STATE OF CALIFORNIA
FRANCHISE TAX BOARD
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BEFORE THE THREE-MEMBER FRANCHISE TAX BOARD
OF THE STATE OF CALIFORNIA

In the Matter of Revenue and Taxation Code
Section 25137 Petition of:

AXOS FINANCIAL INC. AND SUBSIDIARIES ("TAXPAYER")

Taxable Year		*Claimed Refund*
6-30-2015		$3,224,943.47
6-30-2016		$5,744,159.47
6-30-2017		$6,781,721.24
6-30-2018		$7,478,923.06
Total		$23,229,747.24

STAFF'S BRIEF

INTRODUCTION

Axos Financial and subsidiaries (collectively, "Axos" or "Taxpayer"), is a bank holding company that historically apportioned its income pursuant to California Revenue and Taxation Code ("RTC") section 25128 subdivision (b). On November 13, 2019, Taxpayer filed a claim for refund, arguing that it must apportion its income using an alternative, single sales apportionment factor pursuant to California Code of Regulations, title 18, ("CCR") section 25137, subdivision (d) ("Request"). In its Request, Taxpayer asserts the evenly-weighted three factor formula does not fairly reflect Taxpayer's activities in California.

On August 12, 2020, after much deliberation, Franchise Tax Board's ("FTB") staff reviewed and denied Taxpayer's Petition. FTB staff concluded Taxpayer had not carried its burden of proving by clear and convincing evidence that the standard formula – the evenly-weighted three factor formula applicable to banks and financial corporations – does not fairly represent the extent of Taxpayer's business activity in California.

As Taxpayer disagrees with FTB staff's decision, it filed a petition (Petition) with FTB's three-member Board ("Board") for the Board to consider its Petition during an open session. As the following analysis indicates, because Taxpayer failed to carry its burden of proving that the standard formula does not fairly represent its business activities in California, the Board should affirm the FTB staff's denial of Taxpayer's request for an alternative apportionment.

ISSUE

Whether Taxpayer carried its burden of proving by clear and convincing evidence, that the standard formula – the evenly-weighted three factor formula applicable to banks and financial corporations – does not fairly represent the extent of its business activity in California.

BACKGROUND

Facts[1]

Taxpayer is a financial holding company with over $11.7 billion in assets. It provides banking and securities products and services to its customers through its online distribution channels. More than 90 percent of the group's total income is generated by one of its members, Axos Bank, from interest on loans and leases. Axos Bank is a federally charted bank that provides internet banking solutions for personal and business banking needs. One of the first digital-only banks in the world, Axos Bank was founded in 2000. The bank's thrift charter allows it to operate within all 50 states. Axos Bank went public on NASDAQ, as Bank of Internet USA, on March 15, 2005.

Axos Bank has deposit and loan customers nationwide and provides services which include consumer and business checking, savings and time deposit accounts, financing for single family and multifamily residential properties, small-to-medium size businesses in target sectors, and selected specialty finance receivables. Axos Bank generates fee income from consumer and business products, including fees from loans originated for sale and transaction fees earned from processing payment activity.

While the banking segment operates primarily from the company's San Diego headquarters, Taxpayer also conducts loan servicing, deposit operations, and approximately 50 percent of the mortgage banking of Axos Bank in Nevada. The banking segment also has a location in Salt Lake City, Utah, which focuses on commercial and industrial leases to businesses. The Salt Lake City office focuses on leasing, not loans. The securities products and services

[1] Taxpayer's Opening Brief ("TOB"), pp. 2-4.

segment operates from offices in Nebraska, Nevada, and New Jersey. The securities segment is a small component of the business, making up less than 10% of the company's total gross receipts.

Historical Filing Method

Taxpayer has historically filed under the evenly-weighted three factor apportionment formula applicable to banks and financial corporations pursuant to RTC section 25128(b). For sourcing its property, payroll, and sales factors, Taxpayer properly applied CCR section 25137-4.2.

