***15 T.C. 889 (1950)***

The cancellation of indebtedness by a non-stockholder to an insolvent debtor does not increase the debtor's equity invested capital for excess profits tax purposes because the debtor has no basis for loss on a debt after it has been canceled.

**Summary**

Crean Brothers, Inc. sought to include a canceled debt of $99,965.05 in its equity invested capital for excess profits tax calculations. Hudson Coal Co., a non-stockholder but affiliated through a parent company, canceled the debt to aid Crean Brothers in continuing its business. The Tax Court held that the cancellation did not increase Crean Brothers' equity invested capital because a canceled debt has no basis for determining loss upon sale or exchange, a requirement under Section 718(a)(2) of the Internal Revenue Code. This decision emphasized that improvements to a company's financial statement, without the infusion of new assets, do not automatically augment equity invested capital.

**Facts**

Crean Brothers, Inc. was indebted to Foedisch Coal Co. for $317,634.50. Foedisch was, in turn, indebted to Hudson Coal Co. Hudson owned 51% of Middle Atlantic Anthracite Corporation, which owned 77.3% of Crean Brothers. In 1938, Foedisch assigned $99,965.05 of Crean Brothers' debt to Hudson in exchange for cancellation of a like amount of Foedisch's debt to Hudson. Hudson then informed Crean Brothers it was canceling the $99,965.05 debt to help Crean Brothers continue in business, given its financial position. Crean Brothers recorded the cancellation by debiting accounts payable and crediting surplus. Crean Brothers' 1938 tax return showed a deficit of $157,515.72 after the debt cancellation.

**Procedural History**

The Commissioner of Internal Revenue determined a deficiency in Crean Brothers' excess profits tax for 1945, excluding the $99,965.05 from equity invested capital. Crean Brothers petitioned the Tax Court, arguing the amount represented paid-in surplus or a contribution to capital.

**Issue(s)**

1. Whether the cancellation of indebtedness by a non-stockholder constitutes paid-in surplus or a contribution to capital that increases equity invested capital under Section 718(a)(2) of the Internal Revenue Code.

**Holding**

1. No, because a debt, once canceled, has no basis for determining loss upon sale or exchange, as required by Section 718(a)(2) of the Internal Revenue Code.

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## Court’s Reasoning

The court reasoned that while a non-stockholder can contribute to a corporation’s capital, the cancellation of debt does not increase equity invested capital under Section 718(a)(2). The court emphasized that only property with a basis for determining loss upon sale or exchange can be included in equity invested capital. Citing *Doylestown & Easton Motor Coach Co.*, the court stated, “When a debt is settled or forgiven, it is extinguished and is not property in the hands of the debtor even for a moment… His liability has disappeared, but he has no asset represented by the extinguished debt.” The court also noted that the cancellation merely improved Crean Brothers’ financial statement without infusing new assets into the company.

The dissenting opinion argued that Hudson’s indirect stock ownership in Crean Brothers should be considered and that the cancellation should be treated as a contribution to capital, similar to a stockholder forgiving a debt. The dissent cited *Helvering v. American Dental Co.* and other cases supporting the view that cancellation of indebtedness by a stockholder is a contribution to capital.

## Practical Implications

This case clarifies that the mere cancellation of debt, even if intended as a contribution to capital, does not automatically increase a company’s equity invested capital for excess profits tax purposes. The decision emphasizes the importance of a tangible asset with a determinable basis. This ruling impacts how companies structure contributions and debt forgiveness, particularly when calculating equity invested capital. It highlights that improvements to financial statements alone are insufficient; there must be an actual infusion of assets with a basis for loss or gain. Later cases have applied this principle to scrutinize whether debt cancellations truly represent contributions to capital or merely accounting adjustments.

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