

**National Taxpayer Advocate's  
2007 Objectives Report to Congress**

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**Volume II  
The Role Of The IRS In The Refund  
Anticipation Loan Industry**

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## Introduction

With the advent of the earned income tax credit (EITC) and electronic filing, tax refunds have become big business. The EITC is a government benefit to low income workers, many of whom have children. Because approximately 56 percent of Refund Anticipation Loan (RAL) consumers also claim the EITC,<sup>1</sup> there is a government interest in delivering this means-tested benefit to the beneficiary without intermediaries siphoning off fees. Moreover, because approximately ten percent of the population is unbanked,<sup>2</sup> and financial literacy leads to asset building and provides a path out of poverty, the government has an interest in encouraging unbanked persons to enter the financial mainstream. Since tax refunds are often the taxpayer's largest lump receipt during the year,<sup>3</sup> a major focus of "banking the unbanked" should center on taxpayers receiving refunds.

In her 2005 Annual Report to Congress, the National Taxpayer Advocate detailed several of her concerns regarding the IRS's role in the refund anticipation loan industry.<sup>4</sup> As the Taxpayer Advocate Service continues to research these areas and raise them with internal and external stakeholder groups, the following issues require further discussion:

- The IRS does not conduct adequate oversight of Electronic Return Originators (EROs) that facilitate RALs;
- While the Debt Indicator (DI) may reduce the number of RAL defaults, there are legitimate taxpayer privacy and consumer protection concerns, especially under the current IRC § 7216 regulations;
- The legality of the debt collection offset or cross-collection practice is questionable and should be the subject of legislative action;
- By including a Revenue Protection Indicator in the acknowledgement file, the IRS can impact RAL demand as well as protect taxpayers from purchasing RALs when the IRS will either delay the release or reduce the amount of the anticipated refund;
- The IRS should develop its own fast and secure refund delivery option for unbanked taxpayers;

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<sup>1</sup> IRS, Ad Hoc Report 4-05-08-1-036N (IMF-270), ETA Database, Full Tax Year 2003, Total Population = 127,084,129, RAL Population = 13,755,163.

<sup>2</sup> Financial Literacy & Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy 2006*, 67-73.

<sup>3</sup> During the 2006 filing season, the average individual income tax refund was \$2,196. IRS 2006 Filing Season Data, For Week Ending 5/27/2006. A recent research study found that many low- and moderate-income households use RALs to increase net savings, and approximately 80 percent of those surveyed wanted the same amount or more taxes withheld. Despite this motivation to save, only 45 percent of RAL consumers saved some or all of their refund in comparison to 53 percent of non-RAL filers. Michael S. Barr & Jane Dokko, *Tax Preparation Services & Preferences for Withholding Among Low- and Moderate-Income Households*, Working Paper Presented to the IRS Research Conference (June 15, 2006), Paper on file at the Office of the Taxpayer Advocate (The data in this working paper are provisional and weighted. Interested parties should contact the authors for further information).

<sup>4</sup> National Taxpayer Advocate 2005 Annual Report to Congress 162-179.

- The IRS can significantly impact the demand for RALs by stepping up efforts to reduce the refund turnaround time; and
- IRC § 7216 should only permit tax return preparers to disclose tax return information for “tax-related purposes.”

## Background

A refund anticipation loan is a short-term loan based on the taxpayer’s anticipated income tax refund. The taxpayer borrows against all or part of his or her expected refund and is responsible for paying the loan in full, no matter how much of the anticipated refund the IRS actually releases. Financial institutions (banks) issue RALs, but commercial tax preparation businesses facilitate or broker the products. Before transferring any RAL proceeds to the taxpayer, the bank first deducts fees for the preparation, filing, finance charges, and processing. The taxpayer receives the balance of the refund by check, direct deposit, debit card, or as a down payment on a good or service. Once the IRS processes the return generating the refund, the IRS transfers the funds directly to the bank to repay the loan.

## General Uses of Refund Anticipation Loans

In the 2005 filing season, the IRS processed approximately 9.6 million returns with RAL indicators, which claimed approximately \$28.7 billion in refunds.<sup>5</sup> Taxpayers purchase RALs for one or more of the following reasons:<sup>6</sup>

- Need for immediate cash;
- Lack of information about the product or alternatives;
- Immediate access to a large sum of money, typically the earned income tax credit (EITC);
- Inability to pay preparation and filing fees out of pocket; and
- Experience of friends and family.

RAL consumers pay a hefty price for almost immediate access to cash. For example, a \$3,000 RAL facilitated by H&R Block and offered by HSBC Bank carries a \$24.95 bank account set-up fee and a \$75.00 finance charge. Total fees of \$99.95 for the bank product do not include return preparation fees, which averaged about \$150 per client served in the 2005 filing season.<sup>7</sup> It is important to note that in response to pressure initiated by consumer advocates, several tax preparation and filing companies have

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<sup>5</sup> Information provided by IRS Modernization & Information Technology Services (April 11, 2006).

<sup>6</sup> Alan Berube and Tracy Kornblatt, *Step in the Right Direction: Recent Declines in Refund Loan Usage Among Low-Income Taxpayers* (April 2005).

<sup>7</sup> H&R Block Response to Information Request (June 2006); H&R Block, 2005 Form 10-K, Results of Operation (Aug 1, 2005).

agreed to stop charging an additional application fee, which could be as high as \$104.95 on a \$3,000 loan.<sup>8</sup>

Aside from the sheer cost of purchasing a RAL in comparison to the no-cost options provided by the IRS, the large portion of EITC recipients among RAL consumers is cause for concern. IRS data shows that almost 56 percent of RAL consumers in the 2004 filing season were also EITC recipients,<sup>9</sup> even though EITC taxpayers made up only 17 percent of all individual taxpayers that year.<sup>10</sup>

It is also questionable whether RAL consumers actually understand the terms of the product. While EROs are required to obtain taxpayers' signatures on written disclosure forms, there are no requirements that such disclosures be made orally. Despite the written disclosures provided to them, consumers may not fully understand that the RAL is in fact a loan and not simply a way to receive a faster refund from the IRS. Further, without an oral explanation, consumers may lack a general understanding of the nature of the product, its impact on credit reports as well as other consequences of default.

