Another Year of Losses: High-Priced Refund Anticipation Loans Continue To Take a Chunk Out Of Americans' Tax Refunds

The NCLC/CFA 2006 Refund Anticipation Loan Report

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Executive Summary

- Refund anticipation loans (RALs) are usurious short-term loans secured by the taxpayer's expected tax refund. This is the annual update from the National Consumer Law Center and Consumer Federation of America on how much RALs are costing taxpayers.

- RAL volume remained essentially level from 2003 to 2004. Consumers took out approximately 12.38 million RALs during the 2004 tax-filing season compared to 12.15 million in 2003.

- The effective annualized interest rate for RALs based on a 10 day loan period ranges from about 40% (for a loan of $9,999) to over 700% (for a loan of $200). The annualized interest rate for a loan of the average refund size of about $2,150 is 178%.

- Consumers paid an estimated $1.24 billion in RAL fees in 2004 to get quick cash for their refunds – essentially borrowing their own money at extremely high interest rates.

The National Consumer Law Center is a non-profit organization specializing in consumer issues on behalf of low-income people. NCLC works with thousands of legal services, government and private attorneys, as well as community groups and organizations, who represent low-income and elderly individuals on consumer issues.

Consumer Federation of America is a non-profit association of about 300 groups, with a combined membership of over 50 million people. CFA was founded in 1968 to advance consumers' interest through advocacy and education.

The authors would like to thank the many advocates across the country fighting the good fight against RALs, including the CFA state and local members.

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This represents an increase of 14%, mostly due to the fact that the price of a RAL for the average refund rose $10 from 2003 to 2004.

- In addition to the $1.24 billion in RAL fees, consumers paid another $360 million in "administrative", "electronic filing" or "application fees" in 2004. We expect this amount to drop significantly in future years. The largest tax preparation chain, H&R Block, dropped this fee in 13 states in 2004 and nationwide in 2005. Jackson Hewitt has committed to dropping a similar fee for company-owned stores and to encourage its franchisees to do so. Liberty Tax has committed to eliminate its analogous fee.

- A survey commissioned by the Consumer Federation of America finds that RAL borrowers are vulnerable to high cost credit, such as rent-to-own, payday loans and pawnshop loans. These consumers are more likely to be unbanked than non-RAL borrowers and those who do have bank accounts are more likely to have overdrawn in the past year.

- A significant legislative development occurred when Connecticut passed the first law capping RAL rates at 60% by prohibiting tax preparers from brokering loans over that amount. On the other hand, Washington State passed a weak disclosure RAL law that gutted Seattle's better ordinance. Other states passing disclosure-only RAL laws include California, Nevada, and Oregon.

- We have begun to see a new wave of RAL products – "pay stub loans" that are sold to consumer before the tax season begins. These pay stub loan products appear to be the response to the IRS progress, albeit delayed, in providing faster refunds. We are very concerned about these products because they pose additional risk and costs to consumers, creating a "race to the bottom." In addition, these products will continue the drain on tax refunds and EITC dollars created by RALs.

- The IRS renewed its agreement with the Free File Alliance to provide for free Web-based electronic filing for taxpayers who make less than $50,000 annually. Unfortunately, this new agreement does not ban Free File commercial preparers from marketing RALs to taxpayers. Thus, the agreement continues to permit the appearance of an implicit government endorsement of RAL marketing.

I. Introduction

Refund anticipation loans (RALs) are high cost loans secured by and repaid directly from the proceeds of a consumer's tax refund from the Internal Revenue Service (IRS). Because RALs usually run for a duration of about 7-14 days (the difference between when the RAL is made and when it is repaid by deposit of the taxpayer's refund), fees for these loans translate into triple digit annualized interest rates. RALs drain billions from the pockets of consumers and the U.S. Treasury. They are targeted at the working poor, especially those who receive the Earned Income Tax Credit (EITC), a refundable credit provided through the tax system and intended to boost low-wage workers out of poverty. The EITC is the largest federal anti-poverty program, providing over $38.7 billion to 22 million families in 2004.[1]

This report updates the NCLC/CFA annual reports on the RAL industry and the drain caused by RALs from EITC benefits. Those interested in background information on the industry and regulation should refer to the first NCLC/CFA RAL Report published in January 2002.[2]

Advocacy efforts against RALs appear to have made some progress. Connecticut became the first state to regulate RAL interest rates by prohibiting tax preparers from brokering RALs over 60% annualized interest. Several more states passed laws to require better disclosures. However, a Washington State law preempted a superior disclosure ordinance passed by the City of Seattle. Furthermore, better disclosures are only partially effective in combating RALs.

Jackson Hewitt and Liberty Tax Service joined H&R Block in agreeing to stop charging consumers the "administrative" or "application" fee in all or some of their offices. These developments were mostly due to the efforts of grassroots advocates, particularly the Association of Community Organizations for Reform Now (ACORN). This effectively brings down the cost of RALs and refund anticipation checks[3] by $30 or more for many RAL consumers.

The volume of RALs in 2004, the most recent year for which the IRS has data, shows RAL usage remains flat at around 12 million. There is some dispute by the industry as to the accuracy of the IRS data, but we believe the data is within the ballpark of real RAL usage. RALs continue to drain over a billion dollars from the pockets of American taxpayers including EITC recipients.

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[1] IRS, *Tax Stats at a Glance*, available at www.irs.gov/taxstats/article/0,,id=102886,00.html.
[2] 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 31, 2002, [hereinafter "NCLC/CFA 2002 RAL Report"], available at www.consumerlaw.org/action_agenda/refund_anticipation/content/RAL_final.pdf.
[3] Refund anticipation checks are the non-loan bank product that many RAL lenders and tax preparers offer in addition to RALs. With refund anticipation checks, the bank opens a temporary or "dummy" bank account into which the IRS direct deposits the refund check. After the direct deposit of the consumer's refund, the bank issues the consumer a paper check and closes the dummy account. The consumer then picks up the check from the tax preparer's office.

We have additional data on RAL consumers from two surveys conducted by professional polling companies. This data indicates that RAL consumers are vulnerable to other forms of high cost credit, such as payday loans, rent-to-own and pawn transactions. Some RAL consumers may be using the loan proceeds to pay off other high cost credit.

II. RAL Volume Remains Flat

RAL volume has appeared to have leveled off during the past two years. The IRS data indicates there was an increase of just under 2% in the number of RALs from 2003 to 2004. Based on the IRS data, we estimate there were approximately 12.38 million RALs made in 2004.[4] In our last RAL report, we estimated approximately 12.15 million RALs were taken out in 2003.[5] The percentage of taxpayers who took out RALs remained the same, about 1 in 10 taxpayers.[6]

In 2004, taxpayers received an average refund of $2,154.[7] Based on prices charged to the customers of the nation's largest tax preparation chain for that year, the average taxpayer paid about $100 in RAL fees.[8] Thus, taxpayers paid somewhere in the neighborhood of $1.24 billion in RAL fees in 2004. This compares to an estimated $1.09 billion in RAL loan fees in 2003.[9] This represents a 14% increase, which appears mostly due to the fact that prices for RALs increased about $10 from 2003 to 2004.[10]

The following chart documents the trends in RALs since the 2000 filing season: [11]

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[4] The 12.38 million figure was calculated as follows: 1) IRS statistics state that there were 13.76 million tax returns which were associated with a RAL. Data from IRS Stakeholder Partnerships, Education & Communication (SPEC) Return Information Database for Tax Year 2003 (Returns Filed in 2004), October 2005; 2) we assume that since IRS would not know whether a RAL was approved or denied, so these statistics represent the number of RALs applied for. About 90% of RAL applications result in an approved loan. Santa Barbara Bank & Trust, *Why You Should Choose SBBT '05*, available at www.taxwise.com/pdf/Why%20SBBT.pdf; Household International, *Exploring the Refund Anticipation Loan (RAL): Questions and Answers*, on file with the authors. Thus, 90% of 13.76 million is 12.38 million.

[5] Chi Chi Wu and Jean Ann Fox, *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, January 2005, at 4 [hereinafter referred to as "NCLC/CFA 2005 RAL Report."].

[6] There were 127 million returns filed in the 2004 filing season, which was for Tax Year 2003. Data from IRS SPEC, Return Information Database for Tax Year 2003 (Returns Filed in 2004), October 2005.

[7] IRS, *Tax Stats at a Glance*, available at www.irs.gov/taxstats/article/0,,id=102886,00.html.

[8] 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*, January 2004, at 4 [hereinafter referred to as "NCLC/CFA 2004 RAL Report."].

[9] NCLC/CFA 2004 RAL Report at 4.

[10] The average fee for a RAL of $2001 to $5,000 increased from about $90 to $100. Compare the NCLC/CFA 2004 RAL Report at 9 with NCLC/CFA 2003 RAL Report at 6. 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 [hereinafter referred to as "NCLC/CFA 2003 RAL Report."].

[11] NCLC/CFA 2005 RAL Report at 4; NCLC/CFA 2004 RAL Report at 4, NCLC/CFA 2003 RAL Report at 1, NCLC/CFA 2002 RAL Report at 4.

Filing Year	No. of RALs	Increase/decrease from prior year	RAL loan fees
2004	12.38 million	1.89%	$1,240,000,000
2003	12.15 million	(-4)%	$1,090,000,000
2002	12.7 million	5%	$1,140,000,000
2001	12.1 million	12%	$907,000,000
2000	10.8 million	--	$810,000,000

The $1.24 billion for 2004 would be even higher if we could include the added fees paid for additional loan products called "Instant Money Loans" (H&R Block) or "Money Now Loans" (Jackson Hewitt). These products are same-day loans, by which consumers can receive all or part of their RALs immediately when they file their taxes. Lenders charge an additional $20 to $45 for same-day RALs, a fee which the consumer pays on top of regular RAL fees.[12] We know that H&R Block made 1.5 million "Instant Money" RALs in 2004, adding $30 million to the RAL drain.[13] We do not have data on the number of same-day RALs made by the rest of the industry.

In addition to the RAL loan fee, major tax preparation firms had been charging their own separate fees for RALs, often termed "system administration," "document preparation" or "application" fees. All of the major tax preparation chains have agreed to drop this additional fee in part or whole. H&R Block dropped this fee entirely as part of an agreement with ACORN.[14] ACORN had reached an initial understanding with Jackson Hewitt to drop its "application" fee in 50 markets.[15] Subsequently, Jackson Hewitt's Vice President of Legal and Government Affairs testified in a Senate hearing that his chain has agreed to drop this fee entirely in its company-owned offices and to encourage its franchisees to do the same.[16] Liberty Tax has also agreed to drop its application fee as a result of advocacy by ACORN.[17]

Given that the system administration fee was not entirely dropped until this year, we will include this fee in the calculations for the amounts paid in 2004 for RALs. However, given that H&R Block did drop its administrative fee for 13 states in 2004, we assume that only 91% of

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[12] H&R Block, *Sample Refund Anticipation Bank Loan*, January 2006, on file with the authors; Santa Barbara Bank & Trust, *2006 Program Newsletter for Tax Professionals*, available at the Taxwise website at www.taxwise.com/pdf/2006%20SBBT%20Newsletter.pdf.
[13] Peter Tufano and Daniel Schneider, *H&R Block and "Everyday Financial Services*," Harvard Business School, October 2004, at 7. Block customers pay an additional $20 for an Instant Money Loan. H&R Block, *Sample Refund Anticipation Bank Loan*, January 2006, on file with the authors. This is significantly less than the same-day RAL surcharge for other tax preparers; thus, the drain created by these products may even be greater if we had data on industry-wide sale.
[14] ACORN and H&R Block Press Release, *H&R Block and ACORN Partner To Help Working Families Claim And Keep More Of What They've Earned This Tax Season*, January 14, 2005.
[15] ACORN Press Release, *ACORN Suspends Jackson Hewitt Protests*, January 11, 2005 (Jackson Hewitt committing to eliminate the application/administrative fee in 50 of its markets).
[16] Testimony of Gary P. Weinstein, Vice President, Legal and Government Affairs, Jackson Hewitt Tax Service, Before the Permanent Subcommittee on Investigations, April 15, 2005.
[17] Email from ACORN Financial Justice Center to Chi Chi Wu.

RAL customers paid the fee in that year.[18] According to Block, its system administration fee ranged from $28 to $59, with an average of $32.[19] Using the average figure, these additional fees added about $360 million to the amount paid for RALs in 2004.

Industry sources have claimed that the IRS data on RALs includes some non-loan products, such as refund anticipation checks (RACs).[20] However, until recently, there has been no confirmation from IRS about this potential overestimate. Thus, we could only rely on the data provided to us by the IRS. Furthermore, according to the IRS, the estimated number of RALs represents requests for the Debt Indicator. Logically, one would assume requesting a Debt Indicator would not be necessary for a non-loan product such as a RAC because there would be no need for underwriting for such products.

In her 2005 Report to Congress, the National Taxpayer Advocate did confirm there is an "unquantifiable" number of non-loan RACs included in the IRS data.[21] Thus, there is official indication that the RAL figure may overestimate the number of RALs by including some RACs. However, the Brookings Institution has reported that the IRS data may also underestimate the number of RALs because: (a) the IRS data do not report ZIP code preparer debt inquiry totals of less than ten, causing the analysis to miss perhaps several thousand inquiries and associated RALs; and (b) the IRS data does not capture RALs arranged by non-tax preparation firms that are not electronic return originators, and thus do not participate in the Debt Indicator Program, such as Indian Country trading posts and used car and furniture stores.[22] Furthermore, the IRS data does not capture RALs that are made by non-bank storefront lenders, such as the RAL lender sued by the Colorado Attorney General in the *Cash Now* case.[23] Finally, we have always assumed that 10% of the IRS data constitutes RACs due to loan denials, and have adjusted the IRS data downward to compensate. Note that consumers pay a price for RACs as well, albeit in the range of $25 to $30.

Even if the IRS data does include some RACs, the IRS data does not seem off by a great deal. For example, we reported that 12.15 million RALs were made in 2003 based on the IRS data. An analysis of SEC filings corroborates that the number of RALs was in the range of this amount. We know from SEC filings that two of the largest RAL lenders made 9.23 million RALs in 2003 (HSBC/Household reported that it made 7.7 million RALs that year, and Santa Barbara Bank & Trust report 1.53 million RALs).[24] According to industry analysts, Bank One

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[18] H & R Block, *America's Tax and Financial Partner*, January 2004. In 2004, Block had 4.27 million RALs (see Section VII below) or about a 35% share of the market. Since we do not know in which states Block dropped the fee, we will simply conclude that it was dropped for 26% of Block's customers (i.e., 13 out of 50 states is 26%). Twenty-six percent of a 35% share is 9%. Thus we assume that 9% of RAL customers did not pay the administrative fee, and 91% did pay it.
[19] H & R Block, *America's Tax and Financial Partner*, January 2004.
[20] Email from Santa Barbara Bank & Trust to authors, on file with authors.
[21] National Taxpayer Advocate, *FY 2005 Annual Report to Congress*, December 31, 2005, at 164 [hereinafter "National Taxpayer Advocate 2005 Report"].
[22] Alan Berube and Tracy Kornblatt, *Step in the Right Direction: Recent Declines in Refund Loan Usage Among Low-Income Taxpayers*, Brookings Institution, April 2005, at 3 available at www.brookings.edu/metro/pubs/20050412_eitcdecline.htm.
[23] *State ex rel. Salazer v. The Cash Now Store*, 31 P.3d 161 (Colo. 2001).
[24] Household International, *2003 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 7; NCLC/CFA 2005 RAL Report at 14. Many of HSBC/Household's RAL are facilitated

has about the same market share as SBBT.[25] In addition, there are several other RAL lenders, such as Republic Bank (which made $7.4 million in RAL fees in 2003), River City Bank, and First Bank of Delaware (Liberty Tax's RAL provider). If Bank One and the three smaller players made a minimum of 1.5 million RALs, the total is 10.73 million, which is about 11% less than 12.15 million. Put another way, in late 2002, the American Banker estimated that Household had 62% of the RAL marketplace.[26] With 7.7 million RALs, the industry total would be 12.4 million.

In terms of following trends with respect to RALs, the IRS data remains valuable information. This is the same item of data that the IRS has provided to estimate the number of RALs for the past 4 years. Thus, even if the number of RALs is somewhat overstated (or understated), the increases or decreases should continue to provide data about RAL trends. However, the National Taxpayer Advocate's report states that there were 10.7 million RAL indicators in 2005, which is substantially less than the number of requests for 2004. Furthermore, Consumer Federation of America surveyed more than 2000 households in 2005 and found that 7.1% took out RALs in 2005.[27] The National Taxpayer Advocate's report implies there was a greater effort to include only RALs starting in 2005, and thus could indicate an overestimate. This data could also indicate a real drop in RALs for that year due to the cumulative effect of improved disclosures and several years of anti-RAL education efforts.

For 2006, the IRS has instituted a change in the RAL indicator by explicitly requiring tax preparers to indicate whether an electronically filed return is associated with a RAL versus a RAC.[28] This should ensure accurate results without having RACs included in the RAL figure.

III. Price of a RAL for 2005

Based upon the prices for RALs in 2006, a consumer can expect to pay about $100 in order to get a RAL for the average refund of about $2,150 from a commercial tax preparation chain this year. This loan fee includes the fee supposedly for the "dummy" bank account used to receive the consumer's tax refund from IRS to repay the RAL. The effective APR on this RAL would be 178%.[29]

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by independent preparers. HBSC/Household has a relationship with approximately 5,600 tax preparers, most of whom we assume are independent preparers. Household 2003 Form 10-K at 7. Independent preparers represented about 70% of all paid preparer returns in 2003. NCLC/CFA 2005 RAL Report at 15.

[25] Katie Kuehner-Hebert, *California Bank Finds Gold in E-Returns*, American Banker, August 12, 2001, at 1 (noting that both SBBT and Bank One have a 10% share of the market).

[26] Ben Jackson and Alan Kline, *Refund Lending No Problem*, American Banker, November 27, 2002, at 1.

[27] Consumer Federation of America, Omnibus Survey of Consumer Financial Services, conducted by Opinion Research Corporation, November 2005.

[28] IRS, Publication 1346, Electronic Return File Specifications For Individual Income Tax Returns Tax Year 2005, August 30, 2005, at xi.

[29] Most tax preparers and RAL lenders have been reporting APRs lower than our estimates because they do not include the charge supposedly for the "dummy" bank account, claiming that it is comparable to the charge for the non-loan RAC product. However, this unbundling is questionable. For an analysis of why the fee for the dummy bank account should be included in the APR, *see* Appendix A at 7. We continue to include the charges for the dummy account fee in our estimates for the APR to present a truer picture of the real "cost of credit" for a RAL.

The fee for the RAL plus the fee for tax preparation, which averages about $146,[30] would total about $246. If the consumer chooses a tax preparer that charges a "system administration" or "application" fee, in the neighborhood of $30 per loan, the total would rise to $276.[31] Given that the three major tax preparation chains have dropped this fee at least for company-owned offices, only consumers who choose Jackson Hewitt franchisees and independent tax preparers might have to pay this fee. This is still a substantial share of the RAL market, since over 4,800 of the approximately 5,500 Jackson Hewitt offices are franchisees.[32] In addition, HSBC alone has reported partnerships with several thousand independent preparers.[33] We estimated that independent preparers prepared over 50 million tax returns, or about 70% of all paid preparer returns, in 2003.[34] Thus, Jackson Hewitt franchisees and independent brokers probably facilitate several million RALs.

For the 2006 filing season, we estimate that the APRs on RALs range from about 40% (for a loan of $9,999) to over 700% (for a loan of $200).[35] We also continue to report a version of the APR that includes administrative or application fees, if they are charged, because those fees when charged also represent a cost of the credit for a RAL.[36] For loans with administrative or application fees, the fees can translate into APRs of about 70% (for a loan of $7,000)[37] to over 1,800% (for a loan of $200).

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[30] According to industry leader H &R Block, its average tax preparation fee is $146. H&R Block Inc., *2004 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 18. [hereinafter "H&R Block, 2004 Form 10-K"].
[31] Anecdotal reports include even higher totals in the low to upper $300s. *See* Statement of Maerine Henderson ($386), State of Julie Burbach ($322 including Instant Money Loan fee), and Statement of Nila Grant (fee around $300) before the U.S. Senate Permanent Subcommittee on Investigations, Hearing On Tax Related Financial Products Can Be Costly, April 15, 2005.
[32] Jackson Hewitt Tax Service Inc., *2005 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 3 [hereinafter "Jackson Hewitt 2005 Form 10-K".]
[33] HSBC has reported that H&R Block offices make up only 9,200 of the 17,300 (or 53%) outlets with which HSBC does RAL business. Household 2003 Form 10-K at 7. While some of the remaining 8,100 offices may be Jackson Hewitt franchisees, it appears that there are still several thousand independent preparers with which HSBC has a relationship.
[34] NCLC/CFA 2005 RAL Report at 15.
[35] These APRs are based upon a 10 day loan period. The estimated time provided by the federal government to receive a refund with e-filing and direct deposit is 8 to 15 days. IRS, *IRS e-file 2006 Refund Cycle* Chart, Publication 2043, October 2005. The Treasury Inspector General for Tax Administration reports that the average time is 11 days. Treasury Inspector General for Tax Administration, *Individual Income Tax Return Information Was Accurately and Timely Posted to the Customer Account Data Engine*, Ref. No. 2005-40-109, July 2005. One would subtract out the one or two days that it takes for the loan to be made. Moreover, some free tax preparation sites report that during the height of tax season in early February, refunds arrive as quickly as a few days.
[36] The U.S. General Accounting Office reported even higher estimates for RAL APRs of 400% and 900%. U.S. General Accounting Office, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS is a Challenge*, GAO-04-70, October 31, 2003, at 10, available at www.gao.gov/cgi-bin/getrpt?GAO-04-70
[37] We did not calculate an APR with an administrative fee for a loan of $9,999, because Block makes those loans and it no longer charges the administrative fee.

IV. Impact on Low-Income Taxpayers and EITC recipients

RALs are mostly marketed to low-income taxpayers. According to IRS data, 78% of RAL applicants in 2004 had adjusted gross incomes of $35,000 or less.[38] This is consistent with statistics that 58% of H & R Block's customers make less than $30,000 annually.[39] Jackson Hewitt similarly reports in its SEC filings that 73% of its customers make less than $30,000 adjusted gross income,[40] and HBSC states that the majority of their RAL customers have an average household income of $17,800.[41] A 2005 survey by CFA found that the majority of RAL borrowers (58.7%) earned below $40,000. Median income in the United States was $44,400 in 2004.[42]

RALs continue to drain hundreds of millions from the Earned Income Tax Credit. IRS data shows that in 2004 nearly 56% of RAL consumers were EITC recipients, or 7 million families.[43] Yet EITC recipients made up only 17 % of individual taxpayers in 2004.[44] Thus, EITC recipients are vastly overrepresented among the ranks of RAL consumers. In addition, IRS data shows that over 1 in 3 EITC recipients took out a RAL in 2004.[45]

Based on this IRS data, we estimate that about $700 million was drained out of the EITC program in 2004 by RAL loan fees.[46] Administrative/application fees added another $204 million to the drain.[47]

Non-loan fees also drain significantly from EITC benefits. The EITC is the nation's largest anti-poverty program. One criticism has been that no other anti-poverty program requires its beneficiaries to pay for the cost of accessing the benefit, which include both the drain created by RALs as well as tax preparation fees. Including tax preparation and check cashing costs provides a fuller picture of how EITC benefits are chipped away. EITC recipients who got RALs paid an additional $840 million in tax preparation fees, and 45%[48] of them paid $205 million in check cashing fees.

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38 Data from IRS SPEC, Return Information Database for Tax Year 2003 (Returns Filed in 2004), October 2005.
39 Peter Tufano and Daniel Schneider, *H&R Block and "Everyday Financial Services*," Harvard Business School, October 2004, at 7
40 Jackson Hewitt, *Final Prospectus*, June 22, 2004, at 46.
41 Household International, *2003 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 7 [hereinafter "Household 2003 Form 10-K"].
42 Carmen DeNavas-Walt, Bernadette D. Proctor and Cheryl Hill Lee, *Income, Poverty, and Health Insurance Coverage in the United States: 2004,* Census Bureau, P60-229, August 2005 at 3.
43 IRS data reports that 7.77 million EITC returns were associated with a RAL in 2004. Data from IRS SPEC, Tax Year 2003 Return Information (Returns Filed in 2004), October 2005. Using the 90% approval rate, *see* note 4 *supra*, the number of approved RALs is 7 million.
44 There were 21.4 million EITC returns in 2004 and 127 million individual tax returns in 2004. Data from IRS SPEC, Tax Year 2003 Return Information (Returns Filed in 2004), October 2005.
45 Data from IRS SPEC Return Information Database for Tax Year 2003 (Returns Filed in 2004), October 2005.
46 At a fee of $100 for a RAL for the average refund times 7 million. We know longer use the figure for the average EITC because the refunds of EITC recipients often include overwithholding as well.
47 Weighted to 91%, *see* note 8 *supra*.
48 This 45% figure is taken from a study of EITC recipients who used *free* tax preparation services. Timothy M. Smeeding, Katherine Ross Phillips, and Michael O'Connor, *The EITC: Expectation, Knowledge, Use, and Economic and Social Mobility,* Center for Policy Research, Working Paper Series No. 13 (2000), at Table 5. Given the relationship between *commercial* tax preparers and check cashers, *see* NCLC/CFA 2003 RAL Report at 9, we

Type of Fee	Cost to Taxpayer	Drain on EITC Program
RAL loan fee (inc. dummy account fee)	$100	$700 million
Application/Admin. Fee (for 91%)	$32	$204 million
Total	**$132**	**$904 million**
Tax preparation fee	$146	$1 billion
Check cashing fee (for 45% of EITC recipients)	$65[49]	$205 million
Total with tax preparation and check cashing	**$317**	**$2.1 billion**

Each of these fees undermines the effectiveness of the EITC in supporting low-wage workers. These fees transfer billions in wealth, paid out of the U.S. Treasury, from poor families to multi-million dollar corporations.

V. Use of High Cost Credit by RAL Borrowers

A telephone polling survey commissioned by the Consumer Federation of America provides new information about RAL borrowers. The national survey found that RAL borrowers are vulnerable to quick cash loan offers. RAL borrowers are also heavier users than non-RAL borrowers of other high cost fringe financial services, such as rent-to-own, payday loans and pawnshop loans. These consumers are more likely to be unbanked than non-RAL borrowers and those who do have bank accounts are more likely to have overdrawn in the past year.

The CFA survey asked respondents whether they had used various forms of fringe financial credit during the past year. Those who had used RALs were:

- 6 times more likely to have used rent-to-own credit (10.4% of RAL borrowers versus 1.8% of non-RAL borrowers).
- 4 times more likely to have taken out a payday loan (9.7% versus 2.1%).
- 3.5 times more like to have taken out a pawnshop loan (4.2% versus 1.2%).

RAL borrowers were less likely to have traditional credit in the form of credit cards than non-RAL borrowers and those with credit cards were more likely to have high interest rates on the credit cards they do hold.

- Non-RAL borrowers were 15.5% more likely to have credit cards than RAL borrowers. Three-quarters (76.2%) of non-RAL borrowers have credit cards compared to two-thirds (66.0%) of RAL borrowers.

believe this figure actually underestimates the number of EITC recipients who use check cashers. Since there were 7 million RAL consumers who received the EITC in 2004, 45% would be 3.15 million.

[49] The average check cashing fee for a RAL check is about 3%, or $65 for the average refund of $2,150. *See* NCLC/CFA 2003 RAL Report at 12.

- RAL borrowers with credit cards were more than twice as likely to have interest rates over 20% on the credit cards. One in seven (15.8%) of RAL borrowers with credit cards had interest rates above 20% compared to 6.7% of non-RAL borrowers who had interest rates over 20% on their credit cards.

RAL borrowers are less likely to have bank accounts, but when they do, more likely to overdraw their accounts. Specifically, they are:

- Almost 2 times more likely to be unbanked (16.0% of RAL borrowers versus 8.7% of non-RAL borrowers).
- 70% more likely to have overdrawn their checking accounts (34.3% versus 19.5%).

RAL borrowers are more likely to be burdened by debt than non-RAL borrowers.

- RAL borrowers were 29.9% more likely to be concerned about paying their monthly bills than non-RAL borrowers. Two-thirds (66.0%) of RAL borrowers were a little concerned, somewhat concerned or very concerned about paying their monthly bills compared to half (50.8%) of non-RAL borrowers. RAL borrowers were twice as likely as non-RAL borrowers to be very concerned about paying their monthly bills. Nearly a third (31.9%) of RAL borrowers were very concerned about paying monthly bills compared to one in six (16.1%) of non-RAL borrowers.
- RAL borrowers were twice as likely as non-RAL borrowers to be concerned about making monthly mortgage or rental payments. One in eight (12.4%) non-RAL borrowers had a little difficulty, some difficulty or a great deal of difficulty making monthly housing payments compared to 28.5% of RAL borrowers.
- RAL borrowers were more than twice as likely as non-RAL borrowers to make only the minimum monthly payments on any credit cards they may have. About a tenth (11.6%) of RAL borrowers only made the minimum monthly payments on their credit cards compared to 4.4% of non-RAL borrowers.

The survey indicated RAL borrowers are more likely than non-RAL borrowers to be less well educated, work in service or semi-skilled/unskilled jobs, rent instead of own their homes, be female and African American. In particular, RAL borrowers are more likely than non-RAL borrowers to:

- Have a high school education or less (53.5% of RAL borrowers versus 36.0% of non-RAL borrowers).
- Work in a service occupation or a semi-skilled/unskilled blue collar position (34.0% versus 21.2%).
- Rent instead of own (38.9% of RAL borrowers are renters versus 21.8% for non-RAL borrowers)
- RAL borrowers are more than twice as likely to be African American as non-RAL borrowers. About one in seven (15.3%) RAL borrowers were African American compared to one in fifteen (6.9%) non-RAL borrowers who were African American.
- Be female (54.2% of the borrowers were female, 45.8% were male)

- Be below the median income. Three fifths (58.7%) of RAL borrowers earned below $40,000 compared to three fifths (59.7%) of non-RAL borrowers who earned more than $40,000.

The survey was conducted by Opinion Research Corporation in early November 2005 and interviewed 2,038 representative adult Americans. The margin of error for the sample is plus or minus two percentage points.

The relationship between RAL use and use of other fringe lending products may be more than a shared customer base. It appears that tax refunds monies, received either directly from the IRS or through RALs, go in part to pay off other high cost lenders.

During tax season, consumers pay off pawn transactions to redeem their personal property. One of the large publicly traded pawn chains, EZ PAWN reports that its cash flow is greatest in its second fiscal quarter primarily due to a high level of loan redemptions and sales in the income tax refund season.[50] Florida tracks payday loans by month. Its database report documents that loan volume is at its lowest in February of the last three years, followed by March. For the most recent year, loan volume dropped over 24% from January to February of 2005. Loan volume in Florida was below 300,000 per month only for the months of February (267,071) and March (293,720).[51]

Given the high proportion of RAL borrowers who responded to the CFA poll that they also borrow from payday lenders, we believe that RAL customers pay triple digit interest rates to borrow against their tax refunds to repay triple-digit interest rate payday loans and to take a break from the repeat cycle of borrowing while the infusion of tax credits lifts family budgets.

VI. Credit Research Center Study

In 2005, the Credit Research Center at Georgetown University released the results of its own polling survey on RAL usage, funded in part by commercial tax preparation chain Jackson Hewitt. The major conclusion of this survey was that RAL borrowers benefit from the product because they have few sources of other credit (an argument that the report's author has made in defending payday loans). This conclusion does concur with the data from the CFA survey from above, in that both show that RAL borrowers have fewer credit choices than non-RAL borrowers. Thus both surveys found that RAL borrowers were vulnerable to other high cost credit, such as payday loans and rent-to-own, although the CRC study shows RAL borrowers under more financial distress.

The big difference with the Credit Research Center's report are the conclusions drawn from this data. The CRC believes that offering triple digit interest rate loans to financially oppressed consumers is a beneficial activity. We believe that selling super-high cost credit to cash-strapped, sometimes desperate consumers is a form of price gouging that preys on the vulnerable. The difference is not in the data, but in the analysis.

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[50] EZCORP, INC., *2004 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 33.
[51] *Florida Trends in Deferred Presentment*, State of Florida Deferred Presentment Program, September 2005, at 3.

Another conclusion of the CRC study was that RAL borrowers do have information on the costs of RALs and refund options, and had made a deliberate and informed choice to select a RAL. This particular finding may be more challengeable, because the underlying data seems questionable. The Credit Research Center study interviewed 15,177 respondents. Only 330 of these respondents - or 2.17% - reported they had used a RAL. This is a gross underestimate of the percentage of RAL borrowers. The IRS data on RALs show that about 10% of tax returns are associated with a RAL. Even assuming the IRS data slightly overestimates the number of RALs, and that all of the respondents were not taxpayers, that does not explain a four-fold disparity in the data.

One reason for this disparity may be that the Credit Research Center poll described a RAL as "a loan or advance of money against a tax refund, typically provided by a bank," and then asked respondents if they had obtained a "Refund Anticipation Loan." If many consumers who get RALs do not understand that the product is a loan, they will not answer "yes" to such a question. The use of the phrase "typically provided by a bank" may be been particularly confusing, since some RAL borrowers may think it meant they actually had to go a bank branch to get the loan. Thus, only the most informed of RAL borrowers reported that they had received a RAL.

An in-depth analysis of the Credit Research Center's Study is attached as Appendix A to this report.

VII. Overview of Key Industry Players

This section provides basic information on the RAL activity of key industry players, an overview that we provide annually in our RAL reports. In a following section, we discuss industry trends and where certain industry players appear to be headed.

H&R Block

H&R Block is the nation's largest tax preparation chain, accounting for 15.7% of all tax returns by individuals in 2004.[52] For 2004, H&R Block actually experienced an 8% decline in the number of RALs they facilitated that were funded, to 4.27 million.[53] The company attributed this decline to having fewer customers plus less aggressive promotion of the product.[54] In addition, the number of RACs that Block processed rose by 30%.[55] Block processed 16 million tax returns in 2004;[56] thus, 26.6% of its customers got RALs

[52] H&R Block Inc., *2005 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 3. [hereinafter "H&R Block, 2005 Form 10-K"].
[53] H&R Block Inc., *2004 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 17. [hereinafter "H&R Block, 2004 Form 10-K"].
[54] *See* H&R Block, *Year-End Conference call*, June 9, 2004 (comments of Jeff Yabuki).
[55] Peter Tufano and Daniel Schneider, *H&R Block and "Everyday Financial Services,"* Harvard Business School, October 2004, at 7.
[56] H&R Block, 2004 Form 10-K at 17.

in 2004. H&R Block also facilitated 2.95 million refund anticipation checks in 2004,[57] thus 45% of its customers get a refund financial product.

In 2005, Block's RAL business stayed essentially flat. Block made 4.2 million RALs, despite the fact that it heavily marketed RALs in television advertisements and other media that ran frequently during the tax season.

Block earns fees from RALs through its arrangement to have Block Financial Corporation buy a 49.9% interest in RALs arranged by the tax preparation arm. In 2004, Block earned $174.2 million in revenues from RALs, representing 4.1% of the company's revenues.[58] In 2005, Block's RAL profits rose to $182.8 million.[59]

Block formerly earned revenues from RALs by charging a system administration fee ranging from $28 to $59, with an average of $32,[60] but dropped this fee nationwide in 2005.[61] However, the total paid by a Block client for a RAL remains similar because Block's average tax preparation fee has risen about $30 to $150.[62]

Block continues to seek a bank charter from the Office of Thrift Supervision (OTS). It re-filed its application with OTS in May 2005. The third time might be the charm with Block, as this application has progressed further than the previous applications. The OTS held a formal hearing concerning Block's application on October 5, 2005. A decision by OTS is expected in early 2006.

Block has continued to revise its disclosures. It added information about cross-lender debt collection to its "Facts About RALs" flyer, which it provides to customers when they ask for a RAL.

HSBC

After HSBC bought Household International in 2004, it took over Household's RAL lending and re-named the unit "HSBC Taxpayer Financial Services." Thus, HSBC automatically became the largest RAL lender in the industry, using the new national bank charter it acquired in 2004 to make high cost loans with triple digit interest rates.

HSBC reported that in 2004, it had 8.2 million refund product customers.[63] It is unclear whether these accounts were all RALs, or whether some RACs were included in the mix.

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[57] H&R Block, *Answering Your Questions About Refund Anticipation Loans*, January 30, 2005.
[58] H&R Block 2004 Form 10-K at 27.
[59] H&R Block 2005 Form 10-K at 4.
[60] H & R Block, *America's Tax and Financial Partner*, January 2004.
[61] ACORN and H&R Block Press Release, *H&R Block and ACORN Partner To Help Working Families Claim And Keep More Of What They've Earned This Tax Season*, January 14, 2005.
[62] *Compare* H&R Block 2005 Form 10-K at 22 (reporting average fee of $150.67) *with* H&R Block, *Q4 2002 H & R Block Earnings Release Conference Call*, June 12, 2002, available at 2002 WL 26337229 (reporting average fee of $120).
[63] HSBC Finance Corp., *2004 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 10[hereinafter "HSBC 2004 Form 10-K"].

However, we do know that HSBC/Household originated 7.7 million RALs in 2003 and 7 million RALs in 2003.[64] HBSC's RAL/RAC income was $261 million in 2005, represented a 23% increase from its income of $212 million in 2004.[65]

The following is the HSBC/Household price structure for RALs in 2005, for both H&R Block[66] and in general.[67]

HSBC/Household 2006 RAL Fee Schedule for H&R Block

Amount of Loan	H&R Block
$200-$500	$29.95
$501-1,000	$39.95
$1,001-$2,000	$69.95
$2,001-$3,700	$99.95
$3,701-$9,999	$109.95

HSBC/Household 2006 RAL Fee Schedule – Independent Preparers

Amount of Loan	General
$200-$500	$34.95
$501-1,000	$64.95
$1,001-$1,500	$79.95
$1,501-$2,000	$94.95
$2,001-$7,000	$119.95

Block's fees appear to be about $5-25 less than for other tax preparers who offer HSBC RALs. For the non-Block rates, there appears to be significant increases from 2005 prices, ranging from $5 to $15.[68]

<u>Jackson Hewitt</u>

Jackson Hewitt is the second largest tax preparation chain in the country, preparing 3.1 million returns in 2004, or about 2% of all individual tax returns.[69] Its main bank partner for RALs and other tax financial products is Santa Barbara Bank and Trust (SBBT); however, Jackson Hewitt also has a partnership with HSBC, which makes about 20% of the RALs and refund anticipation checks brokered by Jackson Hewitt.[70]

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[64] Household International, *2003 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 7 [hereinafter "Household 2003 Form 10-K"].
[65] HSBC Finance Corp. *Form 10-Q: Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended June 30, 2005*, at 3.
[66] H&R Block, *Sample Refund Anticipation Bank Loan*, January 2006, on file with the authors.
[67] From HSBC's website at www.hsbctaxpayerfinancialservices.com/htax/ERO/Ind?cmd_static=eroExpRefLoan. The fees include both HSBC's stated finance charge as well as the dummy account fee.
[68] NCLC/CFA 2005 RAL Report at 12.
[69] Jackson Hewitt, *Final Prospectus*, June 22, 2004, at 47. Data from IRS SPEC, Return Information Database for Tax Year 2002 (Returns Filed in 2003), July 2004.
[70] Jackson Hewitt, *Final Prospectus*, June 22, 2004, at 30.

In 2004, Jackson Hewitt sold 2.8 million tax refund products, including 1.1 million RALs.[71] Thus for 2004, 90% of JH customers got some sort of financial product and 35.5% got a RAL. In addition, 32% of Jackson Hewitt customers specifically got a refund anticipation check.[72]

In 2005, Jackson Hewitt processed 3.3 million tax returns.[73] About 3.1 million of these taxpayers, or 94%, were sold a financial product.[74] Jackson Hewitt brokered 1.2 million RALs, up 7% from the year before.[75]

Jackson Hewitt continues to derive a startling percentage of its profits from financial products. Nearly 40% or $36 million of the company's revenues are from financial products and 28% of the company's revenues are derived from RALs alone[76] a much higher percentage than Block.

Jackson Hewitt's RAL revenues have increased dramatically over the past few years. The company earned $60.6 million in RAL and refund anticipation check-related fees in 2004, as compared to only about $20 million in 2001.[77] Jackson Hewitt earned fees from RALs two ways: 1) a portion (up to $14.55) of the $25 dummy account fee charged for RALs and refund anticipation checks;[78] and 2) a flat fee of up to $19 per RAL, plus another $2 per RAL if loan losses do not exceed a certain amount.[79]

As mentioned above, Jackson Hewitt has agreed to drop its "application" fee in its company-owned offices and encourage franchisees to do the same.[80] However, only 613 of the approximately 5,500 Jackson Hewitt offices are company-owned,[81] so the extent to which Jackson Hewitt has eliminated this fee is unknown.

In addition, Jackson Hewitt obtained the agreement of SBBT and HSBC to eliminate the $10 additional finance charge for RALs based on the EITC.[82] Interestingly, had this $10 surcharge for EITC recipients continued, there is an argument that it would violate the Equal Credit Opportunity Act, 15 U.S.C. §§ 1691–1691f, which prohibits discrimination in lending against public assistance recipients. Charging EITC recipients even more than other taxpayers creates more drain on these vital benefits, which we had not included in our previous estimates of EITC dollars lost to RALs.

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[71] *Id.* at 35.
[72] *Id.* at 51.
[73] Jackson Hewitt 2005 Form 10-K at 3.
[74] *Id.* at 4.
[75] *Id.*
[76] Jackson Hewitt 2005 Form 10-K at 15.
[77] Jackson Hewitt, *Final Prospectus*, June 22, 2004, at 29-30.
[78] *Id.* at 29. The dummy account fee is the fee allegedly charged for the deposit account used to receive the consumer's tax refund from IRS to repay a RAL.
[79] *Id.* at 39.
[80] Testimony of Gary P. Weinstein, Vice President, Legal and Government Affairs, Jackson Hewitt Tax Service, Before the Permanent Subcommittee on Investigations, April 15, 2005.
[81] Jackson Hewitt 2005 Form 10-K at 3.
[82] Testimony of Gary P. Weinstein, Vice President, Legal and Government Affairs, Jackson Hewitt Tax Service, Before the Permanent Subcommittee on Investigations, April 15, 2005.

Santa Barbara Bank & Trust/Pacific Capital Bancorp

Jackson Hewitt's RAL partner, Santa Barbara Bank & Trust (SBBT), a subsidiary of Pacific Capital Bancorp, originated 5.1 million RALs and refund anticipation checks in 2004.[83] That year, its product mix was 31% RAL and 69% refund anticipation checks,[84] so we estimate SBBT made 1.58 million RALs in 2003. It earned $39.5 million in RAL fees in 2004 and $21.1 million in refund anticipation check fees.[85] About 30% of the bank's pre-tax earnings come from RALs and refund anticipation checks.[86]

SBBT reported that its 2005 RAL and refund anticipation check volume increased to approximately 5.6 million.[87] The product mix for that year was 70% refund anticipation checks and 30% RALs.[88] This means that SBBT made about 1.68 million RALs in 2005.

The following is SBBT's price structure for RALs in 2006.[89]

SBBT 2006 RAL Fee Schedule

Amount of Loan	Loan Fee
$300- $500	$29
$501-1,000	$44
$1,001-$1,500	$69
$1,501-$2,000	$84
$2,001-$5,000	$109

SBBT appears to have raised its RAL prices by $5 to $15 for loans over $1,000.[90] As discussed above, SBBT eliminated its additional finance charge for EITC recipients for Jackson Hewitt offices. It may have eliminated this surcharge entirely.

Other industry players

In addition to HSBC and Santa Barbara Bank & Trust, there are a handful of other banks that make RALs. The largest of these banks is Bank One, which merged in 2004 with J.P. Morgan Chase. Bank One's RAL fees are as follows:[91]

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[83] Pacific Capital Bancorp, *Form 10-Q: Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended June 30, 2004*, at 71. [hereinafter "PCB June 30, 2004 Form 10-Q"]
[84] *Id.*
[85] Pacific Capital Bancorp, *2004 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 63. [hereinafter "PCB 2004 Form 10-K"]
[86] *Id.* at 10.
[87] Pacific Capital Bancorp, *Form 10-Q: Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended June 30, 2005*, at 57.
[88] *Id.*
[89] SBBT, *Program Newsletter '06 E-Filing Financial Services*, available at the Taxwise website at www.taxwise.com/_inc/content-managed/pdf/05Update.pdf.
[90] *See* NCLC/CFA 2005 RAL Report at 14 for last year's SBBT pricing.
[91] Bank One Tax Related Products, *2006 Program Highlights*, available at the Taxwise website at www.taxwise.com/pdf/2006%20Program%20Highlights.pdf

Bank One 2006 RAL Fee Schedule

Amount of Loan	Loan Fee
$200- $499	$34
$500- $999	$54
$1,000-$1,499	$69
$1,500-$1,999	$79
$2,001-$5,000	$109

Republic Bank & Trust in Kentucky is one of the 3 smaller RAL lenders, earning $8.5 million in RAL fees in 2004.[92] In 2004, the Federal Deposit Insurance Corporation gave Republic a poor Community Reinvestment Act rating of "Needs to Improve" based in part of a "pattern or practice of substantive violations of equal credit opportunity laws in the Refund Anticipation Loan product ..."[93]

Liberty Tax is the third significant commercial tax preparation chain in the country, with over 1,700 locations.[94] It processed about 1 million returns in 2004.[95] Its president claimed that only 16% of Liberty customers received a RAL, or about 160,000.[96]

VIII. Directions in the RAL industry

For years, we've heard discussions about how the IRS is planning to increase the speed of refunds to only a few days, and that such an improvement would reduce the demand for RALs. Even industry members have indicated they believe the eventual upshot will be fewer RALs due to faster refunds.[97]

While such claims must be taken with a grain of salt, the dawn of faster refunds appears to be approaching. In 2005, 1.3 million tax returns were processed using a modernized database known as the Customer Account Data Engine (CADE).[98] CADE will provide IRS with the capability to issue refunds in 3 to 5 days with e-file and direct deposit.[99] According to the Treasury Inspector General for Tax Administration, this initial use of CADE was successful and reduced refund times to an average of 7 days for direct deposit refunds.[100] The National

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[92] Republic Bancorp Inc., *2004 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 37.
[93] Federal Deposit Insurance Corporation, Division of Supervision and Consumer Protection, Community Reinvestment Act Performance Evaluation - Republic Bank & Trust Co., October 4, 2004, at 2.
[94] Novelda Sommers, *Head of Liberty Tax Services Takes On Competition One Block at a Time*, Newport News Daily Press, March 28, 2005.
[95] Barbara Slavin, *Rush of Donations from USA is Immediate and Immense*, USA Today, December 30, 2004 at A1.
[96] Mary Wisniewski, *Bill Designed to Kill Off Tax Refund Loans*, Chicago Sun-Times, April 6, 2005.
[97] Statement of H & R Block on Refund Anticipation Loans and Tax-Related Financial Products Statement before the U.S. Senate Permanent Subcommittee on Investigations, Hearing On Tax Related Financial Products Can Be Costly, April 15, 2005.
[98] Treasury Inspector General for Tax Administration, *Individual Income Tax Return Information Was Accurately and Timely Posted to the Customer Account Data Engine*, Ref. No. 2005-40-109, July 2005.
[99] *IRS Oversight Board Annual Report 2005*, Tax Notes Today, 2005 TNT 207-22, October 25, 2005.
[100] Treasury Inspector General for Tax Administration, *Individual Income Tax Return Information Was Accurately and Timely Posted to the Customer Account Data Engine*, Ref. No. 2005-40-109, July 2005.

Taxpayer Advocate has urged that the IRS shorten this timeframe even more by shortening the time needed to run returns through an anti-fraud database.[101]

The major industry players appear to be responding to the eventuality of faster refunds in different ways. Jackson Hewitt and both of its lending partners have developed a new product, called a "pay stub loan" that provides a RAL-like product even before a taxpayer receives her W-2.[102] Since a taxpayer cannot file a return without a W-2, this loan is made pre-filing and before the tax season officially starts. The consumer must then return to Jackson Hewitt when her W-2 does arrive, and take out a RAL to repay the pay stub loan.

We have been informed that the charge for a "pay stub loan" includes several fees. One news report cited fees of $50 to Jackson Hewitt and a finance charge of as much as $95 for loans up to $1,900.[103] In addition, customers must pay a *second* finance charge for a RAL representing the balance of their refund.[104] Thus, the taxpayer might pay up to twice as much as a traditional RAL to get part of her refund monies before tax season begins.

Thus, Jackson Hewitt appears to be responding the potential of faster IRS refunds by introducing a loan product that can get the "jump" on tax season, but at a much more expensive cost. This product concerns us for several reasons - the added expense, the fact that this product enables the RAL industry to keep draining tax refunds and EITC benefits despite IRS efforts to speed refunds, and the additional risk posed by a loan based on a refund where the taxpayer has not even received her W-2, let alone had her taxes calculated. Furthermore, the pay stub loan forces the taxpayer in advance of the tax season to return to Jackson Hewitt to have her taxes prepared.

So far, industry giant H&R Block appears not to have developed a comparable product,[105] although there is no guarantee it will not in the future. Instead, Block is positioning itself to be a major provider of "Everyday Financial Services," especially for low and moderate income consumers.[106] Block's clientele, like that of Jackson Hewitt, is predominately low income; over 58% of Block's clients have a household adjusted gross income of $30,000 or less. More importantly, Block's share of the low and moderate income "market" is enormous. For instance, Block serves approximately 27% of unbanked households in the United States.[107]

With a bank charter, Block will have the potential ability to get many of these unbanked clients into bank accounts. It also could use bank accounts or other financial products, such as stored value cards, to steer consumers away from RALs to less expensive methods of receiving quick refunds that also can serve as asset building mechanisms. Block has stated in its

[101] National Taxpayer Advocate 2005 Report at 166.
[102] Jackson Hewitt advertises "Don't Wait For Your W-2. GET up to $1900 with a Money Now Loan in Minutes. Then Come Back With Your W-2 To File Your Return." Advertisement on file with authors. As of January 30 2006, Jackson Hewitt had a Web ad for this product available at www.jacksonhewitt.com/products_moneynow.asp.
[103] Melissa Burke, Consumers Can't Wait for Tax Refunds, York Daily Record, Jan. 8, 2006.
[104] *Id.*
[105] *Id.*
[106] Peter Tufano and Daniel Schneider, *H&R Block and "Everyday Financial Services,"* Harvard Business School, October 2004.
[107] *Id.* at 9.

Community Reinvestment Act plan filed with its bank application that it intends to market its bank accounts nationwide. This is an improvement over its initial proposal to have the accounts only in pilot cities. However, Block has not made concrete commitments to shift a certain number of clients away from RALs to bank accounts or to expend financial resources into marketing bank accounts by advertising or giving incentives for its tax preparers to sell the accounts.

Block's business strategy is not without risks for consumers. The key issue with Block's business plan is its reliance on the trust relationship, and the potential for exploitation. Already there is a strong degree of trust in the tax preparation relationship. Block's business plan seeks to raise this to the next level to apply to all aspects of the client's financial life. Yet in many states, Block tax preparers are under no obligation to look out for their clients' best interests - legally, they do not have a "fiduciary duty"[108] - so they are free to make recommendations that benefit themselves at the expense of their clients.

According to one source, even some within Block itself have recognized that brokering RALs may conflict with the role of a financial advisor looking out for the client's best interests.[109] By expanding their products to other financial products, the potential for draining client assets is even greater. For instance, Block owns one of the top 10 subprime mortgage lenders, Option One. One can easily imagine a scenario in which Block tax preparers heavily steer their low-income homeowners into Option One subprime loans.

One indicator of Block's future direction is its new agreement with HSBC. Block's prior agreement with HSBC expires in 2006, and consumer advocates had hoped Block would reform its RAL practices by signing an agreement that provides for lower costs and allows them to steer customers away from RALs. The new agreement appears to be a mixed bag, or silent, with respect to these issues. On one hand, the agreement allows Block entities to choose not to offer RALs.[110] On the other hand, Block has decided to retain its participation interest in RALs.[111]

The agreement does permit Block to develop some new products – the identities of which have not been made public.[112] However, it also requires Block to pay HSBC a fee for every RAC in which the funds are deposited into a Block IRA or other savings vehicle.[113] The agreement does not provide information on a cost structure for RALs and thus HSBC appears free to charge exorbitant rates for RALs. The agreement does appear to contemplate that Block will be developing the marketing of RALs.[114] At least on paper, it looks like not much has

[108] *See, e.g., Peterson v. H & R Block Tax Services*, 971 F. Supp. 1204 (N.D. Ill. 1997) (Illinois); *Sorenson v. H & R Block*, 107 Fed. Appx. 227 (1st Cir. 2004) (Massachusetts). Some courts have been willing to impose a fiduciary duty on tax preparers. *See, e.g.*, *Basile v. H&R Block*, 777 A.2d 95 (Pa. Super. Ct. 2001) (Pennsylvania).
[109] Peter Tufano and Daniel Schneider, *H&R Block and "Everyday Financial Services,"* Harvard Business School, October 2004, at 3.
[110] HSBC Retail Settlement Products Distribution Agreement, September 23, 2005, at 5, Exhibit 10.14 to H&R Block, *Form 10-Q: Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended October 31, 2005*. [hereinafter "H&R Block October 31, 2005 Form 10-Q"]
[111] HSBC Refund Anticipation Loan Participation Agreement, September 23, 2005, Exhibit 10.16 to H&R Block October 31, 2005 Form 10-Q.
[112] HSBC Retail Settlement Products Distribution Agreement, September 23, 2005, at 30.
[113] *Id.* at 26-27
[114] *Id.* at 36-37.

changed and in fact, the agreement is written in such a way as to attempt to protect the ability of Block to facilitate high rate loans in excess of state limits by calling Block an "agent" of HSBC in making RALs.[115]

IX. Free File

A significant development in 2005 occurred when the IRS renewed its agreement with the Free File Alliance. The new agreement provides for free Web-based electronic filing for taxpayers who make less than $50,000 annually.[116] Unfortunately, this new agreement does not ban Free File commercial preparers from marketing RALs to taxpayers. Since taxpayers reach Free File preparers by going through www.irs.gov, the IRS agreement continues to permit the appearance of an implicit government endorsement of the marketing of RALs and other ancillary products, such as audit "insurance" or preparing state tax returns.

During the negotiations, the IRS did attempt to keep RALs out of Free File. The new agreement requires Free File vendors to provide free on-line filing for 70% of the taxpayer population, or 93 million.[117] At one point, the IRS offered the Free File vendors a proposal with a lower target of 66% of the taxpayer population, if they agreed not to market RALs through Free File.[118] The industry insisted on being able to keep RALs in Free File, even though it meant covering 5 million more taxpayers under the program. The industry went so far as to have Senator John Ensign (R-NV) introduce a bill to prohibit IRS from developing its own tax preparation software, stripping IRS of its leverage in the negotiation over Free File.[119]

The industry's insistence on the ability to promote RALs is puzzling given that very few RALs are sold through the Internet or software. H&R Block's SEC filings indicate that the company brokers only 34,000 RALs (out of 4.2 million) through its TaxCut software and website.[120] The industry itself claims that only 1% of Free File taxpayers got RALs.[121]

Another criticism of the Free File agreement is that it will not benefit the millions of lower income consumers who are on the other side of the "digital divide" without computer and Internet access at home. Furthermore, for those who do have computers, it is troubling that Congress has not required or funded the IRS to allow taxpayers to electronically file their tax returns directly with the IRS without the need for a third party intermediary, and has even made attempts to bar the IRS from developing a program to do so. As the National Taxpayer Advocate noted "The idea that taxpayers can't get help from the IRS in preparing their return in just plain

[115] *Id.* at 32-36.
[116] Press Release, Free File Alliance, *Private Sector to Provide Free Electronic Tax Returns to Millions*, October 25, 2005.
[117] *Id.*
[118] Allen Kenney, *IRS Offers Industry Free File Options Hinging on RALs*, Tax Notes Today, 2005 TNT 205-2, October 25, 2005.
[119] Allan Kenney, *IRS, Industry Reach Agreement on Free File*, Tax Notes Today, 2005 TNT 206-28, October 26, 2005.
[120] H&R Block 2005 10-K at 22.
[121] Press Release, Free File Alliance, *Private Sector to Provide Free Electronic Tax Returns to Millions*, October 25, 2005.

silly. . . .All this does is put off the day when the IRS has to consider the fundamentally fair option of providing an electronic template on its Web site."[122]

The other significant Free File development concerned an IRS attempt to restrict the ability of Volunteer Income Tax Assistance sites to criticize RALs made through the program. In August 2005, the IRS issued two memos warning that VITA volunteers may not negatively promote RALs to taxpayers, in essence a "gag rule" on anti-RAL efforts.[123] The memos were quickly rescinded;[124] nonetheless the fact that even an attempt was made to stifle the anti-RAL advocacy of free tax preparation programs is troubling.

X. Legislative Update

A number of states passed laws regulating RALs in 2005, as did a few municipalities. Most of these laws provided for additional disclosures, but Connecticut passed the first law that restricts the annualized interest rates on these loans.

Connecticut[125]

Connecticut amended its law regulating RALs to add a cap for RALs of sixty percent (60%) annualized interest rate. The Connecticut law prohibits RAL facilitators, *i.e.*, those who broker or process RALs, from facilitating a RAL over 60% annually and imposes a fine of $500 per violation.

The Connecticut RAL cap is currently being challenged by RAL lender Santa Barbara Bank & Trust, which sued the state in federal District Court arguing that the state law is preempted by the National Bank Act.[126]

California[127]

California passed a statute regulating RALs in 2005. It requires tax preparers to post a prominent fee schedule for RALs, and provide written disclosures. There is no mandatory type size or mandatory language for the written disclosures, but the postings must be in 28 point type. Unlike the bill that previously had passed the California Legislature but was vetoed by Governor Schwarzenegger, this law does not impose a fiduciary duty on tax preparers in RAL transactions or ban cross-lender debt collection.

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[122] Allen Kenney, *National Taxpayer Advocate Attacks Free File Agreement*, Tax Notes Today, 2005 TNT 208-5, October 28, 2005. The National Taxpayer Advocate also criticized the agreement for continuing to allow Free File vendors to market RALs via www.irs.gov.
[123] IRS, Talking Points For Managers - Use Of Free File Products By VRPP (Volunteer Return Preparation Program), August 24, 2005; IRS, VRPP Free File Questions and Answer, August 24, 2005. Both documents available as Attachments to a letter sent by consumer groups expressing concerns over the rescinded memos, at www.consumerlaw.org/action_agenda/refund_anticipation/content/GagRuleLetter.pdf.
[124] Letter from Mark W. Everson, IRS Commissioner to Chi Chi Wu, November 14, 2005 (noting memos were rescinded prior to filing of objections).
[125] Conn. Gen. Stat. § 42-480(d) and (e).
[126] *Pacific Capital Bank, NA v. State of Connecticut*, Case # 3:06-cv-000280PCD (D. Conn. January 2006).
[127] Cal. Bus. & Prof. Code § 22251 *et seq*.

Washington State[128]

Washington State enacted a disclosure-only statue regulating RALs. The statute provides for a written disclosure in 10 point type that a RAL is a loan and setting forth a loan schedule. Most critically, this statute preempted the stronger RAL disclosure ordinance that the City of Seattle passed in 2004. Unlike the Seattle ordinance, the Washington State law does not provide for oral disclosures, mandatory warning language, Spanish language disclosures, or other strong features of the Seattle ordinance.

The Washington State statute does provide for a one-day right to cancel, but permits the RAL lender to flip the taxpayer into a RAC if the taxpayer cancels the loan. The Washington State law was supported by the RAL industry but it is not as strong as consumer advocates had hoped for.[129]

Oregon[130]

Oregon enacted a statute requiring RAL disclosures that is similar to the Washington State law. Like the Washington State law, the Oregon law prohibits any local government from enacting a stronger RAL ordinance. The Oregon law was supported by H&R Block and other major tax preparers.[131] The Oregon law also prohibits anyone from making a RAL who is not licensed as a tax preparer in that state.

Nevada[132]

Nevada enacted a disclosure-only statue regulating RALs. The statute provides for a written disclosure in 10 point type, informing the consumer that a RAL is a loan and certain other information.

Thus, there are a total of 9 states regulating RALs (California, Connecticut, Illinois, Minnesota[133], Nevada, North Carolina[134], Oregon, Washington State, and Wisconsin[135]). With the exception of Connecticut, these laws primarily rely on disclosure to protect consumers from RAL abuses. However, disclosures are only partially effective in addressing the problem of RALs.

Bills that would have capped RAL interest rates were introduced but not passed in Illinois,[136] Iowa,[137] New York,[138] Ohio,[139] Texas,[140] and Montgomery County, Maryland.[141]

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128 Wash. Rev. Code § 19.265.010 *et seq.*
129 Peter Lewis, *New Rules On Loans Head To Governor*, Seattle Times, April 19, 2005.
130 Ore. Rev. Stat. 673.605.
131 Peter Wong, *Law to Regulate Tax-Refund Loans*, Statesman Journal, June 30, 2005.
132 Nev. Rev. Statutes, Title 52, §§ 2 to 18.
133 Minn. Stat. § 270C.445.
134 N.C. Gen. Stat. §§ 53-245 to 53-254.
135 Wis. Stat. §§ 421.301 and 422.310.
136 S.B. 1958.
137 S.F. 145.

The Village of Hempstead in Long Island, New York also passed a RAL ordinance. We do not have the specific provisions of this ordinance, but it appears to require disclosures in both English and Spanish.[142]

On the federal level, Senator Daniel Akaka and Representative Jan Schakowsky again introduced the strongest effort to regulate RALs, the Taxpayer Abuse Prevention Act, which would ban RALs made against the EITC.[143] Senator Bingaman and Representative Becerra introduced bills that would require registration of RAL providers, better disclosures, and funding for free tax preparation programs and bank account pilots to receive refunds.[144] In 2005, Senator Akaka again attempted to introduce a measure to de-fund the Debt Indicator. While this attempt was not successful, Senator Akaka was able to obtain a study by the IRS, in consultation with the National Taxpayer Advocate, on RALs and the Debt Indicator, to be completed by June 30, 2006.[145]

Other federal activity included a hearing on RAL abuses held in April 2005 by Senator Norm Coleman, chair of the Senate's Permanent Subcommittee on Investigations, in Minnesota.[146] The hearing resulted in a Jackson Hewitt representative announcing the chain would drop the application fee at company owned stores and would eliminate a RAL surcharge for EITC recipients.

XI. Litigation

Two major settlements were reached in class actions against H&R Block over its RAL practices. One settlement was approved by a West Virginia state court, the other settlement was rejected by a federal District Court in Chicago.

Carnegie v. Household International[147]

This nationwide class action has had a tortured history that now includes 2 rejected settlement attempts. The first rejected settlement would have required Block and its lending partner Household/HSBC to pay a mere $25 million to millions of RAL recipients, and snuff out a number of other class action proceedings brought against

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[138] A. 1971.
[139] S.B. 59.
[140] H.B. No. 398.
[141] Sonsyrea Tate, *Bill Seeks To Regulate Tax Preparation Companies*, The Gazette - Prince George's County, January 20, 2005.
[142] Emi Endo, Sid Cassese and Lindsay Faber, *New Law Targets 'Rapid Refunds'*, Newsday (Nassau and Suffolk ed.), January 5, 2006.
[143] S. 324 and H.R. 969.
[144] S. 832 and H.R. 894.
[145] H.R. 3058, § 221.
[146] Hearing testimony available at www.senate.gov/~gov_affairs/index.cfm?Fuseaction=Hearings.Detail&HearingID=226.
[147] *Carnegie v. Household International*, 371 F.Supp.2d 954 (N.D. Ill. 2005).

Block and Household/HSBC.[148] The federal Court of Appeals for the Seventh Circuit overturned the approval of the settlement and sent the case back to a different judge,[149] who rejected the settlement and fired the attorneys for the class.[150]

The court then appointed the attorneys who objected to the first settlement as class counsel.[151] In an ironic twist of fate, these attorneys subsequently engineered a second settlement that would have snuffed out a number of strong class actions brought in state court in West Virginia, Ohio and other states. In addition, the settlement would have barred class members from suing Block for future RAL abuses for a period of 3 years. In return, Block and Household/HSBC would have paid $110 million to the class (including attorney's fees, administration costs and notice costs), plus coupons for $6 off Block services.

The federal District Court rejected this settlement, noting its many problems. The court characterized the coupons as "classic free advertising" and noted "the $6 coupon fee would simply be lost in higher fees, and it is at any rate too little to be meaningful." The court also criticized the settlement's attempts to cut off other lawsuits in state courts and its broad injunction of future lawsuits.

Multistate Settlement

In December 2005, the West Virginia Circuit Court preliminarily approved a settlement of a number of class actions against Block in West Virginia, Ohio, Maryland, and Alabama.[152] The settlement provides a total of $62.5 million (including attorneys fees and administration costs but not notice costs) to the class, which includes the above 4 states and 22 other states.[153] There are no coupons involved in this settlement. The breakdown of compensation varies by state and includes:

West Virginia - $32.5 million, up to $175 per RAL for each consumer (after attorneys' fees and costs)
Ohio - $5.8 million
Maryland & Alabama- $1.6 million
Other states - $22.8 million
(includes Arkansas, Arizona, California, District of Columbia, Florida, Illinois, Indiana, Massachusetts, Maryland, Maine, Michigan, Minnesota, Missouri,

[148] *Zawikowski v. Beneficial Nat'l Bank*, 2000 U.S. Dist. LEXIS 11,535 (N.D. Ill. 2000). This settlement and the controversy surrounding it are discussed in the NCLC/CFA 2002 RAL Report at 25.
[149] *Reynolds v. Beneficial Nat'l Bank*, 288 F.3d 277 (7th Cir. 2002). The Seventh Circuit decision is discussed in the NCLC/CFA 2003 RAL Report at 15.
[150] *Reynolds v. Beneficial Nat'l Bank*, 260 F.Supp.2d 680 (N.D. Ill. 2003). This decision is discussed in the NCLC/CFA 2004 RAL Report at 17.
[151] *Carnegie v. Household International*, 220 F.R.D. 542 (N.D. Ill. 2004).
[152] Lawrence Messina, *'Rapid Refund' Lawsuits Resolved: H&R Block Agrees To Pay $62.5 Million*, Associated Press, December 27, 2005.
[153] Agreement of Settlement, *Cummins v. H&R Block*, Civil Action No. 03-C-134 (Circuit Court of Kanawha County December 23, 2005).

Nebraska, New Hampshire, Nevada, Oregon, Pennsylvania, Tennessee, Utah, Virginia, Washington or Wisconsin)

The settlement does not affect already-filed lawsuits against Block in Illinois state court, Texas state court, Pennsylvania, or in the Carnegie case discussed above. It does foreclose all other RAL claims in the 26 states included in the settlement, either under state Credit Services Organization laws or any other legal theory. It also bars class members from suing Block for future RAL abuses for a period of 2 years, unless Block fails to register as a credit services organization in those states.

Hood v. Santa Barbara Bank & Trust

Hood v. SBBT[154] is a class action challenging cross-lender debt collection under California's debt collection and unfair trade practices laws. NCLC is co-counsel for the putative class in this case. In May 2005, the California Superior Court dismissed the plaintiffs' claims against SBBT on the basis of federal preemption under the National Bank Act.[155] The decision is being appealed.

XII. Other Anti-RAL Resources

Other local and national advocacy groups continue their efforts against RALs. A partial list includes the Children's Defense Fund, the Brookings Institution, ACORN, the Neighborhood Economic Development Advocacy Project in New York City, the California Reinvestment Coalition, the Connecticut Association for Human Services (which spearheaded the successful effort to pass the Connecticut RAL interest rate cap) and others. Some of their publications include:

Alan Berube and Tracy Kornblatt, *Step in the Right Direction: Recent Declines in Refund Loan Usage Among Low-Income Taxpayers*, Brookings Institution, April 2005, available at www.brookings.edu/metro/pubs/20050412_eitcdecline.htm.

Keeping What They've Earned: Working Americans and Tax Credits, Children's Defense Fund (February 2005) (versions for Mississippi, New York, Ohio, South Carolina, Tennessee, Texas, and District of Columbia), available at www.childrensdefense.org/benefits/tools/default.aspx.

Children's Defense Fund Minnesota, *Keeping What They've Earned: Working Minnesotans and Tax Credits* (February 2005), available at www.cdf-mn.org/PDF/2005_RAL_report.pdf.

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[154] *See* Complaint, *Hood v. Santa Barbara Bank & Trust*, Case No. 1156354 (Cal. Super. Ct. County of Santa Barbara March 18, 2003), available at www.consumerlaw.org/initiatives/refund_anticipation.
[155] *Order and Final Judgments as to Plaintiffs, Defendants SBBT, et al.*, *Hood v. Santa Barbara Bank & Trust,* Case No. 1156354 (Cal. Super. Ct. County of Santa Barbara May 2005).

New Yorkers for Responsible Lending, *NYS Tax Refund Anticipation Loan Fact Sheet*, available at www.nedap.org/pdfs/NYS_Rals_Fact_Sheet.pdf.

In addition, NCLC released a report analyzing the role of the IRS-provided Debt Indicator in boosting RAL volume and profits. The report, entitled *Corporate Welfare for the RAL Industry: the Debt Indicator, IRS Subsidy, and Tax Fraud* (July 2005), is available at www.consumerlaw.org/action_agenda/refund_anticipation/content/Debt_Indicator_White_Paper.pdf. We also sent a comment to the Federal Reserve Board asking that they apply the consumer protections of the Electronic Funds Transfer Act to stored value card products that receive tax refund or RAL proceeds.[156]

Last, but certainly not least, the National Taxpayer Advocate cited RALs as one of the most serious problems faced by taxpayers (ranked no. 8) in her FY 2005 Report to Congress.[157] While this is not the first time the National Taxpayer Advocate has tackled this subject, her report provides an extensive analysis including criticisms of the Debt Indicator and cross-lender debt collection.

XIII. Reform

The following is a summary of the reform options contained in the National RAL Platform: Issues and Options, discussed in the NCLC/CFA 2005 RAL Report and available at www.consumerlaw.org/action_agenda/refund_anticipation/content/RALplatform.pdf.[158]

A. Options for Federal Legislation

1. Ban RALs.
2. Ban RALs that are secured by EITC refunds.
3. Cap RAL fees.
4. Establish a licensing scheme for tax preparers and/or facilitators.
5. Prohibit or regulate abusive features of RALs, including:
    a. debt collection by set-off of a tax refund.
    b. mandatory arbitration clauses.
6. Modify IRS administrative goals re: reaching the 80% e-file rate.
7. Require better disclosures on RALs, including:
    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.

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[156] National Consumer Law Center, et al, *Supplemental Comments to the Federal Reserve Board's Notice of Proposed Rulemaking - Regulation E Coverage of Payroll Cards*, Docket No. R-1210, March 9, 2005.
[157] National Taxpayer Advocate 2005 Report at 162-179.
[158] The National RAL Platform was developed by a workgroup that included 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, Neighborhood Economic Development Advocacy Project; David Marzahl, Center for Economic Progress; and Chi Chi Wu, National Consumer Law Center. Please note that this list does not include all conceivable options, and workgroup members did not necessarily endorse all options equally.

