

Written Statement of

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Before the

**Committee on Finance
United States Senate**

Hearing on

Tax Return Preparation Options for Taxpayers

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Mr. Chairman, Ranking Member Baucus, and distinguished Members of the Committee:

For most Americans, the annual rite of preparing and filing tax returns represents not merely their most significant contact with the Internal Revenue Service but their most significant contact with the United States Government as well. The importance of making this process run smoothly therefore cannot be overstated. The level of satisfaction – or dissatisfaction – with which taxpayers emerge from this experience shapes, in large measure, their attitudes about the effectiveness and the responsiveness of our government. It is therefore crucial that we establish and enforce rules of the road that enable taxpayers to prepare and file their tax returns easily, transparently, cheaply, and with full respect for the privacy of their personal and financial information.

As you have requested, I will focus my testimony primarily on what my office found in the course of testing the sites of participants in the Free File Alliance. However, I would like to begin by sharing some general thoughts about improving the return preparation and filing process.¹

I. General Tax Return Preparation Issues

Broadly speaking, taxpayers have four options for preparing their returns. They may (1) self-prepare their returns; (2) pay a preparer to prepare their returns; (3) seek assistance from a free volunteer program like the Volunteer Income Tax Assistance (VITA) or Tax Counseling for the Elderly (TCE) programs if they meet specified income or other criteria; or (4) obtain assistance from the IRS at a Taxpayer Assistance Center (TAC). The strengths and weaknesses of each option vary, and I think it's useful to keep in mind the differences between these four options when evaluating how the tax preparation process is working overall. I will offer six general comments, some of which pertain to a single option and some of which pertain to all of them.

A. The return preparation process provides a compelling case for tax simplification.

The percentage of taxpayers who now seek assistance from paid preparers has reached an astonishing 61 percent.² If taxpayers are to gain (or re-gain)

¹ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. The statute authorizing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS or the Treasury Department. Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the Commissioner or the Secretary for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

² IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

confidence in the fairness of the tax system, they need to understand how their taxes are computed – and how their neighbors' taxes are computed. Starting from scratch, no sane person would devise the approximately 1.5 million-word tax code that we have today. As the statutory “voice of the taxpayer,” I strongly urge the Administration and Congress to give the American people a vastly simpler tax code.³

B. The government should make it possible for all taxpayers to file their returns electronically with the IRS without having to pay a fee.

The IRS should place a basic, fill-in template on its website and allow any taxpayer who wants to self-prepare his or her return to do so and file it directly with the IRS for free.⁴

Some representatives of the software industry have taken the position that such a template would place the IRS in the position of improperly competing with private industry or, worse, create a conflict of interest between the IRS's role of tax preparer and tax auditor.

This is nonsense. Since the inception of the tax system, there have always been two categories of taxpayers – those who are comfortable enough with the rules to self-prepare their returns and those who turn to paid professionals for assistance. In the paper-filing world, the IRS has always made its forms and instructions universally available without charge to all taxpayers, and those taxpayers who require help have always been free to seek the assistance of paid preparers.

Imagine that, shortly after the income tax was enacted, a large group of bricks-and-mortar tax preparers had launched a lobbying campaign to try to persuade Congress to prohibit the IRS from making forms and instructions available to the public on the ground that the availability of these materials improperly placed the government in the position of competing with private industry. Or on the ground that it created a conflict between the government's role as preparer and auditor. Congress almost certainly would have rejected such arguments as ludicrous. Yet those are exactly the same conceptual arguments being raised today by those who contend that the government's provision of a basic web-based, fill-in form to all taxpayers would undercut the private sector.

The answer to these arguments in today's electronic environment should be the same answer that Congress would have provided 80 years ago in a paper

³ See National Taxpayer Advocate 2004 Annual Report to Congress 2-7 (Most Serious Problem: The Confounding Complexity of the Tax Code); Testimony of National Taxpayer Advocate Nina E. Olson before the President's Advisory Panel on Federal Tax Reform (March 3, 2005), available at www.taxreformpanel.gov/meetings/meeting-03032005.shtml; see also National Taxpayer Advocate 2005 Annual Report to Congress v (Preface).

⁴ See National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

environment. For those taxpayers who are comfortable preparing their returns without assistance, the government will provide the means to do so without charge. For those taxpayers who do not find a basic template sufficient and would prefer to avail themselves of the additional benefits of a sophisticated software program, they are free to purchase one.

A brief personal anecdote. Although I prepared tax returns professionally for 27 years before I became the National Taxpayer Advocate and don't need assistance from others to prepare my return, my government salary places me above the income cap to qualify to use Free File products. To prepare my return electronically last month, I therefore spent \$19.99 to purchase tax preparation software. When I completed preparing my return, the software program informed me that, to file electronically, I could choose between having \$29.95 deducted from my refund or charging \$14.95 on a credit card. Although I deeply believe that e-filing is best for both taxpayers and the IRS for a host of reasons, I resented the notion that I would have to pay separate fees to prepare my return and to file it, so I printed out my return and mailed it in.

I am hardly alone. IRS data shows that nearly 45 million returns are prepared using software yet are mailed in rather than submitted electronically.⁵ This is a shame, because the practice delays the length of time for processing refunds, it requires the IRS to devote additional resources to entering the data manually when it receives the return, and it creates a risk of transcription error.

There is no reason why taxpayers should be required to pay transaction fees in order to file their returns electronically. A free template and direct filing portal would go a long way toward addressing this problem and would result in a greater number of taxpayers filing their returns electronically. Both taxpayers and the government would stand to benefit.

C. The Federal government should take steps to professionalize the tax preparation industry to protect both taxpayers and the tax system itself.

The return preparation industry has changed significantly since 1976, when Congress first enacted requirements for preparers to sign returns and provide copies to taxpayers along with the penalty provisions of IRC sections 6694 and 6695.⁶ At that time, persons preparing returns for a fee, including unenrolled preparers, were doing precisely that – return preparation. Today, the tax preparation field has increasingly become a vehicle for cross-marketing of non-tax goods and services. What with used car dealers filing taxes so taxpayers can use their refunds as down payments toward automobiles and preparers in check-cashing storefronts charging pay-day loan rates for refund loans (and who

⁵ IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

⁶ See Tax Reform Act of 1976, Pub. L. 94-455.

disappear without a trace after April 15th), taxpayers have no way of knowing whether these purveyors of products are in any way qualified to prepare federal income tax returns.

It is truly remarkable to me that, in the United States today, an insurance agent can't sell insurance without a license, a contractor can't build without a license, and a hairstylist can't touch a lock on a person's head without a license – yet anyone can prepare a tax return for a fee – with no training, no licensing, and no oversight required.

In my 2002 Annual Report to Congress, I proposed a plan for the IRS to register, test, and certify unenrolled preparers.⁷ My proposal was generally well received, and the United States Senate passed it in the last Congress as part of the Tax Administration Good Government Act. The proposal was introduced again in this Congress as part of S. 832, and I am pleased that the chairman and ranking member of the Senate Finance Committee are again co-sponsors. I encourage Congress to enact this common-sense proposal.

The IRS originally expressed some concern that my proposal could place a strain on its enforcement resources, but I have designed the proposal carefully to avoid that result. California, for example, has adopted a registration system that is funded entirely by modest fees that preparers in that state pay. In addition, I note that the IRS itself has already designed a modest but effective version of a testing and certification program – and it did so within a one-year timeframe. “Link and Learn Taxes” is an online training program that allows VITA volunteers to receive the training and certification necessary to prepare tax returns at VITA sites. The IRS estimates that about 10,000 volunteers received certification through this program for the 2005 filing season. So this is eminently do-able.

Apart from education, I also believe that more needs to be done to address the problem of preparers who lack integrity. The civil penalty regime currently in law is not adequate and, in particular, penalty amounts are too low for the IRS to treat enforcement of preparer penalties as priority work. Therefore, in my 2003 Annual Report, I identified the gaps and inadequacies of the current compliance regime for preparers and Electronic Return Originators (EROs), and I recommended that Congress strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.⁸

In the EITC area, I recommended enhanced EITC-specific due diligence requirements, progressively higher preparer accuracy penalties where multiple

⁷ See National Taxpayer Advocate 2002 Annual Report to Congress 216-230 (Key Legislative Recommendation: Regulation of Federal Tax Return Preparers).

⁸ See National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance).

inaccurate returns are prepared, and joint and several liability with the taxpayer for EITC overpayments where the preparer recklessly disregards IRS rules and regulations.⁹ Moreover, I have made several suggestions about how the IRS could strengthen its oversight of EROs.¹⁰

D. The IRS must remain open for business to taxpayers who seek assistance from the government in preparing their returns.

We must not lose sight of the fact that the government is asking its citizens to pay over a significant portion of their annual incomes. For those taxpayers who do not trust private parties, including VITA, with their personal information and want to deal directly with the government, the government should be there to help them compute their tax liabilities. In many cases, the alternative is that these taxpayers won't comply. Yet the IRS has issued annual directives to its walk-in sites to reduce the number of returns they prepare for each of the last several years. As a direct consequence, the IRS will have reduced the number of returns it prepares by more than 50 percent since FY 2003 – from 665,868 returns in FY 2003 to a proposed 305,000 returns in FY 2006. In my view, refusing to assist taxpayers who are literally showing up at the door to try to comply with their tax obligations does not constitute high quality taxpayer service. Nor does it constitute a sound strategy to reduce the tax gap.

While I commend and applaud the outstanding work volunteer preparers perform, I am concerned for several reasons about recent IRS statements that indicate the agency is pulling back from its longstanding policy of assisting taxpayers who seek IRS assistance directly. First, the leaders of many organizations that operate VITA sites tell me that they are already stretched to their limits assisting the numbers of taxpayers that currently seek their help. Second, the IRS is not providing nearly enough support and oversight to volunteer programs to ensure accuracy and confidentiality. Third, the IRS itself imposes limitations on what volunteer programs may do. For example, the IRS directed VITA sites not to prepare returns for taxpayers in the zone where Hurricane Katrina struck, presumably because it believed the returns would be too complex for volunteers to prepare accurately.

The IRS acknowledges that customer service – not mere enforcement alone – is essential to achieving a high compliance rate. Within limits, assisting those taxpayers who seek our help in computing their tax liability and preparing their tax returns should continue to be a central component of taxpayer service.

⁹ See National Taxpayer Advocate 2003 Annual Report to Congress 285-286, 292-294 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance).

