*63-SBE-115*

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of

ROBERT V. AND PAULINE PATTON

Appearances:

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

For Respondent: F. Edward Caine, Senior 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 Robert V. and Pauline Patton to proposed assessments of additional personal income tax in the amounts of $899.22, $2,735.93, $5,657.97 and $5,590.69 for the years 1952, 1953, 1954 and 1955, respectively.

Beginning in July of 1952 Appellant Robert V. Patton (hereinafter called Appellant) conducted a coin machine business in the counties of Fresno, Kings and Tulare. Appellant owned mostly music machines, but he also owned multiple-odd bingo pinball machines, flipper pinball machines, cigarette vending machines and some miscellaneous amusement machines. The equipment was placed in various locations such as bars and restaurants. The proceeds from each machine on the coin machine route except cigarette machines, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between Appellant and the location owner, No detailed information was introduced with respect to the operation of the cigarette machines and so far as we can ascertain, the gross income therefrom is not in issue.

The gross income reported in tax returns was the total of amounts retained by Appellant from locations, Deductions were taken for depreciation, cost of phonograph records, salaries 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, except the cost of cigarettes, 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, except as to the cigarette 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 a joint venture in the operation of these machines is, accordingly, applicable here. Thus, only one-half of the amounts deposited in the machines operated under these arrangements was includible in Appellant's gross income.

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.

At the hearing of this matter, a location owner who had two of Appellant's bingo pinball machines during 1955 testified that he paid cash to players for unplayed free games. A person employed as a collector and repairman by Appellant during 1954 and 1955 testified it was common knowledge that the location owners were making cash payouts. Appellant denied having actual knowledge but admitted that it was common knowledge that the location owners were making cash payouts for free games. Appellant also testified that probably all of his bingo pinball machines had been drilled. This permits the wrongful manipulation of the mechanism by the insertion of a wire or other object to register free games, a form of cheating which would be unlikely in the absence of cash payouts. Respondent's auditor testified that during an interview in 1956 Appellant admitted that payouts had been made on his machines.

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 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. Respondent was therefore correct in applying Section 17297.

There were no complete records of amounts paid to winning players on the bingo pinball machines and Respondent estimated these unrecorded amounts as equal to 44 percent of the total amount deposited in such machines. Respondent's auditor testified that during an interview in 1956 Appellant agreed to the 44 percent payout figure. A location owner testified that on many occasions the expenses were greater than the amount in the machine and he estimated payouts at 30 to 40 percent. A person employed as a collector and repairman by Appellant during 1954 and 1955 estimated payouts at possibly 20 to 30 percent, but qualified his estimate as a "wild guess."

As we held in Hall, supra, Respondent's computation of gross income is presumptively correct. We believe that Respondent's estimate is reasonable under the circumstances and we, therefore, sustain the 44 percent estimate.

In connection with the computation of the unrecorded payouts, it was necessary for Respondent's auditor to estimate the percentage of Appellant's recorded gross income arising from the bingo pinball machines since the records did not segregate such receipts. Using the ratio which the number of bingo pinball machines bore to the total number of coin machines, Respondent's auditor estimated that 10 percent of Appellant's reported income in 1952, 20 percent in 1953, 45 percent in 1954 and 40 percent in 1955 was attributable to the bingo pinball machines. In making his estimates the auditor relied on information given to him by Appellant with respect to the number of the various types of machines owned during each of the respective years under appeal. At the hearing, photocopies of work papers compiled by Appellant's accountant concerning the inventory of equipment for 1952, 1954 and 1955, respectively, were introduced as evidence. In view of the relative number of bingo pinball machines evidenced by these work papers and the superior earning power of such machines, which we have recognized in other cases of this kind, it appears that if the estimates of Respondent's auditor are in error, they are probably too low rather than too high. Consequently, we shall not disturb them.

Appellant and his employee collected from and serviced all types of machines. 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, flipper pinball machines, miscellaneous amusement machines and vending machines for the years 1953 through 1955. Respondent was therefore correct in disallowing the expenses of the entire business for those years.

For the year 1952, however, the evidence indicates that Appellant had not more than five bingo pinball machines out of a total of 77 machines. There is no evidence that these pinball

machines were in the same locations with other machines. Considering the small proportion of the bingo machines, we are of the opinion that, within the intent of the applicable statute, the overall operation of the other machines did not promote or further, and was not associated or connected with the illegal activity. We conclude that in addition to the disallowance of deductions for payouts for free games, only 10 percent of the expenses for 1952 should be disallowed, based upon the percentage of the reported income from the bingo pinball machines as found by Respondent.

## 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 ORLERED, 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 Robert V. and Pauline Patton to proposed assessments of additional personal income tax in the amounts of $899.22, $2,735.93, $5,657.97 and $5,590.69 for the years 1952, 1953, 1954 and 1955, respectively, be modified in that the gross income and disallowance of expenses are 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 1st day of October, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Paul R. Leake, Member

Geo. R. Reilly, Member

Richard Nevins, Member

_____, Member

ATTEST: H.F. Freeman, Executive Secretary