Taxpayer's Petition

For the taxable years ending June 30, 2015 and going forward, Taxpayer requests to apportion its income pursuant to the single sales factor apportionment formula as an alternative. Taxpayer argues that the application of the standard rules – the equally weighted three factor apportionment formula – results in unfair discrimination of Taxpayer compared to traditional banks because Taxpayer engages in "internet banking." According to Taxpayer, the sourcing rules contained in Regulation 25137-4.2 – which apply to banks and financial corporations only and which assign loans according to the location of solicitation, investigation, negotiation, approval and administration activities attributable to each loan ("SINAA rules") – make sense when applied to traditional banks with physical locations, but should not be used when applied to an internet bank because the latter is "qualitatively different."

Taxpayer asserts that while SINAA rules properly assign loans to the property factor based on branch locations in context of traditional banks, the same rules assign almost 100 percent of the loans to the numerator of the property factor for internet banks like Taxpayer. For Taxpayer, headquartered in California, loans are predominantly assigned to California. This, according to Taxpayer, results in it paying 300 percent more in taxes than its conventional

competitors and, thus, evidences that application of the standard rules to Taxpayer results in distortion.

Taxpayer also argues that, because most other states use a single sales factor to apportion bank income, California should follow suit. The existence of differing rules, according to Taxpayer, creates an increased risk of multi-taxation. Taxpayer further argues that assigning loans to one location increases the risk of manipulation by taxpayers because it allows taxpayers change loan sourcing rules by moving relatively small amount of people and servers to a "tax haven." As to the payroll factor, Taxpayer also asserts unfair assignment to one state despite Taxpayer having a "virtual" presence in many states.

Lastly, Taxpayer alleges that the fact that it pays 300 percent more in taxes than traditional banks violates the Internet Tax Freedom Act.[2] Taxpayer asserts that it paying more in state taxes demonstrates that it is being discriminated against.

DISCUSSION

Relevant Law

RTC section 25128 governs how taxpayers, including those that derive income from banking activities, must apportion their income. Subdivision (b)(4) of RTC section 25128 requires that an apportioning trade or business which derives more than 50 percent of its gross business receipts from banking or financial activity, as is the case here, must apportion its income "by multiplying business income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three." This manner of apportionment is referred-to as the equally weighted three-factor formula.

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[2] The Internet Tax Freedom Act, Sec. 1104(6)(A).

While the sales factor is intended to reflect the market for taxpayer's goods or services,[3] the purpose of the property factor is to reflect the income producing effect of capital invested in the taxpayer's trade or business.[4] And, the payroll factor reflects business activities through its employees.[5]

Pursuant to RTC section 25137, if the standard allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the Franchise Tax Board may require, if reasonable, the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. The party attempting to employ another method of apportionment has the burden to prove by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation of the taxpayer's business activity in California, and (2) its proposed alternative is reasonable.[6]

RTC section 25137 applies when California's standard apportionment provisions produce inequitable results.[7] A simple comparison of the varying levels of taxation from differing apportionment methods, by itself, however, does not demonstrate that the standard apportionment formula unfairly reflects the extent of a taxpayer's activity in this state.[8] "The central question under RTC section 25137 is not whether some quantitative comparison has produced a large-enough 'distortive' figure. Rather, the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula."[9] Qualitative and quantitative distortion are not independent and

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[3] *Appeal of Finnigan Corp.,* 88-SBE-002A, Jan. 24, 1990.
[4] *Appeal of Tosco Corp.*, 80-SBE-142, Nov. 18, 1980.
[5] *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*., 89-SBE-017, June 2, 1989.
[6] *Microsoft Corp. v. Franchise Tax Bd.* (Aug. 17, 2006) 39 Cal. 4th 750, 765.
[7] *Merrill, Lynch, supra*.
[8] *Ibid.*
[9] *Appeal of Crisa Corporation,* 02-SBE-004*,* June 20, 2002.

separate requirements for determining whether and alternative apportionment formula may be imposed; rather, these factors should be considered jointly to determine whether the standard formula fairly represents the company's business activity in California.[10]

RTC section 25137 does not authorize deviation from UDITPA's standard provisions merely because a purportedly better approach exists.[11] Allegations that the normal apportionment formula is not precise also do not justify proposed deviations.[12] Rough approximation is sufficient in the formula apportionment of income from a unitary business.[13] As long as the normal apportionment methods fairly represent the extent of the taxpayer's business activity in this state, their use will be upheld.[14]

Analysis

The standard apportionment provisions fairly represent the Taxpayer's activities in California.

As a bank, RTC section 25138 requires that Taxpayer apportion its income to California using the three-factor apportionment formula, which includes a property, payroll, and sales factor. However, Taxpayer seeks to utilize the single sales factor. In order to utilize the single sales factor, Taxpayer must overcome the high burden of demonstrating, by clear and convincing evidence, that the three-factor standard apportionment formula unfairly reflects Taxpayer's activities in California.[15] As discussed in greater detail below, taxpayer has not sustained its burden.

The US Supreme Court has long upheld California's three-factor apportionment methodology – "a **long-accepted** method of apportionment, commonly called the 'three-factor'

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[10] *General Mills, Inc. v. Franchise Tax Board* (Aug. 29, 2012) 208 Cal. App. 4th 1290, 1301.
[11] *Appeal of Kikkoman International, Inc*., 82-SBE-098, June 29, 1982.
[12] *Ibid.*
[13] *Appeal of Crisa, supra*.
[14] *Appeal of Kikkoman, supra*.
[15] See *Microsoft Corp., supra,* 39 Cal. 4th 765.

formula, to arrive at the amount of income attributable to the operations of the enterprise in California."[16] The sales factor alone may not necessarily fully reflect a taxpayer's business activity.[17] In this case, the property and payroll factors, which Taxpayer proposes that your Board discard, also fairly represent Taxpayer's activity in California. "Business activity" also encompasses activities of employees, reflected in the payroll factor, and the use and availability of real and personal property, reflected in the property factor.[18] In this case, these three factors balance each other by reflecting different types of contribution to the business activity and income of the entire unitary business.[19] The Taxpayer's employees and property contribute to the business activity and income of Taxpayer's unitary banking business as a whole. Reflecting the contribution of these employees and property in the property and payroll factors fairly reflects Taxpayer's activities in California.

Taxpayer asserts, for purposes of the property factor, that assigning loans to one state (in this case, California) is unfair because Taxpayer has clients in every state. However, the fact that loans are assigned to one state due to the application of the SINAA rules, for purposes of the property factor, is appropriate. The property factor is meant to reflect the contribution of assets and capital to a business.[20] Taxpayer's loans are assigned to California because that is where the SINAA rules assign them. While Taxpayer operates online, its assets and deployed capital are located in California. Assigning loans to California, for purposes of the property factor, therefore, reflects the purpose of the property factor as well as Taxpayer's activities in the state.

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[16] *Barclays Bank PLC v. FTB* (1994) 512 U.S. 298, 304, emphasis added.
[17] *In the Matter of the Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* 89-SBE-017, June 2, 1989.
[18] *Ibid.*
[19] *Ibid.*
[20] *Appeal of Tosco Corp.*, 80-SBE-142, Nov. 18, 1980.

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

Moreover, according to the Financial Institutions State Tax Coalition:[21]

> The investigation and approval facets in highly automated systems should be attributed to the state in which the greatest cost of the activity occurs. The investigation and approval facets are occurring on all loans, and the mere fact that some elements are automated, rather painstakingly done by employees, should not discount the weight of these two activities. Contrary to what some might think - automation does not result in no or little cost.

