

Analysis of a Proposal to Extend the Child Tax Credit for Residents of Puerto Rico

Proposed Changes – The proposal would make residents of Puerto Rico eligible for the refundable child tax credit (CTC) regardless of family size. Under current law, only those households with three or more children are eligible for the child tax credit. The proposal is effective for tax years beginning after December 31, 2011.

This proposal would limit the total CTC received by a Puerto Rican tax return filer to the amount received by an equivalent tax return filer in the United States. An “equivalent tax return filer” in the states is a filer with the same earned income and family structure as the tax return filer in Puerto Rico. This would mean that credits payable to Puerto Rico residents would be reduced by the Federal income tax liability (if any) of the equivalent filer in the states. As a result, tax return filers in Puerto Rico and the equivalent filers in the states would have the same net income after Federal income and payroll taxes and the child tax credit.

Current Law – Taxpayers with one or more qualifying children may claim a \$500 tax credit per child. The qualifying child must meet the citizen requirements and may not have reached 17 years of age during the tax year. The child tax credit begins to phaseout when the taxpayers’ modified AGI reaches \$110,000 for taxpayers that are married filing jointly and \$75,000 for taxpayers filing as single or head of household.

A portion of the child tax credit is refundable for all taxpayers, regardless of the taxpayer’s regular tax or alternative minimum tax liability. The credit is refundable limited to the lesser of either (1) the unclaimed portion of the nonrefundable credit or (2) to the extent that the taxpayer’s earned income exceeds a specific threshold (times 15 percent). For tax year 2011, the earned income threshold amount is \$3,000.¹

Only households with fewer than three children were included in this analysis, since households in Puerto Rico with three or more children are currently eligible for the child tax credit.

Estimated Revenue Effect

The following sections provide an overview of the steps necessary to estimate the revenue effect of extending the child tax credit to residents of Puerto Rico.

Data from the Puerto Rico Community Survey indicates that overall, 31 percent of households include children under the age of 17. After reducing the child tax credit for comparable Federal income tax liabilities, this provision provides modest benefits.

Behavioral Response – It is important to consider the behavioral response of offering a program that provides a modest benefit, but also requires significant paperwork and information sharing. Early experience in the United States with credits targeting lower income taxpayers indicates that

¹ Since Puerto Rico residents are not liable for individual Federal income tax on Puerto Rico source income, the analysis assumes that the Puerto Rico residents would receive a child tax credit reduced by the comparable Federal income tax liability of a tax return filing in the United States.

(1) those eligible for the credit often did not claim the credit and (2) those that claimed the credit often did not claim the full amount to which they were entitled.

Puerto Rico presents unique challenges, because individuals would have to file a Federal income tax return to claim the benefits from the child tax credit.² While doing so would provide benefits to the household, the take up rate is likely to be slow and gradual.³ The estimates in Table 1 assume a gradual (5 percent per year) increase in the eligible population claiming the child tax credit. Further, during ten-year budget period (approximately mid-way), there is an additional increase in the eligible population to reflect the potential for government programs to educate and inform taxpayers of the availability of the credit.⁴

Table 1 provides the estimated revenue effect of extending the refundable child tax credit to all residents of Puerto Rico regardless of family size.

Table 1 – Estimated Revenue Effect of Making Residents of Puerto Rico Eligible for the Refundable Child Tax Credit, Regardless of Family Size (Assumes an Estimated Learning Curve) <i>(amounts in millions of dollars)</i>												
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total
Child Tax Credit												
Total CTC	–	-60	-80	-90	-100	-160	-180	-200	-220	-240	-250	-1,580
Details may not add due to rounding. Revised estimates reflect current population growth statistics for Puerto Rico, from the Puerto Rico Planning Board, Program of Economic and Social Planning, Subprogram of Economic Analysis.												

² Early experience in the United States with credits targeting lower income taxpayers indicates that (1) those eligible for the credit often did not claim the credit and (2) those that claimed the credit often did not claim the full amount to which they were entitled.

³ A reasonable estimate of the first-year participation is approximately 25 percent.

⁴ This is consistent with actual EIC experience in the United States.

APPENDIX A

Methodology – The following sections document the procedures and data sources that support the revenue estimates of making residents of Puerto Rico eligible for the child tax credit. To estimate the revenue effect of this credit, it is necessary to create tax-filing units that reflect the family size and composition. To determine the unit’s eligibility for the credit, it is necessary to distribute by income the tax-filing units. After determining eligibility, it is necessary to build a tax calculator that estimates the average tax benefits by filing status and income.⁵

I. Creating Tax Units

Transforming household and family units into tax units for Federal income tax purposes is a non-trivial task. Quite often, classification issues arise due to complex eligibility rules (e.g., earned income credit) and child custody arrangements. These issues can result in tax filing outcomes that are very different from family and household arrangements observed in the Census data files. One example of such family arrangements includes multiple generations living in one household. In this case, it is important to know the relationship of the householders as well as the family members responsible for the financial support.

A micro data file that would allow detailed study and creation of tax units is not available for this analysis. For purposes of this analysis, the estimated tax units rely on data from the U.S. Census Bureau, 2008 Puerto Rico Community Surveys and the Puerto Rico Planning Board, Office of the Census. The Community Survey provides demographic statistics by type of household. The Puerto Rico Planning Board provides the population targets as well as the historical population growth rate.

In addition, it is important to note that creating tax-filing units for this analysis differs somewhat from the traditional approach, because residents of Puerto Rico are not liable for individual income tax on Puerto Rico source income. Distributing households by income and filing status mimics the Federal income tax system, with one important distinction – non-filers.

Under the Federal individual income tax system, many taxpayers earn incomes below the filing threshold and do not even file an income tax return (regardless of potential unclaimed tax benefits). This analysis did not exclude individuals as non-filers due to low-income amounts (income amounts that typically would make the individual a non-filer). Instead, the analysis incorporates into the estimate a ‘learning curve’ as a behavioral response. The learning curve, mentioned above, incorporates a gradual take-up rate for the credits, as the general population becomes educated with the programs and comfortable with filing a Federal income tax return.

This analysis includes an adjustment for individuals that earn cash wages or participate in the informal economy and may not fully report their income. In addition, Census data is likely to

⁵ In the absence of a micro data file, it is necessary to estimate the average tax benefit by filing status and income. Targeting the tax-filing units (by family size and composition) to aggregate demographic statistics maintains the bounds of the estimates. The aggregate average tax benefits will remain consistent with the population statistics.

have some degree of underreporting, as certain individuals tend to understate their income in survey responses. As a result, it was necessary to moderate the adjustment for the informal economy or cash wages for this potential underreporting behavior.

Unit of Observation – the Community Survey contains records on households, families and individuals that form the basis for the corresponding tax-filing units. Table 2 provides the unadjusted household statistics. To reflect the presence of dependent children, it is necessary to adjust these figures. Further, the adjustments exclude certain individuals that are over the age of 65 (in cases where the individual is not the head of household for tax filing purposes) who rely on retirement or social security income.

For purposes of this analysis, constructing the tax-filing units assumed that single parent households would file as head of households, married-couple households would file as married filing jointly, and non-family households would file as a single filer.

Table 2 – Puerto Rico Community Survey, Unadjusted Household Structure Source: U.S. Census, Puerto Rico Community Family Survey, 2006-2008				
	Single Parent Families	Married- couple families	Non-Family Households	Total All Households
Less than \$10,000	142,846	83,528	150,082	376,455
\$10,000 to \$14,999	43,459	64,294	45,757	153,510
\$15,000 to \$24,999	64,755	102,761	43,011	210,527
\$25,000 to \$34,999	42,367	80,780	25,014	148,161
\$35,000 to \$49,999	32,213	81,879	18,913	133,005
\$50,000 to \$74,999	20,535	73,636	13,117	107,288
\$75,000 to \$99,999	5,284	29,125	4,576	38,984
\$100,000 to \$149,999	3,017	21,431	3,050	27,499
\$150,000 to \$199,999	294	6,045	915	7,254
\$200,000 or more	650	6,594	915	8,159
Total	355,419	550,074	305,349	1,210,842

Table 3 provides data on children and their presence by household structure. Approximately 31 percent of all households have children present. Approximately 25 percent of the Puerto Rican population is 17 years of age or younger.⁶ As shown in Table 3, based on the available data, the

⁶ See U.S. Census Bureau, 2008 Puerto Rico Community Survey; Table 1283, Selected Social, Economic, Demographic, and Housing Characteristics in Puerto Rico, 2008.

analysis assumes that the vast majority of children reside in households with married couples or single adult as a head of household.⁷

Table 3 – Puerto Rico Community Survey, Selected Statistics Indicating the Presence of Children (under 17 years of age), by Household Structure Source: U.S. Census, Puerto Rico Community Family Survey, 2006-2008					
	In married- couple family household	Male Head of household, no wife present	Female Head of household no husband present	Non- Family Households	Total All Households
Number of Children	530,414	67,680	393,144	6,395	997,633
Average Size of Household	3.73	3.80	3.89	n/a	3.79
Adjusted Average Size of Household	4.52	3.73		1.07	n/a
Percent of Households with Children 17 years or younger	38.2%	35.5%	49.3%	n/a	31.1%

After identifying those households with children, it was necessary to adjust the average household size for purposes of determining the weighted-average child tax credit, as described below.⁸

In addition, it was necessary to make an additional adjustment to those households without children to eliminate households where the heads of household are 65 years of age or older.

⁷ Approximately 6,400 children were in non-family households, based on information from the Puerto Rico Community Family Survey for 2008.

⁸ Generally, the average household size increased