



Children's Defense Fund Minnesota

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"I was a victim because I didn't understand what I was doing," Patty Jackson said. "At first I was embarrassed but I'm not ashamed anymore. I've learned my lesson, and I've been telling everybody I know not to make the same mistake that I did." – Jackson is a mother of three from Duluth and she paid for a refund anticipation loan.



KEEPING WHAT THEY'VE EARNED: WORKING MINNESOTANS AND TAX CREDITS

Updated as of February 2005

As the height of tax-filing season approaches, Americans are being inundated with advertisements from commercial tax preparers promoting alluring options for getting their taxes prepared. Many of these commercial tax preparers concentrate in low-income neighborhoods and lure their clients with the promise of "Fast Money," "Money Now," or "Rapid Refunds." A vast number of these consumers, who because of their low incomes are eligible for tax credits such as the Earned Income Tax Credit (EITC), end up paying high preparation fees and taking out high interest loans against their expected return. More than 67 percent of people nationwide who claim the EITC use commercial tax preparers to prepare their returns. Unfortunately, many low- to moderate- income working Americans are often unaware of all their choices – including free tax preparation such as Volunteer Income Tax Assistance, or VITA, sites.

This story is consistent across the country. In Minnesota, more than 242,000 low- to moderate-income working families in Minnesota claimed approximately \$378 million in federal funds through the EITC during 2004, but tens of millions of these public funds never reached these families and their children. Instead, commercial tax preparers profited from families' need for tax filing assistance, due to the complex tax laws required to claim their credits. An additional sum was diverted to out-of-state banks charging extremely high fees and interest rates in the form of Refund Anticipation Loans (RALs), often so that the families could access their refunds only one week earlier. The average APR for these loans in Minnesota is an estimated 234 percent. During the 2003 tax season (the most recent year for which data is available), an estimated \$23.6 million from the EITC was siphoned away from the intended Minnesota families. All told, about \$1.57 billion is sacrificed nationwide to commercial tax preparation and RALs.¹

The EITC has garnered bi-partisan support as the nation's most powerful anti-poverty tool, but its value to families and communities is being raided by commercial tax preparers and nationally chartered banks. In 2002, the EITC lifted almost 5 million working Americans out of poverty; more than half of them were children. Today, about 1 in 10 Minnesotan households benefit from its support. Families working at low wages deserve to receive the money intended for them by the tax code — to reward their work effort and help off-set the disproportionate share of taxes they pay. To remedy this misuse of public funds, Children's Defense Fund Minnesota (CDF-MN) advocates for increased free tax preparation assistance — that is

both accessible and well-publicized — for these families. In addition, CDF-MN calls for heightened consumer education and disclosure outlining what taxpayers should expect from paid preparers and refund anticipation loans, as well as increased federal oversight and regulation of the tax preparers and national banks promoting RALs.

An *Earned* Income Tax Credit for Working Families

The EITC is a federal tax credit for individuals who work but earn low wages. It is only available to those who work, and thus it rewards them for their efforts. The credit also helps offset the disproportionate percentage of their total income that low-income families spend on payroll, sales and excise taxes.

The value of the EITC largely depends on the number of children in one's family and the amount of income earned through work. During the 2005 tax season, the EITC is worth up to \$4,300 for workers who earned up to \$34,458 in 2004 (\$35,458 if married filing jointly) and have two or more qualifying children, and up to \$2,604 for workers who earned up to \$30,338 in 2004 (\$31,338 if married filing



jointly) and have one qualifying child. Working adults between the ages of 25 and 64 with no children who earn less than \$11,490 (\$12,490 if married filing jointly) are also eligible for a smaller credit worth up to \$390.

The EITC is first used in conjunction with other standard deductions, exemptions, and tax credits to decrease the amount of money a family owes in income taxes, if any. The remaining amount is then returned to the family. More than 94 percent of those who claim the EITC in Minnesota receive a refund. In 2004, the average amount claimed was \$1,559.

