



*Additional Action Is Needed to Expand the
Use and Improve the Administration of the
Free File Program*

June 28, 2007

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 28, 2007

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

A handwritten signature in black ink, appearing to read "Michael R. Phillips".

FROM: (for) Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Action Is Needed to Expand the Use
and Improve the Administration of the Free File Program
(Audit # 200640033)

This report presents the results of our review to determine how effectively the Internal Revenue Service (IRS) is administering the Free File Program.¹ This review is a continuation of our earlier work on the Free File Program² and was conducted to address concerns raised by the Senate Finance Committee; the House Ways and Means Committee, Subcommittee on Oversight; and the IRS National Taxpayer Advocate.³

Impact on the Taxpayer

The Free File Program accounts for a small portion of individual tax returns filed. Only 3 percent of individual taxpayers used the Free File Program in 2006. The IRS has made some improvements to the Program, including removing offers for Refund Anticipation Loans and other collateral solicitations, and most taxpayers who used the Free File Program to prepare and file their tax returns were satisfied with it. While the IRS has taken steps to effectively administer the Program, additional actions are needed to improve its usability and marketing.

¹ The IRS established the Free File Program to allow taxpayers meeting certain income requirements to electronically prepare and file their individual income tax returns free of charge.

² *Use of the Free File Program Declined After Income Restrictions Were Applied* (Reference Number 2006-40-171, dated September 29, 2006).

³ The Taxpayer Advocate Service is an IRS program that provides an independent system to ensure tax problems not resolved through normal channels are promptly and fairly handled.



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Synopsis

The IRS administers the Free File Program as a partnership with a consortium of tax software providers called the Free File Alliance, which provides free electronic tax return preparation and filing services for the Program.

The IRS can do more to evaluate and promote the Free File Program. While it has taken steps to evaluate the experience of Program users, it has not collected data about taxpayers who attempted to use the Program but did not or could not complete and file their tax returns or eligible taxpayers who do not use the Program. Of the 93 million taxpayers eligible for the Program in Calendar Year 2006, only 4.2 percent (3.9 million) used it. For the same year, the Program accounted for only about 3 percent of all individual tax returns filed (compared to the 44 percent filed on paper). The IRS cannot make sound decisions on the success of the Program without complete and accurate data about taxpayers' experiences, including information on why taxpayers are not using it. We believe the IRS could expand use of the Program by focusing its marketing efforts on eligible nonusers who filed paper returns.

The IRS has taken steps to effectively administer the Free File Program. It conducts ongoing reviews of the individual Alliance members' compliance with the Free File and Operating Agreements governing the Program. For the first time since the Program's inception, the IRS had the ability to independently gather data about taxpayers who used the Program. To evaluate taxpayers' experiences, the IRS conducted a Free File Program satisfaction survey, which indicated that 94 percent of all Program users found it easy to use. Due to concerns raised about the Program, the Alliance agreed to remove all ancillary products, including Refund Anticipation Loans, from the Program. Although the IRS has taken steps to effectively administer the Program, its efforts can be improved.

The IRS' oversight reviews of the Alliance members were not fully documented. Alliance members also incorrectly included the new Free File Indicator on approximately 37,000 returns the taxpayers had actually paid to prepare and file. IRS procedures for conducting the compliance reviews were incomplete, and the IRS did not have a formal process in place to validate the accuracy of the Free File Indicator. Without proper oversight of the Alliance, it cannot ensure the Program is providing the expected benefits to its intended recipients.

The Free File Program software did not always accurately compute taxes due, and the *Guide Me To A Company* feature that helps taxpayers select a Program vendor was not always complete or accurate. Errors and omissions in the tax preparation software and the tools provided by the IRS to aid taxpayers when using the Program could undermine taxpayers' confidence in the Program and negatively affect the IRS' efforts to reach its goal of increasing the use of electronic filing.

To identify other potential free tax return filing options available to the IRS, we visited the State tax agencies for California, Kansas, Missouri, and Pennsylvania to discuss their free electronic filing programs. The two programs that appeared to be the most feasible were direct filing and



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2-D Barcoded returns. Direct filing is an Internet-based filing option that allows a taxpayer to file a State tax return directly with the State, without using third-party software. A 2-D Barcoded return is prepared using tax preparation software. The IRS is in the process of modernizing its electronic filing program through its Modernized *e-File*⁴ Project. However, IRS officials indicated they have decided not to pursue 2-D Barcode technology at this time. Instead, the 2-D Barcode technology will be considered as part of a larger Modernized Submission Processing effort that will not begin until 2010 or later. Neither the Modernized *e-File* Project nor the 2-D Barcode filing option will eliminate the need for third-party involvement in the electronic filing process.

Recommendations

We recommended the Director, Electronic Tax Administration, (1) develop a comprehensive plan to evaluate and promote the Free File Program; (2) expand IRS marketing of the Program by directing promotional materials to taxpayers who are eligible for the Program but have filed their returns on paper; (3) establish a process to assess the accuracy of the Free File Indicator early in the filing season;⁵ (4) establish a process to test the software used in the Program before the filing season, to ensure common tax scenarios are handled accurately; and (5) work with the Alliance to expand the *Guide Me To A Company* feature to include a description of special tax situations (e.g., Earned Income Tax Credit, Retirement Savings Contribution Credit,⁶ casualty losses) supported by each Alliance member.

Response

IRS management agreed with four of our five recommendations. The IRS will develop a comprehensive marketing plan for the Free File Program and will consider surveying eligible taxpayers who were either unsuccessful or chose not to use the Program. The IRS will also expand its marketing of the Free File Program by directing promotional materials to eligible taxpayers who filed their returns on paper. Finally, the IRS indicated it would work with the Alliance to analyze the Free File Indicator and identify possible solutions to increase its accuracy and establish a process to assess the Indicator's accuracy early in the filing season. Management did not agree with our recommendation to establish a process to test the software used in the Free File Program to ensure common scenarios are being handled accurately. Management stated the IRS already reviews the accuracy of Alliance members' software to ensure it operates within the parameters of the Free File Agreement, and other tests ensure these electronic returns are compatible with IRS system requirements. However, these tests do not assess the accuracy of

⁴ Electronic filing (*e-file*).

⁵ The period from January through mid-April when most individual income tax returns are filed.

⁶ A credit aimed at promoting tax-qualified retirement savings for middle- and low-income workers.



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applying the tax law. Management stated testing of commercial tax preparation software to determine its accuracy in applying the tax law would be a monumental challenge for the IRS. Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comment

We agree that performing a quality review of all commercial tax preparation software to ensure proper application of all tax laws would not be feasible. However, some quality review of the software associated with the Program is warranted. The Free File Program is an IRS-sponsored program. As such, taxpayers may assume the products they are using as part of the Program are endorsed by the IRS. We are not suggesting the IRS review the Alliance members' software for all aspects of the tax law. Many Program users have common tax issues that should be reviewed, such as claiming dependents, personal exemptions, and tax credits like the Child Tax Credit and the Earned Income Tax Credit. The IRS could easily review the products used as part of the Free File Program for these issues. We reviewed the Alliance members' software for several conditions using simple tax scenarios and limited staff. The IRS indicated it communicates with Free File members when a specific problem is identified, sharing suggestions for correction. However, the Free File Agreement does not require the member to correct those errors. When we notified the IRS of the software errors we had identified, the IRS stated it would notify the applicable members. However, these errors still had not been corrected when we re-tested the members' software in February 2007.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 622-5916.



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Abbreviations

AGI	Adjusted Gross Income
<i>e-file; e-filing</i>	Electronic filing
IRS	Internal Revenue Service
RAL	Refund Anticipation Loan



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Background

The Free File Program (the Program) is a service provided by the Internal Revenue Service (IRS) that allows taxpayers meeting certain income requirements to electronically prepare and file their U.S. Individual Income Tax Returns (Form 1040) free of charge. The IRS partnered with a consortium of tax software companies known as the Free File Alliance, whose members offer tax preparation software accessible to taxpayers from a personal computer. Taxpayers access the software through the Free File Program webpage on the IRS Internet web site, IRS.gov (see Figure 1), where they can prepare and file their returns electronically. The Program made its debut in January 2003, and the number of returns filed through the Program grew from more than 2.79 million returns in Calendar Year 2003¹ to 5.12 million returns in 2005.

Figure 1: Free File Webpage

Source: IRS Free File Program webpage at IRS.gov.

¹ All dates in this report are calendar year unless otherwise stated.



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The IRS established the Free File Program in response to three tax-related reforms or initiatives.

- **The President's E-Government Initiative** – the objective of this Initiative was to make it easier for citizens and businesses to interact with the Federal Government, save taxpayer dollars, and streamline citizen-to-Government transactions.
- **The Office of Management and Budget EZ Tax Filing Initiative** – the objective of this Initiative was to make it easier for citizens to file taxes in a web-enabled environment; its intent was that citizens would no longer have to pay for basic, automated tax preparation.
- **The IRS Restructuring and Reform Act of 1998²** – this Act established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by the end of 2007 and required it to work with private industry to increase the use of electronic filing (*e-filing*).

In the initial Free File Agreement between the IRS and the Alliance, the Program was offered to at least 60 percent of individual taxpayers. However, the Agreement did not prevent the Alliance members from offering free services through the Program to all individual taxpayers, and in 2005 some of the Alliance members opened their offers to all individual taxpayers. The IRS and the Alliance amended their Agreement in October 2005. The new Agreement restricted eligibility for the Free File Program to no more than 70 percent of individual taxpayers, based on adjusted gross income (AGI).³ For returns filed in 2006, taxpayers were eligible to use the Program only if their AGI was \$50,000 or less.⁴ While this still left 93 million taxpayers eligible to use the Program, participation fell by more than 1 million tax returns (from 5.12 million returns in 2005 to 3.9 million in 2006).

In January 2006, the Chairman of the House Ways and Means Committee, Subcommittee on Oversight, asked the Treasury Inspector General for Tax Administration to assess the impact on taxpayer service and *e-filing* resulting from changes in the Free File Agreement. In September 2006, we reported that the Free File Program no longer met the intent of the E-Government and EZ Tax Filing Initiatives to provide free tax preparation and filing services to all citizens. Changes in the scope of the Free File Agreement had eliminated approximately 39 million taxpayers from eligibility for the Program.⁵

This review was performed to further evaluate the Free File Program; it included an evaluation of the effectiveness of the IRS' oversight of the Program, taxpayers' experiences when using the

² Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

³ AGI is income less certain deductions and/or expenses.

⁴ The AGI limit may increase or decrease from year to year depending on the AGI level that corresponds to 70 percent of taxpayers.

⁵ *Use of the Free File Program Declined After Income Restrictions Were Applied* (Reference Number 2006-40-171, dated September 29, 2006).



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Program, characteristics of taxpayers participating in the Program, and whether there are other viable free filing options. We performed our review at the IRS National Headquarters in Washington, D.C., in the Office of Electronic Tax Administration. We also discussed free filing options with officials from the California Franchise Tax Board, Kansas Department of Revenue, Missouri Department of Revenue, and Pennsylvania Department of Revenue. The audit was conducted during the period May through December 2006 and in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



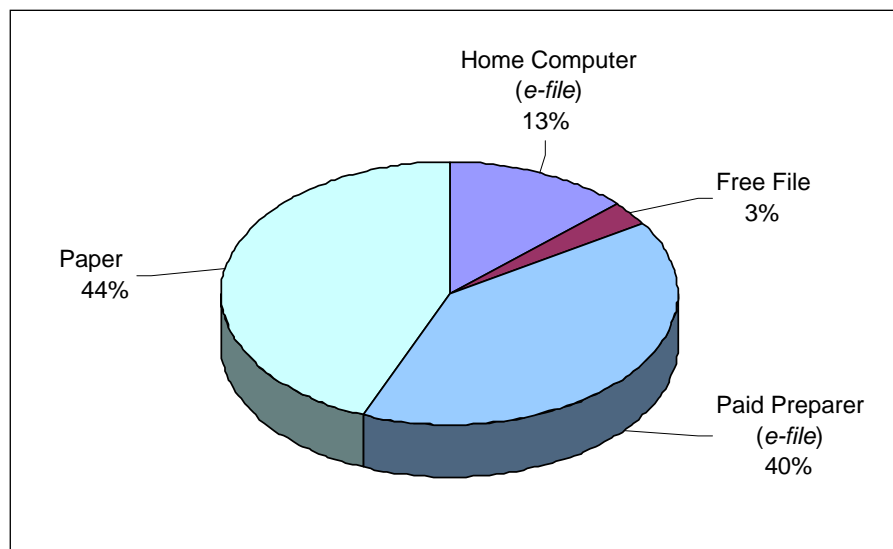
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Results of Review

The Internal Revenue Service Can Do More to Evaluate and Promote the Free File Program

Compared to other methods of filing, the Free File Program accounts for a small portion of individual tax returns filed. Only 3 percent of individual taxpayers used the Free File Program in 2006. Figure 2 shows the percentage of individual tax returns filed by filing method. Use of the Program had been growing until 2006, when income restrictions were implemented. In 2006, the overall use of the Program declined; this was in marked contrast to overall *e-filing*, which increased by 6.4 percent. Decline in Program use appears to be continuing in 2007, as only 3.3 million taxpayers had used the Free File Program as of April 14, 2007, a decline of 4.7 percent from the same time last year.

Figure 2: Filing Method of All Individual Taxpayers in 2006



Source: IRS report on filing statistics entitled "2006 Filing Season Data."

One of the purposes of the Free File Program is to bring new taxpayers into the IRS *e-filing* program. Despite lower overall use of the Program in 2006, there is indication it is helping some taxpayers to convert from filing paper returns to filing electronic returns: 24 percent (819,000 taxpayers) of the Program's users in 2006 were first-time electronic filers.



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Survey of Free File Program users

The IRS contracted with a marketing research company to perform a Free File Program satisfaction survey⁶ for the 2006 Filing Season⁷ to measure taxpayers' experiences with the Program. The company surveyed by telephone 2,980 of the 3.9 million taxpayers who had successfully prepared and filed their returns through the Program, to learn more about their experiences. The objectives of the survey were to:

- Determine how taxpayers were introduced to the Program; their reasons for choosing the Program; how they used it; and how they perceived the product in terms of its ease of use, use of specific product features, and satisfaction with the usage experience.
- Provide results that can be used to assist the IRS with making policy decisions related to expanding the use of *e-filing* and to indicate appropriate, focused marketing strategies.

The survey showed 94 percent of taxpayers who used the Program believed it was easy to use, and 94 percent stated they would use it again next year. The IRS has used the survey's results recently to demonstrate the success of the Program.

While there are benefits in evaluating the user satisfaction rate, we believe the survey is of limited use in helping the IRS improve and market the Program. The survey results do not reflect the experiences of those taxpayers who tried to use the Program but could not or did not complete and file their tax returns. In addition, the survey did not include taxpayers who are eligible for the Program but did not attempt to use it. To improve the Program, it is important for the IRS to understand why some taxpayers tried but could not or chose not to complete and file their returns and why so many eligible taxpayers did not even try to use the Program.

A change in marketing emphasis should be considered

We analyzed data for taxpayers who (1) used the Free File Program and (2) were eligible to use the Program but did not in 2006 (see Appendix V for details). Our analyses pointed to three main barriers to use of the Program: awareness, computer literacy, and return complexity. The Program's low participation rate may be an indicator that few taxpayers know about or understand that they may be eligible for the Program. The IRS recently conducted focus groups of taxpayers and also found that awareness was one of the main challenges facing the Program.

Younger taxpayers tend to be more knowledgeable about computers and are more likely to use them to conduct business. According to a Department of Commerce study,⁸ 70 percent of individuals between the ages of 18 and 24 are most likely to use a computer. As shown in Figure 3, most Free File Program users are in the younger age ranges.

⁶ 2006 *Free File Cognitive & Behavioral Research*.

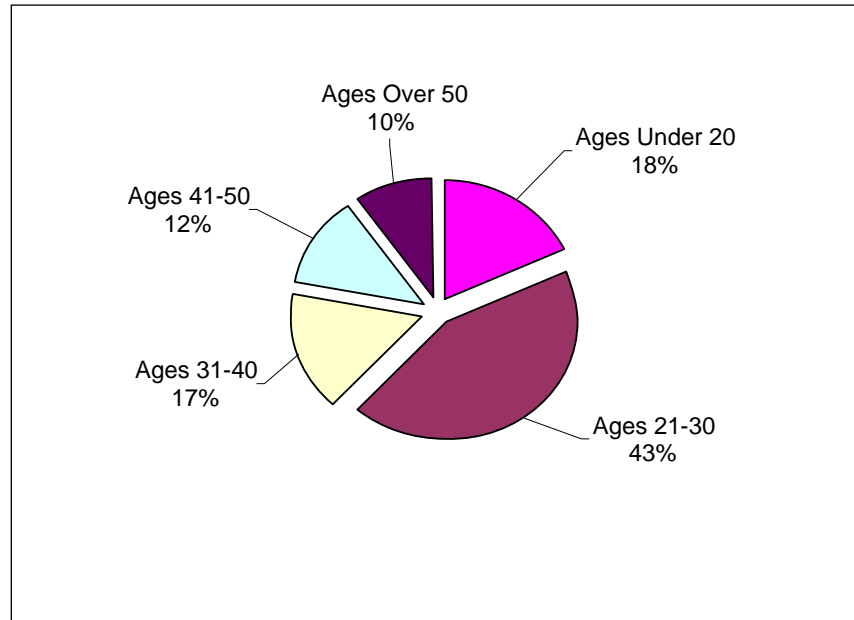
⁷ The filing season is the period from January through mid-April when most individual income tax returns are filed.

⁸ *A Nation Online: Entering the Broadband Age*, dated September 2004.



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Figure 3: Age of Free File Program Users



Source: Our analysis of taxpayer data.

The type of return a taxpayer filed also appeared to be a factor in whether the taxpayer participated in the Free File Program. Most Program users filed fairly simple returns without any supporting schedules or forms. The more complex a return is, the more likely a taxpayer is to seek the help of a professional or use a tax software package when preparing his or her return. When we analyzed the data for taxpayers who were eligible for, but did not use, the Program, we found 85 percent (68 million taxpayers) had used a paid professional or a tax software package to prepare their returns in 2006. Of those, 31 percent filed their returns on paper. Some taxpayers use software to prepare their returns but file the returns on paper because they do not want to pay to file their returns electronically; others are concerned with the security of the *e-filing* system.

The IRS has limited funds available to promote its various programs; however, because electronically filed returns cost less for the IRS to process, funds used to market the Free File Program could be used to help the IRS lower its annual processing costs. The IRS significantly expanded its marketing efforts for the Free File Program in 2007, spending approximately \$1.5 million for a marketing firm to develop and coordinate its Program marketing. One marketing tool used was Internet banner advertising on common web sites. The IRS indicated that this type of marketing is very expensive and a limited marketing budget restricts its ability to use these methods effectively. While it may be one way to reach a large number of taxpayers, Internet marketing does not appear to be the best method to promote the Free File Program to taxpayers who are filing paper returns.



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Furthermore, the majority of IRS marketing was in the form of press releases and other media sources. However, the IRS' 2006 Free File Program satisfaction survey indicates only 9 percent of taxpayers who used the Program learned about it through the media. Many of the users (40 percent) learned about the Program from the IRS web site or IRS materials.

Given the limited use of the Program, a change in marketing emphasis should be considered. The IRS successfully directed marketing in the past when it first started the TeleFile Program. The IRS sent TeleFile packages to taxpayers who, based on their income and filing patterns, appeared to be eligible to use TeleFile. Such a direct-mail approach with the Free File Program may be the best avenue to reach eligible taxpayers.

We evaluated the characteristics of 34.6 million taxpayers who met the eligibility requirements for the Free File Program but filed paper tax returns. Approximately 6 million (17 percent) of these taxpayers had characteristics similar to those of the "typical" Program users (Single or Head of Household filing status taxpayer between the ages of 18 and 28, AGI of \$30,000 or less, 1 or no dependents, and no supporting schedules or forms). These taxpayers may be the most likely to convert from paper to *e-filing* through the use of the Program. Moreover, the IRS may be able to encourage taxpayers who file more complex paper returns to convert to *e-filing* by emphasizing that common forms and supporting schedules can be filed using the Program.

Recommendations

Recommendation 1: The Director, Electronic Tax Administration, should develop a comprehensive plan to evaluate and promote the Free File Program, including (to the extent possible) conducting a survey of taxpayers who tried to use the Program but were unsuccessful and taxpayers who were eligible for but chose not to use the Program.

Management's Response: IRS management agreed with this recommendation and plans to develop a comprehensive marketing plan for the Free File Program. They also plan to consider conducting a survey of taxpayers who tried to use the Program but were unsuccessful and taxpayers who were eligible for but chose not to use the Program.

Recommendation 2: The Director, Electronic Tax Administration, should expand the marketing of the Free File Program by directing promotional materials to taxpayers who are eligible for the Program but have filed their returns on paper. For example, the IRS could send taxpayers who filed paper tax returns but appear to be eligible to use the Program a postcard notifying them they may be eligible to prepare and file their returns electronically for free. The IRS could also publicize the Program during interactions with taxpayers who call into the toll-free telephone lines or visit Taxpayer Assistance Centers⁹ with tax return questions.

⁹ Taxpayer Assistance Centers are a taxpayer's source for personal tax help when his or her tax issue cannot be handled online or by telephone and the taxpayer wants face-to-face assistance.



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Management's Response: IRS management agreed with this recommendation and plans to expand the marketing of the Free File Program by directing promotional materials to taxpayers who are eligible for the Program but have filed their returns on paper. They also plan to consider expansion of Program marketing to programs available within the IRS, such as the toll-free telephone services and Taxpayer Assistance Centers.

Steps Have Been Taken to Improve the Administration of the Free File Program; However, Additional Actions Are Needed

Although the Alliance is responsible for providing the actual services for the Free File Program, the IRS is responsible for Program administration and oversight. Both the Free File Agreement and the Operating Agreement contain a number of criteria the Alliance members must satisfy to participate in the Program. The IRS reviews each Alliance member's web site before the filing season begins to ensure the member's free offering satisfies these guidelines. A member's free offering is not posted on IRS.gov until the member is in compliance. The IRS continues to review members' compliance with the Agreements throughout the filing season.

The IRS must also evaluate the Program's performance. In the 2006 Filing Season, for the first time since the Program started, the IRS was able to independently determine how many taxpayers used the Program. Beginning in 2006, the Alliance members included a Free File Indicator on each return filed through the Program. This Indicator allowed the IRS to determine how many taxpayers used the Program and to gather some general information about the characteristics of these taxpayers. The IRS also took the first step in evaluating taxpayers' satisfaction with the Program. In 2006, it conducted a satisfaction survey of Program users: 94 percent of the survey respondents believed the Program was easy to use, and 94 percent stated they would use it again next year.

Furthermore, to address the concerns of Congress and the National Taxpayer Advocate¹⁰ with the number of paid services the Alliance members were offering as part of the Free File Program, the IRS and the Alliance amended the Operating Agreement by agreeing to remove all ancillary products, including Refund Anticipation Loans (RAL), from the Program.

Reviews of individual Alliance member Free File Program web sites were not adequately documented

Alliance members' Free File Program web sites are not listed on IRS.gov until they meet certain requirements outlined in the Operating Agreement. IRS test results showed some Alliance members' web sites did not meet all requirements of the Operating Agreement, and some of the tests were incomplete. Because related documentation was not available, we were unable to

¹⁰ The Taxpayer Advocate Service is an IRS program that provides an independent system to ensure tax problems not resolved through normal channels are promptly and fairly handled.



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determine what actions the IRS took to ensure these conditions were corrected. Therefore, we could not verify whether the IRS adequately addressed all the conditions it had identified before the Alliance members' service offerings were posted on IRS.gov.

The Free File Agreement outlines standards of practice the Alliance is required to adhere to, including requirements that each Alliance member must:

- Provide a link to its Program web site to allow examination by the IRS. Annual IRS examinations include an assessment of the usability of the Alliance member's software program and compliance with the Operating Agreement.
- Disclose limitations of forms and schedules that are likely to be needed to support its free offering.
- Guarantee the calculations performed by its Federal Program offering.
- Clearly list its customer service options and associated fees.
- Have third-party security and privacy certifications.

The IRS tests each Alliance member's web site before it is listed on IRS.gov. The testing covers areas such as whether the member's Program Internet homepage conforms to the Free File Agreement and the Operating Agreement. In addition, the IRS reviews the member's tax preparation software to ensure it meets the requirements of the Operating Agreement. The software review is not intended to test for technical accuracy but rather to identify treatment of tax returns that qualify for the Free File Program as well as those that do not.

The IRS informed us that problems identified during its reviews of the Alliance members' web sites were investigated and resolved prior to the web sites being listed on the IRS Free File Program webpage. However, the actions taken to investigate or correct these problems were not documented.

According to the IRS, procedures and processes for reviewing Alliance members' web sites were being developed at the time the reviews were conducted for the 2006 Filing Season. There was no process to facilitate documentation of the actions taken to investigate or correct problems identified during its original review of Alliance members' web sites.

Management Actions: The IRS established new procedures for reviews beginning in 2007. These procedures are based on lessons learned to ensure each review guide is completed and any violations are documented. The procedures also ensure actions taken after a review are documented to show changes made, the date the change was verified, and the date the web site passed the IRS review.



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Alliance members incorrectly assigned Free File Indicators to some taxpayers who paid to file their returns

The Free File Indicator gives the IRS the ability to independently evaluate the success of the Program. However, the IRS must rely on Alliance members to assign the Indicator to each return filed through the Program. This Indicator shows the return was prepared and filed for free. We analyzed all returns filed in January through May 2006 that had a Free File Indicator and identified approximately 37,000 tax returns that had the Indicator on the returns even though these taxpayers had paid to prepare and file their tax returns. While the number of returns we identified is small compared to the 3.9 million taxpayers who used the Free File Program in 2006, the accuracy of the Indicator is crucial to the IRS' ability to accurately monitor and evaluate the success of the Program.

The IRS did not have a process in place to validate the Alliance members' programming of the Free File Indicator, to ensure it was properly programmed before the start of the 2006 Filing Season. After we notified the IRS of the issue, it contacted the Alliance about these returns. The Alliance stated almost 35,000 of the returns were the result of a programming error. Eleven of the 20 Alliance members had incorrectly programmed the Indicator, causing every return prepared from the members' Free File Program webpage to have an indicator, regardless of whether the return had qualified for the Program.

Any taxpayer can access a member's Free File Program web site through IRS.gov and prepare his or her return. However, at some point in the process, the taxpayer may be notified that he or she does not qualify for the free services (e.g., AGI may be too high). Taxpayers who do not qualify were given the option to pay for these services instead and continue preparing and filing their tax returns. However, the Free File Indicator was not removed from these returns before they were filed with the IRS.

The Alliance also stated that approximately 2,500 returns were filed through the Free File Program by paid tax preparers who had charged taxpayers to prepare and file their tax returns. The preparers then used the Program software provided by the Alliance to prepare the returns and file them with the IRS. A tax preparer is required by law to enter his or her identification number, called a Preparer Taxpayer Identification Number, on every return he or she prepares for a fee. Only one Alliance member's software provided the option to enter a Preparer Taxpayer Identification Number. The Free File Agreement between the IRS and the Alliance does not prevent paid tax preparers from using the Program, although that is not the Program's intent. Therefore, it is possible paid tax preparers used other members' software and we were unable to identify them.



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Recommendation

Recommendation 3: The Director, Electronic Tax Administration, should establish a process to assess the accuracy of the Free File Indicator early in the filing season, including a review to verify that only those returns qualified for the Free File Program have the Indicator.

Management's Response: IRS management agreed with this recommendation and plans to work with the Alliance to analyze the Free File Indicator and identify possible solutions for increasing its accuracy. They also plan to establish a process to assess the accuracy of the Indicator early in the filing season, including a review to verify that only qualified returns have the Indicator.

Software Was Not Adequately Tested to Ensure Tax Returns Were Accurate

The IRS does not adequately test Alliance members' software to ensure the accuracy of calculations. We developed four common scenarios to test the software provided by the Alliance members (see Appendix IV) and determined the software did not always compute the correct tax amounts.

The software did correctly handle the following situations:

- Disallowed the filing of a return with an AGI greater than \$50,000. However, the taxpayers were not notified that they did not qualify to use the Program until late in the return preparation process.
- Correctly computed the claims for the special casualty loss benefit for Hurricane Katrina victims when the necessary form was supported.

However, the software did not always accurately compute a tax return in the following situations:

- Software for 25 percent of the members would not allow taxpayers to take either the Earned Income Tax Credit or the Child and Dependent Care Credit without also taking the dependency exemption. According to *Earned Income Credit (EIC)* (Publication 596), a taxpayer who meets the qualifications for the Earned Income Tax Credit and the Child and Dependent Care Credit may claim them even if the taxpayer does not claim a related dependency exemption.
- One member's software allowed a dependency exemption that should not have been allowed.
- Software for 45 percent of the members did not have adequate interview questions to determine if the taxpayer could take the dependency exemption. However, the software



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properly computed the return if the taxpayer already knew he or she did not qualify for the exemption.

Taxpayers must be able to rely upon the accuracy and thoroughness of the software they use to calculate their returns. If their returns are calculated incorrectly, taxpayers could experience increased burden if later reviews (audits) of their returns identify the mistakes or if they do not receive credits they are entitled to receive. This could undermine taxpayers' confidence in the Free File Program and negatively affect the IRS' efforts to reach its goal of increasing the number of returns filed electronically. We were unable to project the number of returns affected by these errors because the data we had available were not specific enough to determine how many taxpayers' filing situations involved the same criteria as those in our scenarios. However, the scenarios were developed to test common occurrences. We notified the IRS of the software errors and were informed that it would notify the applicable Alliance members so the errors could be corrected. However, we followed up on these scenarios in February 2007 and found the Alliance members involved had not yet corrected the errors we had identified.

According to Treasury Regulations,¹¹ tax return preparers must exercise due diligence in preparing or assisting in the preparation of tax returns filed with the IRS. In addition, the Free File Program Operating Agreement requires Alliance members to guarantee the calculations performed by their software packages. The IRS conducts two different tests on Alliance members' software. However, these tests do not adequately assess the accuracy of applying the tax law.

The IRS reviews Alliance members' software to ensure it operates within the parameters of the Free File Agreement. The review is not intended to review for technical accuracy. Software packages are also required to pass Participants Acceptance Testing System testing performed by the IRS to ensure the returns transmitted electronically are compatible with IRS systems and the software correctly calculates the tax returns. During this testing, the IRS develops scenarios for tax returns to assess the accuracy of software packages.

In a review of the IRS' process to ensure tax return preparation software developers are provided with accurate tax law specifications, we reported that the Participants Acceptance Testing System testing for tax preparation software was intended to ensure electronic returns can be initially processed much like tax returns submitted on paper.¹² The testing included scenarios to ensure the correct application of the law. However, the test scenarios were not created to check for misapplication of the tax law or for all situations and conditions relating to the laws. The scenarios did not include facts that conflict with the law and would prevent a taxpayer from receiving a credit. We recommended that, in addition to the Participants Acceptance Testing

¹¹ Treas. Reg. § 10.22 (2005).

¹² *Opportunities Exist to Improve Tax Software Packages* (Reference Number 2005-40-025, dated January 2005).



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System and System Acceptability Testing,¹³ the IRS should conduct tests on any tax return preparer software it selects before the software is used by IRS employees and volunteers to prepare tax returns, to ensure returns prepared are accurate. The IRS responded that it would not be feasible to perform additional testing on the tax return preparation software without impeding the availability of the software products for its employees and volunteers and delaying the processing of tax returns. The IRS also responded it could not contractually require that software developers place their products under the IRS configuration management process.

Over one-half of the tax returns filed with the IRS are received electronically. As *e-filing* grows, so does the reliance taxpayers put on tax preparation software. Taxpayers who use the Free File Program access the Alliance members' software through IRS.gov and may assume the IRS offers some level of assurance as to the accuracy of the software.

Recommendation

Recommendation 4: The Director, Electronic Tax Administration, should establish a process to test the software used in the Free File Program before the filing season, to ensure common scenarios such as those we tested are being handled accurately. While this would not be intended to offer absolute assurance of the software's accuracy, it would help identify potential problems early in the filing season.

Management's Response: IRS management disagreed with this recommendation, stating the IRS already reviews the accuracy of Alliance members' software to ensure it operates within the parameters of the Free File Agreement. Other tests ensure these electronic returns are compatible with IRS system requirements and the software correctly calculates the entries on the return. However, these tests do not assess the accuracy of applying the tax law. Management stated testing of commercial tax preparation software to determine its accuracy in applying the tax law would be a monumental challenge for the IRS.

Office of Audit Comment: We agree that performing a quality review of all commercial tax preparation software to ensure proper application of all tax laws would not be feasible. However, some quality review of the software associated with the Program is warranted. The Free File Program is an IRS-sponsored program. As such, taxpayers may assume the products they are using as part of the Program are endorsed by the IRS. We are not suggesting the IRS review the Alliance members' software for all aspects of the tax law. Many Program users have common tax issues that should be reviewed, such as claiming dependents, personal exemptions, and common tax credits like the Child Tax Credit and the Earned Income Tax Credit. The IRS could easily

¹³ The process of testing a system or program to ensure it meets the original objectives outlined by the user in the requirement analysis document.



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review the products used as part of the Program for these issues. We reviewed the Alliance members' software for several conditions using simple tax scenarios and limited staff. The IRS indicated it communicates with Free File members when a specific problem is identified, sharing suggestions for correction. However, the Free File Agreement does not require the member to correct those errors. When we notified the IRS of the software errors we had identified, the IRS stated it would notify the applicable members. However, these errors still had not been corrected when we re-tested the members' software in February 2007.

Some improvements have been made to address the concerns of Congress and the National Taxpayer Advocate

In April 2006, the Senate Finance Committee and the National Taxpayer Advocate raised concerns about the Free File Program. Specifically, they were concerned about the marketing of inappropriate products, difficulties in using the Program, and preparation of incorrect tax returns. We included many of these concerns in our tests of the members' software.

- We did not identify any unknown or hidden filing limits.
- While some Alliance members charged a fee to mail a copy of the tax return to the taxpayer, all companies offered taxpayers the option to print the returns themselves for free.
- The Program does not limit the number of dependents that can be claimed by a taxpayer. However, some Alliance members' software packages do not support claiming more than four dependents.
- None of the members included a charge for preparing the Federal tax return if the State return was not prepared and filed through the member.
- All of the members displayed the charges for filing a State return on their Free File Program webpages, if applicable.
- No fees were charged for taxpayers to file an extension, although not all members supported the filing of extensions.
- Over one-half of the members promoted other products. Most of these products related to enhanced tax software or assistance. We did not identify any offers for inappropriate services such as "get rich quick" schemes.
- There were no solicitations to obtain a RAL (a loan designed to give a taxpayer his or her income tax refund immediately for a fee). We estimate approximately 19,000 of the 3.9 million taxpayers who used the Program last year purchased a RAL. The Alliance and the IRS agreed to no longer offer RALs on the Program web sites. While our initial tests were performed after the peak of the filing season when many of these offers were



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not in effect, we checked the Alliance web sites again in February 2007 to ensure these offers had been removed in accordance with the Free File Agreement.

It should be noted that our testing occurred after the Senate Finance Committee and the National Taxpayer Advocate reported their concerns about the marketing of inappropriate products, the Program's difficulty to use, and incorrect tax returns. Although Alliance members may modify their services throughout the filing season, it is reasonable to assume that we did not see the conditions identified earlier because the Alliance members had made changes to their web sites to address the concerns of Congress and the National Taxpayer Advocate.

