

All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low-Income Americans

NCLC/CFA 2004 Refund Anticipation Loan Report

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Executive Summary

- Refund anticipation loans (RALs) are usurious short-term loans secured by the taxpayer's expected tax refund. Over half of RAL consumers are recipients of the Earned Income Tax Credit (EITC), despite the fact that EITC recipients only constitute 15% of all taxpayers. This is the annual update from the National Consumer Law Center and Consumer Federation of America on RALs.
- Consumers paid an estimated \$1.14 billion in RAL fees and an additional \$406 million in "administrative" or electronic filing fees in 2002 to get quick cash for their refunds. RAL volume increased moderately from 2001 to 2002, with approximately 12.7 million RALs taken out during the 2002 tax-filing season, compared to 12.1 million in 2001.
- RALs siphoned off an estimated \$749 million in loan fees and administrative/electronic filing fees from low-wage workers who receive the EITC. If tax preparation fees are included, the total estimate rises to \$1.59 billion paid by EITC recipients. Check cashing fees for 45% of these EITC recipients add another \$161 million, for a total estimate of \$1.75 billion spent by the working poor to get less than two weeks quicker access to this

Consumer Federation of America is a non-profit association of about 300 groups, with a combined membership of over 50 million people. CFA was founded in 1968 to advance consumers' interest through advocacy and education.

The National Consumer Law Center is a non-profit organization specializing in consumer issues on behalf of low-income people. NCLC works with thousands of legal services, government and private attorneys, as well as community groups and organizations, who represent low-income and elderly individuals on consumer issues.

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government benefit distributed through the tax system.

- The effective annualized interest rate for RALs based on a 10 day loan period ranges from about 70% (for a loan of \$5,000) to over 700% (for a loan of \$200), or 94% to 1837% if administrative or “e-filing” fees are included. Tax preparation chains and RAL lenders have been reporting lower Annual Percentage Rates (APRs) by “unbundling” charges from the loan fees. These APRs give a less accurate picture of the true “cost of credit” for RALs.
- An increasing number of state legislatures and federal and state regulators are addressing the issue of RALs. Legislation has been enacted in Illinois, Minnesota, and New York City during the past few years. Regulators in Massachusetts, California, Illinois, and Oklahoma have issued warnings regarding RALs. The Office of Comptroller of Currency deemed RALs made by a national bank to be loans requiring 100% risk weight capitalization
- A small sampling of RAL consumers indicates that many consumers continue to be unaware that RALs are loans. In a survey of 22 consumers who took out RALs in Arizona and Virginia, 18 of them (over 80%) did not realize that they had gotten a loan. This lack of awareness persists despite consumer advocacy and improved disclosures by tax preparers that RALs are loans.
- The Internal Revenue Service (IRS) continues to tacitly promote RALs by providing the Debt Indicator, which screens loan applicants for tax refund offsets. The IRS also continues to permit commercial tax preparers to market RALs and other paid products through the IRS Free File program.
- The number of partnerships between tax preparers and high-cost fringe financial service providers has increased. In addition to check cashers, commercial preparation chains now partner with rent-to-own companies and purveyors of costly stored value cards.

I. Introduction

Refund anticipation loans (RALs) are high cost loans secured by and repaid directly from the proceeds of a consumer's tax refund from the Internal Revenue Service (IRS). Because RALs only last about 10 days, fees for these loans translate into triple digit annualized interest rates. RALs drain billions from the pockets of consumers and the U.S. Treasury. They are targeted at the working poor who receive the Earned Income Tax Credit (EITC), a refundable credit provided through the tax system and intended to boost low-wage workers out of poverty. The EITC is the largest federal anti-poverty program, with over \$36 billion provided to over 20 million families last year.¹

This report updates the NCLC/CFA annual reports on the refund anticipation loan (RAL) industry and the drain caused by RALs from EITC benefits. Readers who are interested in background information on the RAL industry and regulation are advised to refer to the first NCLC/CFA RAL Report published in January 2002.²

There has been a bit of progress in the effort to regulate RALs and inform consumers of their true nature and costs. Two states and one city have recently enacted legislation requiring better RAL disclosure. One major tax preparation chain has announced improved written disclosures for RALs. The IRS has required additional disclosures in its Free File program.

However, the effect of even these changes, which are all limited to better written disclosures, remains to be seen. The volume of RALs in 2002, which is the most recent year that IRS has data on, did rise but not dramatically. Data from subsequent years when consumer advocacy focused at a greater level will be more instructive. A limited sampling of RAL consumers from two locales indicates that many consumers remain unaware of the basic fact that RALs are loans. In the meantime, RALs continue to drain over a billion dollars from the pockets of American taxpayers, including EITC recipients.

III. Continued Growth in RAL Volume

The most currently available IRS data indicates a moderate but continued growth in RAL volume. During the 2002 filing season, consumers took out approximately 12.7 million RALs.³ This constituted just under 10% of all individual tax returns filed in the U.S.⁴

¹ National Taxpayer Advocate, *FY 2003 Annual Report to Congress*, December 31, 2003, at 27 [hereinafter "National Taxpayer Advocate 2003 Report"].

² Chi Chi Wu, Jean Ann Fox, and Elizabeth Renuart, "Tax Preparers Peddle High Priced Tax Refund Loans: Millions Skimmed from the Working Poor and the U. S. Treasury," National Consumer Law Center and Consumer Federation of America, January 31, 2002, [hereinafter "NCLC/CFA 2002 RAL Report"], available at www.consumerlaw.org/initiatives/refund_anticipation

³ The 12.7 million figure was calculated as follows: 1) IRS statistics state that there were 14.1 million tax returns which were associated with a RAL. Data from IRS SPEC, Tax Year 2001 Return Information (Returns Filed in 2002), October 2003; 2) We assume that since IRS would not know whether a RAL was approved or denied, these statistics represent number of RALs applied for. About 90% of RAL applications result in an approved loan. George Guttman, *IRS Reinstates Debt Indicator to Increase Electronic Filings*, 85 Tax Notes 1125, Nov. 29, 1999. Thus, 90% of 14.1 million is 12.7 million.

In our last RAL report, we estimated based on IRS data that approximately 12.1 million RALs were taken out in 2001, so there was an increase of 5% from 2001 to 2002.⁵ This compares with an estimate of 10.8 million RALs for 2000, and an increase of 12% from 2000 to 2001.⁶

In 2002, taxpayers received an average refund of \$2,043.⁷ Based on prices stated by the leading RAL lender, the average taxpayer paid about \$90 in RAL fees.⁸ Thus, taxpayers paid somewhere in the neighborhood of \$1.14 billion in RAL fees in 2002. This compares to an estimated \$907 million in RAL loan fees in 2001,⁹ and an estimated \$810 million in 2000.¹⁰

This \$1.14 billion would be even higher if we could include the additional fees paid for an additional loan product called the “Instant Money” (H&R Block) or “Money Now” (Jackson Hewitt) loan. These products are same day loans, by which consumers can receive all or part of their RALs immediately when they file their taxes. Lenders charge an additional \$15 to \$30 for same-day RALs, a fee which the consumer pays on top of regular RAL fees.¹¹ We do not have data on the number of same-day RALs taken out by consumers.

In addition to the RAL loan fee, major tax preparation firms charge additional fees for RALs, often termed “system administration,” “document preparation” or “electronic filing” fees. The NCLC/CFA 2003 RAL Report included two such fees in the calculation of the total amounts paid for RALs.¹² However, we were informed by officials at the largest tax preparation chain, H&R Block, that the company will only charge one such fee. It is not clear if the practices of other major tax preparation firms are similar.¹³ On the basis of Block’s representations and given that it is the largest chain, we have included only one additional fee this year. According

⁴ There were 130.9 million tax returns filed in 2002. IRS, *Tax Stats at a Glance*, available at www.irs.gov/taxstats/article/0,,id=102886,00.html. Since 14.1 million taxpayers applied for RALs, *see* note 3 *supra*, this means more than 1 in 10 taxpayers applied for a RAL in 2002.

⁵ Chi Chi Wu and Jean Ann Fox, *The High Cost of Quick Tax Money: Tax Preparation, ‘Instant Refund’ Loans, and Check Cashing Fees Target the Working Poor*, National Consumer Law Center and Consumer Federation of America, January 2003, at 3 [hereinafter referred to as “NCLC/CFA 2003 RAL Report.”].

⁶ NCLC/CFA 2002 RAL Report at 6-7.

⁷ The IRS paid out \$202.3 billion in refunds in 2002. IRS, *Tax Stats at a Glance*, available at www.irs.gov/taxstats/article/0,,id=102886,00.html. Approximately 99 million taxpayers received these refunds. *Id.* \$202.3 billion divided by 99 million is \$2,043.

⁸ This was the loan fee in 2002 for a RAL from \$2,000 to \$5,000 from Household Bank. *See* Household 2002 ExpressRefund flyer, on file with authors.

⁹ NCLC/CFA 2003 RAL Report at 1. The significant increase from the 2001 estimate mainly involves the fact that the average refund amount appears to have crossed the \$2,000 category threshold. Crossing this threshold bumps the fee for a RAL from \$75 to \$90.

¹⁰ NCLC/CFA 2002 Report at 4.

¹¹ www.household.com/corp/hirl_instant_refund_loan.jsp; Santa Barbara Bank & Trust, *2004 Program Newsletter for Tax Professionals*, available at the Taxwise website at [www.taxwise.com/inc/content-managed/pdf/2004newsletter_backSBBT%20\(2\).pdf](http://www.taxwise.com/inc/content-managed/pdf/2004newsletter_backSBBT%20(2).pdf)

¹² NCLC/CFA 2003 RAL Report at 3-4. We included charges for two fees based on loan application/agreements that the authors had collected, as well as statements from the H&R Block website.

¹³ One media report states that Jackson Hewitt charges a \$55 application fee and a \$25 handling fee on top of the RAL loan fee. Tony Pugh, *Short-Term Tax Loan Eats Chunk of Refund*, Charlotte Observer, March 15, 2003.

to Block, its system administration fee ranges from \$28 to \$59, with an average of \$32.¹⁴ Using the average figure, these additional fees add about \$406 million to the amount paid in RAL fees.

Thus, based upon the prices for RALs in 2004, a consumer might pay the following in order to get a \$2,100 RAL from a commercial tax preparation chain this year: 1) a loan fee of \$99.95, which includes a \$24.95 fee supposedly for the “dummy” bank account used to receive the consumer’s tax refund from IRS to repay the RAL; and 2) a system administration fee that averages \$32 per loan. Combine that with tax preparation fees, which average about \$120,¹⁵ and the total is about \$250. The effective APR on this RAL would be 182% (or 245% if the system administration fee is included).

Finally, we note that some tax preparers and RAL lenders have been reporting APRs lower than our estimates.¹⁶ Generally what these lenders have done is to “unbundle” or subtract out amounts from the finance charge, and denominate them as something else in order to make the loans look less expensive. In the case of RALs, the lenders subtract out a charge supposedly for the “dummy” bank account, claiming that it is comparable to the charge for a non-loan product, a “refund anticipation check” (RAC).¹⁷ However, this unbundling is questionable in that: a) some lenders had not previously separated out an independent fee for the dummy account for RALs;¹⁸ 2) the fee for the dummy bank account for a RAL versus a RAC serves two different purposes – repayment of a loan versus a disbursement mechanism for cash; and 3) since RALs are a pure cash loan, there is no comparable non-credit purchase transaction to which they can be compared.¹⁹

We continue to include the charges for the dummy account fee in our estimates for the APR to present a truer picture of the real “cost of credit” for a RAL. For the 2004 filing season, we estimate that the APRs on RALs range from about 70% (for a loan of \$5,000) to over 700% (for a loan of \$200).²⁰ We also continue to report APRs that include the system

¹⁴ H & R Block, *America’s Tax and Financial Partner*, January 2004. Block states that it plans to eliminate this charge over three years, beginning with 13 states in 2004. *Id.* We have included this charge nationally for our 2002 estimates since the phase out begins this year.

¹⁵ According to industry leader H &R Block, its average tax preparation fee is \$121. H&R Block, *Q4 2002 H & R Block Earnings Release Conference Call*, June 12, 2002, available at 2002 WL 26337229. One media report noted that Jackson Hewitt charged a \$179 tax preparation fee in 2003. Tony Pugh, *Short-Term Tax Loan Eats Chunk of Refund*, Charlotte Observer, March 15, 2003. The client in *Hood v. Santa Barbara Bank & Trust* (in which NCLC is co-counsel) was charged \$155 by Jackson Hewitt for tax preparation. Documents on file with the authors.

¹⁶ Jonathan Epstein, *Many Taxpayers Can't Wait To Get Their Refunds*, Delaware News Journal, March 10, 2003.

¹⁷ *Id.* With a “refund anticipation check,” the bank opens a dummy account into which the IRS direct deposits the tax refund. After the direct deposit of the consumer’s refund, the bank issues the consumer a paper check and closes the dummy account. The consumer then picks up the check from the tax preparer’s office.

RACs are often used as the default product if the consumer is denied a RAL. NCLC/CFA 2003 RAL Report at 6-7.

¹⁸ Household 2001 RAL TILA disclosure on file with the authors. *See also* Tommy Snow, Director of Capital Policy, OCC Interpretive Letter No. 959, February 13, 2003, available at www.occ.treas.gov/interp/mar03/int959.pdf (noting that one bank’s RAL application stated APRs of 66.15% to 1880.3%).

¹⁹ Consider this analogy: A bank sends its borrowers envelopes with their monthly bills to make loan payments. These same envelopes are available for sale for \$5 a box. It would be highly questionable for the bank to begin subtracting out \$5 from its loan charges as an “envelope” fee, and then calculate the APR on that basis.

²⁰ These APRs are based upon a 10 day loan period. The estimated time provided by the federal government to receive a refund with e-filing and direct deposit is 8 to 15 days. IRS, *IRS e-file 2004 Refund Cycle Chart*,

administration/electronic filing fees, which are from 94% (for a loan of \$5,000) to 1837% (for a loan of \$200), because those fees also represent a cost of the credit for a RAL.²¹

IV. Impact on EITC

Recently obtained IRS data indicates an astounding impact of RALs on the Earned Income Tax Credit. In the 2002 and 2003 RAL reports, we had assumed based on information provided by IRS that 40% of the RAL customers were recipients of the Earned Income Tax Credit.²² However, more reliable IRS data shows that actually 55% of RAL consumers are EITC recipients, or 7 million families.²³ Yet EITC recipients make up only 15 % of individual taxpayers.²⁴ Thus, EITC recipients are vastly over represented among the ranks of RAL consumers.

Furthermore, since there were 19.6 million EITC returns in 2002,²⁵ this means that 36% of EITC recipients took out a RAL.²⁶ We note that paid preparers were responsible for 68% of EITC tax returns in 2002.²⁷ This means that 53% of EITC recipients (over 1 in 2) who went to a paid tax preparer ended up with a RAL.²⁸

Based on these revised estimates, an estimated \$525 million was drained out of the EITC program by RAL loan fees.²⁹ Tax preparation fees and “system administration”/electronic filing fees add another \$1.06 billion to the drain. Adding check cashing costs, the total drain is \$1.75 billion. Each of these fees undermines the effectiveness of the EITC in supporting low-wage workers. These fees transfer billions in wealth, paid out of the U.S. Treasury, from poor families to multi-million dollar corporations.

Publication 2043, October 2003. The median time would be 11.5 days, and the loan itself takes one or two days to process. Moreover, some free tax preparation sites report that during the height of tax season in early February, refunds arrive as quickly as a few days.

²¹ The U.S. General Accounting Office reported even higher estimates for RAL APRs of 400% and 900%. U.S. General Accounting Office, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS is a Challenge*, GAO-04-70, October 31, 2003, at 10, available at www.gao.gov/cgi-bin/getrpt?GAO-04-70

²² See NCLC/CFA 2002 RAL Report at 6-7; NCLC/CFA 2003 RAL Report at 4.

²³ IRS data reports that 7.83 million EITC returns were associated with a RAL in 2002. Data from IRS SPEC, Tax Year 2001 Return Information (Returns Filed in 2002), October 2003. Using the 90% approval rate, see note 3 *supra*, the number of approved RALs is 7 million.

²⁴ There were 19.6 million EITC returns in 2002. IRS, *Tax Stats at a Glance*, available at www.irs.gov/taxstats/article/0,,id=102886,00.html. There were 130.9 million individual tax returns in 2002. *Id.*

²⁵ *Id.*

²⁶ A study by the Brookings Institution notes that this percentage is as high as 40 to 50% in some cities. Alan Berube, *Rewarding Work Through the Tax Code*, Brookings Institution, January 2003, at 6, available at www.brookings.org. Furthermore, since 7.83 million EITC returns were associated with a RAL, see note 23 *supra*, this means 40% of EITC recipients *applied* for a RAL in 2002.

²⁷ National Taxpayer Advocate 2003 Report at 281.

²⁸ The math is 19.6 million times 68% equals 13.3 million. 7 million divided by 13.3 million is 53%. If you take the number of EITC recipients who applied for RALs (7.83 million), the percentage is even more shocking – 58.9%.

²⁹ Based on an average EITC refund of \$1,700. Alan Berube, *Rewarding Work Through the Tax Code*, Brookings Institution, January 2003, at 2 available at www.brookings.org.

Type of Fee	Cost to Taxpayer	Drain on EITC Program
RAL loan fee (inc. dummy account fee)	\$75	\$525 million
System Admin./Electronic Filing Fee	\$32	\$224 million
Tax preparation fee	\$120	\$840 million
Total	\$207	\$1.59 billion
Check cashing fee (for 45% of EITC recipients) ³⁰	\$51 ³¹	\$161 million
Total with check cashing	\$ 258	\$1.75 billion

V. Tax Preparers and RAL Lenders

In 2002, the major players in the RAL industry experienced significant growth. Because 2003 corporate filings are available for some of these companies, this section also includes selected 2003 data.

H&R Block

H&R Block experienced a 14% growth in the number of RALs they processed, from 4.5 million in 2001 to 5.15 million in 2002.³² In 2003, Block began reporting only the number of RALs that were funded after Block processed them.³³ Block reported that 4 million of the RALs it processed were funded in 2001, and that 4.67 million were funded in 2002.³⁴

In 2003, the number of RALs processed by Block appeared to have stayed flat. Block reported that it processed 4.65 million RALs that were funded.³⁵ Note that Block actually lost tax preparation customers in 2003, declining from 16.9 million to 16.3 million.

In 2002, Block earned over \$200 million in fees from RALs.³⁶ This included both a \$9 per RAL “license fee” and \$160 million in loan fees received by Block Financial Corporation, which had an arrangement to buy a 49.9% interest in RALs arranged by the

³⁰ This 45% figure is taken from a study of EITC recipients who used *free* tax preparation services. Timothy M. Smeeding, Katherine Ross Phillips, and Michael O’Connor, *The EITC: Expectation, Knowledge, Use, and Economic and Social Mobility*, Center for Policy Research, Working Paper Series No. 13 (2000), at Table 5. Given the relationship between *commercial* tax preparers and check cashers, see NCLC/CFA 2003 RAL Report at 9, we believe this figure actually underestimates the number of EITC recipients who use check cashers. Since there were 7 million RAL consumers who received the EITC in 2002, 45% would be 3.15 million.

³¹ The average check cashing fee for a RAL check is about 3%, or \$51 for the average EITC refund of \$1,700. See NCLC/CFA 2003 RAL Report at 12.

³² H&R Block Inc., *2002 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 4 [hereinafter “H&R Block, 2002 Form 10-K”].

³³ H&R Block Inc., *2003 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 5. [hereinafter “H&R Block, 2003 Form 10-K”].

³⁴ Id.

³⁵ Id.

³⁶ H&R Block, 2002 Form 10-K at 4, 7.

tax preparation arm. For 2003, Block waived its right to buy this 49.9% interest in RALs, as well as its “license fee” in exchange for a flat fee per RAL.³⁷ In 2003, Block received \$133 million in payment for its waivers.³⁸ Block will resume collecting license fees and obtaining its participation interest in RALs until 2006.³⁹ In addition to the participation interest in RALs, Block’s incentives to promote RALs include payments by Household to reimburse Block for the cost of advertising.⁴⁰

In 2002, Block applied for a charter to become a bank with the Office of Thrift Supervision.⁴¹ Consumer groups, including CFA and NCLC advocates, submitted comments raising issues concerning Block’s RAL business, as well as concerns over subprime lending by Block subsidiary Option One and the potential for the Block bank to engage in rent-a-charter payday lending.⁴² Block withdrew its application in April 10, 2003, but has since re-filed its application in December 2003.⁴³

Finally, H&R Block revealed in December 2003 that it is being investigated by the Securities and Exchange Commission over its disclosures relating to RAL litigation.⁴⁴

Household Bank/ITLA

In 2002, Household processed 7 million RALs generating nearly \$240 million in income.⁴⁵ This represents a 9% increase in the number of RALs and a 22% increase in RAL income from 2001, in which Household made 6.4 million RALs generating \$196.3 million in income.⁴⁶

As discussed in the NCLC/CFA 2003 RAL Report, Household struck an arrangement in November 2002 with ITLA Capital Corporation for ITLA to originate the RALs, which Household would then buy immediately from ITLA.⁴⁷ Preliminary data shows that ITLA Corporation earned \$14.6 million in income from RALs in 2003.⁴⁸

³⁷ H&R Block, 2003 Form 10-K at 11.

³⁸ Id.

³⁹ Id.

⁴⁰ These payments will be \$3.5 million in 2004, \$4.25 million in 2005, and \$5 million in 2006. Second Amended and Restated Refund Anticipation Loan Operations Agreement, Exhibit 10.27 to H&R Block, 2003 Form 10-K.

⁴¹ A redacted copy of Block’s May 2002 OTS application is on file with the authors.

⁴² Letter from California Reinvestment Committee, Consumers Union, Consumer Federation of America, and National Consumer Law Center to Charles Deardoff, Office of Thrift Supervision, May 31, 2002, on file with the authors.

⁴³ A redacted copy of Block’s December 2003 OTS application is on file with the authors.

⁴⁴ *H&R Block Inc.: SEC Investigation is Related to Refund-Anticipation Loans*, Business Briefs, Wall Street Journal, December 15, 2003, at A10; Bill Draper, *H&R Block Says It Faces SEC Investigation, CEO Expects Smaller Increase In Tax Filers*, Associated Press Newswire, December 13, 2003. Block has also been the subject of shareholder lawsuits regarding its disclosures over RAL litigation. H&R Block, 2003 Form 10-K at 40.

⁴⁵ Household International, *2002 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 8, 32. [hereinafter “Household 2002 Form 10-K”]

⁴⁶ Household International, *2001 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 5, 26.

⁴⁷ NCLC/CFA 2003 RAL Report at 6.

⁴⁸ *ITLA Capital Corporation Reports Earnings for the Third Quarter Ended September 30, 2003*, PR Newswire, November 4, 2003.

The following is the Household/ITLA price structure for RALs in 2004, for both H&R Block⁴⁹ and in general.⁵⁰ At least for the general rates, there appears to be an increase of about \$15 for the loan fee for loans of \$2,001 to \$5,000.⁵¹

Household 2004 RAL Fee Schedule

Amount of Loan	H&R Block	General
\$200-\$500	\$29.95	\$34.95
\$501-1,000	\$39.95	\$44.95
\$1,001-\$1,500	\$59.95	\$64.95
\$1,501-\$2,000	\$69.95	\$74.95
\$2,001-\$5,000	\$99.95	\$104.95

Jackson Hewitt

Jackson Hewitt, the second largest tax preparation chain in the country, prepared 2.5 million returns in 2002.⁵² Jackson Hewitt generated revenues of \$33 million from “various financial products,” which we assume would include RALs and refund anticipation checks (RACs). In 2003, Jackson Hewitt reported that the number of tax returns it processed had increased to 2.8 million.⁵³

Santa Barbara Bank & Trust/Pacific Capital Bancorp

Jackson Hewitt’s RAL partner, Santa Barbara Bank & Trust (SBBT), a subsidiary of Pacific Capital Bancorp, earned \$29.9 million in fees from RALs in 2002, and \$16.6 million in fees from its RAC product, called a “Refund Transfer.”⁵⁴ SBBT earned \$38.2 million in RAL fees in 2003, representing an increase of 28%, and 19.8 million in Refund Transfer fees.⁵⁵ Thus, SBBT’s RAL business has experienced significant growth in 2003.

Interestingly, SBBT reports that its RAC product constitutes about two thirds of its tax-related financial products.⁵⁶ Since SBBT made 3.8 million RALs and RACs in 2002, that means SBBT made about 1.3 million RALs in that year.⁵⁷ For 2003, SBBT made 4.6

⁴⁹ H&R Block, Sample Refund Anticipation (RAL) Loan Fees, on file with the authors. Block’s fees appear to be about \$5 less than for other tax preparers; however, Block also charges a separate administrative fee averaging \$32.

⁵⁰ From Household’s website at www.household.com/corp/hirl_express_refund_loan.jsp. The fees include both Household’s stated finance charge as well as the dummy account fee.

⁵¹ NCLC/CFA 2003 RAL Report at 6.

⁵² Cendant Corporation, *2002 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 53.

⁵³ Press Release, *Tax Season 2003 Brings Jackson Hewitt Near 3 Million Tax Return Mark*, July 23, 2003.

⁵⁴ Pacific Capital Bancorp, *2002 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 34. [hereinafter “PCB 2002 Form 10-K”].

⁵⁵ Pacific Capital Bancorp, *Form 10-Q: Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, November 14, 2003 at 69 (showing \$30.2 million in RAL interest income and \$8 million in gain from the sale of RALs.)

⁵⁶ *Id.* at 65.

⁵⁷ *Id.*

million RALs and RACs, which means SBBT made 1.5 million RALs this past year.⁵⁸ Note that SBBT also earned \$1.6 million in recoveries on bad RAL loans from prior years, presumably through cross-lender debt collection.⁵⁹

The following is SBBT's price structure for RALs in 2004.⁶⁰ Some of these prices appear to be \$5 higher than SBBT's prices in 2003,⁶¹ which adds up to \$10 given the surcharge for RALs secured by the EITC.

SBBT 2004 RAL Fee Schedule

Amount of Loan	Loan Fee w/o EITC	Loan Fee with EITC
Up to \$500	\$29	\$34
\$501-1,000	\$44	\$49
\$1,001-\$1,500	\$64	\$69
\$1,501-\$2,000	\$79	\$84
\$2,001-\$5,000	\$94	\$99

Other industry players

In a victory for consumers, Intuit Corporation announced in September 2003 that it would no longer offer RALs through TurboTax, which is the nation's best-selling do-it-yourself tax software program.⁶² In addition, RALs would no longer be offered through the Web-version of TurboTax, which was part of the IRS Free File program.⁶³

VI. Partnerships with High Cost Financial Providers

In our prior reports, we have discussed the role played by high cost fringe financial providers in the RAL business, such as the H&R Block partnership with ACE Cash Express.⁶⁴ We have also reported on car dealers and payday lenders who engage in tax preparation and facilitate RALs.⁶⁵ These practices appear to be flourishing. ACE Cash Express reports that in 2003, it placed 240 self-serve cash checking machines in H & R Block offices.⁶⁶ Jackson Hewitt has a similar arrangement with CashWorks to place check cashing machines in Jackson Hewitt

⁵⁸ Id.

⁵⁹ Katie Kuhner-Herbert, *In Brief: Problem Loans Hurt Pacific Capital in 3Q*, American Banker, October 28, 2003, at 17.

⁶⁰ SBBT, *2004 Program Newsletter for Tax Professionals*, available at the Taxwise website at [http://www.taxwise.com/_inc/content-managed/pdf/2004newsletter_backSBBT%20\(2\).pdf](http://www.taxwise.com/_inc/content-managed/pdf/2004newsletter_backSBBT%20(2).pdf).

⁶¹ NCLC/CFA 2003 RAL Report at 6.

⁶² Amy Hamilton, *Intuit to Discontinue Offering RALs Through TurboTax*, Tax Notes Today, September 16, 2003.

⁶³ Id.

⁶⁴ NCLC/CFA 2003 RAL Report at 9-11. The NCLC/CFA 2003 RAL Report also included a survey of check cashing outlets conducted by CFA members in nine states that documented the additional cost of cashing tax refund checks and refund anticipation loan checks. Id. at 11.

⁶⁵ Id. at 10-11.

⁶⁶ Ace Cash Express, *2003 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 7.

offices.⁶⁷ TaxMax, which provides tax preparation, filing services, and arranges for RALs for car dealers, reported a substantial 21% growth last year and is expanding beyond automobile dealers.⁶⁸ The website of TRE Financial Services advertises tax preparation support to “check cashing stores, insurance offices, car dealers, and pawn shops...”⁶⁹ The website of AMSCOT Financial, a check casher and payday lender, offers both tax preparation and RAL services.⁷⁰ The National Taxpayer Advocate has noted her concerns over tax preparation by such entities, including concerns over the competency of these services and whether these entities are adequately respecting IRS privacy regulations.⁷¹

We note the emergence of two new partnerships between high-cost financial providers and a major tax preparation chain, i.e., Jackson Hewitt. In November 2003, Jackson Hewitt announced a cross-marketing deal with Rent-A-Center, the nation’s largest rent-to-own company.⁷² Rent-to-own (RTO) businesses are essentially appliance and furniture retailers that arrange lease agreements for those customers who cannot purchase goods with cash. These lease agreements contain purchase options that typically enable consumers to buy the goods by making a nominal payment at the end of the lease. The RTO industry aims its marketing efforts primarily at low-income consumers. The chief problem with RTO companies is that the supposed “leases” are really disguised sales made at astronomical and undisclosed effective interest rates.⁷³

Jackson Hewitt’s partnership with Rent-A-Center involves incentives for Jackson Hewitt customers to enter into RTO arrangements.⁷⁴ Jackson Hewitt customers will receive two free weeks when they pay for an RTO lease with their “Jackson Hewitt Cash Card” (for which they probably pay fees for both the card as well as RAL or RAC fees to get the refund monies to put on the card.)⁷⁵ In addition, Jackson Hewitt will offer tax preparation at selected Rent-A-Center stores, where presumably rent-to-own consumers can obtain RALs and RACs.⁷⁶

Jackson Hewitt also announced the formation of a partnership with the purveyors of the Rush Prepaid Visa Card.⁷⁷ This card is a stored value card offered by Russell Simmons, who is the founder of a hip-hop music label and well-known in the African American community. The Rush Card appears to be targeted at urban minority communities, and is associated with significant fees, such as a \$20 initial fee, a \$1 fee for use at point-of-sale transactions, and a \$5 per 90 days “inactivity” fee. The major problem with pre-paid cards such as the Rush VISA Card is the high cost involved in using the stored value card. One survey found that it cost low-

⁶⁷ Ann All, *Tax Season Provides Nice Return for ATM Deployer*, ATM Marketplace, April 15, 2003.

