

**MSP
#21****REFUND ANTICIPATION LOANS: Increased Demand for Refund Anticipation Loans Coincides with Delays in the Issuance of Refunds****RESPONSIBLE OFFICIALS**

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TAXPAYER RIGHTS IMPACTED¹

- *The Right to Retain Representation*
- *The Right to a Fair and Just Tax System*

DEFINITION OF PROBLEM

Demand for refund anticipation loans (RALs) has more than tripled over the past year.² Over 90 percent of the returns filed with RAL indicators were filed by February 15.³ This substantial increase in demand coincides with the effective date of the provision in Internal Revenue Code (IRC) § 201 of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) that requires the IRS to hold all refunds that include Earned Income Tax Credit (EITC) and Additional Child Tax Credit (ACTC) until February 15.⁴ While the IRS is statutorily required to delay refund issuance, such delay improves tax administration by allowing the IRS to match return information with information reporting documents. However, in the process, taxpayers are absorbing the costs of these short-term loans and, in many cases, they might not even realize the true cost due to the hidden nature of the indirect fees.⁵

ANALYSIS OF PROBLEM**Background***The Demand for Refund Anticipation Loans*

Taxpayers have various refund delivery options, of which the most popular is direct deposit into the taxpayer's bank account. Eight out of ten refunds are delivered through direct deposit, which is a no

- 1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).
- 2 As of May 23, 2017, the IRS accepted over 1.7 million returns with refund anticipation loan (RAL) indicators, up from 468,330 in the same time period in 2016. Returns with refund anticipation check (RAC) indicators decreased during this period with about 21.5 million in 2016 and over 20.2 million in 2017. IRS, *Daily E-File at a Glance*, U.S. Totals for Individual Returns, Nationwide (May 24, 2017).
- 3 IRS, *Daily E-File at a Glance*, U.S. Totals for Individual Returns, Nationwide (Feb. 15, 2017). As of February 15, 2017, the IRS accepted over 1.56 million returns with RAL indicators, up from 437,245 in the same time period in 2016. Therefore, approximately 90 percent of the total 1.7 million RAL returns filed (as of Aug. 23, 2017) were filed by Feb. 15, 2017.
- 4 Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), enacted as part of the Consolidated Appropriations Act, 2016, Division Q, Pub. L. No. 114-113, 129 Stat. 2242 (Dec. 18, 2015); See, e.g., Jackson Hewitt, *How Fast Will You Get Your Tax Refund This Year?*, <https://www.jacksonhewitt.com/Resource-Center/Your-Tax-Refund/> (last visited Sept. 8, 2017).
- 5 Chi Chi Wu (National Consumer Law Center) and Michael Best (Consumer Federation of America), *Big Changes Burden Taxpayers: New Law Delays Refunds, Drives Demand for Loans; Immigrant Taxpayers Face Challenges* 3-4 (Mar. 2017).

Demand for refund anticipation loans (RALs) has more than tripled over the past year. Over 90 percent of the returns filed with RAL indicators were filed by February 15.

cost option. When combined with e-filing, this method is the quickest way for taxpayers to receive refunds, with more than nine out of ten direct deposit refunds delivered within 21 days.⁶ However, direct deposit is not available to unbanked taxpayers.⁷ Unbanked taxpayers can choose to receive a paper check, which takes up to six weeks and may involve check cashing fees, or purchase a commercial product that may reduce the wait but typically involves high fees. Such commercial products include RALs, refund anticipation checks (RACs and also known as refund transfers), and debit cards.⁸ These products also provide a mechanism by which the taxpayer can pay tax preparation fees with the anticipated tax refund.⁹

RALs are short term interest-bearing loans secured by the taxpayer's expected refund. The loans are made by financial institutions, facilitated by tax preparers and tax preparation software, and enable taxpayers to receive advances of a portion of their refund (typically an amount up to \$1,300). The taxpayer contracts with the financial institution for the loan and receives the funds a day or two after applying. The refund is then sent to an account held by the financial institution, which offsets the refund with the amount of the loan, and then disburses the remaining balance, if any, to the taxpayer.¹⁰

The History of Refund Anticipation Loans

RALs were introduced in the tax preparation market in 1987. In 2000, the IRS instated the Debt Indicator (DI) to provide information on refund offsets.¹¹ The National Taxpayer Advocate has raised

6 IRS, *Direct Deposit Your Refund* (Mar. 27, 2017). As of Aug. 18, 2017, almost 88 million refunds were delivered by direct deposit out of a total of over 108 million refunds issued to individual taxpayers. The number of direct deposit refunds increased by one percent from the same time in 2016. *IRS Filing Season Statistics, Cumulative Individual Income Tax Returns*, (Aug. 18, 2017).

7 Unbanked taxpayers are taxpayers with no bank accounts.

8 RALs are loans secured by a taxpayer's anticipated tax refund. RACs are temporary bank accounts established on behalf of a taxpayer into which the IRS can direct deposit a refund and out of which a bank typically issues a payment to the taxpayer. For more information on RALs and RACs, see National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, vol. 2, 2-18 (Study: *The Role of the IRS In the Refund Anticipation Loan Industry*). In addition, some financial institutions offer pay stub loans, also known as holiday loans, in which the tax preparer prepares an estimated return based on the last pay stub, because the taxpayer does not yet have a W-2. The lender advances a small portion of the refund with the pay stub loan and the remainder of the refund is available after the preparer prepares and files the return once the W-2 is available. The IRS does not track pay stub loans specifically. However, it is possible that these loans are included in the RAL data because the tax return would likely list the taxpayer's temporary bank account associated with these loans. An example of a pay stub loan is the Express Refund Advance by MetaBank. See <https://www.jacksonhewitt.com/file-taxes-last-pay-stub/> (last visited on Nov. 14, 2017).

9 Urban Institute and Internal Revenue Service, *Characteristics of Users of Refund Anticipation Loans and Refund Anticipation Checks* 33 (2010); IRS Working Group on Refund Anticipation Loans and Other Refund Settlement Products, *Background Information* 8 (Mar. 2010).

10 See Urban Institute and Internal Revenue Service, *Characteristics of Users of Refund Anticipation Loans and Refund Anticipation Checks* (2010); Karen Masken, Mark Mazur, Joanne Meikle, and Roy Nord, IRS Office of Research, Analysis, and Statistics, *Do Products Offering Expedited Refunds Increase Tax Compliance?* (Nov. 2007).

11 The Debt Indicator (DI) was used as an underwriting tool for RALs. The DI was included in the acknowledge file for electronically filed returns and indicated whether the individual taxpayer would have any portion of the refund offset for delinquent tax or other debts, such as unpaid child support or delinquent federally funded student loans. RAL lenders used the DI to gauge whether the taxpayer's entire anticipated refund would be released by the IRS. IRS, *IRS Removes Debt Indicator for 2011 Tax Filing Season*, IR-2010-89 (Aug. 5, 2010); Urban Institute and Internal Revenue Service, *Characteristics of Users of Refund Anticipation Loans and Refund Anticipation Checks* 12 (2010).