¹⁰ See National Taxpayer Advocate 2003 Annual Report to Congress 287, 294-295 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance); see also National Taxpayer Advocate 2005 Annual Report to Congress 223-237 (Most Serious Problem: Regulation of Electronic Return Originators).

E. The government must reaffirm and maintain the longstanding principle that tax return information generally is confidential and will be protected.

In recent months, a number of high-profile proposals and plans have attracted attention that would require the IRS to share taxpayer return information now protected by section 6103 of the Internal Revenue Code with third parties. Lawmakers concerned about illegal immigration have proposed sharing tax information with border control authorities. Government officials seeking to reduce accounting disparities between tax income and financial income on the part of corporate taxpayers have floated the idea of making corporate tax returns public documents. And the IRS will soon be providing confidential tax information to private debt collectors who are being enlisted to help collect back taxes. In my view, we need to tread very carefully as we consider all these proposals to shed taxpayer privacy.¹¹

I am particularly grateful to Chairman Grassley, Senator Baucus, and the members of this Committee for the strong support they have shown for maintaining the confidentiality of tax information. If taxpayers begin to believe that they are losing control over the privacy of their personal and financial information, I am concerned that we could see a discernable decline in compliance. As I have written in the past, I believe our general rule should continue to be that taxpayer return information is kept confidential, and exceptions should be authorized only where there is a compelling need for the information and it cannot be readily obtained elsewhere.

F. The Treasury Department and IRS should strengthen the “consent” requirements in connection with the use or disclosure of tax information by return preparers. While improvements can perhaps be made, recently proposed regulations under section 7216 of the Code constitute a significant improvement over the existing regulations.

In the last two weeks, significant concerns have been expressed about recently proposed Treasury regulations under section 7216 of the Internal Revenue Code that govern the use or disclosure of tax return information by tax return preparers. The IRS is proposing to update the existing section 7216 regulations because the existing regulations were promulgated in 1974 and therefore do not provide adequate guidance for the e-filing environment that has developed in recent years.

I note at the outset that I believe consumer groups have raised legitimate concerns about exploitation of taxpayers by the return preparation industry. In

¹¹ See National Taxpayer Advocate 2003 Annual Report to Congress 232-255 (Key Legislative Recommendation: Confidentiality and Disclosure of Returns and Return Information – IRC Section 6103).

my annual reports to Congress, I have highlighted several of these concerns.¹² In fact, it was precisely these concerns – about current business practices that I view as questionable and in some cases unacceptable – that led me to be a strong advocate for changing the existing regulations. From a consumer protection standpoint, the worst outcome in my view would be to maintain the *status quo*.

Particularly with regard to an issue as important as use and disclosure of return information, it is important to hear taxpayer and tax preparer concerns. That is why this regulation and the related revenue procedure were published in a proposed form, why we asked for comments from the public, and why the IRS is holding a public hearing today. I can assure you that all – I repeat, all – of the comments will be considered in the course of developing the final regulation. For the reasons I will describe, I believe it is urgent that the current regulations be revised as soon as possible.

In discussing section 7216, it is helpful to review the language of the statute and the provisions of the current regulations. The statute provides for criminal sanctions when any person “engaged in the business of preparing, or providing services in connection with” income tax return preparation either knowingly or recklessly:

- *Discloses* any information furnished to him for or in connection with the preparation of the return; or
- *Uses* any of this information for any purpose other than return preparation.¹³

The statute provides for certain exceptions to the “disclosure” and “use” prohibitions, and it authorizes the Secretary to promulgate regulations for additional exceptions.¹⁴ Section 6713 provides for a parallel civil penalty for violations of the “disclosure” and “use” rules under section 7216.

Note that there are two operative terms here – “disclose” and “use.” Neither the statute nor the current section 7216 regulations provide definitions of these key terms, so in many ways, the field today is wide open for return preparers to decide for themselves what constitutes a disclosure or use.

¹² See National Taxpayer Advocate 2005 Annual Report to Congress 162-179 (Most Serious Problem: Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives); National Taxpayer Advocate 2005 Annual Report to Congress 223-237 (Most Serious Problem: Regulation of Electronic Return Originators); National Taxpayer Advocate 2004 Annual Report to Congress 89-109 (Most Serious Problem: Electronic Return and Filing Preparation); National Taxpayer Advocate 2002 Annual Report to Congress 69-74 (Most Serious Problem: IRS Oversight of EITC Return Preparers Can Be Improved).

¹³ IRC § 7216(a).

¹⁴ IRC § 7216(b).

Under the current regulations, a tax return preparer, with taxpayer consent, may *use* tax return information to promote nontax products and services currently offered by the tax return preparer or a member of the tax return preparer's affiliated group. However, a tax return preparer, even with taxpayer consent, may not use tax return information to promote products and services of unaffiliated entities. For example, a tax return preparer may, with taxpayer consent, use tax return information to calculate the benefits of an IRA product offered by an affiliate, but the tax return preparer may not use that information to calculate the benefits of an IRA product offered by someone outside the affiliated group.

Of greater concern to me are the current regulations' *disclosure* provisions. Today, with taxpayer consent, tax return preparers can disclose (and even sell) tax return information to anyone. The regulations impose no limitations on this disclosure. And once this tax return information is disclosed to a third party, there are no limitations in the tax code on that third party's ability to re-disclose the tax return information.

The distinction between "use" and "disclosure" is significant. In the "use" environment, the tax return preparer herself is holding onto information she already has and is using it to evaluate the appropriateness of a product or service for the taxpayer's situation. The taxpayer has agreed to the preparer's use (but not disclosure) of the data, and if the preparer uses the data in a manner that the taxpayer has not agreed to, the preparer may be subject to civil and criminal sanctions.

In the "disclosure" environment, on the other hand, the tax return preparer can be sending tax return information out to any third person on the open market, where the tax return information can be used in any manner whatsoever, without limitation. There is no way that the taxpayer can know in advance how and by whom his tax return information will be used once it is disclosed. Criminal sanctions apply only if the preparer "knowingly or recklessly" discloses information without the taxpayer's consent. To my mind, this latter situation is extremely worrisome, to put it mildly.¹⁵

¹⁵ Some commentators have argued that the proposed regulation's extension of consent to *use* of taxpayer information by preparers with respect to products and services of unaffiliated entities will harm taxpayers and result in broad dissemination of taxpayer information. I do not agree. First, in the "use" environment, the *preparer* is authorized to use the information, not the affiliated or unaffiliated entity. The information can only be used in the manner to which the taxpayer agrees. Second, under the current regulation, if the taxpayer wants to know how a product of an unaffiliated entity will benefit him, he can consent to disclosure of taxpayer information to that unaffiliated entity. As noted earlier, there are no restrictions on use or re-disclosure once taxpayer information is disclosed to a third party. Thus, the current regulatory ban on use of information by a preparer with respect to products or services by unaffiliated entities probably results in greater dissemination of taxpayer information than the proposed regulation.

We can all imagine how these two provisions – disclosure and use – can be abused and how they can impair tax administration and compliance. Thus, the threshold policy question is whether the regulations should allow any exceptions to the statutory prohibition against use or disclosure.

In fact, the statute and regulation are written so that disclosure and use of such information by a tax return preparer is prohibited except in a few instances. One of those instances, under the existing regulation, is pursuant to the consent of the taxpayer. Unless we ban that consent, the question becomes, “What protections must we provide to ensure that taxpayers have clear and adequate information upon which to decide whether to grant their consent?”

The current regulations require that the consent obtained by the tax return preparer advise the taxpayer about the purpose for which the consent is being furnished. The preparer must obtain the taxpayer’s consent to such use or disclosure in writing.¹⁶ Essentially, that’s it – outside of some additional boilerplate language, that’s the taxpayer protection in the current regulation.

The proposed regulations and a related draft revenue procedure provide significantly greater protections for the taxpayer. These safeguards are specifically designed to ensure that taxpayers are fully informed about the consequences of consent and to limit the open-ended nature of the current structure. Some of these safeguards are:

- Definitions of the terms “use” and “disclosure.”
- A template for the consent language, and a requirement that that language must be prominently displayed.
- Required language, in specified type size, warning the taxpayer that any information disclosed to a third party may be re-disclosed to any other party, *without limit*.
- Required language notifying the taxpayer of his or her right to register a complaint about violations of these regulations with the Taxpayer Advocate Service, including contact information for the Taxpayer Advocate Service.
- Requirements on the placement of these warnings (*i.e.*, they may not be buried in a privacy statement or a licensing agreement but must be prominently displayed).
- A requirement that the preparer must obtain the taxpayer’s consent for each proposed use or disclosure.

¹⁶ Treas. Reg. § 301.7216-3(b).

- A limit on the period of time – one year – during which the tax return preparer may use or disclose the information.
- A clearer definition of what constitutes information covered by section 7216. Some have argued that information entered on a client intake sheet or tax software initial information screen is not covered by section 7216. If such information is not under the protection of section 7216, the tax return preparer may use or disclose it in any manner he chooses, without taxpayer consent and without even notifying the taxpayer. The proposed regulations clarify that client intake or registration information is covered by the regulations' restrictions on disclosure and use.
- Where applicable, a requirement that the tax return preparer disclose to the taxpayer the fact that the tax return preparer intends to use off-shore tax preparers to prepare the taxpayer's return, and a requirement that the preparer obtain the taxpayer's written consent to using the off-shore tax return preparers.
- A requirement that the tax return preparer cannot require the taxpayer to consent to a use or disclosure of taxpayer information as a condition for preparing the tax return.

As the foregoing list demonstrates, the proposed regulations would add significant new taxpayer protections. However, we cannot just stop with the regulations. I do not agree, as some commentators have alleged, that the absence of complaints under the existing regulations indicates there is no real problem with exploitation of taxpayers. First, some taxpayers are not financially sophisticated enough to understand the products that preparers are trying to sell them. Second, taxpayers who do understand are not likely to take the time to lodge formal complaints. Third, the current regulations do not indicate specifically to whom complaints should be addressed.

In my annual reports to Congress, I have criticized the IRS's lax oversight of return preparers and, in particular, of Electronic Return Originators (EROs).¹⁷ I believe the IRS needs to conduct more site visits and better and more frequent suitability and eligibility checks, undertake an extensive education campaign about the need for taxpayers to protect their own tax information and be smart tax consumers, and assess penalties in the appropriate instances. I have also

¹⁷ See National Taxpayer Advocate 2005 Annual Report to Congress 162-179 (Most Serious Problem: Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives); National Taxpayer Advocate 2005 Annual Report to Congress 223-237 (Most Serious Problem: Regulation of Electronic Return Originators); National Taxpayer Advocate 2004 Annual Report to Congress 89-109 (Most Serious Problem: Electronic Return and Filing Preparation); National Taxpayer Advocate 2002 Annual Report to Congress 69-74 (Most Serious Problem: IRS Oversight of EITC Return Preparers Can Be Improved).

called upon Congress to strengthen the monetary penalties against EROs, so that these penalties cannot be absorbed as a mere cost of doing business.

Absent the protections in the proposed regulation, taxpayers will be harmed. Absent prompt implementation of the proposed regulation, taxpayers will be harmed. And absent strong congressional oversight of the IRS and the tax return preparer community, such as you are undertaking at this hearing today, taxpayers will be harmed.

II. Assessment of the Free File Alliance

A. Background

In 1998, Congress directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007. To date, the IRS has decided against making e-filing available to all taxpayers without charge. Instead, the IRS entered into a three-year agreement prior to the 2003 filing season with a consortium of tax preparation software companies known collectively as the “Free File Alliance.”¹⁸

The agreement had a three-year term that ended last year, and in October 2005, the IRS and the Free File Alliance agreed to extend the contract for four years with some modifications.¹⁹ The initial agreement required the Free File companies, in the aggregate, to make free electronic preparation and filing available to *at least* 60 percent of all taxpayers. The new agreement prevents Free File companies, in the aggregate, from making free services available to more than 70 percent of all taxpayers.²⁰ In the agreement, the IRS pledged that it would “not compete with the [Free File Alliance] in providing free, online tax return preparation and filing services to taxpayers.”

From an IRS perspective, the rationale for creating the Free File program was to make e-filing more accessible to taxpayers and thereby help it to achieve the congressionally mandated goal of having 80 percent of all taxpayers filing their returns electronically.

From that standpoint, the Free File program has done little to increase the number of taxpayers who e-file their returns. In 2005, individual taxpayers filed approximately 133 million tax returns. Only about 5 million taxpayers used Free

¹⁸ Free On-Line Electronic Tax Filing Agreement entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2002), available at www.irs.gov/efile/article/0,,id=103626,00.html.

¹⁹ Free On-Line Electronic Tax Filing Agreement Amendment entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2005), available at www.irs.gov/pub/irs-efile/free_file_agreement.pdf.

²⁰ *Id.* Section I.E provides in relevant part: “IRS will utilize the then current Adjusted Gross Income (AGI) number which equates to 70% of the taxpayers to manage the program, and will not accept or post any offer by an Alliance member which exceeds this AGI amount.”

File. Of those, IRS data show that the significant majority had previously filed their returns electronically.²¹ It therefore is far from clear whether Free File attracts new e-filers and brings the IRS closer to its 80 percent goal. In addition, the attractiveness of Free File has diminished markedly this year. In 2005, Intuit and H&R Block made their best-selling tax packages available to all taxpayers through Free File. As noted, the new agreement imposes restrictions on the percentage of taxpayers who may be covered. Not surprisingly, taxpayer usage of the Free File program as of March 30, 2006 has dropped by 21 percent this year compared with the same period last year.²²

B. Overview of Testing of Free File Sites

Partly to follow up on testing my office performed two years ago and partly in response to a request from the staff of this Committee, I asked several tax attorneys in my office to test four scenarios on each of the 20 Free File sites. The results, in my view, are disappointing. Each of the 20 sites has its own eligibility requirements and its own capabilities and limitations. On the whole, we found that trying to navigate the Free File sites was a bit like living in the Wild, Wild West.

In announcing the revised Free File agreement in October 2005, both parties stated that the agreement would result in enhanced services, improved disclosures regarding refund anticipation loans (RALs), and greater privacy protection.²³ With these assertions in mind, my office created four scenarios and tested them on each of the twenty Free File sites accessible through the official IRS website. The goal of the testing was to determine the experience of taxpayers as they attempt to navigate the sites and prepare and file their returns through Free File products accessible through the official IRS website.

I offer one caveat to our results. Our objective was to determine the existence and extent of limitations and problems that a user of the Free File sites would encounter. In some instances, the tax attorneys testing the sites found them very difficult to navigate and were unable to locate forms or answers that later testing was able to locate. Therefore, the results described below reflect simply what our attorneys experienced and not necessarily what a site was capable of accomplishing.

Each of the testers started the return preparation process by going to the official IRS website, www.irs.gov. The IRS website includes a link titled "Check Out

²¹ IRS Wage & Investment Research Group 6, Final Report: Free File Survey Analysis, Research Project 6-05-08-2-038N, 12 (Aug. 31, 2005).

²² IRS Free File statistics (through March 30, 2006); see also IRS News Release IR-2006-44, *IRS e-file and Direct Deposit Outpace Last Year's Results* (March 15, 2006) (noting an increase in e-filing overall but a drop of more than 20 percent in Free File usage).

²³ IRS News Release, *IRS and Free File Alliance Reach Agreement*, IR-2005-16 (Oct. 25, 2005).

