BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SAN JOSE NOVELTY CO.)

Appearances:

For Appellant: Archibald M. Hull, Jr,, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Foard on the protest of San Jose Novelty Co, to proposed assessments of additional franchise tax in the amounts of $1,422.04, $1,422.04, $27,622.71, $29,044.75, $40,004.12, $40,104.48, $30,901.22, $28,401.50 and $20,884.74 for the taxable years 1951, 1952, 1952, 1953, 1954, 1955, 1956, 1957 and 1958, respectively.

Appellant conducted a coin machine business in the San Jose area. It owned from 125 to 150 pinball machines and placed them in some 100 locations such as bars and restaurants. The proceeds from each machine, after exclusion of exsenses claimed by the location owner in connection with the operation of the machine, were divided equally between appellant and the location owner . The machines were mostly multiple-odd bingo pinball machines but some were flipper pinball machines and some were horse race pinball machines.

The gross income reported in tax returns was the total of amounts retained from locations, Deductions were taken for depreciation, salaries and other business expenses. Respondent determined that appellant was renting space in the locations where its machines were placed and that all the coins deposited in the machines constituted gross income to it,, Respondent also disallowed all expenses pursuant to section 24436 (24203 prior to June 6, 1955) of the Revenue and Taxation Code which reads:

> In computing net income, no deductions shall be allowed to any taxpayer on any of its 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 deduction be allowed to any taxpayer on any of its 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 Hal., Cal. St. Bd. of Equal., Dec. 29, 1958, 2 CCH Cal. Tax Cas. Par. 201-197, 3 Y-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,

In Appeal of Advance Automatic Sales Co,, Cal. St. Bd. of Equal,, Oct. 9, 1962, 3 CCH Cal, Tax Cas. Par. ____, 2 Y-H State & Local Tax Serv. Cal. Par. 18288, 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 testified that they paid cash to players of appellant's pinball machines for unplayed free games. One of appellant's officers testified that the locations owners generally claimed exnenses from the proceeds of the machines and that "as far as I know" such expenses included amounts paid. to players for unplayed free games. We conclude that it was the general practice to pay cash to winning players for unplayed free games, Accordingly, 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 disallowing all expenses of the business pursuant to section 24436.

There were no records of amounts paid to winning players on appellant's pinball machines and respondent estimated these unrecorded amounts as equal to 66-2/3 percent of the total amount deposited in the machines. At the time of the audit in 1955, respondent's auditor interviewed 8 location owners. A number of these location owners were able to give him estimates of the percentages which the payouts bore to the total amounts in the machines, These estimates ranged from 60 to 70 percent and the figure used by respondent was based on these estimates, At the hearing, the four location owners who testified gawe estimates of the payout percentages and these ranged from 25 to 50 percent. We find the unrecorded gross income to be equal to 50 percent of the total amount deposited in the machines.

Respondent's assessments for the taxable years 1956, 1957, and 1953 include 5 percent penalties for negligence. Respondent has agreed to withdraw the penalties and we are, accordingly, not called upon to determine whether they were properly imposed,

Appeal of San Jose Novelty Co,

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of San Jose Novelty Co. to proposed assessments of additional franchise tax in the amounts of $1,422.04, $1,422.04, $27,622.71, $29,044.75, $40,004.12, $40,104.48, $30,901.22, $28,401.50 and $20,884.74 for the taxable years 1951, 1952, 1952, 1953, 1954, 1955, 1956, 1957 and 1958, respectively, be modified in that the gross income is to be recomputed in accordance with the opinion of the board and the penalties are to be deleted. In all other respects the action of the Franchise Tax Board is sustained.

Done at Pasadena, California, this 27th day of November, 1962, by the State Board of Equalization.

George R. Reilly, Chairman

Richard Nevins, Member

Paul R. Leak, Member

John W. Lynch, Member

, Member

ATTEST: Dixwell L. Pierce, Secretary