The private sector defends the marketing of RALs by noting the high consumer satisfaction ratings associated with these products and the relatively inelastic demand. RAL marketers often cite a study authored by Gregory Elliehausen of Georgetown University McDonough School of Business Credit Research Center.<sup>11</sup> It should be noted that the study was funded in part by a grant from Jackson Hewitt, a large retailer of RALs.<sup>12</sup> The study found that a significant portion of RAL consumers are credit-constrained and their primary reason for obtaining the loan was to pay bills (41.1 percent) or unexpected expenses (21.2 percent).<sup>13</sup> However, the study does not indicate whether the RAL consumer could have waited an extra week to pay these bills. The study found that most RAL consumers (64.8 percent) were informed of other refund delivery options, but it does not provide sufficient detail to determine whether the EROs orally described the options or merely presented them on paper. Further, the study does not indicate if information, whether presented orally or in writing, was clear enough to allow consumers to make informed decisions.<sup>14</sup>

There is no question that some RAL consumers have a real need to receive their refunds as quickly as possible to avoid dire financial consequences, such as late fees or

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<sup>8</sup> See, e.g., rates provided by CompleteTax at <http://www.completetax.com/ral.asp> (last visited on June 14, 2006).

<sup>9</sup> IRS, Ad Hoc Report 4-05-08-1-036N (IMF-270), ETA Database, Full Tax Year 2003, Total Population = 127,084,129, RAL Population = 13,755,163 (Estimating 7,769,529 RAL recipients claimed EITC).

<sup>10</sup> IRS Statistics of Income, Tax Year 2003, 10, 16 (Showing 130,424,000 returns filed in Tax Year 2003 and 22,024,000 returns claiming EITC). See Alan Berube and Tracy Kornblatt, The Brookings Institution, *Step in the Right Direction: Recent Declines in Refund Loan Usage Among Low-Income Taxpayers* (April 2005) (Found that the lowest rate of decline in RAL usage existed in cities with a greater concentration of commercial preparers).

<sup>11</sup> Gregory Elliehausen, Georgetown University McDonough School of Business Credit Research, *Consumer Use of Tax Refund Anticipation Loans*, Monograph No. 37 (April 2005).

<sup>12</sup> *Id.* at iv.

<sup>13</sup> *Id.* at 61.

<sup>14</sup> *Id.* at 60.

eviction, that would outweigh the additional costs associated with these products.<sup>15</sup> However, it is probable that a significant portion of RAL consumers can wait just a few more days for their refunds without incurring a financial burden. Thus, it is in the best interest of taxpayers for the IRS and the Department of Treasury to create an environment where the demand for RALs is at the absolute minimum. The IRS and Treasury could achieve this environment through several means:

- (1) Improving the oversight of EROs;
- (2) Eliminating the ability of return preparers to have an ownership interest in RALs;
- (3) Providing refund delivery methods other than checks to the unbanked population;
- (4) Closing the gap between the time it takes to receive RAL proceeds and the time it takes to receive a refund directly from the IRS; and
- (5) Ensuring that taxpayers are adequately informed of the options and associated timeframes.

## **IRS Oversight of RAL Facilitators**

As discussed in the 2005 Annual Report, the National Taxpayer Advocate believes that the IRS provides inadequate oversight of the RAL marketing practices.<sup>16</sup>

The IRS has taken the position that it has no role or responsibility in the RAL industry but merely “preserves the integrity of the refund.” Despite this position, IRS Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*, lists several requirements with which EROs must comply, including:

- Ensure the taxpayer understands that the IRS will send the tax refund directly to the financial institution;
- Inform the taxpayer that RALs are loans and not a way to receive the refund quicker;
- Advise the taxpayer of the consequences of default;
- Inform the taxpayer of all fees;
- Secure the taxpayer’s consent to disclose tax return information to the bank pursuant to the requirements under IRC § 7216;

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<sup>15</sup> Outside of the tax realm, individuals are willing to pay additional fees for expedited services. For example, the U.S. Passport Agency charges a \$60 expedited service fee to process passports within two weeks as opposed to the routine six weeks processing period. See [http://travel.state.gov/passport/get/fees/fees\\_837.html](http://travel.state.gov/passport/get/fees/fees_837.html) (last visited June 17, 2006). However, individuals requesting expedited passport services are not necessarily low income individuals and a passport is not typically necessary for living expenses or to stave off a foreclosure or eviction. The fact that a significant portion of RAL consumers claim the EITC weakens this comparison.

<sup>16</sup> National Taxpayer Advocate 2005 Annual Report to Congress 170-172.

- Ensure that the return preparer is not a related taxpayer to the financial institution (This provision has been interpreted to mean that the return preparer cannot own a 50 percent or higher interest in the bank products sold);<sup>17</sup> and
- Refrain from suggesting in advertisements that the bank products offered are methods to receive the refund faster.<sup>18</sup>

The Small Business / Self-Employed Operating Division (SB/SE) of the IRS conducts e-file monitoring visits at ERO establishments to verify compliance with Publication 1345 as well as Revenue Procedure 2000-31.<sup>19</sup> SB/SE employees use an ERO Visitation Checksheet during visits, which includes questions about the following:

- Whether the ERO offers RALs or refund anticipation checks (RACs) and, if so, from which financial institution;
- How the ERO informs the client that a RAL is a loan;
- Whether the ERO provides the customer with a personal check or business check instead of the refund or RAL; and
- Whether they assist the customer in negotiating the refund check or RAL.<sup>20</sup>

The ERO Visitation Checksheet does not address many of the requirements detailed in Publication 1345. For example, the checksheet does not indicate whether monitoring visits by SB/SE employees actually confirm the ERO's procedures with respect to the communication of RAL terms. The checksheet does not even mention fees, consequences of default, or IRC § 7216 consent procedures. Further, although not specifically required in Publication 1345, it would be extremely beneficial to taxpayers if preparers were required to fully explain the various refund delivery alternatives, as well as the associated fees and refund turnaround times.

