BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JULES L. AND EDNA L. KRENTZ)

Appearances:

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

For Respondent: A. Ben Jacobson, 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 protests of Jules L. and Edna L. Krentz against proposed assessments of additional personal income tax in the amounts of $3,690.76 assessed against each Appellant for the year 1951, and in the amounts of $14,463.76, $20,817.73, $26,022.81 and $30,222.98 assessed against Appellants jointly for the years 1752, 1953, 1954 and 1955, respectively.

During the years under review, Appellant Jules L. Krentz owned and operated a coin machine business in the San Bruno area under the name of Krentz Amusement Company. He had the following equipment:

Year	Bingo	Pinball Flipper	5-Ball	Total Pinball	Arcade	Music
			49	86		42
1952	18	25	36	79	26	42
	42			81		40
1954	63	7	16		27	39
1955	73	68	16	87 95	18 20	41

This equipment was placed in bars, restaurants and other locations. In the peak year, 1955, Appellant had approximately 60 locations. The gross receipts from each machine, after the allowance of expenses claimed by the location owner and payment of licenses and taxes, were divided equally between Appellant and the location owner.

The gross income reported in Appellants' tax returns was the total of the net amounts thus retained from locations. Deductions were taken for depreciation, cost of phonograph

records, repair parts and other business expenses. Respondent determined that Appellant wasrenting space in the locations where his machines were placed and that all of the coins deposited in the machines constituted gross income to him. Respondent also disallowed all deductions for expenses of the business pursuant to Section 17297 (17359 prior to June 6, 1955) of the Revenue and Taxation Code, which 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.

Appellant contends that he merely rented his equipment to location owners and has put in evidence a written agreement entered into on June 3, 1952, by Appellant Jules L. Krentz and. one Charles Colletti, location owner. It states that it is a lease agreement and names Appellant as the lessor and Colletti as the lessee. The form provides that the lessor will install coin-operated devices in the lessee's place of business, service and maintain said devices at his own expense, and pay all taxes and licenses assessed on the owner of such devices. The lessee agrees to protect such equipment from damage, to pay all taxes and licenses assessed against the custodian of the devices, to comply with all federal, state and local laws pertaining to their operation (specifically, not to permit the machines to be used for other than amusement purposes), and to pay to the lessor 50 percent of the "gross revenue'? plus $35 a year for each pinball game. The latter amount was one-half the costs of all taxes and licenses applicable to the pinball game. Appellant testified that he had similar agreements with other location owners.

The label chosen by the parties to an arrangement may be given some weight as evidence but it is by no means conclusive. The ultimate conclusion as to the legal relationship between two persons rests solely on the facts. (Appeal of Edward J. Seeman, Cal. St. Bd. of Equal., July 19, 1961, 3 CCH Cal. Tax Cas. Par. 201-825, 3 P-H State & Local Tax Serv. Cal. Par. 58208.) Aside from the lease form, Appellant has offered no proof that his relationship with the location owners differed materially from that which we characterized as a joint venture in the Appeal of C. B. Hall, Yr., 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. In view of the facts disclosed in the record, we conclude that our holding in Hall, that the coin machine owner and each location owner operated the machines as a joint venture,

is applicable here. tine-half of the coins deposited in Appellant's machines were therefore includible in his gross income.

In the Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, 3 CCH Cal. Tax Cas. Par. 201-984, 2 P-H State & Local Tax Serv. Cal. Par. 13288, we held the ownership or possession of a pinball machine to be illegal under Penal Code Sections 330b, 330.1 and 330.5 if the machine was predominantly a game of chance or if cash was paid to players for unplayed free games.

Three location owners testified that they had Appellant's pinball devices during the period under review and that cash payments were made to players fcr free games won on the machines but not played off. They received back the amount of such payouts, together with any incidental expense, from the machine proceeds and the balance was divided equally with Appellant. While Appellant and one of his employees testified that they had no personal knowledge of payouts being made, the employee testified at one point that the expenses claimed by location owners were too great to be accounted for only by payments to players for malfunctions of the machines. He also testified that he sometimes read meters on the machines to determine how many free games had been won and paid for. He stated that these readings were requested by location owners who wanted to check on their employees or on the machines. It is our conclusion that, with the exception of the flipper type games, it was a general practice to make cash payouts to the players of Appellant's pinball machines for free games. Accordingly, these machines were operated illegally and Respondent was correct in applying Section 17297.

The amounts Appellant recorded as gross receipts from pinball games were the net proceeds he received after exclusion of the expenses claimed by location owners. Since no record of the amounts claimed was available, Respondent estimated these unrecorded expenses to be 50 percent of the total receipts of the pinball machines. At the hearing in this appeal, one location owner and one of Appellant's employees estimated that the payouts averaged around 20 percent of the total receipts, while another location owner estimated that it would be 30 percent. All three were firmly convinced that the amounts did not average as high as 50 percent. While we have consistently held that Respondent's computation of gross income is presumptively correct, we conclude that an estimate of 25 percent would be more reasonable here in view of the fact that the record contains no evidence to support the 50 percent figure.

Appellant's records segregated pinball receipts from the income produced by the music and arcade equipment; however, the income from flipper games was not segregated from that of the

other types of pinball equipment. Although Respondent does not contend that there were cash payouts on the flipper games, its assessment added an amount to gross income for payouts on those machines since there were no records available from which such a separation could accurately be made. Under the circumstances we deem it proper to estimate the amounts. From the evidence presented, we believe that a fair estimate of Appellant's share of the average income produced by one of the flipper games would be $325 per year. Accordingly, an adjustment should be made to delete from gross income the amount of the estimated payouts on those machines.

As noted earlier, Respondent disallowed the expenses of the entire business, including the cost of records, repair parts and depreciation on the music equipment. Appellant contends that about one-half of his locations did not have pinball games and were not connected with them. He has not, however, complied with our request for information to substantiate his claim. In view of the fact that Appellant and his employees repaired and collected from all types of coin-operated equipment, interchangeably, we must conclude that all phases of the Krentz Amusement Company were associated or connected with the illegal pinball activity. Respondent was therefore correct in disallowing all deductions for business expenses.

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 Jules L. and Edna L. Krentz against proposed assessments of additional personal income tax in the amounts of $3,690.76 assessed against each Appellant for the year 1951, and in the amounts of

$14,463.76, $20,817.73, $26,022.81 and $30,222.98 assessed against Appellants jointly for the years 1952, 1953, 1954 and 1955, respectively, be modified in that 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 19th day of December, 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