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Expanding Financial Services to Underbanked Consumers:

How Tax Preparation Partnerships Can Help Bridge the Gap

INTRODUCTION

Between January and April each year, millions of workers across the country – including many who may otherwise never enter a bank or meet with a financial advisor – turn to tax preparers for help in completing their income tax returns. This may be the one time of year they consider their income as a whole or talk with someone about money issues. Equally important, it may be the only time that some workers have the financial flexibility to make a significant investment in savings. Families living paycheck-to-paycheck for most of the year frequently receive large tax refunds, due primarily to over-withholding and tax credits – especially the Child Tax Credit and Earned Income Tax Credit (EITC).¹

For Tax Year 2002 (the latest for which IRS data is available), nearly 70 million tax filers with incomes under \$30,000 received more than \$82 billion in federal tax refunds – and more than 21 million filers received nearly \$38 billion in the EITC.² Total refunds in the U.S. exceed \$200 billion per year. Given the right options, the tax refund could serve as a starting point for improved long-term financial security for a large number of American consumers.

Recognizing the market gap for unbanked families that do not have access to many financial vehicles, both financial institutions and other service providers have developed efforts to reach these consumers at tax time. For financial institutions, these groups represent an opportunity to expand service to an untapped, emerging market segment. Some have attempted to connect consumers with traditional services, while others have designed new services to meet the group's unique needs.³

¹ The EITC is a refundable credit available to lower-income individuals and families when they file a tax return. The amount of the credit varies with income and family size, but the largest credits generally go to those earning \$7,500-\$20,000 a year. For Tax Year 2004, the maximum EITC was \$4,300 and the credit phased out at just over \$35,000 in income for married filers with two children. Because it is refundable, the EITC not only reduces the amount of taxes owed, but may result in a refund if the amount of the credit is greater than any taxes due. The Child Tax Credit is worth \$1,000 per child for all families and is partially refundable for some low-income families.

² Internal Revenue Service, Information Services (2004, October). Unpublished data.

³ For more information, see also Center for Financial Services Innovation. (2005, July). *Marrying Financial Transactions with Asset-Building Opportunities*.

While there have been many innovations in this area over the past decades, model efforts are often small and take-up rates are low.

A key question for those interested in reaching underbanked families with financial services is how to effectively market the services and make the connection. This paper looks at the potential for using income tax preparation as part of the answer.

This paper explores opportunities for using the tax preparation moment to bridge the gap between the financial needs of underbanked consumers and services that can meet those needs. It looks at lessons learned from existing programs in both the private and non-profit sectors, and considers additional approaches that might be tested in the future. It discusses six opportunities for linking financial services and tax preparation for underbanked filers:

- Bank Accounts for the Unbanked
- Alternative Refund Anticipation Loans
- Stored Value Cards
- Individual Development Accounts
- Retirement Savings
- Refund Splitting (a newly emerging opportunity)

Interest in offering these services has grown in recent years, as free tax preparation programs have become more experienced and commercial preparers look to expand their market reach and depth. Results of a June 2005 survey by the National Community Tax Coalition gives an indication of the degree to which free tax preparation programs are moving in this direction:

FINANCIAL SERVICES AND FREE TAX PREPARATION PROGRAMS⁴
(of a total of 61 survey respondents)

Type of Financial Product or Service	Programs Intending to Provide the Service in 2006	
	#	%
Savings Account	20	33%
Checking Account	19	31%
IDA	13	21%
Check Cashing	9	15%
Alternative RAL	6	10%
Mortgage Lending	6	10%
IRA	5	8%
Stored Value Card	3	5%
Alternative Short-term Loan Product	3	5%
529 Education Savings Plan	3	5%
Savings Bond	2	3%
<i>Interested in Refund Splitting</i>	25	41%

Additionally, there has been a great deal of activity in the private sector as companies begin to see tax season as a prime moment of opportunity for distributing financial services. For example, H&R Block has sought to expand its presence in the general financial services marketplace for some time, including applying for its own bank charter. In 2004, the company developed the “Everyday Financial Services” or EFS concept in order to build a platform for providing a suite of financial services—in addition to tax assistance—to the majority of its clients who fell into the low- and moderate-income category.⁵ Other firms, such as Jackson Hewitt, have partnered with stored value card providers and other financial institutions to offer enhanced financial services options at tax time. Financial institutions, from large firms such as JP Morgan Chase to small credit unions, have also focused on tax time as a marketing strategy for financial services through the provision of special account products, emergency loans, and deposit vehicles such as stored value cards.

This paper comes at a key juncture, when experiences have yielded lessons that can

⁴ National Community Tax Coalition (2005, June). Unpublished results from a survey of free tax preparation programs. The free tax preparation programs referenced in this report are generally affiliated with the IRS’ Volunteer Income Tax Assistance (VITA) program. Under VITA, the IRS provides free software, electronic filing and materials (and to a varying extent, training, hardware and other assistance) to community-based programs that rely primarily on volunteers to complete tax returns at no charge for low-income filers.

⁵ A more complete description of EFS can be found in Tufano, P and Schneider, D. (2004, October). *H&R Block and “Everyday Financial Services.”* Harvard Business School. To order copies, visit <http://www.hbsp.harvard.edu>.

inform growth in the field, and when the emergence of refund splitting offers the promise of significantly expanding programs in this area. By allowing tax filers to direct their refunds to more than one account, refund splitting provides an opportunity for filers to achieve multiple objectives. This can make it more realistic for underbanked filers to invest in savings and take advantage of asset-building opportunities, because they can still retain a portion of the funds for immediate or ongoing needs. This paper's goal is to encourage innovation while providing direction to those interested in exploring new approaches.

OPPORTUNITY #1: BANK ACCOUNTS FOR THE UNBANKED

As many as 22 million American households do not have either a checking or savings account.⁶ These families, the majority of whom have incomes under \$25,000 a year, may end up paying a premium to access financial services. They also face difficulty in achieving long-term financial security by saving money, building a credit history, avoiding or reducing debt and accumulating assets. The tax preparation moment offers a prime opportunity for marketing accounts to the unbanked because having an account can facilitate rapid receipt of tax refunds. A refund direct deposited from an electronically filed return is generally available to the filer in 8 to 16 days, compared with three weeks or more if a refund check is mailed – and direct deposit is provided by the IRS at no cost to tax filers. Direct deposit can also offer filers greater security than having a check mailed to their home.

Linking tax filers with bank accounts is perhaps the most common financial service offered at free tax preparation sites, usually in partnership with a bank or credit union that has a branch in the community. Credit unions may operate their own tax sites, using tax preparation both as a service to existing members and as a way of attracting new members. Some commercial tax preparation offices have established similar banking partnerships.

Programs have had varying experiences in linking tax preparation and accounts for the unbanked. Take-up rates are often lower than expected, for a variety of reasons. Filers who are focused on getting their taxes done may not be interested in making an immediate decision about a bank account. The partner financial institution may only be able to spare staff to open accounts at the tax site for a portion of the hours the site is open. Filers may not meet criteria to open an account, such as adequate identification or a clean ChexSystems history.⁷ And tax filers may bring their own issues, such as mistrust of banks or a negative prior banking experience.

Programs with the greatest success at opening accounts have often been those that reduced these kinds of barriers. High-volume sites are more likely to offer a rich environment for account opening and therefore an incentive for financial institutions to assign staff full-time (all hours the site is open) to the partnership. Banks that offer

⁶ Stuhldreher, A. and Tescher, J. (2005, February). *Breaking the Savings Barrier: How the Federal Government Can Build an Inclusive Financial System*. Center for Financial Services Innovation.

⁷ ChexSystems is the common name for a series of databases, operated by eFunds, that enables financial institutions to make decisions on new or current account holders based on past history of involuntary account closure, fraudulent activity, nonsufficient funds charges, and a variety of other factors. For more information, see www.efunds.com.

incentives (such as reduced fees or opening deposits) or that lower identification and ChexSystems requirements can also serve more filers. And programs where staff and volunteers actively market new accounts are likely to see a higher percentage of filers respond.

BOX 1

HOW DELAWARE'S EITC CAMPAIGN CONNECTS TAX FILERS WITH BANK ACCOUNTS⁸

At most tax preparation sites that offer access to accounts, bank representatives need to be at the tax site in order to process the new accounts. Recognizing the logistical challenges of doing this, the Delaware EITC Campaign, in partnership with PNC Bank, developed an alternative model:

- PNC Bank agreed to assign a dedicated 800 number, based in their Pittsburgh operations center, to the project. The tax campaign provides PNC with a schedule of when sites are open, and PNC ensures that operators are available during those hours.
- Tax filers are asked early in the intake process if they would like direct deposit of their refund, and the benefits of doing so are explained. If filers do not already have an account, they offered the opportunity to open one with PNC Bank.
- If the filer is interested, the tax site manager dials the 800 number (the number is closely kept to limit access to tax clients only). The tax filer is then put on the phone and interviewed by the bank operator. The interview includes basic information, such as name, address, employer and driver's license or state-issued photo ID number.
- No cash deposit is needed to open the account, and the account has no fees or minimum balance requirements for one year. PNC also does not run ChexSystems on these accounts.
- The tax filer is assigned an account number over the phone, which can be immediately entered on the tax return.
- PNC mails a package to the new account holder including the account agreement, which must be signed and returned. Once the paperwork is returned, the filer can access the account using any PNC branch.

The partnership has been in place for three years, during which time 400 accounts have been opened. While the number of accounts is not large (the campaign completed 8,000 tax returns in 2005), the vast majority of filers (85%) already have accounts and the partnership has helped the campaign assist those who do not (and has also contributed to the program's impressive 70-80% direct deposit rate).

⁸ Interview with and information provided by Mary Dupont, Executive Director, Nehemiah Gateway CDC and Coordinator, Delaware EITC Campaign. July 2005.

OPPORTUNITY #2: ALTERNATIVE REFUND ANTICIPATION LOANS

Refund Anticipation Loans (RALs) are short-term loans secured by tax filers' anticipated refunds. The loans can provide quicker cash to filers who either do not have a bank account or who want or need their money even faster than the 8-16 days it takes for direct deposit. Filers may also use RALs because they do not have the funds to pay for tax preparation up-front, or because they are concerned about the safety of receiving a large refund check in the mail. When making a RAL, the tax preparer essentially fronts the refund amount (minus tax preparation fees and fees and interest for the loan itself) to the filer; the loan is repaid when the refund is direct deposited into a temporary account created by the preparer.

RALs have been criticized by consumer advocates for their expense, as well as for deceptive practices surrounding marketing and disclosures.⁹ The total cost of a RAL is generally between \$180 and \$250, representing about 10% of the consumer's refund. RALs are big business: in 2003, consumers paid an estimated \$1 billion in RAL fees, plus an additional \$389 million in administrative fees related to RALs. Furthermore, low-income tax filers are most likely to take out RALs. Seventy-nine percent of RAL recipients in 2003 had incomes of \$35,000 or less, and more than half of RAL customers receive the EITC.

Some practitioners have developed alternative RAL products in an attempt to balance their concerns about the high cost of RALs with recognition of the market demand for quick refunds. The products are generally both more affordable than traditional RALs (with reduced or eliminated administrative fees and low interest rates) and include upfront, clear disclosure of terms and costs. Alternative RALs are often combined with aggressive consumer education to discourage tax filers from using the product. Filers are told about all their options, including direct deposit, and are encouraged to wait if they can afford to do so. Programs may also suggest that filers take out a RAL only for the portion of the refund they need right away, as a way to minimize the cost of the loan.

In addition, some programs have attempted to use alternative RALs as an entry-point to a longer-term financial relationship. For example (as described in Box 2), the loan could be linked to a permanent bank account and/or structured as a line of credit that can remain open after the tax refund is received. RAL customers can also be linked with other services, from credit repair to Individual Development Accounts.

⁹ Wu, C.C. and Fox, J.A. (2005). *Picking Taxpayers' Pockets, Draining Tax Relief Dollars: Refund Anticipation Loans Still Slicing Into Low-Income Americans' Hard-Earned Tax Refunds*. National Consumer Law Center and Consumer Federation of America.

BOX 2

HOW ONE CREDIT UNION DEVELOPED AND MARKETED AN ALTERNATIVE RAL¹⁰

Since 2003, Alternatives Federal Credit Union, located in Ithaca, New York, has offered a “Refund Express Loan” to filers at the credit union’s free tax preparation site. The loan was developed to draw taxpayers to the site and save them hundreds of dollars in fees. (The product was also used as a tool for encouraging tax filers —especially the unbanked— to open accounts at the credit union.) The loan uses an existing credit union product, the Line of Credit, so there were no new forms, paperwork or policies needed.

Once a tax return was completed, tax filers could apply for a Line of Credit secured by the refund amount. The refund would be direct deposited into the filer’s savings account at the credit union and then transferred to pay off the credit line. At this point, members had the option of applying for an unsecured Line of Credit to keep the credit line open. The cost of the Refund Express Loan was \$20, with an APR of 11.5% (tax preparation and e-filing were free at the site).

The Refund Express Loan was marketed to filers as a way to save money, repair or build a credit history, and receive assistance with financial planning and goal setting. In the first year, 20% of filers requested a Refund Express Loan, but that number fell to only 10% in the second year and 8% in the third – a decrease that staff attribute to increased consumer education. In 2004, the average interest was less than \$5, bringing the total cost to under \$25. One year later, 66% of new members retained their accounts, and many had moved forward with IDAs, car loans, youth savings accounts, share certificates and other products.

OPPORTUNITY #3: STORED VALUE CARDS

Stored value cards (SVCs) work like debit cards, using magnetic stripe technology to store information and track funds. They are often called “prepaid debit cards,” branded with a MasterCard or VISA logo, and can be used at ATM and POS machines. Unlike traditional debit cards, however, SVCs are prepaid, and therefore offer limited risk of overdraft while providing liquidity for consumers. According to industry estimates, nearly 20 million consumers used SVCs to make \$42 billion in transactions in 2003.¹¹

SVCs can be an attractive alternative to a traditional bank account – or additional resource – for underbanked consumers.¹² Depending on how they are structured and how they are used, SVCs can be either more or less expensive than a bank account or check casher. SVCs also

¹⁰ Audetat, A., Myers, B., Cocciarelli, S., and McGill, Y. (2004, November). *Building a Better Refund Anticipation Loan: Options for VITA Sites*. Annie E. Casey Foundation.

¹¹ Federal Reserve Bank of New York. (2004). *Stored Value Cards: An Alternative for the Unbanked*.

¹² For more information, see also: Jacob, K., Su, S., Rhine, S., and Tescher, J. (2005, April). *Stored Value Cards: Challenges and Opportunities for Reaching Emerging Markets*. Center for Financial Services Innovation; and Jacob, K. (2004, July). *Stored Value Cards: A Scan of Current Trends and Future Opportunities*. Center for Financial Services Innovation.

offer varying degrees of consumer protections. Currently, most SVCs do not help consumers build a credit profile or access additional financial services – though the industry is moving in that direction, and products with those features can begin to mimic bank accounts in terms of functionality for consumers.

When offered in conjunction with tax preparation, an SVC can deliver the speed of direct deposit without a bank account. SVCs are also promoted by some commercial tax preparers as a way to receive refunds without needing to cash a check. H&R Block has piloted the H&R Block Debit Plus Card, a partnership with Bank of America. Both Jackson Hewitt and TurboTax partner with UniRush Financial Services to offer the RushCard, a prepaid VISA debit card. Development of SVCs is still early, however, and many of these products are being refined and redesigned each year in an effort to make them more attractive and useful to consumers.

SVCs can also be designed as a first step toward improved financial stability. Programs can educate customers about the use of SVCs and promote bank accounts and IDAs in addition to or as an alternative to SVCs. (A restricted account with a debit card may offer a middle ground, providing more flexibility for consumers while limiting overdraft risk and also promoting bank accounts for the unbanked.) Providing statements or another record-keeping system can also help SVC users track and manage their money. Finally, programs can offer other (low-cost) uses for the card, such as sending foreign remittances, paying bills or purchasing money orders.

BOX 3

THE DESIGN AND DEVELOPMENT OF BANK ONE'S DIRECT CARD

(Bank One is now doing business as "Chase")¹³

In the 2004 filing season, Bank One piloted the Bank One Direct Card® with free tax preparation partners in Texas, Illinois, Michigan and Indiana. The card was designed to be an alternative to a checking or savings accounts for taxpayers who either did not want an account or did not qualify for a typical account. The card was a pre-paid VISA debit card that could be used to get cash at ATM machines, make purchases, and pay bills where VISA was accepted. Because no credit check or bank approval was needed, every taxpayer could qualify for the card – making it more easily and universally available than a regular Bank One account.

