BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
EDWARD J. AND SARAH SEEMAN)
STEWART W. AND ADELE METZ)

Appearances:

For Appellants: Archibald M. Mull, Jr., Attorney at Law

For Respondent: F. Edward Caine, Associate Tax Counsel
Wilbur F. Lavelle, Assistant 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 as follows:

Appellants	Year	Amounts
Edward J. Seeman	1951	$ 4,371.98
Sarah Seeman	1951	4,381.30
Edward J. and Sarah Seeman	1952	42,888.15
	1953	72,524.43
	1954	74,367.04
Stewart W. Metz	1951	4,085.90
Adele Metz	1951	3,292.27
Stewart W. and Adele Metz	1952	38,809.18
	1953	48,175.34
	1954	74,473.74

Appellants Edward J. Seeman and Stewart W. Metz were partners in a business known as the S & A Novelty Co. which business was conducted in and near San Bernardino. S & A Novelty Co. (hereinafter called S & A) owned pinball machines and placed them in bars, restaurants, and other locations under an arrangement with each location owner that S & A would maintain the machine in proper working order, that the location owner would furnish the electricity to operate the machine, that S & A would retain the key to the coin box in the machine and that an S & A representative would visit the location periodically to open the machine and count and wrap the coins. In a few instances, however, a key to the coin box in the machine would be furnished to the location owner so he could obtain change between calls by the S & A representative.

At the time of each collection the location owner informed the S & A representative of the amount of the expenses paid by the location owner in connection with the operation of the machine and this amount would be set aside for him from the coins in the machine. The balance was divided equally between S & A and the location owner. The expenses initially paid by the location owner included cash payouts to players for free games not played off, refunds to players for mechanical malfunction and taxes and licenses assessed against the machine,

The S & A representative prepared a collection slip showing the name of the location, the date and the amount to divide between S & A and the location owner, that is, the amount after expenses. The collection slip was signed by the S & A representative and by the location owner or his representative and a copy was left at the location.

Almost all the pinball machines owned by S & A were of the type known in the industry as bingo pinball machines. A player could deposit a nickel in the machine and play five balls. Upon being played, the balls would fall into holes in the playing surface. If the balls fell into certain combinations of holes the player would win a varying number of free games. Before shooting the five balls, the player could deposit additional coins to increase the odds (that is, the number of free games which could be won for a given winning combination). However, the player was not assured that the odds would advance by the deposit of any given additional coin. Whether or not the odds advanced upon the deposit of a particular coin depended on a mechanism inside the machine over which the player had no control. Many of the machines were equipped with electric reflex units which by automatically adjusting certain mechanisms in the machine controlled the percentage of free games won, so that over a period of time that percentage would approximate a predetermined amount. Many of the machines could be adjusted so that the percentage of free games won was "liberal," "medium," or "conservative." S & A set the adjustment at "liberal" before the machines were placed on location; but some location owners requested a less liberal setting and S & A would then set the adjustment at "medium" or "conservative."

The customary practice of the location owners was to make cash payments to players for free games not played off whenever requested by the player. To facilitate such payments, each machine was equipped with a removal button which, upon being pressed, removed the number of free games registered on the machine. A metering device within the machine automatically recorded the number of unplayed free games voided in this manner.

S & A also owned some claw machines which were placed in locations under arrangements similar to those for pinball- machines.

A person played a claw machine by depositing a nickel. The object of the game was to manipulate the control so that the claw picked up a figurine or article of merchandise from a bed of candy on the playing floor and deposited it in a chute. At times the articles on the playing floor consisted of merchandise having intrinsic value, examples of the more valuable types of items being cigarette lighters or electric shavers. At other times the articles were small figurines of different colors or shapes having little intrinsic value. At times the claw machines were operated with open chutes in which case the player could obtain the article dropped down the chute by the claw. The player could then keep the article or redeem it with the location owner. The articles having intrinsic value would be redeemed according to their value or cost. The figurines having little intrinsic value would be redeemed at fixed amounts with differing amounts for different colors or shapes of figurines. There were times when the machines were operated with closed chutes in which case the player could not remove from the chute the article which the claw had dropped into the chute. In such a case the location owner paid the player a certain amount depending upon the article dropped into the chute.

