Avoiding the Pitfalls of Refund Anticipation Loans

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Children's Defense Fund

25 E Street, NW
Washington, DC 20001
(202) 628-8787
1 (800) 233-1200
www.childrensdefense.org

This tax season, the Earned Income Tax Credit (EITC) will benefit millions of low- and modest-income working families by supplementing their earnings and helping them make ends meet during this severe economic downturn. The EITC is a refundable federal tax credit for low- and modest-income workers. Over the years it has helped to lift more children out of poverty than any other anti-poverty program.[1] With a growing number of working families struggling against the rapid downturn in the economy, it is especially important that all eligible families and individuals know about the EITC and how to take full advantage of it. It could mean the difference between a family being able to pay the rent or having to stay at a homeless shelter. According to data from the Internal Revenue Service (IRS), more than 22 million taxpayers received the EITC in the 2006 tax year but lost $3.1 billion to tax preparation fees, RALs and other commercial products.[2] It is important that we work together to help families keep all of their earned benefits from the EITC this year.

More than 13 million children in America are poor, and that number is bound to rise as a result of the current recession. According to the most recent estimate, the EITC lifted 4.4 million Americans out of poverty, including 2.4 million children in 2003. Without the income supplement that the EITC provides, it is estimated that the child poverty rate would be one-fourth higher.[3] Additionally, the EITC can have other benefits beyond family economic security. According to a recent study, the EITC significantly improves children's academic achievement and is found to be especially beneficial to children from disadvantaged families. It can also have a significant positive impact on the economy of the community as a whole.

While filing taxes can be difficult to do alone and expensive for many families who use commercial tax preparers, the growth of free tax preparation sites in recent years now gives taxpayers more options. These sites offer electronic filing and direct deposit of refunds, allowing taxpayers to get their money in two weeks or less without any unnecessary fees. With the money saved, families can pay bills, purchase needed household items and maybe even save some money. Helping families keep their earned benefits is particularly important now as families struggle more than ever to meet their basic needs.

Especially during this tax season, it is essential that already financially strapped families fully benefit from the EITC. The stakes are extremely high. The EITC can substantially supplement earnings with these maximum benefit levels for tax year 2008:

- $4,824 for families with two or more children
- $2,917 for families with one child
- $438 for individuals between the ages of 25 and 64 with no children

Many working families who receive the EITC are also eligible for the Child Tax Credit—an income supplement for families with children with income above $8,500. This credit can result in a family receiving as much as $1,000 for each child claimed.

More than 22 million taxpayers received the EITC for the 2006 tax year, with an average benefit amount of $1,950. In total, $43.7 billion was invested in low- and modest-income families with children (as well as some childless adults) for that tax year.

Benefits of the EITC Beyond Individual and Family Income

Research has shown that the EITC improves the well-being of children and their families—including increased academic achievement among children and a more stable home environment. The EITC may improve academic achievement by boosting a family's ability to provide food, clothes, books, shelter, and other items that contribute to a child's development. According to a recent study, increased family income from the EITC significantly increases children's math and reading test scores. This is found to be especially true for the most disadvantaged families and for families with younger children. According to the authors, the EITC can raise the future earnings of children whose families benefit from the EITC by as much as 1 to 2 percent.[4] Tax benefits directed to families with children may also improve children's well-being by reducing stress and conflict and improving the psychological well-being of the entire family. Recent research finds that child tax benefits improve several indicators of emotional and behavioral wellbeing for children and their mothers- especially physical aggression and maternal depression. [5]

The financial benefit of the EITC also extends 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.[6] One survey in North Carolina has shown that most EITC recipients use their refunds to meet short- to medium-term needs such as repairing cars, catching up on rent and utility bills, and purchasing clothes for their children.[7] An analysis 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.[8] Another study found that in Baltimore the additional spending from the EITC in the 2002 tax year generated almost $600,000 in local income and property tax revenues.[9] These multiplier effects in state and local economies indicate that the EITC is important to community growth and productivity and even more crucial during a recession.

Billions Lost Annually in EITC Benefits for Working Families

Increased education and advocacy to expand awareness of the EITC and promote its greater use have encouraged millions of working families to claim essential benefits they have earned. However, the full potential of the EITC to decrease poverty has not been attained. For tax year 2006, tax preparation fees, RALs and other commercial products diverted a total of $3.1 billion in EITC benefits from workers and their families. Figure 1 highlights the losses in urban areas with the highest number of returns filed in tax year 2006.

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 2006

City	Number of tax returns	Number of EITC tax returns	% of EITC returns using paid preparers	% of EITC returns with a RAL*	Dollars lost to tax preparation, RALs and RACs**
New York, NY	3,541,431	840,475	77.4%	16.1%	$114,708,780
Chicago, IL	1,163,151	276,805	72.7%	27.3%	$39,491,610
Houston, TX	1,128,581	289,394	76.4%	29.6%	$43,404,630
Los Angeles, CA	908,117	228,152	83.2%	16.5%	$33,293,730
San Antonio, TX	636,322	165,000	65.7%	29.4%	$22,010,910
Philadelphia , PA	611,548	165,547	66.0%	26.6%	$21,874,320
Dallas, TX	590,437	129,800	76.4%	39.6%	$20,613,630
Las Vegas, NV	587,847	95,162	74.5%	30.7%	$13,926,480
San Diego, CA	550,719	70,796	71.2%	16.6%	$8,922,150
Minneapolis, MN	516,118	58,194	63.4%	19.6%	$6,861,930
United States	**134,381,430**	**22,401,882**	**70.3%**	**26.9%**	**$3,056,781,240**

SOURCE: Internal Revenue Service SPEC Information Database, Tax Year 2006 (December 2008). CDF calculations.
Notes: *Of those who receive a refund
****Calculated based on a $150 average tax preparation fee, a $100 average RAL cost and a $30 average RAC cost.**

Three major factors account for this drain on EITC funds:

- **Tax preparation fees.** For millions of tax filers, the complexity of tax laws and the time required to compile necessary documentation to prepare and file tax returns often seem onerous. As a result, a significant portion of U.S. tax filers turn to commercial tax preparation services and private tax consultants to prepare their federal and state tax returns. This is especially the case among EITC recipients, who typically pay about $150 to have their taxes prepared.[10] For tax year 2006, 70 percent of EITC recipients in the United States paid to have their returns completed professionally, compared to 51 percent of non-EITC recipients. Tax preparation fees drained nearly $2.4 billion in EITC benefits from the pockets of families and individuals.

- **Refund Anticipation Loans.** Refund Anticipation Loans (RALs) are high-risk, high-cost short-term loans taken out against a taxpayer's expected refund. Taxpayers who take out RALs often cite the expediency of the loan and the fact that they do not have to pay tax preparation fees before receiving their loan as major factors in their decision to take out a RAL. EITC recipients are more likely than other tax refund recipients to accelerate receipt of their tax funds. In fact, they are more than six and a half times as likely to secure a Refund Anticipation Loan (RAL) as taxpayers who did not file for the EITC. An estimated 5.7 million taxpayers—or more than 1 in 4 (26.9 percent) of those who received EITC refunds—purchased RALs for the 2006 tax year. This contrasted with only 4.0 percent—or 1 in 25—of non-EITC filers who took out RALs that same year.

  This wide disparity is attributable in part to the aggressive marketing of RALs to the working poor and minorities within their communities. Black and Latino taxpayers disproportionately take out RALs, and Native American reservations also have high concentrations of these loans.[11] RALs also are frequently offered in locations not typically used for financial services, including auto dealerships, pawn shops, and rent-to-own stores. Documented marketing techniques include targeting tax filers to use their loan toward a down payment on a car or to purchase items in the store.[12]

  These short-term loans used *to borrow a filer's own money* can have effective annual interest rates (APR) ranging from about 50 percent to almost 500 percent.[13] They can end up costing clients a sizeable portion of their refunds. Unfortunately, it is those workers who most need their hard-earned income that are often sold short-term, expensive RALs.

  In tax year 2006, for example, a taxpayer purchasing a RAL typically paid $100 solely to get his or her refund the same day or within a few days, as most RALs offer.[14] Nationally, these fees totaled a $575 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 7.8 percent of his or her federal refund.

  The extent of RAL usage among EITC recipients remained steady between tax years 2005 and 2006. However, there have been several recent developments in RAL marketing and regulation—both positive and negative. While "pay stub" or "holiday" RALs, which pose additional costs and risks to taxpayers, were almost entirely eliminated during the 2008 tax season due to pressure from community groups and consumer advocates, they have returned among some of the biggest RAL vendors.[15] These RALs are available to taxpayers prior to receiving their W-2s and are taken out against their expected refund. On the positive side, there have been some recent checks imposed on RALS. The IRS announced it was considering restricting the sharing of tax return information with those who market RALs and other financial products sold to access tax refunds. Additionally, interest rates and fees on RALs for members of the military were capped at a maximum APR of 36 percent.

- **Other products and fees.** There are also EITC recipients who purchase other types of financial products to access their refunds. For example, data from the IRS reveal that for tax year 2006 an estimated 18.7 percent of the EITC recipients received a Refund Anticipation Check (RAC), a non-loan financial product in which an account is temporarily opened for taxpayers to receive their refund even though they do not receive their refund any sooner than the IRS sends it. The RACs alone drained $120 million from EITC benefits that year. Additional fees associated with RALs and RACs—such as application and administrative fees—also sap millions from the refunds of EITC recipients.

Extensive use of tax preparation services, RALs and other commercial products used to access tax refunds detrimentally impacts local economies across the country. 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 RAL dollars lost across the 50 states and the District of Columbia.

Figure 2: Counties with the Highest Percentage of Refund Anticipation Loan (RAL) Purchases, Tax Year 2006

County	Number of tax returns	Number of EITC tax returns	% of EITC returns using paid preparers	% of EITC returns with a RAL*	Dollars lost to tax preparation, RALs and RACs**
Todd, SD	2,874	1,680	94.2%	71.1%	$359,190
Shannon, SD	3,736	2,262	92.8%	67.6%	$477,570
Buffalo, SD	572	353	76.5%	63.0%	$63,240
Thurston, NE	2,636	1,028	92.0%	61.8%	$208,200
Sioux, ND	1,356	652	87.6%	60.9%	$127,530
Benson, ND	2,630	963	86.1%	59.8%	$182,520
Webster, GA	752	315	85.4%	59.3%	$59,940
Terrell, GA	4,089	1,901	79.3%	58.8%	$345,330
Dillon, SC	12,613	5,419	79.2%	58.7%	$978,300
Marlboro, SC	11,370	4,908	80.4%	58.6%	$889,080
Hancock, GA	3,443	1,664	79.9%	57.8%	$302,250
Dewey, SD	2,287	970	87.7%	57.8%	$184,200
Rolette, ND	5,289	2,147	85.3%	57.7%	$400,860
Turner, GA	3,966	1,697	87.6%	57.5%	$328,320
Mitchell, GA	8,662	3,663	81.1%	57.3%	$669,300
Edgecombe, NC	23,512	9,025	77.2%	56.6%	$1,586,460
Stewart, GA	1,954	894	72.1%	56.5%	$150,630
Anson, NC	9,844	3,583	91.3%	56.2%	$703,410
Glacier, MT	5,476	2,071	81.7%	56.2%	$375,450
Lake, TN	2,241	764	85.6%	56.1%	$143,850
Lafayette, AR	2,752	969	86.4%	56.1%	$182,340
Corson, SD	1,370	569	90.2%	56.0%	$109,230
Crisp, GA	8,519	3,541	88.2%	56.0%	$682,950
Early, GA	4,727	1,914	91.3%	55.7%	$374,040
Jasper, MS	7,493	2,968	85.0%	55.5%	$554,730
United States	**134,381,430**	**22,401,882**	**70.3%**	**26.9%**	**$3,056,781,240**

