

# Children's Defense Fund

## Policy Report



Children's Defense Fund

### Halting the Loss of Billions of Dollars in Earned Income Tax Credit Benefits in Texas

April 2008

This tax season, the Earned Income Tax Credit (EITC) will benefit millions of low- and modest-income working families by supplementing their earnings. Increased education and advocacy to promote this federal credit has brought much success in helping working families claim the tax benefits they have earned. However, a significant percentage of these taxpayers who will obtain their EITC refunds will also opt to purchase a Refund Anticipation Loan (RAL) or other financial product to receive their refunds. According to data from the Internal Revenue Service (IRS), in Texas, tax preparation fees, RALs and other commercial products used to access tax refunds drained \$325 million from EITC benefits in tax year 2005.<sup>i</sup>

While filing taxes can be difficult and expensive for many families who use commercial tax preparers, the growth of free tax preparation sites in recent years 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 two weeks or less without fees. With the money saved, families can work towards financial stability by paying bills, purchasing needed household items and increasing savings.

#### Tax Credit Benefits Reach Millions of Our Most Vulnerable Children

The EITC lifts more children out of poverty than any other anti-poverty program. In the most recent year for which data are available, the EITC lifted 4.4 million Americans above the poverty line, including 2.4 million children. Without the crucial income supplement that the EITC provides, it is estimated that the child poverty rate would have been one-fourth higher.<sup>ii</sup>

**Figure 1: Total Dollars Lost to Tax Preparation Fees, Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RACs) in Texas Cities with the Highest Number of Returns Filed, Tax Year 2005**

City	Number of Tax Returns	Number of EITC Tax Returns	% of EITC Returns Using Paid Preparers	% of EITC Returns That Received a RAL*	Dollars Lost to Tax Preparation, RALs and RACs**
HOUSTON	1,093,046	293,452	76.9%	28.8%	\$ 44,115,990
SAN ANTONIO	611,971	162,765	66.5%	29.3%	\$ 21,909,150
DALLAS	498,753	127,442	76.6%	39.5%	\$ 20,259,660
AUSTIN	369,274	52,915	60.1%	27.9%	\$ 6,449,580
FORT WORTH	343,207	81,384	74.1%	35.7%	\$ 12,386,340
EL PASO	272,212	104,423	74.4%	20.3%	\$ 14,659,590
ARLINGTON	150,540	30,680	70.2%	31.9%	\$ 4,355,340
CORPUS CHRISTI	120,330	33,278	65.7%	34.9%	\$ 4,614,120
SPRING	116,291	11,871	60.2%	19.9%	\$ 1,365,120
PLANO	112,725	10,134	62.0%	21.7%	\$ 1,193,880
<b>RIO GRANDE CITIES</b>					
BROWNSVILLE	65,046	34,308	84.3%	18.1%	\$ 5,372,580
MCALLEN	46,001	17,569	79.6%	18.6%	\$ 2,611,200
HARLINGEN	29,220	11,122	74.0%	30.1%	\$ 1,667,550
PHARR	20,549	11,837	84.8%	19.4%	\$ 1,891,770
<b>TEXAS TOTALS</b>	<b>9,363,549</b>	<b>2,228,923</b>	<b>72.7%</b>	<b>30.9%</b>	<b>\$ 324,730,080</b>
<b>U.S. TOTALS</b>	<b>130,354,745</b>	<b>22,053,667</b>	<b>70.9%</b>	<b>26.8%</b>	<b>\$ 3,029,007,780</b>

SOURCE: Internal Revenue Service SPEC Information Database, Tax Year 2005 (December 2007). Calculations by CDF.

Notes: \* Of those who receive a refund. \*\* Calculated based on a \$150 average tax preparation fee, a \$100 average RAL fee and a \$30 average RAC fee.

According to the most recent year of available data from the IRS, more than 22 million taxpayers received the EITC for the 2005 tax year nationwide, with an average benefit amount of \$1,894. In total, this 2005 EITC outlay represented a \$41.8 billion investment in low- and modest-income families with children (as well as some childless adults). In Texas, more than 2.2 million taxpayers received the EITC, representing a \$4.7 billion investment in Texas families, individuals and the communities in which they live and work.