⁶⁸ *Carbiz Signs Deal with Select Personnel Services*, CCMMatthews, November 3, 2003.

⁶⁹ <http://trefsc.com/nontrad.asp>.

⁷⁰ www.amscotfinancial.com/financial/pages/about.htm.

⁷¹ National Taxpayer Advocate 2003 Report at 271.

⁷² Press Release, Jackson Hewitt Forms Strategic Alliance with Rent-A-Center, PR Newswire, November 5, 2003.

⁷³ NCLC, *The Cost of Credit: Regulation and Legal Challenges* § 7.5.3.2 (2d ed. 2000 and Supp.).

⁷⁴ Press Release, Jackson Hewitt Forms Strategic Alliance with Rent-A-Center, PR Newswire, November 5, 2003.

⁷⁵ Id.

⁷⁶ Id.

⁷⁷ Press Release, *Russell Simmons Partners with Jackson Hewitt to Offer Direct Deposit of Tax Refunds Onto Rush Prepaid Visa Card*, Business Wire, December 10, 2003.

income consumers nine times as much to use a pre-paid card as opposed to obtaining a basic bank account.⁷⁸

VII. Advocacy

In January 2004, the Association of Community Organizations for Reform Now (ACORN) held protests in front of H & R Block offices in 30 cities to protest Block's RAL business.⁷⁹ As a result of these protests, legislators in Texas and Philadelphia will be introducing legislation to regulate RALs.⁸⁰ The ACORN protests have also prompted the New Jersey Department of Banking to express its concerns over RALs.⁸¹

VIII. Consumer Confusion About RALs Remain: NCLC/CFA Survey

In the NCLC/CFA 2002 RAL Report, we discussed a 1996 study from University of Georgia which revealed that almost 50% of taxpayers who had received a RAL did not understand the product was a loan.⁸² We conducted a small sampling of RAL consumers in the Fall/Winter 2003 for the purposes of determining whether consumers now have a better understanding of RALs. The results of the survey suggest that many RAL consumers may still be unaware that RALs are loans.

Our survey was conducted in two locations: 1) in Christiansburg, Virginia by a faculty member and two trained students from Virginia Polytechnic Institute and State University, and 2) in Phoenix, Arizona by the Arizona Consumers Council. Survey participants were asked whether they had ever gotten a "rapid or speedy refund." Participants who answered affirmatively were then asked a number of follow-up questions. The question regarding understanding the nature of RALs was "Was your rapid or speedy refund the kind that involved a loan?"⁸³

Twenty-two participants responded indicating that they had received a RAL.⁸⁴ Of the 22 participants, 18 of them (or over 80%) indicated they did not know the product involved a loan. The survey admittedly had a small sample size. However, the results provide an indication that

⁷⁸ New York Public Interest Research Group, *Back to Basics: A Report and Survey on Basic Banking, Pre-Paid Mastercards and Visa Cards, and Check Cashers*, June 2003, available at www.nypirg.org/consumer/basicbanking/2003/.

⁷⁹ Rebecca Christie, *Consumer Activists to Protest H&R Block Tax Refund Loans*, Dow Jones Newswires, January 12, 2004; Robert L. Steinback, *Activists Go Straight to Source for Protest of Tax Refund Loans*, Miami Herald, January 14, 2004; Patricia Sabatini, *Pittsburgh Group Warns Consumers About Tax Preparers Offering Refund Loans*, Pittsburgh Post-Gazette, January 14, 2004.

⁸⁰ Adolfo Pesquera, *Tax Refund Loans Hit As Bad Deal*, San Antonio Express-News, January 17, 2004; Larry Rulison, *Tax Loans Scrutinized*, Philadelphia Business Journal, January 20, 2004.

⁸¹ Richard Newman, *Consumer Group Protests Alleged H&R Block Price Gouging*, Bergen Record, January 14, 2004, at B1.

⁸² Joan Koonce Lewis, et al., *Refund Anticipation Loan and the Consumer Interest: A Preliminary Investigation*, Consumer Interests Annual, Vol. 42 (1996), at 167.

⁸³ This is very similar to the question used in the 1996 University of Georgia study cited above, *id.*

⁸⁴ These were survey participants who answered that they had received a "rapid or speedy refund" and that the refund had arrived in less than 8 days (which meant they had not received a non-loan financial product).

despite educational efforts and supposedly better written disclosures, consumers may continue to be confused about RALs.

These survey responses may also be a sign that consumers rely more on oral information about RALs than on written disclosures. For example, in response to the ACORN protests discussed in Section VII, *supra*, Block issued a statement claiming that the company shows customers all filing options, starting with the no-cost filing options.⁸⁵ However, ACORN reported that potential customers who called Block offices were told orally over the telephone about RALs first. They were not informed of other alternatives until the Block employee was specifically asked about them.⁸⁶

This year, H&R Block has revised its written information to provide more information to customers about options for receiving their tax refund. These disclosures include a section in Block's "Welcome" brochure, a refund options handout, and a computer screen during the tax preparation process. Each of these disclosures shows free options in addition to and before RACs and RALs. In addition, Block has produced a Fact Sheet on RALs describing the nature and costs of the product. It remains to be seen whether improved disclosures will be effective in communicating the nature and costs of RALs to consumers. The more important question may be whether employees of tax preparation firms will orally inform consumers of the nature and costs of RALs, and the existence of less costly alternatives.⁸⁷ Finally, while improved disclosures are progress, they do not make RALs any less expensive or a better choice for consumers.

IX. Legislation

A number of state and local governments have enacted laws governing refund anticipation loans during the past 2 years. The following is a summary of these laws:

New York City⁸⁸

New York City enacted a local law which requires tax preparers to provide disclosures to RAL applicants in 14 point type and with mandatory language. These disclosures include: a) the amount of the RAL fees and the amount that the consumer's tax refund will be after fees; b) the amount of the consumer's tax refund if the consumer does not take out a RAL; c) the APR for the RAL; d) estimated times for receiving a RAL vs. receiving a refund with e-file and direct deposit; e) a disclosure that the consumer need not take out a RAL; and f) a warning that the consumer must repay the RAL if the IRS does not issue the expected tax refund.

⁸⁵ Press Release, *H&R Block Statement on the Truth About Refund Anticipation Loans*, U.S. Newswire, January 13, 2004.

⁸⁶ Bill Sulon, *Taxpayers Urged Not to Borrow on Refund*, Harrisburg Patriot-News, January 14, 2004, at D1; *ACORN National President Maude Hurd's Letter to Mark Ernst, President, Chairman and CEO of H&R Block*, US Newswire, January 15, 2004.

⁸⁷ Block employees may have an incentive to promote RALs or other bank products. We have been informed that Block employees receive a flat fee, generally around \$5, for each RAL or RAC they make.

⁸⁸ Section 20-739 of the Administrative Code of the City of New York.

The New York City law also requires tax preparers to disclose in advertisements that a RAL is a loan, the name of the lender, and that a fee will be charged for a RAL. The advertising provisions also prohibit tax preparers from representing or implying that RALs are refunds.

Minnesota⁸⁹

Minnesota enacted a statute which similarly imposes disclosure requirements on tax preparers who facilitate RALs. These disclosures must be made on a separate sheet of paper and in 14 point type. The disclosures include: a) the fact that a RAL is a loan; b) the APR for the RAL; c) the amount that the consumer's refund will be reduced by RAL fees; d) a disclosure that the consumer can get a refund in about two weeks with e-filing and direct deposit; and e) if appropriate, a warning that if the tax refund is delayed, the consumer may have to pay additional interest. The Minnesota statute also contains standards of conduct for tax preparers in general.

Illinois⁹⁰

Illinois passed a law in 2002 that also imposes disclosure requirements on tax preparers who facilitate RALs. These disclosures include the loan fee schedule, electronic filing fee, estimated date for receiving the RAL, the availability of e-filing, the estimated time for receiving a refund with e-filing and direct deposit, and a statement that the consumer is responsible for repaying the RAL if the IRS does not issue the expected tax refund. There are no mandatory font requirements.

These laws are in addition to RAL laws that were already existing in North Carolina⁹¹ and Wisconsin.⁹²

In 2003, another attempt was made to introduce federal legislation to regulate RAL fees. Senators Jeff Bingaman (D-NM) and Daniel Akaka (D-HI) introduced S.685, which would require the IRS to establish guidance on reasonable fees and interest rates for RALs.⁹³ The bill would also eliminate the Debt Indicator Program and require registration of tax preparers.⁹⁴ In addition, S.685 would provide \$10 million in funding for free tax preparation for low-income taxpayers, which would help reduce demand for RALs.⁹⁵ While S.685 has languished in general, the funding provisions in the bill have seen some movement.

Finally, NCLC attorneys have produced a model state law that would regulate refund anticipation loans. This model law primarily focuses on the tax preparers that facilitate RALs. The model law will be available on NCLC's website at

⁸⁹ Minn. Stat. § 270.30.

⁹⁰ Comp. Stat. Ann. ch. 815, § 177/1, *et seq*

⁹¹ N.C. Gen. Stat. §§ 53-245 to 53-254.

⁹² Wis. Stat. §§ 421.301 and 422.310.

⁹³ The Low Income Taxpayer Protection Act of 2003, S. 685, 108th Cong. (2003).

⁹⁴ Id.

⁹⁵ Id. In addition, Senator Akaka offered an amendment eliminating funding for the Debt Indicator to the Treasury Appropriation bill, but withdrew it because of a jurisdiction issue on the House side. Timothy Catts, *Senators Seek Vehicle for Provision to Aid Low-Income Taxpayers*, Tax Notes, October 30, 2003.

www.consumerlaw.org/initiatives/refund_anticipation or can be obtained by contacting NCLC at 617-542-8010.

X. The Internal Revenue Service's Role in RALs

The IRS is under a mandate from Congress to achieve an 80% electronic filing target by 2007, leading the agency to assist commercial tax preparers in making RALs, since the loans boost electronic filing volume. One way the IRS helps RAL providers is to provide the Debt Indicator, which screens electronically filed tax returns and lets the preparer know if there are any federal offset claims against a taxpayer's refunds such as for a delinquent child support or student loan debt.⁹⁶

Another way the IRS is responsible for RALs is the fact that it has permitted commercial tax preparer partners in the Free File program to market the usurious loans, as well other paid products, to taxpayers who use Free File.⁹⁷ NCLC and CFA advocates objected to the ability of Free File providers to cross-market through Free File from the outset of the program.⁹⁸ The National Taxpayer Advocate raised similar concerns in a report to Congress.⁹⁹ Several members of Congress questioned IRS officials on the issue of commercial marketing via a government website during a House Ways and Means hearing on Free File.¹⁰⁰

Despite these concerns, RALs were marketed by some Free File companies. There is evidence that the Free File program may have resulted in an increase in RALs. According to Jeff Yabuki, H & R Block's chief operating officer, "there was a sizable group of [Free File] clients who purchased additional services" in 2003.¹⁰¹ At least one high level IRS official has taken the view that it is acceptable for Free File vendors to offer RALs and other paid services via a government website, because "we're not [the taxpayer's] parents."¹⁰²

Concerns over cross-marketing to Free File taxpayers have been reinforced by evidence that one Free File provider, H&R Block, has been using consumers' tax information to market not only RALs, but mortgages (including potentially subprime mortgages) to Free File users.¹⁰³ Under IRS laws and regulations, taxpayer information cannot be used by tax preparers for

⁹⁶ See NCLC/CFA 2002 RAL Report at 20.

⁹⁷ The Free File program is a partnership established by IRS in which a consortium of commercial preparers has agreed to provide free on-line tax preparation and electronic filing of federal tax returns to certain taxpayers. See the IRS Website at www.irs.gov/efile/article/0,,id=118986,00.html.

⁹⁸ Comment of Consumer Federation of America, National Consumer Law Center, Consumers Union, and U.S. Public Interest Research Group Regarding IRS Proposed Pact with Commercial Preparers, September 4, 2002, available at www.consumerlaw.org/initiatives/refund_anticipation/irs.shtml.

⁹⁹ National Taxpayer Advocate, *Fiscal Year 2004 Objectives Report to Congress*, June 30, 2003, at 17-18.

¹⁰⁰ *Free Electronic Filing and National Taxpayer Advocate Annual Report: Hearing Before The Subcommittee On Oversight Of The House Committee On Ways And Means*, 108th Congr. (2003).

¹⁰¹ H&R Block, *Year-End 2003 Conference Call*, June 11, 2003, at 17.

¹⁰² Neil Downing, *Electronic Tax Returns Free and Easier, IRS Says*, Providence Journal, October 21, 2003 (quote from Terrence Lutes, director of Electronic Tax Administration.)

¹⁰³ Letter from Consumer Federation of America, et al., to Assistant Secretary for Tax Policy Pamela Olson re: Subprime Mortgage Marketing through IRS Free File, March 24, 2003, available at http://www.consumerlaw.org/initiatives/refund_anticipation.

marketing purposes without the specific consent of the consumer.¹⁰⁴ Block obtained a questionable “consent” to this cross-marketing by calling it a “Consent to Receive Personalized Tax Tips and Information.” Indeed, the Block CEO publicly boasted about the company’s ability to exploit confidential tax information, stating “We have a relationship with millions of clients who come to our door once a year, and when they come to our doorstep, they bring all their personal information and effectively pay us to update our database.”¹⁰⁵ NCLC and CFA advocates sent several follow-up complaints to the Treasury Department over Block’s privacy practices.¹⁰⁶

Block has revised its notice and consent forms regarding this issue, which appear to be clearer in informing consumers that they are consenting to use of their confidential tax information for cross-marketing purposes. In addition, the IRS announced improvements to the Free File program that are supposed to reduce concerns about cross-marketing, and inform consumers more readily about service options and fees.¹⁰⁷ The IRS press release included a public statement that Free File users do not have to purchase extra products and services to be permitted to use the free services.¹⁰⁸ However, the IRS has not prohibited participants from marketing expensive extras.

On a positive note, several Free File providers appear to have dropped RALs from their Free File offerings. Intuit’s decision to drop RALs from TurboTax, discussed in Section V, *supra*, extended to the Web version of that program. In addition, there are indications that other Free File providers have dropped RALs.¹⁰⁹ Thus, eligible taxpayers do have RAL-free options amongst Free File providers.

XII. Other State and Federal Agency Activities

A number of state and federal authorities have taken action or issued statements regarding RALs. In March 2003, the Massachusetts Commissioner of Banks issued a warning letter to tax preparers that they would be required to obtain a small loan company license under Massachusetts law if they were offering RALs, regardless of whether the preparer originated the loan.¹¹⁰ The warning letter also noted that any person brokering small loans in Massachusetts must abide by Massachusetts regulations limiting the interest rates on small loans to 23% APR.¹¹¹ The Commissioner of Banks reiterated this warning in December 2003, just prior to the start of tax season.¹¹²

¹⁰⁴ 26 U.S.C. § 7216; 26 C.F.R. § 301.7216-3.

¹⁰⁵ David Breitkopf, *H&R Block CEO Touts Cross-Sales Goals*, American Banker, May 9, 2003, at 11.

¹⁰⁶ Letter from Consumer Federation of America, et al., to Assistant Secretary for Tax Policy Pamela Olson re: Subprime Mortgage Marketing through IRS Free File, April 9, 2003; Letter from Consumer Federation of America, et al., to Assistant Secretary for Tax Policy Pamela Olson, August 6, 2003.

¹⁰⁷ IRS Press Release, *Free File Opens Second Year: Improvements Detailed*, IR-2004-13, January 22, 2004.

¹⁰⁸ *Id.*

¹⁰⁹ Neil Downing, *Electronic Tax Returns Free and Easier, IRS Says*, Providence Journal, October 21, 2003.

¹¹⁰ Letter from Thomas J. Curry, Massachusetts Commissioner of Banks, re: Division of Banks Warns Tax Preparers That They Must Be Licensed to Provide Refund Anticipation Loan, March 5, 2003. *See also* Katie Kuehner-Hebert, *Mass. Hits Rapid Refund*, American Banker, March 11, 2003 at 1.

¹¹¹ *Id.*

¹¹² Letter from Thomas J. Curry, Massachusetts Commissioner of Banks re: Refund Anticipation Loans, December 23, 2003.

The state Attorneys General of California, Illinois, and Oklahoma have publicly warned consumers in their states to avoid RALs.¹¹³ The California Attorney General's Office also indicated it is investigating some tax preparers for inadequate disclosures about the loans.¹¹⁴ On a related front, the Attorneys General of 42 states obtained a \$3.3 million settlement with H&R Block over that company's marketing of its "Peace of Mind" guarantee.¹¹⁵

On the federal level, the GAO has issued a report on problems with paid tax preparers that included a discussion on RALs. The GAO report noted that some paid preparers fail to disclose the costs and risks of RALs and the availability of lower cost alternatives. The GAO report describes how its investigators spoke to several tax preparers who stated they would charge loan fees for RALs ranging from \$130 on a \$1,200 refund (or 400 percent APR) to \$174 on a \$700 refund (or 900% APR).¹¹⁶ The GAO noted that the IRS imposes only limited requirements with respect to regulation of RAL practices by paid preparers.¹¹⁷

The National Taxpayer Advocate continues to express concerns regarding RALs in her 2003 Annual Report to Congress. In her report, she recommended that legislation be passed imposing a civil penalty on tax preparers who failed to advise taxpayers that a RAL is a loan and the terms of that loan.¹¹⁸

At least one federal financial regulator has addressed RALs. In 2003, the Office of Comptroller of Currency announced that RALs would be subject to a "100% risk weight" instead of the lower 20% risk weight for loans guaranteed by the federal government.¹¹⁹ The OCC made the announcement after Santa Barbara Bank & Trust had requested to carry its RAL loans at the lower risk weight, arguing that RALs should be considered low-risk loans because they are a "receivable from the U.S. government" and "effectively collateralized" by a tax refund.¹²⁰

XIII. Update on Court Cases

RAL litigation continues to be active. However, the major RAL lenders have included arbitration clauses in their loan documents to insulate themselves and their tax preparation

¹¹³ Robert Jablon, *California Official Warns Against Cost of "Instant" Tax Refunds*, Associated Press Newswire, March 5, 2003; Press Release, *Attorney General Madigan Warns Consumers, Taxpayers about Instant Tax Refund Schemes*, Office of the Illinois Attorney General, February 13, 2003; *AG Warns of Scams Regarding Tax Refunds*, Tulsa World, February 8, 2003, at A19.

¹¹⁴ Robert Jablon, *California Official Warns Against Cost of "Instant" Tax Refunds*, Associated Press Newswire, March 5, 2003.

¹¹⁵ Gene Meyer, *H&R Block Pays \$3.3 Million to Settle "Peace of Mind" Dispute*, Kansas City Star, April 25, 2003.

¹¹⁶ U.S. General Accounting Office, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS is a Challenge*, GAO-04-70, October 31, 2003, at 10, available at www.gao.gov/cgi-bin/getrpt?GAO-04-70.

¹¹⁷ *Id.*, at 18. The IRS regulations governing RALs are described in the NCLC/CFA 2002 RAL Report at 17-18.

¹¹⁸ National Taxpayer Advocate 2003 Report at 294.

¹¹⁹ Tommy Snow, Director of Capital Policy, OCC Interpretive Letter No. 959, February 13, 2003, available at www.occ.treas.gov/interp/mar03/int959.pdf.

¹²⁰ Todd Davenport, *OCC Tackles Refund Loans*, American Banker, March 27, 2003, at 1. According to this article, and from indications in its corporate filings, SBBT appears to have capitalization issues related to RALs.

partners from liability.¹²¹ H&R Block has even stated that the inclusion of an arbitration provision has “taken away” the issue of RAL litigation.¹²² Thus, consumers may be deprived of the ability to further challenge RALs in court.

Reynolds v. Beneficial National Bank

This was the global settlement for \$25 million that abruptly snuffed out a number of class action proceedings brought against Block and Household.¹²³ In April 2002, the federal Court of Appeals for the Seventh Circuit overturned the approval of the settlement and sent the case back to the district court with the requirement that the case be assigned to a different judge.¹²⁴

On remand, the district court rejected the settlement on the basis that the class counsel who negotiated the settlement were inadequate representatives for the plaintiff class.¹²⁵ The district court particularly noted that class counsel had failed to conduct sufficient discovery to allow a serious analysis of the case.¹²⁶ In a stunning development, the district court essentially fired the attorneys who negotiated the settlement, ordering that they could no longer represent the class.¹²⁷

Beneficial National Bank v. Anderson¹²⁸

Beneficial v. Anderson was a RAL case that reached the U.S. Supreme Court in 2003. The case involved a state law usury claim against Block and Household over RALs. The specific issue dealt with whether the case could be removed to federal district court on the theory that the National Bank Act completely preempted the plaintiff’s claims. The Supreme Court agreed with Household and Block that that the National Bank Act did completely preempt state law usury claims, and thus removal was possible.¹²⁹

¹²¹ Arbitration clauses waive the right of consumers who have been harmed by a consumer-unfriendly practice from seeking a remedy in court. They effectively prevent consumers from getting any relief, especially in an organized effort such as a class action that might make a significant impact. For more information on the hazards of arbitration clauses, see National Consumer Law Center, *Consumer and Media Alert: The Small Print That’s Devastating Major Consumer Rights*, July 28, 2003, available at www.consumerlaw.org/initiatives/model/arbitration.shtml.

¹²² H & R Block, *Conference Call Responding to Texas Judge Ruling*, November 7, 2002, available at 2002 WL 100547400 (statement of Block CEO Mark Ernst).

¹²³ *Zawikowski v. Beneficial Nat’l Bank*, 2000 U.S. Dist. LEXIS 11,535 (N.D. Ill. 2000). This settlement and the controversy surrounding it is discussed in the NCLC/CFA 2002 RAL Report at 25.

¹²⁴ *Reynolds v. Beneficial Nat’l Bank*, 288 F.3d 277 (7th Cir. 2002). The Seventh Circuit decision is discussed in the NCLC/CFA 2003 RAL Report at 15.

¹²⁵ *Reynolds v. Beneficial Nat’l Bank*, 260 F.Supp.2d 680 (N.D. Ill. 2003).

¹²⁶ Id.

¹²⁷ Id.

¹²⁸ 123 S.Ct. 2058 (2003).

¹²⁹ Id.

Kleven v. Household Bank¹³⁰

This was a case before the Court of Appeals for the Seventh Circuit involving taxpayers who filed for bankruptcy shortly after receiving a RAL. The issue before the Seventh Circuit was whether the bankruptcy trustee could avoid repayment of these RALs under bankruptcy law. While the Seventh Circuit ruled that the RALs could not be set aside, the court took the unusual move of remarking on the predatory nature of RALs. In particular, the Seventh Circuit noted: “an attack on RALs based on fairness and equity would certainly have some appeal.” The Seventh Circuit also extensively discussed data regarding RALs in Milwaukee from the Brookings Institution and the University of Wisconsin-Milwaukee Employment and Training Institute.

Haese v. H&R Block

After receiving a favorable ruling that H&R Block breached a fiduciary duty in facilitating RALs, class counsel in this Texas case entered into a controversial settlement, in which class members received only discount coupons for tax preparation, but class counsel received \$49 million in attorneys fees.¹³¹ In 2003, the intervention of objectors resulted in a modification of the settlement whereby class counsel agreed to pay out \$26 million of their \$49 million in fees to class members, so that class members would receive cash payments in addition to coupons.¹³²

Cross-Lender Debt Collection Cases

In the initial NCLC/CFA 2002 RAL Report, we discussed a particularly abusive practice of RAL lenders in collecting prior RAL debts. In general, RALs place taxpayers at risk of owing the full amount of the loan if they do not receive all or part of their refund from the IRS. Furthermore, in order to collect these RAL debts, all of the RAL lenders have included a provision in their RAL agreements allowing them to take a consumer’s tax refund and use it to pay back any prior RAL debts *for any RAL lender*. Thus, if a taxpayer owes money to one RAL lender from a prior year and applies for a RAL from a different lender, her RAL will be denied and her refund will be gone. The second lender will take her refund and use it to repay the prior RAL debt to the first lender.¹³³

There have been several lawsuits filed against RAL lenders and tax preparers over this cross-lender debt collection practice. *Carbajal v. Household Bank, FSB*¹³⁴ involved claims against Household, H &R Block, and a number of other RAL lenders for violation of the federal Fair Debt Collection Practices Act, the Equal Credit Opportunity Act, and Illinois consumer protection laws. In *Carbajal*, Household successfully moved the court to send the case to mandatory arbitration.¹³⁵ *Hood v. Santa Barbara Bank & Trust*¹³⁶ is a

¹³⁰ 334 F.3d 638 (7th Cir. 2003).

¹³¹ This ruling and settlement are discussed in the NCLC/CFA 2003 RAL Report at 15-16.

¹³² *H&R Block to Pay \$26 Million Over Claims That Company Failed to Disclose Loan Fees*, BNA Banking Report, June 30, 2003, at 1052.

¹³³ NCLC/CFA 2002 RAL Report at 24.

¹³⁴ 2003 WL 22159473 (N.D. Ill. Sep. 18, 2003).

¹³⁵ Id.

similar class action and representative action brought under California's debt collection and unfair trade practices laws. NCLC is co-counsel for the putative class in this case. At least one more similar case has been brought.¹³⁷

XIV. Bank Accounts and Alternative RALs

As noted in our last report, bank accounts are critical to providing low-income taxpayers with an alternative to RALs, check cashers, and other high cost financial products. Indeed, our major issue with non-loan financial tax refund products such as RACs is not simply cost (since they are less costly and less risky than RALs), but the fact that it would be better to have the consumer in a bank account. Bank accounts lead to asset building and financial empowerment.

Free tax preparation groups continue to make and promote partnerships with financial institutions to bring unbanked EITC recipients into bank accounts. Many of the EITC Campaigns across the country have partnered with financial institutions, and are developing financial literacy/asset building campaigns.¹³⁸ For example, a First Accounts program operated by the Center for Economic Progress and ShoreBank has resulted in the opening of over 800 bank accounts to low-income residents in Chicago.¹³⁹

In addition, one of the large tax preparation chains has begun to make small steps in this direction. H&R Block has announced it is piloting a partnership with a bank to provide bank accounts in three cities.

One argument often made in defense of RALs is that these loans cannot be eliminated because some consumers will continue to demand them. However, just because consumers want RALs is no reason to charge excessive rates. That the rates charged by major RAL lenders are extremely steep can be shown by the fact that several credit unions provide RALs much more cheaply.

In 2003, Alternatives Federal Credit Union offered a special Tax Anticipation Note based upon its usual Line of Credit. Alternatives charged a \$20 fee and an 11.5% annualized interest rate for this low-cost RAL.¹⁴⁰ For a 10 day loan based on the average refund of about \$2,000, that works out to an APR of 47.5%, which is about one-third of the APR for a comparable RAL from Household or SBBT. Another example of a reasonably-priced RAL is from Progressive Neighborhood Federal Credit Union, which offered RALs at cost for \$17.¹⁴¹

¹³⁶ See Complaint, *Hood v. Santa Barbara Bank & Trust*, available at www.consumerlaw.org/initiatives/refund_anticipation.

¹³⁷ H&R Block, 2003 Form 10-K at 40.

¹³⁸ For examples of EITC campaigns that partnered with financial institutions, see Lisa Kaplan Gordon, et al., *Earn It, Keep It, Save It*, Annie E. Casey Foundation, 2003 (descriptions of EITC campaigns in Boston, Louisville and rural North Carolina).

¹³⁹ Center for Economic Progress, *First Accounts Program: Summary of First Year of Operation*, October 2003.

¹⁴⁰ Email from William Myers, Alternatives Federal Credit Union.

¹⁴¹ Email from Dianne Newhouse, Greater Rochester Earned Income Credit Community Coalition.

XV. Reforms

These are the RAL reforms that relate to the issues raised in this update. Other reforms, such as prohibiting cross-lender debt collection in RALs, halting the IRS Debt Indicator, and having IRS enforce its advertising rules about RALs, are discussed in the NCLC/CFA 2002 RAL Report and NCLC/CFA 2003 RAL Report.

- Regulate RALs by regulating tax preparers who make RALs. The NCLC model RAL law contains suggestions for states that are interested in such an effort.
- Make RALs subject to state usury and small loan interest rate laws. Enforce any existing loan broker statutes against tax preparers who facilitate RALs.
- Prohibit tax preparers from referring consumers to commercial check cashers, rent-to-own stores, or other high-priced financial services.
- Require tax preparers to be licensed and have minimum qualifications. State and federal regulators should address whether car dealers, check cashers, and payday lenders engaged in tax preparation are doing so competently and correctly.
- Require RAL lenders and tax preparers to include all of the costs of a RAL in the Truth in Lending disclosures, including any “dummy” account, administrative, electronic filing, or document preparation fees. RAL lenders should be prohibited from disclosing misleading APRs by subtracting out or “unbundling” charges.
- Streamline the Earned Income Tax Credit application process so that more consumers can apply without hiring commercial preparers. Until the goal of simplification is reached, the federal government should support and/or provide free direct assistance to help eligible consumers apply for the EITC.
- The IRS should carefully monitor the Free File program and report on the experiences of taxpayers who file using commercial tax preparers linked through www.irs.gov. This reporting should include the number of taxpayers that are sold RALs, the number of taxpayers who apply for EITC benefits through Free File, and the prices charged by Free File companies for related tax services.
- Treasury can provide bank accounts for EITC recipients who file their taxes electronically in order to receive direct deposits of refunds without having to purchase a RAL. Bank partnerships with free tax assistance programs can provide free or low cost savings accounts that remain open all year.
- Rethink the Congressional 2007 deadline for achieving an 80 percent electronic filing rate since achieving that goal is being borne by lower income taxpayers who pay for commercial tax preparation and RALs.