



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
W. R. AND EMMA FARLOW }

Appearances:

For Appellants: James Vizzard, Attorney at Law

For Respondent: A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of W. R. and Emma Farlow to proposed assessments of additional personal Income tax and interest in the amounts of \$53.40, \$1,218.27, \$906.38 and \$284.98 for the years 1953, 1954, 1955 and 1956, respectively.

Appellant W. R. Farlow (hereinafter called appellant) conducted a coin machine business in the Bakersfield area. Appellant owned bingo pinball machines, music machines and some miscellaneous amusement machines. The equipment was placed in about fifteen to twenty 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 divided equally between appellant and the location owner.

The gross income reported in tax returns was the total of amounts retained from locations. Deductions were taken for depreciation, cost of phonograph records and other business expenses. Respondent determined that appellant was renting space in the locations where his machines were placed and that all the coins deposited in the machines constituted gross income to him. 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

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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 appellant 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 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 appellant's gross income.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 5, 1955, 2 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.

At the hearing of this matter, respondent's auditor testified that during an interview in 1958 appellant admitted knowing that the location owners made cash payouts to winning players for unplayed free games and that appellant estimated such payouts amounted to about 50 percent of the total amounts deposited in the bingo pinball machines.

Copies of 22 collection reports have been placed in evidence and they indicate that substantial expenses were claimed by the location owners. Many of these collection reports related to both pinball and music machines. Based upon seven of the reports, those on which pinball collections are distinguishable from music collections, the expenses on bingo pinball machines averaged more than 50 percent of the amounts deposited in those machines.

Appellant admitted the possibility that part of the expenses claimed by the location owners was attributable to payouts for free games; that expenses **equalling** about **one-half** of the amount deposited in a machine could not be assumed to be purely due to mechanical malfunctions; that the location owners **having** bingo pinball machines generally claimed higher amounts for expenses than location owners having other types of machines; and that the bingo pinball machines had been

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drilled. Drilling permits the wrongful manipulation of the mechanism by the insertion of a wire or other object, a form of cheating which would be unlikely in the absence of payouts for free games.

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

Appellant's coin machine business was highly integrated, with appellant collecting from and servicing **all** types of machines. We find that there was a substantial **connection** between the illegal activity of operating bingo pinball machines and the legal activity of operating music **machines and** miscellaneous amusement machines. Respondent was, therefore, correct in disallowing the expenses of the entire **business**.

There were not complete 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 amount deposited in such machines. Respondent's auditor testified that the 50 percent figure coincided with the estimate which appellant gave him at the time of the audit. The auditor further testified that a limited sampling of collection reports indicated expenses claimed by the locations averaged about 60 percent. The 50 percent payout figure appears reasonable and, in the absence of evidence to the contrary, it must be sustained.

In connection with the computation of the unrecorded payouts, it was necessary for respondent's auditor to estimate the percentage of appellant's recorded gross income arising from bingo pinball machines, since all game income was lumped together. Respondent's auditor testified that he used the estimate obtained from appellant in attributing 50 percent of appellant's recorded gross income from games to bingo pinball machines. In the absence of other information in this regard, we see no reason to disturb this allocation.

Based on our conclusion that appellant and each location owner were engaged in a joint venture, we conclude that the assessment for the year 1953 is barred by the running of the limitation period. Appellants filed a return for the year 1953 on April 15, 1954. Respondent mailed its notice of proposed deficiency assessment to appellants on March 20, 1959, more than four years after the date the return was filed: Therefore the notice was not mailed within the limitation period provided by section 18586 of the Revenue and Taxation Code. Consequently, the question posed is whether the six-year

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limitation period provided by section 18586.1 of the Revenue and Taxation Code applies.

The applicability of section 18586.1 expressly depends on whether appellants omitted 'from gross income an amount properly **includible** therein which **is** In excess of 25 percent of the amount of gross income stated in the return...." Appellants reported gross income In the amount of **\$8,557.36** in their 1953 return, but failed to report \$511.65 which we conclude was properly **includible In** gross income. Since the latter amount does not exceed **25** percent of the gross income stated in the **1953** return, the six-year limitation period is not **available** to respondent and the assessment is barred.

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 the protest of W. R. and Emma **Farlow** against the proposed assessment of additional personal income tax and interest In the total amount of **\$53.40** for the year **1953**, be reversed.

It is further ordered that the action of the Franchise Tax Board on protests of W. R. and Emma **Farlow** against proposed assessments of additional personal income tax and Interest In the amounts of **\$1,218.27**, **\$906.38** and **\$284.98** for the years **1954**, **1955** and **1956**, 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 Board **is** sustained.

Done at Sacramento California, this 7th day of April , 1964, by the State Board of Equalization.

Paul R. Leake , Chairman
John W. Lynch , Member
Richard J. Stein , Member
Scott H. Kelley , Member
_____ J Member

Attest: [Signature] , Secretary