CDF Houston and Rio Grande Valley are committed to helping working Texas families keep more of the money they earn by promoting the more than 24 Volunteer Income Tax Assistance (VITA) sites operated by the Houston Asset Building Coalition (HABC), which provide free tax preparation in the Houston area and operate four sites in the Rio Grande Valley. For the current tax filing season, the CDF Rio Grande Valley has assisted more than 1,300 families and brought back over \$1.8 million to the community, while CDF Houston has been responsible for providing outreach for the HABC coalition and has helped working families save nearly \$1.2 million in tax preparation services. CDF-RGV has operated free tax preparation sites for over four years and during this period has brought more than \$3.3 million back to Hidalgo County.

Working families like Mr. and Mrs. Solis benefit from CDF's information and services. After having paid \$130 for a 1040EZ return last year, the Solises visited a CDF VITA site. Our volunteer prepared their 2007 return with Mr. Solis seated next to him and Mrs. Solis just behind them. When our volunteer pointed to the computer screen to show the more than \$6,000 refund they would be getting, Mr. Solis asked, "Are you sure it's that much?" Mrs. Solis got up from her chair to look at the screen and with great excitement exclaimed, "We were hoping for some help with a down payment on a better car. With this refund, we won't get a loan and we can save on the interest!" When she started to sit down again, she missed her chair and grabbed on to her husband's arm to help break the fall. Mrs. Solis was truly "floored" by the difference in their refund. Our VITA volunteer reminded them to be sure to file amended returns so they could claim the EITC for the past three years.

### **EITC Boost to Local Economies**

The financial contribution of the EITC extends far beyond enhancing the income and well-being of lower-wage working families and their children. The EITC also infuses substantial money into the local economy.<sup>iii</sup> Surveys show that most EITC recipients use their refunds to meet short- to medium-term needs such as repairing their car, catching up on rent and utility bills, and purchasing clothes for their children.<sup>iv</sup>

### **Billions Lost Annually in EITC Benefits Paid to Working Families**

The limited studies that have attempted to measure the economic impact of the Earned Income Tax Credit on local economies signal substantial potential of these monies to contribute to growth and productivity. An analysis of EITC population and participation rates by researchers in San Antonio concluded that increasing the number of EITC claims would be highly beneficial, with each additional dollar received generating roughly \$1.58 in local economic activity.<sup>v</sup> Another study in Baltimore found that EITC benefits generate almost \$600,000 in local income and property tax revenues.<sup>vi</sup> Unfortunately, cities such as San Antonio and Baltimore do not benefit fully from increasing EITC participation rates because billions of dollars of EITC benefits intended for working families are diverted to commercial tax preparers and lending institutions.

Increased education and advocacy to expand knowledge of the EITC and promote its greater application has helped millions of working families claim these key benefits they have earned. Yet the ability of the EITC to decrease poverty has not been fully attained. For tax year 2005, tax preparation fees, RALs and other commercial products used to access tax refunds diverted \$3 billion in EITC benefits to commercial tax preparers and lending institutions nationwide, including \$325 million in Texas alone.

### **Tax Preparation Fees**

A number of factors underlie this substantial redirection of EITC investments. First is the heavy dependence on external providers for tax preparation. For millions of tax filers both the complex federal and state tax laws and the time required to compile the necessary documentation and prepare and file tax returns often seem onerous. As a result, a significant portion of U.S. tax filers

each year ultimately turn to commercial tax preparation services and private tax consultants to prepare their federal and state tax returns. This is especially the case among low-income filers. For tax year 2005, 71 percent of EITC recipients in the United States paid to have their returns completed professionally, as compared to 57 percent of non-EITC recipients. Those tax preparation fees drained in total nearly \$2.3 billion nationwide in EITC benefits from the pockets of these families and individuals.

**Figure 2: Total Dollars Lost to Tax Preparation Fees, Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RACs) in Texas Counties with the Highest Number of Returns Filed, Tax Year 2005**

County	Number of Tax Returns	Number of EITC Tax Returns	% of EITC Returns Using Paid Preparers	% of EITC Returns That Received a RAL*	Dollars Lost to Tax Preparation, RALs and RACs**
HARRIS	1,533,801	365,185	75.5%	28.4%	\$ 53,931,420
DALLAS	957,195	223,073	74.1%	36.5%	\$ 33,972,000
TARRANT	675,685	132,721	71.9%	33.8%	\$ 19,458,810
BEXAR	657,983	171,462	66.3%	29.2%	\$ 23,016,330
TRAVIS	389,005	58,339	60.8%	28.1%	\$ 7,192,140
COLLIN	300,902	30,600	64.2%	26.5%	\$ 3,870,240
EL PASO	290,975	115,357	75.1%	20.9%	\$ 16,399,500
HIDALGO	229,118	118,559	82.3%	19.6%	\$ 18,455,790
DENTON	220,815	26,276	64.4%	26.4%	\$ 3,337,980
FORT BEND	183,909	31,791	71.4%	26.7%	\$ 4,418,250
MONTGOMERY	155,319	23,863	65.2%	26.3%	\$ 3,070,830
WILLIAMSON	150,722	17,995	59.6%	25.1%	\$ 2,145,270
NUECES	133,996	38,071	67.0%	35.5%	\$ 5,375,730
CAMERON	131,441	63,053	80.5%	22.3%	\$ 9,714,570
GALVESTON	126,099	23,789	68.0%	34.9%	\$ 3,369,810
BRAZORIA	115,833	19,881	70.4%	30.6%	\$ 2,805,090
BELL	115,426	30,397	69.3%	35.3%	\$ 4,406,310
LUBBOCK	106,138	25,938	72.3%	39.9%	\$ 3,949,680
JEFFERSON	96,560	25,331	77.5%	37.7%	\$ 4,044,900
MCLENNAN	90,676	22,611	67.6%	32.9%	\$ 3,127,110
WEBB	82,371	37,968	72.3%	21.3%	\$ 5,252,460
SMITH	82,174	18,076	77.0%	40.3%	\$ 2,894,880
JOHNSON	61,596	11,368	67.9%	34.8%	\$ 1,592,070
BRAZOS	60,032	11,989	68.7%	38.2%	\$ 1,744,440
GREGG	59,235	13,524	73.8%	39.9%	\$ 2,097,870
<b>TEXAS TOTALS</b>	<b>9,363,549</b>	<b>2,228,923</b>	<b>72.7%</b>	<b>30.9%</b>	<b>\$ 324,730,080</b>
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SOURCE: Internal Revenue Service SPEC Information Database, Tax Year 2005 (December 2007). Calculations by CDF.

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### Refund Anticipation Loans

In order to accelerate receipt of their tax refunds, EITC recipients are more than six times as likely to secure a Refund Anticipation Loan (RAL) as taxpayers who did not file for that credit. According to IRS data, an estimated 666,000—or almost 31 percent—of EITC tax filers in Texas receiving refunds for 2005 took out RALs, whereas only 6.5 percent of non-EITC tax filers in Texas who received refunds purchased RALs for the same year. This wide disparity is attributable at least in part to the aggressive marketing of RALs to the working poor within their communities. But these short-term loans based on the filer's expected tax refund often have triple-digit interest rates. Ultimately, they can end up costing the client a sizeable portion of his or her refund. Unfortunately, it is those working families and individuals who most need their hard-earned income that are most often sold short-term, expensive RALs.

In tax year 2005, for example, a taxpayer purchasing a RAL typically paid \$100 solely to get their refund the same day or within a few days, as most RALs offer. In Texas, these fees represented a \$66.6 million loss in EITC benefits. Between the costs of tax preparation and RAL fees, the typical EITC recipient in Texas getting a RAL loses an estimated 7.5 percent of his or her federal refund.

But promising trends are emerging. For tax year 2005, RAL usage among EITC recipients dropped for the second year in a row. While the exact reasons for this decline are not known,

likely reasons include better reporting of data, increased education and awareness, and anti-RAL advocacy.<sup>vii</sup>

Additionally, though progress has been slow, modest steps have been taken recently to reduce the negative impact of RALs on low-income families and communities. “Pay stub” or “holiday” RALs, which posed additional costs and risks to taxpayers, have been almost entirely eliminated. These RALs were available to taxpayers prior to receiving their W-2s and were taken out against their expected refund. Under considerable pressure from community groups and consumer advocates, all of the major RAL banks announced in the spring of 2007 that they would stop offering these types of loans.<sup>viii</sup>

And more reductions in RAL usage may be on the horizon. The IRS has announced it is considering restricting the sharing of tax return information with those who market RALs and other financial products sold to access tax refunds.

