anticipation Loans, or RALs, 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. The average EITC family purchasing a RAL paid \$130—equal to a loan with an Annual Percentage Rate (APR) of about 171 percent<sup>6</sup>—just to get their refund one or two weeks sooner. This means needy Tennessee families lose an additional \$29 million in RAL fees.<sup>7</sup> When tax preparation fees are included, the typical Tennessee family getting a RAL loses over five percent of its federal refund. Between \$48.1 million in tax preparation fees and an additional \$29 million in RAL fees, Tennessee's working families, and their communities, are deprived of more than \$77 million.

In most cases, RALs are paid off once the Internal Revenue Service (IRS) processes the tax return and transfers the funds. But RAL loans can actually place families at greater financial risk since they are responsible for paying the interest accruing on the loan if the IRS denies part of the refund for any reason or even withholds it temporarily for audit purposes. According to a recent study by the National Taxpayer Advocate, nearly 75 percent of the tax returns frozen by the IRS because of suspected fraud belonged to low-income taxpayers claiming the EITC, although well over half of all frozen refunds (56-66 percent) were ultimately found to be free of fraud.<sup>8</sup> Given their often pressing financial needs, it is unlikely that EITC families budget for this possibility. There is also ample anecdotal evidence showing some families, especially those with limited English proficiency, do not fully comprehend that they are taking out a loan. Families could actually *end up in debt* due to their efforts to claim EITC and other tax benefits intended to assist them in becoming more financially secure.

One of the largest commercial tax preparers, H&R Block, is awaiting final federal approval on a proposed settlement to four state class action lawsuits and potential claims involving its use of RALs in 22 other states and the District of Columbia. Other lawsuits, including a national class action, are still pending. Although H&R Block has made an effort to resolve its use of RALs, there are still many other commercial tax preparers, both large companies and small store front operations, that continue to market Refund Anticipation Loans.

## Use of RALs in Tennessee

RAL vendors continue to target EITC families. According to IRS data, more than 226,000—44 percent—of Tennessee EITC filers who received refunds for 2003 also took out RALs, whereas only 7.7 percent of non-EITC taxpayers who received refunds got RALs for the same year.

As Table 1 indicates, counties with high rates of RAL usage also tend to have much higher rates of child poverty than the national average. Forty-four percent of EITC families in Tennessee receive their refunds with a RAL—higher than the national average of 34.2 percent. The child poverty rate in Tennessee's 25 counties with the highest percentage of RALs was 20.1 percent, slightly higher than the state poverty rate and 20 percent higher than the national rate of 16.6 percent.<sup>9</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 those with low percentages of EITC filers.<sup>10</sup>

## Recommendations

**1. Strengthen consumer protection and education.** Currently, there is little regulation of commercial tax preparers—nearly anyone can hang a "tax preparer" shingle, regardless of education or knowledge of ever-changing tax laws. The federal and state governments must do more to regulate and monitor the practices of commercial preparers as well as their partner banks, including:

- Licensing all commercial tax preparers.
- Requiring all RAL brokers to prominently display not only all associated fees and interest rates, but to also inform customers that they could receive their full refund in one to two weeks from the IRS through e-filing and direct deposit without paying for a RAL.

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- Prohibiting RALs to be used with EITC refunds; or placing a cap on interest rates that banks can charge for RALs.

Federal legislation has been proposed that addresses the issues of the Earned Income Tax Credit and RALs. The Taxpayer Protection and Assistance Act (S.832) would increase funds to sites that offer free tax preparation for low- to moderate-income families; require those selling RALs to register with the IRS; and provide oral disclosure to taxpayers regarding loan fees and interest rates.

