BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ERNEST E. AND BILLIE H. SOUSA)

Appearances:

For Appellants: Laura O. Coffield, Attorney at Law

For Respondent: Wilbur F. Lavelle, 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 Ernest E. and Billie H. Sousa to proposed assessments of additional personal income tax in the amounts of $737.44, $693.48, $1,199.08, $1,353.80 and $1,118.45, for the years 1951, 1952, 1953, 1954 and 1955, respectively.

Appellant Ernest E. Sousa (hereinafter called Appellant) conducted a coin machine business in and around the Napa area. He owned and rented music machines, bingo pinball machines, flipper pinball machines, and miscellaneous amusement machines. The equipment was placed in some twenty locations and the proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, and after exclusion of any amounts which Appellant was obliged to pay to a third party as rental on the machine, were divided equally between Appellant and the location owner.

The gross income reported in tax returns was the total of amounts retained from locations. Deductions were taken for depreciation, phonograph records, and other business expenses. Respondent determined that Appellant 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 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.

The evidence indicates that the operating arrangements between Appellant and each location owner were essentially 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 these machines is, accordingly, applicable here.'

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, CCH Cal. Tax Rep. 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 or other things of value were paid to players for unplayed free games, and we also held bingo pinball machines to be predominantly games of chance.

Two location owners who had pinball machines from Appellant, and an employee of one of them, testified that they paid cash or merchandise to players for unplayed free games. One location owner who had a pinball machine from Appellant for about six months testified that she never paid cash to players for unplayed free games. In answer to a question concerning the expenses claimed by the location owners, Appellant stated, "A fellow had any games coming on it, I guess:. they'd give them the money on it." We find that it was the practice of most of the location owners having pinball machines from Appellant to pay cash to players for unplayed free games. Accordingly, the pinball machine phase of Appellant's business was illegal both on the ground of ownership and possession of bingo pinball machines which were predominantly games of chance and on the ground that cash or things of value were paid to winning players. Respondent was therefore correct in applying Section 17297.

Appellant operated his coin machine business as an integrated whole, performing most of the work himself with some assistance from his brother, and there was no segregation of the income from the various machines on Appellant's books. The legal operation of music and other amusement machines was thus associated or connected with the illegal operation of pinball machines and Respondent correctly disallowed the expenses of the entire business.

Appellant's reported gross income did not include the payouts to winning players of pinball machines. In order to determine this amount and add it to the reported income, Respondent's auditor interviewed two location owners and the employee of

another. One of the location owners stated that the payouts averaged 60 percent of the amounts deposited in the pinball machine in his establishment, the employee of another estimated 25 percent and one location owner stated that no payouts were made. Based upon these interviews and his experience in other audits, Respondent's auditor estimated that the payouts averaged 50 percent of the amounts deposited in the pinball machines.

Of the witnesses at the hearing in this appeal, two location owners and the employee of one of them stated that payouts were made only to good customers or to avoid a disturbance and indicated, without making specific estimates, that the amounts were not large. The employee who testified was the person who had previously given Respondent's auditor the 25 percent estimate. The location owner who testified that no payouts were made was the sane person who had so informed Respondent's auditor in the interview prior to this hearing.

Recognizing that Respondent's determination of income carries a presumption of correctness, we nevertheless conclude that the payout estimate with respect to pinball machines should be reduced to 25 percent. In reaching this conclusion, we have taken into consideration the fact that some of the pinball machines were of the flipper type, as to which it is not so likely that payouts were made.

Based upon Appellant's own estimate. Respondent's auditor concluded that for-the years 1951 and 1952, 40 percent of the gross income recorded by Appellant was from pinball machines and that for the years 1953, 1954 and 1955, 60 percent was from such machines. We see no reason to disturb these figures.

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 Ernest E. and Billie H. Sousa to proposed assessments of additional personal

income tax in the amounts of $737.44, $693.48, $1,199.08, $1,353.80 and $1,118.45, for the years 1951, 1952, 1953, 1954 and 1955, 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 Sacramento, California, this 19th day of March, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Richard Nevins, Member

_____, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary