

**Testimony of Children's Defense Fund Minnesota  
Regarding Refund Anticipation Loans**

**Submitted to**

Permanent Subcommittee on Investigations  
Committee on Homeland Security and Governmental Affairs  
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Senator Coleman and Committee members, thank you for this opportunity to testify about Refund Anticipation Loans (RALs) and their impact on working Minnesota families. I am Beth Haney, Research Director for Children's Defense Fund Minnesota (CDF-MN). CDF is a private, non-profit organization with a more than thirty-year history of advocating for children, particularly poor and minority children and those with disabilities. Our mission is to Leave No Child Behind® and to ensure that every child has a Healthy Start, a Head Start, a Fair Start, a Safe Start, and a Moral Start in life as well as successful passage to adulthood with the help of caring families and communities.

RALs are of vital interest to CDF because they dilute the efficacy of the Earned Income Tax Credit (EITC). The EITC is this country's most effective and efficient anti-poverty tool and is a potent force for enhancing child well-being. In 2002, it lifted almost 5 million working Americans out of poverty; more than half were children. More than 242,000 low- to moderate-income working Minnesotan households claimed approximately \$378 million in federal funds through the EITC in 2004. This part of the tax code rewards family's work effort and helps off-set the disproportionate share of taxes they pay. Families spend the majority of their EITC refunds on basic needs like utility bills, rent, and food and clothing for their children. Consequently, the EITC helps stabilize them, and enables them to remain in the workforce and off welfare. In addition, much of the money is spent immediately, boosting the local economy by benefiting grocers, retailers and other local businesses.

However, the value of the EITC to families and communities is eroded when paid tax preparers partner with federally-chartered banks and aggressively market predatory bank products to those most financially vulnerable. During the 2003 tax filing season, an estimated \$5.1 million of Minnesota EITC funds were diverted to pay for Refund Anticipation Loans (RALs), rather than on meeting working families' basic needs.

Our concerns with RALs include:

**1. RALs can be alarmingly expensive to the consumer.** The costs usually include loan fees and “bank account set-up” charges.<sup>i</sup> We estimate that the average total loan cost is about \$100, or about six percent of the average Minnesota EITC refund, causing the APR for a RAL on the average refund to be 234 percent. This predatory rate is more than ten times the APR ceiling Minnesota established to protect consumers; state law limits APRs on consumer loans to 21.75 percent. However, RAL brokers circumvent state usury laws by partnering with federally-chartered banks, which are permitted to ignore state interest rate ceilings.

**2. Research shows that commercial tax preparers target their services to low-income neighborhoods, where financial literacy is often limited.** According to one study, neighborhoods across the nation with more EITC filers have about 50 percent more electronic tax filing and preparation services than neighborhoods with fewer EITC filers.<sup>ii</sup> Statewide about one in five EITC filers got a RAL in 2003, but the percentage was significantly higher in the most impoverished communities. In four of the zip codes of Minnesota’s northern Indian reservations, in which more than half of all returns include the EITC, more than three-fourths of EITC families got a RAL. Clearly, the economic impact of RALS is higher in these poverty-stricken areas of the state, as even greater sums of money are diverted from families and communities.

**3. As a result of extensive protesting last tax season by the consumer advocacy group, the Association of Community Organizations for Reform Now (ACORN), H&R Block agreed to improve the disclosures it gives to customers about the costs and speed of refund options and to drop their administrative fee for RALs. However, we question how well the terms of the agreements are actually implemented in local tax preparers’ offices.** This tax season, advocates have spoken with H&R Block clients who say they were not provided the improved disclosures informing them of each of their refund options. Many preparers push clients into taking out loans based on the profit they personally receive, not corporate policy. ACORN is currently negotiating a similar agreement with Jackson Hewitt, but other preparers, including Liberty Tax, and local, independent preparers, broker also many RALs. Thus, even the existence of agreements with the two largest national companies does not address how clients of these other preparers are sold RALs.

