SUPERIOR COURT OF CALIFORNIA

COUNTY OF SACRAMENTO

RYAN U.S. TAX SERVICES, LLC **v.** **STATE OF CALIFORNIA, acting by and through the GOVERNOR'S OFFICE OF BUSINESS AND ECONOMIC DEVELOPMENT, and the OFFICE OF ADMINISTRATIVE LAW**	Case Number: 34-2014-00167988 **RULING ON SUBMITTED MATTER** Date: December 11, 2015 Time: 9:00 a.m. Dept.: 29 Judge: Timothy M. Frawley

Introduction

Petitioner Ryan U.S. Tax Services, LLC, has filed a petition for a peremptory writ of mandate challenging a portion of the regulation adopted by the California Governor's Office of Business and Economic Development ("GO-Biz") to implement the "California Competes" tax credit program. Petitioner contends the regulation is invalid because it is inconsistent with the language and purpose of the statutes it purportedly implements. The court shall grant the petition and request for declaratory relief.

Background Facts and Procedure

In 2013, Governor Brown signed Assembly Bill 93 ("AB 93") into law as an urgency measure, establishing a new tax incentive policy known as the "California Competes Tax Credit" program. The purpose of the program is to reform and refocus state tax incentives on attracting and retaining jobs in economically distressed areas of the state. (Stats. 2013, ch. 69, §§ 1, 48.) In establishing the program, the Legislature stated that the program "will allow businesses to publicly apply for tax credits allowed on the basis of job creation and retention standards." (*Id.* § 1.) The Legislature also stated that the

program will "be a model of transparency and accountability for the state's job creation efforts in that performance measurements will ensure that the effective use of taxpayer dollars is maximized." (*Ibid.*)

According to the enabling statute,[1] the California Competes Tax Credit Committee determines the overall amount of tax credits available for a fiscal year. (Cal. Rev. & Tax Code §§ 17059.2, 23689.) GO-Biz is the agency responsible for allocating the credits to taxpayers. (*Ibid.*) The statute instructs GO-Biz to allocate the credit to taxpayers based on eleven factors:

(1) The number of jobs the taxpayer will create or retain in this state.

(2) The compensation paid or proposed to be paid by the taxpayer to its employees, including wages and fringe benefits.

(3) The amount of investment in this state by the taxpayer.

(4) The extent of unemployment or poverty in the area according to the United States Census in which the taxpayer's project or business is proposed or located.

(5) The incentives available to the taxpayer in this state, including incentives from the state, local government, and other entities.

(6) The incentives available to the taxpayer in other states.

(7) The duration of the proposed project and the duration the taxpayer commits to remain in this state.

(8) The overall economic impact in this state of the taxpayer's project or business.

(9) The strategic importance of the taxpayer's project or business to the state, region, or locality.

(10) The opportunity for future growth and expansion in this state by the taxpayer's business.

[1] There are actually two enabling statutes, but the relevant language of the statutes is identical. For simplicity, the court shall refer to them collectively as "the statute."

(11) The extent to which the anticipated benefit to the state exceeds the projected benefit to the taxpayer from the tax credit. (*Ibid.*)

The enabling statute authorizes GO-Biz to "prescribe rules and regulations as necessary to carry out the purposes" of the statute. GO-Biz has adopted regulations to implement the program, including California Code of Regulations, title 10, section 8030, governing the application process for tax credit allocation (the "Regulation"). (10 C.C.R. § 8030.)

The Regulation requires applicants for tax credits to provide certain information on the application form, including the name of any "consultant" providing services related to the credit application, the consultant's fee structure and cost of services, and whether payment to the consultant is influenced by whether a credit is awarded. (10 C.C.R. § 8030(b)(10).)

The Regulation establishes a two-phase review process for credit applications. Phase I of the process is an automated phase in which the amount of tax credit requested, aggregate employee compensation, and aggregate investment provided on the application form is evaluated to determine a "cost-benefit" rate of return. (10 C.C.R. § 8030(g)(1).) The applicants with the best cost-benefit ratio move forward to Phase II.

Phase II involves a qualitative evaluation of the applicants, based on eight factors. The first seven factors are: (1) the extent of unemployment or poverty in the area in which the applicant's project is proposed or located; (2) whether incentives are available to the applicant in other states and other incentives available to the applicant in this state; (3) the economic impact in the state; (4) the strategic importance of the applicant's project or business in the state, region or locality; (5) the number of existing employees expected to be retained in California due to the project; (6) the opportunity for future growth and expansion by the applicant in the state; and (7) the salary, benefits, and fringe benefits provided by the applicant to its employees. (10 C.C.R. § 8030(g)(2).)

The eighth factor -- and the one at issue here -- provides that GO-Biz shall evaluate:

> Any other information requested in the application; including, but not limited to, the reasonableness of the fee arrangement between the applicant and any consultant, attorney, tax practitioner or any other third party that prepared or submitted the application, or provided any services related to the credit. Any contingent fee arrangement must result in a fee that is less than or equal to the product of the number of hours of service

provided to the applicant and a reasonable hourly rate for such services. (10 C.C.R. § 8030(g)(2)(H).)

The Regulation essentially eliminates contingency fee arrangements by limiting contingent fee arrangements to a reasonable hourly fee.

Petitioner Ryan is a global tax advisory and site selection firm, based in Dallas, Texas, but authorized to do business in California with offices in Sacramento, San Diego, San Francisco, San Jose, Oakland, Carlsbad, Los Angeles and other California cities. As a tax consulting firm, Ryan derives substantial income from representing California taxpayers with respect to income tax claims. Ryan helps clients identify locations for their businesses, which involves analyzing a variety of factors, including any applicable tax incentives. Where available, Ryan aids its clients in pursuing tax incentives.

The goal of every site-selection project is to find the right location based on the particular client's needs. The process is different for every client. The site selection process may be local, regional, national, or international, depending on the circumstances.

Clients have the option of paying Ryan on either an hourly or contingency basis. Most of Ryan's clients elect a contingent fee arrangement, which Ryan refers to as a "performance-basis." Ryan's agreements are typically multi-year agreements and are not directed at specific tax credits or incentives in particular locations. Rather, the agreements contemplate that Ryan will investigate and pursue any and all potentially available credits and incentives for each potential site. In general, because the services Ryan provides to its clients are interconnected, span multiple years and locations, and encompass a variety of different tax credits and incentives (national, state, regional, and municipal), the fees charged by Ryan cannot be isolated on a "per credit" basis.

On behalf of its clients, Ryan has submitted applications for the California Competes Tax Credit. GO-Biz has rejected at least one application in which Ryan served as an advisor.

In August 2014, Ryan filed this action challenging the provisions of the Regulation governing consultant fee arrangements, and especially the limitation on contingent fee arrangements.

Requests for Judicial Notice

The Request for Judicial Notice filed by Respondent GO-Biz, which is unopposed, is granted.

Standard of Review

The Legislature may delegate authority to an administrative agency to adopt and enforce reasonable regulations to carry out the general purpose of a statute. In assessing the validity of an administrative regulation, the court's task is to inquire into the legality of the challenged regulation, not its wisdom. (*San Diego Nursery Co. v. Agricultural Labor Relations Bd.* (1979) 100 Cal.App.3d 128, 136.)

An administrative agency is not limited to the exact provisions of a statute in adopting regulations to enforce its mandate. The Legislature may confer upon an administrative agency the power to "fill up the details" of a statutory scheme. (*Knudsen Creamery Co. v. Brock* (1951) 37 Cal.2d 485, 492.) However, an administrative agency may not substitute its judgment for that of the Legislature. (*Harris v. Alcoholic Beverage Control Appeals Board* (1964) 228 Cal.App.2d 1, 6.) There is no agency discretion to promulgate a regulation which is inconsistent with the governing statute. The powers of public agencies are derived from the statutes which create them and define their functions. Administrative action that is not authorized by, or is inconsistent with, acts of the Legislature is void. (*Carmel Valley Fire Prot. Dist. v. California* (2001) 25 Cal.4th 287, 299-300.)

An administrative agency may not vary, enlarge, or change the scope of a legislative enactment, nor may it adopt regulations which lie outside the scope of the statute. Administrative regulations that alter or amend a statute or enlarge or impair its scope are void, and are required to be struck down by courts. (*J. R. Norton Co. v. Agric. Labor Relations Bd.* (1979) 26 Cal.3d 1, 29.)

Although the construction of a statute by an agency charged with its enforcement is entitled to consideration and respect, final responsibility for the interpretation of the law rests with the courts. (*Murphy v. Kenneth Cole Productions, Inc.* (2007) 40 Cal.4th 1094, 1105 fn.7; *Aguiar v. Superior Court* (2009) 170 Cal.App.4th 313, 323.) It is the duty of the courts to state the true meaning of the law finally and conclusively, even if this requires the courts to overturn an erroneous administrative construction. (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 7.) The agency's interpretation is one among several tools available to the court. Depending on the

context, it may be helpful, enlightening, or convincing. Other times, it may be of little worth. (*Id.* at pp.7-8.)

