

# Cal-Tax Digest

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June 1997

## Tax Issues



### Legislative Changes Make the Manufacturers' Investment Credit More Attractive to Key Industries

By Chris Micheli

In 1993, California's economy was caught in the throes of the worst recession since the Great Depression. Instead of creating more than 300,000 jobs a year, which had been routine in the 1980s, the state's economy was losing that many, for a net annual loss of 600,000-700,000 jobs.

Alas, a thriving business in California involved the rentals of one-way U-Haul trailers to other states.

Enter the "MIC" - the acronym for the manufacturers' investment (tax) credit. Supporters say the MIC is synonymous with more jobs.

California's reputation as a high-tax state, along with regulatory and tort systems that stack the deck against business interests, needed to be addressed. Being among a minority of states that taxed the purchase of manufacturing equipment, California was at a competitive disadvantage. After passage of SB 671 in 1993, only three states provide no tax credit or exemption for the equipment used to make products. Thirty-nine states currently provide a full exemption. Seven states, including California, have a partial sales tax exemption.

How many of those manufacturing jobs were created because of the MIC? No one can say with certainty, but two years ago officials of Intel Corporation attributed the decision to build a \$600 million research and development plant in Folsom - and the creation of 1,000 jobs - to the state's new MIC. Air Products



Chris Micheli, formerly general counsel to the California Manufacturers Association, is a chief architect of the manufacturers' investment credit in California. He is an attorney and legislative advocate for the Sacramento governmental relations firm of Carpenter Snodgrass & Associates (916/447-2251).

invested \$260 million in a new facility in Southern California. Campbell Soup decided to spend \$200 million to retool their Sacramento plant rather than move it to the East Coast.

According to the governor's Office of Planning and Research (OPR), California was losing 900 jobs a day five years ago. Today, more than 1,000 a day are being created. The "U-Haul Migration" rate in the past year was 2.5 percent more in-bound trailers, compared to 7.5 percent more outbound trailers during 1991, a recent OPR report stated.

On January 1, 1994, the year California's MIC took effect, there were 1,737,900 manufacturing jobs in the state. One year later, there were 1,748,000, and on January 1, 1996, there were 1,783,400. That is a gain of 45,500 in two years.

The MIC enacting legislation requires results: the creation of 100,000 manufacturing jobs by the year 2001. So California is already 45 percent toward the goal, in just two years, with five more years to go. Failure to achieve at least 100,000 additional manufacturing jobs over the seven-year period would cause repeal of the MIC.

The passage of the MIC occurred in probably the most pro-business legislative session in a generation, and SB 671, a hybrid product that included reforms in the unitary method of taxation, a reduced Subchapter S tax rate, and removal of a sunset date on the research and development tax credit, was the crown jewel of legislative pro-business accomplishment. It provides about \$400 million in relief for taxpayers when fully implemented.

Willie Brown, then speaker of the Assembly, encouraged the marriage of business tax incentives with the unitary reforms in SB 671, carried by then-Senator Alfred Alquist. Mr. Brown said SB 671 was the most significant pro-business tax law in California since repeal of the business inventory tax in 1979.

The Franchise Tax Board reports that more than 4,800 personal income tax returns used MIC credits in 1994 and 1995. (The FTB has not completed a review of all the bank and corporation tax returns for those two years.)

Following is a detailed report on the MIC as enacted and amended by more recent acts of the Legislature and Governor Pete Wilson.

In 1993, Senate Bill 671 (Chapter 881) enacted an investment tax credit, sometimes called the manufacturers' investment credit, or "MIC," (**note 1**) that is designed specifically for manufacturers doing business in California. SB 671 also enacted a partial sales/use tax exemption (**note 2**) (referred to hereinafter as "partial exemption") for certain "start-up" manufacturers.

**In 1996, further amendments were made to the MIC and partial exemption statutes by SB 38.**

In 1994, SB 676 (Chapter 751), modified these statutes to add additional benefits, particularly to ensure that leasing transactions are treated equally for purposes of the MIC. In 1996, further amendments were made to the MIC and partial exemption statutes by SB 38 (Chapter 954), which is discussed at length herein.

## Overview of the MIC

SB 671 provides a 6 percent investment tax credit for the "qualified costs" paid or incurred for acquiring, constructing or reconstructing certain machinery and equipment used in the manufacturing process. The credit is "equal to 6 percent of the qualified cost of qualified property that is placed in service in this state."