**4. Finally, there is evidence that many families do not comprehend they are initiating a loan when they opt for “Instant Money,” “Money Now,” or the other terms used to market RALs.** According to a December 2004 poll, 70 percent of respondents who had gotten a RAL did not realize it was actually a loan.<sup>iii</sup> Furthermore, because many RAL users have limited literacy skills and/or English proficiency, even if they sign written disclosure forms, they may not fully comprehend them.

It is not surprising that a public policy as effective as the EITC has had strong bi-partisan support in Congress. We have appreciated your backing Senator Coleman, and hope we can rely on you to champion the EITC during the current federal budget debate. The public funds dedicated to tax credits like the EITC are meant to reward low- to moderate-income taxpayers’ work effort and help strengthen their families, and this has been proven to work. The public funds were not meant to provide a financial windfall for the tax preparation and banking industries. Loans using the EITC should not be allowed for the same reasons Social Security benefits cannot be used as security on a loan. The idea is that these benefits are too important to their recipients to let lenders take them to repay debts. It is a cruel paradox that because of their trust and reliance on paid tax preparers,

“professionals” families believe are there to help, eligible working Minnesota families trying to claim their EITC and get ahead could end up in significantly worse financial jeopardy.

Thank you again for the opportunity to testify. Further information regarding my organization’s stance toward RALs can be found in the attachments: (1) our most recent report on RALs, *Keeping What They’ve Earned: Working Minnesotans and Tax Credit* ([http://www.cdf-mn.org/PDF/2005\\_RAL\\_report.pdf](http://www.cdf-mn.org/PDF/2005_RAL_report.pdf)), and (2) a policy platform on which CDF collaborated, *A National RAL Platform: Issues and Options* ([http://www.nclc.org/initiatives/refund\\_anticipation/content/RALplatform.pdf](http://www.nclc.org/initiatives/refund_anticipation/content/RALplatform.pdf)).

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<sup>i</sup> We include the bank account set-up fee in the APR calculation to more accurately reflect the cost of this credit to taxpayers. RAL lenders usually subtract out this fee from the APR calculation, and thus their APRs are lower. We believe this tactic artificially lowers the APR price tag for RALs.

<sup>ii</sup> Berube, A., Kim, A., Forman, B., and M. Burns (2002). *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC*. Center on Urban and Metropolitan Policy at the Brookings Institution and the Progressive Policy Institute.

<sup>iii</sup> Wu, C.C. and J. A. Fox. (2005). *Picking Taxpayers’ Pockets, Draining Tax Relief Dollars: Refund Anticipation Loans Still Slicing Into Low-Income Americans’ Hard-Earned Tax Refunds*. National Consumer Law Center and Consumer Federation of America.



Children's Defense Fund

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## KEEPING WHAT THEY'VE EARNED: WORKING MINNESOTANS AND TAX CREDITS Updated as of February 2005

"I was a victim because I didn't understand what I was doing," Patty Jackson said. "At first I was embarrassed but I'm not ashamed anymore. I've learned my lesson, and I've been telling everybody I know not to make the same mistake that I did." – Jackson is a mother of three from Duluth and she paid for a refund anticipation loan.



As the height of tax-filing season approaches, Americans are being inundated with advertisements from commercial tax preparers promoting alluring options for getting their taxes prepared. Many of these commercial tax preparers concentrate in low-income neighborhoods and lure their clients with the promise of "Fast Money," "Money Now," or "Rapid Refunds." A vast number of these consumers, who because of their low incomes are eligible for tax credits such as the Earned Income Tax Credit (EITC), end up paying high preparation fees and taking out high interest loans against their expected return. More than 67 percent of people nationwide who claim the EITC use commercial tax preparers to prepare their returns. Unfortunately, many low- to moderate- income working Americans are often unaware of all their choices – including free tax preparation such as Volunteer Income Tax Assistance, or VITA, sites.

