



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
DAVID D. AND ALICE L. MARGASON)

Appearances:

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

For Respondent: Burl D. Lack, Chief 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 David D. and Alice L. Margason to proposed assessments of additional personal income tax in the amounts of \$2,344.55, \$6,310.57, \$4,565.50, and \$6,083.18 for the years 1953, 1954, 1956, and 1957, respectively.

During the years in question, appellant David D. Margason (hereinafter referred to as appellant) operated a coin machine business in the San Jose area which was known as Coinomatic Service. Appellant had multiple-odd bingo pinball machines and some miscellaneous amusement machines,, In addition, appellant had cigarette vending machines and music machines-in 1956 and 1957. The equipment was placed in various 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 usually divided equally between appellant and the location owner, No detailed information was introduced with respect to the operation of the cigarette machines and apparently 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 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 (section 17359 prior to June 6, 1955) of the Revenue and Taxation Code, which reads:

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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 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 the machines is, accordingly, applicable here.

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 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 that they paid cash to tinning players of appellant's bingo pinball machines for unplayed free games and a third location owner testified that he made such payouts only for a month or two. Respondent's auditor, however, testified that all three of those witnesses told him in 1958 that payouts were made for free games and that the third witness indicated at that time that he made payouts starting in 1955 when the bingo machines were first placed in his establishment and continuing through the rest of the years involved. A fourth location owner testified that payouts were made occasionally and another location owner, who at first stated positively that he had no bingo machines in his place during the period in question, admitted under further questioning that he did have them commencing in 1956 and that there could have been some payouts for free games,

Appellant testified that some of his machines had been seized by law enforcement officers and that on the advice of his attorney he did not attempt to recover them; that the locations were reimbursed for any expenses claimed; that the expenses claimed sometimes exceeded the amount in the machine; and he estimated that the expenses averaged around 20 or 25 percent of the total amount deposited in the machines.

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We conclude that it was a common practice to pay cash for unplayed free games to players of appellant's bingo pinball machines. 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.

Appellant collected from all types of machines and his employee serviced all the machines. Appellant's coin machine business was highly integrated and we find a substantial connection between the illegal activity of operating bingo pinball machines and the legal activity of operating music machines, vending machines and miscellaneous amusement machines. Respondent was, therefore, correct in disallowing the expenses of the entire **business**.

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 during interviews in 1958 one location owner estimated payouts at 60 percent while another thought 50 percent was about right. At the hearing, two location owners ventured estimates of 20 percent and another thought payouts amounted to about 25 percent. As indicated previously, appellant estimated the expenses at 20 to 25 percent,

As we held in Hall, supra, respondent's computation of gross income carries a presumption of correctness. Considering all the evidence, however, together with the time between the events and the estimates given and the possibility of bias in the estimate of appellant, we conclude that the payout figure be reduced to 40 percent.

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. Appellant's records segregated the receipts from cigarette machines for the year 1957 but otherwise there was no segregation of income from the various types of equipment. The auditor estimated that about 10 percent of the total receipts in 1956 and 1957 was attributable to music machines; reconstructed the cigarette receipts for 1956 on the basis that the ratio of receipts to recorded purchases for that year was the same as the known ratio for 1957; and concluded that the remaining reported income in 1956 and 1957 and the total reported income in 1953 and 1954 was attributable to bingo pinball machines. Appellant testified that he also had some miscellaneous amusement machines, but he has not established that the income therefrom was significant. Under the circumstances, we have no reason to disturb respondent's allocation.

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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 the protest of David D. and Alice L. Margason to proposed assessments of additional personal income tax in the amounts of \$2,344.55, \$6,310.57, \$4,565.50, and \$6,083.18 for the years 1953, 1954, 1956, and 1957, respectively, be modified in that the gross income is 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 8th day of January, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman

John W. Lynch, Member

Geo. R. Reilly, Member

Richard Nevins, Member

_____, Member

ATTEST: H. F. Freeman, Secretary