The Expanded Scope of Section 189

*by Robert J. Kolasa**

This article describes the general tax shelter abuse which led to the promulgation of Section 189, provides a technical analysis of the statute, and examines the expansive changes to Section 189 wrought by TEFRA and the Tax Reform Act of 1984.

Introduction

The Internal Revenue Service has for the past decade been seriously concerned about lucrative tax shelter schemes involving the deduction of real property interest and taxes. Efforts by the IRS to defer the deductibility of these expenses bore fruit with the enactment of Section 189 of the Code in the Tax Reform Act of 1976. This provision directs taxpayers to deduct construction period real property taxes and interest over a ten-year amortization schedule. If a taxpayer elects under Section 266, he can avoid the restrictions of Section 189 and add these costs to the basis of the building. Under both provisions, the tax savings attributed to the immediate write-off of construction period interest and taxes is lessened by the matching of the expense to income in later years. The postponed deduction appears to strike a reasonable balance between eliminating the opportunity for individuals to engage in abusive tax-sheltering transactions while at the same time maintaining a healthy incentive for investment capital. Nevertheless, Congress recently expanded the scope of Section 189 into areas which differ from its original tax shelter focus. In addition, numerous ambiguities are present in the statutory framework that present problems for tax lawyers and accountants in their efforts to intelligently structure real estate transactions.

Background

The acquisition or construction of apartment buildings, shopping centers, commercial office buildings, and other projects requires the

---

* Robert J. Kolasa received a JD from the University of Detroit School of Law. This article is based on Mr. Kolasa's graduate paper in the LL.M in Taxation program at Georgetown University Law Center.

commitment of large amounts of capital over a relatively long period of time. The real estate investment decision generally involves an evaluation of the expected risks and the overall rate of return, including the potential cash flow, appreciation, and tax benefits.[1] In addition, noneconomic factors such as location and demography can make the investment more or less desirable. With vast amounts of money needed for real estate ventures, there should be a healthy market mechanism to attract new capital to counter these risks. The Code has always contained incentives to encourage investors to funnel their money into real property including deductions for interest, taxes and depreciation, the rules of partnership taxation (especially the provisions allowing a partner's basis to include nonrecourse financing), and capital gain treatment upon the sale of the property.

Various combinations of all or some of the above factors led many investment vehicles to acquire the label "tax shelter." A real estate tax shelter can be described as a real property investment in which a significant portion of the investor's return is derived from tax savings on other income as well as the cash flow from the investment itself. The savings in tax are principally achieved by generating current deductions which can be used by investors and developers to offset income from other sources, such as salary and dividends. Tax shelters encourage investments by wealthy taxpayers since the deductions are worth more to high-bracket taxpayers because of the progressive tax rate system.[2] For example, tax savings on other income generated by a deduction of $10,000 equals $5,000 in the case of a taxpayer in the 50 percent bracket, $4,000 in the case of a taxpayer in the 40 percent bracket, and so forth. Furthermore, there is the additional benefit of excess deductions converting ordinary income into capital gain upon the sale of the property.

The deduction for construction period interest and taxes can be a major source of the deductions used to generate losses in the initial years of a real estate investment. Prior to the Tax Reform Act of 1976, amounts paid for interest and taxes attributable to the construction of real property were allowable as current deductions except to the extent the taxpayer elected to capitalize these items as carrying charges under Section 266. This practice dictated that many investors realized disproportionate accelerated losses during the early years of the invest-

---

[1] Joint Comm. on Taxation, *Tax Shelters: Real Estate* (1975).
[2] *Id.*

ment. The deferral of tax liability was substantial and bred legislative pressures which prompted Congress to enact Section 189.[3]

The principal argument against the allowance of a current deduction for construction period interest and taxes was that it violated fundamental principles of tax accounting which require the matching of income and expenses. The matching concept hinges on the idea that expenses incurred during the construction period should be deducted against rental income received over the life of the building. Put another way, a current expense is deductible in the taxable year paid or accrued because it is a necesary part of producing income during that period. Therefore, expenditures made during a period in which no income is produced (the construction period) should be treated as future expenses and deducted over the time during which the related income is produced.[4] Congress also felt that the aggressive use of tax shelters caused serious distortions in real estate values resulting in investments being made in projects that were economically unsound and thus interfered with the efficient allocation of the nation's resources. This misallocation would come about because investors would be induced to invest in the property for the tax benefits irrespective of the economic significance of the property.[5]

