



CORPORATE WELFARE FOR THE RAL INDUSTRY: THE DEBT INDICATOR, IRS SUBSIDY, AND TAX FRAUD

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Executive Summary

- The debt indicator is an acknowledgement from the IRS telling tax preparers whether a taxpayer's refund will be paid versus intercepted for government debts. The debt indicator has proven to be a substantial benefit to the refund anticipation loan (RAL) industry, as it about doubles the number of RALs made by the industry.
- The debt indicator has helped boost RAL profitability. The IRS terminated the debt indicator in 1994 due to RAL fraud, and the price of RALs rose significantly, from \$29-\$35 to \$29-\$89. The IRS reinstated the debt indicator in 1999 partly to lower RAL prices. RAL prices dipped for a year in 2000, but have gone back up to pre-indicator levels. Meanwhile, the amount of RAL fraud has multiplied since the debt indicator was reinstated.
- The debt indicator raises significant privacy issues. It is unclear whether taxpayers realize they are allowing the IRS to provide sensitive personal information to tax preparers about debts owed to the federal government, such as child support and student loan debts.

The National Consumer Law Center is a non-profit organization specializing in consumer issues on behalf of low-income people. NCLC works with thousands of legal services, government and private attorneys, as well as community groups and organizations, who represent low-income and elderly individuals on consumer issues.

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A. History of the Debt Indicator

The debt indicator is a service provided by the Internal Revenue Service that screens electronically filed tax returns for any claims against a taxpayer's refund.¹ The debt indicator informs the preparer whether a taxpayer's full refund amount will be paid and not offset by other obligations collectible by the federal government, such as prior tax debt, child support arrears, or delinquent student loan debt.²

When the IRS first provided the debt indicator in the early 1990s, it was called the "direct deposit indicator." In 1994, the IRS terminated the debt indicator due to concerns over massive fraud in e-filed returns that involved refund anticipation loans (RALs).³ The elimination of the debt indicator elicited "screams of rage" by the RAL industry.⁴ In addition to cutting into their profits, the RAL industry claimed there would be multitudes of disappointed clients who could not get their RALs.⁵ Two of the four major RAL lenders, Mellon Bank and Greenwood Trust, stopped making RALs and left the market.⁶

Over the next few years, the RAL industry pressed for reinstatement of the debt indicator.⁷ Then, in 1998, Congress imposed a goal on the IRS to have 80% of returns electronically filed.⁸ Not coincidentally, a year later, the IRS announced it was re-instating the Debt Indicator.⁹ However, note that the Congressional 80% e-file goal is not mandatory, but merely exhortatory, in that the statutory language actually states "it *should be the goal* of the Internal Revenue Service to have at least 80 percent of all such returns filed electronically by the year 2007;..."¹⁰

The first year of the reinstatement of the debt indicator was a pilot.¹¹ Subsequently, the IRS decided to make the debt indicator permanent and provide it for all e-filed returns, not just returns associated with a RAL application.¹²

¹ IRS, Publication 1345, at 32. See also George Guttman, *IRS Reinstates Debt Indicator to Increase Electronic Filings*, 85 Tax Notes 1125, Nov. 29, 1999 [hereinafter "Guttman, *IRS Reinstates Debt Indicator*"].

² *Id.*

³ Ryan Donmoyer, *IRS Takes Aim at RAL Fraud, Hits Preparer Profits*, 66 Tax Notes 1750, February 20, 1995 [hereinafter "Donmoyer, *IRS Takes Aim at RAL Fraud*"]. See also Malcolm Sparrow, *Fraud in the Electronic Filing Program: A Vulnerability Assessment Prepared for the Internal Revenue Service*, September 1, 1994.

⁴ See Robert Scott, *E-Filing Vendors Outraged Over Death of DDI*, Accounting Today, November 21, 1994, at 2. See also Timothy J. Mullaney, *IRS Fraud Watch Cuts Refund Loans*, Baltimore Sun, March 12, 1995, at 1D ("The refund loan industry paints the story as a tale of Big Government beating up on the entrepreneurs who made the loans a multi-billion industry between 1990 and last year.").

⁵ Susan Edelman, *There's Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1.

