FAST CASH, LESS REFUND

Refund Anticipation Loans in North Carolina

A Report by
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Executive Summary

Too many North Carolinians use expensive tax loan products

- North Carolina's tax filers spend an estimated $84.1 million on fees and interest for refund anticipation loans (RALs) during tax year 2006.
- Tax filers in low-income and minority communities rely on these products. These communities use these expensive products in spite of the fact that these are the places where households can least afford to bear the burden of additional costs.
- More than 88 percent of RALs originated in North Carolina in 2006 went to low-income households.
- Tax payers in majority-minority zip codes take out more than 40 percent of all refund anticipation loans.
- The use of these products is widespread. 472,226 filers used a refund anticipation loan in tax year 2006. Another 336,634 filers used a refund anticipation check.
- While the use of RALs is still extensive, fewer consumers are using these products compared to just a few years ago. In 2003, for instance, more than 625,000 North Carolina households used a RAL.
- The use of RALs is most prevalent in portions of the Sand Hills and in Northeastern North Carolina.

More North Carolinians are getting the EITC

- More consumers are using the Earned Income Tax Credit. The IRS indicates that more than 780,000 North Carolina tax filers claimed the EITC in tax year 2006.
- Recipients of the EITC still use RALs. Approximately three in five EITC recipients used a RAL or a refund anticipation check (RAC) to expedite the processing of their tax refund during tax year 2006.

Changes in the marketplace and renewed interest from bank regulators could be the beginning of the end. The days of refund anticipation lending may be coming to an end.

- The marketplace is under distress. Bank partners are under pressure from regulators to reform their products. Advocates are calling for increased consumer protections. New rules established by the IRS will enhance tax prep services.

We suggest four steps to protect consumers:

- Hold banks accountable for the actions of their tax prep partners.
- Require banks to demonstrate that they are putting safeguards in place to protect consumers and prevent fraud.
- Prevent banks from using EITC refunds as collateral for RALs.
- Speed up returns from the IRS.

Refund Anticipation Loans (RALs) are high-cost loans that extract money from low-income and minority communities. RALs and their near neighbor, the Refund Anticipation Check (the RAC), drive the retail tax preparation business.

This paper will frame the issue through the North Carolina experience. It will use data on tax refund products (RALs and RACs) consumed in 2007 for the tax year that ended in 2006.

Our estimate is that North Carolinians spent $48.6 million on refund anticipation loans in TY 2006. That estimate reflects the average price of a RAL in 2006, according to a report issued jointly by the National Consumer Law Center and the Consumer Federation of America (Wu, 2010). That price is consistent with a recent sample of RAL fees at local tax prep shops in North Carolina. That cost consists only of fees associated with RALs. It excludes interest charges, which vary depending upon the size of the advance and the interest rate charged by the bank partner. An average RAL might include about $75 in interest, although the amount could be as low as $25 or as much as $250. We estimate that interest adds another $35.4 million to the cost, resulting in a *total cost of $84.1 million paid by North Carolinians for tax year 2006 returns.*

Policy Steps to Address the RAL Issue

Solving the issue of refund anticipation loans must be addressed by fixing the problem at its source. The right approach will go after the institutions that supply the dollars for these loans. We believe that those sources, which consist of bank partners and tax prep firms, are aided by lax enforcement of laws by bank regulators. In turn, administrative procedures in tax return processing should be redesigned to eliminate the loopholes that make these loans possible.

Those reforms should reflect a few principles:

Bank partners should be accountable. The OCC has issued guidelines for their member banks that partner with tax prep firms to provide refund anticipation loans. Those guidelines have merit. The problem, as is often the case with good banking rules that are already in place, is a lack of implementation. The OCC has rarely followed up on its own rules.

Bank regulators should apply an "evidentiary" standard to banks that supply the funds for RALs to tax preparers: Bank partners should be required to document and demonstrate that safeguards are in place to ensure that all lending laws are observed and that all disclosures are being made. The evidentiary standard would place an expectation upon member banks to report to regulators and the public with proof of their performance. Borrowers should receive disclosure due them according to the Truth-in-Lending Act. Preparers should be held accountable to observe the Equal Credit Opportunity Act. The proof of that verification should be required by the regulators of the bank partners, and those findings should be released to the public.

The IRS should improve the speed and lower the cost of tax preparation and processing: Changes to procedures at the IRS could make a big difference. The perceived value of a refund loan is based upon the expectation of 24 hour service by the IRS. Were the IRS to slow down the return time on debt indicator reporting, demand would probably dry up. Speed up return time of IRS refund returns. Allow consumers to prepare and file their tax returns directly through IRS.gov.

The EITC should not serve as collateral for a RAL: Most refund anticipation lending goes for filers who get the Earned Income Tax Credit. For example, in North Carolina in TX 2006, RAL and RAC filers received 57.6 percent of all Earned Income Tax Credits. Tax filers are paying interest and fees to a middleman in order to get their tax credit. It would take legislative action from Congress to remedy this situation. Congress should act to eliminate the ability of banks to collateralize their RALs with expected proceeds from the EITC.

Current Events Have Disrupted the RAL Market

The credit crisis has upended the normal business model for RAL funding. Bank partners provide the capital, but they rely on a secondary market to refresh their stores. The secondary market dried up during the 2009 tax season. Some banks turned to brokered deposits for their funding. That worked relatively well during a period of low short-term interest rates. That option is muted with heightened concerns about safety and soundness. Nowhere is that concern more relevant than at Pacific Capital (PCBC). Over the summer, the FDIC issued a warning to PCBC: increase your regulatory capital ratios or suffer the consequences. PCBC did not meet that warning by the September 30th deadline. In December, the OCC intervened and told PCBC to cease their RAL funding. On December 24th, The Office of the Comptroller of the Currency forced Pacific Capital to withdraw from funding RALs in 2010.

Jackson Hewitt has relied on Pacific Capital to cash flow the better part of its tax refund business. With Pacific Capital's demise, the shares of JTX immediately fell into crisis. In spite of other bank partnerships (MetaBank and Republic), JTX cannot tap enough capital from these relationships to meet demand. In a filing to shareholders, JTX reported that there would be an adverse "material effect," and that it was likely that they would only have the resources to provide about half of the loans that their clients used in the previous tax season.

Tax preparation firms must have access to large sums of money in order to cash flow the distribution of refund anticipation loans. For national firms like H&R Block or Jackson Hewitt, the need runs in the billions of dollars. Those firms must turn to partner banks for credit. In 2009, six banks provide all of the credit for this industry (in order of capitalization): JP Morgan Chase, HSBC USA, Pacific Capital Bancorp, Republic Bank & Trust, and Ohio Valley Bank, and MetaBank.

The most important providers of refund loan credit have been Pacific Capital, HSBC, JP Morgan Chase, and Republic Bank. Chase and Ohio Valley serve independents. Ohio Valley originated 4,670 loans in 2008 (Ohio Valley Bancorp, 2008). MetaBank provides a small portion of the loans for Jackson Hewitt.

Bank Partnerships with Leading Tax Prep Firms

Bank RAL Provider	*Tax Prep Partners*	*Regulator*
HSBC	H&R Block	OCC
JP Morgan Chase	Mo' Money, Independents	OCC
Republic Bank of Kentucky	Jackson Hewitt, Liberty Tax	FDIC
Pacific Capital	None, former Jackson Hewitt	OCC
MetaBank	Jackson Hewitt	OTS
Ohio Valley Bank	Independents	FDIC
Bank Debit Card Provider	*Tax Prep Partner*	*Regulator*
Block Bank	H&R Block	OTS
MetaBank	Jackson Hewitt, Liberty Tax	OTS
Inter National Bank (Grupo Financiero Banorte)	Liberty Tax	OCC

Pacific Capital may shape shift into a new facsimile of its old self. On January 14th 2010, Pacific Capital sold its tax refund business to Santa Barbara Tax Products Group. SBTPG is a new firm. As an entity, it has no prior history. However, Santa Barbara Tax Products Group is hardly new. They are the same staff, operating with the same facilities, in the same building as the old Pacific Capital tax refunds division. They lack two things before they will be back in business. First, they must find a bank partner with a charter. Second, they must negotiate a contract with a tax prep firm.

Some of the bank partners may cease to be a part of the RAL industry. HSBC partners with H&R Block. Their agreement is set to expire in 2011. Their leadership has given the indication that they will exit the market for these products at that point. Pacific Capital has previously supplied the majority of the loans for Jackson Hewitt. The OCC has forced them to stop their lending. Republic Bancorp supports Liberty Tax. They intend to take over as a provider to Jackson Hewitt, but the FDIC has indicated that they want to review those plans.

Regulatory attention has complemented the events in private markets. The OCC's action against Pacific Capital is not the only instance. The FDIC communicated with PCBC about its regulatory capital. They also issued a cease-and-desist order against Republic Bank in spring 2009. The thrust of the FDIC's order surrounded consumer protections, lending laws like TILA and ECOA, safety and soundness, and preparer accountability. In spite of those warnings, Republic stepped in to indicate that it would partner with Jackson Hewitt for some of the business left unmet by Pacific Capital's exit. The FDIC is likely to act, according to a statement issued in a regulatory filing by Republic on Dec. 30th. It remains to be seen if their intervention will bring a remedy during this tax season, though.

New IRS Tax Prep Training Standards are an Important Improvement

Tax prep firms are under pressure to step up their training, and with those expectations are hints that bank partners will also be accountable. The FDIC wants to make sure that bank partners can verify that rules are in place to meet standards. The feeling that tax prep firms lack adequate training to safeguard against fraud, coupled with a documented record of fraud, prompted the IRS to pass a new final rule this spring. The new final rule stipulates that tax preparers must complete 15 hours of training per year and register with the IRS. It covers all individuals who prepare more than 6 returns, exempting CPAs and attorneys.

There are ample reasons to support this action. The GAO issued a report that detailed some of the issues. The GAO found all kinds of unusual tax prep providers, ranging from auto dealers to shoe sellers to vending machine retailers. The IRS has documented many incidents of tax prep fraud. Most include some use of refund anticipation loans. For instance, in 2007 the IRS sued five corporations that owned 125 Jackson Hewitt franchises. The suit said that the chains were using tax credits and deductions to inflate returns. One return, filed in Atlanta, found that a barber shop owner claimed hundreds of thousands of miles as a business deduction. The report observed that “the customer would have had to drive 1370 miles each day, seven days a week, to consumer that much fuel in one year, leaving little if any time to cut hair.” (Internal Revenue Service, 2007) That chain processed 105,000 returns in TX 2006.

It is a needed change. Prior to this final rule, there was no federal standard for tax prep. Only two states had rules of any kind that governed this process.

Existing Laws are Not Implemented by Regulators

Regulatory response to RALs has been, at best, well-intentioned. It has lacked in follow through. The Office of the Comptroller of the Currency oversees the financial institutions that provide the majority of the funding for refund anticipation loans. Those banks include JP Morgan Chase and Pacific Capital. The former provides funding to many of the independent prepares. Pacific Capital works with major tax preparers including Jackson Hewitt and Liberty Tax. The OCC’s guidelines, as written, lay out the framework for attentive supervision. Those guidelines stipulate that:

- Special consumer protections for active duty service members and their dependents (32 CFR 232)
- Limits the maximum size of a RAL to $5,000
- Limits the amount of a RAL covered by an EITC refund to $1,200.

Not all of these rules are enforced. Mo’ Money Taxes, a firm with 250 shops across the Southeast, includes language on its advertisements that tax filers can get up to $10,000 back in 48 hours. Mo’ Money relies upon JP Morgan Chase. Chase is regulated by the OCC.