This product was priced to appeal to the target market demographic. Bank One did not charge customers an initial issuing fee or monthly service fee, and customers had free access to a customer service phone line. Customers could make two free ATM withdrawals per month (\$1.50 per transaction thereafter), and POS transactions were free. However, the card did carry an overdraft fee of \$15.

In order to further facilitate access to the card, it was designed so that nonprofit partners could issue the card online with a user ID and password. This avoided having to place Bank One personnel at every location offering the card. Using the on-line system, account and routing numbers would immediately be assigned that could be entered on the tax return. The tax refund would then be directly deposited into the customer's new Direct Card account. The cards themselves would be received in the mail by clients in 7–10 business days – just about the same time as their refund would be available.

The card was marketed to taxpayers as "a new way to receive your refund" that was safer and more convenient than cash. Out of a sampling of 100 cards issued, most still had balances as of the end of May 2004. Customers used the cards primarily to make purchases or for cash withdrawals; there were no accounts in which the entire refund was withdrawn. The Bank is currently in the process of redesigning the card to enhance its usefulness and flexibility for the 2006 filing season.

¹³ Bank One materials and information provided in August 2004 by Sophie Guerra, Vice President, Office of Community Partnerships, JPMorganChase/Bank One. JP Morgan Chase acquired Bank One in late 2003.

OPPORTUNITY #4: INDIVIDUAL DEVELOPMENT ACCOUNTS

An Individual Development Account (IDA) is a matched savings account designed to encourage and assist low- and moderate-income individuals and families in building assets. Every dollar invested in an IDA is matched – typically at one to three dollars – and the total savings can be used only for defined purposes, such as the purchase of a home, post-secondary education or small business development. IDA programs also include a significant financial education component, which is generally viewed as of equal importance to the matching funds.

Since they were first developed in the 1990s, IDAs have grown as an asset-development strategy among financial institutions, non-profit organizations and policy-makers. A 2003 survey found more than 500 IDA programs across the country, with 15,000 participants.¹⁴ IDAs are generally restricted to individuals with household incomes under \$35,000 a year.

Participants usually contribute to IDAs in regular monthly amounts. However, given their tight finances, it can be difficult – or at least take a very long time – for individuals to save enough to reach their goal. Linking IDAs to tax preparation offers the potential for jump-starting the savings process by using part of the refund to make a substantial contribution to an IDA. Leveraging tax refunds in this way can enable participants to more successfully achieve their asset development goals.

Programs linking IDAs and tax preparation have worked in two directions:

- Providing information on tax credits and free tax preparation services to IDA account holders in order to help them access tax refunds, and encouraging them to deposit those refunds into their IDAs.
- Marketing IDAs to tax preparation clients in an effort to recruit new account holders and using the tax refund as a marketing hook by offering the opportunity to double or triple the refund amount.

In general, programs have had more success with the former than the latter. For example, in San Antonio, during the 2005 filing season, 132 existing IDA members used the city's free tax preparation program, and 22 used their tax refund to make a deposit into their IDA. At the same time, only 33 new IDA accounts were opened from tax preparation customers.¹⁵ One challenge for recruiting tax filers for IDAs is that many low-income filers have essentially spent their refunds before even entering the tax preparation office, and simply do not have the financial flexibility to divert a substantial portion to any savings product – or may not be prepared to make that decision on the spot. Another is that IDAs are only appropriate for a portion of the income-eligible population, so take-up rates are often quite low.

¹⁴ CFED. *A Look at the Growing Individual Development Account Field: Results from the 2003 Survey of IDA Programs.*

¹⁵ Information provided by Dennis Campa, Director, City of San Antonio Department of Community Initiatives. July 2005.

BOX 4

THE CHALLENGE OF LINKING TAX PREPARATION AND IDAS: ONE PROGRAM'S EXPERIENCE¹⁶

The Louisville Asset Building Coalition (LABC) began marketing IDAs in conjunction with free tax preparation in the 2002 filing season. The LABC is a broad coalition, including many local partners who are interested in providing a range of services and opportunities to low-income Louisville residents. The LABC sponsors both an EITC campaign (including free tax preparation assistance at multiple sites) and an IDA program. For many LABC members, tax preparation is seen largely as a recruiting mechanism for IDAs, financial education and other asset-building strategies.

After the first two years of operation, however, results for tax preparation were much more encouraging than for IDAs. The ten LABC tax sites surpassed their goals for 2003, completing more than 1,350 returns and helping residents claim tax refunds of nearly \$2 million. However, only 19 tax customers applied for the 60 available IDA slots.

