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TAX-TIME CONSUMER TROUBLES

Preparer Fraud, High Fees, and Tax-Time Financial Products Plague Consumers

Download the full report:
http://www.nclc.org/images/pdf/high_cost_small_loans/ral/rpt_tax_time_products_22814.pdf

(BOSTON) As the tax season goes into full swing, advocates from the National Consumer Law Center and Consumer Federation of America have issued their annual report on the tax-time consumer issues: *It's a Wild World: Consumers at Risk from Tax-Time Financial Products and Unregulated Preparers.*

The biggest problem cited by the report is the lack of regulation for paid tax preparers. "This year, tens of millions of consumers will use paid preparers to fill out one of the most important financial documents of their year," stated Chi Chi Wu, staff attorney at the National Consumer Law Center (NCLC). "Yet most of these preparers are not subject to any minimum educational, training, or competency standards."

The lack of regulation has allowed incompetence and abuses by tax preparers to flourish, putting consumers at risk of audit by the Internal Revenue Service (IRS) or even criminal sanctions. Another problem faced by consumers is that they cannot get price quotes or estimates about how much a paid preparer will charge them.

One problem that is no longer facing millions of taxpayers are high-cost, high-risk refund anticipation loans (RALs), which are no longer available from banks on a large scale, nationwide basis. However, taxpayers are still at risk of needless fees from tax-time refund products, such as:

- **Refund anticipation checks (RACs)** – RACs do not deliver refund monies any faster than the IRS can, yet cost $30 to $55. Some preparers charge additional "add-on fees," which can range from $25 to several hundred dollars.
- **RALs from fringe, non-bank lenders** – A few payday and other high-cost lenders are offering RALs. These loans could be more expensive and riskier than bank RALs.

Consumer advocates suggest that taxpayers looking for quick refund cash should consider lower-cost or free alternatives. Taxpayers with a bank account can get their tax refunds in 8 to 21 days with e-filing and direct deposit. Taxpayers without a bank account can get the same fast refund by e-filing and having their refund deposited to a prepaid card, including any payroll or prepaid card that the taxpayer already has. Taxpayers without a bank account should also consider opening a bank account to receive their refund. "Getting a big refund is the perfect time to open a savings account and start a nest egg," advised Tom Feltner, director of financial services for Consumer Federation of America.

The Wild World of Paid Tax Preparers

One of the most surprising aspects about paying taxes in the United States is the lack of regulation for most tax preparers. Forty-six states do not have any minimum educational, competency, or training standards for paid tax preparers. While some tax preparers are licensed as certified public accountants (CPAs) or credentialed by the IRS as enrolled agents, the vast majority do not have such qualifications. Indeed, the only tax preparers apart from CPAs and enrolled agents subject to testing and regulatory oversight are the unpaid volunteers at Volunteer Income Tax Assistance (VITA) sites. "All 50 states regulate hairdressers, but only four regulate tax preparers," noted Wu. "It's up to Congress or the states to step up to the plate."

A recent NCLC report documented how this lack of regulation has allowed incompetence and abuses by tax preparers to flourish. The report, *Riddled Returns*, analyzed years of mystery shopper testing by government agencies, consumer groups, and advocacy organizations, all of which found disturbingly high levels of incompetency and outright fraud, such as:

- Intentional omission of income;
- Falsifying information to make the taxpayer eligible for various credits and deductions, such as charitable deductions, job-related or business expenses, and the Earned Income Tax Credit (EITC); and
- Inability to accurately handle education-related items, such as grants and tuition credits.

Government enforcement actions also provide evidence of widespread abuses by paid tax preparers. The latest example is a decision issued this past November by a federal judge shutting down the nation's fourth largest tax preparation chain, Instant Tax Service, and permanently banning its owner from the business of tax preparation due to "an astonishing array of repeated fraudulent and deceptive conduct."

Incompetence and fraud could be costing federal and state governments tens of millions of dollars in lost tax revenue. It ultimately hurts consumers as well, by exposing them to potential IRS audits, civil penalties, or even criminal sanctions.

The NCLC report calls on states to regulate tax preparers to address preparer abuse and incompetency. The IRS attempted to address the problem in 2011 with regulations requiring tax preparers to register with the IRS and pass a competency exam. A federal court struck down these common-sense requirements as exceeding the IRS's statutory authority, a decision that was recently upheld by the D.C. Court of Appeals.

To assist states seeking a solution to the problem of unregulated tax preparers, NCLC released a Model Individual Tax Preparer Act with its report. The model law is based on three of the four state laws that do regulate tax preparers (Maryland, Oregon, and California), as well as the IRS regulations. (In December 2013, New York also began regulating paid preparers.)

High Tax Preparation Fees

Another problem facing consumers when using paid tax preparers is the severe lack of transparency regarding the fees for these services. Taxpayers, especially lower-income recipients of the EITC, may pay up to $500 or more in fees. Yet taxpayers often cannot get information beforehand on how much tax preparation will cost them because many preparers claim they cannot give a quote or give inaccurate lowball estimates. "Tax preparation is one of the few businesses in this country where consumers can't get an accurate price quote before buying the service," stated David Rothstein, director of Resource Development & Public Affairs at NHS of Greater Cleveland and author of "Improving Tax Preparation With a Model Fee Disclosure Box. "The lack of transparency and disclosure is stunning. How can there be a competitive market if consumers can't comparison shop due to lack of price information?"

