BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SAM AND SONIA TESSLER)

Appearances:

For Appellants: Dale I. Stoops., Attorney at Law

For Respondent: Israel Rogers, Associate Tax Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protest to proposed assessments of additional personal income tax as follows:

		Additional Tax	Fraud Penalty	Delinquency Penalty	Total
1951	Sam Tessler	$ 4,693.64	$2,346.82	$1,173.41	$ 8,213.87
1951	Sonia Tessler	4,693.64	2,346.82	1,173.41	8,213.87
1952	Sam Tessler	10,682.72			10,682.72
1952	Sonia Tessler	10,682.72			10,682.72
1953	Sam and Sonia Tessler	15,031.50			15,031.50

During the years in question, appellant Sam Tessler (hereinafter referred to as appellant) operated a coin machine business in Oakland. The business involved music machines which appellant operated under his own name and bingo pinball machines, which were operated under the name of Oakland Automatic Sales Company. 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 appellant and the location owner.

The gross income reported on tax returns was the total of amounts retained from locations. Deductions were taken for depreciation, 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. 201-197, 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. Thus, only one-half of the amounts deposited in the machines operated under the 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, P-H State & Local Tax Ser. 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, appellants introduced a letter from the District Attorney of Alameda County dated December 8, 1952, wherein appellant was informed that certain multiple-coin bingo pinball machines were illegal and appellant testified that he was allowed to convert his multiple-coin bingo pinball machines to single-coin machines and thereby salvage his investment by subsequently conducting his business in a style similar to that allowed in San Francisco. Nevertheless, in Advance Automatic Sales Co., supra, we found bingo pinball machines similar to appellant's converted models to be predominantly games of chance with the ownership and possession of such machines being illegal.

A location owner and one of appellant's collectors testified that cash was paid to players of appellant's bingo pinball machines for unplayed free games. Another employee of appellant estimated that expenses claimed by location owners averaged from 25 to 30 percent of the total amount deposited in the machine and he testified that part of the expenses claimed could have included cash payouts. Several collection slips introduced into evidence indicate that the expenses claimed by the location owners were substantial. In regard to these expenses appellant was asked:

> Q Well, was it for payouts to players for free games'?
>
> A. Well, the general nature of the business, anybody we did business with, his competitor did business certain ways and he was going to meet the competition, and we being in the business had to accept his style of doing business, because his competitors were forcing a certain style.
>
> Q Well, were the competitors making payouts?
>
> A I never left the office. I used to take one days off, and I played golf, believe me.

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Based on the evidence before us, we find that it was the general. pract ice to pay cash to. player-s of the bingo pi nbal 1 machines for unpl ayed free games. 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 17359.

It appears that most 1 ocat ions had both p inball machines and music machines. Although each collector handled only music machines or pinball machines, not both types, the repairmen serviced all types of machines, the business activities relative to all types of machines were conducted from one office and, in sol iciting new locations, appellant's employees would try to place both pinball machines and music machines in the same location. We believe that there was therefore a substantial connection between the illegal operation of the bingo pinball machines and the legal operation of mus ic machines in Oakl and and respondent was correct in not allowing any business expenses relative to Oakl and Automatic Sal es Company and appell ant 's music machines in Oakland.

There were na records of amounts paid to winning players of the bingo pinball machines, and respondent computed these unrecorded amounts as equal to 43 percent of the coins deposited in the machines. Th is percentage was arrived at by averaging about 12 collection slips made out with respect to two locst ions. At the hearing of this matter, appellant expressed the belief that the 43 percent payout figure was excessive and he urged that the sampling did not reflect an average because respondent used collection slips from one location which claimed higher than average expenses. Some support for appellant's contention comes from the fact that the collection slips from the other location indicate an average payout of 31 percent. Appel l ant ventured an estimate that expenses averaged from 10 to 20 percent. One of appel lant's col 1 ectors estimated that the expenses averaged from 25 to 30 percent while a location owner estimated payouts at about 25%. Considering al 1 the ev idence, we conclude that the payout figure should be reduced to 30 per cent.

With respect to 1952, appellant claimed a bad debt deduction in the amount of $11,421.56, cost of sales 1 abel led as "Various" in the amount of $12,206.07, and expenses also depicted as "Various" in the amount of $22,908.75. With respect to 1953, appell ant cl aimed "Various" expenses total l ing $11,994.98. Respondent diallowed these deductions in the bel ief that they were connected with the Oakland pinball and music machine activities. However, appellant and his accountant established at the bearing in this matter that none of' the aforementioned deductions related to the Oakland pinball and music machine activities, but to various other enterprises of appellant, including a bowl ing alley, an apartment house and a restaurant. We conclude, accordingly, that these deductions should be allowed.

Respondent has stipulated to removal of the fraud penalty for 1951 and appellant has not contested the imposit ion or' the penalty for failure to file 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 as follows:

		Additional Tax	Fraud Penalty	Delinquency Penalty	Total
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be modified in that in accordance with the opinion of the board the gross income is to be recomputed, certain expenses are to be allowed and the fraud penalty is to be removed. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 10th day of December, 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 Secretary