12/8/58

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CALIFORNIA JOCKEY CLUB, INC.)

Appearances:

For Appellant: William B, Hornblower, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel; John S. Warren, Associate Tax Counsel

O P _IN _ION

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of California Jockey Club, Inc., to a proposed assessment of additional franchise tax in the amount of $1,159.19 for the income year 1954.

Appellant has been operating a horse racing track known as Bay Meadows. It has, pursuant to statute, conducted extra racing days known as charity days the net proceeds of which were to be donated to charitable organizations (Section 19538 of the Business and Professions Code prior to 1955 amendment). Beginning in 1944 the net proceeds of some of the charity days have been donated to the Veterans Rehabilitation Foundation, a California nonprofit corporation. Appellant supplied substantially all of the Foundation's funds, One of Appellant's officers, William P. Kyne, was an officer of the Foundation.

In 1953 the Attorney General of California, proceeding under his power to enforce charitable trusts, instituted legal proceedings against Appellant, Mr. Kyne, the Foundation and others "for an accounting, for removal and appointment of trustees, for the appointment of a receiver, for an injunction and other relief." He alleged, among other things, that Appellant and Kyne controlled the Foundation and lost certain of its funds by loaning them to and investing them in various organizations in which Kyne had a financial interest. The Attorney General further alleged that Appellant had thereby "violated its obligation as trustee of funds collected by it as the proceeds of charity days at its horse racing meets and allocated by law to charity and benevolent work."

Later in 1953 the parties to the litigation reached an agreement for settlement. It was agreed that Appellant would guarantee restitution of Foundation funds which had been expended as follows:

Loan to Portland Meadows	$225,000.00
Loan to San Mateo Boxing and Wrestling Club	1,000.00
Loss on Operation of National Boxing Club	7,799.53

The agreement provided that these funds were to be restored at the rate of not less than $50,000 a year and that Appellant would use for that purpose the proceeds of at least two racing days per meeting at Bay Meadows, which were not to be deemed "charity days." It was also agreed to submit to the court the question whether $125,000 paid by the Foundation for stock and an unsecured 25-year note of Portland Meadows (a horse racing track in which Kyne had an interest) should be repaid. The court thereafter ordered that this sum be repaid along with the other amounts.

Appellant's original payments to the Foundation and to other charitable organizations, out of the proceeds of "charity days," have consistently been allowed by the Franchise Tax Board as deductible business *expenses.* Thus, for the income year here in question Appellant's "charity day net proceeds" were claimed and allowed as a deduction. Appellant also claimed as a deduction for the same year the proceeds of "two days racing allocated to replenishment of charity funds of Veterans Rehabilitation Foundation" plus a supplementary amount sufficient to bring the total so allocated to $50,000. Respondent disallowed this deduction.

Appellant contends that its repayment to the Foundation, made pursuant to the agreed settlement, was a proper deduction representing a loss. Section 24121d (now 24347) of the Revenue and Taxation Code provides that a deduction for losses sustained during the income year and not compensated by insurance or otherwise shall be allowed in computing net income. Appellant has cited no authority in support of its contention that the amount in question constituted a loss to it within the meaning of this section. In construing a substantially identical provision, Section 23(f) of the Internal Revenue Code of 1939, it has been held that expenditures made in the compromise of litigation are not deductible as losses (Hales-Tillaly Ice Co. v. Commissioner, 509, 512. See also Levitt and Sons, Inc. v. Nunan, 142 Fed. 2d 795, 798; Kornhauser U. S., 276 U.S. 145, 152). Nor can Appellant take as a deduction any of the losses of the Foundation, which concededly was a separate entity (New Colonial Ice Co. v. Helvering, 292 U.S. 435).

As an alternative, Appellant contends that the repayment was an ordinary and necessary expense paid or incurred in carrying on business (see Section 24121a (now 24343) of the Revenue and Taxation Code). There is no evidence that Appellant undertook to manage the Foundation for profit. It does not appear that Appellant had any business other than the operation of its horse racing track. Therefore, we are to determine whether the repayment was an ordinary and necessary expense paid or incurred in carrying on that line of business. While there may have been merit in the determination that its original contributions out of the proceeds of "charity days" were paid or incurred in carrying on horse racing at Bay Meadows it does not follow that its subsequent repayments were of the same character. The original payment of the sums in question and the subsequent repayment, as Appellant itself maintains, were "for two entirely different things."

It is fundamental that an expense must be directly connected with or proximately related to a business in order to be deductible as a business expense (Deputy v. Du Pont, 308 U.S. 488; Kornhauser v. U. S., supra; Hales-y. Inc. v. Commissioner, supra; Stone's Estate v. Commissioner, 115 Fed. 2d 853. *See* also White's Will v. Commissioner, 119 Fed. 2d 619). Appellant has not denied that it did, with Kyne, exercise control over the disbursing and investing of the Foundation's funds, It is apparent that its management of those funds was the basis of the liability which Appellant discharged by agreeing to restore a part of them. That being the case, we do not believe the expenditure in question was directly connected with or proximately related to Appellant's business. Any relationship to that business which may be drawn from the fact that Appellant was authorized by statute to set aside certain racing days for charity and that the funds of the Foundation originally arose from the business is only remotely incidental. The statute neither required nor authorized Appellant to manage the funds after they were transferred to a charitable organization.

In some cases expenses have been held deductible where they were incurred for the protection of the business (Scruggs-Vandervoort-Barney, Inc., 7 TC 779; Robert Gaylord, Inc., 41 BTA 1119; Louisiana Jockey Club, Inc., 13 BTA 752. Cf. Hales-Mullaly, Inc. v. Commissioner, supra; Levitt and Sons, Inc. v. Nunan, supra, Appellant has alleged that its reputation in the community and its standing with the regulatory body, California Horse Racing Board, were being harmed by the Attorney General's suit. It has presented no evidence in support of these allegations and has in fact stated elsewhere that at no time was there any question raised concerning illegality or bad faith on its part. There is no evidence

that the litigation materially threatened the profitable operation of Appellant's race track or that the settlement was entered into primarily for the purpose of protecting its reputation. It may reasonably be inferred that the settlement was, like most settlements, simply the result of a bargaining process the purpose of which was to end the litigation at the lowest possible price. In our opinion, the repayment in question was not an ordinary and necessary expense of the horse racing business operated hy Appellant.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of California Jockey Club, Inc., to a proposed assessment of additional franchise tax in the amount of $1,159.19 for the income year 1954 be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of November, 1958, by the State Board of Equalization.

Geo. R. Reilly, Chairman

J. H. Quinn, Member

Robert C. Kirkwood, Member

Robert E. McDavid, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary