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Contact:

Chi Chi Wu, NCLC, 617-542-8010

Jean Ann Fox, CFA, 928-772-0674

QUICKIE REFUND LOANS: BAD FOR CONSUMERS, BAD FOR THE U.S. TREASURY

*RALs cost consumers hundreds of millions while linked to tax fraud and fringe preparers;
Congress urged to take action*

BOSTON – As tax season goes in full swing, another year has passed in which tax preparers and their partner banks drained hundreds of millions of dollars from refunds by selling refund anticipation loans (RALs), mostly to millions of working families who get the Earned Income Tax Credit (EITC). The National Consumer Law Center (NCLC) and Consumer Federation of America (CFA) issued their annual report today on the RAL industry, entitled “Big Business, Big Bucks: Quickie Tax Loans Generate Profits for Banks and Tax Preparers While Putting Low-Income Taxpayers At Risk.”

The report reveals that RALs drained the refunds of about 8.7 million American taxpayers in 2007, the last year on which the Internal Revenue Service provided data. This represents about \$833 million in loan fees, plus over \$68 million in other fees. In addition, another 11.2 million taxpayers spent \$336 million on related financial products to receive their refunds.

NCLC and CFA also issued a special companion report entitled “RALs, Tax Fraud, and Fringe Preparers.” This report discusses how RALs provide tax preparers with an incentive to inflate refunds and commit tax fraud, while attracting payday loan stores, check cashers, used car dealers, and other questionable businesses into the field of tax preparation.

“Not only do RALs siphon off hundreds of millions from the hard-earned tax refunds of American taxpayers, they also undermine the integrity of our tax system,” stated Chi Chi Wu, NCLC Staff Attorney, “Banning or reforming RALs would save money for taxpayers, and help the federal government reduce fraud and inaccurate filings.”

The report also discusses the need for Congressional action to stem the drain posed by RALs. A key development in 2008 was a decision by the Second Circuit Court of Appeals that obstructs the ability of states to regulate RAL fees. If correct, the Second Circuit’s decision means that only Congress can cap RAL rates. Senator Richard Durbin and Representative Jackie Speier have introduced the “Protecting Consumers from Unreasonable Credit Rates Act” that would cap interest rates for RALs, and other predatory loans like payday loans and auto title loans, to 36 percent.

“The Protecting Consumers from Unreasonable Credit Rates Act would stop RAL and other predatory lending abuses cold in their tracks,” stated Jean Ann Fox, Director of Financial Services for CFA, “That will put more dollars in the wallets of hard-working Americans. Cleaning up RALs and the finance industry in general is essential to a sustainable economic recovery.”

RALs Examined

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.

Using the most recent data available from the IRS, NCLC and CFA calculate that about 8.67 million taxpayers received RALs in the 2007 tax filing season (for tax year 2006). For that year alone, about 1 in 15 tax returns involved a RAL. In addition, 11.2 million taxpayers received a refund anticipation check (RAC)¹ in 2007, at a cost of about \$336 million. Nearly two-thirds of RAL borrowers are EITC recipients, even though they only make up about 17% of taxpayers.

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.

In general, the effective annual interest rate (APR) for a RAL can range from about 50% to nearly 500%. If a \$40 add-on fee is charged and included in the calculation, the effective APRs range from about 85% to nearly 1,300%.

RAL loan fees can vary significantly. H&R Block and JPMorgan Chase generally have lower RAL fees. In fact, they claim that these loans effectively bear APR of 36%. However, this does 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 more than doubles the APR.

Nonetheless, there are some real and significant price differences between various RAL outlets. For example, a RAL in the amount of \$3,000, which is typical, costs from \$62 to \$110.