The MIC is only available to specified manufacturers (**note 3**), and it can only be used to offset income tax liability. In other words, if the taxpayer does not have tax liability in excess of the minimum tax, it cannot derive any benefit from the MIC.

The MIC is *not* a refundable credit. It can reduce the taxpayer's regular tax below the tentative minimum tax. However, the credit cannot reduce the alternative minimum tax or the minimum franchise tax of \$800.

However, the credit under the MIC is allowed to be carried over to reduce net taxes in succeeding years. There is an eight-year carryforward limit for manufacturers, except those who qualify as a "small business", in which case the taxpayer may carryforward the credit for 10 years. "Small" is defined as: (a) gross receipts of less than \$50 million; (b) net assets of less than \$50 million; or, a total credit of less than \$1 million.

For purposes of the MIC, California Revenue and Taxation Code Sec. 23649 provides that a "qualified taxpayer" (**note 4**) is any taxpayer who falls within Standard Industrial Classification (SIC) Codes 2011 to 3999. This is Division D ("Manufacturing") of the

Manual. Those Codes **(note 5)** reference manufacturers and utilize two-, three- and four-digit numbers to describe industrial activities.

It should be noted that a qualified taxpayer may be an individual, partnership, C or S corporation, limited liability company, trust, or estate. **(note 6)**

For purposes of the definition of "qualified property," there are four major requirements **(note 7)** to be met in order for property to be eligible for the MIC: It must be (1) tangible personal property, (2) which is depreciable or amortizable under Internal Revenue Code Sec. 1245(a), (3) which is "primarily used" **(note 8)** in the manufacturing **(note 9)**, processing **(note 10)**, refining **(note 11)**, fabricating **(note 12)** or recycling **(note 13)** processes, and (4) which is placed in service **(note 14)** in California on or after January 1, 1994.

In general, the property must be used for manufacturing, processing, refining, fabricating, recycling, in research and development **(note 15)**, to maintain, repair, measure, or test property, or for pollution control. **(note 16)** Qualified property also includes computer software on which sales tax was paid that is primarily used in a qualifying activity by a qualified taxpayer. Finally, the value of capitalized labor **(note 17)** and certain pollution control equipment **(note 18)** qualifies for the MIC.

### **Partial Exemption Overview**

SB 671 also makes start-up manufacturers (essentially defined as manufacturers who first begin operations in California after December 31, 1993) eligible for a partial exemption from the sales/use tax on certain machinery and equipment. The exemption is a partial exemption from the sales or use tax that otherwise would be imposed on an item of machinery or equipment. Being exempt from paying a portion of the sales/use tax means that a taxpayer does not have to pay as much money "up front" (i.e., at the time of purchase) for any qualified property.

The partial exemption also became effective for purchases made on or after January 1, 1994. For purchases made after January 1, 1994, but prior to December 31, 1994, the exemption rate equals 6 percent. For purchases made after December 31, 1994, the exemption rate equals 5 percent.

For the sales/use tax exemption, the first requirement is also that the taxpayer have an SIC designation between 2011 and 3999. There is another requirement, however. The partial exemption is only available to "start-up" manufacturers, or those engaged in a "new trade or business." The law defines a start-up business as a "new trade or business" which was formed or organized after December 31, 1993, or that commenced doing business in California after that date.

The final criterion is that the partial exemption is only available to the start-up manufacturer for its first three years of existence. At the end of the three-year period, the start-up manufacturer becomes eligible only for the MIC.

In general, for the partial exemption, the property must be primarily used in any stage of the manufacturing, processing, refining, fabricating, or recycling of property, in research and development, to maintain, repair, measure, or test property, or by a contractor purchasing that property as an agent of the qualified taxpayer, or for resale to one, for use in the performance of a construction contract to be used in a qualifying activity.

In addition, for start-up manufacturers, there is no limit on the type of taxpayer who can qualify for special purpose buildings and foundations. All equipment used to operate, control, regulate, or maintain machinery also qualifies. And, perhaps most importantly for some types of manufacturers, fuels "used or consumed in the manufacturing process" also qualify.

