Splitting State Income Tax Refunds Would Help Families Build Assets

- *Allowing Coloradans to split their state income tax refunds among several accounts would enable families to save while meeting immediate needs.*
- *Coloradans could directly deposit part of their refunds in a 529 college savings account, helping increase the opportunities for students from low- to moderate-income families to attend and graduate from college.*

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Executive Summary

Allowing Coloradans to split their state income tax refunds and directly deposit a portion into several accounts would encourage savings overall and help low- to moderate-income families build wealth.

For most low- to moderate-income families, their annual tax refund is the single largest payment they will receive all year. Currently, families can directly deposit their tax refund into *just one* of three accounts, either a checking, savings or 529 college savings account, or receive their refund as a check. **Changing policy to allow families to split and directly deposit the refund among the three types of accounts — checking, savings and 529 college savings accounts — would make saving for college easier, encourage overall savings and help families meet immediate needs.**

In 2014, 1.6 million Coloradans received a state tax refund averaging $489, and that amount will be larger for hard-working families this year thanks to Colorado's Earned Income Tax Credit (EITC) becoming permanent.[1] Although tax refunds can help families build wealth, many low- to moderate-income families cannot afford to save the entirety of their refund because they have immediate expenses. Families can choose to save a portion of their refund after they receive it, but behavioral economics suggest that an automatic, pre-commitment to save will result in greater savings.[2]

Taxpayers can already split federal tax refunds after a 2003-2005 pilot test showed allowing families to automatically split their federal income tax refunds into multiple accounts encouraged saving among low-and moderate-income families who otherwise would not have saved their refund.[3] In 2010, almost 400,000 taxpayers split their federal tax refund, for a total of $1.7 billion saved.

With the state EITC giving a sizeable boost to low- to moderate-income families' tax refunds, now is the time to allow Colorado taxpayers to split their state income tax refund. Combined with outreach to Colorado taxpayers, the option of splitting a state income tax refund can open the door to greater savings, an important step in helping families get ahead and stay ahead economically.

Tax Refunds are a Viable Way to Build and Increase Savings

The accumulation of savings, particularly for children's education, is one of the core components of a two-generation poverty reduction policy, or a policy that helps parents and their children. According to a Pew Charitable Trusts report, 71 percent of children born to high-saving, low-income parents move up from the bottom-income quartile over a generation, compared to only 50 percent of children of low-saving, low-income parents.[4] Additionally, in terms of saving for higher education, research shows that even small amounts of savings can go a long way. **Children with $500 or less saved for college are three times more likely to enroll and four times more likely to graduate than children with no savings.**[5]

Saving can be a difficult task, particularly for low- to middle-income families. A recent report by the Federal Reserve showed that nearly half of all American families have so few savings that they would struggle to pay for a $400 emergency.[6] However, emergency savings are crucial for families, and research shows that having even modest savings can protect low-income Americans from serious hardship in the event of an economic emergency.[7]

Tax refunds are an optimal savings vehicle because of the large dollar amount. In 2010, 76 million people who earned less than $50,000 received an average federal income tax refund of more than $2,300. For this group of taxpayers, the tax refund is likely the largest amount of money they will receive all year.[8]

Tax refund money is often thought of differently than more regular forms of income. The Center for American Progress writes:

> Behaviorally, 'mental accounting' suggests that larger, less common payments like bonuses and tax refunds are treated differently from regular, small amounts like paychecks…In one study of EITC recipients in two cities, 84 percent used part of the tax refund to pay off debt to cover bills. Sixty-one percent used a portion of their refunds on child-related expenses, and one-third used at least part of their refund to purchase or repair a car. But nearly half — 47 percent — also put aside part of their refund for goals such as a security deposit on an apartment, a down payment on a home, or to cover emergencies. The tax refund moment is an opportunity to put aside hundreds of dollars that may have been more difficult to save during the year.[9]

Research indicates that when employees have the option to automatically deposit part of their paychecks into a retirement account, savings are greater than without automatic deductions. In similar fashion, directly depositing part of a tax refund into a savings account provides an institutional mechanism to save. The intention to save is further reinforced if the savings portion is directed to a savings-oriented financial product, such as a 529 college savings account or an Individual Retirement Account (IRA) where penalties exist for early withdrawals.[10]

