

1 REQUEST FOR CALIFORNIA REVENUE & TAXATION CODE SECTION 25137

2 CONSIDERATION BY THREE-MEMBER FRANCHISE TAX BOARD

3 REPLY BRIEF

4
5 Case: 31880726343149410
6 Case Unit: 31880726343149406
7 Reference: 410: RZ
8 Taxpayer: Axos Financial, Inc. & Subsidiaries
9

10 On December 1, 2020 we submitted an opening brief regarding a petition for alternative
11 apportionment (“the Petition”) under California Revenue and Taxation Code section
12 25137 on behalf of Axos Financial, Inc. and its subsidiaries (collectively “Axos,” or
13 “taxpayer”). We are replying to the Staff’s Brief dated December 31, 2020 (“Staff’s
14 Brief”).

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16 In the Petition, Axos Financial (the “Taxpayer”): (1) demonstrated that the standard
17 apportionment formula does not fairly reflect the income earned by Axos in California,
18 and (2) proposed an alternative formula.

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20 The Staff’s Brief concludes that the taxpayer has not shown, with clear and convincing
21 evidence, that application of the standard apportionment formula does not fairly reflect
22 its income in the state. The reasonableness of the alternative proposed formula
23 therefore was not addressed in the Staff’s Brief.
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1 We disagree with the conclusion of the Staff's Brief. In particular, we find fault in the
2 analytical method used in the brief to conclude that the taxpayer has not meet it burden
3 of proof. A proper analysis should consider all the facts and circumstances in totality
4 and weigh them in totality against guidance provided by the courts to reach a
5 conclusion. Instead, the Staff's Brief does not consider all the evidence in total, but
6 focuses on one piece of evidence, determines if that evidence on its own meets the
7 burden of proof, concludes that that piece of evidence on its own does not meet the
8 burden of proof, throws it out, and then considers the next piece of evidence on it own.
9 The correct analysis should weight all the evidence in totality.

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11 In addition to disagreeing with the analytical method used in the Staff's Brief, we also
12 disagree with or would like to respond to certain items stated in the Staff's Brief.

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14 1. THE LAW. The Relevant Law section of the Staff's Brief summarizes the law in five
15 paragraphs. This summary oversimplifies and excludes relevant law that should be
16 considered.

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18 a. The second paragraph states:

19 While the sales factor is intended to reflect the market for taxpayer's
20 goods or services (*Finnigan*). The purpose of the property factor is to
21 reflect the income producing effect of capital invested in the taxpayer's
22 trade or business (*Tosco*). And, the payroll factor reflects business
23 activities through a business's employees (*Merrill Lynch*).

1 This analysis oversimplifies the issue by breaking an entire court case down into a
2 general statement regarding the purpose of each component of the apportionment
3 factor. Also, note that these cases address apportionment issues related to tax years
4 ranging from 1972 to 1978, long before the widespread use of electronic commerce and
5 internet banking. Furthermore, all three cases fail to address the statutory formula in
6 question, California's financial institution apportionment rules.

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8 There are numerous apportionment formulas utilized by the states. These formulas
9 typically range from 3-factors to a single factor with a wide variety in between. The
10 important point is that the overall apportionment factor fairly represents the activity of
11 the taxpayer in the states. The analysis in the Staff's Brief ignores the precedent set in
12 *Moorman Mfg (Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978))*, which held that a single
13 sales factor fairly approximated a corporation's income, even though the apportionment
14 factor did not contain the elements that Staff's Brief indicates are required by *Tosco* and
15 *Merrill Lynch*. The crux of the matter is not that each factor is meant to represent a
16 specific aspect of the business, but that the apportionment factor (regardless of the
17 formula used by the state) taken as a whole, fairly represents the income earned by the
18 taxpayer in the state. The factor as a whole, not each component, must be analyzed to
19 determine if 25137 can be appropriately applied. See *Appeal of Merrill, Lynch, Pierce,*
20 *Fenner & Smith, Inc, California State Board of Equalization, 89-SBE-017, 89SBE017,*
21 *June 2, 1989.*

22
23 In summary, the focus on individual components of an apportionment factor as
24 interpreted by 40-year old cases can be misleading. Due to the very nature of fact
25 patterns that call for alternative apportionment, which generally involves novel or

1 immersing fact patterns, the apportionment formula as a whole must be considered in
2 determining if CRTC 25137 can properly be applied.

