61-SBE-088

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
A. D. AND HARRIET WICKSTROM)

Appearances:

For Appellant: Archibald M. Mull, Jr., Attorney at law

For Respondent: Wilbur F. Lavelle, Associate Tax 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 A. D. and Harriet Wickstrom to proposed assessments of additional personal income tax in the amounts of $202.84 and $881.02 for the years 1953 and 1954, respectively.

Appellant A. D. Wickstrom was a partner with Sam Hables in the Acme Music Company. Acme operated a coin machine business in and near Santa Rosa. It owned music machines and multiple-odd bingo pinball machines. The machines were placed in bars and restaurants and the proceeds, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were generally divided equally between the location owner and Acme.

The gross income reported in Acme Music Company's returns was the total of amounts retained by Acme from locations. Deductions were taken for depreciation, cost of phonograph records, salaries and other business expenses.

Respondent determined that Acme was renting space in the locations where its machines were placed and that all the coins deposited in the machines constituted gross income to Acme. 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.

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The evidence indicates that the operating arrangements between Acme 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, 3 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.

As we also held in Hall, if a coin machine is a game of chance and cash is paid to winning players, the operator is engaged in an illegal activity within the meaning of Section 17359. The multiple-odd bingo pinball machines here involved are substantially identical to the machines which we held to be games of chance in Hall.

A location owner testified that he had a pinball machine from Acme, that cash payouts were made to players for free games not played off, that he received the amount of such payouts from the proceeds in the machine and that the balance of the proceeds was divided with Acme. Appellant A. D. Wickstrom testified that he presumed that the expenses claimed by location owners in connection with the operation of pinball machines included cash payouts for free games not played off. In 1956, Respondent's auditor interviewed Wickstrom and was told by Wickstrom that it was the practice of the location owners to make payouts on the pinball machines.

From this evidence we conclude that it was the general practice to make cash payouts to players of these machines for free games not played off. Accordingly, these machines were operated illegally and Respondent was correct in applying Section 17359.

The collector for Acme prepared a collection report at the time of each collection and left a copy with the location owner. The amounts included on the reports were the net proceeds after exclusion of the amounts claimed by the location owners for expenses. The Acme records showed the pinball machine collections separately from the music machine collections. Since there had been substantial deductions from the proceeds of the pinball machines for expenses and these deductions had not been recorded, Respondent made an estimate of the unrecorded amount.

At the time of the audit in 1956, Wickstrom told Respondent's auditor that the payout expense on pinball machines would range between 35% and 40% of the total receipts of the machines and a location owner estimated to Respondent's auditor that the payouts were 60% of the total receipts of the machine. Respondent's computation of the unrecorded gross income on the pinball machines was on the basis that it equalled 50% of the total receipts of the machines.

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Appeal of A. D. and Harriet Wickstrom

At the hearing in this appeal, Wickstrom was asked if he could estimate the average percentage of expenses claimed by location owners and answered, "I couldn't, because I didn't make the collections." At this hearing, the location owner who had given the 60% payout estimate to Respondent's auditor in 1956 estimated that the payouts averaged between 25% and 30% of the total receipts of the machine.

On this state of the record, we will not upset Respondent's 50% payout estimate. It is noted that the statements made to Respondent's auditor in 1956 were made at a time much closer to the events to which they related than was the time of this hearing, which was held in 1961. Therefore, except for the reduction due to our conclusion that Acme and each location owner were engaged in a joint venture, Respondent's computation of gross income is sustained.

Acme Music Company engaged in the coin machine business in 1944. Originally only music machines were handled. As a result of demands from some location owners that Acme also provide pinball machines or remove their music machines, Acme began purchasing pinball machines and placing them on location. The first pinball machine was placed on location in March of 1953.

Respondent considered that the illegal activity began on April 1, 1953, and disallowed deductions for the period from April 1, 1953, through the balance of the fiscal year ended September 30, 1953, and also disallowed deductions for the entire fiscal year ended September 30, 1954. During the period in question, that is, April 1, 1953, to September 30, 1954, Acme had an average of about fifty music machines and about six pinball machines in various locations. The pinball machines were only put in locations where Acme also had music machines.

As noted above, Respondent disallowed the expenses of the entire business. Considering the relatively large number of music machines compared to the number of pinball machines, and the fact that Acme acquired pinball machines only to prevent the loss of music machine locations, we are of the opinion that, within the intent of Section 17359, the overall operation of the music machines did not tend to promote or further, and was not connected or associated with, the illegal activity of operating pinball machines. We do find, however, that the operation of music machines in the same locations with pinball machines did tend to promote or further and was connected or associated with the illegal activity of operating pinball machines.

Accordingly, the expenses to be disallowed are all expenses of the pinball machines and all expenses of music machines in the same locations with pinball machines. As to those expenses which

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In the Matter of the Appeal of)
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A. D. AND HARRIET WICKSTROM)

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed January 12, 1962, by the Franchise Tax Board for rehearing of the Appeal of A. D. and Harriet Wickstrom, we are of the opinion that none of the grounds for rehearing set forth in the petition constitute cause for the granting thereof and, accordingly, it is ordered that the petition be and the same is hereby denied, and that our order of December 13, 1961, be and the same is hereby affirmed.

Done at Sacramento, California, this 22nd day of March, 1962, by the State Board of Equalization.

Geo. R. Reilly, Chairman

John W. Lynch, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary