

locations, such  
machine,

Appeals of Max M. and Marion J. Andrews, et al.

**exclusion of expenses** claimed by the location owner in connection with the operation of the machine, were divided equally between the machine owner and the location owner.

The gross income reported in tax returns of the partnership was the total of amounts retained from locations. Deductions were taken for **depreciation** and various other business expenses. Respondent determined that the partnership was **renting** space in the locations where the machines were placed **and** that **all** the **coins deposited** in the machines constituted gross income to the machine owner. 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 the partnership 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 these machines is, accordingly, applicable here. Thus, only one-half of the amounts deposited in the machines operated under these arrangements was **includible** in the partnership's gross income,

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.

Four location owners who had the partnership's bingo pinball machines appeared as witnesses at the hearing of this matter. One of them testified that cash was paid to winning players for unplayed free games, one said he did not know whether this was done in his establishment and two **denied** making payouts. Those who did not admit making payouts, however, **identified** certain **collection** reports relative to their respective locations, and each of these reports showed a **meter** reading of the free games which had been won and not **played** off along with a **mathematical computation** of what **this** number represented

Appeals of Max M. and Marion J. Andrews, et al.

in dollars and cents. When questioned whether this meter was used to check against the amount claimed by the location owner as reimbursement for cash payouts to winning players for unplayed free games, appellant Max M. Andrews testified that it **didn't** do any good and, although meter readings were recorded in the collection reports in 1953 and 1954, this practice was discontinued since the partnership had no choice but to pay the location owners whatever they claimed as reimbursement for payouts. Appellant Max M. Andrews estimated that the bingo pinball machines were set to pay out about 30 percent for free games and he testified that the bingo pinball machines were **drilled** "all the time." Drilling permits the wrongful **manipulation** of the mechanism by the insertion of a wire or other object to register free games, a form of cheating which would be unlikely in the absence of cash payouts,

From the evidence before us we conclude that it was the general practice to make cash payouts to players of bingo **pinball** machines for free games not played off. Accordingly, this phase of the partnership'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.

The entire coin machine business appears to have been integrated., Appellants Max M. Andrews and James D. **McClinton** personally collected from all types of machines and serviced **them**. Accordingly, there was a substantial connection between the illegal activity of operating bingo pinball machines and the legal operation of music machines and miscellaneous amusement machines. Respondent was therefore correct in disallowing the expenses of **the** entire business.

**There** were no records of amounts paid to winning players of the bingo pinball machines and respondent estimated these unrecorded amounts as equal to 50 **percent** of the total amounts deposited in such machines. The estimate **was based on** results of audits of other pinball machine operators, primarily in the Vallejo area, and also on a 50 percent estimate given by **one** location owner when interviewed in 1957. About 75 collection reports, representing random samples **of 1953 and 1954 collections**, were given to the auditor by the appellants at the time of the 'audit. These reports disclose an average payout of about 45 percent. We believe that these collection reports constitute the best evidence of the actual payout percentage during the period in question and, accordingly, we **believe the** payout percentage should be reduced to coincide with the 45 percent figure.

In connection with the computation of **the** unrecorded **payouts** and in accordance with the segregation of **income** found

Appeals of Max M. and Marion J. Andrews, et al.

in the records of the partnership, respondent divided the machine income reported by the partnership into the three categories of pinball, music and other machines. Respondent considered all of the pinball income as being attributable to bingo pinball machines. Appellant Max M. Andrews testified that the partnership also had some flipper pinball machines; however, appellants have not established that the Income therefrom was significant. Under the circumstances we have no reason to disturb respondent's allocation,

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 as follows:

<u>Appellant</u>	<u>Year</u>	<u>Amount</u>
Max M. and Marion J. Andrews	1954	\$ 738.16
	1955	1,430.01
Russell B. and Bessie Carlson	1 9 5 4	728.51
	1955	1,459.81
James D. and Dorothy L. McClinton	1954	663.95
	1955	1,440.01

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 18th day of February, 1964, by the State Board of Equalization.'

Paul R. Leake, Chairman

John W. Lynch, Member

Richard G. Lee, Member

Bob Kelly, Member

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Attest: W. Green, Secretary