AN ANALYSIS OF THE FREE FILE PROGRAM*

Michelle S. Chu and *Melissa M. Kovalick,* Internal Revenue Service

BACKGROUND AND PURPOSE

THE RESTRUCTURING AND REFORM ACT OF 1998 (RRA 1998) stated that the Internal Revenue Service (IRS) should set goals to have at least 80 percent of all federal tax and information returns filed electronically by 2007. There are many benefits of electronically filing tax returns; tax law compliance is improved, the IRS reduces operating costs by reducing the need for human inputs to transcribe data, and transcription errors are eliminated.

The electronic file (e-file) program began in 1986. During the 2006 filing season, an estimated total of 83.1 million tax returns were filed electronically (IRS, 2006a), including individual income, corporate, partnership, excise, and exempt organization tax returns. About 73 million individual income tax returns were e-filed during the 2006 filing season.

While many factors affect the growth of the e-file program, this paper focuses on the Free File Program, which provides taxpayers with access to free on-line tax preparation and e-filing services. Although data on the Free File Program is limited, this paper will present a demographic overview of Free Filers. In addition, an overview and analysis of the Program will be provided.

OVERVIEW AND HISTORY OF FREE FILE PROGRAM

The Free File Program was developed in response to President Bush's E-Government initiative and the Office of Management and Budget's EZ Tax Filing Initiative, with the assumption that providing free e-filing services to the majority of taxpayers would help meet the 80 percent e-file target established by RRA 1998. Although some private sector firms offered free e-file services to limited groups of taxpayers in the past, the Free File Program marked an innovative approach by making free services consistently available to the majority of taxpayers on a multiyear basis.

One question that arose during the development of the Free File Program was why the federal government would partner with private industry instead of creating its own software for free-file purposes. When the Department of the Treasury announced new efforts to expand the e-file program in January 2002, Secretary Paul O'Neill asked then-IRS Commissioner Charles Rossotti to partner with the private sector. O'Neill stated that it was not his intent "for the IRS to get into the software business, but rather to open a constructive dialogue with those who already have established expertise in this field. In the end, this effort should come up with a better way to save time and money for both taxpayers and the government" (Office of Public Affairs, 2002). Since software companies had already proven their knowledge in the area of electronic tax services, working with private industry has several advantages. It encourages competition, gives taxpayers more choices, and reduces costs to the American public.

BENEFITS AND OBJECTIVES OF THE FREE FILE PROGRAM

The Free File Program has four main objectives: to increase e-file penetration, provide more free on-line options to taxpayers, ease tax preparation and filing, and provide greater access to taxpayers. The e-file option offers the advantages of reduced burden on filers and quicker refunds, and the Free File Program exposes these benefits to taxpayers who may have previously prepared and filed paper returns. In addition, promoting the Free File Program on the IRS Web site might alleviate taxpayers' concerns about the security of the e-file process.

On October 30, 2002, the original Free On-line Electronic Tax Filing Agreement was signed by the IRS Commissioner and the Manager of the Free File Alliance, LLC. The Free File Alliance is a group of software companies who provide free commercial on-line tax preparation and e-filing services. The agreement had an initial term of three years, followed by automatic options to renew for successive 2-year periods. When this agreement expired, a revised agreement was signed which

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extended the terms from October 30, 2005, through October 30, 2009.

As of October 2006, analysis of the Free File Program is limited due to the availability of data. Although the program has been in existence for four years, in the initial years, data related to Free-Filed returns were the property of members of the Free File Alliance, not the IRS. The IRS did not begin to identify Free-Filed returns until the 2006 Filing Season (Tax Year 2005). Limited quantitative data from prior years is available via survey results from studies conducted by contractors, and volumes of Free-Filers provided by the software companies. However, use of this data is restricted for proprietary reasons. Another constraint is that complete filing season results for 2006 were not available at the time this paper was written. The deadline for Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*)* to be filed was October 16, 2006, and the data used in this analysis was current as of September 26, 2006.

