

**SUMMARY OF H&R BLOCK TESTIMONY ON REFUND LOANS AND TAX-RELATED PRODUCTS
SENATE PERMANENT INVESTIGATIONS SUBCOMMITTEE FIELD HEARING
ST. PAUL, MN, APRIL 15, 2005**

- **Block Background.** H&R Block, founded in 1955, has 205 offices in MN with 1,400 employees who prepare returns for over 245,000 Minnesota residents. H&R Block return preparers average 3 years experience and over 225 hours training.
- **Block Services.** Block services also include financial education; alerts on key government benefits (like Food Stamps and children's health insurance); tax-advantaged savings opportunities for retirement; and free online tax prep and filing for Minnesota taxpayers through the IRS's Free File Alliance.
- **RAL Benefits.** Through a bank partner, we offer refund loans that provide speed, convenience, and security to taxpayers who want funds faster than IRS delivery. Loans save 3-8 weeks for those without bank accounts and about 2 weeks for those with accounts; all fees are deducted.
- **RAL Costs.** RALs are more expensive than some forms of credit. Costs include a \$24.95 bank account set-up fee and a \$5-\$85 finance charge for loans ranging from \$200-\$10,000. At H&R Block corporate offices a \$3,000 loan costs \$99.95 (3.3% of the refund amount) with a 114% APR. RALs can be less costly and less damaging to a consumer's credit rating than alternatives such as late payments, bounced checks, credit card advances, or payday loans.
- **Full Disclosures.** We ensure that consumers are fully informed of all options and costs, presenting free alternatives first. Our disclosures, developed with the former head of the Federal Trade Commission's Bureau of Consumer Protection, include a "Facts About RALs" document and a side-by-side comparison on the tax prep computer screen. Client satisfaction is high.
- **Regulation.** Bank lending is regulated by the federal government. The IRS regulates tax return preparers and electronic return originators, including RAL facilitators, who undergo criminal background and tax filing checks. Advertising is regulated. Deceptive practices are prohibited. Penalties are provided. Consumers must be informed that RALs are not refunds, that they are responsible for payment if the IRS does not issue a full refund, etc.
- **Legislation.** Minnesota has enacted RAL legislation which is working well. We advocate federal legislation to achieve uniform national standards.
- **Peace of Mind.** H&R Block offers an extended service guarantee that is a proven value to our clients including audit representation and limited payment of tax liability resulting from our error. Our policies ensure that clients can make informed decisions, without pressure, about their need for added coverage.

Celebrating its 50th anniversary in 2005, H&R Block is the world's largest tax services provider, having served more than 400 million clients since 1955. The sixth largest retailer in the world, H&R Block has more than 12,500 locations serving taxpayers in the United States, Canada, Australia and other countries. Headquartered in Kansas City, H&R Block served more than 19 million U.S. clients during fiscal year 2004 at approximately 10,000 H&R Block retail offices worldwide and through software and online services. Over 167,000 company and franchise employees deliver tax services including preparation of one out of seven individual tax returns filed with the IRS. H&R Block tax schools trained 250,000 students including 84,000 enrolled in a 66-hour basic tax course. H&R Block served 3.2 million tax clients through its *TaxCut*® software and through online tax preparation services. H&R Block's subsidiaries also deliver financial advice, investment and mortgage services, and business accounting and consulting services. H&R Block Financial Advisors Inc., headquartered in Michigan, offers investment services and securities products. With approximately 1,000 financial advisors serving clients at approximately 270 branch offices, H&R Block Financial Advisors is a member NYSE, SIPC, a registered broker-dealer and investment advisor. H&R Block Inc. is not a registered broker-dealer and is not a registered investment advisor. H&R Block Mortgage Corp. offers a full range of retail mortgage services. Option One Mortgage Corp., headquartered in California, provides mortgage services and offers wholesale mortgages through large financial institutions and a network of 24,000 independent mortgage brokers. RSM McGladrey Business Services Inc., headquartered in Minnesota, and its subsidiaries serve mid-sized businesses and their owners with tax, accounting and business consulting services, as well as personal wealth management services. H&R Block Small Business Resources, operating in 14 U.S. cities, serves the tax, financial and business needs of small business owners. H&R Block Small Business Resources is not a licensed CPA firm.

**STATEMENT OF H&R BLOCK ON REFUND ANTICIPATION LOANS
AND TAX-RELATED FINANCIAL PRODUCTS
SENATE PERMANENT INVESTIGATIONS SUBCOMMITTEE
FIELD HEARING, ST. PAUL, MN
APRIL 15, 2005**

Mr. Chairman, thank you for the opportunity to present the views of H&R Block on refund anticipation loans and other tax-related financial products.

H&R Block in Minnesota. H&R Block has been in business since 1955 and our roots in Minnesota run deep. Our tax subsidiaries and their franchisees have 205 offices (112 company-owned and 93 franchised) in Minnesota with nearly 1,400 employees who prepared tax returns for over 245,000 state residents last year. That number includes many recipients of the federal Earned Income Tax Credit, bringing over \$111 million into the state in addition to the non-EITC portion of tax refunds, as well as recipients of Minnesota's Working Family Credit.

We are committed to high quality tax return preparation and financial advice. Our preparers undergo extensive training and are bound by a company code of ethics as well as federal rules covering tax preparation services. We assist our clients by—

- filing an accurate tax return;
- obtaining all the credits and deductions to which they are entitled, with a particular focus on low-income taxpayer benefits such as the Earned Income Tax Credit;
- advising them of planning and tax-advantaged savings opportunities;
- providing brochures with basic financial education;
- informing them about key government programs for which they may be eligible such as children's health insurance, programs for women, infant and children's nutrition, food stamps, and school lunches;
- informing low-income seniors of available prescription drug discounts; and
- offering free online tax preparation and filing for thousands of Minnesota residents through the IRS Free File partnership.

We strongly support the IRS's volunteer tax preparation program, in which many of our associates participate and for which we provide training scholarships, and our tax associates work in a variety of community and neighborhood activities.

Refund Loans. A refund anticipation loan (RAL) is money borrowed by a taxpayer from a lender based on the taxpayer's anticipated income tax refund. Banks make the loans, which are facilitated by tax return preparers. The loans are lawful, federally sanctioned, and popular with consumers.

Benefits include speed, convenience, and security. Taxpayers value speed to meet immediate needs or family emergencies. Those without a bank account or unable to secure a conventional loan use RALs to expedite funds, saving 3-8 weeks. Those who do have bank accounts and who file their tax return electronically save about 2 weeks. The product is convenient because tax preparation fees are deducted and taxpayers can receive accurate, professionally prepared returns, with work guaranteed and year-round support available, without up-front payment. Delivery of the loan check at the tax office helps those concerned about mail security.

RALs are extensively regulated by federal lending laws and Internal Revenue Service rules that require borrowers to be fully informed of costs and alternatives. H&R Block's tax professionals advise clients of possible refund delivery times, explain non-bank free IRS options first, and caution clients that less expensive forms of credit may be available.

Faster IRS refund processing, which we strongly support, will reduce the need for RALs. Better enforcement of federal regulations can curb any abuses that may occur. Added regulation may help ensure that the product is offered responsibly by all RAL facilitators, which is why we support higher uniform federal standards.

Informed Consumer Choices

Refund Options. Nationally, 77% of taxpayers received refunds averaging \$2,057 in 2004, according to the IRS. Average refunds for filers using direct deposit were \$2,438, and even higher for those who chose a refund loan. Taxpayers have several options for receipt of funds. H&R Block tax professionals are trained to explain the no-added-fee IRS refund options first:

- Taxpayers who elect to file their returns on paper can receive their IRS refund check via mail in 6-8 weeks or via direct deposit to their bank account in 5-7 weeks.
- Taxpayers who file electronically can receive their IRS check in half that time, about 3 weeks by mail or an average of 12 days by direct deposit if they have a bank account.
- Taxpayers who e-file through a paid tax preparer can receive funds in 8-15 days from a bank, after tax preparation and transaction fees have been deducted, through a Refund Anticipation Check (RAC). The RAC is attractive to those who do not have a bank account but want a speedy refund without a loan and who may be unable to pay the preparation fee at the time of filing.
- Taxpayers who e-file through a paid tax preparer can receive funds in 1-2 days (or within an hour for qualified borrowers) with a RAL from a bank. Fees for the loan, as well as tax preparation, are deducted from the loan proceeds. Some return preparers charge their own administration fee, although H&R Block company offices and most franchisees do not.

Informed Choice. To ensure that consumers understand that they are taking a loan and have an obligation to repay it regardless of the size of their actual IRS refund, H&R Block provides layered disclosures developed in consultation with the former head of the Federal Trade Commission's Bureau of Consumer Protection. We objectively advise clients of their refund options in—

- Our welcoming brochure.
- A plain language "Facts About RALs" document at the tax desk.
- A side-by-side comparison on the computer screen facing the consumer and the tax preparer, showing features of each option, including tradeoffs between cost and speed.
- *The Block Advantage Report*, following the completed tax return, which includes tax and financial tips and which advises clients how to keep more of their refund in their pocket.

In each instance, we advise clients of the no-cost IRS options before discussing options that involve additional fees.

Obligations are fully detailed in the bank's RAL application and disclosure forms, which use the term "loan" or "RAL" (clearly defined as a loan) over 100 times and which comply fully with Truth in Lending Act disclosure requirements, as well as federal and state privacy standards. The application includes the word "LOAN" in the background on page one in clear capital letters measuring 2 x 7.5 inches. IRS rules require that taxpayers understand that RALs are interest bearing loans and not substitutes for or a faster way of receiving a refund. Clients acknowledge understanding that—

- (a) I can file my federal income tax return electronically without obtaining a RAL;
- (b) the IRS will send me a refund check or electronically deposit my refund to my existing bank account;
- (c) the IRS normally sends a refund check by mail within 3 weeks after an electronic filing;
- (d) the IRS normally makes an electronic deposit in an average of about 12 days after an electronic filing;

- (e) [the bank] tries to make proceeds of an Instant RAL available on the day of application and a Classic RAL available on the first business day after application;
- (f) [the bank] cannot guarantee when any proceeds of a RAL or an IRS refund will be available to me; and
- (g) a RAL may cost substantially more than other sources of credit, and I may want to consider using other sources of credit.

Surveys show significant customer satisfaction and we receive few complaints. RAL clients return the following year in higher percentages than those with similar incomes who do not take a RAL. While eight of ten H&R Block clients do not choose a RAL, customer demand is strong among those who do.

Why do clients request RALs? Beyond speed, convenience, and security—

- RALs meet seasonal needs. For many consumers it is a once-a-year chance to get caught up and pay pressing medical, holiday, heating, car repair, or tuition bills.
- RALs provide quick closure by relieving emotional stress at tax time, especially for those who may not trust the IRS with bank account numbers or mail delivery.
- RALs serve the unbanked. Other credit may not be available. Most banks or thrifts will only make longer-term loans, usually for existing customers, often after charging for a credit check or application fee. Half of our RAL customers do not have checking accounts, most do not qualify for a conventional bank loan, and many do not have credit cards.

RAL Costs and Risks

RAL Costs. Viewed in *annual* percentage interest rates, RALs appear costly. But RALs are a specialized credit product — essentially a loan for 11 days, not 365 days. The cost of a \$3,000 RAL in Minnesota is \$99.95. That consists of a \$75 finance charge and a \$24.95 account set-up fee, both paid to the bank. The loan would cost 3.3% of the refund amount and have a 114% APR.

Why are RALs more expensive than some other sources of credit? Bank lenders indicate several factors influence their prices:

- Costs are high. The cost of processing the RAL application, setting up a bank account, training customer service personnel, and originating and administering the loan is similar whether a loan is for one day or one year.
- There is a risk of default if the IRS reduces the refund by offsetting delinquent federal or state taxes, unpaid student loans or child support, or nonpayment of other federal debts. The risk is reduced when the IRS advises of pending offsets through an electronic debt indicator, but the IRS does not guarantee that all offsets have been identified.
- There is an additional risk of default when refunds are frozen, only partially paid, or denied as eligibility and fraud issues are resolved. Over 1.2 million returns will be resequenced—or delayed for review—in 2005 for “revenue protection” reasons. First time e-filers and Earned Income Tax Credit claimants receive special scrutiny. Because as many as a third of EITC claims are questionable, 360,000 EITC returns will undergo pre-refund audits. Lenders have no advance notification of these delays or denials.
- There is added risk of disruption and loss because most RALs are made at the start of a tax season when more IRS processing problems occur. For example, three years ago the IRS erroneously dropped the two last digits of taxpayers’ Social Security numbers in administering the debt indicator, a mistake that took two weeks to fix and that tripled the amount of bad debt compared to the rest of the tax filing season.
- It is a once-a-year transaction in which the bank does not have personal contact with the borrower and the borrower may be difficult to locate in case of default. One bank reported loan losses 4-5 times higher than the rest of its portfolio with losses averaging \$20 per loan.

As a result, refund loans involve genuine risk.

Cost Comparisons. The lending bank we use has a finance charge ranging from \$5 to \$85 for a “Classic RAL,” in addition to a bank account set-up fee, for loan amounts from \$200 to \$9,999. These fees are computed as the cost of an 11-day loan, which makes the prominently disclosed annual percentage interest rate high. Studies show many borrowers, however, focus on the dollar amount of the fee rather than on the annual interest rate. They accept the fees as a cost of speed and convenience.

