REQUEST FOR CALIFORNIA REVENUE & TAXATION CODE SECTION 25137

CONSIDERATION BY THREE-MEMBER FRANCHISE TAX BOARD

OPENING BRIEF

Case: 3188072634149410

Case Unit: 3188072634149406

Reference: 410:RZ

Taxpayer: Axos Financial, Inc. & Subsidiaries

Summary of Request – Axos Financial, Inc. & Subsidiaries (collectively "Axos," or "taxpayer") is requesting alternative apportionment under California Revenue and Taxation Code Section 25137. When considered together, all the facts and circumstances support using an alternative method. Such facts and circumstances include:

- The Taxpayer is an internet bank

- Internet banking and traditional banking models are very different

- The formula prescribed by current California regulations ("the Standard Formula") was developed for traditional banking long before the existence of internet banking

- The Standard Formula when applied to the Taxpayer distorts its income apportioned to California and creates a much higher effective state tax rate for the Taxpayer than its traditional banking peers

- 120% of the Taxpayer's income is subject to tax, and the Taxpayer's state tax rate is roughly 300% of the rate of its traditional banking competitors.

- The MTC's apportionment regulation used to prescribe the Standard Formula, but the MTC realized the distortive effect the Standard Formula could have on internet banking and therefore changed the formula that it prescribes

- The Standard Formula does not lead to 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

- Additionally, the Internet Tax Freedom Act places a higher degree of scrutiny on multiple taxation on electronic commerce

The taxpayer is requesting the single sales factor formula. The taxpayer believes it is the best alternative formula for reasons stated below. The taxpayer would also accept the use of the formula prescribed by the Multistate Tax Commission that excludes loans from the property factor calculation. If approved, the taxpayer would apply the alternative method to future tax filings. The taxpayer would also amend prior year returns to reflect the alternative method.

This petition is organized in the following sections:

1. Company background,

2. A discussion of relevant law,

3. A discussion on the distortive effect of the current apportionment method as applied to Axos, and

4. A summary of the reasonableness of the proposed alternative.

1. COMPANY BACKGROUND – First Digital Only Bank

Axos Financial, Inc., is a financial holding company, with over $11.7 billion in assets that provides banking and securities products and services to its customers through its online distribution channels.

Banking Segment

More than 90% of the group's total income is generated by 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. See www.axosbank.com for a view of Axos Bank's online storefront/branch.

Axos Bank was founded in 2000. The bank was among the first digital only banks in the world. The bank's thrift charter allows it to operate within all 50 states. The bank went public on NASDAQ as Bank of Internet USA on March 15, 2005.

Axos Bank has deposit and loan customers nationwide including consumer and business checking, savings and time deposit accounts and financing for single family and multifamily residential properties, small-to-medium size businesses in target sectors, and selected specialty finance receivables. The Bank generates fee income from consumer and business products including fees from loans originated for sale and transaction fees earned from processing payment activity. The banking segment operates primarily from the company's San Diego location but also conducts banking activities in Nevada including loan servicing, deposit operations, and approximately 50% of the mortgage banking of Axos Bank. The banking segment also has a location in Salt Lake City, Utah which focuses on commercial and industrial leases to business.

Traditional loans are not made from the Salt Lake City office, which focuses on leasing. In 2019 Axos opened two small, satellite commercial banking offices, in New York and Los Angeles.

Securities Product and Services Segment

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

RELEVANT LAW

Equitable Adjustment of Standard Allocation and Apportionment

California law provides that if the allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in the state, the taxpayer may petition for or the Franchise Tax Board (FTB) may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

1. Separate accounting;
2. The exclusion of any one or more of the factors;
3. The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
4. The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (CRTC Section 25137)

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 in violation of the Commerce Clause and Due Process Clause of

1 the U.S. Constitution or in violation of other federal and state statutes, such as the

2 Internet Tax Freedom Act discussion below.

3

4 *Constraints on California Apportionment*

5 The Due Process Clause and the Commerce Clause of the U.S. Constitution, as

6 interpreted by the U.S. Supreme Court, prohibit states from taxing extraterritorial income

7 and require states to fairly apportion a taxpayer's income. Though no bright line test

8 exists to determine when an apportionment method does not fairly represent the

9 taxpayer's business activities in the state, there is a plethora of court cases ruling on

10 this matter providing us guidance.

11

12 *General Mills*

13 *General Mills, Inc. et al v. Franchise Tax Board,* No. A131477 (Cal. App. Aug 29, 2012)

14 is one of the more recent cases addressing whether a reasonable alternative formula

15 should be applied to a taxpayer to achieve an equitable result.

16

17 In *General Mills*, the taxpayer applied the statutory formula and the FTB proposed an

18 alternative formula. The factors argued are listed in the following chart.

19

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 FactorFactor
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				

In this case, the FTB was able to successfully apply an alternative apportionment formula even though the alternative apportionment formula resulted in an increase to the apportionment of an average of only 4.4% per year. This is because the rote apportionment method was not developed or meant to fairly reflect manufacturing income mixed with significant hedging receipts. This case shows that if an apportionment formula was not developed for a particular fact pattern, alternative apportionment should be allowed, even if the distortion of the rote formula was as little as 1.3% in a given year.

Burden of Proof

The party invoking section 25137 has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable (Microsoft Corp. v. Franchise Tax Bd. (2006) 39 Cal.4th 750, 757, at p. 765). A quantitative and qualitative analysis can be used to reach the burden of proof. In *General Mills,* even though the FTB showed only a range of 1.3% to 8.1% quantitative distortion in any one year, the

FTB met its burden of proof because of a qualitative difference between the type of business activities the statute was meant to be applied to and the actual commodity hedging futures trades that was in question. In other words, if it is shown that the operative statute or regulation was not originally developed to address the sourcing issues in question the qualitative distortion burden of proof would be met and therefore a lower quantitative distortion threshold (1.3% in *General Mills*) would not be tolerated.

Internet Tax Freedom Act

The Internet Tax Freedom Act (ITFA) prohibits states from asserting *multiple* or *discriminatory taxes* on *electronic commerce*.

A "discriminatory tax" is defined by the ITFA to include any tax on electronic commerce that is not generally imposed on transaction or imposed at the same rate on transaction involving similar property, goods, services, or information accomplished through traditional means (The Internet Tax Freedom Act. Sec. 1104(2)(A)). In other words, the taxation of internet banking at a higher rate than traditional banking violates the ITFA. 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 such taxation at a higher rate violate the ITFA.

The ITFA also prohibits "Multiple Tax' on electronic commerce. 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 (The Internet Tax Freedom Act, Sec. 1104(6)(A)).

California Uncodified Law

Furthermore, 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 corporation 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 they were enacted, the current California regulations had the objective of preventing multiple taxation because it followed the MTC model regulations that were also 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.

Changes to the MTC Regulations

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 realized that the then current model regulations, the one currently used by California, did not correctly apportion internet banking activities. 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 these inequities to online banking taxpayers.

STANDARD FORMULA IS DISTORTIVE

Effective State Tax Rate vs Non-Online Competitors

Axos has a much higher state tax rate, roughly 300% higher, than its traditional banking (non-online) competitors. This is primarily due to the distortive effect of California's financial institution apportionment formula when applied to an online bank.

Exhibit A lists the commonly compared peer group of Axos and banking and finance industry leaders who are not online banks. Exhibit A compares Axos' effective state tax rate to the effective state tax rate of its competitors all of which are traditional (not online) banks. The average rate of the competitors over the last three years was 3.64% and the median rate of the competitors over the last three years was 3.42%. Axos' average effective state tax rate for the prior three years was 11%. Axos has the highest rate, with its effective state tax rate being more than 7 percentage points higher than the average competitor. That translates to a state tax liability that is roughly **300% of the average competitor liability.** In other words, for every dollar the average competitor, who is not an online bank, pays in total state tax on its pre-tax income, Axos pays more than $3 on the same amount of income**.**

This rate that is roughly 300% of competitors' rates, results, in significant part, from the fact that more than 100% of Axos' income is apportioned to various state jurisdictions. In fact, in 2018, 121% of Axos' income was apportioned to various states. See Exhibit B.

Property Factor

An analysis of Axos' apportionment factor on Exhibit B shows that this double taxation is primarily due to the property factor. California uses the SINAA rules, described below, which the Multistate Tax Commission ("MTC") rejected, as detailed later in this petition, due to its distortive effect on internet banking. Because of these rules, almost 100% of the company's loans are being included in the California numerator when under a tradition banking model only about 50% of the loans would have been included in the California numerator.

SINAA – Sourcing of Loans in the Property Factor

Banks include loan receivables in the property factor. However, because loans are intangible property, the location of the loans is debatable. Is the loan located where the borrower is domiciled, where the lender is domiciled, where the property securing the loan is located, at the branch office that made the loan, or some other location?

The SINAA rules try to address this issue by sourcing each loan to a place of business of the taxpayer. It should be noted that these rules were developed before the advent of internet banking.

SINAA stands for the solicitation, investigation, negotiation, approval, and administration of the loan in question. Under the SINAA rules, loans are assigned to a regular place of business of the taxpayer. The assignment of a loan by the taxpayer to a regular place of business is made based on which place of business has the most contacts related to the loan based on the solicitation, investigation, negotiation, approval, and administration of the loan in question.

In a traditional national banking environment, a national bank would have multiple bank branches located throughout the country, loans would be assigned to its branch with the preponderance of substantive contacts with the loans. So, under a traditional banking model the loans are spread among the states in which the bank does business.

However, when applied to internet banking the SINAA rule does not result in a spreading of the loans throughout the states in which the taxpayer is doing business. Because the SINAA rules require the taxpayer to assign loans to a branch (or place of business) of the taxpayer, all the loans in Axos's case are assigned to California and not spread among the states in which it does business.

