Current Status of an IRS Free Direct Electronic Filing Option

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Individuals have two options when they file a federal income tax return and related forms: a paper return or an electronic return. Electronic filing (e-filing) involves preparing a return using software preapproved by the Internal Revenue Service (IRS) and submitting it to the IRS electronically. In the 2021 tax year, 95% (147.2 million) of individual income tax returns were e-filed; paid professional preparers submitted 57% of e-filed returns and self-preparing individuals the other 43%.

The IRS provides several options for free e-filing (e.g., the Free File and the Volunteer Income Tax Assistance programs), but it does not allow taxpayers to file directly with the IRS through a secure portal on its website, an option known as Direct File (DF).

This Insight examines the current status of the IRS's efforts to develop a DF system.

Interest in an IRS Direct-File Option

The IRS looked into creating a DF system in 2001 in response to a directive from the Office of Management and Budget to offer such a service to taxpayers. In 2002, concerned about the cost of and political opposition to providing free direct tax filing, the IRS entered into a partnership with a number of commercial tax preparation firms to provide free tax preparation and e-filing to low- to medium-income taxpayers through a program known as Free File. In return, the IRS agreed to refrain from developing a competing DF option.

This limitation lasted until 2019, when it was dropped from an extension of the memorandum of understanding governing the Free File program. There were several reasons for its disappearance. Usage rates for the program averaged 3% to 4% of eligible taxpayers. The IRS invested little in promoting and policing the program. Media reports in 2019 revealed the efforts of some Free File member companies to divert Free File-eligible taxpayers to the companies' paid filing services.

Interest among some lawmakers in the IRS establishing its own DF service seems to have grown since 2019. The Inflation Reduction Act (IRA, P.L. 117-169) provided the IRS with $15 million to create a direct e-file task force and deliver two reports to Congress by May 16, 2023. The task force was to prepare one report, and an "independent third party" chosen by the IRS was to prepare the second report.

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Mandated Reports on an IRS Direct-File Option

IRS Report

As required by IRA, the IRS report addressed (1) taxpayer "opinions, expectations, and level of trust" for a DF system and (2) the cost of developing and operating such a system under different levels of income and tax complexity.

Taxpayer Opinions

To assess taxpayer attitudes toward a "hypothetical free IRS-provided online tool," the IRS task force reviewed the results of two recent surveys and conducted interviews with 14 taxpayers about their experiences using an IRS prototype of a DF system. The results indicated that 72% of taxpayers would be "very or somewhat interested" in using a free IRS-run online filing tool. The report found that this degree of interest depended on certain conditions, most notably (1) the percentage of taxpayers who regard the IRS as a legitimate provider of such a service; (2) the availability of concurrent filing for federal and state income tax returns; and (3) the possible advantages of an IRS filing tool relative to other filing options (e.g., faster refunds, prefilled filing, and a reduced audit risk).

System Cost

The IRS report identified the three primary cost drivers: (1) critical software and equipment; (2) system maintenance and updating; and (3) customer support. It provided cost estimates for three filing scenarios: 5 million filers, 10 million filers, and 25 million filers, under both a simple and a complex tax situation. The results indicated that the annual cost of developing and operating a DF tool rose in step with the number of filers. But the cost per filer fell as the number of filers rose: the cost per return under the simple tax situation was about $13 with 5 million filers and $9 with 25 million filers.

Independent Third-Party Report

As required by the IRS, the independent third-party report assessed the "the overall feasibility approach, schedule, cost, organizational design, and the Internal Revenue Service capacity to deliver a direct e-file tax return system."

Feasibility

According to the report, the feasibility and success of a DF system largely hinged on the presence of certain conditions. Specifically, the report found that a feasible system would require (1) sustained IRS managerial support; (2) gradual and flexible development; (3) sustained funding that allows for continued upgrades in the system's hardware and software; (4) concurrent e-filing of federal and state income tax returns; (5) accurate, timely, and reliable customer service; and (6) secure protection of taxpayer information and privacy.

System Cost

The third-party report estimated the annual cost of a DF option on the basis of the same cost drivers as the IRS report. The former provided cost estimates for five filing scenarios (1 million users, 2 million users, 5 million users, 10 million users, and 25 million users) under a range of uncertainty about long-term costs. The results showed that the per-return cost fell as the total number of filers rose. Under the least-certain scenario, the cost per return was $9 with 5 million filers and $5 with 25 million filers.

IRS's Planned Test of a Direct-File Prototype in 2024

The IRS is planning to launch a pilot DF program at the start of the 2024 filing season. The program, which aims to assess the feasibility and cost of an IRS DF system, is intended to supplement existing federal free filing options. It is not clear how many taxpayers will participate in the program, which will apply only to relatively simple tax situations. The Treasury Inspector General for Tax Administration reported in early October 2023 that the pilot project will not include an option to concurrently file state income tax returns in 2024.

One issue that could stall or derail this effort is the question of whether the IRS can implement a DF system without congressional approval. Some lawmakers say that such approval is required before the IRS can invest in a DF system. Others disagree, saying that no such authorization is needed because operating a DF system is like any activity that falls within the broad grant of authority the federal tax code gives the IRS to administer tax laws.

Author Information

Gary Guenther
Analyst in Public Finance

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