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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 October 28, 2022, nearly 92% 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 2022 tax year) to e-file their federal income tax returns, free of charge, using software provided by participating tax preparation companies; there are seven such member companies at the start of the 2023 filing season. The IRS provides a secure portal on its website for eligible taxpayers to access the FFP. Taxpayers with AGIs above the FFP limit may e-file their returns, free of charge, through the same portal using Free File Fillable Forms, which are electronic versions of tax forms and schedules.

Origin of the FFP

The FFP has two sources. One was the IRS Restructuring and Reform Act of 1998 (RRA, P.L. 105-206). 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 1998.

A second source was a 2001 directive issued 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 help the IRS achieve an 80% individual e-filing rate by 2007 by making electronic tax preparation and filing more accessible to paper return filers through a partnership with the private sector.

The key to success, according to senior Treasury officials involved in the initiative, was that the IRS 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.)

To implement the EZ Tax Filing Initiative, the IRS first tried to develop digitized versions of Form 1040 and accompanying schedules and instructions that could be accessed at no cost through WhiteHouse.gov. When it became apparent that the IRS lacked the resources and expertise needed to complete such a project anytime soon, Treasury Secretary Paul O'Neill asked IRS Commissioner Charles Rossetti in January 2002 to form a partnership with tax software companies to develop a free online filing system that would be managed by the IRS for low-income taxpayers, who were most likely to file paper returns. The resulting private-public partnership was initially called the Free File Alliance (FFA); it is now known as Free File, Inc. (FFI).

Structure and Evolution of the FFP

The FFP began when the IRS signed an agreement with the 17 original FFI member companies on October 30, 2002. It laid down 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 based on age, income, and state residence. To join the program, each company had to be capable of providing free filing services to at least 10% of individual filers.

Under the agreement, the IRS was responsible for enforcing member company compliance with the terms of the agreement. The agency could cancel the agreement with one year's advance notice, if it determined that most member companies were not providing adequate coverage.

A key element of the agreement was an IRS pledge to refrain from competing in the commercial market for tax filing and preparation. Keeping the IRS out of that market was a major objective of member companies. In return, member companies agreed to provide free electronic tax preparation and filing services to low- to middle-income taxpayers, giving the IRS another avenue for expanding individual e-filing.

The IRS and 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 online taxpayer services. Taxpayers of all income levels could file using these e-forms. The agreement also required FFI companies to embed a link to IRS.gov in their landing pages for the FFP.

The current MOU 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. In a significant shift, the MOU no longer specifies that the IRS should refrain from developing its own electronic direct filing system through its website.

FFI's membership has shrunk since 2020. 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. Usage rose to 4.0% of eligible taxpayers for the 2020 tax year. It is not entirely clear what drove the increase. Some maintain that 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 became an issue for Congress in 2019. In April, 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 opposition from some interest groups and lawmakers and led to a congressional debate on whether to codify the program or abolish it and allow the IRS to provide its own online filing and preparation services. Fueling the opposition were 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 its future still simmers. FFP proponents, including 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 through the FFP. Proponents

also claim that the FFP has saved the IRS hundreds of millions of dollars in processing costs.

FFP critics say 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 remains unacceptably low; and the IRS still 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 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 MOU. In addition, proponents say that 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

Critics of the FFP contend that it should be replaced with an IRS-managed filing system that simplifies the process, especially for taxpayers with uncomplicated tax situations. This could be done by having the IRS prefill returns for individuals whose entire 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. Another option for simplifying the filing process would be for the IRS to adopt a return-free filing system based on either exact withholding or 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, provided the IRS with \$15 million to study the feasibility of developing and operating a direct e-filing system that includes "multi-lingual and mobile-friendly features and safeguards for taxpayer data." The act required 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.

It is unclear whether such a filing option will be available anytime soon. The IRS has not issued the IRA-mandated study, and there is some continuing opposition in Congress to the IRS playing such a direct role in tax return filing.

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