Proposed rules include new rules, amendments to existing rules, and repeals of existing rules. A state agency shall give at least 30 days' notice of its intention to adopt a rule before it adopts the rule. A state agency shall give all interested persons a reasonable opportunity to submit data, views, or arguments, orally or in writing (Government Code, Chapter 2001).

Symbols in proposed rule text. Proposed new language is indicated by underlined text. [~~Square brackets and strikethrough~~] indicate existing rule text that is proposed for deletion. "(No change)" indicates that existing rule text at this level will not be amended.

TITLE 1. ADMINISTRATION

PART 2. TEXAS ETHICS COMMISSION

CHAPTER 18. GENERAL RULES CONCERNING REPORTS

1 TAC §§18.23 - 18.26

The Texas Ethics Commission (the Commission) proposes amendments to Texas Ethics Commission rules in Chapter 18, concerning General Rules Concerning Reports. Specifically, the Commission proposes amendments to §18.23, regarding Administrative Waiver of Fine, §18.24, regarding General Guidelines for Other Administrative Waiver or Reduction of Fine, §18.25, regarding Administrative Waiver or Reduction of Fine: Report Type I and §18.26, regarding Administrative Waiver or Reduction of Fine: Report Type II.

Current rules concerning the administrative waiver process, which determine whether a filer is eligible for a waiver or reduction of a penalty for filing a report late, were created to afford a uniform and objective process by which all filers are adjudged against the same set of standards. The proposed amendments would make some improvements to this process. The proposed revisions delete the distinction between "Type I" and "Type II" reports, instead focusing on whether a penalty is more than $500 or not. All reports with civil penalties of $500 or less will be addressed by §18.25. They also clarify when a waiver will result in a prior offense and when it will not.

J.R. Johnson, General Counsel, has determined that for the first five-year period the proposed amended rules are in effect, there will be no fiscal implications for state or local government as a result of enforcing or administering the proposed rules.

The General Counsel has also determined that for each year of the first five years the proposed amended rules are in effect, the public benefit will be consistency, simplicity and clarity in the Commission's rules that set out the administrative waiver process. There will not be an effect on small businesses, microbusinesses or rural communities. There is no anticipated economic cost to persons who are required to comply with the proposed amended rules.

The General Counsel has determined that during the first five years that the proposed amended rules are in effect, they will not: create or eliminate a government program; require the creation of new employee positions or the elimination of existing employee positions; require an increase in future legislative appropriations to the agency; require an increase or decrease in fees paid to the agency; expand, limit, or repeal an existing regulation; increase or decrease the number of individuals subject to the rules' applicability; or not positively or adversely affect this state's economy.

The Commission invites comments on the proposed amended rules from any member of the public. A written statement should be emailed to public_comment@ethics.state.tx.us, or mailed or delivered to Anne Temple Peters, Texas Ethics Commission, P.O. Box 12070, Austin, Texas 78711-2070. A person who wants to offer spoken comments to the Commission concerning the proposed amended rules may do so at any Commission meeting during the agenda item relating to the proposed amended rules. Information concerning the date, time, and location of Commission meetings is available by telephoning (512) 463-5800 or on the Commission's website at www.ethics.state.tx.us.

The amendments are proposed under Texas Government Code §571.062, which authorizes the Commission to adopt rules to administer Title 15 of the Election Code.

The proposed amended rules affect Title 15 of the Election Code.

§18.23. Administrative Waiver of Statutory Civil Penalties [~~Fine~~].

(a) A filer may request the executive director to waive a civil penalty determined by §§305.033(b) or 572.033(b) of the Government Code or §254.042(b) of the Election Code [~~late fine~~] by submitting an affidavit to the executive director.

(b) If, in the executive director's discretion, the affidavit establishes any of the following grounds for a waiver, the executive director shall waive the civil penalty, and the penalty waived is not a prior offense for purposes of §18.25 of this title (relating to Administrative Waiver or Reduction of Certain Statutory Civil Penalties) or §18.26 of this title (relating to Administrative Waiver or Reduction of Other Statutory Civil Penalties in Excess of $500) [~~that states facts that establish that~~]:

(1) the report was filed late because of an unforeseen serious medical emergency or condition or a death that involved the filer, a family member or relative of the filer, a member of the filer's household, or a person whose usual job duties include preparation of the report;

(2) the report was filed late as a result of verifiable severe weather at the filer's location that prevented the filer from filing the report by the applicable deadline and the report was filed within a reasonable time after the deadline;

(3) the report was filed late because the filer was a first responder, as defined in §6.1 of this title (relating to Definitions), deployed to an emergency situation at the time of the filing deadline or a member of the military deployed on active duty at the time of the filing deadline and the report was filed within a reasonable time after the deadline;

(4) the filer filed a timely report but accidentally selected the incorrect filing year or filing period in the agency's electronic filing system, and:

(A) the filer filed a corrected report amending the filing year or filing period no later than 30 days after the individual was notified that the report appeared to be late; and

(B) the corrected report is substantively identical to the originally-filed report;

(5) the filer reasonably relied on incorrect information given to the filer by the agency; or

(6) the report was filed late because of other administrative error by the agency.

(c) If, in the executive director's discretion, the affidavit establishes any of the following grounds for a waiver, the executive director shall waive the civil penalty, but the penalty waived is a prior offense for purposes of §18.25 or §18.26:

(1) [~~(4)~~] the filer of the personal financial disclosure report is not an elected official, a candidate for election, or a salaried public servant, and the late report:

(A) was the first personal financial disclosure report filed late by the filer under Government Code chapter 572; and

(B) was filed no later than 30 days after the individual was notified that the report appeared to be late;

(2) [~~(5)~~] the filer of the personal financial disclosure report was an unopposed candidate in a primary election, and the late report:

(A) was the first personal financial disclosure report filed late by the filer under Government Code chapter 572; and

(B) was filed before the primary election.

(3) [~~(6)~~] the filer of the campaign finance report:

(A) had filed all previous reports by the applicable deadline;

(B) had no new contributions, expenditures, or loans to report during the filing period; and

(C) filed the report no later than 30 days after the filer first learned that the report was late.[~~;~~]

[~~(7) the filer reasonably relied on incorrect information given to the filer by the agency; or~~]

[~~(8) other administrative error by the agency.~~]

[~~(b) If, in the executive director's discretion, the affidavit establishes grounds for a waiver under this section, the executive director shall waive the fine.~~]

§18.24. General Guidelines for Other Administrative Waiver or Reduction of Statutory Civil Penalties [~~Fine~~].

(a) A filer who does not qualify for a waiver under §18.23 of this title (relating to Administrative Waiver of Statutory Civil Penalties [~~Fine~~]) may request the executive director to waive a civil penalty determined by §§305.033(b) and 572.033(b) of the Government Code or §254.042(b) of the Election Code [~~late fine~~] by submitting an affidavit to the executive director. The executive director may waive or reduce a civil penalty [~~the late fine~~] if the filer meets the criteria and the late report meets the qualifications [~~under the guidelines~~] set out in §18.25 of this title (relating to Other Administrative Waiver or Reduction of Statutory Civil Penalties [~~Fine: Report Type I~~]) and §18.26 of this title (relating to Administrative Waiver or Reduction of Other Statutory Civil Penalties in Excess of $500 [~~Fine: Report Type II~~]).

[~~(b) For purposes of determining a waiver or reduction of a late fine under §18.25 and §18.26 of this title (relating to Administrative Waiver or Reduction of Fine: Report Type I or Administrative Waiver or Reduction of Fine: Report Type II, respectively), a late report will be classified by report type, as follows:~~]

[~~(1) Any report that is not a critical report as defined under paragraph (2) of this subsection will be classified as Report Type I and considered under §18.25 of this title.~~]

[~~(2) A critical report will be classified as Report Type II and considered under §18.26 of this title. A "critical report" is: ~~]

[~~(A) a campaign finance pre-election report due 30 days before an election;~~]

[~~(B) a campaign finance pre-election report due 8 days before an election;~~]

[~~(C) a runoff report;~~]

[~~(D) a daily special pre-election report required under §254.038 or §254.039, Election Code; or~~]

[~~(E) a semiannual report subject to the higher statutory fine under §254.042, Election Code.~~]

(b) [~~(c)~~] For purposes of determining a waiver or reduction of a civil penalty [~~late fine~~] under §18.25 and §18.26 of this title, a filer requesting a waiver or reduction [~~of a late fine~~] will be categorized [~~by filer type,~~] as follows:

(1) Category A includes candidates for and officeholders of the following offices and specific-purpose committees supporting candidates for and officeholders of the following offices:

(A) statewide office;

(B) legislative office;

(C) district judge;

(D) state appellate court justice;

(E) State Board of Education member; and

(F) Secretary of State.

(2) Category B includes all filers not categorized in Category A, as defined by paragraph (1) of this subsection, or Category C, as defined by paragraph (3) of this subsection. Examples of Category B filers include the following filer types:

(A) lobbyists;

(B) salaried non-elected officials;

(C) candidates for and officeholders of district attorney;

(D) candidates for and officeholders of political party chair;

(E) political committees with $3,000 or more in annual activity in the calendar year in which the late report was due; and

(F) a legislative caucus.

(3) Category C includes:

(A) unsalaried appointed board members and officials; and

(B) political committees with less than $3,000 in annual activity in the calendar year in which the late report was due.

(c) [~~(d)~~] For purposes of a reduction of a civil penalty [~~late fine~~] under §18.25 and §18.26 of this title, good cause includes, but is not limited to, the following:

(1) The report was filed no later than three days after the date it was due.

(2) The filer filed the report within five days after first learning the report was late from a late notice sent by the commission.

(3) The report was not a critical report and was prepared and placed in the mail on time but not postmarked by the deadline.

(4) The filer had technical difficulties after regular business hours, but the report was filed no later than the next business day after the commission's technical support staff fixed the technical difficulty.

(5) There are no funds in the filer's campaign or officeholder account and the filer is unemployed.

(6) A first-time filer that is required to file campaign finance reports with a county filing authority and personal financial statements with the commission, who mistakenly files the personal financial statement with the county on the filing deadline and then correctly files with the commission within seven days of realizing the mistake.

(d) [~~(c)~~] For purposes of determining whether a filer is eligible for a waiver or reduction of a civil penalty [~~late fine~~] under §18.25 or §18.26 of this title, a prior offense is any prior late report in which a civil [~~late-filing~~] penalty was assessed except:

(1) the civil [~~late-filing~~] penalty for that prior late report was waived under §18.23(b) [~~§18.23 (a)(1) - (3)~~] of this title; or

(2) no late notices were sent for that prior late report and the filer did not file a request that the civil [~~late-filing~~] penalty be waived or reduced for the prior late report.

(e) [~~(f)~~] A civil penalty [~~late fine~~] that is reduced under §18.25 or §18.26 of this title will revert to the full amount originally assessed if the reduced civil penalty [~~fine~~] is not paid within thirty (30) calendar days from the date of the letter informing the filer of the reduction.

(f) [~~(g)~~] A filer may appeal a determination made under §18.25 or §18.26 of this title by submitting a request in writing to the commission.

(1) The request for appeal should state the filer's reasons for requesting an appeal, provide any additional information needed to support the request, and state whether the filer would like the opportunity to appear before the commission and offer testimony regarding the appeal.

(2) The Executive Director may review the appeal and reconsider the determination made under §18.25 or §18.26 of this title or set the appeal for a hearing before the commission.

(3) After hearing a request for appeal, the commission may affirm the determination made under §18.25 or §18.26 of this title or make a new determination based on facts presented in the appeal.

§18.25. Administrative Waiver or Reduction of Certain Statutory Civil Penalties [~~Fine: Report Type I~~].

(a) The executive director shall apply [~~the guidelines set out in~~] this section to: [~~a late report classified as Report Type I under §18.24(b) of this title (relating to General Guidelines for Other Administrative Waiver or Reduction of Fine).~~]

(1) a late report subject to a statutory civil penalty of not more than $500; or

(2) a late report that:

(A) is subject to a statutory civil penalty in excess of $500; and

(B) discloses less than $3,000 in total political contributions and less than $3,000 in total political expenditures for the reporting period.

(b) In order to qualify for a waiver or reduction of a civil penalty [~~late fine~~] under this section, a filer must meet all of the following criteria:

(1) The filer has no more than two prior late offenses in the five (5) years preceding the filing deadline of the late report at issue;

(2) The filer filed the report within thirty (30) days of learning the report was late;

(3) The civil penalty [~~filer has not had the late fine~~] for the report at issue has not been increased by the commission at a public meeting pursuant to §254.042(b), Election Code, or §305.033(c) or §572.033(b), Government Code; and

(4) The filer does not have an outstanding civil penalty for a prior late report [~~late fine~~].

(c) The executive director shall use the following [~~levels~~] chart to determine the level of waiver or reduction of a civil penalty [~~late fine~~] under this section:
Figure: 1 TAC §18.25(c)
[~~Figure: 1 TAC §18.25(c)~~]

§18.26. Administrative Waiver or Reduction of Other Statutory Civil Penalties in Excess of $500 [~~Fine: Report Type II~~].

(a) The executive director shall apply [~~the guidelines set out in~~] this section to a late report that discloses more than $3,000 in total political contributions or more than $3,000 in total political expenditures during the reporting period and that is subject to a civil penalty in excess of $500 [~~classified as Report Type II under §18.24(b) of this title (relating to General Guidelines for Other Administrative Waiver of Reduction of Fine)~~].

(b) In order to qualify for a waiver or reduction of a civil penalty [~~late fine~~] under this section, a filer must meet all of the following criteria:

(1) The filer has no more than two prior late offenses in the five (5) years preceding the filing deadline of the late report at issue;

(2) The civil penalty [~~filer has not had the late fine~~] for the report at issue has not been increased by the commission at a public meeting pursuant to §254.042(b), Election Code, or §305.033(c) or §572.033(b), Government Code; and

(3) The filer does not have an outstanding civil penalty for a prior late report [~~late fine~~].

[~~(c) The executive director shall use the following levels chart to determine the level of waiver or reduction of a late fine under this section if:~~]

[~~(1) The late report at issue discloses less than $3,000 in total contributions and less than $3,000 in expenditures for the reporting period;~~]

[~~(2) The late report at issue was filed no more than thirty (30) days after the filer learned that the report was late; and~~]

[~~(3) The filer has no prior late offenses or only one prior late offense in the five (5) years preceding the filing deadline of the late report at issue.~~]
[~~Figure: 1 TAC §18.26(c)~~]

(c) [~~(d)~~] The executive director shall use the following [~~formulas~~] chart to determine the level of waiver or reduction of a civil penalty [~~late fine~~] under this section [~~if~~]:

(1) Figure: 1 TAC §18.26(c)(1) [~~The late report at issue discloses either $3,000 or more in total contributions or $3,000 or more in expenditures for the reporting period;~~]

(2) Figure: 1 TAC §18.25(c)(2)[~~The late report at issue was filed over thirty (30) days after the filer learned that the report was late; or~~]

(3) Figure: 1 TAC §18.25(c)(3) [~~The filer has two (2) prior late offenses in the five (5) years preceding the filing deadline of the late report at issue.~~]

[~~(e) Comments, Report Type II Formulas Chart Examples:~~] [~~Figure: 1 TAC §18.26(e)~~]

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

Filed with the Office of the Secretary of State on March 31, 2021.

TRD-202101404
J.R. Johnson
General Counsel
Texas Ethics Commission
Earliest possible date of adoption: May 16, 2021
For further information, please call: (512) 463-5800

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CHAPTER 20. REPORTING POLITICAL CONTRIBUTIONS AND EXPENDITURES
SUBCHAPTER A. GENERAL RULES

1 TAC §20.1

The Texas Ethics Commission (the Commission) proposes amendments to Texas Ethics Commission rules in Subchapter A of Chapter 20. Specifically, the Commission proposes amendments to §20.1(11)(b), regarding Definitions.

The Election Code defines "political advertising" in part as any communication supporting or opposing a candidate for nomination or election to a public office or office of a political party, a political party, a public officer, or a measure that "appears ... in a pamphlet, circular, flier, billboard or other sign, bumper sticker, or similar form of written communication." Tex. Elec. Code §251.001(16) (emphasis added).

Ethics Commission rules further define "political advertising" to address whether e-mail communications can qualify as political advertisements. Specifically, §20.1(11)(B) states that political advertising "does not include an individual communication made by e-mail but does include mass e-mails involving an expenditure of funds beyond the basic cost of hardware messaging software and bandwidth." 1 Texas Administrative Code §20.1(11)(B) (emphasis added). However, current Ethics Commission rules do not address text messages. This amendment would add text messages to §20.1(11)(B).

J.R. Johnson, General Counsel, has determined that for the first five-year period the proposed amended rule is in effect, there will be no fiscal implications for state or local government as a result of enforcing or administering the proposed rule.

The General Counsel has also determined that for each year of the first five years the proposed amended rule is in effect, the public benefit will be consistency in the Commission's rules regarding political advertising. There will not be an effect on small businesses, microbusinesses or rural communities. There is no anticipated economic cost to persons who are required to comply with the proposed amended rule.

The General Counsel has determined that during the first five years that the proposed amended rule is in effect, it will not: create or eliminate a government program; require the creation of new employee positions or the elimination of existing employee positions; require an increase in future legislative appropriations to the agency; require an increase or decrease in fees paid to the agency; expand, limit, or repeal an existing regulation; increase or decrease the number of individuals subject to the rules' applicability; or not positively or adversely affect this state's economy.

The Commission invites comments on the proposed amended rule from any member of the public. A written statement should be emailed to *public_comment@ethics.state.tx.us,* or mailed or delivered to Anne Temple Peters, Texas Ethics Commission, P.O. Box 12070, Austin, Texas 78711-2070. A person who wants to offer spoken comments to the Commission concerning the proposed amended rule may do so at any Commission meeting during the agenda item relating to the proposed amended rule. Information concerning the date, time, and location of Commission meetings is available by telephoning (512) 463-5800 or on the Commission's website at www.ethics.state.tx.us.

The amendment is proposed under Texas Government Code §571.062, which authorizes the Commission to adopt rules to administer Title 15 of the Election Code.

The proposed amended rule affects Chapter 255 of the Election Code.

§20.1. Definitions.

The following words and terms, when used in Title 15 of the Election Code, in this chapter, Chapter 22 of this title (relating to Restrictions on Contributions and Expenditures), and Chapter 24 of this title (relating to Restrictions on Contributions and Expenditures Applicable to Corporations and Labor Organizations), shall have the following meanings, unless the context clearly indicates otherwise.

(1) - (10) (No change.)

(11) Political advertising:

(A) A communication that supports or opposes a political party, a public officer, a measure, or a candidate for nomination or election to a public office or office of a political party, and:

(i) is published in a newspaper, magazine, or other periodical in return for consideration;

(ii) is broadcast by radio or television in return for consideration;

(iii) appears in a pamphlet, circular, flier, billboard, or other sign, bumper sticker, or similar form of written communication; or

(iv) appears on an Internet website.

(B) The term does not include an individual communication made by e-mail or text message but does include mass e-mails and text messages involving an expenditure of funds beyond the basic cost of hardware messaging software and bandwidth.

(12) - (23) (No change.)

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

Filed with the Office of the Secretary of State on March 31, 2021.

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J.R. Johnson
General Counsel
Texas Ethics Commission
Earliest possible date of adoption: May 16, 2021
For further information, please call: (512) 463-5800

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PART 15. TEXAS HEALTH AND HUMAN SERVICES COMMISSION

CHAPTER 355. REIMBURSEMENT RATES

SUBCHAPTER J. PURCHASED HEALTH SERVICES

DIVISION 4. MEDICAID HOSPITAL SERVICES

1 TAC §355.8065

The Executive Commissioner of the Texas Health and Human Services Commission (HHSC) proposes an amendment to §355.8065, concerning Disproportionate Share Hospital Reimbursement Methodology.

BACKGROUND AND PURPOSE

The Disproportionate Share Hospital (DSH) program payments are made by HHSC to qualifying hospitals that serve a large number of Medicaid and uninsured individuals. Federal law establishes an annual DSH allotment for each state that limits Federal Financial Participation (FFP) for total statewide DSH payments made to hospitals. Federal law also limits FFP for DSH payments through the hospital-specific DSH limit. In Texas, the state has established a State Payment Cap that limits the amount of payments that a provider receives through the interim payment process. This proposal amends the definitions of certain provider classes, describes a methodology for redistribution of certain recouped funds, modifies the calculation of the low-income utilization rate to reflect federal law, and makes other clarifying amendments.

Provider Class Definitions

Historically, HHSC has allowed state institutions for mental diseases (IMDs) to participate in the DSH program. However, the rule does not explicitly reference State IMD participation nor the fact that state IMDs have been recognized as state-owned providers for many years. The rule proposal will amend the definition of state-owned hospitals to be broader and include these hospitals.

The definition of Urban public hospital - Class one is being amended to clarify that the providers in this class must be owned and operated by an entity listed in the definition.

Methodology for Redistribution of Recouped Funds

The existing rule provides that HHSC can redistribute recouped funds to eligible providers but does not describe the method of the calculation. HHSC is proposing two methods of calculation. The first method will be used in DSH years 2011-2017 and 2020 and after and would redistribute funds proportionately to remaining Hospital Specific Limit (HSL) room for eligible hospitals.

For DSH years 2018-2019 HHSC will use a second method. Recouped funds from non-state providers will be redistributed to eligible providers using a weighted allocation methodology. First, HHSC will calculate a weight that will be applied to all providers. The weight is calculated based on the provider's final remaining HSL with and without the offset of payments for third-party and Medicare claims and encounters where Medicaid was a secondary payer to determine how significantly the provider's HSL was impacted by not offsetting these payments. Providers who did not have a significant change in their HSL will receive a larger weight.

After calculating the weighting factor, HHSC will make a first pass allocation by multiplying the weight by the provider's final remaining HSL with the offset of payments for third-party and Medicare claims and encounters where Medicaid was a secondary payer. HHSC will divide the product by the total remaining HSLs for all providers and multiply the quotient by the total amount of recouped dollars available for redistribution. HHSC will limit a provider's payment to the amount of the provider's final remaining HSL. If a provider is allocated a payment amount that is higher than its remaining HSL, HHSC will make a second pass allocation to redistribute the excess funds using the remaining HSL for all providers without applying the weight.

Recouped funds from state providers will be redistributed proportionately to eligible state providers based on the percentage that each eligible state provider's remaining final HSL calculated in the reconciliation described in §355.8065(q) is of the total remaining final HSL of all eligible state providers.

Low-Income Utilization Rate Calculation

The low-income utilization rate (LIUR) is a ratio that represents the hospital's volume of inpatient charity care relative to total inpatient services. As currently defined, several providers have a LIUR over one hundred, and the rule is being amended to address this. The rule is also being amended to align with federal statute.

Other Clarifications

The DSH rule requires providers to maintain a Trauma system designation or actively pursue one, but several providers do not have a Trauma system designation because the designation does not fit the hospital's function. Children's hospitals, IMDs, and State IMDs generally fall into this misalignment category. The rule makes no mention of an exemption for these providers, though it has been established practice to exempt them from this requirement, and HHSC proposes an amendment to explicitly exempt these providers.

The DSH rule currently has no provision for the DSH advanced payment methodology and leaves it up to HHSC's discretion. The Provider Finance Department has been using a methodology for several years to accomplish this payment and the proposal incorporates the established methodology into the rule.

SECTION-BY-SECTION SUMMARY

The proposed amendment to §355.8065(b)(15) adds the abbreviation "(HSL)" to the term "Hospital-specific limit."

The proposed amendment to §355.8065(b) adds a new definition "State institution of mental disease (State IMD)" to define an ownership type that was not defined previously. The paragraphs are renumbered to account for the addition.

The proposed amendment to §355.8065(b)(39) replaces the term "State-owned teaching hospital" with "State-owned hospital."

The proposed amendment to §355.8065(b)(45) updates references.

The proposed amendment to §355.8065(b)(46) deletes text and adds "owned and operated" to the definition of "Urban Public Hospital - Class One." There are proposed conforming amendments to §355.8065(h)(2)(C) and (h)(5)(F).

The proposed amendment to §355.8065(b)(47) makes a minor edit for clarity.

The proposed amendment to §355.8065(d)(2) deletes clauses (i) and (ii) and subparagraph (B). Subparagraph (A) is updated and combined with paragraph (2). The edits are made to align with federal statute.

The proposed amendment to §355.8065(d)(4) updates the term by adding "State IMDs" as a new hospital type that is deemed to qualify and deletes the term "teaching" to describe "hospitals" in this paragraph.

The proposed amendment to §355.8065(e)(3) adds subparagraph (C) to exempt Children's Hospitals, IMDs, and State IMDs from this condition of participation.

An edit is made to §355.8065(h)(2)(B)(ii) to update a reference to a definition.

The proposed amendment to §355.8065 adds subsections (p), Recoupment; (q), Reconciliation; (r), Redistribution of Recouped Funds; and (s), Advance Payments in order to document methodology and procedures that are in current practice. Proposed conforming amendments are made to 355.8065(l) and (o)(1)(E).

FISCAL NOTE

Trey Wood, Chief Financial Officer, has determined that for each year of the first five years that the rule will be in effect, enforcing or administering the rule does not have foreseeable implications relating to costs or revenues of state or local governments as a result of enforcing and administering the rule as proposed.

GOVERNMENT GROWTH IMPACT STATEMENT

HHSC has determined that during the first five years that the rule will be in effect:

(1) the proposed rule will not create or eliminate a government program;

(2) implementation of the proposed rule will not affect the number of HHSC employee positions;

(3) implementation of the proposed rule will not require an increase in future legislative appropriations;

(4) the proposed rule will not affect fees paid to HHSC;

(5) the proposed rule will not create a new rule;

(6) the proposed rule will expand an existing rule;

(7) the proposed rule will not change the number of individuals subject to the rule; and

(8) the proposed rule will not affect the state's economy.

SMALL BUSINESS, MICRO-BUSINESS, AND RURAL COMMUNITY IMPACT ANALYSIS

Trey Wood has also determined that there will be no adverse economic effect on small businesses, micro-businesses, or rural communities. The rule does not impose any additional costs on small businesses, micro-businesses, or rural communities that are required to comply with the rule.

LOCAL EMPLOYMENT IMPACT

The proposed rule will not affect a local economy.

COSTS TO REGULATED PERSONS

Texas Government Code §2001.0045 does not apply to this rule because this rule does not impose cost on regulated persons.

PUBLIC BENEFIT AND COSTS

Victoria Grady, Director of Provider Finance, has determined that for each year of the first five years the rule is in effect, the public will benefit from the adoption of the rule because of the increased transparency in the new provisions included in the rule.

Trey Wood has also determined that for the first five years the rule is in effect, there are no anticipated economic costs to persons who are required to comply with the proposed rule because the rule does not impose any additional fees or costs on those who are required to comply.

TAKINGS IMPACT ASSESSMENT

HHSC has determined that the proposal does not restrict or limit an owner's right to his or her property that would otherwise exist in the absence of government action and, therefore, does not constitute a taking under Texas Government Code §2007.043.

PUBLIC HEARING

A public hearing to receive comments on the proposal will be held by HHSC through a webinar. The meeting date and time will be posted on the HHSC Communications and Events Website at https://hhs.texas.gov/about-hhs/communications-events and the HHSC Provider Finance Hospitals website at https://rad.hhs.texas.gov/hospitals-clinic/hospital-services/disproportionate-share-hospitals.

If you have questions, please contact Rene Cantu at UCTools@hhsc.state.tx.us.

PUBLIC COMMENT

Written comments on the proposal may be submitted to the HHSC Provider Finance Department, 4900 North Lamar Blvd., Austin, TX 78751 (Mail Code H-400); P.O. Box 149030, Austin, TX 78714-9030 (Mail Code H-400); by fax to (512)-730-7475; or by email to UCTools@hhsc.state.tx.us.

ADDITIONAL INFORMATION

For further information, please call Rene Cantu at (737) 203-7842 or email Al Anthony in the HHSC Provider Finance for Hospitals department at UCTools@hhsc.state.tx.us.

To be considered, comments must be submitted no later than 31 days after the date of this issue of the *Texas Register.* Comments must be: (1) postmarked or shipped before the last day of the comment period; (2) hand-delivered before 5:00 p.m. on the last working day of the comment period; or (3) faxed or emailed before midnight on the last day of the comment period. If the last day to submit comments falls on a holiday, comments must be postmarked, shipped, or emailed before midnight on the following business day to be accepted. When faxing or emailing comments, please indicate "Comments on Proposed Rule 21R078" in the subject line.

STATUTORY AUTHORITY

The amendment is proposed under Texas Government Code §531.033, which authorizes the Executive Commissioner of HHSC to adopt rules necessary to carry out HHSC's duties; Texas Human Resources Code §32.021 and Texas Government Code §531.021(a), which provide HHSC with the authority to administer the federal medical assistance (Medicaid) program in Texas; and Texas Government Code §531.021(b-1), which establishes HHSC as the agency responsible for adopting reasonable rules governing the determination of fees, charges, and rates for medical assistance payments under the Texas Human Resources Code Chapter 32.

The amendment affects Texas Government Code Chapter 531 and Texas Human Resources Code Chapter 32.

§355.8065. Disproportionate Share Hospital Reimbursement Methodology.

(a) Introduction. Hospitals participating in the Texas Medicaid program that meet the conditions of participation and that serve a disproportionate share of low-income patients are eligible for reimbursement from the disproportionate share hospital (DSH) fund. The Texas Health and Human Services Commission (HHSC) will establish each hospital's eligibility for and amount of reimbursement using the methodology described in this section.

(b) Definitions.

(1) Adjudicated claim--A hospital claim for payment for a covered Medicaid service that is paid or adjusted by HHSC or another payer.

(2) Available DSH funds--The total amount of funds that may be distributed to eligible qualifying DSH hospitals for the DSH program year, based on the federal DSH allotment for Texas (as determined by the Centers for Medicare & Medicaid Services) and available non-federal funds. HHSC may divide available DSH funds for a program year into one or more portions of funds to allow for partial payment(s) of total available DSH funds at any one time with remaining funds to be distributed at a later date(s). If HHSC chooses to make a partial payment, the available DSH funds for that partial payment are limited to the portion of funds identified by HHSC for that partial payment.

(3) Available general revenue funds--The total amount of state general revenue funds appropriated to provide a portion of the non-federal share of DSH payments for the DSH program year for non-state-owned hospitals. If HHSC divides available DSH funds for a program year into one or more portions of funds to allow for partial payment(s) of total available DSH funds as described in paragraph (2) of this subsection, the available general revenue funds for that partial payment are limited to the portion of general revenue funds identified by HHSC for that partial payment.

(4) Bad debt--A debt arising when there is nonpayment on behalf of an individual who has third-party coverage.

(5) Centers for Medicare & Medicaid Services (CMS)--The federal agency within the United States Department of Health and Human Services responsible for overseeing and directing Medicare and Medicaid, or its successor.

(6) Charity care--The unreimbursed cost to a hospital of providing, funding, or otherwise financially supporting health care services on an inpatient or outpatient basis to indigent individuals, either directly or through other nonprofit or public outpatient clinics, hospitals, or health care organizations. A hospital must set the income level for eligibility for charity care consistent with the criteria established in §311.031, Texas Health and Safety Code.

(7) Charity charges--Total amount of hospital charges for inpatient and outpatient services attributed to charity care in a DSH data year. These charges do not include bad debt charges, contractual allowances, or discounts given to other legally liable third-party payers.

(8) Children's hospital--A hospital within Texas that is recognized by Medicare as a children's hospital and is exempted by Medicare from the Medicare prospective payment system.

(9) Disproportionate share hospital (DSH)--A hospital identified by HHSC that meets the DSH program conditions of participation and that serves a disproportionate share of Medicaid or indigent patients.

(10) DSH data year--A twelve-month period, two years before the DSH program year, from which HHSC will compile data to determine DSH program qualification and payment.

(11) DSH program year--The twelve-month period beginning October 1 and ending September 30.

(12) Dually eligible patient--A patient who is simultaneously eligible for Medicare and Medicaid.

(13) Governmental entity--A state agency or a political subdivision of the state. A governmental entity includes a hospital authority, hospital district, city, county, or state entity.

(14) HHSC--The Texas Health and Human Services Commission or its designee.

(15) Hospital-specific limit (HSL)--The maximum payment amount, as applied to payments made during a prior DSH program year, that a hospital may receive in reimbursement for the cost of providing Medicaid-allowable services to individuals who are Medicaid-eligible or uninsured. The hospital-specific limit is calculated using the methodology described in §355.8066 of this title (relating to Hospital-Specific Limit Methodology) using actual cost and payment data from the DSH program year.

(16) Independent certified audit--An audit that is conducted by an auditor that operates independently from the Medicaid agency and the audited hospitals and that is eligible to perform the DSH audit required by CMS.

(17) Indigent individual--An individual classified by a hospital as eligible for charity care.

(18) Inpatient day--Each day that an individual is an inpatient in the hospital, whether or not the individual is in a specialized ward and whether or not the individual remains in the hospital for lack of suitable placement elsewhere. The term includes observation days, rehabilitation days, psychiatric days, and newborn days. The term does not include swing bed days or skilled nursing facility days.

(19) Inpatient revenue--Amount of gross inpatient revenue derived from the most recent completed Medicaid cost report or reports related to the applicable DSH data year. Gross inpatient revenue excludes revenue related to the professional services of hospital-based physicians, swing bed facilities, skilled nursing facilities, intermediate care facilities, other nonhospital revenue, and revenue not identified by the hospital.

(20) Institution for mental diseases (IMD)--A hospital that is primarily engaged in providing psychiatric diagnosis, treatment, or care of individuals with mental illness.

(21) Intergovernmental transfer (IGT)--A transfer of public funds from a governmental entity to HHSC.

(22) Low-income days--Number of inpatient days attributed to indigent patients, calculated as described in subsection (h)(4)(A)(ii) of this section.

(23) Low-income utilization rate--A ratio, calculated as described in subsection (d)(2) of this section, that represents the hospital's volume of inpatient charity care relative to total inpatient services.

(24) Mean Medicaid inpatient utilization rate--The average of Medicaid inpatient utilization rates for all hospitals that have received a Medicaid payment for an inpatient claim, other than a claim for a dually eligible patient, that was adjudicated during the relevant DSH data year.

(25) Medicaid contractor--Fiscal agents and managed care organizations with which HHSC contracts to process data related to the Medicaid program.

(26) Medicaid cost report--Hospital and Hospital Health Care Complex Cost Report (Form CMS 2552), also known as the Medicare cost report.

(27) Medicaid hospital--A hospital meeting the qualifications set forth in §354.1077 of this title (relating to Provider Participation Requirements) to participate in the Texas Medicaid program.

(28) Medicaid inpatient utilization rate (MIUR)--A ratio, calculated as described in subsection (d)(1) of this section, that represents a hospital's volume of Medicaid inpatient services relative to total inpatient services.

(29) MSA--Metropolitan Statistical Area as defined by the United States Office of Management and Budget. MSAs with populations greater than or equal to 137,000, according to the most recent decennial census, are considered "the largest MSAs."

(30) Non-federal percentage--The non-federal percentage equals one minus the federal medical assistance percentage (FMAP) for the program year.

(31) Non-urban public hospital--A rural public-financed hospital, as defined in paragraph (37) of this subsection, or a hospital owned and operated by a governmental entity other than hospitals in Urban public hospital - Class one or Urban public hospital - Class two.

(32) Obstetrical services--The medical care of a woman during pregnancy, delivery, and the post-partum period provided at the hospital listed on the DSH application.

(33) PMSA--Primary Metropolitan Statistical Area as defined by the United States Office of Management and Budget.

(34) Public funds--Funds derived from taxes, assessments, levies, investments, and other public revenues within the sole and unrestricted control of a governmental entity. Public funds do not include gifts, grants, trusts, or donations, the use of which is conditioned on supplying a benefit solely to the donor or grantor of the funds.

(35) Ratio of cost-to-charges (inpatient only)--A ratio that covers all applicable hospital costs and charges relating to inpatient care. This ratio does not distinguish between payer types such as Medicare, Medicaid, or private pay.

(36) Rural public hospital--A hospital owned and operated by a governmental entity that is located in a county with 500,000 or fewer persons, based on the most recent decennial census.

(37) Rural public-financed hospital--A hospital operating under a lease from a governmental entity in which the hospital and governmental entity are both located in the same county with 500,000 or fewer persons, based on the most recent decennial census, where the hospital and governmental entity have both signed an attestation that they wish the hospital to be treated as a public hospital for all purposes under both this section and §355.8201 of this title (relating to Waiver Payments to Hospitals for Uncompensated Care).

(38) State chest hospital--A public health facility operated by the Department of State Health Services designated for the care and treatment of patients with tuberculosis.

(39) State institution for mental diseases (State IMD)--A hospital that is primarily engaged in providing psychiatric diagnosis, treatment, or care of individuals with mental illness and that is owned and operated by a state university or other state agency.

(40) [~~(39)~~] State-owned [~~teaching~~] hospital--A hospital owned and operated by a state university or other state agency.

(41) [~~(40)~~] State payment cap--The maximum payment amount, as applied to payments that will be made for the DSH program year, that a hospital may receive in reimbursement for the cost of providing Medicaid-allowable services to individuals who are Medicaid-eligible or uninsured. The state payment cap is calculated using the methodology described in §355.8066 of this title (relating to Hospital-Specific Limit Methodology) using interim cost and payment data from the DSH data year.

(42) [~~(41)~~] Third-party coverage--Creditable insurance coverage consistent with the definitions in 45 Code of Federal Regulations (CFR) Parts 144 and 146, or coverage based on a legally liable third-party payer.

(43) [~~(42)~~] Total Medicaid inpatient days--Total number of inpatient days based on adjudicated claims data for covered services for the relevant DSH data year.

(A) The term includes:

(i) Medicaid-eligible days of care adjudicated by managed care organizations or HHSC;

(ii) days that were denied payment for spell-of-illness limitations;

(iii) days attributable to individuals eligible for Medicaid in other states, including dually eligible patients;

(iv) days with adjudicated dates during the period; and

(v) days for dually eligible patients for purposes of the MIUR calculation described in subsection (d)(1) of this section.

(B) The term excludes:

(i) days attributable to Medicaid-eligible patients ages 21 through 64 in an IMD;

(ii) days denied for late filing and other reasons; and

(iii) days for dually eligible patients for purposes of the following calculations:

(I) Total Medicaid inpatient days, as described in subsection (d)(3) of this section; and

(II) Pass one distribution, as described in subsection (h)(4) of this section.

(44) [~~(43)~~] Total Medicaid inpatient hospital payments--Total amount of Medicaid funds that a hospital received for adjudicated claims for covered inpatient services during the DSH data year. The term includes payments that the hospital received:

(A) for covered inpatient services from managed care organizations and HHSC; and

(B) for patients eligible for Medicaid in other states.

(45) [~~(44)~~] Total state and local payments--Total amount of state and local payments that a hospital received for inpatient care during the DSH data year. The term includes payments under state and local programs that are funded entirely with state general revenue funds and state or local tax funds, such as County Indigent Health Care, Children with Special Health Care Needs, and Kidney Health Care. The term excludes payment sources that contain federal dollars such as Medicaid payments, Children's Health Insurance Program (CHIP) payments funded under Title XXI of the Social Security Act, Substance Abuse and Mental Health Services Administration, Ryan White Title I, Ryan White Title II, Ryan White Title III, and contractual discounts and allowances related to TRICARE, Medicare, and Medicaid.

(46) [~~(45)~~] Urban public hospital--Any of the urban hospitals listed in paragraph (47) [~~(46)~~] or (48) [~~(47)~~] of this subsection.

(47) [~~(46)~~] Urban public hospital - Class one--A hospital that is owned and operated [~~operated~~] by [~~or under a lease contract with~~] one of the following entities: the Dallas County Hospital District, the El Paso County Hospital District, the Harris County Hospital District, the Tarrant County Hospital District, [~~the Travis County Healthcare District dba Central Health,~~] or the University Health System of Bexar County.

(48) [~~(47)~~] Urban public hospital - Class two--A hospital [~~that is~~] operated by or under a lease contract with one of the following entities: the Ector County Hospital District, the Lubbock County Hospital District, or the Nueces County Hospital District.

(c) Eligibility. To be eligible to participate in the DSH program, a hospital must:

(1) be enrolled as a Medicaid hospital in the State of Texas;

(2) have received a Medicaid payment for an inpatient claim, other than a claim for a dually eligible patient, that was adjudicated during the relevant DSH data year; and

(3) apply annually by completing the application packet received from HHSC by the deadline specified in the packet.

(A) Only a hospital that meets the condition specified in paragraph (2) of this subsection will receive an application packet from HHSC.

(B) The application may request self-reported data that HHSC deems necessary to determine each hospital's eligibility. HHSC may audit self-reported data.

(C) A hospital that fails to submit a completed application by the deadline specified by HHSC will not be eligible to participate in the DSH program in the year being applied for or to appeal HHSC's decision.

(D) For purposes of DSH eligibility, a multi-site hospital is considered one provider unless it submits separate Medicaid cost reports for each site. If a multi-site hospital submits separate Medicaid cost reports for each site, for purposes of DSH eligibility, it must submit a separate DSH application for each site.

(E) HHSC will consider a merger of two or more hospitals for purposes of the DSH program for any hospital that submits documents verifying the merger status with Medicare prior to the deadline for submission of the DSH application. Otherwise, HHSC will determine the merged entity's eligibility for the subsequent DSH program year. Until the time that the merged hospitals are determined eligible for payments as a merged hospital, each of the merging hospitals will continue to receive any DSH payments to which it was entitled prior to the merger.

(d) Qualification. For each DSH program year, in addition to meeting the eligibility requirements, applicants must meet at least one of the following qualification criteria, which are determined using information from a hospital's application, from HHSC, or from HHSC's Medicaid contractors, as specified by HHSC:

(1) Medicaid inpatient utilization rate. A hospital's Medicaid inpatient utilization rate is calculated by dividing the hospital's total Medicaid inpatient days by its total inpatient census days for the DSH data year.

(A) A hospital located outside an MSA or PMSA must have a Medicaid inpatient utilization rate greater than the mean Medicaid inpatient utilization rate for all Medicaid hospitals.

(B) A hospital located inside an MSA or PMSA must have a Medicaid inpatient utilization rate that is at least one standard deviation above the mean Medicaid inpatient utilization rate for all Medicaid hospitals.

(2) Low-income utilization rate. A hospital must have a low-income utilization rate greater than 25 percent.

[~~(A)~~] The low-income utilization rate is the sum (expressed as a percentage) of the fractions calculated as described in the Social Security Act §1923(b)(3). [~~in clauses (i) and (ii) of this subparagraph:~~]

~~f(i)~~ ~~The sum of the total Medicaid inpatient hospital payments and the total state and local payments paid to the hospital for inpatient care in the DSH data year, divided by a hospital's gross inpatient revenue multiplied by the hospital's ratio of cost-to-charges (inpatient only) for the same period: (Total Medicaid Inpatient Hospital Payments + Total State and Local Payments)/(Gross Inpatient Revenue x Ratio of Costs to Charges (inpatient only)).~~]

~~f(ii)~~ ~~Inpatient charity charges in the DSH data year minus the amount of payments for inpatient hospital services received directly from state and local governments, excluding all Medicaid payments, in the DSH data year, divided by the gross inpatient revenue in the same period: (Total Inpatient Charity Charges - Total State and Local Payments)/Gross Inpatient Revenue).~~]

[~~(B) HHSC will determine the ratio of cost-to-charges (inpatient only) by using information from the appropriate worksheets of each hospital's Medicaid cost report or reports that correspond to the DSH data year. In the absence of a Medicaid cost report for that period, HHSC will use the latest available submitted Medicaid cost report or reports.~~]

(3) Total Medicaid inpatient days.

(A) A hospital must have total Medicaid inpatient days at least one standard deviation above the mean total Medicaid inpatient days for all hospitals participating in the Medicaid program, except;

(B) A hospital in a county with a population of 290,000 persons or fewer, according to the most recent decennial census, must have total Medicaid inpatient days at least 70 percent of the sum of the mean total Medicaid inpatient days for all hospitals in this subset plus one standard deviation above that mean.

(C) Days for dually eligible patients are not included in the calculation of total Medicaid inpatient days under this paragraph.

(4) Children's hospitals, state-owned [~~teaching~~] hospitals, and state chest hospitals. Children's hospitals, state-owned [~~teaching~~] hospitals, [~~and~~] state chest hospitals, and State IMDs that do not otherwise qualify as disproportionate share hospitals under this subsection will be deemed to qualify. A hospital deemed to qualify must still meet

the eligibility requirements under subsection (c) of this section and the conditions of participation under subsection (e) of this section.

(5) Merged hospitals. Merged hospitals are subject to the application requirement in subsection (c)(3)(E) of this section. HHSC will aggregate the data used to determine qualification under this subsection from the merged hospitals to determine whether the single Medicaid provider that results from the merger qualifies as a Medicaid disproportionate share hospital.

(6) Hospitals that held a single Medicaid provider number during the DSH data year, but later added one or more Medicaid provider numbers. Upon request, HHSC will apportion the Medicaid DSH funding determination attributable to a hospital that held a single Medicaid provider number during the DSH data year (data year hospital), but subsequently added one or more Medicaid provider numbers (new program year hospital(s)) between the data year hospital and its associated new program year hospital(s). In these instances, HHSC will apportion the Medicaid DSH funding determination for the data year hospital between the data year hospital and the new program year hospital(s) based on estimates of the division of Medicaid inpatient and low income utilization between the data year hospital and the new program year hospital(s) for the program year, so long as all affected providers satisfy the Medicaid DSH conditions of participation under subsection (e) of this section and qualify as separate hospitals under subsection (d) of this section based on HHSC's Medicaid DSH qualification criteria in the applicable Medicaid DSH program year. In determining whether the new program year hospital(s) meet the Medicaid DSH conditions of participation and qualification, proxy program year data may be used.

(e) Conditions of participation. HHSC will require each hospital to meet and continue to meet for each DSH program year the following conditions of participation:

(1) Two-physician requirement.

(A) In accordance with Social Security Act §1923(e)(2), a hospital must have at least two licensed physicians (doctor of medicine or osteopathy) who have hospital staff privileges and who have agreed to provide nonemergency obstetrical services to individuals who are entitled to medical assistance for such services.

(B) Subparagraph (A) of this paragraph does not apply if the hospital:

(i) serves inpatients who are predominantly under 18 years of age; or

(ii) was operating but did not offer nonemergency obstetrical services as of December 22, 1987.

(C) A hospital must certify on the DSH application that it meets the conditions of either subparagraph (A) or (B) of this paragraph, as applicable, at the time the DSH application is submitted.

(2) Medicaid inpatient utilization rate. At the time of qualification and during the DSH program year, a hospital must have a Medicaid inpatient utilization rate, as calculated in subsection (d)(1) of this section, of at least one percent.

(3) Trauma system.

(A) The hospital must be in active pursuit of designation or have obtained a trauma facility designation as defined in §780.004 and §§773.111 - 773.120, Texas Health and Safety Code, respectively, and consistent with 25 TAC §157.125 (relating to Requirements for Trauma Facility Designation) and §157.131 (relating to the Designated Trauma Facility and Emergency Medical Services Account). A hospital that has obtained its trauma facility designation must maintain that designation for the entire DSH program year.

(B) HHSC will receive an annual report from the Office of EMS/Trauma Systems Coordination regarding hospital participation in regional trauma system development, application for trauma facility designation, and trauma facility designation or active pursuit of designation status before final qualification determination for interim DSH payments. HHSC will use this report to confirm compliance with this condition of participation by a hospital applying for DSH funds.

(C) The following hospital types are exempted from the condition of participation described in this paragraph: Children's Hospitals, IMDs, and State IMDs.

(4) Maintenance of local funding effort. A hospital district in one of the state's largest MSAs or in a PMSA must not reduce local tax revenues to its associated hospitals as a result of disproportionate share funds received by the hospital. For this provision to apply, the hospital must have more than 250 licensed beds.

(5) Retention of and access to records. A hospital must retain and make available to HHSC records and accounting systems related to DSH data for at least five years from the end of each DSH program year in which the hospital qualifies, or until an open audit is completed, whichever is later.

(6) Compliance with audit requirements. A hospital must agree to comply with the audit requirements described in subsection (o) of this section.

(7) Merged hospitals. Merged hospitals are subject to the application requirement in subsection (c)(3)(E) of this section. If HHSC receives documents verifying the merger status with Medicare prior to the deadline for submission of the DSH application, the merged entity must meet all conditions of participation. If HHSC does not receive the documents verifying the merger status with Medicare prior to the deadline for submission of the DSH application, any proposed merging hospitals that are receiving DSH payments must continue to meet all conditions of participation as individual hospitals to continue receiving DSH payments for the remainder of the DSH program year.

(8) Changes that may affect DSH participation. A hospital receiving payments under this section must notify HHSC's Rate Analysis Department within 30 days of changes in ownership, operation, provider identifier, designation as a trauma facility or as a children's hospital, or any other change that may affect the hospital's continued eligibility, qualification, or compliance with DSH conditions of participation. At the request of HHSC, the hospital must submit any documentation supporting the change.

(f) State payment cap and hospital-specific limit calculation. HHSC uses the methodology described in §355.8066 of this title to calculate a state payment cap for each Medicaid hospital that applies and qualifies to receive payments for the DSH program year under this section, and a hospital-specific limit for each hospital that received payments in a prior program year under this section. For payments for each DSH program year beginning before October 1, 2017, the state payment cap calculated as described in §355.8066 will be reduced by the amount of prior payments received by each participating hospital for that DSH program year. These prior payments will not be considered anywhere else in the calculation.

(g) Distribution of available DSH funds. HHSC will distribute the available DSH funds as defined in subsection (b)(2) of this section among eligible, qualifying DSH hospitals using the following priorities:

(1) State-owned teaching hospitals, state-owned IMDs, and state chest hospitals. HHSC may reimburse state-owned teaching hospitals, state-owned IMDs, and state chest hospitals an amount less than or equal to their state payment caps, except that aggregate payments to IMDs statewide may not exceed federally mandated reimbursement limits for IMDs.

(2) Other hospitals. HHSC distributes the remaining available DSH funds, if any, to other qualifying hospitals using the methodology described in subsection (h) of this section.

(A) The remaining available DSH funds equal the lesser of the funds as defined in subsection (b)(2) of this section less funds expended under paragraph (1) of this subsection or the sum of remaining qualifying hospitals' state payment caps.

(B) The remaining available general revenue funds equal the funds as defined in subsection (b)(3) of this section.

(h) DSH payment calculation.

(1) Data verification. HHSC uses the methodology described in §355.8066(e) of this title to verify the data used for the DSH payment calculations described in this subsection. The verification process includes:

(A) notice to hospitals of the data provided to HHSC by Medicaid contractors; and

(B) an opportunity for hospitals to request HHSC review of disputed data.

(2) Establishment of DSH funding pools. From the amount of remaining DSH funds determined in subsection (g)(2) of this section, HHSC will establish three DSH funding pools.

(A) Pool One.

(i) Pool One is equal to the sum of the remaining available general revenue funds and associated federal matching funds; and

(ii) Pool One payments are available to all non-state-owned hospitals, including non-state-owned public hospitals.

(B) Pool Two.

(i) Pool Two is equal to the lesser of:

(I) the amount of remaining DSH funds determined in subsection (g)(2) of this section less the amount determined in paragraph (2)(A) of this subsection multiplied by the FMAP in effect for the program year; or

(II) the federal matching funds associated with the intergovernmental transfers received by HHSC that make up the funds for Pool Three; and

(ii) Pool Two payments are available to all non-state-owned hospitals except for any urban public hospital as defined in subsection (b)(46) [~~(b)(45)~~] of this section; rural public hospital as defined in subsection (b)(36) of this section; or rural public-financed hospital as defined in subsection (b)(37) of this section owned by or affiliated with a governmental entity that does not transfer any funds to HHSC for Pool Three as described in subparagraph (C)(iii) of this paragraph.

(C) Pool Three.

(i) Pool Three is equal to the sum of intergovernmental transfers for DSH payments received by HHSC from governmental entities that own and operate [~~or are under lease contracts with~~] Urban public hospitals - Class one, governmental entities that operate or are under lease contracts with an Urban public hospital - [~~and~~] Class two, and non-urban public hospitals.

(ii) Pool Three payments are available to the hospitals that are operated by or under lease contracts with the governmental entities described in clause (i) of this subparagraph that provide intergovernmental transfers.

(iii) HHSC will allocate responsibility for funding Pool Three as follows:

(I) Urban public hospitals - Class two. Each governmental entity that operates or is under a lease contract with an Urban public hospital - Class two is responsible for funding an amount equal to the non-federal share of Pass One and Pass Two DSH payments from Pool Two (calculated as described in paragraphs (4) and (5) of this subsection) to that hospital.

(II) Non-urban public hospitals.

(-a-) Each governmental entity that operates or is under a lease contract with a non-urban public hospital is responsible for funding one-half of the non-federal share of the hospital's Pass One and Pass Two DSH payments from Pool Two (calculated as described in paragraphs (4) and (5) of this subsection) to that hospital.

(-b-) If general revenue available for Pool One does not equal at least one-half of the non-federal share of non-urban public hospitals' Pass One and Pass Two DSH payments from Pool Two, each governmental entity that operates or is under a lease contract with a non-urban public hospital is responsible for increasing its funding of the non-federal share of that hospital's Pass One and Pass Two DSH payments from Pool Two by an amount equal to the Pool One general revenue shortfall associated with the hospital.

(III) Urban public hospitals - Class one. Each governmental entity that owns and operates [~~or is under a lease contract with~~] an Urban public hospital - Class one is responsible for funding the non-federal share of the Pass One and Pass Two DSH payments from Pool Two (calculated as described in paragraphs (4) and (5) of this subsection) to its affiliated hospital and a portion of the non-federal share of the Pass One and Pass Two DSH payments from Pool Two to private hospitals. For funding payments to private hospitals, HHSC will initially suggest an amount in proportion to each Urban public hospital - Class one's individual state payment cap relative to total state payment caps for all Urban public hospitals - Class one. If an entity transfers less than the suggested amount, HHSC will take the steps described in paragraph (5)(F) of this subsection.

(IV) Following the calculations described in paragraphs (4) and (5) of this subsection, HHSC will notify each governmental entity of its allocated intergovernmental transfer amount.

(3) Weighting factors.

(A) HHSC will assign each non-urban public hospital a weighting factor that is calculated as follows:

(i) Determine the non-federal percentage in effect for the program year and multiply by 0.50.

(ii) Add 1.00 to the result from clause (i) of this subparagraph and round the result to two decimal places; this rounded sum is the non-urban public hospital weighting factor.

(iii) If paragraph (2)(C)(iii)(II)(-b-) of this subsection is invoked, the 0.50 referenced in clause (i) of this subparagraph will be increased to represent the increased proportion of the non-federal share of non-urban public hospitals' Pass One and Pass Two DSH payments from Pool Two required to be funded by these hospitals' associated governmental entities.

(B) All other DSH hospitals not described in subparagraph (A) of this paragraph will be assigned a weighting factor of 1.00, except for DSH program years beginning before October 1, 2017, HHSC will assign weighting factors as follows to each non-state DSH hospital:

(i) Other Insurance Weight. HHSC will divide the amount of third party commercial insurance payments for that hospital from the DSH data year by the state payment cap calculated according to §355.8066(c)(1)(D)(ii)(I)(-b-), except that costs are reduced by payments from all payors.

(I) The result, if greater than 1, will be used as a weighting factor.

(II) If the result is less than 1, no weighting factor will be applied.

(ii) Year-To-Date Payment Weight. HHSC will assign a weighting factor of 20 to any hospital that did not receive any prior payments for that DSH program year. This weighting factor will be added to the weighting factor calculated in clause (i) of this subparagraph.

(4) Pass One distribution and payment calculation for Pools One and Two.

(A) HHSC will calculate each hospital's total DSH days as follows:

(i) Weighted Medicaid inpatient days are equal to the hospital's Medicaid inpatient days multiplied by the appropriate weighting factors from paragraph (3) of this subsection.

(ii) Low-income days are equal to the hospital's low-income utilization rate as calculated in subsection (d)(2) of this section multiplied by the hospital's total inpatient days as defined in subsection (b)(18) of this section.

(iii) Weighted low-income days are equal to the hospital's low-income days multiplied by the appropriate weighting factors from paragraph (3) of this subsection.

(iv) Total DSH days equal the sum of weighted Medicaid inpatient days and weighted low-income days.

(B) Using the results from subparagraph (A) of this paragraph, HHSC will:

(i) Divide each hospital's total DSH days from subparagraph (A)(iv) of this paragraph by the sum of total DSH days for all non-state-owned DSH hospitals to obtain a percentage.

(ii) Multiply each hospital's percentage as calculated in clause (i) of this subparagraph by the amount determined in paragraph (2)(A) of this subsection to determine each hospital's Pass One projected payment amount from Pool One.

(iii) Multiply each hospital's percentage as calculated in clause (i) of this subparagraph by the amount determined in paragraph (2)(B)(i)(I) or (II) of this subsection, as appropriate, to determine each hospital's Pass One projected payment amount from Pool Two.

(iv) Sum each hospital's Pass One projected payment amounts from Pool One and Pool Two, as calculated in clauses (ii) and (iii) of this subparagraph respectively. The result of this calculation is the hospital's Pass One projected payment amount from Pools One and Two combined.

(v) Divide the Pass One projected payment amount from Pool Two as calculated in clause (iii) of this subparagraph by the hospital's Pass One projected payment amount from Pools One and Two combined as calculated in clause (iv) of this subparagraph. The result of this calculation is the percentage of the hospital's total Pass One projected payment amount accruing from Pool Two.

(5) Pass Two - Redistribution of amounts in excess of state payment caps from Pass One for Pools One and Two combined. In the event that the projected payment amount calculated in paragraph (4)(B)(iv) of this subsection plus any previous payment amounts for the program year exceeds a hospital's state payment cap, the payment amount will be reduced such that the sum of the payment amount plus any previous payment amounts is equal to the state payment cap. HHSC will sum all resulting excess funds and redistribute that amount to qualifying non-state-owned hospitals that have projected payments, including any previous payment amounts for the program year, below their state payment caps. For each such hospital, HHSC will:

(A) subtract the hospital's projected DSH payment from paragraph (4)(B)(iv) of this subsection plus any previous payment amounts for the program year from its state payment cap;

(B) sum the results of subparagraph (A) of this paragraph for all hospitals; and

(C) compare the sum from subparagraph (B) of this paragraph to the total excess funds calculated for all non-state-owned hospitals.

(i) If the sum of subparagraph (B) of this paragraph is less than or equal to the total excess funds, HHSC will pay all such hospitals up to their state payment cap.

(ii) If the sum of subparagraph (B) of this paragraph is greater than the total excess funds, HHSC will calculate payments to all such hospitals as follows:

(I) Divide the result of subparagraph (A) of this paragraph for each hospital by the sum from subparagraph (B) of this paragraph.

(II) Multiply the ratio from subclause (I) of this clause by the sum of the excess funds from all non-state-owned hospitals.

(III) Add the result of subclause (II) of this clause to the projected DSH payment for that hospital to calculate a revised projected payment amount from Pools One and Two after Pass Two.

(D) If a governmental entity that operates or leases to an Urban public hospital - Class two does not fully fund the amount described in paragraph (2)(C)(iii)(I) of this subsection, HHSC will reduce the hospital's Pass One and Pass Two DSH payment from Pool Two to the level supported by the amount of the intergovernmental transfer.

(E) If a governmental entity that operates or is under a lease contract with a non-urban public hospital does not fully fund the amount described in paragraph (2)(C)(iii)(II) of this subsection, HHSC will reduce that portion of the hospital's Pass One and Pass Two DSH payment from Pool Two to the level supported by the amount of the intergovernmental transfer.

(F) If a governmental entity that owns and operates [~~or leases to~~] an Urban public hospital - Class one does not fully fund the amount described in paragraph (2)(C)(iii)(III) of this subsection, HHSC will take the following steps:

(i) Provide an opportunity for the governmental entities affiliated with the other Urban public hospitals - Class one to transfer additional funds to HHSC;

(ii) Recalculate total DSH days for each Urban public hospital - Class one for purposes of the calculations described in paragraphs (4)(B) and (5)(A) - (C) of this subsection as follows:

(I) Divide the intergovernmental transfer made on behalf of each Urban public hospital - Class one by the sum of intergovernmental transfers made on behalf of all Urban public hospitals - Class one;

(II) Sum the total DSH days for all Urban public hospitals - Class one, calculated as described in paragraph (4)(A) of this subsection; and

(III) Multiply the result of subclause (I) of this clause by the result of subclause (II) of this clause to determine total DSH days for that hospital;

(iii) Recalculate Pass One payments from Pool Two and Pass Two payments from Pools One and Two for Urban public hospitals - Class one and private hospitals following the methodology described in paragraphs (4)(B) and (5)(A) - (C) of this subsection substituting the results from clause (ii) of this subparagraph for the results from paragraph (4)(A) of this subsection for Urban public hospitals - Class one;

(iv) Perform a second recalculation of Pass Two payments from Pools One and Two for Urban public hospitals - Class one as follows:

(I) Multiply each hospital's total Pass Two projected payment amount from Pools One and Two from paragraph (5) of this subsection, after performing the recalculation described in clause (iii) of this subparagraph, by the percentage of the hospital's total Pass One projected payment amount accruing from Pool Two from paragraph (4)(B)(v) of this subsection, after performing the recalculation described in clause (iii) of this subparagraph. The result is the hospital's Pass Two projected payment amount from Pool Two;

(II) Subtract the hospital's Pass Two projected payment amount from Pool Two from subclause (I) of this clause from the hospital's total Pass Two projected payment amount from Pools One and Two from paragraph (5) of this subsection, after performing the recalculation described in clause (iii) of this subparagraph. The result is the hospital's Pass Two projected payment amount from Pool One;

(III) Sum the total Pass Two projected payment amounts from Pool Two, calculated as described in subclause (I) of this clause, for all Urban public hospitals - Class one;

(IV) Multiply the result of clause (ii)(I) of this subparagraph for the hospital by the result of subclause (III) of this clause to determine the Pass Two payment from Pool Two for the hospital; and

(V) Sum the results of subclauses (II) and (IV) of this clause to determine the total Pass Two payment from Pools One and Two for that hospital; and

(v) Use the results of this subparagraph in the calculations described in paragraphs (6) and (7) of this subsection.

(6) Pass One distribution and payment calculation for Pool Three.

(A) HHSC will calculate the initial payment from Pool Three as follows:

(i) For each Urban public hospital - Class one and Class two--

(I) multiply its total Pool One and Pool Two payments after Pass Two from paragraph (5) of this subsection by the percentage of the hospital's total Pass One projected payment amount accruing from Pool Two from paragraph (4)(B)(v) of this subsection;

(II) divide the result from subclause (I) of this clause by the FMAP for the program year; and

(III) multiply the result from subclause (II) of this clause by the non-federal percentage. The result is the Pass One initial payment from Pool Three for these hospitals.

(ii) For each Non-urban public hospital--

(I) multiply its total Pool One and Pool Two payments after Pass Two from paragraph (5) of this subsection by the percentage of the hospital's total Pass One projected payment amount accruing from Pool Two from paragraph (4)(B)(v) of this subsection;

(II) divide the result from subclause (I) of this clause by the FMAP for the program year; and

(III) multiply the result from subclause (II) of this clause by the non-federal percentage and multiply by 0.50. The result is the Pass One initial payment from Pool Three for these hospitals.

(IV) If paragraph (2)(C)(iii)(II)(-b-) of this subsection is invoked, the 0.50 referenced in subclause (III) of this clause will be increased to represent the increased proportion of the non-federal share of non-urban public hospitals' Pass One and Pass Two DSH payments from Pool Two required to be funded by these hospitals' associated governmental entities.

(iii) For all other hospitals, the Pass One initial payment from Pool Three is equal to zero.

(B) HHSC will calculate the secondary payment from Pool Three for each Urban public hospital - Class one as follows:

(i) Sum the intergovernmental transfers made on behalf of all Urban public hospitals - Class one;

(ii) For each Urban public hospital - Class one, divide the intergovernmental transfer made on behalf of that hospital by the sum of the intergovernmental transfers made on behalf of all Urban public hospitals - Class one from clause (i) of this subparagraph;

(iii) Sum all Pass One initial payments from Pool Three from subparagraph (A) of this paragraph;

(iv) Subtract the sum from clause (iii) of this subparagraph from the total value of Pool Three; and

(v) Multiply the result from clause (ii) of this subparagraph by the result from clause (iv) of this subparagraph for each Urban public hospital - Class One. The result is the Pass One secondary payment from Pool Three for that hospital.

(vi) For all other hospitals, the Pass One secondary payment from Pool Three is equal to zero.

(C) HHSC will calculate each hospital's total Pass One payment from Pool Three by adding its Pass One initial payment from Pool Three and its Pass One secondary payment from Pool Three.

(7) Pass Two - Secondary redistribution of amounts in excess of state payment caps for Pool Three. For each hospital that received a Pass One initial or secondary payment from Pool Three, HHSC will sum the result from paragraph (5) of this subsection and the result from paragraph (6) of this subsection to determine the hospital's total projected DSH payment. In the event this sum plus any previous payment amounts for the program year exceeds a hospital's state pay-

ment cap, the payment amount will be reduced such that the sum of the payment amount plus any previous payment amounts is equal to the state payment cap. HHSC will sum all resulting excess funds and redistribute that amount to qualifying non-state-owned hospitals eligible for payments from Pool Three that have projected payments, including any previous payment amounts for the program year, below their state payment caps. For each such hospital, HHSC will:

(A) subtract the hospital's projected DSH payment plus any previous payment amounts for the program year from its state payment cap;

(B) sum the results of subparagraph (A) of this paragraph for all hospitals; and

(C) compare the sum from subparagraph (B) of this paragraph to the total excess funds calculated for all non-state-owned hospitals.

(i) If the sum of subparagraph (B) of this paragraph is less than or equal to the total excess funds, HHSC will pay all such hospitals up to their state payment cap.

(ii) If the sum of subparagraph (B) of this paragraph is greater than the total excess funds, HHSC will calculate payments to all such hospitals as follows:

(I) Divide the result of subparagraph (A) of this paragraph for each hospital by the sum from subparagraph (B) of this paragraph.

(II) Multiply the ratio from subclause (I) of this clause by the sum of the excess funds from all non-state-owned hospitals.

(III) Add the result of subclause (II) of this clause to the projected total DSH payment for that hospital to calculate a revised projected payment amount from Pools One, Two and Three after Pass Two.

(8) Pass Three - additional allocation of DSH funds for rural public and rural public-financed hospitals. Rural public hospitals or rural public-financed hospitals that met the funding requirements described in paragraph (2)(C) of this subsection may be eligible for DSH funds in addition to the projected payment amounts calculated in paragraphs (4) - (7) of this subsection.

(A) For each rural public hospital or rural public financed hospital that met the funding requirements described in paragraph (2)(C) of this subsection, HHSC will determine the projected payment amount plus any previous payment amounts for the program year calculated in accordance with paragraphs (4) - (7) of this subsection, as appropriate.

(B) HHSC will subtract each hospital's projected payment amount plus any previous payment amounts for the program year from subparagraph (A) of this paragraph from each hospital's state payment cap to determine the maximum additional DSH allocation.

(C) The governmental entity that owns the hospital or leases the hospital may provide the non-federal share of funding through an intergovernmental transfer to fund up to the maximum additional DSH allocation calculated in subparagraph (B) of this paragraph. These governmental entities will be queried by HHSC as to the amount of funding they intend to provide through an intergovernmental transfer for this additional allocation. The query may be conducted through e-mail, through the various hospital associations or through postings on the HHSC website.

(D) Prior to processing any full or partial DSH payment that includes an additional allocation of DSH funds as described in this paragraph, HHSC will determine if such a payment would cause total DSH payments for the full or partial payment to exceed the available DSH funds for the payment as described in subsection (b)(2) of this section. If HHSC makes such a determination, it will reduce the DSH payment amounts rural public and rural public-financed hospitals are eligible to receive through the additional allocation as required to remain within the available DSH funds for the payment. This reduction will be applied proportionally to all additional allocations. HHSC will:

(i) determine remaining available funds by subtracting payment amounts for all DSH hospitals calculated in paragraphs (4) - (7) of this subsection from the amount in subsection (g)(2) of this section;

(ii) determine the total additional allocation supported by an intergovernmental transfer by summing the amounts supported by intergovernmental transfers identified in subparagraph (C) of this paragraph;

(iii) determine an available proportion statistic by dividing the remaining available funds from clause (i) of this subparagraph by the total additional allocation supported by an intergovernmental transfer from clause (ii) of this subparagraph; and

(iv) multiply each intergovernmental transfer supported payment from subparagraph (C) of this paragraph by the proportion statistic determined in clause (iii) of this subparagraph. The resulting product will be the additional allowable allocation for the payment.

(E) Rural public and rural public-financed hospitals that do not meet the funding requirements of paragraph (2)(C)(iii)(II) of this subsection are not eligible for participation on Pass Three.

(9) Reallocating funds if hospital closes, loses its license or eligibility, or files bankruptcy. If a hospital closes, loses its license, loses its Medicare or Medicaid eligibility, or files bankruptcy before receiving DSH payments for all or a portion of a DSH program year, HHSC will determine the hospital's eligibility to receive DSH payments going forward on a case-by-case basis. In making the determination, HHSC will consider multiple factors including whether the hospital was in compliance with all requirements during the program year and whether it can meet the audit requirements described in subsection (o) of this section. If HHSC determines that the hospital is not eligible to receive DSH payments going forward, HHSC will notify the hospital and reallocate that hospital's disproportionate share funds going forward among all DSH hospitals in the same category that are eligible for additional payments.

(10) HHSC will give notice of the amounts determined in this subsection.

(11) The sum of the annual payment amounts for state owned and non-state owned IMDs are summed and compared to the federal IMD limit. If the sum of the annual payment amounts exceeds the federal IMD limit, the state owned and non-state owned IMDs are reduced on a pro-rata basis so that the sum is equal to the federal IMD limit.

(12) For any DSH program year for which HHSC has calculated the hospital-specific limit described in §355.8066(c)(2) of this chapter, HHSC will compare the interim DSH payment amount as calculated in subsection (h) of this section to the hospital-specific limit.

(A) HHSC will limit the payment amount to the hospital-specific limit if the payment amount exceeds the hospital's hospital-specific limit.

(B) HHSC will redistribute dollars made available as a result of the capping described in subparagraph (A) of this paragraph

to providers eligible for additional payments subject to their hospital-specific limits, as described in subsection (l) of this section.

(i) Hospital located in a federal natural disaster area. A hospital that is located in a county that is declared a federal natural disaster area and that was participating in the DSH program at the time of the natural disaster may request that HHSC determine its DSH qualification and interim reimbursement payment amount under this subsection for subsequent DSH program years. The following conditions and procedures will apply to all such requests received by HHSC:

(1) The hospital must submit its request in writing to HHSC with its annual DSH application.

(2) If HHSC approves the request, HHSC will determine the hospital's DSH qualification using the hospital's data from the DSH data year prior to the natural disaster. However, HHSC will calculate the one percent Medicaid minimum utilization rate, the state payment cap, and the payment amount using data from the DSH data year. The hospital-specific limit will be computed based on the actual data for the DSH program year.

(3) HHSC will notify the hospital of the qualification and interim reimbursement.

(j) HHSC determination of eligibility or qualification. HHSC uses the methodology described in §355.8066(e) of this title to verify the data and other information used to determine eligibility and qualification under this section. The verification process includes:

(1) notice to hospitals of the data provided to HHSC by Medicaid contractors; and

(2) an opportunity for hospitals to request HHSC review of disputed data and other information the hospital believes is erroneous.

(k) Disproportionate share funds held in reserve.

(1) If HHSC has reason to believe that a hospital is not in compliance with the conditions of participation listed in subsection (e) of this section, HHSC will notify the hospital of possible noncompliance. Upon receipt of such notice, the hospital will have 30 calendar days to demonstrate compliance.

(2) If the hospital demonstrates compliance within 30 calendar days, HHSC will not hold the hospital's DSH payments in reserve.

(3) If the hospital fails to demonstrate compliance within 30 calendar days, HHSC will notify the hospital that HHSC is holding the hospital's DSH payments in reserve. HHSC will release the funds corresponding to any period for which a hospital subsequently demonstrates that it was in compliance. HHSC will not make DSH payments for any period in which the hospital is out of compliance with the conditions of participation listed in subsection (e)(1) and (2) of this section. HHSC may choose not to make DSH payments for any period in which the hospital is out of compliance with the conditions of participation listed in subsection (e)(3) - (7) of this section.

(4) If a hospital's DSH payments are being held in reserve on the date of the last payment in the DSH program year, and no request for review is pending under paragraph (5) of this subsection, the amount of the payments is not restored to the hospital, but is divided proportionately among the hospitals receiving a last payment.

(5) Hospitals that have DSH payments held in reserve may request a review by HHSC.

(A) The hospital's written request for a review must:

(i) be sent to HHSC's Director of Hospital Rate Analysis, Rate Analysis Department;

(ii) be received by HHSC within 15 calendar days after notification that the hospital's DSH payments are held in reserve; and

(iii) contain specific documentation supporting its contention that it is in compliance with the conditions of participation.

(B) The review is:

(i) limited to allegations of noncompliance with conditions of participation;

(ii) limited to a review of documentation submitted by the hospital or used by HHSC in making its original determination; and

(iii) not conducted as an adversarial hearing.

(C) HHSC will conduct the review and notify the hospital requesting the review of the results.

(l) Recovery and redistribution of DSH funds. As described in subsection (p) of [~~Notwithstanding any other provision of~~] this section, HHSC will recoup any overpayment of DSH funds made to a hospital, including an overpayment that results from HHSC error or that is identified in an audit. Recovered funds will be redistributed as described in subsection (r) of this section. [~~proportionately to DSH hospitals that had the same source of the non-federal share of the DSH payment in the program year in which the overpayment occurred and that are eligible for additional payments for that program year. For example, funds recovered from state-owned hospitals will be redistributed first to other state-owned hospitals that are eligible for additional payments for that program year. If there are no hospitals eligible for additional payments for that program year that had the same source of the non-federal share of the recovered funds, any remaining funds will be distributed as follows:~~]

[~~(1) the non-federal share will be returned to the governmental entity that provided it during the program year;~~]

[~~(2) the federal share will be distributed proportionately among all hospitals eligible for additional payments that have a source of the non-federal share of the payments; and~~]

[~~(3) the federal share that does not have a source of non-federal share will be returned to CMS.~~]

(m) Failure to provide supporting documentation. HHSC will exclude data from DSH calculations under this section if a hospital fails to maintain and provide adequate documentation to support that data.

(n) Voluntary withdrawal from the DSH program.

(1) HHSC will recoup all DSH payments made during the same DSH program year to a hospital that voluntarily terminates its participation in the DSH program. HHSC will redistribute the recouped funds according to the distribution methodology described in subsection (l) of this section.

(2) A hospital that voluntarily terminates from the DSH program will be ineligible to receive payments for the next DSH program year after the hospital's termination.

(3) If a hospital does not apply for DSH funding in the DSH program year following a DSH program year in which it received DSH funding, even though it would have qualified for DSH funding in that year, the hospital will be ineligible to receive payments for the next DSH program year after the year in which it did not apply.

(4) The hospital may reapply to receive DSH payments in the second DSH program year after the year in which it did not apply.

(o) Audit process.

(1) Independent certified audit. HHSC is required by the Social Security Act (Act) to annually complete an independent certified audit of each hospital participating in the DSH program in Texas. Audits will comply with all applicable federal law and directives, including the Act, the Omnibus Budget and Reconciliation Act of 1993 (OBRA '93), the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA), pertinent federal rules, and any amendments to such provisions.

(A) Each audit report will contain the verifications set forth in 42 CFR §455.304(d).

(B) The sources of data utilized by HHSC, the hospitals, and the independent auditors to complete the DSH audit and report include:

(i) The Medicaid cost report;

(ii) Medicaid Management Information System data; and

(iii) Hospital financial statements and other auditable hospital accounting records.

(C) A hospital must provide HHSC or the independent auditor with the necessary information in the time specified by HHSC or the independent auditor. HHSC or the independent auditor will notify hospitals of the required information and provide a reasonable time for each hospital to comply.

(D) A hospital that fails to provide requested information or to otherwise comply with the independent certified audit requirements may be subject to a withholding of Medicaid disproportionate share payments or other appropriate sanctions.

(E) HHSC will recoup any overpayment of DSH funds made to a hospital that is identified in the independent certified audit as described in this subsection and will redistribute the recouped funds to DSH providers that are eligible for additional payments, subject to their [~~the~~] hospital-specific limits, as described in subsections [~~subsection~~] (l) and (r) of this section.

(F) Review of preliminary audit finding of overpayment.

(i) Before finalizing the audit, HHSC will notify each hospital that has a preliminary audit finding of overpayment.

(ii) A hospital that disputes the finding or the amount of the overpayment may request a review in accordance with the following procedures.

(I) A request for review must be received by the HHSC Rate Analysis Department in writing by regular mail, hand delivery or special mail delivery, from the hospital within 30 calendar days of the date the hospital receives the notification described in clause (i) of this subparagraph.

(II) The request must allege the specific factual or calculation errors the hospital contends the auditors made that, if corrected, would change the preliminary audit finding.

(III) All documentation supporting the request for review must accompany the written request for review or the request will be denied.

(IV) The request for review may not dispute the federal audit requirements or the audit methodologies.

(iii) The review is:

(I) limited to the hospital's allegations of factual or calculation errors;

(II) solely a data review based on documentation submitted by the hospital with its request for review or that was used by the auditors in making the preliminary finding; and

(III) not an adversarial hearing.

(iv) HHSC will submit to the auditors all requests for review that meet the procedural requirements described in clause (ii) of this subparagraph.

(I) If the auditors agree that a factual or calculation error occurred and change the preliminary audit finding, HHSC will notify the hospital of the revised finding.

(II) If the auditors do not agree that a factual or calculation error occurred and do not change the preliminary audit finding, HHSC will notify the hospital that the preliminary finding stands and will initiate recoupment proceedings as described in this section.

(2) Additional audits. HHSC may conduct or require additional audits.

(p) Recoupment.

(1) In the event of an overpayment identified by HHSC, or its contractor, or a disallowance by CMS of federal financial participation related to a hospital's receipt or use of payments under this section, HHSC may recoup an amount equal to the amount of the overpayment or disallowance.

(2) Payments under this section may be subject to adjustment for payments made in error, including, without limitation, adjustments under §371.1711 of this title (relating to Recoupment of Overpayments and Debts), 42 CFR Part 455, and the Texas Government Code Chapter 403. HHSC may recoup an amount equivalent to any such adjustment.

(3) HHSC may recoup from any current or future Medicaid payments as follows.

(A) HHSC will recoup from the hospital against which any overpayment was made or disallowance was directed.

(B) If, within 30 days of the hospital's receipt of HHSC's written notice of recoupment, the hospital has not paid the full amount of the recoupment or entered into a written agreement with HHSC to do so, HHSC may withhold any or all future Medicaid payments from the hospital until HHSC has recovered an amount equal to the amount overpaid or disallowed.

(q) Reconciliation. HHSC will reconcile actual costs incurred by the hospital for the demonstration year with disproportionate share hospital (DSH) payments, if any, made to the hospital for the same period:

(1) if a hospital received payments in excess of its actual costs, the overpaid amount will be recouped from the hospital, as described in subsection (o) of this section; and

(2) if a hospital received payments less than its actual costs, and if HHSC has available DSH funding for the DSH program year in which the costs were accrued, the hospital may receive reimbursement for some or all of those actual documented unreimbursed costs.

(r) Redistribution of Recouped Funds. Following the recoupments described in subsection (p) of this section, HHSC will redistribute the recouped funds to eligible providers. For purposes of this subsection, an eligible provider is a provider who has room remaining in its final remaining Hospital-specific limit (HSL) calculated in the reconciliation described in subsection (q) of this section after considering all DSH payments made for that DSH program year. Recouped funds from state providers will be redistributed proportionately to el-

igible state providers based on the percentage that each eligible state provider's remaining final HSL (calculated in the reconciliation as described in subsection (q) of this section) is of the total remaining final HSL (calculated in the reconciliation described in subsection (q) of this section) of all eligible state providers. Recouped funds from non-state providers may be redistributed proportionately to state providers or eligible non-state providers as follows.

(1) For DSH years 2011-2017 (October 1, 2011 - September 30, 2017) and for DSH years 2020 and after (October 1, 2019 and after), HHSC will use the following methodology to redistribute recouped funds:

(A) the non-federal share will be returned to the governmental entity that provided it during the DSH program year;

(B) the federal share will be distributed proportionately among all providers eligible for additional payments that have a source of the non-federal share of the payments; and

(C) the federal share that does not have a source of non-federal share will be returned to CMS.

(2) For DSH years 2018-2019 (October 1, 2017 - September 30, 2019), HHSC will use the following methodology to redistribute recouped funds.

(A) To calculate a weight that will be applied to all providers, HHSC will divide the final hospital-specific limit described in §355.8066(c)(2) of this chapter (relating to Hospital-Specific Limit Methodology) by the final hospital-specific limit described in §355.8066(c)(2) of this chapter that has not offset payments for third-party and Medicare claims and encounters where Medicaid was a secondary payer. HHSC will add 1 to the quotient. Any provider who has a resulting weight of less than 1 will receive a weight of 1.

(B) HHSC will make a first pass allocation by multiplying the weight described in subparagraph (A) of this paragraph by the final remaining HSL calculated in the reconciliation described in subsection (q) of this section. HHSC will divide the product by the total remaining HSLs for all providers. HHSC will multiply the quotient by the total amount of recouped dollars available for redistribution described in subsection (p)(1) of this section.

(C) After the first pass allocation, HHSC will cap providers at their final remaining HSL. A second pass allocation will occur in the event providers were paid over their final remaining HSL after the weight in subparagraph (A) of this paragraph was applied. HHSC will calculate the second pass by dividing the final remaining HSL calculated in the reconciliation described in subsection (q) of this section by the total remaining HSLs for all providers after accounting for first pass payments. HHSC will multiply the quotient by the total amount of funds in excess of total HSLs for providers capped at their total HSL.

(s) Advance Payments.

(1) In a DSH program year in which payments will be delayed pending data submission or for other reasons, HHSC may make advance payments to hospitals that meet the eligibility requirements described in subsection (c) of this section, meet a qualification in subsection (d) of this section, meet the conditions of participation in subsection (e) of this section, and submitted an acceptable disproportionate share hospital application for the preceding DSH program year from which HHSC calculated an annual maximum disproportionate share hospital payment amount for that year.

(2) Advance payments are considered to be prior period payments.

(3) A hospital that did not submit an acceptable disproportionate share hospital application for the preceding DSH program year is not eligible for an advance payment.

(4) If a partial year disproportionate share hospital application was used to determine the preceding DSH program year's payments, data from that application may be annualized for use in computation of an advance payment amount.

(5) The amount of the advance payments:

(A) are divided into three payments prior to a hospital receiving its final DSH payment amount; and

(B) in DSH program years 2020 and after a provider that received a payment in the previous DSH program year is eligible to receive an advanced payment, and the calculations for advanced payment 1, 2, and 3 are as follows:

(i) HHSC determines a percentage of the pool to pay out in the advanced payments; and

(ii) the pool amount is fed through the previous DSH program year calculation to determine the advanced payments.

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

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Karen Ray
Chief Counsel
Texas Health and Human Services Commission
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For further information, please call: (737) 203-7842

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TITLE 19. EDUCATION

PART 2. TEXAS EDUCATION AGENCY

CHAPTER 74. CURRICULUM REQUIREMENTS

SUBCHAPTER BB. COMMISSIONER'S RULES CONCERNING HIGH SCHOOL GRADUATION

19 TAC §74.1023

The Texas Education Agency (TEA) proposes new §74.1023, concerning the financial aid application requirement for high school graduation. The proposed new rule would reflect the requirements in House Bill (HB) 3, 86th Texas Legislature, 2019, that each student complete and submit a free application for federal student aid (FAFSA) or a Texas application for state financial aid (TASFA) before graduating from high school and that school districts and open-enrollment charter schools report completion information to TEA.

BACKGROUND INFORMATION AND JUSTIFICATION: The 86th Texas Legislature, 2019, passed HB 3, adding new Texas Education Code (TEC), §28.0256, to require a student to complete a financial aid application, either the FAFSA or the TASFA, in order to graduate. The statute provides an exception for students to opt out of the financial aid application requirement

by submitting a form signed by a parent, guardian, or student aged 18 years old or older that authorizes the student to decline to comply with the financial aid application graduation requirement. A high school counselor may also authorize a student to decline to comply with the financial aid application graduation requirement for good cause. The opt-out form must be approved by TEA. At the January 2021 State Board of Education (SBOE) meeting, the SBOE took action to approve proposed amendment to 19 TAC Chapter 74, Curriculum Requirements, Subchapter B, Graduation Requirements, §74.11, High School Graduation Requirements, to add the financial aid application requirement, effective beginning with students enrolled in Grade 12 during the 2021-2022 school year.

Proposed new §74.1023 would establish requirements for school districts and open-enrollment charter schools regarding the implementation of the financial aid application requirement.

New subsections (b) and (c) would address the conditions under which a student may decline to complete a financial aid application by formally opting out and would establish requirements for the opt-out form.

New subsection (d) would establish standards for required notifications school districts and open-enrollment charter schools must provide to students regarding the financial aid requirement, the financial aid applications, and the opt-out form and would establish timelines for the distribution of the information.

New subsection (e) would identify the methods school districts and open-enrollment charter schools must require as proof that a student has completed and submitted the FAFSA or TASFA. This subsection would also permit school districts and open-enrollment charter schools to adopt a local policy for the method by which a student must provide proof that the student has completed a FAFSA. The subsection would also require school districts and open-enrollment charter schools to adopt a local policy for the method by which a student must provide proof that the student has completed a TASFA.

New subsection (f) would establish a requirement for school districts and open-enrollment charter schools to report the number of students who completed and submitted a financial aid application and the number of students who submitted exceptions in accordance with TEC, §28.0256(b).

New subsection (g) would ensure that school districts and open-enrollment charter schools maintain student financial aid application information securely and ensure compliance with federal and state law regarding the confidentiality of student educational information.

FISCAL IMPACT: Monica Martinez, associate commissioner for standards and support services, has determined that for the first five-year period the proposal is in effect there are no additional costs to state or local government beyond what is required by the authorizing statute. HB 3, 86th Texas Legislature, 2019, required school districts and open-enrollment charter schools to monitor and report the completion of the financial aid application requirement, which will have a cost to the state. The 86th Texas Legislature, 2019, appropriated $1.5 million for the creation of a database to track TASFA completion electronically.

LOCAL EMPLOYMENT IMPACT: The proposal has no effect on local economy; therefore, no local employment impact statement is required under Texas Government Code, §2001.022.

SMALL BUSINESS, MICROBUSINESS, AND RURAL COMMUNITY IMPACT: The proposal has no direct adverse economic impact for small businesses, microbusinesses, or rural communities; therefore, no regulatory flexibility analysis, specified in Texas Government Code, §2006.002, is required.

COST INCREASE TO REGULATED PERSONS: The proposal does not impose a cost on regulated persons, another state agency, a special district, or a local government and, therefore, is not subject to Texas Government Code, §2001.0045.

TAKINGS IMPACT ASSESSMENT: The proposal does not impose a burden on private real property and, therefore, does not constitute a taking under Texas Government Code, §2007.043.

GOVERNMENT GROWTH IMPACT: TEA staff prepared a Government Growth Impact Statement assessment for this proposed rulemaking. During the first five years the proposed rulemaking would be in effect, it would create a new regulation by requiring students to either submit a financial aid application or to opt out of the graduation requirement. Additionally the proposed rulemaking would add requirements for school districts and open-enrollment charter schools to distribute notifications to students regarding the requirement and to report financial aid application requirement data to TEA.

The proposed rulemaking would not create or eliminate a government program; would not require the creation of new employee positions or elimination of existing employee positions; would not require an increase or decrease in future legislative appropriations to the agency; would not require an increase or decrease in fees paid to the agency; would not expand, limit, or repeal an existing regulation; would not increase or decrease the number of individuals subject to its applicability; and would not positively or adversely affect the state's economy.

PUBLIC BENEFIT AND COST TO PERSONS: Ms. Martinez has determined that for each year of the first five years the proposal is in effect, the public benefit anticipated as a result of enforcing the proposal would be promoting students' completion of financial aid applications and eligibility to receive financial aid. The proposal would also establish clear timelines and standards for school districts and open-enrollment charter schools related to implementation of the financial aid application requirement. There is no anticipated economic cost to persons who are required to comply with the proposal.

DATA AND REPORTING IMPACT: The proposal would have a data and reporting impact. TEC, §28.026(e)(2), requires each school district to report to the agency the number of students who complete and submit a financial aid application and the number of students who opted out of the financial aid requirement. The financial aid application graduation requirement will be reported through the Texas Student Data System Public Education Information Management System (TSDS PEIMS) and indicated on the high school transcript.

PRINCIPAL AND CLASSROOM TEACHER PAPERWORK REQUIREMENTS: TEA has determined that the proposal would not require a written report or other paperwork to be completed by a principal or classroom teacher.

PUBLIC COMMENTS: The public comment period on the proposal begins April 16, 2021, and ends May 17, 2021. A request for a public hearing on the proposal submitted under the Administrative Procedure Act must be received by the commissioner of education not more than 14 calendar days after notice of the proposal has been published in the *Texas Register* on April 16, 2021. A form for submitting public comments is available on the TEA website

at https://tea.texas.gov/About_TEA/Laws_and_Rules/Commissioner_Rules_(TAC)/Proposed_Commissioner_of_Education_Rules/.

STATUTORY AUTHORITY. The new section is proposed under Texas Education Code (TEC), §28.0256(a), as added by House Bill (HB) 3, 86th Texas Legislature, 2019, which requires each student to complete and submit a free application for federal student aid (FAFSA) or a Texas application for state financial aid (TASFA) before graduating from high school. TEC, §28.0256(c), allows a student to formally opt out of the financial aid application requirement by submitting a TEA-approved form; TEC, §28.0256(e)(1), as added by HB 3, 86th Texas Legislature, 2019, which requires the commissioner of education by rule to establish timelines for the distribution to students of the FAFSA and TASFA and for the submission of the opt-out form. The rule is required to include standards for information school districts and open-enrollment charter schools must provide to students regarding filling out the FAFSA and TASFA and the option for students to decline to complete a financial aid application. Additionally, the rule is required to establish the method by which a student must provide proof to the school district or open-enrollment charter school that the student has submitted a FAFSA or TASFA; TEC, §28.0256(e)(2), as added by HB 3, 86th Texas Legislature, 2019, which requires the commissioner to adopt rules regarding the requirement that school districts report information regarding the number of students who completed and submitted a financial aid application and the number of students who received an exception by submitting an opt-out form; and TEC, §28.0256(e)(3), as added by HB 3, 86th Texas Legislature, 2019, which requires the commissioner to ensure compliance with federal law regarding confidentiality of student educational information, including the Family Educational Rights and Privacy Act of 1974 (20 U.S.C. Section 1232g), and any state law relating to the privacy of student information.

CROSS REFERENCE TO STATUTE. The new section implements Texas Education Code, §28.0256(a), (c), and (e), as added by House Bill 3, 86th Texas Legislature, 2019.

§74.1023. Financial Aid Application Requirement for High School Graduation.

(a) In accordance with Texas Education Code (TEC), §28.0256, beginning with students enrolled in Grade 12 during the 2021-2022 school year, a student shall complete and submit a free application for federal student aid (FAFSA) or a Texas application for state financial aid (TASFA) as a requirement for receiving a high school diploma.

(b) A student may opt out of the financial aid application requirement in subsection (a) of this section under one of the following conditions:

(1) the student's parent or other person standing in parental relation submits a signed form indicating that the parent or other person authorizes the student to decline to complete and submit the financial aid application;

(2) the student signs and submits the form described by paragraph (1) of this subsection on the student's own behalf if the student is 18 years of age or older or is emancipated under the Texas Family Code, Chapter 31; or

(3) a school counselor signs and submits the form described by paragraph (1) of this subsection indicating that the school counselor authorizes the student to decline to complete and submit the financial aid application for good cause, as determined by the school counselor. In accordance with TEC, §28.0256(d), if a school counselor notifies a school district that a student has declined to complete and submit a financial aid application for good cause, the school counselor may not indicate details regarding what constitutes good cause.

(c) The board of trustees for each school district and open-enrollment charter school shall adopt the standard opt-out form provided by the Texas Education Agency (TEA) for the purpose of the exceptions under subsection (b) of this section.

(1) The opt-out form shall be available in English, Spanish, and any other language spoken by a majority of the students enrolled in a bilingual education or special language program under TEC, Chapter 29, Subchapter B, in the district or charter school. Districts and charter schools are responsible for translations not provided by TEA.

(2) The opt-out form must include the student's signature of intent to decline to complete a financial aid application prior to the student's anticipated graduation date.

(d) Each school district and open-enrollment charter school shall provide students with the following notifications regarding the financial aid application requirement.

(1) Standard information regarding the financial aid requirement and the exceptions under subsection (b) of this section shall be provided at the time a student first registers for one or more classes required for high school graduation.

(2) Detailed information regarding instructions for the completion and submission of a financial aid application shall be provided to a student at the beginning of Grade 12 or at the time a student in Grade 12 transfers into a high school from a non-public school or a public school outside of Texas. The instructions shall include:

(A) an explanation of the FAFSA and TASFA and the difference between the two;

(B) instructions for how to access the FAFSA and TASFA, including key dates and deadlines for completion and submission;

(C) resources available to support completion and submission of the FAFSA and TASFA;

(D) documents and information required to complete the FAFSA or TASFA; and

(E) contact information for school staff or local community resources available to support completion of the forms.

(3) Options available to a student under subsection (b) of this section if a student wishes to decline to complete and submit a financial aid application shall be provided to a student at the beginning of Grade 12 or at the time a student in Grade 12 transfers into a high school from a non-public school or a public school outside of Texas. The options shall include:

(A) the opt-out form and explanation of required signatures; and

(B) notification that if the student chooses to opt out for the purposes of graduation, the student will still be eligible to complete the FAFSA or TASFA that year or in subsequent years.

(e) Each school district and open-enrollment charter school shall require one of the following methods of proof that a student has completed and submitted the FAFSA or TASFA as required by this section.

(1) Completion and submission of the FAFSA shall be confirmed through one of the following methods:

(A) ApplyTexas Counselor Suite FAFSA data;

(B) notification from the United States Department of Education that demonstrates a student has completed and submitted a FAFSA; or

(C) a local policy developed by a school district or an open-enrollment charter school for the method by which a student must provide proof that the student has completed a FAFSA.

(2) School districts and open-enrollment charter schools shall develop a local policy for the method by which a student must provide proof that the student has completed a TASFA.

(f) Each school district and open-enrollment charter school shall report through the Texas Student Data System Public Education Information Management System (TSDS PEIMS) the following information not later than December 1 of each school year for students awarded diplomas in the previous school year:

(1) the number of students who completed and submitted a financial aid application; and

(2) the number of students who submitted an exception.

(g) Each school district and open-enrollment charter school shall maintain student financial aid application information securely and ensure compliance with federal law regarding the confidentiality of student educational information, including the Family Educational Rights and Privacy Act of 1974 (20 U.S.C. Section 1232g), and any state law relating to the privacy of student information.

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

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Cristina De La Fuente-Valadez
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CHAPTER 97. PLANNING AND ACCOUNTABILITY

SUBCHAPTER AA. ACCOUNTABILITY AND PERFORMANCE MONITORING

19 TAC §97.1001

(Editor's note: In accordance with Texas Government Code, §2002.014, which permits the omission of material which is "cumbersome, expensive, or otherwise inexpedient," the figure in 19 TAC §97.1001 is not included in the print version of the Texas Register. The figure is available in the on-line version of the April 16, 2021, issue of the Texas Register.)

The Texas Education Agency (TEA) proposes an amendment to §97.1001, concerning accountability and performance monitoring. The proposed amendment would adopt in rule applicable excerpts of the *2021 Accountability Manual.*

BACKGROUND INFORMATION AND JUSTIFICATION: TEA has adopted its academic accountability manual in rule since 2000. The accountability system evolves from year to year, so the criteria and standards for rating and acknowledging schools in the most current year differ to some degree from those applied in the prior year. The intention is to update 19 TAC §97.1001 annually to refer to the most recently published accountability manual.

The proposed amendment to 19 TAC §97.1001 would adopt excerpts of the *2021 Accountability Manual* into rule as a figure. The excerpts, Chapters 1-11 of the *2021 Accountability Manual,* specify the indicators, standards, and procedures used by the commissioner of education to determine accountability ratings for districts, campuses, and charter schools. These chapters also specify indicators, standards, and procedures used to determine distinction designations on additional indicators for Texas public school campuses and districts. Ratings may be revised as a result of investigative activities by the commissioner as authorized under Texas Education Code, §39.056 and §39.057.

Following is a chapter-by-chapter summary of the changes for this year's manual. In every chapter, dates and years for which data are considered would be updated to align with 2021 accountability.

Chapter 1 gives an overview of the entire accountability system. Introductory language would be revised to note that the manual explains the processes used to produce 2021 accountability data reports instead of to calculate ratings and award distinction designations. The link to accountability development proposals and supporting materials would be updated. The *Not Rated: Declared State of Disaster* description would be updated to remove closure of schools during the state's testing window as a cause for the rating label. The summer administration would be removed from the chart depicting the accountability subset rule as well as from the descriptive bullets below the chart. The "STAAR Retest Performance" section would be updated to indicate that Grades 5 and 8 retests would not be considered, as this administration did not occur. The "STAAR Retest Performance" section would also be updated to reflect that if a student's spring 2021 score is the best result, the student would not meet the accountability subset rule for inclusion at Campus A or Campus B. A section would be added to describe the process for SAT/ACT inclusion. The career and technical education (CTE) and military enlistment indicators would be removed from the "TSDS PEIMS-Based Indicators" list, as these would not be considered for 2021. A note describing the rationale for the removal of military enlistment data would be added.

Chapter 2 describes the "Student Achievement" domain. The "Overview" section would be updated to include that for 2021, component raw scores would be displayed; neither raw nor scaled scores would be calculated for the "Student Achievement" domain. The "STAAR Component-Assessments Evaluated" section would be updated to make conforming changes and to include SAT/ACT results for accelerated testers. The "STAAR Component-Substitute Assessments" section would be removed. The "STAAR Component-Minimum Size Criteria and Small Numbers Analysis" section would be updated to add SAT/ACT methodology, including assessments results, students evaluated, methodology, and accountability subset rules. The "College, Career, and Military Readiness Component" section would be updated to include a deadline of August 31 immediately following high school graduation for an associate degree, to remove the "CTE Coherent Sequence Coursework Aligned with Industry Based Certifications" indicator, and to note data discrepancies in Armed Forces enlistment data. The "CTE Coherent Sequence Coursework Transition" section would be removed. References to the half point credit would be removed from the "College, Career, and Military Readiness

Component-Methodology" section. Clarifying language would be added to the "Graduation Rate" section, noting that the best rate is used. Clarifying language would also be added to the annual dropout rate calculations.

Chapter 3 describes the "School Progress" domain. The "Overview" section would be updated to indicate that for 2021, neither raw nor scaled scores would be calculated for the "School Progress" domain. The "School Progress, Part A" section would be updated to indicate that the U.S. Department of Education (USDE) granted Texas a waiver of assessment, accountability and school identification, and certain related reporting requirements for the 2019-2020 school year. As a result, Texas would not calculate School Progress: Part A: Academic Growth for 2021. The remaining text of School Progress, Part A would be removed. The "Part B: Relative Performance-Assessments Evaluated" section would be updated to remove substitute assessments. A note would be added to the "Part B: Relative Performance Score" section to indicate that component raw scores would be displayed; neither raw nor scaled scores would be calculated. The following example subsection and "Domain Rating Calculation" section would be removed.

Chapter 4 describes the "Closing the Gaps" domain. The "Overview" section would be updated to indicate that for 2021, component raw scores would be displayed; neither raw nor scaled scores would be calculated for the "Closing the Gaps" domain. The "Academic Achievement-Assessments Evaluated" section would be updated to indicate that SAT/ACT results for accelerated testers would be included. The "Academic Achievement-Substitute Assessments" and the "Academic Growth Components" sections would be removed. A note would be inserted to state that because of the USDE waiver, Texas does not have the data necessary to calculate Academic Growth. The remainder of the Academic Growth sections would be removed. Text in the "Federal Graduation Status" section referring to Academic Growth would be removed. The "Four-Year Graduation Rate Target" section would be amended to remove text indicating that Texas requested to amend the graduation rate methodology. The "Federal Graduation Status-Methodology" section would be amended to include updated graduation rate indicator criteria. The "English Language Proficiency Component" section would be updated to remove language referring to the 2020 rating label and add that either a 2019 or 2020 Texas English Language Proficiency Assessment System (TELPAS) composite rating may be used. The "Student Achievement Domain Score" section would be updated to include SAT/ACT results for accelerated testers. The "Student Achievement Domain Score: STAAR Component Only-Substitute Assessments" section would be removed. The College, Career, and Military Readiness Performance Status would be updated to add a deadline of August 31 immediately following high school graduation for an associate degree, to remove the "CTE Coherent Sequence Coursework" criteria, and to add a note describing the data discrepancies in the Armed Forces enlistment data. The "Participation Status" section would be updated to remove the reference to substitute assessments and to note that due to the Every Student Succeeds Act (ESSA) Plan 2021 Addendum, TEA requested to only report reading and mathematics participation rates for districts and campuses for 2021. The "Calculating a Closing the Gaps Domain Score" section would be removed. Baseline graduation rates would be added to the "2021 Closing the Gaps Performance Targets" chart.

Chapter 5 describes how the overall ratings are calculated. Due to all campuses and districts receiving *Not Rated: Declared State of Disaster* in 2021, all language after the "Overview" section would be removed.

Chapter 6 describes distinction designations. Chapter 6 would be updated to clarify that in 2021, all districts and campuses would receive a *Not Rated: Declared State of Disaster* label and that distinction designations would not be awarded. Campus comparison groups would still be calculated, so this section would remain. All other sections in this chapter would be removed.

Chapter 7 describes the pairing process and the alternative education accountability (AEA) provisions. The "Pairing Process" section would be updated to remove language stating that the pairing process was not necessary in 2020. The 50% student enrollment in Grades 6-12 criteria would be updated to 90% in the "AEA Campus Registration Criteria" section. Language in the "AEA Charter School Identification" section would be clarified.

Chapter 8 describes the process for appealing ratings. Language would be added to indicate that in 2021, districts and campuses cannot appeal the rating of *Not Rated: Declared State of Disaster.* All other language would be removed.

Chapter 9 describes the responsibilities of TEA, the responsibilities of school districts and open-enrollment charter schools, and the consequences to school districts and open-enrollment charter schools related to accountability and interventions. Clarifying language would be added to indicate that the rating labels used to determine multiple-year unacceptable status include *F, Improvement Required, Academically Unacceptable,* or *AEA: Academically Unacceptable.* This section would also clarify that an overall rating of *D* or *F* in 2019 and in 2022 would be considered consecutive. Language would be added stating that due to the lack of 2021 accountability ratings, the campuses identified for Public Education Grant (PEG) based on 2019 ratings would remain on the 2022-2023 PEG List. The "Campus Identification Numbers" section is updated to clarify that *Academically Unacceptable* and *AEA: Academically Unacceptable* are also included in ratings history that may be linked across campus numbers.

Chapter 10 provides information on the federally required identification of schools for improvement. The "Overview" section would be updated to acknowledge the addendum to the state's ESSA plan to the USDE, requesting that existing comprehensive support and improvement, targeted support and improvement, and additional targeted support labels be retained for 2021-2022, that the identification of the next cohort be delayed one year until August 2022, that the escalation of three-year additional targeted support (ATS) campuses to comprehensive status be postponed until August 2023, that campuses must opt in for continued interventions to receive funding for 2021-2022, and that current comprehensive support and improvement campuses identified solely by the graduation rate criteria may exit if the campus meets the graduation rate exit criteria. The "Overview" section would also include the updated timeline for Title I campuses identified for ATS for three consecutive years and exit criteria for comprehensive support and improvement campuses. All other sections in Chapter 10 would be removed.

Chapter 11 describes the local accountability system (LAS). Language stating the legislative session that established LAS would be removed. The "Overview" section would be updated to clarify that in 2021, districts and campuses receive a *Not Rated: Declared State of Disaster* label overall and in each domain. Clari-

fying language would be added in the "LAS Implementation" and "Ratings Under LAS" sections. The "2021 LAS Ratings" section would be amended to clarify that in 2021, districts and campuses receive a *Not Rated: Declared State of Disaster* label overall and in each domain and that the 2021 state and LAS ratings are not combined. All other language in this section would be removed. The "LAS Appeals" section would be amended to clarify that neither the 2021 state nor LAS rating labels can be appealed. All other language in this section would be removed.

FISCAL IMPACT: Jeff Cottrill, deputy commissioner for governance and accountability, has determined that for the first five-year period the proposal is in effect there are no additional costs to state or local government, including school districts and open-enrollment charter schools, required to comply with the proposal.

LOCAL EMPLOYMENT IMPACT: The proposal has no effect on local economy; therefore, no local employment impact statement is required under Texas Government Code, §2001.022.

SMALL BUSINESS, MICROBUSINESS, AND RURAL COMMUNITY IMPACT: The proposal has no direct adverse economic impact for small businesses, microbusinesses, or rural communities; therefore, no regulatory flexibility analysis, specified in Texas Government Code, §2006.002, is required.

COST INCREASE TO REGULATED PERSONS: The proposal does not impose a cost on regulated persons, another state agency, a special district, or a local government and, therefore, is not subject to Texas Government Code, §2001.0045.

TAKINGS IMPACT ASSESSMENT: The proposal does not impose a burden on private real property and, therefore, does not constitute a taking under Texas Government Code, §2007.043.

GOVERNMENT GROWTH IMPACT: TEA staff prepared a Government Growth Impact Statement assessment for this proposed rulemaking. During the first five years the proposed rulemaking would be in effect, it would limit an existing regulation due to its effect on school accountability for 2021.

The proposed rulemaking would not create or eliminate a government program; would not require the creation of new employee positions or elimination of existing employee positions; would not require an increase or decrease in future legislative appropriations to the agency; would not require an increase or decrease in fees paid to the agency; would not create a new regulation; would not expand or repeal an existing regulation; would not increase or decrease the number of individuals subject to its applicability; and would not positively or adversely affect the state's economy.

PUBLIC BENEFIT AND COST TO PERSONS: Dr. Cottrill has determined that for each year of the first five years the proposal is in effect, the public benefit anticipated as a result of enforcing the proposal would be continuing to inform the public of the existence of annual manuals specifying rating procedures for public schools by including this rule in the Texas Administrative Code. There is no anticipated economic cost to persons who are required to comply with the proposal.

DATA AND REPORTING IMPACT: The proposal would have no data or reporting impact.

PRINCIPAL AND CLASSROOM TEACHER PAPERWORK REQUIREMENTS: TEA has determined that the proposal would not require a written report or other paperwork to be completed by a principal or classroom teacher.

PUBLIC COMMENTS: The public comment period on the proposal begins April 16, 2021, and ends May 17, 2021. A public hearing on the proposal is scheduled for 9:00 a.m. on April 30, 2021. The public may participate in the hearing virtually by linking to the meeting at https://us02web.zoom.us/meeting/register/tZUtdOGgqj0jGtbMtwqQYIa9bP2QCRH08upD. Parties interested in testifying must register online by 9:00 a.m. on the day of the hearing and are encouraged to also send written testimony to performance.reporting@tea.texas.gov. Individuals in need of a translator or sign language services should contact the TEA Division of Performance Reporting by April 23, 2021. The hearing will conclude once all who have registered have been given the opportunity to comment. Questions about the hearing should be directed to the TEA Division of Performance Reporting at (512) 463-9704.

STATUTORY AUTHORITY. The amendment is proposed under Texas Education Code (TEC), §39.052(a) and (b)(1)(A), which require the commissioner to evaluate and consider the performance on achievement indicators described in TEC, §39.053(c), when determining the accreditation status of each school district and open-enrollment charter school; TEC, §39.053, which requires the commissioner to adopt a set of performance indicators related to the quality of learning and achievement in order to measure and evaluate school districts and campuses; TEC, §39.054, which requires the commissioner to adopt rules to evaluate school district and campus performance and to assign a performance rating; TEC, §39.0541, which allows the commissioner to adopt indicators and standards under TEC, Subchapter C, at any time during a school year before the evaluation of a school district or campus; TEC, §39.0548, which requires the commissioner to designate campuses that meet specific criteria as dropout recovery schools and to use specific indicators to evaluate them; TEC, §39.055, which prohibits the use of assessment results and other performance indicators of students in a residential facility in state accountability; TEC, §39.151, which provides a process for a school district or an open-enrollment charter school to challenge an academic or financial accountability rating; TEC, §39.201, which requires the commissioner to award distinction designations to a campus or district for outstanding performance; TEC, §39.2011, which makes open-enrollment charter schools and campuses that earn an acceptable rating eligible for distinction designations; TEC, §39.202 and §39.203, which authorize the commissioner to establish criteria for distinction designations for campuses and districts; TEC, §29.081(e), (e-1), and (e-2), which define criteria for alternative education programs for students at risk of dropping out of school and subjects those campuses to the performance indicators and accountability standards adopted for alternative education programs; and TEC, §12.104(b)(3)(L), which subjects open-enrollment charter schools to the rules adopted under public school accountability in TEC, Chapter 39.

CROSS REFERENCE TO STATUTE. The amendment implements Texas Education Code (TEC), §§39.052(a) and (b)(1)(A); 39.053; 39.054; 39.0541; 39.0548; 39.055; 39.151; 39.201; 39.2011; 39.202; 39.203; 29.081(e), (e-1), and (e-2); and 12.104(b)(3)(L).

§97.1001. Accountability Rating System.

(a) The rating standards established by the commissioner of education under Texas Education Code (TEC), §§39.052(a) and (b)(1)(A); 39.053, 39.054, 39.0541, 39.0548, 39.055, 39.151, 39.201, 39.2011, 39.202, 39.203, 29.081(e), (e-1), and (e-2), and 12.104(b)(2)(L), shall be used to evaluate the performance of districts, campuses, and charter schools. The indicators, standards, and proce-

dures used to determine ratings will be annually published in official Texas Education Agency publications. These publications will be widely disseminated and cover the following:

(1) indicators, standards, and procedures used to determine district ratings;

(2) indicators, standards, and procedures used to determine campus ratings;

(3) indicators, standards, and procedures used to determine distinction designations; and

(4) procedures for submitting a rating appeal.

(b) The procedures by which districts, campuses, and charter schools are rated and acknowledged for 2021 [~~2020~~] are based upon specific criteria and calculations, which are described in excerpted sections of the *2021* [~~*2020*~~] *Accountability Manual* provided in this subsection.

Figure: 19 TAC §97.1001(b)

[~~Figure: 19 TAC §97.1001(b)~~]

(c) Ratings may be revised as a result of investigative activities by the commissioner as authorized under TEC, §39.057.

(d) The specific criteria and calculations used in the accountability manual are established annually by the commissioner and communicated to all school districts and charter schools.

(e) The specific criteria and calculations used in the annual accountability manual adopted for prior school years remain in effect for all purposes, including accountability, data standards, and audits, with respect to those school years.

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

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Cristina De La Fuente-Valadez
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Texas Education Agency
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TITLE 22. EXAMINING BOARDS

PART 24. TEXAS BOARD OF VETERINARY MEDICAL EXAMINERS

CHAPTER 571. LICENSING

SUBCHAPTER A. GENERAL

22 TAC §571.15

The Texas Board of Veterinary Medical Examiners (Board) proposes this amendment to §571.15, concerning temporary veterinary license. The purpose of the proposed amendment is to help make temporary licensure less restrictive for out of state veterinarians who wish to volunteer their services in high need areas in Texas.

John Helenberg, Executive Director, has determined that for each year of the first five years that the rule is in effect, there are no anticipated increases or reductions in costs to the state and local governments as a result of enforcing or administering the rule. Mr. Helenberg has also determined that for each year of the first five years that the rule is in effect, there is no anticipated impact in revenue to state government as a result of enforcing or administering the rule.

Mr. Helenberg has also determined that for each year of the first five years the rule is in effect, the anticipated public benefit will be that more out of state veterinarians may pursue temporary licensure to provide much needed volunteer or low-cost veterinary services throughout the state.

According to Executive Director John Helenberg, for the first five years that the rule would be in effect, it is estimated that; the proposed rule would not create or eliminate a government program. Implementation of the proposed rule would not require the creation of new employee positions or the elimination of existing employee positions; implementation of the proposed rule would not require an increase or decrease in future legislative appropriations to the agency; the proposed rule would not require an increase in the fees paid to the agency; the proposed rule would not create a new regulation; the proposed rule would limit an existing regulation; the proposed rule would not increase or decrease the number of individuals subject to the rule's applicability; and the proposed rule would not positively or adversely affect the state's economy.

The Texas Board of Veterinary Medical Examiners invites comments on the proposed amendment to the rule from any interested persons, including any member of the public. A written statement should be mailed or delivered to Valerie Mitchell, Texas Board of Veterinary Medical Examiners, 333 Guadalupe, Ste. 3-810, Austin, Texas 78701-3942, by facsimile (FAX) to (512) 305-7574, or by e-mail to *Valerie.mitchell@veterinary.texas.gov.* Comments will be accepted for 30 days following publication in the *Texas Register.* Comments must be received within 30 days after publication of this proposal in order to be considered.

The rule is proposed under the authority of §801.151(a), Occupations Code, which states that the Board may adopt rules necessary to administer the chapter, and the authority of §801.151(b), Occupations Code, which states that the Board may adopt rules of professional conduct appropriate to establish and maintain a high standard of integrity, skills and practice in the veterinary medicine profession. No other statutes, articles, or codes are affected by the proposal.

§571.15. Temporary Veterinary License.

(a) Eligibility and Application Requirements. An application for a temporary veterinary license shall be submitted to the Board on the form provided by the Board. To be complete, an application must include at least the following items:

(1) a letter of good standing issued within the previous six months from another state or jurisdiction of the United States or foreign country with substantially similar licensing requirements in which the applicant is currently actively licensed;

(2) an attestation that the applicant is a graduate of a school or college of veterinary medicine that is approved by the Board and accredited by the Council on Education of the American Veterinary Medical Association (AVMA), or that possesses an Educational Commission for Foreign Veterinary Graduates (ECFVG) Certificate or a Program for Assessment of Veterinary Education Equivalence (PAVE) Certificate;

(3) a copy of the applicant's driver's license, passport, or other government-issued photo identification; and

(4) the license number and signature of the Texas veterinarian who agrees to provide general supervision of the applicant's practice of veterinary medicine for the duration of the temporary veterinary license.

(b) Scope and Duration.

(1) A temporary veterinary license is valid only for a specific patient, client, continuing education course, or task.

(2) A temporary veterinary license is valid for 60 days from issuance. The 60-day period does not have to run consecutively. A temporary veterinary license may not be renewed or reissued. A person may not be issued more than two temporary veterinary licenses in a calendar year.

(c) Penalties.

(1) A person who exceeds the scope or duration of a temporary veterinary license, or who violates the Act or Board Rules while practicing under a temporary veterinary license, is subject to:

(A) disciplinary action under Occupations Code §801.401;

(B) a cease and desist order pursuant to Occupations Code §801.508;

(C) future denial of any type of license issued by the Board for which the person may otherwise be eligible;

(D) referral to any jurisdiction in which the person is currently licensed; and

(E) referral to an appropriate law enforcement agency.

(2) A Texas veterinarian who signs an application for a temporary veterinary license agreeing to provide general supervision of the applicant's practice of veterinary medicine for the duration of the temporary veterinary license is subject to discipline if the Texas veterinarian fails to provide such supervision.

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

Filed with the Office of the Secretary of State on April 5, 2021.

TRD-202101413
John Helenberg
Executive Director
Texas Board of Veterinary Medical Examiners
Earliest possible date of adoption: May 16, 2021
For further information, please call: (512) 305-7555x3

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CHAPTER 573. RULES OF PROFESSIONAL CONDUCT

SUBCHAPTER C. RESPONSIBILITIES TO CLIENTS

22 TAC §573.27

The Texas Board of Veterinary Medical Examiners (Board) proposes this amendment to §573.27, concerning honesty, integrity and fair dealing. The purpose of the proposed amendment is to ensure that the rule for honesty, integrity and fair dealing is more inclusive and reflective of the types of complaints received and adjudicated by the Board. This rule modifies existing regulations.

John Helenberg, Executive Director, has determined that for each year of the first five years that the rule is in effect, there are no anticipated increases or reductions in costs to the state and local governments as a result of enforcing or administering the rule. Mr. Helenberg has also determined that for each year of the first five years that the rule is in effect, there is no anticipated impact in revenue to state government as a result of enforcing or administering the rule.

Mr. Helenberg has also determined that for each year of the first five years the rule is in effect, the anticipated public benefit will be that potentially anti-competitive language is removed from the Board's rules and more complaints may now fall under this rule, giving the Board and public greater flexibility when investigating and adjudicating complaints.

Mr. Helenberg has determined that there are no anticipated adverse economic effects on small business, micro-businesses, or rural communities as a result of the rule. Thus, the Board is not required to prepare an economic impact statement or a regulatory flexibility analysis pursuant to §2006.002, Government Code.

According to Mr. Helenberg, for the first five years that the rule would be in effect, it is estimated that; the proposed rule would not create or eliminate a government program. Implementation of the proposed rule would not require the creation of new employee positions or the elimination of existing employee positions; implementation of the proposed rule would not require an increase or decrease in future legislative appropriations to the agency; the proposed rule would not require an increase in the fees paid to the agency; the proposed rule would not create a new regulation; the proposed rule would expand an existing regulation; the proposed rule would not increase or decrease the number of individuals subject to the rule's applicability; and the proposed rule would not positively or adversely affect the state's economy.

The Texas Board of Veterinary Medical Examiners invites comments on the proposed amendment to the rule from any interested persons, including any member of the public. A written statement should be mailed or delivered to Valerie Mitchell, Texas Board of Veterinary Medical Examiners, 333 Guadalupe, Ste. 3-810, Austin, Texas 78701-3942, by facsimile (FAX) to (512) 305-7574, or by e-mail to *Valerie.mitchell@veterinary.texas.gov.* Comments will be accepted for 30 days following publication in the *Texas Register.* **Comments must be received within 30 days after publication of this proposal in order to be considered.**

The rule is proposed under the authority of §801.151(a), Occupations Code, which states that the Board may adopt rules necessary to administer the chapter, and the authority of §801.151(b), Occupations Code, which states that the Board may adopt rules of professional conduct appropriate to establish and maintain a high standard of integrity, skills and practice in the veterinary medicine profession.

No other statutes, articles, or codes are affected by the proposal.

§573.27. Honesty, Integrity and Fair Dealing.

Licensees shall conduct their practice with honesty, integrity, and fair dealing [~~to clients in time and services rendered, and in the amount charged for services facilities, appliance and drugs~~].

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

Filed with the Office of the Secretary of State on April 5, 2021.

TRD-202101415
John Helenberg
Executive Director
Texas Board of Veterinary Medical Examiners
Earliest possible date of adoption: May 16, 2021
For further information, please call: (512) 305-7555x3

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SUBCHAPTER G. OTHER PROVISIONS

22 TAC §573.65

The Texas Board of Veterinary Medical Examiners (Board) proposes this amendment to §573.65, concerning proof of acceptable continuing education. The purpose of the proposed amendment is to allow licensees the flexibility to earn continuing education hours in whatever format they prefer, whether that be live or virtual.

John Helenberg, Executive Director, has determined that for each year of the first five years that the rule is in effect, there are no anticipated increases or reductions in costs to the state and local governments as a result of enforcing or administering the rule. Mr. Helenberg has also determined that for each year of the first five years that the rule is in effect, there is no anticipated impact in revenue to state government as a result of enforcing or administering the rule.

Mr. Helenberg has also determined that for each year of the first five years the rule is in effect, the anticipated public benefit will be that Board licensees have more flexibility to earn their required continuing education hours, requiring less time out of the office which helps increase access to veterinary services.

Mr. Helenberg has determined that there are no anticipated adverse economic effects on small business, micro-businesses, or rural communities as a result of the rule. Thus, the Board is not required to prepare an economic impact statement or a regulatory flexibility analysis pursuant to §2006.002, Government Code.

For the first five years that the rule would be in effect, it is estimated that; the proposed rule would not create or eliminate a government program; implementation of the proposed rule would not require the creation of new employee positions or the elimination of existing employee positions; implementation of the proposed rule would not require an increase or decrease in future legislative appropriations to the agency; the proposed rule would not require an increase in the fees paid to the agency; the proposed rule would not create a new regulation; the proposed rule would not expand, limit, or repeal an existing regulation; the proposed rule would not increase or decrease the number of individuals subject to the rule's applicability; and the proposed rule would not positively or adversely affect the state's economy.

The Texas Board of Veterinary Medical Examiners invites comments on the proposed amendment to the rule from any interested persons, including any member of the public. A written statement should be mailed or delivered to Valerie Mitchell, Texas Board of Veterinary Medical Examiners, 333 Guadalupe, Ste. 3-810, Austin, Texas 78701-3942, by facsimile (FAX) to (512) 305-7574, or by e-mail to *Valerie.mitchell@veterinary.texas.gov.* Comments will be accepted for 30 days following publication in the *Texas Register.* **Comments must be received within 30 days after publication of this proposal in order to be considered.**

The rule is proposed under the authority of §801.151(a), Occupations Code, which states that the Board may adopt rules necessary to administer the chapter, and the authority of §801.151(b), Occupations Code, which states that the Board may adopt rules of professional conduct appropriate to establish and maintain a high standard of integrity, skills and practice in the veterinary medicine profession.

No other statutes, articles, or codes are affected by the proposal.

§573.65. Proof of Acceptable Continuing Education.

(a) (No change.)

(b) Distribution of Continuing Education Hours.

(1) Veterinary Licensees.

(A) Of the required seventeen (17) hours of continuing education for veterinary licensees, no more than five (5) hours may be derived from either:

(i) correspondence courses; or

(ii) practice management courses.

(B) Hours claimed for self study shall not exceed three (3) hours.

~~[(C) Hours claimed for online interactive, participatory programs shall not exceed 10 hours.]~~

~~[(D) Notwithstanding the allowable hours provided in subparagraphs (A) - (C) of this paragraph, at least seven (7) hours must be obtained from personal attendance at live courses, seminars and meetings providing continuing education.]~~

(2) Equine Dental Provider Licensees.

(A) None of the required six (6) hours of continuing education for equine dental provider licensees may be derived from either correspondence courses or practice management courses.

(B) Hours claimed from self study shall not exceed one (1) hour.

~~[(C) Hours claimed from online interactive, participatory programs shall not exceed two (2) hours.]~~

~~[(D) Notwithstanding the allowable hours provided in subparagraphs (A) - (C) of this paragraph, at least four (4) hours must be obtained from personal attendance at live courses and seminars providing continuing education.]~~

(3) Licensed Veterinary Technicians.

(A) Licensed veterinary technicians are required to complete ten (10) hours of continuing education annually. Of the required ten (10) hours, no more than two (2) hours of continuing education for licensed veterinary technicians may be derived from practice management.

(B) No more than four (4) hours of continuing education for licensed veterinary technicians may be derived from correspondence courses.

(C) Hours claimed from self study shall not exceed two (2) hours.

[(D) Hours claimed from online interactive, participatory programs shall not exceed four (4) hours.]

[(E) Notwithstanding the allowable hours provided in subparagraphs (A) - (D) of this paragraph, at least six (6) hours must be obtained from personal attendance at live courses and seminars providing continuing education.]

(c) (No change.)

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

Filed with the Office of the Secretary of State on April 5, 2021.

TRD-202101414
John Helenberg
Executive Director
Texas Board of Veterinary Medical Examiners
Earliest possible date of adoption: May 16, 2021
For further information, please call: (512) 305-7555x3

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TITLE 28. INSURANCE

PART 1. TEXAS DEPARTMENT OF INSURANCE

CHAPTER 5. PROPERTY AND CASUALTY INSURANCE

SUBCHAPTER B. INSURANCE CODE, CHAPTER 5, SUBCHAPTER B

DIVISION 2. REGULATION OF EXCESS LIABILITY INSURANCE

28 TAC §5.1201

INTRODUCTION. The Texas Department of Insurance (TDI) proposes to repeal Division 2 of 28 TAC Chapter 5, consisting of §5.1201, concerning the regulation of umbrella liability insurance. The repeal is necessary because Senate Bill 14, 78th Legislature, 2003, made the requirements in §5.1201 obsolete, and §5.1201 is the only section in Division 2.

EXPLANATION. Section 5.1201 was adopted to ensure that umbrella liability insurance requirements aligned with promulgated forms. However, under changes made to the Insurance Code by SB 14, insurers are no longer restricted to promulgated forms for the underlying policies. Therefore, it is not necessary to have a rule that aligns the requirements for umbrella policies with promulgated forms.

In addition, §5.1201 requires each insurer writing personal or commercial umbrella liability insurance to file rates and rules on a prior-approval basis, and file policy forms and statistical data. However, SB 14 repealed the prior-approval requirements in Insurance Code art. 5.15, which applied to personal umbrella liability insurance, and it also repealed Insurance Code art. 5.13-2, which applied to commercial liability insurance. Currently, rates and rules for both types of umbrella liability insurance must be filed under Insurance Code §2251.101, policy forms must be filed under Insurance Code §2301.006, and statistical data must be filed under Insurance Code §38.205. Considering these statutory requirements, the provisions in §5.1201 addressing this are no longer necessary.

As a result, TDI proposes to repeal §5.1201. Because this section is the only one in Division 2, TDI also proposes the repeal of the entire division.

FISCAL NOTE AND LOCAL EMPLOYMENT IMPACT STATEMENT. Marianne Baker, director, Property and Casualty Lines Office, has determined that during each year of the first five years the proposed repeal is in effect, there will be no measurable fiscal impact on state and local governments as a result of enforcing or administering the section. Ms. Baker made this determination because the proposed amendments do not add to or decrease state revenues or expenditures, and because local governments are not involved in enforcing or complying with the proposed amendments.

Ms. Baker does not anticipate any measurable effect on local employment or the local economy because of this proposal.

PUBLIC BENEFIT AND COST NOTE. For each year of the first five years the proposed repeal is in effect, Ms. Baker expects that the proposed repeal will have the public benefits of eliminating an obsolete regulation and ensuring that TDI's rules conform to Insurance Code Chapters 2251 and 2301.

Ms. Baker expects that the proposed repeal will not increase the cost of compliance for insurers because the repeal does not create or impose any requirements and reduces regulatory burdens on insurers.

ECONOMIC IMPACT STATEMENT AND REGULATORY FLEXIBILITY ANALYSIS. TDI has determined that the proposed repeal will not have an adverse economic effect on small, micro businesses, or on rural communities. There are no additional costs as a result of this proposal because it only repeals an existing regulation. As a result, and in accordance with Government Code §2006.002(c), TDI is not required to prepare a regulatory flexibility analysis.

EXAMINATION OF COSTS UNDER GOVERNMENT CODE §2001.0045. TDI has determined that this proposal does not impose a possible cost on regulated persons. This proposal repeals an existing regulation, eliminating requirements on insurers.

GOVERNMENT GROWTH IMPACT STATEMENT. TDI has determined that for each year of the first five years that the proposed repeal is in effect, the proposal:

- will not create or eliminate a government program;

- will not require the creation of new employee positions or the elimination of existing employee positions;

- will not require an increase or decrease in future legislative appropriations to the agency;

- will not require an increase or decrease in fees paid to the agency;

- will not create a new regulation;

- will repeal an existing regulation;

- will decrease the number of individuals subject to the rule's applicability; and

- will positively affect the Texas economy.

TAKINGS IMPACT ASSESSMENT. TDI has determined that no private real property interests are affected by this proposal and

that this proposal does not restrict or limit an owner's right to property that would otherwise exist in the absence of government action. As a result, this proposal does not constitute a taking or require a takings impact assessment under Government Code §2007.043.

REQUEST FOR PUBLIC COMMENT. TDI will consider any written comments on the proposal that are received by TDI no later than 5:00 p.m., central time, on May 17, 2021. Send your comments to *ChiefClerk@tdi.texas.gov* or to the Office of the Chief Clerk, MC GC-CCO, Texas Department of Insurance, P.O. Box 12030, Austin, Texas 78711-2030.

To request a public hearing on the proposal, submit a request before the end of the comment period to *ChiefClerk@tdi.texas.gov* or to the Office of the Chief Clerk, MC GC-CCO, Texas Department of Insurance, P.O. Box 12030, Austin, Texas 78711-2030. The request for public hearing must be separate from any comments and received by TDI no later than 5:00 p.m., central time, on May 17, 2021. If a public hearing is held, TDI will consider comments presented at the hearing.

STATUTORY AUTHORITY. TDI proposes the repeal of 28 TAC §5.1201 under Insurance Code §§2251.003, 2301.003, and 36.001.

Insurance Code §2251.003, which provides that Insurance Code Chapter 2251, Subchapters B, C, and D, concerning Rate Standards, Rate Filings, and Prior Approval of Rates Under Certain Circumstances, applies to personal umbrella insurance and general liability insurance, which includes commercial umbrella insurance.

Insurance Code §2301.003, which provides that Insurance Code Chapter 2301, Subchapter A, concerning Policy Forms Generally, applies to personal umbrella insurance and general liability insurance, which includes commercial umbrella insurance.

Insurance Code §36.001 provides that the Commissioner may adopt any rules necessary and appropriate to implement the powers and duties of TDI under the Insurance Code and other laws of this state.

CROSS-REFERENCE TO STATUTE. The proposed repeal of Division 2 and §5.1201 implements SB 14, 78th Legislature, 2003, and affects Insurance Code Chapters 2251 and 2301.

§5.1201. Regulation of Umbrella Liability Insurance.

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

Filed with the Office of the Secretary of State on April 5, 2021.

TRD-202101424
James Person
General Counsel
Texas Department of Insurance
Earliest possible date of adoption: May 16, 2021
For further information, please call: (512) 676-6584

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TITLE 34. PUBLIC FINANCE

PART 1. COMPTROLLER OF PUBLIC ACCOUNTS

CHAPTER 3. TAX ADMINISTRATION
SUBCHAPTER O. STATE AND LOCAL SALES AND USE TAXES

34 TAC §3.340

The Comptroller of Public Accounts proposes amendments to §3.340, concerning qualified research. The comptroller amends this section to provide guidance regarding the research and development sales tax exemption.

Throughout the section, the comptroller adds titles to statutory citations and makes minor revisions to improve readability.

The comptroller adds a new subsection (a)(1) to define the term "business component." The comptroller bases this term on IRC §41 (d)(2)(B) (Business component defined), with non-substantive changes. The comptroller renumbers subsequent paragraphs.

The comptroller amends the definition of "combined group" in renumbered subsection (a)(2) to remove unnecessary information and to add a cross-reference to §3.590 of this title (relating to Combined Reporting).

The comptroller adds new subsection (a)(4) to define the term "Four-Part Test." The comptroller derives this term from IRC, §41(d) (Qualified research defined) and the regulations applicable to that section.

The comptroller amends the definition of "Internal Revenue Code (IRC)" in renumbered paragraph (6) to explain that a regulation adopted after December 31, 2011 must require a taxpayer to apply that regulation to the 2011 federal income tax year to be included in this definition. The definition for IRC in Tax Code, §151.3182 (a)(2) (Certain Property Used in Research and Development Activities; Reporting of Estimates and Evaluation) incorporates by reference Tax Code, §171.651 (Definitions). The definition of IRC in Tax Code, §171.651 (1) states: "'Internal Revenue Code' means the Internal Revenue Code of 1986 in effect on December 31, 2011, excluding any changes made by federal law after that date, but including any regulations adopted under that code applicable to the tax year to which the provisions of the code in effect on that date applied."

The current version of Treasury Regulation, §1.41-4 (Qualified research for expenditures paid or incurred in taxable years ending on or after Dec. 31, 2003), adopted on November 3, 2016, is an example of a regulation that does not fully apply to the 2011 federal income tax year. With respect to its applicability, Treasury Regulation, §1.41-4 (e) provides: "Other than paragraph (c)(6) of this section, this section is applicable for taxable years ending on or after December 31, 2003. Subsection (c)(6) of this section is applicable for taxable years beginning on or after October 4, 2016. For any taxable year that both ends on or after January 20, 2015 and begins before October 4, 2016, the IRS will not challenge return positions consistent with all of paragraph (c)(6) of this section or all of paragraph (c)(6) of this section as contained in the Internal Revenue Bulletin (IRB) 2015-5 (see www.irs.gov/pub/irs-irbs/irb15-05.pdf). For taxable years ending before January 20, 2015, taxpayers may choose to follow either all of §1.41-4(c)(6) as contained in 26 CFR part 1 (revised as of April 1, 2003) and IRB 2001-5 (see www.irs.gov/pub/irs-irbs/irb01-05.pdf) or all of §1.41-4(c)(6) as contained in IRB 2002-4 (see www.irs.gov/pub/irs-irbs/irb02-04.pdf)." The first sentence quoted above shows that, other than paragraph (c)(6), the cur-

rent version of Treasury Regulation, §1.41-4 applies to the 2011 federal income tax year. With respect to paragraph (c)(6), the third sentence quoted above shows that the current language in Treasury Regulation §1.41-4 (c)(6) does not apply to the 2011 federal income tax year. The fourth sentence quoted above allows taxpayers to choose one of two proposed regulations described in the Internal Revenue Bulletins incorporated by reference. The proposed regulations referenced in those Internal Revenue Bulletins were finalized prior to the 2011 federal income tax year. Although the federal regulations allow taxpayers to choose whether they follow this prior IRS guidance, the options are not included in the term "Internal Revenue Code" because Treasury Regulation, §1.41-4 (e) does not require taxpayers to follow either of those options.

Another example of a regulation that does not apply to the 2011 federal income tax year is Treasury Regulation 1.174-2 (Definition of research and experimental expenditures), adopted July 21, 2014. With respect to its applicability, Treasury Regulation, §1.174-2 (d) provides: "The eighth and ninth sentences of §1.174-2(a)(1); §1.174-2(a)(2); §1.174-2(a)(4); §1.174-2(a)(5); §1.174-2(a)(11) Example 3 through Example 10; §1.174-2(b)(4); and §1.174-2(b)(5) apply to taxable years ending on or after July 21, 2014. Taxpayers may apply the provisions enumerated in the preceding sentence to taxable years for which the limitations for assessment of tax has not expired." While the federal statute of limitations for the assessment of tax for the 2011 federal income tax year had not expired at the time this regulation was adopted, the provisions enumerated in this applicability provision are not included in the term "Internal Revenue Code" because the regulation does not require taxpayers to apply those provisions to the 2011 federal income tax year.

The comptroller amends the definition of "qualified research" in renumbered paragraph (7) to explain that qualified research must be research conducted in Texas and that qualified research must satisfy the Four-Part Test. The comptroller also deletes subparagraphs (A) and (B). The information currently found in these subparagraphs is included in the expanded discussion in new subsections (c) and (d) regarding the Four-Part Test and the exclusions from qualified research.

The comptroller amends subsection (b) to add paragraphs (4) through (7). The comptroller adds paragraphs (4) and (5) to explain the requirement that property must be subject to depreciation in order to be eligible for the exemption. Paragraph (4) explains that the property qualifies for the exemption even if taxpayers do not actually depreciate the property. Paragraph (5) explains that property does not qualify for the exemption if it is not subject to depreciation in the form in which it was purchased, even if it is later used to create property that is subject to depreciation. Paragraph (5) contains an example illustrating this point. The comptroller adds paragraph (6) to explain that the taxpayer has the burden of proof to establish its entitlement to the exemption by clear and convincing evidence and that qualified research activities must be supported by contemporaneous business records. The comptroller adds paragraph (7) to explain that any determination by the IRS that a taxpayer is entitled to the federal research and development credit does not bind the comptroller when determining a taxpayer's eligibility for the exemption.

The comptroller adds new subsections (c) and (d) and reletters subsequent subsections.

In new subsection (c), the comptroller discusses the application of the Four-Part Test to explain the basic requirements for research activities to be qualified research. The comptroller bases this subsection primarily on IRC, §41(d) and Treasury Regulation, §1.41-4.

In paragraph (1), the comptroller describes the four individual components of the Four-Part Test: subparagraph (A) describes the Section 174 Test; subparagraph (B) describes the Discovering Technological Information Test; subparagraph (C) describes the Business Component Test; and subparagraph (D) describes the Process of Experimentation Test. In subparagraph (D), the comptroller provides several examples illustrating the Process of Experimentation Test.

In new paragraph (2), the comptroller explains that the Four-Part Test applies separately to each business component of the taxpayer.

In new paragraph (3), the comptroller explains that, if the whole business component does not meet the requirements of the Four-Part Test, the taxpayer may then shrink back the business component to the next most significant subset of elements of the business component. This process continues until the Four-Part Test is satisfied, or the most basic element of the product fails the Four-Part Test.

In new paragraph (4), the comptroller explains how the Four-Part Test applies to software development activities. The comptroller also identifies a list of software development activities that are likely to be qualified research and a list of software development activities that are unlikely to be qualified research. The explanation and lists in this paragraph are adapted from the Internal Revenue Service's Audit Guidelines on the Application of Process of Experimentation for all Software.

In new subsection (d), the comptroller lists activities that do not constitute qualified research. This list is based on IRC, §41(d)(4) and Treasury Regulation, §1.41-4(c) (Excluded activities). The discussion of the funded research exclusion is also based on Treasury Regulation, §1.41-4A(d) (Qualified research for taxable years beginning before January 1, 1986). This subsection contains examples for the research after commercial production exclusion and the adaptation of existing business components exclusion.

The comptroller amends relettered subsection (e). In paragraph (5), the comptroller replaces the word "will" with the word "may" to better reflect current comptroller practice concerning cancellation of a sales and use tax registration number before claiming a franchise tax research and development credit. In paragraph (6) the comptroller explains the effective date of cancellation for a registrant whose registration number is cancelled because of a failure to file an annual information report.

The comptroller amends relettered subsection (g), related to divergent use, to explain that divergent use applies to any item that the taxpayer uses for any purpose other than for use in qualified research, whether that use occurs before, during, or after the time when the taxpayer uses the item in qualified research.

Tom Currah, Chief Revenue Estimator, has determined that during the first five years that the proposed amendment is in effect, the amendment: will not create or eliminate a government program; will not require the creation or elimination of employee positions; will not require an increase or decrease in future legislative appropriations to the agency; will not require an increase or decrease in fees paid to the agency; will not increase or decrease the number of individuals subject to the rules' applicabil-

ity; and will not positively or adversely affect this state's economy. This proposal amends a current rule.

Mr. Currah also has determined that for each year of the first five years the rule is in effect, proposed amendment would benefit the public by improving the clarity and implementation of the section. This rule is proposed under Tax Code, Title 2, and does not require a statement of fiscal implications for small businesses. The proposed amendment would have no significant fiscal impact on the state government, units of local government, or individuals. There would be no significant anticipated economic costs to the public.

Comments on the proposal may be submitted to Teresa G. Bostick, Director, Tax Policy Division, P.O. Box 13528, Austin, Texas 78711-3528. Comments must be received no later than 30 days from the date of publication of the proposal in the *Texas Register.*

The amendments are proposed under Tax Code, §111.002 (Comptroller's Rules; Compliance; Forfeiture), which provides the comptroller with the authority to prescribe, adopt, and enforce rules relating to the administration and enforcement of the provisions of Tax Code, Title 2 (State Taxation).

The amendments implement Tax Code, §151.3182.

§3.340. Qualified Research.

(a) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

(1) Business component--A business component is any product, process, computer software, technique, formula, or invention, which is to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer.

(2) [~~(1)~~] Combined group--Taxable entities that are part of an affiliated group engaged in a unitary business and that are required to file a combined group report under Tax Code, §171.1014 (Combined Reporting; Affiliated Group Engaged in Unitary Business). For more information about combined groups, see §3.590 of this title (relating to Margin: Combined Reporting).

[~~(A) A combined group may not include a taxable entity that conducts business outside the United States if 80% or more of the taxable entity's property and payroll are assigned to locations outside the United States. If either the property factor or payroll factor is zero, the denominator is one. For example, if Corporation Z has no property, but does have payroll located entirely outside the United States, Corporation Z will not be included in the combined group. The combined group may not include a taxable entity that conducts business outside the United States and has no property or payroll if 80% or more of the taxable entity's gross receipts are assigned to locations outside the United States. See Tax Code, §171.1014.~~]

[~~(B) A combined group may not include an exempt entity.~~]

[~~(C) A combined group must include eligible entities even if those entities do not have nexus as described in §3.586 of this title (relating to Margin: Nexus).~~]

[~~(D) Eligible pass-through entities including partnerships, limited liability companies taxed as partnerships under federal law, limited liability companies that are disregarded under federal law and S corporations are included in a combined group.~~]

[~~(E) Passive entities are not included in the combined group; however, the pro rata share of net income from a passive entity shall be included in total revenue to the extent it was not generated by the margin of another taxable entity.~~]

(3) [~~(2)~~] Directly used in qualified research--Having an immediate use in qualified research activity, without an intervening or ancillary use.

(4) Four-Part Test--Four tests described in IRC, §41(d) (Qualified research defined) that determine whether research activities are qualified research. The four tests are the Section 174 Test, the Discovering Technological Information Test, the Business Component Test, and the Process of Experimentation Test.

(5) [~~(3)~~] Franchise tax research and development activities credit--A credit against franchise tax for qualified research activities that is allowed under Tax Code, Chapter 171, Subchapter M (Tax Credit for Certain Research and Development Activities).

(6) [~~(4)~~] Internal Revenue Code (IRC)--The Internal Revenue Code of 1986 in effect on December 31, 2011, excluding any changes made by federal law after that date, but including any regulations adopted under the code applicable to the tax year to which the provisions of the code in effect on that date applied. A regulation adopted after December 31, 2011 is only included in this term to the extent that the regulation requires a taxpayer to apply the regulation to the 2011 federal income tax year.

(7) [~~(5)~~] Qualified research--This term has the meaning given in IRC [~~Internal Revenue Code~~], §41(d), except that the research must be conducted in Texas. Qualified research activities must satisfy each part of the Four-Part Test.

[~~(A) Qualified research means research undertaken for discovering information that is technological in nature, and its application must be intended for use in developing a new or improved business component of the person undertaking the research. Substantially all of the activities of the research must be elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality.~~]

[~~(B) Qualified research does not include the following activities:~~]

~~*(i)* research related to style, taste, cosmetic or seasonal design factors;~~]

~~*(ii)* research conducted after the beginning of commercial production of the business component;~~]

~~*(iii)* research adapting an existing product or process to a particular customer's need;~~]

~~*(iv)* duplication of an existing product or process;~~]

~~*(v)* surveys or studies;~~]

~~*(vi)* research relating to certain internal-use computer software;~~]

~~*(vii)* research conducted outside the United States, Puerto Rico, or a U.S. possession;~~]

~~*(viii)* research in the social sciences, arts, or humanities; or~~]

~~*(ix)* research funded by another person or governmental entity.~~]

(8) [~~(6)~~] Registrant--A taxpayer [~~person~~] who holds a Texas Qualified Research Registration Number issued by the comptroller.

(9) [~~(7)~~] Registration number--The Texas Qualified Research Registration Number issued by the comptroller to a taxpayer [~~person~~] who submits the Texas Registration for Qualified Research and Development Sales Tax Exemption form.

(10) [~~(8)~~] Taxable entity--This term has the meaning given by Tax Code, §171.0002 (Definition of Taxable Entity).

(b) Depreciable tangible personal property used in qualified research.

(1) Subject to paragraph (2) of this subsection, the sale, storage, or use of tangible personal property is exempt from Texas sales and use tax if the property:

(A) has a useful life that exceeds one year;

(B) is subject to depreciation under:

(i) generally accepted accounting principles; or

(ii) IRC [~~Internal Revenue Code~~], §167 (Depreciation) or §168 (Accelerated cost recovery system) [~~of 1986, in effect on December 31, 2011~~]; and

(C) is sold, leased, rented to, stored, or used [~~or stored~~]by a taxpayer [~~person~~] engaged in qualified research; and

(D) is directly used in qualified research. Depreciable tangible personal property is directly used in qualified research if it is used in the actual performance of activities that are part of the qualified research. For example, machinery, equipment, computers, software, tools, laboratory furniture such as desks, laboratory tables, stools, benches, and storage cabinets, and other tangible personal property used by personnel in the process of experimentation are directly used in qualified research. Tangible personal property is not directly used in qualified research if it is used in ancillary or support activities such as administration, maintenance, marketing, distribution, or transportation activities, or if it is used in activities excluded from qualified research. For example, machinery and equipment used by administrative, accounting, or clerical personnel are not directly used in qualified research.

(2) A taxpayer [~~person~~] may not claim the exemption if that taxpayer [~~person~~] will, as a taxable entity or as a member of a combined group, claim a franchise tax research and development activities credit on a franchise tax report based on the accounting period during which the depreciable tangible personal property used in qualified research would first be subject to Texas sales or use tax.

(3) A claim for a carryforward of an unused franchise tax research and development activities credit under Tax Code, §171.659 (Carryforward) does not affect a taxpayer's [~~person's~~] ability, as a taxable entity or as a member of a combined group, to claim the sales and use tax exemption provided by paragraph (1) of this subsection.

(4) Property satisfies paragraph (1)(B) of this subsection if it is subject to depreciation under generally accepted accounting principles, IRC, §167, or IRC, §168 even if the taxpayer does not actually depreciate that property.

(5) Property satisfies paragraph (1) of this subsection only if it is tangible personal property subject to depreciation at the time a taxpayer purchases it. For example, assume a taxpayer purchases tangible personal property that is not subject to depreciation. The taxpayer later incorporates that property into real property that is subject to depreciation. Although the real property with the incorporated tangible personal property is subject to depreciation, the tangible personal property, on its own, was never subject to depreciation. The tangible personal property does not satisfy paragraph (1) of this subsection because it was never subject to depreciation as tangible personal property.

(6) A taxpayer has the burden of establishing its entitlement to the exemption by clear and convincing evidence, including proof that the research activities meet the definition of qualified research and applying the shrink-back rule described in subsection (c)(3) of this section. All qualified research activities must be supported by contemporaneous business records.

(7) An Internal Revenue Service audit determination of eligibility for the federal research and development credit under IRC, §41 (Credit for increasing research activities), whether that determination is that the taxpayer qualifies or does not qualify for the federal research and development credit, is not binding on the comptroller's determination of eligibility for the exemption.

(c) Application of the Four-Part Test. Research activities must satisfy each part of the Four-Part Test, as described in paragraph (1) of this subsection, to be qualified research.

(1) Four-Part Test.

(A) Section 174 Test. Expenditures related to the research must be eligible to be treated as expenses under IRC, §174 (Research and experimental expenditures).

(i) Expenditures are eligible to be treated as expenses under IRC, §174, if the expenditures are incurred in connection with the taxpayer's trade or business and represent a research and development cost in the experimental or laboratory sense. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.

(ii) For the purposes of this test, the term "product" includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

(iii) Expenditures for the following are not eligible to be treated as expenses under IRC, §174:

(I) land;

(II) depreciable property;

(III) the ordinary testing or inspection of materials or products for quality control;

(IV) efficiency surveys;

(V) management studies;

(VI) consumer surveys;

(VII) advertising or promotions;

(VIII) the acquisition of another's patent, model, production, or process; or

(IX) research in connection with literary, historical, or similar projects.

(iv) Although expenditures for depreciable property are not eligible to be treated as expenditures under IRC, §174, those expenditures qualify for the purposes of the sales tax research and development exemption, provided that the research activities otherwise satisfy the Four-Part Test and are not excluded under subsection (d) of this section.

(B) Discovering Technological Information Test. The research must be undertaken for the purpose of discovering information that is technological in nature.

(i) Research is undertaken for the purpose of discovering technological information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.

(ii) In order to satisfy the requirement that the research is technological in nature, the process of experimentation used to discover information must fundamentally rely on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement.

(iii) A determination that research is undertaken for the purpose of discovering information that is technological in nature does not require that the taxpayer:

(I) seek to obtain information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research; or

(II) succeed in developing a new or improved business component.

(C) Business Component Test. The application of the technological information for which the research is undertaken must be intended to be useful in the development of a new or improved business component of the taxpayer, which may include any product, process, computer software, technique, formula, or invention that is to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer.

(i) If a taxpayer provides a service to a customer, the service provided to that customer is not a business component because a service is not a product, process, computer software, technique, formula, or invention. However, a product, process, computer software, technique, formula, or invention used by a taxpayer to provide services to its customers may be a business component.

(ii) A design is not a business component because a design is not a product, process, computer software, technique, formula, or invention. While uncertainty as to the appropriate design of a business component is a qualifying uncertainty for the Section 174 Test and the Discovering Technological information test, the design itself is not a business component. For example, the design of a structure is not a business component, although the structure itself may be a business component. Similarly, a blueprint or other plan used to construct a structure that embodies a design is not a business component.

(D) Process of Experimentation Test. Substantially all of the research activities must constitute elements of a process of experimentation for a qualified purpose. A process of experimentation is undertaken for a qualified purpose if it relates to a new or improved function, performance, reliability, or quality of a business component. Any research relating to style, taste, cosmetic, or seasonal design factors does not satisfy the Process of Experimentation Test.

(i) A process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities.

(ii) A process of experimentation must:

(I) be an evaluative process and generally should be capable of evaluating more than one alternative; and

(II) fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and involve:

(-a-) the identification of uncertainty concerning the development or improvement of a business component;

(-b-) the identification of one or more alternatives intended to eliminate that uncertainty; and

(-c-) the identification and the conduct of a process of evaluating the alternatives through, for example, modeling, simulation, or a systematic trial and error methodology.