### **Other products**

A proportion of EITC recipients purchase other types of financial products to access their refunds. New data from the IRS reveals for the first time how many taxpayers received a Refund Anticipation Check (RAC), a non-loan financial product in which an account is temporarily opened for taxpayers to receive their refund—although they do not receive their refund any sooner than the IRS sends it. An estimated 19 percent of EITC recipients obtained this service for tax year 2005, thereby draining \$120 million from their EITC benefits nationwide and \$15.3 million in Texas alone.

Extensive usage of tax preparation services, RALs and other commercial products used to access tax refunds also detrimentally impacts local economies across the country. Figure 1 summarizes the total dollars lost in the Texas cities with the highest number of returns filed, while Figure 2 highlights the losses endured by Texas counties with the highest number of returns filed. Figure 3 shows Texas counties with the highest percentage of Refund Anticipation Loan purchases.

### **Maximizing EITC Benefits for Working Families**

While millions of families and individuals across the country have benefited immensely from the EITC, these same taxpayers lost an estimated total of \$3 billion in fees from commercial tax preparation, RALs and other products used to access tax refunds for tax year 2005 alone. Government officials and community leaders have within their power the ability to formulate public policies that address the root causes and mitigate the effect of RALs and costly tax preparation fees on lower-income communities.

This 2007 tax season, it is essential that low- and modest-income families benefit fully from the existing EITC. The stakes are high. The EITC holds significant potential to substantially supplement earnings with these current maximum benefit levels:

- \$4,716 for families with two or more children;
- \$2,853 for families with one child; and
- \$428 for individuals between the ages of 25 and 64 with no children.

In addition, many working families who are EITC recipients are also eligible for other federal tax credits such as the Child Tax Credit (CTC)—an income supplement for those working families with children with incomes above \$11,750. It can contribute as much as \$1,000 for each child claimed. Overall, it has been estimated that the CTC adds as much as 40 percent to EITC-eligible taxpayers' refunds.<sup>ix</sup>

CDF Texas partnered with State Representative Michael Villareal (D-San Antonio) to help working families keep more of the money they earn by supporting legislation to protect EITC filers against Refund Anticipation Loans (RALs). During the 80th Texas Legislature, Representative Villareal and Senator Leticia Van de Putte (D-San Antonio) sponsored House Bill 1344, Refund Anticipation Loans (RALs) Protection. The bill requires institutions that offer RALs to register with the state and plainly disclose their annual percentage rates. The bill will help inform and protect consumers by providing a clear lending agreement. Lenders will now be required to inform customers that they

might receive their refunds only one week earlier and will likely incur hefty fees. Furthermore, if the lenders advertise loans in Spanish, they must also provide these details in Spanish.

CDF-Texas encourages families through its many partners and outreach activities to avoid commercial tax preparers and short-term loans and instead use the United Way 2-1-1 Help Line to locate free tax preparation sites around the state operated by trained volunteers. We educate community leaders and families about the problems with short-term loans and extremely high interest rates that can cost families hundreds of dollars of their own money. By partnering with community organizations, elected officials and faith communities we are helping families save thousands of dollars and bringing value revenue back into the community.

### **Recommendations**

To maximize EITC benefits, the Children's Defense Fund recommends the following key measures:

**1. Strengthen consumer protections.** During recent sessions of Congress, EITC and RAL legislation has failed to gain solid traction. Low-income families cannot continue to lose significant portions of their intended EITC benefits. This year lawmakers must take action to adopt policies that protect consumers, such as establishing licensing requirements for commercial tax preparers, ensuring full disclosure of RAL fees and interest rates, and placing a cap on the interest rates and fees that banks can charge for RALs.

**2. Expand access to free tax assistance.** A substantial share of taxpayers nationwide still pays to have their taxes completed and filed. Alternatives have emerged to reduce the cost of tax filing for low-income individuals and families. The most important of these are free tax preparation sites—particularly Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs—the numbers of which have grown significantly in recent years. These sites typically offer electronic filing and direct deposit of refunds, allowing taxpayers to get their money in two weeks or less without fees. With the money saved, families can enhance their own financial stability by paying bills, purchasing needed household items and/or increasing savings. It is essential that elected officials and community leaders find ways to build and maintain free tax preparation networks across the country by investing in the VITA and TCE programs, as well as other free tax assistance centers.

