



Children's Defense Fund

The Children's Defense Fund - Texas

4500 Bissonnet, Suite 260, Bellaire, TX 77401
Tel: (713) 664-4080 Fax: (713) 664-1975
www.cdf-texas.org

February 2006

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

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 Texas, 2.1 million taxpayers claimed \$4.2 billion in the EITC but they lost an estimated \$294 million to tax preparation and high-interest loans during the 2003 tax year.¹ 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

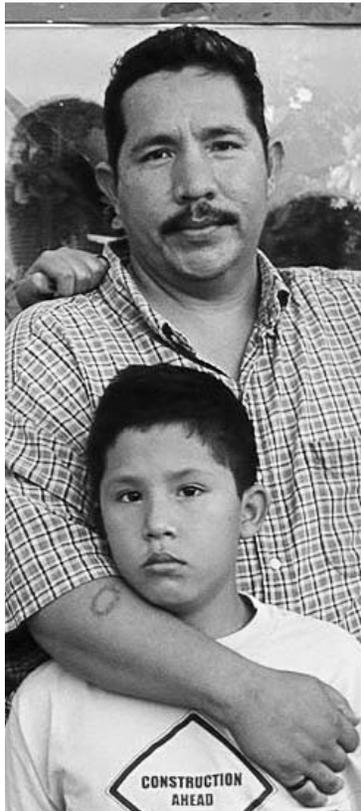
The EITC has wide bipartisan support and has been a part of the federal tax system since 1975. It is the most effective work support tool to assist families who work full- or part-time but earn low wages. EITC refunds received for the 2003 tax year helped to lift 4.4 million people, including 2.4 million children, out of poverty.² 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 2003, the average total refund for Texas taxpayers claiming the EITC who also received other tax credits was \$2,978.

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 73 percent of Texas 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.³ For EITC families living paycheck to paycheck, this is a significant amount of money—four percent of their total refund.⁴ Statewide tax preparation costs represent about \$183 million lost to poor working families.⁵





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.

Tanya is a single black female living in Houston, Texas, and raising two children and one grand-child. Tanya went to a national commercial tax preparer to have her taxes done and was expecting a large refund of approximately \$3,200. She paid \$200 to have her taxes prepared and to have the proceeds deposited within seven days to her checking account. The IRS later sent her an audit letter requesting that she report to their offices because there was a question about the number of children she was claiming. She went to the IRS meeting alone because the national commercial tax preparer refused to accompany her despite a signed agreement that indicated a representative would do so. When she met with the IRS, she had all of the necessary documentation (divorce decree and custody proof) to satisfactorily address the issue. About four weeks later she received her refund. After her ordeal, she has vowed to go to VITA sites from now on. She will be having her taxes prepared at Sunnyside Multi-Service Center VITA site this year—and she won't have to pay a fee. She expects to use her refund to pay bills, get a much-needed bedroom set, and start saving for the future.

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 Texas EITC family purchasing a RAL paid \$130—equal to a loan with an Annual Percentage Rate (APR) of about 166.6 percent⁶—just to get their refund one or two weeks sooner. This means needy Texas families lose an additional \$111 million in RAL fees.⁷ When tax preparation fees are included, the typical family getting a RAL loses nearly five percent of its federal refund. Between \$183 million in tax preparation fees and an additional \$111 million in RAL fees, Texas working families, and their communities, are deprived of \$294 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.⁸ 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 Texas

RAL vendors continue to target EITC families. According to IRS data, more than 856,000—42 percent—of Texas' EITC families receiving refunds for 2003 also took out RALs, whereas only 7.9 percent of non-EITC taxpayers in Texas 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. More than 42 percent of EITC families in Texas receive their refunds with a RAL—higher than the national average of 34.2 percent. The child poverty rate in Texas' 25 counties with the highest percentage of RALs was 22.9 percent, slightly higher than the state rate and 20 percent higher than the national rate of 16.6 percent.⁹ 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.¹⁰

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 also to 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.

The Children's Defense Fund



- 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. Several pieces of legislation regarding RALs were introduced during the 79th session of the Texas state legislature, including HB 398 (introduced by Representative Mike Villareal) and SB 1030 (introduced by Senator Judith Zaffirini), that would regulate RALs, require full disclosure about their costs, and provide for administrative penalties.

- 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. In Texas, CDF partners with the Houston Asset Building Coalition and the Coalition for Valley Families 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. Although it would be difficult to administer a state EITC in Texas because there is no state income tax, it could be possible to administer the credit as a direct payment.

Conclusion

Texas lost an estimated \$294 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*.

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

² 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>.

³ 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>.

⁴ These values are based on all EITC claimants who receive a refund.

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

⁶ 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.

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

⁸ 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.

⁹ U.S. Census Bureau, 2000 Census. Calculations by CDF.

¹⁰ 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>.