LABC members identified a number of potential reasons for the lack of interest in IDAs. Based on their own observations and anecdotal evidence, they speculated that:

- Tax clients were single-mindedly thinking about their returns when they came to the sites, and were not prepared to consider longer-term financial strategies.
- Tax clients had essentially already spent their refunds before completing their tax returns, and therefore had no additional funds to invest in an IDA.
- The financial behavior of low-income residents was strongly formed, making it an uphill battle to promote new ideas.
- Tax clients had more pressing short- and middle-term needs, from paying bills to car repair to paying down debt – all things for which an IDA cannot be used.

OPPORTUNITY #5: RETIREMENT SAVINGS

Americans at all income levels save little for retirement. But the problem is especially severe for lower-income Americans, who are less likely to be covered under employer-provided pensions or to contribute to Individual Retirement Accounts (IRAs). Less than 2.1 percent of households with incomes below \$40,000 contributed to an IRA in 2004.¹⁷ In an effort to address the low savings rate, policy makers have looked primarily to the tax system, subsidizing retirement savings through tax incentives for 401(k) plans and IRAs.

The Retirement Savings Contributions Credit, also called the Saver's Credit, was introduced in the 2003 filing season (Tax Year 2002) and is aimed specifically at lower-income filers. The

¹⁶ Watson, O. (2003, October). *Earn It Keep It Save It? Transforming Earned Income Tax Credits into Family Assets in Louisville*. Case Study developed for the Annie E. Casey Foundation.

¹⁷ Burman, L.E., Gale, W., Hall, M., and Orszag, P. (2004, September). "Distributional Effects of Defined Contribution Plans and Individual Retirement Arrangements." *National Tax Journal*. 57:3. September. 671-701.

Saver's Credit applies to the first \$2,000 contributed to a 401(k) or IRA (\$2,000 each for married filers). The credit offers the greatest advantages (50% of funds contributed) to the lowest income filers (for Tax Year 2004, ranging from single filers earning less than \$15,000 to those earning under \$30,000 filing Married Jointly). As income rises, the credit drops to 20% and then 10% of contributions, until it phases out at a maximum income of \$50,000 for married filers. Because the credit is non-refundable, however, those who can benefit most are least likely to be able to, because their low incomes mean that they likely have little or no tax liability, after standard deductions, personal exemptions and other credits are applied.

One answer is to increase tax incentives for low-income filers, and especially to make the tax credits refundable. Another is to better explain and market existing incentives to low-income filers, in an effort to increase take-up among those eligible. A third is to enhance existing incentives by increasing their value.

The latter approach was tested during the 2005 filing season at 60 H&R Block offices (see Box 5 for more details).¹⁸ In the test, H&R Block offered matching funds as an incentive for clients to invest in the IRAs. Results suggest that while the Saver's Credit alone did little to encourage retirement investment, matching funds can greatly increase both the number of people who open IRAs and the amount they contribute.

The evaluation also uncovered some lessons for similar efforts:

- Matching funds were the key to promoting savings. Tax clients offered the regular Express IRA product, even with the \$15 set-up fee waived, were unlikely to take advantage of it, despite the potential tax benefits.
- Simplicity is also important. The offer should be easy to understand and directly relevant to the transaction at hand, namely the tax preparation moment. This may be one reason why the match was so much more effective than Saver's Credit, since it is can be difficult to explain the credit or to calculate exactly what the economic benefit is at different income and contribution levels.
- Individual marketing of the incentives appears to have been critical to success. A limited number of tax professionals were responsible for opening almost all of the new accounts. These tax preparers were somehow much more successful at recommending the IRAs to tax clients.

¹⁸ In addition to the IRA pilot, H&R Block also partnered in a variety of ways with local tax preparation programs in 2005. For more information on those partnerships, see Jacob, K. (2005, July). *Utilizing Partnerships to Test Emerging Market Strategies: A Case Study of H&R Block Initiatives in Five Cities*. Center for Financial Services Innovation.

BOX 5

PROMOTING IRA INVESTMENT THROUGH MATCHED SAVINGS: A PILOT AT H&R BLOCK¹⁹

Since 2001, H&R Block has offered an Express IRA product, which allows tax filers to make an IRA contribution at the time of tax preparation and – especially important to lower-income customers – to fund all or part of the contribution from their expected tax refund. In the 2005 tax season, H&R Block tested the effectiveness of offering matching funds as an incentive to open Express IRAs.

All tax clients at 60 Block offices in the St. Louis metropolitan area were randomly offered one of three opportunities: the regular Express IRA product, an Express IRA with a 20% match, or an Express IRA with a 50% match. The regular \$15 IRA set-up fee was waived for all filers. In the end, the match rate had a significant effect on contributions. Only 3% of clients took up the offer in the no-match group, compared with 10% in the 20% group and 17% in the 50% group. Furthermore, clients offered higher matches also saved more. The average contribution by those who took up the offer (not including the match) was \$860, \$1,280 and \$1,310 for each group, respectively.

The effect of the match rate was less pronounced for EITC recipients (17% of the overall sample). In other words, increasing the match was more likely to encourage higher income filers to contribute more to the accounts. However, the larger matches still significantly increased investment by lower-income filers. The effects were largest for married filers: 25% of low- and middle-income married filers contributed when offered the 50% match – similar to take-up rates for higher-income married filers.

OPPORTUNITIES FOR THE FUTURE: REFUND SPLITTING

An emerging opportunity may soon create an environment that supports significant growth of efforts to link financial services and income tax preparation. The IRS has announced that beginning in the January 2007 filing season (Tax Year 2006), taxpayers will be able to split their refunds – that is, they will be able to direct refund dollars to more than one place. For low-income filers, who want or need to get cash back for immediate use, refund splitting will allow them to set aside at least part of their refund for longer-term savings or other uses. For example:

- A filer could get most of her refund as a check mailed to her home, but put a portion into a new bank account as a first step towards the financial mainstream.²⁰

¹⁹ Duflo, E., Gale, W., Liebman, J., Orszag, P., and Saez, E. (2005) *Savings Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block*. The Retirement Security Project. No. 2005-5.

²⁰ At the time of this writing, it is unclear whether Treasury will allow split refunds to be sent via check in addition to direct deposit.

- A filer could direct deposit half of his refund into his existing bank account but earmark the other half towards an IDA.
- A filer could put part of her refund onto a stored value card, while investing the remainder in a retirement or 529 college savings account.

While refund splitting presents an opportunity for connecting tax filers to financial services, it is also important to consider how unbanked filers would be able to open accounts at tax time. One option could be that, with a check of a box, tax filers could open a checking, savings, or IRA account directly on their tax forms. The IRS could help in facilitating this process by soliciting proposals for private financial institutions to provide low-cost quality products nationwide. Another possibility would be for the IRS to create and maintain a web-based directory of financial institutions that offer low- or no-cost products online for tax filers. Indeed, research suggests that allowing filers to sign up for financial services directly on the tax form would help to push the adoption of certain products, such as savings bonds, especially for lower-income consumers.²¹ Today, a few companies, such as Vanguard and H&R Block, allow customers to send their tax refunds to them electronically to be deposited into an IRA, but the practice is not widespread.

Despite challenges related to reaching the unbanked, refund splitting offers great promise. The opportunity presented by refund splitting has been tested in recent years under a pilot initiative developed by the Doorways to Dreams (D2D) Fund (see Box 6 for details). The premise of the test revolved around the notion that it is easier to pre-commit to saving – that is, to decide to direct money to savings before it is received and the temptation to spend it competes with savings goals. Refund splitting was therefore used in the pilot as a way to encourage low-income tax filers to decide at the time of tax preparation to set aside a portion of their refund into a savings account; the remainder of the refund would be received as a check to be used for other purposes. The test's designers hoped to learn whether filers would respond to this idea and whether making an early decision would in fact facilitate saving among low-income filers.

Early results from the test have been promising: in the first year of the pilot (the 2004 filing season) in Tulsa, Oklahoma, 27% of the 500 people offered the option responded to the offer, and those who participated earmarked nearly half of their refunds for savings. Follow-up data suggest that participants were more likely than other tax filers to have retained some savings four months after receiving their refunds.

²¹ For a more complete description of this concept, see Tufano, P. and Schneider, D. (2005). *Reinventing Savings Bonds: Working Paper*. Boston, MA: Harvard Business School. See authors for copies.