Payroll Factor

The payroll factor augments the problem for the same reason the SINAA sourcing rule for loans distorts the income of an online banker. Under a traditional banking model, the payroll factor would be spread amongst the states in which the company has customers, since there would be payroll at all the branch locations. However, under an internet banking model, the payroll is not spread amongst the states in which the taxpayer is doing business even though the taxpayer has a virtual presence in the state.

11

Additionally, California is in the minority of states that include payroll in the

apportionment factor.

The California apportionment method as applied to Axos, does not reasonably reflect

the amount of income earned by Axos in California. There is sufficient qualitative and

quantitative distortion to justify departure from the standard formula. Such departure

also would result in national uniformity, predictability in commerce in tax collection, and

reduce the risk of creating exploitable loopholes in the tax system. See General Mills,

Inc. et al v. Franchise Tax Board, No. A131477 (Cal. App. Aug 29, 2012) in which the

court considered (1) qualitative and quantitative distortion, (2) the impact of the ruling on

national uniformity in taxation of national corporations, (3) the impact on predictability of

commerce and in tax collection for the state, and (4) the risk of creating exploitable

loopholes in the tax system.

Qualitative and Quantitative Distortion

The apportionment rules contained in Regulations 25137-4.2 were adopted in 1996 for

the purposes of fairly apportioning the income of a traditional bank or financial institution

doing business in more than one state. Under the traditional banking model, national

banks have locations or branches in states where loans were being made. Under the

SINAA rules, loans of a traditional bank would be assigned to a location and therefore

the loans were fairly apportioned amongst the states in which the bank was doing

business.

Internet banking is qualitatively different. Unlike traditional branch banking, an internet

bank's website can be run from anywhere in the country, with the website being virtually

located in all 50 states. With traditional banking, the loans get spread amongst the

states. With online banking, the loans are sourced 100% to one state. This assignment

of all loans to one state, even though the loans were made to borrowers across the

country, flies in the face of reason. The loans are arguable worthless without the courts

of the other states to enforce them and yet the other states have no representation of

the loans under this method. Additionally, when a state sources 100% of an online

bank's loans to that state, it guarantees double taxation if any other state were to use a

customer-based approach to source the loans. The taxpayer believes this is a

significant qualitative difference. For the quantitative analysis see Exhibits A and B.

National Uniformity

National Uniformity should also be considered. A review of Exhibit B shows that most

states do not follow California's apportionment method regarding the property factor and

that 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.

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 tax

haven state. The adoption of the alternative apportionment method proposed would close that possibility to an internet bank.

Discrimination Against and Multiple Taxation of Electronic Commerce

Axos does its banking online through electronic commerce. 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. By following the current apportionment rule, the effective state tax rate of Axos is roughly 300% of that of similar sized national banks doing business under a traditional banking model.

Additionally, Axos' income is clearly being subject to multiple taxation as summarized in Exhibit B. Such multiple taxation violates the "multiple tax" provision of the ITFA. Allowance of alternative apportionment will not only fairly represent the income earned from California sources, it will also avoid multiple taxation, and the violation of the ITFA.

Payroll Factor

Similar to the property factor, the payroll factor also creates distortion as well as discrimination against and multiple taxation on online banking transactions for the same

14

reason the SINAA sourcing rule for loans distorts the income of an online banker.

Under a traditional banking model, the payroll factor would be spread amongst the

states in which the company has customers, since there would be payroll at all the

branch location. However, under an internet banking model, the payroll is not spread

amongst the states in which the taxpayer is doing business even though the taxpayer

has a virtual presence in the state. Additionally, California is in the minority of states

that include payroll in the apportionment factor.

REASONABLENESS OF PROPOSED APPORTIONMENT METHOD

The taxpayer proposes to use a single sales factor apportionment. This method

resolves all the qualitative and quantitative "distortion factors" that result in applying the

Standard Formula to the Taxpayer. This method would achieve the following:

- 100% apportionment. Since all states use a similar sales factor sourcing

    method, there is little to no risk of double taxation or nowhere taxation.

- 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.

- Predictability.

- An apportionment method that is not prone to tax avoidance schemes.

It can be noted that this method is different from the method proposed by the MTC to

resolve this issue. In our case, single sales factor apportionment resolves all the

quantitative and qualitative issues and is superior to the MTC recommendation for that

reason. However, the Taxpayer does recognize the MTC recommendation is superior

to the Standard Formula and would be willing to accept that apportionment method.

We respectfully request you approve this alternative apportionment petition, preferably the single sales factor formula, but alternatively the MTC formula would be acceptable to the taxpayer.

Sincerely,

Robert J. Johnson

Managing Director

Crowe LLP

Attached:

Exhibit A – State Tax Rate Comparison to the Non-Online Competitors

Exhibit B – Apportionment Analysis

Exhibit C – Comparison of Taxpayer Liability under Standard Formula to Alternative Formula