Thus, the fact that a taxpayer automates certain functions does not minimize their importance. With a traditional bank, employees at physical branch locations perform SINAA activities. With Taxpayer, such activities are apparently performed, albeit electronically, primarily in California.

Though Taxpayer operates differently than traditional banks, the difference does not establish that the application of the standard rules result in unfair representation in need of a remedy. Traditional banks have employees and property in numerous states. Those employees and that property are utilized by traditional banks to generate income, so their property and payroll are properly assigned to numerous states. However, Taxpayer has property and employees primarily in California. It is therefore appropriate to assign the bulk of Taxpayer's property and payroll to California.

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[21] *Payroll Factor* (Aug. 24, 2008) Financial Institutions State Tax Coalition <http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/Financial_Institutions_Working_Groups/Definitions_Group/FIST%20Property%20Factor%20Paper%20(26%20August%202008).pdf>.

The existence of minimal multiple taxation is insufficient to show distortion.

Taxpayer asserts that 120 percent of its income is taxed and that it is therefore subject to "multiple taxation." Assuming Taxpayer is correct, the fact that 120 percent of Taxpayer's income is taxed does not mean Taxpayer is entitled to RTC section 25137 relief. Though Taxpayer asserts that it is subject to "multiple taxation," this is insufficient to show that California's apportionment method unfairly reflects Taxpayer's activities in California.[22]

Precise state taxation of multijurisdictional businesses is often an elusive goal, both in theory and in practice. [23] States have differing taxation methodologies, and whenever differences exist, the possibility of double taxation also exists.[24] For this reason and others, the Supreme Court has long held that the Constitution imposes no single formula on the States,[25] and that the taxpayer has the "'distinct burden of showing by "clear and cogent evidence" that [the state tax] results in extraterritorial values being taxed . . . .'"[26]

Evidence of actual double taxation has been held as insufficient to invalidate California's three factor apportionment methodology. In *Container,* the US Supreme Court recognized that California tax "had resulted in actual double taxation . . . stemming from a serious divergence in the taxing schemes adopted by California and the foreign taxing authorities." However, the Court held the double taxation was not sufficient for the taxpayer to prevail. Instead, according to *Barclays*, double taxation must be the **inevitable result** of a state's method of taxation.[27]

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[22] See *Appeal of Kikkoman, supra*..
[23] *Container Corp. of Am. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 164 ("*Container*").
[24] *Ibid.*
[25] *Wisconsin v. J. C. Penney Co.* (1940) 311 U.S. 435, 445.
[26] *Exxon Corp. v. Dep't of Revenue* (1980) 447 U.S. 207, 221
[27] *Barclays Bank, supra,* 512 U.S. 318.

Though the Court in *Container* did not address RTC section 25137, the Court's discussion of multiple taxation is relevant in considering whether multiple taxation warrants RTC section 25137 relief. The Court's discussion demonstrates that, while some multiple taxation may result, it does not invalidate California's taxation method. The multiple taxation, which may exist in this instance, is the product of difference in state taxation methodologies, with multiple jurisdictions applying different rules. Taxpayer has not demonstrated that the purported double taxation is an "inevitable result" of California's method of taxation. The presence, if any, of double taxation, therefore is insufficient to show that California's method of taxation inevitably drives it.

Similarly, the multiple taxation encountered by Taxpayer does not demonstrate that application of California's apportionment provisions fails to fairly represent the extent of Taxpayer’s business activity in this state. The multiple taxation, as discussed above, is merely the product of differing state taxation methodologies, by multiple jurisdictions with differing rules. The fact that other states have differing rules does not show that California's method of taxation unfairly reflects Taxpayer's activities **in California**, as required by RTC section 25137. Taxpayer's multiple taxation argument does not support its request for alternative apportionment and must therefore be rejected.

Taxpayer paying more in state taxes than its competitors is of no avail.