Section 189 lessened the tax benefits of many real estate shelters by stretching out the deductibility of construction period interest and taxes. However, real estate tax shelters in today's economy are still attractive and in this respect investment decisions are still largely a function of the available tax benefits. For example, when an investment is solicited in a real estate venture, it is common to promise a prospective investor substantial tax losses which can be used to decrease the tax on income from other sources. Thus, under present law there exists substantial dealing in "tax losses" which must be reconciled with the need to attract capital for the real estate industry. Whenever the legislature lessens tax incentives it must consider the extent to which the discontinuance of the inducement will discourage investment. The Tax Reform Act of 1984 (TRA '84) reflects a congressional policy to curb abusive tax shelters through an expanded penalty and registration program which will enhance the Service's ability to identify tax shelters.[6]

---

[3] Joint Comm. on Taxation, *General Explanation of the Tax Reform Act of 1976*, 26 (1976).

[4] Carlin, "Taxation of Investments in Real Estate Under the New Rules," 36th N.Y.U. Inst. on Fed. Tax'n 351, 355 (1978).

[5] *General Explanation*, note 3 *supra*, at 26.

[6] See I.R.C. §§ 6111, 6112, 6700, 6621.

A Technical Description of Section 189

The Amortization Period

In a nutshell, Section 189 requires construction period interest and real property taxes to be deducted over a ten-year amortization period rather than deducted when paid or accrued. Section 189(a) states the general rule that no deduction is allowed for "real property construction period interest and taxes" while Section 189(b) creates a major exception to provide for the amortization period:

> (b) Amortization of Amounts Charged to Capital Account. Any amount paid or accrued which would (but for subsection (a)) be allowable as a deduction for the taxable year shall be allowable for such taxable year and each subsequent amortization year in accordance with the following table. . . .

Under the table set out in Section 189(b), a percentage of real property construction period interest and taxes is deducted in the year paid or accrued, with the rest amortized in later years. The amortization period was scheduled by Congress to reach ten years, with separate phase-in rules for nonresidential and residential real property. Until recently, transitional rules presented significant planning opportunities for cash-basis taxpayers to control payment in earlier years to assure a shorter amortization schedule.

> EXAMPLE: A cash-basis investor undertakes the building of a residential complex. Construction is scheduled to cover six months and the interest attributable to the construction period is $90,000 annually.
>
> Variation 1. The construction period falls completely within 1983 and the interest is paid in December 1983. Result: The interest is to be deducted over *nine* years; *$10,000* of the interest is amortizable in 1983 and the remainder is to be amortized at $10,000 a year over the next eight years.
>
> Variation 2. The construction period falls completely within 1983 but the interest is paid in January 1984. Result: The interest is to be deducted over *ten* years. No interest can be amortized in 1983, even though the construction period falls entirely within that year, because the interest has not been "paid" until 1984. The amount amortizable in 1984 is *$9,000*, with the remaining $81,000 to be amortized at $9,000 a year over the next nine years.[7]

---

[7] Gill, "How to Maximize Interest and Tax Deductions in a Real Estate Development," 14 Prac. Accountant 47 (1981).

The accounting problems generated by the amortization period can cause considerable complexities in long-term construction projects. For example, if in Variation 1 the construction period included 1983 and 1984, interest would amount to $90,000 in each year of construction. As concluded, the $90,000 paid during 1983 will be amortized over a nine-year period, with a $10,000 current deduction beginning in 1983. But the *next* $10,000 deduction for interest paid in 1983 will not be allowed until 1985. This strange two-year gap is mandated by Section 189(c) which states that the second year of amortization begins with the taxable year after the taxable year in which the amount is paid or accrued or, if later, the taxable year in which the real property is ready to be placed in service or is ready to be held for sale. To maximize deductibility under Section 189, it behooves the taxpayer to finish construction within two taxable years to avoid gaps. The $90,000 of interest paid in 1984 will be amortized over ten years; 10 percent in each of the years 1984-1993 without any discontinuity in the amortization schedule.

If a taxpayer wishes to avoid Section 189, he may elect under Section 266 to capitalize and add to the basis of the property construction period interest and taxes. In effect, another capitalization period is substituted for the amortization schedule of Section 189. In general, the Section 266 election and subsequent deductions under the accelerated cost recovery system of Section 168 will not provide a faster write-off than the Section 189 ten-year 10 percent amortization schedule. The ACRS write-off period for real property was increased from fifteen years to eighteen years by TRA '84. But if constructed projects are depreciated under the recovery schedule assigned to "ten-year property" a slightly faster write-off can be obtained (8 percent for year 1, 14 percent for year 2, 12 percent for year 3, 10 percent for years 4 through 6 and 9 percent for years 7 through 10), in contrast to the constant 10 percent rate of Section 189. It is doubtful that new construction will meet the definitional criteria of "ten-year property" and have a class life of twelve and a half years or less. Possible exceptions would be improvements that extend the useful life of real property or construction on a leasehold interest, in which case the Section 266 election should be explored in lieu of Section 189. A reversal of strategy occurs when the taxpayer does not have sufficient income to be offset by construction period deductions. In this case, a longer capitalization period may be obtained by Section 266. Before exercising the Section 266 election, the carryover and carryback provisions of the law should be considered, as capitalization will subject the taxpayer to bothersome recapture rules if the property is sold in later years.

Section 189(c)(2)(B) states the general rule that in the case of a sale or exchange of property subject to Section 189, the portion of the amount not allowable shall be treated as an adjustment to basis under Section 1016 for purposes of determining gain or loss. This provision means that the transferor will normally decrease his gain by the unamortized balance of construction period interest and taxes. Section 189(c)(2)(C) provides that an exchange or transfer after which the property received has a basis determined in whole or in part by reference to the basis of the property to which the amortizable construction period interest and taxes relate, shall not be treated as an exchange. In this instance, the transferor can usually continue to deduct construction period interest and taxes equal to the unamortized balance.

The Construction Period

Section 189(e)(2) describes real property construction period interest and taxes as items "attributable to the construction period." Therefore, the key to calculating the amount subject to amortization is the determination of the "construction period" since interest and taxes attributable to preconstruction or postconstruction activities avoid Section 189. Controlling the length of the construction period presents important planning opportunities. As a general rule, developers should strive to keep this period as short as possible to maximize current deductions. To this end, it is important to preserve and document necessary records (i.e., progress reports of contractors and subcontractors) to support this determination.

Section 189(e)(2) defines "construction period" as that portion of time beginning on the date on which construction of the building or other improvement begins, and ending on the date on which the item of property is ready to be held for sale. The first part of the definition is redundant and has spawned substantial uncertainty as to just when the construction period begins. The report of the Joint Committee on Taxation in 1976 addressed this issue as follows:

> [T]he construction period is not to be considered to have commenced solely because drilling is performed to determine soil conditions, architect's sketches or plans are prepared, or a building permit is obtained. Generally, the construction period will be considered to have commenced when *land preparations and improvements such as clearing, grading, and filling, are undertaken.* However, the construction period will not be considered to have commenced solely because clearing or grading work is undertaken, or drainage ditches are dug if such work is undertaken pri-

> marily for the maintenance or preservation of raw land and existing structures and is not an integral part of a plan for the construction of new or substantially renovated buildings and improvements.[8]

The Joint Committee's interpretation suggests that the construction period does not begin until physical construction of an asset has commenced. Supporting this view are references to the beginning of the construction period contained in other Code sections, which have been interpreted to mean the time when physical construction begins.[9] Alternatively, the Service and courts may take the position that the construction period begins when the construction loan is secured. A favorite example is the collapsible corporation regulations which aggressively reach a definition of construction that is broader than physical construction. At the risk of coming within the grasp of Section 189 is the period between when financing is obtained and when actual work is begun. It appears that taxpayers can take a good faith position that the construction period begins with physical construction. An open question is whether the stoppage of construction activities on a project terminates the operation of Section 189.

Section 189(e)(2)(B) states that the construction period ends when the property is placed in service or is ready to be held for sale. Presumably, the rules governing "placed in service" for depreciation purposes also apply to Section 189. But when multiple unit projects are finished in phases, real estate developers are faced with countless headaches in determining the end of the construction period. If a project consists of a large shopping complex with an adjoining hotel, are there separate construction periods for each building or is there one construction period which continues until the entire project has been completed?