This story is consistent across the country. In Minnesota, more than 242,000 low- to moderate-income working families in Minnesota claimed approximately \$378 million in federal funds through the EITC during 2004, but tens of millions of these public funds never reached these families and their children. Instead, commercial tax preparers profited from families' need for tax filing assistance, due to the complex tax laws required to claim their credits. An additional sum was diverted to out-of-state banks charging extremely high fees and interest rates in the form of Refund Anticipation Loans (RALs), often so that the families could access their refunds only one week earlier. The average APR for these loans in Minnesota is an estimated 234 percent. During the 2003 tax season (the most recent year for which data is available), an estimated \$23.6 million from the EITC was siphoned away from the intended Minnesota families. All told, about \$1.57 billion is sacrificed nationwide to commercial tax preparation and RALs.<sup>1</sup>

The EITC has garnered bi-partisan support as the nation's most powerful anti-poverty tool, but its value to families and communities is being raided by commercial tax preparers and nationally chartered banks. In 2002, the EITC lifted almost 5 million working Americans out of poverty; more than half of them were children. Today, about 1 in 10 Minnesotan households benefit from its support. Families working at low wages deserve to receive the money intended for them by the tax code — to reward their work effort and help off-set the disproportionate share of taxes they pay. To remedy this misuse of public funds, Children's Defense Fund Minnesota (CDF-MN) advocates for increased free tax preparation assistance — that is

both accessible and well-publicized — for these families. In addition, CDF-MN calls for heightened consumer education and disclosure outlining what taxpayers should expect from paid preparers and refund anticipation loans, as well as increased federal oversight and regulation of the tax preparers and national banks promoting RALs.

### **An *Earned* Income Tax Credit for Working Families**

The EITC is a federal tax credit for individuals who work but earn low wages. It is only available to those who work, and thus it rewards them for their efforts. The credit also helps offset the disproportionate percentage of their total income that low-income families spend on payroll, sales and excise taxes.

The value of the EITC largely depends on the number of children in one's family and the amount of income earned through work. During the 2005 tax season, the EITC is worth up to \$4,300 for workers who earned up to \$34,458 in 2004 (\$35,458 if married filing jointly) and have two or more qualifying children, and up to \$2,604 for workers who earned up to \$30,338 in 2004 (\$31,338 if married filing jointly) and have one qualifying child. Working adults between the ages of 25 and 64 with no children who earn less than \$11,490 (\$12,490 if married filing jointly) are also eligible for a smaller credit worth up to \$390.



The EITC is first used in conjunction with other standard deductions, exemptions, and tax credits to decrease the amount of money a family owes in income taxes, if any. The remaining amount is then returned to the family. More than 94 percent of those who claim the EITC in Minnesota receive a refund. In 2004, the average amount claimed was \$1,559.

This refund has a tremendous impact not only on families' financial circumstances, but also their overall well-being. Research indicates that families spend the majority of their EITC refunds on basic needs like utility bills, rent, and food and clothing for their children. Consequently, the EITC helps stabilize families by shoring up their needs, thereby helping them to remain in the workforce and off of welfare. In addition, much of the money is spent immediately, boosting the local economy by benefiting grocers, retailers and other local businesses. While local economies vary due to the interaction of numerous different sectors, one study in San Antonio, Texas, found that EITC dollars spent in the local community generated an economic impact 60 percent greater than those initial expenditures.<sup>2</sup> Assuming Minnesota benefits from a similar multiplier, the Earned Income Tax Credits claimed in 2004 generated an additional economic impact of nearly \$605 million statewide.

### **The Use of Paid Preparers and Refund Anticipation Loans (RALs)**

To claim the EITC and other tax credits for which they are eligible, taxpayers need to complete and file their federal and state income taxes — a task that can be very complex and daunting for those with no experience doing so themselves. The laws and procedures that govern this area of the tax code in particular are very complicated, and often change from one year to the next. In addition, many low-income families face language and literacy barriers. Therefore, it is not surprising that a high percentage of low-income Minnesotans — approximately two-thirds — hire a professional to prepare their taxes. The average cost of having their taxes prepared and electronically filed is about \$120 — a large amount for families who may be living paycheck to paycheck. More than 162,000 Minnesotan households (or two-thirds) who claimed the EITC in 2004 made \$20,000. On average, a Minnesota EITC family who uses a paid preparer sacrifices more than seven percent of their credit just to claim it.

Collectively, the dollars lost are fairly substantial as well. It is estimated that in 2003, at least \$18.5 million of the federal EITC funds claimed in Minnesota were spent on tax preparation and filing costs, rather than on meeting working families' basic needs.

