BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
ADVANCE AUTOMATIC SALES CO., INC., and)
MELVIN R. AND REVA L. BOND)

Appearances:

For Appellants: Archibald M. Mull, Jr., and
Conrad T. Hubner, Attorneys at Law

For Respondent: A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

The appeal of Advance Automatic Sales Co., Inc., is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests to proposed assessments of additional franchise tax in the amounts of $17,908.40, $19,863.44, $22,048.87 and $24,553.45 for the income years ended June 30, 1952, 1953, 1954 and 1955, respectively. The appeal of Melvin R. and Reva L. Bond is 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 in the amounts of $4,926.67, $4,308.53, $5,212.62 and $4,488.93 for the years 1952, 1953, 1954 and 1955, respectively.

Advance is a corporation with its principal place of business in San Francisco, It is a distributor of new and used coin-operated equipment. For the most part it has franchise agreements with various manufacturers as to certain geographical areas which may be, for example, Northern California for one kind of equipment and eleven Western states for another kind of equipment. During the period here involved, it handled pinball machines, music machines, guns, bowlers and miscellaneous amusement machines. Sometime during the years under appeal, it also commenced to handle cigarette machines.

Its primary business was the sale of the coin machines to route operators, that is, to persons who placed them in locations, such as bars and restaurants, and shared the net proceeds with the location owner. Its sales organization sold all types of equipment handled by Advance to such route operators. Due to the pattern of the industry, however, only a minor portion of the sales of cigarette machines was made to route operators who also had

pinball machines on their routes, Advance had a repair department which repaired used machines that it had acquired and did some repair work for route operators. The repair department was required on occasion to service new equipment which Advance had purchased from a manufacturer. There was also a parts department which sold replacement parts for all types of coin machines.

Advance leased some coin machines to route operators. In most cases, the rental was a fixed sum. In some cases, the rental was a percentage of the route operator's gross from the machine.

Advance operated a metal working factory under the name of Royal Machine Manufacturing Company. Royal manufactured cigarette vending machines which were sold by Advance. Royal also did some outside contract work and performed jobs for various defense contractors. The Royal plant was located in a separate building across an alley from the building housing the office and warehouse used for the balance of the Advance business.

Advance had its own route of pinball machines and miscellaneous amusement machines. This route was serviced by William Otley, a salaried employee. There was also a route of cigarette machines serviced by other employees. The cigarette machine route was begun sometime during the years in question on this appeal. In addition, Advance was a partner with Appellant Melvin R. Bond in a pinball machine route operation.

As to both the Otley route and the Bond route, coin-operated machines were placed in bars, restaurants 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 with the location owner. The Otley route consisted of from fifteen to thirty locations in San Francisco. The Bond route consisted of about forty locations in Contra Costa County. The equipment on the Otley route considered of approximately equal numbers of bingo pinball machines and flipper pinball machines together with relatively few miscellaneous amusement machines. The equipment on the Bond route consisted solely of multiple-odd bingo pinball machines,

The gross income of the Otley and Bond routes as reported in tax returns was the total of amounts retained by the machine owner from locations. Deductions were taken for depreciation, salaries and other business expenses.

Respondent determined that the machine owner was renting space in the locations where machines were placed and that all the coins deposited in the machines constituted gross income to the machine owner. Respondent also disallowed expenses of the Bond route and of the entire business of Advance pursuant to Sections 17297 and 24436 (17359 and 24203 prior to June 6, 1955) of the

Revenue and Taxation Code. Sections 17297 and 24436 are identical in substance, the former applying to individuals and the latter to corporations. Section 17297 reads:

> In computing taxable 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.

Penal Code Section 330b, paragraphs (1) and (2), and Section 330.1 prohibit the possession of a slot machine and define slot machine broadly.

Section 330.1 provides, in part:

> Every person who . . . owns, stores, possesses, sells, rents . . . any slot machine or device ... is guilty of a misdemeanor.... A slot machine or device . . . is one that ... as a result of the insertion of any . . . coin ... such machine or device . . . may be ... played, mechanically, electrically, automatically or manually, and by reason of any element of hazard or chance, the user may receive or become entitled to receive any thing of value . . . or the user may secure additional chances or rights to use such machine or device....

Penal Code Section 330b, paragraph (4), and Section 330.5 contain an exception to the definition of "slot machine or device. Section 330.5 provides the exception in the following language:

> ... pin ball, and other amusement machines or devices which are predominantly games of skill, whether affording the opportunity of additional chances or free plays or not, are not intended to be and are not included within the term slot machine or device....

Sections 330b, 330.1 and 330.5 of the Penal Code became effective on July 15, 1950. On February 19, 1951, the Attorney General issued an opinion holding a "Citation" one-ball pinball machine to be within Sections 330b and 330.1 and not within the exceptions. (17 Ops. Cal. Atty. Gen. 68.) The opinion describes the mechanical operation of the machine and concludes that the result of operation of the machine depends almost exclusively on

chance. Concerning the exception contained in Section 330.5, which we have quoted above, the opinion states:

> We understand the contention has been made that because of the comma appearing after the word "pin ball," all pin ball machines are exempt from the sections even though they are strictly games of chance. Certainly this was not the legislative intent. Such a strained interpretation would single out pin ball machines from all other gambling devices. We have no hesitancy in concluding that pin ball machines, as well as any other machines or devices that are predominantly games of chance, are prohibited by the section.

In Sharpensteen v. Hughes, 162 Cal. App. 2d 381 (1958), the District Court of Appeal considered a case involving the application of Section 330.5 to four pinball machines as to which there was no evidence that they had been used for gambling. The trial court had found them to be games of chance solely on the ground that a player could win free games. It concluded, nevertheless, that the machines were within the exception stated in Section 330.5.

The conclusion of the District Court of Appeal was that the machines were within the exception stated in Section 330.5. The court held that the winning of free games is no basis on which to hold them to be games of chance and therefore concluded that they were predominantly games of skill. In the course of its opinion, the court stated:

> It appears to us that the more reasonable construction of the exception would be that it was intended thereby that the mere possession of pinball machines and other amusement machines or devices (indicating pinball machines, as such, are designed for amusement) which are predominantly games of skill, whether affording the opportunity of additional chances or free play, come within the exception.

On April 17, 1961, the Attorney General issued an opinion holding that a multi-play pinball machine is predominantly a game of chance and therefore that possession of such a machine is illegal since the machine is not within the exception stated in Section 330.5. (37 Ops. Cal. Atty. Gen. 126.) The description of a multi-play pinball machine in the opinion coincides with what we have called a multiple-odd bingo pinball machine. The opinion cites the language we have quoted from Sharpensteen v. Hughes as direct authority for its holding.

We are of the opinion that the word "other" in the phrase "other amusement machines or devices which are predominantly games of skill" in Section 330.5 necessarily ties the words "pin ball" to "amusement machines" and "predominantly games of skill" even though a comma follows "pin ball." This interpretation means that a pinball machine is within the exception stated in Section 330.5 only if it is both an amusement machine (player receives no money or thing of value for winning) and predominantly a game of skill. Phrasing it otherwise, our conclusion is that the ownership, storage, possession, sale or rental of a pinball machine is illegal if the machine is predominantly a game of chance or if cash or other thing of value is paid to winning players.

In People v. One Mechanical Device, 9 Ill. App. 2d 38, 132 N. E. 2d 338 (1956) the Illinois Appellate Court held that the result of operation of a pinball machine of the type we have called a multiple-odd bingo pinball machine did not depend, even in part, on the skill of the player.

As previously indicated, the Attorney General concluded that multiple-odd bingo pinball machines were predominantly games of chance and thus were not within the exceptions provided in Sections 330b and 330.5 of the Penal Code. Moreover, one of the bingo pinball machines on the Bond route was seized by the Sheriff of Contra Costa County and was examined and tested by a professor of engineering from the University of California. As in the case of the machines which were the subject of the Attorney General's Opinions, the machine confiscated from the Bond route was of the multiple-coin variety, that is, additional coins could be inserted to increase the odds or number of free games won on a given winning combination, Additional coins could also be inserted to activate other special features of the machines which increased the opportunities of winning. Whether a particular coin advanced the odds or produced the special feature depended on the interaction of three cams inside the machine and was completely subject to chance. An operating instruction manual found inside the machine stated that the odds and features "advance at mystery intervals." Four of the features of the machine activated by additional coins could be adjusted to liberal, medium or conservative settings.

Tests of the multiple-coin mechanism were made to determine its actual operations. Six runs were made to advance the odds. Odds of 100-1 were achieved with from 3 to 7 coins; odds of 150-1 were achieved with from 10 to 96 coins; and odds of 192-1 were achieved with from 37 to 192 coins.

Six runs were made of one of the other features activated by insertion of additional coins and maximum results were achieved with from 2 to 39 coins. Six runs were made of still another of

the features activated by insertion of additional coins and maximum results were achieved with from 7 to 74 coins. Six runs were made of the "Extra Ball" feature. In one run, the first and second extra balls were obtained together on the 6th coin and the third on the 18th coin. The maximum number of coins to obtain the first extra ball was 51, to obtain the second extra ball, an additional 70, and to obtain the third ball, an additional 22.

Tests were conducted of the actual operation of a ball on the playing field. A specially built release mechanism was used to release the plunger which propelled the ball. The professor's report continues:

> The design of the release mechanism was such as to provide an identical release each time, with far greater accuracy and reproducibility than could be achieved by the most highly skilled player. It thus represented the maximum attainable skill in the single act of shooting the ball.
>
> The release of the plunger is an extremely critical factor--a difference of 1/8 inch in the release point is all that is required to make the ball go across the arch and strike the bumper instead of just going out the gate.
>
> * * *
>
> With the special release mechanism it was possible to make 23 out of 25 shots hit the same bumper post. I am certain that no human can do this.

One hundred shots were made from each of four release points. In the case of one set of 100 shots, the maximum number of times the ball went in any one of the 25 holes was 12; for another set, the maximum was 10; and, for the other two sets, the maximum was 11.

Thus, using a special mechanism to assure uniform release of the plunger, a particular hole could be achieved only 12 percent of the time at bet. A human player not using such special mechanism undoubtedly could not do as well.

As to this phase of the operation of the pinball machine, the professor's report concludes:

> ... the ball <u>always</u> must hit at least one bumper before it can enter any hole. There is very little skill that the player can exercise over the ball

before it hits a bumper and after it has struck a bumper its subsequent action is determined almost completely by chance.

The machines on the Bond route were exclusively multiple-odd bingo pinball machines. The analysis made by the professor of engineering of the machine seized by the Sheriff of Contra Costa County from the Bond route indicates that the operation of this machine depended almost entirely on chance. Accordingly, the ownership and possession of such machines was illegal. Respondent was correct therefore in disallowing all expenses of the Bond route.

The machines on the Otley route consisted of about equal numbers of bingo pinball machines and flipper pinball machines together with relatively few miscellaneous amusement machines. These bingo pinball machines were not of the multiple-odd variety. Therefore, there was no element of hazard or chance involved in the deposit of coins in the machines.

Nevertheless, as in the case of other bingo pinball machine: the bingo pinball machines on the Otley route were constructed so that a ball could not drop into a hole without first hitting a bumper on the playing field. Whatever degree of control a player might have exercised over the path of the ball before it hit a bumper was lost as soon as the ball hit a bumper because the direction of its rebound from the bumper was determined almost completely by chance.

The bingo pinball machines on the Otley route were thus predominantly games of chance and the ownership and possession Of such machines was illegal. William Otley did all the soliciting, collecting and repairing for all types of machines on the Otley route. We need not decide whether the operation of flipper pinball machines on the Otley route was illegal, since the operation of flipper pinball machines and miscellaneous amusement machines was associated or connected with the operation of the bingo pinball machines.

In its principal business as a distributor, Advance handled a full line of coin-operated equipment. Its distribution function: of warehousing, selling and accounting were handled as an integrated business without differentiation based on type of machine being sold. We think that this integration of the principal function of Advance coupled with many sales of music and amusement machines and some sales of cigarette machines to customers who also were customers for bingo pinball machines necessarily means that the legal activity of distributing music, amusement and cigarette machines was connected or associated in a substantial way with the illegal activity of distributing bingo pinball machines.

The repair and parts departments were integral units of the distribution business in that the repair department mainly repaired used machines preparatory to their sale and the parts department offered customers a source of replacement parts to keep machines operable and thereby maintained the goodwill of the general distribution business.

In its returns Advance apparently showed the cost of cigarette machine manufacture and the metal working factory as expense rather than as cost of goods sold. Respondent's auditor made no attempt to segregate such items because he was denied full access to records. The result is that such costs were disallowed in Respondent's general disallowance of all claimed expenses. In the recomputation following our decision such costs should be segregated and allowed since cost of goods sold may not be disallowed regardless of illegal activity.

