



## THE EARNED INCOME TAX CREDIT PROVIDES BILLIONS TO TEXANS, YET \$1.2 BILLION WENT UNCLAIMED LAST YEAR

More than two million Texas workers claimed over \$4 billion in federal dollars for tax year 2003 through the federal Earned Income Tax Credit (EITC), ranking ahead of the more populous California. The EITC not only boosts the earnings of low-wage workers and stimulates the Texas economy; it also provides an excellent opportunity for working families to save for the future. Although outreach and free income tax assistance have improved awareness of the program, the Texas economy and working families lost out on nearly \$1.2 billion in unclaimed EITC payments last year. Not only that, but over two-thirds of EITC filers used commercial tax filing services, and two-fifths used "Refund Anticipation Loans"—a high-cost loan used primarily by low-income taxpayers to get their refunds immediately, without having to wait for the IRS to process their returns. Taken together, tax preparation and RAL fees can drain hundreds of dollars from low-income Texans' hard-earned tax refunds. This Policy Page analyzes the most recently available EITC data for Texas, summarizes recent developments relevant to the EITC taxpayer, and provides links to EITC resources.

### WHAT IS THE EARNED INCOME TAX CREDIT?

The Earned Income Tax Credit provides eligible workers with low or moderate income a rebate of all federal income taxes deducted from their paychecks the previous year. In 2005, low-income workers are potentially eligible for a credit up to \$4,400, depending on their earnings and number of dependents. For example, workers who were raising one child in their home and had income less than \$31,030 (or \$33,030 for married workers) in 2005 can receive an EITC up to \$2,662. Workers between the ages of 25 and 64 without dependents are eligible for a credit up to \$399, depending on their earnings.

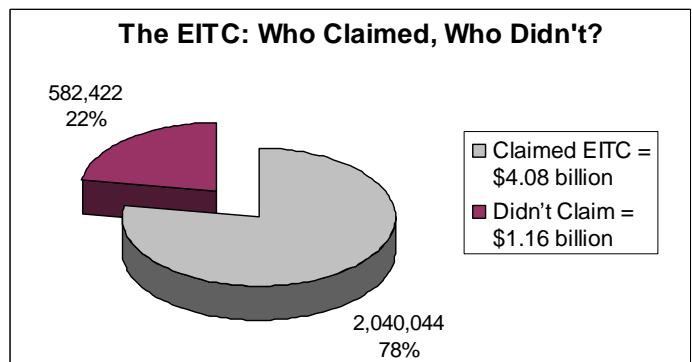
### WHO CLAIMS IT, WHO DOESN'T, AND WHY?<sup>1</sup>

In tax year 2003, over two million Texas workers claimed \$4 billion through the EITC—10.9 percent of the \$37.5 billion in EITC refunds claimed nationwide. The average EITC refund in Texas was \$2,002.

Of the more than 2 million EITC filers in Texas, about 55% filed as head of household for Tax Year 2003. The remainder either filed a married/widow(er) return (27%) or filed a single return (18%). In Tax Year

2003, more than 190,000 (9.1%) EITC filers did not file a return the previous year.

**Although more and more Texans claim the EITC each year, 22.2 percent of eligible tax filers—582,422 workers—did not claim their refunds in 2003. As a result, these low-income Texans and the Texas economy lost out on \$1.2 billion (based on the average EITC refund).** The primary reasons that eligible Texas workers don't claim the EITC are a lack of awareness about the tax benefit and/or difficulty completing the EITC-component of their tax returns.



Source: CPPP Analysis of IRS Data (Tax Year 2003).

The average rate of unclaimed EITC refunds nationwide was 23.8 percent in 2003, representing approximately \$11.8 billion. Texas' share of unclaimed EITC dollars nationwide was 9.9 percent.

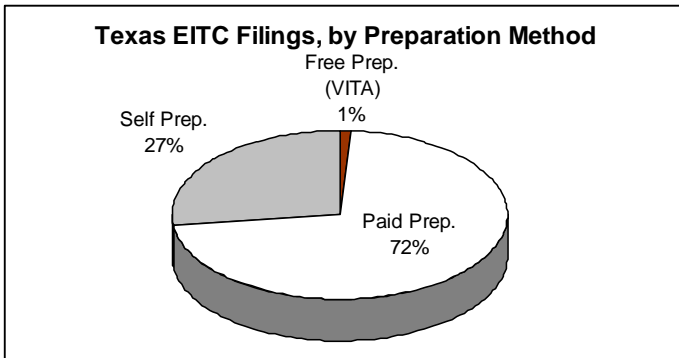
<sup>1</sup> EITC data are from an analysis of IRS data by the Administration for Children & Families, U.S. Dept. of Health and Human Services.

The data on the amount of unclaimed EITC refunds in 2003 **only capture those taxpayers who filed a tax return, but did not claim the EITC**; they do NOT include potentially eligible workers who do not file a tax return. Therefore, the data underestimate both the number of workers who miss out on the EITC and the amount of unclaimed EITC refunds.

## USE OF PAID TAX PREPARERS AND REFUND ANTICIPATION LOANS

Despite the expansion of free tax preparation and ongoing outreach about the EITC, the vast majority of low-income filers in Texas still use paid tax preparers for their returns. In Tax Year 2003, volunteer-assisted tax sites in Texas generated 28,329 returns—less than 2% of all EITC returns.<sup>2</sup>

In contrast, 72 percent of EITC filers in Texas used paid tax preparers. Assuming each of these tax filers paid \$120—the average tax preparation fee nationwide—then an estimated \$140 million was lost on tax preparation fees in 2003, or 3.4 percent of total EITC claims.<sup>3</sup>



Source: CPPP Analysis of IRS Data (Tax Year 2003).

Some tax preparers also offer “Refund Anticipation Loans” (RALs) that charge taxpayers additional fees

<sup>2</sup> Volunteer tax preparation includes VITA sites sponsored by the IRS (in conjunction with an external group), Military VITA, and Tax Counseling for the Elderly (TCE).

<sup>3</sup> Average fee is from H&R Block, Q4 2002 H & R Block Earnings Release Conference Call, June 12, 2002, reported in *Picking Taxpayers’ Pockets, Draining Tax Relief Dollars: Refund Anticipation Loans Still Slicing Into Low-Income Americans’ Hard-Earned Tax Refunds*, The National Consumer Law Center’s and Consumer Federation of America’s 2006 Refund Anticipation Loan Report, by Chi Chi Wu, NCLC, and Jean Ann Fox, CFA (contributing author), January 2006. See <http://www.nclc.org/news/content/2006RALReport.pdf>. CPPP used this average fee to estimate the total EITC dollars lost to tax preparation fees in 2003.

to receive their EITC refunds immediately. RALs are predatory loans secured by and repaid directly from the proceeds of a consumer’s tax refund from the IRS. The interest rate on these loans can be as high as 700 percent over a typical 7-14 day period—depending on the amount and the fee charged by the lender. If the IRS determines that the refund is lower than anticipated, the taxpayer also bears the risk of having to pay back the difference at the same exorbitant interest rate.

The National Consumer Law Center (NCLC) published a report showing that RAL usage has remained constant over the past couple of tax seasons. Using IRS data, the NCLC study concluded that over 900,000 tax filers in Texas used RALs in 2003—over 40 percent of all EITC filers that year.<sup>4</sup> In some large ZIP codes, more than half of tax filers used a RAL—compared to 35 percent nationwide. The rate of RAL use among taxpayers who didn’t file for the EITC (i.e., higher-income taxpayers) was much lower, only 10%.<sup>5</sup>

For Tax Year 2005, a RAL for an average EITC refund costs approximately \$100, which means that RALs could drain over \$87 million in fees from Texas EITC recipients this year.<sup>6</sup> Additional fees for check cashing services, loan application, and tax preparation often accompany RALs and could drain an additional \$150 million from Texas taxpayers this year.

During the 79<sup>th</sup> regular session, HB 398 was introduced to regulate RAL disclosure and interest rates. HB 398 received a hearing in the House Financial Institutions Committee, but was never voted on so failed to pass.

This tax season, some commercial tax preparers have introduced a new product—the “**pay stub loan**.” This product enables taxpayers to get an advance of their tax refund even before they receive a W-2 annual earnings statement from their employer or file their taxes. These loan fees are reported to cost twice the amount of a traditional RAL product and require the taxpayer to visit the commercial preparer twice, once to apply for the loan and then

<sup>4</sup> The Brookings Institution, Metropolitan Policy Program, Tax Year 2002. Interactive data download available at <http://www.brookings.edu/metro/eitc.htm>.

<sup>5</sup> “Keeping What They’ve Earned: Working Texans and Tax Credits,” Children’s Defense Fund – Texas, February 2005.

<sup>6</sup> NCLC/CFA 2006 Refund Anticipation Loan Report.

again to prepare a tax return once they have received their W-2 forms.

