



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
CARL P. AND ROWENA REINERT, and)
GERALD A. AND RUTH L. PEART)

Appearances:

For Appellants: Archibald M. Mull, Jr., Attorney at Law
For Respondent: Burl D. Lack, Chief 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 against Carl P. and Rowena Reinert in the amounts of \$24,412.54, \$33,069.95, \$23,073.68, \$19,617.28, \$12,914.59 and \$7,476.37 for the years 1952 through 1957, respectively, and against Gerald A. and Ruth L. Peart in the amounts of \$11,014.91, \$9,182.96, \$5,657.40 and \$2,773.30 for the years 1954 through 1957, respectively.

Reinert Music Company operated a coin machine business in the Marysville-Yuba City area. The business was a single proprietorship owned by Appellant Carl P. Reinert from some time prior to 1952 until November 1, 1953. On that date, the business became a partnership among Appellants Reinert and Appellant Gerald A. Peart. The partnership continued through the year 1957 and beyond. The partnership established a fiscal year ending October 31.

Reinert Music Company owned multiple-odd bingo pinball machines, flipper pinball machines, music machines, cigarette vending machines, bumper pool equipment, and some miscellaneous amusement machines. The equipment was placed in bars, restaurants, and other locations. The proceeds from each machine except cigarette vending machines, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between Reinert Music Company and the owner of the location where the machine was placed. Equipment was placed in approximately 80 locations.

The gross income reported in the Reinert Music Company returns was, except as to cigarette machines, the total of amounts retained by Reinert Music Company from locations. The gross

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income reported by Reinert Music Company as to cigarette machines was the total of the coins deposited in the machines. Deductions were taken for depreciation, cost of phonograph records, salaries and other business expenses.

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

The evidence indicates that the operating arrangements between Reinert Music Company and each location owner were, except as to cigarette machines, 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.

In the case of cigarette machines, the collector from Reinert Music Company would open the machine, remove and count the coins, refill the machine with cigarettes, prepare a report showing the number of packages necessary to refill the machine, and give a copy of the report to the location owner. The collector did not give any money to the location owner, but a check was mailed to the location owner monthly from the Reinert Music Company office. The amount received by the location owner was termed a commission and was usually computed at a given amount per package sold. For example, when the cigarettes were priced at ~~25¢~~ a package, the commission to the location owner was typically ~~3¢~~ a package. The cigarette machines required no attention from the location owner other than the making of change.

In Hall, the single most important factor leading to our conclusion that there was a joint venture between the pinball machine owner and the location owner was the equal division of the proceeds of the pinball machine after expenses. With a cigarette machine, however, the compensation of the location owner is a

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fixed amount for each package sold. The machine owner assumes the benefits and risks of changes in the wholesale price of cigarettes until such time as those changes might result in a change in the retail price of cigarettes sold through vending machines.

The location owner looks upon the cigarette machine as a source of income and as a convenience to customers. He does not, however, feel that customers will enter or remain in his establishment due to the presence of the cigarette machine. Pinball machines, on the other hand, are sources of entertainment of customers and it is expected that their presence will cause some customers to enter the establishment or to stay longer than they otherwise would, thus increasing beverage and food sales: Where the pinball machine is used for gambling, the machine owner and the location owner share equally in the profits and losses attributable to the illegal activity.

A music machine is similar to the pinball machine in this respect except that there is no gambling involved with the music machine. The music is part of the atmosphere of the location and frequently, if no customer is playing the music machine at the moment, the location owner will put in coins to keep the music going.

Accordingly, while adhering to our opinion that there is a joint venture between the machine owner and the location owner with respect to pinball machines, music machines and other amusement machines, it is our opinion that the machine owner rents space in the location with respect to cigarette vending machines and other vending machines. The Reinert Music Company's gross income from cigarette vending machines was therefore the entire amount of coins deposited in such machines.

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 17297. The multiple-odd bingo pinball machines here involved are substantially identical to the machines which we held to be games of chance in Hall.

