Consumer Federation of America

NATIONAL CONSUMER LAW CENTER®

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BEGINNING OF THE END?: MAJOR CHANGES TO QUICK TAX REFUND LOANS INDUSTRY

8.4 Million Refund Anticipation Loans Made in 2008; One of Biggest RAL Lenders Forced To Drop Loans

BOSTON – New figures show that some of America's most financially vulnerable taxpayers – those from low- and moderate-income families – lost about $800 million from their refunds in the latest year recorded to quickie tax refund loans, an often unnecessary and risky product.

As tax season gets started, consumer advocates at the National Consumer Law Center (NCLC) and Consumer Federation of America (CFA) are warning taxpayers to stay away from refund anticipation loans (RALs), one of the most avoidable tax-time expenses. New figures reveal that RALs drained the refunds of about 8.4 million American taxpayers in 2008, costing them in the neighborhood of $738 million in loan fees, plus over $68 million in other fees. In addition, another 12 million taxpayers spent $360 million on related financial products to receive their refunds.

There is good news in the fight against RALs. Santa Barbara Bank & Trust, which is one of the three biggest RAL lenders, was ordered out of the RAL business by its federal regulator. SBBT provided the bulk of Jackson Hewitt's RALs, leaving that company without a RAL source for over half of its stores.

Another RAL lender, Republic Bank & Trust, has dropped the price of its RALs to the same levels as H&R Block and JPMorgan Chase. This reduction means the vast majority of RALs now have reduced prices. Even with lower prices, however, consumer advocates urged taxpayers to avoid RALs.

"Taxpayers can save themselves loan fees altogether by just saying 'no' to quick refund loans," advised NCLC Staff Attorney Chi Chi Wu. "Taxpayers shouldn't forget that these are loans, and they carry the risk of loans, including unmanageable debt if your refund doesn't arrive as expected."

Furthermore, consumer advocates pointed out that some tax preparers may charge extra "add-on" fees for RALs, anywhere from $25 to several hundred dollars. The major chains generally do not charge these add-on fees, but other preparers may, which can easily double or triple the price of a RAL

<u>RALs Examined</u>

RALs are bank loans secured by the taxpayer's expected refund -- loans that last about 7-14 days until the actual IRS refund repays the loan. That's a good indication of just how needless most RALs are: Most taxpayers could have their refund in two weeks or less even without the costly loan.

"In tough economic times, quick money may be tempting. But American taxpayers need every dollar of their refunds, and waiting just a week or two will put more money in their pockets," says Jean Ann Fox, Director of Financial Services for CFA.

Using the most recent data available from the IRS, NCLC and CFA calculate that about 8.4 million taxpayers received RALs in the 2008 tax filing season (for tax year 2007). For that year alone, about 1 in 17 tax returns involved a RAL.

In addition to RALs, refund anticipation checks (RACs) are another product offered by tax preparers and their partner banks.[1] In 2008, about 12 million taxpayers received a RAC, at a cost of about $336 million. Taxpayers who have a bank account can avoid the expense of a RAC (generally about $30) by having their refunds direct deposited into their account, which is just as fast. H&R Block customers who received the Block Emerald Card in a prior year can have their refunds direct deposited onto those cards, and avoid a RAL or RAC.

"If you want your refund fast, file electronically and have your refund direct deposited to your own bank account," noted Chi Chi Wu, "You'll generally receive your refund in 8 to 15 days, or even faster."

<u>Price of RALs</u>

How much will taxpayers pay if they get a quickie tax loan? The price of a RAL includes several components –

- A loan fee ranging from $34 to $130, which is usually broken down into a "Refund Account" fee and a "Bank Fee."
- Some tax preparers may charge one or more separate add-on fees, sometimes called "application," "administrative," "e-filing," "service bureau," "transmission," or "processing" fees. Add-on fees can range from $25 to several hundred dollars. Add-on fees are not charged by H&R Block, Jackson Hewitt or Liberty Tax.

Due to changes over the last several years, the price of RALs has dropped significantly for loans in the $1,000 to $4,000 range. Thus, for example, the price for a typical RAL of $3,300 has decreased from over $100 in 2007 to about $65 in 2010 – a savings of 35% or more.

In general, the effective annual percentage rate (APR) for a RAL can range from about 50% (for a $10,000 RAL) to nearly 500% (for a $300 RAL).[2] If a $40 add-on fee is charged and included in the calculation, the effective APRs range from about 85% to nearly 1,300%. An average RAL of $3,300 carries an APR of 72%.

Tax preparers and their bank partners also offer an "instant" same day RAL for an additional fee, from $25 to $39. Some of the APRs for an instant RAL of around $1,500 are 185% (Block) and 211% (Chase).

[1] With RACs, the bank opens a temporary bank account into which the IRS direct deposits the refund check. After the refund is deposited, the bank issues the consumer a check and closes the temporary account. Also, if a taxpayer's RAL application is rejected, she is automatically given a RAC at a cost of $30 or so, even though the taxpayer may not have asked for it.

[2] Note that the RAL industry claims that these loans bear an effective APR of 36%, which is the traditional small loan rate cap in many states, but they do not include the "Refund Account" fee, which they claim is for the temporary account into which the taxpayer's refund is later deposited to repay the RAL. If the Refund Account Fee is included, it dramatically increases the APR, especially for loans under $1,000.

Finally, consumers who do not use one of the major commercial chains should ask if the preparer charges any add-on fees.

Changes in the RAL industry

On Christmas Eve 2009, Pacific Capital Bancorp announced that its federal banking regulator, the Office of Comptroller of Currency, had refused to provide regulatory approval for the bank to make RALs in the 2010 tax season. Pacific Capital Bancorp is the parent company for Santa Barbara Bank & Trust (SBBT). Pacific Capital Bancorp also announced that it would sell SBBT's Tax Division to a private equity firm.

SBBT was the main RAL lender for Jackson Hewitt, providing about 75% of the RALs offered by that chain. Jackson Hewitt reached a deal with a smaller RAL lender, Republic Bank & Trust, for that bank to provide for more RALs to Hewitt, but the increase only made up about 45% of Hewitt's RAL volume. Thus, Jackson Hewitt was left without a RAL lender for over half its stores. The private equity firm that purchased SBBT's RAL business has stated that it will make non-loan RACs to those stores, but not RALs.

Consumer advocates applauded the OCC's decision, but urged all of the federal regulators to take vigorous actions with respect to RALs for the banks under their supervision. The advocates urged regulators to prohibit any new banks from making RALs. For banks that currently make RALs, regulators were urged to monitor such lending closely, protect consumers, require adequate capital standards for these products, and ensure that banks properly train and supervise front-line staff in non-bank tax partner firms.

IRS to Regulate Tax Preparers

On January 4, 2010, the Internal Revenue Service (IRS) announced its plans to finally regulate the tax preparation industry. Currently, most tax preparers are not subject to any sort of licensing, competency or minimum educational requirements, a fact long criticized by consumer advocates and others, such as the National Taxpayer Advocate (www.irs.gov/advocate).

The IRS has proposed regulating tax preparers by requiring paid preparers to:

- register with the IRS and obtain a unique identification number;
- pass a competency test;
- take fifteen hours per year of continuing professional education; and
- comply with a code of ethics.

The IRS's proposals were the result of its six month review of the tax preparation industry, which it also published on the same day. The IRS's plan to regulate tax preparers will phase in over the next few years, and not apply to this tax year.

As for RALs and RACs, the IRS announced that it would create a task force to look at these products. It also promised to reexamine the Debt Indicator, an electronic acknowledgement service provided by the IRS that tells tax preparers whether a taxpayer's refund will be paid or will be intercepted for government debts. The Debt Indicator has benefited the RAL industry by lowering potential loan losses.

Consumer advocates had hoped that the IRS would go further and enact rules to prohibit or regulate RALs and RACs. The IRS had already opened a rulemaking docket in January 2008 asking whether the agency should prohibit tax preparers from sharing tax return information with banks to make RALs.

While more was hoped-for on RALs and RACs, consumers will benefit greatly from the IRS effort to strengthen regulation of tax preparers. A tax return is probably the most critical financial interaction that a consumer has with the federal government during the year, and a wrongly prepared return can lead to dire economic consequences. Ensuring that tax preparers are competent, licensed and bound by a code of ethics will benefit the consumers that rely on this industry for critical advice and assistance.

Reports on RALs

NCLC and CFA will be publishing their annual comprehensive report on the RAL industry, regulation, and litigation later in February 2010. The report will be available on NCLC's website at www.consumerlaw.org or on CFA's website at www.consumerfed.org.

In addition, a coalition of state and local consumer groups will be releasing reports on RALs for their regions, including the Community Reinvestment Association of North Carolina (www.cra-nc.org), NEDAP (www.nedap.org - based in New York City), Woodstock Institute (www.woodstockinst.org - based in Illinois) and the California Reinvestment Coalition (www.calreinvest.org).

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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 organizations, who represent low-income and elderly individuals on consumer issues.

CFA is a nonprofit association of some 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

Tips to Help Consumers Save Money and Your Privacy This Tax Season

Wait for your tax refund from the IRS. Don't pay a bank to loan you your own refund. If you file your return electronically and have the IRS direct deposit your refund into your checking or savings account, you can get all the money you have coming to you in less than two weeks. By waiting a week or two for your refund, you can save $65 or more.

Use free tax sites to prepare your tax return. Volunteer Income Tax Assistance (VITA) programs and AARP's TaxAide offer free tax preparation for low-income taxpayers. It'll save you the steep cost of tax preparation, keeping you from having to come up with money to pay for tax prep – a leading reason why people take out refund anticipation loans. Plus, non-profit community groups won't pitch you a pricy loan.

You can locate VITA sites by calling the IRS at 1-800-829-1040. Some of these sites are also listed on the website of the National Community Tax Coalition (http://tax-coalition.org/programs.cfm). Last year, programs were listed in over half the states.

AARP Tax-Aide offers free volunteer tax assistance at about 6,500 locations in senior centers, libraries, and other convenient sites. AARP Tax-Aide is available to taxpayers with low- and moderate-incomes, with special attention to people age 60 and older. To find a Tax-Aide location, go to www.aarp.org/VMISLocator/searchTaxAideLocations.do

The IRS partners with commercial tax preparation and software companies to provide free online federal tax preparation services and e-filing to most consumers. Tax preparers are not permitted to sell refund anticipation loans through Free File. To locate an online free service, go to www.irs.gov and click on "Free File" on the right hand side of the page.

Avoid check cashing fees. Get direct deposit of your refund into your own bank account. Tell the IRS to direct deposit your tax refund into your checking or savings account. Take your account number with you when you go to get your taxes prepared. If you don't have a bank account, you might want to open a savings account before you file your tax return in order to benefit from speedy direct deposit.

If you don't have a bank account, you can select a debit card that can receive direct deposit from the IRS. Watch out for debit card fees and restrictions that can make them a bad deal. Also avoid high-cost cash advance features that come with some prepaid cards.

Using direct deposit to get your refund also avoids the high cost of paying to cash a tax refund check. Check cashers typically charge 2 percent or more of the face value of a check. Cashing a $3,000 refund check can cost $60 or more. Funds direct deposited into a bank account are also protected by FDIC insurance.

Be careful of your privacy – watch what you sign! Tax preparers are permitted to share or even sell your private, confidential tax return information to marketers by simply getting you to sign on the dotted line. Read all the forms that your tax preparer gives you, and watch out for anything that gives permission for your preparer to share your tax information.