### LOCAL EITC DATA

Local data on the EITC in Texas are available for local workforce development regions, by county, and by congressional district. To view and download these data, visit CPPP's web site at <http://www.cppp.org/eitc.php>.

### IRS AND STATE EITC OUTREACH

**IRS Outreach:** Run by the IRS and staffed by community-based volunteers, the Volunteer Income Tax Assistance (VITA) Program offers free tax preparation to low-and moderate-income taxpayers (with annual income at or below \$38,000). Local organizations sponsor the volunteers, who are trained by the IRS to prepare basic tax returns and determine whether taxpayers are eligible for the EITC and other tax credits. VITA sites are generally located at community and neighborhood centers, libraries, schools, shopping malls, and other convenient locations. In addition to free tax return preparation, many sites also offer free electronic filing (e-filing). With e-filing, workers receive their refunds twice as fast as filing paper returns—even faster if their refunds are deposited directly into their bank account.

*To find a VITA site in your community, call 211.*

Workers may also use the IRS' online Free File program to e-file their tax returns, without the aid of a VITA volunteer.

*To access IRS' Free File program, see <http://www.irs.gov/efile/article/0,,id=118986,00.html>*

**State EITC outreach:** Several state agencies conduct EITC outreach. The **Comptroller of Public Accounts** is required by law to conduct EITC outreach and has launched the Earned Income Tax Credit Campaign 2006 to increase statewide awareness. For more information and to view bilingual outreach materials published by the Comptroller, see <http://www.window.state.tx.us/taxinfo/eitc/>.

A new law passed in 2005 required other state agencies that serve the EITC population to do outreach as well. HB 401 (79<sup>th</sup> Legislature) requires the **Health and Human Services Commission** to make VITA site referrals and furnish EITC outreach

materials to its clients, including recipients for Food Stamps, Medicaid, and TANF cash assistance programs. Eventually, HHSC staff will provide pre-populated EITC tax forms (Schedule EIC) to potentially eligible clients. The law also required the Attorney General to disseminate EITC information to child support obligors.

The **Texas Workforce Commission** (TWC) also provides information about the EITC to 28 local workforce development boards and encourages them to educate their clients (primarily Food Stamp and TANF cash assistance recipients) about the EITC. In 2005, the Governor awarded **\$500,000** in TANF grants for EITC outreach, which expanded TWC's "Earn it. Claim it. Save it." campaign from three to seven local workforce boards. Phase I – initiated towards the end of last year's tax season—of the campaign includes the Heart of Texas, North Central, and Central Texas Workforce Board areas. Phase II—begun at the onset of this year's EITC campaign—includes the Lower Rio Grande, Cameron Works, South Texas, and the Gulf Coast Workforce Board areas.

This campaign raises awareness of the EITC among employers and working families and offers tax preparation assistance and financial literacy classes.

### KATRINA, RITA, & THE EITC

Last year, Congress passed the Gulf Opportunity Zone Act of 2005 and the Katrina Emergency Tax Relief Act of 2005 to provide special assistance to individuals directly affected by Hurricanes Katrina, Rita, and Wilma. As of January 2006, the Federal Emergency Management Agency (FEMA) had received approximately 642,000 applications for assistance from Hurricane evacuees in Texas by January 2006.<sup>7</sup>

These new federal laws make several changes relevant to a Hurricane survivor's tax obligations. The primary EITC provision enables eligible workers to calculate their EITC or refundable Child Tax Credit using their earned income from the previous tax year (2004) (see <http://www.cppp.org/research.php?aid=73&cid=2> for more information about the Child Tax Credit).

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<sup>7</sup> Texas Legal Services Center, 2006.

For eligibility criteria and to learn more about EITC options for hurricane survivors, see <http://www.irs.gov/individuals/article/0,,id=151658,00.html>

For more specific information about other changes to tax law for hurricane survivors, see <http://www.irs.gov/newsroom/article/0,,id=152734,00.html>.

## THE EITC REFUND “FREEZE”

Each year, the IRS’ Questionable Refund Program (QRP) “freezes” hundreds of thousands of refund claims to stem potential fraud and abuse by American taxpayers. This year the IRS Taxpayer Advocate Service randomly sampled 500 “frozen” refund claims from tax year 2004. Based on the findings of the Advocate’s *Criminal Investigation Refund Freeze Study*, it appears that the IRS’ freeze program discriminates against low-income taxpayers. Among the findings were:

- About 75% of the refunds were from taxpayers claiming the EITC;
- Over one half of refunds were from taxpayers with an adjusted gross income (AGI) below \$13,000;
- The sum of all frozen refunds equaled over 25% of the filers’ yearly incomes;
- Nearly two-thirds of the frozen claims were not fraudulent, and over 80% received at least a partial refund.

Because of the disproportionate number of low-income tax filers investigated for fraud, the Taxpayer Advocate concluded that “the extended delays often impose a severe economic hardship on taxpayers who ultimately received refunds.” The study recommended various options to reduce the burden placed upon taxpayers targeted for submitting fraudulent refund claims.<sup>8</sup>

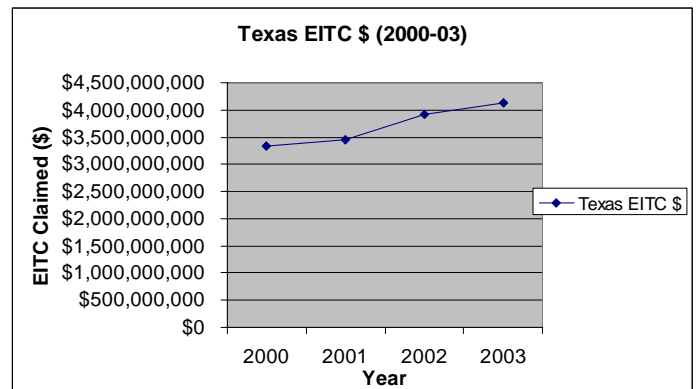
## EITC FILINGS ON THE RISE

Since Tax Year 2000, EITC returns have significantly outpaced non-EITC filings—both statewide and nationally. In fact, Texas’ EITC filings grew at nine times the rate of other tax returns. From 2000-03, total returns increased by only 1.6%, while EITC returns increased by 13.6%.

<sup>8</sup> [http://www.irs.gov/pub/irs-utl/section\\_4.pdf](http://www.irs.gov/pub/irs-utl/section_4.pdf)

The rate of Texas EITC filings far outpaced the national average in 2004. Texas EITC returns for tax year 2003 comprised nearly a quarter (23.3%) of all returns; nationally, EITC filings were 17.4% of all tax returns.

Over the past several years, the most significant trend in EITC growth in Texas and nationwide is the large monetary increase in EITC refunds. From 2000-2003, Texas’ EITC refunds increased by more than \$787 million (23.6%). Every congressional district (except for the 25<sup>th</sup>) experienced double-digit percentage increases in EITC refunds during this period.<sup>9</sup>



Source: CPPP, Brookings Analysis of IRS Data, 2004.

## POLICY RECOMMENDATIONS

Texas can build on its commitment to maximize the benefits of the EITC for working families and the state by expanding outreach and free tax preparation and combining these initiatives with increased financial education and savings options for low-income taxpayers.

The EITC provides an excellent opportunity for low-income working families to begin saving for the future. Unfortunately, low-income taxpayers are more likely to spend their EITC refunds than to save them, often because they have fallen behind in paying their bills and rely on their refund check to catch up. However, low-income workers face other barriers to saving as well, such as limited access to savings products (such as IRAs, 529s, Roth IRAs) designed to benefit higher-income families. Texas can overcome these barriers by encouraging low-income workers to save their EITC refunds and providing them with incentives to maximize their savings.

<sup>9</sup> CPPP, Brookings analysis of IRS data.

**Individual Development Accounts (IDA)** offer an excellent way for states to help low-income individuals save for the future. These interest-bearing accounts help low-wage workers to save for a specific purpose—usually a home, education, or to start a small business—by matching their savings with public or private funding. In 2005, legislation to establish a statewide IDA program passed the legislature unanimously, but was defeated on a technical error on the last day of the session.

## **ADDITIONAL RESOURCES**

To access the IRS' Free File program and file your taxes online for free, see <http://www.irs.gov/efile/article/0,,id=118986,00.html>.

Visit CPPP's web site to learn more about our **Family Asset Building Project**, an effort to help low-and moderate-income families build financial security through assets, savings, and financial literacy: <http://www.cppp.org/eitc.php>.

Download an EITC outreach toolkit from the Center on Budget and Policy Priorities: <http://www.cbpp.org/eic2006/index.html>

Download an EITC outreach toolkit designed for use by employers from Corporate Voices for Working Families: <http://www.cvworkingfamilies.org/2006EITC/2006EITC.shtml>

Use the IRS' interactive "EITC Assistant" to find out if you're eligible for the EITC: <http://www.irs.gov/individuals/article/0,,id=96406,00.html>

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