



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

For millions of hard-working Americans, tax season means another trip to the commercial tax preparer to have their returns completed and filed. Many of these very same taxpayers will be eligible for the Earned Income Tax Credit (EITC)—a federal tax credit designed to supplement the earnings of low- to moderate-income workers—and will opt to receive their refund sooner by purchasing a Refund Anticipation Loan (RAL). The growth of free tax preparation sites in recent years, however, has given taxpayers more options when they file their tax returns. These sites offer electronic filing and direct deposit of refunds, allowing taxpayers to get their money in about 10 days without fees. With the money saved, families can work towards financial stability by paying bills, investing in a house, and increasing savings.

Throughout the country this tax season, millions of low- to moderate-income families will claim billions of dollars in EITC refunds. A large percentage of these taxpayers will pay outrageous fees to have their taxes prepared and to receive their refund more quickly. According to data from the Internal Revenue Service (IRS), recent success in promoting the EITC has been accompanied by losses to commercial tax preparers and RAL lenders:

- More than 21.7 million taxpayers received the EITC in 2004, representing a \$39.8 billion investment in children, families, and the communities in which they live, work, and play. Tax preparation fees and RALs drained nearly \$2.9 billion from this investment.<sup>1</sup>
- In Tennessee, over 541,000 taxpayers claimed an estimated \$1 billion in Earned Income Tax Credits. These EITC claims composed roughly 2.5 percent of the national total, but Tennesseans lost an estimated \$80.5 million to tax preparation fees and high interest loans.

### Support for Working Families

Each year, the EITC lifts nearly 5 million Americans above the poverty line.<sup>2</sup> Its contribution to the well-being of lower-wage, working families is significant—giving working parents an opportunity to support their families and infusing money into the local economy.<sup>3</sup> For tax year 2006, this federal tax credit is worth up to:

- \$4,536 for families with two or more children;
- \$2,747 for families with one child; and,
- \$412 for individuals between the ages of 25 and 64 with no children.

In addition, many EITC recipients are also eligible for other tax credits such as the Child Tax Credit (CTC). The CTC is a federal tax credit for working families with children and incomes above \$11,300. It is worth up to \$1,000 for each child claimed in tax year 2006. In 2004, the average total refund for Tennessee

taxpayers claiming the EITC who also received other tax credits was \$3,112.

### Costs of Using Commercial Tax Preparers and Refund Anticipation Loans

In order to claim the EITC and CTC, taxpayers must file their federal and state tax returns. This task can be quite challenging, as large numbers of EITC-eligible families hire commercial preparers to complete their returns. In 2004, almost 74 percent paid to have their return completed professionally. Tax preparation fees drained over \$60 million from the pockets of working families.

In addition to paying high fees to commercial tax preparers, many working families also use 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 a taxpayer a large percentage of what they are owed. In 2004, the average family in Tennessee purchasing a RAL paid \$100 just to get their refund sooner—meaning that hard-working families lost \$20.4 million in RAL fees. What's more troubling is that EITC recipients are about five times as likely to purchase a RAL than taxpayers who did not file for the credit. According to IRS data, more than 204,000—nearly 40 percent—of Tennessee's EITC tax filers receiving refunds for 2004 also took out RALs, whereas only 7.6 percent of non-EITC taxpayers who received refunds purchased RALs for the same year. Figure 1 illustrates the disproportionate usage of RALs by EITC families

Figure 1: EITC v. Non-EITC Filers who Purchased Refund Anticipation Loans (RALs)

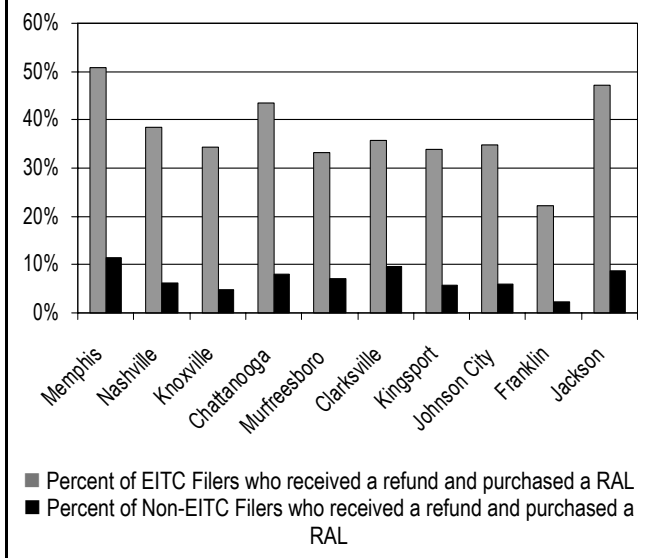


Figure 2: Total Dollars Lost to Tax Preparation and the Purchase of RALs in Cities with the Highest Total Number of Returns Filed, Tax Year 2004

