NEW AMERICA FOUNDATION

ASSET BUILDING PROGRAM

SPLITTING REFUNDS: A PROPOSAL TO LEVERAGE THE TAX FILING PROCESS TO PROMOTE SAVINGS AND ASSET BUILDING

By Reid Cramer

According to leading economic indicators, American households are not saving enough. Over the last ten years, the percentage of after-tax, disposable income not spent has declined precipitously. Dropping from its historic range of between 7 and 11 percent, the personal saving rate dipped below 1% for the first quarter of 2005. This amounts to just over $80 billion a year in savings—a relatively small contribution to national savings. Whether the objective is to promote retirement security, improve educational attainment, provide a financial cushion for life transitions, or increase national savings, the need to increase household savings is clear.

Even as there are many plausible explanations for the declining personal savings rate, it remains true that the extent of savings at the household level is a function of both individual and institutional characteristics. Families will save more if the savings process is made easy and accessible. Public policy can and should contribute to this effort by offering mechanisms that support savings in the one activity that almost every household undertakes—the process of paying taxes.

The Proposal

To encourage savings, federal income tax forms should be amended to allow households to split their tax refunds among multiple accounts.

Given the size and scope of tax refunds issued by the federal government each year, the tax filing process is a logical place to support and encourage savings behavior. In fact, the forms that IRS prepares for taxpayers are a nexus where individual behavior and institutional structures coincides. Allowing taxpayers to split their tax refunds directly on their tax returns will encourage increased household savings by making it easier for taxpayers to divide their refund between "money to save" and "money to spend." A simple one-step approach, with the advantages of direct deposit, is a proven, safe, and fast way to save.

The split refund proposal will facilitate financial planning and simplify money management at the same time as it promotes savings and maximizes taxpayer choice. For example, an individual anticipating a refund of $2,000 could direct half of it to a checking account to meet immediate expenses and the other half to an individual retirement account, such as a Roth IRA. Permitting deposits in up to three accounts would enable a married couple filing jointly to contribute to a savings account for each spouse and have some left over for a shared account. Similarly, a household could direct a portion of their refund to pay down debts that erode their ability to save in the future or contribute to other tax-preferred savings accounts, such as Section 529 Savings Plans.

The Promise

A simple change to the tax forms to allow for the splitting of tax refunds is a promising, low-cost proposal that offers the potential to support a significant amount of savings. This is because many families view their tax refunds as a primary asset. The average taxpayer's refund is approximately $2,100 per year, or almost 5% of national median income. As all tax filers would have access to this savings mechanism, allowing for the splitting of refunds has the potential to promote billions of dollars in new saving among tax payers at all income levels.

This opportunity is particularly relevant for the millions of lower-income households that receive refunds the Earned Income Tax Credit (EITC), a credit designed to reward the work initiative of lower income Americans. For many of the families that qualify for the EITC, tax refunds are often their only realistic opportunity to save during the year. A recent pilot project tested the split refund concept in order to examine how this type of facilitation might affect savings behavior of lower-income households. The results were encouraging. The Community Action Project of Tulsa County offered the users of their free tax preparation services the option to split their refunds between a savings accounts and a refund check. Of the 488 people who were offered the opportunity, about one-third wanted to participate. On average, people deposited $649—47 percent of their refunds—into savings accounts. Significantly, seventy-six percent of these individuals had no prior savings.

Nationally, over 22 million working-poor Americans claim the Earned Income Tax Credit, and receive over $34 billion in benefits. With refunds attributable to the EITC averaging about $1,700—with some as high as $4,000—the opportunity to split their refunds would allow people to convert some of these assets into first-time savings. Moderate- and middle-income taxpayers would also benefit. Many of these households qualify for the Child Tax Credit (CTC), another refundable credit, accounts for refunds that total over $13 billion. Assuming a similar take-up rate to the one in the Tulsa demonstration, the ability to split refunds could generate up to $7 billion in new savings amongst EITC and CTC filers nationwide.

All told, over seventy-six percent of all tax filers received a refund during the 2005 tax filing season according to the IRS. The average refund was over $2,100, and over $205 billion was distributed in tax refunds. If just 10% of these tax refunds were saved, this would increase the current personal saving rate by 25%.

Nothing currently prevents someone from cashing a tax refund and then depositing of portion of it in a particular savings account. But it is much more likely to happen if it is done directly on a tax return. It is fair to assume that families will be more willing to save if they are educated about the benefits, and if the process of saving is easy. The split refund proposal simplifies the savings process and provides tax preparers with a natural opportunity to educate their clients about the tax and non-tax benefits of saving. After learning about their options, a taxpayer can immediate make a decision about how they want to receive their tax refund and where they want it to go. Tax filers without bank accounts may also use their refunds to open accounts and begin the savings process by accessing mainstream financial services.