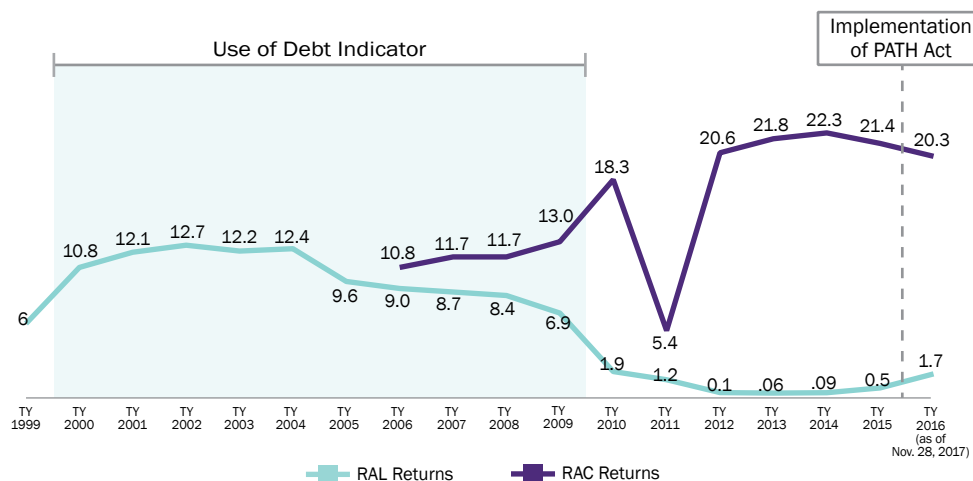
concerns about the high costs as well as compliance risks associated with these products since 2005.¹² The IRS stopped providing the DI to the financial institutions beginning in Filing Season (FS) 2011 and, as a result, most banks exited the RAL market by 2012.

A Spike in RAL Demand Coincides with the Effective Date of the PATH Act

Beginning in FS 2017, RALs have reemerged in the refund product market. The increase in demand coincided with the effective date of the provisions in the PATH Act preventing the IRS to release EITC or ACTC refunds before February 15.¹³ The demand for RALs spiked significantly in FS 2017.¹⁴ The chart below shows the demand for RALs and RACs from Tax Year (TY) 1999 to 2016.

FIGURE 1.21.1¹⁵

Refund Anticipation Loan (RAL) and Refund Anticipation Check (RAC)
Demand From Tax Years (TYs) 1999 to 2016 (in millions)



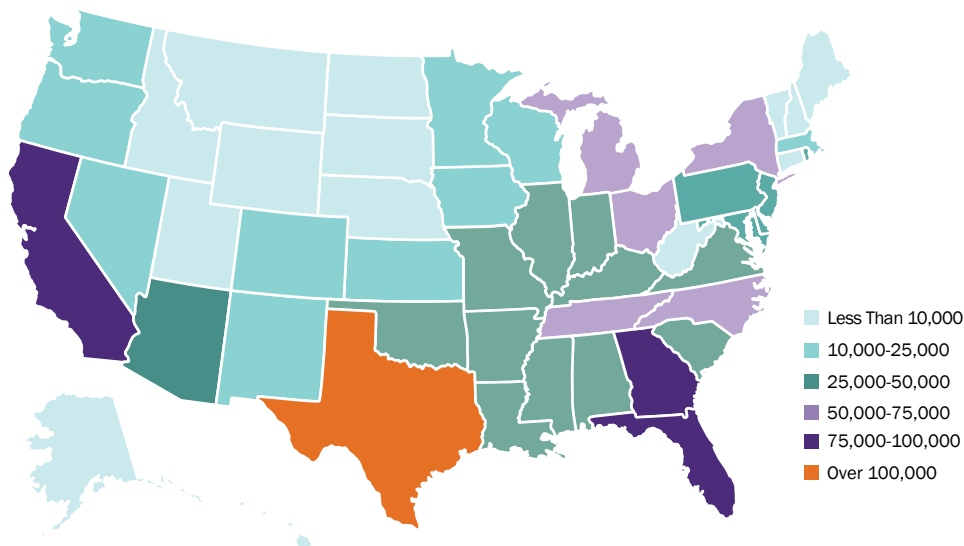
- 12 National Taxpayer Advocate 2011 Annual Report to Congress 404-419; National Taxpayer Advocate 2008 Annual Report to Congress 427; National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, *The Role of the IRS in the Refund Anticipation Loan Industry, Vol. II* (June 30, 2006); *Tax Return Preparation Options for Taxpayers: Hearing Before S. Comm. On Finance, 109th Cong.* (Apr. 4, 2006) 1-5 (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2005 Annual Report to Congress 162-79; *Fraud in Income Tax Return Preparation: Hearing Before Subcomm. on Oversight, H. Comm. on Ways & Means, 109th Cong.* (July 20, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).
- 13 To address the EITC improper payment rate, Congress included a directive in the PATH Act that requires the IRS to delay payment of any refund that includes the EITC or the refundable portion of the Child Tax Credit (CTC) until February 15 of each filing year. The freeze on refunds involving EITC or the refundable portion of the CTC applies to refunds made after December 31, 2016. Protecting Americans from Tax Hikes (PATH) Act of 2015, Pub. L. No. 114-113, Division Q, Title II, § 201(b), 129 Stat. 2242, 3076 (2015) (codified at IRC § 6402(m)).
- 14 IRS, *IRS Removes Debt Indicator for 2011 Tax Filing Season*, IR-2010-89 (Aug. 5, 2010); Chi Chi Wu and Chantal Hernandez, National Consumer Law Center, *Minefield of Risks: Taxpayers Face Perils from Unregulated Preparers, Lack of Fee Disclosure, and Tax-Time Financial Products* 7 (Mar. 2016).
- 15 Counts from Urban Institute and Internal Revenue Service, *Characteristics of Users of Refund Anticipation Loans and Refund Anticipation Checks* (2010) for tax years 1999 through 2007 and from Compliance Data Warehouse (CDW) for tax years 2008 through 2016 (as of Aug. 29, 2017). The IRS did not provide information to confirm or disprove the figures during the TAS Fact Check process.

