



BFFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
LAWRENCE AND JUNE MARTINI }

Appearances:

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

For Respondent: Wilbur F. Iavelle, Associate Tax 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 Lawrence and June Martini to proposed assessments of additional personal income tax in the amounts of \$3,436.29, \$8,548.94, \$18,616.97 and \$20,097.18 for the years 1951, 1952, 1953 and 1954, respectively.

Appellant Lawrence Martini owned and operated a coin machine business principally in and near Santa Rosa and Petaluma. The business name was L & M Sales Company. L & M had multiple-odd bingo pinball machines, flipper pinball machines, music machines, bowlers, shuffle alleys, gun machines and some other pieces of amusement equipment. The equipment was placed in restaurants, bars and other locations. The proceeds from each machine after exclusion of expenses claimed by the location owner in connection with the operation of the machine were divided equally between the location owner and L & M. Equipment was placed in about one hundred locations.

The gross income reported by Appellants from the L & M Sales Company business was the total of the amounts retained by L & M from locations, together with gross receipts from sales of used phonograph records. Deductions were taken for salaries, depreciation, cost of phonograph records and other business expenses. The cost of prizes given to players of some of the machines was accounted for in the tax returns as cost of goods sold.

Respondent determined that L & M was renting space in the locations where its machines were placed and that all the coins, deposited in the machines constituted gross income to L & M. Respondent also disallowed all expenses and the cost of prizes pursuant to 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

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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 L & M and each location owner were the same as those considered by us in Appeal of C. B. Hall, Sr., Cal; St. Rd. 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 in a joint venture in the operation of the machines is, accordingly, applicable here.

As we also held in Hall, if a coin machine is a game of chance and cash is paid to winning players, the operator is engaged in an illegal activity within the meaning of Section 17359. The multiple-odd bingo pinball machines here involved are substantially identical to the machines which we held to be games of chance in Hall.

Three location owners testified that they had multiple-odd bingo pinball machines owned by Martini, that cash was paid to players for free games not played off, that at the time of each collection they received their payout expense from the proceeds in the machine and that the balance was divided 50% to Martini and 50% to the location. One of these location owners testified that she kept no records of payments to players for free games not played off and that the expenses she received from the proceeds were based on a meter in the machine.

An employee of L & M testified that it was the general practice of location owners to claim expenses in connection with the operation of the pinball machines, that the machines were equipped with a meter to record free plays removed without being played off, that at the time of the collection he would read this meter, that in some locations the meter reading coincided with the claimed expenses and in other locations the meter reading was short of the claimed expenses, and that some of the machines had been drilled by players to insert a wire and run up free games. Appellant Lawrence Martini testified that he sometimes made collections and that usually at the time of a collection the location owner claimed an amount for expenses.

From this evidence, we conclude that it was the general practice to make cash payouts to players of multiple-odd bingo pinball machines for free games not played off. It follows that

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these machines were operated illegally and Respondent was correct in applying Section **17359**.

The typical location had a music machine and one or two pinball machines. The employees of L & M collected from and serviced all types of machines. We thus find there was a substantial connection between the illegal activity of **operating** multiple-off bingo pinball machines and the other aspects of the business, and Respondent was correct in **disallowing** all deductions for expenses of the entire **business**.

Since we have found that L & M was **engaged** in a joint venture with the location owners, L & M was not selling prize merchandise to the location owners, but was **furnishing** such prize merchandise to the joint venture. **Accordingly**, Respondent was correct in **regarding** the cost of **prizes** as an **expense** to be disallowed rather than as cost of **goods** sold as reported by L & M.

The collector for L & M prepared a collection report at the time of each collection and left a copy with the location owner. One kind of form was used for music machine collections and another kind of form for collections from the other **types** of machines. The amounts included on the reports were, with rare exceptions, the net proceeds after exclusion of the amounts claimed by the location owners for expenses. Since there were not complete records of amounts paid to **winning** players and other expenses initially paid by the location owner, Respondent **made** an estimate of the unrecorded amounts.

Respondent's auditor interviewed ten location owners. Each stated that cash payouts were made to players of pinball machines for free **games** not played off. Seven gave estimates of the percentage which the payouts bore to the **total amounts** in the machines. These estimates were 75, 60, 60, 60, 50, 50 and 33-1/3 percent, respectively. The **average** of these is **55.474**.

L & M's journal records did not **segregate** income according to type of equipment. As mentioned, however, a **separate** form of collection report was used for music machine collections. From a **sampling** of collection reports, Respondent's auditor was able to determine the percentage of recorded income derived each year from music machines.

The balance of the recorded income was from all other types of equipment. Respondent's auditor was unable to break this down by type of equipment and therefore assumed that it represented the income after exclusion of the location owners' shares and after exclusion of cash **payouts** of **55.474** of the total proceeds in the machines. This was the basis for Respondent's computation of additional **gross** income not reflected in the records.

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Payout percentage estimates of about 35% were made by Appellant Lawrence Martini and by one of his employees. There were introduced in evidence a number of collection reports showing payouts and some additional collection reports showing notations which could be inferred to be payouts. The average of these collection reports indicates a payout percentage higher than 35%, but considerably less than 55.47%.

Since, in addition to music machines, L & M had a substantial amount of equipment (for example, pin machines, baseball games, shuffle alleys and bowlers) as to which there is no claim that payouts were made to winners or on which the amount of any payouts or prizes which might have been given was small, we find that a more accurate determination of the gross income would be made if it is assumed that there was no payout or prize as to 20% of the income from non-music equipment. We further resolve the conflicting evidence on payout percentage by finding that on equipment on which there were payouts, the amount of such payouts was 45% of the total amount deposited in the equipment.

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 protest of Lawrence and June Martini to proposed assessments of additional personal income tax in the amounts of \$3,436.29, \$8,548.94, \$18,616.97 and \$20,097.18 for the years 1951, 1952, 1953 and 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. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 13th day of December, 1961, by the State Board of Equalization.

John W. Lynch, Chairman
Geo. R. Reilly, Member
Paul R. Teake, Member
_____, Member
_____, Member

ATTEST: Dixwell L. Pierce, Secretary