Taxpayer asserts that it pays 300 percent more in taxes than its competitors. The fact that Taxpayer might pay more in taxes than its competitors does not demonstrate that California's apportionment rules do not fairly represent the extent of Taxpayer's business activity in California. The fact that another bank is taxed at a lower effective rate is likely the product of varying state tax rates, application of various state tax rules, along with numerous other factors, like competitor banks' different business models and states of operation.

Even if Taxpayer paid substantially more in taxes than its competitors, California's apportionment rules do not violate IFTA.

Taxpayer asserts that California's apportionment rules, as they relate to Taxpayer, violate the Internet Tax Freedom Act ("IFTA"). ITFA prohibits state and local governments from imposing multiple or discriminatory taxes on electronic commerce. However, California's apportionment method of taxation does not constitute a multiple or discriminatory tax on electronic commerce. The US Supreme Court has long upheld California 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."[28] The mere fact that Taxpayer alleges that is subject to multiple taxation therefore does not demonstrate that California has imposed a multiple or discriminatory tax on Taxpayer.

The fact that the MTC removed the SINAA rules does not demonstrate that Regulation 25137-4.2 is distortive.

Taxpayer asserts that California's use of the California's SINAA rules for Taxpayer's property factor is distortive. In support for its assertion, Taxpayer stated that the Multistate Tax Commission ("MTC") revised model regulations to remove the SINAA rule. The MTC made numerous changes to its model regulations. Some of the changes were brought about by the repeal of Glass-Steagall Act as well as by technological changes that allowed firms to provide services online.[29]

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[28] *Barclays Bank, supra,* 512 U.S. 304.
[29] See Sheldon Laskin, Multistate Tax Comm., Report of the Hearing Officer Regarding Proposed Amendments to the Formula for the Apportionment and Allocation of Net Income of Financial Institutions (Jul. 2014) p. 1.

The MTC model rules no longer rely on SINAA, and the rules also removed loans from the calculation of the property factor. However, the MTC did not entirely remove the property factor. Additionally, the MTC made changes relating to credit/debit card-related receipts, including definitional changes and changes to the sourcing of receipts from merchant discounts, receipts from automated teller machine services, and receipts from services not otherwise apportioned by specific rules within the regulation.[30]

Though the MTC stated that its changes to the model regulation were generally influenced by firms increasingly operating on the internet, this does not demonstrate that the MTC's SINAA changes were influenced by the increased prevalence of the internet in banking. It is unclear which MTC changes were influenced by internet/technological advancements. In addition, during a conversation with MTC's staff attorney, Mr. Bruce Fort, Mr. Fort confirmed that the fact that a bank operated over the internet was not a primary consideration for removal of the SINAA rules.[31] When discussing the MTC's changes, Mr. Fort stated that MTC's removal of the SINAA rules was spurred by difficulty in administering it, not because SINAA rules created unfair internet banking results. It is important to note that Taxpayer has not alleged or demonstrated that application of SINAA rules to Taxpayer is administratively problematic. Thus, Taxpayer's characterization of the MTC's changes, as spurred by the increased prevalence of the internet in banking, should be rejected.

Finally, even if FTB were to acquiesce and take the MTC approach, Taxpayer's proposed remedy – i.e., the use of a single sales factor – is inconsistent with the MTC's approach, as the MTC regulation still left the property and payroll factors in place for banks and financial corporations. Thus, the MTC's approach, though different from California's, does not provide clear

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[30] See *Id.* at p. 3.
[31] Telephone Conversation with Bruce Fort, MTC Staff Attorney, conducted on February 20, 2020.

and convincing evidence that the application of California rules does not fairly represent Taxpayer's business activity in California.

CONCLUSION

Taxpayer has not shown, with clear & convincing evidence, that application of the applicable standard apportionment formula unfairly reflects its activities in California. For the reasons discussed above, staff recommends that Taxpayer's petition for alternative apportionment under RTC section 25137 be denied.

Respectfully submitted,

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