For both the MIC and the partial exemption, it is also important to consider the types of property which do *not* qualify for the tax incentives **(note 19)**: Consumables with a normal useful life of less than one year **(note 20)**; furniture; inventory; equipment used in the extraction process; equipment used to store finished products; and, certain types of vehicles. **(note 21)** Qualified property also does not include any property that is used in administration, general management, or marketing. **(note 22)**

Finally, it should be noted that the MIC and partial exemption do not apply in certain circumstances, including when qualified property is, within one year from the date the property was placed in service in this state, removed from California, converted from a qualifying use to a non-qualifying use, or disposed of to an unrelated party. **(note 23)**

In addition, the benefits of the MIC and the partial exemption will be lost if 100,000 jobs in the manufacturing sector are not created by January 1, 2001, or on January 1 of the earliest year thereafter. The law requires that an annual report be made to the State Legislature by the Employment Development Department showing the total employment in the manufacturing sector (excluding aerospace) in this state.

### Statutory Amendments

SB 38 makes five significant changes, as well as a number of minor, technical amendments, to the MIC and partial exemption that were enacted in 1993 by SB 671. First, SB 38 made special purpose buildings and foundations (commonly referred to as "cleanrooms") that are constructed or modified by semiconductor equipment manufacturers under SIC Code 3559 eligible for the MIC for property placed in service in this state after January 1, 1997.

By way of background, manufacturers engaged in business under SIC Code 3559 (which includes manufacturers of semiconductor equipment and materials among many others) are deemed "qualified taxpayers" for purposes of the MIC. However, there is a limitation placed on the types of manufacturers who can qualify for the MIC that construct special purpose buildings and foundations.

During consideration of SB 671 in 1993, as well as the amendments made to it by SB 676 in 1994, it was portrayed that "high-tech" companies, as well as biotech firms, would qualify for the MIC on their special purpose buildings. Unfortunately, the "high-tech" SIC Codes listed in the statute did not include semiconductor equipment manufacturers. It was this oversight that was corrected by SB 38.

**Observers believe that California is positioned to capture a large segment of the expanding commercial satellite industry.**

Second, SB 38 made cleanrooms constructed or modified by commercial space and communications satellite manufacturers under SIC Codes 3663, 3761-3769, and 3812 eligible for the MIC for property placed in service in this state after January 1, 1996. Although this proposal was not contained in a piece of legislation, it was proposed for consideration by the two-house conference committee on SB 38 that held several meetings in August 1996.

Observers believe that California is positioned to capture a large segment of the expanding commercial satellite industry. Over the next 10 years, this is expected to become a substantial growth field

and will enable many of the state's defense contractors to reposition themselves in newly created high-technology fields. The clean-rooms are critical to the development and manufacture of commercial space satellites.

The new language in CRTC Secs. 17053.49 and 23649 Subdivision (d)(3) (**note 24**) reads: "(3) In the case of any qualified taxpayer engaged in manufacturing activities described in SIC Code 357 or 367 or, those activities related to biotech *biotechnology* described in SIC Code 8731, or those activities related to biopharmaceutical establishments only that are described in SIC Codes 2830 2833 to 2836, inclusive, *those activities related to space vehicles and parts described in SIC Codes 3761 to 3769, inclusive, those activities related to space satellites and communications satellites and equipment described in SIC Codes 3663 and 3812 (but only with respect to "qualified property" that is placed in service on or after January 1, 1996), or those activities related to semiconductor equipment manufacturing described in SIC Code 3559 (but only with respect to "qualified property" that is placed in service on or after January 1, 1997), "qualified property" also includes the following:*"

Third, SB 38 allows a manufacturer-lessor to elect to pay the sales or use tax at the "front end" of the lease. As a result, it permits the lessee of the property to take advantage of the MIC, so long as the lessee meets the definition of "qualified taxpayer." Under the MIC statute, a manufacturer's equipment purchases are eligible for the tax credit through a sale or a lease.

However, in a leasing transaction, a buyer-lessee can take advantage of the MIC only if the seller-lessor elects to pay the sales/use tax "up front," rather than over the life of the lease. Unfortunately, under existing law prior to the enactment of SB 38, a manufacturer-lessor (unlike a leasing company) had to pay the sales tax over the life of the lease and, therefore, could not elect to pay the tax at the front end of the lease.

