



a child's voice



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Public funds committed to Minnesota working families are being diverted into the hands of major tax preparation franchises and their out-of-state banking partners. This report details how the use of tax preparation services and refund anticipation loans (RALs) is concentrated among low-income families and communities. The report finds that a typical Earned Income Tax Credit (EITC) filer pays roughly \$175 for commercial tax preparation, electronic filing and a RAL loan. The authors estimate that collectively \$7.3 million in public funds statewide were diverted to pay for these services in 2001. The report includes recommendations to help preserve the full value of the EITC and other family tax credits.

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Keeping What They've Earned: Working Minnesotans and Tax Credits

*Beth Haney and Diane Benjamin,
Children's Defense Fund Minnesota*

Enacted in 1975, the Earned Income Tax Credit (EITC) is the largest and most effective national anti-poverty program. As a result of this and similar state credits like Minnesota's Working Family Tax Credit (WFTC), working families have earned billions of dollars in needed assistance and are successfully remaining in the workforce.

Yet public funds committed to Minnesota families through income tax credits are being diverted. Major franchise tax preparers are targeting their businesses to low-income taxpayers. Then, with the promise of quick and easy refunds, the commercial tax preparers encourage customers to borrow against their anticipated income tax refund. Such loans, called Refund Anticipation Loans (RALs), provide families relatively immediate access to the amount of money they expect to receive from the IRS. However, the loans carry extremely high fees and interest rates, thereby denying families a portion of their earned tax credits and withholding. Moreover, if the IRS should deny part of the refund or even delay it for audit purposes, the loan continues to accrue interest, potentially leaving the family in a financial crisis.

Collectively these dollars add up to large amounts—these practices cost Minnesota families more than \$7.3 million in federal funds in tax year 2001. The preparation fees plus the price of these loans cost, on average, \$175 for each family. In effect, many families are paying five percent of their tax credits just to claim them, and another five percent to have prompt access to them. While this

amount may seem small, these are critical dollars to a family whose average monthly income is \$1,130. It is money that will most likely be spent immediately in the local economy on basic needs, like housing or food.

Tax Credits for Working Families

Earned Income Tax Credit

The Earned Income Tax Credit (EITC) is a federal tax credit for taxpayers who work but do not earn enough to maintain a basic standard of living. It is only available to those who work, and thus it rewards them for their efforts. The credit also helps offset the disproportionate share of their income that low-income families spend on payroll, sales, and excise taxes.

The value of the EITC depends on the number of children in a family and the amount of income earned through work. For tax year 2002, working families raising one child but earning less than \$29,201 are eligible for a tax credit up to \$2,506. Working families raising two or more children and earning less than \$33,178 are eligible for a credit up to \$4,140.¹

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. Any remaining amount is then refunded to the family. This is a critical aspect of the EITC. Many of these families do not make enough money to owe income taxes after the other deductions and exemptions, so they receive

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the bulk of their EITC money as a refund. About 87% of EITC money is sent as a refund.²

The EITC provides more than \$31 billion to more than 19 million Americans. During tax year 2001, approximately 211,000 Minnesotans earned \$310 million from this federal tax credit alone. At least three quarters were families with children.³

Working Family Tax Credit

The Working Family Tax Credit (WFTC) is Minnesota's state version of the EITC. Originally calculated as a percentage of the EITC, the WFTC is now determined using a complex formula based on a family's earnings. It continues to use the same income eligibility limits as the EITC. For tax year 2002, the WFTC is worth up to \$750 for eligible families raising one child and worth up to \$1,447 for eligible families raising two or more children.⁴ During tax year 2001, 203,779 Minnesota families earned more than \$103 million from this state tax credit.⁵

Other Tax Credits for Working Families

Working families can also realize benefits from several other income tax credits like the federal Child Tax Credit (CTC). The CTC is worth up to \$600 per child in tax year 2002, and will be worth \$1,000 per child by the year 2010. There are also federal and state tax credits working families can claim for their child care expenses, as well as a state tax deduction and a state tax credit for families' K-12 educational expenses.

Impact of the Credits

The sum of all of these credits can potentially add almost 50% of needed income to a family's earnings. For example, a single parent of two making minimum wage working full-time in 2002 would have earned only

\$10,712, but will be eligible for more than \$5,100 from just the EITC and WFTC. The average combined refund for working Minnesotans from these two tax credits was \$1,900 during tax year 2001.⁶ The addition of this needed income can have a powerful effect on a family as well as the broader community. An emerging body of research is beginning to delineate these influences.

Poverty has devastating effects on children's development. By adding critical dollars to a family's income, tax credits may be able to help minimize these consequences. Although the exact role of tax credits has yet to be examined, new research is beginning to show how crucial increases in a family's income can be for a child's developmental outcomes.⁷

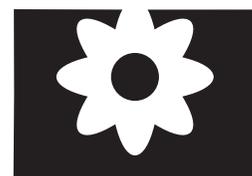
Research does suggest, however, how the tax credits can help. One study found that 83% of families said that paying bills such as utilities and rent was one of their top three priorities for their EITC money, while 74% of families said that purchasing basic household commodities and clothing was a priority. In addition, 50% of the families were going to save at least part of their EITC money, and 16% were going to pay tuition.⁸ In sum, earned income tax credits help low- to moderate-income families meet their basic immediate needs and make ends meet.

An additional body of research demonstrates that the EITC is effective at helping low-income families work. For example, one study concluded that changes in the EITC from

1984 to 1996 explained more than 60 percent of the increase in the

employment rate of single mothers during that time period.⁹ State versions like the WFTC have an additional positive effect on families' workforce participation.¹⁰

Finally, because much of this tax credit money is spent immediately on paying bills and buying necessary items for the family, the majority of it is immediately reinvested in the local economy. In tax year 1998, one in seven residents of Minneapolis and St. Paul filed for the EITC, resulting in a total of \$58 million. Families in the surrounding Twin Cities metro area benefited from \$91 million in federal funds because of the EITC.¹¹ Families in greater Minnesota earned another \$148 million.¹²



Use of Paid Preparers

To receive the tax credits, a family must complete both federal and state tax returns. Tax forms are complex and the directions can be confusing. Taxpayers may often feel that they are not taking enough advantage of the tax benefits for which they are eligible, while being nervous that they are making innocuous mistakes that could be costly. Perhaps for

AccountAbility Minnesota

AccountAbility Minnesota provides a good model of how families in need of free tax assistance can be served well. This Twin Cities based non-profit leverages volunteer and staff resources to provide low-income individuals and small businesses with tax and accounting assistance at no cost. During 2002, AccountAbility Minnesota trained 410 volunteers to work at 30 metro sites. They helped more than 7,400 Minnesotans file for \$8,473,000 in federal and state tax credits.

Table A: Zip Codes with Highest Percentage of EITC Filers Receiving RALs (Refund Anticipation Loans), Tax Year 1999

ZipCode	Post Office Name	Total Returns with a RAL	% returns without EITC		Amount of EITC returns with RALs
			% returns with EITC with a RAL		
56671	Red Lake	946	76%	21%	\$876,858
56633	Cass Lake	1,893	51%	5%	\$747,119
55411	Minneapolis	9,969	47%	5%	\$3,857,202
56557	Mahnomen	1,217	41%	4%	\$183,367
56716	Crookston	4,185	40%	4%	\$449,875
55404	Minneapolis	9,615	40%	4%	\$2,197,466
55458	Minneapolis	594	39%	3%	\$139,171
55412	Minneapolis	10,196	37%	3%	\$1,792,187
56619	Bemidji	611	37%	2%	\$86,861
56484	Walker	1,718	36%	2%	\$170,630
55407	Minneapolis	15,451	36%	2%	\$2,101,233
56721	E. Grand Forks	4,157	35%	3%	\$407,468
55429	Minneapolis	12,621	34%	2%	\$1,070,324
55405	Minneapolis	8,158	33%	1%	\$580,147
55408	Minneapolis	15,020	33%	2%	\$1,314,003
56621	Bagley	1,821	33%	6%	\$243,044
56589	Waubun	751	33%	3%	\$98,357
55334	Gaylord	1,430	30%	1%	\$120,400
55808	Duluth	2,596	30%	3%	\$278,278
55807	Duluth	4,602	30%	3%	\$425,752
55430	Minneapolis	10,068	30%	3%	\$805,031

these reasons, more than half of all Minnesotans used a professional preparer to complete their taxes for tax year 2000.¹³

The need to seek professional tax assistance may be more acute for low-income families. The laws and procedures governing low-income tax credits are increasingly complex. For example, to claim the federal and state standard deduction, exemptions, earned income credits, and the Child Tax Credit (CTC), low-income Minnesota families with children need to complete at least five tax forms.¹⁴ Families who have more than \$10,000 in earned income and/or three or more qualifying children may also need to complete another federal

form for the CTC. Additional forms are also needed if families want to claim tax benefits for their dependent care expenses, their education expenses, or their property taxes. Finally, depending on the family's circumstances, a child may qualify as a tax benefit in one area (e.g., the EITC), but not in another (e.g., the CTC).

