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United States Senate

COMMITTEE ON FINANCE

WASHINGTON, DC 20510–6200

July 17, 2015

The Honorable Jacob J. Lew
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Lew:

Puerto Rico's outstanding debt of more than $70 billion—greater than 100 percent of its gross national product (GNP)—is "not payable," according to Puerto Rico Governor Alejandro Garcia Padilla, raising prospects of default. By some measures, deficits are around five percent of GNP in Puerto Rico which, when coupled with nominal growth of just around one percent, help explain lack of debt sustainability and suggest that Puerto Rico's debts may indeed not be payable.

Much of the debt issued by the Commonwealth of Puerto Rico, its political subdivisions, and public corporations is "triple-tax-free," exempt from federal, state, and local taxes in the United States. Few other municipal bonds in the U.S. are similarly triple-tax-exempt in all states. Many municipal bond mutual funds, retirement funds, hedge funds, and distressed debt investors hold debt issued by Puerto Rico and its public corporations, such as the water and sewerage utility (PRASA), state electricity company (PREPA), and highway authority (HTA). Given Puerto Rico's dire fiscal situation, including limited liquidity and sluggish economy, rating agencies have downgraded debt issued by Puerto Rico, including debt issued by its public corporations. The central government of Puerto Rico effectively includes PRASA, PREAP, HTA, all aspects of the public sector except the municipalities, and retirement funds.

The recent so-called "Krueger Report," a study commissioned by the Governor of Puerto Rico and authored by former officials of the International Monetary Fund and the World Bank, identifies the dire need for pro-growth reforms in Puerto Rico.[1] According to the report, reforms are needed in Puerto Rico's: fiscal policies, including debt reduction and expenditure control; labor-market policies (the unemployment rate has persistently been in double digits); "the welfare system [that] makes employment unattractive for workers whose productivity is not much above the minimum wage;" policies that impact energy and transport costs; and "local laws and regulations [which] restrict domestic competition and raise the costs of doing business and uncertainty."

Unfortunately for residents of Puerto Rico, the Commonwealth has made unsustainable government benefit promises that have been papered over for far too long with debt-fueled expenditures which fail to align benefits with underlying economic fundamentals such as productivity, leading to the ultimate prospect of debt default. Tragically, unsound financial decisions of government officials have led to a sharp rise in outmigration.

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[1] Anne O. Krueger, Ranjit Teja, and Andrew Wolf, "Puerto Rico's Growth and Macroeconomic Situation and Prospects," Government Development Bank for Puerto Rico, June 29, 2015, available at http://www.gdb-pur.com/ . See, also, Anne O. Kreuger, Ranjit Teja, and Andrew Wolf, "Puerto Rico – A Way Forward," available also at http://www.gdb-pur.com/ .

I believe that the Obama administration may be in agreement with two reasonable principles to apply to the debt difficulties facing Puerto Rico: 1) there shall not be a federal bailout; and 2) orderly resolution of debt defaults are preferred to chaotic resolutions. As Chairman of the Senate Committee on Finance, I take great interest in this situation and seek additional information regarding the Administration's views and plans moving forward. To that end, I ask that you provide the following information:

1. What is the administration's position on stand-alone proposals to allow Puerto Rico's government to be treated as a state under chapter 9, including retroactive application to already outstanding indebtedness?

2. Has the administration given consideration to appointing a special mediator or arbitrator to work with Puerto Rico and its creditors to establish an orderly resolution of a Puerto Rican default?

3. What is the administration's position on exempting Puerto Rico from the Jones Act, as recommended in the so-called "Krueger report?"

4. What is the administration's position on exempting Puerto Rico from federal minimum wage law, or reducing the level of the federally-imposed minimum wage as President Obama has done in other instances (e.g., delays of scheduled minimum wage increases for American Samoa and for the Northern Mariana Islands), where the President acknowledges that a one-size-fits-all federal minimum wage can be costly to residents in areas where productivity and living costs are well below the national averages?

5. According to press reports, in June, Puerto Rico hired a retired federal judge who oversaw Detroit's bankruptcy case, as an advisor. The government reportedly is "consulting with a group of bankers from Citigroup who advised Detroit on a $1.5 billion debt exchange with certain creditors" and "United States Treasury officials...have been advising the island's government in recent months amid the worsening fiscal situation."[2] What advice have Treasury officials been offering to Puerto Rico? Have Treasury officials pledged any federal resources to Puerto Rico in conjunction with the advice, including expediting fund flows from the General Fund of the U.S. Treasury to Puerto Rico?

6. What actions are officials from Treasury's recently formed Office of State and Local Finance taking with respect to Puerto Rico's assertion that its debts are not payable? The Office of State and Local Finance at Treasury was formed, according to a Treasury spokesperson, to "serve as Treasury's liaison to state and municipal officials and associations, monitor developments in municipal bond markets, support policies to improve the management of public pensions and other liabilities, and develop potential federal policy responses to issues that emerge in municipal financing markets." Statements by officials of Puerto Rico that Puerto Rico's debts are not payable certainly qualifies as an emerging issue in the municipal financing markets. What "potential federal policy responses" have the Office of State and Local Finance at Treasury developed?

7. Does the administration intend to appoint an official to manage any federal aid packages to Puerto Rico, as was the case when former administration official Don Graves was appointed to manage aid given to Detroit following its filing for bankruptcy?

8. Do you, as Chair of the Financial Stability Oversight Council (FSOC), still agree with the assessment in FSOC's latest annual report that "Despite problems exhibited by Puerto Rico, there has been little

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[2] New York Times, June 29, 2015, available at http://www.nytimes.com/2015/06/29/business/dealbook/puerto-ricos-governor-says-islands-debts-are-not-payable.html?_r=0 .

spillover thus far to the broader municipal bond market."?[3] Do you also still agree with the FSOC annual report that notable municipal defaults in recent years, though "severe events," "appear to be idiosyncratic and not representative of a broader trend in municipal credit?"

9. Are there any anticipated executive actions under discussion among administration officials with respect to any changes in Treasury rules or regulations that may affect how the federal tax system impacts residents and businesses in Puerto Rico or the flow of transfers from the General Fund of the Treasury to Puerto Rico?

10. Does the administration intend for its proposed 19 percent minimum tax on foreign income to be applied to Controlled Foreign Corporation (CFC) operating in Puerto Rico in the same way it would apply to CFCs operating elsewhere?

11. For over four years, pursuant to Treasury Notice 2011-2, a Puerto Rican excise tax has received treatment from the Internal Revenue Service (IRS) as though it was eligible for the Foreign Tax Credit. The Notice stated that the excise tax presents new concerns and that "determination of the creditability of the Excise Tax requires the resolution of a number of legal and factual issues." Until such a resolution, the IRS has not and is not challenging claims as to the creditability of the excise tax. Furthermore, the Notice states that if the IRS eventually decides that the excise tax is not creditable, such a lack of creditability will only apply on a forward-going basis.

    a. When will Treasury finish its review to determine the creditability of the excise tax?
    b. Are there other examples of Treasury, currently or in the past, allowing a tax to be eligible for Foreign Tax Credit treatment while the tax is under examination?
    c. Has Treasury ever announced that, if a tax was determined to not be eligible for the Foreign Tax credit, such a lack of eligibility would apply on a prospective basis?

Please respond to the questions raised above by July 31, 2015.

Sincerely,

Orrin G. Hatch
Chairman
Senate Committee on Finance

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[3] 2015 Annual Report, Financial Stability Oversight Council, available at http://www.treasury.gov/initiatives/fsoc/Pages/home.aspx .