3 b. There is relevant law that is not referred to in the Relevant Law section of the
4 Staff's Brief that should be considered.

5 i. First, The Internet Tax Freedom Act (ITFA) has applicability. As the
6 Staff's Brief states, both qualitative and quantitative factors should
7 be considered jointly to determine whether the standard formula
8 fairly represents the company's business activity in California. In
9 other words, to the extent qualitative factors are high, even smaller
10 quantitative factors could lead to the conclusion that an
11 apportionment factor is distortive and visa-versa. The ITFA
12 prescribes that a higher level of scrutiny applies to electronic
13 commerce to make sure it is free of multiple taxation, and
14 accordingly should be included as part of the qualitative analysis.

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16 ii. Second, uncodified California law (Sec. 3, Ch. 1442, Laws 1987)
17 states that the Franchise Tax Board (FTB) shall adopt regulations
18 dealing with apportionment and allocation of income with respect to
19 banks and financial corporations which consider the laws and
20 regulations of other states with an objective of preventing multiple
21 taxation or circumstances where income is taxed in no state. This
22 law is relevant for two reasons: (1) it adds to the qualitative
23 analysis, in that it suggests a higher level of scrutiny on multiple
24 taxation is to be applied to banks and financial corporations, and (2)
25 **with respect to Banks, it instructs the FTB to consider other**

1 **states' apportionment methods in developing apportionment**
2 **schemes with the objective of reaching 100% apportionment.**

3
4 iii. Third, the MTC Regulations, though not technically law, is relevant
5 in that it is the primary method through which the FTB can fulfill the
6 mandate of the uncodified law referred to above. Additionally, it
7 should therefore be considered as part of the qualitative analysis.
8 See page 5 of the Petition for a short discussion on the 2014
9 changes in the MTC regulations to address the distortive issue
10 occurring in our case.

11
12 2. ANALYSIS. The taxpayer believes the Analysis section of the Staff's Brief is
13 incomplete. The following are some example of where we disagree.

14
15 Section 1 – The Standard Apportionment Provisions fairly represent the Taxpayer's
16 activities in California.

17 i. The Staff's Brief states that the fact that the loans are assigned to one
18 state is not problematic and basis this conclusion on *Tosco Corp* and
19 Financial Institutions State Tax Coalitions submission to the FTB.

20
21 First, *Tosco* was a case addressing tax years 1972 and 1973, fair
22 apportionment to electronic commerce was not considered at all in that
23 case nor was the fair inclusion of loans consider for inclusion in the
24 property factor. *Tosco* was in the oil and shale recovery business. A
25 property factor analysis for a company whose property is primarily tangible

1 property and oil reserves clearly in specific locations requires a very
2 different analysis than for a bank. Loans, as intangible property, have
3 unique issues.

- 4
- 5 ii. On the same page of the analysis, the Staff's Brief disagrees with the
6 taxpayer's assertion that the payroll factor is unfair using circular
7 reasoning. Such reasoning will always result in justifying the standard
8 formula. The Staff's Brief merely states that the petitioner wants
9 something other than the standard rule, which is not the rule, and
10 therefore the petitioner should not be granted the request. We quote the
11 statement:

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13 Taxpayer also asserts that payroll assignment to a single (or a few)
14 states is "unfair." Taxpayer supports its argument by stating that it
15 has a "virtual presence" in every state. However, the payroll factor
16 does not look to the "virtual presence" of taxpayers. Instead, it
17 looks to where employees are located. Since Taxpayer's
18 employees are located in a handful of states, it makes sense that
19 Taxpayer would assign its payroll only to those states. California's
20 standard apportionment method, which utilizes the property factor,
21 therefore fairly reflects Taxpayer's activities in California.

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23 Our point is that the standard apportionment formula was developed years ago before
24 there was such a thing as virtual presence. Therefore, when the standard rule is
25 applied to Axos, an internet bank, it distorts the income of the bank earned in California.

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2 Finally, the recommendation of the Financial Institution State Tax Coalition, was merely
3 one opinion on the matter of sourcing loans in the property factor. This opinion was
4 submitted to the MTC as new regulations for banks and financial institutions were being
5 developed. Additionally, the sourcing recommended by the coalition did not make it into
6 the final regulations. When the MTC released the final regulations that deleted the
7 referred to rules they included the following statement with the release:

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

14
15 In other words, the MTC believed, after consideration of all comments like the one
16 referred to in Staff's Brief, the inclusion of that loan sourcing rule in the property factor
17 would not fairly reflect the income of an online bank.

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19 Section 2 – Existence of minimal multiple taxation is insufficient to show distortion

20 The Staff's Brief asserts that even though the taxpayer is taxable on 120% of its
21 income, this would not mean the Taxpayer is entitled to 25137 relief and that is
22 insufficient to show that California's apportionment factor method unfairly reflects
23 Taxpayer's taxable income.
24

1 Our argument is not that a 120% apportionment factor is sufficient evidence that the
2 Taxpayer is entitled to alternative apportionment, but that the taxpayer is entitled to
3 alternative apportionment given all the qualitative and quantitative factors. We believe
4 that given a proper analysis of the total impact of each of the qualitative factors outlined
5 in our petition, the appropriate conclusion is that the petitioner has met the burden of
6 proof in showing alternative apportionment is warranted. The petitioner's 120%
7 apportionment factor demonstrates that quantitatively the petitioner is subject to double
8 taxation.

9
10 Section 3 – Taxpayer paying more in state tax than its competitors is of no avail.

11 The Staff's Brief states that the fact that Axos has a 200% to 300% higher rate than its
12 competitors is non-conclusive, and the fact is disregarded from the analysis, just like the
13 fact that the taxpayer is subject to multiple taxation is disregarded in the analysis. In
14 fact, the Staff's Brief states that it is of "no avail".

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16 We believe this is an analytical error. All facts should be considered in totality and the
17 fact that their rate is significantly higher than competitors is relevant to the analysis.
18 Additionally, it should be made clear that the competitors being compared to are
19 competitors that are not internet banks; that point is key to the analysis since it further
20 supports the point that the standard rule distorts the taxable income of an internet bank.

21
22 When this quantitative factor is considered in conjunction with all the other factors,
23 (qualitative and quantitative) it supports the taxpayer argument that the standard
24 formula is distortive.

1 Section 4 – The fact that the MTC removed the SINAA does not demonstrate the
2 Regulation 25137-4.2 is distortive.

3 There are a few points to be made about the statements made in this section.

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- 5 i. As with other points, the Staff’s Brief takes a “divide and conquer”
6 approach. Instead of the Staff’s Brief addressing the totality of the
7 taxpayer’s facts, it considers each fact separately to defeat that one
8 fact, then tosses that argument out of the equation. This is not the
9 proper approach to the analysis.

- 10
- 11 ii. The Staff’s Brief states:

12 The MTC made numerous changes to its model regulations. Some
13 of the changes were brought about by the appeal of Glass Steagall
14 as well as by technological changes that allowed firms to provide
15 services online.

16

17 The MTC model rules no longer rely on SINAA, and the rules also
18 removed loans from the calculation of the property factor.

19 However, the MTC did not entirely remove the property factor.

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21 Regarding this statement in the Staff’s Brief, we would like to make a few points. First,
22 the statement starts by insinuating that the SINAA changes to the MTC regulations was
23 a minor change and insignificant as one of “numerous changes.” The perception left
24 from this statement is misleading. Even a quick comparison of the new MTC

1 Regulations to the old makes it very apparent the SINAA rule revision was the major
2 change made.

3
4 Second, the Staff's Brief points out that the MTC resolved the problem by removing the
5 loans from the property factor and not by using the alternative apportionment method
6 we requested in the Petition.