BOX 6

THE D2D PILOT: TESTING THE MARKET FOR AND EFFECTS OF REFUND SPLITTING²²

For the past two years, the Doorways to Dreams (D2D) Fund, based in Boston, has partnered with financial institutions and local tax campaigns to test refund splitting. The test involved marketing refund splitting to tax preparation clients, offering new bank accounts to clients who did not currently have one, and then working with each client to determine how much of their refund would be received as a check and how much would be deposited into the bank account. (Because the IRS does not yet allow refund splitting, the project developed its own mechanism for splitting the refund after it was received into a designated account.)

In the 2004 tax season, 516 filers at free tax preparation sites operated by the Community Action Project of Tulsa County (CAPTC) were given the opportunity to open an account at Bank of Oklahoma and to split their tax refunds (at an individually determined amount) between the new account and a check. Approximately 27% of filers accepted the offer, though only 15% were able to participate. The primary reason for inability to participate was not meeting identification and ChexSystems criteria to open the bank account.

Of those who did participate, 56% opened a new account and split their refunds, 27% used an existing account to split their refunds, and 17% deposited their entire tax refund into a new account. Participants chose to save approximately 47% of their refunds – an average of \$606 and a significant increase (90% or more) over their existing savings. Four months later, 66% of participants were still saving a portion of their refunds, compared with 36% of a comparison group.

The D2D test also provides lessons for future refund splitting efforts:

- The simpler the design of the option, the better, for explaining and marketing it to potential customers.
- On-site account opening seems important to scale; only 27% of people who accessed refund splitting used an existing account. Furthermore, making accounts more accessible (for example by waiving the ChexSystems requirement) could have substantially increased take-up of the offer.
- Participants who opened new accounts often seemed more interested in the account opening than the refund splitting – though they were interested in both. This suggests that the pilot's results may overstate interest in splitting, but also points to the power of co-marketing the two ideas. Follow-up focus groups uncovered the fact that the savings mechanism was very convenient; this was not specific to refund splitting per se.
- Another major challenge – as with other efforts described in this paper – is that many low-income taxpayers have already spent their anticipated refunds before they complete

²² Beverly, S., Schneider, D., and Tufano, P. (2005, April) *Splitting Tax Refunds and Building Savings: An Empirical Test*. Draft Working Paper.

their tax return. Using refund splitting to promote savings may require either earlier marketing or working with clients over multiple years so they can plan further ahead.

- There is a potential market for refund splitting to other financial products besides savings accounts. In follow-up research, survey respondents expressed interest in retirement accounts, college savings products, Certificates of Deposit, Savings Bonds and mutual funds – as well as directing refund dollars to pay down debt on car loans, credit cards and mortgages.

CONCLUSION

A wide range of financial products and services can help individuals and families manage their money, increase their financial stability and build savings. For millions of underbanked Americans, however, these services are either not available or are available only at high cost. Linking these individuals with consumer-friendly services has posed a challenge for banks, credit unions and other institutions that have tried to bridge the gap. Perhaps the biggest challenge has been one of outreach and engagement – how to access the target population at a time and place where they are best prepared to listen to the marketing message and take advantage of the services offered.

The tax preparation moment offers one promising answer. Bank accounts, alternative refund loans and stored value cards can all help tax filers access refunds more quickly and conveniently, and can be an entry point for long-term financial services. At the same time, large tax refunds can open the door to opportunities for saving and investment, including retirement accounts, IDAs and other asset-building strategies. Finally, the upcoming availability of refund splitting offers the potential for significant growth in the number and scale of efforts to link tax preparation with asset development.

Yet linking these pieces is not simple. Despite the access to a target population and the power of the tax moment, programs have still struggled to engage participants at any real scale. The experiences of programs that have pioneered these efforts reveal significant challenges, including marketing services to customers who come focused only on getting their taxes done, and developing products that can effectively compete with the convenience and ease of check cashers. Programs that have had the greatest success tend to be those that have built strong relationships among the partners involved, have engaged in aggressive marketing and outreach, and have reduced barriers or offered special incentives (for example, by waiving fees and requirements or providing matching funds).

Finally, while all the ideas described in this paper can help meet the needs of underbanked consumers, the most useful will be those that offer a combination of convenience, functionality, affordable pricing, consumer protections and opportunities for future asset development. Those same features are critical components for achieving the ultimate goal of promoting the long-term financial success of un- and underbanked Americans.

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