Moreover, an estimated additional \$5.1 million of the EITC funds in Minnesota were diverted to pay for Refund Anticipation Loans. RALs are extremely short-term loans that use the family's anticipated tax refund as collateral. Most EITC claimants need their refund as soon as possible, and many do not have the \$120 necessary to have their

taxes prepared. Knowing this, many paid tax preparers partner with out-of-state banks and aggressively market RALs to those most financially vulnerable.

RALs can be alarmingly expensive to the consumer. The costs usually include loan preparation and processing fees, which are added to a finance charge. In the end, the average total loan cost is about \$100. This translates into a shockingly high APR, or the loan's cost calculated at a yearly rate. If a family paid \$100 for the average EITC refund of \$1,559, the average APR on the loan was 234 percent. This predatory rate is more than ten times the APR ceiling



Minnesota established to protect consumers, considering that Minnesota law limits APRs on consumer loans to 21.75 percent. However, RAL brokers circumvent state usury laws by partnering with nationally chartered banks that are only subject to federal regulation, of which there is little. Heightened federal regulation is needed to halt these companies' maneuvering around state law.

For families who claim the EITC, the added cost of a RAL represents an additional six percent of their average refund, and it is a price they end up paying to access their money often by only a week earlier. RALs enable families to access their refunds (minus the tax preparation fees, loan fees and finance charges) within 48 hours. However, it only takes the IRS 10 days on average to process an electronically filed return and then electronically deposit the refund into a bank account. Many families are unaware of how short this turnaround time is for the IRS.

Furthermore, because they are loans, RALs can actually send a struggling family into greater financial crisis. Usually, a RAL is paid off once the IRS processes a family's tax return and transfers the funds. However, if the IRS denies part of the refund for any reason or even withholds it temporarily for audit purposes (which the IRS is doing increasingly with EITC returns), the loan continues to accrue interest. Given their immediate financial needs, it is unlikely that EITC families budget for this possibility. Although one commercial preparer, H&R Block, has stopped charging its \$32 administrative fee this year on the RALs it brokers, this does nothing to address the inherent risk posed by the loans.

There is also evidence that many families, especially those with limited English proficiency, do not comprehend they are initiating a loan when they opt for a "rapid refund," as RALs are often marketed. In December 2004, the National Consumer Law Center commissioned a public opinion polling firm to conduct a telephone poll of over 2,000 consumers about their experiences with RALs. The survey found that 70% of RAL borrowers didn't realize that a RAL is actually a loan, with younger consumers being the most unaware.<sup>3</sup> Ironically, families could end up in debt as a result of claiming tax credits that reward their work effort and are intended to strengthen their families. Despite these families' sincere efforts to get ahead, commercial lenders are profiting from their limited financial understanding, and putting families at risk of financial jeopardy.

### **Refund Anticipation Loans in Minnesota**

According to the IRS, more than 51,000 Minnesota families who claimed the EITC in 2003 also applied for a RAL. (This is the most recent year for which RAL data is available). This represents about 1 out of every 5 Minnesota EITC families, or 21 percent. (By comparison, only 4.5 percent of all Minnesotan households received a RAL that year.) Over 4,600 more Minnesotan families applied for RALs in 2003 than in 2002, a 9.6 percent increase.

As can be seen in Table 1, the percentage of EITC claimants seeking RALs is significantly higher in certain zip codes, notably those blanketing more impoverished communities in the state. More than 75 percent of EITC claimants on some of the northern Minnesota Indian Reservations and as many as 50 percent of EITC claimants in some Minneapolis zip codes took out a RAL in 2003. And in 40 zip codes in Minnesota, more than one-third of EITC families applied for a RAL when claiming their refunds.

Research documents that commercial tax preparers target low-income neighborhoods, *i.e.*, those home to individuals with limited financial literacy, for their services. Neighborhoods across the nation with high percentages of EITC filers have about 50 percent more electronic tax filing and preparation services than neighborhoods with low

percentages of EITC filers.<sup>4</sup> Clearly, the economic impact of RALS is higher in these poverty-stricken areas of the state, as even greater sums of money are diverted from families and communities.

