30 T.C. 10 (1958)

Payments made by a corporation to subscribers of unissued preferred stock, calculated as a percentage of the subscription payments, are considered dividends rather than deductible interest expense when the subscribers have the characteristics of stockholders, not creditors.

Summary

The IOT Discount Corporation sought to deduct payments made to subscribers of its unissued preferred stock as interest expense. The Tax Court examined the nature of the payments, focusing on whether the subscribers were creditors or stockholders. Despite arguments that the payments were tied to installment payments and functioned like interest, the court found the payments to be dividends. The court noted that the subscribers had the risk of loss, the potential for profit, and other attributes of stockholders, and that there was no fixed maturity date for an indebtedness. Therefore, the payments were not deductible as interest under Section 23(b) of the 1939 Internal Revenue Code.

Facts

IOT Discount Corporation (Petitioner), a Texas corporation, issued common and preferred stock. Subscribers to the unissued preferred stock made installment payments before receiving stock certificates. The corporation paid subscribers a sum equal to a 72 cent dividend on each $12 payment made. These payments were made at the same time and from the same funds as dividends on the issued preferred stock. The corporation deducted these payments as interest expense on its 1953 tax return, which the Commissioner disallowed. The corporation argued that the subscribers had a creditor-debtor relationship with the corporation.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in IOT Discount Corporation’s income tax for 1953, disallowing the deduction for payments made on unissued preferred stock subscriptions. The corporation petitioned the Tax Court to challenge the deficiency, arguing that the payments were deductible as interest expense under the Internal Revenue Code. The Tax Court sided with the Commissioner.

Issue(s)

1. Whether payments made by IOT Discount Corporation to subscribers of its unissued preferred stock, based on the subscription installments, constitute deductible interest on indebtedness under Section 23(b) of the Internal Revenue Code of 1939.

Holding

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1. No, because the payments were dividends to stockholders and not interest to creditors. Subscribers bore the risk of loss and were entitled to a share of the profits, characteristics of stockholders.

Court’s Reasoning

The court determined whether the relationship between the corporation and the subscribers was that of debtor-creditor or corporation-stockholder. The court noted that several factors must be considered, including the name given to the certificates, the presence or absence of a maturity date, the source of the payments, the right to enforce the payment of principal and interest, participation in management, status equal to or inferior to that of regular corporation creditors, and the intent of the parties.

The court emphasized that the essential difference between a stockholder and a creditor is that the stockholder’s intention is to

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