In her 2005 Annual Report to Congress, the National Taxpayer Advocate noted the high rate of noncompliance found during 2004 e-file monitoring visits (approximately 33 percent received sanctions and 17 percent received warnings). The IRS countered by stating that this noncompliance rate is attributable to its effective selection methodology. To bolster its argument, the IRS stated that random visits produced only a 7.8 percent noncompliance rate.<sup>21</sup> However, because the IRS has not provided any information regarding the selection process for the random visits, we cannot apply the 7.8 percent rate to the general ERO population. We invite the IRS to work closely with our office to determine a methodology to select random sites.

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<sup>17</sup> IRS, Electronic Tax Administration, Response to Information Request (Oct. 14, 2005). It appears that the purchase of an interest in a RAL creates a partnership interest and the RAL interest is an indirect ownership of a capital or profit interest, pursuant to IRC § 707(b)(1).

<sup>18</sup> IRS Pub. 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns* 44-45.

<sup>19</sup> Rev. Proc. 2000-31, 2000-31 I.R.B. 146, § 7 (The revenue procedure sets forth the obligations for participants in the Form 1040 IRS e-file program and states that the IRS may sanction violations of Pub. 1345).

<sup>20</sup> IRM 4.21.1.

<sup>21</sup> National Taxpayer Advocate 2005 Annual Report to Congress 170-172, 175-179.

Several states regulate the RAL industry to protect taxpayers, primarily by imposing disclosure requirements on both the RAL banks and the preparers who facilitate the RALs.<sup>22</sup> Congress has also expressed interest in regulation. The Taxpayer Protection and Assistance Act of 2005 includes provisions to regulate income tax preparers<sup>23</sup> as well as RAL facilitators. In conjunction, the establishment of both regulatory programs would address many of the problems related to EROs marketing RALs and other ancillary products during the tax return preparation and filing process. Specifically, the proposed program to regulate RAL facilitators would require EROs to disclose the following items both orally and on a separate written form at the time the taxpayer applies for the RAL: (1) the RAL is a loan, (2) expected time frames for different filing options, (3) consequences of default, (4) any cross collection arrangements, and (5) fees. Further, to achieve meaningful compliance, the bill provides for monetary penalties.<sup>24</sup>

## Financial Incentives for EROs

The IRS currently permits EROs to receive financial incentives to sell RALs. Specifically, the IRS allows EROs to purchase a less than 50 percent ownership interest in RALs facilitated by the ERO.<sup>25</sup> This approach appears to be a blatant conflict of interest which could lead preparers to sell these products despite the best interest of their customer.<sup>26</sup>

The IRS prohibits EROs from accepting a fee contingent upon the amount of the refund or financial product.<sup>27</sup> However, it appears that the EROs are accomplishing on an aggregate basis what they are prevented from doing on an individual loan basis. For example, in H&R Block's 2005 Form 10K, the company attributes the 8.6 percent increase in RAL participation fees (the increase amounted to \$14.4 million of the total participation fees of \$182.7 million in fiscal year 2005) to "an increase in the dollar amount of loans in which [H&R Block] purchased participation interests, resulting from

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<sup>22</sup> See, e.g., Cal. Bus. & Prof. Code § 22251 et seq.; Minn. Stat. § 270C.445; N.C. Gen. Stat. §§ 53-245 to -254.; Wisc. Stat §§ 42.301 to -.310.

<sup>23</sup> For information on the National Taxpayer Advocate's proposal to establish a federal program to regulate unenrolled tax preparers, as well as increase preparer penalties, see National Taxpayer 2002 Advocate Annual Report to Congress 216-230; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2004 Annual Report to Congress 67-88.

<sup>24</sup> S.832, §§ 4,6, 109<sup>th</sup> Cong.

<sup>25</sup> IRS Pub. 1345, *Handbook for Authorized E-File Providers of Individual Income Tax Returns* 44; Electronic Tax Administration Response to Information Request (Oct. 14, 2005). It appears that the purchase of an interest in a RAL creates a partnership interest and the RAL interest is an indirect ownership of a capital or profit interest, pursuant to IRC § 707(b)(1).

<sup>26</sup> For a detailed discussion of this issue, see Jeff Engerman, *Administering the Earned Income Tax Credit: Paid Preparers, Problems, and Possibilities*, Submission of Supervised Written Work Requirement, Harvard Law School (Under the Supervision of Professor Daniel Halperin) (May 13, 2006), Paper on File at the Office of the Taxpayer Advocate.

<sup>27</sup> IRS Pub. 1345, *Handbook for Authorized E-File Providers of Individual Income Tax Returns* 45.

an increase in the fee charged by the lender, *an increase in our clients' average refund size and the maximum loan amount allowed by the lender.*"<sup>28</sup>

Permitting EROs to receive financial incentives to sell RALs is a serious issue that requires further review. In fact, H&R Block recently agreed to settle four class action lawsuits addressing this issue for \$62.5 million.<sup>29</sup>

## The Debt Indicator

The Financial Management Service (FMS) of the Treasury Department manages liabilities owed by taxpayers to federal agencies through the Treasury Offset Program. Pursuant to FMS's statutory authority to offset such debts against federal income tax refunds, the agency provides weekly information to the IRS, which updates its system to reflect such debts in the form of a Debt Indicator (DI).<sup>30</sup> Every taxpayer has a Debt Indicator entry that indicates one of the following: no outstanding liabilities (N), IRS debt (I), FMS debt (F), or both IRS and FMS debts (B).

Taxpayers receive information on their outstanding debts in the following manner:<sup>31</sup>

- Before the federal agency to which the debt is owed transfers the debt to FMS for collection, it is statutorily obligated to contact the taxpayer to inform the taxpayer of the collection action and provide a 60-day period to dispute the debt.<sup>32</sup> FMS will only send a notice to the taxpayer after the refund is offset.
- All taxpayers who file their returns electronically receive information regarding their Debt Indicator in the e-file acknowledgement file.
- For taxpayers who do not learn about the Debt Indicator through the e-file acknowledgment file, they can also receive DI information from "Where's My Refund," an online service provided by the IRS to inform the taxpayer about the status of the refund, or from IRS Customer Service Representatives (CSRs).
- The IRS only receives limited information from FMS stating whether the debt is an IRS or FMS debt. The IRS has detailed information regarding tax debts, but for other federal debts, the IRS directs taxpayers to the Treasury Offset Program Call Center in Birmingham, Alabama. The Call Center can confirm the existence of a debt and refer taxpayers to the specific agency to which the debt is owed for further information.

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<sup>28</sup> H&R Block Inc, 2005 Form 10-K, Results of Operations (Aug. 1, 2005) (emphasis added). Jackson Hewitt's 2005 annual report noted that the company earned several RAL-related fees, which include a fee of \$19.00 for each RAL facilitated as well as other fees calculated pursuant to formulas based on collections of defaulted RALs and net finance fees received by Santa Barbara Bank and Trust. Jackson Hewitt's 2005 Annual Report, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

<sup>29</sup> Lawrence Messina, *'Rapid Refund' Lawsuits Resolved: H&R Block*, The Plain Dealer (Dec. 27, 2005); H&R Block Press Release, H&R Block and Attorneys Propose Refund Loan Settlement to Court (Dec. 21, 2005).

<sup>30</sup> IRC § 6402(d).

<sup>31</sup> Briefing by the Treasury Offset Program (Feb. 23, 2006).

<sup>32</sup> 31 U.S.C. § 3720A.

IRS data demonstrates that the DI prevents taxpayers from defaulting on RALs. As noted previously, during the 2005 filing season the IRS processed 9.6 million returns with RAL indicators claiming \$28.7 billion in refunds. After processing the returns, the IRS paid out only \$28.1 billion, which means taxpayers never received approximately \$602 million of the claimed refunds with RAL indicators. Of this amount, \$429 million (on 844,569 returns) was offset pursuant to the Treasury Offset Program.<sup>33</sup> Thus, the DI prevented taxpayers with existing debt problems from taking out additional loans that would never have been funded. If the DI had not prevented the purchase of the RAL, the RAL would have defaulted once the IRS failed to pay out the anticipated refund. The default would lead to further credit problems for the taxpayer and cross-collection issues in the future, as discussed below.

Despite these positive effects, the Debt Indicator is controversial for two reasons:

- (1) The provision of the service by the IRS may actually facilitate the RAL industry; and
- (2) Providing such information about the debts to preparers and RAL banks raises privacy concerns.

It is unclear whether the DI actually facilitates the demand for RALs. The DI is clearly a tool that helps reduce risks for banks, which plays a role in keeping RAL fees down. However, the DI provides no information on whether IRS compliance checks will flag the return for further investigation. In fact, during the 2005 filing season, \$173 million of refund claims with RAL indicators were not paid out due to IRS compliance checks (not offsets).<sup>34</sup> If the IRS eliminated the DI, the banks would be forced to base eligibility on the taxpayer's credit history. Because a low credit score generally indicates financial problems, which could include delinquent government debts or tax compliance problems, it may very well be the case that the taxpayer's credit history will provide more useful information to the bank than even the DI.

Because the Debt Indicator provides information to EROs on government debts such as child support in arrears, it carries real privacy concerns. The IRS sends e-file acknowledgement information, including the DI, to an e-file transmitter, which in turn transmits the data to the ERO. The taxpayer provides consent for this transmission of data when he or she either provides an electronic signature or signs IRS Form 8453, *U.S. Individual Income Tax Declaration for an IRS e-file Return*.<sup>35</sup> Allowing the ERO access to information in the acknowledgement file is vital to the e-file process because the file also provides information as to whether the IRS accepts or rejects the e-filed return. However, the ERO must also obtain the taxpayer's consent pursuant to IRC § 7216 in order to share the information in the acknowledgement file with the RAL bank.

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<sup>33</sup> The remaining \$173 million was not subject to offset, but was not paid out due to IRS compliance checks. Information provided by IRS Modernization & Information Technology Services (April 11, 2006).

<sup>34</sup> *Id.*

<sup>35</sup> The electronic equivalent to Form 8453 is Form 8453-OL, *U.S. Individual Income Tax Declaration for an IRS e-file Online Return*. IRS Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns* 44-45.

The current consent provisions in the Treasury regulations under IRC § 7216 are inadequate as applied to the electronic filing environment. Once this information is shared with a RAL bank, IRC § 7216 no longer protects the information in the hands of the bank. Thus, taxpayers may not fully comprehend that they are sharing information about outstanding government debts beyond just their return preparers and into the marketplace.

## Debt Collection Offset Practice

After the IRS transmits the acknowledgement file, it runs the return through the Dependent Database and Criminal Investigation screens, either of which could place a full or partial hold on the account. When the IRS does not release the entire anticipated tax refund in a timely manner to the taxpayer's temporary account set up at the RAL bank, the RAL will default. Once the default takes place, the banks typically transfer the debt to their collections departments or contractors, which try to work out an additional arrangement with the consumer. Additional interest may accrue during this time.<sup>36</sup> As part of their collection efforts, the main RAL provider banks sign reciprocal contracts with each other agreeing to withhold and pay back defaulted RALs should the defaulted RAL consumer attempt to purchase another RAL from either of the contracting parties. Thus, pursuant to the practice, if a taxpayer owes money on a defaulted RAL to Bank A and subsequently attempts to buy another RAL from Bank B, Bank B is authorized to collect the outstanding debt from the RAL proceeds, transmit the funds to Bank A, and provide the remaining balance to taxpayer, typically in the form of a refund anticipation check, because the existence of the outstanding debt rendered the taxpayer ineligible for the loan.

The National Taxpayer Advocate addressed the issue of cross-collection in the 2005 Annual Report to Congress.<sup>37</sup> She questioned whether taxpayers fully understand the cross-collection provisions of standardized RAL contracts and whether some individuals would have actually purchased the RALs had they known these cross-collection agreements existed between banks. It is questionable whether the provisions are enforceable under the modern case law approach to contracts of adhesion or standard form contracts. The cross-collection provision unilaterally benefits the banks, which have a grossly disproportionate bargaining power in relation to the taxpayer. Moreover, a reasonable person may not expect a RAL agreement to provide the contracting bank with authority to act as a debt collector for a third party bank.<sup>38</sup>

Cross-collection has also been challenged based on fair debt collection principles. The Fair Debt Collection Practices Act requires collectors to inform consumers in the initial written communication (in addition to the first oral communication if the initial communication is oral) that the collector is attempting to collect a debt and any

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<sup>36</sup> Industry Response to Information Request (April 28, 2006).

<sup>37</sup> National Taxpayer Advocate 2005 Annual Report to Congress 162-179.

<sup>38</sup> For more a more detailed legal analysis, see National Taxpayer Advocate 2005 Annual Report to Congress 172-173.

information obtained will be used for collection purposes.<sup>39</sup> Further, within five days of the initial communication, the collector must send the consumer a written notification containing the amount of the debt, the name of the creditor and a statement providing that the consumer has 30 days to dispute the validity of the debt, or any portion thereof.<sup>40</sup> Accordingly, with cross-collection, it is unclear whether the taxpayer had a reasonable opportunity to dispute the existence or amount of the debt before the third party bank collects it from the taxpayer's refund. The debts may even be so old that they are past the legal statute of limitations period for court collection.<sup>41</sup>

The industry has defended the cross-collection practices on two grounds:

- (1) No courts have determined the practice to be illegal, and
- (2) The practice is similar to the Treasury Offset Program.

In *Hood v. Santa Barbara Bank & Trust*,<sup>42</sup> a California case often referenced on the subject of cross-collection, the Santa Barbara Superior Court judge dismissed the case because federal laws preempted state laws on this matter. Thus, the case did not determine the legality of the cross-collection practice, but merely dismissed the case based on choice of law grounds. The case is currently on appeal to the California Court of Appeal.

Cross-collection practices are incomparable to the Treasury Offset Program. First, this government program is authorized by federal statute.<sup>43</sup> In addition, before any collection action is taken, the federal agency to whom the debt is owed must notify the taxpayer that it will commence collection action and provide the taxpayer with at least 60 days to present evidence that the debt is either not delinquent or not legally enforceable.<sup>44</sup> Banks do not recognize or adhere to any such requirement. Further, it is reasonable to assume that one federal agency would collect on the debts of another, since they are all part of one entity, the federal government, but it is not reasonable to assume that a third party bank will collect on the debts of another.

It is also interesting to note that federal law prohibits banks from exercising their right to offset Social Security benefits for the recipients' defaulted loans to that bank.<sup>45</sup> It would make sense to protect EITC funds in a similar manner. At the very least, banks should

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<sup>39</sup> 15 U.S.C. § 1692e(11).

<sup>40</sup> 15 U.S.C. 1692g.

<sup>41</sup> Consumer Advocates' Response to Information Request (May 2006); The California Attorney General filed a lawsuit in early 2006 against H&R Block alleging that the debt collection offset practice is deceptive. State of California Office of the Attorney General News Release, *Attorney General Lockyer Files Lawsuit Against H&R Block for Illegally Marketing and Selling High-Cost Loans as 'Instant' Tax Refunds*, Release No. 06-013 (Feb. 15, 2006).

<sup>42</sup> Order and Final Judgment as to Plaintiffs, Defendants SBBT, *Hood v. Santa Barbara Bank & Trust*, Case No. 1156354 (Cal. Super. Ct. County of Santa Barbara May 2005).

<sup>43</sup> 26 U.S.C. § 6402(d).

<sup>44</sup> 31 U.S.C. § 3720A.

<sup>45</sup> 42 U.S.C. § 407a).

be barred from transferring EITC under a cross-collection arrangement to satisfy a debt owed to a third party bank.<sup>46</sup>

Cross-collection has also received congressional attention. Section 3 of S.324, the Taxpayer Abuse Prevention Act, prohibits soliciting the execution of, processing, receiving, or accepting an application or agreement for a RAL or RAC with such debt offset provisions.<sup>47</sup> Prohibiting cross-collection would certainly address many concerns surrounding this practice. However, this prohibition is not a complete answer. Taxpayers would still default on RALs, and because the banks could no longer perform one of their established collection practices, RAL fees will increase even further.

## Revenue Protection Indicator

The IRS cannot directly regulate banking practices but can indirectly address cross-collection by minimizing the number of RAL defaults in the first place. The IRS already attempts to decrease defaults by providing the Debt Indicator in the acknowledgement file. In furtherance of this policy, the IRS needs to address the main reason RALs default, which is IRS compliance activity that either significantly delays the release or reduces the amount of refunds. Ideally, the acknowledgement file would include a Revenue Protection Indicator, which would provide information about compliance activity. The inclusion of this sort of indicator would require the IRS to run additional compliance screens, such as the Dependent Database and Criminal Investigation screens, *before* releasing the acknowledgement file. While it is likely that this method would delay the release of the acknowledgement file, it may be worthwhile to reduce RAL defaults. In addition to protecting taxpayers, the delay would reduce the desirability of RALs, since taxpayers would receive a direct deposit refund directly from the IRS in approximately the same time period as receiving a RAL. However, given the confidential nature of IRS screens, Criminal Investigation screens in particular, it is imperative that a Revenue Protection Indicator provide general information and not a roadmap for the unscrupulous to work the system.

**The National Taxpayer Advocate acknowledges that delaying the release of the acknowledgement file could potentially impact the rate of electronic filing. Thus, in order to address this concern, we propose that that the IRS run a pilot program to determine exactly how the inclusion of a Revenue Protection Indicator in the acknowledgement file will affect the individual e-file rate. Further, we recommend that the IRS explore mandating e-file for return preparers of five or more individual income tax returns, subject to procedures allowing the taxpayer to opt-out if the taxpayer chooses to file a paper return.**<sup>48</sup>

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<sup>46</sup> See National Taxpayer Advocate 2005 Annual Report to Congress, *Additional Legislative Recommendation: Social Security Levies*, 466.

<sup>47</sup> S. 324, § 3 (a), 109<sup>th</sup> Cong. (2005).

<sup>48</sup> A federal e-file mandate is currently prohibited by IRC § 6011(e). For information on the states' experience with preparer e-file mandates, see Federation of Tax Administrators, *Electronic Filing Mandates: Lessons Learned* 1-3 (June 2005).

