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

The Internal Revenue Service first allowed individual income tax returns to be filed electronically (e-filed) through a pilot program involving five tax preparers during the 1986 tax filing season. Since then, e-filing has grown to the point that 97% of individual tax returns for the 2022 tax year were e-filed.

E-filing has advantages for both tax administrators and taxpayers. For the former, e-filing substantially lowers the cost of processing returns and results in lower error rates, relative to paper returns. For the latter, e-filing allows individuals to receive a tax refund sooner than they would with a paper return.

A key element of the IRS's efforts to promote e-filing is the Free File Program (FFP). The FFP makes it possible for individuals, regardless of filing status, with adjusted gross incomes (AGIs) at or below a specified amount (\$79,000 in the 2023 tax year) to e-file their federal income tax returns, free of charge, using software provided by participating tax preparation companies. Seven such companies participated in the FFP during the 2024 filing season. Taxpayers wishing to file through the FFP must use a secure portal on the IRS's website to access the websites of participating companies. Taxpayers with AGIs above the FFP limit may e-file their returns free of charge through the same portal, using a service called Free File Fillable Forms.

Origin of the FFP

The FFP has its origin in 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 from 23% in 1998, with input from the private sector.

A second source was a 2001 directive from the Office of Management and Budget's (OMB's) Quicksilver Task Force implementing President George W. Bush's E-Government Initiative. The taskforce identified 24 projects to achieve the initiative's main objectives, one of which was the EZ Tax Filing Initiative. It was intended to help the IRS reach an 80% individual e-filing rate by 2007 by drawing on the experience and resources of tax preparation software companies.

Initially, the IRS tried to accomplish the aims of the EZ Tax Filing Initiative by developing digitized versions of Form 1040 and related schedules and instructions that could be accessed at no cost through WhiteHouse.gov. When it became apparent that the IRS would not complete this project anytime soon, Treasury Secretary Paul O'Neill asked IRS Commissioner Charles Rossetti in January 2002 to establish 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), which is now known as Free File, Inc. (FFI).

Despite this collaboration, the IRS did not achieve the 2007 e-filing goal until 2012, when 83% of individual returns were e-filed.

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.

The agreement laid down a clear division of authority and responsibility between the IRS and the member companies. It required the companies to provide their tax preparation and filing services through IRS.gov at no cost to the bottom 60% of individual taxpayers, ranked by AGI. The companies, not the IRS, set the eligibility requirements for free filing based on a taxpayer's age, income, and state residence. To participate in the FFP, a company had to prove that it was capable of providing such a filing service to at least 10% of individual filers.

The agreement made the IRS responsible for enforcing member company compliance with the terms of the agreement. The agency had the authority to cancel the agreement with one year's advance notice, if it determined that member companies were failing to provide the required coverage.

A controversial element of the agreement was a commitment by the IRS to not compete in the market for tax filing and preparation. Preventing the IRS from becoming a competitor was a major incentive for tax software companies to create and participate in the FFP.

The IRS and FFI have extended and revised the original agreement five times. These subsequent agreements are linked to various memoranda of understanding (MOU) intended to implement the revised agreements.

The second agreement (2005) reduced the free services a member company could offer eligible taxpayers, including refund anticipation loans. In addition, the agreement barred any member company from providing free filing to more than 50% of eligible taxpayers, 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 making free fillable individual income tax forms available

to any taxpayer, regardless of income, through the IRS's Free File portal. The agreement also required FFI companies to embed a link to IRS.gov in their FFP online landing pages.

The current MOU has been extended to October 31, 2029. 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 FFP internet searches. And in a significant departure from previous rules, the MOU contains no commitment from the IRS to not develop its own free direct e-filing system.

Use of the FFP

A perennial concern with the FFP has been low usage rates among eligible taxpayers. In FY2002, the first year of the program, 2.8 million individuals (3.5% of eligible taxpayers) filed their tax returns through the FFP. To date, use of the program reached a peak in FY2005, when 5.1 million individuals (6.4% of eligible taxpayers) filed through the FFP. Between FY2003 and FY2019, 2.8% of eligible taxpayers, on average, filed using the FFP. Usage jumped to 4.0% of eligible taxpayers in FY2020, driven in part by low-income taxpayers who usually file no returns claiming the economic impact payments managed by the IRS.

Policy Issues

Concerns about the FFP's performance surfaced during congressional consideration in 2019 of a bill to reform certain aspects of IRS's taxpayer service. In April of that year, the House passed a bill (the Taxpayer First Act, H.R. 1957) to strengthen and codify taxpayer rights and further transform the IRS into a customer-friendly agency. One provision would have codified the existing FFP, which would have permanently barred the IRS from providing its own direct e-file service.

The prospect of a statutory ban on an IRS direct-file tool triggered a vigorous debate over the pros and cons of such a step. Opposition from some interest groups and lawmakers led to the enactment of a version of the bill (P.L. 116-25) without the controversial provision. The amended Free File MOU adopted in 2019 removed the provision barring the IRS from developing its own direct-file tool.

Adding to this opposition were media reports (mainly from ProPublica) that some FFI companies had steered FFP-eligible taxpayers to using the firms' paid services.

Pros and Cons of Retaining the FFP

FFP proponents, including FFI companies, argue that the program should be retained because of its significant cost savings. According to one estimate, FFP filing saved taxpayers \$1.7 billion in tax preparation and filing fees and saved the IRS hundreds of millions of dollars in processing costs from 2002 to 2018. Another reason to retain the FFP is the advanced technology embedded in the program.

FFP critics say the FFP has too many flaws and should be replaced by an IRS direct-file tool open to all taxpayers, regardless of income. Among the problems cited by critics

are that (1) member company webpages for FFP filing are confusing and in some cases misleading; (2) the program's take-up rate remains too low; and (3) the IRS still invests too little in promoting the program, assessing taxpayers' experiences with it, and monitoring member company compliance with the existing MOU.

Critics also say that the program allows FFI companies to divert FFP-eligible taxpayers to using their paid filing services. 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 company paid services in FY2019.

Reforming the FFP

Some argue that the FFP should be retained, but only if certain changes are made in its rules and procedures. These changes would require the IRS to invest more in promoting the FFP among eligible taxpayers and in monitoring member company compliance with the MOU. In addition, some argue 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

Some advocate replacing the program with an IRS e-filing service that simplifies the process, especially for taxpayers with simple tax situations. One option would allow the IRS to send prefiled returns to taxpayers whose income is reported to the IRS by third parties; recipients could accept the prefiled return or reject it and file their own return.

Free Direct E-Filing with the IRS

Some FFP critics call for replacing or supplementing it with a free direct-file system managed by the IRS. P.L. 117-169, commonly known as the Inflation Reduction Act (IRA), provided the IRS with \$15 million to study the feasibility and cost of developing and operating a direct-file tool that offered "multi-lingual and mobile-friendly features and safeguards for taxpayer data." The IRS and an independent third party issued reports in May 2023 addressing these issues. The IRS found that 72% of a survey group expressed an interest in using an IRS direct-e-file system; it estimated that the annualized cost of developing and operating such a system may range from \$64 million to \$249 million, depending on the number of users and the complexity of their returns.

During the 2024 filing season, the IRS operated a pilot program that allowed specified taxpayers in 12 states to e-file their returns directly with the IRS. Participants were restricted to taking the standard deduction and to reporting income from wages, Social Security and unemployment benefits, and up to \$1,500 in interest earnings. The IRS is evaluating the results and intends to decide soon whether to offer the pilot again during the 2025 filing season.

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