



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
THOMAS F. AND MARION SHUEY)
PETE AND FRANCES PELLEGRINO)

Appearances:

For Appellants Shuey: George P. Coulter,
Attorney at Law

For Respondent: Hebard P. Smith, Chief
Special Investigations Division,
Burl L. Lack, Chief Counsel

No appearance for Appellants Pellegrino

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 Thomas F. and Marion Shuey in the amount of \$2,565.82 for the year 1951, against Thomas F. Shuey in the amounts of \$5,795.89, \$4,926.55, \$5,723.77 and \$11,357.14 for the years 1952, 1953, 1954 and 1955, respectively, and against Pete and Frances Pellegrino in the amounts of \$905.74, \$2,662.04, \$1,634.32, \$4,864.15 and \$10,523.14 for the years 1951, 1952, 1953, 1954 and 1955, respectively.

Appellants Thomas F. Shuey and Pete Pellegrino owned multiple-odd bingo pinball machines, music machines and miscellaneous amusement machines in 1951 and 1952 and until October of 1953. Each operated a separate business. In October of 1953 they formed a partnership and the partnership adopted a fiscal year ending March 31. During the operation of the partnership, cigarette vending machines were added to the business,, Respondent's audit as to the partnership covered the period through March 31, 1955.

Appellants (which term will be used to include the Shuey single proprietorship, the Pellegrino single proprietorship and the Shuey-Pellegrino partnership) placed the equipment in about one hundred locations, such as bars and restaurants,, The locations were in Los Angeles County. The proceeds from each pinball machine, music machine and amusement machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided between appellants and each location owner. The division of the proceeds of pinball

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machines and amusement machines was sometimes two-thirds to appellants and one-third to the location owner, sometimes one-half to appellants and one-half to the location owner and in a few cases was one-quarter to appellants and three-quarters to the location owner. The division of the proceeds of music machines was one-half to appellants and one-half to the location owner. In the case of cigarette vending machines, appellants supplied the cigarettes and the location owner received 40 percent of the proceeds in excess of the cost of the cigarettes,

In their tax returns appellants reported the total of amounts retained from locations. Deductions were taken for salaries, depreciation and other business expenses. The cost-of-goods-sold computation included cost of phonograph records used in the music machines as well as the cost of cigarettes sold through the cigarette machines*

Respondent determined that appellants were renting space in the locations where the machines were placed and that all the coins deposited in the machines constituted gross income to appellants. 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 appellants and each location owner were, except as to cigarette vending machines, the same as those considered by us in Appeal of Hall, 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 Appeal of Reinert, Cal, St. Bd. of Equal., March 22, 1962, 3 CCH Cal, Tax Cas. Par. 201-913, 3 P-H State & Local Tax Serv. Cal, Par. 58232, we held that a cigarette vending machine owner who furnished the cigarettes and serviced the machine was renting space in the location and that the gross income of the

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machine was attributable entirely to the machine owner. The conclusion in Keinert is applicable here and appellants' gross income from cigarette vending machines will be the entire receipts from the machines less the cost of goods sold.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct., 9, 1952, 3 CCH Cal, Tax Cas. Par. - -, 2 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,

Two location owners testified that they paid cash to players of bingo pinball machines for unplayed free games. One location owner testified that he did not pay cash to players of the bingo pinball machines for unplayed free games. According to respondent's auditor, this location owner stated at an interview in 1956 that such payments were made and that the payouts equalled 60 percent or 70 percent of the proceeds in the machines.

An employee of appellants testified that the expenses claimed by the location owners averaged 30 percent or more of the amounts deposited in the pinball machines, that the claimed expenses on a machine sometimes exceeded the proceeds of the machine, and that the machines were sometimes drilled by players to actuate the mechanism and register free plays,

Appellant Thomas F. Shuey was called as a witness and was asked if the location owners paid cash to players of his bingo pinball machines for unplayed free games, if the amounts of such cash payouts were returned to the location owners from the proceeds of the machines prior to the division of the net proceeds and if such cashpayouts averaged 45 percent of the amounts deposited in the machines. He refused to answer on grounds of possible self-incrimination. From such refusal we infer that if the questions had been answered truthfully, the answers would have supported respondent's factual contentions that cash was paid to players of bingo pinball machines for unplayed free games and that the amounts of such cash payouts were returned to the location owners from the proceeds of the machines prior to the division of the net proceeds. (Fross v. Wotton, 3 Cal. 2d 384 [44 P.2d 350].)

From the record we conclude that it was the general practice to pay cash to players of bingo pinball machines for

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unplayed free games. Accordingly, the bingo pinball machine phase of appellants' coin machine businesses 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 same collectors collected from all types of machines, the same repairmen repaired all types of machines and the same offices were used to conduct the operations as to all types of machines. Many of the locations which had a bingo pinball machine also had a music machine or a cigarette vending machine. There was, therefore, a substantial connection between the illegal operation of bingo pinball machines and the legal operation of the other equipment and respondent was correct in disallowing all expenses of appellants' coin machine businesses.

Respondent also disallowed the cost of phonograph records which appellants had included in their returns as a cost of goods sold. Section 17297 disallows deductions from gross income arising from certain kinds of activities. It does not disallow items which are subtracted from gross receipts in arriving at income.

The Franchise Tax Board's regulations provide, in part, "In the case of a ... merchandising ... business 'gross income' means the total sales, less the cost of goods sold ...". (Cal. Admin. Code, tit. 18, Reg. 17101(g).) Cost of goods sold is an item subtracted from gross receipts in arriving at gross income and may not be disallowed under section 17297. Since the phonograph records were used in the music machines rather than sold in a merchandising business, however, respondent was correct in disallowing their cost as a deduction,

There were no records of amounts paid to winning players and respondent estimated the unrecorded amounts as equal to 45 percent of the amounts deposited in the bingo pinball machines.

At the time of the audit in 1956, respondent's auditor interviewed four location owners who had bingo pinball machines from appellants during the years in question. One location owner told respondent's auditor that cash was not paid to players for unplayed free games. The other three location owners made estimates that the cash payouts averaged 33 percent, 40 percent and 60 to 70 percent, respectively, of the coins deposited in the machines,