The new language in CRTC Sec. 6244.5 (**note 25**) reads: "(a) *Notwithstanding any other provision of law, a lessor of tangible personal property described in Sec. 17053.49 or 23649, who is the manufacturer of that property and who leases that property to a qualified taxpayer, as defined in Secs. 17053.49 and 23649, in a form that is not substantially the same form as acquired, may, in lieu of reporting use tax measured by the rentals payable, elect to pay tax measured by his or her cost price of that property if the*



*election is made on or before the due date of the return for the period in which the property is first leased. The election shall be made by reporting use tax measured by the cost price on the return for that period. The election shall not be revoked with respect to the property as to which it is made. The lease of that property for which an election is made pursuant to this Sec. shall thereafter be excluded from the terms 'sale' and 'purchase.'*

(b) "'Cost price,' as used in subdivision (a), means the price at which similar property has been previously sold or offered for sale. If that property has not been previously sold or offered for sale, then the cost price shall be deemed to be the aggregate of the following:

(1) Cost of materials.

(2) Direct labor.

(3) The pro rata share of all overhead costs attributable to the manufacture of the property.

*(4) Reasonable profit from the manufacturing operations which, in the absence of evidence to the contrary, shall be deemed to be 5 percent of the sum of the factors listed in paragraphs (1) to (3), inclusive."*

Fourth, SB 38 allows biotech and biopharmaceutical companies to be treated as "small businesses" under the MIC in certain cases. This provision creates a new category of "small business" on January 1, 1997 for certain biopharmaceutical and biotechnology companies that have not received regulatory approval for any product from the U.S. Food and Drug Administration. By qualifying as a small business, these companies can carryforward their unused MIC credits for ten years, rather than eight years.

The new language in CRTC Secs. 17053.49 and 23649 Subdivision (e)(10)(D) (**note 26**) reads: "(D) For taxable years beginning on or after January 1, 1997, is engaged in biopharmaceutical activities or other biotechnology activities that are described in Codes 2833 to 2836, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition, and as further amended, and has not received regulatory approval for any product from the United States Food and Drug Administration."

**SB 38 allows leased property under the partial exemption to qualify for the 5 percent exemption for six years under a rental agreement, rather than the current three years.**



Fifth, SB 38 allows leased property under the partial exemption to qualify for the 5 percent exemption for six years under a rental agreement, rather than the current three years. It makes leased equipment under the partial exemption an attractive alternative for manufacturers who cannot afford to purchase the equipment through a sales transaction.

The new language in CRTC Secs. 17053.49 and 23649 Subdivision (h) (**note 27**) reads: "*(h) This Sec. applies to leases of tangible personal property classified as 'continuing sales' and 'continuing purchases' in accordance with Secs. 6006.1 and 6010.1. The exemption established by this Sec. shall apply to the rentals payable pursuant to such a lease, provided the lessee is a qualified person and the property is used in an activity described in subdivision (a). Rentals which meet the foregoing requirements are eligible for the exemption for a period of six years from the date of commencement of the lease. At the close of the six-year period from the date of commencement of the lease, lease receipts are subject to tax without exemption.*"

Moreover, SB 38 contains a number of important technical amendments to the MIC and partial exemption statutes. The first amendment clarifies the method of determining the MIC for pass-through entities (such as a partnership, LLC or Subchapter S corporation). This new statutory language also makes the determination of the tax credit at the entity level.

The new language reads CRTC Secs. 17053.49 and 23649 Subdivision (c)(2) (**note 28**) reads: "*(2) In the case of any pass-through entity, the determination of whether a taxpayer is a qualified taxpayer under this Sec. shall be made at the entity level and any credit under this Sec. or Sec. 23649 shall be allowed to the pass-through entity and passed through to the partners or shareholders in accordance with applicable provisions of Part 10 (commencing with Sec. 17001) or Part 11 (commencing with Sec. 23001). For purposes of this paragraph, the term 'pass-through entity' means any partnership or S corporation.*"

The new language in CRTC Secs. 17053.49 and 26349 Subdivision (c)(3) (**note 29**) reads: "*(3) The Franchise Tax Board may prescribe regulations to carry out the purposes of this Sec., including any regulations necessary to prevent the avoidance of the effect of this Sec. through splitups, shell corporations,*

*partnerships, tiered ownership structures, sale-leaseback transactions, or otherwise."*

Another technical amendment specifies a definition of the "beginning and end of the manufacturing process." This definition, which was not included in the original legislation, is taken from existing State Board of Equalization (BOE) Regulation 1525.2 (which implements the partial exemption) and Franchise Tax Board Regulations 17053.49 and 23649 (which implement the MIC).

The new language in CRTC Sec. 6377 Subdivision (b)(4), and CRTC Secs. 17053.49 and 23649 Subdivision (e)(6) **(note 30)** reads: *"(6) 'Process' means the period beginning at the point at which any raw materials are received by the qualified taxpayer and introduced into the manufacturing, processing, refining, fabricating, or recycling activity of the qualified taxpayer and ending at the point at which the manufacturing, processing, refining, fabricating, or recycling activity of the qualified taxpayer has altered tangible personal property to its completed form, including packaging, if required. Raw materials shall be considered to have been introduced into the process when the raw materials are stored on the same premises where the qualified taxpayer's manufacturing, processing, refining, fabricating, or recycling activity is conducted. Raw materials that are stored on premises other than where the qualified taxpayer's manufacturing, processing, refining, fabricating, or recycling activity is conducted, shall not be considered to have been introduced into the manufacturing, processing, refining, fabricating, or recycling process."*

In addition, SB 38 added several other definitions to the MIC which were sought by the biotechnology community. A definition of "biopharmaceutical activities" was added.

The new language in CRTC Secs. 17053.49 and 23649 Subdivision (e)(1) **(note 31)** reads: *"'Biopharmaceutical activities' means those activities which use organisms or materials derived from organisms, and their cellular, subcellular, or molecular components, in order to provide pharmaceutical products for human or animal therapeutics and diagnostics. Biopharmaceutical activities make use of living organisms to make commercial products, as opposed to pharmaceutical activities which make use of chemical compounds to produce commercial products."*

In addition, a definition of "other biotechnology activities" was added. The new language in CRTC Secs. 17053.49 and 23649 Subdivision (e)(4) (**note 32**) reads: *"(4) 'Other biotechnology activities' means activities consisting of the application of recombinant DNA technology to produce commercial products, as well as activities regarding pharmaceutical delivery systems designed to provide a measure of control over the rate, duration, and site of pharmaceutical delivery."*

**There undoubtedly will be additional measures in the years to come that will attempt to modify the MIC and partial exemption statutes.**

The final technical amendments changed the SIC Code Manual references to commence at 2011, rather than 2000, which does not exist in the 1987 Manual.

CRTC Secs. 17053.49 and 23649 Subdivision (c)(1): This subdivision was changed to (1). Reference to Division D SIC Codes was changed from 2000 to 2011. (**note 33**)

CRTC Secs. 17053.49 and 23649 Subdivision (d)(1): Reference to Division D SIC Codes was changed from 2000 to 2011. (**note 34**)

CRTC Sec. 6377 Subdivision (b)(6)(B): Reference to Division D SIC Codes was changed from 2000 to 2011. (**note 35**)

There undoubtedly will be additional measures in the years to come that will attempt to modify the MIC and partial exemption statutes. Manufacturers should follow legislative efforts in this area to examine whether the tax incentives have been expanded or diminished. In 1996, the MIC and partial exemption for manufacturing machinery and equipment were expanded to make them better for California businesses.

## Footnotes

1. California Revenue and Taxation Code Sec. 23649 (corporate tax provisions); Sec. 17053.49 (parallel personal income tax provisions). In discussing the MIC, citations to the statute will only be to the corporate tax provisions. The subdivisions are the same for both the corporate and personal income tax provisions. All other citations in this article are to the Revenue & Taxation Code unless otherwise specified. Citations to FTB Regulations 17053.49 and 23649 will be made only to Regulation 236. The subsections are the same for both of these regulations.

2. Sec. 6377.

3. Defined as those taxpayers whose activities are described in Secs. 2011 to 3999 of the 1987 edition of the **Standard Industrial Classification Manual**. Sec. 23649(c)(1). Reg. Sec. 23649-3(a).

4. **See, also**, Reg. Sec. 23649-3.

5. It should be noted that the SIC Code number is not the same as the Principal Business Activity Code used on federal and state corporate tax returns.