- 2. Expand access to free tax assistance.** Although free tax assistance for low-income families is available at Volunteer Income Tax Assistance (VITA), Tax Counseling for the Elderly (TCE), AARP, and other preparation sites in many communities nationwide, less than two percent of EITC-eligible taxpayers use them. Federal, state, and local governments should partner with employers, foundations, churches, and other community groups to provide financial assistance, make site locations available, donate computers for electronic filing, help recruit volunteers, and conduct outreach with potential EITC families. These preparation sites, along with free or low-cost filing Web sites offered by the IRS and other organizations, should be better promoted to working families. Throughout the United States, CDF state and regional offices operate VITA sites and work with other organizations and federal and state agencies to provide and promote free tax assistance.
- 3. Simplify the rules and process.** Federal and state laws that govern working families' income taxes need to be simplified, and federal and state tax credit programs should be coordinated, so working families can complete their own taxes without having to pay for professional assistance.
- 4. Connect families with financial services and help them develop 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. Connecting families with banks and credit unions offering free or very low-cost bank accounts can make a tremendous difference; and recent efforts by financial institutions to offer free tax assistance and financial literacy are proving successful.
- 5. Create a state EITC.** Most poor children live in families with a working parent, and the creation of a state EITC could supplement wages and help to lift a family out of poverty. Nineteen states including the District of Columbia have enacted a state EITC worth some percentage of the federal credit. Research indicates that tax refunds, including state EITC refunds, can be used to help families build assets while stimulating local economies.

## Conclusion

Tennessee lost an estimated \$77 million in large fees to commercial tax preparers and "rapid refund" vendors in tax year 2003—money that could have been used to help lift children and families out of poverty and boost local economies. Much more can and should be done on the local, state, and national levels to ensure that EITC dollars make it into the pockets of working families. The Children's Defense Fund's efforts to educate and assist families are making a difference in the lives of working families. Only when every eligible working family has access to free and fair tax preparation services can we truly *Leave No Child Behind*.



# Table 1: Percent of EITC and Non-EITC Returns with RALs and Dollars Lost

The 25 Counties with the Highest Percentage of EITC Filers Taking Out RALs (Refund Anticipation Loans), Tax Year 2003 and Select Cities

	Number of EITC Returns	Percent of All Returns with EITC	Percent of EITC Returns with RAL*	Percent of Non-EITC Returns with RAL*	Dollars Lost to Tax Preparation	Dollars Lost to Purchasing a RAL	Total Dollars Lost to Tax Prep and RAL	Child Poverty Rate
<b>Highest RAL Counties</b>								
Lake	753	33.5%	65.1%	16.0%	\$76,440	\$62,103	\$138,543	35.7%
Shelby	112,699	27.9	56.6	12.7	9,941,040	8,146,150	18,087,190	23.2
Haywood	3,013	39.1	56.1	16.2	303,600	216,133	519,733	24.1
Hardeman	3,606	34.4	54.8	12.8	321,480	250,401	571,881	24.6
Madison	9,917	25.2	53.3	11.3	912,960	672,608	1,585,568	19.2
Fayette	2,812	27.2	52.3	13.3	255,600	184,672	440,272	18.7
Lauderdale	3,373	32.9	51.8	12.9	339,840	221,864	561,704	25.2
Dyer	3,939	25.8	48.9	12.5	369,840	242,565	612,405	21.3
Gibson	5,291	23.7	48.4	10.4	509,400	321,626	831,026	17.2
Marion	1,611	22.3	47.7	12.4	155,640	96,722	252,362	20.3
Bedford	3,552	21.4	47.4	13.3	341,520	208,531	550,051	17.1
Hamilton	27,500	19.5	47.1	9.3	2,489,640	1,622,751	4,112,391	17
Tipton	5,252	23.6	45.9	10.6	478,920	302,563	781,483	16.6
Crockett	1,584	26.3	45.9	11.0	152,400	90,640	243,040	19.7
Obion	2,903	22.1	45.3	11.0	277,920	164,088	442,008	19
Dickson	3,895	19.9	45.0	11.8	358,680	217,185	575,865	13.4
Coffee	4,397	19.5	44.0	10.0	403,920	241,044	644,964	18
Greene	6,025	22.4	43.6	10.3	571,320	325,252	896,572	19.9
McNairy	2,850	26.6	43.6	10.8	277,920	152,860	430,780	19.5
Trousdale	642	23.9	43.4	11.4	66,000	34,034	100,034	14.9
Carroll	3,142	23.8	43.2	10.3	298,200	170,637	468,837	18.1
Marshall	2,289	19.0	42.8	11.1	215,280	121,048	336,328	11.4
Davidson	50,813	18.7	42.8	9.2	4,303,440	2,709,496	7,012,936	19.5
Henry	3,240	24.6	42.7	9.2	300,000	171,573	471,573	20.4
Chester	1,270	24.3	42.5	10.4	112,440	66,781	179,221	18.6
<b>Selected Counties</b>								
Blount	7,753	16.4	38.1	8.1	664,200	364,549	1,028,749	12.8
Anderson	4,782	16.4	37.9	7.9	393,960	224,554	618,514	18.5
Loudon	3,591	16.8	36.7	7.5	320,280	162,918	483,198	12.9
<b>Ten Biggest Cities**</b>								
Memphis	104,096	33.8	58.1	15.1	9,263,520	7,745,462	17,008,982	30.4
Nashville	36,058	19.4	44.4	8.7	3,064,920	1,996,539	5,061,459	19.5
Knoxville	24,667	15.7	38.2	6.8	2,064,120	1,171,421	3,235,541	26.5
Chattanooga	19,996	23.8	51.6	10.8	1,839,240	1,302,060	3,141,300	27.4
Clarksville	13,405	25.7	40.1	12.3	1,109,640	685,707	1,795,347	14.1
Jackson	8,755	25.3	54.5	11.1	810,120	607,347	1,417,467	23.7
Murfreesboro	7,916	14.7	38.2	9.7	675,240	374,724	1,049,964	12.9
Kingsport	6,419	17.5	37.3	7.2	541,920	297,650	839,570	25.3
Johnson City	6,432	18.0	37.7	7.6	538,200	301,042	839,242	19.5
Franklin	2,633	7.5	28.2	4.6	200,880	88,184	289,064	8.0
Clinton	1,904	18.2	40.9	9.9	165,720	95,903	261,623	21.6
Maryville	5,014	15.6	37.3	8.0	427,200	231,337	658,537	12.8
<b>Tennessee Totals</b>	<b>535,528</b>	<b>21.3%</b>	<b>44.0%</b>	<b>7.7%</b>	<b>\$48.1 million</b>	<b>\$29.4 million</b>	<b>\$77.5 million</b>	<b>18.0%</b>
<b>U.S. Totals</b>	<b>21.4 million</b>	<b>16.9%</b>	<b>34.2%</b>	<b>5.1%</b>	<b>\$1.8 billion</b>	<b>\$908 million</b>	<b>\$2.7 billion</b>	<b>16.6%</b>