Free File.” This link brought the testers to the IRS’s “Free File Home – Your Link to Free Online Filing” webpage, which describes the Free File program in general and instructs individuals to carefully review the specifications of each provider. When the testers clicked the “Start Now!” button, they were taken to a page that gave them the option to “Browse All Services” or “Guide Me to a Service!” If the testers chose the first item, they were presented with an apparently randomly sorted list of all the providers. If the testers chose the second item, they were asked specific questions about age, state of residence, adjusted gross income, earned income tax credit eligibility, and military pay. Based on their answers to these questions, the second option provides a list of “Services for Which You May Qualify.” The testers noted which services the IRS guided them to, but tested all of the services available.

C. Description and Results of the Four Scenarios We Tested

1. Scenario 1: Hurricane Katrina and Education Tax Credits

a. Fact Pattern

Mary Doe is a full-time law student at a university located in New Orleans and earned \$25,000 in wages in 2005. During Hurricane Katrina, the entire contents of her car and rental apartment were destroyed. The casualty loss is valued at \$17,000. Ms. Doe also paid \$25,000 for tuition at the university, which is located in the Gulf Improvement Zone. This scenario was designed to determine whether each of the Free File sites supported the tax relief provisions applicable to the victims of Hurricane Katrina²⁴ as well as the complicated education incentive provisions.

b. Results

- Only seven of the Free File sites (TaxACT.com, OLT.com, Taxslayer.com, TaxCut, eSmartTax, CompleteTax, and TurboTax) calculated the correct tax.
- The following sites did not apply the special casualty loss tax benefits available to Hurricane Katrina victims:²⁵ FreeTaxReturns.com, CitizenTax, TaxEngine.com, FreeTaxUSA.com, Online Tax Pros, 123Easytaxfiling.com, FileYourTaxes.com, eFileTaxReturns.net, 1040Now ExelTax, ezTaxReturn.com, average1040.com, and Free Tax Return. As a consequence, taxpayers using these Free File sites may be unknowingly

²⁴ The Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-35, 119 Stat. 25 (2005); The Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, 119 Stat. 2016 (2005).

²⁵ Section 402 of the Katrina Emergency Tax Relief Act of 2005 provided that casualty losses attributable to Hurricane Katrina are not subject to the limitations of IRC § 165(h). IRC § 165(h) ordinarily requires casualty losses to be reduced by \$100 and 10 percent of adjusted gross income.

overpaying their taxes by failing to claim the tax benefit that Congress specifically created for them.

- The following sites did not increase the Lifetime Learning Credit for eligible education expenses of individuals affected by Hurricane Katrina as authorized by the Gulf Opportunity Zone Act of 2005:²⁶ FreeTaxReturns.com; 1040Now ExelTax; CitizenTax; FreeTaxUSA.com, Online Tax Pros, 123Easytaxfiling.com, FileYourTaxes.com, average1040.com, and Free Tax Return. Again, taxpayers using these Free File sites may be unknowingly overpaying their taxes by failing to claim the tax benefits that Congress specifically created for them.

2. Scenario 2: The Earned Income Tax Credit

a. Fact Pattern

Jane Jones is a single mother living in an apartment in Buffalo, New York, with her 10-year-old son, her 25-year-old brother (who earned \$3,500 during 2005), and the 5-year-old daughter of a friend. Ms. Jones is a cashier and earned 13,500 in wages and \$100 in interest income in 2005. This scenario was designed to test whether the sites properly determined head-of-household filing status, and accurately calculated the dependency exemption and the child tax credit, based on the new Uniform Definition of a Qualifying Child rules in IRC § 152,²⁷ as well as eligibility for the EITC.

b. Results

- In general, all of the sites accurately determined the head-of-household filing status, the dependency exemption and the child tax credit, based on the new Uniform Definition of a Qualifying Child rules, as well as EITC eligibility.
- The CitizenTax site would not accept the information for the taxpayer's brother, so the test was abandoned at that point.

²⁶ Section 102 of the Gulf Opportunity Zone Act of 2005 provides that for individuals affected by Hurricane Katrina, the Hope Credit in IRC § 25A is expanded from a maximum of \$1,000 per student to 100 percent of the first \$2,000 in eligible expenses and 50 percent of the next \$2,000 (for a maximum credit of \$3,000). The Act also expanded the Lifetime Learning Credit in IRC § 25A to include 40 percent (as opposed to the normal 20 percent) of qualified tuition and related expenses up to a maximum of \$10,000. See IRS Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita and Wilma.

²⁷ The Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, 118 Stat. 1166 (2004).

3. **Scenario 3: Self-Employed Taxpayer (Schedule C)**

a. **Fact Pattern**

Linda Smith is a divorced mother who lives in her apartment in Albany, New York, with her 17-year-old daughter and 12-year-old son. Ms. Smith is a self-employed dressmaker. She purchased a sewing machine during the year for \$2,000, and her cost of goods sold was \$10,000. This scenario was designed to test whether the sites support Schedule C, *Profit or Loss from Business*, as well as IRC § 179 deductions claimed on Form 4562, *Depreciation and Amortization*.

b. **Results**

- In general, the sites that supported Schedule C and Form 4562, *Depreciation and Amortization*, correctly calculated the federal and state (if available) refunds.
- Schedule C was not supported by several sites.
 - FreeTaxReturns.com allowed the tester to continue with the preparation but never advised the taxpayer that it didn't support business income or loss.
 - CitizenTax only supported Schedule C-EZ. This limitation was not apparent until the tester was about to enter the business information.
 - Several sites (FreeTaxUSA.com, 123Easytaxfiling.com, average1040.com, and Free Tax Return) warned the testers when no income was entered but otherwise gave no indication that they did not support business income or loss.²⁸ This red flag would not be raised if the scenario included other types of income. For example, if the taxpayer was a sole proprietor but also had interest or dividend income, the “no income” warning would not be triggered, and the taxpayer would not be warned that his or her sole proprietorship income was not included in the return.²⁹ As a consequence, taxpayers using these sites might unknowingly be underreporting their income and tax liability.
 - eSmartTax claimed to support Schedule C, but there was no place to enter the information for the IRC Section 179 deduction.

²⁸ Each of the sites includes a link on its home page listing the tax forms it supports. However, many taxpayers do not know tax forms by number.

²⁹ Prior to the act of filing, most sites provide either a tax summary or the ability to view the tax forms. At that point, assuming the taxpayer notices the absence of income on the return, the taxpayer would have to start over and use a different product to prepare his return accurately.

Similarly, although Online Tax Pros claimed to support Schedule C, it did not support Form 4562 for the Section 179 deduction (perhaps leading the taxpayer to try to enter it as a supply or other expense).

- EFileTaxReturns.net claimed to support Schedule C, but it did not ask the pertinent questions. This limitation could possibly lead a taxpayer to claim business income as “other income,” which would not trigger the self-employment tax calculation, resulting in an underpayment of self-employment tax and presumably a later IRS assessment.
- ezTaxReturn.com and Free Tax Return did not support Schedule C, which was apparent early in the preparation process.

4. Scenario 4: The Brady Bunch and the AMT

a. Fact Pattern

Michael and Carol Brady live in North Hollywood, California, with their six children, ages 5-16. Mr. Brady is an architect with wages of \$73,160. Mrs. Brady is a part-time teacher with wages of \$25,000. The Bradys claim “married filing jointly” as their filing status. This scenario was designed to determine the results when an ineligible taxpayer attempts to prepare and file a return through Free File. The scenario was also designed to test whether the sites support the alternative minimum tax calculations.

b. Results

- All sites noted that Free File was not available to taxpayers with an adjusted gross income (AGI) of more than \$50,000. Some taxpayers, however, may not be familiar with the terms “adjusted gross income” or “AGI” and may attempt to use a Free File site even when their AGI exceeds \$50,000. When this occurs, all tested sites require the taxpayer to go through the entire federal return preparation process (and sometimes the state return preparation process) before informing the taxpayer that he or she does not qualify for Free File.
- At least two sites (Free Tax Returns and Average1040.com) did not support more than four dependents.
- At least three sites (Average1040.com, CitizenTax.com and eSmartTax) omitted the Alternative Minimum Tax (AMT) calculation and thus incorrectly calculated the “Bradys” taxes. Because millions of American taxpayers are subject to the AMT, many taxpayers may be unknowingly understating their tax liability.

- Several sites (such as OLT.com, FileYourTaxes.com and CompleteTax.com) correctly recognized that the Bradys were subject to the AMT and correctly calculated their tax liability, but these sites did not inform the taxpayer that he was subject to the AMT.

D. Findings Common to All Scenarios

- **“Guide Me To A Service!”** As described above, the IRS website provides a feature called “Guide Me To A Service!” This feature requires the taxpayer to enter information about age, adjusted gross income, state of residence, eligibility for EITC, and military pay. Based on the information entered, the site presents a list of Free File providers for which the taxpayer may qualify for free return preparation and filing. However, many of the sites that were included on the list generated by “Guide Me To A Service!” did not support the four scenarios we tested. Thus, taxpayers could start entering information into the tax preparation program only to discover later that the program lacks the capability to prepare their returns. They are then placed in a position of closing out the program and beginning a different one (and perhaps wondering what will happen to the personal information they entered into the first program) or paying an upgrade fee to continue with their current program to avoid having to re-enter their returns from scratch.

Even more troubling, some taxpayers may not realize that a site does not completely support their facts and may lead them to file inaccurate returns. Moreover, while each site provides a link to a list of supported forms, many only list the form number, which renders the list unhelpful to most taxpayers.

- **Privacy Policy.** Several of the sites include the privacy policy in the license agreement (or Terms and Conditions) and condition the preparation on the taxpayer’s acceptance of the terms. Such sites include TaxCut, Taxslayer.com, OLT.com; EFileTaxReturns.net, and TurboTax. The 1040Now ExelTax site’s privacy policy is displayed on a separate page, and the taxpayer is required to agree to the terms before beginning return preparation. The average1040.com site’s policy could be found on a link at the top of the page and states that, by using the site, an individual is deemed to consent to the terms. However, there is no requirement that the taxpayer actually view the terms of the policy.
- **Customer Service Fees.** At least three sites charge a fee to contact customer service. The FreeTaxReturns.com site charges a \$4.88 fee for each customer service question and a \$14.88 fee for each tax question. EFileTaxReturns.net charges \$9.99 for customer support. Free Tax Return charges \$1.95 per customer service question and \$5.95 per tax law question. Of course, the IRS itself provides this service for free.