<u>How it Could Work</u>

Currently, tax refunds are issued as a lump sum – delivered through a paper check in the mail or direct deposit to a designated account. Implementing the split refund proposal would only require that the number of direct deposit accounts available is increased from one to three or more. Transferring payments via routing numbers is a core competency of government. The Financial Management Service, the Division of Treasury that performs this function, has a strong track record of delivering accurate electronic payments on-time and without error.

The split refund proposal can be implemented under current law, does not require additional legislation, and can be made at little cost to the federal government. The Bush Administration has committed to making this change, but Internal Revenue Service (IRS) has yet to set a date when taxpayers will be given access to this savings opportunity.

<u>The Split Refund Campaign</u>

The Asset Building Program of the New America Foundation supports the expeditious implementation of the split refund proposal and for the past two years has helped direct a campaign to bring about this promising change to the tax filing process. This campaign has proceeded along several fronts.

The first objective was to raise the general awareness of the proposal's potential by publishing news articles and convening public events. The second goal was to build a coalition of stakeholders. Along with the Retirement Security Project, Doorways to Dreams, the National Community Tax Coalition, and former IRS Commissioner Fred Goldberg, now with Skadden Arps, The New America Foundation organized a series of national sign-on letters. These were delivered to the IRS and the Bush Administration as a way to highlight the savings opportunities created by the split refund option.

Letters from elected officials were also facilitated, including one from a bipartisan group of House members participating in the newly formed Congressional Savings and Ownership Caucus. Many members of the caucus have taken a keen interest in the proposal, finding common ground in this low-cost, common sense approach to promoting savings.

Having secured a commitment by the Bush administration to implement the proposal, the challenge now is to ensure that it is implemented effectively and in a timely manner. The New America Foundation remains committed to the ongoing convening of the table of experts capable of dealing with the technical issues which must be addressed to ensure the successful introduction of this proposal. Meetings with officials from the Treasury Department have lead to a series of recommendations for IRS to guide their implementation of the split refund proposal.

Next Steps

The IRS should take immediate steps to ensure that all appropriate tax forms and their programming, processing, and testing system are revised to support the splitting of tax refunds. To accomplish this, several policy and technical issues must be addressed and resolved in the near future to permit changes to tax forms for use during the 2007 tax filing season.

First, taxpayers should be able to split their refunds into at least three accounts. This would permit married couples filing jointly to divide their refunds between a tax-preferred savings vehicle for each spouse and a shared account.

Second, deposit rules need to be established to determine adjustments in cases of math errors, tax offsets, or non-tax offsets, such as delinquent child support, that may cause a refund to be smaller than claimed. In this event, the portion designated for each account should be reduced in a pro rata fashion in order to simplify administration.

Third, Treasury and the IRS will need to consider how to handle incorrect routing and account numbers. In line with current policy, if the account information provided by the taxpayer is incorrect, the IRS should issue a check to the taxpayer for the refund amount.

Finally, the tax treatment of deposits to tax-favored accounts will be required. Specifically, IRS must clarify how depositing refunds to a tax-preferred savings vehicle will affect a taxpayer's tax liability for the prior and current year. Presently, contributions made through April 15 to IRAs can be treated as if made in the prior year for purposes of deductibility, contribution limits, and the Saver's Credit. Replicating this treatment for split refund contributions would promote savings because tax benefits would not be contingent on future income. Rather a taxpayer would know whether they are eligible for tax credits and deductions associated with a refund contribution when they make the contribution. This will likely encourage the marketing of tax-preferred savings vehicles by financial institutions and tax preparation services as it will enable them to tell their clients exactly how much their refund will increase if they contribute to an IRA before the April 15th deadline.

A Savings Campaign

Saving is a virtuous activity, one that is beneficial when done both individually and collectively, and at this point in time it should be a national policy objective. At the household level, it helps families increase their security. At the national level, it creates pools of capital available for investment that promotes productivity and keeps interest rates low. A campaign to increase personal savings is an inherent component of improving national savings.

The issues described above are essentially policy matters. Establishing a set of rules and regulations to govern the contingencies of depositing tax refunds into multiple accounts can build on current practice. The federal government has increasingly moved toward electronic payments, but the policy goals should be expanded to more aggressively promote savings. The split refund proposal is intended to remake the tax filing process in just such a manner—so that the habit of savings is encouraged, facilitated, and made easy. Implementing the split refund proposal will establish the infrastructure to carry out future policy efforts. It is a necessary first step in the waging of a national savings campaign.

More Information

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