

REPORT ON TAX REFUND LOANS



**NORTH CAROLINA
OFFICE OF THE COMMISSIONER OF BANKS**

APRIL 24, 2007

Introduction

This report will discuss the regulation of loans secured by a borrower's anticipated tax refund. These loans, called refund anticipation loans (or "tax refund loans"), are short-term loans made at the time of filing a tax return in order for the taxpayer to obtain the benefits of the tax return immediately or within a day or two, instead of waiting for the Internal Revenue Service (IRS) to process the tax return and provide a refund.

The tax refund loans have been subjected to much criticism for the high effective interest rates charged on the loans, as many loans have annual percentage rates (APRs) of 100% to 200%, with some rates as high as 803% this year. Tax refund lenders have countered the criticism by pointing out that their customers desire these loans, are informed of the charges related to the loans, and that the APR may be misleading since these loans are outstanding for a short period of time.

In addition to concerns regarding interest charges, policymakers and advocates have criticized tax refund lenders for other practices, including using the tax refund to offset other debts of the borrowers (called "cross-collection") and deceptive advertising (such as marketing the loans as "instant refunds").

This report will discuss the current tax refund loan market and the regulation of these products. Due to federal preemption of state interest rate limitations, North Carolina has constrained options to address concerns regarding tax refund loans. This report will discuss North Carolina's legal and regulatory efforts regarding these loans and options for legislative consideration.

The Tax Refund Loan Market

Approximately half a million North Carolina taxpayers obtain a tax refund loan each year.¹ This represents 11% of the total tax returns filed by individuals, although this percentage has been decreasing in recent years. Based on an estimated average charge of \$100 per loan, this amounts to \$44.3 million in refunds that do not go to taxpayers. Of the estimated 492,000 tax refund loan applications, 86% were from low-income borrowers.² In addition, 65% of the tax refund loan applications were made by borrowers that received the earned income tax credit, the largest federal expenditure to benefit working families with children. African-American and Latino tax filers are over-represented in the tax refund loan population.³

¹ The Community Reinvestment Association of North Carolina estimates that 443,000 North Carolina tax filers received a refund anticipation loan, *See The High Cost of Refund Anticipation Loans in North Carolina* (Jan 2007) at p.3 (using IRS data for 2004 federal tax returns)

² *CRANC Study* at p. 3.

³ We do not have specific data on North Carolina tax filers; however, national consumer advocates have reported that 28% of African American tax filers and 21% of Latino tax filers purchased a tax refund loan, as compared with 17% of white tax filers. *See* Chi Chi Wu and Jean Ann Fox, *Picking Taxpayers Pockets, Draining Tax Relief Dollars*, National Consumer Law Center and Consumer Federation of America (2005),

These loans come at a high cost from the perspective of an annual percentage rate (APR), with many tax refund loans in the 100-200% APR range. At the same time, risk of loss for these loans is low, given that the loan is secured by the borrower's anticipated federal tax refund and that refund lenders can determine existing liens with priority for repayment through the IRS system.⁴

Why do people take out tax refund loans? Some reasons identified by researchers are: 1) persistent financial stress (e.g. need to pay bills or cover unexpected expenses); 2) convenience and peace of mind (e.g. customers are able to complete transaction immediately); 3) desire to make a new purchase; 4) lack of awareness of costs of tax refund loan; and 5) steering by tax preparer into tax refund loans.⁵

The convenience factor is important, as one researcher has noted that 15% of tax refund loan customers identified not wanting to wait for the refund as a primary reason for taking out a refund loan.⁶ In fact, this factor may have been the critical factor that led to the development of tax refund loans. Tax refund loans were started by H&R Block and Beneficial Bank (now a subsidiary of HSBC) in 1987 based on experience with customers that had to wait eight to ten weeks to receive a tax refund from the IRS.⁷

As technology has improved, both in the funding of the loans and the processing of tax returns through electronic filing ("e-filing"), the turnaround time for both a tax refund loan and a tax refund itself have dramatically shortened. For this year, the turnaround time between electronic filing of taxes and the deposit of funds into a customer's bank account is as little as seven to ten days.⁸ In addition, the IRS now permits free e-filing for taxpayers making less than \$52,000 per year.⁹ Improved processing times may have reduced demand for tax refund loans, as tax refund loans in North Carolina declined 21%

available at: http://www.consumerlaw.org/initiatives/refund_anticipation/content/2005RALreport.pdf. The *CRANC Study* suggests that tax refund loans are more likely to occur in minority neighborhoods. *CRANC Study* at p. 5.

