



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
 CLYDE H. AND CLARA DENLINGER,)
 HENRY F. AND ARMYSTA FOST,)
 CALVIN E. AND MARGUERITE J. CALLAHAN)
 ESTATE OF H. T. FOST, SR.)
 EMIL W. AND JANET W. FOST)
 RHA E. FOST)
 JULIA E. FOST)

Appearances:

For Appellants: Archibald M. Mull, Jr., Attorney at Law
 For Respondent: Wilbur F. Lavelle, Associate Tax Counsel
 F. Edward Caine, 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</u>	<u>Amount</u>
Clyde H. and Clara Denlinger	1951	\$ 2,128.48
	1952	2,804.46
	1953	6,162.42
	1954	13,026.86
Henry F. and Armysta Foust	1951	7,522.95
	1952	13,975.16
Henry F. Foust	1953	359.74
Armysta Foust	1953	375.74
Henry F. and Armysta Foust	1954	154.44
Calvin E. and Marguerite J. Callahan	1953	6,431.64
	1954	15,596.40
Estate of H. T. Foust, Sr.	1951	2,162.55
	1952	5,900.33
	1/1 - 6/29 1953	1,317.78
	7/1 -12/31 1953	1,421.42

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<u>Appellant</u>	<u>Year</u>	<u>Amount</u>
Emil W. and Janet W. Foust	1951	\$ 1,667.96
	1954	192.16
Rhae E. Foust	1954	118.69
Julia E. Foust	1954	118.69

Beach Amusement Company was a partnership between F & S Sales Company and Appellant Clyde Denlinger until March 31, 1953, after which Denlinger operated it as a sole proprietorship. It conducted a coin-machine business in and near Newport, Balboa and San Clemente. It owned multiple-odd bingo pinball machines, other types of pinball machines and a few bowling machines. The equipment was placed in restaurants, bars and other locations and the proceeds were divided equally between Beach Amusement Company and the location owners. It had equipment in about 25 locations.

F & S Sales Company was a partnership but the partners changed at times during the period in question. All Appellants except Clyde and Clara Denlinger either owned an interest in F & S Sales Company during at least a portion of the years 1951 through 1954 or filed a joint return with a spouse who owned such an interest.

F & S Sales Company conducted a coin-machine business in and near Santa Ana and Huntington Beach. It owned multiple-odd bingo pinball machines, other types of pinball machines and bowling machines. The equipment was placed in restaurants, bars and other locations and the proceeds were generally divided equally between F & S Sales Company and the location owners. At some locations F & S received less than 50%. It had equipment in 60 to 80 locations,

Respondent determined that both Beach Amusement Company and F & S Sales Company were renting space in the locations where their machines were placed and that all the coins deposited in the machines constituted gross income to them. Respondent disallowed all expenses pursuant to Section 17359 (now 1'7297) 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 Beach Amusement Company 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. 58,145. 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.

Some of the locations having F & S Equipment were considered house accounts and the machines in these locations were serviced by a salaried collector. Most of the F & S machines were in locations which were serviced by a collector who turned in to F & S 75% of the amounts he collected and retained 25% for himself. F & S did not consider the commission collectors to be employees for social security or withholding tax purposes.

F & S entered into several written agreements with the commission collectors. These agreements provided that F & S rented machines to the collectors for 75% of the gross receipts of the machines, that the collectors were to keep the machines in good repair at their own expense and that the collectors were to collect for the use of the machines according to a schedule prescribed by F. & S.

In practice, the expenses of repairing the machines were borne by F & S and not by the collectors. When a machine needed repair the location owner telephoned the F & S office. An F & S mechanic (not a collector) performed the necessary repair work either at the location or in the F & S shop. Collection report forms were supplied to the collectors by F & S and these forms had the name "F & S Sales Company" printed at the top. At the time of each collection, the collector prepared the form in duplicate and left a copy with the location owner. One of the F & S partners testified that the arrangements with the commission collectors were not actually regarded as rentals. Similarly, one of the commission collectors testified that he did not consider himself as in fact renting machines from F & S.

We conclude that the commission collectors as well as the salaried collectors represented F & S in their contacts with location owners, and that all of the arrangements as to the machines were between the location owners and F & S. Accordingly, the written agreements between F & S and the collectors were of no significance as respects the relationship between F & S and the location owners.

In every essential feature, the arrangements between F & S and the location owners were the same as those considered by us in Appeal of Hall, supra. Thus, there was a joint venture between F & S and each location owner. It follows that F & S became

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entitled to its share of the gross proceeds at the time the coins were deposited in the machines. Accordingly, the gross income of F & S included the gross income recorded on its books, the 25% commission retained by the commission collectors (and not recorded on the F & S books), and its share of the cash payouts to winning players.

The F & S records do not indicate which locations were serviced by salaried collectors and which by commission collectors. Therefore, the total amount of the 25% commissions retained by the commission collectors cannot be directly computed. While the locations serviced by the commission collectors represented the bulk of the F & S business, it would not be correct to attribute commissions to the entire recorded gross income. From the record before us, a reasonable estimate is that 80% of the recorded income was from locations serviced by commission collectors. Adjustments should be made in Respondent's computation in accordance with this finding.

Neither Beach Amusement Company nor F & S Sales Company segregated income between that received from multiple-odd bingo pinball machines and that received from other kinds of equipment. Appellant Clyde Denlinger estimated that 90% of the income of Beach Amusement Company was from multiple-odd bingo pinball machines. Appellant Henry F. Foust estimated that 75% of the income of F & S Sales Company was from multiple-odd bingo pinball machines. Respondent used these two estimates in its audit.

Respondent further estimated as to Beach Amusement Company and F & S Sales Company that cash payouts to winning players of multiple-odd bingo pinball machines were 37% and 47%, respectively, of the amounts deposited in the machines. The 37% figure as to Beach Amusement Company was based on the average payout shown on 19 collection slips found by Respondent's auditor. These slips were for several locations and for several dates in 1951, 1952 and 1953. These 19 slips were the only ones found by Respondent's auditor which showed amounts for payouts. The 47% figure as to F & S Sales Company was based on an average of estimates given to Respondent's auditor by six location owners.

As we also held in Appeal of Hall, supra, Respondent's computation of gross income is presumptively correct. There were no complete records of the amounts paid to players of multiple-odd bingo pinball machines for free games not played off. Respondent's method of estimation was reasonable under the circumstances. No reliable evidence has been presented that the payout percentages were less than 37% and 47%, respectively, or that less than 75% and 90%, respectively, of the income was from multiple-odd bingo pinball machines, and therefore Respondent's use of these percentages must be sustained.

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From the evidence it is clear that the general practice was to pay cash on request to players of multiple-odd bingo pinball machines for free games not played off. The multiple-odd bingo pinball machines were substantially identical to the machines which we held to be games of chance in Hall. Accordingly, these machines were operated in violation of Section 330a of the Penal Code, and Respondent was correct in disallowing deductions from gross income from such machines.

Beach Amusement Company and F & S Sales Company also placed on location other types of machines not operated in violation of the Penal Code. However, the same collectors and repairmen serviced both the legally operated machines and the illegally operated machines. Frequently both types of equipment were placed in the same location. The illegal activity of operating multiple-odd bingo pinball machines was therefore associated or connected in a substantial way with the legal activity of operating other types of coin machines and Respondent was correct in disallowing all expenses of the Beach Amusement Company and of F & S Sales Company.

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 of the following Appellants to proposed assessments of additional personal income tax in the amounts and for the periods indicated 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.

<u>Appellant</u>	<u>Year</u>	<u>Amount</u>
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	1952	2,804.46
	1953	6,162.42
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