

TESTIMONY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT

BY:

TIMOTHY HUGO
Executive Director
Free File Alliance

Thursday, April 6, 2006

10:00 a.m.

1100 Longworth House Office Building

Good morning, Mr. Chairman, and other distinguished Members of the Subcommittee.

I am the Executive Director of the Free File Alliance, LLC (“Alliance”). I have served in that capacity since July of 2005. I am only part-time on this role. I also serve as an elected Member of the Virginia General Assembly where I am in my third term.

The Free File Alliance is a voluntary association of tax software companies that provide free tax preparation and efilings services under the growing set of rules that govern the IRS Free File Program. Currently, we have twenty member companies. Member companies can and do come and go. We are open to new members each year.

I am very proud of the public-private partnership the Alliance and IRS have created. Over the life of the program, now in its fourth year, the Alliance companies have donated over 14,000,000 free tax returns to the U.S. taxpayers. I estimate that each return has saved U.S. taxpayers approximately \$30 and a case can be made for an even greater number. That would indicate U.S. taxpayers have directly saved over \$42,000,000. But the savings to the IRS are far greater, and can be summarized as follows.

First, the IRS has been able to avoid the costs industry must accept to develop a software product – which must be changed each year as Congress makes its changes in the Code.

Second, the IRS has avoided the necessity of building the computer and telecommunications infrastructure to take individual returns from taxpayers – Alliance companies pay these costs.

Third, the IRS saves \$7 or more each time a paper return filer converts to submitting a return electronically.

Fourth, and perhaps most importantly, it keeps the IRS from accepting the conflicting role of tax preparer and tax cop.

Fifth, the IRS has also avoided significant technological and political risks of a security breach or failure of an IRS product.

Sixth, the Free File Program makes the IRS and Alliance members partners, not opponents. If the IRS becomes a competitor, it will create a very different and dynamic relationship with industry.

The 2005 renewal of the Agreement between the IRS and the Alliance after three pioneering years was a mark of the program’s maturity and success, but required a balance between conflicting policy goals. The 2005 Agreement continues the same core agreement as was originally negotiated, but with some interesting changes. The IRS is still not permitted to take on the role of a tax preparation company.

The Alliance member companies do not always agree on what is good policy, or what is good for their companies. Within the government there is also disagreement as to what should be the requirements of this program, which revealed itself when the IRS and Treasury took slightly different negotiating positions with the Alliance in 2005, notwithstanding that they both work for the same President. Important Members of Congress have urged different policies for the Free File Program. The 2005 Agreement is a product of all these forces. Let me tick off what I think are the key elements of the 2005 Agreement.

First, the Alliance member companies have over time voluntarily agreed to impose standards of conduct on themselves which exceed all government regulation and requirements. These standards were often suggested or sought by the IRS. While accepting this challenge, the Alliance has an appropriate corresponding fear that over time the IRS or Congress will use the existence of the Free File Program to create a new regulatory regime that will burden the companies in the Free File Program, but not companies who do not participate. After years of experience, it became clear that both the IRS and the Alliance need to have authority to restrict any Alliance member company that does not meet the voluntary high standards. Correspondingly, a dispute resolution mechanism was created in the 2005 Agreement to utilize the General Services Board of Contract Appeals (“GSBCA”) to arbitrate with companies who contest IRS determinations that their practices do not meet the high standards.

Second, and related to the first issue, Alliance members agreed to restrictions on sale of certain ancillary products, particularly Refund Anticipations Loans (“RALs”), that exceed those required by law and regulation.

Third, the IRS and the Alliance agreed to certain measures designed to refocus the Free File Program on its original intent to service lower income, disadvantaged and underserved taxpayer populations. How and why did we do so?

The Alliance companies are currently required to provide free services to 93 million taxpayers, which is 70% of the U.S. taxpayers. This is an increase from the 60% of taxpayers the Alliance agreed to cover in the original Agreement. This binding 70% coverage requirement will increase in numbers as the taxpayer population increases.

This focus on the poor, lower income, disadvantaged and underserved was an underpinning of the original Alliance-IRS agreement. It has been recognized throughout the Program’s history. It is contained in many of the documents that collectively constitute our forming our agreement.

For example, this language is written in the first and only Supplemental Memorandum of Understanding Between the IRS and Free File Alliance. A copy of this one page document is appended to my statement.

It also appears as a portion of the Purpose in the Alliance Operating Agreement (a current version of paragraph 2.6 of that document is appended to my statement).

It is contained in the Preamble of the Memorandum of Understanding on Service Standards and Disputes Between the IRS and Free File Alliance executed in 2005 (“offer online preparation and filing services to taxpayers least able to afford e-filing tax returns ...”).

It also appears in a letter from Chairman Ernest Istook, then Chairman of the Transportation, Treasury and Independent Agencies Appropriations Subcommittee, to the current Treasury Secretary and IRS Commissioner, and states in part that the program should be focused upon the “under served and lower income citizens ... There should be no uncertainty that the Free File Alliance program is not intended to provide universal free service to all regardless of need. Such an objective could break the market-based model that enables the donation of the services at no cost to those who truly need them.”

Some may assert the program should provide Bill Gates and Warren Buffett, or other wealthy folks, with free returns. But I do not think a compelling policy case can be made that such high wealth individuals need such free services. Last year \$4 billion in eligible EITC payments were not paid to U.S. taxpayers who qualify. Those are the people to whom I want to provide free services to, and potentially transform their lives.

Fifty-five million people in this country have no bank account. Let’s bring them into some aspect of the modern financial system, even if they have to do their Free File return at a VITA site or public library. A very few miles from this hearing room, in Anacostia, on the aptly named Good Hope Road, Operation HOPE, an African-American focused financial literacy group, provides 16 internet work stations where people in the community can and do take advantage of Free File services. Those are the people I believe we should focus upon.

Both the IRS and the Alliance made their own evaluations of how to ensure the long term success of the program. Both concluded the 2005 agreement meets a variety of needs. The 2005 Agreement has created a stable program with well understood rules. Free for everyone may sound great, but it has consequences, such as creating pressure for sales of ancillary products. We have tried to appropriately balance policy concerns, and now we need to see how that balance works out in practice. If any company wants to give away their product free to everyone, there is no restriction in their choosing to do so at their own web page, or in Union Station, or anywhere else but the Free File site.

We do not yet know the final volumes of Free File returns in this tax season. The IRS and Alliance annually cooperate in evaluating each season, decide what went well, what needs to be fixed, and what research is needed to better evaluate this season. We need to do so again, and evaluate how the IRS can help the 93 million eligible taxpayers generate savings for themselves and the IRS.

The Alliance program remains dynamic. But it cannot be used to satisfy every policy. Let me give an example. All fifty states have little IRS-type organizations to collect taxes, and these agencies have a professional association called the Federation of Tax Administrators (FTA). Approximately 20 states, led by New York, Michigan and many others, are working to replicate the success of the Free File model. We appreciate those states’ efforts. The Alliance does not administer these state Free File programs. But the FTA has in the past focused their

efforts on the other 20 states that have chosen to compete and create tax software products. FTA took the position that the IRS should require that the Alliance provide free state tax returns to states that compete. We do not feel comfortable dealing in an indirect manner with groups like the FTA. If the FTA wants to talk to us about this program, we welcome them — but note that the FTA walked out of such talks when the Free File Program was starting and hence are not fully reaping the benefits of the program.

CONCLUSION

We appreciate the Subcommittee's interest in the Free File Program, and look forward to answering your questions.

January 19, 2004

SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING

Between the Internal Revenue Service and
Free File Alliance, LLC

Preamble

This Supplemental Memorandum Of Understanding is to establish a formal agreement between the Internal Revenue Service and the Free File Alliance, LLC to identify and implement a reasonable solution to measure the continued success of the Free File program, a public-private partnership agreement, principally designed to advance electronic filing and assist lower income, disadvantaged and underserved taxpayer populations.

Background

The IRS had requested and required the members of the Free File Alliance to include a software data indicator that will permit the IRS to identify tax returns filed through the Free File program in 2004. The information is sought by the IRS in order to create a baseline measure as to the number of returns electronically filed through the Free File program, as well as to analyze the taxpayer segments that have taken advantage of the program, and those that have not. The IRS agrees with the Alliance that any data gathered in conjunction with the Free File program must be used in a manner that is consistent with federal law and regulations governing taxpayer privacy and the original rulemaking. For both parties, taxpayer privacy concerns are of paramount importance.

Scope of Agreement

The IRS and the Alliance hereby agree as follows:

1. Each Alliance member will be required to submit to the IRS a report, certified by the sending official to the best of knowledge and belief, on a weekly basis with the total number of accepted e-filed tax returns originating from their Free File service. The reports will be submitted to the IRS at an agreed upon time beginning January 29, 2004 and ending April 22, 2004. At any point during or after the reporting period, these reports can be subjected to a review by the Alliance, or upon agreement as to such procedures, by a trusted third party for purposes of ensuring accuracy and completeness.

2. Prior to July 1, 2004, the IRS and the Free File Alliance will devise a reasonable solution that will allow the IRS to effectively measure the success of the Free File program for program management and taxpayer satisfaction reasons.

Internal Revenue Service

Terence H. Lutes, Director of Electronic Tax Administration Date

Free File Alliance, LLC

Michael Cavanagh, Executive Director Date

AMENDED AND RESTATED
OPERATING AGREEMENT, VERSION 5.0
FOR
FREE FILE ALLIANCE, LLC,
A VIRGINIA LIMITED LIABILITY COMPANY

2.6 Purpose and Business of the Alliance. The purpose of the Alliance is to meet the following objectives: (i) work in concert with government to increase electronic filing of tax returns, especially extending the benefits of online federal tax preparation and electronic filing to economically disadvantaged and underserved populations at no cost to the individual or the government. In recognition of this commitment, the federal government has pledged to not enter the tax preparation software and e-filing services marketplace; (ii) make tax return preparation and filing easier and reduce the burden on individual taxpayers, particularly the groups noted in (i); (iii) support the IRS's statutory goals of increased electronic filing, pursuant to the IRS Restructuring and Reform Act of 1998; (iv) provide greater service and access to the Services to taxpayers; and (v) implement one of the proposals in the President's Fiscal Year 2003 budget, specifically to encourage further growth in electronic filing by providing taxpayers the option to file their tax return on-line without charge using cooperation with, and encouraging competition within, the private sector.

As the Free File Alliance initiative matures, it is the Alliance's expectation that this public-private partnership will utilize a market-based means of providing independent electronic tax preparation and e-filing services for underserved and lower income citizens at no cost to either the individual or the public treasury. The Free File Alliance program is not intended to provide universal free service to all regardless of need or lack thereof. Such an objective would break the market-based model that enables the donation of the services at no cost to those who truly need them. It would also be inconsistent with well-established precedents for other taxpayer assistance programs, such as the VITA volunteer project and the IRS walk-in program.

Therefore, to provide proper program focus and clarity of purpose, and to ensure continued success, it is the Alliance's expectation that the Alliance and the IRS will ensure that the mission, content and execution of the initiatives is to provide electronic federal tax return preparation and e-filing services at no cost to the working poor, and other disadvantaged and underserved taxpayers. Likewise, the Electronic Tax Administration's related marketing and promotional activities shall be consistently carried out in a manner to advance this defining purpose in addition to the on-going advancement of electronic transmission as the preferred method of tax filing.

**MEMORANDUM OF UNDERSTANDING ON SERVICE STANDARDS AND DISPUTES
Between the Internal Revenue Service and Free File Alliance, LLC**

This Memorandum of Understanding ("MOU") is entered into as of December 20, 2005 by and between the Free File Free File Alliance, LLC ("Alliance") and the Internal Revenue Service ("IRS").

Preamble

WHEREAS, the Free File Alliance LLC ("Alliance") and the Internal Revenue Service ("IRS") entered into a three-year agreement which was published in the Federal Register (Vol. 67, No. 153, page 51621) on August 8, 2002 and executed on October 30, 2002 (the "IRS Agreement") that set forth parameters to which industry members of the Alliance would offer online tax preparation and filing services to taxpayers least able to afford e-filing tax returns at no cost to such taxpayers ("Services"), and pursuant to which it was agreed that the Alliance will offer the Services and the IRS will provide taxpayers with links to the Services offered by the Alliance participants through a web page, which is hosted at irs.gov with links from firstgov.gov;

WHEREAS, on October 29, 2005, the Alliance and the IRS agreed to amend and extend the IRS Agreement for an additional four (4) years (the "2005 IRS Agreement");

WHEREAS, the IRS has hosted and maintained its website in accordance with the IRS Agreement;

WHEREAS, during the term of the IRS Agreement the Alliance and the IRS have adopted processes similar to those described in this MOU whereby if the IRS and/or the Alliance determined a Member temporarily did not meet a standard or standards of practice and/or applicable IRS regulations, then such Member would be denied permission to list their company on the IRS website and/or required to remove Member's listings from the IRS website;

WHEREAS, the parties agree that it would be in the best interests of the IRS and the Alliance to formalize the process whereby a Member may be denied permission to list its company on the IRS website and/or a Member's listing may be removed from the IRS website; and

WHEREAS, the parties further agree that Members should be permitted a mechanism to appeal the IRS's individual, or joint decision with the Alliance, to refuse to permit a Member to list its company on the IRS website and/or the IRS's individual, or joint decision with the Alliance, to remove a company's listing from the IRS website;

NOW THEREFORE, for good and valuable considerations, the parties, intending to be legally bound by this MOU, hereby agree as follows:

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Congress of the United States
House of Representatives
Committee on Appropriations
Washington, DC 20515-6015

November 21, 2003

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The Honorable John Snow
Secretary, Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Mark W. Everson
Commissioner, Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Secretary Snow and Commissioner Everson:

I write to you to clarify program implementation issues that require attention for the future success of the Free File Alliance program between industry, and Treasury and the IRS. The Committee noted in its FY2003 appropriations report for the IRS, 107-575, "the IRS stated that it did not have the resources to build, implement and maintain a free Internet tax preparation and filing option by itself... IRS in its budget is seeking no such resources, nor has this Committee provided any. The Committee strongly believes in the industry-IRS partnership concept." The Committee's commitment in this area still holds fast, which I amplify in this letter.

The Committee has vigorously supported Treasury and IRS efforts over the last decade toward electronic filing of income tax returns. I am pleased that much progress has been made toward the 2007 goal of achieving a target of 80% e-filing of all personal income tax returns, with much also yet to be done, and I believe that my following guidance will significantly aid Treasury and the IRS for reaching its goal.

I am encouraged by the first year results of the Free File Alliance initiative, and commend the IRS and the tax software industry for the success of their public-private partnership. The 2.7 million electronic tax returns and e-filings achieved through this initiative was of great benefit to the American public, far exceeded expectations, and was achieved while avoiding cost incurrence to the Federal government.

The Committee's actions and position on this question have been consistent over a period of years. As the Free File Alliance initiative matures, it is the Committee's expectation that this public-private partnership will utilize a market-based means of providing independent electronic tax preparation and e-filing services for underserved and lower income citizens at no cost to either the individual or the public treasury. There should be no uncertainty that the Free File Alliance program is not intended to provide universal free service to all regardless of need. Such an objective would break the market-based model that enables the donation of the services at no cost to those who truly need them. It would also be inconsistent with well-established precedents for other taxpayer assistance programs, such as the VITA volunteer project and the IRS walk-in program.

Therefore, to provide proper program focus and clarity of purpose, and to ensure continued success, it is the Committee's expectation that the Department of the Treasury and the IRS ensure that the mission, content and execution of the initiative is to provide electronic federal tax return preparation and e-filing services at no cost to the working poor, and other disadvantaged and underserved taxpayers. Likewise, the Electronic Tax Administration's related marketing and promotional activities shall be consistently carried out in a manner to advance this defining purpose in addition to the ongoing advancement of electronic transmission as the preferred method of tax filing.

Likewise, it is essential that the Department of the Treasury and the IRS ensure that program implementation is carried out in a manner consistent with commercial best practices, is compliant with pertinent law and regulation, and fully protects the identity, privacy and confidentiality of the taxpayer's free return preparation and e-filing transaction, assuring the continued independence from government of the software services employed and of the individual tax preparation transactions donated by the participating service providers. It is similarly essential that the program continue to provide that the federal tax return and filing service donations will require no other product or service purchases from citizens, and that government does not act to promote such purchases.

The Committee expects the Department of the Treasury and the IRS to work in cooperation with the participating software industry to implement appropriate policies and procedures to ensure that each of the sponsored service offerors have the necessary business credentials, relevant prior commercial track records for the provision of such services, corporate integrity, and financial and technical capabilities, in which taxpayers can have confidence. The Department of the Treasury and the IRS shall take no less care in assuring such confidence than it would for protection of public funds if these firms were prospective candidates for receiving government contracts for provision of commercial services for the government's own end use.

With these types of governance standards and clarified program parameters, the public-private partnership strategy being pursued by the IRS holds great promise, and I look forward to receiving regular reports from the IRS on the progress being made to achieve these objectives. In particular, in this year and future years, the Committee requests that the Treasury Department and the IRS report to the Committee on Appropriations in advance of each tax season on their implementation and governance plans for the Free File Alliance for each upcoming tax season, demonstrating the consistency of those plans with the Committee's direction. I look forward to learning soon of the detailed implementation plans and governance procedures for this program for the 2004 tax season.

If you or your staff have any questions or require additional information, please call on me, or Rich Efford of the Committee staff at (202) 225-2141:

Very Truly Yours,

A handwritten signature in black ink, appearing to read "Ernest J. Istook, Jr.", written in a cursive style.

Ernest J. Istook, Jr.
Chairman, Transportation, Treasury,
and Independent Agencies
Appropriations Subcommittee