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United States Government Accountability Office
Washington, DC 20548

June 5, 2008

The Honorable John Lewis
Chairman
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Subject: *Refund Anticipation Loans*

Dear Mr. Chairman:

Taxpayers who do not want to wait for their tax refunds from the Internal Revenue Service (IRS) may choose to obtain refund anticipation loans (RAL). RALs are short-term, high-interest bank loans that are advertised and brokered by both national chain and local tax preparation companies. Although the annual percentage rate (APR) on RALs can be over 500 percent,¹ they allow taxpayers to receive cash refunds quickly—sometimes within the same day and even within an hour of filing their tax returns. After filing a taxpayer's return electronically, the tax preparer works in cooperation with a bank to advance the refund as a loan minus tax preparation costs, other fees, and a finance charge. As part of the RAL process, the taxpayer provides authorization to IRS to send the refund directly to the bank to repay the loan.

Despite the benefits of receiving cash quickly based on an expected refund, IRS officials and others have raised concerns about whether taxpayers are fully aware of the costs involved and their tax filing alternatives. For example, in a 2007 report to Congress, the IRS National Taxpayer Advocate questioned whether RAL consumers actually understand the nature of the loan product they are receiving. According to the Advocate, while tax preparers offering RALs are required to obtain taxpayers' signatures on written disclosure forms, there are no requirements that such disclosures be made orally. The Advocate wrote that 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 IRS. Further, without an oral explanation, consumers may lack a general understanding of the nature of the product and its impact on credit reports, as well as other consequences of default. In January 2008, in order to address this issue, IRS and the Department of the Treasury (Treasury) indicated in a *Federal Register* notice that they were considering rules to prohibit tax preparers from marketing RALs based on information gathered during the tax preparation process. In their notice, IRS and Treasury cite concerns about tax preparers improperly inflating refunds in order to market RALs, particularly when working with

¹ At the tax preparers we visited, we found APRs ranging from 36% to over 500%.

customers eligible for the earned income tax credit (EITC).² IRS studies have found that this credit is particularly susceptible to fraud, in many cases perpetuated by paid tax preparers. In 1999, an IRS compliance study found \$10.4 billion³ of overclaims on the EITC, of which \$7.2 billion (70 percent) was attributed to tax returns completed by paid preparers.

Based on continuing concerns over how RALs are marketed to taxpayers, you requested that we perform a limited investigation to identify examples of where RALs are marketed and the types of information tax preparers disclose to potential RAL applicants.

To identify where tax preparation and RALs are marketed to taxpayers, we used Internet searches to identify a nonrepresentative selection of 22 different tax preparers across the country that advertised both tax preparation and RALs. We called these preparers to confirm the availability of the RALs they offered, as well as any incentives or discounts connected with tax preparation and RALs. We confirmed that these tax preparers were located in an existing business, but we did not attempt to investigate the types of business arrangements between the tax preparers and the colocated business. Posing as taxpayers, our investigators also visited a nonrepresentative selection of 18 different tax preparers in proximity to GAO, specifically preparers in the Washington, D.C., and Baltimore, Maryland, metropolitan areas. We took photographs of the offices used by the tax preparers where appropriate. We selected national chain preparers and small, local companies for our site visits.

To determine what types of information tax preparers disclose to potential RAL applicants, our undercover investigators had bogus paper tax returns prepared at five of the preparers they visited. Investigators used fictitious names, cover stories, and income information. It was not in the scope of our work to test a scenario in which we qualified for the EITC and we did not allow our bogus returns to be filed with IRS—the final requirement for obtaining a RAL.⁴ We therefore attempted to collect information about fees and charges associated with RALs through our interactions with the tax preparers, displays in the tax preparation offices, information on the preparers' Web sites, and any literature the preparers offered us on RALs. Using this information, we calculated the APR associated with the RALs where possible.

We conducted this investigation from January 2008 through March 2008 in accordance with standards prescribed by the President's Council on Integrity and Efficiency. Since we did not apply for a RAL as part of this investigation, we were not able to evaluate whether the tax preparers gave legally sufficient written disclosure. We also did not use an EITC scenario and therefore were not able to test whether tax preparers would use the credit to improperly inflate our refunds. Because we selected a nonrepresentative selection of tax preparers across the country for this investigation, it is not possible to generalize the results of our work and draw conclusions about all tax preparers.

