

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
GEORGE AND LOUISE ARNERICH;)
HARRY AND MILDRED LUDWIG;)
RICHARD P. AND THELMA DE SMET)

Appearances:

For Appellants: A. M. Mull, Jr., and
F. S. Wahrhaftig, Attorneys at Law

For Respondent: Burl D. Lack, Chief Counsel;
F. Edward Caine, Associate Tax
Counsel; and James T. Philbin,
Junior Counsel

O P I N I O N

These appeals are made pursuant to Section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax for the years 1952 and 1953, respectively, in the amounts of \$87.60 and \$114.92 against George and Louise Arnerich and, for the years 1951, 1952 and 1953, respectively, in the amounts of \$1,521.47, \$2,435.27 and \$2,513.66 against Harry and Mildred Ludwig and \$1,629.66, \$6,527.93 and \$6,687.26 against Richard P. and Thelma DeSmet.

Appellants George Arnerich, Harry Ludwig and Richard P. DeSmet, as individuals and as partners, were owners of pinball and other coin machines which they furnished for use in various cigar stores, bars, cafes and similar locations in Sacramento County. They were partners with respect to one operation>--or-route;--and--Harry Ludwig and Richard DeSmet each had--an---individual route of his own.

As individuals or as partners, depending upon the route involved--Appellants periodically divided the proceeds of each pinball machine with the owner of the establishment where it was located, after first reimbursing the location owner for any cash which he had paid in lieu of free games won by customers who played the machine and for any payments by him for items such as refunds to the players for machine malfunctions. In addition to pinball machines, Richard DeSmet had a number of "shuffle bowlers" which were placed in various locations on his individual route. Prizes were awarded to players of these machines. Richard DeSmet

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divided the proceeds of these machines with the location owners.

Appellants maintained a single repair shop for all of the machines and one man, George Arnerich, maintained and repaired all of them. Ordinarily, Richard DeSmet made the collections on his own route and from time to time made collections on all of the routes. One master key fit all of the machines. Appellants did not keep separate records as to each machine or as to each location. The proceeds from all of the machines on a particular route were mingled together.

The Franchise Tax Board determined that the entire amount deposited by players in each machine was the gross income of the--machine owner. In the absence of records, the Franchise Tax Board estimated that payouts for free-games and other reimbursable expenditures by the location owners aggregated 50 percent of the gross proceeds of the machines. Upon the theory that the income was from illegal gambling activities, the Franchise Tax Board, acting under Section 17359 (now Section 17297) of the Revenue and Taxation Code, allowed no deductions-therefrom.

During the period in question, Section 17359 provided as follows:

"In computing net income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10, or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities."

Without reciting all of the facts and contentions in detail, suffice it to state that the pinball machines in this matter, the arrangements with the location owners and the contentions of the parties are, except as hereafter noted, substantially identical to those considered by us in Appeals of C. B. Hall, Sr., et al., Cal. St. Bd. of Equal., December 29, 1958 (CCH, 2 Cal. Tax Cases, Par. 201-197), (P-H, St. & Loc. Tax Serv., Cal., Par. 58,145). Here, as in those appeals,, the evidence shows that cash was paid to winning players at most of the locations, The evidence also supports the estimate 'of the Franchise Tax Board that 50 per-

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cent of the proceeds of the pinball machines was paid out at the locations. Appellants have not offered any evidence to the contrary.

We concluded in the Appeals of C. B. Hall, Sr., et al., that the position of the Franchise Tax Board was correct except that each arrangement between a machine owner and a location owner was a joint venture, requiring that only half of the proceeds be considered as income of the machine owner. The same conclusion must be reached in this matter.

Appellants contend that if each arrangement between a machine owner and a location owner is a joint venture, then Section 17359 has no application. This contention is based upon the fact that Section 17359 applies by its terms to a "taxpayer" and that a joint venture, as a form of partnership, is not a "taxpayer." In the alternative, Appellants take the position that if Section 17359 applies to each joint venture, then the Franchise Tax Board must establish that each joint venture, as a separate entity, made "payouts" and thus was engaged in an illegal activity. In support of its position, Appellants advance the view that the gross income, deductions and net income of a particular joint venture are those of the venture and not of the individuals.

Appellants lay unwarranted stress upon the distinction between a partnership and the individual partners. As stated in Charles H. Palda, 27 T. C. 445, 452, aff'd. 253 Fed. 2d 302:

"It has frequently been said that a partnership is not a taxable entity and has its place in the scheme of taxation solely for income computation and reporting for tax purposes. Randolph Products Co. v. Manning, (C.A. 3), 176 F. 2d 190. It has resulted from this that generally speaking the partnership is not considered to have any income for tax purposes but that the share of the partnership's transactions is in each case attributable proportionately to the respective partners. The general rule is that an individual partner is deemed to own a share interest in the gross income of the partnership."

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Moreover, as we have pointed out in Appeals of C. B. Hall, Sr., et al. (Supra), even if we assume that the burden of proving the existence of illegal activities is upon the Franchise Tax Board, the taxpayers have the burden of proving that their gross income is less than that determined by the Franchise Tax Board and the amount of any deductions to which they are entitled. It has been established that the operations at most of the locations were illegal. Appellants have failed to establish the amount of income derived from any location at which the operation of the pinball machines was legitimate.

Although the Franchise Tax Board included in the income of Richard P. and Thelma DeSmet certain amounts as payouts in the operation of the "shuffle bowlers," it does not now contend that such payouts were made or that the operation of these machines was illegal. It does, however, contend that their operation was "associated or connected" with the pinball activities so that under Section 17359 all deductions relating to the bowlers should be disallowed. It is apparent to us that this contention is correct. All of the machines were in the same general class of coin-operated games. Richard DeSmet operated the bowlers and the pinball machines as a single, unified business, with one repair shop, one mechanic, one collector and even one master key. He kept a combined record of the receipts from all of his machines rather than separate records and he mingled all of the receipts together. The separate joint ventures with location owners merely facilitated his business of furnishing machines for use at various locations.

Pursuant to a stipulation of the Franchise Tax Board and the DeSmets, after the adjustment required by our determination that the operation of each machine constituted a joint venture, the amounts of \$5,400, \$2,937 and \$2,994 for the years 1951, 1952 and 1953, respectively, shall be deleted from the income of the DeSmets on account of the erroneous inclusion of payouts in the estimated gross income from the bowlers.

OR-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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on protests to proposed

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assessments of additional income tax for the years 1952 and 1953, respectively, in the amounts of \$87.60 and \$114.92 against George and Louise Arnerich and, for the years 1951, 1952 and 1953, respectively, in the amounts of \$1,521.47, \$2,435.27 and \$2,513.66 against Harry and Mildred Ludwig and \$1,629.66, \$6,527.93 and \$6,687.26 against Richard P. and Thelma DeSmet be, and the same is hereby modified by recomputation of the gross income of the Appellants in accordance with the Opinion of the Board. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 19th day of May, 1960, by the State Board of Equalization.

John W. Lynch, Chairman

Alan Cranston, Member

George R. Reilly, Member

Richard Nevins, Member

 Member

ATTEST: Dixwell L. Pierce, Secretary