Accounting Questions

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INTEREST PAYABLE DURING CONSTRUCTION

Question: I am one of the receivers of the X Hotel Corporation. One of the auditors feel that certain of the items can not be handled the way I would like to have them and we would both greatly appreciate an expression on the matter.

The problem relates to how we should treat interest payable on certain notes, the proceeds of which were used in the construction of the X hotel. The corporation was organized April 9, 1930. It thereupon assumed payment of certain notes, the proceeds of which were used for the construction of the X hotel. It also assumed payment of interest on these notes from December 1, 1929. For the purposes of this letter, you may consider that the hotel was completed October 1, 1930, and after that was in operation.

You will note therefore that there are three periods:

1. December 1, 1929, to April 9, 1930, period for which corporation assumed payment of interest but in which the corporation itself was not in existence.
2. April 9, 1930, to October 1, 1930, period during which corporation was in existence but had no income. Hotel was being constructed during this period.
3. October 1, 1930, onward, period of operation of hotel.

Mr. Doe is of opinion that the interest applicable to the first two periods, that is, the pre-corporation period and the construction period up to October 1, 1930, should be charged to the cost of the hotel building as a capital expenditure. He has shown me several books on accountancy indicating that this may be done.

I believe that there is some discretion in a matter of this sort, and that it would be permissible and would also be considered good accounting to handle the matter in the following way:

The interest for the pre-corporation period, that is, from December 1, 1929, to April 9, 1930, payment of which the corporation assumed April 9, 1930, should be capitalized as of April 9, 1930, as "pre-organization loan expense."

This should then be amortized over the remaining life of the loan just like so much additional interest.

The interest applicable to the period from April 9, 1930, to October 1, 1930, that is, the period after the corporation was organized but during the construction of the building, should be considered simply as interest and would be treated as a deduction from income, thus resulting in a loss for the period. It would not be capitalized at all.

I feel that my method is more conservative than Mr. Doe's. I think that it is just as logical to consider this interest as a cost of getting the money as it is a part of the cost of the building. It seems to me that it would be conservative and would be good accounting to get all of this interest and finance charge out of the way during the course of the loan, as I propose doing, and not to have it added to the cost of the building where it would stay on the books long after the loan had been paid off.

I also have in mind that by considering this interest as an income item a better showing is made for income-tax purposes. The receivers of the corporation are, of course, obliged to prevent the imposition of any income-taxes which may not properly be due.

I think this fully presents the question. What we would like to know exactly is this:

1. According to good accounting principles, must we capitalize and charge to the building interest paid after the organization of the corporation but during the construction period on money which was used for the construction of the building, or

2. Is it discretionary and also consistent with good accounting not to capitalize the interest paid after the organization of the corporation during the construction period, but to consider it an income item and a proper deduction for computing net income for that period?

Answer No. 1: It is generally recognized that interest accruing during a period of construction is a proper charge to capital assets. As a matter of accounting theory, this treatment may be amply supported by reference to any of the works of well-known authors on accounting. Capitalization of interest during construction is prescribed for railroads and other public utilities by the interstate commerce commission and other regulatory bodies.

In the case of commercial concerns, while it is unquestionably correct theoretically to capitalize interest charges during construction, there are doubtless instances in which, for good and sufficient reasons, it is justifiable not to capitalize such interest charges. In such instances the accounts should show clearly the procedure followed. On the other hand, we do not see that there is a connection, as your correspondent suggests, between the life of a loan and the period during which interest accruing thereon prior to the commencement of operations should be written off, either directly by charges to profit-and-loss or indirectly through depreciation charges.

With regard to the statement that "by considering this interest as an income item a better showing is made for income-tax purposes," we can not see how this could be the case if the effect of charging off interest during a non-operating period would be to produce a loss to the extent of the interest charges. In reporting for federal income-tax purposes, interest may, generally speaking, be deducted in the period in which it has been paid or accrued in spite of the fact that it may have been capitalized on the books; but where this is done a corresponding amount must be deducted from the relative assets in computing depreciation charges.

Answer No. 2: Recognized principles of accounting procedure require that interest paid during the course of construction of a building, where the money is borrowed for the purpose of financing such construction, should be capitalized and added to the cost of the building. It is true that under such procedure the cost of the building in the case given would be more than in another case where the owner of the property could furnish more of the required capital out of his own funds, but the difference in cost is an actual fact. It is not considered good practice to show a loss during the period of construction of the building merely by reason of the financing operations of the corporation in construction. Such treatment is generally not regarded as discretionary but as the only proper procedure in the circumstances.

The setting up of the interest for the pre-corporation period as "preorganization loan expense," presumably the equivalent of a discount on the loan, to be amortized over the life of the loan, is not in our opinion the proper procedure. Such interest should be treated in exactly the same manner as the interest paid by the corporation for the period from its organization to the completion of the construction of the building. Interest for the period after the completion of the building is, of course, charged to expense.

With respect to the tax status of the interest paid during the course of construction, attention is directed to Art. 561, of Reg. 74 as amended August 6, 1931, by T. D. 4321: ". . . In computing the amount of gain or loss, however, the cost or other basis of the property shall be properly adjusted for any expenditure, receipt, loss, or other item properly chargeable to capital account, including the cost of improvements and betterments made to the property since the basic date. Carrying charges, such as interest and taxes on unproductive property, may not be treated as items properly chargeable to capital account, except in the case of carrying charges paid or incurred, as the case may be, prior to August 6, 1931, by a taxpayer who did not elect to deduct carrying charges in computing net income and did not use such charges in determining his liability for filing returns of income. . . ." In other words, prior to August 6, 1931, without reference to proper accounting procedure, the income-tax regulations permitted the treatment of carrying charges either as a deduction from income or as an addition to the cost of the property in respect of which the carrying charges were paid. Subsequent to August 6, 1931, such carrying charges could not be capitalized but were required to be treated as deductions on the taxpayer's income-tax return.

Answer No. 3: The accounting rule is well established that interest accruing on securities issued to provide funds for construction purposes should be capitalized as part of the property, for the period from the date of issue of the securities to the date the construction project goes into operation.