Children's Defense Fund
Policy Report

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

March, 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), tax preparation fees, RALs and other commercial products used to access tax refunds drained $3 billion from EITC benefits in tax year 2005.[i]

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.[ii]

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, 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).

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

City	Number of Tax Returns	Number of EITC Tax Returns	% of EITC Returns That Used Paid Preparers	% of EITC Returns with a RAL*	Dollars Lost to Tax Preparation, RALs and RACs**
New York, NY	3,384,565	824,724	76.9%	16.1%	$ 111,910,470
Chicago, IL	1,132,144	277,041	73.8%	27.3%	$ 40,030,170
Houston, TX	1,093,046	293,452	76.9%	28.8%	$ 44,115,990
Los Angeles, CA	883,651	233,721	83.0%	15.5%	$ 33,846,930
San Antonio, TX	611,971	162,765	66.5%	29.3%	$ 21,909,150
Philadelphia, PA	594,580	162,738	64.3%	26.4%	$ 21,106,440
Las Vegas, NV	561,704	92,214	74.6%	31.1%	$ 13,556,820
San Diego, CA	537,792	70,113	72.3%	16.5%	$ 8,937,960
Dallas, TX	498,753	127,442	76.6%	39.5%	$ 20,259,660
Miami, FL	493,334	126,958	75.4%	12.7%	$ 16,534,950
U.S. TOTALS	**130,354,745**	**22,053,667**	**70.9%**	**26.8%**	**$ 3,029,007,780**

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

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.[iii] 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.[iv]

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.[v] Another study in Baltimore found that EITC benefits generate almost $600,000 in local income and property tax revenues.[vi] 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 in total diverted $3 billion in EITC benefits to commercial tax preparers and lending institutions.

Figure 2: U.S. 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 That Used Paid Preparers	% of EITC Returns with a RAL*	Dollars Lost to Tax Preparation, RALs and RACs**
Benson, ND	2,643	998	87.6%	60.5%	$191,970
Dillon, SC	12,380	5,353	75.4%	59.6%	$939,720
Marlboro, SC	11,299	5,009	80.4%	59.5%	$913,170
Ziebach, SD	444	184	91.8%	58.8%	$35,700
Anson, NC	9,739	3,621	90.8%	57.8%	$713,220
Corson, SD	1,334	563	91.3%	57.0%	$109,650
Bamberg, SC	5,711	2,316	65.3%	56.3%	$365,070
Scotland, NC	15,717	5,441	85.8%	56.0%	$1,019,190
Terrell, GA	4,471	2,003	79.5%	55.7%	$359,070
Shannon, SD	6,364	3,216	89.6%	55.4%	$617,760
Rolette, ND	5,009	2,023	85.7%	55.2%	$375,270
Edgecombe, NC	23,331	8,932	79.5%	55.2%	$1,593,300
Crisp, GA	8,450	3,523	80.0%	55.0%	$633,180
Emporia, VA	5,598	1,853	78.1%	54.6%	$326,790
Tunica, MS	5,244	2,843	88.4%	54.4%	$551,070
Greensville, VA	1,387	388	74.5%	54.3%	$65,580
Issaquena, MS	331	181	48.6%	54.2%	$23,970
Bennett, SD	1,138	419	88.1%	53.8%	$78,990
Glacier, MT	5,332	2,050	81.9%	53.8%	$369,570
Kenedy, TX	157	68	60.3%	53.7%	$10,080
Sharkey, MS	2,180	1,193	41.1%	53.3%	$143,490
Taliaferro, GA	706	301	63.5%	52.9%	$45,900
Tallahatchie, MS	4,663	2,560	78.3%	52.8%	$449,730
Desha, AR	5,796	2,271	78.6%	52.8%	$394,980
Pemiscot, MO	6,757	2,513	85.4%	52.7%	$463,080
U.S. TOTALS	**130,354,745**	**22,053,667**	**70.9%**	**26.8%**	**$3,029,007,780**

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.

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 in EITC benefits from the pockets of these families and individuals.

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 5.6 million EITC recipients, or 27 percent of all EITC filers who received refunds for the 2005 tax year, took out RALs, whereas only 4.1 percent of non-EITC taxpayers who received refunds purchased RALs 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's 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. Nationally, these fees represented a $565 million loss in EITC benefits. Combining the costs of tax preparation and RAL fees, the typical EITC recipient in the U.S. who obtains a RAL loses an estimated 8.1 percent of their 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.[vii]

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.[viii]

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.

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 country's largest urban areas, while Figure 2 highlights the losses endured by counties with the highest percentage of RAL purchases among EITC claimants. 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. Figure 3 provides an overview of the distribution of RAL dollars lost across 50 states and the District of Columbia

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.

As we enter the 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.[ix]

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.

4. Institute state EITCs nationwide. Since the vast majority of poor children live in families with a working parent, the institution of state EITCs nationwide could further supplement wages and help lift our most vulnerable families out of poverty. Only 22 states and the District of Columbia currently have a state EITC in effect. In addition, New York City and Montgomery County, Maryland, offer local Earned Income Tax Credits. Research indicates that tax refunds can be used to help low-income families meet their immediate and medium-term needs while stimulating local economies.

Figure 3: Total Dollars Lost to Tax Preparation Fees, Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RACs) in U.S. States, Tax Year 2005

STATE	Number of Tax Returns	Number of EITC Tax Returns	% of EITC Returns That Used Paid Preparers	% of EITC Returns with a RAL*	Dollars Lost to Tax Preparation, RALs and RACs**
ALABAMA	1,894,034	492,443	76.3%	40.4%	$78,716,880
ALASKA	330,060	39,366	52.8%	20.5%	$ 4,055,100
ARIZONA	2,384,952	399,683	69.1%	24.4%	$ 53,098,740
ARKANSAS	1,123,679	280,710	77.0%	38.8%	$ 44,314,770
CALIFORNIA	14,801,518	2,376,158	76.3%	16.5%	$ 319,651,470
COLORADO	2,091,650	263,790	63.1%	19.1%	$ 30,986,730
CONNECTICUT	1,638,502	166,934	67.7%	21.5%	$ 21,241,320
DELAWARE	392,178	57,904	61.1%	26.1%	$ 7,129,890
DISTRICT OF COLUMBIA	269,268	47,437	69.7%	32.0%	$ 6,740,280
FLORIDA	7,945,051	1,569,635	70.3%	24.8%	$ 211,238,730
GEORGIA	3,828,404	881,933	74.5%	36.7%	$ 135,963,960
HAWAII	599,645	83,779	63.2%	18.4%	$ 9,780,840
IDAHO	596,582	102,450	60.4%	16.1%	$ 11,315,580
ILLINOIS	5,672,924	858,630	71.3%	25.8%	$ 118,033,440
INDIANA	2,819,872	436,901	68.8%	31.1%	$ 60,514,500
IOWA	1,322,984	172,490	72.3%	19.3%	$ 22,440,720
KANSAS	1,207,638	175,758	67.3%	22.3%	$ 22,347,690
KENTUCKY	1,743,646	345,824	75.3%	33.3%	$ 51,638,130
LOUISIANA	1,699,167	484,825	74.4%	35.8%	$ 74,566,740
MAINE	610,850	86,575	58.8%	17.3%	$ 9,377,040
MARYLAND	2,573,172	339,125	66.0%	23.7%	$ 43,275,600
MASSACHUSETTS	3,007,416	308,758	65.2%	15.0%	$ 35,847,300
MICHIGAN	4,422,552	656,552	68.8%	25.1%	$ 87,382,050
MINNESOTA	2,392,012	263,419	64.7%	14.8%	$ 30,199,950
MISSISSIPPI	1,130,867	370,490	75.7%	42.6%	$ 59,772,330
MISSOURI	2,551,791	439,951	70.5%	28.1%	$ 60,569,610
MONTANA	436,920	72,010	64.9%	21.6%	$ 8,736,510
NEBRASKA	796,285	109,980	67.3%	19.5%	$ 13,638,570
NEVADA	1,101,500	163,585	72.6%	30.3%	$ 23,440,050
NEW HAMPSHIRE	639,226	62,267	59.7%	18.4%	$ 6,912,810
NEW JERSEY	4,018,176	482,758	76.8%	23.8%	$ 69,155,460
NEW MEXICO	821,706	194,879	65.7%	23.1%	$ 24,539,040
NEW YORK	8,429,982	1,464,896	74.2%	18.7%	$ 196,110,990
NORTH CAROLINA	3,776,977	770,481	73.4%	38.9%	$ 118,066,860
NORTH DAKOTA	302,211	38,825	64.8%	18.8%	$ 4,559,280
OHIO	5,349,583	796,636	64.6%	29.8%	$ 104,097,120
OKLAHOMA	1,447,449	310,467	69.4%	31.1%	$ 43,147,950
OREGON	1,587,260	221,482	55.1%	16.6%	$ 22,768,140
PENNSYLVANIA	5,767,982	781,794	65.0%	22.3%	$ 97,193,190
RHODE ISLAND	488,221	65,728	74.1%	21.8%	$ 9,042,540
SOUTH CAROLINA	1,843,872	431,130	77.4%	42.0%	$ 69,896,370
SOUTH DAKOTA	361,828	55,090	69.9%	27.8%	$ 7,383,390
TENNESSEE	2,591,549	554,713	73.4%	37.5%	$ 83,745,090
TEXAS	9,363,549	2,228,923	72.7%	30.9%	$ 324,730,080
UTAH	1,000,057	140,395	59.8%	15.6%	$ 15,318,150
VERMONT	305,339	37,809	58.3%	13.1%	$ 3,886,920
VIRGINIA	3,432,364	489,562	66.0%	29.9%	$ 65,054,580
WASHINGTON	2,838,948	351,363	58.2%	20.9%	$ 39,168,450
WEST VIRGINIA	746,205	144,958	63.3%	29.1%	$ 18,426,030
WISCONSIN	2,609,517	302,504	65.0%	17.1%	$ 35,794,590
WYOMING	243,539	32,363	64.0%	22.6%	$ 3,931,440
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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.

SOURCES:

[i] 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.
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[viii] *Positive Improvements for Tax Refund Loans, but Consumers Still Warned to Avoid Them,* National Consumer Law Center, January 2008.
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