\*Of returns with a refund

\*\*Ten cities in the state with the highest total number of tax returns filed

SOURCE: IRS SPEC Return Information Data Base, Tax Year 2003 (October 2005). Poverty figures are from U.S. Census Bureau, 2000 Census. Calculations by CDF.

## Endnotes

<sup>1</sup> IRS SPEC Return Information Data Base, Tax Year 2003 (October 2005). Calculations by CDF.

<sup>2</sup> Robert Greenstein, "The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor," Center on Budget and Policy Priorities, August 17, 2005. Retrieved from <http://www.cbpp.org/7-19-05eic.htm>.

<sup>3</sup> H&R Block, Q4 2002 H&R Block Earnings Release Conference Call, June 12, 2002, available at 2002 WL 26337229. Cited in Wu, Chi Chi 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. Retrieved from <http://www.consumerfed.org/pdfs/RefundAnticipationLoanReport.pdf>.

<sup>4</sup> These values are based on all EITC claimants who receive a refund.

<sup>5</sup> IRS SPEC Return Information Data Base, Tax Year 2003 (October 2005). Calculations by CDF.

<sup>6</sup> IRS Publication 2043. Based on this publication, the IRS direct deposits refunds in 8 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.

<sup>7</sup> IRS SPEC Return Information Data Base, Tax Year 2003 (October 2005). Calculations by CDF.

<sup>8</sup> National Taxpayer Advocate 2005 Annual Report to Congress, Criminal Investigation Refund Freeze Study, December 31, 2005. Retrieved from [http://www.irs.gov/pub/irs-utl/section\\_4.pdf](http://www.irs.gov/pub/irs-utl/section_4.pdf).

<sup>9</sup> U.S. Census Bureau, 2000 Census. Calculations by CDF.

<sup>10</sup> A. Berube, A. Kim, B. Forman, and M. Burnes, "The Price of Paying Taxes," The Brookings Institution, May 2002. Retrieved from <http://www.brookings.edu/dybdocroot/es/urban/publications/berubekimeitc.pdf>.