



*Use of the Free File Program Declined After
Income Restrictions Were Applied*

September 29, 2006

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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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FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 29, 2006

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM:

Michael R. Phillips
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Use of the Free File Program Declined After
Income Restrictions Were Applied (Audit # 200640029)

This report presents the results of our review to determine the impact of the October 2005 Agreement between the Internal Revenue Service (IRS) and the Free File Alliance (referred to as the Alliance) on taxpayer service and electronic filing. This audit was requested by the Chairman of the House Ways and Means Committee, Subcommittee on Oversight.

Impact on the Taxpayer

The IRS established the Free File Program to provide taxpayers with the ability to prepare and file their returns electronically for free. The IRS partnered with the Alliance to provide these services. Changes in the Agreement between the IRS and the Alliance eliminated roughly 39 million taxpayers from eligibility for the Free File Program, and participation in the Program dropped almost 23 percent.

Synopsis

The Free File Program was established in response to the IRS Restructuring and Reform Act of 1998,¹ President Bush's E-Government Initiative, and the Office of Management and Budget's EZ Tax Filing Initiative. The IRS partnered with a group of tax software companies (the Alliance) to provide free online tax return preparation and filing services through the IRS web site (IRS.gov). The Free File Program made its debut in January 2003. In October 2005, the IRS and the Alliance renegotiated the Agreement to continue the Free File Program through 2009.

¹ 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.).



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The intent of the E-Government and EZ Tax Filing Initiatives was to provide all taxpayers a way to prepare and file their tax returns electronically without having to pay for those services. The IRS' current Free File Program does not fully satisfy this intent. The Program is limited to specific taxpayers, may be difficult for some taxpayers to use, and allows Alliance members to promote products that are not always in the best interest of taxpayers.

The amended Free File Program Agreement eliminated roughly 39 million taxpayers from eligibility for the Program, and participation in the Program dropped almost 23 percent.

The addition of a limit on eligibility for the Free File Program as well as the negative publicity generated by that limit reduced participation in the Program. The amended Agreement between the IRS and the Alliance eliminated roughly 39 million taxpayers from eligibility for the Free File Program during 2006 by limiting the Program to 70 percent of taxpayers, or an adjusted gross income² of \$50,000 or less. The negative publicity resulting from this limit may have further discouraged taxpayers from participating. As of the end of April 2006, participation in the Program had dropped almost 23 percent compared to the same time last year.

There are indications that the income limit also has affected the growth of electronic filing. Electronic filers include taxpayers who pay a tax professional to prepare and file their tax returns, taxpayers who prepare their own returns using tax preparation software and file the returns online using their personal computers, and taxpayers who use the Free File Program. While the online portion of electronic filing had grown 19 percent by the end of April 2006, participation in the Free File Program had declined substantially as mentioned above. Overall, electronic filing grew slightly over 6 percent during the same period.

The income limit is not the only factor affecting the success of the Free File Program. A significant number of taxpayers continue to prepare their returns electronically but file the returns on paper. In 2005, 72.5 percent of the approximately 62 million taxpayers who filed their returns on paper actually prepared their returns on computers. If these taxpayers would file electronically, the IRS could save approximately \$106.7 million in processing costs.

The amended Agreement did add additional consumer protections, including limiting offers for Refund Anticipation Loans,³ improved security over taxpayer data, and improved performance standards for Alliance members. However, the Senate Committee on Finance and the National Taxpayer Advocate noted questionable advertising and fees on the individual Alliance members' Free File webpages. Such practices can discourage taxpayers from using the Program. Our

² Adjusted gross income is income less certain deductions and/or expenses.

³ A Refund Anticipation Loan is a loan designed to give taxpayers their income tax refund immediately for a fee. The refund is then paid directly to the loan originator as payment on the loan.



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review of the Free File webpage also showed the webpage could be confusing or difficult for some taxpayers to use.

Many of these issues are the result of the IRS having to work through the tax preparation industry to provide the Free File Program. Some members of Congress, the tax preparation industry, and other tax professionals question whether it is appropriate for the IRS to offer assistance in preparing tax returns and also make necessary adjustments and/or additional assessments as part of processing returns and collecting the proper taxes. Regardless, Congress is still concerned that the current Free File Program Agreement is not adequate and does not serve the best interests of taxpayers or meet the intent of the E-Government and EZ Tax Filing Initiatives. The Senate Committee on Finance has asked the Government Accountability Office to study the feasibility of providing taxpayers a way to prepare their tax returns electronically through the IRS rather than through a third party. In addition, we plan to continue our work on the IRS Free File Program to make additional assessments of the IRS' efforts to provide free electronic tax return preparation and filing services.

Recommendations

We recommended the Director, Electronic Tax Administration, expand the *Guide Me To A Service* tool to include a summary of the services available from the Alliance member companies and provide a direct link to a Spanish version of the Free File webpage. The Spanish version of the page should include basic information about the Program and its benefits as well as a tool similar to *Guide Me To A Service* that will help Spanish-speaking taxpayers identify a provider.

Response

IRS management agreed with both of our recommendations. Management indicated they would consider the feasibility of expanding the *Guide Me To A Service* tool and will initiate discussions with the Electronic Tax Administration Public Portal Branch and the Alliance to discuss the steps necessary to provide additional information in the tool. The IRS will also study the feasibility of providing a Spanish language entry portal for the Free File Program. The Electronic Tax Administration Office plans to initiate discussions with the Multilingual Language Initiative Strategy Office, the Electronic Tax Administration Public Portal Branch, the Alliance, and the IRS Office of Chief Counsel to discuss the steps necessary to provide this Spanish link. Management's complete response to the draft report is included as Appendix VIII.



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Office of Audit Comment

The IRS provided only the initial steps for its corrective actions. We will follow up to evaluate whether its actions are adequate to achieve the intent of the recommendations. In response to our draft report, the Commissioner, Wage and Investment Division, included some general comments and assertions we believe warrant additional comment. Our response to these issues can be found in Appendix VII.

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-filed</i>	Electronically Filed
IRS	Internal Revenue Service
RAL	Refund Anticipation Loan
RRA 98	IRS Restructuring and Reform Act of 1998



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Background

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98)¹ established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. It also required the IRS to work with private industry to increase electronic filing.

In 2001, President Bush established an agenda to improve management of the Federal Government. One of the agenda items is the E-Government Initiative, which is an integral part of the President's Management Agenda to make it easier for citizens and businesses to interact with the Federal Government, save taxpayer dollars, and streamline citizen-to-Government transactions. In response to the President's E-Government Initiative, the Office of Management and Budget developed the EZ Tax Filing Initiative. EZ Tax Filing was intended to make it easier for citizens to file taxes in a web-enabled environment. Citizens would no longer have to pay for basic, automated tax preparation. The goal of the Initiative was to increase the number of citizens who filed electronic tax returns.

In response to the RRA 98, the President's Management Agenda, and the EZ Tax Filing Initiative, the Department of the Treasury, the Office of Management and Budget, and the IRS launched the Free File Program featuring private-sector partners that allow qualifying taxpayers to prepare and file their tax returns online for free. This Program was made possible through a public-private partnership with a consortium of tax software companies known as the Free File Alliance, LLC² (referred to as the Alliance).

In January 2003, the IRS and the Alliance launched the Free File Program, which provides taxpayers with access to free online tax preparation and electronic filing services. Eligible taxpayers may prepare and file their Federal income tax returns electronically using commercial online software provided by Alliance members. According to statistics provided by the Alliance, more than 2.79 million taxpayers used the Program in its first year. In subsequent years, the Alliance reported the use of the Free File Program increased significantly, to about 3.51 million taxpayers in 2004 and 5.12 million taxpayers in 2005.³

Taxpayers access the Free File webpage through the IRS Internet web site, IRS.gov (see Figure 1). The Free File page contains a list of free offer descriptions available from the various companies participating in the Program. The IRS does not endorse any particular Free File company or product offered. Individual company offers vary, and some may be limited to

¹ 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., 26 U.S.C., 38 U.S.C., and 49 U.S.C.).

² An LLC is a limited liability corporation.

³ All years mentioned in this report are calendar years unless otherwise specified.



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specific States and income levels. Companies are also allowed to offer additional services to taxpayers for a fee. Taxpayers are not obligated to purchase any of those services as a condition of electronically preparing and filing their Federal tax returns free of charge.

Figure 1: Free File Webpage

Home | Contact IRS | About IRS | Site Map | Español | Help

Internal Revenue Service
United States Department of the Treasury

Keyword/Search Terms SEARCH
Advanced Search Search Tips

INDIVIDUALS BUSINESSES CHARITIES & NON-PROFITS GOVERNMENT ENTITIES TAX PROFESSIONALS RETIREMENT PLANS COMMUNITY TAX EXEMPT BOND COMMUNITY

Free File Home - Your Link to Free Online Filing

IRS Resources

- [Compliance & Enforcement](#)
- [Contact My Local Office](#)
- [e-file](#)
- [Forms and Publications](#)
- [Frequently Asked Questions](#)
- [News](#)
- [Taxpayer Advocacy](#)
- [Where To File](#)

Whoever said there is no such thing as a free lunch may have been right. But for millions of eligible taxpayers, with an Adjusted Gross Income of \$50,000 or less, there is Free File. Free File is online tax preparation and electronic filing through a partnership agreement between the IRS and the Free File Alliance, LLC. In other words, you can e-file... free.

Before Getting Started...
A few points are worth noting. For instance:

- Free File is a free service offered by companies for taxpayers with an Adjusted Gross Income (AGI) of \$50,000 or less.
- Carefully review the free offer descriptions before starting your return. Individual company offers may be limited to specific states and income levels. Additional fees may apply for state tax return preparation services.
- Each company has a description of their eligibility criteria for preparing and e-filing your federal tax return for free.
- When choosing a company, be sure to link to the company's web site through IRS.gov. By going directly to a company's web site, you may not get the free service.
- You are under no obligation to buy any products or services.
- Telephone filing (Telefile) is no longer available. Many taxpayers who used this telephone service in the past may qualify to use Free File.

Source: IRS Free File webpage at IRS.gov.

This review was performed at the IRS National Headquarters in Washington, D.C., in the Office of Electronic Tax Administration during the period January through April 2006. This audit was requested by the Chairman of the House Ways and Means Committee, Subcommittee on Oversight. The Chairman requested an assessment of the impact of the changes in the IRS' Agreement with the Alliance on taxpayer service and electronic filing. The audit was conducted 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

Changes to the Agreement Reduced the Number of Taxpayers Eligible for the Free File Program

After the 2005 Filing Season,⁴ the IRS and the Alliance amended the 2002 Agreement to continue the Free File Program through October 2009. The 2005 amended Agreement significantly changed the overall focus of the Program. While the amended Agreement still contributes to the original goal of increasing the number of citizens who file electronic tax returns, new limits effectively changed the intent of the Free File Program. The original intent was to provide free electronic tax preparation and filing services to all taxpayers. The revised intent is to assist low-income and underserved taxpayers. As part of the amended Agreement, new limits were set for participating in the Free File Program. The new limits stem, in part, from the differing objectives of the IRS and the Alliance members. One of the IRS' principal purposes for establishing the Program was to add another avenue of electronic filing, with the intent of increasing electronic filing overall. However, the Alliance members are businesses that incur a cost to provide free services. According to representatives of Alliance member companies we interviewed,⁵ their primary goal is to keep the Federal Government from entering the tax preparation business. A secondary benefit of their participation in the Program is the opportunity to advertise and promote other products. Taxpayers opting to use and pay for these services provide additional revenues to Alliance members.

Per the initial Agreement, a minimum of 60 percent of all taxpayers (approximately 78 million) were eligible for the Free File Program. In 2005, the Alliance made the Program available to nearly all 132 million individual taxpayers and reported that 5.12 million taxpayers used the Program to file their tax returns. The amended Agreement now limits the Program's availability to 70 percent of taxpayers (approximately 93 million). For Tax Year 2005, this limitation equates to an adjusted gross income (AGI)⁶ of \$50,000 or less. The net impact of this new limit is that approximately 39 million taxpayers⁷ were no longer eligible for free filing services through the Program during the 2006 Filing Season. See Appendix IV for details of the changes made in the amended Agreement.

⁴ The period from January through mid-April when most individual income tax returns are filed.

⁵ We interviewed representatives from a sample of 6 of the 20 Alliance member companies.

⁶ AGI is income less certain deductions and/or expenses. The AGI limit is \$50,000 for Tax Year 2005. The AGI limit may increase or decrease from year to year depending on the AGI level that corresponds to 70 percent of taxpayers.

⁷ This figure was calculated from 132 million taxpayers minus 93 million taxpayers.



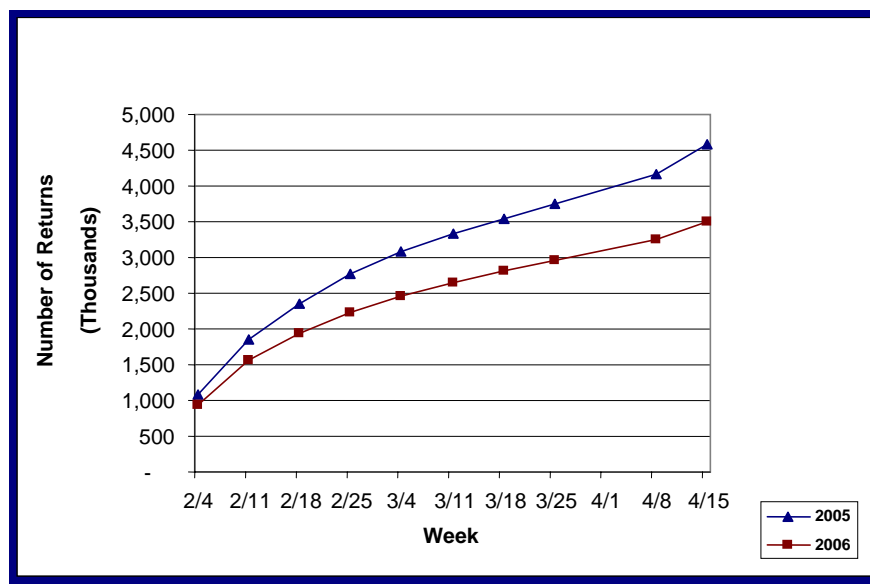
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We validated the methods the IRS used to calculate the aggregate percentage of taxpayers being offered free services and the number of taxpayers eligible for free services from any one Alliance member and found no problems with either method.

The income limit negatively affected participation and electronic filing

It appears the addition of the 70 percent limit contributed to a decline in participation in the Free File Program. As of the end of April 2006, approximately 3.9 million taxpayers had used the Free File Program compared to approximately 5 million during the same time last year. Figure 2 shows a comparison of the numbers of taxpayers using the Free File Program in 2005 and 2006. We were unable to determine how many prior users no longer qualify for the Program because the IRS did not have a way to capture Program usage data prior to the October 2005 Agreement.

Figure 2: Free File Program - Comparison of Returns Filed



Source: IRS Filing Season statistics for the 2006 Filing Season through the week ending April 15, 2006.

The lack of positive publicity for the Program in 2006 also may have played a factor in its declining use. When the Free File Program was open to all taxpayers last year, the Program received positive publicity that may have increased taxpayer use. However, most of the publicity this year has been focused on the reductions in eligibility for the Program. This negative publicity may have discouraged some eligible taxpayers from using the free services. Another contributing factor could be that the IRS is trying to promote the Program to taxpayers who do not have the technological means to take advantage of it. It is estimated that only 38 percent of

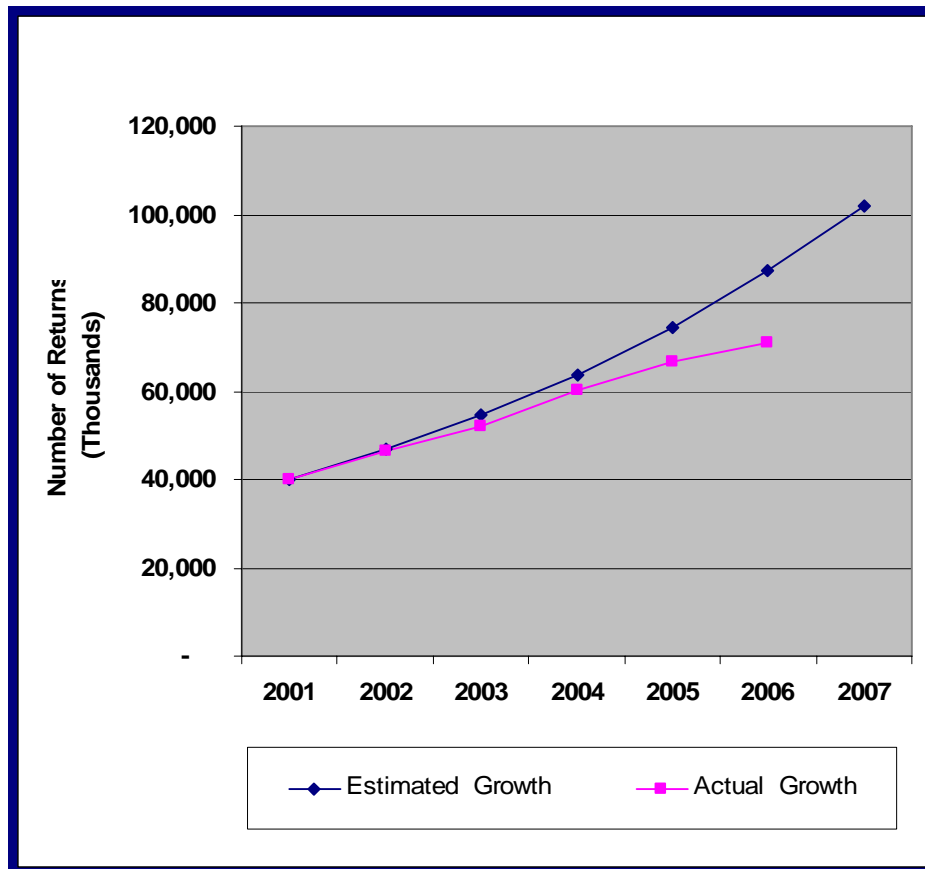


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taxpayers with income below \$25,000 have access to the Internet.⁸ Taxpayers cannot use the Free File Program unless they can access the IRS Internet web site.

The reduced participation in the Free File Program may also be affecting the growth rate of electronic filing. Although electronic filing continues to grow, the percentage growth from year to year has begun to slow. Electronic filing grew by 16.2 percent in 2002 and 15.6 percent in 2004, but the IRS estimates continued growth will be no more than 4 percent over the next 4 years. The actual growth in electronic filing also is not enough to reach the IRS' mandated 80 percent goal. Figure 3 shows the actual percentage growth in electronic filing compared to the growth the IRS needs to reach its 80 percent goal.

Figure 3: Growth in Electronic Filing - Actual Compared to Estimated



Source: IRS Filing Season projections and actual statistics for 2001 through 2007.

Taxpayers who use a return preparation software package on their home computers to prepare and file their returns electronically are considered online filers. Although online filing was up

⁸ National Taxpayer Advocate 2004 Annual Report to Congress, December 2004.



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about 19 percent at the end of April 2006 compared to last year at that time, the increase appears to be the result of additional taxpayers who are paying for those services. As of the end of April 2006, paid online filing was up roughly 36 percent over the same period last year while free online filing was down almost 23 percent.

Although more taxpayers may be using online services to file their returns, growth in electronic filing as a whole had reached only 6.3 percent at the end of April 2006.⁹

Figure 4: Electronic Filing Statistics¹⁰

Type of Electronic Filing	Returns Filed April 2005 (in millions)	Returns Filed April 2006 (in millions)	Percentage Growth
Total Electronic Filing	66.1	70.3	6.3%
Paid Preparer	46.1	50.5	9.4%
Total Online	16.7	19.8	18.6%
Paid Online	11.7	15.9	36.3%
Free Online	5.0	3.9	(22.6%)
Telefile Program ¹¹	3.3	0	N/A

Source: IRS Filing Season Statistics for the periods ending April 29, 2005, and April 29, 2006.

Another factor that appears to have negatively affected electronic filing is the elimination of the Telefile Program. The IRS and the Alliance had hoped many of the 3.3 million taxpayers who filed their Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ) using the Telefile Program in 2005 would migrate to the Free File Program. However, many of these taxpayers did not file electronically and instead filed their returns on paper this year. As of April 28, 2006, the number of electronic Form 1040EZ returns filed had decreased 17.4 percent from the previous year, while the number of paper Form 1040EZ returns filed had increased 17.6 percent. The IRS has performed reviews that show a large percentage of previous users of the Telefile Program filed a paper Form 1040EZ in 2006. In a separate audit, we are evaluating the impact of the elimination of the Telefile Program on electronic filing.

Prior to January 2006, the IRS had no mechanism to collect data about the Free File Program. The IRS had to rely on the Alliance to provide basic information, such as the number of

⁹ Electronic filing includes paid online filing, free online filing, returns electronically prepared and submitted by a paid preparer, and returns filed over the telephone via the Telefile Program.

¹⁰ Percentages shown were computed using actual figures and may not equal due to rounding.

¹¹ The Telefile Program was a process of submitting tax returns to the IRS over the telephone. The IRS discontinued this Program after the 2005 Filing Season.



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taxpayers who used the Program, and it lacked a method to verify the accuracy of the data being provided. In August 2003, we reported that the IRS should have a method through which to evaluate the effectiveness of the Free File Program.¹² The IRS agreed it needed a way to evaluate the success of the Free File Program, but the Alliance was concerned about providing data to the IRS about the taxpayers who used the Program because the information could be used by the IRS to target compliance efforts to those taxpayers or to develop its own tax preparation and filing software.

During the 2005 Agreement negotiations, the Alliance agreed to add an indicator to each return submitted through the Free File Program. This Free File Indicator will allow the IRS to independently collect data about the Program. For example, it will give the IRS the ability to answer basic questions about the Free File Program such as why only a small percentage of eligible taxpayers are participating in the Program.

A significant number of taxpayers continue to prepare their returns electronically but file the returns on paper

Another issue affecting the growth of electronic filing is the significant number of taxpayers who use computers to prepare their tax returns (either directly or through a tax preparer) but choose to print and mail the tax returns. During 2005, approximately 62 million taxpayers filed paper tax returns. Of those, 45 million (72.5 percent) prepared their returns using computer software, printed the returns, and mailed the paper returns to the IRS. Many of these may be taxpayers who purchased software to prepare their returns but chose not to pay the required additional fee to file their returns electronically. These taxpayers may also have concerns about the security and privacy of electronic transactions with the IRS or have the perception that there is a greater chance they will be contacted or audited by the IRS if they file electronically.

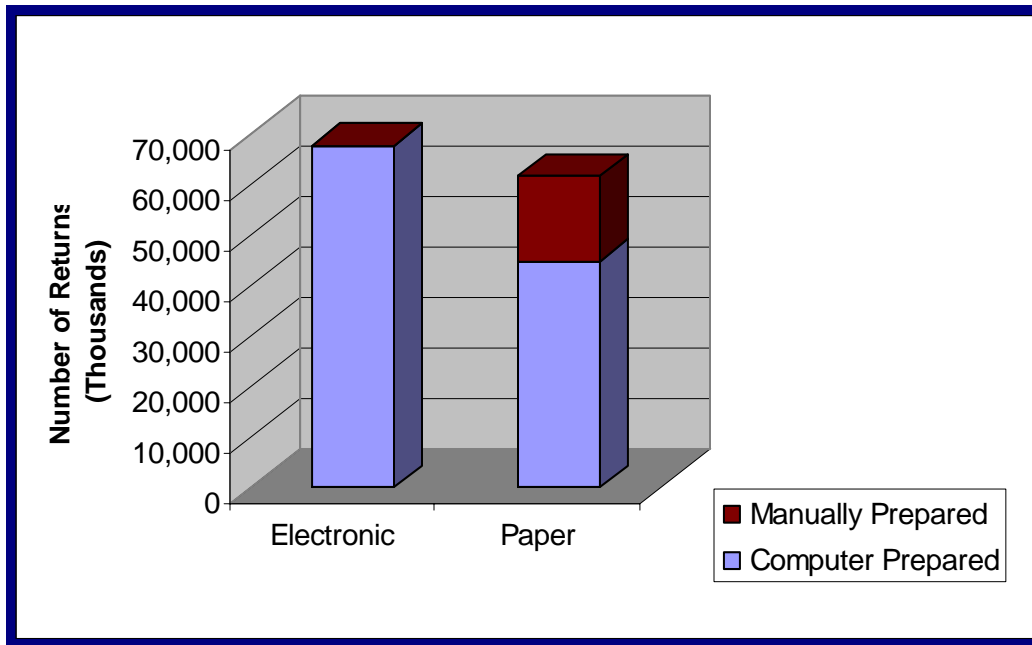
When taxpayers choose to file paper instead of electronic returns, they have to wait longer (about 5 weeks) for their refunds and the IRS has to devote additional resources to manually enter the return data into its computer system. When a taxpayer files an electronic instead of a paper return, the IRS estimates it saves \$2.37 in processing costs for that return. If the 45 million taxpayers who prepared their returns using software but filed the returns on paper in 2005 changed to electronic filing, the IRS would save approximately \$106.7 million. Even if only a small portion of these taxpayers would use the Free File Program or otherwise file their tax returns electronically, the IRS could save a substantial amount of resources. Figure 5 shows that two-thirds of the taxpayers who prepare their returns electronically file those returns via paper.

¹² *Improvements Are Needed to Ensure Individual Taxpayers Have an Easy, No-Cost Option to e-file Their Tax Returns* (Reference Number 2003-40-165, dated August 2003).



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Figure 5: Tax Year 2004 Filing Trends



Source: IRS 2004 Taxpayer Usage Study.

The amended Agreement effectively changed the purpose of the Free File Program

The purpose of the Free File Program, as stated in the original 2002 Agreement, is to assure access to a free and secure electronic preparation and filing option, make tax return preparation and filing easier and reduce burden on taxpayers, support the IRS' statutory goal to increase electronic filing, provide greater service and access, and implement one of the proposals in the President's Fiscal Year 2003 budget to encourage further growth of electronic filing. The purpose does not specifically limit delivery of the Free File Program to any one segment of taxpayers. The amended Agreement did not formally change the purpose of the original Agreement. However, the IRS and the Alliance have effectively changed the purpose of the Free File Program by restricting the Free File Program to 70 percent of taxpayers.

The Director of the Alliance disagrees that the purpose of the Free File Program was changed when the Agreement with the IRS was amended in 2005. We spoke with the Director of and Chief Counsel for the Alliance as well as representatives from a sample of Alliance members. Although the formal stated purpose of the Agreement does not mention focusing service on low-income taxpayers, generally everyone we interviewed from the Alliance and the IRS believed the purpose of the Free File Program had always been to provide free electronic tax preparation and filing services to taxpayers who are least able to afford to file their returns electronically.



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On April 6, 2006, the Director of the Alliance testified before the House Ways and Means Committee, Subcommittee on Oversight, that a supplemental Agreement between the Alliance and the IRS focused the Free File Program on “the poor, lower income, disadvantaged, and underserved.” However, this supplemental Agreement, signed in January 2004, does not appear to change or clarify the purpose of the Program; rather, it establishes a way for the IRS to obtain statistics about the Free File Program to monitor the Program’s success. The only mention of providing services to “lower income or underserved” taxpayers appears in the document’s preamble. The terms or scope of the Agreement do not include any mention of limiting or refocusing the Free File Program to a specific segment of taxpayers.

Prior to January 2006, the Free File Program was the only free electronic tax return preparation and filing tool available to all taxpayers. Now, all of the IRS’ tax preparation and filing services are limited to low-income taxpayers.¹³ The only other options available for taxpayers who do not qualify for one of the free services are to pay a fee to have their returns prepared and filed electronically or to file a return on paper and wait an additional 5 weeks to receive their refunds. Taxpayers pay an average of \$50.74 to purchase computer software to prepare and file electronic tax returns. Fees charged by tax return preparers may be significantly higher.

The IRS indicated that it did not perform any data analysis to determine what percentage of taxpayers would benefit most from the Free File Program or which taxpayer segment would be most likely to use the Program. The only justification provided by the IRS for setting the eligibility limit at 70 percent was its desire to set the limit high enough to include taxpayers who had previously used the IRS Telefile Program. However, setting the limit at 70 percent, or an AGI of \$50,000, includes only a portion of the prior users of the Telefile Program. Taxpayers with an AGI as high as \$100,000 could file their returns through the Telefile Program as long as they met certain other requirements. The IRS was unable to provide more specific information to justify the limit and define the taxpayers that the IRS and/or the Alliance considered least able to afford electronic filing services.

The IRS’ partnership with the Alliance restricts its ability to modify the Agreement

The RRA 98 requires the IRS to work with private industry to expand electronic filing. As long as the IRS must rely on the Alliance to provide free electronic tax return preparation and filing services, the IRS will be limited in its ability to provide the current Free File Program to all taxpayers. The arrangement between the IRS and the Alliance more closely resembles a partnership than a contract. A contract is a business agreement for the supply of certain goods or services at a fixed price. Generally, the contracting party can specify the types of services and the method of delivery for that price. The arrangement between the IRS and the Alliance is an

¹³ The IRS offers free tax preparation and filing assistance through its Taxpayer Assistance Centers and the Voluntary Income Tax Assistance and Tax Counseling for the Elderly Programs. However, these services are available to a limited number of taxpayers who meet specific requirements. Those requirements generally limit service to low-income taxpayers.



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agreement between two parties to provide a service. However, the IRS does not compensate the Alliance for providing that service, and it does not have the ability to unilaterally specify the characteristics of the service. The IRS must negotiate with the Alliance to determine how free electronic tax preparation and filing services will be delivered and to whom.

The IRS used two principles to guide its development of the Free File Program:

- No one should be forced to pay extra to file his or her return.
- The IRS should not get into the software business.

The IRS' goal for entering into such a partnership with the Alliance was to fulfill the President's Management Agenda and the EZ Tax Filing Initiative to provide free services to all citizens and to promote electronic filing in an effort to meet its RRA 98 electronic filing goal. The Alliance's main purpose for entering into the partnership was to keep the IRS out of the tax return preparation and filing business. While the IRS agrees it should leverage the experience and talent of private industry rather than developing its own tax return preparation software, these are two very different and potentially conflicting goals.

Prior to 2005, the Alliance generally provided its Free File Program offerings to no more than the 60 percent minimum (approximately 78 million taxpayers) defined in the October 2002 Agreement. For the 2005 Filing Season, one Alliance member opted to lift its eligibility restrictions and allow all taxpayers to use its services to prepare and file their tax returns for free through the Free File Program. Soon many of the other Alliance members followed suit. Participation in the Program jumped 46 percent, from 3.51 million taxpayers in 2004 to 5.12 million taxpayers in 2005. While increased participation in the Free File Program was good from the IRS' viewpoint, the method used to gain that increase created unwillingness among the Alliance members to participate in the Program. The Alliance was concerned that, if the Program were not restricted, the Alliance may have ceased to exist. The IRS was also concerned about jeopardizing the continuation of the Alliance.

The original Agreement expired in 2005, and the IRS and the Alliance met to negotiate a new Agreement. This process of compromise and the difference in goals between the IRS and the Alliance hindered the IRS' ability to fulfill the intent of the President's Management Agenda and the EZ Tax Filing Initiative. The IRS found it necessary to agree to limit the scope of the Program to maintain the stability of the Alliance and gain some of the other conditions it was requesting. The result of this agreement limited the IRS' ability to use the Free File Program as a tool to expand electronic filing. To reduce the impact of the limit, the IRS worked with the Alliance to set the AGI threshold as high as possible.



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The Additional Limitations and Fee-Based Services of Free File Providers Increase Complexity for Taxpayers

The IRS' mission is to provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. The Free File Program contributes to this mission and provides a valuable service to some taxpayers; however, portions of the Free File Program could be improved to make it easier for taxpayers to fulfill their tax obligations. Both the National Taxpayer Advocate and the Senate Committee on Finance have raised concerns with the number and type of products being offered on the individual Alliance member's Free File webpages. Issues identified by the National Taxpayer Advocate and the Committee on Finance included:

- The promotion of unsuitable and sometimes expensive products not related to tax preparation and filing.
- Inappropriate fees for services such as technical assistance and printing a copy of the tax return.
- Undisclosed "conditions" for receiving the Federal tax preparation and filing services for free.

For example, the Committee on Finance noted that an Alliance member offered a link through which a taxpayer could sign up to purchase a tax preparation franchise for \$15,500. The concern is that this type of product is not necessarily in the best interests of taxpayers who use Free File. While this type of offering does not appear to violate the Agreement, the concerns about these products have been made known to the Alliance members. In the IRS' June 27, 2006, response to the Senate Committee on Finance, the IRS Commissioner stated that many of the Alliance members had stopped offering ancillary products on their Free File webpages.

Taxpayers must access the Free File Program through IRS.gov, which identifies the basic requirements for participation in the Program and provides a tool for taxpayers that will help guide them to a Free File Program provider. This tool, called *Guide Me To A Service*, provides the taxpayer with a number of providers from which to choose. The choices provided by the tool are based on general information provided by the taxpayer such as age, income, State of residence, whether the taxpayer qualifies for the Earned Income Tax Credit, or whether the taxpayer received military pay. Figure 6 provides an illustration of this tool.



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Figure 6: “Guide Me To A Service” Tool

Home | Contact IRS | About IRS | Site Map | Español | Help

Internal Revenue Service
United States Department of the Treasury

Keyword/Search Terms SEARCH
Advanced Search Search Tips

INDIVIDUALS | BUSINESSES | CHARITIES & NON-PROFITS | GOVERNMENT ENTITIES | TAX PROFESSIONALS | RETIREMENT PLANS COMMUNITY | TAX EXEMPT BOND COMMUNITY

Guide Me To A Service

Use this tool to help choose a company and service from our listing. Complete all the questions below, then click the submit button. A list will then be displayed showing only the services for which you may qualify.

If you are uncertain about your answers to the questions contained in this Guide you may want to view the complete [list of companies](#) and their services. The accuracy of the results is dependent on the accuracy of the answers you provide.

If the amount is not specified, Free File services are limited to taxpayers with Adjusted Gross Income of \$50,000 or less; or otherwise as noted. Individual company offers may be limited to specific states and income levels. Taxpayers who used Free File in past filing seasons might not qualify for the free services for the 2006 filing season. Carefully review the free offer descriptions before starting your return.

Important Note: This information is being used for purposes of determining the services for which you may qualify. The information is entirely anonymous and will not be retained or used for any determination of tax liability. IRS policy prohibits the use of permanent Internet cookies.

Please complete all of the following statements:

I am years of age. If filing a joint return, my spouse is years of age.

My estimated 2005 Adjusted Gross Income is \$.00

My state of residence is

I may be eligible for [Earned Income Tax Credit](#). Yes No

Did my spouse or I receive [Military](#) pay in 2005? Yes No

Source: IRS Free File webpage.

Although *Guide Me To A Service* tells taxpayers which companies they qualify to use, it may be difficult for some taxpayers to determine which of those companies best meets their needs. The tool will provide a list of companies that the taxpayer may qualify to use, but the taxpayer must access each company’s Free File webpage to determine the specific services offered and if there are any requirements or other limits that may disqualify the taxpayer from using the services. A taxpayer must then compare the services offered by each to determine which company is best.

For example, a 28-year-old married taxpayer from Michigan with a 27-year-old spouse and income of \$42,000 using the *Guide Me To A Service* tool would find he qualified to use the services of 18 providers. However, not all providers offer the same services. For example, some providers may restrict their services to specific tax forms and/or schedules. Thus, the hypothetical taxpayer noted above would have to access the individual web sites for each of the 18 providers through the IRS Free File webpage to determine which one is best. *Guide Me To A Service* would be more helpful to taxpayers if it provided a list of companies the taxpayers qualify for and the services provided by each company.



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The IRS Free File webpage may also be difficult to use for some Spanish-speaking taxpayers. According to July 2004 United States Census Bureau data, there are approximately 43.1 million Hispanic-origin residents in the United States and an additional 3.9 million residents in Puerto Rico. A study conducted by Simmons Market Research estimates that 19 percent of Hispanic-origin residents (approximately 8.9 million) prefer to speak Spanish.¹⁴ To address the needs of these taxpayers, the IRS has signed a Language Assistance Policy underscoring its commitment to provide high-quality service to each taxpayer, including those who have limited English proficiency. The Policy provides the foundation for the IRS' language assistance strategy that focuses on providing language assistance in Spanish.

Spanish-speaking taxpayers who access the IRS web site are given an option to go to the Spanish version of the web site by clicking the 'Español' (Spanish) link located in the upper right corner of the web site. The link takes the taxpayer to a webpage that is in Spanish. However, unlike the English web site, the Spanish webpage does not mention anything about the Free File Program. For Spanish-speaking taxpayers to access the Free File webpage, they must first select 'Opciones Electrónicas' (Electronic Options) from the main menu of the Spanish webpage. The link brings taxpayers to a webpage that informs them they may be able to electronically file their returns for free. The link does not contain any information about the Free File Program but tells taxpayers to click on a link to the Free File webpage to determine if they qualify. The link successfully takes taxpayers to the Free File webpage, but the page is available in English only. Spanish-speaking taxpayers who follow this path through the IRS web site are provided only the knowledge that they may be able to file electronically for free. They are not provided details about the Free File Program in Spanish, nor are they told how the Program works or if they qualify to use it.

Spanish-speaking taxpayers can obtain more information about the Free File Program by selecting the 'Consejos Útiles' (Useful Advice) link on the main Spanish webpage and then choosing the 'Pruebe el Servicio (Prove the Service) Free File' link. The 'Pruebe el Servicio' webpage contains an overview of the Free File Program and the benefits of using it, but it does not provide information on the basic eligibility requirements for the Program. Taxpayers are then directed back to IRS.gov for more information. Taxpayers following this path through the IRS web site are led in a circle that leads back to where they started, assuming these taxpayers are knowledgeable enough to navigate through the maze of links necessary to find information on the Free File Program in Spanish.

Many Spanish-speaking taxpayers may not be participating in the Free File Program because they are unaware of the Program or because it is simply too difficult to use. The IRS should provide a Spanish option on its Free File webpage rather than forcing these taxpayers to navigate through multiple webpages to learn about the Program. The IRS already provides Spanish options for other programs. For example, it provides a Spanish webpage for taxpayers to

¹⁴ *The Financo Review: The Retail and Consumer Newsletter, Volume 1, Issue 4, October 2004.*



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determine if they qualify for the Earned Income Tax Credit. Creating a Spanish version of the Free File Program eligibility webpage would ensure all taxpayers who qualify for the Program will be able to participate.

Recommendations

Recommendation 1: The Director, Electronic Tax Administration, should expand the *Guide Me To A Service* tool to include a table that provides the basic services offered by each provider.

Management's Response: The IRS agreed with this recommendation and will consider the feasibility of expanding the *Guide Me To A Service* tool to include a table that provides the basic services offered by each provider. The IRS will also initiate discussions with the Electronic Tax Administration Public Portal Branch and the Alliance to discuss the steps necessary to provide additional information in the tool.

Recommendation 2: The Director, Electronic Tax Administration, should provide a direct link to a Spanish version of the Free File webpage. The Spanish version of the page should include basic information about the Program and its benefits as well as a tool similar to *Guide Me To A Service* that will help Spanish-speaking taxpayers identify a provider.

Management's Response: The IRS agreed with this recommendation and will study the feasibility of providing a Spanish language entry portal for the Free File Program. The Electronic Tax Administration Office will also initiate discussions with the Multilingual Language Initiative Strategy Office, the Electronic Tax Administration Public Portal Branch, the Alliance, and the IRS Office of the Chief Counsel to discuss the steps necessary to provide this Spanish link.

Office of Audit Comment: The IRS provided only the initial steps for its corrective actions to each of the above recommendations. We will follow up to evaluate whether its actions are adequate to achieve the intent of those recommendations. In response to our draft report, the Commissioner, Wage and Investment Division, included some general comments and assertions we believe warrant additional comment. Our response to these issues can be found in Appendix VII.



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The New Agreement Added Additional Consumer Protections

The new Free File Program Agreement resulted in several changes that promote public confidence in the Program and provide additional consumer protection. The most significant of these changes are:

- The addition of a Free File Indicator.
- Improved disclosure for Refund Anticipation Loans (RAL) (see Appendix V).
- Increased security requirements and additional performance requirements for the Alliance members.
- The ability to file for an extension of time to file an individual income tax return.

The commercial nature of the Free File Program made many of the enhancements in the amended Agreement necessary. According to representatives of some of the individual Alliance member companies, one of the underlying benefits of the Free File Program is their ability to market their products to more people for free. If the Free File Program Agreement were not administered in a commercial environment, there would be no concern on the Alliance's part with the IRS gathering data about the taxpayers who use the Free File Program. There also would not be a need to regulate the promotion of RALs or any other ancillary product. Appendix IV provides a detailed description of the changes to the Free File Program Agreement.

Improved disclosure of RALs enhances public awareness

The Free File Program Agreement allows Alliance members to offer taxpayers other services in addition to free tax preparation and filing services. One of the most common products offered is a RAL. RALs have caused concern from members of Congress as well as consumer advocacy groups because of the exorbitant interest costs associated with them. A nationwide survey of consumers commissioned by the National Consumer Law Center¹⁵ found over 12 million taxpayers had taken out a RAL in 2003, and two-thirds of these taxpayers did not realize a RAL is a loan. In 2003, consumers paid an estimated \$1 billion in RAL fees, plus an additional \$389 million in administrative fees, to get quick cash for their refunds—essentially borrowing their own money at extremely high interest rates.

The amended Agreement created several new requirements relating to the promotion and disclosure of RALs. The changes limit the promotion of RALs and require Alliance members to disclose additional information on the nature, costs, and alternative methods of receiving a faster refund. These new requirements protect taxpayers by ensuring they are not misled into purchasing a RAL. They allow taxpayers to make a more informed decision about whether

¹⁵ National Consumer Law Center Inc., *Picking Taxpayers' Pockets, Draining Tax Relief Dollars: Refund Anticipation Loans Still Slicing Into Low-Income Americans' Hard-Earned Tax Refunds*, January 2005.



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purchasing a RAL is in their best interest by eliminating some of the common misunderstandings pertaining to RALs and disclosing all costs in a manner that can easily be compared with those of other forms of credit. The IRS reported that, as of April 15, 2006, only 0.5 percent of Free File Program taxpayers had opted for a RAL.

Improved security requirements, new performance measures, and additional services improve the level of service for eligible taxpayers

The renegotiated Agreement also increased security requirements and added performance measures for the individual Alliance members. Alliance members must now have the security of their computer systems assessed by the Alliance to ensure taxpayer information is adequately protected. Prior to the new Agreement, Alliance members provided documentation that they had acquired third-party security and privacy certifications. The members must also maintain a 60 percent acceptance rate¹⁶ for returns filed electronically through the Free File Program. This acceptance rate will gradually increase in future years. The improved security requirements and added performance measures serve as valuable tools in promoting public confidence in the security and accuracy of the Free File Program.

Another valuable change to the Free File Program was the addition of the option to file an Application for Automatic Extension of Time To File U.S. Individual Income Tax Return (Form 4868). Prior to January 2006, taxpayers could not request an extension to file through the Free File Program. Under the new Agreement, more than one Alliance member must offer free preparation and electronic filing of Form 4868 from April 1 to the due date of the return.

Overall, the enhancements to the Free File Program increased consumer protection, security, and performance standards. The enhanced security and performance standards indirectly affect electronic filing by contributing to increased public confidence in the Program. The addition of the ability to file a Form 4868 offers a service that previously was not available through the Free File Program and may increase the number of taxpayers who consider using the Program. While the Free File Indicator does not affect taxpayer service or electronic filing, it does provide the IRS with an important tool for managing the Program. Unfortunately, the nature of the Free File Program Agreement made many of these enhancements necessary. Figure 7 provides an overview of the number of taxpayers affected by some of these changes during the 2005 and 2006 Filing Seasons.

