Ernst Kern Co. v. Commissioner, 1 T.C. 249 (1942)

A taxpayer can deduct interest payments made within the taxable year on indebtedness, provided the obligation to pay that interest accrued within that year.

Summary

Ernst Kern Co. sought to deduct interest payments made in 1940 related to bonds issued as part of a reorganization. The Commissioner argued these payments were not deductible because they related to obligations from 1939. The Tax Court held that the interest payments were indeed deductible in 1940 because the company's obligation to pay the interest only accrued in 1940, when the company was formed and the bonds were issued. The court emphasized that the company's liability to pay interest arose only when it came into existence and issued the bonds.

Facts

A reorganization occurred, resulting in the creation of Ernst Kern Co. in 1940.
As part of the reorganization, the company issued 3%-6% consolidated mortgage bonds.
In 1940, the company redeemed 1939 coupons associated with these bonds, paying $1,787,206.88.
The company claimed this amount as an interest deduction on its 1940 income tax return.

Procedural History

The Commissioner disallowed the deduction, arguing the interest obligation accrued in 1939, not 1940.
Ernst Kern Co. appealed to the Tax Court.
The Tax Court reviewed the Commissioner's determination.

Issue(s)

Whether the payments made by Ernst Kern Co. in redemption of the 1939 coupons on its consolidated mortgage bonds constituted interest on indebtedness that accrued in 1940 and, therefore, was deductible from gross income for that year.

Holding

Yes, because the petitioner's obligation to pay the interest accrued in 1940, when the company was formed, issued the bonds, and became legally bound to the obligation. Inherent in the accrual of an obligation is the existence of an obligor, and petitioner's obligation accrued in 1940 when it came into existence and was legally capable of contracting obligations.

Court's Reasoning

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Section 23(b) of the Internal Revenue Code allows a deduction for

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