## RAL Alternatives

### *Existing Government Options*

The IRS offers several refund delivery options to taxpayers:

- E-File/Direct Deposit. The quickest way to receive a refund is to file electronically and request a direct deposit to an account at a financial institution. This method provides the refund to the taxpayer within two weeks.<sup>49</sup>
- E-File/Paper Check. Taxpayers who e-file may also request a paper check. This method will provide the refund within three weeks.<sup>50</sup>
- Paper Return/Direct Deposit. Taxpayers who file paper returns can request the IRS to direct deposit their refunds. They can expect their refunds within five weeks.
- Paper Return/Paper Check. The slowest refund turnaround time is associated with paper returns on which the taxpayer requests the IRS to mail a paper check. With this method, the taxpayer can expect the refund within six weeks.<sup>51</sup>

The IRS will further expand refund delivery options in the 2007 filing season for taxpayers who choose to direct deposit their refunds on their e-filed or paper returns. A new IRS Form 8888 will give taxpayers the option of dividing their anticipated refunds between as many as three different accounts. By providing taxpayers the ability to split refunds between financial accounts, Treasury hopes to encourage savings. Although a taxpayer can potentially provide RAL account information on Form 8888, the IRS hopes the new program will actually reduce the demand for RALs.<sup>52</sup>

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<sup>49</sup> IRS News Release, *IRS Opens 2006 Filing Season*, IR-2006-1 (Jan. 3, 2006).

<sup>50</sup> IRS Tax Topic 152, Refunds – How Long They Should Take, available at <http://www.irs.gov/taxtopics/tc152.html> (last visited June 12, 2006).

<sup>51</sup> IRS Tax Topic 152, Refunds – How Long They Should Take, available at <http://www.irs.gov/taxtopics/tc152.html> (last visited June 12, 2006).

<sup>52</sup> IRS News Release, *IRS Expands Taxpayers' Options for Direct Deposit of Refunds*, IR-2006-85 (May 31, 2006). Because the program only requires the taxpayer to list domestic bank routing and account numbers, it is possible that one of the listed accounts is a bank product set up in the taxpayer's name to receive a portion of the refund equal to tax preparation, filing and processing fees. The taxpayer can assign rights to the account funds to the tax preparer at the time of return preparation. While the taxpayer would still incur a bank account set up fee, this option would eliminate the need for taxpayers to seek out RALs and RACs for their entire refund amount merely because they cannot pay the tax preparation and filing fees.

## **Private Sector Options<sup>53</sup>**

Aside from the options offered by the IRS, taxpayers also have a wide choice of products offered by the private sector. Although these products continue to evolve, the following list provides general information on some of the main products available in the 2006 filing season:

- Refund Anticipation Checks (RACs). A RAC is a non-loan alternative to a RAL and enables a taxpayer who does not have a bank account to receive a refund by direct deposit. The IRS deposits the refund into a temporary account, and the bank deducts return preparation, filing, and bank processing fees before distributing the remainder of the funds to the consumer. RACs typically involve a bank account setup fee and cost approximately \$25 to \$30.
- Instant or Advance RALs. An Instant RAL or Advance RAL is sold in conjunction with a RAL. It advances the RAL proceeds to the taxpayer from the time of tax preparation and filing until the acknowledgement file is received and the RAL is approved. Because Instant or Advance RALs are approved without the benefit of the Debt Indicator, the resulting additional risk is built into the price of the loan.
- Pay Stub Loans. A pay stub loan (also referred to as a “holiday loan”) is an extension of credit for an anticipated tax refund calculated on a preliminary tax return based on pay stubs with no supporting W-2. Pay stub consumers will typically pay the loan back with RAL proceeds once W-2s are issued.
- Debit Cards. Debit cards are also known as prepaid cards, gift cards, and stored value cards. However, there are differences between the various types. A debit card accesses a bank account; a prepaid card accesses a virtual account with funds pre-loaded; a gift card typically replaces a gift certificate; and a stored value card includes a circuit chip and can be reloaded (such as a subway farecard). These various cards typically involve an initial setup fee as well as transactional fees.

## **Options for the Unbanked**

It is estimated that approximately ten percent of American households do not have an account at a financial institution.<sup>54</sup> These unbanked taxpayers have fewer refund delivery choices. They can request that the IRS mail a paper refund check on either an e-filed or paper return. However, these options generally entail high check cashing fees and take up to six weeks to actually deliver the refund. For taxpayers unwilling to wait four to six weeks for a check, the only real option is to buy a bank product, which typically involves high fees.

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<sup>53</sup> See the written statements submitted for Tax Related Financial Products Can Be Costly: Field Hearing Before the U.S. Senate Committee on Homeland Security and Government Affairs, Permanent Subcommittee on Investigations, 109<sup>th</sup> Cong. (April 15, 2005); Industry Response to Information Request (April 28, 2006).

<sup>54</sup> Financial Literacy & Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy 2006*, 67-73.

The government should develop a quick and secure refund delivery mechanism for unbanked taxpayers. One option would be to expand the availability of the Electronic Transfer Account (ETA) program and develop an outreach program specifically targeting the unbanked.<sup>55</sup> The Department of Treasury developed the ETA program in 1999 to provide a low cost account alternative for unbanked federal payment recipients. However, it appears that the program was only modestly marketed and marginally successful in attracting participants.<sup>56</sup> Treasury should review and improve the program to attract more unbanked taxpayers as well as other federal payment recipients.<sup>57</sup>

Section 9 of S.324, the Taxpayer Abuse Prevention Act, establishes a program to encourage unbanked taxpayers to open bank accounts. Specifically, the provision requires the Department of Treasury, in cooperation with FDIC-insured financial institutions, to develop a program to provide low and moderate income taxpayers with the option of establishing low cost direct deposit accounts through the use of appropriate tax forms.<sup>58</sup> This program would present an excellent opportunity for Volunteer Income Tax Assistance (VITA) sites to partner with financial institutions and credit unions.<sup>59</sup>

Another option, discussed in more detail below, would be to develop a debit card program targeting unbanked taxpayers. While this option does not result in unbanked taxpayers opening bank accounts, it would move them in the right direction by placing them one step closer to the financial mainstream.

### **Debit Cards<sup>60</sup>**

Many taxpayers purchase RALs or RACs simply because they do not own bank accounts and do not wish to wait the time it would take to receive a refund check by mail. With a RAL or RAC product, the preparer will typically issue the loan proceeds or

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<sup>55</sup> An ETA is a low-cost account offered by participating federally insured financial institutions to individuals who receive federal benefit, wage, salary or retirement payments. For more information, see <http://fms.treas.gov/eta/index.html> (last visited June 21, 2006).

<sup>56</sup> FMS initially expected one to two million unbanked individuals to open up ETAs. There are currently over 77,000 active ETA accounts, but the level of participation by financial institutions and federal check recipients has fallen over the last two years. Nonetheless, there are still more ETA accounts opened each month than closed. Information Provided by Treasury Department Banking the Unbanked Initiative (March 2006).

<sup>57</sup> A 2004 research study commissioned by the Financial Management Service of the Department of Treasury, the Social Security Administration and the Federal Reserve Bank of St. Louis surveyed social security benefit recipients and found that more than 40 percent would be unlikely to open an ETA. Reasons given for disinterest included: lack of understanding as to how ETAs would meet their needs, a dislike of banks and credit unions, high cost, and lack of understanding as to how the account works. Financial Management Service, *Understanding the Dependence on Paper Checks: A Study of Federal Benefit Check Recipients and the Barriers to Boosting Direct Deposit*, OMB Control # 1510-0074, 11 (Sept. 2004).

<sup>58</sup> S. 324, § 9, 1409<sup>th</sup> Cong.

<sup>59</sup> See National Community Investment Fund, *From the Margins to the Mainstream: A Guide to Building Products and Strategies for Underbanked Markets*, 2.1-2.8 (Discusses the establishment of referral programs between banks, credit unions and free tax preparation sites).

<sup>60</sup> FMS, Debit Cards Office Response to Information Request (May 24, 2006).

refund to the customer by commercial check or debit card, both of which require the unbanked taxpayer to incur additional fees just to access the money.

While the Department of Treasury has devoted substantial resources to programs to bank the unbanked, it is equally important to develop a quick and secure means of delivering refunds to unbanked taxpayers. The National Taxpayer Advocate supports the development of a government debit card program to deliver tax refunds to the unbanked. However, it is important that any government debit card program be widely acceptable at local establishments and ATMs, entail low setup and transactional fees, and include security safeguards to limit the taxpayer's liability in the case of loss or theft.<sup>61</sup>

A debit card program to distribute refunds would not undermine other "banking the unbanked" initiatives. The debit card program would provide a stepping stone for unbanked taxpayers and help them establish relationships with financial institutions. In fact, the program may create new educational opportunities for the unbanked. The debit cardholder could also use the card to pay tax preparation and filing fees, which would eliminate the need for RACs. Further, if the card is linked to a financial institution, it might offer an opportunity to build or repair credit history, assuming the institution could work out arrangements with credit bureaus.<sup>62</sup>

The U.S. Debit Card program at FMS currently offers various federal departments, including Treasury, Interior, Commerce, and Defense both PIN or signature-based (Mastercard) debit cards as a method of distributing funds. The program partners with banks to gain access to signature-based cards and FDIC insurance. Unfortunately, the program does not yet have the capability to commingle funds from various government agencies and programs.

An IRS debit card program should be designed to provide unbanked taxpayers with tax refunds in the same timeframe as direct deposit for banked taxpayers. This goal will be difficult to accomplish unless the IRS distributes the cards through local channels such as post offices, social service offices, or approved IRS partners, or the IRS mails the cards to taxpayers before filing season. Taxpayers could activate the cards online or by phone.

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<sup>61</sup> Regulation E, 12 C.F.R. § 205.15 provides that a government agency is covered by the Regulation if it directly or indirectly issues access devices to consumers for use in electronic fund transfer (EFT) of government benefits. Regulation E establishes the basic rights, liabilities and responsibilities of consumers who use EFT services. In a 2004 study commissioned by FMS, unbanked social security benefit recipients were polled regarding their receptivity to prepaid cards. Close to half of those surveyed indicated that they would not likely use a prepaid card. The reasons given were concerns regarding acceptability at local stores, risk of theft, fees and a distrust of ATMs. Financial Management Service, *Understanding the Dependence on Paper Checks: A Study of Federal Benefit Check Recipients and the Barriers to Boosting Direct Deposit*, OMB Control # 1510-0074, 11 (Sept. 2004).

<sup>62</sup> See National Community Investment Fund, *From the Margins to the Mainstream: A Guide to Building Products and Strategies for Underbanked Markets*, 4.1-4.8 (Discusses the use of stored value cards to reach the unbanked).

Although not as cost-effective as direct deposit, debit cards may be an efficient and low cost option for both the government and the taxpayer. After initial program setup costs, the electronic transfer to a debit card would likely cost less than printing and issuing a check. Further, assuming the IRS kept the transaction fees low, taxpayers would avoid the fees associated with RACs and check cashing.

### ***Faster Refund Processing***

Taxpayer demand for RALs will decrease if the refund turnaround time associated with a direct deposit is not significantly more than the time it takes to receive loan proceeds from a RAL. Thus, the IRS could impact RAL demand through two steps: (1) include a Revenue Protection Indicator (RPI) in the acknowledgement file, and (2) decrease refund turnaround times.

As discussed earlier, in order to include an RPI in the acknowledgement file, the IRS would need to run compliance screens before releasing the file. If the IRS needs to run the return through the Dependent Database and Criminal Investigation screens before releasing the acknowledgement file, the IRS would delay the release of the file. Banks do not approve RALs and release the funds until the acknowledgement file is received. Thus, including the RPI in the acknowledgement file would lengthen the amount of time it takes to receive RAL proceeds.

The IRS should strive to reduce refund turnaround times by fully deploying the Customer Account Data Engine (CADE) as soon as possible. As the IRS routes more types of individual income tax returns through CADE instead of the Individual Master File (IMF), refunds will be issued faster. The IRS can issue refunds on returns processed through CADE in five to seven days, compared to nine to 15 days for IMF refunds. Thus, CADE could shorten the processing time by four to eight days, which could have significant impact on RAL demand.

In addition to the hastening the incremental deployment schedule of CADE, the IRS needs to analyze its processing pipeline to uncover any inefficiencies. For example, if it runs compliance screens (such as the Dependent Database and Criminal Investigation screens) consecutively, the IRS should consider the feasibility of running the screens concurrently to save processing time.

Closing the gap between the time it takes to receive RAL proceeds as opposed to the direct deposit of refunds will only decrease RAL demand if taxpayers are aware of the different time periods associated with each option. A taxpayer has the ability to make an informed decision to not purchase a RAL if the taxpayer is aware that he or she can expect the refund directly from the IRS in five to seven days, which may not be significantly more time than a RAL, especially if the IRS delays the release of the acknowledgement file to include an RPI until after compliance checks are completed. Therefore, it is equally important to provide outreach to taxpayers directly through the media as well as through IRS partners.

## Use and Disclosure of Tax Return Information

Under Internal Revenue Code § 7216, the taxpayer may consent to preparers using and disclosing confidential tax return information for purposes of marketing RALs and other products offered by the preparer or an affiliate, and sold during the return preparation and filing process.<sup>63</sup> The Treasury Department and the IRS are currently revising the regulations under IRC § 7216 to address advances in technology as well as provide taxpayers with a more informed consent. However, as discussed in more detail in this report, the National Taxpayer Advocate believes that IRC § 7216 should only permit the disclosure of tax return information for “tax-related purposes,” the definition of which would specifically exclude RALs, RACs, and other similar products. Taxpayers demanding these products would need to make the disclosures to the banks themselves. This step may pose an inconvenience for some taxpayers, but this inconvenience is outweighed by the paramount concern for protecting confidential tax information obtained in the course of return preparation.<sup>64</sup>

## Conclusion

Based on the above discussion, the IRS and Congress should take the following actions to adequately address concerns regarding RALs and similar bank products offered during the tax return preparation and filing process:

- The IRS should enhance ERO monitoring and oversight as well as enforce the requirements of IRS Publication 1345.
- Congress should strengthen the oversight of preparers by establishing a system to register, test and certify unenrolled federal income tax preparers. In addition, Congress should enact a more stringent compliance and penalty regime to deter reckless disregard of the rules and/or negligence by paid preparers.<sup>65</sup>

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<sup>63</sup> Treas. Reg. § 301.7216-3. The National Taxpayer Advocate also supports the exception in Treas. Reg. § 301.7216-2(e) allowing preparers legally engaged in the lawful practice of law or accountancy to use or disclose the information to a member of the same firm (with limitations on sharing the information internationally) for purposes of rendering other legal or accounting services. This exception was further enhanced in proposed regulations by limiting disclosure outside the United States Treas. Prop. Reg. § 301.7216-2(h).

<sup>64</sup> The California Attorney General filed a lawsuit against H&R Block in early 2006 alleging that the company used and disclosed confidential tax return information without written consent, in violation of state and federal law, for the purpose of marketing financial products. See State of California Office of the Attorney General News Release, *Attorney General Lockyer Files Lawsuit Against H&R Block for Illegally Marketing and Selling High-Cost Loans as ‘Instant’ Tax Refunds*, Release No. 06-013 (Feb. 15, 2006).

<sup>65</sup> The Taxpayer Protection and Assistance Act of 2005. S. 832, 109<sup>th</sup> Cong. For information on the National Taxpayer Advocate’s proposal to establish a Federal program to regulate unenrolled tax preparers, as well as increase preparer penalties, see National Taxpayer 2002 Advocate Annual Report to Congress 216-230 (Key Legislative Recommendation: Regulation of Federal Tax Return Preparers); National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (Key Legislative Recommendation to enhance due diligence and signature requirements, increase the dollar amount of preparer penalties,

- The IRS should amend Publication 1345 to prohibit EROs from receiving RAL participation fees or any other financial incentives for facilitating RALs. Publication 1345 should also require oral disclosure of relevant RAL terms, such as fees and the consequences of default, as well as an explanation of other available options and the associated timeframes. .
- Congress should prohibit the debt collection offset practice in a manner similar to § 3 of S. 324, the Taxpayer Abuse Prevention Act.<sup>66</sup>
- The IRS should provide more useful information in the acknowledgement file, most importantly a Revenue Protection Indicator (RPI), which would serve to protect taxpayers from purchasing RALs when the IRS either delays the issuance or reduces the amount of the refund claimed on the return as a result of a compliance check. In addition, inclusion of the RPI in the acknowledgement file would delay the release of the file, which would render RALs less desirable. The IRS should initially run a pilot program to determine the impact the delay of the release of the acknowledgement file will have on the rate of e-file. Further, although currently prohibited by statute, the IRS should explore an e-file mandate for return preparers of five or more individual income tax returns; However, any proposed mandate must include procedures for the taxpayer to opt-out of e-file.
- Treasury should develop a debit card program that will allow unbanked taxpayers to receive tax refunds in a safe, fast manner which does not entail high processing or transactional fees.
- The IRS should reduce the refund turnaround time by deploying CADE as quickly as possible as well as running any compliance screens concurrently.
- Congress should amend IRC § 7216 to provide that use and disclosure of tax return information is only allowed for “tax-related purposes,” a term to be defined by regulation. The legislative history should also clearly state that Congress expects the Department of Treasury to continue to provide an exception allowing preparers legally engaged in the lawful practice of law or accountancy to use or disclose the information to a member of the same firm (with limitations on sharing the information internationally) for purposes of rendering other legal or accounting services.<sup>67</sup> The language in the legislative history should also support the limitations included in the proposed regulation which further limit disclosure outside the United States.<sup>68</sup>

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and assess and collect those penalties, as appropriate.); National Taxpayer Advocate 2004 Annual Report to Congress 67-88.

<sup>66</sup> S.324, § 3, 109<sup>th</sup> Cong.

<sup>67</sup> Treas. Reg. § 301.7216-2(e).

<sup>68</sup> Treas. Prop. Reg. § 301.7216-2(h).