TO:

MR. ECCLES:

Here are two copies of a memorandum on Treasury Tax Notes and a suggestion for using those also for investment of corporate and other short-term balances. This is for the purpose of our meeting Wednesday.

DWB

July 20, 1942

Office of the Under Secretary

July 17, 1942

Secretary Morgenthau

Mr. Haas

Subject: Suggested Changes in the Terms of Tax Savings Notes


## SUMMARY

Sales of Tax savings notes in the eleven months following their initial issuance on August 1, 1941, amounted to $4,156 millions, of which $4,084 millions, or 98 percent, consisted of Series B notes, which were designed principally as a vehicle for corporate tax reserves.

It is suggested, as a means of increasing the attractiveness of the Series A notes, which were designed as an accommodation to the small taxpayer, as well as to keep pace with increasing tax rates, that the limit on the amount of these notes which can be presented annually, by any holder, in payment of taxes be increased from $1,200 to $5,000.

It is suggested that the rate of interest on Series B notes be raised to 0.72 percent to bring these notes again into line with short-term interest rates in the open market. The suggestion is also made, with respect to Series B notes, that by permitting non-banking corporations to receive interest even though the notes are not presented in payment of taxes, and by permitting the notes to be pledged as collateral, Series B notes could serve the additional purpose of absorbing unused corporate balances, and probably do so more effectively than could be done by offering a separate "short-term tap" security.

## I. Sales of Tax Savings Notes

In the eleven months since they were first placed on sale on August 1, 1941, gross sales of Tax savings notes amounted to $4,156 millions. Of this amount only about $72 millions, or slightly less than 2 percent, consisted of Series A notes, while 98 percent consisted of Series B notes. Sales of each series are shown by months in the following table:

Sales of Tax Savings Notes
Monthly, August 1941 - June 1942, Inclusive

| Month | Series A | Series B | Total |
|---|---|---|---|
| | (In millions of dollars) | | |
| 1941 | | | |
| August | 20 | 1,075 | 1,095 |
| September | 7 | 281 | 288 |
| October | 6 | 432 | 438 |
| November | 4 | 316 | 320 |
| December | 6 | 340 | 346 |
| 1942 | | | |
| January | 6 | 222 | 228 |
| February | 3 | 125 | 128 |
| March | 5 | 232 | 237 |
| April | 5 | 256 | 261 |
| May | 5 | 390 | 395 |
| June | 5 | 415 | 420 |
| Totals | 72 | 4,084 | 4,156 |

The Series A notes were designed as a convenience for the small taxpayer and were, therefore, issued in small denominations and bore a rate of interest above competitive market rates. Use of these notes for tax purposes by any taxpayer was limited to $1,200 a year. The Series B notes were intended principally as a vehicle for corporate tax reserves. They were issued in large denominations, at an interest rate comparable to competitive rates in the market, and there was no limit on the amount which a single taxpayer could use for taxes annually.

Experience with Tax savings notes during the fiscal year 1942 suggests certain modifications in their terms of issuance which are discussed in the following sections.

## II. Limitation upon the Annual Use of Series A Notes

Series A notes have played an unimportant part in the past eleven months. This may be due, in some degree, to a failure of the majority of small taxpayers to appreciate the advantages of Tax savings notes. It may be due to apathy on the part of these taxpayers; to their unwillingness to make advance preparation for increased tax liabilities. A remedy for the first of these conditions is, of course, intensified publicity and sales effort. It is doubtful that there is a truly effective remedy for the second situation.

It is also possible that a significant number of small taxpayers find it not worth their while to purchase Series A notes because of the $1,200 limitation referred to above. The amount of interest which can be earned on a maximum holding of these notes is only $1.92 a month, or $23.04 a year. Out of this sum, the holder must presumably pay the cost of safekeeping for the notes and, when tendering them in payment of taxes, the cost of transmission by registered mail.

It should also be borne in mind that tax rates are rising with the result that, with no change in the maximum amount of Series A notes which a taxpayer can use annually, the body of taxpayers who are able to use these notes to discharge their entire tax liability diminishes in size. For example, under the Revenue Act of 1941, $1,200 of Series A Tax savings notes was sufficient to discharge the tax liability of a single person without dependents, whose net income was about $8,800. Under the new rates proposed by the Treasury for 1942, the same amount of notes would only discharge the tax liability of a person, in similar circumstances, whose net income did not exceed about $5,400.

It is suggested, therefore, that, as a device to increase sales of Series A Tax savings notes as well as to keep pace with increasing tax rates, the limit on the amount which can be used annually by each taxpayer be increased to, perhaps, $5,000. For purposes of comparison, the following table shows the approximate income ceilings corresponding to a $1,200 limit and to a $5,000 limit, under the provisions of the Revenue Act of 1941, under the rates proposed by the Treasury, and under the rates approved by the House Ways and Means Committee. Within the proposed limit, it would be possible for holders to earn as much as $8.00 monthly, or $96.00 annually, in interest. This amount would probably offer sufficient attraction to a large number of taxpayers who are not now buying Series A Tax savings notes.

Approximate Net Incomes Before Personal Exemption
which Would be Subject to Taxes of
$1,200 and $5,000, Respectively,
Under Various Conditions

| Amount of tax | 1941 Law | Rates Proposed by Treasury | Rates Approved by Ways and Means Committee |
|---|---|---|---|
| | A. Single person - no dependents | | |
| $1,200 | $ 8,800 | $ 5,400 | $ 6,100 |
| 5,000 | 20,200 | 15,100 | 16,400 |
| | B. Married person - no dependents | | |
| $1,200 | $ 9,600 | $ 6,000 | $ 6,800 |
| 5,000 | 21,000 | 15,700 | 17,100 |
| | C. Married person - two dependents | | |
| $1,200 | $10,400 | $ 6,600 | $ 7,600 |
| 5,000 | 21,700 | 16,300 | 17,900 |

## III. Interest Rates on Series B Notes

At the time that they were first issued, the interest rate on the Series B notes was approximately in line with market rates for short-term money. Since that time, however, short-term interest rates in the open market have risen substantially. The following table compares the yields of selected short-term Treasury securities on August 1, 1941, and on July 1, 1942:

Comparison of Yields on Short-term
Treasury Securities
August 1, 1941, and July 1, 1942

| | August 1, 1941 | July 1, 1942 |
|---|---|---|
| | (Percent) | |
| Three-month Treasury bills (taxable) | 0.094 a/ | 0.360 a/ |
| Seven-month Treasury certificates of indebtedness (taxable) | b/ | 0.61 |
| One-year Treasury note (wholly tax-exempt): | | |
| 2 percent due September 15, 1942 | 1-4/32 c/ | - |
| 1 percent due September 15, 1943 | - | 0.35 |

a/ Average rate of discount for bills issued at date nearest to August 1, 1941, and July 1, 1942, respectively.

b/ None outstanding.

c/ Excess of price over zero yield.

In view of the change in market conditions, it would appear that there is warrant for an increase in the interest rate on this series of Tax savings notes. To be sure, monthly sales have continued high, despite this discrepancy in interest rates; but sales might be considerably larger if the rate on the tax notes were in closer agreement with market rates. It would seem highly desirable, however, that any rate selected be one which there is a reasonable chance of maintaining for a protracted period. A series of frequent rate increases would have a distinctly unsettling effect on the market for short-term Treasury securities. A rate of 0.72 percent, which comes to 6 cents a month per $100, is suggested as being probably the lowest rate which could safely be maintained.

## IV. Possibility of Using Series B Tax Notes TO Absorb Idle Corporate Balances

There has been a great deal of discussion of suitable means of diverting to the Treasury, for the war effort, unused balances of non-financial corporations. These funds, which arise to a considerable extent from diminution of inventories and postponement of capital expenditures, will probably become increasingly important as the war continues. One function of the issuance of Treasury certificates of indebtedness is the provision of a short-term investment instrument to absorb them. Consideration has also been given to the offering of a short-term tap security for the same purpose.

Such discussion usually involves a non-negotiable security redeemable at the holder's demand at a price which is part of the contract; and to discourage premature redemption, the rate of interest is low during the early part of its term and increases afterwards. It should be pointed out in this connection that Series B Tax savings notes would, after slight changes in their terms of issuance, satisfy most of these requirements without adding another special-purpose Treasury issue to an already complex list.

To accomplish this end, it would be necessary first, to permit cash redemption with accrued interest after six months from date of issue (the notes are now redeemable for cash without interest, or acceptable for taxes with interest after three months from date of issue); and, second, to permit the notes to be pledged as collateral in the same manner as is permitted in the case of the restricted 2-1/2's of 1962-67.* Provisions with respect to redemption for tax purposes would remain unchanged. The cash redemption privilege with interest should not, of course, be made available to banks accepting demand deposits. If these changes were made, it would also be desirable, but not necessary, to extend the maturity of the Series B notes to 3 years.

A dual-purpose issue, such as the one suggested, as compared with the issuance of a new separate "short-term tap security" would have the advantage from the point of view of the Treasury that it would have an assured success, since it would have the backlog of the popularity of the tax notes to rely upon. Like the short-term tap, it would also provide the Victory Fund Committees with a constant backlog to work on.

It is also believed that a dual-purpose issue would probably have attractions for corporations with idle balances which neither a single tax-note nor a short-term tap issue would have alone. On the one hand, there would be no need for corporations to confine their purchases to their estimated tax liabilities. On the other, acceptability for taxes would make the notes more liquid because it would offer the holders an alternative to cash redemption. This alternative would be especially valuable to those corporations which, despite all assurances, are reluctant to purchase obligations which can be realized upon only by formal demand upon the Treasury for cash redemption. The provision for borrowing would provide another "out" for holders desiring that their needs for money should be kept anonymous as far as the Treasury is concerned, as well as protecting all holders against possible loss of interest due to sudden temporary demands for cash. The amount of such borrowing would probably be so small, however, that the inflationary aspect of the matter can be ignored.

---

* In case the notes are acquired by banks as a result of default on a loan, they could be redeemed at original cost, plus accrued interest up to the time they came into possession of the bank.