**3. Connect working families to mainstream financial services.** A high priority is improving the financial literacy of low-income families. Free or low-cost checking and savings accounts, credit counseling opportunities and financial education programs offer working families the tools to build a better financial future. Public-private partnerships should be promoted and established to ensure that working families have easy access to these resources.

**Figure 3: Texas Counties with the Highest Percentage of Refund Anticipation Loan (RALs) Purchases, Tax Year 2005**

County	Number of Tax Returns	Number of EITC Tax Returns	% of EITC Returns Using Paid Preparers	% of EITC Returns That Received a RAL*	Dollars Lost to Tax Preparation, RALs and RACs**
KENEDY	157	68	60.3%	53.7%	\$ 10,080
DAWSON	4,756	1,659	87.6%	51.3%	\$ 306,960
HOWARD	11,801	3,183	71.3%	49.3%	\$ 505,950
MCCULLOCH	3,417	942	84.5%	48.6%	\$ 167,820
SHELBY	9,609	2,839	79.1%	48.3%	\$ 479,820
LAMB	5,660	1,800	82.9%	48.2%	\$ 315,870
CHEROKEE	16,190	4,972	83.7%	47.9%	\$ 880,290
REFUGIO	3,290	820	74.9%	46.8%	\$ 133,530
TERRY	4,589	1,498	85.5%	46.8%	\$ 265,500
MITCHELL	2,704	680	79.3%	46.4%	\$ 112,980
HOUSTON	8,539	2,498	78.7%	45.8%	\$ 415,530
JACKSON	5,555	1,270	78.3%	45.8%	\$ 210,750
BOWIE	36,888	9,374	73.0%	45.5%	\$ 1,485,030
WASHINGTON	13,778	2,805	77.5%	45.1%	\$ 459,090
SCURRY	6,288	1,459	72.9%	45.0%	\$ 229,560
LIMESTONE	8,576	2,595	80.9%	44.9%	\$ 445,500
ROBERTSON	6,297	1,846	74.9%	44.8%	\$ 299,880
NOLAN	6,387	1,871	83.8%	44.4%	\$ 324,210
CROSBY	2,467	887	73.5%	44.2%	\$ 140,940
FLOYD	2,763	952	80.0%	43.9%	\$ 160,950
MARION	3,339	1,013	78.3%	43.8%	\$ 166,590
KLEBERG	11,943	3,660	66.5%	43.8%	\$ 540,090
PANOLA	9,115	2,078	80.0%	43.6%	\$ 345,030
RED RIVER	5,409	1,685	78.1%	43.6%	\$ 271,440
CAMP	5,338	1,520	77.8%	43.3%	\$ 249,810
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## Endnotes

<sup>i</sup> IRS SPEC Return Information Database, Tax Year 2005 (December 2007). All figures contained in this report have been retrieved from the 2005 SPEC database unless otherwise noted. CDF calculations. Note that tax returns for tax year 2005 occurred in calendar year 2006.

<sup>ii</sup> Greenstein, Robert, *The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor*, Center on Budget and Policy Priorities, August 17, 2005.

<sup>iii</sup> Berube, Alan, *Using the Earned Income Tax Credit to Stimulate Local Economies*, The Living Cities Policy Series, 2006.

<sup>iv</sup> Rhine, Sherrie L.W., et al., *Householder Response to the Earned Income Tax Credit: Path of Sustenance or Road to Asset Building?* Federal Reserve Bank of New York, 2005.

<sup>v</sup> *2004 Update: Increased Participation in the Earned Income Tax Credit in San Antonio, Texas Perspectives*, 2004.

<sup>vi</sup> *The Importance of the Earned Income Tax Credit and Its Economic Effects in Baltimore City*, Jacob France Institute, 2005

<sup>vii</sup> *Positive Improvements for Tax Refund Loans, But Consumers Still Warned to Avoid Them*, National Consumer Law Center, January 2008. See also 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*, National Consumer Law Center, January 2007.

<sup>viii</sup> *Positive Improvements for Tax Refund Loans, But Consumers Still Warned to Avoid Them*, National Consumer Law Center, January 2008.

<sup>ix</sup> Berube, Alan, *Using the Earned Income Tax Credit to Stimulate Local Economies*, The Living Cities Policy Series, 2006.