The Guide Me To A Company Feature for Selecting Free File Program Providers Was Not Always Complete or Accurate

Taxpayers must access the Free File Program through IRS.gov, which identifies the basic requirements for participation in the Program and provides a feature, *Guide Me To A Company*¹⁴ (hereafter referred to as the *Guide*), to help taxpayers find a Program provider. The *Guide* gives the taxpayer a number of providers to choose from based on general information provided by the taxpayer such as age, AGI, State of residence, whether the taxpayer qualifies for the Earned Income Tax Credit, and whether the taxpayer received military pay.

The individual Alliance members establish the eligibility requirements for participation in their individual Free File Program offers. For example, some members restrict eligibility based on age, whereas others base it on the State of residence. The members can change their requirements no more than twice throughout the filing season.

We had evaluated the *Guide* as part of our prior work on the Free File Program. As a result of that work, we recommended the IRS expand the *Guide* feature. To determine if the *Guide* is now effective, in this audit we expanded the testing begun in our prior review. We developed scenarios to test the responses the *Guide* provided to taxpayers in certain situations based on the general information provided by the taxpayer.

The IRS considers the Free File Program one method to bring taxpayers into its *e-filing* program. Errors and omissions in the *Guide* can increase taxpayers' frustration with the Program and may prevent them from using the Program or recommending it to others. This could also negatively affect the IRS' efforts to reach its goal of increasing the use of *e-filing*.

The IRS' mission is to provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying tax law with integrity and fairness to all. For the 2007 Filing Season, the IRS made improvements to its Free File Program webpage and the *Guide* feature, including better disclosures of the services available in the Program, a link to a Spanish Program webpage, and additional interview questions related to

¹⁴ Formerly called *Guide Me To A Service*.



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State tax returns. While these updates should improve taxpayers' experiences, the IRS can further enhance the *Guide*.

The Guide Me To A Company feature did not reflect changes in one Alliance member's service requirements

The *Guide* was incorrectly programmed for one Alliance member. The member provided free Federal online tax preparation and *e-filing* if a taxpayer's AGI was \$50,000 or less and the taxpayer was age 50 or under. At the time of our review, the member did not restrict free filing to certain States. Earlier in the filing season, this member had not had an age limit but had restricted filing to certain States. The change in the member's requirements did not get programmed into the *Guide*.

We conducted 5 queries of the *Guide* using an age over 50 years; the Alliance member was incorrectly displayed in all 5 query results. This could increase the burden of the approximately 23.5 million taxpayers over age 50 that may attempt to file using the member's program, only to learn they do not qualify for the free services. We also conducted queries of the *Guide* using various States and determined some States did not display results for this member. This unnecessarily restricts the choices of free service providers to taxpayers in these States. We notified the IRS of this condition, and it reprogrammed the *Guide* to correctly reflect this member's requirements for receiving free services.

The Guide Me To A Company feature does not always meet taxpayers' needs

In our prior review, we reported that, although the *Guide* instructs taxpayers which members they qualify to use, it may be difficult for some taxpayers to determine which of those members best meets their needs. Additional testing showed the *Guide* would advise taxpayers of members that do not meet the taxpayers' needs based on the forms needed to file their returns.

Incomplete information in the *Guide* increases the burden experienced by taxpayers who use the Free File Program. The *Guide* provides taxpayers with a list of members that supposedly meet their filing needs. However, taxpayers must access each member's Free File Program webpage separately to determine if the member offers all the forms and supporting schedules necessary to file their returns. In some instances, a taxpayer may not even be aware that a specific form or schedule is required until he or she has already begun to prepare the return. In this instance, the taxpayer would be notified that he or she cannot file the return using the member's product. The only alternative is to begin again using another member's product. It is also probable that taxpayers may decide not to attempt to use the Free File Program again and choose to either prepare their returns on paper or pay to have the returns prepared.



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We tested a scenario that involved a casualty loss as a result of Hurricane Katrina and a scenario that claimed the Retirement Savings Contribution Credit.¹⁵ When we tested the Hurricane Katrina casualty loss scenario, the *Guide* showed we could use 16 members based on age, AGI, and State of residence. However, 11 of the 16 members could not prepare our returns because the software did not support the form necessary to claim the casualty loss as a result of Hurricane Katrina.

Testing of the Retirement Savings Contribution Credit scenario using the *Guide* resulted in identification of 19 members that qualified based on age, AGI, and State of residence. However, 2 of the 19 could not prepare the return because the software did not support Credit for Qualified Retirement Savings Contributions (Form 8880). One member was not shown by the *Guide* because we did not meet the member's State of residence requirement. However, the member's software would have prepared the return correctly if we had met the other qualifications because it supported the Form 8880.

Recommendation

Recommendation 5: The Director, Electronic Tax Administration, should work with the Alliance to expand the *Guide Me To A Company* feature to include a generic description, by Alliance member, of the types of special tax situations each member supports (e.g., Earned Income Tax Credit, Retirement Savings Contribution Credit, casualty losses).

Management's Response: IRS management agreed with this recommendation and plans to consider the feasibility of expanding the *Guide Me To A Company* feature to include a generic description, by Alliance member.

Other Filing Options Are Being Considered

To identify other potential free tax return filing options available to the IRS, we visited the State tax agencies for California, Kansas, Missouri, and Pennsylvania to discuss their free *e-filing* programs. We determined the two most feasible programs were direct filing and 2-D Barcoded returns. Direct filing is an Internet-based filing option that allows a taxpayer to file a State tax return directly with the State, without using third-party software. A 2-D Barcoded return is prepared using tax preparation software. When the return is printed, the software produces a barcode that contains 100 percent of the return information. The taxpayer mails the 2-D Barcoded return to the State, which scans the barcode to enter the return information into its computer system electronically. Some States allow taxpayers to prepare a 2-D Barcoded return directly from their Internet web sites. These returns can also be prepared using purchased tax preparation software or by a paid tax preparer.

¹⁵ A credit aimed at promoting tax-qualified retirement savings for middle- and low-income workers.



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The IRS currently has in the planning stage some alternative filing options that would increase *e-filing* choices for taxpayers. The first is the I-File Program,¹⁶ the feasibility of which depends on the capability of the IRS Modernized *e-File* Project.¹⁷ The second is 2-D Barcoded tax returns, which would replace manual transcription with 2-D Barcode processing. Neither of these options allows taxpayers to file a tax return directly with the IRS without the use of a third party.

I-File Program

Twenty States have a form of direct filing. States are moving aggressively to use the Internet and electronic technologies to improve taxpayer service and reduce their operating costs. The IRS I-File Program is an extension of this approach and is consistent with the direction that State Governments and the private sector are taking in terms of interacting with their customers. The States view their direct-filing programs as aimed at a segment of the taxpayer population that is comfortable with computers and electronic commerce. These taxpayers do not require a paid preparer or commercial software to complete their State income tax obligations.

The Federation of Tax Administrators¹⁸ Executive Director cautioned that there are three issues to consider in implementing a Federal direct-filing program similar to programs offered by States.¹⁹

- *Complexity – Federal return filing is more complex than return filing on the State level. Most State income tax is based on the Federal income tax base, and the bulk of entries and calculations on a State return involve only areas of deviations from numbers calculated for Federal tax purposes. All State direct-filing applications presume prior completion of a Federal tax return and begin with Federally computed numbers. For a Federal direct-filing program to be feasible, the IRS should consider limiting the types of returns and schedules available through the program to those considered less complex, such as the U.S. Individual Income Tax Return (Form 1040A) and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ). This would reduce complexity challenges.*
- *Security – Any breach of security or other lapse that caused a loss of taxpayer confidence in the system would have ramifications throughout the system.*

¹⁶ The I-file Program involves submitting an electronically prepared tax form directly to the taxing authority's Internet web site.

¹⁷ The IRS Modernized *e-File* Project is the future of *e-filing* with the IRS. The Project's goal is to replace the current filing technology with a modernized, Internet-based *e-filing* platform for any IRS form.

¹⁸ The Federation of Tax Administrators is an association of the principal tax administration agencies in each of the 50 states, the District of Columbia, and New York City.

¹⁹ *Preparing Your Taxes: How Costly Is It?* Statement of the Federation of Tax Administrators Before the Committee on Finance, United States Senate (April 4, 2006).



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- *Scalability* – A single Federal return application would require considerable peak load capacity. This peak load requirement could be alleviated in part by limiting the types of returns for which the application could be used and possibly extending the due date for such returns.

A major deciding factor for the IRS in providing the I-File Program is the capability of its Modernized *e-File* Project. As part of this Project, the IRS has developed a web-based platform for filing tax and information returns through the Internet via third parties. The IRS intends to begin adding Form 1040 in 2009; however, these plans are uncertain. The IRS has not decided how the Form 1040 series of returns and related schedules will be made available for use. In addition, plans to schedule Modernized *e-File* Project development of the Form 1040 series are pending approval from the Office of Management and Budget.

The I-File Program is a step toward improving taxpayers' abilities to file their returns electronically. However, it does not eliminate the need for third-party involvement. In 2006, roughly 19 million taxpayers purchased a software package to prepare and file their tax returns. Providing direct Internet access to prepare and file tax returns would enable these taxpayers to do the same without incurring a fee. Some members of Congress believe the IRS should provide tax preparation and filing services directly from its Internet web site. The Government Accountability Office recently issued a report on the challenges the IRS would face in implementing an Internet filing system.²⁰

2-D Barcoded returns

The IRS has considered plans to replace the costly and labor-intensive process of transcribing tax return information with a 2-D barcode on the face of a newly designed Form 1040. This process would condense and print all of the return information into a barcode located on the front of the tax return. The IRS would then use hand-held scanners to scan each barcode and capture 100 percent of the return data. Figure 4 presents an example of a State 2-D Barcoded return.

²⁰ *Taxpayer Service: State Experiences Indicate IRS Would Face Challenges Developing an Internet Filing System with Net Benefits* (GAO-07-570, dated April 2007).



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Figure 4: Example of a 2-D Barcoded Tax Return

MISSOURI DEPARTMENT OF REVENUE 2006 FORM MO-1040
INDIVIDUAL INCOME TAX RETURN—LONG FORM
 FOR CALENDAR YEAR JAN. 1–DEC. 31, 2006, OR FISCAL YEAR BEGINNING
 Select Month 2006, ENDING Select Month Select Year

AMENDED RETURN — CHECK HERE SOFTWARE VENDOR CODE **006**

NAME AND ADDRESS SOCIAL SECURITY NUMBER 000-00-0000 SPOUSE'S SOCIAL SECURITY NUMBER

NAME (LAST) (FIRST) M.I. JR. SR. TAXPAYER JANE R DECEASED IN 2006

SPOUSE'S (LAST) (FIRST) M.I. JR. SR. DECEASED IN 2006

THIS IS A 2-D BARCODE. DO NOT ERASE IT OR WRITE ON IT.

IN CARE OF NAME (ATTORNEY, EXECUTOR, PERSONAL REPRESENTATIVE, ETC.) COUNTY OF RESIDENCE MARIES SCHOOL DISTRICT NO. MARIES CO. R-II (BELLE)

PRESENT ADDRESS (INCLUDE APARTMENT NUMBER OR RURAL ROUTE) 123 TAXPAYER STREET CITY, TOWN, OR POST OFFICE TAX CITY STATE MO ZIP CODE 64013

You may contribute to any one or all of the trust funds on Line 44. See instructions for a description of each trust fund, as well as trust fund codes to enter on Line 44.

PLEASE CHECK THE APPROPRIATE BOXES THAT APPLY TO YOURSELF OR YOUR SPOUSE.

AGE 65 OR OLDER YOURSELF SPOUSE

BLIND YOURSELF SPOUSE

100% DISABLED YOURSELF SPOUSE

NON-OBLIGATED SPOUSE YOURSELF SPOUSE

	Yourself		Spouse	
	1Y	2S	3Y	4S
1. Federal adjusted gross income from your 2006 federal return (See worksheet.)	30,000	00	1S	00
2. Total additions (from Form MO-A, Part 1, Line 4)	0	00	2S	00
3. Total income — Add Lines 1 and 2.	30,000	00	3S	00
4. Total subtractions (from Form MO-A, Part 1, Line 10)	500	00	4S	00
5. Missouri adjusted gross income — Subtract Line 4 from Line 3.	29,500	00	5S	00
6. Total Missouri adjusted gross income — Add columns 5Y and 5S.	6		29,500 00	
7. Income percentages — Divide columns 5Y and 5S by total on Line 6. (Total of columns 7Y and 7S must equal 100%.)	7Y		7S	
	100 %		0 %	

Source: Missouri Department of Revenue. The information contained in this figure is hypothetical and presented for illustration only.

The IRS Wage and Investment Division stated in its Fiscal Year 2007-2008 Strategy and Program Plan that it planned to replace the costly and labor-intensive process of transcribing tax return information with a 2-D barcode on the face of a newly designed Form 1040 by the 2009 Filing Season. The 2-D barcode would allow the IRS to process paper returns more efficiently while reducing the number of errors. During 2006, approximately 39 million taxpayers used a software package to prepare their returns but printed and filed the returns on paper. A 2-D barcode program would enable the IRS to enter the data on these paper returns more rapidly and reduce the likelihood of transcription errors. Some States estimate that barcodes reduce the time and effort involved in processing paper returns by 50 percent to 90 percent. States also estimate that use of a barcode is \$.57 to \$.70 cheaper than use of a conventional paper return. However, Wage and Investment Division officials recently indicated they have decided not to pursue 2-D Barcode technology at this time. Instead, the 2-D Barcode technology will be considered as part of a larger Modernized Submission Processing effort that will not begin until 2010 or later.



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In one State we visited, the State's Free File Alliance had refused to provide 2-D Barcoded returns through its software packages if the State did not do away with its direct-filing program. In this particular State, over 50 percent of paper returns filed are 2-D Barcoded returns. To protect its 2-D Barcode Program, the State found it necessary to partner with the State's Free File Alliance.

Although the IRS is considering other *e-filing* options, neither option currently under consideration will eliminate the need for a taxpayer to file a return through a third party. The IRS also does not anticipate providing taxpayers with the ability to prepare their tax returns directly from IRS.gov. As a result, even taxpayers who choose to use a 2-D Barcoded return will first have to purchase a software package or pay a tax preparer to prepare the returns.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine how effectively the IRS administered the Free File Program (the Program). To accomplish this objective, we:

- I. Evaluated the effectiveness of the IRS' oversight of the Free File Program.
 - A. Interviewed Electronic Tax Administration management and obtained documentation to evaluate the process used to provide oversight of the Program to ensure the Free File Alliance¹ members satisfy the terms of the Agreement.
 - B. Identified efforts by Electronic Tax Administration management to ensure all taxpayers, regardless of financial position, are offered free *e-filing* services; determined the method used to promote or inform taxpayers the Program is available; and identified IRS efforts to use these tools to promote the Program.
 - C. Evaluated the IRS' efforts to determine why taxpayers did not participate in the Program and evaluated its process for determining taxpayer satisfaction with the Program during the 2006 Filing Season.²
 - D. Assessed the accuracy of the Free File Indicator by comparing the Indicator counts taken from the IRS Tax Return Database³ to the counts of Program returns provided by the IRS. We determined whether the Indicator was applied to any returns with a paid preparer indicator and/or an AGI⁴ greater than \$50,000 and assessed the impact on the reliability of Program information by determining the number of incorrect Program participants involved in any discrepancies identified. We determined the reliability of the Tax Return Database data by comparing critical fields on a small number of cases to the same fields on the Individual Master File.⁵
- II. Evaluated taxpayers' experiences when using the Free File Program.
 - A. Evaluated the Alliance members' software packages to determine the accuracy of tax computations for common taxpayer situations. We input four predeveloped scenarios

¹ The Free File Alliance is a consortium of tax software companies whose members offer tax preparation software accessible to taxpayers from a personal computer.

² The filing season is the period from January through mid-April when most individual income tax returns are filed.

³ The Tax Return Database is a relational database that stores tax return information submitted by the taxpayer.

⁴ Adjusted gross income is income less certain deductions and/or expenses.

⁵ The Individual Master File is the IRS database that maintains transactions or records of individual tax accounts.



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- to each Alliance member's software program and determined whether the software correctly computed the tax due.
- B. Evaluated the *Guide Me To A Company* feature on IRS.gov to determine whether the list of Alliance members given to taxpayers are providers that best meet their needs. We queried the feature's options to determine whether companies that do not meet a taxpayer's qualifications are eliminated. We tested age, AGI, State of residence, Earned Income Tax Credit eligibility, and military income.
 - C. Evaluated each Alliance member's Free File Program web site and software for unknown or hidden limits, extra fees for printing a tax return, customer service, or tax questions. We determined whether there were charges for (1) preparing a Federal tax return if a State return was not filed, (2) State returns evident on landing page,⁶ and (3) returns with more than four dependents. We determined (1) the point at which a taxpayer is told he or she does not qualify for free services or the point at which the taxpayer is told there is a fee for filing a State return or for other services, (2) whether there was a link back to the IRS Free File Program landing page if a taxpayer finds he or she no longer qualifies for that company's offer, and (3) whether the taxpayer had the ability to file an extension and there were any related fees. We also evaluated the promotion of ancillary products, including product upgrades.
 - D. Determined whether taxpayers choosing the RAL option are provided with required disclosure information by determining the number of times a taxpayer was asked whether he or she wanted a RAL. We evaluated whether it was clearly disclosed that the RAL is a loan, the terms were clear, and the "free" offer was contingent on obtaining a RAL.
 - E. Obtained and validated statistics on the percentage of taxpayers who accepted RALs. The RAL information was extracted from the Tax Return Database; we determined the reliability of the Tax Return Database data by comparing critical fields on a small number of cases to the same fields on the Individual Master File.
- III. Researched other free filing options that may be suitable for the IRS to use by reviewing IRS webpages and individual State web sites to determine what other options for free filing are available. We interviewed personnel in the State tax agencies for California, Kansas, Missouri, and Pennsylvania to determine the costs of offering these services and the benefits of direct-filing programs to their individual States; reviewed IRS webpages to determine what other options for free filing are available for special interest groups; identified the IRS' plans for addressing individual tax returns in its Modernized *e-File* Project, determined whether these plans will ensure free filing for all taxpayers, and

⁶ A landing page is the first Internet page a person views when completing access to a web address.