In addition, many low-income families face language and literacy barriers, making the task even more challenging. (Consider that the EITC instruction booklet was 54 pages long this past year.) Moreover, EITC filers are much more likely to be audited.¹⁵ Given the barriers and the higher chance of an audit, it is not surprising that a greater percentage

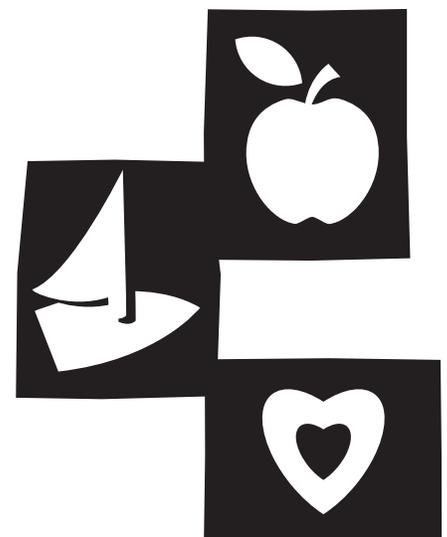
of low-income Minnesotans — more than two-thirds — hire a professional to prepare their taxes.¹⁶

What Is the Cost?

Tax preparation fees can vary widely, depending on the preparer, the complexity of the taxpayer's situation, and the number of necessary tax forms (which as noted above can be quite substantial for the typical low-income family). In addition, to shorten the time it takes to receive their refunds, families are encouraged to file their taxes electronically, but many commercial tax preparers charge an additional fee for this service. The average total for tax preparation and filing for the typical low-income family was \$100 during 2002.¹⁷ Given that the average refund for the EITC plus the WFTC was \$1,900, many working families lost approximately five percent of their earned income tax credits just to claim them.

Minnesotans who file for these tax credits earn on average \$1,130 per month.¹⁸ Given the real expenses of providing for a family, many of these families are likely to be in financial crisis and need their tax credit money as soon as possible. As noted earlier, they are likely to spend this money on basic needs like rent and utilities. Knowing this, many commercial tax

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preparers partner with nationally chartered banks and aggressively market Refund Anticipation Loans (RALs). RALs are short-term loans that use the family's anticipated refund as collateral.¹⁹

RALs may appeal to families for a couple of reasons. First, many are unlikely to have \$100 on hand to pay for tax preparation fees. In setting up the loan, the commercial tax preparers deduct these fees first, relieving the families from needing to find alternative resources. Secondly, and probably more significantly, RALs enable families to access the amount of money they expect from their refunds within 48 hours, rather than having to wait 1-2 weeks for the Internal Revenue Service to process their returns. This wait could last 6-8 weeks if the family does not file electronically and does not have a bank account to accept an electronic transfer of the refund. Indeed, many low-income families lack bank accounts. According to the Federal Reserve, one out of four families with incomes less than \$25,000 do not have one of any kind.²⁰

Many low-income families may feel they have little choice but to take out a RAL. At least one out of every three EITC filers nationwide received their refund through a RAL for tax year 1999.²¹ In Minnesota that year, one out of every five EITC filers took out a RAL. The percentage was even higher in some inner city and rural communities however, including several American Indian reservations. Table A lists the Minnesota zip codes in which 30% or more of EITC filers took out a RAL. For comparison, only 2% of Minnesotans who did not claim the EITC received a refund loan.²²

Determining the total cost of a RAL is difficult. For example, the web sites of the largest national tax preparation companies advertise the availability of refund anticipation loans, but do not offer any information regarding fees and interest rates. One of the web

Fig. A: Zip Codes With Highest Percentage of RAL's. Tax Year 1999.



More than 20% of filers used RALs in these zip codes.
Data source: ETA IMF Marketing Database, Tax Year 1999. Internal Revenue Service W&I, Research Group 2, Boston Field Office. Analysis by CDF Minnesota.

sites indicates that the loan fee and annual percentage rate (APR) will "be disclosed on your disclosure statement or RAL check stub," but presumably a family would not see the RAL check stub until after they had committed to taking out the RAL.²³

One of the most alarming features of RALs is that they are very expensive to the customer. The costs usually include loan preparation and processing fees, which are then added to a finance charge. The sum of these was between \$75 and \$100 on average during 2002.²⁴ This represents about five to six percent of the average EITC refund. However, even the lower end of the average range, \$75, translates to a shockingly high APR, which is the loan's cost calculated as a yearly rate. The APR is determined by first dividing the amount of a loan by the total cost. The result is then divided by the length of the loan expressed as a percentage of a year. The average length of a RAL is a

week and a half. Since the average EITC refund in Minnesota was \$1,469 and the average RAL cost was \$75, the average APR would have been 166%, as calculated above.

Minnesota state law limits APRs on consumer loans to 21.75%. However, RAL lenders are able to circumvent state usury laws because they are nationally-chartered banks and therefore only subject to federal regulation. Moreover, there is very little federal regulation in this area.²⁵

The other disturbing aspect of RALs is that because they are loans, they can actually leave a family in greater financial crisis. Usually, a RAL is paid off once the IRS processes the tax return and transfers the funds. However, if the IRS denies part of the refund for some reason (e.g., the tax preparer made an error), or even withholds it temporarily for audit purposes, interest continues to accrue and the family is responsible. Given their real needs, it is unlikely that

Fig. B: Highest Percentage of EITC Filers, Tax Year 1999.



More than 12% of filers filed for EITC. Data source: ETA IMF Marketing Database Tax Year 1999. Internal Revenue Service W&I Research Group 2, Boston Field Office. Analysis by CDF Minnesota.

families would budget for this possibility. Anecdotal evidence suggests that some families, especially those with limited English proficiency, may not fully comprehend they are taking out a loan.²⁶ Ironically, families could end up in debt due to their efforts to claim earned income tax credits intended to assist them in becoming more financially secure.

Once the \$75 average RAL cost is added to the \$100 tax preparation and filing fees, many working families end up paying approximately ten percent of their earned income tax credits to private tax preparation companies and partnering banks, most of which are not based in Minnesota.

If one out of every five Minnesota families who claimed the EITC in tax year 2001 took out an RAL and the average cost was \$175, then an estimated \$7.3 million in federal EITC funds was diverted from Minnesota's working families to commercial tax preparers and their affiliated national

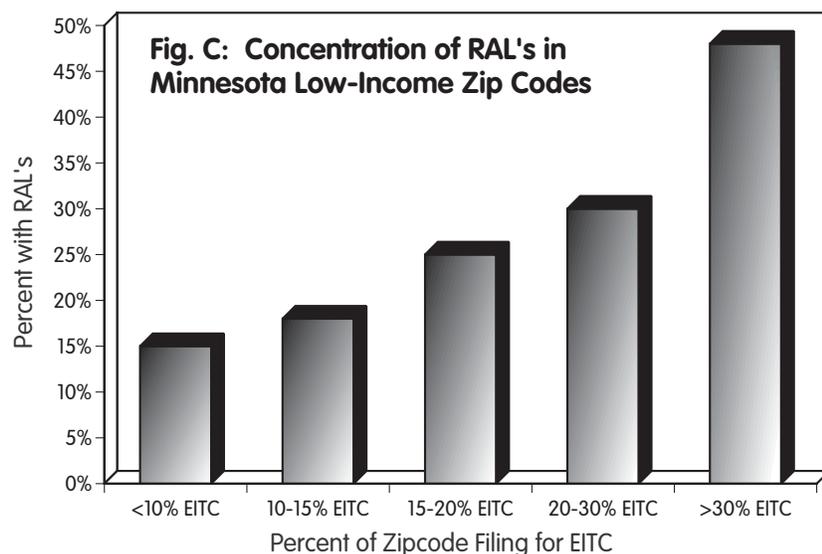
banks. These costs are a disservice to the greater community in two ways. First, they are public funds, raised through taxes, that the community at large dedicated to ensuring working

taxpayers can provide for their families. These funds were not meant to be spent on financing a handful of private companies. Second, as noted earlier, working families spend the majority of their tax credit money on immediate, basic necessities in the local economy. While some of the diverted money will go to a small number of local tax preparers, a substantial percent will go to their out-of-state parent companies and partners.

Commercial Tax Preparers Target Low-Income Neighborhoods

The community costs will be greater in certain communities across the state — specifically those with higher percentages of working low-income families. Using data from the IRS for tax year 1999, Figures A and B identify these Minnesota communities. Figure A displays zip codes in which the highest percentages of taxpayers took out a Refund Anticipation Loan. Figure B reveals which zip codes had the highest percentages of taxpayers

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Data source: ETA IMF Marketing Database, Tax year 1999. Internal Revenue Service W&I Research Group 2, Boston Field Office. Analysis by CDF Minnesota

who claimed the EITC. While not identical, the two maps include many of the same zip codes. Figure C provides a more concise analysis of the relation. This graph illustrates that Minnesota zip codes with the least number of EITC filers also have the least number of individuals taking out RALs, whereas zip codes with the highest percentage of EITC filers also have a high percentage of individuals who take out a RAL.

Commercial tax preparers are able to achieve these high RAL usage rates in part by virtue of where they locate. Neighborhoods across the nation with high percentages of EITC filers have 50 percent more electronic tax filing and preparation services offices per filer than neighborhoods with low percentages of EITC filers.²⁷ More than three quarters of the 89 Twin Cities metro area offices of the nation's two largest tax preparation companies are located in zip codes with higher than the median number of EITC filers.²⁸ Clearly, commercial tax preparers target low-income families for their business.

Availability of Alternatives

There are a few alternatives for these families, but not many. First, some communities are fortunate to have access to a local Volunteer Income Tax Assistance (VITA) site. These sites, which are often run by independent non-profit organizations or local groups, recruit and train community volunteers to offer free tax preparation to low-income taxpayers. During the 2002 tax filing season, more than 350 free tax assistance sites were open in Minnesota.²⁹ However, these sites are not serving all who need them. Although it may be somewhat of an undercount, the IRS estimates that less than three percent of the Minnesota EITC returns in tax year 2000 were prepared at a free tax assistance site.³⁰

In addition, it is important to note that the vast majority of these free tax assistance sites are part of a related program, called Tax Counseling for the Elderly (TCE). The AARP Tax-Aide predominantly manages TCE sites. Although younger low-income families may seek assistance from the TCE sites, the sites cater their outreach to elderly taxpayers. Many TCE sites are located in senior citizen centers and offer limited hours of service, often during the workday, making these sites relatively inaccessible to working low-income families. In contrast, the commercial sites mentioned earlier are open daily, with extended night and weekend hours; are usually in visible, high traffic locations; and are supported by national advertising campaigns.

Accessibility is an even bigger barrier for working families outside of the Twin Cities metro area. All but a handful of the free tax assistance sites in greater Minnesota are TCE sites and almost all of the non-TCE sites are located in metropolitan areas like Duluth, Rochester, Mankato, and St. Cloud.

Other alternatives include services like Intuit Inc.'s Tax Freedom Project web site. The site, www.taxfreedom.com, enables taxpayers who earn less than \$25,000 (the bulk of the EITC-eligible population) to use tax preparation software to complete and file their income taxes for free. More than 22,000 Minnesotans filed their federal and state taxes through this site during the 2002 tax season.³¹ Other tax preparation companies will offer similar on-line services soon. These programs could be especially helpful to families who do not have access to a VITA site. However, there are other limitations. Taxpayers need to have access to and be comfortable using a computer with Internet access. In addition, many families' situations may necessitate the hands-on assistance of someone with some tax preparation training.

Recommendations

- 1. Simplify the rules and the process.** Ideally, working families should be able to complete their own taxes, without having to pay for professional assistance. Federal and state tax laws, especially those that govern working families' income taxes, need to be simplified, and federal and Minnesota tax credit programs should be coordinated. A first step would be to adopt the Treasury Department's proposal to make the definition of a "qualifying child" uniform across the different tax exemptions and credits.³² At a minimum, tax forms should be available in a wide range of languages.
- 2. Increase the availability and accessibility of free tax preparation assistance.** By allowing large national tax preparers and their partners to use their marketing campaigns and office locations to dominate low-income families' tax-related needs, our community is doing a disservice to itself. Public and private, national and local organizations need to understand the community benefits of earned income tax credits and then invest resources into helping people access them. Different levels of government, employers, foundations, unions, churches, and other community groups can all provide financial assistance, make site locations available, donate computers for electronic filing, and help recruit more volunteers. Minnesota needs more tax assistance sites, especially in areas with the most poverty, and the sites need to be open for more hours.