- **Error Scan Fee.** FreeTaxReturns.com offered error scans for a \$3.88 fee per return.
- **Cross-Marketing.** All of the Free File sites are accessed through the official IRS website, yet cross marketing of ancillary products and services is common on many of the sites. For example:
 - Upgrades. The following sites, throughout the preparation process, offered to upgrade to a paid service for a more enhanced interview process:
 - TaxACT.com (which charged \$9.95).
 - TurboTax (which charged \$19.95).
 - Gift Card. TurboTax offers to transfer the tax refund, or a portion thereof, to a gift card of a retail partner. A \$14.95 fee is deducted from the balance for this service.
 - Audit Protection. Several programs offered an “audit protection” product, including FreeTaxReturns.com (\$29.88 fee), Free Tax Return (\$25.95 fee), EFileTaxReturns.net (\$47.95 fee) and TurboTax (\$29.95 for federal and \$5.00 for state).
 - Return Packaging. The FreeTaxUSA.com site offers a professionally bound copy or CD copy of the return for \$12.95 and vault service for a \$9.95 fee.
 - Professional Review. Professional review services were offered by TaxCut (\$29.95 fee), TurboTax (\$49.95 fee), and OLT.com (\$49.95 fee).
 - Miscellaneous. The TaxACT.com site offers the option to turn the taxpayer’s keyboard into a calculator for a \$9.95 fee.
 - Bank Products. Several of the sites offered bank products as a method to receive tax refunds. Refund Anticipation Loans (RALs) were offered by CompleteTax, Tax\$imple.com, TaxCut, EFileTaxReturns.net, and ezTaxReturn.com. Refund Anticipation Checks (RACs) were offered by 1040Now ExelTax and EfileTaxReturns.net. The H&R Block TaxCut site offered to prepare the state tax return for free if the taxpayer agreed to receive his or her refund on an H&R Block prepaid Visa card. Other sites may have offered these products, but the testers were unable to identify them.
 - Opt Out of Free File. On several sites, the taxpayer must opt out of Free File and pay for tax preparation and filing if the taxpayer

chooses to purchase a bank product as a means of receiving the tax refund. For example, when a taxpayer purchases a bank product, FileYourTaxes.com charges \$23.95 for preparation and filing of a federal return, and EFileTaxReturns.net charges \$24.95 for federal and \$19.95 for state preparation and filing.

- Refund Processing Fee. Where our testers sought to prepare and file state tax returns, TurboTax charged a fee of \$19.95. In addition, TurboTax offered our testers the option of having their return preparation and filing fees deducted from their refund for an additional processing fee of \$29.95 (for a total cost of \$49.90).

- **Technical or Navigational Issues.**

- The TaxSimple.com site was not functional at the time of the testing. Hyperlinks on the homepage appeared to work, but it would not permit our testers to start a new return.
- Taxslayer.com was extremely difficult to navigate and continually kicked our testers out of the program when the “back” button was pressed.
- The eSmartTax site appeared to have technical difficulties when we tested scenarios 2 and 3. It allowed the entry of either all or substantially all of the information for scenarios 2 and 3 and then failed to continue preparing the returns. The testers were forced to abandon the preparation on that site.

- **Payment of State Fee.** On FreeTaxReturns.com, our testers who elected to prepare both federal and state returns were unable to file the federal return electronically unless they first paid the \$9.88 state return preparation and filing fee.

- **Fee to Mail Returns to Taxpayer.** Several sites offered to print the tax return and mail it to the taxpayer for filing with the IRS. However, due to the late time of the testing and the approaching April 15th deadline, many sites discouraged the testers from selecting this option. FileYourTaxes.com site charged a \$19.75 fee for this service, FreeTaxUSA.com charged \$5.95, and OLT.com charged \$4.95.

E. Where Do We Go from Here?

The results of our testing demonstrate that Free File is not an easy service for taxpayers to navigate, and it can even result in inaccurate returns. As currently structured, Free File amounts to a Wild, Wild West of differing eligibility requirements, differing capabilities, differing availability of and fees for add-on products, and many sites that are difficult to use.

The original rationale for creating the Free File Alliance was to help the IRS achieve the congressionally mandated goal that 80 percent of all returns be filed electronically by 2007. However, the relatively low usage in prior years, the lack of usage by new e-filers, and the decline in usage this year indicate that the program is not meeting its objectives. Taking into account the additional concerns about cross marketing of other products, the appearance that the IRS is endorsing the Free File products (notwithstanding disclaimers, taxpayers are starting out from the official IRS website), and taxpayer concerns about the confidentiality of their tax data, there is little justification to continue with Free File and every justification for the IRS to develop a tax preparation template and to provide free e-filing for all taxpayers – just as it does for paper filers. I believe the IRS template and direct filing portal must be simple, accurate, and confidential.

III. Conclusion

For several years, my office has advocated for the regulation of unenrolled tax preparers as a means to professionalize the tax preparation industry and protect both taxpayers and the tax system. Combined with enhanced due diligence penalties and more robust enforcement, professionalizing the tax preparation industry will strengthen taxpayer confidence in the tax system and improve the accuracy of returns. In addition, the IRS itself must remain open for business. I do not believe it is prudent for the IRS to continue to shift its return-preparation services to volunteer programs, many of which have already reached the limits of their capacity.

The issues I have discussed in my testimony make clear that the role of tax preparation is central to effective tax administration, and as the tax administrator, the IRS should do more both to provide a high-quality free vehicle for paper and electronic filing and to oversee more closely those persons and entities that provide tax preparation services.

I appreciate the Committee's interest in these important issues and would be happy to provide you with any additional information you might find helpful.