BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
EVERETTE AND MARIANNE GRAY and)
MARCELLUS AND EILEEN B. STEARNS)

Appearances:

For Appellants Gray: Ray Manwell, Attorney at Law

For Appellants Stearns: Archibald M. Mull, Jr., Attorney at Law

For Respondent: A. Ben Jacobson, Associate Tax Counsel

OPINION

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 Everett E. and Marianne Gray in the amounts of $745.78, $2,232.18, $2,647.84, $3,422.66, $1,785.76 and $2,665.29 for the years 1952, 1953, 1954, 1955, 1956 and 1957, respectively, and against Marcellus and Eileen B. Stearns in the amounts of $811.97, $784.96, $1,081.94, $629.13, $579.41 and $214.76 for the years 1952, 1953, 1954, 1955, 1956 and 1957, respectively,

Appellants Everett E. Gray and Marcellus Stearns were partners in the Valley Amusement Company from before 1952 until August 5, 1957. Thereafter Valley Amusement Company was operated as the sole proprietorship business of Everett E. Gray. Valley Amusement Company conducted a coin machine business in the Marysville-Yuba City area. It owned music machines, bingo pinball machines and miscellaneous amusement machines. The equipment was put in as many as 65 locations such as bars and restaurants, and the proceeds from each machine, after exclusion of amounts claimed by the location owner for expenses, were divided between Valley Amusement and the location owner. Generally this was an equal division but on some of the music machines Valley Amusement received 60 percent and the location owner, 40 percent.

The gross income reported in Valley Amusement tax returns was the total of amounts retained from locations. Deductions were taken for depreciation, phonograph records, repair parts and other business expenses. Respondent determined that Valley Amusement was renting space in the locations where its machines were placed and that all the coins deposited in the machines

constituted gross income to it. 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 Valley Amusement 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 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 was paid to players for unplayed free games, and we also held bingo pinball machines to be predominantly games of chance,

It is clear from the testimony of appellant Everett E. Gray and of two location owners that cash was paid to players of most of the bingo pinball machines for unplayed free games. Accordingly, the pinball machine phase of the Valley Amusement 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 was paid to winning players. Respondent was therefore correct in applying section 17297.

Appellant Everett E. Gray and his employees collected from and repaired all types of machines except that for an unspecified period some employees collected solely from music machines. The income from the various machines was not segregated on the books. More than half of the locations in which Valley Amusement had machines had both a music and one or more pinball machines. We conclude that the legal operation of music and miscellaneous amusement machines was connected with the illegal operation of bingo pinball machines and that respondent was correct in disallowing all the expenses of Valley Amusement.

There were no records of the amounts paid to winning players of the bingo pinball machines. Respondent made an estimate that the unrecorded payouts averaged 50 percent of the total amounts deposited in these machines. This estimate was based on statements of two location owners, of whom one stated that the payouts averaged 20 percent and the other stated that they averaged 65 percent. Respondent's estimate was also based on experience in auditing other pinball machine operators in the immediate area and in other areas.

Appellant Everett E. Gray testified that some locations did not make Payouts for free games won on bingo pinball machines. Considering his testimony, together with the above statements by location owners, we believe that the payout estimate should be reduced to 35 percent.

The records of Valley Amusement Company did not segregate income according to type of machine, and in order to apply the payout percentage, respondent's auditor made a segregation of the income according to the number of pinball machines in relation to all other types of machines. The segregatior was on the assumption that each machine produced an equal amount of income during the year.

Although some of the pinball machines were of the flipper variety, as to which it is unlikely that payouts were made, this circumstance is offset by our own observation in cases of this kind that the bingo types usually produce more income than other machines. In our opinion, the auditor's segregation reaches a reasonable result.

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 Everett E. and Marianne Gray in the amounts of $745.78, $2,232.18, $2,647.84, $3,422.66, $1,785.76 and $2,665.29 for the years 1952, 1953, 1954, 1955, 1956 and 1957, respectively, and against Marcellus and Eileen B. Stearns in the amounts of $811.97, $784.96, $1,081.94, $629.13, $579.41 and $214.76 for the years 1952, 1953, 1954, 1955, 1956 and 1957, 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 17th day of April, 1963, by the State Board of Equalization.

Paul R. Leake, Acting Chairman
Richard Nevin, Member
Geo. R. Reilly, Member
Alan Cranston, Member
_____, Member

ATTEST: Dixwell L. Pierce, Secretary