¹⁶ The percentage of returns an individual provider must transmit to the IRS error free.



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Figure 7: Free File Program Statistics - 2005 and 2006 Filing Seasons

Filing Season Statistic	2005 Filing Season	2006 Filing Season
Number of taxpayers who filed through the Free File Program	4,583,000	3,661,477
Number of RALs made by taxpayers who filed through the Free File Program.	Not Available ¹⁷	19,945
Number of Forms 4868 filed through the Free File Program	0	46,671

Source: IRS Office of Electronic Tax Administration.

***The Internal Revenue Service and Government Accountability Office
Are Evaluating Other Free Tax Preparation and Filing Options***

Many of the issues discussed in this report are the result of the IRS having to work through the tax preparation industry to provide the Free File Program. Whether the IRS should provide these same services directly to the taxpayer on its own is a matter of tax policy. There have been concerns raised by some members of Congress, tax professionals, and the tax preparation industry as to whether it is appropriate for the IRS to offer assistance in preparing tax returns and whether this conflicts with its role of making necessary adjustments and/or additional assessments as part of processing returns and collecting the proper taxes.

Notwithstanding, there are continuing concerns by Congressional oversight committees that the current Free File Program Agreement is not adequate and does not serve the best interests of taxpayers or meet the intent of the E-Government and EZ Tax Filing Initiatives. Consequently, the Senate Committee on Finance has asked the IRS to provide information on its capability and the cost to provide Free Filing services; it also has asked the Government Accountability Office to study the feasibility of providing taxpayers a way to prepare their tax returns electronically through the IRS rather than through a third party. Specifically, the Government Accountability Office will examine the potential benefits of online return preparation directly on the IRS web

¹⁷ Because the Free File Indicator was not available in 2005, the IRS did not have data on the number of Free File Program users who also used a RAL during the 2005 Filing Season.



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site, the lessons learned from States' and other countries' experiences with online return preparation, and the potential costs and obstacles associated with the IRS developing its own online return preparation capability.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine the impact of the October 2005 Agreement between the IRS and the Free File Alliance, LLC¹ (referred to as the Alliance) on taxpayer service and electronic filing. This audit was requested by the Chairman of the House Ways and Means Committee, Subcommittee on Oversight. The Chairman requested an assessment of the impact of the changes in the IRS' Agreement with the Alliance on taxpayer service and electronic filing. We were unable to quantify the impact of the changes to the Free File Program Agreement because the IRS does not have adequate data available on the Free File Program. Therefore, our audit was limited to an assessment of the potential impact those changes have had and could have on the IRS' efforts to expand electronic filing. To accomplish our objective, we:

- I. Compared the 2002 Agreement to the 2005 Agreement and determined whether the changes to the 2002 Agreement should have enhanced taxpayer service and electronic filing.
 - A. Evaluated the method used to calculate the aggregate percentage of taxpayers who had free services offered to determine whether an appropriate method was used and evaluated the method used to calculate the number of taxpayers that were eligible for free services from any one Alliance member company.
 - B. Evaluated the information on the IRS Free File webpage to determine whether the IRS provided sufficient information to taxpayers seeking free filing services.
 - C. Accessed each Alliance member's web site through the IRS Free File webpage to determine the eligibility requirements for free services each member had posted on its site (see Appendix VI). In addition, from information on each member's web site, we determined fees for preparing and filing electronic State returns, information regarding RALs, other fees, and the presence of links to inappropriate content.
 - D. Interviewed IRS personnel to determine why changes were made to the 2002 Agreement and the goal of the changes.
 - E. Interviewed representatives of the Alliance, including the Director and Chief Counsel, and a sample of 6 of the 20 Alliance members to gain their perspectives on the changes to the 2002 Agreement. We included two major providers (members) in our sample. The four small providers in our sample were chosen at random. We used random sampling to allow us to limit our sample size to a manageable number based

¹ An LLC is a limited liability corporation.



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on available audit resources and to ensure a mix of large and small providers were contacted.

- II. Determined the use of Free File services during the 2005 Filing Season² by researching the IRS Internet and Intranet sites for information on taxpayer participation in the Free File Program. Because the information on Program participation was provided to the IRS by the Alliance rather than gathered by the IRS, we were unable to validate the reliability of the information. The IRS had no mechanism in place during the 2005 Filing Season to independently assess Program results.

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



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Appendix II

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Appendix III

Report Distribution List

Commissioner C
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
Chief, Performance Improvement, Wage and Investment Division SE:W:S:PI
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
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

Changes to the Free File Program Agreement

The IRS and the Free File Alliance (referred to as the Alliance) renegotiated the Free File Program Agreement during Calendar Year 2005 and signed an amended Agreement in October 2005 that resulted in a number of changes. The IRS and the Alliance did not formally change the purpose of the Agreement. However, changes in the Agreement's Scope of Offerings shifted the focus of the Agreement from all taxpayers to low-income taxpayers.

Scope of Offerings

The October 2002 Agreement ensured 60 percent or more of taxpayers, or at least 78 million taxpayers, would have free services available. The October 2005 Agreement limits free services to no more than 70 percent of taxpayers based on an AGI¹ amount. The AGI limit is \$50,000 for the 2006 Filing Season² or approximately 93 million taxpayers. This change effectively eliminated roughly 39 million taxpayers from the Free File Program.³ The Scope of Offerings in the October 2005 Agreement states the IRS and the Alliance agree that, to serve the greater good and to ensure the long-term stability of the Alliance, the scope of the Free File Program is focused on covering taxpayers least able to afford electronic filing on their own.

In addition to the change in the total number of taxpayers that would have free services available, a change was made to limit the number of taxpayers that an individual company can cover. In the October 2005 Agreement, an individual company cannot offer free services to more than 50 percent of total taxpayers or approximately 66.5 million taxpayers.⁴ Companies were not limited in the total number of taxpayers they could offer free services to in the prior Agreement.

RALs

Several new requirements relating to the promotion and disclosure of RALs were added to the Agreement. These new requirements protect taxpayers from misleading RALs and reduce taxpayer burden by limiting the promotion of RALs. The changes also require the Alliance to disclose additional information on the nature, costs, and alternative methods of receiving a faster refund. Appendix V includes details of the new RAL requirements.

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

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

³ Approximately 132 million taxpayers filed an individual income tax return during Calendar Year 2005. Based on the October 2002 Agreement, all were eligible to use the Free File Program. The difference between the 132 million taxpayers eligible for the Program in 2005 and the 93 million eligible in 2006 is 39 million taxpayers.

⁴ The number of taxpayers an individual company can offer free services to may change from year to year depending on the total number of taxpayers.



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Performance Standards

Under the new Agreement, Alliance members must meet a graduating performance standard. This standard is based on the number of returns each member transmits to the IRS error free. For the 2006 Filing Season, the performance standard requires Alliance member companies to transmit 60 percent of the returns prepared through the Free File Program to the IRS error free. This percentage will gradually increase in future years.

Security Requirements

The new Agreement requires each Alliance member to conduct an annual penetration and vulnerability assessment prior to the start of the filing season. These assessments must be conducted by a third party and are designed to test the overall security of a member's computer systems.

Free File Indicator

Prior to January 2005, the IRS did not have a mechanism through which to collect information about the effectiveness of the Free File Program. Data about the Program, such as the number of taxpayers who used it, were provided to the IRS by the Alliance. The October 2005 Agreement requires the Alliance to provide an indicator on returns filed through the Free File Program. The Free File Indicator will give the IRS the tool it needs to effectively track the success of the Program. The Agreement also places restrictions on who can use the data gathered as a result of the Free File Indicator. The IRS must inform the Alliance when a Governmental agency such as Congress or the Treasury Inspector General for Tax Administration requests data concerning individual companies. The Alliance has the option to discontinue providing the Free File Indicator at that time.



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Appendix V

Refund Anticipation Loan Requirements

The amended Free File Program Agreement signed by the IRS and the Free File Alliance (referred to as the Alliance) in October 2005 expanded the disclosure requirements for RALs. Details follow.