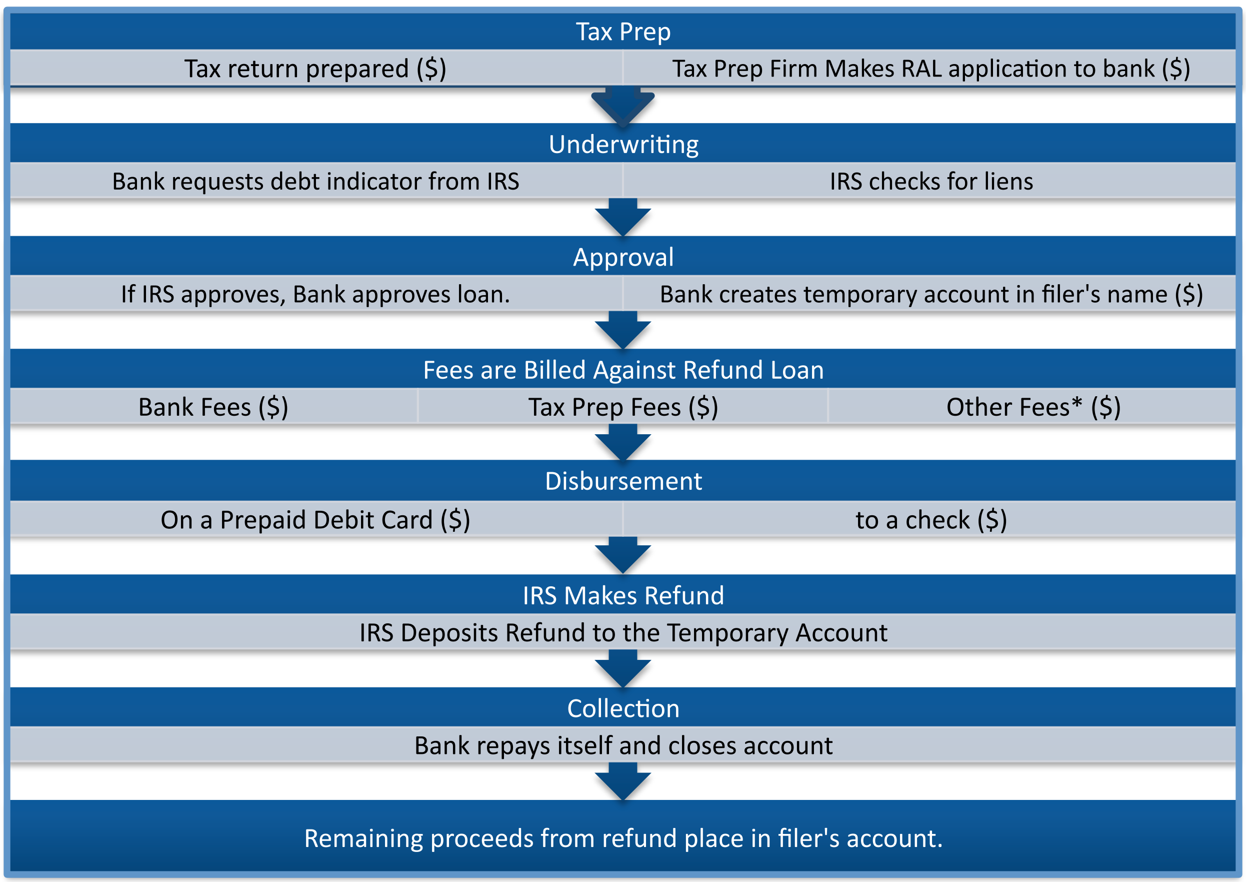
The OCC has established a risk-weighting measure for refund anticipation loans. They have determined that “100 percent is the appropriate risk weight for this type of consumer lending.” (Office of the Comptroller of the Currency, 2003). A member bank requested that the risk-weighting be lowered to just 20 percent. The OCC denied that request.

The FDIC issued a cease-and-desist order against Republic Bank of Kentucky in March 2009. The order criticized the lack of safeguards at RBCAA. In spite of that constraint, Republic signed an agreement with Jackson Hewitt to cash flow more refund anticipation loans. The FDIC has requested a meeting with Republic. The meeting is expected to take place after the main portion of the RAL season.

About Tax Refund Products

Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RACs) cost a lot and only offer a slight advantage over a return filed electronically to the IRS with a direct deposit. The IRS sends checks out on Fridays. Refunds come back in as little as 8 days, and in as much as 15 days. Many people don't want to wait. There could be several motives. Perhaps they need money right away, or perhaps these loans are borne out of habit. Either way, it is an expensive proposition.

RALs and RACs are expensive financial products. Although some would argue that a RAC is preferable to a RAL, most consumers would be better off to not use either one. RALs are sold with a complex set of fees that add costs to the basic tax prep package. At some tax preparers, the margin on RALs supports the entire business. Normally, tax prep firms charge an account fee for a RAL, plus interests costs for the time between the distribution of the refund product and the time when the IRS deposits the client's refund. The State of Wisconsin estimates that a 10 day refund anticipation loan on a typical refund of $2,000 will represent a loan with an interest rate of 521 percent! (Wisconsin Department of Revenue, 2009)This chart shows the step-by-step mechanics of refund anticipation loan processing.



Other fees include e-file fees, technology fees, federal bank processing fees, et al. $ denotes a cost to tax filer

There are a few important things to notice from this chart:

a) Notice that the disbursement is made prior to the receipt of the IRS refund. This is the point of risk. If there is a mistake on the part of the IRS, then the bank will have issued a refund on funds that are not going to be returned. If the tax preparer makes an error that reduces the refund due to the borrower, then the filer has to make up that difference plus the interest on the overextended portion of the refund. There are also instances where fraud takes place.

b) Banks and tax prep partners shift the responsibility of underwriting on tax refund products to the IRS. The application for a RAL triggers an inquiry from the IRS debt indicator. The debt indicator is a communication between the IRS and a tax prep firm that reveals the presence of any kind of government lien (student loan, back taxes, child support) that might cancel the return of a filer. Banks check in with the IRS to make sure that the filer has no outstanding debts to the government. Those outstanding debts hold up a refund.

c) There are fees at multiple points throughout the process. The bank levies interest on the loan, as well as several fees. Those fees include one for setting up the temporary bank account. Tax preparers charge multiple fees as well.

d) This process can accommodate tax filers who have no regular bank account.

The demand for these products stems from demand among consumers to get their tax refund back as soon as possible. The IRS can provide a consumer with a refund in 8 to 15 days if they e-file and have direct deposit. A normal refund anticipation loan can bring a refund in 24 to 48 hours. An instant refund loan can shorten the turnaround time to one day. Refund anticipation checks, while still slower than refund anticipation loans, still get money back to a consumer in as little as four days.

Consumers are also motivated by the ability to file their tax return without paying any money of their pocket. Tax prep fees can be expensive. At one local tax prep shop, tax prep fees were $315. For a filer living paycheck-to-paycheck, a RAL is not just a means to getting a return sooner. It is also a means to avoid having to write a big check for tax services.

Many working households operate outside of the banking system. In its 2009 report, the FDIC estimated that 9 million US households (with 17 million adult residents) lack a bank account. The FDIC went on to say that there are another 21 million US households that have either a checking or savings account, but that still rely on alternative financial service providers for basic transactional services (FDIC, 2009). They use check cashers, payday lenders, rent-to-own agreements, and pawn shops.

The presence of so many people without bank accounts is challenging. This undermines the ability of the IRS to return a refund. The bank partners circumvent this shortcoming by providing consumers with short-term bank accounts or with prepaid debit cards. Jackson Hewitt offers the "*i-power*" card. H&R Block offers the "Emerald Card". Liberty Tax offers the "*Liberty Visa PrePaid Card*". MetaBank partners with Jackson Hewitt, while Block uses its own bank charter for its card. Liberty Tax partners with MetaBank and with Inter National Bank. Inter National Bank is a non-subchapter S Bank subsidiary of Grupo Financiero Banorte, a Mexican bank headquartered in Mexico City. These products can accept an electronic funds transfer. Naturally, consumers who utilize these products pay additional fees.

