BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
BLANKENSHIP NOVELTY COMPANY)

Appearances:

For Appellant: Richard N. Rapoport
Attorney at Law

For Respondent: A. Ben Jacobson
Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Blankenship Novelty Company against proposed assessments of additional franchise tax in the amounts of $3,394.15, $3,791.21, $4,490.51, and $4,812.95 for the taxable years ended May 31, 1967, 1968, 1969, and 1970, respectively.

Appellant is a California corporation engaged in the business of owning and leasing mechanical and electrical amusement devices. During the years in issue, appellant received income from 142 machines. Of these machines, 128 were bingo pinball machines. Of the 128 bingo pinball machines, 10 were rented to a third party for a rent of $20 each, or $200 per week. The remaining machines were placed at various locations pursuant to agreements between appellant and the owners of the establishments. The operation was typical of coin machine routes. Appellant made the collections and after deducting any expenditures claimed by the location owners the net proceeds were split between appellant and the location owners. Appellant serviced all the machines. The latter were licensed by the Police Department of the City and County of San Francisco under Article 4 of Part III of the San Francisco Municipal Code.

Respondent determined that the gross income from the operation of the bingo pinball machines was derived from illegal activities and came within the provisions of section 24436 of the Revenue and Taxation Code. 1/ In accordance with section 24436 respondent disallowed most of appellant's claimed deductions for business expenses. The amount of the deductions disallowed was determined on the basis of the proportion of the number of illegal machines to legal machines, doubleweighting the illegal machines. This resulted in the disallowance of approximately 96 percent of the claimed expenses. After receiving additional in-formation from appellant, respondent reconsidered the matter and reduced the amount of deductions disallowed to 94. 4 percent of the total deductions claimed.

1/ During the years in issue Revenue and Taxation Code section 24436 provided:

> 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 Chapter 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deduction 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.

Respondent also increased appellant's reported gross income by an amount which respondent estimated was paid out to winning players in consideration for the cancellation of free games. This estimated amount was determined to be 25 percent of the total amount of coins deposited in the machine. In other words, appellant's reported gross income was only 75 percent of respondent's estimate of the total amounts actually deposited in the machines.

Appellant maintains that the bingo pinball machines involved in this matter are games of skill and not games of chance. Therefore, appellant concludes that the machines are not illegal and respondent's disallowance of its claimed deductions was improper. Appellant also points to the absence of any evidence that cash payouts were made and argues that none were ever made. Therefore, it is appellant's position that respondent's redetermination of gross income has no basis in fact.

The first issue for determination is whether respondent properly disallowed appellant's claimed business expense deductions. The chapters of the Penal Code referred to in section 24436 of the Revenue and Taxation Code prohibit various forms of gaming and the possession, ownership, sale, repair, lease, etc., of certain gaming devices. Through the years this board has considered the application of the Revenue and Taxation Code sections 17297 and 24436 in many appeals involving, mainly, multiple coin bingo pinball machines. Some of our opinions contained dicta to the effect that the mere possession of certain coin machines which are predominately games of chance comes within the prohibition of section 17297 or section 24436 and renders one of those sections applicable. However, in every instance the finding of illegality was primarily based upon evidence that cash payouts had been made by the location owners; consequently, we concluded the machines had been used as gambling devices.

Obviously, clear evidence that illegal cash payouts were made supports a finding that the particular machines were gambling devices and that they were the type which are illegal to possess. In the instant case, since there is no evidence of cash payouts, the applicability of section 24436 turns on whether the machines possessed by appellant during the years under appeal

were gambling devices as defined in the referenced chapters of the Penal Code. (Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962; Appeal of Coin Machine Service Co., Cal. St. Bd. of Equal., Oct. 24, 1972.)

Certainly, the harsh results of applying section 24436 are not warranted in the absence of a clear showing of illegality. Absent clear evidence of cash payouts, special emphasis must be placed upon identifying and describing the particular machines. While the instant appeal involves the taxable years ended May 31, 1967, 1968, 1969,and 1970, it was not until early 1975 that one of respondent's employees visited locations having appellant's machines in order to observe and play them. There is no evidence that during the years in issue the machines in question were used as gambling devices through the making of cash payouts to winners of free games. Although the record does contain some evidence that appellant had the same type of machines during the appeal years as it did in 1975, the absence of evidence of cash payouts in the earlier years tends to cast doubt upon whether those machines were in fact games intended for use as gambling devices.

Nothing short of a clear showing of illegality warrants the imposition of section 24436. (Hall v. Franchise Tax Board, 244 Cal. App. 2d 843 [53 Cal. Rptr. 597].) In the instant case we are not convinced that such a showing has been made. Accordingly, we are reversing the action of the respondent in this matter. In view of our determination of this issue, there is no need to consider the propriety of respondent's computation of appellant's gross income.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Blankenship Novelty Company

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Blankenship Novelty Company against proposed assessments of additional franchise tax in the amounts of $3,394. 15, $3,791. 21, $4,490. 51, and $4,812. 95 for the taxable years ended May 31, 1967, 1968, 1969, and 1970, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 8th day of March, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Executive Secretary