BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
LEE PARKHURST,)
ESTATE OF CARL G. DICKSON, DECEASED,)
AND IRENE DICKSON)

Appearances:

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

For Appellants Dickson: Carl Kuchman, Attorney at Law

For Respondent: Wilbur F. Lavelle, Associate Tax Counsel, and 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 protests to proposed assessments of additional personal income tax against Lee Parkhurst in the amounts of $3,752.87 and $9,089.78 for the years 1952 and 1953, respectively, and against Estate of Carl G. Dickson, deceased, and Irene Dickson in the amounts of $2,904.85 and $4,050.94 for the years 1952 and 1953, respectively.

Carl G. Dickson conducted a business in Sacramento under the name of Valley Distributors. The manager of the business was Del Scotto. Dickson was the sole owner of the business during 1952 and through November 30, 1953. The organization of Valley Distributors was changed to a partnership between Dickson and Scotto on December 1, 1953.

The primary business of Valley Distributors was the distribution of various types of coin-operated equipment and the sale at wholesale of sporting goods. The coin equipment was sold to route operators, that is persons who placed the equipment in various locations, such as bars and restaurants, and shared the proceeds with the location owner. Some of the machines handled by Valley Distributors were rented to route operators rather than being sold. Most of the rentals were on the basis of a flat fee per month. However, in the case of rentals to one route operator the rental fee was 50 percent of the route operator's share of the proceeds from the machines.

Appeals of Lee Parkhurst,
Estate of Carl G. Dickson, Deceased,
and Irene Dickson

In 1950 Valley Distributors and Appellant Lee Parkhurst entered into a partnership which operated under the name of ABC Novelty Co. This partnership continued through June 30, 1952, after which Parkhurst operated ABC Novelty Co. as a sole proprietor.

ABC Novelty Co. was a coin machine route operation. The company had pinball machines, music machines, shuffle-bowlers and miscellaneous amusement equipment. This equipment was placed in some fifty different locations in the Sacramento area and 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 ABC and the location owner. In the case of the shuffle-bowlers, prizes were furnished by ABC to many of the location owners and distributed by the location owners among the players. ABC took from the proceeds of the shuffle-bowler the cost of the prize and the balance was divided equally between ABC and the location owner.

The gross income reported in tax returns by ABC was the total of amounts retained from locations, excluding the retained cost of shuffle-bowler prizes. ABC took deductions in its tax returns for depreciation, cost of phonograph records and other business expenses. Respondent determined that ABC was renting space in the locations where the machines were placed and that all the coins deposited in the machines, except music machines, constituted gross income to ABC. It appears that no change was made in the reported gross income from music machines.

Respondent disallowed all expenses of ABC Novelty Co. and of Valley Distributors 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 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 ABC and each location 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 in

joint venture in the operation of these machines is, accordingly, applicable here.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, 3 CCH 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, and we also held bingo pinball machines to be predominantly games of chance.

Appellant Lee Parkhurst testified that it was the customary practice of location owners to pay cash to winning players of the pinball machines for unplayed free games. He estimated that the expenses claimed by the location owners in connection with the pinball machines ran between 35 percent and 65 percent of the total amounts deposited in such machines. Accordingly the pinball machine portion of the ABC business was illegal.

Apyellant Lee Parkhurst described the shuffle-bowlers as games which resembled bowling, being played on a long board with a puck propelled by hand which slid over electric contracts under raised bolwing-type pins. It was the practice of many location owners to award prizes to players of shuffle-bowlers. The most common method of awarding a prize was to allow each player who achieved better than a given score, for example 150, to put his name on a slip of paper and drop it into a container. At the end of the week or the month a name was drawn out of the container and a prize awarded to that person. Another method was to have a similar drawing except that each person playing the game could put his name into the container without first achieving a particular score. A third method was to give a prize to the person who achieved the high score for the week or for the month.

The first two of the above-mentioned methods of awarding prizes on the shuffle-bowlers constituted illegal lotteries in that the awarding of the prize was by chance and the prize was awarded only to a person who had paid to participate. (Pen. Code, § 319.)

Since there was illegal activity related to pinball machine and shuffle-bowlers it was proper to disallow all deductions from the gross income of these machines. These types of machines together produced by far the bulk of the income of the ABC Novelty co. Virtually every location owner had one or both of such types of machines in his location. Furthermore, the entire business was operated as a unit. It appears, therefore, that there was a substantial connection between the illegal operation of pinball machines and shuffle-bowlers and the legal operation of music

machines and miscellaneous amusement machines, Thus, Respondent did not err in disallowing all the expenses of the ABC Novelty co.

The business of Valley Distributors was the sale and rental of all types of coin-operated equipment and the sale at wholesale of sporting goods, Valley Distributors handled pinball machines including the bingo type of pinball machines, the ownership, possession, storage, sale and rental of which we held to be illegal in Advance Automatic, supra. Valley Distributors was operated as an integrated business with a manager and approximately five employees. The bookkeeper kept all the records and the mechanics worked primarily on the new coin-operated equipment which had been purchased from manufacturers and was being made ready for delivery to route operators. It therefore appears that there was a substantial connection between the illegal activity of owning, possessing, storing, selling and renting bingo pinball machines and the other phases of the business of Valley Distributors. Respondent, accordingly, was correct in disallowing all expenses of Valley Distributors.

As stated above, there was omitted from the recorded gross income of ABC Novelty Co. the payouts to winning players of the pinball machines and the cost of prizes awarded on the shuffle-bowlers. Respondent estimated such amounts as equal to 50 percent of the total amounts deposited in these machines. The estimate was based on results of audits of other pinball machine operators and also on the estimate of Appellant Lee Parkhurst that the payouts on pinball machines ran between 35 percent and 65 percent of the total amounts deposited in such machines. In addition, Respondent's auditors in examining the records of ABC Novelty Co. discovered one collection report which recorded the meter readings on a pinball machine. This collection report indicates a payout of approximately 80 percent. Respondent's auditor also found three collection reports showing detiuctions for prizes on shuffle-bowlers. The average cost of prizes on the three collection reports was 47 percent of the gross amount in the machines. We believe there was a reasonable basis for Respondent's estimate, and the estimate is sustained.

The recorded gross income of the ABC Novelty Co. was not segregated according to class of machines, and in order to compute the unrecorded payouts and prizes it was necessary for Respondent': auditor to determine the percentage of the total gross income which was derived from music machines and other types of machines on which no such payouts had been made or prizes awarded. Respondent's auditor did this on the basis of the total cost of music machines as against the total cost of all equipment. The share of the recorded gross income thus attributed to music machines was 25 percent 'for the first six months of 1952, 38 percent for the last six months of 1952 and 36 percent for the year 1953. Under the circumstances we believe this is a satisfactory method of proceeding, except that Respondent's auditor assumed

that there had been payouts or prizes on all types of machines except music machines. From the nature of the equipment and from the testimony of Appellant Lee Parkhurst we believe that there were some items of equipment other than music machines on which there were no payouts or prizes. Accordingly, the percentage of recorded gross income attributable to machines used only for amusement should be increased 10 percentage points for each of the three periods developed by Respondent's auditor.

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 protests to proposed assessments of additional personal income tax against Lee Parkhurst in the amounts of $3,752.87 and $9,089.78 for the years 1952 and 1953, respectively, and against Estate of Carl G. Dickson, deceased, and Irene Dickson in the amounts of $2,904.85 and $4,050.94 for the years 1952 and 1953, respectively, be 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 26th day of February, 1963, 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