April 15, 2013

Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515
tax.reform@mail.house.gov

Comments: Education and Family Benefits Tax Reform Working Group

To The Education and Family Benefits Tax Reform Working Group:

The Financial Clinic (the "Clinic") applauds the Ways and Means Committee's efforts to enact meaningful and comprehensive tax reform. The tax filing moment is crucial to helping low- and moderate income Americans build financial security. The Clinic offers the following comments to help illustrate some of the strategies that our Financial Coaches use to help 4,500 residents of New Yorkand New Jersey overcome financial barriers each year.

I. Background

The Clinic exists to improve the financial security of working poor families who earn income but do not have enough to cover basic needs. We do this by addressing their immediate financial challenges, creating trajectories for long-term goals, and leveraging this knowledge into policies and practices that create systemic change. Tax preparation represents the single most important financial transaction for the 25 million American households receiving refundable low-income tax credits like the Earned Income Tax Credit (EITC), American Opportunity Credit (AOC), and Additional Child Tax Credit (ACTC). These credits provide much-needed income supports to meet basic household expenses that occur regularly throughout the year:

- Jose G, who struggles to find enough money to pay rent every month;
- Anne B, a community college student, who can barely afford the expensive books she has to buy at the beginning of every semester; and
- Joyce L, who is looking to reduce the amount of taxes taken out of each of her paychecks so that she has more money in her pocket to address her debt.

Most government benefits, including Social Security, Supplemental Security Income, and SNAP are distributed monthly. Yet like all tax credits, the government issues refundable ones in a single lump sum amount once per year. Twenty five million of the most vulnerable families in the country—those with the scarcest resources, little to no emergency savings, and highest debt-to-income ratios—are expected to plan for year-round expenses when they file in the winter. This sort of lump sum delivery has unintended consequences for working poor families: (1) it creates a "feast or famine" cycle of income that strains household budgets, and (2) it makes low-income filers more likely to resort to high cost, predatory financial products to make ends meet.

On behalf of The Financial Clinic, I respectfully urge the Education and Family Benefits Tax Reform Working Group to consider changing the distribution of tax refunds from a single lump sum to quarterly payments throughout the year. By doing so, Americans who receive a significant portion of their annual household at tax time will be able to receive and use their refunds more effectively to meet household expenses throughout the year.

II. “Feast or Famine” Cycles are Barriers to Financial Security

Working poor families often face the challenge of managing their household budgets on “variable” income—they are the more likely to receive a significant portion of their income in lump sums (tax refunds or retroactive benefits) or in inconsistent amounts from short-term employment, cash-based work, or seasonal jobs. For New York City’s families under federal poverty level, a family of four may receive as much as 40 percent of their income on the day that they receive their tax refunds or receive the bulk of their income during seasonal employment. According to the Clinic’s internal survey of its tax filers, 70 percent of filers will use their refunds to pay for basic household expenses, including rent, utility bills, as well as food and clothing. Because most EITC filers spend their refunds in their local communities, it should come as no surprise that every $1 of EITC returned to a filer generates an estimated $1.4 in local economic activity.

EITC filers brave these “feast or famine” financial cycles that lead to difficulties in budgeting and may compel them to use expensive credit to survive. In the end, saving and building assets falls by the wayside. Clinic customers rely heavily on credit in the months before the tax season in anticipation of their hefty refunds. Sometimes, they even opt for the extremely predatory refund anticipation checks or “holiday” programs. The Clinic believes that the cycle of financial insecurity can be broken if appropriate income-smoothing strategies and products are made available to re-orient lump sums.

III. Behavioral Economics & Lump Sums

Lump sums can easily be perceived as bonuses, rather than as income supports. Behavioral economists have noted the psychological perception differences between a dollar and ten dimes. The dollar is perceived as larger and implies a “proliferation of choices” that is inherently limited by smaller amounts. When receiving the larger amount, the customer can face the challenge of “mental accounting” that a lump sum can sometimes distort. By the time the money comes in, a customer may have already allocated portions of it to meet previous debts—leaving less money for future fixed expenses or current savings.

In October 2012, the Clinic launched the Now&Later Program with Spring Bank to offer linked savings and checking accounts. Account holders can open up accounts with $500 minimum deposit into a savings account that is not ATM accessible and restricts monthly statements to online access. Equal monthly transfers are made into the checking account that is then set to electronically pay specific fixed expenses (transportation cards, cell phone bills). By allowing customers to set up fixed monthly transactions, the Now&Later Accounts help customers manage lump sums over an extended period of time, ultimately bridging the gaps in their cash flow that otherwise threaten their financial security.

IV. Predatory Practices

Another negative consequence of lump sums is that they can be transformed into an opportunity for windfall profits through predatory products and practices. When lump sums become significant, expensive fees and interest rates seem disproportionately small and therefore, more reasonable and acceptable. In fact, taxpayers living in extremely low-income communities are 215 percent more likely to use refund anticipation checks (controlling for their family characteristics and their income).[1] This is an unfortunately common occurrence across low-income and immigrant communities in New York City,

[1] Brett Theodos, et al., Who Need Credit at Tax Time and Why: A Look at Refund Anticipation Loans and Refund Anticipation Checks 18 (Nov. 2010), available at http://www.urban.org/publications/412304.html..

where unscrupulous commercial tax preparers with poor training and no professional credentials are prevalent.[2]

For the past six tax seasons, the Clinic has seen various strategies by paid preparers to obtain greater fees:

- Pushing filers to use refund anticipation loans whose interest rates are over 200 percent;
- Advising filers to file only some of their W2s to generate the largest refund and then telling filers to amend the returns later (after the tax preparation site has closed) to include the remaining W2s leaving the filers to owe the initial refund;
- Adding false information like self-employment income to increase tax credit amounts; and
- Using a filing status that is incorrect such as filing a married couple who lives together under two tax returns as "heads of households."

V. Periodic Earned Income Tax Credit

__Proposed Solution__: The Financial Clinic advocates creating a Periodic Earned Income Tax Credit (PEITC) which would provide an option at tax filing to receive federal tax refunds in four equal quarterly payments throughout the year.

By allowing working poor families to receive refunds throughout the year, refunds would be more likely to be used for the very purpose they were created for: provide additional income to meet basic household expenses. PEITC would put more money into the pockets of the working poor all year round, thus decreasing the need for short-term, high costs loans like Refund Anticipation Loans and Refund Anticipation Checks. Unlike the Advanced Earned Income Tax Credit (phased out in 2009), the PEITC is not

[2] Testimony of Jamie Woodward, IRS Public Forum, "Tax Return Preparer Review" September 2, 2009, available at http://www.irs.gov/taxpros/article/0,,id=212450,00.html (last accessed November 15, 2011).

a guess of how much the filer will receive when he files at tax time--it is simply the refund redistributed later in the year. Also, the Advanced Earned Income Tax Credit was distributed through employers and paychecks--making the process unnecessarily complicated.

We believe that the PEITC helps working poor families for the following reasons:

- Families who receive the PEITC are better able to cover their month-to-month expenses, and so are less likely to turn to credit card debt or payday loans to get by, and in this way avoiding usurious finance charges (as well as perhaps late fee and other penalties).
- At tax time, families will be less likely to pay for expensive predatory products that proliferate each filing season.

VI. Conclusion

The EITC offers tremendous financial support to Americans who struggle to make ends meet, despite having paying jobs. Periodic payment of the EITC is well-poised to ameliorate the "feast or famine" conditions working poor families face during the tax season by improving their financial security all year round.

Sincerely,

Haidee Cabusora
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