SOURCE: Internal Revenue Service SPEC Information Database, Tax Year 2006 (December 2008). CDF calculations.
Notes: *Of those who receive a refund
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Recommendations to Maximize 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 $3.1 billion in fees from commercial tax preparation, RALs and other products used to access tax refunds for tax year 2006 alone. Government officials and community leaders need to enact or implement policies to mitigate the effect of RALs and costly tax preparation fees on lower-income communities. These efforts are especially important during the economic downturn we are currently experiencing as lower-income families are struggling more than ever.

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

1. **Expand access to free tax assistance.** A substantial share of taxpayers nationwide pay to have their taxes completed and filed. Yet 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, which helped more than 3 million taxpayers for tax year 2007.[16] These sites typically offer electronic filing and direct deposit of refunds, allowing taxpayers to receive their money in two weeks or less without any 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 through increased funding and outreach in the VITA and TCE programs and other free tax assistance centers.

2. **Strengthen consumer protections.** During recent sessions of Congress, EITC and RAL legislation has failed to gain solid traction. Meanwhile, low-income families continue to lose significant portions of their intended EITC benefits. This year lawmakers must take action to adopt policies that protect consumers. These include: establishing licensing requirements for commercial tax preparers; ensuring full disclosure of RAL fees and interest rates; and capping interest rates and fees that banks can charge for RALs. Additionally, the IRS should shorten the turnaround time for tax refunds so that workers are less likely to request a RAL in order to receive their refunds more quickly.

3. **Connect working families to mainstream financial services.** A national priority should be to improve the financial literacy of low-income families so they can build a stronger financial future for themselves, their children and the communities where they live. Free or low-cost checking and savings accounts, credit counseling opportunities, and financial education programs offer working families important tools to forge and secure a more stable financial future. Public-private partnerships should be promoted and established to ensure that working families have easy access to these resources throughout the year and not just during tax season.

4. **Institute more state and local 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. Although eligible individuals in any state could benefit from the EITC, only 23 states and the District of Columbia currently have a state EITC in effect. In addition, New York City; San Francisco; and Montgomery County, Maryland, offer local Earned Income Tax Credits.

Step Up and Take Action

Now is the time to step up and take action to ensure that families in your community claim and keep all of the tax benefits they have earned to help them weather this recession.

- Volunteer at a free tax-preparation site to help low-income families access the tax benefits they qualify for and avoid costly tax preparation fees.

- Work with a local bank representative to host financial workshops for low-income families to provide them with the knowledge and tools necessary to build a better financial future. Increasing the financial literacy of families will connect them to mainstream financial services and help them make more informed financial decisions.

- Call or write your Member of Congress and tell him or her to enact legislation that caps interest rates and fees on RALs and ensures their full disclosure. If you live in a state without a state EITC, contact your state lawmakers and tell them to institute a state EITC.

Figure 3: Dollars Lost to Tax Preparation Fees, Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RACs) by State, Tax Year 2006

State	Number of tax returns	Number of EITC tax returns	% of EITC returns using paid preparers	% of EITC returns with a RAL*	Dollars lost to tax preparation, RALs and RACs**
Alabama	1,961,713	498,995	77.0%	40.7%	$80,421,690
Alaska	325,655	40,049	53.6%	21.6%	$4,237,560
Arizona	2,488,769	410,324	68.6%	24.4%	$54,270,060
Arkansas	1,156,418	282,972	76.6%	38.8%	$44,532,360
California	15,238,900	2,391,365	76.1%	17.3%	$322,680,750
Colorado	2,155,959	268,516	62.2%	19.7%	$31,338,060
Connecticut	1,672,928	171,742	66.1%	22.1%	$21,541,770
Delaware	401,147	58,909	59.9%	25.9%	$7,132,020
District of Columbia	275,690	46,927	68.8%	32.5%	$6,624,600
Florida	8,316,250	1,600,980	70.0%	25.6%	$216,062,400
Georgia	3,968,790	909,995	74.0%	36.0%	$138,888,540
Hawaii	616,578	85,385	62.4%	18.5%	$9,882,960
Idaho	623,011	103,332	59.8%	17.0%	$11,391,000
Illinois	5,815,120	870,335	70.5%	25.9%	$118,609,950
Indiana	2,901,418	449,988	67.9%	31.3%	$61,734,870
Iowa	1,354,604	177,343	70.7%	20.3%	$22,923,150
Kansas	1,252,908	177,822	66.0%	23.3%	$22,475,370
Kentucky	1,783,947	353,631	74.8%	33.8%	$52,713,690
Louisiana	1,800,219	496,041	74.6%	38.1%	$77,392,500
Maine	623,264	87,815	57.3%	18.0%	$9,376,680
Maryland	2,619,686	341,385	65.4%	23.3%	$43,173,660
Massachusetts	3,069,471	315,298	64.5%	15.4%	$36,439,200
Michigan	4,514,689	677,552	68.0%	24.6%	$88,741,320
Minnesota	2,504,244	272,832	63.5%	15.3%	$30,902,670
Mississippi	1,182,057	380,644	75.1%	43.6%	$61,350,990
Missouri	2,655,791	450,246	69.5%	28.6%	$61,461,330
Montana	455,237	72,072	64.8%	22.6%	$8,809,380
Nebraska	813,549	112,214	65.7%	19.9%	$13,702,800
Nevada	1,148,747	168,084	72.3%	30.3%	$23,991,090
New Hampshire	648,752	63,298	58.7%	19.3%	$6,985,860
New Jersey	4,102,070	485,935	76.4%	23.4%	$69,202,500
New Mexico	860,694	195,276	65.5%	22.4%	$24,426,570
New York	8,681,944	1,487,516	74.2%	18.9%	$199,525,650
North Carolina	3,893,599	784,179	73.1%	37.1%	$118,374,690
North Dakota	309,886	39,565	64.3%	21.1%	$4,720,620
Ohio	5,414,059	816,699	63.6%	29.4%	$105,183,600
Oklahoma	1,497,944	309,797	68.8%	31.4%	$42,860,370
Oregon	1,636,795	225,257	54.5%	17.1%	$23,028,270
Pennsylvania	5,940,230	796,141	64.7%	22.6%	$98,789,010
Puerto Rico	276,442	2,282	58.4%	20.7%	$255,060
Rhode Island	504,040	67,382	73.8%	22.3%	$9,288,360
South Carolina	1,900,742	437,209	77.4%	41.2%	$70,560,750
South Dakota	372,068	56,154	69.4%	28.5%	$7,554,660
Tennessee	2,678,708	567,251	73.0%	37.4%	$85,135,950
Texas	9,824,355	2,247,543	72.1%	31.2%	$325,669,770
Utah	1,041,765	140,614	59.1%	16.4%	$15,298,890
Vermont	314,853	38,397	58.3%	15.1%	$4,034,580
Virginia	3,504,003	495,705	65.0%	27.9%	$64,029,180
Washington	2,922,927	354,415	57.2%	21.0%	$39,026,310
West Virginia	762,663	145,456	62.4%	29.4%	$18,366,360
Wisconsin	2,691,212	311,945	63.9%	17.7%	$36,577,860
Wyoming	252,593	31,757	62.9%	23.6%	$3,843,090
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