⁶ Donmoyer, *IRS Takes Aim at RAL Fraud*, 66 Tax Notes at 1088.

⁷ See Council For Electronic Communication Advancement, *Testimony before the Subcommittee on Oversight - House Ways and Means Committee*, March 23, 1995 (statement of industry group advocating for revival of the debt indicator); Stuart Kahan, *Blackout on Electronic Filing*, Practical Accountant, September 1, 1995, at 50.

⁸ Pub. L. 105-206, 112 Stat. 723, § 2001(a)(2) (1998).

⁹ Internal Revenue Service, *Announcement of Opportunity to Obtain a Debt Indicator in a Pilot Program for Tax Year 1999 Form 1040 IRS E-file and On-Line Returns*, 64 Fed. Reg. 67,621 (December 2, 1999).

¹⁰ Pub. L. 105-206, 112 Stat. 723, § 2001(a)(2) (1998) (emphasis added).

¹¹ Internal Revenue Service, *Announcement of Opportunity to Obtain a Debt Indicator in a Pilot Program for Tax Year 1999 Form 1040 IRS E-file and On-Line Returns*, 64 Fed. Reg. 67,621 (December 2, 1999).

B. The Debt Indicator Increases RAL Volume

The debt indicator has had a dramatic effect on the volume of RALs and electronically filed returns. In 1994, prior to the elimination of the debt indicator, the number of RALs had risen to 9.5 million.¹³ After the termination of the debt indicator, RAL volume dropped and by 1999, the numbers of RALs had fallen to 6 million.¹⁴ When the debt indicator was reinstated effective the 2000 tax season, the number of RALs rose sharply to 10.8 million.¹⁵ The number of RALs continued to increase to 12.1 million in 2001 and 12.7 million in 2002.¹⁶

Data from individual companies in the RAL industry showed similar trends. In 1994, the nation's largest commercial preparation chain, H&R Block, processed 5.5 million RAL applications.¹⁷ After the debt indicator was eliminated, that number dropped to less than half, 2.35 million in 1995.¹⁸ By 1999, that number was at 2.8 million.¹⁹ When the debt indicator was reinstated, RAL volume rose to 4.8 million for Block.²⁰

¹² Internal Revenue Service, *Publication 1345A - Filing Season Supplement for Authorized IRS e-file Providers* (Rev. January 2002).

¹³ Donmoyer, *IRS Takes Aim at RAL Fraud*, 66 Tax Notes at 1088.

¹⁴ Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1125. We were unable to find industry RAL volume data from 1995-1998.

¹⁵ The IRS reported that there were 12 million requests for the Debt Indicator in 2000. (Statistic provided by the Internal Revenue Service, on file with the author). We assume that each of these requests for the Debt Indicator was for purposes of a RAL application. Since 90% of RAL applications result in an approved loan (see note 37 below), this means there were about 10.8 million RALs in 2000. Note that even when a RAL application is denied, the consumer is usually flipped into a refund anticipation check, which is the non-loan tax financial product offered by RAL banks, and still must pay a fee. See also Chi Chi Wu, Jean Ann Fox, and Elizabeth Renuart, *Tax Preparers Peddle High Priced Tax Refund Loans: Millions Skimmed from the Working Poor and the U. S. Treasury*, National Consumer Law Center and Consumer Federation of America, January 31, 2002, [hereinafter "NCLC/CFA 2002 RAL Report"], available at www.consumerlaw.org/initiatives/refund_anticipation.

¹⁶ Based on 13.4 million RAL applications in 2001 and 14.1 million RAL applications in 2002. Chi Chi Wu and Jean Ann Fox, *The High Cost of Quick Tax Money: Tax Preparation, 'Instant Refund' Loans, and Check Cashing Fees Target the Working Poor*, National Consumer Law Center and Consumer Federation of America, January 2003, at 3 [hereinafter referred to as "NCLC/CFA 2003 RAL Report."]; Chi Chi Wu and Jean Ann Fox, *All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low-Income Americans*, January 2004, at 4 [hereinafter referred to as "NCLC/CFA 2004 RAL Report."].

¹⁷ Gene Meyer, *H&R Block Joins Program That May Trim Cost of Fastest Refunds*, Kansas City Star, November 17, 1999.

¹⁸ H&R Block Inc., *1995 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*.

¹⁹ H&R Block Inc., *1999 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 5-6.

²⁰ H&R Block Inc., *2000 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 4.

Year	Overall # of RALs	H&R Block # of RAL applications ²¹
1994	9.5 million	5.5 million
1995	NA	2.3 million
1996	--	2.4 million
1997	--	2.6 million
1998	--	2.4 million
1999	6 million	2.8 million
2000	10.8 million	4.8 million
2001	12.1 million	4.5 million
2002	12.7 million	5.2 million

Other industry player reported similar trends. In 1994, all but 10,630 of the returns prepared by Jackson Hewitt were associated with RALs.²² After the debt indicator was dropped, the number of returns without RALs at Jackson Hewitt rose to 138,000 by late February 1995.²³ RAL lender Santa Barbara Bank & Trust reported a sharp increase in loans versus non-loan refund anticipation checks following reinstatement of the debt indicator.²⁴

The debt indicator also had similar effects on the volume of electronically-filed returns in general. The IRS reported there were 14 million e-filed returns in 1994, but only 12 million in 1995.²⁵ H&R Block reported that its e-filed returns declined 22% in 1995.²⁶ This decrease reflects the close link between e-filed returns and RALs that existed in the mid-1990s.²⁷

When the IRS reinstated the debt indicator, it publicly acknowledged that it expected the program to produce 2 million more e-filed returns than if it were not reinstated.²⁸ With the close link between e-filing and RALs, the IRS surely must have been aware that there would be a corresponding increase in the number of RALs. Indeed, RAL issuers predicted that the reinstatement of the debt indicator would increase RAL demand by 50%.²⁹ These predictions proved correct, as Block alone nearly doubled its RAL volume and made 2 million more loans

²¹ Based on H &R Block Form 10-Ks for respective fiscal years.

²² James Denn, *IRS's Hunt for Tax Cheats to Delay Refund Checks*, Albany Times Union, February 19, 1995, at A1.

²³ *Id.*

²⁴ Pacific Capital Bancorp, 2000 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, at 23. [hereinafter "PCB 2000 Form 10-K"]

²⁵ Stuart Kahan, *Blackout on Electronic Filing*, Practical Accountant, September 1, 1995, at 50. *See also NACTP Steps Up Communication Efforts*, Accounting Today, August 21, 1995, at S22.

²⁶ H&R Block Inc., 1995 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. *See also* Timothy J. Mullaney, *IRS Fraud Watch Cuts Refund Loans*, Baltimore Sun, March 12, 1995, at 1D.

²⁷ *See* NCLC/CFA 2002 RAL Report at 19-20.

²⁸ Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1127.

²⁹ *Id.*

(and thus e-filed returns) in 2000. Thus, much of the expected increase in e-filed returns was actually an increase in the number of RALs.

C. The Debt Indicator and RAL Approval Rates: The IRS Security Blanket

The debt indicator promotes RALs by assuring lenders that the taxpayer's refund will be issued and thus the loan will be repaid. For the pre-1995 debt indicator, if the indicator came back showing there was no federal offset, there was an over 99% chance the IRS would issue the refund.³⁰ At that time, the approval rate for RALs was 92% -- and all but 0.5% of loan denials were turned down based on the debt indicator.³¹ As one IRS employee stated, the debt indicator was a "federally supplied security blanket" and "we were doing their credit check for them."³²

The elimination of the debt indicator in 1995 significantly lowered RAL approval rates. The approval rate for Beneficial (which became Household) dropped from 92% to 78%.³³ This 78% rate includes partial approvals; the approval rate for a RAL of the taxpayer's full refund was only 40-50%.³⁴ Banc One's approval rate for RALs also dropped by 25-30%.³⁵ Even with the decrease in approval rates, Beneficial ended up with significant losses on RALs in 1995.³⁶

With the reinstatement of the debt indicator, RAL approval rates appear to be back around 90%.³⁷ Thus, the debt indicator helps increase RAL approval rates and RAL profits. Of course, this service is not without its cost. One question is how much does it cost IRS to provide the debt indicator? While we do not have definitive information, note that in 1994, the IRS suggested imposing a fee for the debt indicator of \$8 per return.³⁸

³⁰ Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1125.

³¹ *Id.*

³² Timothy J. Mullaney, *IRS Fraud Watch Cuts Refund Loans*, Baltimore Sun, Marh 12, 1995, at 1D (quoting an IRS spokesperson in Baltimore).

³³ James R. Kraus, *Beneficial's Tax-Refund Lending Program Seen on Course After Pullout from Earned-Income Side*, American Banker March 8, 1995.

³⁴ Susan Edelman, *There's Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1.

³⁵ *Id.*

³⁶ Daniel Dunaief, *Deals: Mellon Leads \$1.25B Loan to Underpin H&R Block's Tax-Refund Loan Program*, American Banker, November 7, 1996, at 20. However, much of the defaults were recovered, probably through the rather heavy-handed tactic of cross-lender debt collection. See NCLC/CFA 2002 RAL Report at 24. Beneficial alone expected to collect \$180 million in bad loans in 1997. Daniel Dunaief, *Deals: Mellon Leads \$1.25B Loan to Underpin H&R Block's Tax-Refund Loan Program*, American Banker, November 7, 1996, at 20.

³⁷ Household International, *Exploring the Refund Anticipation Loan (RAL): Questions and Answers*, on file with the authors. This 90% approval rate is reflected in H&R Block's SEC filings as well. In 2003, H&R Block stopped reporting in its 10-K the number of RAL applications it processed, and started reporting the number of RALs that were actually made. Block processed 5.15 million RAL applications in 2002. H&R Block, 2002 Form 10-K, at 4. Of those, 4.67 million loans were approved. H&R Block, 2003 Form 10-K, at 5. The latter number divided by the former is 91%.

³⁸ Robert W. Scott, *IRS Mulls New RAL Charge; Banks Likely to Pass It On*, Accounting Today, July 11, 1994. It is unclear whether the \$8 represented the cost of the debt indicator or was a revenue enhancer for the IRS.

D. Reinstatement of the Debt Indicator Has Not Lowered RAL Fees

The existence of the debt indicator has had an impact on RAL fees as well, although in the end it appears to be more of a profitability boost for RAL lenders. Prior to the elimination of the debt indicator, the loan fee for RALs was approximately \$29 to \$35.³⁹ The largest RAL lender, Beneficial, charged a flat fee of \$29 per RAL.⁴⁰ Bank One charged a flat fee of \$31,⁴¹ while the lender for Jackson Hewitt charged \$29 to \$35.⁴²

After the debt indicator was eliminated, RAL fees jumped dramatically. Beneficial began using a tiered fee structure, with fees of \$29 to \$89, depending on the size of the loan.⁴³ Banc One began charging \$41 to \$69 and Jackson Hewitt charged \$69 to \$100.⁴⁴ By 1999, Beneficial loans made through H&R Block cost \$40 to \$90.⁴⁵

One of the benefits that the IRS and industry touted for reinstating the debt indicator was lower RAL fees.⁴⁶ In fact, lower RAL fees constituted one of four measures by which the success of the pilot program for reinstatement was to be judged.⁴⁷ The IRS Assistant Commissioner for Electronic Tax Administration, Bob Barr, threatened to end the debt indicator if RAL prices did not decrease.⁴⁸ Industry expressed its agreement that fees would decrease, with one RAL issuer claimed that its fees would be reduced 30 to 40%.⁴⁹

When the debt indicator was reinstated, RAL fees did go down. However, this decrease turned out to be temporary. For example, RAL fees at H&R Block and Household Bank dropped for one year, but then shot back to pre-Debt Indicator levels. After the IRS reinstated the debt indicator, Household and Block's fees went from \$40-\$90 to \$20-\$60 for the 2000 tax season.⁵⁰ Both the IRS⁵¹ and industry touted this decrease in RAL fees.⁵² However, fees went back up in

³⁹ These figures and the figures used in the following discussion include only the loan fee, and do not include the administrative fee charged by the tax preparers for processing the RAL application.

⁴⁰ Timothy J. Mullaney, *IRS Fraud Watch Cuts Refund Loans*, Baltimore Sun, March 12, 1995, at 1D; Susan Edelman, *There's Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1; James Denn, *IRS's Hunt for Tax Cheats to Delay Refund Checks*, Albany Times Union, February 19, 1995, at A1.

⁴¹ Susan Edelman, *There's Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1.

⁴² James Denn, *IRS's Hunt for Tax Cheats to Delay Refund Checks*, Albany Times Union, February 19, 1995, at A1.

⁴³ George Guttman, *Electronic Filing: Who Pays, Who Benefits*, 66 Tax Notes 1750, March 20, 1995;

Susan Edelman, *There's Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1.

⁴⁴ James Denn, *IRS's Hunt for Tax Cheats to Delay Refund Checks*, Albany Times Union, February 19, 1995, at A1.

⁴⁵ Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1127.

⁴⁶ *Id.*; PCB 2000 Form 10-K, at 23.

⁴⁷ Amy Hamilton, *Taxwriter Zeroing in on 'Rapid Refund Loans,'* 91 Tax Notes at 192-193. The other measures were significantly increased levels of e-filing, increased service to taxpayers, and effectiveness of refund lenders in identifying fraudulent returns.

⁴⁸ Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1127.

⁴⁹ *Id.*

⁵⁰ *Refund Anticipation Loans May Include Several Fees*, St. Louis Dispatch, Feb 22, 2000, at C6.

⁵¹ *Preliminary IRS Modernization Conference Transcript*, 2000 Tax Notes 24-65, Jan. 14, 2000.

⁵² Statement of Mark Ernst, President and CEO of H&R Block, Testimony Before the Subcommittee on Oversight of the House Ways and Means Committee, April 3, 2001.

2001, with Block/Household charging \$30 to \$87 -- close to the fees charged prior to reinstatement of the debt indicator.⁵³

Also, part of the decrease in RAL fees in 2000 occurred because Block offered a “no fee” RAL in six markets, including entire state of California.⁵⁴ However, Block and Beneficial appear not to have offered this “no fee RAL” after the 2000 tax season. One reason was probably that the “no fee RAL” program was subject of a lawsuit for deception by a competitor.⁵⁵

RAL fees never went down again after 2001, but RAL profits have increased. The increase in RAL fees from 2000 to 2001 for H&R Block/Beneficial resulted in Block’s RAL revenues increasing by 49% from 2000 to 2001.⁵⁶ Most of the revenue increase appears to be the result of the higher RAL fees, because per-RAL-revenue rose by 43.9%, while sales volume only increased by 2.7%.⁵⁷

Thus, the main effect of the debt indicator appears to be, not in lowering RAL fees, but in higher RAL profits. If the reinstatement of the debt indicator had really lowered RAL fees back to pre-1995 prices, a RAL would only cost a flat fee of \$37.53 or \$45.91 in 2005 (the equivalent of \$29 or \$35 in 1994 adjusted for inflation).⁵⁸ Instead, they currently cost about \$35 to \$115, with Block and its lending partner charging a fee of \$100 for RALs for the average refund of slightly over \$2,000.⁵⁹ These fees translate into effective annual interest rates (APR) ranging from about 40% to over 700%.⁶⁰

⁵³ Chris Serres, *Speedy Refunds, Hefty Fees*, Raleigh News and Observer, February 25, 2001, at E1. Pamela Yip, *Personal Finance Column*, Dallas Morning News, February 25, 2001.

⁵⁴ Amy Hamilton, *Taxwriter Zeroing in on ‘Rapid Refund Loans,’* 91 Tax Notes 189, 192 (April 9, 2001).

⁵⁵ *JTH Tax v. H&R Block Eastern Tax Services*, 128 F. Supp. 2d 926, 938 (E.D. Va. 2001), *aff’d in part, vacated in part, and remanded in part*, 2002 U.S. App. LEXIS 477 (4th Cir. January 10, 2002).

⁵⁶ H&R Block, *One to One: 2001 Annual Report*, at 23.

⁵⁷ *Id.*

⁵⁸ According to the Department of Labor’s cost of living calculator at www.bls.gov

⁵⁹ Chi Chi Wu and Jean Ann Fox, *Picking Taxpayers’ Pockets, Draining Tax Relief Dollars: Refund Anticipation Loans Still Slicing Into Low-Income Americans’ Hard-Earned Tax Refunds*, National Consumer Law Center and Consumer Federation of America, January 2005, at 12.

⁶⁰ NCLC issues a series of annual reports on the RAL industry, which are available at www.consumerlaw.org. The last report documented how RALs drained over \$1 billion in loan fees, plus \$389 million in separate fees charged by tax preparers, from the wallets of more than 12 million American taxpayers in 2003.

Year	RAL Price – Beneficial/Household & Block ⁶¹	RAL price – Bank One ⁶²	RAL Price – Jackson Hewitt ⁶³
1994	\$29	\$31	\$29 to \$35
1995	\$29 to \$89	\$41 to \$69	\$69 to \$100
1996	\$29 to \$89	---	---
1997	\$40 to \$90	---	---
1998	\$40 to \$90	---	---
1999	\$40 to \$90	---	\$49 to \$80 ⁶⁴
2000	\$20 to \$60	---	---
2001	\$30 to \$87	---	---
2002	\$30 to \$90	\$34 to \$87	---
2003	\$30 to \$90	\$34 to \$89	\$34 to \$89
2004	\$30 to \$100	\$34 to \$89	\$29 to \$94(& \$5 for EITC)
2005	\$30 to \$110	\$34 to \$99	\$29 to \$99(& \$5 for EITC)

It appears the debt indicator is an IRS subsidy that increases profits for the RAL industry. The debt indicator has made each individual RAL more profitable, encouraging RAL lenders to aggressively promote RALs and increase RAL volume.

E. Privacy Issues

In addition to being a taxpayer-funded subsidy to the RAL industry, the debt indicator program raises significant privacy concerns. In fact, the IRS may be violating its own privacy law in providing the service to tax preparers. The IRS Code contains broad and strong privacy protections for taxpayer information. Section 6103 of the IRS Code states that all “[r]eturn and return information shall be confidential” and shall not be disclosed.⁶⁵ “Return information” is broadly defined and includes the taxpayer’s “nature, source, or amount of his ... liabilities ...”⁶⁶

⁶¹ From: George Guttman, *Electronic Filing: Who Pays, Who Benefits*, 66 Tax Notes 1750, March 20, 1995; Susan Edelman, *There’s Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1; Anne Willette, *Tax Refund Loans Benefit Beneficial*, USA Today, March 13, 1996, at 3B; James M. Odatto, *Speedy Returns: Electronic Filing Gets Your Refund To You Faster*, Buffalo News, Feb. 18, 1997; Jane Bryant Quinn, *Borrowing is Expensive Way to Get Tax Refund Money Fast*, Baltimore Sun, Feb. 23, 1998, at 13C; Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1127; Chris Serres, *Speedy Refunds, Hefty Fees*, Raleigh News and Observer, February 25, 2001, at E1; David Breitkopf, *Rollout Points to H&R Block’s Diversification*, American Banker, April 5, 2002; NCLC/CFA Reports from 2002 to 2005.

⁶² From the Taxwise website at www.taxwise.com/banks/bankone.asp.

⁶³ For 2003 to 2005, these are the prices of Jackson Hewitt’s lending partner, Santa Barbara Bank & Trust, from the Taxwise website at www.taxwise.com/banks/santabarb.asp.

⁶⁴ *Beware of Those Who Offer Tax Refund Loans ‘A Bad Buy’*, Roanoke Times, February 22, 1999.

⁶⁵ 26 U.S.C. § 6103.

⁶⁶ 26 U.S.C. § 6103(b)(2)(A).

Therefore, information as to whether a taxpayer is subject to a refund offset would be information about the nature or amount of a taxpayer's liabilities.

It would seem that the information disclosed by the IRS to a RAL provider would constitute a violation of the IRS privacy statute, unless there is an exemption. One possible exemption would be the provision that allows the IRS to disclose return information with a taxpayer's consent.⁶⁷ However, the IRS regulations set forth clear and definite requirements for such consent, including that the consent be set forth in a separate written document pertaining to the disclosure, and that the document reference the particular data item of return information to be disclosed.⁶⁸

A document that conceivably grants such consent is IRS Form 8453, which is used to authenticate an e-filed return. Yet the consent to disclose information in Form 8453 is not a separate, stand-alone document pertaining solely to the disclosure.⁶⁹ Furthermore, the consent is buried in small print inadequate to clearly inform taxpayers that they are permitting the IRS to disclose personal financial information to their tax preparers about whether they owe a child support or student loan debt.

Another exemption allows the IRS to send an acknowledgement to an e-file provider without the need for a stand-alone consent form, along with "such other information as the [IRS] determines is necessary to the operation of the electronic filing program."⁷⁰ Because RALs increase the number of e-filed returns, the IRS may argue that this language permits it to send the debt indicator in the e-file acknowledgement (as it currently does) without a stand-alone consent form. However, while it increases the number of e-filed returns, that is not a factor that is "necessary" to the operation of the e-file program.

Even if IRS can legally provide the debt indicator, there still remain significant privacy issues regarding the program. With the debt indicator, the IRS is providing an indicator that communicates personal and potentially embarrassing financial tax information to the tax preparer.⁷¹ Indeed, when the IRS proposed requiring a similar indicator on tax returns filed through the Free File Alliance, commercial preparers objected strongly, citing privacy concerns.⁷² National Taxpayer Advocate Nina Olson noted ironically "These businesses already rely heavily on returns flagged with an indicator to tell them that this return has other outstanding refund offsets" and "Let's use the same argument to say the debt indicator should be eliminated."⁷³

⁶⁷ 26 U.S.C. § 6103(c).

⁶⁸ 26 C.F.R. § 301.6103(c)-1(b) and (b)(iii).

⁶⁹ The IRS also requires that tax preparers who receive the debt indicator to have return preparation software that includes a mandatory consent to disclose the debt indicator. IRS Publication 3614, Application for Memorandum of Agreement – Debt Indicator. As with Form 8453, the question is whether the consent is meaningful and meets the requirements of the regulation.

⁷⁰ 26 C.F.R. § 301.6103(c)-1 (d).

⁷¹ While the tax preparation process often results in taxpayers divulging their personal financial information to a tax preparer, the debt indicator may reveal additional information that would not necessarily be part of that process, and would be sensitive since it involves delinquent debts owed to the government.

⁷² Amy Hamilton, *Businesses Resist IRS Requests to Flag Taxpayers Using Free File*, Tax Notes Today, December 1, 2003, at 1062.

⁷³ *Id.*

Given the lack of prominence of the consent in Form 8453, it is unclear whether most taxpayers actually realize they are giving permission for IRS to reveal the presence of government debts to their preparer. It is even unclear whether they know about the debt indicator itself or understand what it is.

F. Re-Emergence of Fraud

The debt indicator represents an IRS subsidy in another respect, that is, in the amount of fraud it promotes and the taxpayer dollars spent combating that fraud. As discussed above, the IRS dropped the debt indicator in 1994 due to concerns over mounting fraud in refund claims.⁷⁴ IRS data had indicated that 92% of fraudulent returns filed electronically involved RALs.⁷⁵ It was believed that the debt indicator led to tax fraud because of its role in supporting RALs, whose quick turnaround period makes fraud detection difficult.⁷⁶

The elimination of the debt indicator seems to have had its intended effect. According to the Assistant Attorney General in charge of the Tax Division at the Department of Justice, eliminating the debt indicator, along with other fraud prevention measures, successfully reduced the number of fraudulent claims.⁷⁷

When IRS reinstated the debt indicator in 1999, it attempted to address the fraud issue by requiring tax preparers to institute fraud prevention measures. The first year of the debt indicator was termed a pilot, and only certain tax preparers who entered into memoranda of agreement with the IRS were eligible to receive the debt indicator.⁷⁸ As a condition of the agreement, tax preparers were required to actively screen returns for potential fraud and abuse, using measure such as requiring two valid forms of identification and verifying questionable W-2s.⁷⁹ However, after the 2000 tax season, the debt indicator is no longer a pilot and is provided to all taxpayers who e-file.⁸⁰ Thus, it is unclear whether these fraud prevention measures are still mandatory.

Whether or not these fraud prevention measures are in effect, fraud is still a significant issue with respect to RALs. Gary Bell, Director of the IRS Criminal Investigation Division's Refund Crimes Unit, noted that currently 80% of fraudulent e-filed returns are tied to a RAL or other refund financial product.⁸¹ Furthermore, fraud appears to have increased since the debt indicator was reinstated. Bell noted that e-file fraud had increased by more than 1,400 percent

⁷⁴ Malcolm Sparrow, *Fraud in the Electronic Filing Program: A Vulnerability Assessment Prepared for the Internal Revenue Service*, September 1, 1994. Robert D. Hershey, *I.R.S. Fraud Found to Net Big Refunds*, New York Times, October 6, 1994, at A21.

⁷⁵ George Guttman, *Improper Refunds Sapping Billions*, 66 Tax Notes 19, October 3, 1994, at 23.

⁷⁶ *Id.* Note that tax refund fraud is often perpetrated, not by taxpayers, but by unscrupulous preparers. The taxpayer is often herself a victim of the fraud.

⁷⁷ John Tighe & Linda Lacewell, Tax Litigation – Interview with Loretta C. Argrett – Part II, New York Law Journal, July 17, 1997. See also *NACTP Steps Up Communication Efforts*, Accounting Today, August 21, 1995, at S22.

⁷⁸ Internal Revenue Service, Announcement of Opportunity to Obtain a Debt Indicator in a Pilot Program for Tax Year 1999 Form 1040 IRS E-file and On-Line Returns, 64 Fed. Reg. 67,621 (December 2, 1999).

⁷⁹ IRS Publication 3614, Application for Memorandum of Agreement – Debt Indicator.

⁸⁰ IRS Publication 1345A - Filing Season Supplement for Authorized IRS e-file Providers (Rev. January 2002).

⁸¹ Allen Kenney, *IRS Official Shines Spotlight on E-Filing Fraud*, 2004 Tax Notes Today 130-4, July 6, 2004.

since 1999 (when the debt indicator was reinstated), and that approximately 1 in every 1,200 e-filed returns was phony, compared with a rate of about 1 in every 5,000 four years ago.⁸²

The Treasury Department's Financial Crimes Enforcement Network (FinCEN) has raised similar concerns about the role of RALs in promoting tax fraud. FinCEN issued a warning to banks in August 2004, regarding RAL fraud.⁸³ In this report, FinCEN also noted that RAL fraud had multiplied between 2000 and 2003.⁸⁴ FinCEN noted that "To make this type of loan appealing to the public, funds are made immediately available, leaving little time for the lender to perform due diligence to prevent fraud."⁸⁵ As one commentator noted, the IRS has a fraud detection system, but "it may take the IRS three or more weeks to process the return, especially in the peak of the spring filing season. Meanwhile, the RAL lenders have processed the loan within a couple of days of the return being filed, the money is in the hands of the bad guys, and they can disappear without a trace,..."⁸⁶

G. Conclusion

As it did in 1994, the IRS should terminate the debt indicator. The program represents a form of corporate welfare and government subsidy of an industry already rolling in profits from making usurious loans to low-income taxpayers. It has increased profits for the RAL industry, while resulting in no permanent price decreases for consumers. Not only does the RAL industry siphon off hundreds of millions of tax dollars by skimming the Earned Income Tax Credit from working poor families, the IRS abets this drain and makes it more profitable by conducting part of the RAL lenders' credit checks using taxpayer-funded resources. Furthermore, the debt indicator represents even more of a subsidy, in that it generates more fraud related to RALs, which the IRS must spend enforcement dollars to address.

⁸² *Id.*

⁸³ FinCEN, SAR Activity Review, Issue 7, August 2004, at 15, *available at* www.fincen.gov/sarreviewissue7.pdf.

⁸⁴ *Id.* at 17.

⁸⁵ *Id.* at 17.

⁸⁶ Gail Perry, *Electronic Filing Fraud: Latest Tax Scam's Got Legs*, Accounting Today, August 9, 2004, at 3.