61-SBE-084

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Platter of the Appeal of)
)
JOHN H. AFJD HELEN MONCOVICH)

Appearances:

For Appellants: John L. McCarthy, Attorney at Law

For Respondent: Israel Rogers, Assistant Counsel

OPI _ N I ON

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 John H. and Helen Moncovich to proposed assessments of additional personal income tax in the amounts of $2,893.70, $8,167.38, $8,857.24 and $7,986.22 for the years 1951, 1952, 1953 and 1954, respectively.

Appellant John D. Moncovich owned and operated a coin machine business in and near Watsonville and Hollister. He had multiple--odd bingo pinball machines, flipper pinball machines, music machines, bowlers and shuffle alleys. The equipment was placed in bars and restaurants and the proceeds from each machine, after exclusion of certain expenses claimed by the location owner in connection with the operation of the machine, were divided equally between Moncovich and the location owner.

The gross income reported by Moncovich from the coin machine business was the total of amounts retained by him from locations together with net gain from the sale or exchange of used equipment. Deductions were taken for depreciation, cost of phonograph records, salaries and other business expenses.

Respondent determined that Moncovich was renting space in the locations where his machines were placed and that all the coins deposited in the machines constituted gross income to him. Respondent also disallowed all expenses 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 income derived from illegal activities as defined in Chanters 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.

As we held in Appeal of C. R. 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, 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.

The evidence as to cash payouts to players of such machines for free games not played off is in conflict. One location owner stated that he had a multiple-odd bingo pinball machine from Moncovich, that he made cash payouts to players for free games not played off, that when collections were made by Moncovich's employees he received the amount of such payouts from the proceeds of the machine, and that the balance was divided equally with Moncovich,

Two location owners stated that they had multiple-odd bingo pinball machines from Moncovich, but did not pay players for free games not played off. An employee of Moncovich testified that he made collections from pinball machines, that he advised location owners not to make payouts and that location owners made no claims against the proceeds of the machines for payout expense except in very small amounts for refunds to players for tilts or malfunctions. However, his testimony concerning payouts was impeached by evidence as to a conversation he had with one of Respondent's investigators about two months preceding the hearing on this appeal. The investigator testified that the employee on that occasion stated that payouts were made by all locations and that they averaged about 50% of the amounts [illegible] deposited in the machines.

Moncovich testified that he had about 40 locations in the Watsonville area and about 10 locations in the Hollister area, that he had a large number of music machines, that the Hollister route consisted solely of music machines, that before 1951 he had many one-ball pinball machines on which cash payouts were made to winners and that sometime in 1950 or early in 1951, he removed from locations all the one-ball pinball machines and stored them in a warehouse. He further testified that thereafter, he had no pinball machines on location until the fall of 1951 when he put on location a number of flipper pinball machines, two bingo pinball machines and some of the former one-ball pinball machines which he had converted to five-ball operation. He also testified that he had a considerable number of multiple-odd bingo pinball machines on location in 1952, 1953 and 1954; that in 1951 and 1952

the pinball machine income was a rather small part of the total income of the business, but in 1953 and 1954 the pinball machine income was about half of the total income of the business; and that for the period from the fall of 1951 through 1954, he instructed his collectors that there would be no payouts on pinball machines.

Respondent's auditor testified that he interviewed Moncovich in 1955. At the time of the interview he made notes and a few days later wrote a report. At the time of the hearing on this appeal he had little or no independent recollection as to many of the details of the interview and therefore his answers to many questions consisted of reading the relevant portions of his report. He testified that Moncovich told him that cash payouts for free games were made on pinball machines, that the payouts averaged 33-1/3% of the amounts deposited in the machines, that the amounts of such cash payouts were returned to the location owners from the proceeds of the machines and that the balance of the proceeds was divided equally between the location owners and Moncovich. The auditor's report states, "No pinball operations were conducted from April 9 through September 5, 1951."

Moncovich testified that he had no memory of being interviewed by Respondent's auditor.

While Moncovich and his employee testified that they never made allowances to location owners for payouts for free games during the period in question, this testimony was in conflict with that of a location owner and with the testimony of Respondent's investigator and its auditor. The investigator and the auditor had no great stake in the outcome, and we accept their testimony that Moncovich and his employee previously admitted that such payouts were made.

Under the circumstances, we find that it was the general practice to make cash payouts to players of pinball machines for free games not played off for the period from September 6, 1951, through December 31, 1954. However, we find that there were no pinball operations from April 9 through September 5, 1951.

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

Since the pinball machines were games of chance and cash was paid to winning players, these machines were operated illegally and Respondent was correct in applying Section 17359 to the period from September 6, 1951, through December 31, 1954.

Respondent was in error in applying Section I.7359 to the period from May 3, 1951 (effective date of Section 17359) through September 5, 1951, and to this extent its action must be reversed.

The Hollister route consisted solely of music machines. The income and exnenses of the Hollister route were recorded separately from the income and expenses of the machines in Watsonville. Respondent's auditor conceded that he found no connection between the Hollister operations and the Watsonville operations other than their common ownership. Since there was no illegal activity in connection with the Hollister route, the expenses of that route may be disallowed under Section 17359 only if the operation of the music machines in Hollister tended to promote or further, or was connected or associated with, the operation of the pinball machines in Watsonville. Mere common ownership is not the type of relationship between a legal activity and an illegal activity contemplated by Section 17359. Accordingly, Respondent's disallowance of expenses of the Hollister route must be reversed.

The evidence indicates that most of the locations in and near Watsonville had both a music machine and a pinball machine. Thus, there was a substantial connection between the legal activity and the illegal activity and Respondent was correct in disallowing all the exnenses of the Watsonville operations.

The amounts retained from locations were entered in Moncovich's records as income, but there were no records indicating the fact of or the amount of the cash pavouts to winners. Respondent made an estimate of these unrecorded amounts.

Moncovich's records showed income in three senarate categories; namely, Hollister, Watsonville music, and Watsonville pinball. As indicated previouslv, the Hollister income was entirely from music machines. The Watsonville music category included income from music machines in the Watsonville area. The Watsonville pinball category included income from pinball and all other types of machines in the Watsonville area excent income from music machines.

Based upon the interview with Moncovich in 1955, Respondent estimated that the unrecorded cash payouts equalled 33-1/3% of the amounts deposited in all machines other than music machines.

There were a number of machines other than music machines as to which there is no claim that payouts were made for free games and there is reason to believe that Moncovich in the interview meant that payouts equalled 33-1/3% of the amounts deposited in only those machines as to which such payouts did occur. There is no direct evidence before us, however, that the payouts were

in fact 33-1/3% of the amounts deposited in those machines alone. As we have previously pointed out, an employee of Moncovich told one of Respondent's investigators two months before this hearing that the payouts averaged 50%. This figure, as a percentage of the amounts deposited in machines on which payouts were made, is typical of the percentages which we have found in prior appeals involving pinball operators. Thus, there is some indication that the dollar amount of payouts ultimately arrived at by Respondent is not less than the actual amount, regardless of the precise meaning that should be attached to Moncovich's estimate in the interview with Respondent's auditor.

Appellants must carry the burden of showing that Respondent's computation of gross income is erroneous. We will not upset Respondent's finding as to the amount of payouts, which entered into the computation of gross income, without more positive evidence than we have before us.

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 John H. and Helen Moncovich to proposed assessments of additional personal income tax in the amounts of $2,893.70, $8,167.38, $8,857.24 and $7,986.22 for the years 1951, 1952, 1953 and 1954, respectively, be and the same is hereby modified in that the gross income and disallowance of expenses are to be recomputed in accordance with the Opinion of the Board.

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. Leake, Member

____________, Member

____________, Member

ATTEST: Dixwell L. Pierce, Secretary