If the project consists of one building, with the building to be completed in sections, is there a separate construction period for each section?[10] While no clear-cut answers exist to these questions, in the case of separate units such as in a shopping center, the completion of one unit would seem to justify the end of the construction period for that "item" of property. Therefore, enlightened tax planning for a multiple-unit project would be to sever the units, so that each unit or

---

[8] *General Explanation*, note 3 *supra*, at 27 (emphasis added).

[9] Cook, "Determining 'When Construction Period Begins' Key to Realty Deductions Under 189," 47 J. Tax'n 8 (1977).

[10] Cole & Jones, "Construction Period Taxes and Interest," 12 Tax Adviser 532, 535 (1981).

series of units has a readily discernible start and finish. In this way, completed units escape the mandatory amortization period of Section 189 even though construction may still be in progress. The use of a staggered completion schedule can substantially increase the interest deduction:

> EXAMPLE: Construction for a project made up of four warehouses starts on January 1, 1983. Interest is $36,000 a month for borrowings directly related to the six-month aggregate construction period. The first of the four warehouses is completed and ready for occupancy on March 31, 1983, and the other three warehouses are completed at the end of April, May and June. Since one-fourth of the project is completed in April, one-fourth of the interest ($9,000) is currently deductible. Each month, as another unit is completed, the current deduction grows in $9,000 increments as interest charges are no longer subject to section 189 of the Code.[11]

The problem with the above approach is that instead of completing each unit individually, cost savings may be achieved by constructing the entire project at the same time. It would seem that clearing and preparing the land should not trigger the construction period for the entire project if units are intended to be developed separately. In addition, the taxpayer is faced with choosing an accounting method allocating portions of construction period interest and taxes to particular units within a project.

The Need for Administrative Guidance

In constructing real estate projects, the taxpayer is under the sword of Damocles, in the guise of future income tax regulations. It has been reported that the Service has opened a regulations project on Section 189, and it is expected that proposed regulations will be released for rule-making purposes in the near future.[12] Until then, the informed tax planner is left with legislative history to sort out numerous interpretative problems, since administrative and judicial guidance has been nonexistent. Of course, the sword is two-edged in that the absence of authority probably means that the Service is not aggressively scrutinizing Section 189 transactions.

A perpetual controversy in partnership accounting is whether a partnership is simply an aggregation of individuals or a separate entity. One of the fundamental problems of Section 189 is that it is unclear as

---

[11] Gill, note 7 *supra*, at 48-49.
[12] See 49 Fed. Reg. 41,978, 42,009 (Oct. 22, 1984).

to whether many of the determinations and calculations of Subchapter K apply at the partner or partnership level. For example, if the rules are applied at the partnership level, a transfer of a partnership interest would entitle the new partner to the benefit of amortization deductions if the selling partner has not completely amortized his share of the construction costs. In return, the selling partner would probably increase the basis of his partnership interest by the unamortized amount. Alternatively, the selling partner could still use up the deductions after the divestment of his partnership interest if they were considered personal to him. This result flows from the fact that the amortized amounts would have been currently deductible by the selling partner but for the workings of Section 189.[13]

It is interesting that the legislative history of the statute reveals that Congress confronted the partnership dichotomy only when it considered nontaxable transfers of Section 189 property. In this circumstance, the transferor partners are entitled to amortize the deduction if the property is exchanged for stock under Section 351, in a like-kind exchange under Section 1031, or by gift.[14] Planning opportunities are thus presented to high-tax-bracket taxpayers to enjoy the benefit of ordinary deductions while gain is realized to low-bracket donees at capital gain rates. At the same time, if property subject to Section 189 is sold or exchanged, Section 189(c)(2) permits the transferor to deduct a portion of the amortized amount for the year, with the remaining amounts added to basis to reduce gain or increase loss.

The partnership accounting question of entity versus aggregate may present an all-or-nothing situation when a partner dies who has not amortized his entire deduction. A literal application of the aggregate theory to transfers at death under Section 1014 would permanently deny any deduction.[15] This seems like a harsh result in view of the mechanics of Section 189, which concentrate on deferring, not eliminating, construction period deductions. A better result would allow the estate to enjoy a tax benefit through instant deductibility, or as an increase in the bases of assets in the estate.

Congressional Expansion of Section 189

Recent legislation has substantially expanded Section 189. First, the statute is now applicable to corporations for residential and non-

[13] Carlin, note 4 *supra*, at 364-365.
[14] H.R. Rep. No. 1515, 94th Cong., 2d Sess. 409 (1976).
[15] Cole & Jones, note 10 *supra*, at 534-535.

residential property. Second, the Service is empowered to develop and impose accounting tracing rules to identify portions of working capital loans allocable among current construction projects.

Section 189 Applicable to Corporations

Prior to TEFRA, corporations (other than personal holding companies and S corporations) were not subject to the capitalization of construction period interest and taxes. Amounts paid or accrued for interest and real property taxes by corporate entities were allowed as deductions for the year in which such amounts were paid or accrued. The corporation, not being a conduit through which losses flow through, could not really spawn excess deductions for its investors. It thus lacked the potential for income sheltering which was the perceived abuse prompting the enactment of Section 189. TEFRA extended Section 189 to require corporations (other than S corporations and personal holding companies) to capitalize construction period interest and taxes for nonresidential real property. The TEFRA amendments are not applicable to property under construction if such property is an "integral part of an integrated facility" and construction of part of that facility began before January 1, 1983.[16] The TEFRA revisions were bottomed on revenue-raising concerns, even though a loose coalition of developers claimed that enactment would prove a major hindrance to recovery in the construction industry. Somewhat ameliorating this anxiety was the fact that Section 189 did not reach residential real property acquired, constructed or carried by a corporation. Section 189(e)(4) defines residential real property as property which is or can reasonably be expected to meet one of three categories. The first category is residential rental property under Section 167(j)(2)(B), which encompasses a house or apartment used to provide living accommodations (except for units used on a transient basis such as a hotel, motel, or inn), if 80 percent or more of the gross rental incomes are from such dwelling units. The second category includes dwelling units held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business. The third category was added by TRA '84 and includes real

---

[16] H.R. Rep. No. 760, 97th Cong., 2d Sess. 484-486 (1982) (property is an "integral part of an integrated facility" if the property is described as part of the same project in written plans of the taxpayer in existence on July 1, 1982; the property is an integral part of the planned operation of the project when the project will first be placed in service; and the property will be constructed during the same construction period as the rest of the project).

property held by a cooperative housing corporation and used for dwelling purposes.[17]

Accordingly, the distinction between residential and nonresidential real property for purposes of Section 189 has been attenuated. The different amortization schedules for these property classes and the exception for residential real property that existed prior to 1984 provided a safe haven for many corporate developers under prior law. Under TRA '84, corporations must capitalize construction period interest and taxes on residential real property because Congress felt that the residential real property exception was not compatible with the general objective of capitalizing the costs of construction of property with an extended useful life.[18] In addition, for purposes of computing corporate earnings and profits, construction period interest, taxes, and carrying charges are required to be capitalized as a part of the asset to which they relate and written off as is the asset itself. This new rule applies to all corporations for both residential and nonresidential real property.[19]

It had been anticipated in many quarters that the expanded capitalization requirement applicable to corporations would apply only to real property as defined under Section 1250. In connection with the consideration of the TEFRA legislation in the Senate, Finance Committee Chairman Robert Dole explained that efforts to restrict the application of amortization to Section 1250 property would decrease expected revenues by $500 million, thereby indicating that some Section 1245 property would probably fit under Section 189.[20] The Senate explanation of TRA '84 indicates that for purposes of Section 189 real property include certain "Section 38 property" described in Section 48(a)(1).[21] This definition of real property incorporates the "inherently permanent" standard of the investment tax credit. Unfortunately, the standard rests on a facts-and-circumstances test which may well result in Section 189's becoming embroiled in myriad uncertainties and breed litigation.

The two major exemptions from capitalization are for low-income housing[22] and real property acquired, constructed, or carried which cannot reasonably be expected to be held in a trade or business or in an

---

17 I.R.C. § 189(e)(4)(C) is retroactive to the enactment of TEFRA.

18 S. Rep. No. 169, 98th Cong., 2d Sess. 280 (1984).

19 I.R.C. § 312(n).

20 Brown, "Oil Companies, Utilities Caught by Construction Period Tax Change," Tax Notes, Oct. 25, 1982, at 343.

21 S. Rep. No. 169, note 18 *supra*, at 280.

22 I.R.C. § 189(d)(1).

activity conducted for profit.[23] This latter safe harbor for personal residences, vacation homes, and the like seems proper in that the primary motivation toward the purchase of a personal residence is not to shelter income. Taken literally, the provision would require an allocation of interest and taxes incurred during the construction of a multiple dwelling if one of the units is to be occupied by the taxpayer. The potential noncompliance and administrative burden among small property owners who construct rental property but automatically deduct their financing costs suggests that a de minimis rule should be adopted.

Allocation of Interest to Real Property Under FASB 34

In TEFRA, Congress delegated legislative authority to the Service to prescribe regulations which provide for the allocation of interest to real property under construction.[24] The Conference Report delineated the scope of future regulations:

> [I]t would be expected that these regulations would adopt rules similar to those contained in Financial Accounting Standards Board Statement Number 34, as amended. Under those rules, the amount of interest to be capitalized is the portion of the total interest expense incurred during the construction period that could have been avoided if funds had not been expended for construction. Interest expense that could have been avoided includes interest costs incurred by reason of *additional borrowings* to finance construction and interests costs incurred by reason of *borrowings that otherwise could have been repaid with funds expended for construction.*[25]

The Service, in being directed to follow Financial Accounting Standards Board Statement 34 (FASB 34), has in effect been given carte blanche powers to tremendously increase the interest payments subject to Section 189 amortization. Under prior law, a loan would have to be directly associated with the real property under construction to trigger Section 189. FASB 34, on the other hand, provides a mechanism to trace *all* interest costs from outstanding loans to the construction period, irrespective of whether the borrowing has a relationship to the construction financing. The analysis below examines the financial accounting theory behind FASB 34 and the compatibility of the financial standard with tax accounting.

---

23 I.R.C. § 189(d)(2).
24 I.R.C. § 189(e)(1)(B).
25 H.R. Rep. No. 760, note 16 *supra*, at 485 (emphasis added).

Prior to the passage of FASB 34, the Securities and Exchange Commission became concerned with the diverse treatment of interest costs for financial accounting purposes. Enterprises were expensing or capitalizing all interest costs, or using a hybrid method to capitalize only certain interest charges. The diversity of treatment violated the accounting principle of uniformity, and FASB 34 was enacted to provide systematic criteria for the capitalization of interest.[26]

Under traditional accounting theory, when an asset is being created, the direct costs of labor, materials, and overhead are capitalized as part of the cost of the asset.[27] The fundamental thrust of FASB 34 is that interest is a direct cost which should be allocated to an asset during the construction period. It must be emphasized that the FASB's conception of interest as a cost of financing extends beyond specific construction borrowings to encompass most borrowings outstanding during the period. The contrast of this treatment compared with prior tax practice is significant, since Section 189 was not interpreted as a means of tracing unrelated borrowings to the construction period. The accounting rationale is that the amount of interest cost to be capitalized should include the interest that theoretically could have been avoided during the construction period, if funds had not been expended for construction. It follows that interest costs can be avoided by repaying existing borrowings as well as by not borrowing additional funds. In short, all borrowing is seen as an avoidable cost. When the decision to invest in an asset is made, the taxpayer forgoes the opportunity to repay existing debt and therefore the incurrence of interest cost is a consequence of the investment decision which should be reflected in the asset's cost.[28]

FASB 34 directs that the cost of financing expenditures for a qualifying asset should be measured by assigning to the asset an appropriate portion of the interest cost incurred on borrowings during the period of its acquisition.[29] But how is the capitalized interest actually determined? The FASB methodology is to multiply the amount expended for the asset (the accumulated expenditures) by a capitalization rate which represents the firm's cost of borrowing. The determination of the capitalization rate forms the backbone of the computation, and can be derived from two sources. First, the rate on specific borrowings

---

[26] Statement of Financial Accounting Standards No. 34, "Capitalization of Interest Cost" ¶ 26 (FASB 1979).

[27] *Id.* ¶ 48.

[28] *Id* ¶¶ 12, 51.

[29] *Id.* ¶ 49.

directly related to the construction period can be used. Next, an average rate extracted from other borrowings is applied to expenditures not covered by specific new borrowings. All expenditures for the asset are multiplied by an interest rate even if no new borrowings were incurred for the asset, such as internal financing through the issuance of new stock. An important limit is that the total amount of interest capitalized in an accounting period cannot exceed the amount of interest cost actually incurred.[30]

Paragraph fourteen of FASB 34 states:

> In identifying the borrowings to be included in the weighted average rate, the objective is a reasonable measure of the cost of financing the acquisition of the asset in terms of the interest cost incurred that otherwise could have been avoided. Accordingly, a judgment will be required to make a selection of borrowings that best accomplishes that objective in the circumstances.

This language reveals the tensions in applying a financial accounting standard for tax law purposes. The financial accountant is motivated by objective information reporting, while the tax practitioner's motivation is having his client pay less tax. In order to restrain artificial capitalization, the weighted rate should be limited to identifiable classes of outstanding debt. For example, borrowings below the applicable federal rate or from related parties could be excluded from this determination. At the very least, because of the competing professional objectives, a good case can be made for not having financial statement conformity.

The following example gives an overview of the computational structure of FASB 34. It should be noted that the fact pattern ignores many complexities (such as multiple units being constructed in different construction periods) and may not be indicative of the approach taken in future regulations.[31]

> EXAMPLE: Tract Corporation, a June 31 fiscal year taxpayer, contracted for the construction of an office building for its own use. Estimated total expenditures were $4,000,000 which were financed through the issuance of common stock. Total expenditures for the project during the fiscal year amounted to $3,900,000. The construction period for the project began on July 1, 1984 when land preparations were commenced. The building was completed and ready for use on June 31, 1985. The interest expense on unrelated borrowings for the year equalled $402,500.

---

30 *Id.* ¶ 15.

31 J. Booker & B. Jarnagin, *Financial Accounting Standards: Explanation and Analysis* (2d ed., 1980). Our example is adapted from a problem at 220-229.

Pre-TEFRA Section 189 Analysis

Since Tract internally financed the project, no specific borrowings can be traced to the construction period. Hence, no interest is amortized under Section 189. Assuming the interest payments are otherwise deductible, Tract Corporation would be entitled to the full $402,500 deduction at the end of the fiscal year.

FASB 34 Analysis

It is appropriate to capitalize interest on the land and buildings because interest expenses were incurred during the accounting period, while activities were undertaken to make the asset ready for its intended use.

Capitalized interest equals Tract Corporation's capitalization rate multiplied by the project's accumulated expenditures. Each individual expenditure is weighed for the length of time outstanding during the capitalization period. For instance, a $500,000 expenditure made on July 1, 1984 has been outstanding the full period and should be valued for twelve months while the $800,000 final payment should be weighed proportionately less. All expenditures were incurred on the first of each month, so a monthly indexing is appropriate and Tract's weighted accumulated expenditures equals $1,933,331:

Date of Expenditure	*Amount*	*Capitalization Period*[a]	*Weighted Accumulated Expenditures*[b]
July 1, 1984	$ 500,000	12/12	$ 500,000
August 1, 1984	500,000	11/12	458,333
September 1, 1984	300,000	10/12	250,000
December 1, 1984	400,000	7/12	233,333
February 1, 1985	500,000	5/12	208,333
March 1, 1985	400,000	4/12	133,333
May 1, 1985	500,000	2/12	83,333
June 1, 1985	800,000	1/12	66,666
	$3,900,000		$1,933,331

[a] Period from date of expenditure to June 31, 1985

[b] $500,000 × 12/12 = 500,000
$500,00 × 11/12 = 458,333 etc.

The next step is to determine Tract's capitalization rate. As noted above, this variable is bifurcated between the interest rate paid on direct construction borrowings and an average rate from other loans. The average rate is the soul of FASB 34, for when multiplied by the weighted accumulated expenditures (less expenditures traced to construction borrowings), the product represents interest costs which theoretically could have been avoided by servicing existing debt. Of course, the interest liability generated by specific construction loans would not exist but for creation of the asset. Tract's debt structure for the fiscal year ending June 31, 1985 was:

Debt	*Interest Rate (%)*	*Interest Expense*
$ 500,000	10	$ 50,000
50,000	5	2,500
1,000,000	11	110,000
2,000,000	12	240,000
$3,550,000		$402,500

One possible formulation of the average rate in the instant circumstance would be:

$$\text{Average Capitalization Rate} = \frac{\text{Interest Cost}}{\text{Amount Debt}} = \frac{\$\ 400{,}000}{3{,}500{,}000} = 11.43\%$$

It should be noted that the $50,000 debt at 5 percent has been omitted from the above calculation to demonstrate the inherent subjectivity of the capitalization rate. Since FASB 34 requires judgment in determining the debt to include and exclude in the calculation, a strong argument exists that the low 5 percent rate should not be counted in the capitalization rate as it does not reflect Tract's current borrowing reality. This means a higher capitalization rate and more interest capitalized. If the debt had been included, the resulting lower capitalization rate would mean that less interest would be capitalized. For tax purposes, relatively objective debt ordering rules should probably be prescribed.

In general, the amount of interest to be capitalized is the average capitalization rate (11.43%) multiplied by the weighted accumulated expenditures ($1,933,331), which equals $220,979. The current interest deduction for Tract Corporation under Section 189 and FASB 34 would be:

Interest expense	$402,500	
Less amount capitalized	220,979	
		$181,521
Section 189 amortization (10% × $220,979)		22,097
Current interest deduction		$203,618

The above result strikes a phenomenal contrast to the $402,500 current interest deduction which would be allowed without the application of FASB 34. Application of FASB 34 increases Tract's current tax liability by $198,882. However, this amount represents a deferral of the interest deduction which the corporation will recoup in later years.

It can be argued that FASB 34 is an accounting standard which may work toward different ends than the equitable and fair allocation of the tax burden. Financial accounting entails objective reporting to investors of the company's financial affairs. But even among accountants there remains controversy concerning the theoretical soundness of FASB 34. A fundamental charge questions the premise that interest on debt can be directly allocated to noncash resources in the same way as material, labor, and overhead costs.[32] In addition, FASB 34 is founded on a view of interest cost that may not meet the needs of users of financial statements because it makes the requirement to capitalize interest dependent on meeting an undefined test of materiality, and because it is not evenhanded in application.[33]

Probably the most troubling aspect of FASB 34 is that to attach an interest cost to all expenditures for a qualifying asset imputes an interest cost to equity funds that have been used to finance the construction of the asset. In the prior example, there were no specific borrowings directly associated with Tract Corporation's construction project. The project was solely funded with equity capital, yet the corporate liability was increased because of the imputed relationship between construction activity and other borrowing costs. To trace unrelated borrowings to constructed assets may be laudable accounting treatment, but the use of this fiction to increase tax liability seems unreasonable to this author. However, the structure of Section 189 as a deferral mechanism does breed hardships which, arguably, FASB 34

---

[32] FASB 34, note 26 *supra*, Dissenting statement of Messrs. Block, Kirk, and Morgan.

[33] *Id.*

can cure. Under present law, equity investors can construct their projects with less after-tax economic costs because of the avoidance of the amortization provisions. The question becomes whether limiting capitalized interest to specific construction borrowings unfairly subsidizes the "all equity" enterprise even though it incurs an economic cost of the same order as an enterprise that borrows funds. FASB 34 reverses this result a bit, only to raise the caveat that it unduly penalizes equity financing of asset construction by linking the latter with unrelated borrowings to trigger Section 189.

Irrespective of the theoretical or equitable virtue of FASB 34, Congress has given the Treasury a directive to write regulations consistent with the accounting standard. The inquiry becomes how aggressively the Treasury will follow this mandate. It is not mandatory that the regulations literally adopt FASB 34, and certain quantitative limits could be made on the amount of interest attributed to Section 189 through nonconstruction borrowings. Of course, such permutations would run the risk of not being consistent with legislative intent. Whatever interpretation is adopted, clear-cut regulations should supplement existing accounting rules in order to present a workable framework for the treatment of real property construction period interest and taxes.

Conclusion

The success of our tax system is dependent upon an equitable division of the tax burden. Prior to the Tax Reform Act of 1976, taxpayers were taking accelerated deductions of real property construction period interest and real property taxes to offset against other income. Taxpayers in high income tax brackets could claim deductions that arguably were matched to future periods. In an effort to stem this practice, Congress enacted Section 189 which amortizes these costs over ten years. The breadth of Section 189 was greatly expanded by TEFRA and TRA '84. Section 189 is now applicable to Subchapter C corporations for residential and nonresidential real property and the Treasury is authorized to issue regulations to allocate interest in accordance with FASB 34. This latter accounting standard traces unrelated borrowing costs to the construction period and will present numerous administrative and tax accounting problems.