8. Dramatically simplify tax code for low-income filers.
9. Fund "banking the unbanked" programs.

B. Options for State or Local Regulation

1. Cap RAL fees by regulating facilitators.
2. Impose a duty on return preparers to act in the best financial interests of their customers.
3. Establish a registration scheme for RAL facilitators.
4. Require better disclosures on RALs, including:
    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.
6. Prohibit or regulate abusive features of RALs, including:
    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.
8. No RALs based on state tax refunds.

C. Options for Treasury/IRS Administrative Action

1. Speed IRS refund turnaround time to 48–72 hours.
2. Eliminate the Debt Indicator program.
3. Improve and expand the Advance EIC.
4. Prohibit RALs from being made through the Free File program.
5. Amend IRS privacy regulations to strengthen protections against use of taxpayer information to cross-market financial products.
6. The Federal Reserve Board should apply the consumer protections of the Electronic Funds Transfer Act to stored value card products that receive tax refund or RAL proceeds.

Appendix A

AN ANALYSIS OF THE CREDIT RESEARCH CENTER'S *STUDY OF CONSUMER USE OF REFUND ANTICIPATION LOANS*

by Chi Chi Wu
National Consumer Law Center

The Credit Research Center (CRC) of the McDonough School of Business at Georgetown University received funding from Jackson Hewitt to produce a study on consumer use of refund anticipation loans.[1] We analyze and respond to various conclusions in the CRC study.

A. RAL Consumers and "Credit Rationing"

The major conclusion of the CRC report is that RAL borrowers benefit from the product because they have few sources of other credit. This is an argument that the report's author has made in defending payday loans).[2] The CRC's data shows RAL borrowers have fewer credit choices than non-RAL borrowers. It generally concurs with the data from a survey by Consumer Federation of America from November 2005,[3] although CRC's findings show RAL borrowers under more financial stress than the CFA survey.

In particular, the CRC RAL study found:[4]

-39% of RAL borrowers have a credit card as compared to 72.5% of the population. They are more likely to have maxed out.
- 42% of RAL borrowers are homeowners as opposed to 67.7% of the population. Only 28% have a mortgage, compared to 45% of the population.
- 25% of RAL borrowers do not have a bank account.
- RAL borrowers have higher debt-to income ratios. They are 4 times more likely to be delinquent 60 days or more on a bill (26% versus 7%).
- 23.4% of RAL recipients used a pawnshop; 18% used a payday lender.
- RAL borrowers are twice as likely to be turned down for credit as the general population.

The major difference with the CRC's report and the CFA study are the conclusions drawn from this data.[5] The CRC believes that offering triple digit interest rate loans to financially oppressed consumers is a beneficial activity. We believe that selling super-high cost credit to cash-strapped, sometimes desperate consumers is a form of price gouging that preys on the vulnerable. The big difference is not in the data, but in the analysis.

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[1] Gregory Elliehausen, Consumer Use of Tax Refund Anticipation Loans, Monograph #37, Credit Research Center (April 2005), available at http://msb.georgetown.edu/faculty/research/credit_research/pdf/M37.pdf [hereinafter referred to as "CRC RAL Study"]. For more on the Credit Research Center's affiliations, see John C. Ruoff, The Credit Research Center Study of Payday Loan Customers, South Carolina Fair Share, June 2005, at 1 n. 1.
[2] Elliehausen and Lawrence, *Payday Advance Credit in America: An Analysis of Customer Demand*, Monograph 35, Credit Research Center (April 2000); available at http://www.msb.edu/prog/crc/pdf/mono35.pdf.
[3] Consumer Federation of America, Omnibus Survey of Consumer Financial Services, conducted by Opinion Research Corporation, November 2005.
[4] CRC RAL Study at 40-50.
[5] The CFA data found that 66.0% of RAL borrowers had a credit card compared to 73.1% of the population; 55.6% of RAL borrowers were homeowners compared to 70.7% of the population; and 16.0% of RAL borrowers did not have a banking account. CFA found that RAL borrowers are much more likely than non-RAL borrowers to use fringe financial services than non-RAL borrowers, but found lower numbers than CRC. CFA found that 4.2% of RAL borrowers used pawnshops and 9.7% used payday lenders.

The CRC study confirms that RAL customers are mostly low and moderate income – 74% had incomes of less than $40,000 per year. Most RAL borrowers are parents - over 77.5% of RAL customers have children as compared to 36% of sample, and 86% are in their child bearing years (age 45 and under).[6]

The demographics above make perfect sense -- they reflect the high proportion of EITC recipients among RAL recipients (since taxpayers only receive a large EITC refund if they have children). However, the CRC's conclusion is much different; it argues that RAL borrowers are credit constrained households with high credit demands.

Even if RAL borrowers were motivated by credit demands, the CRC analysis did not distinguish between long term and short term credit demands. RAL customers may be credit constrained, but the RAL may not be the solution to their credit needs. The ability to get a refund two weeks faster will not help a consumer who is unable to get a mortgage or car loan. It does not replace an open-end credit device such as a credit card to allow repeat borrowing.

The fundamental problem with RALs is that they exact a high cost for the consumer to borrow against money that the consumer will be receiving anyway, in as quickly as 1 to 2 weeks. Thus, a RAL only "satisfies" a credit need for consumers who truly and urgently need it within that 2 week period. We find it hard to believe that 12 million consumers have a crisis that prevents them from waiting to receive their refunds in 2 weeks.

The CRC does posit a scenario in which it argues that a consumer benefits from getting the money faster by 1 or 2 weeks - if there is an appliance for sale and the sale will end before the refund is received from the IRS.[7] However, this scenario only works if the sale truly only is for that short period of time. In reality, appliances and other consumer durables are often on sale throughout the year. Furthermore, if it's not on sale at one store, it is at another store. Again, it is questionable whether 12 million consumers need a product that is only on sale during late January/early February.

B. Consumer Understanding of RALs

Another conclusion of the CRC study was that RAL borrowers do have information on the costs of RALs and refund options, and have made a deliberate and informed choice to select a RAL. This particular finding is challengeable, because the underlying data seems questionable. The CRC survey interviewed 15,177 respondents. Of these, only 330 - or **2.17**% - reported they had used a RAL.[8] This is a gross underestimate of the percentage of RAL borrowers. The IRS data on RALs, in contrast, finds that about 10% of tax returns are associated with a RAL.[9] Even assuming the IRS data contains a modest overestimate in the number of RALs,[10] and that all of the respondents were not taxpayers, it does not explain a four-fold disparity in the data. CFA found that 7.2% of survey respondents had used RAL loans, which is more than three-fold higher than the CRC survey.

One reason for this disparity may be that the question asked in the CRC poll described a RAL as "a loan or advance of money against a tax refund, typically provided by a bank," and then asked

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[6] CFA found that 58.7% of RAL borrowers earned below $40,000 and a smaller majority (60.4%) of RAL borrowers under age 45.
[7] *Id.* at 36-37.
[8] *Id.* at 21.
[9] *See* discussion in main report at page 4, *supra*
[10] *See* discussion in main report at pages 6-7, *supra*.

respondents if they had obtained a "Refund Anticipation Loan."[11] If many consumers who get RALs do not understand that the product is a loan, they will not answer "yes" to such a question. The use of the phrase "typically provided by a bank" may have been particularly confusing, since some RAL borrowers may think it meant they actually had to go a bank branch to get the loan.

Thus, only the most informed of RAL borrowers who knew it was a loan (which in our NCLC survey was about 30%)[12] would report that they had received a RAL. It was this more-informed subset that composed the sample of RAL respondents. In other words, this response rate indicates that many people who got RALs did not respond because of the phrasing of the question.

Other statistics from the CRC study also indicate the survey missed many RAL borrowers. The CRC survey found that 51.7% of respondents used a commercial tax preparation service,[13] which does not differ greatly with IRS data showing 58.9% of taxpayers use commercial preparers.[14] However, the survey found that only 5.2% of those who used a commercial preparer got a RAL.[15] In contrast, IRS data shows that 16.6% of taxpayers who used a commercial preparer got a RAL.[16] So the data on who uses a commercial preparer was consistent with IRS data, but the data on those customers who received a RAL was again a gross underestimate. Again, we believe it was the asking of the RAL question that skewed the data.

Thus, respondents of the CRC study who answered that they had received a RAL were in the minority of RAL recipients who knew what they were getting. Perhaps that is why 64.8% of these taxpayers reported they had discussed other refund options before getting a RAL.[17] These respondents were among the subgroup of customers where the tax preparer took the time to discuss other options.

A startling finding of the CRC poll is that, of these more knowledgeable RAL customers, many of them still did not have good information about the costs of the loan. About 43% of these consumers did not know the amount of the RAL fee. Only 26% reported getting an APR disclosure.

This data is troubling, but not surprising, and we have no reason to question it. However, we draw very different conclusions from the CRC regarding this data. CRC's conclusion is that price and APR information is not important to consumers. Our conclusion is that some RAL consumers never truly had this information. The tax preparers may have provided this information, but in a form that was not salient to the consumer.

The price and APR information was probably provided in pile of paperwork given to consumers when they signed their tax returns and loan applications. Some of these consumers may not have had a chance to review the paperwork. For instance, the lead plaintiff in one RAL case recounts how she was

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[11] CRC RAL Study at 23.
[12] 2005 NCLC/CFA Report at 8.
[13] CRC RAL Study at 40.
[14] Data from IRS Stakeholder Partnerships, Education & Communication (SPEC) Return Information Database for Tax Year 2003, October 2005.
[15] CRC RAL Study at 40. The survey found that 7.9 % of those who used a commercial preparer *and* claimed a refund got a RAL. Since the survey found that 67% of those who used a commercial preparer claimed a refund, 2/3 of 7.9% is 5.2%.
[16] 12.38 million consumers got a RAL. 74.8 million consumers used a commercial preparer in 2004. Data from IRS Stakeholder Partnerships, Education & Communication (SPEC) Return Information Database for Tax Year 2003, October 2005. Thus, the percentage is 16.6%.
[17] CRC RAL Study at 60.

instructed to sign a stack of documents without being given a chance to read them.[18] Getting information in a pile of paperwork versus having the chance to actually read, digest and understand it are completely different things.

Finally, the CRC concludes that the vast majority of RAL customers are happy with the product, finding that 85% are satisfied and 14% are not.[19] Given that half of the most knowledgeable RAL customers aren't aware of the fee and nearly all are unaware of the APR, it is not surprising they are happy.[20] Of the 15% that were dissatisfied, most of them were unhappy because of the cost of the loan. So once they are aware of the high price of a RAL, borrowers are dissatisfied.

C. Why Consumers Get RALs

The CRC study contains information about why consumers get RALs. However, this information is limited in that the survey only provided 7 choices as to reasons for getting a RAL:[21]

Pay bills from Christmas
Pay credit card bills (not from Christmas)
Pay for tax preparation
Pay unexpected expenses
Make planned purchase
Take advantage of favorable purchase opportunity
Other (self-volunteered reasons)

Thus, the ready-made choices provided for getting a RAL did not include some significant reasons why consumers get RALs, including:

The preparer convinced me to get it
I've always done it this way
My friends or relatives recommended it.

In the polling survey commissioned by NCLC last year, nearly one third of taxpayers selected those reasons for getting a RAL.[22]

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[18] *See* Complaint, Hood v. Santa Barbara Bank & Trus*t*, Case No. 1156354 (Cal. Super. Ct. County of Santa Barbara March 18, 2003), available at www.consumerlaw.org/action_agenda/cocounseling/content/s_barbara_case.pdf.
[19] CRC RAL Study at 67.
[20] As one taxpayer put it, she agreed to a RAL "because who does not want their money back the same day if you can get it?" but later regretted the choice due to the high costs. Statement of Maerine Henderson before the U.S. Senate Permanent Subcommittee on Investigations, Hearing On Tax Related Financial Products Can Be Costly, April 15, 2005.
[21] *Id.* at 24.
[22] The exact percentages were:

13% chose a RAL because the tax preparer recommended it
9% because a friend or relative encouraged them
10% because that's the way they've always done it

Analysis of survey results commissioned by NCLC and conducted by Opinion Research Corporation International from December 9-13, 2004.

Despite these flaws, the CRC study does provide some interesting data that supports the concept that RALs aren't beneficial to consumers. Of the reasons provided, many of them show that the RAL borrower could have saved money by waiting:[23]

> -13% of RAL borrowers said they used the money for a planned purchase and 7% said they used the money to take advantage of favorable purchase opportunity. Thus, about 20% of RAL consumers could have saved an average of $100 by deferring their purchase one to two weeks.
>
> -Sadly, 15% of respondents simply cited impatience for their reason for getting a RAL, *i.e.*, they did not want to wait. This was a self-volunteered reason, and thus it is significant that 15% offered up this reason unsolicited. These 15% of consumers paid a hefty price for their impatience.
>
> - Interestingly, only a tiny percentage of RAL borrowers (0.8%) cited the need to pay for tax preparation as their reason for getting a RAL. This concurs with the survey commissioned by NCLC last year, in which only 4% cited the same reason for getting a RAL.[24]
>
> -14% of RAL borrowers said they needed the funds to pay off credit card bills and 13% said to pay off Christmas bills, some of which might be credit card debt. Thus, as many as a quarter of consumers could have saved money by carrying a credit card balance instead of getting a RAL. While we usually advise against carrying a credit card balance, taking out even higher cost credit to pay off a credit card is not a financially sound move. On a credit card bill, ***if*** one can pay the minimum *and* avoid late or overlimit fees, the primary expense of carrying debt another 2 weeks or even a month would be the periodic interest, which is usually 14-18%. For instance, to carry over a $2,000 credit card debt for one month at 18% APR (or 1.5% per month) is only $30.[25]

Finally, the CRC study found that 1/3 of RAL customers reported that they had extra tax withheld in order to get a larger tax refund.[26] In general, having extra taxes withheld in order to get a big refund is essentially giving the government an interest-free loan, and not financially beneficial. Getting a RAL after having extra taxes withheld is an extremely foolish combination. If a consumer can wait all year and give the government his money for free, he should be able to wait another 2 weeks to get it back without a charge. Even the CRC admits getting a RAL after having extra taxes withheld is a costly idea, but justifies it as "consumers making arrangements to protect themselves against their own bad habits."[27]

D. Limitations of Telephone Polling

Another limitation of the Credit Research Center's study is that telephone polling misses any consumer who does not have a landline telephone. Of course, we readily admit this is a limitation of our studies as well. The CRC made a similar admission, noting that:[28]

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[23] CRC RAL Study at 61.

[24] Analysis of survey results commissioned by NCLC and conducted by Opinion Research Corporation International from December 9-13, 2004.

[25] Some RAL providers have compared a RAL to a cash advance and claimed the expense is equivalent. However, if someone is using a RAL to pay off a credit card bill, that consumer would not incur a cash advance fee, only the periodic interest, since the debt is from purchases. Furthermore, even with a cash advance, the consumer usually doesn't pay the advance off in 1-2 weeks, but may take months to do so. The effective interest rate is much lower because the consumer is able to pay off the debt over several months at 14-18% periodic interest.

[26] CRC RAL Study at 49.

[27] *Id.*

[28] *Id.* at 19.

> The primary disadvantage of a telephone survey is that it does not cover households that do not have a telephone. About six-percent of US households do not have a telephone. These households are more likely to be low income, minority, and in the south, than households with a telephone.

As South Carolina Fair Share noted, "we know from experience that lower-income residents are more likely to be renters and more likely to be in the kinds of financial difficulties that lead you to have to move and/or cut off the phone."[29] The demographic characteristics of being low-income, minority, in the South, and renters are all prevalent among RAL borrowers.

Thus, the CRC, the NCLC, and the CFA surveys probably missed many RAL borrowers who did not have landlines.

E. Responses to CRC's Criticism of Our Reports

CRC criticized the NCLC/CFA RAL reports at several points during its reports. We respond to some of these criticisms in turn.

1. <u>The NCLC Survey</u>

The CRC was critical of the survey commissioned by NCLC in that we asked consumers whether they had obtained a "rapid or speedy" refund, or a refund received in 1 to 3 days. The CRC questioned whether respondents would recognize they were being asked about a RAL, and theorized that knowledgeable respondents would have said "no" because they realized they had not received a refund in 1 to 3 days, but had received a loan.

Our first response is simply that our numbers speak for themselves. The IRS data indicates that about 1 in 10 taxpayers gets a RAL. The NCLC survey had a response rate of 18% to our question which asked whether respondents had *ever* received a "rapid or speedy refund."[30] The CFA survey used the same question but limited it to the prior year. It received a response rate of 7.1%[31]. The CRC poll, on the other hand, received a response rate of *only* 2.17%. Our numbers appear much closer to the IRS data.

Furthermore, it is difficult to imagine a RAL borrower answering "no" to the question about whether they received a "rapid or speedy refund" because the borrower knew it was a loan and the question did not refer to the word "loan." One of the specific and most troublesome problems with RALs is that consumers think of them as refunds. The product is often referred to a rapid refund, even if that supposedly technically only refers to Block's non-loan product.[32] Finally, the CRC's criticism of our use of the word "refund" as misleading in describing a RAL is misplaced - we are testing recognition of the product, not making legal disclosures to inform consumers.

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[29] John C. Ruoff, The Credit Research Center Study of Payday Loan Customers, South Carolina Fair Share, June 2005.
[30] 2005 NCLC/CFA Report at 7.
[31] Consumer Federation of America, Omnibus Survey of Consumer Financial Services, conducted by Opinion Research Corporation, November 2005.
[32] For example, the lead plaintiff in a RAL case describes how she referred to a RAL as a "rapid refund" when she requested one, even though the preparer worked for a Jackson Hewitt office. *See* Complaint, Hood v. Santa Barbara Bank & Trus*t*, Case No. 1156354 (Cal. Super. Ct. County of Santa Barbara March 18, 2003), available at www.consumerlaw.org/action_agenda/cocounseling/content/s_barbara_case.pdf. Other consumers report using the term "Rapid Refund" for a RAL or other terms such as "Same Day Funds." Statements of Julie Burbach and Maerine Henderson before the U.S. Senate Permanent Subcommittee on Investigations, Hearing On Tax Related Financial Products Can Be Costly, April 15, 2005.

The CRC does acknowledge there has been criticism and lawsuits over RAL promotion. However, it claims the courts have not found evidence of misrepresentation or fraud except for the JTH Tax Service v. H&R Block case, which the CRC characterizes as an 'exception'.[33] Yet both the District Court and Court of Appeals in the JTH case did not think it was an exception, discussing the many prior legal actions against H&R Block over similar misleading advertising, especially by state Attorneys General.[34] Furthermore, the reason that other courts have not found misrepresentation and fraud is because the cases were barred due to procedural hurdles, or they case settled with the parties never reaching the merits.[35] Finally, the CRC report fails to mention government compliance actions over RALs, including repeated enforcement actions by the New York City Department of Consumer Affairs.[36]

2. Cost of RALs

The CRC report criticizes the NCLC/CFA RAL Reports' calculation of the costs and the Annual Percentage Rates (APRs) on RALs. In particular, it questions the inclusion of the dummy account fee in the finance charge.

This particular issue involves the fact that tax preparers and RAL lenders disclose APRs lower than our estimates. Generally what lenders do to make loans look less expensive is to "unbundle" or subtract out amounts from the finance charge, and denominate them as something else in order to make the loans look less expensive. In the case of RALs, the lenders subtract out a charge supposedly for the "dummy" bank account, claiming that it is comparable to the charge for the non-loan RAC product. The Truth in Lending Act permits lenders to exclude a fee from the finance charge if it is the same as "charges of a type payable in a comparable cash transaction." 15 U.S.C. § 1605(a).

We have challenged the unbundling of the dummy account fee on the basis that: (1) lenders had not previously separated out an independent fee for the dummy account for RALs;[37] (2) the fee for the dummy bank account for a RAL versus a RAC serves two different purposes – for a RAL, it is how the loan is repaid while for a RAC, it a disbursement mechanism for cash; and 3) since RALs are a pure cash loan (unlike for example, a car loan), the RAC is not a comparable non-credit purchase transaction to which they can be compared. The type of fees that were contemplated under the "comparable cash transaction" exemption are sales taxes, license fees, and registration fees.[38] Consider this analogy: A credit card lender sends its borrowers envelopes with their monthly bills to make loan payments. These same envelopes are available for sale for 10 cents a piece. It would be highly questionable for the lender to begin subtracting out 10 cents from its finance charge as an "envelope" fee, and then calculate the APR

[33] CRC RAL Study at 10.
[34] *JTH Tax v. H&R Block Eastern Tax Services*, 128 F. Supp. 2d 926, 938 (E.D. Va. 2001) and *JTH Tax v. H&R Block Eastern Tax Services*, 28 Fed. Appx. 207 (4th Cir. 2002). In fact, Block had argued to the Court of Appeals the same argument that the CRC study makes - that Block "never suffered an adverse adjudication concerning its RAL advertising practices." *Id.* at 212. The Court of Appeals found the argument "unpersuasive" and that a review of the state Attorney General actions revealed "a shared, simply described purpose: to halt Block's practice of misrepresenting loans as refunds."
[35] *See* main report at pages 24-26 *supra*, 2005 NCLC/CFA RAL Report at 24-27; 2004 NCLC/CFA RAL Report at 18-20; 2003 NCLC/CFA RAL Report at 15-17; 2002 NCLC/CFA RAL Report at 25-26.
[36] *See* 2005 NCLC/CFA Report at 22; 2002 NCLC/CFA Report at 26-27.
[37] Household 2001 RAL TILA disclosure on file with the authors. *See also* Tommy Snow, Director of Capital Policy, OCC Interpretive Letter No. 959, February 13, 2003, available at www.occ.treas.gov/interp/mar03/int959.pdf (noting that one bank's RAL application stated APRs of 66.15% to 1880.3%).
[38] *See* S. Rep. No. 96-73, at 12 (1979) ("The bill will eliminate some current confusion by making clear that charges which would also be incurred in a similar transaction for cash, such as sales taxes, license and registration fees, are not to be included in the finance charge."); S. Rep. 96-368, at 26 (1979) (same).

on that basis. Finally, even if such unbundling is not technically in violation of the Truth in Lending Act, it disguises the true cost of credit for the loan. We report an APR without the unbundling to show how expensive these loans are in reality.

The CRC also criticizes our reports for including tax preparation fees in the cost of getting a RAL. ***However, we have never included the cost of tax preparation in the finance charge or in the APR calculation.*** We have noted the cost of tax preparation as part of what a consumer will pay and we have calculated the drain on the EITC as a policy issue regarding how much of the benefit is lost to the tax preparation industry. However, the CRC report suggests that we have included it in the finance charge and APR calculation, which is simply incorrect. What we have included in the APR is the administrative fee, but solely in an alternative calculation. Including the administrative fee in the APR is legitimate under the Truth in Lending Act, given that the fee is similar to a broker fee, which can be a finance charge under TILA.[39]

Finally, the CRC study attempts to justify the cost of RALs by arguing that the "breakeven" point for a small loan is quite high. It cites data from 1975 that the breakeven point was $53 then or $275 in today's dollars. While the CRC acknowledges that the data is old, the CRC uses the data to suggest the cost of a RAL is reasonable. However, not only is the data old, it is irrelevant due to computerization and other automation. We have data from a smaller credit union that its processing cost today for a small loan is $30.[40] This is the cost for a small institution; for larger institutions we assume the cost is much cheaper given their economies of scale and that they have been engaged in RAL lending for years, making much of the activity routine and automated. Thus, $275 is an extremely exaggerated estimate for the transaction costs of a RAL.

[39] Regulation Z, 12 C.F.R. § 226.4(a)(2).
[40] Sheila Bair, *Low-Cost Payday Loans: Opportunities and Obstacles*, Isenberg School of Management - University of Massachusetts at Amherst, June 2005, at 23.