**Table 1: Minnesota Zip Codes with Highest Percentage of EITC Filers Seeking Refund Anticipation Loans, 2003 (Tax Year 2002)**

Zip Code	City	County	% of All Returns with EITC	Average EITC	Total Sum of EITCs claimed	% of EITC Returns with RALs	Sum Lost to RALs and Paid Preparation by EITC Claimants*
56671	Red Lake	Beltrami	75	\$2,040	\$1,323,745	79	\$119,334
56670	Redby	Beltrami	76	\$2,046	\$796,018	78	\$71,345
56666	Ponemah	Beltrami	84	\$2,064	\$451,972	77	\$39,712
56566	Naytahwaush	Mahnomen	61	\$2,006	\$242,741	75	\$22,055
56591	White Earth	Becker	73	\$1,902	\$171,171	61	\$13,417
56626	Bena	Cass	51	\$1,921	\$107,558	61	\$9,878
56633	Cass Lake	Cass	52	\$1,848	\$1,448,719	60	\$126,977
55415	Minneapolis	Hennepin	28	\$1,731	\$119,468	55	\$9,678
55440	Minneapolis	Hennepin	32	\$1,524	\$114,286	55	\$9,858
55458	Minneapolis	Hennepin	42	\$1,731	\$351,348	54	\$27,435
56575	Ponsford	Becker	46	\$1,940	\$186,208	52	\$13,278
56641	Federal Dam	Cass	46	\$1,845	\$83,029	49	\$6,999
55411	Minneapolis	Hennepin	53	\$1,907	\$7,096,796	49	\$501,149
55165	Saint Paul	Ramsey	54	\$1,734	\$116,172	48	\$8,598
56557	Mahnomen	Mahnomen	31	\$1,773	\$466,390	45	\$36,734
55404	Minneapolis	Hennepin	37	\$1,583	\$4,371,341	45	\$327,158
56569	Ogema	Becker	36	\$1,887	\$230,242	44	\$16,677
55412	Minneapolis	Hennepin	37	\$1,763	\$4,056,787	43	\$291,270
55175	St. Paul	Ramsey	50	\$1,872	\$129,159	42	\$8,059
55454	Minneapolis	Hennepin	49	\$1,854	\$1,930,375	42	\$117,018
56619	Bemidji	Beltrami	31	\$1,851	\$236,889	39	\$16,038
55429	Minneapolis	Hennepin	27	\$1,662	\$3,165,483	38	\$230,683
56201	Willmar	Kandiyohi	29	\$1,608	\$2,932,302	38	\$229,385
55334	Gaylord	Sibley	25	\$1,780	\$391,552	38	\$30,736
55312	Brownton	McLeod	16	\$1,569	\$108,251	38	\$9,679
56589	Waubun	Becker	33	\$1,770	\$300,911	37	\$21,517
55407	Minneapolis	Hennepin	31	\$1,664	\$4,599,631	37	\$319,828
55408	Minneapolis	Hennepin	24	\$1,510	\$3,384,368	37	\$255,478
<b>STATE AS A WHOLE</b>			<b>10</b>	<b>\$1,537</b>	<b>\$368,176,143</b>	<b>21</b>	<b>\$23,663,988</b>

SOURCE: Internal Revenue Service, Tax Year 2002. NOTE: In some cases, the above zip codes correspond to P.O. Boxes located within the city and identified on filer's returns.  
\* Figure calculated by using average RAL cost of \$99.95 and average paid preparation cost of \$120.

## Potential Solutions

### *To Prevent the Erosion of Public Funds from Minnesota's EITC Families*

1. **Simplify the rules and process for income tax filing.** Working families should be able to complete their own taxes, without having to pay for professional assistance. Federal and state laws, especially those that govern working families' income taxes, need to be simplified, and federal and state tax credit programs need to be coordinated.
2. **Ensure that free tax assistance for EITC families is widely available, accessible, and well-publicized.** Free tax assistance for low-income families is available at Volunteer Income Tax Assistance (VITA) sites in many Minnesota communities, but many families are not aware of them, and the reach of these efforts is limited. In fact, these sites serve less than five percent of the EITC-eligible taxpayers. The community groups and non-profit organizations like AccountAbility Minnesota that operate many of these sites need help. Different levels of government, employers, foundations, churches, and other community groups can all provide financial assistance, launch additional locations, donate computers for electronic filing, help recruit volunteers, and conduct outreach with potential EITC families.
3. **Strengthen consumer protection and education.** There is extremely little regulation of tax preparers — they are not even required to have completed high school. Yet, they are entrusted with sensitive personal information and expected to stay abreast of many complex tax laws. Taxpayers need additional education to fully understand what they can expect of their tax preparer as well as the true nature and hidden costs of RALs until they are abolished, so they can make informed decisions. The federal and state governments could do more to regulate and monitor the practices of paid preparers as well as the national banks with which they partner to offer RALs. In 2003, Minnesota passed a Taxpayer Protection Bill that created some standards of conduct for tax preparers and tightened disclosure laws for RALs. On the federal level, the Taxpayer Abuse Prevention Act (TAPA) is being re-introduced in Congress on February 8, 2005, by Sen. Daniel Akaka (D-Hawaii). The act would prohibit the use of RALs against the Earned Income Tax Credit, similar to the existing ban on loans that use Social Security checks as collateral. Citizens and organizations can express their support for the bill by contacting their members of Congress.
4. **Connect more low-income families with financial institutions and increase their financial literacy.** Having a tax refund electronically deposited directly into a bank account speeds up the turnaround time significantly, but many low-income families are not connected to mainstream financial institutions. Free tax assistance sites have attempted to partner with financial institutions, but these efforts are limited. Existing research suggests that efforts to promote financial literacy can be enhanced when people have an event – such as a significant tax refund – where they can start new practices. Some nonprofit organizations offer financial literacy courses; however, too rarely are they connected to receiving a real monetary asset, like a tax refund. Making such program connections will help more people make decisions in the best interests of their families.

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<sup>1</sup> Wu, C.C., and Fox, J.A., *Picking Taxpayers' Pockets, Draining Tax Relief Dollars: Refund Anticipation Loans Still Slicing Into Low-Income Americans' Hard-Earned Tax Refunds*. National Consumer Law Center and Consumer Federation of America, 2005, Available at: [http://www.consumerlaw.org/initiatives/refund\\_anticipation/content/2005RALreport.pdf](http://www.consumerlaw.org/initiatives/refund_anticipation/content/2005RALreport.pdf).

<sup>2</sup> Texas Perspectives, Inc. *Increased Participation in the Earned Income Tax Credit in San Antonio*, 2004 Update, Prepared for City of San Antonio, TX

<sup>3</sup> Wu and Fox. *Op Cit*.

<sup>4</sup> Berube, A., Forman, B., & Burns, M. *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC*. The Brookings Institution Center on Urban and Metropolitan Policy and The Progressive Policy Institute, 2002.

*The mission of the Children's Defense Fund is to Leave No Child Behind® and to ensure every child a Healthy Start, a Head Start, a Fair Start, a Safe Start, and a Moral Start in life and successful passage to adulthood with the help of caring families and communities. CDF provides a strong, effective voice for all the children of America who cannot vote, lobby, or speak for themselves. We pay particular attention to the needs of poor and minority children and those with disabilities. CDF educates the nation about the needs of children and encourages preventive investment before they get sick or into trouble, drop out of school, or suffer family breakdown. CDF began in 1973 and is a private, nonprofit organization supported by foundations, corporation grants and individual donations and does not accept government funds. In 1985, CDF established the St. Paul office to direct its efforts in Minnesota.*



## **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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\* This document was developed by a workgroup including the following members: Jordan Ash, ACORN; Amy Brown, Consultant, Annie E. Casey Foundation; Deborah Cutler-Ortiz, Children's Defense Fund; Jean Ann Fox, Consumer Federation of America; Sarah Ludwig, NEDAP; David Marzahl, Center for Economic Progress; Chi Chi Wu, National Consumer Law Center. The goal of this document is to promote, facilitate and coordinate efforts to address RALs in communities nationwide. Please note that this list does not include all conceivable options, and we do not necessarily endorse all options equally.

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.