BEFORE THE STATE BGARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
LELA M. SMITH, INDIVIDUALLY AND AS)
EXECUTRIX OF THE ESTATE OF RAY N. SMITH,)
DECEASED)

Appearances:

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

For Respondent: F. Edward Caine, Senior 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 the protests of Lela M. Smith as executrix of the Estate of Ray N. Smith, deceased, to proposed assessments of additional personal income tax in the amounts of $3,932.20 and $7,409.30 for the years 1951 and 1952, respectively, and from the action of the Franchise Tax Board on the protests of Lela M. Smith, individually, to proposed assessments of additional personal income tax in the amounts of $741.25 and $10,415.95 for the years 1952 and 1953, respectively.

Lela M. Smith's husband, Ray N. Smith, died before 1951. He had been the sole owner and manager of the Smith Music Company. Upon his death she was appointed executrix and managed the business. Until November 15, 1952, she filed returns for the estate as executrix and thereafter she filed as the individual owner of the business.

The Smith Music Company operated a coin-machine business in and near Barstow. It owned about 80 pieces of equipment, including music machines, multiple-odd bingo pinball machines, flipper pinball machines and shuffleboards. The equipment was placed in restaurants, bars and other locations and the proceeds, after the deduction of certain expenses initially paid by the location owners, were divided equally between the Smith Music Company and the location owners.

The total of the amounts retained by the Smith Music Company from locations during the years in question was reported as the gross income of the business. Deductions were taken for depreciation, cost of phonograph records, salaries and other business expenses.

Respondent determined that the Smith Music Company was renting space in the locations where its machines were placed and that all the coins deposited in the machines constituted gross income to the Smith Music Company. Respondent also disallowed all expenses pursuant to Section 17359 (now 17293) 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,

The evidence indicates that the operating arrangements between the Smith Music Company and each location owner were essentially the same as those *considered by us 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. 58145. Our conclusion in Hall that the machine owner and each location owner were engaged a joint venture in the operation of the machines is, accordingly, applicable here.

From the evidence, we conclude that it was the general practice to pay cash on request to players of multiple-odd bingo pinball machines for free games not played off. The multiple-odd bingo pinball machines were substantially identical to the machines which we held to be games of chance in Hall. Accordingly, these machines were operated in violation of Section 330a of the Penal Code and Respondent was correct in disallowing deductions from gross income from such machines.

The collector for the Smith Music Company prepared a collection report at the time of each collection. The report was prepared in duplicate and one copy was left with the location owner and one copy was retained for the Smith Music Company records. Generally, the amounts included on the reports were the net proceeds after amounts claimed by the location owners for expenses. However, on many of the collection reports for machines at a military base near Barstow there is shown the total in the machines, the "expenses," and the amount to be divided between the location owner and the Smith Music Company.

Since there were not complete records of the amounts paid to winning players and other expenses initially paid by the location owners, Respondent made an estimate of these unrecorded

amounts. Based on 47 collection reports from the military base which showed "expenses," Respondent computed that the expenses averaged 41.6% of the total amounts in the machines. Respondent assumed that these "expenses" were cash payouts on bingo pinball machines and that cash payouts on all bingo pinball machines owned by the Smith Music Company were 41.6% of the total amounts deposited in the machine.

The Smith Music Company records did not show income of bingo pinball machines separately from income of other types of equipment. The Smith Music Company owned approximately 50 music machines, 20 bingo pinball machines, 10 flipper pinball machines and 6 shuffleboards. Appellant Lela M. Smith estimated for Respondent's auditor that the music machines provided about 40% of the income of the business, the bingo pinball machines 50% and the other machines 10%. By combining the 41.6% cash payout estimate with the estimate that 50% of the recorded income was from bingo pinball machines, Respondent derived its estimate of the unrecorded cash payouts.

As we also held in Hall, supra, Respondent's computation of gross income is presumptively correct. There were no complete records of the amounts paid to players of bingo pinball machines for free games not played off. Respondent's method of estimation 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.

There was evidence that the entire business was integrated. The same collector collected from all types of machines and the same repairman repaired all types of machines. There was thus a substantial connection between the illegal activity of operating bingo pinball machines and the legal activity of operating music and amusement machines. Accordingly, except for the item to be discussed below, Respondent was correct in disallowing all deductions for expenses of the business.

Among the expenses itemized on the income tax returns and disallowed by Respondent were "Returned Checks." The Smith Music Company was on a cash receipts basis of reporting gross income. Therefore, any income receipt in the form of a check would be income, subject to payment of the check. Upon return of the check the item was eliminated from gross income. *(Estate of Modie J. Spiegel, 12 T.C. 524; Charles F. Kahler, 18 T.C. 31.) Accordingly, the amounts of the returned checks should be treated as exclusions from gross income.

Appeals of Lela M. Smith, Individually and as Executrix of the Estate of Ray N. Smith, Deceased

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 of Lela M. Smith as executrix of the Estate of Ray N. Smith, deceased, to proposed assessments of additional personal income tax in the amounts of $3,932.20 and $7,409.30 for the years 1951 and 1952, respectively, and the action of the Franchise Tax Board on the protests of Lela M. Smith, individually, to proposed. assessments of additional personal income tax in the amounts of $741.25 and $10,415.95 for the years 1952 and 19.53, respectively, be and the same are 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.

Done at Pasadena, California, this 16th day of October, 1961, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary