

A National RAL Platform: Issues and Options*

I. Background on Refund Anticipation Loans (RALs)

RALs are high cost short-term loans secured by taxpayers' expected tax refunds. Instead of waiting for their refund to arrive, RAL customers borrow against part or all of it to obtain the money within one or two days. Consumers pay three fees to get a RAL:

- a fee for commercial tax preparation, typically around \$120;
- a fee to the commercial preparer to process the RAL, sometimes called a "system administration", "application", or "document preparation" fee, with the average fee being about \$30;
- a loan fee to the lender, ranging from about \$30 to over \$100 in 2004.

The total amount of the three fees can range from \$180 to over \$250, and eat away at about 10% of the consumer's refund. A RAL is essentially a loan of 8-15 days, since that's how long it takes the IRS to issue a refund if the taxpayer chooses e-filing and direct deposit. Thus, the RAL loan fee translates into effective annualized interest rates of about 70% to over 700%, or 94% to 1837% if administrative fees are included.

The loan is not made by the tax preparer, but by a separate lender, usually a bank. Commercial preparers facilitate the loans, acting as loan agents. The RAL industry is dominated by the two major commercial preparation chains -H&R Block and Jackson Hewitt -- and by three banks -- Household/HSBC, Santa Barbara Bank & Trust, and Bank One.

RAL volume has increased steadily over the past few years. In 2000, an estimated 10.8 million consumers received RALs, paying approximately \$810 million in loan fees. In 2001, the number of consumers receiving RALs rose to about 12.1 million, with \$907 million spent in loan fees. By the 2002 filing season, the RAL volume rose again, to 12.7 million RALs, with \$1.14 billion spent in loan fees.

EITC earners make up a majority of those taxpayers requesting a RAL. In 2002, EITC recipients made up 55 percent of RAL borrowers, even though they made up only 15 percent of taxpayers generally. The drain on the EITC caused by RALs is substantial. In 2002, EITC recipients spent an estimated \$525 million in loan fees on RALs. Tax preparation fees and "system administration"/electronic filing fees add another \$1.06 billion to the drain. Further, many EITC recipients lack a bank account to cash their checks. Thus, they rely heavily on check cashing outlets, which charge high fees. Adding check cashing fees, the total drain on EITC earners is \$1.75 billion.

II. Options for Federal Legislation

Congress has the ultimate authority to ban or regulate RALs. Options to regulate RALs range along a spectrum and include:

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1. **Ban RALs.** Congress could make it illegal to make loans secured by an anticipated refund.
2. **Ban RALs that are secured by EITC refunds.** Congress could ban RALs secured by the EITC by prohibiting attachment, set-off, or other seizure of EITC benefits. Such a measure would not be unprecedented - there is a similar law protecting Social Security and SSI benefits.
3. **Cap RAL fees.** Congress could establish a legislative interest rate cap for RALs. Historically, the states, not the federal government, have regulated interest rates. Because of the deregulation of credit by federal preemption, however, the states are not able to regulate the interest rates charged by federally-chartered banks such as the major RAL lenders
4. **Establish a licensing scheme for tax preparers and/or facilitators.** RALs could be regulated as part of an overall scheme to regulate tax preparers.
5. **Prohibit or regulate abusive features of RALs.** There are a number of other aspects of RALs, besides their cost, that can be considered abusive, including:
 - a. debt collection by set-off of a tax refund.
 - b. mandatory arbitration clauses.
 Congress could ban or regulate these abusive practices.
6. **Modify IRS administrative goals re: reaching the 80% e-file rate.** One of the main reasons IRS takes a hands-off approach toward RALs, and in fact aids them through the debt indicator (see IV.2 below) is because RALs help increase the number of e-filed returns. The IRS is under a mandate set forth in the IRS Restructuring and Reform Act of 1998 to reach an e-file rate of 80%. Congress could revisit this goal, or could require that a new e-filing goal exclude returns accompanied by a RAL.
7. **Require better disclosures on RALs.** Better disclosures would not eliminate RALs or change their negative aspects, but it may result in some consumers having adequate information to choose to decline them. Options include:
 - a. mandatory warning language and text size
 - b. wall postings
 - c. amend the Truth in Lending Act to prohibit unbundling of fees, so that the disclosed APR reflects the true costs of getting a RAL.
8. **Dramatically simplify tax code for low-income filers.** Simplifying the tax code for low-income taxpayers would reduce the need for them to use commercial preparation services, and hence reduce the number of RALs.
9. **Fund “banking the unbanked” programs.** These programs could provide alternatives in the form of bank accounts that enable low-income taxpayers to receive their refunds quickly through direct deposit.

III. Options for State or Local Regulation

States are limited in their ability to regulate the banks that make RALs due to preemption by federal banking statutes and regulators. In particular, the doctrine of rate exportation preempts state usury laws by allowing banks to charge the maximum interest rate permitted in the banks’ own home states – to avoid usury caps, banks simply charter in a state without one. Because of federal preemption, state and local regulation should be primarily targeted at “facilitators,” i.e., the tax preparers who partner with banks to offer RALs and other tax refund financial products to consumers. Components of state regulation of RALs could include:

1. **Capping RAL fees by regulating facilitators.** States could prohibit facilitating RALs where the total loan fees exceed 36% or the state usury cap, whichever is lower. However, some state legislators and regulators have been skittish about preemption even with this approach.
2. **Impose a duty on return preparers to act in the best financial interests of their customers.** This duty – called a “fiduciary duty” - would require preparers to truthfully inform customers about their options to receive a refund and recommend the option that would be most beneficial to the customer, not the preparer.
3. **Establish a registration scheme for RAL facilitators.** A state could require RAL facilitators to register with a state agency, put up a bond, file annual reports, and adhere to a code of conduct.
4. **Require better disclosures on RALs.** Again, better disclosures would not eliminate RALs or change their negative aspects, but it may result in some consumers having adequate information to choose to decline them. These include:
 - a. mandatory warning language.
 - b. wall postings.
 - c. require disclosure of special “RAL interest rate” that includes all RAL fees.
5. **Regulate advertising of RALs.** States could require certain language be included in all advertisements for RALs (e.g., “A RAL is a loan”) or prohibit advertising that does not meet certain requirements (e.g., a conspicuous statement that the product is a loan).
6. **Prohibit or regulate abusive features of RALs.** Similar to the federal option, a state could prohibit:
 - a. debt collection by set-off of a tax refund.
 - b. certain aspects of mandatory arbitration clauses.
 - c. referrals to check cashers or permitting check cashing on the premises.
7. **Regulate check cashing fees for RALs and refund checks.** Since a significant percentage of EITC recipients do not have bank accounts, one way to save them money is to regulate the fee for cashing a RAL or tax refund check. Some states already cap the fee for cashing a government check, but tax refund and RAL checks may not be covered under these caps – a state could extend the cap to RAL and refund checks.
8. **No RALs based on state tax refunds.** A state could prohibit RALs secured by a state refund, as does North Carolina. (Note that most RAL lenders don’t make RALs against state refunds.)

A critical feature of any state legislation is the ability of consumers to sue for violations. Without a “private right of action,” consumers harmed by violations of the law do not have the ability to seek relief. As for local governments, their ability to enact the options listed above will depend on their authority under state law, which varies by state.

See the Resources Section re: the National Consumer Law Center’s model state legislation which includes most of these options.

IV. Options for Treasury/IRS Administrative Action

There are also administrative actions that can be taken by the Department of Treasury and/or IRS without passage of any new laws. The administrative options described below include steps that address some of the problematic features of RALs as well as ones which can reduce market demand for RALs.

1. **Speed IRS refund turnaround time to 48–72 hours.** The IRS has asserted that it will have the ability to issue a refund within two to three days using direct deposit, versus an average of

- ten days under the current system. Faster refund processing would reduce the attractiveness of RALs. However, the current timetable for accomplishing this is unclear and – with the agency facing budget cuts – it seems to have fallen aside as an IRS priority. Also, the IRS has previously indicated that it may not expedite refunds for the EITC portion of the refund. The move to quicker refunds should apply to all of the refund.
2. **Eliminate the debt indicator program.** With the debt indicator program, the IRS screens electronically filed returns and informs tax preparers whether the federal government has any claims against the taxpayers' refunds. The debt indicator has been criticized as a government-funded program that aids RALs, increasing lender profitability. The IRS could drop the debt indicator program as it did in the mid-1990s.
 3. **Improve and expand the Advance EIC.** Less than one percent of EITC taxpayers used the advance credit option in 2002. By reducing the portion of the credit refunded at tax time, the Advance EIC could presumably serve to reduce the demand for RALs—by increasing RAL price relative to the refund amount, and perhaps by giving families more resources to help them avoid falling behind on bills during the year. However, the Advance EIC is not appropriate for all families (and can result in overpayment and tax liability if incorrectly applied). Therefore, any attempts to promote the Advance EIC should be combined with steps to help ensure it is claimed only in appropriate situations.
 4. **Prohibit RALs from being made through the Free File program.** The IRS Free File program is a partnership between the IRS and commercial tax preparers. Under the program, low-income and certain other taxpayers are eligible to prepare and electronically file their taxes for free; those who qualify are referred from the IRS website directly to the website of a participating commercial preparer, where they use the preparer's on-line software. Currently, the IRS permits commercial preparers to market RALs to taxpayers who use Free File. However, the IRS could choose to prohibit preparers from offering RALs to Free File taxpayers.
 5. **Amend IRS privacy regulations to strengthen protections against use of taxpayer information to cross-market financial products.** The IRS Code has strong privacy protections for tax return information, including a prohibition on the use of such information for marketing purposes. However, the IRS regulations include an exception that allows preparers to use taxpayer information for marketing so long as the preparers obtain the taxpayer's consent. This consent is generally a boilerplate form embedded in a stack of documents that taxpayers are given to sign. Stronger protections against marketing might lessen the number of RALs.
 6. **The Federal Reserve Board should apply the consumer protections of the Electronic Fund Transfer Act to stored value card products that receive tax refund or RAL proceeds.** The Electronic Fund Transfer Act (EFTA) is a federal law that provides consumer protections for ATM, debit card, Internet and other electronic transactions from a consumer's bank account. Currently, it is unclear whether these protections, including protections from liability due to loss or theft, apply to stored value cards. The Federal Reserve Board could ensure that stored value cards that receive tax refunds or RAL proceeds are covered under EFTA by amending Regulation E, which implements EFTA.

V. Resources

ACORN (Association of Community Organizations for Reform Now), *Increasing Incomes and Reducing the Rapid Refund Rip-Off*, September 2004.

Alan Berube and Thacher Tiffany, *The "State" of Low-Wage Workers: How the EITC Benefits Urban and Rural Communities in the 50 States*, February 2004.

Alan Berube, *Rewarding Work Through the Tax Code*, Brookings Institution, January 2003.

Alan Berube, et al., *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC*, Brookings Institution and Progressive Policy Institute, May 2002.

Children's Defense Fund Minnesota, *Keeping What They've Earned: Working Minnesotans and Tax Credits*, January 2003.

Children's Defense Fund, *How You Can Help Working Families: Recommendations to Address Costly Tax Preparation*, February 2004.

Community Action Committee of the Lehigh Valley and the Rising Tide Community Loan Fund, *Refund Anticipation Lending Report*, August 2004.

National Consumer Law Center, *Model Refund Anticipation Loan Act*, February 2004.

National Consumer Law Center, *Don't Pay to Borrow Your Own Money: The Risks and Costs of Tax Refund Anticipation Loans* (consumer education brochure).

Chi Chi Wu and Jean Ann Fox, *All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low-Income Americans*, National Consumer Law Center and Consumer Federation of America, January 2004.

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.

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 2002.