While some would contend that these 'habits' are a personal preference, it has a negative effect on taxpayer supported efforts to reduce poverty. Most filers that use either a RAL or a RAC receive the Earned Income Tax Credit. The EITC is the nation's most successful anti-poverty program. It is efficient due to its simplicity. It rewards work. It is a refundable credit and it increases as families on the lower rungs of the economic ladder earn more wage income.

Tax Refunds in North Carolina

The following bullet points outline the scope of RAL and RAC use in North Carolina in TX 2006. This is the most recent year with available data. RAC use has been on the increase in recent years, and the balance among the two products is likely to have shifted.

BASIC STATISTICS about REFUND ANTICIPATION LENDING IN NORTH CAROLINA

- More than one in five returns filed in North Carolina in TX 2006 was processed through a RAL or a RAC. 808,860 filers used a refund product (RAL or RAC).
- More than 26 percent of filers that were due a refund chose to expedite their compensation with a refund product.
- Filers applied for 472,226 RALs.
- 415,849 of those RALs went to low-income households.
- 312,435 RALs to households that received the Earned Income Tax Credit.
- Filers applied for 336,634 RACs.
- 241,398 RACs went to low-income households.
- 140,708 RACs to households that received the Earned Income Tax Credit.
- More than 783,956 households received the Federal EITC. Collectively, those filers received $1.58 billion.
- Only 289,483 filers made an IRA contribution – less than 7.5 percent of filers.
- One in 8 tax filers (12.2 percent) uses a refund anticipation loan.

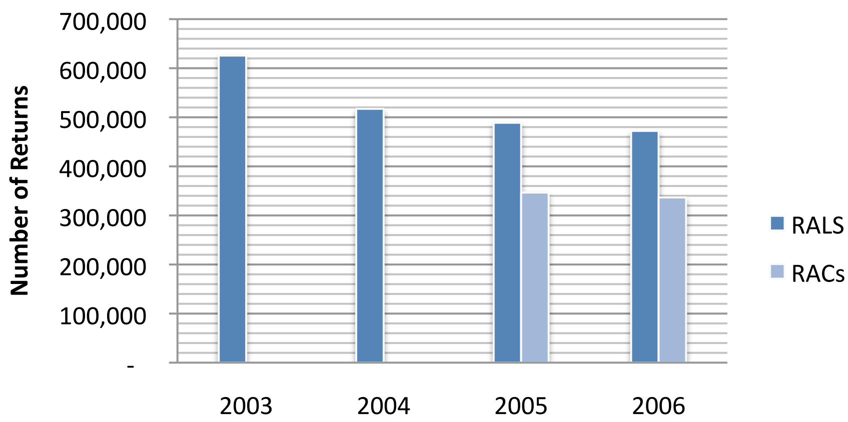
Low-income and minority households are using these expensive products.

- RAL use is more prevalent in high poverty areas.
- In our areas with more poverty, more people are using RALs than are using IRAs.
- RAL use is above average in only 81 of 262 zip codes where there are less than 10 percent nonwhite residents.

RAL use has declined in recent years.

- There were 626,000 RALs in 2003, but only 472,336 in TX 2006.
- In 2003, by contrast, 373,047 of North Carolina's 733,495 EITC recipients (50.9 percent) utilized a refund anticipation loan.

- The RAL market has always focused on EITC recipients. In 2003, more than 60 percent of RALs went to EITC recipients. In TX 2006, 66 percent of RALs went to EITC recipients. We know that RAL use is declining, but the EITC market is the most resistant to change.



Use of RALs declining as RACs emerge in North Carolina

As more and more clients go to the RAC, users of RALs are increasingly made up from EITC recipients.

RAL use has dropped dramatically since 2003. The problem is that the people who use these products are most often those who can least afford it. More than 87 percent of RAL filers in North Carolina in TX 2006 qualified as "low-income." That standard is created by the IRS. It is drawn from a formula that applies the adjusted gross income and family size of tax filers. Larger families can have higher incomes and still be considered "low-income."

RALs afflict poor and minority neighborhoods

Refund anticipation loans are popular in low-income and minority areas. The next table cross tabulates the communities in North Carolina according to their average income and the percentage of tax filers who use a RAL. The median share of RAL users across North Carolina's 783 zip codes is 12.2 percent.

Sorting the Use of RALs by Zip Code Income and Minority Status

Income Level	high RAL	low RAL	Total
less than 30K	145	42	187
30 to 40K	212	154	366
40 to 50K	33	116	149
50 to 60 K	1	48	49
60K plus	0	31	31
Totals	*391*	*391*	*782*
Minority Concentration	high RAL	low RAL	Total
less than 10 percent	55	207	262
10 to 20 percent	52	103	155
20 to 50 percent	173	76	249
majority minority	111	5	116
Total	*391*	*391*	*782*

A “high RAL” area is one with greater than 12.2 percent of its filers attaining refunds through a RAL. There are an equal number of zip codes on each side of this distribution. It is a statistically significant distribution.

The previous table confirms that not only is RAL use high in low-income areas, but it is also concentrated in communities of color. One in eight tax filers uses a refund anticipation loans. Use is higher in communities of color. In zip codes where more than half of the residents claim a “non-white” status on the Census, the use of RALs is much more prevalent. The percentage of filers with a RAL is greater than 12.5 percent in 95.7 percent of North Carolina’s 116 majority minority census tracts. This table shows that there is a consistent trend between the level of minority concentration in a zip code and the use of refund anticipation loans in that sector.

The top communities for RAL use exhibit the patterns, without exception. Each is a high-poverty, majority-minority area.

Top Zip Codes for RAL and RAC use, TX 2006

Zip Code	Community	County	Percent RALs	Percent RACs	Returns	RALs	Percent in Poverty	Percent Non-White
28362	Marietta	Robeson	42.72%	13.59%	103	44	25	66.3
28039	East Spencer	Rowan	41.79%	19.13%	481	201	21.2	88.2
28119	Morven	Anson	41.60%	10.44%	1,149	478	39.9	77.2
27890	Weldon	Halifax	38.80%	9.91%	1,080	419	40.7	74.5
27821	Edward	Beaufort	38.10%	8.93%	168	64	48.8	89.7
27823	Enfield	Halifax	37.48%	12.08%	3,311	1241	44.6	84.8
27849	Lewiston	Bertie	37.47%	12.53%	726	272	40.6	83.4
27831	Garysburg	Northampton	37.15%	12.66%	1,319	490	45	90.3
28007	Ansonville	Anson	36.56%	8.87%	372	136	27	82

Most of these communities are out-of- the-way places. With the exception of East Spencer, all are located in rural areas.

Exploring Why RALs appeal to the Poor

It is hard to pinpoint the exact reason for the ongoing use of these loans in minority areas. It may reflect customs that are passed on through social networks. Refer-a-friend coupons are a common marketing ploy. It could also reflect the ongoing gap in asset wealth. Median earnings for minority workers were about two-thirds of those of white workers in 2002. Still, the gap in earnings is far less distinct than the difference in savings between whites and minority citizens. A 2004 study found that Hispanic households have about 10 cents in savings compared to the average white household, and that African-Americans have even less (Kochhar, 2004). Those numbers reflect changes that took place after the 2001 downturn. They include home equity. In the wake of the subprime crisis, these numbers are likely to have changed. Most likely, gaps in assets are even greater. These numbers suggest that poverty drives the decision to use a short-term high-cost loan. These consumers are making sub-optimum choices borne out of desperation.

Marketing techniques contribute to the clustering of RAL demand. Tax prep shops use word-of-mouth marketing. Jackson Hewitt offers cash to its existing customers who can convince their friends to come into the stores through the "Refer-A-Friend" certificate program. The location of the stores points to the same conclusion. The chains put their franchises in minority and low-income areas. The Chicago Reporter found that 64 percent of stores operated by the three large tax prep chains (Jackson Hewitt, H&R Block, Liberty Tax) were located in majority minority neighborhoods (Martinez-Carter, 2008) or in neighborhoods where more than 1/3 of residents earned less than $25,000 per year.

Alan Berube and Tracy Kornblatt, both of the Brookings Institution EITC program, suggest several motives to explain the use of refund anticipation loans (Berube, 2005):

- Real or perceived need for immediate cash for low income households.
- Lack of information about the product, specifically its costs and alternatives.
- Windfall effect in treating tax refunds as found money rather than earned and therefore willing to pay a higher cost for immediate cash.
- Inability to pay for tax preparation out of pocket which may range from $100 to $250.
- Peer effects - high usage of RALs within the community influences others to do so.

Many people might not realize how many dollars are being extracted from households in their own communities. The next table shows the North Carolina legislative districts where RAL use is the highest. These findings are helpful, though, because they suggest that perceptions and custom make a significant impact on decision-making. These characteristics mean that policy solutions should be designed with the decision-making process in mind.

The EITC

The Brookings Institute believes that many tax filers leave money on the table. They estimate that between 15 and 25 percent of filers that would be eligible for the EITC fail to claim the federal credit. In an estimate of 2003 returns, Brookings reports that more than 129,000 filers missed out on an EITC benefit. In total, those missed claims amounted to $119 million. That is money that could have been spent in North Carolina. Presumably, that additional demand would have produced additional jobs. The average EITC benefit (GAO) is $1766. More than 780,000 people got the EITC in North Carolina in TX 2006. That is a lot of money – more than $1.5 billion. It is a once-a-year windfall for many poor households, but everyone shares in the benefits. That money is spent locally. Research at Vanderbilt University estimated that an additional 7 cents of spending occurred in the surrounding metro area (Nashville) for every EITC dollar (Haskell, 2006)

Qualifications for the EITC (TY 2009)

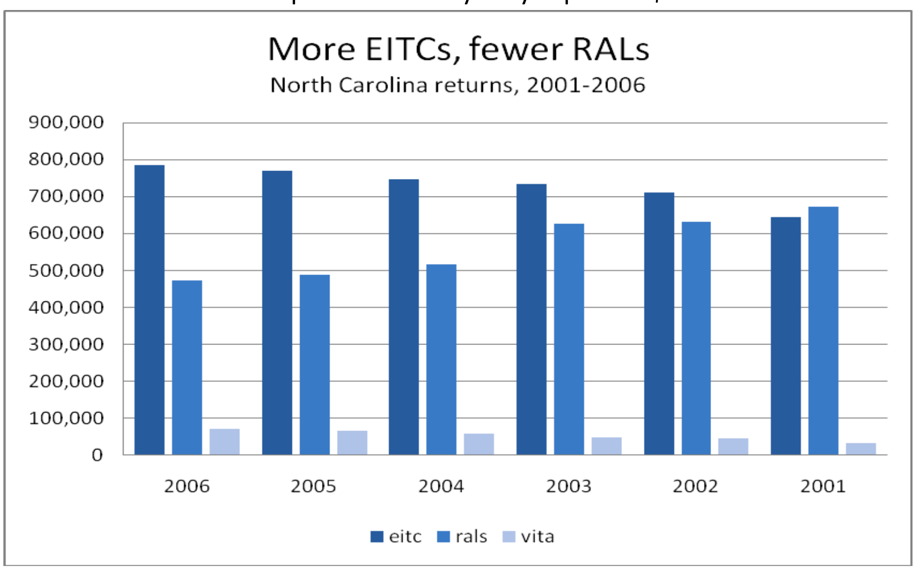
Qualifying Dependents	**Maximum Adjusted Gross Income and/or Earned Income**	
	Single	Married Filing Jointly
None	$13,440	$18,440
One	$35,463	$40,463
Two	$40,295	$45,295
Three or more	$43,279	$48,279

Source: Brookings Institution, EITC program

The EITC is designed to reward low-income families that have wage income. Its maximum income standards make it relatively difficult for filers without dependents to get the credit. It is much more attainable for filers with children.

RALs are Less and Less Popular, but More are Using the EITC
Recent trends are positive: more people are claiming the EITC, but fewer are using RALs. In TX 2006, 39.8 percent of EITC recipients in North Carolina used a RAL.

RALs are not driven by the EITC, but the scale of their use would fall off dramatically without the RAL. The presence of so many tax prep chains that lead with the opportunity to get fast cash would be a thing of the past. Jackson Hewitt relies on financial product income. In 2008, JTX reported $59 million in revenues from financial products. They only reported $19 million in net income for the year. RAL and RACs contribute more than $21 in revenue per return. Without RALs, they would have to change their business model.



This underscores why there is a legitimate authority to change RAL lending through legislation. Congress should pass a law that prevents an earned income tax credit from serving to collateralize a RAL. That change would protect the integrity of the EITC. Taxpayer dollars provide for the EITC. It makes little sense for policy to allow private companies to divert that support into high cost loans.

The IRS allows EITC refunds to serve as collateral for tax refund products. That is instance of a policy that allows its underlying purpose to be undermined. It is no small concern. More than two-thirds of all RALs went to families with the EITC. More than 57 percent of EITC recipients used either a RAC or a RAL. Handling fees alone, based upon the $29.95 fee charged by Block for both RACs and RALs, would exceed $13.5 million in North Carolina. That is just the estimated sum of costs among EITC recipients. The sum for the entire state is higher. Either way, this represents a drag on the impact of taxpayer dollars.

Asset Building

It is not just that many people in these neighborhoods resort to paying a high cost fee to get their tax refunds back sooner. It is also the case that very few filers in these neighborhoods are saving money. IRAs are the main tool for long-term savings utilized by working people. IRA use is rarer than might be expected. Only 7.4 percent of filers made an IRA contribution in TX 2006.

More people use refund anticipation loans or RACs than make an IRA contribution. Whereas 472,226 filers used a RAL and another 336,634 used a RAC, only 289,483 filers made any contribution to their IRA in TX 2006. There is no data for the use of RALs among IRA contributors. Intuitively, it seems that there would be no crossover at all. After all, how many people are prepared to put money away until retirement, but cannot wait 8 days for their tax refund?

Trends reflect more asset building behavior. More filers are getting the EITC every year. Fewer are getting refund anticipation loans. In 2001, more filers got RALs than qualified for the EITC. In TX 2006, EITC filers outnumber RAL users, 1.6:1.0. One hopeful statistic is the number of low-income households making IRA contributions. The IRS reports that 116,548 low-income filers made an IRA contribution. That is good, but there are other indicators that suggest that IRA use lags with minorities. IRA use is popular in low-minority areas. In 76 percent of low-diversity census tracts (less than 10 percent minority status), IRA use exceeds the state median.

Asset advocates see annual Earned Income Tax Credits as an opportunity for families of modest means to build wealth. In many instances, the EITC returns more than $2,000 to households at tax time. It is a sizable benefit for families whose incomes generally don't exceed $40,000. Still, it is generally a lost opportunity. Only a fraction of these families move their credit into a savings vehicle. The IRS counts the number of EITC recipients that make an IRA contribution during the year. Only 6714 North Carolina families with an EITC made a RAL contribution in TX 2006. That accounts for just a bit more than 8/10ths of one percent.

Behavioral economics suggests that more people will save when there are fewer impediments to doing so. Some people might have the inclination and the resources to save, but might not be able to implement a plan to do so. The split refund, where filers can designate that a portion of their return goes to a savings account, promises to make saving easier.   An experiment, conducted from a test pool of low-income tax filers due a tax refund, found that more than 20 percent used the split refund (Tufano, 2005). The split refund has not been widely adopted. IRS Spec reports 809 instances when a filer used the split refund in North Carolina in TX 2006.

VITA sites are helpful, but there are not enough locations. In TX 2006, VITA returns were only filed in about one of every three zip codes in North Carolina.

Looking Forward

This is an unusual time in the history of the refund anticipation loan business. The industry is experiencing rapid change. One national bank partner has been forced to leave the industry altogether. Another is under a cease-and-desist order. A third has stated publicly that it will not renew its relationship with its only current tax prep partner when their contract expires in 2011. A new firm has risen from the ashes but needs to a bank charter and a tax prep contract.

Regulators are waking up to the problems that this lending poses. Their interest reflects concern over the safety and soundness of banks as well as apprehension about how well the interests of consumers are protected.

Tax prep rules will make a difference. A few years back, the General Accounting Office (GAO) looked into the state of this industry. They documented all kinds of examples of questionable tax prep. They found unusual suppliers, including car dealers, furniture stores, pawn shops, shoe stores, payday loan offices, vending machine salesman, and equipment trailer rentals services.

All of these groups offer tax prep because of tax refunds. A tax refund can be more than $2000. That constitutes enough to make a down payment on a car. Furniture dealers, jewelry retailers, and other businesses are known to provide tax services in order to gain access to customers at a time when they have a lot of cash.

National chains will adapt to these new laws. They may have some difficulty with some aspects of the new rule, but those challenges will be overcome if their firms are to continue to exist. The difference could come from the firms that are not primarily purposed as tax prep agencies. The new rules will pose an administrative burden to some groups (auto dealers, furniture salesman, et al) that may opt to drop out of tax prep rather than to take annual training and certification.

About this Paper

This report is part of a coordinated effort among four nonprofit groups in four states. We are working in collaboration through the support of the Ford Foundation. The groups are the Woodstock Institute (Chicago, Illinois), the California Reinvestment Coalition (Los Angeles, California), the Neighborhood Economic Development Advocacy Project (New York, New York), and the Community Reinvestment Association of North Carolina (Durham, North Carolina.)

The report uses data from the Internal Revenue Service. The IRS provides reports, broken down to the zip code level, on tax returns. Data on returns is available for as recently as 2007 (filed in 2008). Data for returns with information on refund anticipation loan usage is available for as recently as TX 2006.

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Appendix One

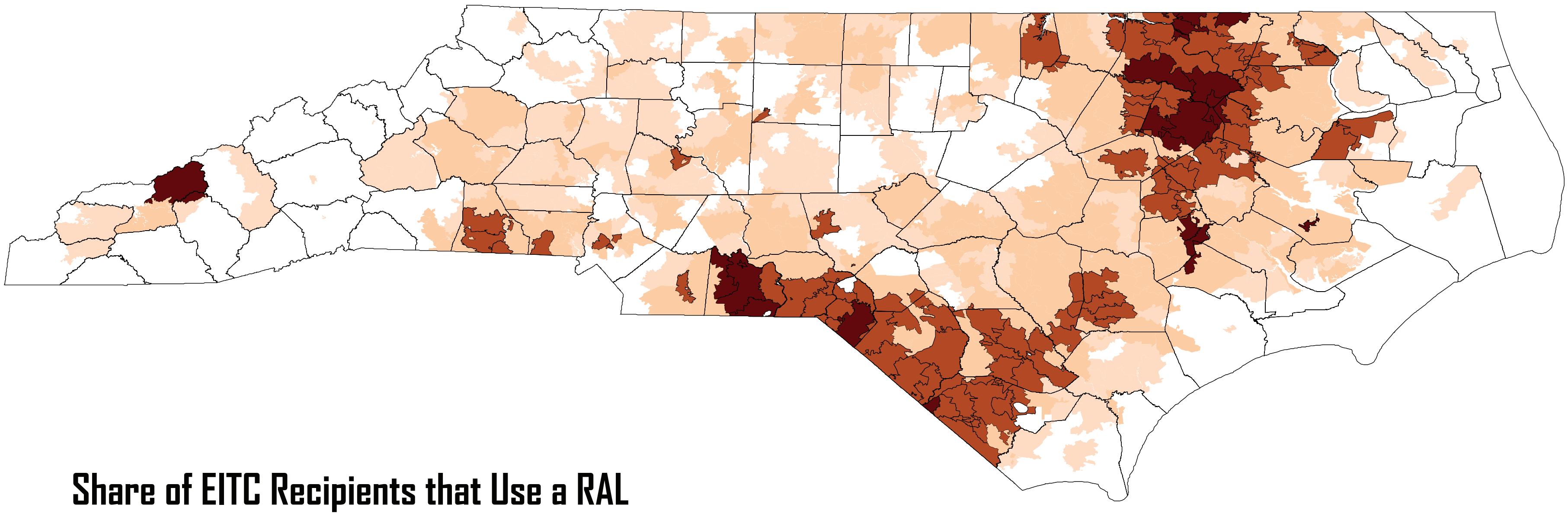
Legislative Districts (NC House) with Highest RAL Costs

Representative	Constituency	Returns	EITC	RALs	EITCs w/ RALs	Est. Cost
Garland Pierce	Hoke, Robeson, Scotland	27,721	11,361	8,162	6,434	$840,658
Beverly Earle	Mecklenburg	37,532	10,239	7,113	4,967	$732,627
Melanie Goodwin	Montgomery, Richmond	27,667	8,919	6,866	4,953	$707,238
Jeanne Farmer-Butterfield	Edgecombe, Wilson	26,375	9,010	6,766	5,309	$696,885
Joe Tolson	Edgecombe, Wilson	28,652	8,943	6,755	5,089	$695,802
Douglas Yongue	Hoke, Robeson, Scotland	24,832	9,079	6,689	5,046	$688,969
Kelly Alexander	Mecklenburg	35,543	9,588	6,452	4,664	$664,516
Pryor Gibson	*Anson, Union*	30,085	8,019	6,389	4,390	$658,059
Angela Bryant	Halifax, Nash	25,137	8,493	6,368	5,026	$655,919
Edith Warren	Martin, Pitt	28,160	9,393	6,360	4,995	$655,112
Ronnie Sutton	Robeson	22,142	9,689	6,333	5,023	$652,260
Michael Wray	Northampton, Vance, Warren	26,306	9,423	6,201	4,867	$638,731
Earl Jones	Guilford	29,421	8,581	5,814	4,203	$598,830
William Brisson	Bladen, Cumberland	29,083	8,702	5,813	4,056	$598,789
Larry Bell	Sampson, Wayne	29,186	8,674	5,678	4,099	$584,802

All of these districts are either in large urban areas, or in impoverished parts of the state running from the Sandhills over to Eastern North Carolina.

The column on the far right calculates an estimated cost based upon the specific cost of RALs (not including interest) at a local tax prep chain. At this chain, a RAL costs $103. That includes a Bank Fee ($32), an e-file fee ($29), a technology fee ($15) and a Federal Bank Product Application Fee ($27). Those majority-minority census tracts are struggling.

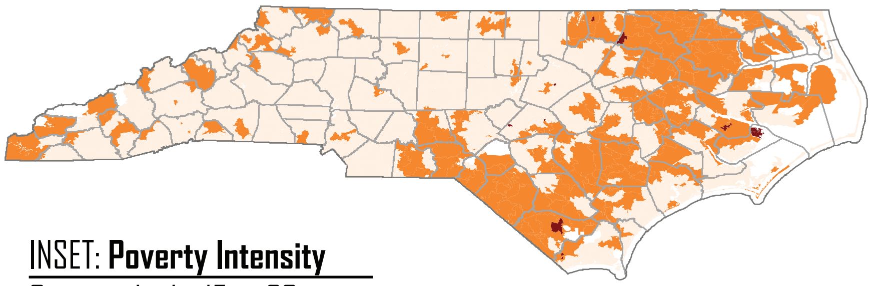
EITC Recipients Use RALs in High Poverty Areas



Share of EITC Recipients that Use a RAL
(refund anticipation loan)
Tax Year 2006

- Less than one-third
- 33 to 40 percent
- 40 to 50 percent
- 50 to 60 percent
- 60 to 70 percent

source: IRS

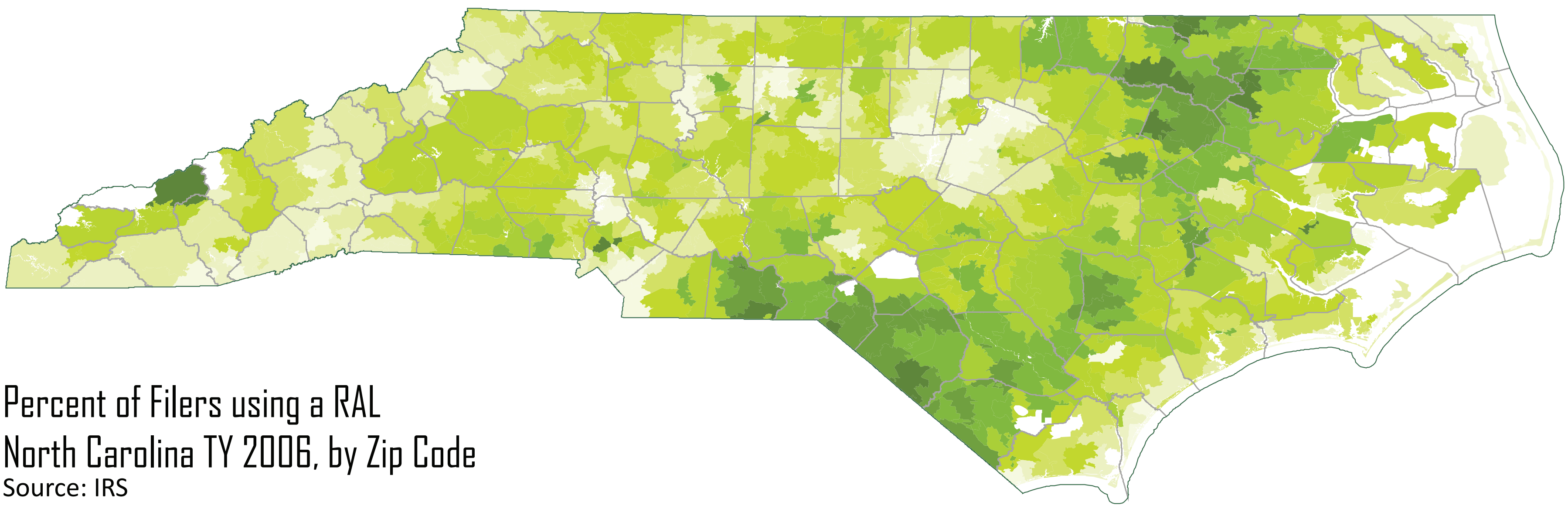


INSET: **Poverty Intensity**
Orange shade: 15 to 30 percent poverty
Red Shade: More than 30 percent poverty