THE FREE ON-LINE ELECTRONIC TAX FILING AGREEMENTS

The initial agreement between the IRS and the Alliance was executed on October 30, 2002. The arrangement covers a wide array of topics such as performance standards, scope of marketing efforts, terms of terminating the agreement, and the operation of the Alliance Web page. The contract specifies that, in total, Alliance members must provide the free e-filing option to at least 60 percent of all individual income taxpayers during the primary tax filing season (January through April). If the Alliance fails to reach the 60 percent coverage, the group must raise the coverage within a 6-month period. In addition, each individual Alliance member must provide this free service to cover at least 10 percent of the total individual income tax returns filed.

The agreement also addresses disclosure issues, privacy, and security provisions. In order to ensure satisfactory level of quality, the members were required to submit test returns for certification prior to being identified as a member of the Alliance on the Web page. In addition, all members must have a security and privacy seal certificate from a third party. The certification process was based on an assessment of the member system's ability to protect taxpayer data and privacy concerns.

The agreement also specifies the guidelines for operating the Alliance Web page on the IRS site. The IRS will host and maintain the Web page but the Alliance will determine the final content of the Web site. This includes determining the rank order placement of the links to individual offerings, presence of a link to the free services, and prohibition of advertisements on the Free File Web page. The IRS must be notified if an offering will be unavailable for five hours or more and IRS has the authority to delist a member if its service remains unavailable for more than 24 hours.

Marketing issues are explored in the agreement. Although the IRS will promote the availability of the free services, it will not specifically endorse products. The IRS and the Alliance will also explore ways to support fed/state filing of returns through the Free File Program. The option of IRS offering free e-filing services also remains open. If the IRS notifies the Alliance of this decision to offer free e-filing services during the primary filing season, the Alliance may terminate the agreement effective April 16.

After three successful filing seasons, the agreement between the IRS and the Alliance was extended for an additional period of four years (October 30, 2005 through 2009) with amendments stemming from lessons learned from the first agreement. The new agreement specified an aggregate coverage of 70 percent of taxpayers. The volume of taxpayers eligible to use the free service would change each filing season. In the first year of the new agreement, Filing Season 2006, 93 million taxpayers qualified to use the service. The IRS will use the most current Adjusted Gross Income (AGI) number that equates to 70 percent of all individual income taxpayers. However, no single Alliance member can cover more than 50 percent of total taxpayers. Also new to the agreement was the introduction of Form 4868.

A number of amendments to the program content were included in the new agreement. The first topic addressed was Refund Anticipation Loans (RALs). Although less than 1 percent of the 2.8 million Free File users in Tax Year (TY) 2002 opted for RALs, this was one of the key issues addressed in the new agreement. Both parties agreed that RALs may be offered by the members under several guidelines. The offer of free on-line service cannot be condi-

tional on the purchase of a RAL. The language must clearly indicate that a RAL is a short-term loan and must be repaid within a certain time, independent of the refund issued by IRS. All fees and interest rates associated with RALs must be disclosed. Finally, RALs cannot be promoted and some Alliance firms will not offer RAL products, thus ensuring that consumers have RAL-free options.

During the first three years of the program, IRS relied on the Alliance members to provide the number of returns that were Free Filed through their respective offers. One of the amendments included an agreement that the Alliance members would provide an electronic Free File indicator. In return, the IRS confirmed that they will not build a marketing database or to compile company-specific proprietary data. Although the IRS cannot refuse to comply with requests from governmental agencies and Congress, the IRS will promptly notify the Executive Director of the Alliance if this information is provided. The Alliance members will then have the option to cease providing the indicator. Also, amendments addressed Web site compliance measures and customer satisfaction surveys. The performance standard was placed at a 60 percent acceptance rate and additional privacy and security issues were addressed.

FREE FILE VOLUMES

The unprecedented alliance between the IRS and the private sector to offer free e-filing services met with success from the start. In the first year of the program (Filing Season 2003), 2.8 million returns were filed through the 17-member Alliance. The second year resulted in a more than 26 percent increase, with 3.5 million returns filed through the 17-member Alliance. The third and the most recent filing years resulted in 5.1 million Free-Filed returns (a 46 percent increase) in TY 2004 and almost four million returns (22 percent decrease) in TY 2005, from the 20-member Alliance.

The initial agreement specified a minimum coverage of 60 percent, which the members abided by in the first two filing seasons. In the third year of the program, one of the Alliance members decided to offer the free preparation and filing service to all taxpayers (TIGTA, 2006). Other members followed, and in TY 2004, 100 percent of taxpayers had the option to Free File. This was the main contributing factor to the 46 percent increase in Free-Filed returns in Filing Season 2005. This caused some friction among the Alliance members and the existence of the Alliance was threatened. Hence, one of the amendments included in the new agreement includes the stipulation that no single member can offer more than 50 percent coverage. Since the past filing season represents the first year the IRS started identifying the Free-Filed returns, the consistency of prior year data cannot be verified for accuracy.

Projections of Free File volumes produced by the IRS indicate that almost five million returns are expected to be Free Filed in TY 2006. This represents a 25 percent increase from the TY 2005 filing season. The volume is expected to reach almost 6 million by TY 2009.

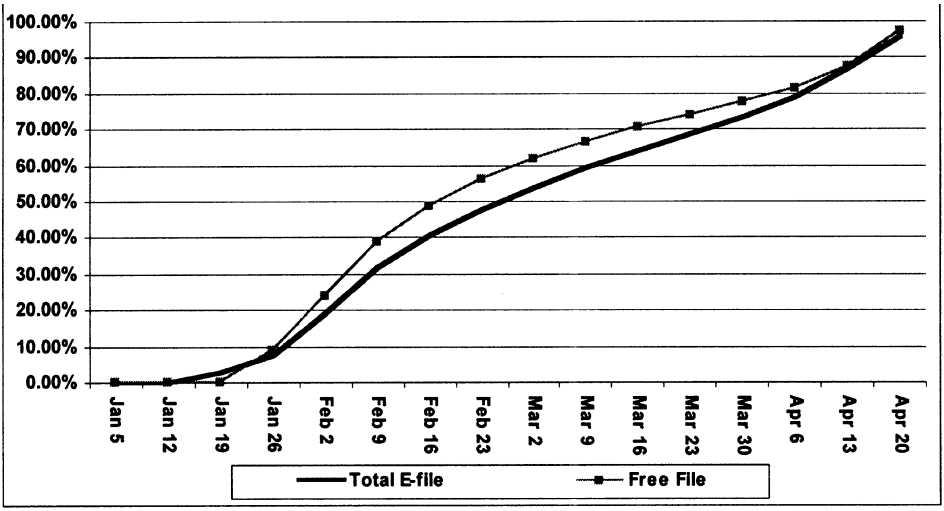
WEEKLY TRENDS

Although Free Filers reflect the early filing patterns of the overall e-filers, calculation of the cumulative weekly filing percentages show that the Free Filers generally filed even earlier in the filing season compared to the total electronically filed returns. The comparisons are based on the TY 2005 filing results. By the end of January, 9 percent of Free Filed returns had been filed compared to less than 8 percent of total e-filed returns. However, the difference increased to over 7 percent in early February and another percentage towards the end of the month. More than half of the Free Filed returns (56 percent) were received by the end of February, versus 48 percent of total e-filed returns. The gap continues to range from 3 percent to almost 8 percent until the end of the primary filing season. By April 20, approximately 97 percent of Free Filed returns, and 95 percent of total e-file returns, were filed (see Figure 1).

TAX YEAR 2004 DEMOGRAPHICS

In order to gather more information about Free File Program users, the Electronic Tax Administration within the IRS contracted with Russell Marketing Research and Foote, Cone & Belding to implement an on-line survey of taxpayers who Free Filed their TY 2004 individual returns. The purpose of the survey was to obtain results which would be used to further develop marketing campaigns for the Free File Program. Each eight-hundredth Free Filer was asked to complete the on-line

Figure 1: **TY 2005 Cumulative Weekly Filing Percentages**



Source: Electronic Tax Administration Data

survey. The contractors collected the results that were summarized by research teams within IRS's Wage & Investment Division (IRS, 2005).

Although these results provide an overview of Free Filers, they must be interpreted with caution. Participation in the survey was voluntary and many taxpayers opted not to complete the questionnaire, leading to an estimated response rate of 2 percent. Thirteen of the 20 Free File Alliance members offered the on-line survey. In addition, not all of the participating companies offered the survey at the start of the filing season, and some companies did not initially follow the skip pattern (offering the survey to the 800th filers). However, by February 14, all 13 Alliance members who participated in the survey were offering it according to the agreed-upon pattern. For the purposes of this paper, only those surveys collected after February 14 are included in the analysis.

According to survey results, 17 percent of taxpayers who Free Filed in Filing Season 2005 were first-time filers. Of the remaining 83 percent who had previously filed federal income taxes, 29 percent were e-filing for the first time. Seventy-eight percent of this group of prior paper filers self-prepared their tax returns during the previous filing season. Of the approximately 70 percent of respondents who had used e-file methods during the prior filing season, only 2 percent claimed to have used the TeleFile Program. About 41 percent used tax preparation software, and 15 percent e-filed via tax preparers. The remaining 42 percent stated that they used Free File in the previous year. When questioned about previous use of Free File, 51 percent had used the program in prior years; about 49 percent of those surveyed were first time Free Filers.

Based on survey responses, Free File participants share certain demographic characteristics. Over half (52 percent) claimed a single filing status. Thirty-two percent were married filing jointly, and 14 percent filed as head of households. The remaining 2 percent were married filing separately or qualifying widows. Fifty percent of Free Filers were 35 years or younger. Forty-two percent had a pretax income of less than $25,000, and 56 percent reported a pretax income of less than $35,000. Sixteen percent of survey responders reported that they claimed the Earned Income Tax Credit on their 2004 federal income tax return. Almost 90 percent of respondents were owed a refund in Filing Season 2005.

Respondents were also asked about their future plans to e-file tax returns. Seventy-five percent stated that they would use e-file again in the future, and an additional 21 percent expressed that they

would be likely to e-file future returns. Only 1 percent indicated that they would either file (or probably file) a paper return in upcoming filing seasons.

When asked about how they heard about the Free File Program, responses covered a range of topics. Communication from the IRS was the most likely source for hearing about Free File; 49 percent of respondents heard about the program from either information on the IRS Web site, tax forms, or IRS mailings. Specific responses indicated that 35 percent learned about the program from the IRS Web site and 22 percent heard about it from relatives or colleagues.

TY 2005 DEMOGRAPHICS OF FREE FILERS

Analysis of TY 2005 Free-Filed returns (which was the first year Free File data was flagged by the IRS) illustrated several interesting characteristics of Free Filers. The data showed that Free Filers are mostly in their twenties with a single filing status, and have relatively low AGIs. Most received refunds. Around 47 percent of Free Filers were between the ages of 20 to 29, and an additional 12 percent were between the ages of 16 and 19. Seventy-three percent of Free Filed returns indicated Single filing status; 15 percent of returns were Head of Household; and 11 percent were Married Filing Jointly. Over half of the returns had AGI of less than $17,000. Nineteen percent had an AGI greater than or equal to $17,000 but less than $25,000; 17 percent had an AGI greater than $24,999 but less than $35,000. Of the 3.8 million Free Filed returns, 96 percent were refund returns with an average refund amount of $1,300. This compares to 88 percent of total e-filed returns (IRS, 2006b) that were estimated to be refund returns. The data indicated that 34 percent of the returns were the long and more complicated form type (Form 1040). The short form, Form 1040EZ, constituted an additional 38 percent of the returns. Around 5 percent of total electronically filed individual returns were filed through the Free File Program.

An analysis of how TY 2005 Free Filers filed their tax returns in the previous year (TY 2004) showed that the Free File Program is contributing to the growth of the overall e-file program. As expected, not all Free Filers are first time e-filers. Around 66 percent electronically filed their returns in TY 2004. Thirty-nine percent of these filed online, 17 percent used the TeleFile Program, and the remaining 10 percent e-filed via practitioners. However, 17 percent of TY 2005 Free Filers had paper filed their tax returns in TY 2004. Furthermore, almost 42 percent of this population (TY 2004 paper filers) had V-Coded their returns, meaning that they prepared their returns on the computer but printed the return and mailed in a paper return. In addition, around 18 percent of current Free Filers are new filers that did not file a return in TY 2004, indicating that the Free File Program is attracting new taxpayers to the e-file program.

STATE LEVEL DATA AND PARTICIPATION RATES – TAX YEAR 2005

An analysis of state-level data (including the District of Columbia) yielded several interesting patterns in terms of Free Filers during the 2006 Filing Season. Although these results are based on one filing season, future studies may result in more conclusive relationships among demographic variables and participation in the program. To calculate the Free File participation rate (FFPR) per state, a ratio was calculated based on each state's number of Free Filed returns as a percent of that state's total return volume (including paper and electronic volumes). The FFPR for the United States was 1.30 percent in TY 2005, with state levels ranging from 4.40 percent in Ohio to 1.64 percent in New York. The average state FFPR was 3.15 percent. The 10 states with the highest FFPR were Ohio, South Dakota, Wisconsin, Maine, West Virginia, Nebraska, Utah, Oklahoma, Idaho, and North Dakota. These states represent a broad range of geographic locations, state sizes, and total populations.

Using age and population data from Global Insight, Inc. (2005), it was determined that 3 of the 10 states with the highest FFPRs – Utah, Idaho, and North Dakota – also ranked in the 10 U.S. states with the highest ratio of residents in the "15 to 34 year old" age range. This range includes teenagers and those entering the workforce for the first time who would be likely to have lower incomes and meet the AGI limit.

State level per capita income was also analyzed to determine if states with lower per capita incomes had higher FFPRs. West Virginia, Utah, and Idaho were within the 10 states having the lowest per capita incomes, which may indicate that states with lower incomes have more participation in the program, particularly if the states (like Utah and Idaho) also have a high percentage of younger resi-

dents. States with the lowest FFPRS tended to have higher per capita income levels. The 6 states with the highest per capita incomes were the District of Columbia, Connecticut, Massachusetts, New Jersey, Maryland, and New York. With the exception of Massachusetts, the other states with higher per capita incomes were skewed toward having the lowest FFPRs. The District of Columbia was 37th, and the other 4 high-income states ranked in the bottom 10 in terms of FFPR, with New Jersey and New York having the lowest participation rates of all states.

TAX YEAR 2005 SURVEY RESULTS – FREE FILER ATTITUDES

For TY 2005, the IRS again contracted with Russell Marketing Research (2006) to conduct telephone interviews of Free Filers. The sample consisted of 1,800 Free Filers who were selected from lists provided by the IRS. Although this survey yielded some demographic data similar to the survey efforts of the prior filing season, the objectives were to determine the overall usage and perception of Free File, the usage and evaluation of specific site features, and other learning experiences.

Data collected regarding the overall usage and perception of the Free File Program was highly favorable; 94 percent of respondents indicated that they would like to use the program again and 97 percent said they would recommend the program to friends or family. In terms of improving the program, 30 percent of respondents had suggestions for improvement. Among the feedback offered was making Free File easier to use (7 percent), increasing awareness of the program (4 percent), removing the income criteria (4 percent), and providing more information on the tax preparation companies (4 percent).

In terms of the ease of using the Free File option, 60 percent of those surveyed rated the experience as very easy, and 34 percent rated it as somewhat easy. One percent responded that the experience was very difficult. Free Filers who used step-by-step instructions, the frequently asked questions guide, and the "Guide Me to a Service" feature rated the program as easier to use than those who contacted the Help Desk for assistance. Among those who felt that the Free File Program Web site and pages could be improved (18 percent of respondents), 25 percent indicated that the pages should be easier to use and the company selection process could be improved. Eighty-two percent were satisfied with the Free File pages and did not think the pages could be improved.

Early surveys of taxpayers' attitudes toward e-file indicated some level of concern about the security of on-line transactions with the IRS (Russell Marketing, 2003). However, over half of the respondents (54 percent) felt very confident that the information they provided during the Free File process was secure; 42 percent indicated that they were somewhat confident. Although the majority of responses were highly favorable, increasing the level of confidence in the security of the Free File process represents an area that the IRS and the Alliance can work to improve in the future.

In terms of deciding which provider to use, no one factor appears to dominate the decision making process. Twenty-one percent based their decision on a software company they had used in the past; 19 percent used a company recommended by family or friends; 14 percent based their decision on the criteria that the company's "offer met my needs." Only 11 percent of respondents based their decision on the company's reputation. Those using the "Guide Me to A Service" feature were far more likely to indicate that their deciding factor in selecting a company was the fact that the company was suggested by this IRS-provided feature. Fifty-five percent responded that they would use the same tax provider next year, and 36 percent said they would probably use the same company again. Only 1 percent said they would definitely not use the same company again.

Survey results for Filing Season 2006 indicated that more Free Filers learned about the program from family or colleagues (over one-third gave this response) than in Filing Season 2005. Forty percent cited the IRS as their initial source of information about Free File, a drop from the almost 50 percent who gave this response in the Filing Season 2005 survey. Although 89 percent felt that the initial information they received provided sufficient knowledge of the program, only 49 percent stated that their initial source mentioned the income limit of $50,000 for using the Program.

CONCLUSION AND FUTURE OF THE FREE FILE PROGRAM

Although there is concern that Free File volumes seemed to decline in Filing Season 2006,

the program is considered to be an overall success. According to the Electronic Tax Administration Advisory Committee's (ETAAC) 2006 Annual Report to Congress, the Program's most positive accomplishment was attracting four million taxpayers to the e-file program, including many who would have not otherwise used e-file. This growth occurred at no cost to the IRS, taxpayers, or the American public.

The Treasury Inspector General for Tax Administration (TIGTA) also conducted a review of the Free File Program in 2006. The report agreed that the amended Agreement added additional levels of taxpayer protection, security, and performance standards. TIGTA does acknowledge that many of these issues resulted from the unique relationship the IRS must maintain with the private sector for the program to work, with the realization that the IRS cannot entirely control the program. TIGTA also recommends that the IRS improve Free File options offered to Spanish-speaking taxpayers via the IRS Web site.

In response to the TIGTA report, the IRS will conduct a study to evaluate providing a Free File entry portal in Spanish. The IRS will begin discussions with the Multilingual Language Initiative Strategy Office, the Electronic Tax Administration, and representatives from the Free File Alliance to discuss the resources, requirements, and funding needed for this effort. It is anticipated that the decision to provide a Spanish entry portal will be made in 2007.

New for TY 2006, the IRS will offer Form 1040EZ-T (Claim for Refund of Federal Telephone Excise Tax) to those taxpayers who will be filing a federal return for the sole purpose of claiming the TETR. This may result in several hundred thousand Forms 1040EZ-T filed via the Free File Program. The cessation of the TeleFile Program in TY 2004 will also continue to have implications on Free File volumes. As of April 27, 2006, over 650,000 returns that were filed via the TeleFile Program in Filing Season 2005 came in through the Free File Program during Filing Season 2006. This represents almost 20 percent of the total TeleFile returns from Filing Season 2005.

Since its inception, the Free File Program continues to evolve and make valuable contributions to the e-File Program while reducing taxpayer burden. It offers another e-file option when other programs, like TeleFile, end. As the program prepares to offer Forms 1040EZ-T and Spanish language option, it continues to be an innovative arrangement benefiting taxpayers, private companies, and the IRS.

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