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The Internal Revenue Service's Free File Program (FFP): Current Status and Policy Issues

The option to electronically file (e-filing) federal individual income tax returns began in 1986. Since then its usage has grown considerably. As of July 28, 2022, 99% of such returns for the 2021 tax year had been e-filed.

E-filing has advantages for both tax administrators and taxpayers. Generally, e-filing substantially lowers the cost of processing returns and leads to fewer error rates. E-filing also speeds up the processing of tax refunds for individuals, allowing them to receive refunds sooner than they would if they were to file a paper return.

The IRS has been actively promoting e-filing for individuals, businesses, and tax practitioners since the late 1990s. A key element of this strategy is the Free File Program (FFP). The program permits individuals, regardless of filing status, with adjusted gross incomes (AGIs) at or below a specified amount (\$73,000 in the 2021 tax year) to e-file their federal income tax returns, free of charge, using software provided by participating tax preparation companies; there were eight such member companies at the start of the 2022 filing season. The IRS provides a portal on its website for eligible taxpayers to access the FFP. Taxpayers with AGIs above FFP limit may e-file their returns, free of charge, through the same portal using Free File Fillable Forms.

Origin of the FFP

The FFP has two sources. One was the IRS Restructuring and Reform Act of 1998 (RRA, P.L. 105-206). Among other things, the act directed the IRS to increase the share of e-filed individual returns to 80% by 2007, with assistance from the private sector. The e-filing rate was 23.5% in the 1998 tax year.

A second source was a directive issued in 2001 by the Office of Management and Budget's (OMB's) Quicksilver Task Force to implement President George W. Bush's E-Government Initiative. One of the 24 initiatives chosen by the task force was the EZ Tax Filing Initiative. It was intended to assist the IRS's efforts to achieve an 80% e-filing rate for individuals by 2007 by making electronic tax preparation and filing more accessible to paper return filers without requiring them or the federal government to pay for commercial tax services. The key to success, senior Treasury officials thought at the time, was for the IRS to establish a "single point of access" for lower- and middle-income taxpayers to free online tax preparation and filing services provided by tax software companies. (The IRS did not achieve its 2007 e-filing goal until 2012, when 83% of individual returns were e-filed.)

As a first step in implementing the EZ Tax Filing Initiative, the IRS tried to develop a digitized version of Form 1040 and accompanying schedules and instructions that could be accessed at no cost through WhiteHouse.gov. It soon became apparent that the IRS lacked the resources and expertise needed to launch such a project anytime soon. To overcome these obstacles, in January 2002, Treasury Secretary Paul O'Neill asked IRS Commissioner Charles Rossetti to form a partnership with tax software companies to develop a system managed by the IRS for providing free online tax preparation and filing services for lower-income taxpayers. The resulting private-public partnership was called the Free File Alliance (FFA).

Structure and Evolution of the FFP

The FFP began when the IRS signed an agreement with the 17 original FFA member companies on October 30, 2002. The agreement contained a clear division of authority and responsibility between the IRS and the participating companies.

The initial agreement required the companies to make available at no cost their tax preparation and filing services through IRS.gov to at least 60% of taxpayers, ranked by AGI. The companies retained complete control over the services they provided and eligibility requirements, except that each member company had to be capable of providing free filing services to at least 10% of individual tax returns filed for a year.

The IRS was responsible for enforcing member company compliance with the terms of the agreement. As a result, the agency was authorized to cancel the agreement with one year's advance notice, if it determined that member companies, over an extended period, were failing to provide adequate or required coverage.

The agreement involved a trade-off between increased access to e-filing for paper filers and the benefits from a free direct-filing option for all taxpayers through the IRS website. Under the agreement, the IRS pledged not to compete in the market for tax filing and preparation. In return, member companies agreed to offer free electronic tax preparation and filing services to low- to middle-income taxpayers. This meant that the IRS could not develop prefiled tax forms and make them available at no cost to taxpayers through its website.

The IRS and FFA (now known as Free File, Inc. or FFI) have extended and revised the original agreement five times. These subsequent agreements are linked to nine memoranda of understanding (MOU).

The second agreement (2005) reduced the range of free services a company could offer to eligible taxpayers, limited the share of eligible taxpayers a single company could serve to 50%, and increased the share of taxpayers eligible for free filing through the FFP to the bottom 70% of individuals ranked by AGI.

The 2009 agreement expanded the scope of the FFP by adding free fillable individual income tax forms to available services. Taxpayers of all income levels could file using these e-forms. The 2009 agreement also required FFA companies to embed a link to IRS.gov in their landing pages for the FFP.

The current agreement is due to expire on October 31, 2023. It includes provisions intended to raise taxpayer awareness of the program, encourage eligible taxpayers to regularly use it, and prevent participating companies from excluding their Free File landing pages from internet searches for the FFP. The agreement no longer specifies that the IRS should refrain from developing its own online direct filing system.

FFI's membership has shifted since 2020, as the two largest providers of tax preparation and filing services in the United States withdrew from the FFA: H&R Block in 2020 and Intuit in 2021. Together they handled about 70% of returns filed through the FFP for the 2019 tax year.

Use of the FFP

An ongoing concern with the FFP has been its low usage rates. In the first year of the program, 2.8 million individuals filed their tax returns through the FFP, or 3.5% of all eligible taxpayers. Use of the program peaked in FY2005, when 5.1 million individuals (or 6.4% of eligible taxpayers) filed through the FFP. From 2003 to 2019, an average of 2.8% of eligible taxpayers filed using the FFP. But usage rates rose for the 2019 and 2020 tax years. In 2019, FFP filers represented 2.4% of all individual filers; in 2020, that percentage grew to 2.7%. It is not entirely clear why the filing rate rose. Claims for the economic impact payments issued by the IRS in 2020 by individuals who normally do not file a tax return may have been a factor.

Policy Issues

The future of the FFP came into sharp focus in 2019. In April of that year, the House passed a bill (Taxpayer First Act, H.R. 1957) to reform various aspects of how the IRS interacts with taxpayers; one provision would have permanently extended the FFP, as it then existed. The provision triggered protests from some interest groups and lawmakers and led to a congressional debate on whether to codify the program, or to abolish it instead and allow the IRS to provide its own online filing and preparation services. Fueling the protests were certain media reports that some FFA companies earned revenue from FFP-eligible taxpayers by steering them to e-file using the firms' paid services. The 116th Congress eventually passed a similar bill, but without the FFP provision (P.L. 116-25).

Pros and Cons of Retaining the FFP

The FFP still operates, and the debate about whether to retain it still percolates. FFP proponents, led by the FFI

companies, say it should be kept, although not necessarily without changes, because it saves low- and middle-income taxpayers and the IRS considerable money each year. According to the FFI, taxpayers saved an estimated \$1.5 billion from 2003 to 2018 as a result of e-filing free through the FFP. Proponents also claim that the FFP has saved the IRS hundreds of millions of dollars in processing costs.

FFP critics contend that the current program is too flawed to retain. They say member companies' websites for FFP filing are too complicated and in some cases deceiving; the program's take-up rate is too low; and the IRS has not done enough to promote the program, assess taxpayers' experiences with it, and monitor member companies' compliance with the current agreement. Critics are also concerned that some FFI companies may continue to use the FFP as a marketing tool for their paid filing services to FFP-eligible taxpayers. In a 2020 report, the Treasury Inspector General for Tax Administration found that over 34.5 million FFP-eligible taxpayers e-filed their returns by using member companies' commercial software in FY2019.

Reforming the FFP

Some argue that the FFP should be retained, but only if certain changes are made in its operation. These changes would require the IRS to invest more in promoting the FFP among eligible taxpayers, and to more closely monitor member companies' compliance with the current MOU. In addition, reform proponents contend the MOU should be revised to require member companies to disclose to the IRS any revenue they receive from marketing their paid services to FFP-eligible taxpayers.

Return-Free Filing

Others argue that the FFP should be replaced with a federal tax return filing system that simplifies the process, especially for taxpayers with uncomplicated tax situations. This could be done by allowing the IRS to prefill returns for individuals whose income is reported to the IRS by third parties; the returns would be electronically sent to taxpayers for their review; recipients would either accept the IRS-generated returns or reject them and file their own returns. Two other options for simplifying the filing process would be for the federal government to adopt a return-free filing system based on exact withholding or one based on tax-agency reconciliation.

Direct E-Filing with the IRS

Another simplification option is to replace the FFP with a free, direct e-filing system managed by the IRS. P.L. 117-169, commonly known as the Inflation Reduction Act, provides the IRS with \$15 million to study the cost of developing and operating a direct e-filing system that includes "multi-lingual and mobile-friendly features and safeguards for taxpayer data." The act requires the IRS to consider taxpayers' level of trust and expectations for a direct-file system, as well as the views of independent third-party entities on the cost, feasibility, and design of a direct e-file tax return system, and the ability of the IRS to "deliver" such a system.

Gary Guenther, Analyst in Public Finance

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