Other alternatives, like web sites that enable families to complete and file their taxes at no cost, should be available and accessible as well. Perhaps public libraries with Internet access could reserve one terminal to these web sites during the tax season. The web sites must be as user-friendly as

possible so that even families with limited tax knowledge can use them.

3. Expand outreach efforts and educate eligible families.

Families need to understand the costs of using commercial tax preparers, especially the drawbacks and hidden costs of Refund Anticipation Loans. They also need to know about their alternatives.

Using materials like those provided by the Center on Budget and Policy Priorities (www.cbpp.org) or the WFTC Marketing Program (<http://ftw.che.umn.edu/wftc/>), public and private organizations can initiate and/or sustain major ongoing outreach campaigns. The Legal Aid Society of Minnesota has created outreach materials regarding RALs in particular. Importantly, the outreach and education efforts should target and partner with other services families use (e.g., schools, health care providers, child care).

4. Connect more low-income families with financial institutions and increase their financial literacy.

Recent efforts to partner free tax assistance with financial institutions have proven very successful in Chicago, Milwaukee, and Tulsa. By providing low-income families with bank accounts, these programs can help remove low-income families' need for RALs. Some of the endeavors have also helped families become more financially literate, for example by helping families understand how to use part of their refunds to build assets. These innovative programs should be pursued in Minnesota.

5. Strengthen consumer protection.

This is both a national and local problem. Because RALs are usually issued through nationally chartered banks, the lenders are able to circumvent state usury laws on consumer loans. Nonetheless, the federal government could and should impose regulations. Additionally, practices could be

more closely monitored within Minnesota to ensure that state laws are being followed.

Endnotes

1. The EITC is also available to workers ages 25 through 64 who do not have children but earned up to \$11,060 in tax year 2002. In addition, every EITC income guideline is increased by \$1,000 for married filing jointly filers. For more information about the EITC, see Center on Budget and Policy Priorities. *The 2003 Earned Income Tax Credit Outreach Kit*. 2003. www.cbpp.org/eic2003/index.html or Cauthen, N. K. *Earned Income Tax Credits*. (Improving Children's Economic Security: Research Findings About Increasing Family Income Through Employment, Policy Brief No. 2.) National Center for Children in Poverty, Columbia University Mailman School of Public Health. 2002.
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15. See Cook, C.L. Tax hurdles for low-income workers. *Journal of Poverty Law and Policy*. March-April, 2002.
16. Unpublished data. Minnesota Department of Revenue. 2002.
17. See Berube, A., Kim, 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. In March 2002, CDF Minnesota conducted an informal survey of local tax preparers and arrived at the same average.
18. Minnesota Department of Revenue, Unpublished data, August 2002.
19. For more information about RALs, see Berube, Forman, & Burns, *The Price of Paying Taxes*, *op cit*. Also, Wu, C. C., Fox, J. A., and Reunart, E. *Tax Preparers Peddle High-Priced Tax Refund Loans*. Consumer Federation of America and the National Consumer Law Center. January, 2002.
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22. ETA IMF Marketing Database Tax Year 1999. Internal Revenue Service Wages & Investment, Research Group 2, Boston Filed Office. Analysis by CDF Minnesota.
23. http://www.hrblock.com/taxes/doing_my_taxes/products/instant_ral.html
24. These averages were taken from research examining the tax season 2002 rates of the largest national tax preparation companies, and although these rates vary by location, there is no reason to believe that they would have been drastically different for Minnesotans who used the same national companies. Berube, Forman, & Burns, *The Price of Paying Taxes*, *op cit*. Also Wu, Fox, and Reunart, *Tax Preparers Peddle High-Priced Tax Refund Loans*, *op cit*.

25. As reported by Christina Cook, Legal Aid Society of Minneapolis.
26. *Ibid*.
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32. *Proposal for Uniform Definition of a Qualifying Child*. Department of the Treasury. April 2002.

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Linda Coffin, PageCrafters

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Children's Defense Fund Minnesota
200 W. University Ave., Suite 210
St. Paul, MN 55103