Defrauding the American Taxpayer - The Earned Income Tax Credit

EITC and the Culture of Debt

Part 6 of 7
By Edwin S. Rubenstein
For *The Social Contract*
April, 2011

For poor families, the tax refund check is often the largest single sum of money they 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 they are costly.

RALs are bank loans secured by the taxpayer's expected refund—loans that last about 7-14 days until the actual IRS refund repays the loan. That's 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. http://www.consumer-action.org/press/articles/rals_drain_off_millions_in_taxpayer_refunds

RALs cost 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. 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 EITC loans can be over 1,100%. http://www.consumer-action.org/press/articles/rals_drain_off_millions_in_taxpayer_refunds

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, Refund Anticipation Loans are not. Yet RALs and sub-prime mortgages have much in common.

Both are marketed to poor, unsophisticated borrowers. Borowing costs of both products are understated - by teaser rates in the case of sub-primes; 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.

RALs Target EITC recipients

The biggest market for RALs are workers who claim the EITC. Over 60% of all RAL borrowers are EITC recipients according to IRS data, despite the fact that EITC recipients only make up 17% of taxpayers. About 30% of EITC recipients get a RAL. http://www.consumer-action.org/press/articles/rals_drain_off_millions_in_taxpayer_refunds

Taxpayers paid an estimated $960 million in Refund Anticipation Loan interest and fees in 2005 (the latest year of available data) – essentially borrowing their own money at extremely high interest rates. http://www.consumer-action.org/press/articles/rals_drain_off_millions_in_taxpayer_refunds

Finance costs are just the beginning. Most EITC households hire commercial 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 – or roughly equal to 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. (Needless to say, those cozy arrangements 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. http://cdf.convio.net/site/DocServer/RAL_report_CA.pdf?docID=6821

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. http://www.brookings.edu/ES/urban/publications/berubekimeitc.pdf

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 (electronically) 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 earned income tax credit (EITC) refunds prior to April 15.
http://www.gppf.org/article.asp?RT=&p=pub/HealthCare/healthtensteps081031.htm
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. According to the company's public filings, 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: The clear relationship between the location of EITC tax filers and the location of Electronic Return Originators (EROs) - tax preparation companies authorized by 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 returns claim EITC there are about 16 tax preparers per 10,000 population.
http://www.brookings.edu/ES/urban/publications/berubekimeitc.pdf

Recent RAL trends are not all bad, however:

Refund Anticipation Loans, 2000-2005

Filing Year	No. of Ralls (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			

http://www.consumerlaw.org/action_agenda/refund_anticipation/content/2007_RAL_Report.pdf

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: 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.
http://www.consumerlaw.org/action_agenda/refund_anticipation/content/2007_RAL_Report.pdf

On the other hand, a new line of products – pay stub and holiday Ralls – 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.
http://www.consumerlaw.org/action_agenda/refund_anticipation/content/2007_RAL_Report.pdf

Who is to blame?

With 60 percent of Refund Anticipation Loans going to EITC recipients, the government has an interest in minimizing RAL costs, or eliminating the need for the costly loans 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.
http://www.brookings.edu/ES/urban/publications/berubekimeitc.pdf

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:

IRS blames the tax preparation services for inflating refund amounts in order to market RALs – especially when working with taxpayers elgible for the EITC.
http://www.gao.gov/products/GAO-08-800R

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.” http://www.irs.gov/pub/irs-utl/2007_objectives_report_vol_ii_ral_final.pdf

But an undercover GAO investigation found no evidence that tax preparers inflate refund amounts - raising the possibility that the fraud originated with EITC taxpayers - including illegal aliens. http://www.gao.gov/products/GAO-08-800R

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 multi-million dollar corporations.” http://www.consumerlaw.org/action_agenda/refund_anticipation/content/SenateRALltr.pdf

Reality check: Commercial tax preparers flourish because they provide a level of convenience, speed, and expertise that free non-profit 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 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 non-profit alike - to screen clients with E-verfy. This would insure that only individuals authorized to work in the U.S. recive EITC – resulting in a sizable reduction in fraudulent payments.

E-Verify could become EITC-verify.