Axos Financial, Inc.

Request for California Revenue & Taxation Code Section 25137 Consideration by Three-Member Franchise Tax Board

Granting Section 25137 Relief

Company Background

- Axos Bank (Axos) is a federally chartered bank that provides internet banking solutions for personal and business banking needs.

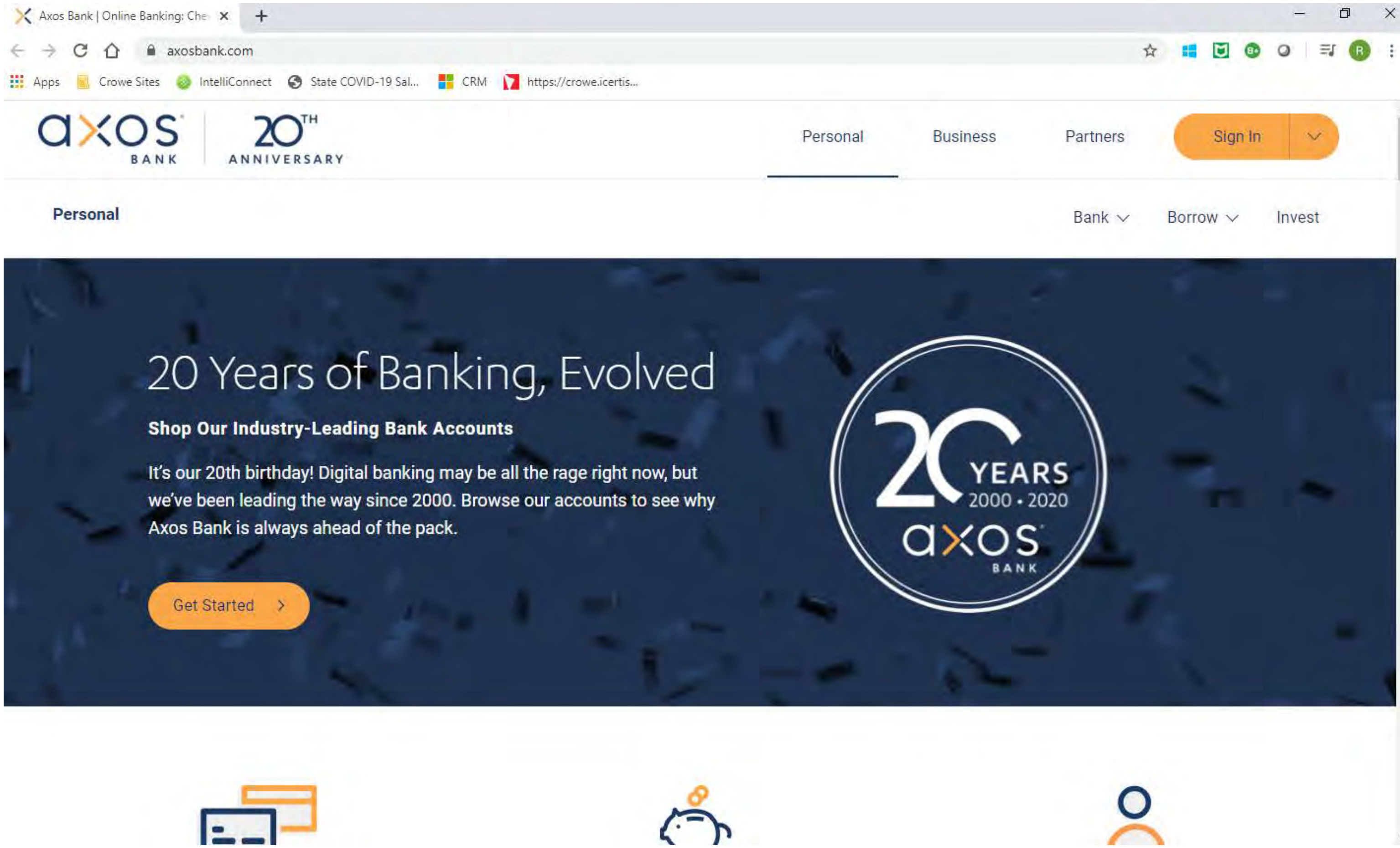
- The bank's thrift charter allows it to operate in all 50 states.

- Axos has deposit and loan customers nationwide.

- Physical Locations:
  - San Diego – Primary banking segment operations
  - Nevada – Loan servicing, deposit operations, approximately 50% of the mortgage banking
  - Utah - Commercial and industrial leasing
  - New York – Small banking office recently opened

Facts (continued)

- Taxpayer’s Primary Place of Business:



Facts (continued)

- The standard apportionment rules requires a bank to include loans in the property factor and assign those loans based on the SINAA rules to a “regular place of business of the taxpayer within the state”.
- Main place of business or method of distribution where product is delivered to customers is not physically located anywhere, it is a virtual location/website. (See previous slide).
- The Payroll Factor and Property Factor have no representation in the virtual location/branch.

Law – CRTC Section 25137 and Fair Apportionment

- An alternative apportionment method may be allowed if the standard apportionment provisions do not fairly represent the extent of the taxpayer's activity in the states.
- This statute acts as a "safety valve" to assure that the apportionment formula, when applied to a particular fact pattern, fairly apportions income to the state and does not tax extraterritorial income.
- Though no bright line test exists to determine when an apportionment method does not fairly represent the taxpayer's business activities in the state, there is a plethora of court cases ruling on this matter providing us guidance.

Law – *General Mills*

- One of the more recent cases in CA addressing alternative apportionment is *General Mills*
- Taxpayer applied statutory formula and FTB proposed alterative formula
- The FTB was able to successfully apply an alternative apportionment formula even though the alternative apportionment formula resulted in only a quantitative distortion of an average 4.4% increase to the apportionment per year.
- This is because of the rote apportionment method was not developed or meant to fairly reflect manufacturing income mixed with significant hedging receipts leading to a high level of qualitative distortion.
- This case shows that if an apportionment formula was not developed for a particular fact pattern, alternative apportionment should be allowed, even if the change is as little as 1.3% in a given year.