⁴ IRS uses "debt indicator" system to indicate whether there is an existing lien on a federal refund due to failure to pay taxes, child support obligations, student loans, or certain other federal debts. Tax refund lenders have access to this debt indicator, which enables them to have confidence that if the tax return is prepared properly, that the refund will be provided. See, National Taxpayer Advocate, *The Role of the IRS in the Refund Anticipation Loan Industry* (Jun 30, 2006) at p. 9 ("The D[ebt] I[ndicator] is clearly a tool that helps reduce risks for banks."), Damon Darlin, *Tax Loans Are Losing Some Allure*, New York Times (Mar 24, 2007) (the refund loan "carries almost no risk to tax preparers").

⁵ See, e.g., Gregory Elliehausen, *Consumer Use of Tax Refund Anticipation Loans*, Credit Research Center (Apr 2005); Chi Chi Wu, *Another Year of Losses: High-Priced Refund Anticipation Loans Continue to Take a Chunk Out of Americans' Tax Refunds*, National Consumer Law Center and Consumer Federation of America (Jan 2006).

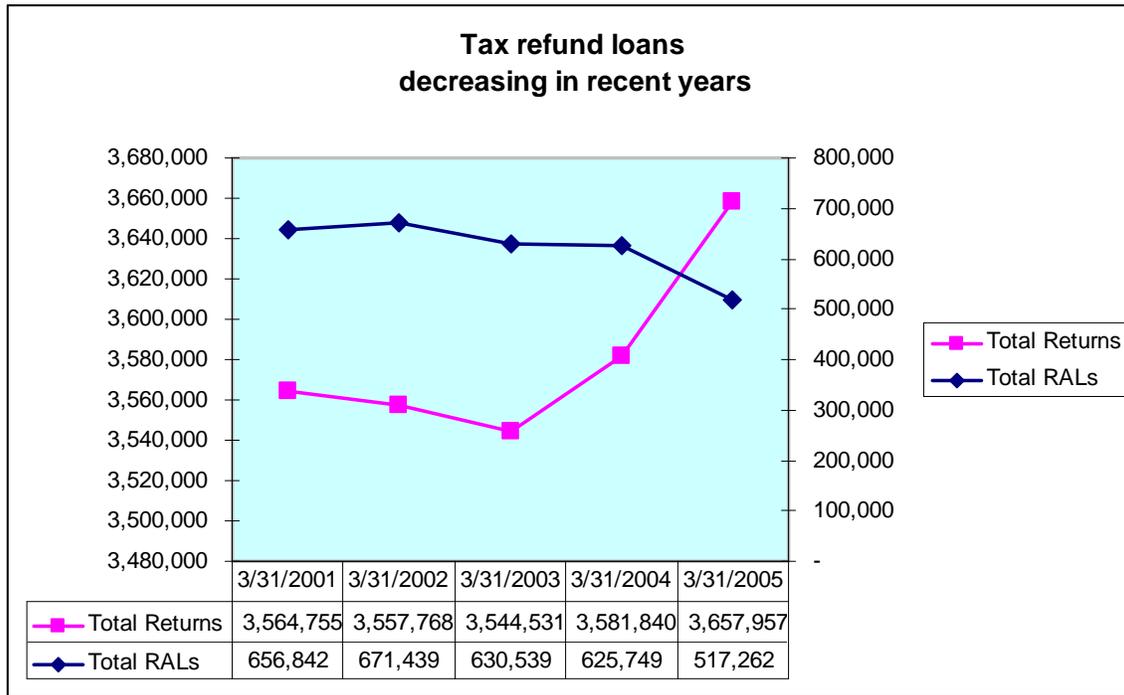
⁶ *Credit Research Center Study* at p. 61.

⁷ Peter Tufano and Daniel Schneider, *Harvard Business School Case Study: H&R Block and "Everyday Financial Services"*, Harvard Business School (Sept 2005).

⁸ See Damon Darlin, *Tax Loans Are Losing Some Allure*, New York Times (Mar 24, 2007) (refunds within seven days); Internal Revenue Service, *IRS Free File Press Kit, Free Tax Preparation & Filing Available in Spanish* (Jan 2007) (refunds in ten days) at <http://www.irs.gov/pub/newsroom/freefilepresskit.pdf>.