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.

| Preparer/Bank | RAL fee (including Refund Account Fee) | APR (inc. Refund Account Fee) | Application/ Administrative Fee | Total Fee | APR with Application Fee |
|--|--|-------------------------------|---|--------------------|--------------------------|
| H&R Block/HSBC | \$62.14 | 77% | None (but addn \$20 if a paper check is issued for the RAL) | \$62.14 | 77% |
| Jackson Hewitt ² | \$105.95 or 110.45 | 134% or 140% | None | \$105.95 or 110.45 | 134% or 140% |
| Independent Preparer /Santa Barbara Bank & Trust | \$105.95 | 134% | up to \$40 | up to \$146 | Up to 187% |
| Independent Preparer/JPMorgan Chase | \$62 | 77% | Unknown | --- | at least 77% |
| Independent Preparer /Republic Bank & Trust | \$110.45 | 140% | Unknown | --- | at least 140% |

The Role of RALs in Tax Fraud and Fringe Preparers

In addition to draining the refunds of consumers, RALs have a negative impact on the integrity of tax administration. They promote tax fraud by preparers, and attract questionable fringe preparers into the tax preparation business. Fringe preparers include payday lenders, check cashers, pawn shops, rent-to-own stores, auto title lenders, used car dealers, travel agents, shoe stores, beauty salons, furniture stores, grocery stores, jewelry stores, liquor stores, and even an occasional “therapy” office.

Concerns over whether RALs provide incentives to inflate refunds prompted the IRS to open a rulemaking proceeding in 2008. NCLC, CFA and other consumer groups submitted extensive evidence in this rulemaking, which is included in the special report. The report includes updates with more recent information.

The report cites several dozen criminal tax fraud cases involving RALs, including 11 announced in the past year all over the country. It notes that many experts on fraud, including the Treasury Department’s financial crimes experts, a Harvard professor fraud specialist, and even IRS’s own criminal investigators had made the connection between RALs and fraud. In 2008, IRS conducted its own study finding that RAL returns are 27% to 36% more noncompliant than returns without a bank product.

RALs also promote the existence of fringe tax preparers, who are attracted by the financial incentives for RALs and/or taxpayers’ ability to use loan proceeds to buy merchandise. The special report discusses how software providers and remote tax preparation services enable fringe preparers to operate. It includes dozens of examples of fringe preparers, plus a review of

² Based on pricing by SBBT or Republic.

IRS authorized e-file providers from five states (Arizona, Florida, Illinois, Massachusetts, and South Dakota) listing hundreds of fringe preparers.

Other Developments

Pacific Capital Bancorp v. Connecticut

The Second Circuit Court of Appeals issued a major decision hampering the ability of states to regulate RALs. The Second Circuit held that federal banking law preempted the interest rate caps of the Connecticut RAL law, despite the fact that the law does not regulate what the banks can charge, but only prohibits third-party tax preparers from facilitating RALs over 60% APR. In response to the Second Circuit's decision, NCLC has issued a revised Model RAL law that focuses on the abuses that states can still regulate according to the Second Circuit.

RALs and Pricing of Tax Preparation Services

The NCLC/CFA 2009 RAL report also discusses how RALs and RACs allow tax preparers to obfuscate the price of tax preparation. Tax preparation fees are almost always deducted from the RAL or RAC proceeds, making taxpayers less sensitive to their costs. This permits preparers to resist giving a firm quote for the price of preparation. It also allows them to pad their fees with extra "add-on" charges. One software provider for tax preparers brazenly recommends "lowballing" tax preparation charges to get the customer in the door, then charge more in add-on fees to make up for the "lowball" price.

Studies on RALs and Tax Preparers

This past year, government investigators and consumer/advocacy groups issued several significant studies documenting RAL abuses as well as incompetent tax preparation. Consumer/advocacy groups conducted mystery shopper testing in Philadelphia, Durham, NC, and Alabama. The Treasury Inspector General for Tax Administration conducted a survey of RAL borrowers finding that 85% would be willing to wait up to nine days to receive their refund directly from the IRS, and that the IRS' average time for an e-filed, direct deposit refund is 10 days. The same agency also conducted mystery shopping of tax preparers, finding many did not prepare an accurate return.

Report Available for Download

The NCLC/CFA 2009 RAL report and its companion report on RALs, Tax Fraud and Fringe Preparers is available at http://www.consumerfed.org/pdfs/2009_RAL_Report.pdf.

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CFA is a nonprofit association of some 300 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.