Regulations adopted by an administrative agency also must be "reasonably necessary to effectuate the purpose of the statute." (Cal. Gov. Code § 11342.2.) When a regulation is challenged on the ground that it is not "reasonably necessary," the scope of the court's review is more deferential. Judicial review is confined to whether the agency's determination is supported by substantial evidence. (Cal. Gov. Code § 11350(b).) The issue is not whether the regulation is wise or sensible, but whether the regulation is reasonably related to a statutory objective. (*Samantha C. v. State Dept. of Developmental Services* (2010) 185 Cal.App.4th 1462, 1482.)

A regulation also may be declared invalid if it substantially fails to comply with the APA's "clarity" standard. (Cal. Gov. Code § 11350; *Sims v. Department of Corrections & Rehabilitation* (2013) 216 Cal.App.4th 1059, 1076.) Clarity means written or displayed so that the meaning of regulations will be easily understood by those persons directly affected by them. (Cal. Gov. Code § 11349(c).) Under the OAL's regulatory guidelines, a regulation is presumed not to comply with the clarity standard if, among other things, (1) the regulation can, on its face, be reasonably and logically interpreted to have more than one meaning; or (2) the regulation uses terms which do not have meanings generally familiar to those directly affected by it. (1 C.C.R. § 16; see also *Sims, supra*, 216 Cal.App.4th at p.1080.)

The petitioner has the burden of proving that the regulation is invalid. The agency's action comes before the court with a presumption of correctness and regularity. (*Geftakys v. State Pers. Bd.* (1982) 138 Cal.App.3d 844, 867.)

Discussion

Ryan contends that the Regulation exceeds the scope of authority conferred on the agency, is not reasonably necessary to effectuate the purpose of the statute, and is impermissibly vague. Ryan objects that the Regulation impairs the ability of Ryan and other site selection/tax advisers to serve clients potentially seeking the California Competes tax credit.

GO-Biz argues that Ryan lacks standing to challenge the Regulation, and that, even if Ryan has standing, the Regulation is valid.

The court does not agree that Ryan lacks standing. Ryan has standing to challenge the Regulation, both because it is beneficially interested in the validity of the Regulation,

and because it falls within the "public interest" exception to the standing requirement. The court now turns to the merits of Ryan's challenge to the Regulation.

Ryan contends that the Regulation is inconsistent with the statute because it expands the qualifications for tax credit applicants. While Ryan does not dispute that GO-Biz has the power to adopt regulations "to carry out the purposes" of the statute, Ryan contends that the statute sets forth the exclusive list of qualifying factors, leaving no room for GO-Biz to add further qualifications. Because the amount of consultant fees paid by tax credit applicants is not one of the qualifying factors in the statute, Ryan argues the Regulation impermissibly alters the substantive requirements that applicants must meet to qualify for a tax credit.

GO-Biz argues that the Legislature delegated to it broad authority to "fill up the details" of the tax credit program. While the statute does not explicitly list "consultant fees" as a consideration, GO-Biz asserts that the challenged Regulation falls within the scope of the eleventh qualifying factor, which authorizes GO-Biz to consider the "extent to which the anticipated benefit to the state exceeds the projected benefit to the taxpayer from the tax credit." (Cal. Rev. & Tax Code §§ 17059.2(a)(2)(K), 23689(a)(2)(K).) GO-Biz contends that regulating consultant fees furthers this purpose by ensuring tax credits are used for job creation and are not unnecessarily diverted to "unreasonable" consultant fees.

GO-Biz's focus on the "use" of tax credits is misguided. The California Competes program is not a grant of earmarked funds subject to specific guidelines or restrictions. It is a "tax credit." As the name implies, a tax credit is an offset against a tax liability -- a "dollar for dollar" reduction in a person's tax liability.

Many tax credits also serve as policy incentives, reducing a taxpayer's liability in exchange for specific actions or investments. Any taxpayer that meets the qualifications for such a tax credit can receive it. Sometimes qualifications are tied to particular expenditures: to qualify for the credit, the taxpayer must have incurred certain "qualifying expenditures."[2] However, the court is not aware of any tax credit programs dictating how the credit itself must be used.[3]

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[2] In some cases, the "qualifying expenses" must be "reasonable."

[3] A child and dependent care credit, for example, is allowed if a taxpayer incurred certain household and dependent care expenses during the preceding tax year. The credit is applied against the taxpayer's net tax liability. The taxpayer is not required to use the "tax savings" to pay for additional child and dependent care.

This is no coincidence. A "tax credit" is not an expenditure of public funds; it is merely an offset against a tax liability. (See *State Building & Construction Trades Council of California v. Duncan* (2008) 162 Cal.App.4th 289, 312-13 [low income housing tax credits involve no expenditure of public funds]; see also Cal. Rev. & Tax Code §23663 [allowing the credit to be assigned to an affiliated corporation].) By definition, a tax credit is "used" for only one purpose: to reduce the person's tax liability. The fact that a tax credit reduces a taxpayer's liability, and thereby frees up funds that otherwise would be paid to the State as taxes, does *not* give the State the right to control how the tax "savings" are used.

Limiting consultant fees does not "preserve" tax credits or ensure that tax credits will be "used" to create new, good-paying jobs. Thus, reducing consultant fees does not directly "benefit" the state.[4] GO-Biz does not contend otherwise. Rather, GO-Biz argues that there is a relationship between the amount of the credit requested and the amount of consultant fees paid by the applicant. In short, GO-Biz argues that fees paid to a consultant are taxpayer funds that otherwise could be used to increase the taxpayer's investment in the proposed project -- by expanding the project, or by reducing the amount of tax credit requested for the project, which, in either case, would improve the "cost-benefit ratio" of the project to the State.

However, this is true for nearly every aspect of the taxpayer's business. Any increase in revenues, or reduction in expenses, generates funds that theoretically could be used to increase the taxpayer's investment in the proposed project. Thus, carried to its logical end, this interpretation would mean that GO-Biz may regulate nearly every aspect of a taxpayer's business. The language of the statute does not support such a broad interpretation.

The statute provides that the amount of credit allocated to a taxpayer shall be based on the eleven specified factors, one of which is the "extent to which the anticipated benefit to the state exceeds the projected benefit to the taxpayer from the tax credit." (Cal. Rev. & Tax Code §§ 17059.2(a)(2), 23689(a)(2).) Read in context, it is clear that this language is referring to the "anticipated benefits" to the state from the taxpayer's project or business, consisting primarily of the jobs and investments to be provided by the taxpayer as part of its proposed project. The statute requires GO-Biz to evaluate the applicants and choose the projects with the best cost-benefit ratios.

[4] Fees paid to a California consultant may benefit the State, but this is merely an incidental benefit, not one "anticipated" from the program.

This does not mean that GO-Biz is necessarily limited to accepting or rejecting a particular taxpayer's proposal. The statute requires GO-Biz to "negotiate" with the taxpayer the "terms and conditions" of a proposed written agreement. (Cal. Rev. & Tax Code §§ 17059.2(c)(2), 23689(c)(2).) This language arguably supports an interpretation that GO-Biz may, through negotiation, attempt to secure a "better" deal for the State. However, the statute does not empower GO-Biz to reject a proposal merely because GO-Biz finds a consultant's cost of services to be "too high."

The cost of a consultant's services is a matter between the taxpayer and the consultant. There is no evidence in the record that the amount of a consultant's fee has any effect – direct or indirect -- on the "anticipated benefits" to the State from that taxpayer's proposal. Excluding an applicant because it pays "too much" for consultants is equivalent to excluding an applicant because it pays "too much" rent, pays "too much" interest on loans, or pays "too much" for office supplies.

GO-Biz suggests that if outside consultant fees are capped, applicants will request smaller tax credits, thereby "maximizing" the effective use of taxpayer dollars. This is rank speculation and it is not supported by any evidence in the record. It also defies common sense. Applicants have an incentive to request the largest credit possible, regardless of costs. Lowering an applicant's site selection costs might allow the applicant to accept a lesser tax credit and still go forward with the project, but it does not mean the applicant *will* request or accept a lesser tax credit.

Moreover, even if there were evidence establishing a link between an applicant's site selection costs and the amount of tax credit requested, it is arbitrary and capricious for GO-Biz to focus exclusively on the cost of outside consultants while ignoring other site selection costs, such as, for example, the cost to purchase/construct/lease the site. If site selection costs are relevant, why focus only on that one particular cost to the exclusion of all others? The evidence in the record does not explain.

Finally, even if the statute is construed as allowing GO-Biz to consider whether consultant fee arrangements are reasonable, the court finds the Regulation's *de facto* ban on contingent fee arrangements to be arbitrary and capricious and not reasonably necessary to carry out the purpose of the statute.

GO-Biz argues that the Regulation does not prohibit contingent fee arrangements; it merely limits them to a reasonable hourly rate. This is a distinction without a difference. A contingent fee must be higher than the fee for services performed at an hourly rate to compensate the party for the risk of not being paid. (*Ketchum v. Moses* (2001) 24 Cal.4th 1122, 1132-33.) A contingent fee contract involves a gamble on the result, and

therefore must provide more compensation than would otherwise be considered "reasonable" on a fee-for-services basis. (*Ibid.*) A consultant who bears the risk of not being paid if unsuccessful, and who is compensated only at fair market value if successful, will not accept the work. (See *Ketchum, supra*, 24 Cal.4th at p.1133.) Thus, limiting contingent fee arrangements to a "reasonable hourly rate" is a *de facto* ban on contingent fee arrangements.

A *de facto* ban on contingent fee arrangements is inconsistent with the purposes of the statute because it effectively disqualifies businesses with contingent fee arrangements from receiving the tax credit. The evidence before the court shows that many businesses elect to pay on a performance-basis. Thus, the Regulation unnecessarily restricts the number of businesses able to compete for the tax credit – businesses that may provide significant benefits to the State.

GO-Biz disputes the Regulation discourages businesses from using consultants or applying for the tax credit. GO-Biz asserts that businesses simply will switch to a fee-for-services arrangement. However, there is no evidence before the court to support this assertion. Nor is there any evidence to support finding that a *de facto* ban on contingent fee arrangements will produce more competitive project proposals. Logic and common sense suggest the opposite is true.

Whatever interest GO-Biz may have in ensuring that consultant fee arrangements are reasonable, there is no rational basis for banning contingent fee arrangements.[5] Contingency fee agreements are a recognized and reasonable method of pricing fees. It is arbitrary and capricious to ban them solely because GO-Biz finds the contingency fees associated with two applications – at 15% and 20% -- to be "egregious."[6] In essence, GO-Biz has concluded that no applicant employing a consultant under a contingent fee arrangement could possibly benefit the state, no matter how many jobs the applicant will create.

Site selection consultants assist businesses with the site selection process. The Regulation allows applicants to use outside consultants, implicitly recognizing that they add value. However, the Regulation bans contingent fee arrangements, based on the reasoning that this will "ensure the credits are used to stimulate new employment and

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[5] If the concern was "unreasonable" contingent fee arrangements, one would expect the Regulation to require contingent fee arrangements to be "reasonable." Instead, the Regulation effectively bans them.
[6] The reasonableness of a contingent fee is judged by the "situation as it appeared to the parties at the time the contract was entered into." Contingent attorney fee contracts for one-third of the recovery have frequently been upheld as reasonable. (See *Setzer v. Robinson* (1962) 57 Cal.2d 213, 218.) The court expresses no opinion on what is a reasonable contingent fee for a site selection consultant.

economic growth." (See State's Request for Judicial Notice, Exh. 5 [0062].) As discussed above, this is a fallacy. Credits are "used" for only one purpose: to offset tax liability. Banning contingent fee arrangements does nothing to change this, does nothing to stimulate "new employment" or "economic growth," and does nothing to encourage businesses to invest in California.

The only thing the ban is likely to accomplish is discourage businesses with contingent fee arrangements from participating in the California Competes tax credit program. This is inconsistent with the statutory goal of encouraging applications so that California can choose the projects that provide the most "bounce to the ounce."[7]

If the Legislature had intended to ban contingent fee arrangements for outside consultants, it easily could have prohibited them in the language of the statute. It did not. There is nothing in the language of the statute to suggest the Legislature intended to ban contingent fee arrangements as a prerequisite to qualifying for a tax credit.

The court is mindful that the agency's construction is entitled to some deference from this court. However, deference does not mean abdication. Statutory construction ultimately remains a matter for the courts. In this case, the court is persuaded that GO-Biz exceeded its statutory authority by expanding the statutory factors on which the credit is required to be based and adding an additional factor – the price applicants pay for outside site selection consultants. In addition, GO-Biz exceeded the scope of the statute by imposing a *de facto* ban on contingent fee arrangements. For both of these reasons, the court finds the challenged portion of the Regulation to be invalid and void.[8]

Disposition

The petition and request for declaratory relief is GRANTED. Counsel for Ryan is directed to prepare a formal judgment, consistent with this ruling and incorporating it as an exhibit; submit it to opposing counsel for approval as to form; and thereafter submit it to the court for signature and entry of judgment in accordance with Rule of Court.

Dated: January 7, 2016

Hon. Timothy M. Frawley
California Superior Court Judge
County of Sacramento

[7] Pepsi-Cola slogan from the 1950s.
[8] This renders it unnecessary for the court to consider the "clarity" of the regulatory language.