BEFORE THE STATE BOARD OF EQUAL IZAT I ON

OF THE STATE OF CAL IFORNIA

In the Matter of the Appeals of)
)
CLARENCE T. AND THERESA WILL IAMS)

Appearances:

For Appel 1 ants: Archibald M. Mull, Jr., Attorney at Law

For Respondent: F. Edward Caine, Sen i or 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 and penalties in the total amounts of $1,249.46, $4,536.28 and $7,982.02 for the years 1951, 1952 and 1953, and to a proposed assessment of additional personal income tax in the amount of $583.90 for the year 1954.

During the years 1951, 1952 and 1953, appellant Clarence T. Williams (hereinafter called sppellant) conducted a coin machine business within the City of Sacramento as a sole prbprietor under the name of Ajax Pinball Company. On January 1, 1954, Ajax Pinball Company (hereinafter called Ajax) became a partnership with appellant and Frank W. Bartley as equal partners. Ajax owned multiple-odd, multiple-coin bingo pinball machines and some miscellaneous amusement machines. The equipment was placed in bars, restaurants and other locations, and the proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equal ly between Ajax and the location owner.

The gross income reported in tax returns was the total of the amounts retained from locat ions. Deductions were taken for depreciation and other business expenses.

Respondent determined that Ajax was renting space in the locations where its machines were placed and that all the coins deposited in the machines constituted gross income to it. Respondent al so d i sal 1 owed al 1 expenses pursuant to section 17359 (now 17297) of the Revenue and Taxation Code which read:

> In computing net income, no deduct ions shall be al lowed to any taxpayer on any of his gross income derived from illegal activites as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of Cal ifornia; nor shall tiny deduct ions be al 1 owed. 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 Ajax 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 CCW Cal. Tax Cas. Par. 201-197, 3 P-H State & Local Tax Serv. Cal. Par. 58145. Our conclusion in Mall that the machine owner and each location owner were engaged in a joint venture in the operation of the machine is, accordingly, appl icable here.

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In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, CCM 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, two location owners denied making payouts although respondent's auditor testified that both had admitted making payouts when interviewed during 1954. A person employed by appellant to do the collecting and to run the business testified that he reimbursed the location owners for whatever expenses they claimed with respect to the bingo pinball machines and, although disclaiming actual knowledge, he testified that. he "figured" that, as a general practice, par% of the expenses claimed by the locations constituted amounts paid to winning players on Ajax's bingo pinball machines. Appellant also disclaimed having actual know": ledge of cash payouts for unplayed free games but admitted that the amount of expenses claimed by the location owners was in excess of amounts reasonable, attributable to refunds for machine malfunctions and that part of the expenses claimed by location owners could have constituted cash payouts. Both appellant and his collector testified that the expenses claimed by the location owners equalled approximately a third of the gross proceeds of the machines;.

We conclude that 6% was the general practice to pay cash for unplayed free games to players of Ajax's bingo pinball machines- Accordingly, this phase of the 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, on March 25, 1954, the City of Sacramento enacted an ordinance, designated as an emergency measure to take effect immediately, prohibiting the operation of multiple-coin pinball machines and appellant testified that Ajax had multiple-odd, multiple-coin bingo pinball machines only until early in 1954. In the absence of the exact date when the bingo pinball machines were sold, we conclude that the illegality ceased by March 25, 1954, and that respondent was correct in applying section 17359 during the period from May 3, 1951, to March 25, 1954, only.

Appellant's employee operated the entire business. He made collections and did all the tasks encompassed by the business except the repair work which was done by another. 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 March 25, 1954.

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 investigation of other pinball operations in the Sacramento area. One location owner involved in appellant's operation had given the auditor a payout estimate of 25 to 30 percent. At the hearing befoue us, the person employed by appellant to run the route

estimated the payouts to be about 33-1/3 percent of the proceeds in the machines and appellant testified that he always tried to operate the equipment so that he wound up with a third of the gross. On the evidence before us, we conclude that the payout figure should be reduced to 33-1/3 percent.

In connection with the computation of unrecorded payouts, respondent determined that all of Ajax's recorded income was derived from multiple-odd, multiple-coin bingo pinball games. However, appellant testified that such games were predominant in the business during 1952, 1953 and early 1954 but not during 195%, and he estimated that the bingo machines produced less than 40 percent of his income during 1951, about $0 percent during 1953 and early 1954, and somewhere in between during 1952. Appellant estimated that he had about 20 multiple-odd, multiple-coin bingo machines during 1952 and he indicated that more machines of that type were acquired during 1953. In a schedule dated January 12, 195.3, requested by the assessor-collector inconnection with the renewal of appellant's City of Sacramento business licenses for amusement machines, appellant indicated that his entire business consisted of 40 five-ball machines and one shuffle game. Appellant's employee ventured an estimate that there were about five miscellaneous games owned and operated in addition to the bingo pinball machines;,

Considering the evidence before us, we conclude that the receipts from bingo pinball machines constituted 40 percent of the total receipts from the various machines in 1951, 70 percent in 1952 and 90 percent in 1953. With respect to 1954 when the business was operated as a partnership, the information return filed for the year reported total receipts of $12,720.32 and a net loss from the business. It should be noted that appellant reported total receipts from the business in the amount of $40,380.09 for 1953. Appellant indicated in his testimony before us that various revised versions brought in to replace the multiple-odd, multiple-coin bingo pinball machines early in 195% received very poor response from the customers.,

We conclude that 80 percent of appellant's partnership share of the total 1954 machine receipts reported by the partnership constituted income attributable to the multiple-odd, multiple-coin bingo pinball machines during the period extending from January 1, 1954, to March 25, 1954.

Our conclusion that the illegality ceased in March 1954 necessitates an allocation of the reported business expenses to be disallowed as deductions. Since the business was most active in the first quarter of 1954, we believe that half of the business expenses for the year are properly attributable to the first quarter.

With respect to the penalties imposed by respondent under section 18684 of the Revenue and Taxation Code relative to the years-1951, 1952 and 1953, respondent has stipulated to their removal from the assessments.

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,

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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 the protests of Clarence T. and Theresa Williams to proposed Assessments of additional personal income tax and penalties in the total amounts of $1,249.46, $4,536.28 and $7,982.02 for the years. 1951, 1952 and 1953, and to a proposed assessment of additional personal income tax in the amount of $583.90 for the year 1954 be, and the same is hereby modified in that the gross income is to be recomputed in accordance with the opinion of the board, the disallowance of expenses for 1954 is to be limited in accordance with the opinion of the board, and the penalties are to be removed in accordance with the stipulation noted in the opinion of the board. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Pasadena, California, this 11th day of December, 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