This refund has a tremendous impact not only on families' financial circumstances, but also their overall well-being. Research indicates that families spend the majority of their EITC refunds on basic needs like utility bills, rent, and food and clothing for their children. Consequently, the EITC helps stabilize families by shoring up their needs, thereby helping them to remain in the workforce and off of welfare. In addition, much of the money is spent immediately, boosting the local economy by benefiting grocers, retailers and other local businesses. While local economies vary due to the interaction of numerous different sectors, one study in San Antonio, Texas, found that EITC dollars spent in the local community generated an economic impact 60 percent greater than those initial expenditures.² Assuming Minnesota benefits from a similar multiplier, the Earned Income Tax Credits claimed in 2004 generated an additional economic impact of nearly \$605 million statewide.

The Use of Paid 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 very complex and daunting for those with no experience doing so themselves. The laws and procedures that govern this area of the tax code in particular are very complicated, and often change from one year to the next. In addition, many low-income families face language and literacy barriers. Therefore, it is not surprising that a high percentage of low-income Minnesotans — approximately two-thirds — hire a professional to prepare their taxes. The average cost of having their taxes prepared and electronically filed is about \$120 — a large amount for families who may be living paycheck to paycheck. More than 162,000 Minnesotan households (or two-thirds) who claimed the EITC in 2004 made \$20,000. On average, a Minnesota EITC family who uses a paid preparer sacrifices more than seven percent of their credit just to claim it.

Collectively, the dollars lost are fairly substantial as well. It is estimated that in 2003, at least \$18.5 million of the federal EITC funds claimed in Minnesota were spent on tax preparation and filing costs, rather than on meeting working families' basic needs.

Moreover, an estimated additional \$5.1 million of the EITC funds in Minnesota were diverted to pay for Refund Anticipation Loans. RALs are extremely short-term loans that use the family's anticipated tax refund as collateral. Most EITC claimants need their refund as soon as possible, and many do not have the \$120 necessary to have their taxes prepared. Knowing this, many paid tax preparers partner with out-of-state banks and aggressively market RALs to those most financially vulnerable.

RALs can be alarmingly expensive to the consumer. The costs usually include loan preparation and processing fees, which are added to a finance charge. In the end, the average total loan cost is about \$100. This translates into a shockingly high APR, or the loan's cost calculated at a yearly rate. If a family paid \$100 for the average EITC refund of \$1,559, the average APR on the loan was 234 percent. This



predatory rate is more than ten times the APR ceiling Minnesota established to protect consumers, considering that Minnesota law limits APRs on consumer loans to 21.75 percent. However, RAL brokers circumvent state usury laws by partnering with nationally chartered banks that are only subject to federal regulation, of which there is little. Heightened federal regulation is needed to halt these companies' maneuvering around state law.

For families who claim the EITC, the added cost of a RAL represents an additional six percent of their average refund, and it is a price they end up paying to access their money often by only a week earlier. RALs enable families to access their refunds

(minus the tax preparation fees, loan fees and finance charges) within 48 hours. However, it only takes the IRS 10 days on average to process an electronically filed return and then electronically deposit the refund into a bank account. Many families are unaware of how short this turnaround time is for the IRS.

Furthermore, because they are loans, RALs can actually send a struggling family into greater financial crisis. Usually, a RAL is paid off once the IRS processes a family's tax return and transfers the funds. However, if the IRS denies part of the refund for any reason or even withholds it temporarily for audit purposes (which the IRS is doing increasingly with EITC returns), the loan continues to accrue interest. Given their immediate financial needs, it is unlikely that EITC families budget for this possibility. Although one commercial preparer, H&R Block, has stopped charging its \$32 administrative fee this year on the RALs it brokers, this does nothing to address the inherent risk posed by the loans.

There is also evidence that many families, especially those with limited English proficiency, do not comprehend they are initiating a loan when they opt for a "rapid refund," as RALs are often marketed. In December 2004, the National Consumer Law Center commissioned a public opinion polling firm to conduct a telephone poll of over 2,000 consumers about their experiences with RALs. The survey found that 70% of RAL borrowers didn't realize that a RAL is actually a loan, with younger consumers being the most unaware.³ Ironically, families could end up in debt as a result of claiming tax credits that reward their work effort and are intended to strengthen their families. Despite these families' sincere efforts to get ahead, commercial lenders are profiting from their limited financial understanding, and putting families at risk of financial jeopardy.

Refund Anticipation Loans in Minnesota

According to the IRS, more than 51,000 Minnesota families who claimed the EITC in 2003 also applied for a RAL. (This is the most recent year for which RAL data is available). This represents about 1 out of every 5 Minnesota EITC families, or 21 percent. (By comparison, only 4.5 percent of all Minnesotan households received a RAL that year.) Over 4,600 more Minnesotan families applied for RALs in 2003 than in 2002, a 9.6 percent increase.

As can be seen in Table 1, the percentage of EITC claimants seeking RALs is significantly higher in certain zip codes, notably those blanketing more impoverished communities in the state. More than 75 percent of EITC claimants on some of the northern Minnesota Indian Reservations and as many as 50 percent of EITC claimants in some Minneapolis zip codes took out a RAL in 2003. And in 40 zip codes in Minnesota, more than one-third of EITC families applied for a RAL when claiming their refunds.

Research documents that commercial tax preparers target low-income neighborhoods, *i.e.*, those home to individuals with limited financial literacy, for their services. Neighborhoods across the nation with high percentages of EITC filers have about 50 percent more electronic tax filing and preparation services than neighborhoods with low percentages of EITC filers.⁴ Clearly, the economic impact of RALS is higher in these poverty-stricken areas of the state, as even greater sums of money are diverted from families and communities.

Table 1: Minnesota Zip Codes with Highest Percentage of EITC Filers Seeking Refund Anticipation Loans, 2003 (Tax Year 2002)

Zip Code	City	County	% of All Returns with EITC	Average EITC	Total Sum of EITCs claimed	% of EITC Returns with RALs	Sum Lost to RALs and Paid Preparation by EITC Claimants*
56671	Red Lake	Beltrami	75	\$2,040	\$1,323,745	79	\$119,334
56670	Redby	Beltrami	76	\$2,046	\$796,018	78	\$71,345
56666	Ponemah	Beltrami	84	\$2,064	\$451,972	77	\$39,712
56566	Naytahwaush	Mahnomen	61	\$2,006	\$242,741	75	\$22,055
56591	White Earth	Becker	73	\$1,902	\$171,171	61	\$13,417
56626	Bena	Cass	51	\$1,921	\$107,558	61	\$9,878
56633	Cass Lake	Cass	52	\$1,848	\$1,448,719	60	\$126,977
55415	Minneapolis	Hennepin	28	\$1,731	\$119,468	55	\$9,678
55440	Minneapolis	Hennepin	32	\$1,524	\$114,286	55	\$9,858
55458	Minneapolis	Hennepin	42	\$1,731	\$351,348	54	\$27,435
56575	Ponsford	Becker	46	\$1,940	\$186,208	52	\$13,278
56641	Federal Dam	Cass	46	\$1,845	\$83,029	49	\$6,999
55411	Minneapolis	Hennepin	53	\$1,907	\$7,096,796	49	\$501,149
55165	Saint Paul	Ramsey	54	\$1,734	\$116,172	48	\$8,598
56557	Mahnomen	Mahnomen	31	\$1,773	\$466,390	45	\$36,734
55404	Minneapolis	Hennepin	37	\$1,583	\$4,371,341	45	\$327,158
56569	Ogema	Becker	36	\$1,887	\$230,242	44	\$16,677
55412	Minneapolis	Hennepin	37	\$1,763	\$4,056,787	43	\$291,270
55175	St. Paul	Ramsey	50	\$1,872	\$129,159	42	\$8,059
55454	Minneapolis	Hennepin	49	\$1,854	\$1,930,375	42	\$117,018
56619	Bemidji	Beltrami	31	\$1,851	\$236,889	39	\$16,038
55429	Minneapolis	Hennepin	27	\$1,662	\$3,165,483	38	\$230,683
56201	Willmar	Kandiyohi	29	\$1,608	\$2,932,302	38	\$229,385
55334	Gaylord	Sibley	25	\$1,780	\$391,552	38	\$30,736
55312	Brownton	McLeod	16	\$1,569	\$108,251	38	\$9,679
56589	Waubun	Becker	33	\$1,770	\$300,911	37	\$21,517
55407	Minneapolis	Hennepin	31	\$1,664	\$4,599,631	37	\$319,828
55408	Minneapolis	Hennepin	24	\$1,510	\$3,384,368	37	\$255,478
STATE AS A WHOLE			10	\$1,537	\$368,176,143	21	\$23,663,988

SOURCE: Internal Revenue Service, Tax Year 2002. NOTE: In some cases, the above zip codes correspond to P.O. Boxes located within the city and identified on filer's returns.
* Figure calculated by using average RAL cost of \$99.95 and average paid preparation cost of \$120.

Potential Solutions

To Prevent the Erosion of Public Funds from Minnesota's EITC Families

1. **Simplify the rules and process for income tax filing.** Working families should be able to complete their own taxes, without having to pay for professional assistance. Federal and state laws, especially those that govern working families' income taxes, need to be simplified, and federal and state tax credit programs need to be coordinated.
2. **Ensure that free tax assistance for EITC families is widely available, accessible, and well-publicized.** Free tax assistance for low-income families is available at Volunteer Income Tax Assistance (VITA) sites in many Minnesota communities, but many families are not aware of them, and the reach of these efforts is limited. In fact, these sites serve less than five percent of the EITC-eligible taxpayers. The community groups and non-profit organizations like AccountAbility Minnesota that operate many of these sites need help. Different levels of government, employers, foundations, churches, and other community groups can all provide financial assistance, launch additional locations, donate computers for electronic filing, help recruit volunteers, and conduct outreach with potential EITC families.
3. **Strengthen consumer protection and education.** There is extremely little regulation of tax preparers — they are not even required to have completed high school. Yet, they are entrusted with sensitive personal information and expected to stay abreast of many complex tax laws. Taxpayers need additional education to fully understand what they can expect of their tax preparer as well as the true nature and hidden costs of RALs until they are abolished, so they can make informed decisions. The federal and state governments could do more to regulate and monitor the practices of paid preparers as well as the national banks with which they partner to offer RALs. In 2003, Minnesota passed a Taxpayer Protection Bill that created some standards of conduct for tax preparers and tightened disclosure laws for RALs. On the federal level, the Taxpayer Abuse Prevention Act (TAPA) is being re-introduced in Congress on February 8, 2005, by Sen. Daniel Akaka (D-Hawaii). The act would prohibit the use of RALs against the Earned Income Tax Credit, similar to the existing ban on loans that use Social Security checks as collateral. Citizens and organizations can express their support for the bill by contacting their members of Congress.
4. **Connect more low-income families with financial institutions and increase their financial literacy.** Having a tax refund electronically deposited directly into a bank account speeds up the turnaround time significantly, but many low-income families are not connected to mainstream financial institutions. Free tax assistance sites have attempted to partner with financial institutions, but these efforts are limited. Existing research suggests that efforts to promote financial literacy can be enhanced when people have an event – such as a significant tax refund – where they can start new practices. Some nonprofit organizations offer financial literacy courses; however, too rarely are they connected to receiving a real monetary asset, like a tax refund. Making such program connections will help more people make decisions in the best interests of their families.

¹ Wu, C.C., and Fox, J.A., *Picking Taxpayers' Pockets, Draining Tax Relief Dollars: Refund Anticipation Loans Still Slicing Into Low-Income Americans' Hard-Earned Tax Refunds*. National Consumer Law Center and Consumer Federation of America, 2005, Available at: http://www.consumerlaw.org/initiatives/refund_anticipation/content/2005RALreport.pdf.

² Texas Perspectives, Inc. *Increased Participation in the Earned Income Tax Credit in San Antonio*, 2004 Update, Prepared for City of San Antonio, TX

³ Wu and Fox. *Op Cit*.

⁴ Berube, A., Forman, B., & Burns, M. *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC* The Brookings Institution Center on Urban and Metropolitan Policy and The Progressive Policy Institute, 2002.

The mission of the Children's Defense Fund 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. CDF provides a strong, effective voice for all the children of America who cannot vote, lobby, or speak for themselves. We pay particular attention to the needs of poor and minority children and those with disabilities. CDF educates the nation about the needs of children and encourages preventive investment before they get sick or into trouble, drop out of school, or suffer family breakdown. CDF began in 1973 and is a private, nonprofit organization supported by foundations, corporation grants and individual donations and does not accept government funds. In 1985, CDF established the St. Paul office to direct its efforts in Minnesota.