Law – *General Mills (Table)*

General Mills - Alternative Apportionment Analysis					
Tax Year	Sales Factor Statutory Formula	Alternative Sales Factor Proposed by the FTB and Supported by the Court	Percentage Change in Sales Factor	Percentage Change in the Total Apportionment Factor	
1992	10.5%	10.9%	3.81%	1.3%	*
1993	10.8%	11.2%	3.70%	1.9%	
1994	10.3%	11.0%	6.80%	3.4%	
1995	9.5%	10.4%	9.47%	4.7%	
1996	9.3%	10.8%	16.13%	8.1%	
1997	8.9%	10.2%	14.61%	7.3%	
Average				4.4%	
* In 1992 the apportionment factor was an equally weight three factor formula.					
In 1993 and after, the total apportionment factor double weighted the sales factor					

Qualitative and Quantitative Factors Considered in *General Mills*

Qualitative

- Standard rules written for a different business model
- National uniformity
- Potential for tax loopholes
- The impact on predictability of commerce and in tax collection for the state

Quantitative

- Apportion Analysis 1-8 % distortion

Qualitative and Quantitative Analysis – Axos Bank

<u>Qualitative</u>

- Standard Rules Written for a different business model
- Internet Banking v. Traditional Banking
- MTC revises regulation
- Uncodified California law
- Internet Tax Freedom Act (“ITFA”)
- National Uniformity
- Potential for Tax Loopholes

<u>Quantitative</u>

- Exhibit A – Axos has a blended state rate in excess of 300% of traditional bank competitors
- Exhibit B – More than 120% of Axos’ income is being subject to tax

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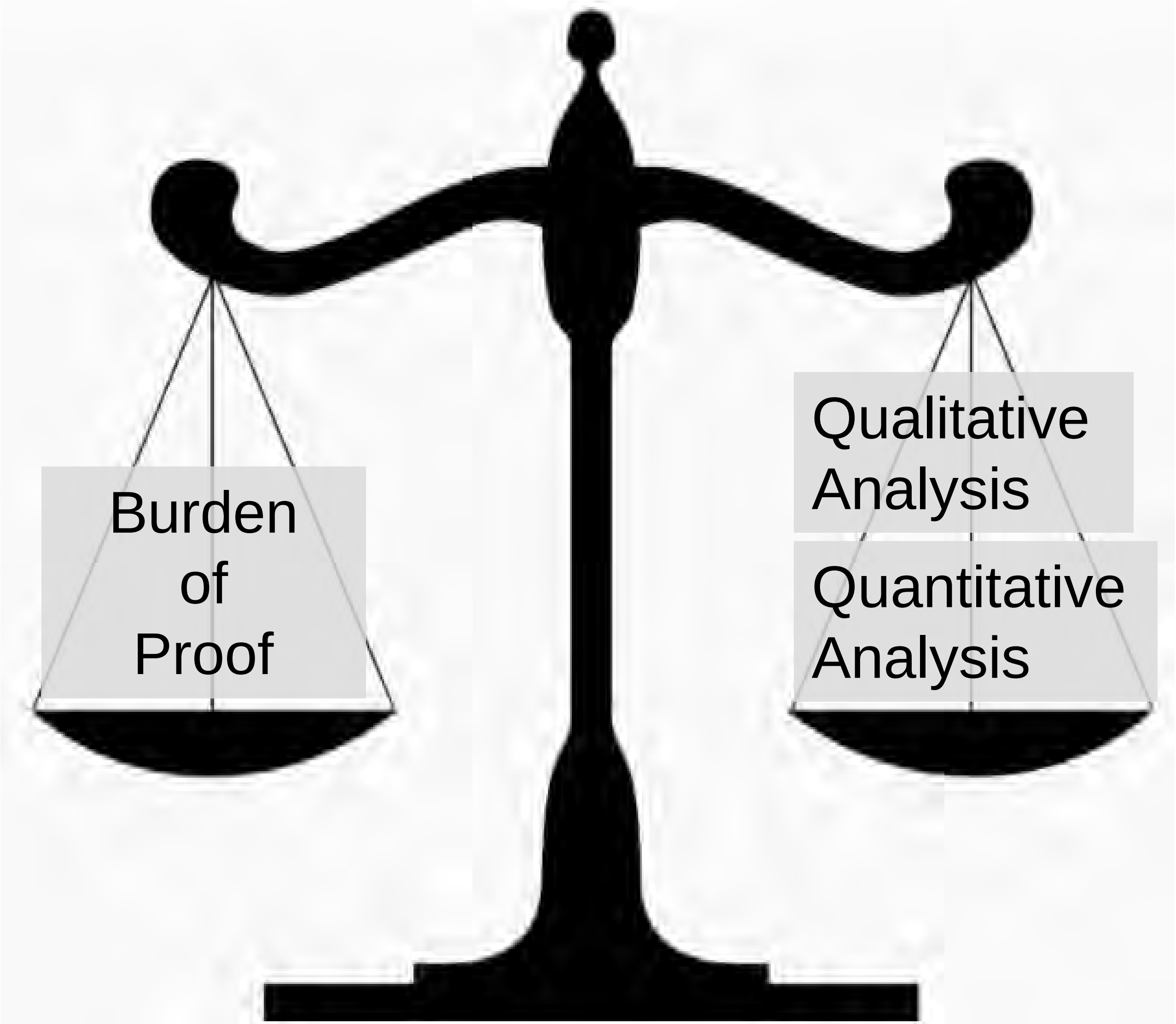

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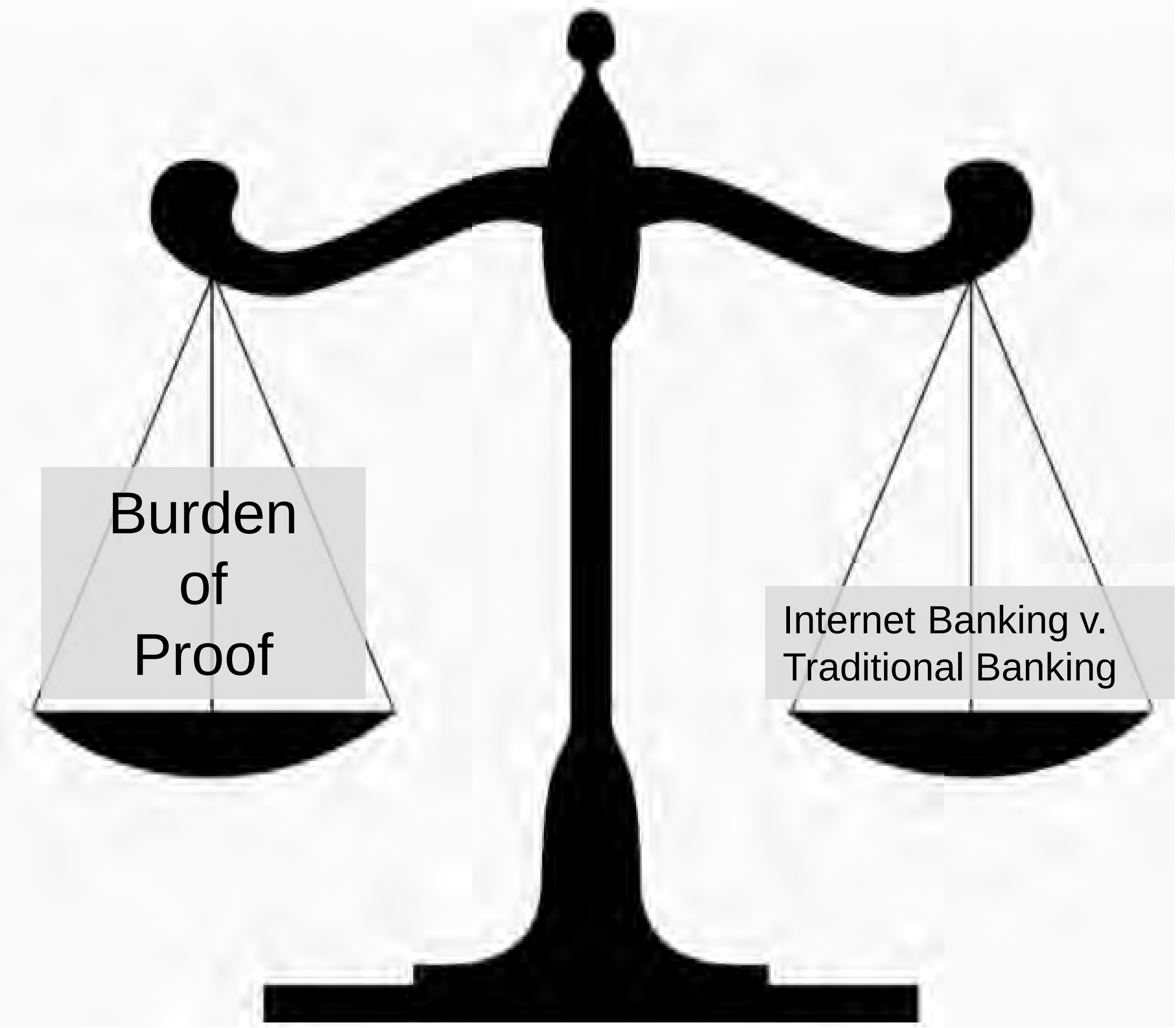