The \$99.95 cost for a \$3,000 RAL can be compared to alternative credit transactions: a \$3,000 credit card cash advance would cost \$110; three credit card late fees for \$3,000 in arrears would cost \$122; three bounced checks, with bank and merchant fees, would cost \$165. Some of these alternatives have the added penalty of impairing a consumer’s credit rating.

Viewed not as a credit cost but as a convenience fee, RALs can be compared to a choice between sending a letter by overnight delivery compared to regular mail (\$13.65 vs. 37¢). The wire transfer of funds via Western Union—for a service fee and with zero credit risk—can cost as much as a RAL (\$139 for \$3,000). Even the IRS charges a minimum service fee of \$43 to set up an installment agreement for monthly late payments (not including interest or penalties), and a \$150 user fee to process Offers in Compromise. For taxpayers using a credit card to pay a balance due to the IRS, there is a 2.5% convenience fee, or \$75 (not including credit card interest), for a \$3,000 balance due. The U.S. Passport Agency charges \$85 for regular 6-week delivery but double that, \$173, for expedited service with overnight delivery. Added fees for speed or convenience are a well established feature of our economy, as convenience stores, ATMs, and one-hour photo services show.

Extensive Existing RAL Regulation

Lending Laws Regulate RALs. Fees and interest rates charged by refund anticipation lenders are regulated under the National Bank Act, the Home Owners' Loan Act, or by authorities in a financial institution's home state, which permits interest rates to be exported to other states.

The Truth in Lending Act and the Federal Reserve Board’s Regulation Z require full and uniform disclosure of annual percentage rates and finance charges and regulate calculations of annual interest rates, oral disclosures, and advertising of credit terms. Inconsistent state laws are preempted. The stated purpose of Reg Z is “to promote the informed use of consumer credit by requiring disclosures about its terms and cost.”

IRS Regulates RAL Facilitation. The IRS extensively regulates RALs through Revenue Procedure 2000-31 and five IRS publications, including Publications 1345 and 3112. A tax return preparer who is an electronic return originator (ERO) cannot also be a lender. In addition, most e-filers must undergo an FBI criminal background check, fingerprinting, verification that they have filed individual and business tax returns and paid balances due, and a history check of any prior noncompliance with IRS e-filing programs. Violators are subject to suspension from the e-filing program by the IRS. Advertising is regulated, deceptive practices are prohibited, and RAL facilitation fees are regulated. All tax preparers are subject to laws covering fraud, misrepresentation, diligence, etc., and they can be enjoined from misconduct. Tax preparers who represent taxpayers before the IRS are subject to suspension and additional rules.

Specifically, for example, IRS rules require that the provider must —

- “advise taxpayers that RALs are interest bearing loans and not a quicker way of receiving their refunds from the IRS” and “ensure that taxpayers understand that by agreeing to a RAL ... they will not receive their refund from the IRS as the IRS will send their refund to the financial institution.”

- “advise taxpayers that if a Direct Deposit is not received within the expected time frame for whatever reason, the taxpayer may be liable to the lender for additional interest and other fees, as applicable for the RAL... .”
- “advise taxpayers of all fees and known deductions to be paid from their refund and the remaining amount the taxpayer will actually receive.”
- Fees charged by EROs are regulated: they must be the same for all customers and not related to the refund amount or RAL or any figure from the tax return; separate fees may not be charged for direct deposits.
- Advertising, marketing and promotion are regulated: the use of any form of public communication that contains false, fraudulent, misleading, deceptive, unduly influencing, coercive or unfair statements or claims is prohibited.
- Tax preparers who are e-filers must undergo annual suitability checks.
- Tax preparers that violate these provisions can be sanctioned for three levels of infraction including suspension or expulsion from the e-filing program—approval for which is essential to facilitate a RAL.
- The Internal Revenue Code also sets related tax preparer penalties for understating tax liabilities (§6694); negotiating a client’s refund check (§6695); failing to sign a return, provide a copy to the client, retain a copy of the return, or furnish a preparer’s identification number (§6695); unauthorized disclosure or use of tax return information (§6713 and §7216); and preparing a false or fraudulent return (§7206(2)).

IRS Role. RALs were developed in the mid-1980s by a bank in tandem with the IRS’s e-filing program and helped fuel its early growth; as many as 90% of early e-filed returns involved a RAL. Today, about 26% of taxpayers who e-file use a refund-related bank product and about 7% of all taxpayers use a RAL. RALs could not function without IRS cooperation. The IRS sanctions RALs for several reasons: to honor the taxpayer’s choice; to provide a clean, regulated alternative to back-alley discounting of tax refunds (a practice, widespread before the advent of RALs, in which undisclosed interest rates could exceed 3,000% APR with no consumer protections); and to reach the congressionally-mandated goal of 80% of all tax returns being e-filed by 2007—obtaining a faster refund is a compelling incentive for taxpayers to e-file, and RALs deliver funds even faster.

Future Direction

Diminishing Issue. RALs exist because of overwithholding and slow government processing of tax refunds. As part of its computer modernization program, the IRS has begun to introduce a new customer account data engine (CADE), which has the potential to deliver refunds more rapidly, initially to filers of the simplest returns. Over the next few years, increasing numbers of 1040 filers will receive their refunds more quickly. Quicker refunds will reduce the need for short-term loans, a development H&R Block supports as a solid plus for the tax system and for taxpayers.

In 2005, a unique public-private partnership to reduce the cost and burden of tax preparation has again offered all Minnesota taxpayers *free* online tax preparation and filing at www.irs.gov. H&R Block’s *Online Tax Program* is among the programs featured. Online filing that speeds refunds may diminish the need for loans.

We are also assisting many “unbanked” clients in connecting to low-cost basic accounts, which may also reduce the need for refund-related bank products by allowing direct deposit of refunds. We are testing basic banking accounts in seven cities in 2005 and hope to broaden the program next year.

Legislation. Because of bank laws and court decisions, states cannot regulate interest rates of national or out-of-state banks and thrifts, but five states (including Minnesota), two counties (Westchester and Nassau, NY), and the cities of New York and Seattle have adopted laws requiring disclosures by RAL facilitators, in some cases duplicating or providing variations on federal requirements. Illinois, for example, requires the annual percentage interest rate to be

given for a 10-day loan period, although the federal Truth in Lending Act requires that the APR be stated for the actual, truthful time, which is 11 days. Other states are considering RAL legislation.

Federal legislation, adopted by the Senate in May, 2004, would require registration of all RAL facilitators, disclosures of loan terms and alternatives, and penalties for noncompliance. It will be reconsidered in the current Congress. This legislation would follow eight federal laws and IRS rules that apply to refund anticipation loans and their facilitation. We request that a summary of them be included in the record following this statement.

We favor high standards of disclosure and responsible practices in offering refund-related bank products, as our own multiple disclosures—developed in consultation with consumer groups and former federal officials—attest. We support strong IRS rules and welcome appropriate federal legislation as preferable to repetitive or conflicting disclosures, however well intentioned, from state or local governments that may confuse, more than protect, taxpayers.

Peace of Mind

The Subcommittee staff has reviewed a number of our tax-related financial products and asked additional questions about the Peace of Mind (POM) Extended Service Plan.

POM is an extended guarantee. Our Standard Guarantee includes client assistance in answering questions about the preparation of a return in an audit and payment of any penalties and interest assessed due to an error by an H&R Block tax return preparer. Peace of Mind extends this guarantee to include representation at any audit (with power of attorney) by an H&R Block Enrolled Agent and payment of additional federal, state, or local taxes, up to \$5,000, due to an H&R Block tax return preparer's error. The product costs \$27. Clients have a seven-day money back guarantee if they wish to rescind the plan for any reason.

Client Benefits. Our clients see value in Peace of Mind for several reasons: (1) consultation with an expert and the assurance of active professional representation at an audit; (2) the security of knowing that additional taxes owed due to a preparer error will be taken care of; and (3) reduction of the anxiety often associated with the tax filing process and the IRS's review of returns. Clients who purchase POM have a much higher level of retention compared to H&R Block clients who do not, reflecting high levels of satisfaction with the product. Peace of Mind is most popular in client segments with more complicated returns and the highest IRS audit rates.

Process Enhancements. We offer POM consistent with keeping our clients' interest first. We have made process changes over several years as part of those efforts: enhanced training materials; fuller and clearer explanations of the product's costs and features; and a computerized process to ensure that the product is explained to all of our clients but "pushed" on none.

The tax professional is aided by two computer screens that allow a full explanation of the Standard Guarantee and POM. Clients are then given the choice to purchase POM. They can decline or affirm their choice by signing the POM agreement. Thus, two "opt-ins" are required before any purchase and there is a seven-day money-back "opt-out" opportunity after the purchase.

This process is designed to ensure that all clients are given the choice to make a fully informed decision about POM. Our tax preparers receive a small payment when POM is chosen to compensate them for the time taken, but our management has made it clear that there is no demand that tax professionals sell more. Our procedures reflect changes reviewed and approved by a group of state attorneys general.

Mr. Chairman, we appreciate the opportunity to share our views and welcome any questions.