BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
GEORGE AND DORIS PEREA)

Appearances:

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

For Respondent: Israel Rogers, Assistant 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 the protest of George and Doris Perea to proposed assessments of additional personal income tax in the amounts of $714.86, $1,831.45, $4,077.48 and $1,116.01 for the years 1951, 1952, 1953 and 1954, respectively,

During the years in question George Perea (hereafter referred to as appellant) owned and operated a coin machine business in Sacramento. He had multiple-odd, multiple-coin bingo pinball machines, flipper pinball machines, music machines, shuffle alleys and gun machines. The equipment was placed in locations such as bars and restaurants. The proceeds from each machine, after deduction of expenses claimed by the location owner in connection with the machine, were divided equally between the location owner and appellant.

The gross income reported by appellant was the total of the amounts retained by him from locations. Deductions were taken for depreciation, cost of 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 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 appellant 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. 201497, 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 the 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.

The testimony of appellant and persons connected with three locations indicates that it was the general practice to pay cash to players of appellant's multiple-odd, multiple-coin bingo pinball machines for free games not played off, Accordingly, this 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 was paid to winning players. However, early in 1954 the City of Sacramento enacted an ordinance prohibiting the operation of multiple-coin pinball machines and appellant testified that he had multiple-odd, multiple-coin bingo pinball machines only until early in February of 1954 with the last collection on those machines being made the first week in that month. Respondent's auditor interviewed appellant during March of 1954 and he testified that no multiple-coin pinball machines belonging to appellant were then out on location. We conclude that the illegality ceased by February 7, 1954, and that respondent was correct in applying section 17359 during the period from May 3, 1951, to February 7, 1954, only.

Appellant George Perea operated the entire business by himself, He made collections, repaired equipment and solicited new locations. We thus find that there was a substantial connection between the illegal activity of operating multiple-odd, multiple-coin bingo pinball machines and the other aspects of the business. Therefore, respondent was correct in disallowing all deductions for expenses of the entire business for the period from May 3, 1951, to February 7, 1954.

Based on an estimate given by appellant, respondent determined that one-half of appellant's recorded income was derived from multiple-odd, multiple-coin bingo pinball games. There were not complete records of amounts paid to winning players on the multiple-odd, multiple-coin bingo pinball machines and respondent estimated these unrecorded amounts as equal to 50 percent of the total amounts deposited in such machines. Respondent's auditor testified that the 50 percent payout estimate was based on investigations of other pinball operations in the Sacramento area. At the hearing before us appellant estimated the payouts to be about 20 percent of the proceeds in the

machines. A manager at one of the locations having several of appellant's machines, including at least one multiple-odd, multiple-coin bingo pinball machine, testified that in his estimation such payouts averaged from 20 to 40 percent,

As we held in Hall, supra, respondent's computation of gross income is presumptively correct. Nevertheless, on the evidence before us, we conclude that the payout figure should be reduced to 30 percent.

Our conclusion that section 17359 is not applicable after February 7, 1951 necessitates a determination of the gross income and expenses for the early part of 1954. Appellant's records disclose that he had a gross income of $14,043.75 for 1954 with $2,669 of this being attributable to pinball machines. In addition, appellant's testimony indicates that during 1954 his pinball machines were predominantly the multiple-odd bingo type. We conclude that $2,000 of the recorded pinball income was attributable to the bingo pinball machines. We further conclude that 20 percent of appellant's recorded expenses during 1954 arose during the existence of the illegality and are therefore to be disallowed as deductions.

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 185% of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of George and Doris Perea to proposed assessments of additional personal income tax in the amounts of $714.86, $1,831.45, $4,077.48 and $1,116. for the years 1951, 1952, 1953 and 1954, 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 the disallowance of expenses for 1954 is to be limited 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 7th day of May, 1963, by the State Board of Equalization,

Paul R. Leake, Chairman
Geo. R. Reilly, Member
Richard Nevins, Member
, Member
, Member

ATTEST: Dixwell L. Pierce, Secretary