Internet Banking v. Traditional Banking

- Like in *General Mills,* the fact that the apportionment formula was developed for a business model (traditional banking) that is very different from online banking is a significant qualitative factor to be considered in our analysis.
- Internet banking is qualitatively different from traditional banking.
- Unlike traditional branch banking, a national internet bank's website can be run from anywhere in the country, with the website being virtually located in all 50 states.

Internet Banking v. Traditional Banking (Continued)

- The banking apportionment regulations were developed to fairly apportion the income of a traditional "brick and mortar" bank.
- A traditional national bank making loans across the country would have branches in each state and the loans made would be assigned to branches across the country.
- Merely because it uses electronic commerce rather than physical branches, Axos assigns all its loans to California.
- Though Axos may have a similar national client base as a traditional national bank, its electronic commerce banking is subject to income tax in California at a higher rate than a similar national traditional bank with the same clientele.
- Exhibit A also illustrates the actual effect of this discrimination against electronic commerce. Axos' state rate is 300% of that of a traditional national bank.

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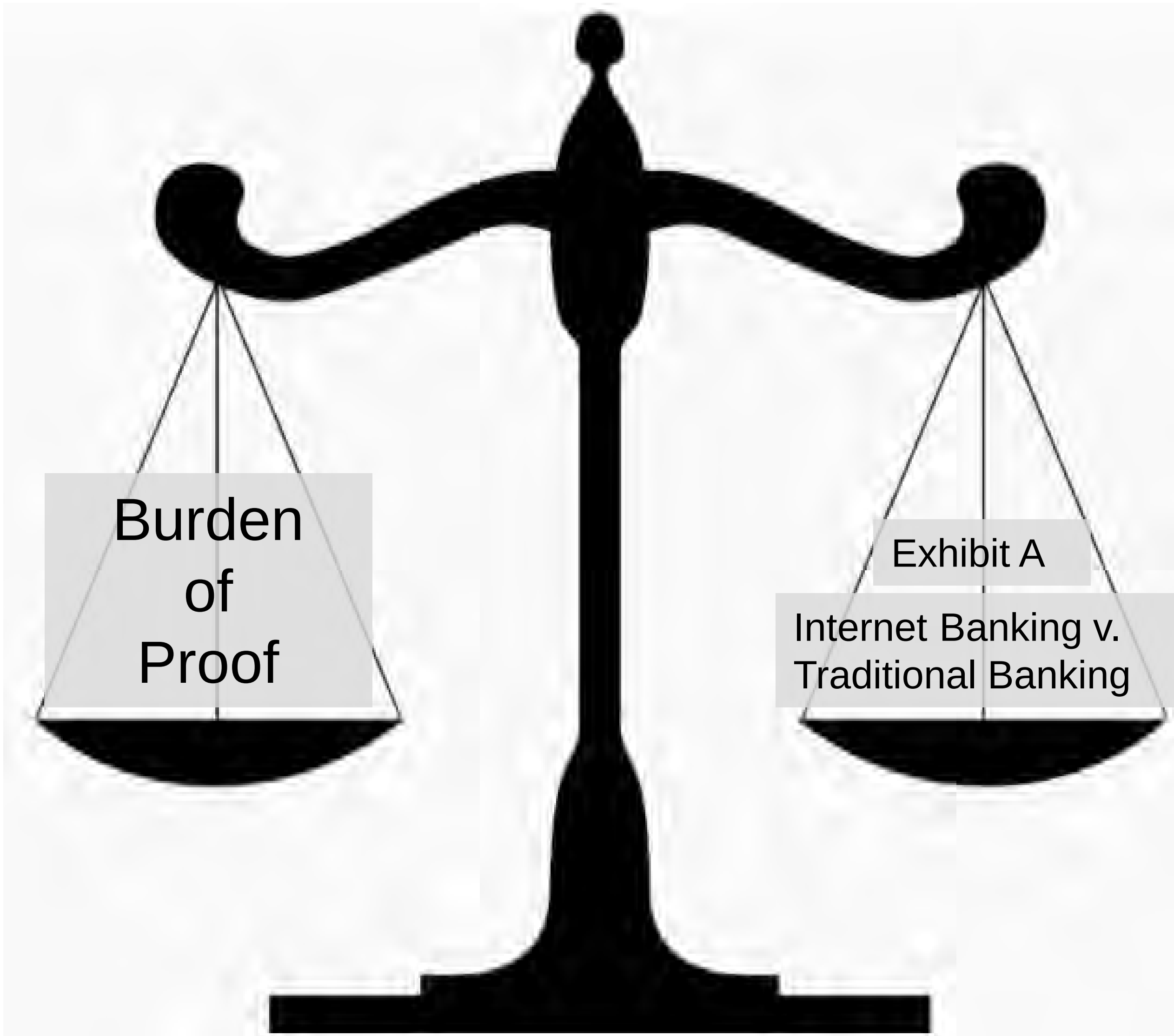

Exhibit A

Axos Financial, Inc. and Subsidiaries

State Tax Rate Comparison to the Competitors

EXHIBIT A

Bank	Gross Effective State Tax Rate 2018	2017	2016	Average
Bank of Hawaii	2.90%	2.31%	0.92%	2.04%
Bank of the Ozarks	7.09%	6.31%	6.00%	6.47%
Eagle Bancorp	7.38%	5.25%	8.57%	7.07%
First Financial Bankshares	0.13%	0.15%	0.15%	0.14%
Home Bancshares	5.44%	6.23%	6.28%	5.98%
Trustco Bank Corp	2.40%	1.77%	1.80%	1.99%
United Community Banks	3.97%	4.07%	4.73%	4.26%
Washington Federal	1.60%	2.17%	2.00%	1.92%
Western Alliance Bancorp	2.24%	3.68%	3.71%	3.21%
Bank of America	5.06%	4.62%	2.62%	4.10%
JPMorgan Chase	2.78%	3.69%	2.31%	2.93%
Charles Schwab	3.80%	3.38%	3.69%	3.62%
Citigroup Inc.	2.28%	1.69%	2.77%	2.25%
Wells Fargo	4.94%	5.23%	4.77%	4.98%
Average	**3.71%**	**3.61%**	**3.59%**	**3.64%**
Median	**3.35%**	**3.69%**	**3.23%**	**3.42%**
Axos Bank	**10.96%**	**10.92%**	**11.12%**	**11.00%**

Difference Axos from Competitors		Difference in Percentage Points	Difference As A Percentage
Difference from Average	[redacted]	**7.36**	**302%**
Difference from Median		**7.58**	**321%**

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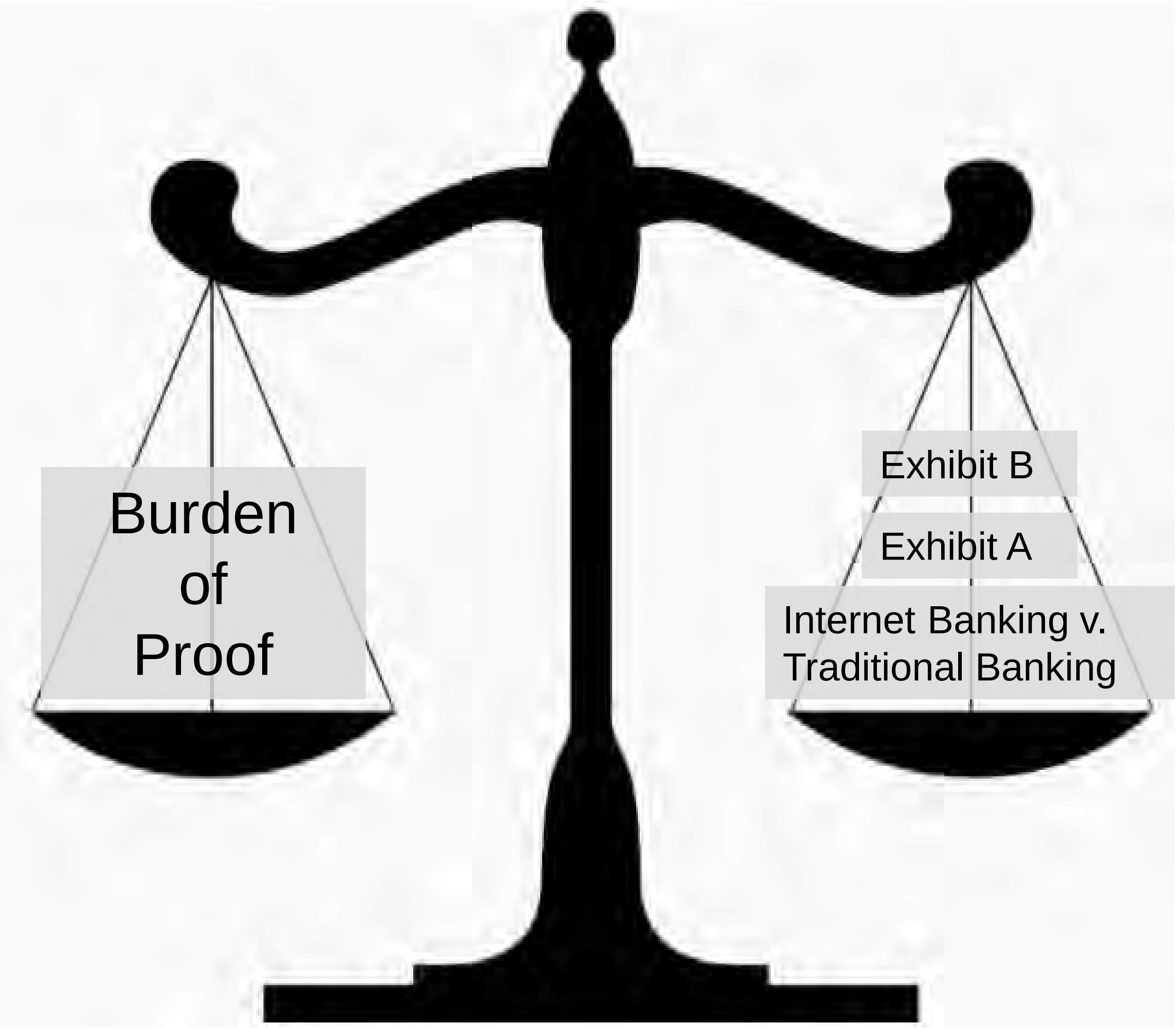

Exhibit B

Axos Financial, Inc. and Subsidiaries

Apportionment Analysis

EXHIBIT B

Number of States	Apportionment Method	Loan Sourcing Rule	Property Factor	Sales Factor %	Actual Apportionment %
CA	California - 3 Factor	SINAA	97.7911%	46.0729%	77.7964%
8 (excluding CA)	3-Factor	SINAA	2.5345%	3.6672%	3.2205%
3	Double Weighted Sales Factor	SINAA	0.0056%	0.7491%	0.3793%
1	Double Weighted Sales Factor	Loans not included	0.2379%	1.5887%	0.8998%
3	3-Factor	Loans not included	0.0000%	1.0396%	0.3465%
2	3-Factor	Location of Borrower	0.2187%	0.2187%	0.0726%
1	Double Weighted Sales Factor	Location of Borrower	5.0493%	4.6456%	3.6355%
25	Single Sales Factor	NA	NA	39.9726%	33.1514%
8	Other	NA	NA	2.0455%	1.7301%
			106%	100%	121%

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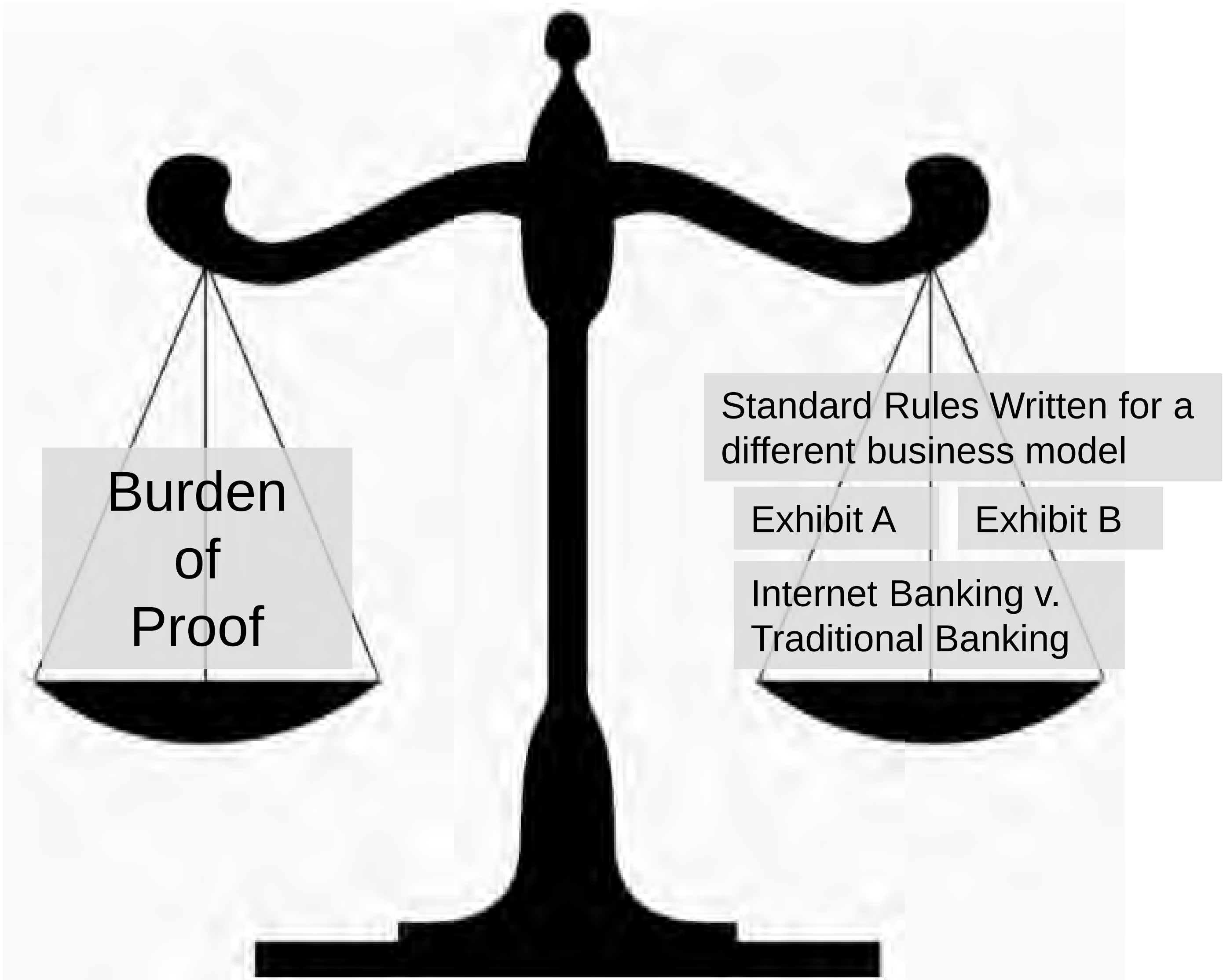

•Standard Rules Written for a different business model

- The California banking apportionment rules were written in 1987. These rules focused on fair apportionment of traditional banking and did not consider internet banking, which didn't exist.

- Under a traditional banking model, and as intended by the regulation, in developing the apportionment factor, the loans are spread among the states in which the taxpayer does business by being assigned to a bank's various brick and mortar branches.

- However, when applied to internet banking, the bank has a virtual branch, not brick mortar branches to which loans can be assigned. In the case of Axos, the rule resulted in assigning virtually all the loans to California, the location that oversees the virtual nationwide branch.

- Additionally, with traditional banking, payroll is spread amongst the states in which the bank has brick and mortar branches. However, in Axos' case as an internet bank, the payroll is assigned to the headquarter of the taxpayer and does not result in a spreading of the payroll throughout the states.

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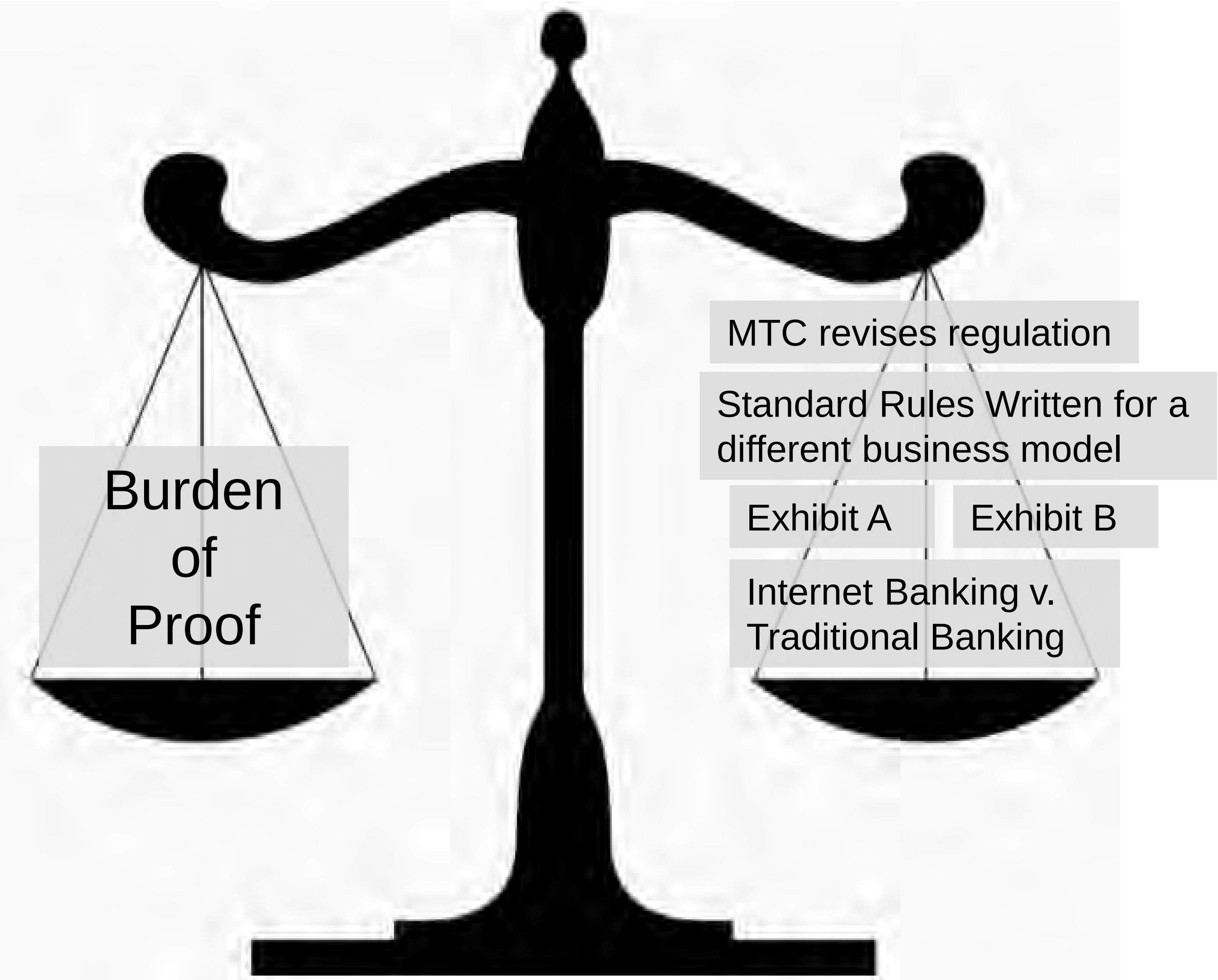

MTC Regulation Changes

- When internet banking became more common place, the MTC revised its model regulations in 2014 to remove the SINAA rule. In the project description for the revised regulations the MTC states:

  … These changes were caused both by the deregulation of the industry as a result of the repeal of Glass-Steagall, and by technological innovations that allow financial institutions to provide a full range of services, such as mortgage loan and credit card application processing, credit approval and account servicing, **entirely online.**

- The MTC believed that the inclusion of that loan sourcing rule in the property factor would not fairly reflect the income of an online bank.

- Most states currently do not apply SINAA and do not use a 3-factor formula. But California has not revised its apportionment rules to address its inequities to online banking taxpayers

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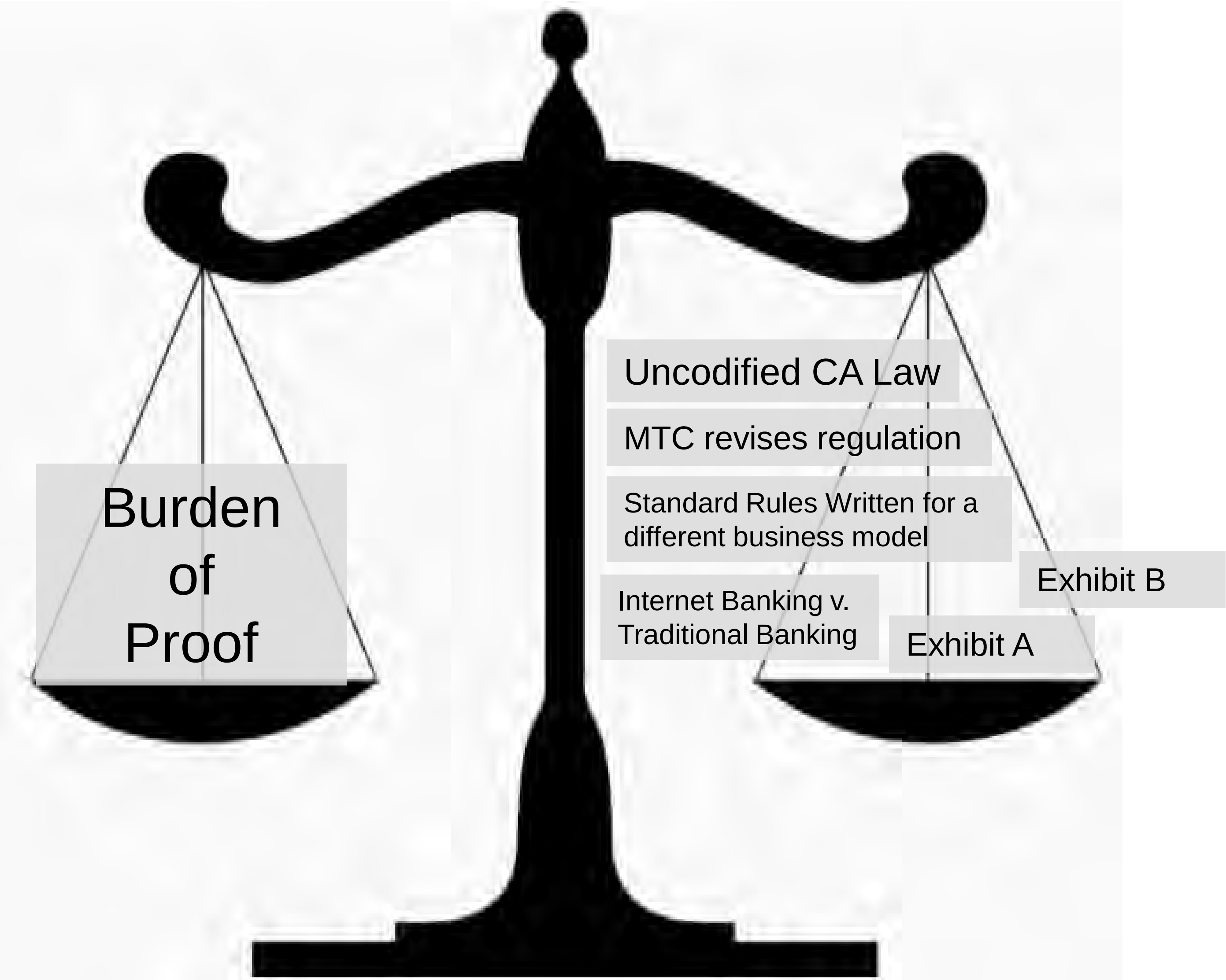

Uncodified CA law

- Uncodified California law (Sec. 3, Ch. 1442, Laws 1987) states that the Franchise Tax Board (FTB) shall adopt regulations dealing with apportionment and allocation of income with respect to banks and financial corporations which consider the laws and regulations of other states with an objective of preventing multiple taxation or circumstances where income is taxed in no state.
- At the time of enactment, the current California regulations had the objective of preventing multiple taxation, which was achieved by following the MTC model regulations being adopted by other states.
- This model regulation focused on fair apportionment of traditional banking businesses and did not consider internet banking.
- But since the advent of internet banking the current California regulations fall short of this statutory mandate when applied to internet banking.

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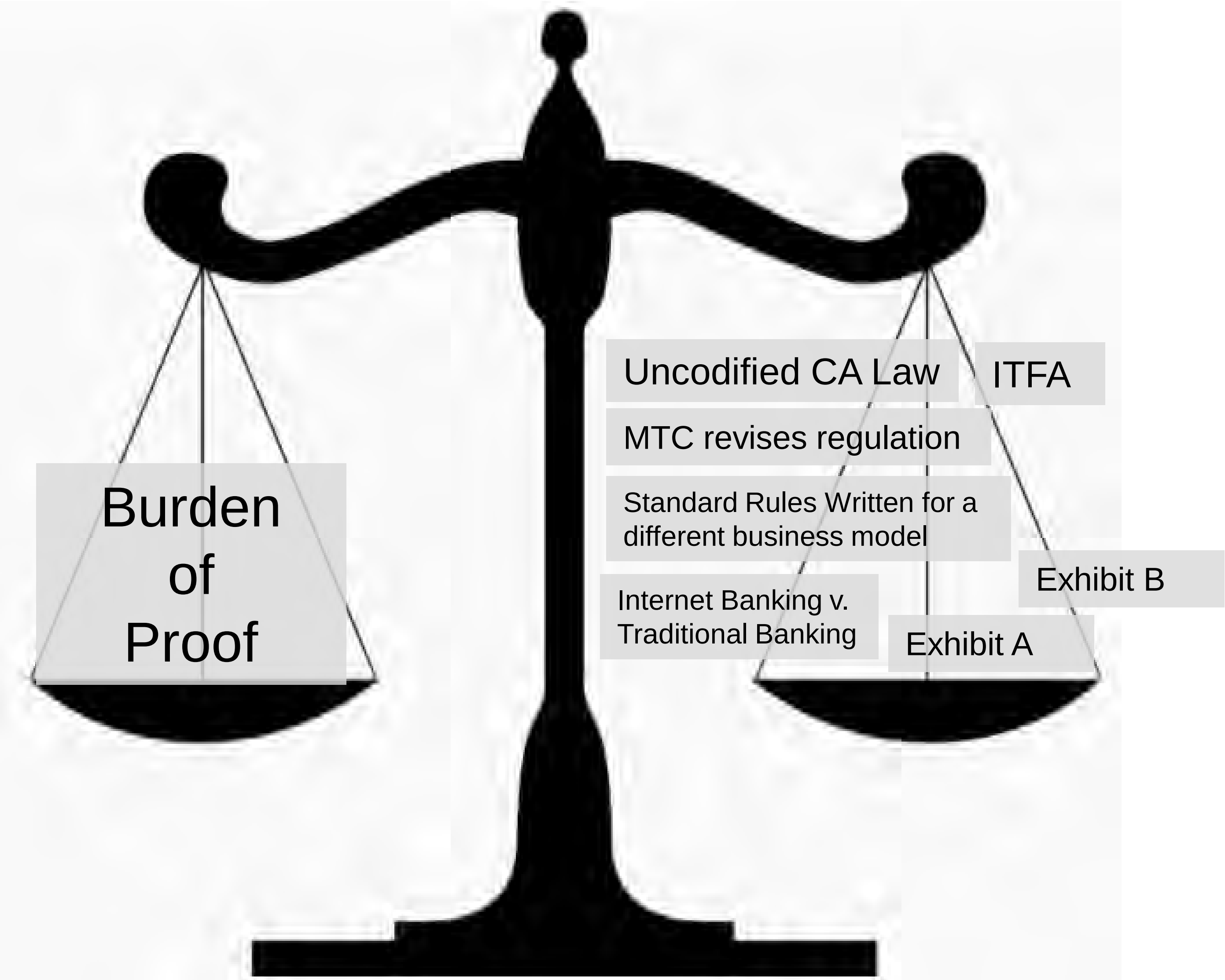

Internet Tax Freedom Act (“ITFA”) Arguments

- The ITFA prohibits states from asserting *multiple* or *discriminatory taxes* on *electronic commerce* and therefore should be factored into the analysis as one of the qualitative factors for consideration.
- When a national internet bank is required to use a higher apportionment factor than a national traditional bank with the same client base, it is being taxed at a higher rate and violates the ITFA as a discriminatory tax.
- Multiple tax is defined to include **any tax** (including income tax) that is imposed by one State on the same or essentially the same electronic commerce that is also subject to another tax imposed by another state without a credit for taxes paid in other jurisdictions.

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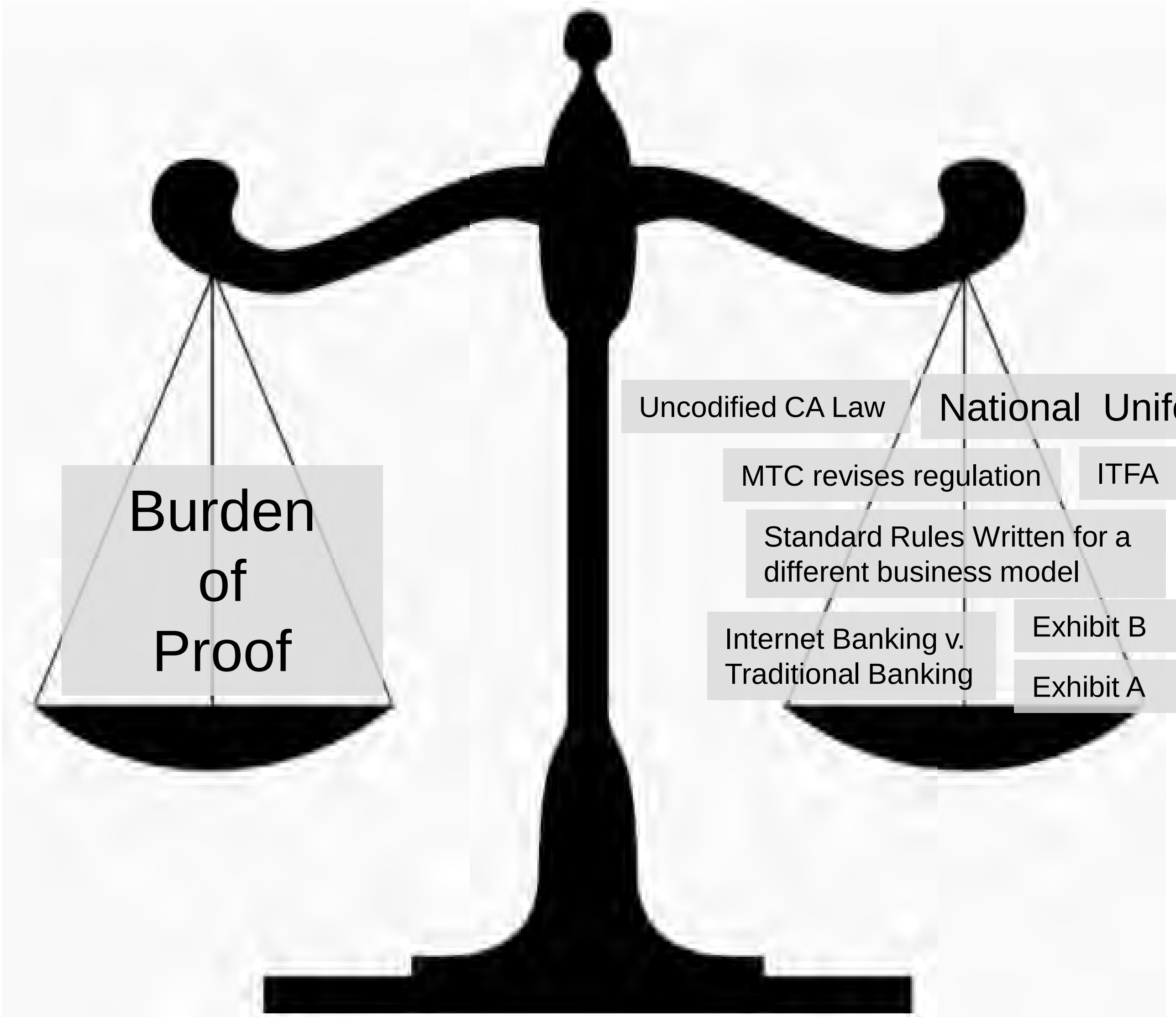

National Uniformity

- National Uniformity should also be considered in the analysis. (See *General Mills* and Uncodified CA Law)
- Most states do not follow California’s apportionment method regarding the property or payroll factors.
- A single sales factor, which the taxpayer proposes, would result in the highest amount of national uniformity, avoidance of multi-taxation, and avoidance of no-where sales.