²73 Fed. Reg. 1131 (Jan. 7, 2008).

³IRS estimates that \$31.9 billion in EITC claims was paid to 19.3 million taxpayers for the 1999 filing season.

⁴In order to avoid electronically filing our returns, we paid cash for our paper tax returns. However, the tax preparers we visited automatically included tax preparation fees in the cost of the RAL, allowing customers to avoid paying cash up front for tax preparation.

In summary, we found that RALs are marketed by tax preparers that operate in a wide variety of businesses, ranging from major retail stores to automobile dealers and shoe stores. Of the 40 tax preparers we called or visited, 37 offered RALs. 13 tax preparers offered year-round tax preparation in their own stand-alone offices, while 27 were open only during the tax season and operated at tables or desks within existing businesses offering other products and services. Of these 27 preparers, 13 were located in businesses that target low-income customers, such as check cashers, payday loan vendors, rent-to-own stores, and pawn shops, and 9 offered incentives to encourage tax customers to spend their refunds on the businesses' primary goods and services. For example, an auto dealer we visited told us that if we didn't have enough money for the down payment on a car, we could get our taxes done by its tax preparer and use the refund as a down payment. 14 tax preparers took advantage of the low overhead costs of operating in an existing business, but did not appear to target low-income populations.

The tax preparers we visited were generally willing to provide information about RALs, though because of the limited nature of our investigation, we were not able to assess the legal sufficiency of all tax preparers' advertisements and written disclosures. All five preparers that completed federal and state tax returns for our fictitious individuals gave an estimate of the fees and finance charges associated with a RAL, and most calculated the refund amount available after deducting fees. However, we found that tax preparers did not use a consistent method to calculate the APRs in their advertisements and at least one preparer did not calculate its advertised APR according to Truth in Lending Act requirements. For example, the APR on a \$1,000 RAL at this tax preparer was represented in advertisements as 36 percent. However, when a \$30 account fee is included in the APR calculation in accordance with the act, the APR is actually 135 percent. The preparer included this fee in an advertisement showing the various fees and finance charges associated with a RAL, but noted in small print that the account fee is not actually included in the calculated APR shown in the advertisement.

Background

According to IRS data, the average individual tax refund for calendar year 2006 tax returns was \$2,324 on approximately 106 million tax returns.⁵ According to the IRS National Taxpayer Advocate, during the 2005 filing season, 9.6 million taxpayers eligible for refunds that all together totaled \$28.7 billion applied for RALs.

Previous GAO reports have found that fees for RALs vary widely and, when combined with tax preparation fees, may considerably reduce a taxpayer's refund.⁶ However, these loans remain popular, especially among low-income taxpayers. IRS data show that RALs are disproportionately purchased by low-income taxpayers, especially those receiving the EITC. The EITC is a refundable federal income tax credit for low-income working individuals and families designed to offset the burden of Social Security taxes and to provide an incentive to work. To qualify, taxpayers must meet certain requirements and file

⁵Out of approximately 140 million tax returns filed during this filing season.

⁶See GAO, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS Is a Challenge*, GAO-04-70 (Washington, D.C.: Oct. 31, 2003); and GAO, *Paid Tax Preparers: Most Taxpayers Believe They Benefit, but Some Are Poorly Served*, GAO-03-610T (Washington, D.C.: April 1, 2003).

tax returns. According to IRS 2004 filing season data, 56 percent of taxpayers who obtained RALs also received the EITC, even though EITC recipients made up only 17 percent of the general population of taxpayers. In its *2007 Objectives Report to Congress*, the National Taxpayer Advocate identified several reasons taxpayers purchase RALs:

- need for immediate cash,
- lack of information about the product or alternatives,
- immediate access to a large sum of money, typically the EITC,
- inability to pay preparation and filing fees out of pocket, and
- experience of friends and family.

Refund anticipation loans are subject to the Truth in Lending Act,⁷ which is intended to help consumers avoid the uninformed use of credit through meaningful disclosure of credit terms by lenders and to protect consumers against inaccurate and unfair credit practices. Under regulations issued to implement this act, if a RAL vendor advertises an APR, it must be the calculated according to specific formulas and must include certain fees in the finance charge. The finance charge is defined as the cost of consumer credit as a dollar amount and includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as incident to or as a condition of credit.⁸ Finance charges include interest; service, transaction, activity, and carrying charges; and loan fees. Any additional fees imposed as a result of the customer taking a RAL must be included as part of the finance charge.⁹ Finance charges do not include application fees charged to all applicants or late payment charges.

If a consumer asks about the cost of a RAL, the creditor is required to disclose the APR, unless it cannot be determined in advance. In this case, the creditor is required to state the APR for a sample transaction. Before the transaction is consummated, the creditor must disclose certain information in writing to the borrower. This information must be disclosed clearly and conspicuously in a form that the consumer may keep¹⁰ and includes the following:¹¹

- itemization of the amount provided to the borrower, minus prepaid finance charges (fees);
- finance charges, or “the dollar amount the credit will cost you;”
- the APR, or “the cost of your credit as a yearly rate;” and
- total of payments, or “the amount you will have paid when you have made all scheduled payments.”

⁷15 U.S.C. § 1601 et seq.

⁸12 C.F.R. § 226.4.

⁹This requirement is included in the official staff interpretation of the regulations; compliance with these interpretations affords a creditor relief from certain civil liabilities. 12 C.F.R. 226 supplement I.

¹⁰12 C.F.R. § 226.17.

¹¹12 C.F.R. § 226.18.

Tax preparers providing electronic filing services must comply with rules in the IRS *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*, which requires tax return preparers that sell RALs to their clients to

- ensure that taxpayers understand that by agreeing to a RAL or other financial product they will not receive their refunds from IRS as IRS will send their refunds to the financial institutions;
- advise taxpayers that RALs are interest-bearing loans and not a quicker way of receiving their refunds from IRS;
- advise taxpayers that if a direct deposit is not received within the expected time frame for whatever reason, the taxpayers may be liable to the lender for additional interest and other fees, as applicable for the RAL or other financial product;
- advise taxpayers of all fees and other known deductions to be paid from their refunds and the remaining amounts the taxpayers will actually receive;
- secure the taxpayers' written consent to disclose tax information to the lending financial institutions in connection with applications for RALs or other financial products; and
- adhere to fee restrictions and advertising standards prohibiting tax preparers from accepting fees contingent upon the amount of the RAL or using improper or misleading advertising in relation to time frames for refunds and RALs.

Results of Investigation

RALs are marketed by tax preparers that operate in a wide variety of businesses, ranging from major retail stores to automobile dealers and shoe stores. Of the 40 tax preparers we called or visited, 37 offered RALs. 13 tax preparers offered year-round tax preparation in their own stand-alone offices, while 27 were open only during the tax season and operated at tables or desks within existing businesses offering other products and services. Of these 27 preparers, 13 were located in businesses that target low-income customers; however, 14 chose the locations of their businesses because of low overhead costs. One tax preparer we observed minimized overhead costs by operating out of a trailer in the parking lot of a gas station. Tax preparers we visited were generally willing to provide information about RALs, but did not use a consistent method to calculate their advertised APRs.

See table 1 for examples of seasonal tax preparers that we identified during our investigation.

Table 1: Selected Businesses Marketing Tax Preparation and RALs

	Primary services	Location	Incentive (if offered)
	Auto dealer	Virginia	Free tax preparation with purchase of car
	Check cashing	Maryland	
	Check cashing	Mississippi	Will cash refund check for 1.5 percent (regularly 3 percent)
	Equipment trailer	Maryland	
	Discount shoe store	Maryland	Free pair of shoes with tax preparation
	Pawn shop	Alabama	
		Alabama	
		New Hampshire	A \$5 to \$10 discount on buying back previously pawned item
		North Carolina	
		Virginia	A \$50 gift certificate to use in the store
	Pawn shop, rent to own	Mississippi	Willing to negotiate a discount on rental items
	Payday loans	Missouri	
	Real estate	Alabama	
	Rent to own	Virginia	Tax customers eligible for reduced prices on selected merchandise for sale and rental
		Mississippi	Willing to negotiate a discount on rental items
	Retail store	Kentucky	
	Small business services	Kentucky	
	Van rental	Mississippi	
	Vending machine service	North Carolina	

Source: GAO.

See figure 1 for a photograph of a tax preparer located in the parking lot of a former gas station in Maryland.

Figure 1: Seasonal Tax Preparation Service Operating Out of a Trailer



Source: GAO.

27 of the tax preparers we called or visited were located in existing businesses in order to market to the businesses' customer base, and 13 of these were located in businesses targeting low-income customers. IRS data show that RALs are disproportionately purchased by low-income taxpayers, and some seasonal tax preparers market to this population by operating within businesses that serve low-income customers, such as check cashers, payday loan vendors, rent-to-own stores, and pawn shops. See figure 2 for a photograph of one check cashing business offering tax preparation.

Figure 2: Check Cashing Service Offering Tax Preparation



Source: GAO.

We called or visited 9 businesses that had partnered with seasonal tax preparers to use tax preparation and RALs to offer customers incentives to purchase the businesses' primary goods or services. In some cases, RAL customers are able to receive their cash refunds in as little as an hour after filing their returns, while they are still inside the business or store where the seasonal tax preparer is located. Some of these businesses encourage customers to spend the refund immediately, by offering discounts on their products and services. For example, an auto dealer we visited told us that if we didn't have enough money for the down payment on a car, we could get our taxes done by its tax preparer and use the refund as a down payment. See figure 3 for a photograph of this business.

Figure 3: Auto Dealer Encouraging Customers to “Bring Your W2 Form” for Credit toward a Car Purchase



Source: GAO.

Furthermore, a rent-to-own store advertised that it “will put money in your hands in as little as 4 hours!” and that getting your taxes done at the store “results in greater buying power. All tax customers are eligible for reduced prices on selected merchandise.” We visited two shoe stores that offered customers a free pair of shoes as an incentive to use the in-store tax preparation services. See figure 4 for a photograph of one of these business.

Figure 4: Shoe Store Offering a Free Pair of Shoes with Tax Preparation



Source: GAO.

Note: Name of tax preparer obscured in this photo.

We found 14 tax preparers that operated within existing businesses in order to take advantage of low overhead costs but did not specifically target low-income customers. These included those in a vending service company, a small business services company, and a van rental store. In general, these businesses did not offer any incentives to attract tax customers to their primary products. Some national tax preparers also market RALs by offering tax preparation in major retail chains. Tax preparation services in these retail stores are seasonal and generally close around April 15. Several of the businesses we observed offered multiple services unrelated to tax preparation. See figure 5 for a photograph of a business that offers various services in addition to tax preparation and RALs.

Figure 5: Business Offering Insurance, Travel, Notary, and Payroll Services in Addition to Tax Preparation and RALs



Source: GAO.

See figure 6 for a photograph of an immigration services business with a sign encouraging customers to file taxes and “Get Money Fast” with a RAL.

Figure 6: Immigration Services Business Encouraging Customers to “Get Money Fast” with a RAL



Source: GAO.

Note: Name of tax preparer obscured in this photo.

We found that tax preparers were generally willing to provide information about RALs during the tax preparation process. All 5 preparers that completed federal and state tax returns for our fictitious taxpayers gave an estimate of the fees and finance charges associated with a RAL based on our refund amounts. Four of the preparers calculated the refund amount available after deducting fees and 4 others warned us that RALs are subject to bank approval. Three preparers explained the average time required to receive a direct deposit refund from IRS compared to the time to receive a RAL and 3 others ensured that we understood that a RAL is a loan, not a quick refund. However, only 2 of the tax preparers we visited had RAL fees or APRs posted prominently in their offices and none were willing or able to give us written materials on fees or APRs unless we applied for a RAL.¹² During our visits, we did not experience any pressure to apply for a RAL. Of the 40 tax preparers we called or visited, 6 discouraged us from applying for RALs because of the high interest rates or the short time it actually takes to receive a refund directly from IRS.

Tax preparers offering refund anticipation loans must abide by the requirements of the Truth in Lending Act and the IRS *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*. Under the Truth in Lending Act, if a tax preparer chooses to advertise the APR for a RAL, it must be calculated with a finance charge that includes all fees exceeding the fees charged for the same tax preparation service without a RAL.¹³ During our limited investigation, we collected information from advertisements posted in the tax preparation offices we visited. Some of these advertisements gave sufficient information on APRs, finance charges, and other fees to determine how the preparer had

¹²One tax preparer has a table of RAL fees and APRs posted on its Web site, but did not offer us written materials in the tax preparation office.

¹³This requirement is included in the official staff interpretation of the regulations; compliance with these interpretations affords a creditor relief from certain civil liabilities. 12 C.F.R. 226 supplement I.

arrived at its advertised APR, while others gave only limited information. The examples discussed below are based on two preparers whose calculations we were able to replicate. Tax preparers offering RALs are also required to provide a written disclosure, but because we did not complete the RAL application process, we did not receive written disclosures and were not able to evaluate the legal sufficiency of these statements under the Truth in Lending Act.

We found that tax preparers did not use a consistent method to calculate the APRs presented in advertisements, and at least one preparer did not calculate its advertised APR according to Truth in Lending Act requirements. One preparer included all fees in its advertised APR, while another did not include an account fee, which substantially understates the actual APR for the RAL. The inclusion of these fees, known as account fees, standard fees, or handling fees, and which are charged to open a bank account into which IRS will eventually deposit the taxpayer’s refund, is required by the Truth in Lending Act because consumers are required to pay the fee in connection with obtaining RALs and do not have the option of using existing accounts to obtain their tax refunds. Such fees can significantly affect the APR. For example, the APR on a \$1,000 RAL at one tax preparer was represented in advertisements as 36 percent. However, when a \$30 account fee is included in the APR calculation in accordance with the act, the APR is actually 135 percent.¹⁴ The preparer included this fee in an advertisement showing the various fees and finance charges associated with a RAL, but noted in small print that the account fee is not actually included in the calculated APR shown in the advertisement. The advertisement’s small print also notes that all published APRs are estimates. Since we did not actually file our tax returns, we did not obtain Truth in Lending written disclosures to verify whether the APRs in the required disclosures included all fees, in contrast to the APRs presented in the preparers’ advertisements. Table 2 shows sample APRs from two of the preparers we visited that use different methods to calculate their advertised APRs.

Table 2: Example of How Omission of Fees Affects APR Calculations

	Preparer 1		Preparer 2	
	Advertised	GAO calculated	Advertised	GAO calculated
Amount of refund	\$1,000	\$1,000	\$1,250	\$1,250
Finance charge	\$10.73	\$10.73	\$80	\$80
Account fee	Not included in calculation	\$30	None	None
Total fees used to find APR	\$10.73	\$40.68	\$80	\$80
APR	35.6%	135.0%	212.4%	212.4%

Sources: Tax preparers and GAO analysis.

Note: According to GAO analysis, these preparers calculate the APR using a loan period of 11 days, and therefore we also used an 11-day loan period for our calculations.

We are sending a copy of this report to the Commissioner of IRS. In addition, this report will be available at no charge on our Web site at <http://www.gao.gov>. If you or your staff have any questions about this report, please contact me at (202) 512-6722 or kutzg@gao.gov. Contact points for our Offices of Public Affairs and Congressional Relations may be found on the last page of this report. GAO staff who made major

¹⁴This APR calculation includes all fees that apply only to RAL customers, such as finance charges on the RAL and any account fees. It does not include the tax preparation fees, which apply to all customers regardless of whether they obtain RALs.

contributions to this report include Matthew Harris, Assistant Director; Ken Hill; Jeffrey McDermott; Andrew McIntosh; Sandra Moore; and Philip Reiff.

Sincerely yours,

A handwritten signature in black ink that reads "Gregory D. Kutz". The signature is written in a cursive style with a large, stylized initial "G".

Gregory D. Kutz, Managing Director
Forensic Audits and Special Investigations

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