



STATE OF CALIFORNIA
Franchise Tax Board

Section 25137 Petition Hearing



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Issue

Whether Revenue and Taxation Code section 25137 (“Section 25137”) can be invoked to allow Taxpayer to use an alternative apportionment formula.

Section 25137

“If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state.”

Section 25137 Two Prong Test per *Microsoft*

The party invoking section 25137 has the burden of proving by clear and convincing evidence that:

- the approximation provided by the standard formula is not a fair representation, and
- its proposed alternative is reasonable.

Taxpayer Has Failed to Meet its Burden to Invoke Section 25137

- Taxpayer has failed to show the apportionment formula does not fairly represent its business activities.
- Taxpayer's arguments are to no avail:
 - Purported, better apportionment formula;
 - Multiple taxation; and
 - Quantitative distortion metrics alone.

Purpose of Apportionment Formula

States are permitted to tax “an apportionable share of the multistate business carried on in part in the taxing State.” (*Allied-Signal, Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768, 778.)

States Given Wide Latitude When Crafting Apportionment Formula

- Supreme Court has held that:
 - “States [are given] wide latitude to fashion formulae designed to approximate the in-state portion of value produced by a corporation's truly multistate activity.” (*Allied-Signal, Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768, 784.)
- “[T]he Constitution imposes no single formula on the States.” (*Container Corp. of Am. v. FTB* (1983) 463 US 159, 164.)

Role of Section 25137

- Invoked if apportionment formula at issue is not fairly representative of the business activities.
- “Revenue and Taxation Code section 25137, does not authorize deviation from [the] normal provisions simply because one purports to have found a better approach.”
(*Appeal of Kikkoman International, Inc.*, 82-SBE-098, June 29, 1982)

Business Activities

- Over 90 percent of combined reporting group's gross income is generated by Axos Bank from interest on loans and leases.
- Axos Bank is a federally chartered bank that operates primarily over the internet and serves customers nationwide.
- Banking segment operates primarily from headquarters located in San Diego, California.

Apportionment Formula at Issue

- Section 25128(b) – Three-factor formula

“If an apportioning trade or business derives more than 50 percent of its “gross business receipts” from . . . a banking or financial business activity . . .

- Legislative intent to use three-factor formula reaffirmed in 2009

“[B]anks and financial activities currently are limited to a single-weighted sales factor and will continue to use three-factor apportionment.” (Senate Bill No. 15XXX (2009-2010, 3rd Ex. Sess.)

Apportionment Formula at Issue (cont.)

- Cal. Code of Regs., tit. 18, section 25137- 4.2
 - Loans are included in the property factor.
 - In general, loans are assigned to the regular place of business of the taxpayer with which the loans have a preponderance of “substantive contacts.”
 - The relevant factors for determining “substantive contacts” include solicitation, investigation, negotiation, approval, and administration of the loans (“SINAA”).

Three-Factor Apportionment Methodology

The United States Supreme Court has long upheld California's three-factor apportionment methodology – “a long-accepted method of apportionment, commonly called the 'three-factor' formula, to arrive at the amount of income attributable to the operations of the enterprise in California.” (*Barclays Bank PLC v. FTB* (1994) 512 U.S. 298, 304.)

No Evidence the Payroll Factor Does Not Fairly Represent the Business Activities in This State

- Payroll factor purpose:
 - Payroll factor includes all compensation paid to employees for services performed in connection with the earning of the income to be apportioned by the formula.
- Taxpayer's payroll factor:
 - Properly assigned to location where Taxpayer's employees performed services, which fairly represents its business activities in this state.

No Evidence the Property Factor Does Not Fairly Represent the Business Activities in This State

- Property factor purpose:
 - The property factor is intended to reflect the income producing effect of capital invested in the taxpayer's trade or business. (*Appeal of Tosco Corp.*, 80-SBE-142, Nov. 18, 1980.)
- Taxpayer's property factor:
 - Properly included loans, as required by Cal. Code of Regs., tit. 18, section 25137 - 4.2.
 - Loans properly assigned based on SINAA factors that gave rise to such loans.

No Evidence the Apportionment Formula Does Not Fairly Represent the Business Activities

- No evidence the three-factor methodology does not fairly represent Taxpayer's business activities.
 - Internet banking has not diminished the importance of the payroll and property factors.
 - Taxpayer's banking segment operates mostly out of the headquarters located in this state, and the apportionment formula fairly reflects this.

Difference in Methodology Does Not Prove Unfair Representation of Business Activities

- Taxpayer points to other formulas as evidence of an unfair representation of its business activities in this state
- However, arguments of a purported, better formula do not prove an unfair representation of business activities.

(Appeal of Kikkoman International, Inc., 82-SBE-098, June 29, 1982.)

Difference in Methodology Does Not Prove Unfair Representation of Business Activities (cont.)

- MTC Hearing Officer Report demonstrates revision made in response to concerns SINAA rules difficult to administer:
 - “After initially identifying several issues regarding the application of the property factor to financial institutions,² the work group turned its attention to definitional issues and refining the receipts factor.”

² “These issues largely revolved around whether reliance on the SINAA ([solicitation], investigation, negotiation, approval and administration) factors for sourcing loans in the property factor is administrable and if not, how they should be modified or replaced.”

Assertions of Multiple Taxation Does Not Prove Unfair Representation of Business Activities

- Assertions of multiple taxation are not relevant to the question of whether the standard formula results in an unfair representation of business activities in this state.
- Nevertheless, apportionment prevents multiple taxation.
 - Under U.S. Constitution, a state can only tax “an apportionable share of the multistate business carried on in part in the taxing State.” (*Allied-Signal, Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768, 778.)

Assertions of Multiple Taxation Does Not Prove Unfair Representation of Business Activities (cont.)

- Double taxation created from interaction of two different, but nondiscriminatory tax schemes is permitted. (*Container Corp. of Am. v. Franchise Tax Bd.* (1983) 463 U.S. 159; *Comptroller of Treasury v. Wynne* (2015) 575 U.S. 542.)

Internet Tax Freedom Act Does Not Prove Unfair Representation of Business Activities

- Not applicable to the question of whether there is an unfair reflection of business activities in this state.
- Does not apply:
 - No discrimination.
 - No multiple taxation.

Effective Tax Rate Differences to No Avail

- No evidence the effective tax rate differences are due to the three-factor formula.
- Quantitative comparisons alone are not dispositive:
 - “The central question under section 25137 is not whether some quantitative comparison has produced a large-enough “distortive” figure. Rather, the question is whether there is . . . [a] situation that leads to an unfair reflection of business activity under the standard apportionment formula.” (*Appeal of Crisa Corporation*, 2002-SBE-004, June 20, 2002.)

Alternative Formulas

Taxpayer did not prove by clear and convincing evidence that the standard formula results in an unfair representation of the extent of its business activities in this state; as such, the alternatives proposed are not reasonable.

Closing Considerations

Questions?