⁹ See Internal Revenue Service, *Improved, Expanded Free File Program Opens Today for 95 Million Taxpayers* (Jan 16, 2007) (press release).

between tax years 2000 and 2004, while overall individual tax returns filed increased by 3%.¹⁰



Similarly, tax refund loans have become automated to the point where lenders are able to approve loans instantly and disburse funds to customers at the time of the filing of the tax return. These tax refund loans are called “instant” loans, and have an additional fee over “traditional” or “classic” tax refund loans. Since tax preparers do not typically handle cash, the proceeds of the tax refund loans are loaded onto a debit card or are issued as a check. Customers may also pay charges to access the money on a debit card, or may pay fees for cashing the disbursement check if they do not have a bank account.

The tax refund loan market is currently composed of a handful of lenders, most of whom are located out of state. The three largest tax refund lenders are HSBC, Santa Barbara Bank & Trust, and JP Morgan Chase. Until recently, the rates charged for the tax refund loans were relatively consistent, although each lender has a different (and somewhat confusing) matrix of charges depending on when the loan is made, how fast the customer receives the loan, and what mechanism is used to disburse the funds. For the 2007 tax season, here is a chart that describes charges for a tax refund loan of \$2,000 (roughly the average amount), with the customer obtaining as much of that \$2,000 as possible at the time of tax filing (e.g. they use the “instant” loan option to the full extent).

¹⁰ Based on data from the IRS SPEC database, as provided by the Brookings Institute, the total number of tax refund loans decreased 21% between the 2000 and 2004 tax years, while total individual tax returns in the state increased by 3%.

Cost of "Instant" Tax Refund Loans							
Prepared: February 1, 2007							
Tax Preparer	Bank partner	Loan Amount	Fees				Total Cost
			Bank Fee for Loan	Bank Fee to Set up Refund Account	Bank Fee to get money by check	Fees to get money on card	
H & R Block	HSBC	\$ 2,000.00	\$ 48.35	\$ 29.95	\$ 21.60	\$ -	\$78.30 to \$99.90
Jackson Hewitt	HSBC or Santa Barbara Bank	\$ 2,000.00	\$ 95.00	\$ 29.95	\$ -	\$30 to \$50	\$124.95 to \$174.95
Liberty	HSBC	\$2,000/\$598	\$ 110.00	\$19.95 to 29.95	\$ -		\$129.95 to \$139.95
Independent #1	JP Morgan Chase	\$ 2,000.00	\$ 98.00	\$ 30.00	\$ -	\$ -	\$128.00
Independent #2	Republic	\$2,000/\$1,800	\$ 119.00	\$ -	\$ -	\$ 25.00	\$119.00 to \$144.00
Independent #3	River City	\$2,000/\$1,000	\$ 127.00	\$ -	\$ -	\$ 10.00	\$127.00 to \$137.00

Notes:

- Summary chart prepared by NCCOB, based on disclosures provided by RAL facilitators and phone calls to individual RAL offices.
- Chart shows total cost for Refund Anticipation Loans of \$2,000 that include the maximum available same-day or instant Refund Anticipation Loan. Less costly refund loans may be available in 1-2 days; actual fees may vary from the above chart.
- Total Cost *does not* include fees for tax preparation (which averages \$150) or other products.

Pre-file loans: Recent industry actions suggest these products will no longer be offered

In the last couple of years, a number of tax preparers have partnered with lenders to offer “pre-file” loans in advance of the filing of a customer’s tax refund. Started by Jackson Hewitt, these pre-file loans fall into two categories: a pre-file loan made in January (the “pay-stub loan”) after the customer’s final paycheck of the year, and a smaller loan made in November or December of the prior year (the “holiday loan” or “preseason loan”). **As this report was going to press, a number of lenders and tax preparers have recently announced they will no longer offer the pre-file products.**¹¹

Pay-stub loans. The pay-stub loan is a loan made between the beginning of January and early February based on the anticipated amount of the tax refund; however, the loan is not technically a tax refund loan because the customer is not filing the tax return simultaneously with the origination of the tax refund loan. The customer cannot file the tax return in January usually because most employers do not provide W-2 statements to their employees until the latter part of the month. If the customer has an earnings statement at the end of the year, the tax preparer and tax refund lender can derive a reasonably accurate estimate of the customer’s tax return. The pay-stub loan provides a means for the customer to obtain a loan a month or so prior to the filing. The pay-stub loan is due in mid-February, thus ensuring that the customer will return to the tax preparer to submit the tax return soon after the receipt of the W-2. For this year’s tax season, we believe the three major tax preparers and many of the independent tax preparers had relationships with lenders to offer pay-stub loans. As noted above, a

¹¹ See Katie Kuchner-Hebert, *Refund Loan Variants Lose Last Provider*, American Banker (Apr 11, 2007).

number of lenders and tax preparers have made announcements that they will no longer offer or facilitate pre-file loans.

The pricing for the pay-stub loan varies somewhat among the various lenders that offer them, as different lenders have different appetites for risk in these loans. The pay-stub is not a tax refund loan, as it cannot legally be secured by the future tax refund, and as such, the pay-stub loan is entirely unsecured. Some lenders have chosen to make the pay-stub loan in a similar amount as a comparable tax refund loan, based on the assumption that most of the pay-stub loan customers will return to the same tax preparation office to file their return. Other lenders have taken a more conservative approach and offered pay-stub loans in a much smaller amount than the potential tax refund loan. Furthermore, since some lenders cap the ultimate charges for all loans made in a tax season, the actual cost of the tax refund loan may be reduced somewhat.

Holiday/Preseason loans. The holiday loan is a loan made between early November and late December. This loan is usually a small pre-set amount (either \$400 or \$600) and is due in mid-February. The tax preparer and tax refund lender takes basic data from the customer (similar to the paystub loan) and may or may not charge the borrower for additional products, such as a tax planning guide. For November and December prior to this tax season, we believe Jackson Hewitt and H&R Block were the only two tax preparers that actively marketed a holiday loan; however, as noted earlier, both have recently announced they will not offer these products.

Regulation of Tax Refund Loans in North Carolina

North Carolina's regulation of tax refund loans is based on its underlying regulation of consumer loans in Chapter 24 of the General Statutes and in the specific laws relating to the facilitation of these loans by tax preparers and other third parties in the Refund Anticipation Loan Act. As discussed below, North Carolina has limited ability to control the interest rates charged in tax refund loans, since these loans are made by national or out-of-state state-chartered banks.

Like other unsecured loans with principal balances not exceeding twenty-five thousand dollars (\$25,000), tax refund loans made in North Carolina would normally be governed by the provisions of G.S. § 24-1.1(c). This statute provides that the interest imposed on such small loans shall not exceed an annualized rate of sixteen percent (16%).¹²

¹² In fact, the statute provides that the rate shall be calculated by adding the "latest published noncompetitive rate for U.S. Treasury bills with a six-month maturity as of the fifteenth day of the month plus six percent (6%), rounded upward or downward, as the case may be, to the nearest one-half of one percent (1/2 of 1%) *or* sixteen percent (16%), whichever is greater" [emphasis added]. Given that the noncompetitive rate for U.S. Treasury bills with a six-month maturity has not exceeded 10% since the early 1980's, unless we see a dramatic rise in interest rates, this provision effectively amounts to a sixteen percent (16%) interest rate ceiling on such loans.

Nonetheless, most tax refund loans offered in North Carolina carry annualized interest rates far in excess of the statutory ceiling.¹³ This occurs because all of the major tax refund lenders are federally-chartered or out-of-state state-chartered banks. Pursuant to Section 85 of the National Bank Act (NBA),¹⁴ federally-chartered lending institutions may preempt our state's usury laws, including G.S. § 24-1.1(c). Section 85 permits such federally-chartered institutions to export the interest rate laws of their home states into any state in which these lenders do business, essentially displacing our strong usury laws with the weaker laws of other states. Out-of-state state chartered banks derive similar authority to export interest rates through Section 27 of the Federal Deposit Insurance Act (FDIA).¹⁵

In order to take advantage of weak state usury laws, local tax preparers partner with national or out-of-state state-chartered banks that can export the higher allowed interest rates into North Carolina. The local tax preparer then solicits taxpayers for a tax refund loan on behalf of the bank as the bank's agent. In the event that a taxpayer expresses interest in obtaining a tax refund loan, the tax preparer forwards the taxpayer's application to the bank which approves or denies the loan. Once the loan is approved, the proceeds of the loan (which ostensibly originate in the home state of the bank) are disbursed to the borrower by check or debit card. Because the loan is being made by a bank (and not the local tax preparer), it does not need to comport with North Carolina's small-loan interest rate ceiling.

Federal courts have reviewed and upheld national banks' rights to make tax refund loans through agents and to export their home state's interest rates. In Cades v. H & R Block, Inc., 43 F.3d 869 (4th Cir. 1994), cert. denied, 515 U.S. 1103 (1995), and Christiansen v. Beneficial Nat'l Bank, 972 F. Supp. 681 (S.D. Ga. 1997), courts have held that Section 85 of the NBA governed the interest rate a national bank could charge on a tax refund loan made through tax preparer agents to borrowers in other states and, accordingly, that the usury laws of states in which the borrowers reside are preempted.

In Cades, the largest tax refund lender, Beneficial National Bank (now HSBC Bank), was declared to have the right to export Delaware law (which has no interest rate ceiling) into every state in which it was originating tax refund loans. In the wake of Cades and Christiansen, it is unlikely that North Carolina could successfully impose interest rate limitations on banks that elect to originate loans through local tax preparers/brokers.¹⁶

¹³ The effective interest rates on these short-term loans can be quite sizable. Findings by the General Accounting Office quoted loan fees ranging from \$130 on a \$1,200 refund (approximately 400% APR) to \$174 on a \$700 refund (approximately 900% APR). See Gen. Accounting Office, Pub. No. GA-04-07, Tax Administration: *Most Taxpayer Believe They Benefit from Paid Tax Preparers, but Oversight for IRS is a Challenge* (Oct. 31, 2003) at p.10.

¹⁴ See 12 U.S.C. § 85.

¹⁵ See 12 U.S.C. §27.

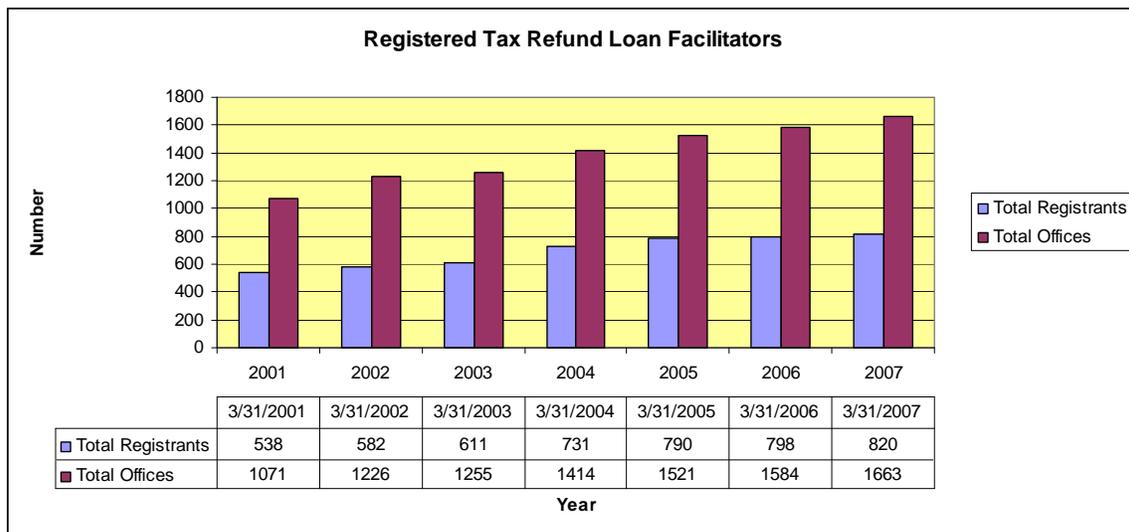
¹⁶ The state of Connecticut recently attempted to impose interest rate limitations on tax refund loans. A national bank challenged the statute's application to loans made by a national bank and a federal district court agreed the statute did not apply to loans made by the national bank. *Pac. Capital Bank, N.A. v. Connecticut*, 2006 U.S. Dist. Lexis 55627 (D. Conn. Aug. 10, 2007).

Regulation of Tax Refund Loan Facilitators

While North Carolina has limited control over interest rates charged on tax refund loans, North Carolina does have minimal regulations of tax refund loan facilitators (*e.g.*, tax preparers), and has extensive authority to control the operation of tax preparers. In 1990, North Carolina enacted the Refund Anticipation Loan Act (the “RAL Act”).¹⁷ The RAL Act primarily creates a requirement for tax preparers and other third parties that offer tax refund loans to register with NCCOB.

NCCOB is responsible for the registration of tax refund loan facilitators. Upon application and payment of a \$250 fee, the Commissioner shall register applicants as tax refund facilitators if the “responsibility and general fitness of the applicant are such as to command the confidence of the community and to warrant belief that the business of facilitating refund anticipation loans will be operated within the purposes of” the RAL Act.¹⁸ The tax refund loan facilitator must file a form with NCCOB to identify various rates and fees charged in relation to the tax refund loan, must post these fees in a prominent location in its office, and must provide this information to its customers.¹⁹ In contrast with other statutes administered by NCCOB, the RAL Act does not provide for the routine examination of tax refund loan facilitators.

