The EITC and the Culture of Debt

Section 4

The tax refund check is often the largest single sum of money that poor families receive during the year. They may need the money immediately, however. Refund Anticipation Loans (RALs) give them cash quickly—sometimes in the same day or even within an hour of filing their tax returns. But these loans are costly.

RALs are bank loans secured by the taxpayer's expected refund—loans that last about 7 to 14 days until the actual IRS refund repays the loan. This is the first indicator of just how unnecessary most RALs are: Most taxpayers could have their refund in two weeks or less even without the costly loan.[1]

Loan fees for RALs can range from about $30 to over $125 in loan fees. Some tax preparers also charge a separate fee, often called an "application" or "document processing" fee, up to $40.

The smaller the RAL, the higher the effective interest rate. Annual percentage rates (APRs) for a 10-day loan range from about 40 percent for a loan of $10,000 to 500 percent for a loan of $300. Most EITC loans are less than $500.

If application fees are included in the calculation, the effective APRs on the Earned Income Tax credit (EITC) loans can be over 1,100 percent.[2]

RALs Target EITC Recipients

The biggest market for RALs are workers who claim the EITC. According to IRS data, over 60 percent of all RAL borrowers are EITC recipients, despite the fact at EITC recipients only make up 17 percent of taxpayers. About 30 percent of EITC recipients get a RAL.[3]

A Slippery Slope: RAL to Sub-Prime

Sub-prime mortgages are marketed to poor borrowers who, as we now know, have little prospect of paying off the loans. The resulting defaults threaten the entire U.S. economy and the financial system. While the sub-prime story is well known, RALs are not. Yet RALs and sub-prime mortgages have much in common. Both are marketed to poor, unsophisticated borrowers. The borrowing costs of both products are understated—by teaser rates in the case of sub-prime mortgages; by instant cash in the case of RALs. Both are extremely lucrative, mass-market financial products. Regulatory failure is apparent in both markets.

We suspect many sub-prime mortgagees were introduced to the culture of debt by RALs. Did the widespread availability of RALs make poor borrowers easier targets for sub-prime mortgages? Are sub-prime mortgage defaults higher among RAL borrowers than those who did not borrow against their refunds?

A topic for future research, we hope.

Taxpayers who received RALs paid an estimated $960 million in RAL interest and fees in 2005 (the latest year of available data)—essentially borrowing their own money at extremely high interest rates.[4]

Finance costs are only the beginning. Most EITC households hire commercial tax preparers to complete their returns. (In 2005, almost 71 percent did so.) H&R Block reports tax preparation fees for a federal return (including the EITC application) average about $100—roughly equal to the interest on a typical RAL loan. Further, H&R Block and other tax preparers frequently steer customers to companies that charge fees to cash RAL checks, with the preparer getting a kickback on a portion of those fees. (These cozy arrangements frequently are not disclosed to clients.)

Tax preparation fees alone are estimated to drain nearly $2.3 billion in EITC benefits from the pockets of working families.[5]

When you total up the interest payments, tax preparation fees, and check cashing fees, EITC recipients often spend more than 10 percent of their credit just to get the credit.[6]

The mechanics of RALs are stacked against the taxpayer. Commercial tax preparers like H&R Block act as loan brokers, but banks actually issue the refund loans. Before transferring the RAL proceeds to the taxpayer, the banks deduct interest, the tax preparer's fees, loan application fees, and all other charges. As part of the RAL process, the taxpayer must authorize the IRS to send the refund directly through electronic deposit to the bank to repay the loan.

The hapless EITC beneficiary is responsible for paying the loan in full no matter how much of the anticipated refund the IRS actually releases. The IRS can deduct any outstanding federal debts—e.g., back taxes, child support, or student loans—from the EITC payment. If the taxpayer cannot repay the RAL, the lender may send the account to a debt collector.

For large tax preparers, RALs are not just a sideline; they are the main line. The vast majority of H&R Block's clientele consists of people who are filing for EITC refunds prior to April 15.[7] Another large tax preparer—Jackson Hewitt—derives 29.8 percent of total revenues from RALs and related products, according to a 2002 Brookings Institution study. The company's public filings indicate that more than half of its customers purchase RALs or similar products.

EITC-related business is driving the entire tax preparation industry. One telling piece of evidence is the clear relationship between the location of EITC tax filers and the location of Electronic Return Originators (EROs)—tax preparation companies authorized by the IRS to file tax returns electronially, a prerequisite for issuing RALs.

In zip codes where less than 10 percent of all filers receive the credit, there are roughly 10 EROs for every 10,000 filers. This figure increases as the fraction of EITC returns increases: In zip codes where 40 percent of tax filers claim the EITC, there are about 16 tax preparers per 10,000 population.[8]

Refund Anticipation Loans, 2000-2005

Filing Year	No. of RALs (millions)	Change from prior year (%)	RAL loan fees ($, millions)
2000	10.8		$0.810
2001	12.1	12.0%	$0.907
2002	12.7	5.0%	$1.140
2003	12.2	-4.3%	$1.090
2004	12.4	1.9%	$1.240
2005	9.6	-22.5%	$0.960

Source:
National Consumer Law Center, "2007 Refund Anticipation Loan Report," January 2007.[9]

Recent RAL trends are not all bad, however (see table above).

The number of RALs dropped by a dramatic 22.5 percent between 2004 and 2005, the latest year of available data. Prominently mentioned among possible reasons for the decline are more public awareness of the nature of RALs and anti-RAL advocacy.

Loan fees also declined. Both industry giant H&R Block and major RAL lender JP Morgan Chase have lowered prices for some of their RALs.

H&R Block is marketing debit-card-based accounts that may help its low-income customers become banked and even avoid RALs in the future.[10]

On the other hand, a new line of products—pay stub and holiday RALs—is worse than traditional RALs. These are longer-term loans made during the Christmas season before taxpayers receive their IRS Form W-2s and can prepare and file their returns. They present additional costs and risks to taxpayers and will allow tax preparers to drain tax refunds even after the IRS speeds refund delivery times to a few days.[11]

Who Is To Blame?

With 60 percent of RALs going to EITC recipients, the government has an interest in minimizing the costs of these loans, or eliminating the need for them entirely. To this end, the IRS offers low-income taxpayers free tax preparation services through the Volunteer Income Tax Assistance (VITA) program. Unfortunately, VITA is neither readily available nor well advertised.[12]

Free e-filing, a three-day turnaround time for tax refunds, alerting EITC recipients to free non-IRS tax preparation alternatives—the IRS has tried them all to wean poor taxpayers off RALs, albeit with equally discouraging results. The overwhelming majority of RALs are still procured via professional tax preparation services, at exorbitant costs to low-income taxpayers.

Assigning blame for the (alleged) RAL extortion is not easy:

The IRS blames the tax preparation services for inflating refund amounts in order to market RALs—especially when working with taxpayers eligible for the EITC.[13]

The National Taxpayer Advocate, an IRS watchdog organization, disagrees, claiming that: "The IRS does not conduct adequate oversight of Electronic Return Originators (EROs) that facilitate RALs."[14]

But an undercover GAO investigation by the Government Accountability Office (GAO) found no evidence that tax preparers inflate refund amounts—raising the possibility that the fraud originated with EITC taxpayers, including illegal aliens.[15]

Nevertheless, a coalition of liberal advocacy groups wants to kill the RAL industry:

> **Tax preparers and their bank partners should be prohibited from making loans secured by or expected to be repaid from the EITC. The EITC is the nation's largest anti-poverty program, and its benefits should go to its intended beneficiaries, not be skimmed off by large banks and multimillion dollar corporations.[16]**

Reality check: Commercial tax preparers flourish because they provide a level of convenience, speed, and expertise that free nonprofit tax services cannot match. Increased competition among the H&R Blocks of the world has significantly reduced preparation fees and RAL interest costs. All U.S. taxpayers, especially those who receive the EITC, would be worse off if commercial tax preparers were prohibited from making loans against future credit payments.

A modest proposal: Require all tax preparers—commercial and nonprofit alike—to screen clients with e-verify. This would ensure that only individuals authorized to work in the U.S. receive the EITC—resulting in a sizable reduction in fraudulent payments.

E-Verify could become EITC-verify. ■

Endnotes

1. http://www.consumer-action.org/press/articles/rals_drain_off_millions_in_taxpayer_refunds.

2. http://www.consumer-action.org/press/articles/rals_drain_off_millions_in_taxpayer_refunds.

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