Prepared by the Community Reinvestment Association of North Carolina

Refund Anticipation Loans in North Carolina

Tax Year 2006



Percent of Filers using a RAL
North Carolina TY 2006, by Zip Code
Source: IRS

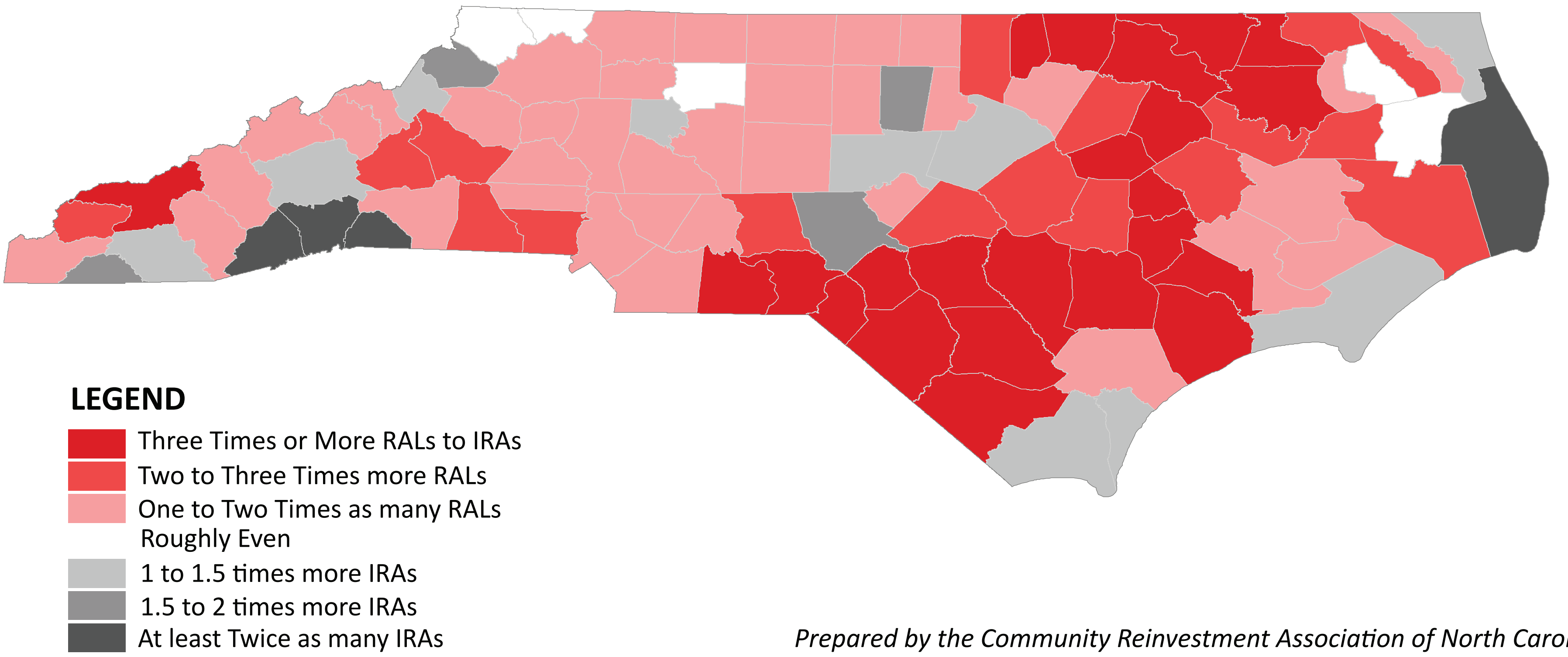
- Less than 4 percent
- 4 to 7 percent
- 7 to 9 percent
- 9 to 12 percent
- 12 to 14 percent
- 14 to 17 percent
- 17 to 21 percent
- 21 to 27 percent
- 27 to 33 percent
- 33 to 43 percent

Inset: Share of Residents
in Poverty, by Zip Code

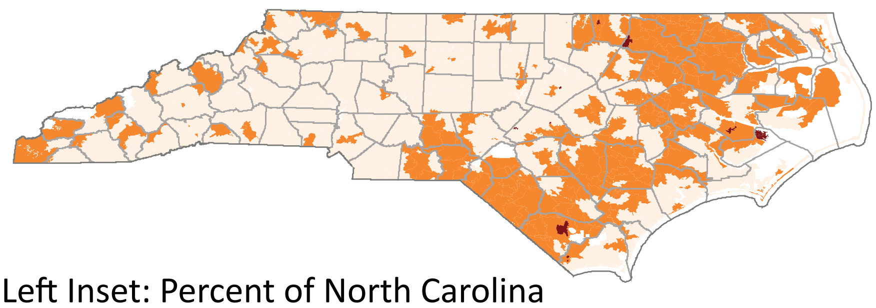
Prepared by the Community Reinvestment Association of North Carolina

The Geography of Asset Growth

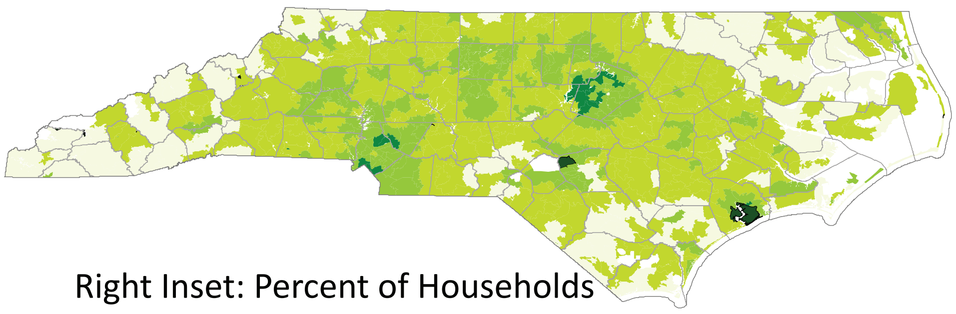
Ratio of Tax Filers Borrowing with a RAL to Tax Filers Making an IRA Contribution



Prepared by the Community Reinvestment Association of North Carolina



Left Inset: Percent of North Carolina Households in Poverty, 2000
Census 2000



Right Inset: Percent of Households with Wage Income, TX 2006
IRS SPEC