There was a 72 percent *decrease* in demand after TY 2009 when the IRS discontinued the DI and a significant *increase* in demand during FS 2017. More importantly, 90 percent of returns filed with RAL indicators were filed on or before February 15.¹⁶ This substantial increase in demand coincides with the effective date of the provision in the PATH Act requiring the IRS to delay the issuance of refunds with EITC and ACTC until February 15.¹⁷ Taxpayers who are facing financial hardship and need the money before February 15 to pay bills may be willing to incur the additional costs.

The map below illustrates the number of RAL filers across the continental United States.

FIGURE 1.21.2, TY 2016 RAL Filings Through Feb. 15, 2017

Refund Anticipation Loans, Tax Year 2016 (through February)



Texas had the most filings, with approximately 156,000 RAL returns, or 10.6 percent of the total, almost twice that of Florida and California. Larger representation was also noted for states such as Georgia, North Carolina and Ohio.¹⁸

The Compliance Risk Associated with RALs

The National Taxpayer Advocate is particularly concerned about the rate of noncompliance for returns with RALs. For filings through February 15, 2017, 83 percent included EITC claims and the median Adjusted Gross Income (AGI) was \$20,600 (average AGI was \$24,800).¹⁹ The following chart provides the number of RAL returns in which the taxpayer received their expected refund, less than

16 IRS, *Daily E-File at a Glance*, U.S. Totals for Individual Returns, Nationwide (Feb. 15, 2017).

17 See, e.g., Jackson Hewitt, *How Fast Will You Get Your Tax Refund This Year?*, <https://www.jacksonhewitt.com/Resource-Center/Your-Tax-Refund/> (last visited Sept. 8, 2017).

18 State counts of RAL filings are from IRS, CDW, Individual Returns Transaction File (IRTF), Form 1040. Data represents tax year 2016 returns filed with a RAL indicator through February 15. The IRS did not provide information to confirm or disprove the figures during the TAS Fact Check process.

19 EITC, Adjusted Gross Income (AGI) and RAL counts are from IRS, CDW, IRTF, Form 1040. Data represents tax year 2016 returns filed with a RAL indicator through February 15. The IRS did not provide information to confirm or disprove the figures during the TAS Fact Check process.

the anticipated refund, or no refund. The chart also indicates if the refund was subject to an offset (indicating either no offset, partial offset of the refund, or full offset of the refund). In the chart, when a TY 2016 refund is offset either partially or fully in FS 2017, it is used to repay a federal tax debt from a prior tax year.²⁰ Therefore, an offset, whether partial or full, that occurs in FS 2017 does not indicate TY 2016 noncompliance.

FIGURE 1.21.3, FS 2017 RAL Return Refunds, Filed by Feb. 15, 2017 (counts rounded to nearest hundred)²¹

Refund Status	Count	No Offset	Partial Offset	Full Offset
Expected Refund Received	1,398,000			
Percent of Total	95.3%			
Less Refund Received	54,900	7,900	47,000	
Percent of Total	3.7%	0.5%	3.2%	
No Refund Received	13,300	5,000	400	7,800
Percent of Total	0.9%	0.3%	0.03%	0.5%
Total	1,466,200			

Therefore, the above chart indicates that the IRS did not issue the entire claimed refund for reasons other than refund offsets on less than one percent of the RAL returns. A subset of this population was subject to a refund hold due to issues including Income Wage Verification, Taxpayer Protection Program Identity Theft filters and similar programs. The following chart illustrates the number of RAL returns filed during FS 2017 with refund holds, also indicating whether or not the refund was subject to offset:

FIGURE 1.21.4, FS 2017 Refund Holds for RAL Returns (counts rounded to nearest hundred)²²

Refund Status	Count	No Offset	Partial Offset	Full Offset
Less Refund Received	2,300	1,000	1,300	
No Refund Received	4,000	3,600	100	300
Total	6,300			
Percent of Total RALs	0.4%			

20 Internal Revenue Manual (IRM) 21.4.6.2, *What is a Refund Offset* (Sept. 22, 2017). IRC § 6402 provides authority for the Treasury Secretary to apply a taxpayer's refund to any outstanding federal tax debt, child support obligation, other federal agency debt, state income tax debt, or unemployment compensation debt prior to crediting the overpayment to a future tax year or issuing a refund. The offsets in the chart only include offsets for past due federal tax debts.

21 IRS, CDW, IRTF, Form 1040, and Individual Master File (IMF) Transaction History for individuals filing returns through Feb. 15, 2017 for the tax year ending Dec. 31, 2016. Totals were compiled for returns with a RAL indicator. The IRS did not provide information to confirm or disprove the figures during the TAS Fact Check process.

22 IRS, CDW, IRTF, Form 1040, and IMF Transaction History for individuals filing returns through Feb. 15, 2017 for the tax year ending Dec. 31, 2016. Totals were compiled for returns with a RAL indicator and for all returns. The IRS did not provide information to confirm or disprove the figures during the TAS Fact Check process.

While the initial noncompliance rate for RAL returns appears low, it is higher than the rate for overall individual returns filed in the same time period.²³ The Taxpayer Advocate Service will evaluate the compliance rates of RAL returns into the future as awareness of and demand for the product continues to increase. Our concern stems from past noncompliance associated with these products. For example, a 2007 study conducted by IRS Research found a significant correlation between taxpayers using RALs and noncompliance. In fact, the study found that RAL users are 27 percent to 36 percent more noncompliant than taxpayers who do not use a bank product.²⁴

Taxpayers Still Pay for “No-Fee RALs”

In the wake of the PATH Act, some lenders are now offering “no-fee” RALs.²⁵ For FS 2017, the loans were limited to amounts up to \$1,300, depending on the lender. With no-fee RALs, the taxpayer does not directly pay a fee or incur any interest charges for the loan. The preparer pays the loan fee to the financial institution.²⁶ The no-fee RAL differs from those offered in the past as they are now nonrecourse loans, meaning that the taxpayer is not liable if the IRS does not release the entire anticipated refund in a timely manner.²⁷ In addition, at least one of the lenders provided that there is no negative credit reporting of the taxpayer in such a case.²⁸ On its face, it appears that the financial institution takes the greatest risk with this new refund product. However, the taxpayer does not necessarily walk away from the deal without any consequences if the IRS fails to release part or all of the refund, because the taxpayer may be subject to taxation on cancellation of debt income.²⁹

While the taxpayer does not directly pay any fees when purchasing a no-fee RAL, it is inevitable that the banks and preparers are recouping the costs indirectly. Banks often charge preparers a fee for the RAL. In addition, banks can also recoup the costs of providing RALs through indirect means. For example, during FS 2017, River City Bank required RAL customers to also purchase a RAC (also known as a refund transfer) at a cost of \$44.95. If the taxpayer decided against purchasing a RAL and only

23 While approximately 95 percent of all RAL returns received their expected refund, 96 percent of all individual TY 2016 returns filed through Feb. 15, 2017 received their expected refund. Further, while 0.4 percent of RAL returns were subject to a refund hold, 0.2 percent of all individual returns filed through Feb. 15, 2017 were subject to refund holds. Therefore, the initial no-fee RAL data appears to show low noncompliance but, when compared to overall individual returns filed in the same time period, it may signal potential noncompliance issues. IRS, CDW, IRTF, Form 1040, and IMF Transaction History for individuals filing returns through Feb. 15, 2017 for the tax year ending Dec. 31, 2016. Totals were compiled for returns with a RAL indicator and for all returns. The IRS did not provide information to confirm or disprove the figures during the TAS Fact Check process.

24 Karen Masken, Mark Mazur, Joanne Meikle, and Roy Nord, IRS Office of Research, Analysis, and Statistics, *Do Products Offering Expedited Refunds Increase Tax Compliance?* 19 (Nov. 2007).

25 Some of the financial institutions that offered “no-fee” RALs during FS 2017 include: MetaBank (lender for H&R Block through FS 2017 and Jackson Hewitt), Santa Barbara Tax Products Group, Republic Bank & Trust (lender for Liberty Tax), and River City Bank. Chi Chi Wu, National Consumer Law Center, and Michael Best, Consumer Federation of America, *Big Changes Burden Taxpayers: New Law Delays Refunds, Drives Demand for Loans; Immigrant Taxpayers Face Challenges* 3-4 (Mar. 2017).

26 Chi Chi Wu, National Consumer Law Center, and Michael Best, Consumer Federation of America, *Big Changes Burden Taxpayers: New Law Delays Refunds, Drives Demand for Loans; Immigrant Taxpayers Face Challenges* 3-4 (Mar. 2017); Chi Chi Wu and Chantal Hernandez, National Consumer Law Center, *Minfield of Risks: Taxpayers Face Perils from Unregulated Preparers, Lack of Fee Disclosure, and Tax-Time Financial Products* 7 (Mar. 2016); See, e.g., Republic Bancorp, Inc., Form 10-K for year which ended on December Dec. 31, 2016 at 12.

27 Chi Chi Wu (National Consumer Law Center) and Michael Best (Consumer Federation of America), *Big Changes Burden Taxpayers: New Law Delays Refunds, Drives Demand for Loans; Immigrant Taxpayers Face Challenges* 3 (Mar. 2017).

28 Republic Bancorp, Inc., Form 10-K for year ending Dec. 31, 2016 at 12.

29 See IRC § 61(a)(12); Rev. Rul. 91-31, 1991-1 CB 19 (1991). Depending on the amount of the debt discharge, the lender may be subject to reporting requirements, in which case the lender issues to the taxpayer IRS Form 1099-C. IRC § 6050P. For detailed explanation of the taxation of, as well as exceptions for and exclusions from cancellation of debt income, see IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (For Individuals)*.

Because tax preparers directly incur the refund anticipation loan fees, the IRS should require Electronic Return Originators to prepare a “truth-in-lending” statement if they are offering a Refund Anticipation Loan product. This statement would incorporate clear language and design to help the taxpayer better understand the terms of the loan product, including any “hidden” or indirect costs of the loan product.

purchased a RAC, the RAC fee would be \$29.95.³⁰ Therefore, there is a \$15 price difference in the RAC depending on whether the taxpayer also purchased a RAL. Other lenders directly charge preparers a fee for the RAL.³¹

Preparers can also recoup the costs they incur to offer no-fee RALs to their clients by increasing return preparation fees. Due to the lack of transparency in preparation fees charged by many preparers, the hidden fees may be difficult to identify. To prevent this, at least one no-fee RAL bank prohibits preparers from passing this cost along to taxpayers by padding fees.³² Some preparers may be willing to incur the RAL fee as a marketing expense to get clients in the door.³³

While some taxpayers facing an immediate financial hardship may be willing to incur any additional costs associated with RALs, all taxpayers would benefit from a detailed breakdown of fees incurred. Because tax preparers directly incur the RAL fees, the IRS should require Electronic Return Originators (EROs) to prepare a “truth-in-lending” statement if they are offering a RAL product.³⁴ This statement would incorporate clear language and design to help the taxpayer better understand the terms of the loan product, including any “hidden” or indirect costs of the loan product. Working with the industry and consumer advocates, the IRS could develop and require a standard form for disclosures. The IRS could enforce this requirement through its e-file monitoring authority.³⁵

In addition, as the demand for no-fee RALs continues to increase, it is incumbent on the IRS to conduct a consumer education campaign before the filing season about RALs and the hidden costs associated with these loan products. The campaign should warn taxpayers to carefully review the accuracy of their returns, especially if they purchase a RAL.

30 River City Bank, *2017 Freedom to Choose Pricing Tiers*, <http://www.rcbtaxdivision.com/pricing.aspx> (last visited Aug. 18, 2017).

31 Chi Chi Wu (National Consumer Law Center) and Michael Best (Consumer Federation of America), *Big Changes Burden Taxpayers: New Law Delays Refunds, Drives Demand for Loans; Immigrant Taxpayers Face Challenges* 3-4 (Mar. 2017).

32 *Id.* at 4-5; See, e.g., Republic Bancorp, Inc., Form 10-K for the fiscal year which ended on Dec. 31, 2016, at 12 (“All fees for the product were paid by the Tax Providers with a restriction prohibiting the Tax Providers from passing along the fees to the taxpayer customer.”).

33 Stacy Cowley, *Tax Refund Loans Are Revamped and Resurrected*, THE NEW YORK TIMES (Jan. 15, 2017).

34 Truth-in-Lending disclosures are now termed “Loan Estimates” for mortgage applications submitted before Oct. 3, 2015. The Loan Estimate provides the applicant with important information about estimated interest rate, monthly payments, and total closing costs for the loan. It also informs the applicant about estimated tax and insurance costs, any anticipated changes in interest rate, penalties, and a negative amortization feature, if applicable. Consumer Financial Protection Bureau, *What is a Loan Estimate?* (Aug. 4, 2017).

35 See IRS Pub 3112, *IRS e-file Application and Participation*; IRS Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns* Rev. Proc. 2007-40, 2007-26 I.R.B. (June 25, 2007).

CONCLUSION

Demand for RALs substantially increased in FS 2017, likely due to the PATH Act's required delay in the issuance of EITC and ACTC refunds. The private industry accommodated this demand by offering no-fee RALs. While the tax preparation industry and financial institutions are claiming to absorb the costs associated with these refund products, the IRS should survey the products currently available on the market and evaluate the impact on taxpayers as well as tax administration. Finally, regardless of which party absorbs the costs of these refund products, taxpayers will benefit from better consumer education about these products and a clear disclosure of all fees and terms associated with the product.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Survey the RAL products currently on the market, including detailed analysis of direct and indirect fees, to understand how taxpayers and tax administration are impacted.
2. Conduct a consumer education campaign before the filing season about RALs and RACs, including some tips on how to identify indirect costs associated with these products.
3. Revise Revenue Procedure 2007-40; IRS Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*; and IRS Publication 3112, *Applying and Participating in IRS e-file*, to require all e-file participants offering RAL and RAC products to provide a standard "truth-in-lending" statement to help the taxpayer better understand the terms of the loan product, including any "hidden" or "indirect costs of the loan product."