



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
PETER AND EDYTHE McCARTY and)
PAUL AND ELYSE M. McCARTY)

Appearances:

For Appellants: Dale I. Stoops, Attorney at Law

For Respondent: Wilbur F. Lavelle, 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 against Peter and Edythe McCarty in the amounts of \$5,051.93, \$8,051.71, \$10,452.48 and \$12,737.21 for the years 1952, 1953, 1954 and 1955, respectively, and against Paul and Elyse M. McCarty in the amounts of \$5,113.52, \$8,131.08, \$10,489.48 and \$12,776.38 for the years 1952, 1953, 1954 and 1955, respectively,

Appellants Peter and Paul McCarty were partners in McCarty Brothers, which operated a coin machine business with headquarters in Ukiah. The business owned multiple-odd bingo pinball machines, pinball machines which had been converted from one-ball to five-ball types (hereafter referred to as "converted pinball machines), flipper pinball machines, music machines and some miscellaneous amusement machines. The equipment was placed in about 70 locations such as bars and restaurants. The proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were, except as to the music machines, divided equally between the partnership and the location owner. The proceeds from the music machines were divided 60 - 40 or 70 - 30, with the location owner receiving the lesser amount.

The gross income reported in the partnership's tax returns was the aggregate of amounts retained from locations. Deductions were taken for depreciation, salaries, cost of phonograph records and other business expenses.

Respondent determined that the partnership was renting space in the locations where its machines were placed and that all of the coins deposited in the machines constituted gross income to it. Respondent also disallowed all expenses connected with the coin machine business pursuant to section 17297 (17359 prior to June 6, 1955) of the Revenue and Taxation Code which

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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, 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 Advance Automatic Sales Co., Cal, St. Bd. of Equal., Oct. 9, 1962, CCH Cal. Tax Rep. Par. 201-984.2 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**.

The testimony of appellant Paul McCarty and four location owners indicate; that it was the general practice to pay cash to players of the partnership's pinball machines, except the flipper-type, for unplayed free games. **Accordingly**: this phase of the partnership business was illegal, Respondent was therefore correct in applying section 17297.

Most of the locations had both pinball machines and music machines. The collectors **collected** from all types of machines and the repairmen serviced all types of machines. There was therefore a substantial connection between the illegal operation of the pinball machines and the legal operation of music machines **and** miscellaneous amusement machines and respondent was correct in disallowing all the expenses of the coin machine business.

There were no records of amounts paid to winning players of the pinball machines, and respondent estimated these unrecorded amounts as equal to 50 percent of the total amounts deposited in the bingo and converted pinball machines. Respondent's auditor testified that the 50 percent payout figure was based on an estimate of 40 to 60 percent which was given by appellant Paul. McCarty when he was interviewed in 1956. At the hearing of this matter appellant Paul McCarty testified that he had not been asked to give an estimate of the average payout percentage when interviewed by respondent's auditor in 1956, but instead, that he had merely stated that on occasion a payout might

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have been as high as 60 percent. He proceeded to testify that in his estimation payouts averaged 20 to 25 percent, exclusive of taxes. One location owner testified and estimated payouts as averaging from 10 to 25 percent. Another location owner testified that "lots of times" more money was paid out than was deposited in the machine. Respondent introduced into evidence four collection reports which indicated payouts averaging 48 percent. Appellant Paul McCarty testified that one of these collection reports related to a location having no pinball machines during the period in question and that the deduction was for the cost of prizes to be given away to winning players of a bowler. In addition, he expressed the belief that the designation "Payout" on another one of the four collection reports was in reality the deduction of certain taxes. However, appellants' belief is disaffirmed by several other collection reports on file wherein the deduction of taxes is clearly evidenced by the written insertion of the words "Fed. Tax" and "City Tax." Accordingly, three collection reports in the record clearly indicate payouts and they reflect a payout average of 49 percent.

As we held in Hall, supra, respondent's computation of gross income is presumptively correct. We do not believe that appellants have overcome this presumption, and since respondent's estimate seems reasonable, we sustain the 50 percent estimate.

In connection with the computation of the unrecorded payouts it was necessary for respondent's auditor to estimate the percentage of the partnership's recorded gross income arising from the bingo and converted pinball machines since, although the records of the partnership segregated the receipts from music machines, game machine receipts were lumped together. When interviewed in 1956 appellant Paul McCarty estimated that the receipts from bingo and converted pinball machines constituted 60 percent of the total receipts from the various games in 1952, 75 percent in 1953, 80 percent in 1954, and 85 percent in 1955. These estimates were used in respondent's computation and appellant Paul McCarty testified at the hearing that they seemed reasonable. Accordingly, we see no reason to disturb them.

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 Peter and Edythe McCarty in the amounts of \$5,051.93, \$8,051.71, \$10,452.48 and \$12,737.21 for the years 1952, 1953, 1954 and 1955, respectively, and against Paul and Elyse M. McCarty in the amounts of \$5,113.52, \$8,131.08, \$10,489.48 and \$12,776.38 for the years 1952, 1953, 1954 and 1955, respectively, 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