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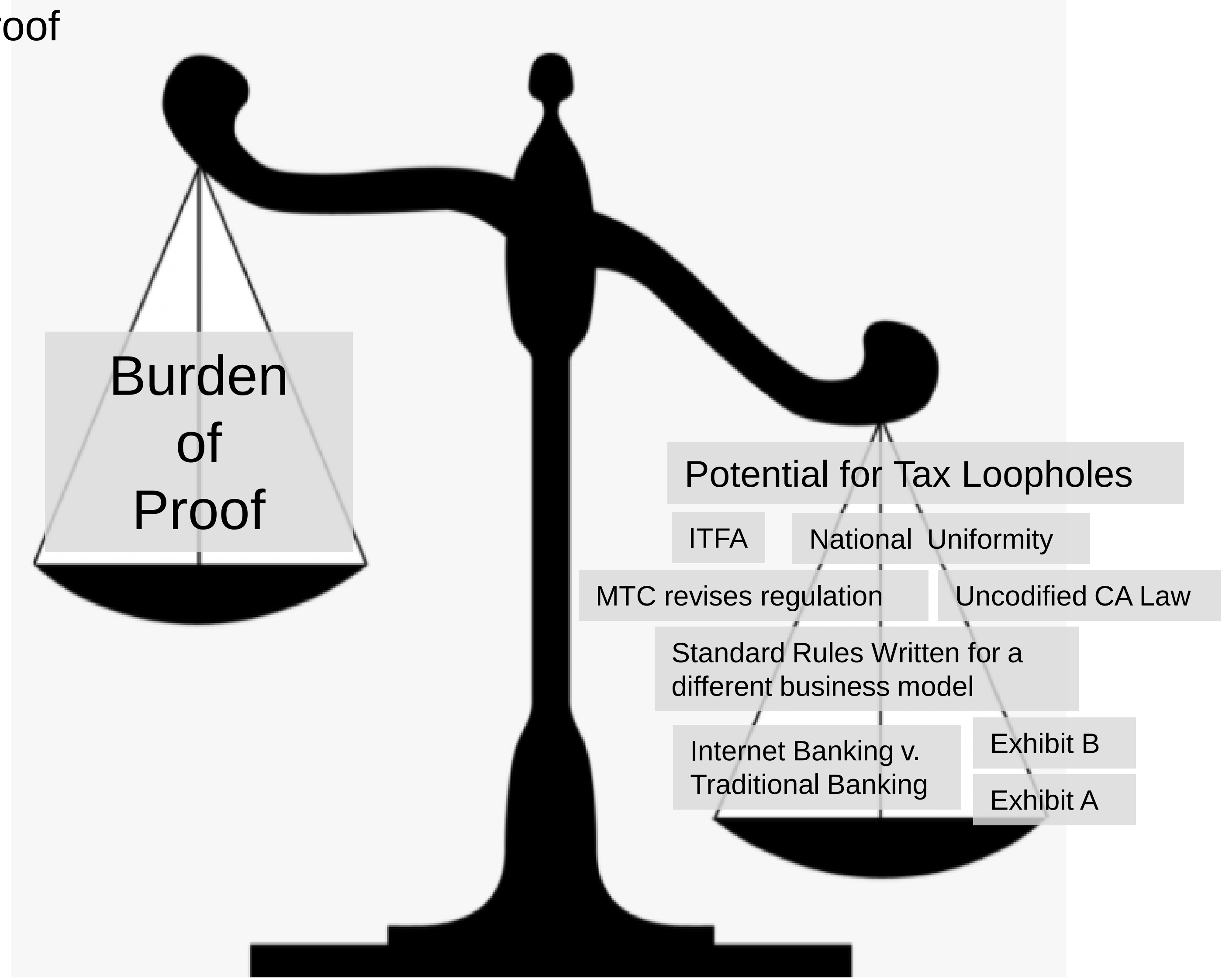
Burden of Proof



Predictability and Avoidance of Tax Loopholes

- Applying the rote rule of 25137-4.2 to an internet bank not only is distortive and cuts against national uniformity, it also is susceptible to manipulation and taxpayer loopholes.
- For an internet bank a single sales factor will create consistency based on the bank's customers.
- Under the current banking apportionment rules, it would be relatively easy for an internet bank to manipulate the rules by moving servers and a relatively small number of people to a tax haven state to assign all loans to that state.
- The adoption of the alternative apportionment method proposed would close that possibility to an internet bank.

Proposed Apportionment Method

- The taxpayer proposes to use a single sales factor apportionment. This method would achieve the following:

  - 100% apportionment. Since all states use a similar revenue sourcing method, there is no double taxation and no risk of nowhere sales.
  - No discriminatory or multiple taxation on e-commerce.
  - 100% apportionment and avoidance of double tax in conformity with uncodified California law (Sec. 3, Ch. 1442, Laws 1987).
  - National uniformity.
  - Not prone to tax avoidance schemes.

- Taxpayer believes that a single sale factor would be the best alternative, however Taxpayer is willing to use the MTC apportionment rule as well.

Summary

- An all facts and circumstances approach should be used for the analysis
- Internet banking and traditional branch banking are very different business models
- A formula developed for traditional banking does not clearly reflect the income of an internet bank
- The MTC recognized this and revised its regulations to address the problem
- The FTB has not yet corrected the problem, even though uncodified law directs the FTB, with regard to banks, to adopt apportionment regulations considering the laws and regulations of other states with an objective of preventing multiple taxation
- Also, the FTB should consider that the ITFA which places a higher degree of scrutiny on multiple taxation on electronic commerce
- Exhibits A shows that > 120% of the bank’s income is being subject to tax
- Exhibit B shows that Axos’ state tax rate is more than 300% of that traditional bank competitors
- The standard formula does not lead to national uniformity; the proposed formula does
- The standard formula when applied to an internet bank leaves itself open to tax loopholes and would be detrimental to the predictability of the state’s income
- A single sales factor resolves all these issues

Thank You