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identified the timeline for implementation of the individuals phase of the Project; and determined the IRS' plans for developing return free filing.

- IV. Evaluated the Free File Program participant characteristics to determine why taxpayers may not be participating in the Program and how the IRS can more effectively promote *e-filing*. We performed a computer analysis of the Tax Year 2005 Tax Return Database for taxpayers who filed using the Program, to evaluate characteristics of these taxpayers. We analyzed this same file for taxpayers who were eligible to but did not file using the Program, to evaluate the characteristics of eligible but nonparticipating taxpayers. These records were matched to the Tax Year 2005 Individual Master File Returns Transaction File on the Treasury Inspector General for Tax Administration's Data Center Warehouse to obtain additional data fields. We determined the reliability of the Tax Return Database and Individual Master File Returns Transaction File data by comparing critical fields on a small number of cases to the same fields on the Individual Master File. We compared the taxpayer characteristics in both groups to identify barriers to participating in the Program. See Appendix V for details.



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Appendix II

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Appendix III

Report Distribution List

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Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Wage and Investment Division SE:W
Director, Electronic Tax Administration, Wage and Investment Division SE:W:ETA
Director, Strategy and Finance, Wage and Investment Division SE:W:S
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Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Senior Operations Advisor, Wage and Investment Division SE:W:S



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Appendix IV

Taxpayer Scenarios Used to Test Software Accuracy

We developed four taxpayer scenarios¹ to test the accuracy of the Free File Alliance² member software used for the Free File Program. These scenarios incorporate common taxpayer characteristics related to filing status and dependency issues as well as special legislation related to the 2005 Hurricane Katrina victims. Our scenarios were also used to test when in the process taxpayers received notification that they did not qualify for the Free File Program. We tested all of the Alliance members' software using the following scenarios.

- **Scenario 1:** The taxpayer is divorced and lived with her 10-year-old child. Taxable wages were \$28,383, and \$712 was contributed to the employer's 401(k) retirement plan. Interest income was \$82.12. As part of the divorce agreement, the taxpayer signed a Release of Claim to Exemption for Child of Divorced or Separated Parents (Form 8332). The taxpayer received \$275 a month for child support. Babysitting expenses totaled \$946. This scenario tested whether the Alliance members' software correctly calculated the Child Tax Credit, the Child and Dependent Care Credit, dependency exemption, Earned Income Tax Credit, filing status, and Retirement Savings Contribution Credit.³ Software for 25 percent of the members incorrectly prevented the taxpayer from claiming either the Earned Income Tax Credit or the Child and Dependent Care Credit because the ex-spouse was taking the dependency exemption.
- **Scenario 2:** The taxpayer has never been married and lived in her sister's home. The taxpayer's 12-year-old child and 9-year-old child lived with the taxpayer and her sister in the sister's home during school vacations and the months of June, July, and August (a total of 4 months). The children lived with their father during the school year. The taxpayer works part time and earned \$13,315 a year. The sister earned \$52,000. This scenario tested whether the Alliance members' software correctly calculated the Child Tax Credit, dependency exemption, Earned Income Tax Credit, and filing status. One Alliance member's software allowed a dependency exemption that should not have been allowed. Software for 45 percent of the members had inadequate interview questions to determine whether the taxpayer could take the dependency exemption; however, if the taxpayer was aware that she should not claim the dependency exemption, the software would compute the return correctly.

¹ These scenarios present hypothetical taxpayer situations. They do not present actual taxpayer or tax return information.

² The Free File Alliance is a consortium of tax software companies whose members offer tax preparation software accessible to taxpayers from a personal computer.

³ A credit aimed at promoting tax-qualified retirement savings for middle- and low-income workers.



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- **Scenario 3:** The taxpayer is single with no dependents. He had wages of \$52,000 and interest income of \$35. The taxpayer wants to take out a RAL if that option is provided. He does not want a direct deposit. This scenario tested the point in the return preparation process at which the Alliance members' software informed the taxpayer that he did not qualify for the Free File Program. The Alliance members' software correctly disallowed a return with AGI over \$50,000 to be filed for free at the time of our review. However, the taxpayer was not notified that he did not qualify for the Program until late into the return preparation process.
- **Scenario 4:** The taxpayer is a helicopter pilot and is single with no dependents. The taxpayer had wages of \$54,500 and interest income of \$301. He was divorced during 2005, and the divorce decree requires alimony payments of \$600 per month beginning in March 2005. He works on oil rigs and is gone 1 week at a time. He has been renting a room in a historic home in New Orleans since his divorce. He does not normally itemize his deductions. He is a Hurricane Katrina victim. This scenario tested whether the Alliance members' software correctly calculated a special casualty loss benefit for Hurricane Katrina victims. Not all Alliance members' software supported the form necessary to claim the casualty loss. However, the software provided by members who supported the form correctly computed the loss.



Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program

Appendix V

Comparison of Free File Users to Nonusers

We compared data for taxpayers who used the Free File Program (the Program) in 2006 to data for those who were eligible for the Program but did not use it, to identify potential barriers to use of the Program. The average Program user is in a young age range (18 years to 28 years) and unmarried. Users filed fairly simple tax returns with no supporting schedules, and many could be claimed as a dependent by someone else. The majority of Program users had an AGI¹ of \$30,000 or less, and most received a small refund (\$1,000 or less). We compared these characteristics to those of all eligible taxpayers who did not use the Free File Program to determine if there were any significant differences between taxpayers who used the Program and those who did not.

We did not identify any significant differences in users' and nonusers' AGIs. The majority of Program users had an AGI of \$30,000 or less. The majority of Program-eligible nonusers also had an AGI in this range.

Figure 1: Percentages of Free File Program Users and Nonusers (by AGI Range)

AGI	Program Users (Actual)	Program-Eligible Nonusers (Projected)
Less than or equal to \$10,000	32%	27%
\$10,001 to \$20,000	26%	25%
\$20,001 to \$30,000	21%	20%
\$30,001 to \$40,000	13%	16%
\$40,001 to \$50,000	7%	12%

Source: Our analysis of taxpayer data. Percentages may not total 100 percent due to rounding.

¹ AGI is income less certain deductions and/or expenses.



Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program

Almost one-half of the Free File Program users had total income between \$10,001 and \$30,000. This did not vary significantly from the income levels of Program-eligible nonusers.

Figure 2: Percentages of Free File Program Users and Nonusers (by Total Income Range)

Total Income	Program Users (Actual)	Program-Eligible Nonusers (Projected)
Less than or equal to \$10,000	32%	26%
\$10,001 to \$20,000	26%	25%
\$20,001 to \$30,000	21%	20%
\$30,001 to \$40,000	13%	16%
\$40,001 to \$50,000	7%	12%

Source: Our analysis of taxpayer data. Percentages may not total 100 percent due to rounding.

Further analysis of total income showed wages were the sole source of income for 69 percent of all Free File Program users. Another 29 percent (about 1.1 million users) had income from wages and at least 1 other source (e.g., self-employment income). Two percent of Program users had income from a source other than wages or self-employment income. Program-eligible nonusers had similar trends, but a smaller percentage of nonusers had income from wages only (45 percent or approximately 35.8 million nonusers). However, about 38 percent (30.6 million nonusers) had income from wages and another source, and about 11 percent had income from sources other than wages or self-employment.



Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program

Figure 3: Percentages of Free File Program Users and Nonusers (by Source of Income)

Source of Income	Program Users (Actual)	Program-Eligible Nonusers (Projected)
Wages	69%	45%
Wages and Other Sources	29%	38%
Self-Employment	1%	5%
Other Sources	2%	11%
No Income	0%	1%

Source: Our analysis of taxpayer data. Percentages may not total 100 percent due to rounding.

There were significant differences in the ages of taxpayers who used the Free File Program and those who were eligible to but did not. Most Program users were in the younger age ranges; 61 percent were age 30 or under. The majority (45 percent) of Program-eligible nonusers were over age of 40.

Figure 4: Percentages of Free File Program Users and Nonusers (by Age Range)

Age	Program Users (Actual)	Program-Eligible Nonusers (Projected)
Under 20	18%	13%
21 to 30	43%	26%
31 to 40	17%	17%
41 to 50	12%	16%
Over 50	10%	29%

Source: Our analysis of taxpayer data. Percentages may not total 100 percent due to rounding.

We also identified a significant difference in the filing status taxpayers used to file their tax returns. While 55 percent of all Program-eligible nonusers filed their returns as a single taxpayer, more than 73 percent of taxpayers who used the Program filed as single taxpayers. Almost 23 percent of nonusers filed as married taxpayers filing a joint return compared to 11 percent of users who used the Married Filing Jointly status.



Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program

Figure 5: Percentages of Free File Program Users and Nonusers (by Filing Status)

Filing Status	Program Users (Actual)	Program-Eligible Nonusers (Projected)
Single	73%	55%
Head of Household	15%	20%
Married Filing Jointly	11%	23%
Married Filing Separately	1%	2%

Source: Our analysis of taxpayer data. Percentages may not total 100 percent due to rounding.

It is also important to understand how taxpayers who used the Free File Program have filed their tax returns in the past. One of the goals of the Program was to increase the use of *e-filing*, and the Program has been somewhat successful in that endeavor. About 24 percent of the taxpayers who used the Program in 2006 filed a paper return in 2005 and approximately 64 percent filed electronically in 2005.

Figure 6: Percentages of Free File Program Users and Nonusers (by Filing Method)

Filing Method	Program Users 2005 (Actual)	Program-Eligible Nonusers 2006 (Projected)
Paper	17%	34%
Paper Computer Generated	7%	21%
Electronic Self-prepared	55%	10%
Electronic – Practitioner	9%	35%
Did Not File	12%	0%

Source: Our analysis of taxpayer data. Percentages may not total 100 percent due to rounding.



Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program

Appendix VI

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

May 23, 2007

RECEIVED
MAY 23 2007

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard J. Morgante *Richard J. Morgante*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Additional Action is Needed to Expand the Use and Improve the Administration of the Free File Program (Audit # 200640033)

I reviewed the draft report and appreciate your acknowledgement of our efforts to effectively administer the Free File Program. As noted, we have taken steps to evaluate users' experiences with the program by conducting a satisfaction survey during the 2006 filing season. The survey indicated that 94 percent of taxpayers that used the program felt it was easy to use, and they would use it again next year. Also during the 2006 filing season, we were able to independently determine how many taxpayers used the program as well as general information about the characteristics of the taxpayers by utilizing a Free File indicator on each return filed.

In addition, we conduct ongoing reviews of the individual Alliance members' compliance with the Free File and Operating Agreements governing the program. This includes reviews of each Alliance member's website before and during the filing season. Finally, the IRS and the Free File Alliance agreed to remove all ancillary products, including Refund Anticipation Loans, from the program to address Congressional and National Taxpayer Advocate concerns.

While we have taken many steps to improve administration of the program, we agree there are additional actions that can be taken. We agree with your recommendations to develop a comprehensive plan to evaluate and promote the Free File Program and to expand the IRS's marketing of the program. We also agree with the recommendation to establish a process to assess the accuracy of the Free File Indicator early in the filing season and to work with the Alliance to expand the Guide Me To A Company feature to include a description of special tax situations.

However, we do not agree with the recommendation to establish a process to test the software used in the Free File Program for accuracy in applying the tax law. The IRS



Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program

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reviews the accuracy of Alliance members' software to ensure it operates within the parameters of the Free File Agreement. Other tests ensure their electronic returns are compatible with IRS' systems requirements and that the software correctly calculates the entries on the return. Current Free File software is subjected to IRS Participants Acceptance Testing System (PATS) testing. The purpose of PATS is to ensure, prior to live processing, that providers transmit in the correct format and meet the IRS electronic filing specifications; that required fields will post to the IRS Master File; and that providers understand the mechanics of IRS e-file. These tests do not assess the software's accuracy in applying the tax law. Further challenges of testing the legal adequacy of commercial tax preparation software are explained in the attachment.

We do share information with the tax preparation industry regarding trends or problems that are identified prior to and during the filing season. If a specific problem is identified with a Free File software product, the IRS communicates with the company, sharing suggestions for correction. Usually, Alliance members will correct any identified errors, but contractually they are under no obligation to make corrections.

Attached are our specific comments to your recommendations. If you have any questions, please contact me at (404) 338-7060, or members of your staff may contact Bert DuMars, Director, Electronic Tax Administration, at (202) 283-2610.

Attachment



Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program

Attachment

RECOMMENDATION 1

The Director, Electronic Tax Administration, should develop a comprehensive plan to evaluate and promote the Free File Program, including (to the extent possible) conducting a survey of taxpayers who tried to use the Program but were unsuccessful and taxpayers who were eligible for but chose not to use the Program.

CORRECTIVE ACTION

We agree and will develop a comprehensive marketing plan for the Free File Program. We will also consider conducting a survey of taxpayers who tried to use the program but were unsuccessful, and taxpayers who were eligible for but chose not to use the program.

IMPLEMENTATION DATE

December 15, 2007

RESPONSIBLE OFFICIAL

Director, Electronic Tax Administration, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2

The Director, Electronic Tax Administration, should expand the marketing of the Free File Program by directing promotional materials to taxpayers who are eligible for the Program but have filed their returns on paper. For example, the IRS could send taxpayers who filed paper tax returns but appear to be eligible to use the Program a postcard notifying them they may be eligible to prepare and file their returns electronically for free. The IRS could also publicize the Program during interactions with taxpayers who call into the toll-free telephone lines or visit Taxpayer Assistance Centers with tax return questions.

CORRECTIVE ACTION

We agree and will expand the marketing of the Free File Program by directing promotional materials to taxpayer who are eligible for but have filed their returns on papers. We will also consider expansion of Free File marketing to programs available within the IRS such as the toll-free telephone services and Taxpayer Assistance Centers. This marketing expansion is contingent on the Electronic Tax Administration marketing budget.

IMPLEMENTATION DATE

October 15, 2007



Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program

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RESPONSIBLE OFFICIAL

Director, Electronic Tax Administration, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3

The Director, Electronic Tax Administration, should establish a process to assess the accuracy of the Free File Indicator early in the filing season, including a review to verify that only those returns qualified for the Free File Program have the Indicator.

CORRECTIVE ACTION

As noted in your report, for the first time during the 2006 filing season we were able to independently determine how many taxpayers used the Free File Program, because Free File Alliance members included a new Free File Indicator on each return filed through the program. This new Indicator also allows us to develop useful data about the characteristics of Free File users. While your review determined that Alliance members incorrectly assigned a Free File Indicator slightly over one percent of the time, we agree with this recommendation. We will work with the Free File Alliance to analyze the Free File Indicator and identify possible solutions for increasing its accuracy. We will also establish a process to assess the accuracy of the Indicator early in the filing season, including a review to verify that only qualified returns have the Indicator.

IMPLEMENTATION DATE

December 15, 2007

RESPONSIBLE OFFICIAL

Director, Electronic Tax Administration, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 4

The Director, Electronic Tax Administration, should establish a process to test the software used in the Free File Program before the filing season, to ensure common scenarios such as those we tested are being handled accurately. While this would not be intended to offer absolute assurance of the software's accuracy, it would help identify potential problems early in the filing season.



Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program

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CORRECTIVE ACTION

We disagree with this recommendation. As noted in your report, the IRS reviews the accuracy of Alliance members' software to ensure it operates within the parameters of the Free File Agreement. Other tests ensure these electronic returns are compatible with IRS' systems requirements, and that the software correctly calculates the entries on the return. However, these tests do not assess the accuracy of applying the tax law. Testing of commercial tax preparation software to determine its accuracy in applying the tax law would be a monumental challenge for IRS for several reasons:

- The magnitude of the tax law itself and the interpretations of the enormous number of provisions of the tax law.
- Performing software testing to determine the accuracy of a company's interpretation of the tax law would require significant resources throughout the IRS and the federal judicial system.
- In TIGTA Audit 2005-40-025 Opportunities Exist to Improve Tax Software Packages, the IRS states "...we cannot contractually require that these commercial preparers place their products under the IRS configuration management process, where software and documentation baselines must be established and strictly controlled, because this would also require that these commercial preparers deliver to the IRS all of their programming functional specifications and design documentation."
- The IRS would be in the position of serving as the software industry's quality review.
- The IRS could be held liable for errors resulting from taxpayers using IRS certified software.

IRS does share information with the tax preparation industry on trends or problems that are identified prior to and during the filing season. If a specific problem is identified for a Free File software product, the IRS communicates with the company, sharing suggestions for correction. The IRS will continue to work closely with the Free File Alliance companies communicating any problems identified with their software products. Usually, Alliance members will correct any identified errors, but contractually they are under no obligation to make corrections.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A



Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program

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RECOMMENDATION 5

The Director, Electronic Tax Administration, should work with the Alliance to expand the Guide Me To A Company feature to include a generic description, by Alliance member, of the types of special tax situations each member supports (e.g., Earned Income Tax Credit, Retirement Savings Contribution Credit, casualty losses).

CORRECTIVE ACTION

We agree with this recommendation and will consider the feasibility of expanding the Guide Me To A Company feature to include a generic description, by Alliance member. We will initiate discussions with the Free File Alliance and conduct an analysis of the proposed changes impact on requirements, resources, funding, and usability.

IMPLEMENTATION DATE

September 15, 2007 - Decision to expand tool

RESPONSIBLE OFFICIAL

Director, Electronic Tax Administration, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.