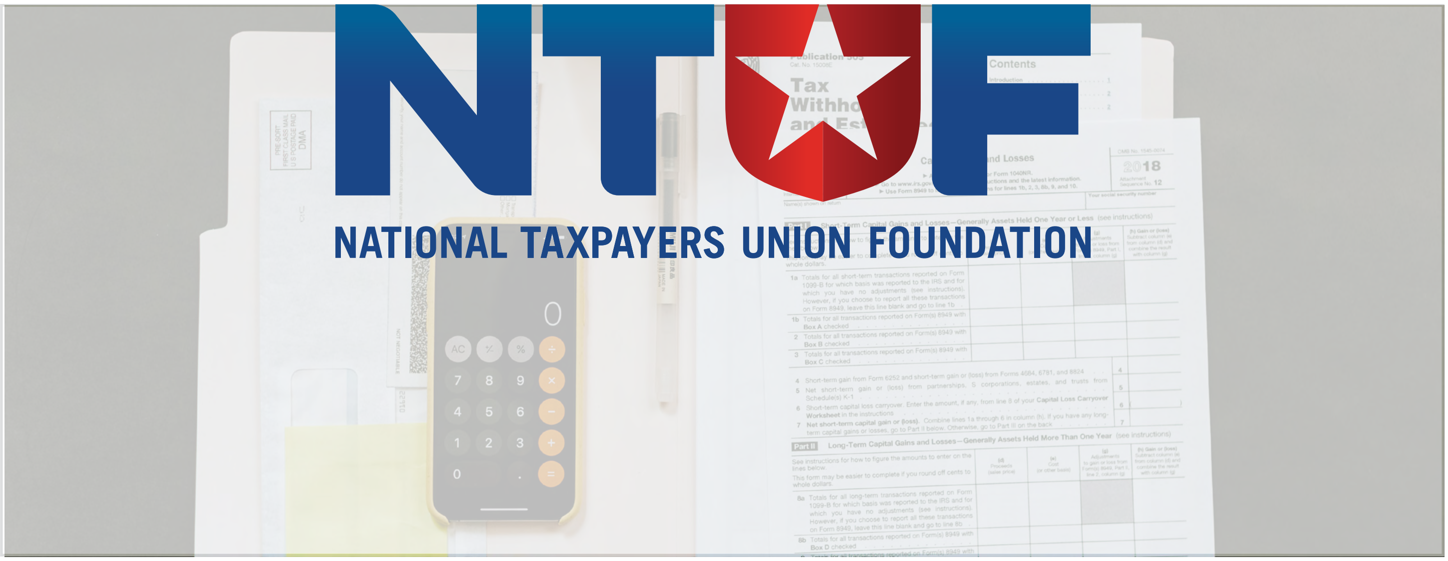

The IRS's Direct File Folly: Key Transformational Projects Left Behind in Pursuit of Costly Program

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Key Takeaways

- The IRS's Direct File program, initially a limited pilot for the 2024 tax filing season, is being made permanent and expanded, despite significant costs to taxpayers, lack of congressional authorization, and insufficient transparency in its development and budgeting.

- The pursuit of the Direct File program has caused significant opportunity costs in taxpayer dollars and staff time as the IRS has neglected crucial priorities including updating its 60-year-old legacy systems and reducing improper payments.

- These opportunity costs will grow as the costs and scope of the program also increases.

Introduction

On May 30th, the Internal Revenue Service (IRS) announced that the Direct File program, a limited pilot for the 2024 tax filing season, will be made permanent and expanded to cover more taxpayers and more states.

The IRS has pitched Direct File as a "free" filing program, but there are significant costs to taxpayers. Additionally, there exists a conflict of interest and intimidation factor in having the IRS prepare taxes, a lack of congressional authorization to establish the program, a lack of transparency in its development, and the absence of a full accounting of the costs of the pilot and the newly announced expansion. Moreover, the IRS's work on Direct File also represents a significant opportunity cost at the same time as the IRS struggled with important priorities and lagged on its modernization efforts.

The IRS Has Not Accounted for the Total Costs and Staff Time Devoted to Developing Direct File

The IRS budgeted $114 million for Direct File in FY 2024 using $50 million from its business systems modernization funding, $38 million from taxpayer services, and $26 million from operations support. But the total cost of the pilot is higher than what the IRS has reported.

It has yet to be reported how many total IRS personnel worked on the programming and administration of the project and how many hours went into it. The IRS did note that it trained 400 customer service agents, and the Government Accountability Office (GAO) recommended in its preliminary report on the pilot's costs that the IRS should account for those training costs.

The IRS also used support from the General Services Administration's Office of 18F which works with federal agencies on software development and website design. The IRS will reimburse 18F for its services but an account of the expenses and staff resources from 18F is not yet available.

The GAO also reported that 29 employees in the U.S. Digital Services (USDS) worked on the development of Direct File. An accounting of that funding is not available. In fact, there is very little budgetary transparency regarding USDS. Its website, usds.gov, has no budgetary information. USDS is under the umbrella of the Office of Management and Budget (OMB) in the White House. OMB provides no line-item information on USDS initiatives beyond a top-line funding level in FY 2024 of $94 million provided by the American Rescue Plan Act.

The lack of transparency of USDS spurred an effort to rescind its funding in 2023. As reported by FedScoop:

> "[G]overnment IT leaders and lawmakers have raised concerns about a lack of operational transparency from the unit. Speaking with FedScoop, one currently serving government technology leader described USDS's strategic plan as opaque and said it was often difficult to obtain operational details from the unit. "What the hell are they working on? What are they doing that is pushing forward the enterprise and the administration's priorities?" they said, speaking with FedScoop on the condition of anonymity because they were not authorized to share their concerns."

The Opportunity Costs of Direct File

The Inflation Reduction Act provided the IRS with $15 million to study the feasibility and costs of establishing a direct file program. The IRS produced the study in May 2023, giving a range of annual estimates based on the size and scope of a direct filing system from $64 million to $249 million. We now know that the IRS was already secretly working to create the system at that time.

John Kartch of Americans for Tax Reform has put together a timeline of the IRS Commissioner Daniel Werfel's statements about IRS intentions regarding Direct File that we now know were not fully forthcoming.

To date, a significant amount of money and staff resources have gone into developing this program without transparency and without congressional authorization. This investment of dollars and staff time diverted the IRS from solving its decades-long modernization challenges and from achieving several statutory requirements. These opportunity costs stand to grow now that the IRS has announced its intention to make Direct File permanent and expand it.

Several crucial IRS priorities have languished as the IRS developed Direct File:

- **Complete the upgrade of the Individual Master File and the Business Master File.** These databases are at the core of the IRS tax system and were built on coding languages that are 60 years old. The IRS has promised for decades to update these systems, but there is still no announced timeline for achieving this. Completing these upgrades would enable the IRS to consolidate and streamline the 60-odd different case management systems it uses.

- **Reduce improper payments.** Under the Payment Integrity Act, the IRS is required to reduce the amount of improper payments to less than 10 percent but they have failed to meet this goal. According to a new GAO report, the 2023 rates of payments that should not have been made through refundable tax credits total $25 billion, with improper payment rates of 14 percent for the Additional Child Tax Credit, 32 percent for the American Opportunity Tax Credit, 33 percent for the Earned Income Tax Credit, and 26 percent for the Net Premium Tax Credit.

- **Reduce the backlog of amended returns.** When a return is amended either by a taxpayer or by the IRS as it notes an error, Form 5147 is used by the IRS to help its agents locate the information in its processing systems. In a new report, the Treasury Inspector General for Tax Administration found that:

  > "The IRS faces challenges eliminating the significant backlog of adjustment source documents to be associated with corresponding Forms 5147, with some of this inventory dating back to adjustments made in June 2021. As of November 2023, the IRS reported it had over 2.6 million source documents that needed to be associated with a corresponding Form 5147. This backlog represents an increase of 241 percent in inventory since May 2020. However, as it relates to the validity of the IRS's reporting of its adjustment source inventory, our evaluation identified that the IRS's inventory reports are inaccurate and unreliable based on our identification of significant inaccuracies in closures being reported."

  Many taxpayers are left in the lurch for needed tax refunds or just basic information as a result of this backlog.

- **Reduce the area of tax questions that are out of scope for customer service**. The IRS has designated 130 areas of the tax code as "out of scope" for telephone assistance. The guidance means that IRS agents cannot answer questions about these specified areas of the tax laws. Similarly, IRS tax preparation assistance programs like the Volunteer Income Tax Assistance and Tax Counseling for the Elderly also cannot provide assistance on certain topics and can only provide limited assistance on others. Better training would help boost customer service and better services would ultimately boost tax compliance by helping taxpayers understand the tax laws.

- **Enhance protections of taxpayer information from both cyber threats and internal (employee and contractor) threats.** One of GAO's top priority open recommendations for the IRS is to develop an oversight structure to enhance protection of taxpayer data. This was first proposed in 2019. In its most recent report, GAO suggests:

  > "To fully implement this recommendation, IRS needs to develop a structure to coordinate across seven different offices working on information security-related activities, such as updating existing standards, monitoring Authorized e-file Provider program compliance, and tracking security incident reports. Without this structure, it is unclear how IRS can respond to changing security threats and ensure threats are mitigated."

- **Provide timely relief for victims of identity theft**. On June 6, National Taxpayer Advocate Erin Collins wrote that, on average, it takes the IRS 675 days – almost two years – to process ID theft cases and issue refunds to victims. The resolution rate has worsened since a year ago when it took an average of 556 days. The agency's target processing goal is to resolve these cases in 120 days.

Conclusion

In March 2024, GAO warned that the IRS's technology modernization efforts were at "the risk of cost overruns, schedule delays, and overall project failure" unless the IRS clarifies how it plans to use IRA funding to achieve its IT modernization goals. Diverting funds for side quests from decade-long priorities hasn't helped the situation. Its secretive pursuit of Direct File only sets back the needed modernization of core e IT programs and processes.

Modernizing its systems and processes has been an ongoing challenge at the IRS. On the one hand, IRS's work on the Direct File pilot program shows that the IRS can actually develop and implement a technological program. On the other hand, the IRS was not transparent during the process, has not properly accounted for all the costs entailed with the pilot as well as with the planned expansion, and diverted funds and staffing away from several key long-standing problem areas at the agency.

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