

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of )  
 )  
H. W. AND EVELYN BAILEY, )  
ANGELO T. AND CLARICE LAZZARESCHI, )  
and LEONARD J. AND CLARA HICKMAN )

Appearances:

For Appellants H. W. and Evelyn Bailey and Angelo T. and Clarice Laszareschi: Anthony J. Chargin, Attorney at Law

For Appellants Leonard J. and Clara Hickman: Archibald M. Mull, Jr., Attorney at Law

For Respondent: Wilbur F. Lavelle, Associate Tax 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 as follows:

<u>Appellant</u>	<u>Year Ended</u>	<u>Amount</u>
H. W. Bailey	1/1/51-9/30/51	\$3,200.89
	9/30/52	7,101.17
Evelyn Bailey	1/1/51-9/30/51	3,200.89
	9/30/52	7,101.17
H. W. Bailey and Evelyn Bailey	9/30/53	24,226.92
	9/30/54	6,013.82
	9/30/55	11,425.12
Leonard J. Hickman and Clara Hickman	1952	4,971.96
	1953	1,209.07
	1954	187.70
	1955	4,224.86
Angelo T. Lazzareschi	1/1/51-9/30/51	3,206.77
	9/30/52	7,193.30
Clarice Lazzareschi	1/1/51-9/30/51	3,206.77
	9/30/52	7,193.30
Angelo T. Lazzareschi and Clarice Lazzareschi	9/30/53	23,145.89
	9/30/54	5,728.98
	9/30/55	11,310.64

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During the years in question, appellants H. W. Bailey and Angelo T. Lazzareschi were partners in Redwing Novelty Company and they were also partners with appellant Leonard J. Hickman in Superior Novelty Company. Redwing Novelty Company owned claw machines which were placed in bars, restaurants and other locations in the Stockton area and Superior Novelty Company had claw machines which were placed in similar locations in the Sacramento area. The proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machines, were divided equally. Each partnership had arrangements under which certain individuals collected from the locations and retained a percentage of the amounts remaining after the locations received their shares. These individuals also "dressed" the claw machines and repaired them. They received  $33\frac{1}{3}$  percent of the amounts they collected from the locations except for one collector who received 40 percent,

The gross income reported in tax returns filed by the partnerships was approximately two-thirds of the amounts taken from the locations by the collectors. Deductions were taken for depreciation and other business expenses.

Respondent determined that both partnerships were renting space in the locations where their claw machines were located and that all the coins deposited in the machines constituted gross income to the partnerships. Respondent also disallowed all expenses 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,

Our decision in the 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, supports the conclusion that each location owner was engaged in a joint venture with some other person in the operation of the claw machines. We must decide, however, whether that other person was one of the respective partnerships or a collector.

Two collectors, one handling claw machines owned by Redwing Novelty Company and the other handling claw machines provided by Superior Novelty Company, testified that the machines were obtained from the respective partnerships under oral rental agreements. However, there is a considerable amount of evidence indicating that the various collectors acted as agents of the two partnerships. The two collectors testified that they reported in income tax returns only the amounts retained by them and not the entire amounts collected from locations, with deductions for the alleged rentals. They also testified that the collection slips had only the names of the respective partnerships; that transportation equipment of the

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respective partnerships was used to transport the claw machines; that they utilized the repair shop facilities of the respective partnerships; and that their agreements with the respective partnerships were for indefinite period of time and thus could be terminated at any time by the partnerships, With respect to one collector, the evidence indicates that most of the service calls went to Redwing Novelty Company, which in turn notified the collector. The other collector testified that calls for repair service came into a telephone exchange used and paid for by Superior Novelty Company, Two location owners testified and both indicated they understood that they were dealing with appellants H. W. Bailey and Leonard Hickman, respectively, as the principals,

The evidence leads us to conclude that the collectors acted as agents of the partnerships and accordingly that the location owners were engaged in joint ventures with Redwing Novelty Company and Superior Novelty Company, respectively. Thus, one-half of the amounts deposited in the machines operated under these arrangements was **includible** in the gross income of Redwing Novelty Company and Superior Novelty Company, **respectively**.

It was the general practice to pay cash to players of the claw machines in redemption of figurines withdrawn by the players from the machines. We have previously held the operation of a claw machine to be illegal where a successful player receives cash or merchandise, (Appeal of Peter and Joy M. Perinati, Cal. St. Bd. of Equal., April 6, 1961, CCH Cal. Tax Rep, Par. 201-733, P-H State & Local Tax Serv. Cal, Par. 58191; Appeal of Edward J. and Sarah Seeman, Cal. St. Bd. of Equal., July 19, 1961, CCH Cal. Tax Rep. Par. 201-825, P-H State & Local Tax Serv. Cal. Par, 58208.) Accordingly, the claw machine business of each partnership was illegal and respondent was, therefore, correct in disallowing all the expenses of the businesses under section 17297.

There were no records of amounts paid to winning players of the claw machines, and respondent estimated these unrecorded amounts as--equal to 80 percent of the total amounts deposited in those machines, Respondent's auditor testified that the 80 percent payout figure was based on an 'estimate given by appellant H. W. Bailey when interviewed in 1956. A collector for Redwing Novelty Company testified that they tried to operate the claw machines "**where** they paid out at least **95 percent.**" A collector for Superior Novelty Company estimated payouts at 90 percent. A location owner having a claw machine from Superior Novelty Company testified that sometimes more was paid out than was taken in,

As we held in Hall, supra, respondent's computation of gross income is presumptively correct, The evidence indicates that respondent's computation was conservative and it will not be disturbed.

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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 protests to proposed assessments of additional personal income tax as follows:

<u>Appellant</u>	<u>Year Ended</u>	<u>Amount</u>
H. W. Bailey	1/1/51-9/30/51	\$ 3,200.89
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	9/30/52	7,193.30
Angelo T. Lazzareschi and Clarice Lazzareschi	9/30/53	23,445.89
	9/30/54	5,728.98
	9/30/55	11,310.64

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 7th day of January, 1964,  
by the State Board of Equalization,

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Paul R. Leake, Chairman

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John W. Lynch, Member

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Geo. R. Reilly, Member

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Richard Mevins, Member

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Member

ATTEST: H. F. Freeman, Secretary