1. No offer of free return preparation and filing of an electronic return in the Free File Program shall be conditioned on the purchase of a RAL.
2. RALs may be offered only in a manner consistent with all statutes and regulations, as well as any guidance issued by the Department of the Treasury or the IRS, applicable at the time of the offering.
3. RALs will be offered with clear language indicating that (a) they are loans, not a faster way of receiving an IRS refund; (b) they must be repaid even if the IRS does not issue a full refund; (c) because RALs are short-term loans, interest rates may be higher than those on some other forms of credit and consumers may wish to consider using other forms of credit; and (d) the time period in which tax refunds are typically paid is based upon the different filing options available to the taxpayer, including the different options through which taxpayers can receive refunds directly from the Federal Government (paper check versus direct deposit).
4. No RAL will be made unless the consumer affirmatively consents in advance to receive a RAL. The refund loan facilitator must disclose the expected time within which the loan will be paid to the taxpayer if such loan is approved. No RAL will be made unless the consumer affirmatively consents to share any personal data, in accordance with Federal Government regulations, with the financial institution making a refund loan.
5. RALs may be offered only as one option among options, including a no-added-fee refund from the IRS. The IRS refund option shall be presented first.
6. RALs may be offered but not promoted. A taxpayer may be asked only once if he or she is interested in a RAL.
7. Some Alliance members will not offer RAL products, thus ensuring consumers have RAL-free options.
8. The refund loan facilitator shall disclose all fees related to the RAL. Such disclosures shall include (a) a copy of the fee schedule of the refund loan facilitator, (b) the typical fees and interest rates (using annual percentage rates as defined by Federal Government regulations) for several typical amounts of such loans, (c) typical fees and interest charges if a loan is not



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paid or payment is delayed, and (d) the amount of a fee (if any) that will be charged if the loan is not approved.



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Appendix VI

Eligibility Requirements for Each Alliance Member

Each Free File Alliance (referred to as the Alliance) member has established its own eligibility requirements for using its Free File services. The intent is to help ensure no one member's services are available to more than 50 percent of the total taxpayers eligible for the IRS Free File Program. The combination of the individual Alliance members' eligibility requirements must guarantee that no more than 70 percent of all taxpayers have the opportunity to use the Program.

Eligibility Requirements and Services Provided¹
<u>CompleteTax</u> : Free Federal online tax preparation and electronic filing if AGI ² is \$29,000 or less.
<u>OLT.COM</u> : Free Federal online tax preparation and electronic filing if AGI is between \$10,000 and \$50,000. Extensions electronically filed (<i>e-filed</i>) for free.
<u>FREE TAX RETURN</u> : Free Federal online tax preparation and electronic filing if AGI is between \$10,000 and \$50,000. Extensions <i>e-filed</i> for free.
<u>TaxEngine.com</u> : Free Federal online tax preparation and electronic filing if AGI is between \$10,000 and \$50,000.
<u>Online Tax Pros</u> : Free Federal online tax preparation and electronic filing if AGI is between \$10,000 and \$50,000. Services available in Spanish.
<u>123Easytaxfiling.com</u> : Free Federal online tax preparation and electronic filing if AGI is between \$10,000 and \$50,000. Extensions <i>e-filed</i> for free.
<u>CitizenTax</u> : Free Federal online tax preparation and electronic filing if AGI is between \$10,000 and \$50,000. Extensions <i>e-filed</i> for free.
<u>TAXSLAYER.com</u> : Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer is age 25 or younger or 68 or older, or active in the military, or qualifies for the Earned Income Tax Credit. Extensions <i>e-filed</i> for free.
<u>TURBOTAX</u> [®] : Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer is age 50 or under.

¹ Requirements as of April 18, 2006. Companies have the option of changing their requirements.

² AGI is income less certain deductions and/or expenses.



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H&R BLOCK'S TAXCUT: Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer is age 50 or under.

TAX\$IMPLE.com: Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer is age 50 or under.

ezTaxReturn.com: Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer is between ages 16 and 51.

eSmartTax: Free Federal online tax preparation and electronic filing return if AGI is \$50,000 or less and taxpayer is between ages 19 and 53. Services available in Spanish. Extensions *e-filed* for free.

FileYourTaxes.com: Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer lives in AL, AZ, CA, CO, DE, GA, IL, KS, KY, LA, MD, MI, MO, MS, NC, NJ, NY, OH, OK, OR, or WI or is age 18 or under. Extensions *e-filed* for free.

TaxACT.com: Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer lives in AL, AR, AZ, CA, CO, CT, DC, DE, GA, HI, IA, ID, IN, KS, KY, LA, MA, MD, ME, MI, MN, MO, MS, MT, NC, NE, ND, NH, NJ, NM, NY, OH, OK, OR, RI, SC, UT, VA, VT, WI, or WV. Extensions *e-filed* for free.

1040NOW EXELTAX®: Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer lives in AL, AR, AZ, CA, CO, CT, DC, DE, GA, HI, IA, ID, IN, KS, KY, LA, MD, MI, MO, MS, MT, NC, ND, NE, NJ, NM, NY, OH, OK, OR, PA, RI, SC, UT, VA, VT, WI or WV.

EFILETAXRETURNS.NET: Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer lives in AL, AR, AZ, CA, CO, DC, DE, GA, IA, ID, IL, IN, KS, KY, LA, MA, MD, ME, MI, MN, MO, MS, MT, NC, NE, NJ, NM, NY, OH, OK, OR, SC, VA, VT, WI, or WV.

FreeTaxReturns.com: Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer lives in AZ, CA, CO, CT, DE, GA, HI, IA, ID, IL, IN, KS, KY, LA, MD, MI, MO, MS, MT, NC, ND, NE, NJ, NM, NY, OH, OK, PA, RI, SC, UT, VA, VT, WI, or WV. Extensions *e-filed* for free.

FreeTaxUSA.com: Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer lives in AL, AZ, CA, CO, CT, GA, IA, IL, IN, KS, KY, LA, MD, MI, MO, NC, NJ, NY, OH, OK, OR, PA, SC, UT, or VA.

average1040.com: Free Federal online tax preparation and electronic filing if AGI is \$50,000 or less and taxpayer lives in AZ, GA, MI, NC, or NY.

Source: IRS Free File webpage as of April 18, 2006.



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Appendix VII

Office of Audit Comments on Management's Response

In response to our draft report, the Commissioner, Wage and Investment Division, included some general comments and assertions we believe warrant additional comment. We have included portions of management's response and our related comments below.

Management's Response: *Your report asserts that EZ Tax Filing was intended to provide a way for all taxpayers to file their tax returns with the IRS at no cost. In reality, this is not how the initial project of the EZ Tax Filing initiative, NetFile, was developed in affiliation with [the Department of the] Treasury and the Office of Management and Budget (OMB). Therefore, we do not agree that the intent was to provide a free service for all taxpayers.*

The intent of NetFile is evidenced in the EZ Tax Filing Business Case and Capital Asset plan... . This document stated that the objective of the EZ Tax Filing initiative was to decrease the tax preparation and filing burden on wage earners by expanding the availability of online, Internet information and filing options. The OMB stated that NetFile, the initial project of the EZ Tax Filing initiative, would provide no-cost online internet filing capabilities to a broad market of 20 million taxpayers – wage earners who self-prepare and mail-in paper returns [Forms] (1040EZ and 1040A). The EZ Tax Filing Business Case also listed providing a no-cost online Internet option for direct e-filing with the IRS by taxpayers with simple returns as a project objective of NetFile.

The IRS has successfully fulfilled the intent of the initiative. Through the IRS Free File program, the vehicle used to implement EZ Tax Filing, it is easier and free for millions of taxpayers to file their taxes in a web-enabled environment. Since the inception of Free File in 2003, more than 15.4 million returns have been filed electronically through this valuable free service.

Office of Audit Comment: We agree the IRS Free File Program is a valuable component of the IRS' overall electronic filing strategy and has allowed a significant number of taxpayers the option to file their tax returns for free. However, we continue to believe the Free File Program does not satisfy the intent of the E-Government Initiative or the EZ Tax Filing Initiative.

According to the IRS, almost all of the income earned by the 118 million individual taxpayers served by the Wage and Investment Division is wages reported by third parties. Therefore, focusing the Free File Program on wage earners would make it available to most individual taxpayers. The IRS and the Alliance, however, limited the Program to only a portion of wage earners by establishing a level of service or AGI limit. In



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addition, the information the IRS cited does not show that the EZ Tax Filing Initiative should focus on taxpayers who self-prepare a paper tax return, only that the initial project provided under the Initiative should be focused on these taxpayers. The IRS has not indicated that it has plans to expand the Free File Program to other users; therefore, it is not clear why the IRS cites the objective of the initial phase of the Initiative as the criteria with which to gauge the Program. The language of the Initiative clearly states “the initiative will make it easier for citizens to file taxes in a Web-enabled environment. Citizens will no longer have to pay for basic automated tax preparation.”

Management’s Response: *I also disagree with the following statement in your report, “Our review of the Free File webpage also showed the webpage could be confusing or difficult for some taxpayers to use.” The results from the recent Free File survey conducted in June 2006 indicate that the level of taxpayer satisfaction with the Free File program is extremely high.*

Office of Audit Comment: The results of the Free File survey were not available at the time we conducted our audit. Notwithstanding the positive survey results, the IRS still needs to take action to improve service to taxpayers who are eligible for the Free File Program. The survey presents only the views of taxpayers who were successful in preparing and filing a return through the Free File Program. The IRS has not provided any data on the experience of taxpayers who attempted to use the Program but were unable to complete their returns. Fewer than 4.2 percent of taxpayers who were eligible for the Program used it during the 2006 Filing Season.¹ While a number of factors can affect participation in the Free File Program, making the Program as easy to use as possible for all eligible taxpayers should be one of the IRS’ primary focuses.

Management’s Response: *The Alliance contract only guaranteed coverage to 60 percent of taxpayers. Universal coverage was not guaranteed, although individual companies did make their services available to all taxpayers. These individual members made no guarantees that their companies would continue to provide this level of service in the future, nor did the Alliance endorse or support the continuation of this level of service. Although free tax preparation and filing was offered to all taxpayers, it was for a limited time and not guaranteed by the Alliance contract.*

Office of Audit Comment: The October 2002 contract with the Alliance guaranteed a minimum coverage of 60 percent of taxpayers but did not prevent the individual Alliance members from offering their services to all taxpayers. Last year, several of the Alliance members opened their services to all taxpayers, which made the Free File Program available to nearly all 132 million taxpayers. While this level of service may not have been guaranteed in the contract with the Alliance, it is the actual coverage offered during the 2005 Filing Season. At the time this level of service was offered, the contract with the Alliance was silent as to the maximum level of service the Alliance would support.

¹ The period from January through mid-April when most individual income tax returns are filed.



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The maximum level of service was not defined until the October 2005 Agreement was signed.

Management's Response: *I am also concerned that portions of your report would lead a reader to infer that the decrease in e-filed [Form] 1040EZs was directly and primarily attributable to former Telefile [Program] users moving to paper. Our analysis shows that as of August 30, 2006, of those who had previously Telefiled [used the Telefile Program], 1,533,562 or 46.6 percent electronically filed their returns in 2006. Of these, 1,138,430 or 74.2 percent e-filed their returns using an on-line product. Based on this data, it is clear that a significant number of former Telefile [Program] users are changing to e-file.*

Office of Audit Comment: Historically, the IRS has considered the Telefile Program to be part of its electronic filing program and has included data on the number of taxpayers using the Telefile Program in its overall electronic filing statistics. Although 46.6 percent of Telefile Program users did change to another electronic filing method, the majority (53.4 percent of prior Telefile Program users) either chose to file a paper tax return, or had not filed any tax return. As of July 31, 2006, about 1.4 million of these taxpayers had filed a paper return, and the other 313,000 had not filed a return. Because less than one-half of the former Telefile Program users chose to file an electronic tax return, the decrease in electronically filed Forms 1040EZ is at least partially attributable to the elimination of the Telefile Program. We are in the process of further evaluating the impact of the elimination of the Telefile Program on taxpayers and the IRS' electronic filing program.



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Appendix VIII

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
SEP 15 2006

September 15, 2006

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 – Use of the Free File Program Declined After
Income Restrictions Were Applied (Audit # 200640029)

I have reviewed the subject draft report and appreciate your acknowledgement that the new Free File Agreement resulted in several changes that promoted public confidence in the program and provided additional consumer protection. The most significant of these changes were:

- The addition of a Free File Indicator.
- Improved disclosure for Refund Anticipation Loans (RAL).
- Increased security requirements and additional performance requirements for the Free File Alliance members.
- The ability to file for an extension of time to file an individual income tax return.

The objective of your review was to assess the impact of the changes in the IRS' agreement with the Free File Alliance on taxpayer service and electronic filing. In general, we agree with your recommendations, which we are already considering for the 2008 filing season by examining the benefits and feasibility of an expanded *Guide Me To A Service* tool and a Spanish version of the Free File webpage.

I appreciate your assessment that changes in the Free File Agreement promoted public confidence and provided additional consumer protection. However, I do not agree with your assertion that the intent of the E-Government and the IRS Free File (formerly known as EZ Tax Filing) initiatives was to provide all taxpayers a way to prepare and file their tax returns electronically without having to pay for those services. As outlined in more detail below, this initiative was directed toward providing a basic electronic filing option for a limited taxpayer segment filing simple returns.

Your report asserts that EZ Tax Filing was intended to provide a way for all taxpayers to file their tax returns with the IRS at no cost. In reality, that is not how the initial project of the EZ Tax Filing initiative, NetFile, was developed in affiliation with Treasury and the



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Office of Management and Budget (OMB). Therefore, we do not agree that the intent was to provide a free service for all taxpayers.

The intent of NetFile is evidenced in the EZ Tax Filing Business Case and Capital Asset plan developed by the IRS dated December 10, 2001. This document was written to provide justification and costs for implementing the Department of Treasury's EZ Tax Filing initiative – part of the President's e-gov (Quick Silver) program. This document stated that the objective of the EZ Tax Filing initiative was to decrease the tax preparation and filing burden on wage earners by expanding the availability of online, Internet information and filing options. The OMB stated that NetFile, the initial project of the EZ Tax Filing initiative, would provide no-cost online internet filing capabilities to a broad market of 20 million taxpayers – wage earners who self-prepare and mail-in paper returns (1040EZ and 1040A). The EZ Tax Filing Business Case also listed providing a no-cost online Internet option for direct e-filing with the IRS by taxpayers with simple returns as a project objective of NetFile.

The IRS has successfully fulfilled the intent of the initiative. Through the IRS Free File program, the vehicle used to implement EZ Tax Filing, it is easier and free for millions of taxpayers to file their taxes in a web-enabled environment. Since the inception of Free File in 2003, more than 15.4 million returns have been filed electronically through this valuable free service.

I also disagree with the following statement in your report, "Our review of the Free File webpage also showed the webpage could be confusing or difficult for some taxpayers to use." The results from the recent Free File survey conducted in June 2006 indicate that the level of taxpayer satisfaction with the Free File program is extremely high. Key findings include:

- 94 percent of the taxpayers surveyed intend to use Free File again during the 2007 filing season.
- 97 percent would recommend Free File to a friend or family member.
- 94 percent rated their tax filing experience as Very Easy or Somewhat Easy.
- 96 percent of those surveyed found the navigation within the Free File website at IRS.gov to be easy to use.

Likewise, your report states, "In 2005, the Alliance made the Free File program available to nearly all 132 million individual taxpayers and reported that 5.12 million taxpayers used the free service to file their tax returns." This statement is not correct. The Alliance contract only guaranteed coverage to 60 percent of taxpayers. Universal coverage was not guaranteed, although individual companies did make their services available to all taxpayers. These individual members made no guarantees that their



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companies would continue to provide this level of service in the future, nor did the Alliance endorse or support the continuation of this level of service. Although free tax preparation and filing was offered to all taxpayers, it was for a limited time and not guaranteed by the Alliance contract.

I am also concerned that portions of your report would lead a reader to infer that the decrease in e-filed 1040EZs was directly and primarily attributable to former Telefile users moving to paper. Our analysis shows that as of August 30, 2006, of those who had previously Telefiled, 1,533,562 or 46.6 percent electronically filed their returns in 2006. Of these, 1,138,430 or 74.2 percent e-filed their returns using an on-line product. Based on this data, it is clear that a significant number of former Telefile users are changing to e-file.

Finally, you note that a significant number of taxpayers continue to prepare their returns electronically but file them on paper. Based on an analysis of the ETA Marketing Database, a total of 40.9 million taxpayers had their returns prepared on a computer and filed them on paper. Of that number, 12.5 million or 30.6 percent self-prepared their returns and 28.4 million or 69.4 percent had their returns prepared by a paid preparer. We have used different incentives and marketing approaches to encourage e-filing by both of these groups. We have developed incentive products, such as e-services, to encourage paid tax preparers to file electronically. We will continue to work with the industry to encourage their continued marketing of e-file as well as participation in the program.

Our response to your recommendation is detailed in the attachment. 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



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Attachment

RECOMMENDATION 1

The Director, Electronic Tax Administration, should expand the *Guide Me To A Service* tool to include a table that provides the basic services offered by each provider.

CORRECTIVE ACTION

We will consider the feasibility of expanding the *Guide Me To A Service* tool to include a table that provides the basic services offered by each provider. We will initiate discussions with the ETA Public Portal Branch and the Free File Alliance to discuss the steps necessary to provide additional information in the tool. These steps will include discussions of all the necessary elements such as requirements, resources, and funding.

IMPLEMENTATION DATE

Decision to expand tool – January 15, 2007

RESPONSIBLE OFFICIAL

Director, Electronic Tax Administration

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 provide a direct link to a Spanish version of the Free File Webpage. The Spanish version of the page should include basic information about the Program and its benefits as well as a tool similar to *Guide Me To A Service* that will help Spanish-speaking taxpayers identify a provider.

CORRECTIVE ACTION

We will study the feasibility of providing a Spanish language entry portal for Free File. We will initiate discussions with the Multilingual Language Initiative (MLI) Strategy Office, ETA Public Portal Branch, the Free File Alliance, and Chief Counsel to discuss the steps necessary to provide this Spanish link. These steps will include discussions of all the necessary elements such as requirements, resources, and funding.

IMPLEMENTATION DATE

Decision to provide a Spanish language entry portal – January 15, 2007

RESPONSIBLE OFFICIAL

Director, Electronic Tax Administration

CORRECTIVE ACTION MONITORING PLAN

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