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 and Counties

	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
Highest RAL Counties								
Kenedy	74	47.1%	65.3%	14.6%	\$6,840	\$6,199	\$13,039	n/a
Culberson	524	48.1	60.2	15.7	56,400	40,349	96,749	31.3
Dawson	1,694	33.7	58.0	12.6	172,560	124,557	297,117	29.3
Limestone	2,497	29.8	57.6	16.1	231,840	182,099	413,939	23.5
Hale	4,935	34.8	56.5	14.0	463,800	354,608	818,408	23.6
Brooks	1,411	46.5	53.8	19.3	136,800	96,488	233,288	51.8
Howard	3,186	26.8	53.7	11.8	290,040	217,653	507,693	25.2
Hudspeth	613	52.2	53.0	15.1	62,640	41,402	104,042	41.4
Wharton	4,781	27.3	53.0	10.1	420,960	319,404	740,364	18.7
Duval	1,826	39.2	52.9	21.9	174,960	123,154	298,114	35.9
Navarro	4,769	28.4	52.8	12.6	425,040	318,001	743,041	23.7
Lamb	1,803	31.4	52.5	11.4	177,720	119,411	297,131	27.9
Floyd	957	33.4	52.0	11.4	89,400	63,039	152,439	29.0
Crosby	864	34.4	52.0	10.3	74,760	57,074	131,834	36.9
Scurry	1,447	23.4	51.9	12.0	120,480	94,734	215,214	22.1
Jim Wells	5,420	34.1	51.2	17.5	485,400	352,970	838,370	32.1
Shelby	2,862	30.6	51.1	14.0	276,240	181,631	457,871	25.1
Potter	14,553	31.4	51.0	12.2	1,061,760	940,786	2,002,546	25.7
Kleberg	3,638	30.2	50.8	12.6	296,040	235,080	531,120	35.7
Camp	1,468	28.9	50.7	13.4	133,440	94,149	227,589	30.2
Delta	526	25.9	50.3	11.0	47,400	33,332	80,732	21.7
Hidalgo	110,632	51.2	50.3	14.1	10,634,040	7,053,205	17,687,245	45.7
Andrews	1,254	24.3	50.0	14.9	125,160	79,529	204,689	20.8
Willacy	3,469	50.1	49.9	13.3	330,120	221,162	551,282	42.1
Jim Hogg	707	36.2	49.5	19.6	63,000	44,209	107,209	30.0
Select Counties								
Washington	2,744	20.5	49.5	7.3	249,840	170,871	420,711	15.1
Lubbock	25,221	24.3	48.2	9.6	2,187,600	1,534,567	3,722,167	21.9
Walker	4,752	24.5	47.7	11.1	410,760	288,294	699,054	20.3
Nueces	37,511	28.2	47.4	11.0	3,013,920	2,249,980	5,263,900	24.5
Cameron	59,623	46.8	45.5	11.5	5,802,000	3,441,284	9,243,284	43.4
Grimes	2,678	27.5	45.3	12.3	248,040	152,509	400,549	20.8
Dallas	207,950	22.1	44.7	11.6	18,418,440	11,591,644	30,010,084	18.4
Jefferson	25,482	25.7	44.2	10.0	2,319,360	1,424,629	3,743,989	25.0
Bell	30,255	27.4	43.0	15.2	2,519,640	1,663,451	4,183,091	16.6
Bexar	162,577	25.8	42.8	9.4	13,069,080	8,786,946	21,856,026	22.7
Tarrant	119,774	18.6	42.5	9.8	10,399,680	6,368,785	16,768,465	14.2
Harris	334,232	22.6	41.5	10.6	29,758,440	17,179,286	46,937,726	19.9
Starr	11,234	59.4	37.4	12.9	1,113,120	525,947	1,639,067	59.5
Travis	55,382	14.6	37.1	7.9	4,188,000	2,533,713	6,721,713	14.3
Webb	35,724	45.8	34.9	10.7	3,155,640	1,581,349	4,736,989	39.7
El Paso	110,423	39.4	34.1	10.0	9,867,000	4,770,244	14,637,244	31.7
Largest Cities**								
Houston	273,576	25.5	42.5	11.1	24,743,040	14,385,348	39,128,388	26.4
San Antonio	154,187	26.2	43.0	9.5	12,423,600	8,373,510	20,797,110	24.6
Dallas	121,783	24.4	46.9	11.7	11,109,600	7,167,938	18,277,538	25.5
Austin	49,380	14.1	36.9	7.6	3,716,400	2,248,109	5,964,509	17.0
Fort Worth	68,748	23.6	45.1	10.7	6,185,160	3,911,794	10,096,954	21.8
El Paso	100,899	38.2	33.7	9.9	8,958,840	4,303,944	13,262,784	30.1
Arlington	27,468	18.5	40.8	10.4	2,308,800	1,389,075	3,697,875	12.7
Corpus Christi	32,669	27.4	46.7	10.7	2,582,640	1,935,137	4,517,777	23.3
Plano	9,153	8.4	28.2	5.9	678,240	313,089	991,329	4.9
Spring	9,372	9.0	28.7	7.0	672,480	329,696	1,002,176	5.2
Rio Grande Valley Cities								
Brownsville	32,336	51.6	43.6	11.6	3,337,560	1,784,265	5,121,825	45.3
McAllen	16,859	37.5	45.2	11.8	1,556,520	948,973	2,505,493	30.6
Pharr	10,934	57.0	52.5	15.2	1,081,200	729,448	1,810,648	46.6
Harlingen	10,362	36.3	49.4	11.2	908,880	649,802	1,558,682	35.0
Texas Totals	2.1 million	23.4%	42.2%	7.9%	\$183 million	\$111 million	\$294 million	20.5%
U.S. Totals	21.4 million	16.9%	34.2%	5.1%	\$1.8 billion	\$908 million	\$2.7 billion	16.6%

* 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.