

February 16, 1942.

STRICTLY PERSONAL  
AND CONFIDENTIAL

Mr. Harry D. White,  
Special Assistant to the  
Secretary,  
Treasury Department,  
Washington, D. C.

Dear Harry:

I am sending you for your personal and confidential use a copy of the suggested program for Government financing. This is the program which has already been submitted to Secretary Morgenthau, but which has not yet been discussed with the Treasury. We are hoping to have some discussions shortly.

Sincerely yours,

M. S. Eccles,  
Chairman.

Enclosure

VE:hbw

February 19, 1942.

MEMORANDUM ON TAXATION OF PARTIALLY TAX-EXEMPT FEDERAL SECURITIES

STRICTLY CONFIDENTIAL

According to the February 14, edition of Goldsmith's letter, which is widely read in financial circles, the following statements on taxation of partially tax-exempt Federal securities were made at the Secretary's press conference on January 26:

"Since Secretary Morgenthau gave the war as a reason for a change of policy on outstanding State and Municipal securities, he was naturally asked by reporters why the war did not also necessitate a change in the tax policy on outstanding partially tax-exempt Treasury bonds. He replied:

"Because where Federal issues are concerned, there is a contract between the Federal Government and the holder of these issues, and there is no contract between the Federal Government and a holder of a State or Municipal." And later Secretary Morgenthau added: 'I feel that there is a contract which stands between the Federal Government and the holder of these Federal tax-exempt securities, and I don't intend to directly or indirectly break that contract or circumvent it. Is that flat enough?'

"When asked specifically whether he had any intention of indirectly reaching some of the partially tax-exempt Treasury bonds by lowering the normal tax, Secretary Morgenthau indicated that he was expecting that question which he referred to Assistant Secretary John L. Sullivan. Mr. Sullivan said:

"We have not considered lowering the normal tax on individuals or corporations. On the other hand, we are opposed to any increase in the normal tax, and we think that any increase the Congress considers should be increases in surtaxes, rather than in normal taxes. The reason why we are not considering a reduction in the normal taxes, is, as the Secretary said, we do not wish to attempt to do by indirection what we think we cannot openly accomplish directly. We think it would be pretty much ---' At this point Secretary Morgenthau added: 'We don't want to circumvent.'

"Then Secretary Morgenthau was asked whether what he said applied to the old Glass scheme (proposed by Senator Carter Glass when he was Secretary of the Treasury in 1919) of placing taxable income of people who had tax-exempt income in a higher tax bracket. Secretary Morgenthau replied:

'I think we have gone around the thing pretty much. I said I am opposed -- let me go over it once more. I recognize a contract exists between the Federal Government and the men or women who have bought our securities, and we don't propose by direction or indirection to tax them on this income as long as these issues are outstanding. Doesn't that cover the waterfront?'

It appears that these remarks say explicitly that the Treasury does not propose directly or indirectly to break or circumvent the contract with the holder of Federal tax-exempt securities. This seems clearly to indicate not only that the Treasury does not propose to lower the normal tax rate but that they do not propose any change in the law or in the regulations that would have the same effect as would a lowering of the normal tax rate. The market seems at first to have placed the same interpretation on the statement. The 1960-65s, which had declined by 26/32 since the rumors first started, recovered by 10/32 on the two days following the press conference. As new rumors developed, however, this recovery was quickly lost, and at yesterday's close the 1960-65s were quoted at 108 3/32, a decline since January 13 of 2 1/32.

As far as the law is concerned, Congress has the power to reduce the normal tax to a negligible figure if not to eliminate it altogether. Congress has power also to change the provisions regarding deductions in computing net income. Neither change would directly abrogate the Treasury's contract regarding partially tax-exempt Treasury bonds, which reads "The bonds shall be exempt, both as to principal and interest, from all taxation now or hereafter imposed by the United States, any State, or any of the possessions of the United States, or by any local taxing authority, except (a) estate or inheritance taxes, or gift taxes, and (b) graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States, upon the income or profits of individuals, partnerships, associations, or corporations". As far as indirection and circumvention are concerned, there appears to be no difference from the point of view of the investor whether the normal tax is lowered or the same result is achieved by reducing deductions.

If it is argued that the present deduction provisions are unfair and should never have been inserted in the law, the argument could be made that the normal rate should never have been raised to 2 1/2 per cent, and the tax increases of recent years should all have been in the form of a surtax. If this had been done the rate of interest on new issues of partially tax-exempt Federal securities would have been higher than was actually the case. It is true that some of these securities were issued when the normal tax rate was lower than the present 2 1/2 per cent and that original purchasers have received somewhat of a windfall as a result of subsequent increases in the normal tax rate. It is also true, however, that investors since that time have bought partially tax-exempt securities at premiums that were predicated on the maintenance of the 2 1/2 per cent rate. It would appear to be a violation not of the strict legal contract but of the implied terms of the contract to reduce the normal rate. From the point of view of investors, however, the deduction provisions are as much a part of the implied terms of the contract as is the normal rate, since the two are tied together in determining the amount of tax that will have to be paid.

It appears that the discussion of changing the deduction provisions has stirred up a large amount of uncertainty, both as to present and future tax policy, where only a small amount of revenue is involved. The present provisions do not seem to be a loophole any more than is the existence of Federal tax-exempt securities, and as mentioned above they appear to be as much a part of the implied contract as is maintenance of the present normal rate. The original reason for inserting the provision in the law was to help both the Federal and the State and local security markets. There is more reason now than there was in 1934, when the provision was enacted, for helping the Federal security market.

It does not appear that failure to change the deduction provisions would affect the possibility of obtaining the taxation of State and local securities. The argument for the latter is that the Federal Government has no contractual obligation to holders of these securities. It is proposed to remove the tax-exemption of State and local securities by a new provision of the law with no reference to the deduction provisions. In fact there seems to be no reason for drawing attention to this provision in connection with the proposed tax bill.

In view of the present market situation it seems certain that the Treasury should make a statement clarifying the position, so that investors can appraise the relative values of partially tax-exempt as against taxable securities and can proceed with their investment programs. Under the present situation investors are unlikely to do any important buying until they can decide which type of bond meets their own individual requirements. Even if the decision is unfavorable to holders of partially tax-exempt bonds, such an announcement would remove one important uncertainty and probably would greatly improve the situation in the market. In view of the statements at the press conference, however, it would seem that the Treasury is already committed against changing the deduction provisions as well as against lowering the normal tax rate.



February 19, 1942

In view of the current uncertainty over the possibility of taxing outstanding partially tax-exempt Federal securities, attention is called to a statement by the Secretary of the Treasury at a press conference on January 26, when he said: "I feel that there is a contract which stands between the Federal Government and the holder of these Federal tax-exempt securities, and I don't intend to directly or indirectly break that contract or circumvent it." The Assistant Secretary of the Treasury later said: "We have not considered lowering the normal tax on individuals or corporations." Subsequently consideration has been given to the possibility of changing the provisions of law which now permit the deduction of expenses incurred in connection with the production of tax-exempt interest. Although this possibility has been under study, the Treasury at no time reached a decision to recommend its enactment. After careful consideration the Treasury has reached the conclusion that such a change in the law might be construed as an attempt to circumvent the existing contract and has decided not to recommend that the change be made.