Once a day or once every two days an S & A representative would visit each location having a claw machine and "dress" the machine. Dressing the machine is a term used in the industry to refer to smoothing out the candy on the playing floor and rearranging the figurines or merchandise. The ease or difficulty with which a player could obtain the figurine or merchandise from the machine could be varied by the way the machine was dressed. Thus, if the objects were pushed far down into the candy it was more difficult for the player to cause the claw to pick up the object. The player's degree of success could also be varied by altering the proportion of high to lower valued objects placed in the machine. The purpose of dressing the machine was to make the machine attractive and still have the proper balance so that the machine would be profitable to the machine owner and to the location owner.

At the time of a collection on a claw machine, the S & A representative would open the coin box in the machine and count the coins in the presence of the location owner or his employee. From the proceeds in the machine an amount would be paid to the location owner equal to the amount for which the location owner had redeemed merchandise or figurines and such merchandise or figurines would be put back into the machine. The balance of the proceeds of the machine was divided equally between the location owner and S &.'A.

During the years in question S & A had approximately 180 locations, in each of which one or more of its machines was

placed. Commencing on January 30, 1954, S & A began to sign written agreements with a large number of its location owners. These written agreements were all identical to each other and were on printed forms prepared by S & A. The form stated that it was a rental agreement and named S & A as the lessor and the location owner as the lessee. It provided the lessor would place coin-operated amusement devices in the place of business of the lessee, that the lessee would not be liable for loss or damage to such devices, that the lessee would not be liable for any injury to any person in connection with the use or possession of such devices, that the lessor would keep the devices in good repair, that the type and quantity of such devices would be mutually approved by lessor and lessee, that the lessor would remove the device upon demand of the lessee, that title to the device remained in the lessor, and that the lessee would pay to the lessor as rental for the use of such device an amount equal to one-half of the proceeds.

Appellant Stewart Metz, the managing partner of S & A, testified that the relationship between S & A and the location owners subsequent to the signing of the written agreements was the same as it had been prior to the signing of the agreements and that the actual practice with respect to the operation of the machines was the same before and after the signing of the agreements.

S & A also owned cigarette vending machines. The arrangement between S & A and the location owners with respect to cigarette machines was different from that with respect to pinball or claw machines. Periodically an S & A representative would visit the cigarette machine, open it, remove the coins and dump them in a bag without counting them. He would refill the machine with cigarettes and make a report showing the number of packages of each brand of cigarettes necessary to refill the machine. A copy of this report would be left with the location owner. Every three months S & A would send a check to the location owner which check would be based on a certain commission per package of cigarettes sold. The location owner furnished the space and the electricity and S & A kept the machine in good repair.

S & A conducted its cigarette vending operations under a different business name. Separate books of account were maintained for this portion of its business. Cigarette vending machines not on location were stored and repaired in a separate building not used for the repair of pinball and claw machines. Employees who collected from and repaired cigarette vending machines did not collect from or work on other types of machines and vice versa.

S & A filed partnership information returns and reported as gross income the amounts retained from locations with respect to

pinball and claw machines and the total amounts deposited in the machines with respect to cigarette vending machines. S & A took the usual types of business deductions on its returns, including depreciation and salaries.

Respondent concluded that S & A rented space for its machines in each location and that all the coins deposited in the pinball and claw machines constituted gross income of S & A. Respondent computed the gross income from pinball and claw machines as equal to the amounts reported, plus an equal amount as the location owner's share, plus the amount estimated to have been paid out for taxes and licenses and to winning players. Respondent estimated that the amounts paid out to winning players on pinball machines averaged 55% of the coins deposited in the machines. It estimated that the amounts paid out to winning players on claw machines averaged 70% of the total amounts deposited in the claw machines.

Respondent concluded that cash payouts to winning players were made on pinball and claw machines in violation of Section 330a of the Penal Code and Respondent therefore disallowed all deductions from gross income pursuant to Section 17359 (now 17297) of the Revenue and Taxation Code. Respondent did not disallow the cost of cigarettes because the gross income from selling cigarettes is the excess of selling price over cost. To the extent that cost is recovered there is no income.

In the course of the investigation Respondent's auditor found several collection slips which indicated the amounts which had been deducted prior to the division of the proceeds from pinball machines. These slips taken together show that the amounts deducted averaged 55% of the total amounts deposited in the machines. Respondent's auditor also came upon a group of collection slips in the possession of one of the location owners who had a claw machine in his location. When these collection slips were combined the amounts shown for "Free Plays Redeemed'? were determined to be 70% of the total. amounts deposited in the machine.

That it was the customary practice to make cash payouts to winning players in connection with the pinball and claw machines has been established by the testimony of several location owners, three employees of S & A and the managing partner of S & A. That the multiple-coin pinball machines here in question were games of chance is obvious, if for no other reason than the unpredictability of the change in odds and winning combinations upon the insertion of additional coins. On claw machines the player's degree of success depended to a considerable extent upon the way the machine was dressed and the proportion and placement of higher

valued and lower valued figurines in the machine. Since these conditions were under the control of the operator of the machine and were frequently altered it must also be concluded that a player's success depended primarily on chance rather than on skill. (Boies v. Bartell, 82 Ariz. 217, 310 P. 2d 834; Tooley v. United States, 134 F. Supp. 162.)

Section 17359 (now 17297) read:

> 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 or 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.

Section 330a of the Penal Code is in Chapter 10 of Title 9 of Part 1 of the Penal Code and makes it a crime to possess or control a "mechanical device, upon the result of action of which money ... is ... hazarded, and which is operated . . . by . . . depositing therein any coins ... and by means whereof . . . any merchandise, money, representative or articles of value, checks, or tokens, redeemable in, or exchangeable for money or any other thing of value, is won or lost . . . when the result of action ... of such machine ... is dependent on hazard or chance...."

The operation of the pinball machines clearly violated Section 330a of the Penal Code in that they were games of chance, they were operated by depositing a coin and money was won or lost on the result of action of the machines. Similarly, the operation of the claw machines violated Section 330a of the Penal Code in that they were games of chance, they were operated by depositing a coin and money or merchandise was won or lost on the result of action of the machines. Accordingly, Respondent was correct in concluding that Section 17359 applied.

Respondent and Appellants agree that S & A rented space in locations for the cigarette vending machines and that the entire receipts from such machines were receipts of S & A. Respondent contends that there was a similar relationship with respect to pinball and claw machines. Appellants, on the other hand, contend that the pinball and claw machines were rented to the location owners, that the gross receipts from the machines were the gross receipts of the location owners, and that if there was any illegal activity in connection with the operation of the machines S & A did not participate therein.

In Appeal of C. B. Hall, Sr., Cal. St. Bd. of Equal., December 29, 1958 (2 CCH Cal. Tax Cas., Par. 201-197), (3 P-H State & Local Tax Serv., Cal., Par. 58,145), we held that the pinball machine owners there involved were engaged in a joint venture with each location owner and said:

> Moreover, we think that the evidence convincingly demonstrates that Appellants and the location owners participated in the operation of the pinball machines in violation of Section 330(a) of the Penal Code. Appellants contributed the use of their machines, technical knowledge and maintenance. Each location owner contributed space in his establishment, supervision of the play and the service of making the pavouts. Appellants were aware of and discussed with location owners the making of payouts. The cash outlays for such payouts, as well as for other operating expenses such as license fees, refunds for tilts,, etc. were shared by Appellants and the location owners, as'were the net proceeds from machine operations. We are of the opinion, accordingly, that the arrangement between Appellants and each location owner constituted a joint venture for the operation of the pinball machines. Horace and Ruby A. Mill v. Commissioner, 5 T.C. 691; Charles A. Clark v. Commissioner, 19 T.C. 48.

The only difference between the facts in this appeal and the facts in Hall is that during the last year of the period in question S & A entered into written agreements with most of its location owners. Such agreements called the arrangement a rental and referred to S & A as the lessor and the location owner as the lessee. The ultimate-conclusion as to the legal relationship between two persons, however, must be based on the facts. The labels used by the parties are not conclusive, although such labels may be given some recognition as evidence of the relationship. (Thompson v. Childs Estate Co., 90 Cal. App. 552; San Joaquin L. & P. Corp. v. Costaloupes, 96 Cal. App. 322; Cal. Emp. etc. Comm'n v. Walters, 64 Cal. App. 2d 554; Service Tank Lines v. Johnson, 61 Cal. App. 2d 67.)

Taking into consideration all the circumstances it is our opinion that the labels used in the written agreements did not make the essence of the relationship between machine owner and location owner in this appeal different from the relationship between machine owner and location owner found in Hall. We, therefore, conclude that S & A and each -location owner were engaged in a joint venture as to pinball and claw machines and that 50% of the coins deposited in the machines were includible in

the gross income of S & A. Since Respondent included 100% of such amounts in the gross income of S & A, Respondent's assessment must be revised accordingly.

As we held in Appeal of C. B. Hall, Sr., supra, Respondent's computation of gross income is presumptively correct. There were no records of the amounts of gross income taken out of the machines for expenses such as taxes and licenses and redemption of free games or figurines. The amounts computed by Respondent for taxes and licenses were based on the actual rates charged by the Federal Government and by the cities in which the machines were located. Respondent has admitted a minor error in computing the taxes and licenses on the machines for 1951 and this should be corrected in the recomputation following our decision.

The amounts computed by Respondent for redemption of free games on pinball machines were based on 58 actual collection slips for the year 1951 and the amounts computed for redemption of figurines for claw machines were based on 23 actual collection slips for the years 1951 and 1952. Several witnesses gave estimates of the percentage which the cash payouts for free plays on pinball machines bore to the total coins deposited in the pinball machines and most of these estimates were quite close to the percentage used by Respondent. Appellants offered no substantial evidence to indicate that Respondent's estimates of payouts were excessive. Accordingly, subject only to the minor correction to be made for the year 1951, we must sustain Respondent's computation of the expenses paid from gross receipts prior to the division of the net proceeds.

S & A also owned a few flipper type pinball machines which were on location. Respondent does not contend that there were cash payouts on these machines. Apparently, however, S & A's records commingled the income from flipper and bingo pinball machines. Respondent's assessment therefore necessarily added to gross income an amount for cash payouts on flipper pinball machines. Respondent did not separate the income from the two types of pinball machines because there were no records from which such a separation could be made with accuracy. Under the circumstances, however, we believe it proper to estimate the amounts rather than to leave the amounts unseparated. From the evidence presented, it is our opinion that a fair estimate would be that 5% of the recorded pinball machine income was derived from flipper pinball machines. An adjustment should be made, accordingly, to delete from gross income the amount of the estimated payouts on these machines.

Respondent disallowed all the deductions taken for the usual types of business expenses. S & A's legal activity of operating a relatively few machines for amusement only was

associated or connected with the illegal activity of operating bingo pinball machines in that the same employees made collections from and repairs to both types of machines. Therefore, Respondent was correct in disallowing all deductions for business expenses on pinball and claw machines.

S & A operated its cigarette vending machine business in a manner entirely separate from its amusement machine business. We are of the opinion that the cigarette vending machine business did not tend to promote or to further and was not associated or connected with the illegal operation of pinball and claw machines. A deduction in the amount of expenses attributable to the cigarette vending machine business should, accordingly, be allowed for each of the years in question.

In the proposed assessment against Appellants Edward J. and Sarah Seeman for the year 1953, Respondent included as income the sum of $8,000 which had not been derived from the S & A Novelty Co. It also imposed a fraud penalty in an amount equal to 50% of the proposed assessment for failure to report this item as income. Respondent now concedes that the item was not income to the Seemans. Both the fraud penalty and the $8,000 addition to income should, therefore, be eliminated from the proposed assessment.

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax as follows:

Appellants	Year	Amounts
Edward J. Seeman	1951	$ 4,371.98
Sarah Seeman	1951	4,381.30
Edward J. and Sarah Seeman	1952	42,888.15
	1953	72,524.43
	1954	74,367.04
Stewart W. Metz	1951	4,085.90
Adele Metz	1951	3,292.27
Stewart W. and Adele Metz	1952	38,809.18
	1953	4w75.34
	1954	74,473.74

be and the same is hereby modified in that the gross income is to be recomputed in accordance with the Opinion of the Board, the expenses of the cigarette vending machine business are to be allowed as deductions and the fraud penalty is to be deleted from the proposed assessment against Edward J. and Sarah Seeman for the year 1953. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 19th day of July, 1961, by the State Board of Equalization,,

John W. Lynch, Chairman

Geo. R. Reilly, Member

Richard Nevins, Member

_____, Member

_____, Member

ATTEST: Dixwell L. Fierce, Secretary