Federal Taxpayers Can Split Refund into up to Three Accounts

The 2003-2005 split refund pilot program was tested throughout the nation by the Doorways to Dreams Fund, an organization that looks to improve the savings experience among lower-income consumers. The concept of split refunds was tested at Volunteer Income Tax Assistance (VITA) sites, which services low-income and EITC-eligible participants. The test found that there was, in fact, a demand among low-income families for a refund-splitting program that supports emergency needs as well as asset-building, especially if a basic savings product is available to all at the time of tax filing. **In the pilot test, 20 percent of all refund recipients saved part of their refunds, and about 75 percent of those who used the split refund option reported that they had no prior savings.** The proposal for allowing federal split income tax refunds was accepted by the Bush administration and implemented in 2007. [11]

Since then, families have been able to save more. Taxpayers can choose to have their refunds directly deposited into a checking account for immediate spending, as well as up to two other accounts such as an IRA or 529 college savings account. They can also use a portion of their refund to purchase U.S. savings bonds. **In 2010, the IRS estimated that 385,882 refund recipients split their refunds, saving a total of $1.7 billion.**[12]

Six States Allow Taxpayers to Split State Income Tax Refunds

Several states have replicated the federal option and adopted legislation to allow taxpayers to split their refunds among several accounts. To date, California, Hawaii, Maryland and Ohio allow split refunds into multiple accounts on state income tax returns. Arkansas and Oregon allow taxpayers to deposit a portion of their refund into multiple existing 529 college savings accounts, with the remainder of their refund going into one other account.

State	Year Passed	Number of Accounts Refunds can be Split Into	Types of Accounts Refunds can be Split Into
Arkansas	2009	2	529 college savings account
California	2006	2	Checking, savings, IRA, money market and 529 college savings account
Hawaii	2008	3	Checking, savings, IRA and 529 college savings account
Maryland	2009	3	Checking, savings, IRA and 529 college savings account
Ohio	2011	3	Checking, savings, IRA and 529 college savings account
Oregon	2012	4	529 college savings account

State EITC Furthers Case for Allowing Split Refunds in Colorado

In Colorado, the benefits of allowing split refunds are evident. In addition to their typical state refunds, nearly 350,000 Coloradans will see an increased refund from the state EITC projected to average $234. For families with incomes near the poverty level, their state EITC could total $400-$500. These tax credits will provide a substantial boost in state income tax refunds, making it feasible for more Coloradans to save part of their refunds for college or to build emergency funds.

House Bill 16-1371 would allow Coloradans the option of splitting their refund into up to three types of accounts, checking, savings and 529 CollegeInvest accounts, and also receive a portion as a check. Within those types of accounts, taxpayers would be able to directly deposit part of their refund into up to four individual accounts. For example, a taxpayer could directly deposit part of their refund into two 529 CollegeInvest accounts and a savings account. The taxpayer could also receive a portion of their refund as a check.

In 2013, Senate Bill 13-206 was adopted, allowing Coloradans to *directly deposit their entire refund* into an existing 529 CollegeInvest account. CollegeInvest allows Coloradans to open a 529 college savings account for free and use their state income tax refund as an initial deposit. **The option to directly deposit just a portion of an income tax refund into a 529 college**

savings account would encourage more families to start college savings accounts, which in turn would help more children enter and graduate from college.

The experience of other states with a split state refund suggests that more outreach is needed to ensure that families take advantage of this option. One avenue of improving outreach is through the Colorado Department of Human Services' (CDHS) Children's Savings Account Pilot Program. CDHS is proposing an Aspire to College Colorado Pilot Program (House Bill 16-1196) to give nearly 6,000 low-income, preschool-age children access to a college savings product. Children will be given a $50 initial deposit with $100 per year in savings matches. The program provides financial education for children and parents, which presents an opportunity for outreach on the split refund option. Parents can be further encouraged to direct a portion of their state income tax refund into a college savings plan and have some of their savings matched by the CDHS program. In addition, the ongoing EITC outreach campaigns throughout Colorado and the VITA sites can help market the benefits of the split refund option.

Conclusion

Tax season represents a prime opportunity to build and encourage savings, and policies should work to help families take advantage of this opportunity. Allowing Coloradans to split and directly deposit their state income tax refunds among several savings vehicles simplifies the savings process. This policy change would help expand overall savings in the state, as well as have a huge impact on the ability of low- and moderate-income families to save for college.

When the IRS began to allow split refunds in 2007, the Doorways to Dreams Fund wrote:

> This simple procedural change opens the door for millions of taxpayers to set aside a portion of their refund for saving each year. For many tax filers, this could evolve in to an annual ritual, which could have far-reaching consequences for both their family's well-being and the nation's savings rate.[13]

Offering split income tax refunds in Colorado presents a broad opportunity for hard-working Coloradans to build assets. Split refunds are a tool that, when coupled with outreach efforts, can encourage thousands of Coloradans to save, helping them to get ahead and stay ahead economically.

Endnotes

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