



Children's Defense Fund

## The Children's Defense Fund - Ohio

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### Keeping What They've Earned: Tax Credits for Working Families in Ohio

**M**ore than 13 million children live in poverty in the United States. Across the country this tax season, millions of their low- to moderate-income families will receive tax refunds through the Earned Income Tax Credit (EITC) program—one of the most effective federal weapons against poverty. More than 21.4 million taxpayers claimed over \$38.3 billion in 2003. The EITC not only helps to alleviate poverty among working families, it also boosts local economies since refunds are often used to pay for rent, utilities, food and child care. Unfortunately, up to 20 percent of eligible low-income taxpayers do not claim the EITC, while others claim the credit but pay exorbitant fees to have their taxes prepared or to receive their refund more quickly. Millions of dollars are lost to families and communities nationwide through Refund Anticipation Loans (RALs), high-interest loans that tax filers take out against their expected tax refunds, commonly marketed as "Rapid Refunds" or "Fast Money." Approximately 70 percent of families claiming the EITC use commercial tax preparers, unaware of other choices available to them, including free tax preparation at Volunteer Income Tax Assistance (VITA) sites.

In Ohio, 769,000 taxpayers claimed \$1.3 billion in the EITC, but they lost an estimated \$95 million to tax preparation and high-interest loans during the 2003 tax year.<sup>1</sup> Much more needs to be done on the national, state, and local levels to ensure that EITC dollars make it into the pockets of the needy recipients who the program was designed to help.

#### *Earned Tax Credits for Working Families*

The EITC has wide bipartisan support and has been a part of the federal tax system since 1975. It is the most effective work support tool to assist families who work full- or part-time but earn low wages. EITC refunds received for the 2003 tax year helped to lift 4.4 million people, including 2.4 million children, out of poverty.<sup>2</sup> Recipients can use the credit to help pay income taxes owed or, in most cases, even get money back in the form of a refund.

The EITC means real money in the pockets of eligible individuals and families. For the 2005 tax year, the EITC is worth up to \$4,400 for workers who earned less than \$35,263 (\$37,263 if married and filing jointly) and have two or more qualifying children. Workers earning less than \$31,030 (\$33,030 if married and filing jointly) with one qualifying child may be eligible for up to \$2,662. Working adults between the ages of 25 and 64 with no children, who earned less than \$11,750 (\$13,750 if married and filing jointly) may also qualify for an EITC worth up to \$399.

In addition, many EITC recipients are also eligible for other tax credits such as the Child Tax Credit (CTC). The Child Tax Credit is a federal tax credit for working families with children and incomes above \$11,000 that may be worth up to \$1,000 for each child claimed in 2005. In 2003, the average total refund for Ohio taxpayers claiming the EITC who also received other tax credits was \$2,767.

#### *Costs of Using Commercial Tax 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 quite complex since tax laws, especially those regarding the EITC, are very complicated and often change from year to year. In addition, many low-income families face language and literacy barriers. Consequently, it is not surprising that more than 65 percent of Ohio's low-income families eligible for the EITC hire commercial tax preparers to do their tax returns. It is estimated that these recipients spend an average of \$120 to have their taxes prepared and electronically filed.<sup>3</sup> For EITC families living paycheck to paycheck, this is a significant amount of money—over four percent of their total refund.<sup>4</sup> Statewide tax preparation costs represent about \$60 million lost to poor working families.<sup>5</sup>





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The Children's Defense Fund® (CDF) mission 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. The Children's Defense Fund's national Tax and Benefits Outreach Initiative is entering its third year of working with coalitions across the country during the tax season. CDF has partnered with organizations in local community coalitions to run Volunteer Income Tax Assistance (VITA) sites and provide outreach to working families. These partnerships have resulted in helping families and local communities get an estimated \$170 million in tax refunds during the past two years.

**Martha came to a VITA site almost certain she would leave with little or no refund due to her. In fact, in the past she had paid several hundred dollars to get her taxes prepared and get her refund back quickly! She is a single mother raising a young son and two grandsons. After speaking with a volunteer tax preparer at the VITA site, she discovered that she could claim her son and grandsons for the EITC. The result was that she qualified for the Earned Income Tax Credit and the Child Tax Credit and received a total refund of \$4,680. The tax refund would help her take care of her son and grandsons through a slow employment season. If she had used a commercial tax preparer, she likely would have paid approximately \$120 to have her taxes prepared and an additional \$130 if she wanted to get a Refund Anticipation Loan (RAL). This would have meant spending \$250—approximately five percent of her refund—just to get her tax refund sooner!**

*\*This is a composite example of some of the clients who walk into VITA sites across the country.*

In addition to paying high fees to commercial tax preparers, many working families also use Refund Anticipation Loans, or RALs, to get their refund money on the same day or within a few days. These short-term, high-interest loans are based on the filer's expected tax refund and can end up costing the client a large percentage of their refund. The average Ohio EITC family purchasing a RAL paid \$130—equal to a loan with an Annual Percentage Rate (APR) of about 180 percent<sup>6</sup>—just to get their refund one or two weeks sooner. This means needy Ohio families lose an additional \$35 million in RAL fees.<sup>7</sup> When tax preparation fees are included, the typical family getting a RAL loses almost five percent of its federal refund. Between \$60 million in tax preparation fees and an additional \$35 million in RAL fees, Ohio's working families, and their communities, are deprived of \$95 million.

In most cases, RALs are paid off once the Internal Revenue Service (IRS) processes the tax return and transfers the funds. But RAL loans can actually place families at greater financial risk since they are responsible for paying the interest accruing on the loan if the IRS denies part of the refund for any reason or even withholds it temporarily for audit purposes. According to a recent study by the National Taxpayer Advocate, nearly 75 percent of the tax returns frozen by the IRS because of suspected fraud belonged to low-income taxpayers claiming the EITC, although well over half of all frozen refunds (56-66 percent) were ultimately found to be free of fraud.<sup>8</sup> Given their often pressing financial needs, it is unlikely that EITC families budget for this possibility. There is also ample anecdotal evidence showing some families, especially those with limited English proficiency, do not fully comprehend that they are taking out a loan. Families could actually *end up in debt* due to their efforts to claim EITC and other tax benefits intended to assist them in becoming more financially secure.

One of the largest commercial tax preparers, H&R Block, is awaiting final federal approval on a proposed settlement to four state class action lawsuits and potential claims involving its use of RALs in 22 other states and the District of Columbia. Other lawsuits, including a national class action, are still pending. Although H&R Block has made an effort to resolve its use of RALs, there are still many other commercial tax preparers, both large companies and small store front operations, that continue to market Refund Anticipation Loans.

## Use of RALs in Ohio

RAL vendors continue to target EITC families. According to IRS data, more than 270,000—over 36 percent—of Ohio's EITC tax filers receiving refunds for 2003 also took out RALs, whereas only five percent of non-EITC taxpayers in Ohio who received refunds got RALs for the same year.

As Table 1 indicates, counties with high rates of RAL usage also tend to have higher rates of child poverty than the national average. More than 36 percent of EITC families in Ohio receive their refunds with a RAL—slightly higher than the national average of 34.2 percent. The child poverty rate in Ohio's 25 counties with the highest percentage of RALs was 15.2 percent, slightly higher than the rate state-wide and slightly lower than the national rate of 16.6 percent.<sup>9</sup> In fact, research indicates that commercial tax preparers target low-income neighborhoods for their services. Neighborhoods across the nation with high percentages of EITC filers have 50 percent more electronic tax filing and preparation services than those with low percentages of EITC filers.<sup>10</sup>

## Recommendations

**1. Strengthen consumer protection and education.** Currently, there is little regulation of commercial tax preparers—nearly anyone can hang a "tax preparer" shingle, regardless of education or knowledge of ever-changing tax laws. The federal and state governments must do more to regulate and monitor the practices of commercial preparers as well as their partner banks, including:

- Licensing all commercial tax preparers.
- Requiring all RAL brokers to prominently display not only all associated fees and interest rates, but to also inform customers that they could receive their full refund in one to two weeks from the IRS through e-filing and direct deposit without paying for a RAL.

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- Prohibiting RALs to be used with EITC refunds; or placing a cap on interest rates that banks can charge for RALs.

Federal legislation has been proposed that addresses the issues of the Earned Income Tax Credit and RALs. The Taxpayer Protection and Assistance Act (S.832) would increase funds to sites that offer free tax preparation for low- to moderate-income families; require those selling RALs to register with the IRS; and provide oral disclosure to taxpayers regarding loan fees and interest rates. Ohio has also introduced state legislation to address RALs. In February 2005, Senator Mark Mallory introduced the Tax Refund Protection Act (SB 59) to provide for registration of entities offering RALs in addition to disclosure requirements, but the bill did not move out of committee.

- 2. Expand access to free tax assistance.** Although free tax assistance for low-income families is available at Volunteer Income Tax Assistance (VITA), Tax Counseling for the Elderly (TCE), AARP, and other preparation sites in many communities nationwide, less than two percent of EITC-eligible taxpayers use them. Federal, state, and local governments should partner with employers, foundations, churches, and other community groups to provide financial assistance, make site locations available, donate computers for electronic filing, help recruit volunteers, and conduct outreach with potential EITC families. These preparation sites, along with free or low-cost filing Web sites offered by the IRS and other organizations, should be better promoted to working families. Throughout the United States, CDF state and regional offices operate VITA sites and work with other organizations and federal and state agencies to provide and promote free tax assistance.
- 3. Simplify the rules and process.** Federal and state laws that govern working families' income taxes need to be simplified, and federal and state tax credit programs should be coordinated, so working families can complete their own taxes without having to pay for professional assistance.
- 4. Connect families with financial services and help them develop financial literacy.** Having a tax refund electronically deposited directly into a bank account speeds up the turnaround time significantly, but one out of four families with incomes less than \$25,000 does not have a bank account. Connecting families with banks and credit unions offering free or very low-cost bank accounts can make a tremendous difference; and recent efforts by financial institutions to offer free tax assistance and financial literacy are proving successful.
- 5. Create a state EITC.** Most poor children live in families with a working parent, and the creation of a state EITC could supplement wages and help to lift a family out of poverty. Nineteen states including the District of Columbia have enacted a state EITC worth some percentage of the federal credit. Research indicates that tax refunds, including state EITC refunds, can be used to help families build assets while stimulating local economies.

## Conclusion

Ohio lost an estimated \$95 million in large fees to commercial tax preparers and "rapid refund" vendors in tax year 2003—money that could have been used to help lift children and families out of poverty and boost local economies. Much more can and should be done on the local, state, and national levels to ensure that EITC dollars make it into the pockets of working families. The Children's Defense Fund's efforts to educate and assist families are making a difference in the lives of working families. Only when every eligible working family has access to free and fair tax preparation services can we truly *Leave No Child Behind*.



# Table 1: Percent of EITC and Non-EITC Returns with RALs and Dollars Lost

The 25 Counties with the Highest Percentage of EITC Filers Taking Out RALs (Refund Anticipation Loans), Tax Year 2003 and Select Cities

	Number of EITC Returns	Percent of All Returns with EITC	Percent of EITC Returns with RAL*	Percent of Non-EITC Returns with RAL*	Dollars Lost to Tax Preparation	Dollars Lost to Purchasing a RAL	Total Dollars Lost to Tax Prep and RAL	Child Poverty Rate
<b>Highest RAL Counties</b>								
Jackson	2,933	21.9%	46.3%	11.7%	\$237,240	\$171,924	\$409,164	20.5%
Hamilton	60,259	15.0	45.2	6.8	4,959,000	3,447,132	8,406,132	16.6
Pike	2,356	22.5	44.7	10.1	174,120	133,212	307,332	24.4
Fayette	2,210	18.0	43.8	10.6	172,800	121,633	294,433	12.7
Clark	10,871	16.8	43.0	8.7	873,600	591,909	1,465,509	15.5
Vinton	1,144	24.1	42.7	11.2	91,800	61,869	153,669	28.3
Hocking	2,243	18.6	41.5	11.7	168,960	115,902	284,862	16.2
Marion	4,873	16.8	41.3	9.4	378,960	253,675	632,635	13.9
Butler	18,850	12.2	41.2	7.6	1,593,240	975,054	2,568,294	9.4
Franklin	81,842	15.3	40.9	7.3	6,443,760	4,228,274	10,672,034	14.6
Clinton	3,295	15.1	39.6	8.9	249,840	162,100	411,940	10.1
Montgomery	39,992	14.7	39.5	6.8	3,022,560	1,999,112	5,021,672	15.8
Pickaway	3,023	13.3	39.2	7.9	245,400	148,065	393,465	14.1
Richland	8,979	15.4	39.0	7.5	729,480	442,090	1,171,570	15.9
Lucas	33,885	16.9	39.0	6.9	2,659,680	1,677,719	4,337,399	20.0
Ross	5,519	17.0	38.9	8.2	479,520	270,634	750,154	15.3
Muskingum	7,429	17.8	38.3	7.2	633,720	357,298	991,018	18.5
Scioto	7,048	23.1	38.2	8.6	596,640	339,403	936,043	25.8
Madison	2,548	12.2	38.1	7.7	196,200	120,230	316,430	10.8
Lawrence	5,812	22.9	37.9	8.7	485,400	276,949	762,349	27.6
Brown	2,998	17.2	37.7	9.4	270,960	139,176	410,136	15.5
Adams	2,946	23.8	37.7	9.9	277,920	135,434	413,354	21.0
Crawford	3,605	15.8	37.5	7.4	294,720	171,105	465,825	14.5
Highland	3,625	19.5	37.5	9.1	315,960	168,415	484,375	16.0
Athens	4,276	17.9	37.3	10.8	289,200	197,186	486,386	21.9
<b>Ten Biggest Cities**</b>								
Cleveland	75,106	21.8	39.7	6.2	6,125,400	3,789,459	9,914,859	38.0
Columbus	66,022	18.4	43.0	8.1	5,286,600	3,592,507	8,879,107	19.0
Cincinnati	59,106	15.1	45.3	6.9	4,868,760	3,393,098	8,261,858	32.5
Toledo	29,889	20.5	40.8	8.1	2,378,280	1,556,671	3,934,951	26.1
Akron	23,728	18.7	39.6	7.0	1,806,120	1,187,093	2,993,213	26.0
Dayton	19,369	25.5	47.0	10.1	1,549,560	1,163,001	2,712,561	32.3
Canton	14,228	15.3	39.8	5.6	1,146,360	712,958	1,859,318	28.1
Youngstown	14,259	18.2	33.8	4.7	1,119,240	609,453	1,728,693	37.7
Springfield	8,563	18.1	45.5	9.1	698,280	494,486	1,192,766	24.6
Hamilton	7,916	14.1	45.1	8.6	673,080	451,329	1,124,409	18.4
<b>Ohio Totals</b>	<b>769,212</b>	<b>14.4%</b>	<b>36.3%</b>	<b>5.0%</b>	<b>\$60 million</b>	<b>\$35 million</b>	<b>\$95 million</b>	<b>14.4%</b>
<b>U.S. Totals</b>	<b>21.4 million</b>	<b>16.9%</b>	<b>34.2%</b>	<b>5.1%</b>	<b>\$1.8 billion</b>	<b>\$908 million</b>	<b>\$2.7 billion</b>	<b>16.6%</b>

\* Of returns with a refund

\*\* Ten cities in the state with the highest total number of tax returns filed

SOURCE: IRS SPEC Return Information Data Base, Tax Year 2003 (October 2005). Poverty figures are from U.S. Census Bureau, 2000 Census. Calculations by CDF.

## Endnotes

<sup>1</sup> IRS SPEC Return Information Data Base, Tax Year 2003 (October 2005). Calculations by CDF.

<sup>2</sup> Robert Greenstein, "The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor," Center on Budget and Policy Priorities, August 17, 2005. Retrieved from <http://www.cbpp.org/7-19-05eic.htm>.

<sup>3</sup> H&R Block, Q4 2002 H&R Block Earnings Release Conference Call, June 12, 2002, available at 2002 WL 26337229. Cited in Wu, Chi Chi and Jean Anne Fox, "All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low Income Americans," NCLC/CFA 2004 Refund Anticipation Loan Report, January 2004, page 5. Retrieved from <http://www.consumerfed.org/pdfs/RefundAnticipationLoanReport.pdf>.

<sup>4</sup> These values are based on all EITC claimants who receive a refund.

<sup>5</sup> IRS SPEC Return Information Data Base, Tax Year 2003 (October 2005). Calculations by CDF.

<sup>6</sup> IRS Publication 2043. Based on this publication, the IRS direct deposits refunds in 8 to 15 days. APR calculations are based on a 10-day loan period and are based on the full RAL cost, including all fees and surcharges.

<sup>7</sup> IRS SPEC Return Information Data Base, Tax Year 2003 (October 2005). Calculations by CDF.

<sup>8</sup> National Taxpayer Advocate 2005 Annual Report to Congress, Criminal Investigation Refund Freeze Study, December 31, 2005. Retrieved from [http://www.irs.gov/pub/irs-utl/section\\_4.pdf](http://www.irs.gov/pub/irs-utl/section_4.pdf).

<sup>9</sup> U.S. Census Bureau, 2000 Census. Calculations by CDF.

<sup>10</sup> A. Berube, A. Kim, B. Forman, and M. Burnes, "The Price of Paying Taxes," The Brookings Institution, May 2002. Retrieved from <http://www.brookings.edu/dybdocroot/es/urban/publications/berubekimeitc.pdf>.