As noted in the chart below, over the past six years, the number of registered tax refund loan facilitators has increased by 52%, with the number of registered offices increasing proportionately.



Beyond the registration scheme, the RAL Act identifies six prohibited practices:

1. misrepresenting a material fact or condition in a tax refund loan;

¹⁷ Article 20 of Chapter 53, N.C.G.S. §53-245, et. seq.

¹⁸ N.C.G.S. § 53-248(a).

¹⁹ N.C.G.S. § 53-249.

2. failing to arrange for a loan promptly after filing;
3. engaging in a practice that operates a fraud upon any person in connection with a tax refund loan;
4. facilitating a tax refund loan at a fee that either differs from the posted amount on file with NCCOB or at a fee that the Commissioner has determined to be unconscionable (see below);
5. arranging for the payment of proceeds of the tax refund loan to a good or service other than a fee for the preparation of the tax return or a fee for the refund loan itself; and
6. arranging for the tax refund loan to be secured by anything other than the anticipated refund.²⁰

In addition to the enumerated prohibited practices, the RAL Act prohibits tax refund loans based on refunds of North Carolina tax.²¹

Commissioner has limited ability to declare fees unconscionable

The RAL Act provides that tax refund loan facilitators may not facilitate “a refund anticipation loan for which the refund anticipation loan fee is... in an amount which the Commissioner has notified the facilitator is unconscionable.”²² While the face of the statute provides authority to the Commissioner to set rates on tax refund loans, in reality, the Commissioner has limited ability to control rates due to the high hurdle in determining unconscionability under North Carolina law and federal preemption of North Carolina’s interest rate limitations against national banks and out-of-state state-chartered banks.

The high hurdle of unconscionability: Although the term “unconscionable” is not defined by the statute and commentators agree that the term cannot be defined with precision,²³ the Commissioner cannot define unconscionability in an arbitrary or capricious manner. North Carolina case law has established that one must look to “procedural and substantive elements” when “analyzing the connotations of that term.”²⁴

Procedural unconscionability involves “bargaining naughtiness” in the formation of the contract, and is equated with the words “unfair surprise” and with the phrase “lack of meaningful choice.”²⁵ The term encompasses not only “the employment of sharp practices and the use of fine print and convoluted language, but a lack of understanding and an inequality of bargaining power.”²⁶

²⁰ N.C.G.S. § 53-250.

²¹ N.C.G.S. § 53-245(b).

²² N.C.G.S. § 53-249(b).

²³ See e.g. 2 R. Anderson, Anderson on the Uniform Commercial Code § 2-302:25 (3d ed. 1982); J. White & R. Summers, Uniform Commercial Code § 4-3 (3d ed. 1988).

²⁴ See *Rite Color Chemical Co. v. Velvet Textile Co.*, 105 N.C. App. 14, 19 (1992). See also *King v. King*, 114 N.C. App. 454, 458 (1994); *Widener v. Widener*, 2003 N.C. App. LEXIS 1556 at *8 (2003).

²⁵ *Rite Color Chemical Co. v. Velvet Textile Co.*, 105 N.C. App. at 20 (1992).

²⁶ *Id.* at 20.

Substantive unconscionability involves “harsh, one-sided, and oppressive terms of a contract.”²⁷ However, “the inequality of the bargain must be ‘so manifest as to shock the judgment of a person of common sense, and... the terms... so oppressive that no reasonable person would make them on the one hand, and no honest and fair person would accept them on the other.’”²⁸

While certain elements of unconscionability may be found in most tax refund loan contracts (*e.g.*, fine print and a lack of full understanding on the part of the borrowers), other elements are more difficult to prove. Given that these products are discretionary in nature, it is difficult to assert that the borrowers had no meaningful choice. Moreover, in light of the seeming popularity of the product, it seems difficult to assert that no reasonable person would freely give his or her consent to the terms.

Finally, given the similarity of charges across the tax refund loan market, any determination of unconscionability would have the effective outcome of declaring all tax refund loans unconscionable. As a matter of statutory interpretation, NCCOB does not believe the General Assembly anticipated such a broad-based use of unconscionability, but rather intended its application to extreme charges outside the industry norms. In any event, NCCOB believes such a broad-based determination would best be made by the General Assembly, rather than an administrative agency.

The high hurdle of federal preemption: Even if the Commissioner were to find that certain tax refund loans contained fees which were in fact unconscionable, it is questionable whether these fees could be regulated if they were imposed and collected by a national or out-of-state bank. As was discussed above, national and out-of-state banks are entitled under applicable interpretations of the National Bank Act and the Federal Deposit Insurance Act to preemption regarding the fees and interests they may charge on loan contracts. As such, even if a fee was determined to be unconscionable in North Carolina, a national bank or out-of-state state-chartered bank could impose such a fee in a contract with a North Carolinian, if such a fee were deemed permissible in the bank’s home state. The indirect application of usury limits on the broker/agents of national banks is an unsettled area of law in the wake of recent United States Supreme Court opinion regarding preemption of state laws by national banks.²⁹

Potential application of the Consumer Finance Act to tax refund or pre-file loans

²⁷ *Id.* at 20.

²⁸ *Widener v. Widener*, 2003 N.C. App. LEXIS 1556 at *9 (2003) (*quoting Brenner v. School House, Ltd.*, 302 N.C. 207, 213 (1981)).

²⁹ *Watters v. Wachovia Bank, N.A.*, 2007 U.S. LEXIS 4336 (Nov. 29, 2006) (National Bank Act preempted Michigan’s requirement that a state-chartered operating subsidiary of a national bank obtain a license to conduct mortgage lending in the state). *See*, Comptroller of Currency, *Interpretative Letter #1000* (Aug. 2004) (Georgia predatory lending law preempted for mortgage loans funded by a national bank but originated by mortgage broker). While the OCC preemption applies to the terms of the loans, the extent to which the National Bank Act preempts state authorities from holding state non-bank licensees accountable for loans brokered in contravention of state law is not entirely clear.

Some advocates have argued that the tax refund loan business model is similar to that recently employed by payday lenders found to be in violation of the Consumer Finance Act. While there are some similarities between payday lenders and tax refund lenders, there are differences.

In 2005, the Commissioner of Banks held that a payday loan facilitator violated the Consumer Finance Act by engaging in the business of lending on consumer loans without a license.³⁰ This ruling was based on many factors, including the:

- prior operation of the payday loan facilitator as a payday lender during the time when North Carolina licensed payday loan companies;
- retention of a 90% economic interest in the loans by the payday facilitator;
- absence of an applicable precedent or clear federal bank regulator opinion supporting preemption of state regulation of non-bank actors in similar arrangements with state-chartered banks;
- absence of a meaningful agency relationship between payday loan facilitator and its state bank partners; and
- absence of legislative, regulatory, or other official statements supporting the legality of payday loan facilitators arrangements with state-chartered banks.

While the Commissioner has not held an investigative or formal hearing on whether or not any tax refund loan facilitator has engaged in the business of lending, available public information suggests a less one-sided relationship between tax preparer and tax refund lender than in the Advance America matter.³¹

NCCOB's Approach to Tax Refund Loans

Based on this legal and regulatory context, NCCOB has emphasized public education in hopes of educating North Carolina taxpayers on the alternatives to tax refund loans. In January of this year, NCCOB began its first ever public service campaign to warn North Carolina taxpayers of the high-cost of tax refund loans. NCCOB ran a short radio ad on over a dozen radio stations and developed a website, www.savetherefund.org, to provide citizens with information regarding tax refund loans and alternatives to these loans.

³⁰ *In Re Advance America, Cash Advance Centers of North Carolina, Inc.*, 05:008:CF, Order at 28 (2005) (presently on appeal to the North Carolina Court of Appeals). See also *BankWest, Inc. v. Baker*, 324 F.Supp. 2d 1333 (2004) (holding that the local payday lenders were in fact the *de facto* lenders in payday loan arrangements with out-of-state banks; subsequently vacated as moot).

³¹ This statement in no way expresses a declaration of whether or not any particular tax refund loan facilitator has engaged in the business of lending such as to warrant the need to secure a license under the Consumer Finance Act; rather, this discussion is intended to describe generally and facially NCCOB's understanding of the tax refund loan marketplace based on public reports.

NCCOB staff participated in a number of interviews with radio and newspaper reporters. In addition, NCCOB printed flyers that were distributed in churches in Greensboro and Raleigh.

NCCOB is active in developing alternatives to tax refund loans

While public awareness may address one of the possible reasons why taxpayers choose tax refund loans, NCCOB has been active in developing alternatives to tax refund loans to assist taxpayers in obtaining lower-cost options for short-term credit and in securing tax advice without potential steering toward tax refund loans.

First, the Commissioner has a strong interest in promoting short-term credit options for underbanked families. NCCOB has worked with First Charter in Charlotte to begin development of a short-term credit product connected to large employers of working people. NCCOB continues to work with bank and non-bank lenders to develop responsible alternatives to high-cost short-term credit products.

Second, NCCOB conducted a two year project to promote the development of free volunteer income tax assistance (VITA) sites to enable low-income tax payers to receive tax advice without a tax refund loan. In its two years of operation, VITA sites sponsored by NCCOB enabled 1,400 low-income taxpayers to secure \$1.3 million in tax refunds. Each dollar invested by NCCOB in the VITA project saved North Carolina taxpayers \$33 in tax refund loan fees and \$5 in tax preparation fees.

NCCOB investigation into pre-file loan products

Early last fall, NCCOB began investigating the legality of various practices related to pre-file loan products. In October, NCCOB began collecting information from various tax refund facilitators on their facilitation of pre-file loans. In December, NCCOB sent each tax refund loan facilitator a letter that identified two specific areas of concerns about the pre-file loan products. As a result of that letter, all of the major tax refund loan facilitators worked with their lending partners to ensure the loan products offered to North Carolina taxpayers did not lead to a payday-loan like cycle of repeated borrowing. With the recent announcement that lenders will cease offering these products, we hope to soon conclude our inquiry into these loan products.

Legislative Options to Improve Regulation of Tax Refund Loans

As requested, NCCOB has identified options for legislation that may increase regulatory control over tax refund loans. NCCOB takes no position on these options, but offers them as possibilities in the event policymakers desire to further restrict these loans.

1. Increase NCCOB oversight over tax refund loan facilitators. The RAL Act provides for a minimalist registration of tax refund loan facilitators. The General Assembly could amend the RAL Act to provide for examination and supervision

- of the facilitators' activities in order to increase compliance with North Carolina laws. It is worth noting that NCCOB has received only 15 complaints regarding tax refund loans since 2001, and that the Attorney General's office has not received any complaints not otherwise forwarded to NCCOB for consideration. Examination and supervision of the 900 tax refund loan facilitators would entail a substantial cost, requiring a significant increase to the current registration fee. At the same time, recent investigations into tax preparers point to potential fraudulent activities that may impact tax refund borrowers.³²
2. Require counseling before obtaining a tax refund loan. The General Assembly could require that a borrower obtain counseling prior to the consummation of a tax refund loan. The General Assembly has previously required counseling when it believed the risk of abuse in a transaction was such that borrowers needed independent advice, such as for high-cost home loans³³ and for reverse mortgages.³⁴ Adoption of this approach would bring with it the need to determine who would pay the cost of counseling.
 3. Prohibit tax refund loan facilitators from preparing tax returns. The General Assembly could amend the RAL Act to add as an additional prohibited practice the preparation of tax returns. This prohibition would break the link between the preparation of the tax return and the securing of the loan, possibly increasing the opportunities for competition by lenders as it would end the captive relationship between preparers and lenders. This change would significantly alter the current tax refund loan marketplace.

Conclusion

The Commissioner of Banks believes that many tax refund loans are not in the interest of North Carolina taxpayers. As scrutiny of these loan products has increased, some tax preparers and refund lenders have lowered fees charged, and in the last month, several have stopped offering pre-file products. Despite that, tax refund loans are currently legal in North Carolina and expressly authorized by the General Assembly, while the interest rates charged in the marketplace are rarely governed by North Carolina law. Without changes in federal law,³⁵ North Carolina policymakers have constrained options to regulate these products. NCCOB will continue to invest its resources in building public

³² See, e.g., David Ranii, *34 Tax Outlets Accused of Fraud*, News & Observer (Apr 4, 2007) at p. A1.

³³ N.C.G.S. § 24-1.1-E(c)(1)

³⁴ N.C.G.S. § 53-270(6).

³⁵ There have been various efforts in Congress to regulate refund anticipation loans. Most recently, Congress passed the Talent Amendment to the 2006 Defense Reauthorization Act, P.L. 109-364 (Oct. 17, 2006), § 670, which aimed to restrict cost of loans, including tax refund loans, to military personnel and their families. The Department of Defense has recently released proposed regulations to implement this legislation, and specifically identified tax refund loans as one of three main targets for restrictions. See *Limitations on Terms of Consumer Credit Extended to Service Members and Dependents*, 72 Fed. Reg. 18,157 (Apr 11, 2007).

awareness of alternatives to tax refund loans, initiatives to develop alternatives to these loans, and enforcing North Carolina law in the best way to promote fairness to North Carolina taxpayers.