The location owners testified that it was their general practice to make cash payouts to players in redemption of free games. Appellant Gerald A. Peart testified that as an employee of Reinert Music Company prior to November 1, 1953, and as a partner thereafter, he made most of the collections and that when collecting on multiple-odd bingo pinball machines he would read the meter which recorded the number of free plays removed from the machine without being played off. Peart indicated that the location owner received expenses from the proceeds of the machine and that the amount of expenses allowed was the amount recorded by the location owner on a slip of paper or the amount indicated by the

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meter, whichever was greater. Peart further stated that the expenses listed by the location owners on the slip of paper included taxes and licenses and refunds to players for tilts, malfunctions and cash payouts for free games not played off.

We find that it was the general practice to make cash payouts to players of multiple-odd bingo pinball machines for free games not played off. Accordingly, these machines were operated illegally and Respondent was correct in applying Section 17297.

The evidence indicates that when soliciting a new location, the representative of Reinert Music Company offered to furnish the location with whatever types of coin-operated machines were desired by the location owner, whether pinball machines, music machines, or cigarette machines. There was centralization of the bookkeeping and office functions. **Mechanics** repaired all types of machines and there was a single repair shop for all types of machines. A single collector collected from and filled all cigarette machines. Two women collectors collected from all the music machines exclusively and changed the records. Peart did most of the collecting from pinball machines.

Although the collection function was separated, it is our opinion that the common solicitation of locations and centralized office and repair functions indicate that the legal operation of cigarette and music machines was associated or connected with the illegal operation of pinball machines. Respondent was correct in disallowing expenses of the entire business.

The collector 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 proceeds after exclusion of the amounts claimed by the **location** owners for expenses. Since there were no records of amounts paid to winning players and other expenses initially paid by the location owners, Respondent made an estimate of the unrecorded amounts.

At the time of the audit in 1958, Respondent's auditor interviewed three location owners who had pinball machines from Reinert Music Company during the years in question. They gave him estimates of the average percentage which the payouts bore to the total amount of coins deposited in the pinball machines. Based on these estimates, Respondent computed the unrecorded gross income as equal to 50% of the coins deposited in the pinball machines.

At the hearing before us, Appellant Gerald A. Peart testified that the average amount claimed by location owners for expenses was between 25% and 35% of the total amount in the machines. One location owner testified that the payouts for pinball games won in his establishment equalled between 40% and 50%

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of the coins deposited and another testified that such payouts in his establishment equalled 50% of the coins deposited.

As we also held in Hall, supra, Respondent's computation of gross income is presumptively correct. There were no records of amounts paid to winning players. Respondent's method of estimation was reasonable under the circumstances. Because of his personal interest in the result, we cannot be certain that Peart's estimate is not low, although his experience ought to make him qualified to make an estimate. Therefore, except for the reduction due to our conclusion that Reinert Music Company and each location owner were engaged in a joint venture as to pinball, music and amusement machines, Respondent's computation of gross income is sustained.

Reinert Music Company sold all its pinball machines on August 5, 1957, and Respondent concedes that there was no illegal activity after that date. Since Respondent's assessment disallows expenses through October 31, 1957, Respondent must be reversed to that extent.

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 protests to proposed assessments of additional personal income tax against Carl P. and Rowena Reinert in the amounts of \$24,412.54, \$33,069.95, \$23,073.68, \$19,617.28, \$12,914.59 and \$7,476.37 for the years 1952 through 1957, respectively, and against Gerald A. and Ruth L. Peart in the amounts of \$11,014.91, \$9,182.96, \$5,657.40 and \$2,773.30 for the years 1954 through 1957, respectively, be modified in that the gross income is to be recomputed in accordance with the Opinion of the Board and expenses subsequent to August 5, 1957, are to be allowed. In all other respects the action of the Franchise Tax Board is sustained,

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

Geo.R. Reilly, Chairman
Paul R. Leake, Member
Richard Nevins, Member
_____, Member
_____, Member

ATTEST: Dixwell L. Pierce, Secretary