The cigarette vending machine route would appear to be independent of the business of distributing bingo pinball machines and the expenses of this route are therefore allowable.

Respondent's disallowance of all expenses of Advance must therefore be modified to allow the expenses of operating the cigarette machine route and to allow cost of goods sold not previously identified as such.

The evidence as to the Bond and Otley routes indicates that the operating arrangements between the machine owner and each locution owner were 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.

On both the Otley and the Bond routes, the collector prepared a collection report. This report did not show the total of the coins in the machine. Rather, it showed the amount remaining after the expenses initally paid by the location owner but claimed by him from the total deposited in the machine. Since there were no records of the amounts paid to the winning players and other expenses initially paid by the location owners, Respondent made an estimate of the unrecorded amounts.

In support of the fact that cash was paid to players for unplayed free games, there is evidence in the record as to the practices on both the Otley and the Bond routes. The evidence as to the Otley route is not completely clear as to whether it was the general practice to pay cash to players for unplayed free games., One location owner testified that such cash payouts were made occasionally. Another location owner testified that he did

not make cash payouts for unplayed free games, but when interviewed by Respondent's auditor in 1956 he told him that the payout expense averaged 60 percent of the proceeds of the machine. Another location owner testified that he sometimes made cash payouts for free games and further stated that he had given Respondent's investigator an estimate that the expenses averaged from 25 percent to 30 percent of the amounts in the machine. The testimony of William Otley indicates that at the time he made collections, it was the general practice for the location owners to claim amounts for expenses. We find that cash payouts were generally made to players for unplayed free games as to bingo pinball machines on the Otley route.

As to the Bond route, three location owners stated that they did not make payments to players for unplayed free games and one location owner stated that he made such payments only to prevent an argument, but all four also stated that at the time of each collection the collector read a meter inside the machine. One location owner stated that he paid players for unplayed free games. All of these locations owners, upon being interviewed by Respondent's auditor in 1956, told him that they paid cash to players for unplayed free games. Appellant Melvin R. Bond stated that the pinball machines had meters to record free games run off rather than being played off. The transcript of Bond's testimony shows the following:

Q. Did you look at the meter inside the machine when you opened the machine?

A. Sometimes I would and sometimes I wouldn't.

Q. Did you ever keep a record in the machine of the meter readings?

A. Sometimes.

Q. This would be a record of the free games run off on the machine by means of the removal button?

A. Yes.

Q. Why would that record be of interest to you?

A. No particular reason.

We conclude as to the Bond route that it was the general practice to pay players for unplayed free games.

Respondent estimated that the payouts to winnings players and other expenses claimed by the location owners amounted to 60 percent of the total in the machine. This was based on estimates given to Respondent's auditor by two location owners on the Otley route (although one of the two was not a location owner during the period covered by this appeal but became such subsequent thereto) and by five location owners on the Bond route. In evaluating these estimates in the light of the evidence, we conclude that this percentage should be reduced to 50 percent.

Respondent's auditor was granted access to only a portion of the records of Advance. He assumed that amounts set forth in a classification entitled "route operations" were the income from the Otley route. It now appears that this classification included income from the Otley route and other income as well. There must, therefore, be an appropriate adjustment in accordance with the evidence submitted by Advance and subject, as agreed by the parties, to verification by Respondent,

Respondent assumed that there were payouts to winners as to every machine on the Otley route. However, in view of the nature of the equipment, this is an unlikely assumption. We believe that a more accurate estimate of the unrecorded gross income will be reached by assuming that as to 50 percent of the recorded incom from the Otley route, there were no payouts to winners.

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 CRDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Advance Automatic Sales Co., Inc., to proposed assessments of additional franchise tax in the amounts of $17,908.40, $19,863.44 $22 048.87 and $24 553.45 for the income years ended June 30, 1652, 1953, 1954 and 1955, 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; and, it is hereby further 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 Melvin R. and Reva L. Bond to proposed assessments of additional personal income tax in the amounts of $4,926.67, $4,308.53, $5,212.62 and $4,488.93 for the years 1952, 1953, 1954 and 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, and in all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 9th day of October, 1962, by the State Board of Equalization.

Geo. R. Reilly, Chairman

John W. Lynch, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary