# Building a Better Refund Anticipation Loan: Options for VITA Sites*

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Refund Anticipation Loans, or RALs, are an extremely popular means for taxpayers to access their refunds more quickly than waiting for a paper check or even direct deposit. The negative effects of these loans—including their cost and lack of consumer protections—are well documented. Many consumer advocates and community development professionals are rightfully concerned about the popularity of these products, but also recognize that they can be useful to some filers. Fortunately, free tax preparation sites across the country are working to design and deliver RALs that promote the long-term financial health of low-income taxpayers through encouraging asset development and financial education. This document discusses the costly effects of the current RAL market, makes the case that a well-designed RAL program can actually benefit consumers, and provides guidance on evaluating and developing a worthwhile RAL program.

## A. How They Work, What They Cost, and Who Uses Them

RALs, or Refund Anticipation Loans, are short-term loans secured by taxpayers' expected tax refunds. Instead of waiting to receive tax refunds, RAL customers borrow against part or all of their expected tax refunds. Consumers pay three fees to get a RAL:

- A fee for commercial tax preparation, typically $120;
- A fee to the commercial preparer to process the RAL, sometimes called a "system administration," "application," or "document preparation" fee, with the average fee being about $30; and
- A loan fee to the lender, ranging from about $30 to over $100 in 2004.

The total amount of these fees can range from $180 to over $250, and eat away at about 10% of the consumer's refund. The effective interest rate for RALs ranges from about 70% to over 700%, or 94% to 1837% if administrative fees are included. Commercial preparer and RAL lenders have been reporting lower annual percentage rates (APRs) by "unbundling" charges from the loan fees.

The loan is generally not made by the tax preparer, but by a separate lender, usually a bank. Commercial preparers facilitate the loans, acting as loan agents. The advantage of this partnership is the ability of the bank to avoid state interest rate caps due to federal preemption. When the loan is made, the bank prepares to collect on the loan by opening a temporary or "dummy" bank account for the borrower to receive electronic deposit of the refund. The documents signed by the borrower instruct the IRS to direct deposit the refund into that account. The contract usually contains a right of setoff, so the lender is repaid when the refund appears in the bank's account. The consumer is liable for the full amount of the loan if the refund is disallowed in whole or in part.

Taxpayers who purchase RALs generally have lower incomes and are claiming substantial refunds, largely due to the Earned Income Tax Credit (EITC). In 2001, approximately 72% of taxpayers who

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* For more information on this and related topics, see the companion documents: "Refund Loan Products and VITA: A Summary of Issues and Options," "A Primer on Fringe Products Related to RALs," "Building a Better Refund Anticipation Check: Options for VITA Sites" and "Building a Better Stored Value Card: Options for VITA Sites." All documents are available on the National Consumer Law Center's website at www.nclc.org.

used RALs had adjusted gross income (AGI) under $32,280, while only 45% of all taxpayers fell into the same income range. EITC claimants purchased 55% of all RALs, even though these taxpayers represented only 15% of all filers. Information available to consumers about the relative cost of RALs is misleading, or unclear at best. RALs are overpriced – these loans are very low risk, secured by U.S. Treasury funds that flow directly to the RALs provider.

There are some financially valid reasons for choosing a RAL: many low-income taxpayers don't have the money to pay preparation fees upfront; don't have access to bank accounts for direct deposit; are experiencing time-sensitive financial crises (i.e. broken down car or imminent eviction); or don't believe their mailboxes are a safe means of receiving large checks. However, anecdotal evidence indicates that many taxpayers are paying substantial fees to buy accessibility that they could have obtained cost-free.

Lenders and their brokers siphon off a substantial amount of EITC, a government benefit intended to boost the incomes of the working poor. In 2002 EITC recipients spent an estimated $525 million in loan fees while preparation and administration fees added an additional $1.06 bill. The total drain comes to $1.75 billion once check-cashing costs are added in, or seven cents of every EITC dollar.

## B. <u>Building A Better RAL: A Gateway to Asset Development</u>

While these statistics make it clear that the most affordable option is to wait the 10-15 days for a refund to be direct deposited, it is nevertheless important to recognize that many people, for a variety of reasons, will want RALs regardless of the circumstances. The free tax preparation field can meet this demand with non-predatory products, or alternative RALs, that also provide opportunities for asset development.

- By definition, an alternative RAL will save consumers hundreds in fees, which can translate to higher savings rates.
- Alternative RAL providers should avoid cross selling predatory products, such as the rent-to-own agreements that many commercial preparers push on their customers. Helping taxpayers to avoid these products may decrease the use of such products and help more people break predatory lending cycles.
- Encouraging unbanked taxpayers or those who have unaffordable accounts to open new accounts is another goal of an alternative RAL program. Having an account is strongly correlated with asset development.
- These new RALs can also provide a means to create relationships between the newly banked member and the institution. Affordable RALs mean good member service, which builds trust and brings the members back for more services. This trusting relationship can lead the member toward more products, such as IDAs, credit repair, alternative to payday loans, alternative to rent-to-own loans, and financial education.
- Alternative RALs can also be converted to secured or unsecured personal loans, which give the taxpayer an opportunity to create a positive credit history.
- Finally, a well-designed RAL program should create opportunities for financial education: receiving a RAL may be the first time a borrower is involved in a traditional lending situation where he or she has an opportunity to see a credit report or speak with a loan officer.

Considering the high cost of traditional RALs and the potential of alternative RALs as an asset development tool, the creation and diffusion of alternative RALs is a step that the free tax preparation field can take to "fight fire with fire." The next step, then, is learning to recognize the features of traditional RALs that harm taxpayers and understanding which features can make a non-predatory RAL into an asset development tool.

## C. Features to Think About When Evaluating a Product

Contrary to conventional wisdom, it's possible to provide these loans in a way that is safe for the lender and the consumer. The following is a list of features that will provide guidance for tax preparers seeking to evaluate RAL programs, as well as RAL providers thinking of creating or adopting an alternative RAL program.

### Creating a Fair, Non-Predatory RAL

The first step is to avoid many of the worst practices of the current RAL providers:

- Including cross collection arrangements among creditors allowing for automatic collection of other debts from the refund in loan agreements
- Including mandatory arbitration clauses in loan agreements
- Failing to disclose all tax preparation fees (if any) prior to rendering service
- Failing to provide an option to pay tax preparation fees out-of-pocket
- Failing to inform customer of timetable for receiving refund directly from IRS
- Charging extra for cashing refund check
- Charging extra to create a new account if customer is already banked
- Charging junk administrative fees -- similar to mortgage broker context
- Linking the RAL to, or pushing, additional fringe banking products such as Rent-A-Center arrangements

To ensure that your RAL is fair and non-predatory, include these features:

- Reasonable tax preparation fees (if any) so that customer is not compelled to take a RAL
- Upfront, clear, and simple disclosure of costs of loan
- Clear advertisement that the RAL is actually a loan and not an accelerated refund
- Clearly allow client to pay all or some of the fees out-of-pocket
- Create a true bank account for unbanked recipients who would like an account
- Special fee structure for EITC customers
- Loan fees should be capped at 36% APR / priced as close to cost as possible (these are always oversecured loans, unless preparer incorrectly estimates refund, that are backed by the U.S. Treasury)
- Indemnification against claims by the lender from improper tax prep for RAL recipients
- Education on the cost of RALs and all options for receiving the refund cost-free
- Offer free preparation or provide other means to pay for preparation besides receiving a RAL.
- Provide incentives for becoming banked that include access to financial education (discussed below).

### RALs and Banking the Unbanked

- Provide RAL cost-free in exchange for customer's agreement to put remainder of refund in savings account
- Eligible for savings account regardless of Chex Systems / credit history
- Free opening of savings account (no new account or set-up fee)

- The account stays free (no monthly fees)
- The account is affordable to people with limited cash flow (no minimum balance, or a low minimum that is waived until the refund comes in)
- A number of free transactions each month (at least 20)
- Free or low-cost money orders, bank checks
- Possibility of opening a checking account -- also low or no cost, may be a special "second chance" account if required by the credit history
- Low-balance certificates: savers' club
- Incorporate linkages to asset-building programs like financial counseling, financial education, IDAs, credit builder loans, small business development, consolidation loans, first-time homeowners' mortgages, college funds

The Refund as a Teachable Moment

In spite of its potential as a catalyst for asset development, a good RAL program should include a campaign to limit RAL use and should also incorporate further financial education into the preparation process. There are many models of successful education campaigns available from organizations like the National Community Tax Coalition, the Center on Budget and Policy Priorities, the Annie E Casey Foundation, the National Tax Assistance for Working Families Campaign, and many others. Below are a few examples of successful education efforts.

Before tax season even begins, there should be an anti-RAL campaign in place. Many cities have undertaken outreach campaigns that include fliers, radio ads, and even billboards, which have had varying degrees of success. If alternative RALs are available, they should be advertised. ("Can you wait 7 days to get $350? If you can't, try this alternative.")

Because refund time may be the one time of year when taxpayers have financial breathing space, it is a good time to provide educational opportunities. However, it's important that tax preparation sites not require education as a condition for free preparation services. There is a variety of ways to reach out to taxpayers that require various levels of involvement. Some tactics include:

- Using a "take it or leave it" method that includes a financial tip sheet and educational or referral pamphlets.
- Inviting the taxpayer to learn about ways to achieve their own financial goals. A brief survey that would inform site staff about the taxpayer's goals is a good starting point for conversation. This relationship building could lead to other products and services.
- Using materials that co-opt credit card language like "achieve your dream," "get what you need," "feel safe with your money" to interest taxpayers in learning more.
- Encouraging "smart spending," or spending a large refund on items that can prevent financial emergencies down the road: doctor's appointments, upgrading appliances, tune up on car, etc.
- Encouraging better consumer habits, which is another way to help both the banked and unbanked to increase net worth. Paying down debts, understanding the cost of credit, and learning what to look for when shopping for credit or large consumer items are all ways that average consumers can save themselves a lot of money.

## D. The DIY: Do It Yourself

While it's clear that alternative RALs benefit the taxpayers who use them, free tax preparation programs and their financial institution partners can also benefit. Offering an alternative RAL will attract taxpayers who are accustomed to receiving RALs from commercial preparers (though the participation rates for Alternative RALs should be lower due to education, free or affordable accounts, and the lack of fees). Local economic development will be enhanced as the fees that are normally siphoned from the community in the form of preparation and RAL fees stay local. Finally, offering an alternative RAL is a great way to connect with a financial institution and can lead to further asset development collaborations.

Financial institutions will benefit because the RAL provides a targeted source for new accounts; serves as inexpensive marketing for other programs; and leads to income generation as members move toward financial self-sufficiency.

The Alternatives Model

With this in mind, Alternatives Federal Credit Union in Ithaca, NY opened a VITA site that offered an alternative RAL—the Refund Express—in 2003. Alternatives used their existing Line of Credit to offer the Refund Express, which meant no new forms, paperwork, or policies required. The loan had a $20 set up fee and an APR of 11.5%. In Alternatives' experience, this loan was extremely safe if the VITA and Consumer Lending staff followed these simple procedures:

*VITA Staff & Volunteers*

1. Prepare the loan and offer direct deposit.
2. Ask the filer to complete a membership card and present a picture ID to be photocopied. Open the account.
3. Enter the account and routing numbers on the return. If the taxpayer is interested in the RAL, the refund must be direct deposited to an Alternatives savings account. Note that only the federal refund qualifies for the loan.
4. Ask the filer to fill out and sign the standard loan application; put the completed application in the client's tax folder.
5. Print an extra copy of the 1040 for the folder. Highlight the direct deposit information and the refund amount.
6. E-file the return as soon as possible.
7. Twelve to 48 hours after filing the return, receive and print two copies of the IRS acknowledgement – one for VITA records, one for the loan department.
8. On the loan department's copy, highlight the person's name and refund amount and double check to be sure that there is lien and that the return was accepted as filed.
9. Staple the loan application and 1040 copy together; give the whole package with the acknowledgement to the loan department.

*Credit Union Staff*

10. Verify the information on the 1040 and the acknowledgement.
11. Set up the loan as a Line of Credit, extending the amount of the federal refund minus the $20 fee and the estimated interest cost.
12. Call the member to let him know that the loan proceeds are available for in-person withdrawal at the Credit Union and mail the Refund Express Letter.
13. Place a hold on the savings account for the full amount of the federal refund.
14. Each Friday, check the accounts of the Refund Express recipients. Once the refund comes in, remove the hold on the savings account and transfer the refund to pay off the LOC. Close the LOC and put any remaining funds in the savings.
15. If the filer indicated an interest in maintaining the LOC or otherwise building a positive credit history, meet with member before completing step 12.

One-third of non-member filers opened accounts with Alternatives. In the first year, 20% of filers requested a Refund Express Loan, while only 10% requested these loans the second year. VITA staff believes this decrease in participation was due to increased education efforts. In 2004, the average interest cost was less than $5, bring the total cost to under $25. One year after opening their accounts, 66% of new VITA members had retained their accounts. Many new members had moved forward with IDAs, car loans, youth savings accounts, share certificates, small business development services, and other products. In 2004, thanks to developed procedures and a well-trained staff, Alternatives sustained no losses with the Refund Express program.