6. **See** FTB Publication 1137. Under Regulation 23649 and Publication 1137, the FTB utilizes the language of the SIC Manual for determining how a taxpayer designates the SIC Code. "An establishment is an economic unit, generally at a single physical location, where business is conducted or where services or industrial operations are performed. If distinct and separate economic activities are performed at a single physical location, each activity is treated as a separate establishment. For the purpose of this publication, the terms establishment and line of business are synonymous." **See, also**, Reg. Sec. 1525.2(c)(5)(B).

7. Sec. 23649(d). Reg. Sec. 23649-5(b).

8. "Primarily used" is defined as "50 percent or more of the time" in a qualifying activity. Sec. 23649(e)(5). Reg. Sec. 23649-5(b)(4). The parallel citation for the sales/use tax exemption is found in Sec. 6377(b)(3). Reg. Secs. 1525.2(c)(2) and (c)(3).

9. Sec. 23649(e)(3). Sec. 6377(b)(2). Under FTB Regulation 23649-2(l) and SBE Regulation 1525.2(a)(1), the process begins "at the point any raw materials are received by the qualified person and introduced into the process and ending at the point at which the process has altered the property to its completed form, including packaging, if required."

10. Sec. 23649(e)(7). Sec. 6377(b)(5). This means "the physical application of the materials and labor necessary to modify or change the characteristics of property." Reg. Sec. 23649-2(m). Reg. Sec. 1525.2(c)(4).

11. Sec. 23649(e)(8). Sec. 6377(b)(8). This means "the process of converting a natural resource to an intermediate or finished product." Reg. Sec. 23649-2(p). Reg. Sec. 1525.2(c)(6).

12. Sec. 23649(e)(2). Sec. 6377(b)(1). This means "to make, build, create, produce, or assemble components or property to work in a new or different manner." Reg. Sec. 23649-2(d).

13. The term "recycling" is not defined by statute.

**But see** Reg. Sec. 23649-2(o) and Reg. Sec. 1525.2(c)(9)(F).

14. Reg. Sec. 23649-2(I).

15. This term is defined as those activities which are described in Internal Revenue Code Sec. 174. Sec. 23649(e)(9) (for the MIC) and Sec. 6377(b)(9) (for the partial exemption). Reg. Sec. 23649-2(q) (for the MIC) and Reg. Sec. 1525.2(c)(7) (for the partial exemption).

16. Sec. 23649(d)(1)(D). Reg. Sec. 23649-2(j).

17. Sec. 23649(d)(2). Reg. Sec. 23649-2(c).

18. Pollution control equipment is defined as that which "meets or exceeds standards established by the state or by any local or regional governmental agency within the state." Sec. 23649(d)(1)(D). Reg. Sec. 23649-2(j).

19. Reg. Sec. 1525.2(c)(8).

20. Sec. 6377(b)(10)(A). Reg. Sec. 1525.2(c)(8)(B).

21. Sec. 6377(b)(10)(B). These are vehicles for which the low-emission tax credit has been claimed.

22. Sec. 6377(a)(4).

23. The State recaptures the credit on the tax return for the taxable or income year in which it is disposed of, removed, or put to a non-qualifying use.

24. Reg. Secs. 23649-5(a) and (c) should be amended to reflect these statutory changes.

25. Reg. Secs. 23649-6 and 23649-11 should be amended to reflect this new statute.

26. Reg. Sec. 23649-2(t) should be amended to reflect this statutory change.
  27. Reg. Sec. 1525.3 should be amended to reflect this statutory change.
  28. Reg. Secs. 23649-7, 23649-8(f), and 23649-9(e) should be amended to reflect these statutory changes.
  29. Reg. Sec. 23649-7 should be amended to reflect this statutory change.
  30. See Reg. Sec. 23649-2(l) and Reg. Sec. 1525.2(a)(l).
  31. See Reg. Sec. 23649-2(a).
  32. Reg. Sec. 23649-2 should be amended to reflect this statutory change.
  33. Reg. Sec. 23649-1(d)(6) should be amended to reflect this statutory change.
  34. Reg. Sec. 23649-1(d)(6) should be amended to reflect this statutory change.
  35. Reg. Secs. 1525.2(a)(5)(B) and (a)(5)(B)2.c. should be amended to reflect this statutory change.
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