61-SBE-047

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
QUINTON LAIN)

Appearances:

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

For Respondent; Wilbur F. Lavelle, Assistant Counsel

O P I N I O N

This appeal is made pursuant to Section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Quinton Lain to proposed assessments of additional personal income tax in the amounts of $554.56, $1,401.35, $1,978.98 and $1,562.56 for the years 1951 through 1954, respectively,

Appellant conducted a coin-machine business. Among the devices that he owned were pinball, music, shuffleboard and gun machines, Appellant placed the machines in restaurants and other locations under an arrangement with each location owner that Appellant would maintain the machine in proper working order, that the location owner would furnish the electricity to operate the machine, that Appellant would retain the key to the coin box in the machine and that Appellant would visit the location periodically to open the machine and count and wrap the coins, At the time of each collection, the location owner informed Appellant of the amount of the expenses paid by the location owner in connection with the operation of the machine and this amount was set aside for him from the amount in the machine. The balance was divided equally between Appellant and the location owner. The expenses paid by the location owner included cash paid to players of pinball machines for free games not played off, refunds to players for mechanical malfunction, the cost of taxes and licenses assessed against the machines and the cost of promotion (which represented coins furnished by the location owner to players to play the machine or coins deposited in a music machine by the location owner, in either event to enliven the premises), Generally Appellant did not leave the location with the nickels to which he was entitled but the nickels remained with the location owner for purposes of making change and the location owner gave Appellant paper money and large coins equal to the amount of nickels to which Appellant was entitled,

The pinball machines owned by Appellant 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 land in holes. If the balls landed in certain combinations of holes, the player would win a varying number of free games. The machine had a device which

would void the score if the player tilted the machine. Before shooting the five balls, the player could deposit additional coins to increase the odds (that is, increase the number of free games 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. 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.

The customary practice of the location owner was to make a cash payment to a player for free games not played off whenever requested by the player, To facilitate such payment the machines were equipped with a removal button which, upon being pressed, removed the number of free games registered on the machine.

Appellant reported as his gross income the amounts he retained after the division with the location owner. He deducted expenses, such as salary of a mechanic, depreciation, and cost of phonograph records,

Respondent recomputed gross income on the theory that all the coins deposited in the machines by patrons constituted gross income to Appellant. Appellant had no records of such amount and Respondent reconstructed it by adding back to gross income the location owner's share of the net proceeds of each machine, which share in the aggregate was equal to Appellant's reported gross income. Respondent than estimated the total expenses for which the location owners were reimbursed prior to the divisions of the net proceeds with Appellant and added this amount to the gross income. Respondent's auditor estimated that 50% of the reported gross income was derived from bingo pinball machines. This estimate was derived from the fact that Appellant owned from seven to fourteen bingo pinball machines, fourteen to twenty-one music machines, two or three shuffle boards and a few other amusement games (apparently upon the assumption that the bingo pinball machines provided a considerably higher income per machine than other types of equipment)* The auditor then estimated that the cash payouts equalled 50% of the coins deposited in the pinball machines, This estimate was based on statements made by two location owners and a former employee of Appellant.

From the gross income as computed by Respondent all deductions for expenses were disallowed based on Section 17359 (now 17297) of the Revenue and Taxation Code which 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 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,

Section 330a of the Penal Code 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 ... money ... is won or lost ... when the result of action of such machine . . . is dependent upon hazard or chance," Section 330a is a part of Chapter 10 of Title 9 of Part 1 of the Penal Code of California.

Respondent contends that the bingo pinball machines in question are primarily games of chance and that money may be won or lost on the result of action of the machines. Respondent concludes, therefore, that Section 17359 of the Revenue and Taxation Code is applicable, It is of the opinion that it made a reasonable estimate of Appellant's gross income, and that in accordance with Section 17359 it was proper to disallow all expenses of the business since the expenses were either related to the operation of bingo pinball machines or were related to other types of equipment the operation of which was connected or associated with the operation of bingo pinball machines,

The pinball machines here involved were substantially the same as those which we held to be games of chance in Appeal of C. B . Hall Sr., Cal. St, Bd. of Equal,, Dec. 29, 1958 (2 CCH Cal. Tax Cas., Par, 201-197), (3 P-H State & Local Tax Serv., Cal., Par. 58,145). An added feature here that we did not discuss in that case was the reflex unit which controlled the percentage of free games won over a period of time so that the percentage would be neither greater nor less than a predetermined figure. Accordingly, an "unskilled" player playing a large number of games would have the same degree of success as a "skilled" player playing a large number of games and therefore whatever element of skill might otherwise have been present was removed by the action of the reflex unit. In United States v. Korpan, 354 U.S. 271, the United States Supreme Court held a similar type of pinball machine to be a gambling device,,

The result of action of the bingo pinball machines in question was therefore dependent on hazard or chance, Since money was won or lost on the result of such action, the operation of the bingo pinball machines owned by Appellant violated Section 330a of the Penal Code and Respondent is correct in applying Section 17359.

The operating arrangements between Appellant and each location owner were the same as those considered by us in Appeal of C. B. Hall. Sr., supra, Cur conclusion in Hall that the machine owner and each location owner were engaged in a joint venture in the operation of the machines is, accordingly, applicable here. Respondent's assessment therefore must be revised to reduce Appellant's gross income from 100% to 50% of the coins deposited in the machines.

The only adjustment to Appellant's reported gross income will be to add back his share of the cash payouts. There were no records of such amounts and Respondent estimated them by a combination of two other estimates, namely, that 50% of Appellant's reported gross income was derived from bingo pinball machines and that the cash payouts amounted to 50% of the coins deposited in the machines. These later two estimates are admittedly not accurate to the penny but were based on interviews with persons having knowledge of the circumstances, As we also held in Hall, supra, Respondent's computation of gross income is presumptively correct. Appellant has presented no evidence to establish a different and better method of estimating the cash payouts. We thin!: Respondent's method was reasonable under the circumstances and therefore, except for the reduction due to our conclusion that Appellant and each location owner were engaged in a joint venture, Respondent's computation of gross income is sustained,

Respondent disallowed all the expenses of the business including cash payouts for free games not played off, depreciation, salary of a mechanic, cost of phonograph records and miscellaneous expenses. Appellant personally made collections on all types of machines. Appellant's mechanic repaired all types of machines. Appellant had both a pinball machine and a music machine in many of his locations. When Appellant solicited a new location, he offered to install either a pinball machine or a music machine or both as desired by the location owner,,

Appellant's business was an integrated one with the various segments each contributing to the success of the entire business and the profitable operation of the pinball machines was a major objective of the business. Accordingly, the legal activity of operating amusement equipment was connected or associated in a substantial way with the illegal activity of operating bingo pinball machines and Respondent properly disallowed deductions from any part of the gross income of the business.

Respondent's assessment included negligence penalties, Respondent has agreed to withdraw these penalties and we are, accordingly, not called upon to determine whether they were properly imposed.

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Quinton Lain to proposed assessments of additional personal income tax in the amounts of $554.56, $1,401.35, $1,978.98 and $1,562.56 for the years 1951 through 1954, respectively, be and the same is hereby modified in that the gross income is to be recomputed in accordance with the Opinion of the Board and the penalties are to be deleted. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 18th day of July, 1961, by the State Board of Equalization.

John W. Lynch, Chairman

George R. Reilly, Member

Paul R. Leake, Member

Richard Nevin, Member

____________, Member

ATTEST: Dixwell L. Pierce, Secretary