BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
MARION S. JOHN, VICTORIA A. JOHN,)
LU M. JOHN, ED LEE AND KATHERYN LEE)

Appearances:

For Appellants: Richard F. Harris, Attorney at Law

For Respondent: A. Ben Jacobson, Associate Tax Counsel

OPINION

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:

Appellant	Year	Amount
Marion S. John and Victoria A. John	1951	370.36
Marion S. John	1952	1,420.61
	1953	416.93
Marion S. John and Lu M. John	1954	359.16
	1955	506.14
Ed Lee and Xatheryn Lee	1951	311.70
	1952	541.46
	1953	165.12
	1954	298.00
	1955	431.36

Marion S. John and Victoria A. John filed a joint return for 1951 as husband and wife. Marion S. John and Lu M. John filed joint returns for 1954 and 1955 as husband and wife. Ed Lee and Katheryn Lee filed joint returns for all years in question

as husband and wife, Ed Lee and Katheryn Lee are now deceased.

As alleged by Respondent, the facts are as follows:

Marion S. John and Ed Lee (hereinafter called Appellants) were partners in a coin-operated machine business. The coin-operated machines were bingo pinball machines, other types of pinball machines, bowling machines and other types of amusement machines.

Appellants purchased the machines and placed them in various locations such as bars and restaurants under an agreement with each location owner that the net proceeds of the machines would be divided so that the location owner would receive 50% and Appellants 50%, that Appellants would keep the machines in good repair, that any cash payments made by the location owner to players of bingo pinball machines in redemption of free games would be returned to the location owner prior to the equal division and that any amounts for taxes or licenses assessed against the machines and paid by the location owner would be returned to him prior to the equal division.

The bingo pinball machines were operated by a player by depositing one or more nickels. The player then shot five balls and if the balls fell in certain combinations of holes, free games were won. The player could deposit additional coins to increase the winning odds or to obtain additional scoring opportunities, The machines were equipped with electrical reflex units to automatically control the percentage of free games won over a period of time. The free games registered on a machine could be removed by pushing a button under the machine, A player upon deciding to play no more was paid cash by the location owner for the free games won but not played off. Such free games were then removed by pressing the button under the machine and the location owner made a record of the cash payouts.

Appellants had keys to the coin boxes in the machines. Periodically Appellants visited each location, opened the machine and counted the coins, The location owner informed Appellants of the amount of the payouts on bingo pinball machines and other expenses in connection with any kind of machine. The location owner received this amount from the proceeds plus 50% of the balance and Appellants retained the rest of the proceeds. Appellants then prepared a collection slip in duplicate showing the amount of the collection and left one copy with the location owner.

Appellant Marion S. John was called as a witness and was

asked questions concerning the facts as stated above. As to each of the questions, he refused to answer on the ground of possible self-incrimination. From such refusal, we infer that if the questions had been answered truthfully, the answers would have supported Respondent! s factual contentions. (Fross v. Wotton, 3 Cal. 2d 384,)

A location owner and the manager of another location testified that Appellants' bingo pinball machines were on the premises and that payouts were made to players in redemption of free games not played off. Their testimony as to the collection procedure was in accordance with Respondent's contentions as stated above.

Respondent's auditor testified that he was furnished the business records by Mr. Lee, that the records showed purchases of various pieces of coin-operated machines including many machines described by names commonly known in the industry as being names of bingo pinball machines, and that the income from all machines was commingled in the income records. The auditor stated that in their personal income tax returns, Mr. John and Mr. Lee had each reported as income from the business half of the amounts retained from the machines at each location and had each claimed half the expenses of the business.

Upon the foregoing evidence, together with the inference arising from Mr. John's refusal to testify, we find that the facts alleged by Respondent as set forth above are true.

The auditor further testified that he asked Mr. Lee to estimate the proportion of the reported gross income which was derived from bingo pinball machines and Mr. Lee was unable to make an estimate, The auditor stated that from his examination of the equipment records he concluded that 75% to 80% of the reported gross income might have been derived from bingo pinball machines. He asked Mr. Lee if 75% to 80% might be the approximate amount and Mr. Lee stated that this would be reasonable, The assessments were made on the basis that 80% of the reported gross income was from bingo pinball machines,

To the reported gross income from all types of machines Respondent added an equal amount representing the share retained by the location owner. Respondent also added an amount equal to the estimated cash payouts to players of bingo pinball machines in lieu of free games. The cash payouts were estimated to be 36% of the total amount deposited in the machines. The assessments also disallowed all expenses of the business pursuant to Section 17359 (now 17297) of the Revenue and Taxation Code.

The manager of one location estimated that the cash payouts average 33-1/3% of the amounts deposited in the pinball machines. Among the records furnished to the auditor by Mr. Lee were numerous collection slips which recorded the amounts in a

machine at a specific location on a certain date. Three of these slips showed the total amount in the machine, the expenses and the balance to divide, The expenses on these three slips averaged 39% of the amounts in the machine, The auditor took into account the 33-1/3% estimate and the 39% average on the three slips and concluded that the cash pay-outs equalled 36% of the amounts deposited *in* the bingo pinball machines.

Section 17359 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 is in Chapter 10 of Title 9 of Part 1 of the Penal Code of California 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 ... money ... is won or lost ... when the result of action of such machine ... is dependent upon hazard or chance."

The bingo pinball machines in question 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). For the reasons stated in that opinion we find that the binpo pinball machines in question were games of chance. Since money was won or lost on the result of action of the machines, the operation of the bingo pinball machines owned by Appellants violated Section 330a of the Penal Code and Respondent is correct in applying Section 17359.

The operating arrangements between Appellants and each location owner were the same as those considered by us in Appeal of C. B. Hall, Sr., supra. Our conclusion- in Hall that the machine owner and each location owner were engaged in a joint venture is, accordingly, applicable here. Since Respondent's assessments were based on the assumption that 100% of the coins deposited in the machines were the gross

income of Appellants, the assessments must be revised to reduce Appellants' gross income to 50% of the coins deposited in the machines.

In the absence of adequate records of cash payouts, Respondent estimated them at 36% of the total deposited in the machines. This estimate was based on the only available evidence. As we also held in Hall, supra, Respondent's computation of gross income is presumptively correct. We think Respondent's method was reasonable under the circumstances and, therefore, except for the reduction due to our conclusion that Appellants and each location owner were engaged in a joint venture, Respondent's computation of gross income is sustained.

In Hall, supra, we also held that, the illegal activity having been established by the evidence, Respondent's action in disallowing deductions was presumptively correct and the burden of proving error is on the taxpayer; Appellants have presented no evidence, It may be inferred? therefore, that all the expenses either were incurred in tne illegal activity or were incurred in a legal activity which was associated or connected with the illegal activity. On this basis, and since Respondent's action was not patently arbitrary, the disallowance of all expenses must be sustained.

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 the protests to proposed assessments of additional personal income tax against Marion S. John and Victoria A, John in the amount of $370.36 for the year 1951, against Marion S. John in the amounts of $1,420.61 and $416.93 for the years 1952 and 1953, respectively, against Aiarion S. John and Lu M. John in the amounts of $359.16 and $506.14 for the years 1954 and 1955, respectively, and against Ed Lee and Katheryn Lee in the amounts of $311.78, $541.46, $165.12, $298.00 and 2431.36 *for* the years 1951 through 1955, 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. In all other respects, the action of the Franchise Tax Board is sustained.

Appeals of Marion S. John, Victoria A. John, Lu M. John, Ed Lee and Katheryn Lee

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

John W. Lynch, Chairman

Geo. R. Riley, Member

Richard Nevins, Member

_____, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary