Kerbaugh-Empire Co. v. Commissioner, 2 T.C. 1022 (1943)

For an accrual basis taxpayer, forgiven accrued interest is not taxable income to the debtor when the forgiveness is gratuitous, but interest accrued in the same taxable year as the debt forgiveness is not deductible.

Summary

Kerbaugh-Empire Co., an accrual basis taxpayer wholly owned by Patapsco Corporation, accrued interest on notes payable to Patapsco during 1936 and 1937. In November 1937, Patapsco forgave the principal and accrued interest as a contribution to capital. The Commissioner argued that the forgiven accrued interest was taxable income and disallowed the deduction for interest accrued in 1937. The Tax Court held that the forgiven interest was not taxable income because it was a gratuitous contribution to capital under *Helvering v. American Dental Co.* However, the court disallowed the deduction for interest accrued in 1937, the year of forgiveness, citing the principle that adjustments within the taxable year affect the income for that year.

Facts

Petitioner, Kerbaugh-Empire Co., was wholly owned by Patapsco Corporation and used the accrual method of accounting.

Petitioner owed Patapsco $1,325,000 in notes, accruing interest monthly at 6%.

Petitioner accrued interest on its books from 1933 through October 31, 1937, and deducted these accruals on its tax returns.

Petitioner made some interest payments in prior years and in 1936 and 1937, but these were not specifically designated as applying to current interest.

On November 16, 1937, Patapsco surrendered and canceled the notes and all accrued interest ($1,628,475.68 total) as a contribution to petitioner’s capital, pursuant to an agreement with Depew Securities Co., to whom Patapsco was indebted.

As part of the agreement, petitioner declared and paid a $74,000 dividend to Patapsco, which Patapsco then paid to Depew.

Petitioner paid no consideration for the cancellation of the debt and accrued interest.

Procedural History

The Commissioner determined deficiencies in petitioner’s income and excess profits taxes for 1936 and 1937, including increasing income by the amount of forgiven

© 2025 SCOTUSreports.com. All rights reserved.

accrued interest and disallowing interest deductions.

Petitioner appealed to the Tax Court.

Issue(s)

1. Whether the accrued interest forgiven by Patapsco in 1937 should be included in petitioner's taxable income for 1936 and 1937.

2. If the forgiven accrued interest is not included in income, whether petitioner should be allowed a deduction for the interest accrued on its books in 1937 prior to the forgiveness.

3. Whether petitioner should be allowed a deduction for interest actually paid in 1937 on the forgiven indebtedness.

Holding

1. No, because the forgiveness of interest was a gratuitous contribution to capital and therefore not taxable income under *Helvering v. American Dental Co.*

2. No, because the debt and interest were canceled within the taxable year, disallowing the deduction for interest accrued in that same year, following *Shellabarger Grain Products Co.*

3. No, because the interest paid in 1937 was not specifically allocated to 1937 interest and was considered applicable to interest accrued in prior years; furthermore, as an accrual basis taxpayer, the actual payment in 1937 does not change the deductibility of interest accrued and subsequently forgiven in the same year.

Court's Reasoning

Forgiven Interest as Income: The court applied *Helvering v. American Dental Co.*, holding that the forgiveness of interest was gratuitous as between Patapsco and petitioner, regardless of Patapsco's motives related to its creditor, Depew. The court stated, "As between them no consideration passed, the forgiveness of indebtedness was gratuitous, and the matters between Patapsco and its creditor, in our opinion, come clearly within the ambit of 'motives leading to the cancellation' which under the American Dental Co. case are not significant even though they are 'those of business or even selfish.'" The court distinguished the situation from scenarios where debt forgiveness is part of a bargained-for exchange.

Deductibility of Accrued Interest: The court relied on *Shellabarger Grain Products Co.* and cases beginning with *H.C. Couch*, stating that "where, as here, the indebtedness and interest were canceled during the taxable year, deduction of such interest for the taxable year may not be allowed." The court reasoned that events

© 2025 SCOTUSreports.com. All rights reserved.

within the taxable year that adjust income must be considered for that year's tax calculation. The court rejected the argument that the capital contribution was equivalent to a payment and recontribution of interest, emphasizing that the petitioner was on the accrual basis, and the actual transaction was forgiveness, not payment.

Deductibility of Paid Interest: The court found that under Pennsylvania law and in accordance with the Commissioner's determination, the interest payments made were applied to the earliest accrued interest, meaning interest from prior years. As the petitioner was not on a cash basis, and the payments were not specifically for 1937 interest, they were not deductible in 1937, especially given the subsequent forgiveness of the entire debt and accrued interest within the same year.

Practical Implications

Kerbaugh-Empire Co. clarifies the tax treatment of forgiven accrued interest and interest deductions for accrual basis taxpayers when debt is forgiven by a shareholder as a capital contribution.

It reinforces that gratuitous forgiveness of debt, including accrued interest, is generally not taxable income to the debtor, aligning with the principle established in *American Dental*.

However, it establishes a clear rule that interest accrued within the same taxable year as the debt forgiveness is not deductible, even for accrual basis taxpayers who typically deduct interest as it accrues. This creates an exception to the general accrual rules when forgiveness occurs within the same year.

Taxpayers and practitioners must consider the timing of debt forgiveness and its interaction with accrual accounting for interest expense. If debt forgiveness occurs, previously accrued but unpaid interest in the same tax year should not be deducted.

This case highlights the importance of considering events within the entire taxable year when determining taxable income and deductions for accrual basis taxpayers, especially in situations involving debt adjustments or forgiveness.

© 2025 SCOTUSreports.com. All rights reserved.