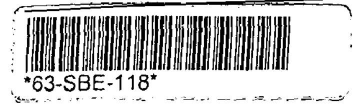

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

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Appeals and Review Office
FRANCHISE TAX BOARD

In the Matter of the Appeals of)
)
ARDY T. THOMPSON AND HELEN THOMPSON)
and HARRY G. AND AGNES THOMPSON)

Appearances:

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

For Respondent: F. Edward Caine, Senior 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 Ardy T. and Helen Thompson in the amounts of $482.44, $7,355.68, $17,257.05 and $906.23 for the years 1951, 1352, 1953 and 1954, respectively, and against Harry G. and Agnes Thompson in the amounts of $2,717.69 and $1,303.60 for the years 1951 and 1952, respectively.

Appellants Ardy and Harry Thompson (hereinafter called Appellants) are father and son. Each conducted a coin machine business in the Sacramento area during 1951 and part of 1952. On June 30, 1952, Appellant Ardy Thompson took over his son's business and combined the two businesses. Harry thereafter continued in the business as a salaried employee of his father. Before that, the businesses were separate, although they shared a shop and both used the same mechanic to make repairs. In addition to flipper pinball machines, shuffle bowlers, music machines, and some miscellaneous amusement machines, both Appellants owned a proportionately large number of multiple-odd bingo pinball machines.

The equipment was placed in various locations, such as bars and restaurants. The proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between the machine owner and the location owner.

The gross income reported in Appellants' tax returns was the total amount retained from locations. Deductions were taken for depreciation and various other business expenses. Respondent determined that Appellants in the years in question were renting

space from the owners of the locations in which the machines were placed, and that consequently all the coins deposited in the machines constituted gross income to them. 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 the individual Appellants 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 is, accordingly, applicable here. Consequently, only one-half of the amounts deposited in the machines operated under these arrangements was includible in the gross income derived from Appellants' respective operations.

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,

Here, the evidence clearly indicates that it was the general practice to pay cash to players of the bingo pinball machines for unplayed free games. Accordingly, the bingo pinball phase of Appellants' businesses 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, the evidence indicates that Appellant Ardy Thompson sold all of his bingo pinball machines by February 15, 1954. We conclude that the illegality ceased by February 15, 1954, and that Respondent was correct in applying Section 17359 during the period from May 3, 1951, to February 15, 1954, only.

All of the equipment owned by Appellants was usually serviced by Appellants! mechanic. Appellants personally collected

from all types of machines and often serviced them themselves, Accordingly, there was a substantial connection between the illegal activity of operating multiple-odd bingo pinball machines and the legal operation of music machines and miscellaneous amusement machines and Respondent was correct in disallowing all the expenses of the businesses for the period from May 3, 1951, to February 15, 1954.

The evidence also clearly indicates that it was the general practice to give prizes to winning players of the shuffle bowlers. There were no records of amounts paid to winning players on Appellants' bingo pinball machines or the cost of prizes given relative to the shuffle bowlers and Respondent estimated these unrecorded amounts as equal to 50 percent of the total amounts deposited in those machines.

With respect to the bingo pinball machines of Appellants, Respondent's auditor testified that the 50 percent payout figure was based upon an estimate of 40 - 60 percent given to him by a location owner when interviewed at the time of the audit.

At the hearing in this matter, a location owner having one or two of Appellant Harry Thompson's bingo pinball machines estimated that cash payouts to winning players for unplayed free games constituted from 10 to 20 percent of the proceeds in the machines. An employee at a location having two or three of Appellant Ardy Thompson's bingo pinball machines also estimated cash payouts at from 10 to 20 percent. Appellant Harry Thompson estimated that cash payouts on his bingo pinball machines ran from 15 to 20 percent while Appellant Ardy Thomspon estimated that expenses claimed by locations having his bingo pinball machines ran about 20 percent. With respect to the shuffle bowlers, no evidence was submitted by Appellants at the hearing in regard to the cost of the prizes.

Based upon our experience in many other cases of this kind, the payout estimates at this hearing were unusually low. Being mindful that these estimates were made long after the years in which the payouts occurred and that Respondent's computation of gross income is presumptively correct, we believe the payout figure relative to both bingo pinball machines and shuffle bowlers should be reduced to 30 percent with respect to the businesses of both Appellants.

In connection with the computation of the unrecorded payouts, it was necessary for Respondent's auditor to estimate the percentage of Appellants' recorded gross incomes arising from bingo pinball machines and shuffle bowlers since all machine income was lumped together. On the basis of an interview with Appellants, Respondent's auditor attributed 5/6 (83 percent) of the reported machine income of each Appellant to machines as to which payouts

and prizes were given. At the hearing, Appellants estimated that during each of the years in question about 70 percent of their respective reported machine incomes was attributable to bingo pinball machines. Both Appellants had a considerable number of shuffle bowlers and Appellant Harry Thompson estimated that about 10 percent of his reported machine income was attributable to such machines. The evidence before us, therefore, appears to confirm the validity and reasonableness of Respondent's allocation and we can see no reason to disturb it.

Our conclusion that Section 17359 is not applicable after February 15, 1954, necessitates a determination of expenses for the early part of 1954. Appellant Ardy Thompson filed a schedule showing a breakdown of expenses for the year 1954 which indicated that only $5,752.29 out of $21,082.42 for the entire year was attributable to the period extending from January 1 to February 15, 1954. There being no other evidence in this regard, we conclude that $5,752.29 represents the disallowance expenses occurring prior to February 15, 1954, and that the remaining expenses in the amount of $15,330.13 for the year should be allowed.

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 Ardy T. and Helen Thompson in the amounts of $482.44, $7,355.68, $17,257.05 and $906.23 for the years 1951, 1952, 1953 and 1954, respectively, and against Harry G. and Agnes Thompson in the amounts of $2,717.69 and $1,303.60 for the years 1951 and 1952, respectively, be modified in that the gross income for all of the years and the disallowance

of expenses for 1954 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 Pasadena, California, this 21st day of October, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

_______________, Member

ATTEST: H. F. Freeman, Executive Secretary