A free or inexpensive alternative for low-income taxpayers are free tax preparation sites, including VITA sites (1-800-906-9887 or www.irs.gov) and AARP Tax-Aide sites (https://locator.aarp.org/vmis/sites/tax_aide_locator.jsp). Choosing a VITA or AARP Tax-Aide site saves eligible taxpayers the cost of a tax preparation fee. Many VITA sites can also help taxpayers open a bank account or get a low-cost prepaid card, which enables taxpayers to get fast refunds without paying a fee. Free tax preparation may be available on military bases as well.

There are also a number of websites that allow low- and middle-income taxpayers to prepare and file their taxes online for free, such as the IRS Free File program (www.irs.gov).

RACs and Non-Bank RALs

Refund anticipation checks (RACs) are a financial product used to deliver refunds and to pay for tax preparation fees by deducting them from the consumer's tax refund. With RACs, the bank opens a temporary bank account into which the IRS direct deposits the refund monies. After the refund is deposited, the bank issues the consumer a check or prepaid card and closes the temporary account. A RAC allows the consumer to pay for tax preparation fees out of the refund and provides the speed of direct deposit of tax refunds for unbanked taxpayers, but generally at an additional cost.

Banks generally charge about $30 - $55 for a RAC delivered via check (with discounts for delivery by prepaid card or direct deposit). In addition, some tax preparers charge their own "add-on" fees, which can range from $25 to several hundred dollars. Consumer advocates recommend that taxpayers consider alternatives to a RAC, or at least choose a preparer that does not charge add-on fees.

Since the main purpose of a RAC is to defer payment of the tax preparation until the refund arrives, it can be viewed as a high-cost loan of that fee. If a taxpayer pays $30 to defer payment of a $200 tax preparation fee for 3 weeks, the annual percentage rate (APR) is 260%. Two courts have held that a RAC constitutes a loan of the tax preparation fee, and thus the fee is a finance charge under the Truth in Lending Act.

With the end of RALs made by banks, high cost non-bank lenders have stepped into the fray. Last year, Liberty Tax Service offered a non-bank RAL in partnership with two companies that appeared to be linked with Texas payday lenders. Fortunately, RALs made by nonbank lenders are not nearly as widespread as bank RALs. Last year – the first in which only nonbank lenders made RALs – a mere 100,000 consumers applied for the loans. In comparison, about 12.7 million consumers obtained a RAL at the height of the industry in 2002.

One reason that non-bank RALs are not as widespread is that nonbank lenders do not have the legal ability, unlike banks, to flout state laws that cap interest rates, *i.e.*, usury laws. Tax-time loans from payday lenders and other storefront outlets that offer to prepare taxes and make loans may be subject to state loan laws, usury caps, or loan broker requirements in states that have them. Seventeen states and the District of Columbia do not permit payday lending at all. Also, nonbank lenders may not have the funding necessary to make RALs on a broad scale. In order to make even those 100,000 RALs, nonbank lenders needed access to $150 million in capital (assuming loans of $1,500).

RAL and RAC Data for Prior Years

RALs were bank loans secured by the taxpayer's expected refund ─ loans that lasted about 7 to 14 days until the actual IRS refund repays the loan. RALs are expensive. In 2012, the last of the RAL banks (Republic Bank) charged $61.22 for a RAL of $1,500, which translated into an APR of 149%.

RAL lending dropped significantly during the last two years in which banks made the loans.

- In 2012, about 840,000 taxpayers applied for a RAL and we estimate that 630,000 obtained them.
- In 2011, one million taxpayers applied for a RAL and we estimate that 750,000 received them.

In contrast:

- In 2010, 6.85 million taxpayers applied for a RAL and we estimated that 5 million received them.
- At their height in 2002, about 12.7 million taxpayers obtained a RAL.

The small number in 2012 was due to the fact that only one bank, Republic Bank & Trust, made RALs that year. All of the other RAL-lending banks had either voluntarily stopped making the loans or were forced out of the business by their federal bank regulator. By 2013, the first year in which only nonbank lenders made RALs, a mere 100,000 consumers applied for a RAL.

Many RAL borrowers have now shifted to RACs. In 2012 and 2013, the number of taxpayers receiving a RAC increased to an estimated 21 million. This is in comparison to 18.4 million taxpayers in 2011; 14.6 million taxpayers in 2010 and 12.9 million in 2009.

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Since 1969, the nonprofit **National Consumer Law Center® (NCLC®)** has worked for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the U.S. through its expertise in policy analysis and advocacy, publications, litigation, expert witness services, and training. **www.nclc.org**

The **Consumer Federation of America** is an association of nearly 300 nonprofit consumer groups that was established in 1968 to advance the consumer interest through research, advocacy and education. **www.consumerfed.org**