



Free File Options for Minnesota

A Summary of Research and Recommendations

January 12, 2024

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January 12, 2024

The Honorable Aisha Gomez
Chair, House Taxes Committee
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The Honorable Ann Rest
Chair, Senate Taxes Committee
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The Honorable Matt Norris
Vice Chair, House Taxes Committee
507 State Office Building

The Honorable Matt Klein
Vice Chair, Senate Taxes Committee
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Chair, Property Tax Division
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The Honorable Liz Lee
Vice Chair, Property Tax Division
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The Honorable Duane Quam
Minority Lead, Property Tax Division
247 State Office Building

Dear Committee Chairs:

Minnesota Law Chapter 64, Article 15, Section 23, Subdivision 1 requires the Department of Revenue provide a report on free electronic filing options for preparing and filing Minnesota individual income tax returns. The report includes a review of options that other states use for state electronic filing, an assessment of taxpayer needs for electronic filing and current filing practices, an analysis of alternative options to provide free filing (i.e. tax credits, vendor incentives, or other benefits), and an analysis of the Internal Revenue Service Free File Program usage.

Sincerely,



Paul Marquart
Commissioner
Minnesota Department of Revenue

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Introduction

A 2023 law directed the Department of Revenue to survey tax software providers and report on free electronic options to prepare and file Minnesota individual income tax returns. This law required Revenue to submit its report to the Minnesota Legislature by January 15, 2024.¹

The law required Revenue’s survey to ask providers for information about:

1. System development, capability, security, and costs for consumer-based tax filing software.
2. Costs per return for the state of Minnesota to provide an electronic individual income tax return preparation, submission, and payment remittance process.
3. Providing customer service and issue resolution to taxpayers using the software.
4. Providing and maintaining an appropriate link with the IRS Modernized Electronic Filing Program.
5. Maintaining and protecting taxpayer return information as required by Minnesota Statutes, chapters 13 and 270B, IRS Publication 1075, and any other requirements that apply.
6. Current availability of products for the free filing and submitting a Minnesota return offered to customers and the income thresholds for using those products.

Revenue sent surveys to 27 software providers capable of administering a Minnesota-based electronic filing method, using the modern electronic filing (“MeF”) method. Nine providers responded to the survey. Four of those providers expressed interest in providing a state-based solution for taxpayers to prepare and file Minnesota individual income tax returns.

About This Report

This report considers potential free file options for state individual income taxes and opportunities to provide a better taxpayer experience for Minnesotans. This report includes information on:

- Tax Filing Practices
- IRS Free Filing Program
- Survey of Tax Filing Providers
- Alternative Options²
- Other States
- Conclusions

¹ Minnesota Session Laws 2023, Chapter 64, article 15, section 23 – Department of Revenue Free Filing Report, enacted May 23, 2023. The law appropriated \$175,000 to conduct the survey and produce this report. (<https://www.revisor.mn.gov/laws/2023/0/Session+Law/Chapter/64/>, viewed December 22, 2023)

² This report also provides basic information on the IRS Direct File pilot program but does not include a full review. Comprehensive data about this pilot program is not yet available.

About Revenue

The Department of Revenue oversees Minnesota’s revenue system and takes responsibility for advising the Governor and Legislature on tax policy and operations. Our mission is “Working together to fund the future for all of Minnesota.”

This report further aligns with Revenue’s vision – “Everyone reports, pays, and receives the right amount: no more, no less” – and our strategies that strive to provide customers with services they need to efficiently navigate tax opportunities and obligations.

Revenue has a significant impact on the lives of Minnesotans and is responsible for collecting revenue to support the operations of counties, schools, and cities in the state.

Our team of report writers, advisors, and approvers included communications specialists, electronic filing subject matter experts, tax statistics researchers, legislative liaisons, and legislative policy experts. Team members attended conferences and presentations from software providers, the IRS, other states, and tax industry partners with the goal of improving the ease, usability, and effectiveness of Minnesota’s tax filing process.

Overview

Filing individual taxes is generally seen as an annual paperwork burden for taxpayers across the country. The IRS estimates an average non-business filer spends about 8 hours and \$140 preparing their taxes each year. For business filers, the time and costs more than triple, to an average of 25 hours and \$530.³

Individual taxes can be filed electronically or on paper. Taxpayers may prepare and file their own returns (self-preparation) or use a paid tax professional. Of the 27 tax software providers surveyed for this report, 13 (48%) offer products for self-preparation of individual taxes; the other 14 (52%) serve tax professionals.

One overarching challenge with tax preparation is the current complexity of Minnesota’s income tax laws. As greater complexity is introduced, it becomes more difficult for taxpayers and tax preparers to file a return, as well as for Revenue to administer the laws passed.

Some existing programs provide free tax preparation to filers who meet income, age, or other requirements. The federal government partners with tax filing programs that also serve Minnesota individual income taxpayers. These IRS programs include (among others):

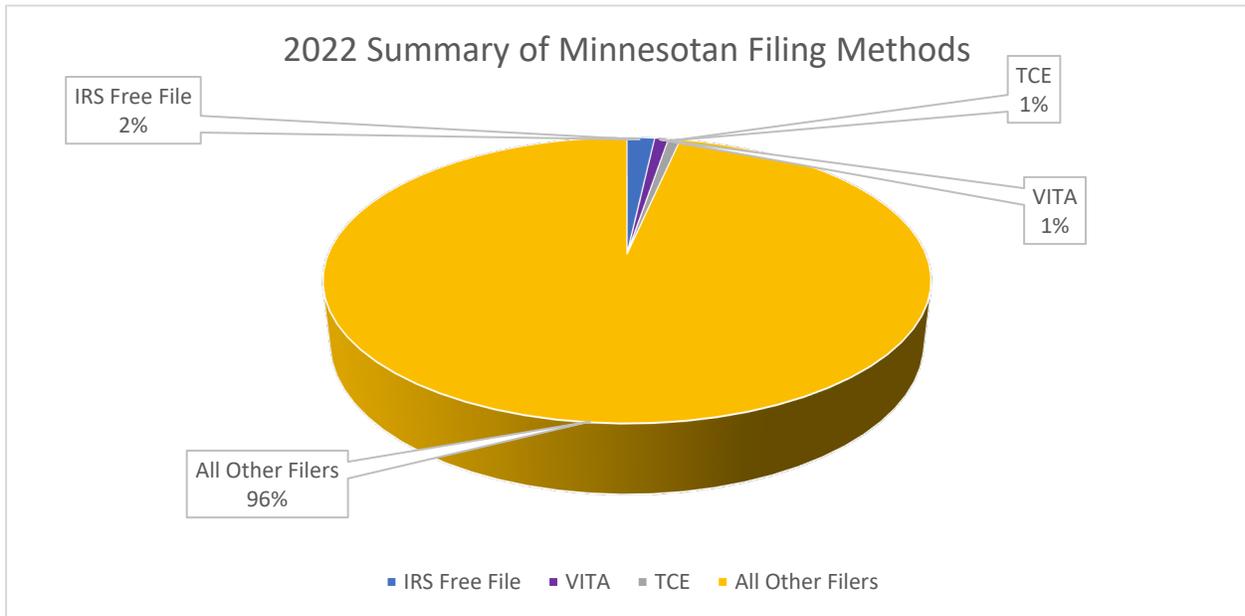
- IRS Free File
- Volunteer Income Tax Assistance (VITA), which includes MyFreeTaxes by United Way

³ IRS 2022 Instructions 1040 (and 1040-SR), p. 107. (<https://www.irs.gov/pub/irs-pdf/i1040gi.pdf#page=107>, viewed December 18, 2023)

- Tax Counseling for the Elderly (TCE), which includes American Association of Retired Persons (AARP) Tax-Aide⁴

These programs do not meet the needs of all Minnesotans, however, as not all customers are eligible. In 2022, only 4% of Minnesotans used one of the listed programs (Figure 1).

Figure 1



Summary: In 2022, free file tax programs accounted for only 4% of all Minnesota filed returns.

The next sections will focus on trends in Minnesota taxpayer filing data, free market pricing research, and the IRS Free File program.

