



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS**

DRAFT

Date Amended:	04/19/05	Bill No:	SB 17
Tax:	Property	Author:	Escutia
Related Bills:			

BILL SUMMARY

This bill would:

- Provide that a change in ownership occurs when more than 50% of the ownership interests in a legal entity are transferred to one or more persons or entities during a calendar year.
- Establish a penalty if a legal entity does not report a change in ownership as newly defined within 60 days after it occurs to the Board of Equalization (Board).
- Increase from 45 to 60 the number of days a legal entity has to respond to a Board inquiry to investigate into a possible change in ownership.
- Establish a penalty for willfully misrepresenting information in responding to a Board inquiry.
- Require the Franchise Tax Board to furnish the Board with the name and address of any entity that does not respond to a question concerning change in ownership on partnership, bank, and corporate tax returns.
- Revise the change in ownership question on the income tax return.
- Expressly authorize the Board and local assessors to subpoena witnesses and documents related to ownership inquiries.

Summary of Amendments

The amendments to this bill delete the prior provisions which would have redefined "change in ownership" as it applies to the purchase or transfer of ownership interests in legal entities that own real property (i.e., "split roll"). Under the prior definitions:

- Property owned by a publicly traded company would be reassessed to current market value every three years.
- Property owned by other types of legal entities would be reassessed to current market value in proportion to the percentage of ownership interests in the legal entity transferred.

This bill instead proposes a new change in ownership definition for all legal entities, excluding publicly traded companies, whereby property would be subject to reassessment to current market value whenever more than 50% of the ownership

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interests in a legal entity are transferred to one or more persons or entities during a calendar year.

ANALYSIS

Current Law

Part 1. Change in Ownership Definitions

Under existing property tax law, real property is reassessed to its current fair market value only when there is a “change in ownership.” (*Article XIII A, Sec. 2; Revenue and Taxation Code Sections 60 - 69.5*) Revenue and Taxation Code Section 64 sets forth the change in ownership provisions related to the purchase or transfer of ownership interests in legal entities that own real property. Generally, when real property is owned by a legal entity, the purchase or transfer of ownership interests in that legal entity does not trigger a change in ownership of the property. An exception to this general rule is when there is a “change in control” of the legal entity. Subdivision (c) of Section 64 generally provides that a “change in control” occurs when one person or legal entity acquires more than 50 percent of the ownership interests in the legal entity. In addition, subdivision (d) of Section 64 provides that a “change in ownership” occurs when cumulatively 50% of ownership interests transfer in a legal entity, but only in a very limited instance. That is after a legal entity receives a change in ownership exclusion pursuant to Section 62(a)(2). This section of law excludes transfers between legal entities and individuals (or between two legal entities) that result solely in a change in the method of holding title and in which proportional ownership interests in each and every piece of real property remain the same after the transfer.

Part 2. Change in Ownership Reporting and Discovery

Section 480.1 requires legal entities to report a reassessable event by filing a “change in ownership statement” with the Board within 45 days of a change in control under Section 64(c). Section 480.2 makes a similar requirement when there is a change in ownership under Section 64(d). However, there is no penalty for not reporting these reassessable events. A penalty applies only if after the Board makes a written request to file a statement the legal entity does not respond within 45 days. Section 482 outlines the penalties to be charged if the statement is not filed within 45 days of the request. The penalty is:

- 10 percent of the taxes applicable to the new base year value reflecting the change in control or change in ownership of the real property owned by the legal entity, *or*
- if no change in control or change in ownership occurred, 10 percent of the current year's taxes on that property shall be added to the assessment made on the roll.

The penalties for failure to respond apply whether or not it is determined that a change in ownership actually occurred. However, the penalty is automatically extinguished if the person or legal entity files a complete statement no later than 60 days after the date on which the person or legal entity is notified of the penalty.

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To help discover changes in ownership of legal entities, information is requested on the state income tax return pursuant to Section 64(e). The Franchise Tax Board provides this information to the Board for follow up.

Under existing law, Section 484 provides the assessor with a variety of mechanisms to secure change in ownership information including the authority to seek a court order to obtain information or records pursuant to Section 468. Government Code Section 15613 authorizes the Board to issue subpoenas for the attendance of witnesses or the production of books, records, accounts, and papers.

Proposed Law

Part 1. Change in Ownership Definitions

This bill would provide that a change in ownership occurs when more than 50% of the ownership interests in a legal entity (excluding publicly traded companies) are transferred to one or more persons or entities during a calendar year.

Part 2. Change in Ownership Reporting and Discovery

This bill would repeal existing Section 480.2 and amend Section 480.1 to detail change in ownership reporting requirements for legal entities, including a requirement for the new change in ownership event created by this bill. Specifically, it would:

Requirement to Report. Extend from 45 to 60 the number of days to file a change in ownership statement with the Board to a report a change in ownership. §480.1

Failure to Self-Report. Establish a penalty if the legal entity does not timely self-report the change in ownership. The penalty would be levied on each property subject to reassessment at the greater of \$1,000, or 10 percent of the taxes applicable to the new base year value reflecting the change of ownership. §482(1)(A)

Board Inquiries - Discovery and Investigation into Potential Changes in Ownership. This bill would not change the requirement to file a change in ownership statement after a written request by the Board. Nor would it change the penalty structure, or automatic abatement provisions, for not timely filing a statement after a written request. As such, this bill specifies that a penalty levied for failure to respond to a Board inquiry *is in addition* to the penalty for failure to timely self-report the change in ownership in the first instance. This bill would establish a penalty if a legal entity or publicly traded company willfully misrepresents information on the change in ownership statement. The penalty on each property would be the greater of \$2,500, or 25% of the taxes applicable to the current year's taxes. In addition, an escape assessment for each year the property was underassessed may be issued pursuant to Section 532(b). §482

Subpoenas. This bill would add Section 486 to provide that the Board, pursuant to Government Code Section 15613, and the assessor, pursuant to Section 468, may issue subpoenas for the attendance of witnesses or the production of information or records required for assessment purposes.

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In General

Property Tax System. Proposition 13 approved by voters in 1978 substantially changed the property taxation system in California. In general, California's system of property taxation under Article XIII A of the State Constitution (Proposition 13) values property at its 1975 fair market value, with annual increases limited to the inflation rate, as measured by the California Consumer Price Index, or 2%, whichever is less, until the property changes ownership. At the time of the ownership change, the value of the property for property tax purposes is redetermined based on current market value.

Change in Ownership. While Proposition 13 provided that a “change in ownership” would trigger reassessment, the phrase was not defined. The Assembly Revenue and Taxation Committee appointed a special Task Force - a broad based 35-member panel that included legislative and Board staff, county assessors, attorneys in the public and private sectors, and trade associations - to recommend the statutory implementation for Proposition 13 including its change in ownership provisions. The Task Force findings are published in California State Assembly Publication 723, **Report of the Task Force on Property Tax Administration**, January 22, 1979. A second report, **Implementation of Proposition 13, Volume 1, Property Tax Assessment**, prepared by the Assembly Revenue and Taxation Committee, California State Assembly Publication 748, October 29, 1979, provides additional information on how changes in ownership would be determined under Proposition 13.

Property Owned by Legal Entities. One issue the Task Force faced was how to apply the change in ownership provisions of Proposition 13 to property owned by a legal entity. For instance, would a transfer of ownership interests in a legal entity that owns real property be considered a transfer of the real property interests and, thus, a change in ownership? The Task Force considered two alternatives coined the “separate entity theory” and the “ultimate control theory”.

- **Separate Entity Theory.** The separate identity theory would respect the separate identity of the legal entity. Accordingly, for as long as the legal entity owned the property it would not be reassessed, even if all of the ownership interests in the legal entity had transferred.
- **Ultimate Control Theory.** The ultimate control theory would look through the legal entity to determine who held the ownership interests and, thus, who had “ultimate control” of the legal entity. Under this theory, real property owned by the legal entity would be reassessed only when a single holder of ownership interests gained control of the legal entity through the acquisition of a majority of those ownership interests.

The Task Force recommended that the separate entity theory be adopted for the following two reasons:

"(a) The administrative and enforcement problems of the ultimate control approach are monumental. How is the assessor to learn when ultimate control of

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a corporation or partnership has changed? Moreover, when the rules are spelled out (and the Task Force actually drafted ultimate control statutes) it became apparent that without trying to cheat many taxpayers as well as assessors would simply not know that a change in ownership occurred. The separate entity approach is vastly simpler for taxpayers and assessors to understand, apply and enforce. Transfers between individuals and entities, or among entities, will generally be recorded. Even if unrecorded the real property will have to be transferred (by unrecorded deed or contract of sale, for example). Taxpayers can justifiably be expected to understand that a transfer of real property is a change in ownership and must be reported to the assessor.

(b) The ripple effects of ignoring the general separate entity laws of the state could not be predicted. The ultimate control theory threatened unknown disruptions of business organizations and practices. The separate entity approach avoids that pitfall by adopting the existing structure of corporate, partnership, etc. laws and building upon them."

The change in ownership definitions related to ownership interests in legal entities initially placed in statute in 1979 were based on the separate entity theory as recommended by the Task Force. However, thereafter, subdivision (c) of Section 64 was added which provided that a change in ownership occurred whenever there was a change in control by a transfer (or transfers) of more than 50% of the total ownership interests to a single person or entity.

According to **Implementation of Proposition 13**, Assembly Publication 748, subdivision (c) of Section 64, coined "the majority-takeover-of-corporate stock" provision was added "out of a concern that, given the lower turnover rate of corporate property, mergers or other transfer of majority controlling ownership should result in a reappraisal of the corporation's property -- an effort to maintain some parity with the increasing relative tax burden of residential property statewide, due to more rapid turnover of homes. It was also a trade-off for exempting certain transfers among 100% wholly-owned corporations¹."

Tax Burden. The Task Force was concerned that because commercial and industrial property changes ownership less frequently than residential property that a shift in tax burden to residential taxpayers could occur. The definitions originally proposed for legal entities (based on the separate entity theory) were chosen to mitigate administrative difficulties. Because of this concern, the Task Force proposed that the Legislature study the idea of a constitutional amendment to periodically appraise commercial and industrial property noting:

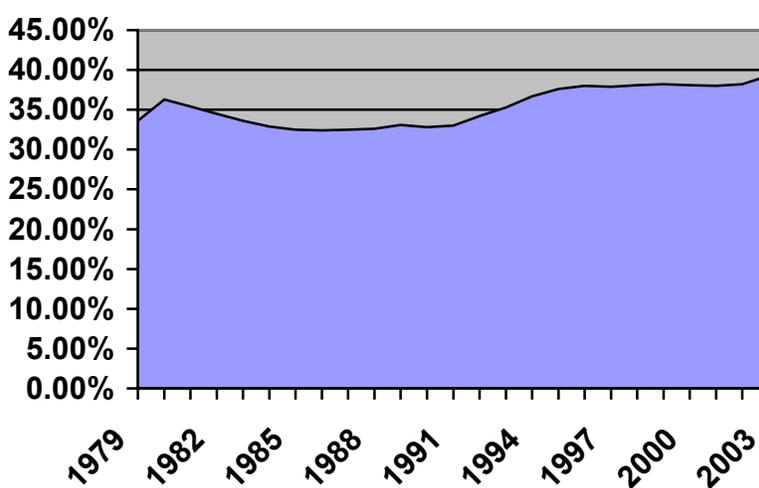
"[s]uch a constitutional change would also result in far greater simplicity in the treatment of legal entities. If commercial and industrial properties were to be

¹ Section 64(b) excludes transfers of ownership interests between affiliated corporations and Section 62(a)(2) excludes transfers which result in change in the method of holding title while the proportional ownership interests remain unchanged.

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periodically reappraised for reasons other than change in ownership, the difficult and controversial policy issues in choosing between the ‘ultimate control’ approach or ‘separate entity’ approach, outlined previously, would largely be avoided. The Task Force commends the principle of such a change to the Legislature for additional study."

There is now more than two decades worth of data to evaluate the Task Force concern that a shift in tax burden could occur. While the Board does not have statewide data on the percentage of *residential* property compared to all other property types, the following illustrates the **Percentage of Gross Assessed Value from Properties Receiving the Homeowners’ Exemption** (i.e., owner occupied principal places of residence) **compared to total assessed value:**



1979-80	33.6%
1980-81	36.3%
1981-82	35.4%
1982-83	34.5%
1983-84	33.6%
1984-85	32.9%
1985-86	32.5%
1986-87	32.4%
1987-88	32.5%

1988-89	32.6%
1989-90	33.1%
1990-91	32.8%
1991-92	33.0%
1992-93	34.2%
1993-94	35.3%
1994-95	36.7%
1995-96	37.6%
1996-97	38.0%

1997-98	37.9%
1998-99	38.1%
1999-00	38.2%
2000-01	38.1%
2001-02	38.0%
2002-03	38.2%
2003-04	39.3%

Legal Entity Change in Ownership – Discovery. The Board’s Legal Entity Ownership Program (LEOP) assists assessors in discovering changes in control or changes in ownership of legal entities under Section 64(c) and (d) that might not otherwise be captured by a county’s own discovery systems. This function began in January 1983 as a result of Chapter 1141 of the Statutes of 1981 (AB 152) which added Sections 480.1 and 480.2 to require the Board to participate in the discovery of changes in control of corporations, partnerships, and other legal entities. It was recognized that such events, which are not evidenced by a recorded document, would fall outside the parameters of assessors’ normal

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means for discovering changes in ownership. Discovery of these changes can be difficult because ordinarily there is no recorded deed or notice of a transfer of an ownership interest in a legal entity. The basic LEOP operations include:

- Follow up on legal entities that have reported a change in ownership on their income tax returns.
- Monitor business publications, such as *Mergers & Acquisitions* and the Wall Street Journal.
- Send a “[Statement of Change in Control or Ownership of Legal Entities](#)” to identified entities.
- Process completed statements to determine whether there has been a change in control or ownership.
- Notify county assessors of changes in control and ownership identified by these efforts.

Background

Related Legislation. Previous bills to require more frequent reassessment of property owned by legal entities or on nonresidential property are summarized below.

Year	Bill	Author	Summary
2003	SB 17	Escutia	Redefine change in ownership for nonresidential commercial and industrial property. (Legislative intent)
2003	ACA 16	Hancock	Annual reassessment of nonresidential, nonagricultural property.
2003	SB 3X	Escutia	Redefine change in ownership for nonresidential commercial and industrial property. (Legislative intent)
2002	SB 1662	Peace	Reassessment of nonresidential property when cumulatively more than 50% of the ownership has been transferred. Broaden the state and local sales and use tax base and reduce both the state and local sales and use tax rate. (Legislative intent):
2001	AB 1013	Leonard	Reassessment of property owned by a legal entity when more than 50% of the ownership shares transfer.
2000	AB 2288	Dutra	Reassessment of property owned by legal entity once every three years - Rebuttable presumption of change in ownership. Possible income tax credit to homeowners based on fair market value of homes from additional revenue. Reduce the sales and use tax rate by 0.25 percent.
1991	SB 82	Kopp	Reassessment of legal entities when cumulatively more than 50% of the ownership has been transferred.

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Pending Initiatives. There are multiple constitutional initiatives on the split roll issue approved for circulation and pending the required 598,105 signatures needed to qualify for the ballot.

Deadline	Summary
August 8	In part, requires annual reassessment of all nonresidential real property excluding property used for commercial agricultural production. (Two versions) Submitted by Roberta B. Johansen and James C. Harrison
August 19	Increases the tax rate on commercial real property except commercial residential rental property by either .30% or .50%. (Two versions) Submitted by Roberta B. Johansen and James C. Harrison
August 19	In part, increases the maximum tax rate from 1% to 3% on nonresidential property; counties set the actual rate but at no less than 2%. Limits the 1% tax rate on residential property to the first \$2 million dollars. Submitted by Ken Heredia
August 22	Annual reassessment of all nonresidential real property excluding property used for commercial agricultural production and personal property exemption of first \$500,000. Submitted by Lenny Goldberg
August 22	Annual reassessment of all nonresidential real property excluding property used for commercial agricultural production and personal property exemption of first \$500,000. Submitted by Wayne Ordos

Prior Initiatives. Two other initiatives on the split roll issue were pursued in 2004 and 1992.

Year	Result	Summary
2004	Initiative Dropped	Increase tax rate to 1.5% nonresidential real property excluding property used for commercial agricultural production. Proponent: California Teachers Association & Rob Reiner
Prop. 167	Failed 41.16% - 58.84%.	Addressed a number of tax related items, including a provision to modify the change in ownership definitions related to legal entities.
1992		Proponent: California Tax Reform Association

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COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the Pacific Institute for Community Organization (PICO) www.PICOcalifornia.org and the California Tax Reform Association www.caltaxreform.org. According to the author's office, SB 17 "seeks to reform the state's loophole-ridden commercial property tax system by closing loopholes in the "change of ownership" statutes, improving enforcement of the law and increasing penalties for violators."
2. **Key Amendments.** As introduced, this bill would have redefined "change in ownership" as it applies to the purchase or transfer of ownership interests in legal entities that own real property. Under the prior definitions:
 - Property owned by a publicly traded company would be reassessed to current market value every three years.
 - Property owned by other types of legal entities would be reassessed to current market value in proportion to the percentage of ownership interests in the legal entity transferred.

The April 19 amendments delete these provisions and instead create a new change in ownership trigger point when more than 50% of the ownership interests in a legal entity (excluding publicly traded companies) are transferred to one or more persons or entities during a calendar year.

Part 1. Change in Ownership Definitions

3. **What is a "split roll"?** Typically when the term "split roll" is used it means taxing certain types of property according to a different tax rate or standard of value. When the term "split roll" is used within the context of the existing property tax structure of Proposition 13 (Article XIII A of the California Constitution), it generally means changing the law to trigger more frequent "change in ownership" of property owned by legal entities by modifying the change in ownership definitions as this bill proposes. A **true** "split roll" is not possible without a constitutional amendment.
4. **Modifying "Change in Ownership" definitions.** While Proposition 13 provided that a "change in ownership" would trigger reassessment, the phrase was not defined. Statutory language defines the term "change in ownership" and details various transfers that are included or excluded from "change in ownership." Therefore, statutory amendments could, arguably, modify those definitions initially established.
5. **Proponents of this bill note that the current system is inequitable and this bill would treat the transfer of ownership interests in legal entity transfers more fairly.** Any transfer of real property interests by an individual results in a change in ownership absent applicable exclusion while generally transfers of ownership interests in a legal entity do not result in a change in ownership of property owned by the legal entity. For example:

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- Four individuals (A, B, C and D) each own a 25% interest in a property. Each time an individual sells his or her interest to another person a change in ownership of a 25% interest in the property is triggered.
- If the same property is owned by a legal entity in which the same four individuals each own a 25% interest in the legal entity, instead of the property, then if an individual sells his or her 25% interest in the legal entity to someone else, no change in ownership of the property owned by the legal entity will occur. This is true even if there is a complete turnover of ownership interests as a single event or multiple transfers over the years. Only if one person obtains control of the legal entity (more than 50%) will a change in ownership be triggered.

The following table illustrates the above example as well as the assessment consequences of transfers of ownership interests in a legal entity that would occur under this bill.

Year	Transfer	Reassessment		Reassessment
		Current Law <i>Individual</i>	Current Law <i>Legal Entity</i>	Proposed Law <i>Legal Entity</i>
2006	A sells out to E B sells out to F C sells out to G	75%	0%	100%*
2007	D sells out to H	25%	0%	0%
2008	E buys out F & G	50%	100%	100%**
2009	E buys out H	25%	0%	0%
2010	E sells 50% to I	50%	0%	0%

* Transfer of more than 50% in the calendar year = 100% reappraisal due to new change in ownership trigger point.

** Change in control – one person has acquired “control” i.e., more than 50% ownership interests = 100% reappraisal due to change in ownership trigger point under existing law.

6. **Is the effect of the change in ownership provisions for legal entities an unintentional loophole?** The Proposition 13 Task Force considered and debated the issue of transfers of interests in legal entities and current change in ownership definitions were consciously made. The question appears to be whether the definitions are still appropriate after more than 25 years. The Task Force recognized the potential effect of these definitions over the long term noting "(t)he Task Force admits that some of its own recommendations, such as those regarding legal entities, while the best of a seemingly 'no-win' choice of options and adopted to mitigate administrative difficulties, may, in the long run, further exacerbate this [tax burden] shift to residential property because it will result in fewer potential commercial and industrial property transfers being recognized for reappraisal purposes." Consequently, the Task Force proposed that the Legislature later study a constitutional change to periodically reappraise commercial and industrial property.
7. **This bill only affects real property owned by a legal entity that is not publicly traded – it would have no impact on property owned by an individual.** Bills similar

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to this legislation are typically viewed in the context of commercial properties, but any real property owned by a legal entity (partnerships, limited liability corporations, corporations, etc.) that is not publicly traded would be subject to the change in ownership definition revisions. This could include single family homes, multi-family properties such as apartments, duplexes and mobilehome parks, agricultural property, family farms², and small businesses.

8. **Opponents of "split roll" legislation note that ultimately the higher property taxes paid by legal entities that own California real estate would result in:**
- loss of business growth to other states and countries,
 - higher cost of goods and services,
 - increase in rents for leased real property,
 - decrease in profits to owners and investors including retirees,
 - lower wages for employees of legal entities,
 - increase in the size of government, and
 - increase in government employee salaries.
9. **Proponents of this bill note that the tax burden is shifting to homeowners.** With respect to shifting tax burdens, the share of assessed value from owner occupied homes has increased from 33.6% in 1979 to 39.3% in 2003. The percentage change from year to year varies and in some years has declined.
10. **Property taxes paid by legal entities generally increase over time.** Businesses, unlike homeowners, also pay property taxes on their personal property holdings. Business personal property is assessed every year at its current market value. Additionally, as businesses grow and expand, any real property that a legal entity newly constructs or acquires is reassessed to current market value. Further, mergers and takeovers of corporations can trigger reassessment.
11. **Legal challenges of any new definition might be made on the grounds that different change in ownership definitions violate the Equal Protection Clause.** The U.S. Supreme Court has held in many cases that a differential system of taxation does not violate the Equal Protection Clause provided that the state legislature has a rational basis for such a system.

² The parent-child change in ownership exclusion does not apply to transfers of ownership interests in legal entities. However, it is possible to use the parent-child exclusion by using a multi-step process: (1) Property is transferred from the legal entity to the parent as an individual. (2) The parent transfers the property to the child. (3) If desired, the property may be transferred from an individual into another legal entity. There is a one million dollar cap (assessed value not market value) on the value of property that may be transferred without reassessment under the parent-child change in ownership exclusion.

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Part 2. Change in Ownership Reporting and Discovery

1. **Changes in ownership or control of a legal entity triggered due to transfers of ownership interests in legal entities (Section 64(c) and (d)) are not easy to discover.** Unlike transfers of interests in real property, a deed is not recorded with the county recorder nor is there any other type of public notice that the Board or the assessor could use to monitor and track transfers of ownership interest in a legal entity.
2. **The law requires legal entities to report changes in ownership under Section 64(c) and (d) by filing a change in ownership statement within 45 days of the event, but there is no penalty if they fail to do so.** Under current law, a penalty is incurred only if a legal entity does not respond to a written request by the Board to file a statement and the entities are given two opportunities to provide information before a penalty is levied.
3. **The Franchise Tax Board currently informs the Board of legal entities that do not answer the property tax question on their income tax return.** This provision would codify existing administrative practices.
4. **This bill would establish a minimum penalty of \$1,000 per property for not timely reporting a change in ownership.** If it is ultimately discovered that a change in ownership of a legal entity occurred, which the legal entity did not self-report, this bill would require a penalty to be levied. The amount of the penalty is calculated based upon the value of each property owned by the legal entity subject to the penalty. Generally, the flat amount of \$1,000 would apply to any real property with a value of less than \$1 million in current fair market value (\$1,000 is greater than 10% of the taxes on a property with a new base year value of \$1,000,000 or less).

COST ESTIMATE

There would be administrative costs to process the additional change in ownership statements that legal entities owning real property in California would file with the Board when a change in ownership occurs under this bill. A detailed cost estimate is pending.

REVENUE ESTIMATE

A detailed revenue estimate is pending, but the revenue gain is expected to be in the tens of millions.

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