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8 There are two issues to be resolved when allowing alternative apportionment: first, it
9 must be determined whether the standard formula is fair; and second, if not, it must be
10 determined if the alternative formula proposed is fair. It should also be noted that it is
11 possible that more than one method could be fair. The Staff's Brief does not address
12 the second issue. It incorrectly concludes that the standard formula is fair and provides
13 no further analysis of the proposed method. The statement that the MTC did not use
14 the same apportionment method to fix the problem that the taxpayer is requesting does
15 not support the argument that the standard formula is correct; it indicates the opposite.

16
17 Additionally, on page 13, the Staff's Brief refers to a private conversation held with a Mr.
18 Bruce Fort. According to the brief, Mr. Fort represented that the changes in the
19 regulations were "spurred by difficulty in administering it, not because SINAA rules
20 created unfair internet banking results." We believe this private conversation should not
21 be considered by the FTB in making its determination for the following reasons.

- 22 1. This was a private conversation of which we do not know the context, nor were
23 we able to participate in the discussion.
- 24 2. The Staff Brief provides no evidence of the MTC or Mr. Fort ever making such a
25 statement publicly.

1 3. The statement is irrelevant. Based on public statements the MTC changed the
2 rules because of “technological innovations that allow financial institutions to
3 provide a full range of services, such as mortgage loan and credit card
4 application processing, credit approval and account servicing, entirely online”
5 ([http://www.mtc.gov/Uniformity/Project.-Teams/Model-Uniform-Financial-
7 Institutions-Apportionment](http://www.mtc.gov/Uniformity/Project.-Teams/Model-Uniform-Financial-
6 Institutions-Apportionment)). It is clear that the regulations were changed
8 because they were not adequate, especially with regards to online banking.
9 Whether the old regulations were changed because they did not fairly
10 apportionment income due to a formulaic matter or due to an administrative
11 matter is beside the point. The fact is the MTC changed the regulations since
12 they could not be relied on (either formulaically or administratively), with
13 electronic banking, to fairly apportionment income.

14 Finally, the Staff’s Brief states that even if the FTB were to acquiesce and take the MTC
15 approach, taxpayer’s proposed remedy that is the use of a single sale factor is
16 inconsistent with the MTIC’s approach, as the MTC regulation left the property and
17 payroll factors in place for banks and financial corporations. As stated in our brief, we
18 prefer the single sale factor, as an alternative position for the reason stated therein.
19 However, we are willing to accept the MTC’s solution of excluding loans from the
20 property factor.

21 Summary

22 An analysis of the qualitative and quantitative factors indicates that the standard formula
23 as applied to Axos does not fairly represent the income of Axos in California and
24 alternative apportionment is warranted.
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2 **Qualitative Factors**

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- Internet banking and traditional banking are very different business models and a formula developed for traditional banking does not clearly reflect the income of an internet bank.
 - The MTC realized this was a problem and revised its regulations to address it. California has not yet revised its regulations to address the problem even though uncodified California law directs the FTB, with regard to the taxation of banks, to adopt apportionment regulations considering the laws and regulations of other states with an objective of preventing multiple taxation. The FTB should also consider that the ITFA places a higher degree of scrutiny on multiple taxation of electronic commerce.
 - The standard formula does not lead to national uniformity, and the proposed formula would result is significantly more uniformity with other states. This runs contrary to the directive of the CA Uncodified regulations that direct the FTB to consider the laws of other states.
 - The standard formula, when applied to an internet bank, results in double taxation from the inclusion of the payroll and property factors. This goes against the intent of the Internet Tax Freedom Act by subjecting an internet business to multiple taxation.
 - Finally, the standard formula when applied to an internet bank leaves itself open to tax loopholes. *General Mills* lists this as one additional qualitative factor for consideration in a distortion analysis and should be factored into this analysis.

1 **Quantitative Factors**

2 This distortion of Axos' income was demonstrated in Exhibits A and B of the opening
3 brief which showed more than 120% of the banks income being subject to tax and the
4 taxpayer's state tax rate being more than 200 to 300% of traditional bank competitors.

5

6 **Proposed Method**

7 A single Sales Factor would mitigate all the qualitative and quantitative indicia of
8 distortion; we believe it would be the fairest way of sourcing income for Axos. However,
9 the taxpayer would also be open to using the MTC apportionment rule.