⁴ Free Tax Return Preparation for Qualifying Taxpayers, IRS website. (<https://www.irs.gov/individuals/free-tax-return-preparation-for-qualifying-taxpayers>, viewed December 18, 2023)

Taxpayer Filing Practices

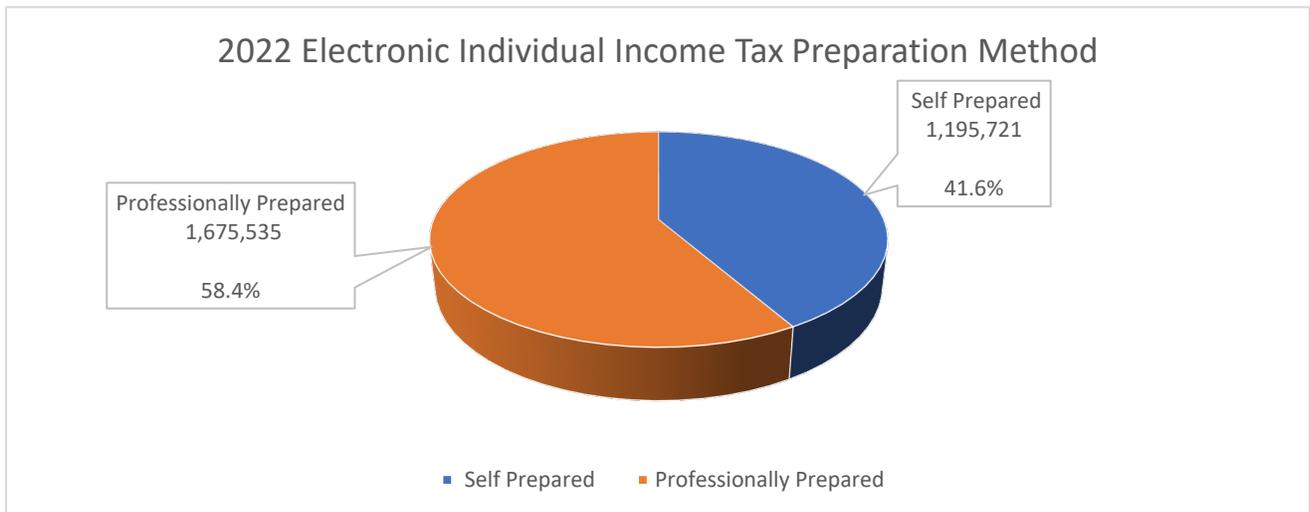
Taxpayers may use various methods to prepare and file Minnesota income tax returns each year. They may self-prepare or use a tax professional and deliver their returns by electronic or paper filing.

- **Electronic filing options:**
 - IRS Free File Program
 - Volunteer Income Tax Assistance (VITA) sites
 - Tax Counseling for the Elderly (TCE) sites
 - Commercial tax software products
- **Paper filing options:**
 - IRS Fillable forms
 - Print and Mail

Electronic Filing by Preparation Method

Most individual income returns are filed electronically (94% for tax year 2022). Minnesotans hiring tax professionals to prepare and file their individual income taxes accounts for 58.4% of electronically filed state returns (Figure 2). State law requires tax professionals to file electronically if they prepare 10 or more returns.⁵ Minnesotans using tax software, self-preparing, and electronically filing their taxes accounts for 41.6%.

Figure 2



Summary: For tax year 2022, over 1.1 million Minnesota electronic income tax returns were self-prepared and over 1.6 million were prepared by paid tax professionals. Complexity in the tax code drives a high percent of Minnesotans to choose tax professionals.

⁵ Minnesota Statute 289A.08. (<https://www.revisor.mn.gov/statutes/cite/289A.08> viewed December 22, 2023)

IRS Free File Program

The IRS Free File program allows qualified taxpayers to prepare and file federal income tax returns online using guided tax software. Established in 2002, Free File is a Public-Private Partnership (PPP) between the IRS and the Free File Alliance (or Free File Inc.), a coalition of tax software companies. The partnership is governed by agreements linked to Memos of Understanding (MOUs).⁶

Seven tax software providers participated in Free File for tax year 2022. The IRS limits eligibility to those with adjusted gross income (AGI) \$73,000 or less, but all seven members restricted eligibility further by income, age, or both. Two of the members offered a free federal return but charged a fee for state returns. Four of the providers make their free file software available for Minnesotans.

Taxpayers with an AGI above \$73,000 can use fillable PDF forms provided by the IRS Free File program.

Key stats about the IRS Free File program as of 2023 include:

- Around 68 million returns have been filed through the Free File program since it began in 2003
- 70% of American taxpayers (about 100 million people) are eligible for Free File
- 97% of users would recommend the program to others (based on a 2021 survey)⁷

While the IRS Free File program has many benefits, some shortfalls have been identified, such as:

- Free File providers are not required to meet requirements for federal digital services in areas such as accessibility, analytics, multi-language support, and mobile support
- Some Free File providers have redirected customers from free to paid services
- Free File providers may charge a fee to file amended returns
- Taxpayers may not know how to access the Free File versions of software
- Free File providers may use more restrictive criteria than the IRS for filing a free return
- Free File providers are not paid by the IRS and can leave the program when they choose

National usage remains low, at an average of 2.8% of eligible taxpayers from 2003 to 2019.⁸

⁶ About the Free File Alliance, IRS website. (<https://www.irs.gov/e-file-providers/about-the-free-file-alliance#Why%20Was%20The%20Free%20File%20Alliance%20formed?>, viewed December 18, 2023)

⁷ Free File Alliance website. (<https://freefilealliance.org>), viewed December 18, 2023)

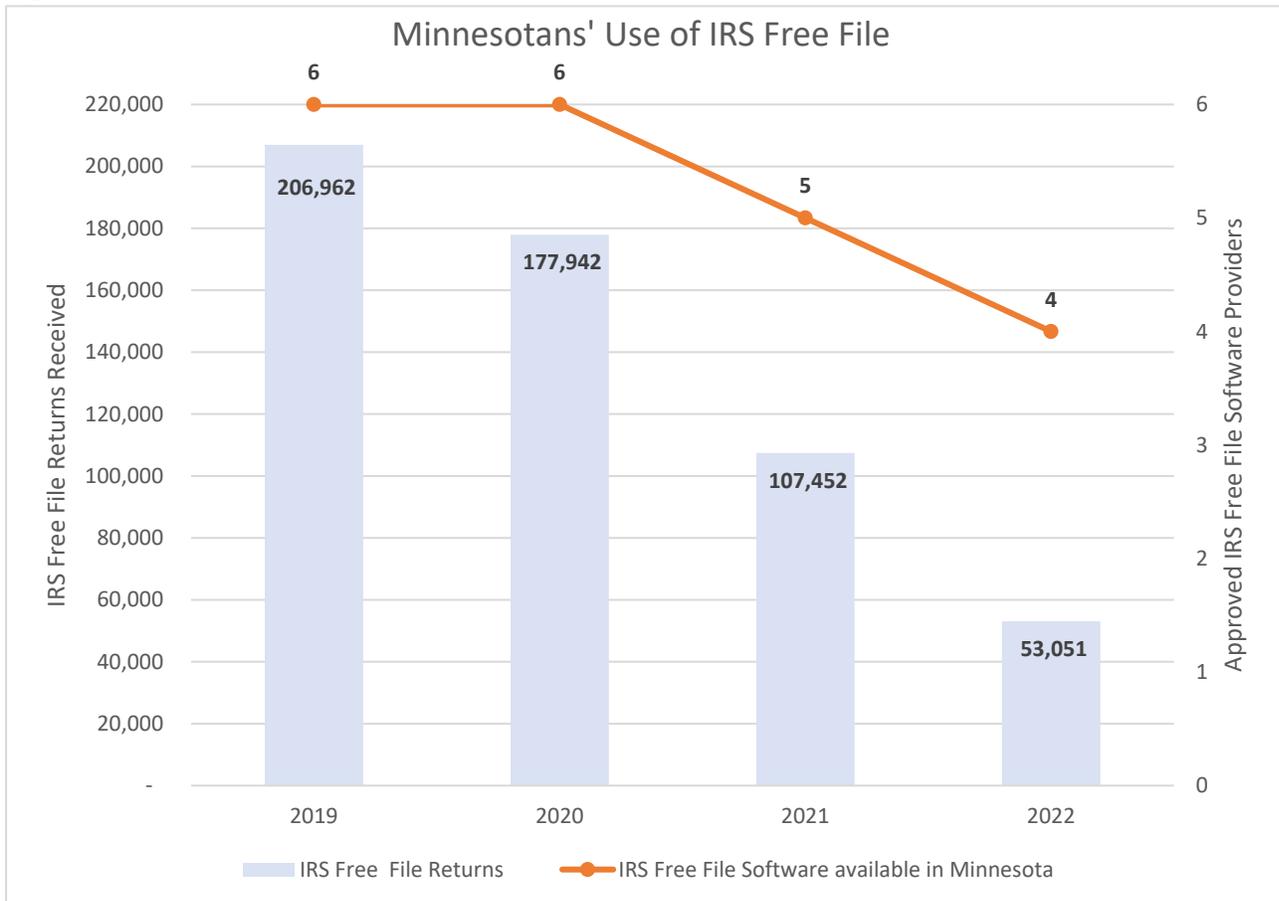
⁸ The Internal Revenue Service's Free File Program: Current Status and Policy Issues, p. 2, "Use of the FFP." Congressional Research Service, January 26, 2023. (<https://crsreports.congress.gov/product/pdf/IF/IF11808>, viewed December 18, 2023)

Free File in Minnesota

Free File usage is low in Minnesota, accounting for 2% of returns filed in tax year 2022 (Figure 3). The number of state returns filed through the program has declined over the last four years, despite efforts to promote the program.

Though Minnesota has never signed an MOU to participate in the IRS Free File program, the Department of Revenue website promotes the four software providers available for Minnesotans.⁹

Figure 3



Summary: Free File usage by Minnesotans has declined steadily over the past four years. A large factor is that the two largest IRS Free File software providers, Intuit/Turbo Tax and H&R Block, left the program in 2021 and 2022, respectively.

⁹ Free Electronic Filing, Minnesota Department of Revenue website. (<https://www.revenue.state.mn.us/free-electronic-filing>, viewed December 22, 2023)

IRS Direct File Pilot Program

Until 2019, the IRS stated it would not develop its own filing services to replace the Free File member services. In 2022, the IRS began actively developing its own free filing program called Direct File.¹⁰ The IRS has published analysis around usage and cost estimates of the program.¹¹

The IRS will pilot test its Direct File program in 2024. Thirteen states in total have been invited to participate in the program, with four of those being individual income tax states (Arizona, California, Massachusetts, and New York).

Survey of Tax Software Providers

Interest

The Department of Revenue sent an electronic survey to 27 tax software vendors to gather information on potential Free File options for Minnesotans. None of the vendors who responded to the survey currently operate a similar e-File program in other states.

Of the providers surveyed, 13 offer products for self-preparation and self-filing of Minnesota individual income taxes and 14 offer products specifically for paid tax professionals.

In all, nine providers responded to the survey, and four indicated potential interest in contracting with the state of Minnesota to provide e-File services.

Cost to Minnesota and Services Provided

To help identify the cost of implementing a Free File system for Minnesotans, we asked about estimated costs to the state of Minnesota and any additional costs not included in the contract. The request included estimated costs to the state to provide a system that allows Minnesotans to prepare and file their Minnesota Individual Income Tax return (Form M1 and related schedules).

Estimates varied by software provider, but followed some general trends:

- We derived cost estimates based on software provider responses and Revenue's data on customer filing habits. We estimated a cost range from \$2.4 million to \$19.5 million per year to support a free file program.

¹⁰ Direct File, IRS website. (<https://www.irs.gov/about-irs/strategic-plan/direct-file>, viewed December 22, 2023)

¹¹ "Under varying scenarios relating to the scope and usage of Direct File, the study estimates that annual costs of Direct File may range from \$64 million (assuming 5 million users and a narrow scope of covered tax situations) to \$249 million (assuming 25 million users and a broad scope of covered tax situations). Customer support accounts for more than half of the cost in all scenarios, and 84% of the cost in the 25 million users broad scope scenario. These estimates do not include potential cost savings due to taxpayers who may shift from paper filing to a potential Direct File option." p. 3. IRS Publication 5788 (5-2023). (<https://www.irs.gov/pub/irs-pdf/p5788.pdf>, viewed December 22, 2023)

- Only two providers gave cost estimates, which indicates a difficulty in pricing this unique type of public-private partnership.
- The estimates were provided without a firm set of requirements and depended on a large set of assumptions from the software providers. Reasonable estimates of cost need to be further analyzed.
- Costs for Revenue and MNIT to support this program have not been evaluated and are not included in the above estimates.
- Mid-year or federal conformity tax law changes would increase costs, with estimates varying by software provider.
- Costs would have to be discussed each year or by each contract, as the number and scope of returns could change based on customer use and complexity of legislation.
- A minimum fee or fixed cost would be needed to support the development of the software product, and a variable cost could be set based on the usage of the product.
- The product could offer optional add-on services for purchase by Minnesota customers, just as commercial tax software offers additional à la carte beyond the basic product. Examples include, but are not limited to:
 - Speaking with a tax expert by phone, video, or text
 - Additional reviews of a return by a tax expert before submitting the individual income tax return
 - Prepaying for tax expert support in case of future audit
 - Ability to file an amended return or prior year return
 - Prepared and printed copies of returns sent to the customer
 - Refund transfer products

Tax software providers use different pricing models. Getting a more precise cost estimate would require a full discovery and requirements analysis through an RFP (request for proposal).

Security

Security and the protection of customer data are crucial to provide a successful and trusted free file solution. The survey for this report directed tax software providers to consider in their estimates the cost and time needed to meet the requirements of both:

- Minnesota Statutes, [Chapter 13](#) and [Chapter 270B](#)
- [IRS Publication 1075](#)

Providers already meet these standards with their current software products. They are required to secure customer data, report any data breaches, perform and report fraud analysis, and share information related to keeping customers' data safe.

The Department of Revenue would maintain current costs and efforts to ensure customer data is protected by the security standards. This would not drive additional costs for the software providers.

Quality

Two of the four interested software providers reported a plan for their testing and quality assurance process. Their responses detailed stages and types of quality assurance, demonstrating their commitment and interest in creating a long-term quality product.

The Department of Revenue would also participate in quality reviews and field user feedback and complaints as part of any future free file arrangement. The reputation of both the software provider and Minnesota state government would relate to the performance of any free file solution.

We also asked about resources the vendor would need to develop, roll out, and run a Minnesota free file program. The software providers did not see this as a barrier, provided future contracts would allow a rollout period of up to two years.

Alternative Options

This section explores alternate options for Minnesota customers to file their state income taxes, including:

1. Reimburse taxpayers for Minnesota filing costs
2. Reimburse software providers for Minnesota filing costs
3. Provide a free in-house solution for all Minnesota filers
4. Keep the current system (business as usual)
5. Build capabilities based on the IRS Direct File pilot
6. Try to increase the use of IRS free file VITA, TCE, and other existing free programs

Each alternative option has its own potential benefits and drawbacks, as summarized below. All of the options that reduce filing costs could reduce the need for professional tax preparers.

Option 1: Reimburse Taxpayers for Minnesota Filing Costs

Summary: The state of Minnesota could provide a refundable credit or directly reimburse income tax filers with a variable or set amount of money to cover the cost of using a software product to file their own taxes.

Opportunities:

- Refundable credit would reduce tax owed or increase refund for taxpayers who file electronically

Challenges:

- Complex to implement and operate
- Could increase the rate of fraudulent refund claims
- Hard to administer equitably in some scenarios (such as married separate filers, deceased taxpayers, or those with no access to file electronically)
- 1-year lag between taxpayer buying the software and receiving the credit
- Refund could be reduced (offset) by tax debt and not sent directly to taxpayer
- Minnesota taxpayers must still file a federal return which may not be free unless the state also reimburses those costs

Option 2: Reimburse Software Providers for Minnesota Filing Costs

Summary: The state could directly reimburse tax software vendors for the cost of providing and submitting Minnesota returns through their products.

Opportunities:

- An efficient, easier-to-implement reimbursement method
- No taxpayer behavior change needed
- Offers both immediate and long-term solution

Challenges:

- No incentive for software providers to keep costs low for Minnesota customers over time
- A flat fee reimbursement may:
 - Underpay for the service if add-ons are chosen by the customer
 - Over-pay for the actual value of the service with less-complex returns
- Minnesota taxpayers must still file a federal return which may not be free unless the state also reimburses those costs

Option 3: Provide a Free In-House Solution to All Minnesota Filers

Summary: The state could work with its current tax administration software vendor to develop its own free file system. Currently 19 states have done this or are in the process of doing so. Minnesota's tax software administration solution is compatible with this approach.

Opportunities:

- The state of Minnesota has full control over development of its free file solution
- Can be built and more easily customized to fit Minnesota's specific needs and guidelines

Issues:

- Roll out requires a phased approach to customers over years
- IRS link to federal return information (Form 1040) does not currently exist
- Complex tax filings would be costly to support
- Data entry from federal return (Form 1040) required for customers

Option 4: Keep Current System (Business as Usual)

Summary: The state could continue with its current system. Do not change the scope of Revenue work and minimize any impact to the tax industry.

Opportunities:

- Does not change the scope of Department of Revenue's people, processes, and technology
- Minimizes impact to tax software providers and paid tax professionals

Challenges:

- Inaction will not alleviate the burden or cost for Minnesotans to file their taxes

Option 5: Build Capabilities based on the IRS Direct File Pilot

Summary: The state could be an early adopter of the IRS Direct File system, which will allow individuals to directly file taxes through an online portal. This would preserve the integrity of Minnesota tax data and provide a way to file state income tax based on customers' federal tax returns.

Opportunities:

- Customers can fill out and send a free federal return (Form 1040) and be directed to a state supported tool to file a Minnesota return

Challenges:

- Direct File program is in early stages of development and is limited to simple tax filings
- Level of state effort needed to participate is unknown
- Current plans don't solve the issue of linked federal returns (1040). Some federal information will be provided to Minnesota Revenue, but it will involve duplicate data entry, depend on customer timing, or not include the full accepted federal return information. Linked federal information is needed for fraud prevention and to administer complex tax filings.

Option 6: Try to Increase Use of IRS Free File, VITA, TCE and Other Free Programs

Summary: The state could sponsor, promote, and take a larger role in running current no-cost programs – such as Free File, VITA, and TCE – to increase the number of eligible Minnesotans using them. The state could also advertise private no-cost software products.

Opportunities:

- Increased promotion would cost less than some other alternatives
- IRS provides tax software to VITA and TCE sites at no cost

Challenges:

- VITA and TCE programs are more income restrictive than Free File, which limits eligibility and usage
- High costs to support rural sites
- Promoting other non-IRS supported free tax services may be seen as a conflict of interest by customers¹²

Other States

All 50 states and the District of Columbia participate in electronic filing to some degree. e-File programs standardize the transmission of tax data among various stakeholders, both private and public.

The use of e-File extends beyond self-prepared returns to include (for example) how corporations file employee W2 data and how tax software providers update their products to stay current with federal and state tax changes.

The IRS administers the VITA and TCE grant programs to help operate free tax service sites. Grant recipients for 2024 include:

- VITA sites in all 50 states and the District of Columbia
- TCE sites in 22 states and the District of Columbia¹³

Other state e-File efforts include:

¹² For example, Cash App Taxes is a free and commercially available tax filing software, available to filers without age or income limitations. (<https://cash.app/taxes>, viewed December 28, 2023)

¹³ Tax Counseling for the Elderly (TCE) and Volunteer Income Tax Assistance (VITA) Grant Recipients – October 1, 2023-September 30, 2024. IRS Publication 5788 (5-2023). (<https://www.irs.gov/pub/irs-pdf/p5788.pdf>, viewed December 22, 2023)

- 22 states and the District of Columbia belong to Free File Inc., the non-profit that operates the IRS Free File program¹⁴
- 19 states have built some form of direct e-File service for individual income tax filers
- 13 states have been invited to participate in the IRS Direct File pilot. Four of those states have individual income taxes (Arizona, California, Massachusetts, and New York)

Conclusions

Based on our survey of tax software providers and the other research outlined in this report, the Department of Revenue has three policy recommendations about potential free filing solutions:

1. Partnering with a single software provider to give Minnesotans a free filing option is feasible if the solution is adequately funded and allows a multi-year rollout period.
2. Future legislative direction for any free filing solutions must be politically stable, multi-year commitments.
3. Recent advances in technology and our software capabilities could make any of the options in this report feasible.

Future policy decisions on free filing in our state should be weighed at a higher level with these three questions:

- What is the role and scope of government?
- What is the role of public-private partnerships?
- Is it worth the cost and resources to provide Minnesotans a free or subsidized filing service?

Thank you for reading this report. Should the Minnesota Legislature choose one of the options available in this report or require more information, we stand ready to partner with legislators and other stakeholders to benefit all Minnesotans.

¹⁴ Many taxpayers may be able to file their state tax return using IRS Free File, IRS website. <https://www.irs.gov/newsroom/many-taxpayers-may-be-able-to-file-their-state-tax-return-using-irs-free-file>, viewed December 22, 2023)