*1 T.C. 673 (1943)*

A stock redemption is treated as a taxable dividend under Section 115(g) of the Revenue Acts of 1936 and 1938 when the redemption is essentially equivalent to the distribution of taxable dividends, especially when the stock was initially issued as a stock dividend rather than for cash.

**Summary**

DeNobili Cigar Co. was assessed deficiencies in income (withholding) tax for 1936, 1937, and 1938. The central issue was whether amounts paid to redeem preferred stock were essentially equivalent to the distribution of taxable dividends under Section 115(g) of the Revenue Acts, and if so, whether nonresident alien stockholders were subject to tax on those amounts. The Tax Court held that the redemption of shares initially issued as stock dividends was essentially equivalent to a taxable dividend, while the redemption of shares originally issued for cash was not. The Court reasoned that the stock dividends were issued for the advantage of the stockholders, not for legitimate business purposes, and therefore were taxable as dividends.

**Facts**

DeNobili Cigar Co. was incorporated in 1912. Its original capital stock consisted of preferred and common stock issued for the assets and goodwill of a partnership. A majority of the stockholders were nonresident aliens residing in Italy. The company's certificate of incorporation mandated using a portion of net earnings to retire preferred shares. Over time, the company issued additional preferred stock, some for cash and some as stock dividends. In 1937 and 1938, the company redeemed a significant amount of its preferred stock. The Commissioner of Internal Revenue determined that these redemptions were essentially equivalent to taxable dividends.

**Procedural History**

The Commissioner of Internal Revenue assessed deficiencies in income (withholding) tax against DeNobili Cigar Co. for the years 1936, 1937, and 1938. DeNobili Cigar Co. petitioned the Tax Court for a redetermination of these deficiencies.

**Issue(s)**

1. Whether amounts paid in redemption of preferred stock were essentially equivalent to the distribution of taxable dividends under Section 115(g) of the Revenue Acts of 1936 and 1938.

2. If the stock redemptions were deemed equivalent to taxable dividends, whether nonresident alien stockholders are subject to tax on such distributions.

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## Holding

1. No, for shares issued for cash; Yes, for shares issued as stock dividends; because the redemption of shares originally issued as stock dividends was equivalent to a taxable dividend, while the redemption of shares originally issued for cash at par was not.

2. Yes, because nonresident aliens are subject to tax on distributions deemed to be dividends.

## Court’s Reasoning

The court reasoned that Section 115(g) was enacted to prevent the distribution of corporate earnings free from the tax on ordinary dividends. The court considered various factors, including the purpose of the stock issuance, whether the redemption was dictated by business needs or stockholder benefits, and the timing and manner of the distribution. The court noted the conflicting views among circuits regarding the interpretation of Section 115(g). Regarding the stock initially issued as dividends, the court found that the company’s explanation of business necessity was unconvincing, especially concerning the third preferred stock issued in 1934 when the business was declining. The court emphasized that the stock dividends appeared to be for the advantage of stockholders rather than for legitimate business reasons. As to stock issued for cash at par and later redeemed at par, the court found that there was no distribution of earnings. As for the transfers, the court found there was no presumption the transfers were sales, and the burden was on the petitioner to prove that the transfers were of value.

## Practical Implications

This case clarifies that the redemption of stock, especially stock issued as a dividend, can be treated as a taxable dividend if the redemption is essentially equivalent to a dividend distribution. Courts will examine the circumstances surrounding the issuance and redemption of the stock to determine the true nature of the transaction. The case emphasizes the importance of demonstrating a valid business purpose for stock issuances and redemptions to avoid dividend treatment. This decision impacts how corporations structure stock transactions and how tax advisors counsel clients on the tax consequences of stock redemptions. Later cases have cited this ruling to determine whether a stock redemption should be considered a dividend for tax purposes, focusing on the business purpose of the stock issuance and redemption.

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