

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
BARNIE L. AND JANE SEABOURN and)
ROY E. SMITH)

Appearances:

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

For Respondent: A. Ben Jacobson, Associate Tax 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 **Barnie L. and Jane Seabourn** in the amounts of \$214.25, \$251.05, \$823.10, \$810.52 and \$1,284.79 for the years 1951, 1952, 1953, 1954 and 1955, respectively, and against **Roy E. Smith** in the amounts of \$251.74, \$452.11, \$1,539.54, \$1,460.64 and \$2,239.24 for the years 1951, 1952, 1953, 1954 and 1955, respectively.

Barnie L. Seabourn and **Roy E. Smith** were partners in the **Madera Amusement Company** which operated a coin machine business in the **Madera area**. The partnership owned music machines, flipper pinball machines and some miscellaneous amusement machines throughout the years under appeal. It also owned multiple-odd binpo pinball machines beginning early in 1953 and cigarette vending machines beginning late in 1954. The equipment was placed in about 44 locations such as bars and restaurants. The proceeds from each machine except cigarette machines, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between the partnership and the location owner. With respect to cigarette machines, the partnership paid the location owners 2 cents per package sold,,

The gross income reported in tax returns was, except as to cigarette vending machines, the total of amounts retained by the partnership from locations. The gross income reported by the partnership as to cigarette vending machines was the total of the coins deposited in the machines less the cost of the cigarettes. Deductions were taken for depreciation, cost of phonograph records,

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salaries and other business expenses.

Respondent determined that the partnership was renting space in the locations where its machines were placed and that all the coins deposited in the machines, less the cost of the cigarettes, 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 the partnership and each location owner were, except as to cigarette vending machines, 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 the machines is, accordingly, applicable here.

The evidence indicates that the operating arrangements between the partnership and each location owner as to cigarette vending machines were the same as those considered by us in Appeal of Carl P. and Rowena Reinert, Cal. St. Bd. of Equal., March 22, 1962, CCH Cal. Tax Rep. Par. 201-913, 3 P-H State & Local Tax Serv. Cal. Par. 58232. Our conclusion in Reinert that the machine owner rented space in the locations for his cigarette vending machines is applicable here. Therefore, the machine owner's gross income from such machines was the entire amount of coins deposited therein less the cost of the cigarettes.

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 evidence indicates that the bingo pinball machines were first owned and operated by the partnership early in 1953 and that no cash payouts to winning players were made before that

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time. We conclude that there were no illegal activities for the years 1951 and 1952. Therefore, the action of Respondent with respect to those years will be reversed. The following discussion relates only to the years after 1952.

Two location owners who had bingo pinball machines from the partnership testified that they paid cash to players for unplayed free games. Appellant Roy E. Smith testified that he was under the impression that part of the amounts claimed as expenses by location owners were for payouts to players for unplayed free games. An employee of the partnership and Appellant Roy E. Smith testified that machines had been drilled. This permits the wrongful manipulation of the mechanism by the insertion of a wire or other object, a form of cheating which would be unlikely in the absence of payouts for unplayed free games. From the evidence before us we conclude that it was the general practice to make cash payouts to players of bingo pinball machines for free games not played off. Accordingly, this phase of the partnership 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 with respect to the years after 1952.

The evidence indicates that the partnership conducted a highly integrated coin machine business with the repairman servicing all types of machines and with the collector collecting from all types of equipment. We find that there was a substantial connection between the illegal activity of operating bingo pinball machines and the legal activity of operating music machines, amusement machines and vending machines. Respondent was therefore correct in disallowing the expenses of the entire business for the years 1953, 1954 and 1955.

There were not complete records of amounts paid to winning players on the bingo pinball machines and Respondent estimated these unrecorded amounts as equal to 50 percent of the total amount deposited in such machines. Respondent's auditor testified that he relied on the estimate given to him in 1956 by Appellant Roy E. Smith in setting up the 50 percent payout figure. At the hearing of this matter, a location owner, an employee of the partnership and Appellants Roy E. Smith and Barnie L. Seabourn, estimated that on the average cash payouts equalled 30 percent of the coins deposited in the bingo pinball machines.

Recognizing that respondent's computation of gross income carries a presumption of correctness, we nevertheless conclude that the payout estimate with respect to bingo pinball machines should be reduced to 40 percent.

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In connection with the computation of the unrecorded payouts it was necessary for Respondent's auditor to estimate the percentage of the partnership's, recorded gross income arising from the bingo pinball machines. Although the records of the partnership segregated the receipts of the **cigarette** vending machines all other coin machine revenue was lumped together. The auditor estimated that 60 percent of the total game and amusement income was attributable to bingo pinball machines during 1953, 1954 and 1955.

During an interview with Respondent's auditor in 1956 Appellant Roy E. Smith estimated that the bingo pinball income represented 30 percent of the total income for all types of game and amusement machines. At the hearing of this matter, Appellant Roy E. Smith guessed the same to have been "probably 20 percent" and Appellant **Barnie L. Seabourn** estimated it at the same percentage. Appellants and one of their employees testified that there were about eight bingo pinball machines out on location. Appellant Roy E. Smith testified that the number of music machines increased through the years and that the partnership may have had as many as 70 music machines toward the end of the period in question.

Respondent's auditor compiled a list of 44 locations where the partnership had its machines during 1955 and we believe it to be unlikely that more than one music machine would ever be placed at a single location. Consequently, it would seem that the partnership had no more than 44 music machines out on location. The evidence indicates that the income from machines almost doubled in 1953 with the acquisition of bingo pinball machines. Under the facts presented we believe that the percentage of the recorded income from all game and amusement machines attributable to bingo pinball machines was 40 percent.

At the hearing of this matter it was disclosed that Respondent had disallowed the depreciation expense erroneously claimed in the partnership returns relative to taxicabs which were individually owned by Appellants and rented to their wholly owned corporation. There is no evidence indicating that the taxicabs were associated or connected with illegal activities. Consequently, the depreciation expense attributable to the taxicabs was clearly deductible by the Appellants in their individual returns.

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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 Bernie L. and Jane Seabourn in the amounts of \$214.25 and \$251.05 for the years 1951 and 1952, respectively, and against Roy E. Smith in the amounts of \$251.74 and \$452.11 for the years 1951 and 1952, respectively, be reversed.

It is further ordered that the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax against Bernie L. and Jane Seabourn in the amounts of \$823.10, \$810.52 and \$1,284.79 for the years 1953, 1954 and 1955, respectively, and against Roy E. Smith in the amounts of \$1,539.54, \$1,460.64 and \$2,239.X+ for the years 1953, 1954 and 1955, respectively, be modified in that the gross income is to be recomputed and the taxicab depreciation expense allowed 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 11th day of July, 1963,
by the State Board of Equalization.

John W. Lynch, Chairman
Geo. R. Reilly, Member
Richard Nevins, Member
_____, Member
_____, Member

ATTEST: H. F. Freeman, Secretary