City	Total Returns	EITC Returns	% of EITC Filers who used Paid Preparers	% of EITC Returns with a RAL*	% of Non-EITC Returns with a RAL*	Dollars Lost to Tax Prep and RALs**	Child Poverty Rate
Memphis	306,712	105,401	74.5%	50.9%	11.5%	\$17,073,060	30.4%
Nashville	187,568	36,657	68.5%	38.5%	6.2%	\$5,121,480	19.5%
Knoxville	159,539	25,121	68.7%	34.4%	4.9%	\$3,412,950	26.5%
Chattanooga	84,386	20,137	72.2%	43.5%	8.1%	\$3,031,110	27.4%
Murfreesboro	56,449	8,241	68.0%	33.1%	7.0%	\$1,101,510	12.9%
Clarksville	55,542	12,258	67.1%	35.7%	9.7%	\$1,663,710	14.1%
Kingsport	36,845	6,565	72.8%	33.8%	5.8%	\$930,510	25.3%
Johnson City	36,294	6,480	68.6%	34.7%	5.9%	\$882,960	19.5%
Franklin	36,258	2,622	63.3%	22.1%	2.2%	\$301,500	8.0%
Jackson	35,037	8,979	75.9%	47.2%	8.6%	\$1,436,730	23.7%
Tennessee Totals	2,552,768	541,580	73.9%	39.3%	7.6%	\$80,494,110	18.0%
US Totals	128,599,631	21,721,218	70.6%	28.8%	4.5%	\$2,896,229,700	16.6%

Source: Internal Revenue Service SPEC Information Database, Tax Year 2004 (December 2006). Poverty figures from US Census Bureau 2000 Census. CDF calculations.

\*Of those who received a refund

\*\*Calculated based on a \$150 average tax preparation fee and a \$100 average RAL fee.

in the state's largest cities. Between the costs of tax preparation and RAL fees, the typical EITC family in Tennessee getting a RAL loses an estimated 5 percent of its federal refund.

Although RAL usage dropped significantly in 2004, new industry developments put lower-wage families at greater financial risk.<sup>4</sup> Vendors introduced the pay stub or holiday RAL, which is available to taxpayers prior to receiving their W-2s and is taken out against their expected refund. As advocates educate taxpayers about the dangers of purchasing RALs, lenders are finding more ways to reach taxpayers earlier. These developments hurt community efforts to encourage the use of free tax filing sites because loans are now accessible before the tax season begins. To complicate matters, some preparation businesses require pay stub and holiday RAL users to return to the same office to have their tax returns completed.<sup>5</sup>

#### *Effects on Economic Activity*

RAL fees and tax preparation costs represent a significant drain on local economies across Tennessee. Figure 2 summarizes the total dollars lost in Tennessee's largest cities while Figures 3 and 4 highlight the losses endured at the county level. Of note, sixteen of the top 25 counties in the state with the highest percentage of RAL purchases are located in West Tennessee. More disturbing, Lake County is ranked among the top 25 counties in the nation in terms of the percentage of RAL purchases among EITC claimants.

Additionally, the figures reveal that counties with high rates of RAL usage also tend to have higher rates of child poverty than the national average. The average child poverty rate in Tennessee's 10 counties with the highest percentage of RALs was 21.9 percent, higher than the state-wide rate of 18.0 as well as the national rate of 16.6 percent.

While only a handful of studies have measured the economic impact of the Earned Income Tax Credit on local communities, their results are telling. An analysis of EITC population and participation rates by researchers in San Antonio concluded that increasing the number of EITC claims would benefit the city's economy. Not only would two-thirds of additional EITC dollars be spent locally on retail, general services, and utilities, but each additional dollar received would generate roughly \$1.58 in local economic activity.<sup>6</sup> Unfortunately, cities such as San Antonio do not benefit fully from increasing EITC participation rates because money that was intended for working families is diverted into the portfolios of commercial tax preparers and lending institutions. Tennessee communities are similarly affected because fewer dollars in the hands of working families means less economic activity.

#### *Recommendations*

Tennessee families lost an estimated \$80.5 million because of tax preparation fees and RALs in 2004. Government officials and community leaders are in a unique position to develop public policies that address the cause and mitigate the effect of RALs and costly tax preparation on lower-income communities. To that end, Children's Defense Fund recommends the following :

1. ***Strengthen consumer protections.*** Tennessee lawmakers must consider adopting policies that establish licensing requirements for commercial tax preparers, ensure full disclosure of RAL fees and interest rates, prohibit the sale of RALs to EITC recipients, and place a cap on the interest rates that banks can charge for RALs. In February 2007, House Bill 1226 and Senate Bill 1488 were introduced and sent to the Commerce, Labor, and Agriculture committees, respectively. These bills would require tax preparers to disclose the annual percentage rate for RALs and to provide information about the

Figure 3: Total Dollars Lost to Tax Preparation and RALs in Tennessee Counties with the Highest Number of Total Returns Filed, Tax Year 2004

County	Total Returns	EITC Returns	% of EITC Filers who used Paid Preparers	% of EITC Returns with a RAL*	% of Non-EITC Returns with a RAL*	Dollars Lost to Tax Prep and RALs**	Child Poverty Rate
Shelby	405,354	114,647	73.8%	49.4%	9.3%	\$18,263,340	23.2%
Davidson	276,762	52,047	68.5%	37.2%	6.6%	\$7,203,480	19.5%
Knox	177,883	28,213	69.1%	34.0%	5.0%	\$3,840,540	14.9%
Hamilton	141,976	27,709	71.8%	39.8%	6.8%	\$4,046,580	17.0%
Rutherford	93,784	14,603	68.7%	32.9%	7.4%	\$1,966,230	8.9%
Williamson	70,608	4,792	62.5%	20.8%	2.1%	\$539,280	5.6%
Sullivan	67,767	12,613	71.4%	33.1%	6.1%	\$1,750,740	17.8%
Montgomery	59,472	13,024	67.0%	35.5%	9.6%	\$1,760,970	12.9%
Sumner	58,593	9,512	73.0%	33.9%	6.6%	\$1,347,420	10.8%
Washington	52,536	9,429	70.2%	33.3%	5.9%	\$1,292,340	17.3%
Blount	48,395	7,948	70.8%	33.6%	6.1%	\$1,097,730	12.8%
Wilson	41,131	5,870	73.4%	34.4%	6.2%	\$837,210	8.2%
Madison	39,877	10,150	75.7%	46.0%	8.8%	\$1,609,530	19.2%
Bradley	37,906	7,658	76.5%	35.8%	7.9%	\$1,140,390	15.6%
Sevier	37,903	7,975	76.2%	30.8%	6.0%	\$1,140,900	13.4%
Maury	36,570	6,416	73.8%	38.3%	6.6%	\$946,170	15.0%
Putnam	30,940	6,454	77.7%	33.2%	7.8%	\$954,900	16.4%
Anderson	29,213	4,841	67.0%	34.3%	6.7%	\$644,580	18.5%
Robertson	27,553	4,777	74.9%	38.3%	8.3%	\$709,920	11.5%
Greene	27,150	6,152	77.7%	38.8%	9.3%	\$944,070	19.9%
Hamblen	26,050	5,579	78.0%	36.6%	8.0%	\$849,840	19.7%
Coffee	23,082	4,537	76.3%	39.1%	8.5%	\$689,580	18.0%
Tipton	23,014	5,411	76.1%	39.9%	7.8%	\$826,500	16.6%
Roane	22,673	4,585	73.1%	37.1%	8.8%	\$665,430	19.2%
Gibson	22,416	5,272	78.8%	43.6%	9.0%	\$847,320	17.2%
Tennessee Totals	2,552,768	541,580	73.9%	39.3%	7.6%	\$80,494,110	18.0%
US Totals	128,599,631	21,721,218	70.6%	28.8%	4.5%	\$2,896,229,700	16.6%

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amount of time the IRS takes to send refunds for returns filed electronically.

2. **Expand access to free tax assistance.** Large numbers of Tennessee families pay to have their taxes completed and filed. Elected officials and community leaders must find ways to build and maintain free tax preparation networks throughout the state by investing in the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs and other free tax assistance centers.
3. **Connect working families to mainstream financial services.** Free or low-cost checking and savings accounts, credit counseling opportunities, and financial

education programs offer working families the tools to build for a better financial future, and public-private partnerships should be explored to ensure that working families have easy access to these resources.

4. **Create a state EITC.** Tennessee does not have a state Earned Income Tax Credit. Most poor children live in families with a working parent, and the creation of a state EITC could supplement wages and help lift a family out of poverty. Nineteen states including the District of Columbia currently have a state EITC in effect. Research indicates that tax refunds, including a state EITC refund, can be used to help families build assets while stimulating local economies.

Figure 4: Tennessee Counties with the Highest Percentage of Refund Anticipation Loan Purchases, Tax Year 2004

County	Total Returns	EITC Returns	% of EITC Filers who used Paid Preparers	% of EITC Returns with a RAL*	% of Non-EITC Returns with a RAL*	Dollars Lost to Tax Prep and RALs**	Child Poverty Rate
Lake	2,233	752	85.4%	60.7%	13.4%	\$141,030	35.7%
Haywood	7,632	2,933	85.1%	53.0%	13.9%	\$527,010	24.1%
Hardeman	10,520	3,488	74.6%	50.6%	11.4%	\$561,870	24.6%
Shelby	405,354	114,647	73.8%	49.4%	9.3%	\$18,263,340	23.2%
Dyer	15,442	4,017	78.2%	48.2%	11.8%	\$659,580	21.3%
Fayette	10,758	2,781	76.3%	46.0%	8.5%	\$442,290	18.7%
Madison	39,877	10,150	75.7%	46.0%	8.8%	\$1,609,530	19.2%
Trousdale	2,740	665	86.95	45.9%	13.9%	\$116,220	14.9%
Bedford	17,218	3,718	81.1%	45.8%	11.0%	\$615,810	17.1%
Marion	7,139	1,607	80.0%	44.9%	10.4%	\$262,020	20.3%
Lauderdale	10,313	3,470	83.4%	44.2%	11.2%	\$582,690	25.2%
Gibson	22,416	5,272	78.8%	43.6%	9.0%	\$847,320	17.2%
Crockett	6,082	1,604	78.4%	43.5%	9.5%	\$256,380	19.7%
Obion	13,142	2,920	78.65	41.7%	10.1%	\$462,210	19.0%
Carroll	13,017	3,168	77.8%	41.1%	9.6%	\$496,620	18.1%
Henderson	10,244	2,374	75.9%	41.0%	9.1%	\$365,130	15.1%
Scott	7,368	2,416	60.8%	40.7%	10.5%	\$314,340	24.3%
Henry	13,251	3,229	77.0%	40.1%	8.2%	\$496,440	20.4%
Tipton	23,014	5,411	76.1%	39.9%	7.8%	\$826,500	16.6%
Hamilton	141,976	27,709	71.8%	39.8%	6.8%	\$4,046,580	17.0%
Campbell	14,345	3,908	82.5%	39.7%	11.3%	\$631,770	32.4%
Coffee	23,082	4,537	76.3%	39.1%	8.5%	\$689,580	18.0%
McNairy	10,849	2,887	83.1%	39.0%	8.8%	\$466,410	19.5%
Johnson	6,546	1,750	81.5%	38.9%	11.6%	\$277,860	26.8%
Greene	27,150	6,152	77.7%	38.8%	9.3%	\$944,070	19.9%
Tennessee Totals	2,552,768	541,580	73.9%	39.3%	7.6%	\$80,494,110	18.0%
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**ENDNOTES**

1. IRS SPEC Return Information Database, Tax Year 2004 (December 2006). All figures contained in this report have been retrieved from the 2004 SPEC database unless otherwise noted. CDF calculations.
2. Alan Berube, *Using the Earned Income Tax Credit to Stimulate Local Economies* (The Living Cities Policy Series, 2007).
3. Steve Holt, *The Earned Income Tax Credit at Age 30: What We Know* (Washington: Brookings Institution, 2006).
4. The number and cost of RALs purchased declined significantly in the 2004 tax year, possibly due to more education and awareness, advocacy, and changes to IRS reporting. Chi Chi Wu, *One Step Forward, One Step Back: Progress Seen in Efforts Against High-Priced Refund Anticipation Loans, but Even More Abusive Products Introduced* (Boston: National Consumer Law Center, 2007).
5. Chi Chi Wu, *One Step Forward, One Step Back*.
6. *2004 Update: Increased Participation in the Earned Income Tax Credit in San Antonio* (Austin: Texas Perspectives, 2004). CDF calculations.

Children's Defense Fund®

**Healthy Child Campaign**



In addition to the EITC and access to VITA sites, health insurance is critical to financial stability. Health care costs have increased drastically in recent years, leaving an estimated 9 million children uninsured. Families that lack medical insurance tend to have higher credit card debt because they cannot pay for services, and, as a result, medical expenses account for nearly 50 percent of bankruptcy filings. CDF unveiled a legislative proposal in January that would ensure that all children would receive coverage for all medically necessary care. For more information, visit [www.childrensdefense.org/healthychild](http://www.childrensdefense.org/healthychild).