BEFORE THE STATE BOARD OF EQUALIZATION

OF. THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DEL MAR TURF CLUB, TAXPAYER,)
ANDDONALDB. SMITH, ASSUMER)
AND/OR TRANSFEREE)

Appearances:

For Appellants: Richard L. Kintz
Attorney at Law

For Respondent: Paul J. Petrozzi
Counsel

OPINION

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 Del Mar Turf Club, Taxpayer, and Donald B. Smith, Assumer and/or Transferee, against proposed

assessments of additional franchise tax in the amounts of $5,259.27 and $6,880.75 for the income years ended May 31, 1969, and 1970, respectively.

The question presented for resolution is whether Del Mar Turf Club (hereafter appellant), an accrual basis taxpayer, properly treated a particular business expenditure paid during its income year ended May 31, 1968, as a prepaid expense deductible in aliquot portion in its income years ended May 31, 1969, and 1970.

During the income years under appeal, appellant was a California corporation licensed to conduct thoroughbred horse racing at the Del Mar Race Track. As track operator, appellant's primary source of revenue was its share of the parimutuel handle derived from money wagered during each racing season. To attract horse owners to the track, appellant periodically paid a negotiated percentage of its parimutuel revenue to the Horsemen's Benevolent and Protective Association (HBPA). As representative of the horse owners, the HBPA distributed these proceeds in the form of purses and stakes.

Prior to the 1967 racing season, appellant entered into a contract with HBPA whereby appellant agreed to set aside 40 percent of its share of the parimutuel handle for payment of purses and stakes. The purse award advertised by appellant for each race was based upon its estimation of the total parimutuel commission anticipated for the 1967 racing season. Since the total amount of advertised purses might exceed the negotiated percentage of actual revenue, the contract provided that in the event appellant elected to pay advertised purses in excess of its contractual obligation, within certain limits, the purses to be paid in the subsequent year would be reduced by the amount of overpayment. Conversely, if appellant advertised and paid purses of an amount less than 40 percent of its 1967 parimutuel revenue, the contract provided that the underpayment would be added to purses to be paid in the subsequent year.

The above described contract, including the overpayment and underpayment provisions, represented an established and customary method of dealing between HBPA and California racetrack operators. Accordingly, as an accrual basis taxpayer,

appellant consistently treated an underpayment of purses for a particular racing season as an expense of the current year, and an overpayment of purses as an expense applicable to the subsequent year.

The racing season at the Del Mar track was extended four weeks in 1967, pursuant to state authorization. However, due to decreased patronage during the first week of the supplemental season,' it became apparent that the amount to be wagered during the extended meet would be considerably less than anticipated. Operating under the contract described above, appellant realized that the amount of purses advertised for the remainder of the season substantially exceeded that which it would be obligated to pay. At this time HBPA was negotiating with track operators to raise the share of the parimutuel handle going to horse owners from 40 percent to 45 percent. Apparently anticipating HBPA's success in this regard, appellant entered into a contract which provided, in effect, that appellant would continue payment of the purses advertised for the remainder of the 1967 season on condition that it would pay only 40 percent of its parimutuel revenue for purses in 1968 and 1969. Thus, appellant's overpayment of purses in 1967 would be offset by a 5 percent reduction of its purse liability for each of the 1968 and 1969 racing seasons.

Prior to the 1968 racing season, appellant and HBPA entered into a contract which set at 43 percent, instead of the anticipated 45 percent, the amount of appellant's parimutuel revenue to be paid for purses in 1968 and 1969. The parties also amended their prior agreement concerning the 1967 overpayment to provide that the 43 percent rate would be reduced to 40 percent for 1968 and 1.969 only if the parimutuel wagering for the first seven days of each season fell short of a specified amount.

Appellant paid purses of approximately $200,000 above those required under its original contractual obligation for the 1967 racing season. By virtue of its agreements with HBPA, appellant's payment of purses for the 1968 racing season was reduced by 3 percent of its parimutuel revenue, approximately $100,000 below the amount which it was otherwise obligated to pay. However,. since the parimutuel wagering for the first seven

days of the 1969 season exceeded the specified amount, appellant paid the required 43 percent rate for purses without the 3 percent reduction.

Appellant claimed as business expense deductions the amounts of $99,364.86 and $98,296.44 in its franchise tax returns for the income years ended May 31, 1969, and 1970, respectively. The, 1969 figure represents the portion of the 1967 purse overpayment offset as a result of the 3 percent reduction of appellant's purse liability for the 1968 racing season, while the 1970 figure represents the remainder of the overpayment.

Respondent disallowed the deductions on the basis of its determination that they represented a business expenditure which accrued in the income year ended May 31, 1968, and that, as an accrual basis taxpayer, appellant could claim the expense as a deduction only in that year.

Initially, it must be noted that California tax law does not provide a definitive answer to the question presented by this appeal. Subdivision (a) of section 24681 of the Revenue and Taxation Code provides simply that "[t]he amount of any deduction or credit allowed by this part shall be taken for the income year which is the proper income year under the method of accounting used in computing income." (See also Rev. & Tax. Code, § 24651, subd. (a).) With respect to the accrual method of accounting, the regulations provide that:

> Under such a method, deductions are allowable for the income year in which all the events have occurred which establish the fact of the liability giving rise to such deduction. ... The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted tax accounting principles and is consistently used by the taxpayer from year to year. (Cal. Admin. Code, tit. 18, reg. 24651, subd. (c)(1)(B).) (Emphasis added.)

Appellant does not deny that all events necessary to establish its liability for the expenditure in question occurred during the income year ended May 31, 1968. However, it is appellant's contention that the overpayment of purses for the 1967 racing season was, in effect, a prepaid expense the deduction for which,, according to generally recognized tax accounting principles, must be deferred to the income year to which it relates. We agree.

Appellant was under no legal obligation to continue paying the advertised purses for the supplemental racing season of 1967 until it contracted to do so. The consideration flowing to appellant under that contract was HBPA's promise to credit appellant for the overpayment by allowing for a corresponding reduction of appellant's future purse liability. Therefore, by virtue of the contract, appellant's overpayment constituted a prepayment of future liability. In this respect, the expenditure is analogous to the advance payment of rent under a long-term lease. It is a generally recognized principle of tax accounting that advance rental payments are deductible in the income year to which they relate, whether the taxpayer reports income on the accrual or cash basis. (Wolan v. Commissioner, 184 F. 2d 101, 104; Harry W. Williamson, T. C. 941; Appeal of Joe Seinturier, Cal. St. Bd of Equal., May 10, 1967.) The principle is applicable with' respect to the prepayment of interest, insurance premiums, and other types of business expenses. (See 2 Mertens, Law of Federal Income Taxation § 12.24,)

Respondent contends that because appellant continued to pay the purses advertised for the supplemental racing season of 1967 to protect its reputation and avoid losses, the expenditure was related to and deductible in the income year ended May 31, 1968. However, appellant's motivation in making the overpayment is not relevant to the propriety of treating the expenditure as a prepaid expense. The overpayment secured for appellant the contingent right to retain a greater percentage of its parimutuel revenue for 1968 and 1969 than it otherwise would have retained under its standard contract with HBPA. Therefore, to require appellant to deduct the full amount of the overpayment in 1967 would result in a distortion of its income. (See Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 273 F. Supp. 229, 231.)

The principle which requires or allows deferment of the deduction for prepaid expenses is based upon the theory that such expenses are in the nature of capital expenditures; the prepayment of future expenses creates an asset which has a life extending beyond the year of payment. (Stewart Title Guaranty Co., 20 T. C. 630, 635.) Appellant's agreement to overpay purses in 1967 created a contractual right or asset which had a value subject to exhaustion over a two year period. The proration of the expenditure over the life of the contract was in accordance with a generally accepted principle of tax accounting. (See Commissioner v. Boston Elevated Ry. Co., 196 F. 2d 923, 926.)1/ Furthermore, appellant's treatment of the expense was consistent with its normal accounting treatment of purse overpayments for previous years. While not conclusive, this factor has some bearing upon the propriety of the taxpayer's method of reflecting income. (See, e.g. , Waldheim Realty & Investment Co. v. Commissioner, 245 F. 2d-823, 827; Cal. Admin. Code, tit. 18, reg. 24651, subds. (a)(2), (c)(1)(B).)

Therefore, we conclude that appellant utilized an acceptable accounting method in determining to defer its claim for a deduction relative to the prepaid purse expense. Accordingly, respondent's action in this matter must be reversed.

1 Also; the regulations promulgated under the Personal Income Tax Law provide, in pertinent part, that with respect to an accrual basis taxpayer "any expenditure which results in the creation of an asset having,a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. " (Cal. Admin. Code, tit. 18, reg. 17591, subd. (a)(Z).)

Appeal of Del Mar Turf Club, et al.

ORDER

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 Del Mar Turf Club, Taxpayer, and Donald B. Smith, Assumer and/or Transferee against proposed assessments of additional franchise tax in the amounts of $5,259.27 and $6,880.75 for the income years ended May 31, 1969, and 1970, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 2nd day of February, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____. Member

_____, Member

ATTEST: _____ Secretary