(iii) A taxpayer may undertake a process of experimentation if there is no uncertainty concerning the taxpayer's capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayer's research activities. Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.

(iv) The substantially all requirement of this subparagraph is satisfied only if 80% or more of a taxpayer's research activities, measured on a cost or other consistently applied reasonable basis constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability, or quality. The substantially all requirement is satisfied even if the remainder of a taxpayer's research activities with respect to the business component do not constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability, or quality.

(v) Non-experimental methods, such as simple trial and error, brainstorming, or reverse engineering, are not considered a process of experimentation.

(vi) Factors considered in determining whether a trial and error methodology is experimental systematic trial and error or non-experimental simple trial and error include, but are not limited to:

(I) whether the person conducting the trial and error methodology stops testing alternatives once a single acceptable result is found or continues to find multiple acceptable results for comparison;

(II) whether all the results of the trial and error methodology are recorded for evaluation;

(III) whether there is a written procedure for conducting the trial and error methodology; and

(IV) whether there is a written procedure for evaluating the results of the trial and error methodology.

(vii) Examples.

(I) Example 1. A taxpayer is engaged in the business of developing and manufacturing widgets. The taxpayer wants to change the color of its blue widget to green. The taxpayer obtains several different shades of green paint from various suppliers. The taxpayer paints several sample widgets, and surveys its customers to determine which shade of green its customers prefer. The taxpayer's activities to change the color of its blue widget to green do not satisfy the Process of Experimentation Test because its activities are not undertaken for a qualified purpose. All of the taxpayer's research activities are related to style, taste, cosmetic, or seasonal design factors.

(II) Example 2. The taxpayer in Example 1 chooses one of the green paints. The taxpayer obtains samples of the green paint from a supplier and determines that it must modify its painting process to accommodate the green paint because the green paint has different characteristics from other paints it has used. The taxpayer obtains detailed data on the green paint from its paint supplier. The taxpayer also consults with the manufacturer of its paint spraying machines. The manufacturer informs the taxpayer that it must acquire new nozzles that operate with the green paint it wants to use because the current nozzles do not work with the green paint. The taxpayer tests the new nozzles, using the green paint, to ensure that they work as specified by the manufacturer of the paint spraying machines. The taxpayer's activities to modify its painting process are not qualified research. The taxpayer did not conduct a process of evaluating alternatives in order to eliminate uncertainty regarding the modification of its painting process. Rather, the manufacturer of the paint machines eliminated the taxpayer's uncertainty regarding the modification of its painting process. The taxpayer's activities to test the nozzles to determine if the nozzles work as specified by the manufacturer of the paint spraying machines are in the nature of routine or ordinary testing or inspection for quality control.

(III) Example 3. A taxpayer is engaged in the business of manufacturing food products and currently manufactures a large-shred version of a product. The taxpayer seeks to modify its current production line to permit it to manufacture both a large-shred version and a fine-shred version of one of its food products. A smaller, thinner shredding blade capable of producing a fine-shred version of the food product is not commercially available. Thus, the taxpayer must develop a new shredding blade that can be fitted onto its current production line. The taxpayer is uncertain concerning the design of the new shredding blade because the material used in its existing blade breaks when machined into smaller, thinner blades. The taxpayer engages in a systematic trial and error process of analyzing various blade designs and materials to determine whether the new shredding blade must be constructed of a different material from that of its existing shredding blade and, if so, what material will best meet its functional requirements. The taxpayer's activities to modify its current production line by developing the new shredding blade satisfy the Process of Experimentation Test. Substantially all of the taxpayer's activities constitute elements of a process of experimentation because it evaluated alternatives to achieve a result where the method of achieving that result, and the appropriate design of that result, were uncertain as of the beginning of the taxpayer's research activities. The taxpayer identified uncertainties related to the development of a business component, and identified alternatives intended to eliminate these uncertainties. Furthermore, the taxpayer's process of evaluating identified alternatives was technological in nature and was undertaken to eliminate the uncertainties.

(IV) Example 4. A taxpayer is in the business of designing, developing and manufacturing automobiles. In response to government-mandated fuel economy requirements, the taxpayer seeks to update its current model vehicle and undertakes to improve aerodynamics by lowering the hood of its current model vehicle. The taxpayer determines, however, that lowering the hood changes the air flow under the hood, which changes the rate at which air enters the engine through the air intake system, which reduces the functionality of the cooling system. The taxpayer's engineers are uncertain how to design a lower hood to obtain the increased fuel economy, while maintaining the necessary air flow under the hood. The taxpayer designs, models, simulates, tests, refines, and re-tests several alternative designs for the hood and associated proposed modifications to both the air intake system and cooling system. This process enables the taxpayer to eliminate the uncertainties related to the integrated design of the hood, air intake system, and cooling system. Such activities constitute 85% of its total activities to update its current model vehicle. The taxpayer then engages in additional activities that do not involve a process of evaluating alternatives in order to eliminate uncertainties. The additional activities constitute only 15% of the taxpayer's total activities to update its current model vehicle. In this case substantially all of the taxpayer's activities constitute elements of a process of experimentation because it evaluated alternatives to achieve a result where the method of achieving that result, and the appropriate design of that result, were uncertain as of the beginning of its research activities. The taxpayer identified uncertainties related to the improvement of a business component and identified alternatives intended to eliminate these uncertainties. Furthermore, the taxpayer's process of evaluating the identified alternatives was technological in nature and was undertaken to eliminate the uncertainties. Because 85% of the taxpayer's activities to update its current model vehicle constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability, or quality, all of its activities satisfy the Process of Experimentation Test.

(V) Example 5. A taxpayer is in the business of providing building and construction services, including the construction of warehouses, strip malls, office buildings, and other commercial structures. The taxpayer is engaged to construct a structure in a part of Texas where foundation problems are common. The taxpayer's engineers were uncertain how to design the structure to ensure stability of the structure's foundation because the taxpayer had never designed a structure in a similar location. The taxpayer's engineers used their professional experience and various building codes to determine how to design the foundation based on the conditions at the construction site. The engineers chose to use piles in the foundation. The taxpayer constructed a test pile on site to confirm whether this would work in the conditions present on the construction site. This test pile would become part of the foundation of the structure regardless of whether the engineers had to redesign the additional piles required for the foundation. The taxpayer's activities in using professional experience and business codes to design the foundation did not meet the Process of Experimentation Test because the activities did not resolve technological uncertainties through an experimental process. Constructing the test pile also did not meet the Process of Experimentation Test because it was not an evaluative process.

(VI) Example 6. A taxpayer is in the business of providing building and construction services, including the construction of warehouses, strip malls, office buildings, and other commercial structures. For one of its projects to construct an office building, the taxpayer was uncertain how to design the layout of the electrical systems. The taxpayer's employees held on-site meetings to discuss different options, such as running the wire under the floor or through the ceiling, but did not actually experiment by installing wire in different locations. The taxpayer did use computer-aided simulation and modeling to produce the final electrical system layout, but, in this case, such use was not an experimental process. The taxpayer's activities did not satisfy the Process of Experimentation Test because it did not conduct an experimental process of evaluating alternatives to eliminate a technological uncertainty.

(VII) Example 7. A taxpayer is an oil and gas operator that recently acquired rights to drill in an area in which it had not previously operated. The taxpayer decided to use horizontal drilling in this area, but it had never drilled a horizontal well and was uncertain how to successfully execute the horizontal drilling. At the time the taxpayer began horizontal drilling, the technology to drill horizontal wells was established. The taxpayer selected technology from existing commercially available options to use in its horizontal drilling program. The taxpayer's activities did not satisfy the Process of Experimentation Test because evaluating commercially available options does not constitute a process of experimentation.

(VIII) Example 8. A taxpayer is an oil and gas operator that recently acquired rights to drill in an area in which it had not previously operated. The taxpayer decided to use horizontal drilling in this area. The taxpayer had drilled a horizontal well before in a different formation and at different depths. However, it had never drilled a horizontal well in this formation or at the required depths and was uncertain how to successfully execute the horizontal drilling. The taxpayer utilized its existing technology to perform its horizontal drilling operations in this area and the existing technology was successful. The taxpayer's activities did not satisfy the Process of Experimentation Test because the taxpayer did not evaluate alternative any drilling methods.

(IX) Example 9. A taxpayer sought to discover novel cancer immunotherapies. The taxpayer was uncertain as to the appropriate design of the proteins to be used as a drug candidate. The taxpayer identified several alternative protein constructs and used a process to test them. The taxpayer's process involved testing the constructs using in vitro functional assays and binding assays, and either modifying the designs or discarding them and repeating the previous steps. The taxpayer took the resulting products from the in vitro testing and tested the drug candidate in living organisms. This process evaluated the various alternatives identified by the taxpayer. The taxpayer's activities satisfied the Process of Experimentation Test.

(2) Application of the Four-Part Test to business components. The Four-Part Test is applied separately to each business component of the taxpayer. Any plant process, machinery, or technique for commercial production of a business component is treated as a separate business component from the business component being produced.

(3) Shrink-back rule. The Four-Part Test is first applied at the level of the discrete business component used by the taxpayer in a trade or business of the taxpayer. If the requirements of the Four-Part Test are not met at that level, then they are applied at the next most significant subset of elements of the business component. This shrinking back of the product continues until either a subset of elements of the product that satisfies the requirements of the Four-Part Test is reached, or the most basic element of the product is reached and such element fails to satisfy any part of the Four-Part Test.

(4) Software development as qualified research. In determining if software development activities constitute qualified research, the comptroller shall consider the facts and circumstances of each activity.

(A) Application of Four-Part Test to software development activities.

(i) A taxpayer must prove that a software development activity is qualified research and meets all the requirements of the Four-Part Test under paragraph (1) of this subsection, even if the activity is likely to qualify as described in subparagraph (B) of this paragraph.

(ii) A taxpayer may prove that a software development activity described as unlikely to qualify in subparagraph (C) of this paragraph, is qualified research by providing evidence that the activity meets all the requirements of the Four-Part Test under paragraph (1) of this subsection.

(B) Software development activities likely to qualify. Types of activities likely to qualify include, but are not limited to:

(i) developing the initial release of an application software product that includes new constructs, such as new architectures, new algorithms, or new database management techniques;

(ii) developing system software, such as operating systems and compilers;

(iii) developing specialized technologies, such as image processing, artificial intelligence, or speech recognition; and

(iv) developing software as part of a hardware product where the software interacts directly with that hardware in order to make the hardware/software package function as a unit.

(C) Software development activities unlikely to qualify. Types of activities unlikely to qualify include, but are not limited to:

(i) maintaining existing software applications or products;

(ii) configuring purchased software applications;

(iii) reverse engineering of existing applications;

(iv) performing studies, or similar activities, to select vendor products;

(v) detecting flaws and bugs directed toward the verification and validation that the software was programmed as intended and works correctly;

(vi) modifying an existing software business component to make use of new or existing standards or devices, or to be compliant with another vendor's product or platform;

(vii) developing a business component that is substantially similar in technology, functionality, and features to the capabilities already in existence at other companies;

(viii) upgrading to newer versions of hardware or software or installing vendor-fix releases;

(ix) re-hosting or porting an application to a new hardware such as from mainframe to PC, or software platform, such as Windows to UNIX, or rewriting an existing application in a new language, such as rewriting a COBOL mainframe application in C++;

(x) writing hardware device drivers to support new hardware, such as disks, scanners, printers, or modems;

(xi) performing data quality, data cleansing, and data consistency activities, such as designing and implementing software to validate data fields, clean data fields, or make the data fields consistent across databases and applications;

(xii) bundling existing individual software products into product suites, such as combining existing word processor, spreadsheet, and slide presentation software applications into a single suite;

(xiii) expanding product lines by purchasing other products;

(xiv) developing interfaces between different software applications;

(xv) developing vendor product extensions;

(xvi) designing graphic user interfaces;

(xvii) developing functional enhancements to existing software applications/products;

(xviii) developing software as an embedded application, such as in cell phones, automobiles, and airplanes;

(xix) developing software utility programs, such as debuggers, backup systems, performance analyzers, and data recovery;

(xx) changing from a product based on one technology to a product based on a different or newer technology; and

(xxi) adapting and commercializing technology developed by a consortium or open software group.

(d) Excluded research activities. Qualified research does not include the activities described in this subsection.

(1) Research after commercial production. Any research conducted after the beginning of commercial production of the business component.

(A) Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use or meets the basic functional and economic requirements of the taxpayer for the component's sale or use.

(B) The following activities are deemed to occur after the beginning of commercial production of a business component:

(i) preproduction planning for a finished business component;

(ii) tooling-up for production;

(iii) trial production runs;

(iv) troubleshooting involving detecting faults in production equipment or processes;

(v) accumulating data relating to production processes;

(vi) debugging flaws in a business component; and

(vii) any activities that involve the use of an item for which the taxpayer claimed the manufacturing exemption under Tax Code, §151.318.

(C) In cases involving development of both a product and a manufacturing or other commercial production process for the product, the research after commercial production exclusion applies separately for the activities relating to the development of the product and the activities relating to the development of the process. For example, even after a product meets the taxpayer's basic functional and economic requirements, activities relating to the development of the manufacturing process may still constitute qualified research, provided that the development of the process itself separately satisfies the requirements of this section, and the activities are conducted before the process meets the taxpayer's basic functional and economic requirements or is ready for commercial use.

(D) Clinical testing of a pharmaceutical product prior to its commercial production in the United States is not treated as occurring after the beginning of commercial production even if the product is commercially available in other countries. Additional clinical testing of a pharmaceutical product after a product has been approved for a specific therapeutic use by the Food and Drug Administration and is ready for commercial production and sale is not treated as occurring after the beginning of commercial production if such clinical testing is undertaken to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms for the product. A functional use, characteristic, indication, combination, dosage, or delivery form shall be considered new only if such functional use, characteristic, indication, combination, dosage, or delivery form must be approved by the Food and Drug Administration.

(E) Examples.

(i) Example 1. A taxpayer is a tire manufacturer and develops a new material to use in its tires. The taxpayer conducts research to determine the changes that will be necessary for it to modify its existing manufacturing processes to manufacture the new tire. The taxpayer determines that the new tire material retains heat for a longer period of time than the materials it currently uses for tires, and, as a result, the new tire material adheres to the manufacturing equipment during tread cooling. The taxpayer evaluates several alternatives for processing the treads at cooler temperatures to address this problem, including a new type of belt for its manufacturing equipment to be used in tread cooling. Such a belt is not commercially available. Because the taxpayer is uncertain of the belt design, it develops and conducts sophisticated engineering tests on several alternative designs for a new type of belt to be used in tread cooling until it successfully achieves a design that meets its requirements. The taxpayer then manufactures a set of belts for its production equipment, installs the belts, and tests the belts to make sure they were manufactured correctly. The taxpayer's research with respect to the design of the new belts to be used in its manufacturing of the new tire may be qualified research under the Four-Part Test. However, the taxpayer's expenses to implement the new belts, including the costs to manufacture, install, and test the belts were incurred after the belts met the taxpayer's functional and economic requirements and are excluded as research after commercial production.

(ii) Example 2. For several years, a taxpayer has manufactured and sold a particular kind of widget. The taxpayer initiates a new research project to develop a new or improved widget. The taxpayer's activities to develop a new or improved widget are not excluded from the definition of qualified research under this paragraph. The taxpayer's activities relating to the development of a new or improved widget constitute a new research project to develop a new business component and are not considered activities conducted after the beginning of commercial production.

(iii) Example 3. For the purposes of this example, assume that the taxpayer's development of its products satisfies the Four-Part Test described by subsection (c) of this section and is not otherwise excluded under this subsection. A taxpayer is a manufacturer of integrated circuits for use in specific applications. The taxpayer designs various integrated circuit devices and assembles various product configurations for testing. After an internal process of testing, the taxpayer delivers a sample quantity of the integrated circuit to a potential customer for further testing. At the time when the samples are delivered to the taxpayer's potential customer, the potential customer has not agreed to purchase any integrated circuits from the taxpayer. This process of testing by both the taxpayer and its potential customer continues until an acceptable design is achieved. At that point, the taxpayer and the potential customer enter an agreement for the delivery of an order of the integrated circuits. In some cases, no acceptable design is achieved, and no agreement is reached with the potential customer. Research activities occurring prior to an agreement are not considered activities conducted after the beginning of commercial production because the integrated circuits were not yet ready for commercial use. Any research that occurs after an agreement is reached are excluded as activities conducted after the beginning of commercial production because the integrated circuits were ready for commercial use once the design was accepted by the potential customer.

(2) Adaptation of existing business components. Activities relating to adapting an existing business component to a particular customer's requirement or need. This exclusion does not apply merely because a business component is intended for a specific customer. For example:

(A) Example 1. A taxpayer is a computer software development firm and owns a general ledger accounting software core program that it markets and licenses to customers. The taxpayer incurs expenditures in adapting the core software program to the requirements of one of its customers. Because the taxpayer's activities represent ac-

tivities to adapt an existing software program to a particular customer's requirement or need, its activities are excluded from the definition of qualified research under this paragraph.

(B) Example 2. Assume that the customer from Example 1 pays the taxpayer to adapt the core software program to the customer's requirements. Because the taxpayer's activities are excluded from the definition of qualified research, the customer's payments to the taxpayer are not for qualified research and are not considered to be contract research expenses.

(C) Example 3. Assume that the customer from Example 1 uses its own employees to adapt the core software program to its requirements. Because the customer's employees' activities to adapt the core software program to its requirements are excluded from the definition of qualified research, the wages the customer paid to its employees do not constitute in-house research expenses.

(D) Example 4. A taxpayer manufactures and sells rail cars. Because rail cars have numerous specifications related to performance, reliability and quality, rail car designs are subject to extensive, complex testing in the scientific or laboratory sense. A customer orders passenger rail cars from the taxpayer. The customer's rail car requirements differ from those of the taxpayer's other existing customers only in that the customer wants fewer seats in its passenger cars and a higher quality seating material and carpet that are commercially available. The taxpayer manufactures rail cars meeting the customer's requirements. The rail car sold to the customer was not a new business component, but merely an adaptation of an existing business component that did not require a process of experimentation. Thus, the taxpayer's activities to manufacture rail cars for the customer are excluded from the definition of qualified research because the taxpayer's activities represent activities to adapt an existing business component to a particular customer's requirement or need.

(E) Example 5. A taxpayer is a manufacturer and undertakes to create a manufacturing process for a new valve design. The taxpayer determines that it requires a specialized type of robotic equipment to use in the manufacturing process for its new valves. Such robotic equipment is not commercially available. Therefore, the taxpayer purchases existing robotic equipment for the purpose of modifying it to meet its needs. The taxpayer's engineers identify uncertainty that is technological in nature concerning how to modify the existing robotic equipment to meet its needs. The taxpayer's engineers develop several alternative designs, conduct experiments using modeling and simulation in modifying the robotic equipment, and conduct extensive scientific and laboratory testing of design alternatives. As a result of this process, the taxpayer's engineers develop a design for the robotic equipment that meets its needs. The taxpayer constructs and installs the modified robotic equipment on its manufacturing process. The taxpayer's research activities to determine how to modify the robotic equipment it purchased for its manufacturing process are not considered an adaptation of an existing business component.

(F) Example 6. A taxpayer is an oil and gas operator and has been engaged in horizontal drilling for the past ten years. Recently, the taxpayer was hired by a customer to drill in a formation. The drilling objectives included targeting an interval within that formation for horizontal drilling. The taxpayer was uncertain about the successful execution of the horizontal drilling because it had not previously drilled a horizontal well in that formation. The taxpayer was also uncertain about the economic results from the targeted interval. The taxpayer drilled several horizontal wells before its customer was satisfied with the economic results. The taxpayer modified its existing horizontal drilling program based on these results. The taxpayer's activities to identify a horizontal drilling process are excluded from the definition of qualified research because the activities consisted of adapting an existing business component (its existing horizontal drilling process) to meet a particular customer's need.

(G) Example 7. For the purposes of this example, assume that the taxpayer's development of its products satisfies the Four-Part Test described by subsection (c) of this section and is not otherwise excluded under this subsection. A taxpayer is a manufacturer of rigid plastic containers. The taxpayer contracts with major food and beverage manufacturers to provide suitable bottle and packaging designs. The products designed by the taxpayer may be for repeat customers and the sizes and types of bottle may be similar to previous products. The development of each new product, and the production process necessary to produce the products at sufficient production volume, starts from new concept drawings developed by engineers. The taxpayer uses a qualifying process of experimentation to evaluate alternative concepts for the product and production processes. The taxpayer's activities related to both the product and the production process are not excluded from the definition of qualified research as an adaptation of an existing business component.

(3) Duplication of existing business component. Any research related to the reproduction of an existing business component, in whole or in part, from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component. This exclusion does not apply merely because the taxpayer examines an existing business component in the course of developing its own business component.

(4) Surveys, studies, etc. Any efficiency survey; activity relating to management function or technique; market research, testing or development (including advertising or promotions); routine data collection; or routine or ordinary testing or inspection for quality control.

(5) Computer software. Any research activities with respect to internal use software.

(A) For the purposes of this paragraph, internal use software is computer software developed by, or for the benefit of, the taxpayer primarily for internal use by the taxpayer. A taxpayer uses software internally if the software was developed for use in the operation of the business. Computer software that is developed to be commercially sold, leased, licensed, or otherwise marketed for separately stated consideration to unrelated third parties is not internal use software.

(B) Software developed by a taxpayer primarily for internal use by an entity that is part of an affiliated group to which the taxpayer also belongs shall be considered internal use software for purposes of this paragraph.

(C) This exclusion does not apply to software used in:

(i) an activity that constitutes qualified research, or

(ii) a production process that meets the requirements of the Four-Part Test.

(D) The determination as to whether software is internal use software depends on the facts and circumstances existing at the beginning of the development of the software.

(6) Social sciences, etc. Any research in the social sciences, arts, or humanities.

(7) Funded research. Any research funded by any grant, contract, or otherwise by another person or governmental entity.

(A) Research is considered funded if:

(i) the taxpayer performing the research for another person retains no substantial rights to the results of the research; or

(ii) the payments to the researcher are not contingent upon the success of the research.

(B) For the purposes of determining whether a taxpayer retains substantial rights to the results of the research:

(i) Incidental benefits to the researcher from the performance of the research do not constitute substantial rights. For example, increased experience in a field of research is not considered substantial rights.

(ii) A taxpayer does not retain substantial rights in the research it performs if the taxpayer must pay for the right to use the results of the research.

(C) If a taxpayer performing research does not retain substantial rights to the results of the research, the research is considered funded regardless of whether the payments to the researcher are contingent upon the success of the research. In this case, all research activities are considered funded even if the researcher has expenses that exceed the amount received by the researcher for the research.

(D) If a taxpayer performing research does retain substantial rights to the results of the research and the research is considered funded under subparagraph (A)(ii) of this paragraph, the research is only funded to the extent of the payments and fair market value of any property that the taxpayer becomes entitled to by performing the research. If the expenses related to the research exceed the amount the researcher is entitled to receive, the research is not considered funded with respect to the excess expenses. For example, a taxpayer performs research for another person. Based on the contract, the research activities are considered funded under subparagraph (A)(ii) of this paragraph because payments to the researcher are not contingent on the success of the research. The taxpayer retains substantial rights to the results of the research. The taxpayer is entitled to $100,000 under the contract but spent $120,000 on the research activities. In this case, the research is considered funded with respect to $100,000 and is not considered funded with respect to $20,000.

(E) A taxpayer performing research for another person must identify any other person paying for the research activities and any person with substantial rights to the results of the research.

(F) All agreements, not only research contracts, entered into between the taxpayer performing the research and the party funding the research shall be considered in determining the extent to which the research is funded.

(G) The provisions of this paragraph shall be applied separately to each research project undertaken by the taxpayer.

(e) [~~(c)~~] Texas Qualified Research and Development Exemption Registration. In order to claim an exemption under this section, a taxpayer [~~person~~] must first register with the comptroller and obtain a registration number.

(1) Registration procedure. To obtain a registration number, a taxpayer [~~person~~] must complete Form AP-234, Texas Registration for Qualified Research and Development Sales Tax Exemption, its electronic equivalent, or any form promulgated by the comptroller that succeeds such form.

(A) The taxpayer [~~person~~] requesting the registration number must certify that it will not, as a taxable entity or as a member of a combined group, claim a franchise tax research and development activities credit on a franchise tax report based on an accounting period during which it claims an exemption under subsection (b) of this section.

(B) The taxpayer [~~person~~] requesting the registration number must provide all data and information required by the comptroller to administer the exemption and comply with Tax Code, §151.3182(c) (Certain Property Used in Research and Development Activities; Reporting of Estimates and Evaluation).

(2) Retroactive registration. A taxpayer [~~person~~] may request that a registration number be given retroactive effect.

(A) A taxpayer [~~person~~] may request that a registration number have retroactive effect by following the procedures [~~submitting a registration as~~] required under paragraph (1) of this subsection and by completing an annual information report, described in paragraph (3) of this subsection, for each prior year for which the registration number is to be effective.

(B) The registration number may be made retroactive to the later of January 1, 2014, or a date requested by a registrant that is no more than four years prior to the date the registration is received, if the date requested is not within an accounting period during which the registrant, as a taxable entity or as a member of a combined group, claimed the franchise tax research and development activities credit.

(C) A registrant who is issued a retroactive registration number may file a claim for refund of Texas sales and use tax paid on purchases made on or after the later of January 1, 2014, or the effective date of the registration number, that qualify for exemption under subsection (b) of this section, in accordance with the requirements of §3.325 of this title (relating to Refunds and Payments Under Protest).

(D) A claim for a carryforward of an unused franchise tax research and development activities credit under Tax Code, §171.659 does not affect a taxpayer's [~~person's~~] ability, as a taxable entity or as a member of a combined group, to request a retroactive registration.

(3) Annual information report. A registrant must submit an annual information report for each calendar year its registration number is effective, irrespective of the date on which the original registration occurred.

(A) The registrant must provide all data and information required by the comptroller to administer the exemption and comply with Tax Code, §151.3182(c).

(B) The annual information report must be submitted electronically unless the comptroller issues a waiver. A registrant who cannot comply with this requirement due to hardship, impracticality, or other valid reason must submit a written request to the comptroller for a waiver of the requirement.

(C) The due date for the annual information report for the preceding calendar year is March 31. If March 31 falls on a Saturday, Sunday, or a legal holiday, the due date is the next business day.

(i) An annual information report filed electronically must be completed and submitted by 11:59 p.m. central time on the due date to be considered timely.

(ii) Reports submitted on paper must be postmarked on or before the due date to be considered timely.

(D) A registrant who fails to timely file an annual information report for its registration number will be given written notice of the failure to file. If an annual information report is not submitted within 60 days of the date of the notice of failure to file, the registration number will be cancelled by the comptroller in accordance with paragraph (5) of this subsection.

(4) Direct payment permit holders. A direct payment permit holder must obtain a registration number as required by paragraph (1) of this subsection in order to claim an exemption under this section. A direct payment permit holder with a registration number must file an annual information report for each year the number is effective as required by paragraph (3) of this subsection.

(5) Cancellation of registration number by the comptroller. The comptroller will cancel the registration number of a registrant who fails to comply with the provisions of this section. For example, the comptroller may [~~will~~] cancel the registration number of a registrant who fails to file an annual information report or who claims the franchise tax research and development activities credit without first cancelling its registration number, as required by paragraph (8) of this subsection. The comptroller shall give written notice of the cancellation to the registrant. The notice may be personally served on the registrant or sent by regular mail to the registrant's address as shown in the comptroller's records. The former registrant may not claim an exemption under this section during the period when the registration number is cancelled. A former registrant that purchases an item under a cancelled registration number may be subject to a criminal penalty under Tax Code, §151.707 (Resale or Exemption Certificate; Criminal Penalty) and §3.287(d)(3) of this title (relating to Exemption Certificates).

(6) Effective date of cancellation. A registrant whose registration number is cancelled by the comptroller is responsible for remitting Texas sales and use tax, and penalty and interest from the date of purchase, on any items purchased tax-free pursuant to Tax Code, §151.3182 on or after the effective date of cancellation. In the case of a registrant whose registration number is cancelled because of a failure to file an annual information report, the effective date of the cancellation is December 31 of the last year for which the registrant filed an annual information report. In the case of a registrant whose registration number is cancelled because the registrant, as a taxable entity or as a member of a combined group, claimed the franchise tax research and development activities credit, the effective date of cancellation is the beginning date of the accounting period covered by the franchise tax report on which the credit was claimed.

(7) Reinstatement following cancellation. A former registrant who has had its registration number cancelled by the comptroller may submit a request in writing to have the registration number reinstated.

(A) A former registrant whose registration number has been cancelled may request reinstatement of the number be given retroactive effect. The registrant must file an annual information report for each prior year for which the registration number is to be effective.

(B) A registration number will not be reinstated for periods during which the former registrant is not eligible for the exemption under this section.

(C) Before the comptroller will reinstate a registration number, the former registrant must remit any Texas sales and use taxes, as well as applicable penalties and interest from the date of purchase, on all purchases made tax-free under this section during periods when the registrant was not eligible for the exemption under this section.

(8) Cancellation of registration number by registrant. A registrant who has received a registration number and subsequently chooses to claim the franchise tax research and development activities credit must cancel the registration number. The registrant is responsible for remitting Texas sales and use tax, and penalty and interest from the date of purchase, on any items purchased tax-free under this section during any accounting periods covered by a franchise tax report on which the credit is claimed.

(f) [~~(d)~~] Texas Qualified Research Sales and Use Tax Exemption Certificate. Beginning January 1, 2014, a retailer may accept a valid and complete Form 01-931, Texas Qualified Research Sales and Use Tax Exemption Certificate or any form promulgated by the comptroller or that succeeds such form, in lieu of Texas sales and use tax on the sale of depreciable tangible personal property that qualifies for exemption under subsection (b) of this section. To be valid and complete, a Texas Qualified Research Sales and Use Tax Exemption Certificate must bear the registration number issued to the registrant by the comptroller and must be signed by the registrant or the registrant's authorized agent. Texas Qualified Research Sales and Use Tax Exemption Certificates are subject to the requirements of §3.287(d) of this title. A retailer must maintain a copy of the Texas Qualified Research Sales and Use Tax Exemption Certificate accepted in lieu of tax on a sale and all records supporting that transaction. Refer to §3.281 of this title (relating to Records Required; Information Required).

(g) [~~(e)~~] Divergent use. When a registrant uses an item purchased under a valid Texas Qualified Research Sales [~~Sale~~] and Use Tax Exemption Certificate in a taxable manner, the registrant is liable for payment of Texas sales and use tax, plus penalty and interest as applicable, based on the fair market rental value of the tangible personal property for the period of time used in the taxable manner. This subsection applies to an item that is used for any purpose other than for use in qualified research, whether that use occurs before, during, or after the time when the item is used in qualified research. Refer to Tax Code, §151.155 (Exemption Certificate).

(h) [~~(f)~~] Refund of Texas sales and use tax paid on depreciable tangible personal property used in qualified research. A registrant with a valid registration number may file a claim for refund of Texas sales and use tax paid on purchases made on or after the later of January 1, 2014, or the effective date of the registration number, that qualify for exemption under subsection (b) of this section in accordance with the requirements of §3.325 of this title.

(i) [~~(g)~~] Expiration. The sales and use tax exemption for depreciable tangible personal property used in qualified research expires on December 31, 2026.

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

Filed with the Office of the Secretary of State on April 5, 2021.

TRD-202101421
William Hamner
Special Counsel for Tax Administration
Comptroller of Public Accounts
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For further information, please call: (512) 475-0387

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SUBCHAPTER V. FRANCHISE TAX

34 TAC §3.599

The Comptroller of Public Accounts proposes amendments to §3.599, concerning margin: research and development activities credit. The comptroller amends this section to provide guidance regarding the franchise tax research and development activities credit.

Throughout the section, the comptroller adds titles to statutory citations and makes minor revisions to improve readability.

The comptroller amends subsection (b)(1) by deleting the term "affiliated group" and adding a new term, "business component." The comptroller deletes the term "affiliated group" because the definition of combined group refers to Tax Code, §171.1014 (Combined Reporting; Affiliated Group Engaged in Unitary Business), which provides sufficient guidance. The comptroller defines the term, "business component," and bases this term on Internal Revenue Code (IRC), §41(d)(2)(B) (Business component defined), with non-substantive changes.

The comptroller adds new paragraph (4) to define the term "Four-Part Test" and renumbers subsequent paragraphs. The comptroller derives this term from IRC, §41(d) (Qualified research defined) and the regulations applicable to that section.

The comptroller amends the definition of "Internal Revenue Code (IRC)" in renumbered paragraph (5) to explain that a regulation adopted after December 31, 2011 must require a taxable entity to apply that regulation to the 2011 federal income tax year to be included in this definition. The definition of IRC in Tax Code, §171.651 (1) states: "'Internal Revenue Code' means the Internal Revenue Code of 1986 in effect on December 31, 2011, excluding any changes made by federal law after that date, but including any regulations adopted under that code applicable to the tax year to which the provisions of the code in effect on that date applied."

The current version of Treasury Regulation, §1.41-4 (Qualified research for expenditures paid or incurred in taxable years ending on or after Dec. 31, 2003), adopted on November 3, 2016, is an example of a regulation that does not fully apply to the 2011 federal income tax year. With respect to its applicability, Treasury Regulation, §1.41-4 (e) provides: "Other than subsection (c)(6) of this section, this section is applicable for taxable years ending on or after December 31, 2003. Paragraph(c)(6) of this section is applicable for taxable years beginning on or after October 4, 2016. For any taxable year that both ends on or after January 20, 2015 and begins before October 4, 2016, the IRS will not challenge return positions consistent with all of subsection (c)(6) of this section or all of subsection (c)(6) of this section as contained in the Internal Revenue Bulletin (IRB) 2015-5 (see www.irs.gov/pub/irs-irbs/irb15-05.pdf). For taxable years ending before January 20, 2015, taxpayers may choose to follow either all of §1.41-4(c)(6) as contained in 26 CFR part 1 (revised as of April 1, 2003) and IRB 2001-5 (see www.irs.gov/pub/irs-irbs/irb01-05.pdf) or all of §1.41-4(c)(6) as contained in IRB 2002-4 (see www.irs.gov/pub/irs-irbs/irb02-04.pdf)." The first sentence quoted above shows that, other than paragraph (c)(6), the current version of Treasury Regulation, §1.41-4 applies to the 2011 federal income tax year. With respect to subsection (c)(6), the third sentence quoted above shows that the current language in Treasury Regulation §1.41-4 (c)(6) does not apply to the 2011 federal income tax year. The fourth sentence quoted above allows taxable entities to choose one of two proposed regulations described in the Internal Revenue Bulletins incorporated by reference. The proposed regulations referenced in those Internal Revenue Bulletins were finalized prior to the 2011 federal income tax year. Although the federal regulations allow taxable entities to choose whether they follow this prior IRS guidance, the options are not included in the term "Internal Revenue Code" because Treasury Regulation, §1.41-4 (e) does not require taxable entities to follow either of those options.

Another example of a regulation that does not apply to the 2011 federal income tax year is Treasury Regulation 1.174-2 (Definition of research and experimental expenditures), adopted July 21, 2014. With respect to its applicability, Treasury Regulation, §1.174-2 (d) provides: "The eighth and ninth sentences of §1.174-2(a)(1); §1.174-2(a)(2); §1.174-2(a)(4); §1.174-2(a)(5); §1.174-2(a)(11) Example 3 through Example 10; §1.174-2(b)(4); and §1.174-2(b)(5) apply to taxable years ending on or after July 21, 2014. Taxpayers may apply the provisions enumerated in the preceding sentence to taxable years for which the limitations for assessment of tax has not expired." While the federal statute of limitations for the assessment of tax for the 2011 federal income tax year had not expired at the time this regulation was adopted, the provisions enumerated in this applicability provision are not included in the term "Internal Revenue Code" because the regulation does not require taxable entities to apply those provisions to the 2011 federal income tax year.

The comptroller amends the definition of "qualified research" in renumbered paragraph (7) to explain that qualified research must satisfy the Four-Part Test.

The comptroller amends the definition of "qualified research expense (QRE)" in renumbered paragraph (8) based on IRC, §41(b) (Qualified research expenses) and Treasury Regulation, §1.41-2 (Qualified research expenses). The amended definition of QREs does not limit the applicability of any provisions of IRC, §41(b) or Treasury Regulation, §1.41-2. Rather, the amended definition describes the basic requirements for an expense to be a QRE. QREs are the sum of all in-house research expenses and contract research expenses.

The comptroller adds subparagraph (A) to explain that in-house research expenses include wages paid to an employee for qualified services, supplies, and amounts paid to another person for the right to use computers. The comptroller adds clause (i) to explain that qualified services include engaging in qualified research, or the direct supervision or direct support of qualified research. In subclauses (I) through (III), the comptroller defines the terms "engaging in qualified research," "direct supervision," and "direct support."

The comptroller adds clause (ii) to explain that supplies include any tangible personal property other than land, improvements to land, or property of a character subject to the allowance for depreciation.

The comptroller adds clause (iii) to explain that certain items purchased without paying sales or use tax are not included in the definition of in-house research expenses. This is because certain sales or use tax exemptions require that the item be used in specific ways that are not compatible with the item's use in qualified research. The comptroller provides five examples illustrating this clause.

Subclause (I) contains examples illustrating this clause. Item (-a-) identifies two sales or use tax exemptions which are excluded under this clause: the manufacturing exemption under Tax Code, §151.318 (Property Used in Manufacturing) and the sale for resale exemption under Tax Code, §151.302 (Sales for Resale). To qualify for the manufacturing exemption, items used by a manufacturer must be used in or during the actual manufacturing, processing, or fabricating of tangible personal property for ultimate sale. IRC §41 (d)(4)(A) excludes: "any research conducted after the beginning of commercial production of the business component." A taxable entity cannot claim both the franchise tax credit and sales tax exemption for the same purchases or activities. The sales tax manufacturing exemption applies to items used to produce items for ultimate sale to a cus-

tomer, while the franchise tax R&D credit excludes items that are ready for commercial sale or use. Thus, a taxable entity cannot claim both the credit and exemption for the same activities. Furthermore, under Tax Code, §151.318 (c)(3), the manufacturing exemption excludes "equipment or supplies used in research or development of new products." While this exclusion to the manufacturing exemption is not directly tied to the definition of qualified research applicable to the franchise tax R&D credit, it does indicate that the manufacturing exemption was not intended to apply to research and development activities. To qualify for the sale for resale exemption, an item must be purchased with the intent to resell it to someone else, either in the form or condition in which it is acquired or as an attachment to or an integral part of other tangible personal property or taxable service. *See* Tax Code, §151.006 ("Sale for Resale."). Items used in qualified research are not resold and do not qualify for the sale-for-resale exemption.

Item (-b-) identifies three types of purchases that are not excluded under this clause: purchases of water, Sulphur, and items for which sales or use tax was paid to another state. These items are not taxable for reasons unrelated to the use of the items so there is not an inherent conflict with these items being used in qualified research, unlike the manufacturing or resale exemptions.

Subclause (II) explains that if the item were actually used in qualified research after claiming an exemption, that item may be included as an in-house research expense if sales or use tax, penalty, and interest is paid on the item.

The comptroller adds clause (iv) to explain that wages are defined by reference to IRC §3401(a) (Definitions). The comptroller adds clause (v) to explain how to allocate wages between qualified services and nonqualified services when an employee performs both types of services. The comptroller adds clause (vi) to explain that if over 80% of the services an employee provides are qualified services, then all of the services provided by that employee are qualified services.

The comptroller adds subparagraph (B) to provide that contract research expenses are 65% of any amount paid by the taxable entity to another person for qualified research. In this subparagraph, the comptroller explains: the type of agreement that is necessary for an expense to be a contract research expense; that payments contingent upon the success of the research are not contract research expenses; that qualified research is performed on behalf of a taxable entity if that taxable entity has a right to the research results; and with respect to which report year the contract research expenses can be taken. The comptroller cross-references IRC, §41(b), which provides that the allowable percentage of contract research expenses can change in certain circumstances.

The comptroller deletes paragraph (10), which contained a definition for the term research and development credit. This term is only used once in the section, in subsection (j)(2)(A), which includes information concerning the January 1, 2008 repeal of Tax Code, Chapter 171, Subchapter O (Tax Credit for Certain Research and Development Activities). This information sufficiently distinguishes the prior credit from the current credit without the need for a separate definition.

The comptroller adds new subsections (c) and (d) and reletters subsequent subsections.

In new subsection (c), the comptroller discusses the application of the Four-Part Test to explain the basic requirements for research activities to be qualified research. The comptroller bases this subsection primarily on IRC, §41(d) and Treasury Regulation, §1.41-4.

In new paragraph (1), the comptroller describes the four individual components of the Four-Part Test: subparagraph (A) describes the Section 174 Test; subparagraph (B) describes the Discovering Technological Information Test; subparagraph (C) describes the Business Component Test; and subparagraph (D) describes the Process of Experimentation Test. In subparagraph (D), the comptroller provides several examples illustrating the Process of Experimentation Test.

In new paragraph (2), the comptroller explains that the Four-Part Test applies separately to each business component of the taxable entity.

In new paragraph (3), the comptroller explains that, if the whole business component does not meet the requirements of the Four-Part Test, the taxable entity may then shrink back the business component to the next most significant subset of elements of the business component. This process continues until the Four-Part Test is satisfied, or the most basic element of the product fails the Four-Part Test.

In new paragraph (4), the comptroller explains how the Four-Part Test applies to software development activities. The comptroller also identifies a list of software development activities that are likely to be qualified research and a list of software development activities that are unlikely to be qualified research. The explanation and lists in this paragraph are adapted from the Internal Revenue Service's Audit Guidelines on the Application of Process of Experimentation for all Software.

In new subsection (d), the comptroller lists activities that do not constitute qualified research. This list is based on IRC, §41(d)(4) and Treasury Regulation, §1.41-4(c) (Excluded activities). The discussion of the funded research exclusion is also based on Treasury Regulation, §1.41-4A(d) (Qualified research for taxable years beginning before January 1, 1986). This subsection contains examples for the research after commercial production exclusion and the adaptation of existing business components exclusion.

The comptroller amends relettered subsection (e) by moving the current language to paragraph (1) and adding two new paragraphs. The comptroller adds new paragraph (2) to explain that the taxable entity has the burden of proof to establish its entitlement to, and value of, the credit by clear and convincing evidence. In subparagraph (A), the comptroller explains that all qualified research expenses must be connected to specific qualified research activities. In subparagraph (B), the comptroller explains that all qualified research expenses must be supported by contemporaneous business records. The comptroller defines these contemporaneous business records for wages, supplies, and contract research expenses, including a non-exhaustive list of examples for each type of expense. The comptroller adds new paragraph (3) to explain that any determination by the IRS that a taxable entity is entitled to the federal research and development credit does not bind the comptroller when determining a taxable entity's eligibility for the credit.

The comptroller amends relettered subsection (g)(3) to change the term "this state" to "Texas."

The comptroller amends paragraph (5) to provide additional details regarding verification of prior year QREs when those prior years are outside of the statute of limitations.

The comptroller adds paragraph (6) to explain that if a taxable entity has any QREs under a higher education contract, then all of its QREs are included in the calculation at the higher rate allowed by paragraph (3) or (4) of subsection (g). This is the case even if not all of the QREs relate to higher education contracts.

The comptroller restructures relettered subsection (i) into five paragraphs. The first sentence of the current subsection is now new paragraph (1). New paragraph (2) provides that each member of a combined group determines the amount of the credit separately and then the combined group includes the credits of each member on the combined report. New paragraph (3) explains that a combined group must prorate any carryforward of the credit among the members of the combined group. This prorated carryforward credit remains with the member of the combined group for future tax periods, regardless of whether the member remains in the same combined group. New paragraph (4) explains that the higher education rate described in relettered subsections (g)(3) - (4) applies separately to each member of the combined group, and not to the combined group as a whole. One member of a combined group qualifying for the higher education rate does not qualify any other member of the combined group for that rate. New paragraph (5) contains the second sentence of the current subsection, which the comptroller amends to state that a combined group is the taxable entity for the purposes of claiming the credit.

The comptroller amends relettered subsection (l) by adding paragraph (3) to explain that the comptroller may verify credit carryforwards by verifying the qualified research activities on which the credit that created the carryforward was based. This verification may occur even if the statute of limitations has expired for the report year on which the original credit was claimed. This verification will not result in an assessment of tax, penalty, or interest for any period for which the statute of limitation is closed, but may result in an adjustment to the credit carryforward for any periods for which the statute of limitations is open.

Tom Currah, Chief Revenue Estimator, has determined that during the first five years that the proposed amendment is in effect, the amendment: will not create or eliminate a government program; will not require the creation or elimination of employee positions; will not require an increase or decrease in future legislative appropriations to the agency; will not require an increase or decrease in fees paid to the agency; will not increase or decrease the number of individuals subject to the rules' applicability; and will not positively or adversely affect this state's economy. This proposal amends a current rule.

Mr. Currah also has determined that for each year of the first five years the rule is in effect, proposed amendment would benefit the public by improving the clarity and implementation of the section. This rule is proposed under Tax Code, Title 2, and does not require a statement of fiscal implications for small businesses. The proposed amendment would have no significant fiscal impact on the state government, units of local government, or individuals. There would be no significant anticipated economic costs to the public.

Comments on the proposal may be submitted to Teresa G. Bostick, Director, Tax Policy Division, P.O. Box 13528, Austin, Texas 78711-3528. Comments must be received no later than 30 days from the date of publication of the proposal in the Texas Register.

The amendments are proposed under Tax Code, §111.002 (Comptroller's Rules; Compliance; Forfeiture), which provides the comptroller with the authority to prescribe, adopt, and enforce rules relating to the administration and enforcement of the provisions of Tax Code, Title 2 (State Taxation).

The amendments implement Tax Code, Chapter 171, Subchapter M (Tax Credit for Certain Research and Development Activities).

§3.599. Margin: Research and Development Activities Credit.

(a) Effective dates.

(1) The provisions of this section apply to franchise tax reports originally due on or after January 1, 2014.

(2) These provisions expire on December 31, 2026. The credits allowed under this section cannot be established on a report originally due after December 31, 2026. The expiration does not affect the carryforward of a credit authorized under these provisions as provided in subsection (l) [~~(i)~~] of this section and established on a report originally due prior to the expiration date of these provisions.

(b) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

(1) Business component--A business component is any product, process, computer software, technique, formula, or invention, which is to be held for sale, lease, or license, or used by the taxable entity in a trade or business of the taxable entity. [~~Affiliated group--Entities in which a controlling interest is owned by a common owner, either corporate or noncorporate, or by one or more of the member entities.~~]

(2) Combined group--Taxable entities that are part of an affiliated group engaged in a unitary business and that are required to file a combined group report under Tax Code, §171.1014 (Combined Reporting; Affiliated Group Engaged in Unitary Business).

(3) Controlling interest--

(A) For a corporation, either more than 50%, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation.

(B) For a partnership, association, trust, or other entity other than a limited liability company, more than 50%, owned directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity.

(C) For a limited liability company, either more than 50%, owned directly or indirectly, of the total membership interest of the limited liability company or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company.

(4) Four-Part Test--The test described in IRC, §41(d) (Qualified research defined) that determines whether research activities are qualified research. The four parts of the test are the Section 174 Test, the Discovering Technological Information Test, the Business Component Test, and the Process of Experimentation Test.

(5) [~~(4)~~] Internal Revenue Code (IRC)--The Internal Revenue Code of 1986 in effect on December 31, 2011, excluding any changes made by federal law after that date, but including any regulations that are later adopted under that code applicable to the tax year to which the provisions of the code in effect on that date applied. A regulation adopted after December 31, 2011 is only included in this term to the extent that the regulation requires a taxable entity to apply the regulation to the 2011 federal income tax year.

(6) [~~(5)~~] Public or private institution of higher education--

(A) an institution of higher education, as defined by Education Code, §61.003 (Definitions); or

(B) a private or independent institution of higher education, as defined by Education Code, §61.003.

(7) [~~(6)~~] Qualified research--This term has the meaning given in IRC [~~Internal Revenue Code~~], §41(d), except that the research must be conducted in Texas.Qualified research activities must satisfy each part of the Four-Part Test.

(8) [~~(7)~~] Qualified research expense--This term has the meaning given in IRC [~~Internal Revenue Code~~], §41(b) (Qualified research expenses), except that the expense must be for qualified research conducted in Texas. IRC, §41(b) defines qualified research expenses as the sum of in-house research expenses and contract research expenses.

(A) In-house research expenses include any wages paid or incurred for qualified services performed by an employee; any amount paid or incurred for supplies used in the conduct of qualified research; and any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.

(i) Qualified services include an employee either engaging in qualified research or engaging in the direct supervision or direct support of qualified research.

(I) For the purposes of this clause, the term "engaging in qualified research" means the actual conduct of qualified research. For example, a scientist conducting laboratory experiments could be engaging in qualified research.

(II) For the purposes of this clause, the term "direct supervision" means the immediate supervision (first-line management) of qualified research. For example, a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments, could be directly supervising qualified research. "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

(III) For the purposes of this clause, the term "direct support" means services in the direct support of either: Persons engaging in actual conduct of qualified research, or persons who are directly supervising persons engaging in the actual conduct of qualified research.

(-a-) Direct support of research includes, but is not limited to, the services of: a secretary for typing reports describing laboratory results derived from qualified research; a laboratory worker for cleaning equipment used in qualified research; a clerk for compiling research data; and a machinist for machining a part of an experimental model used in qualified research.

(-b-) Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of: payroll personnel in preparing salary checks of laboratory scientists; an accountant for accounting for research expenses; a janitor for general cleaning of a research laboratory; or officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department.

(-c-) Direct support does not include supervision. Supervisory services constitute "qualified services" only to the extent provided in subclause (II) of this clause.

(ii) Supplies are any tangible property other than land, improvements to land, or property of a character subject to the allowance for depreciation.

(iii) If a taxable entity claimed a sales or use tax exemption under Tax Code, Chapter 151 (Limited Sales, Excise, and Use Tax) when it purchased a taxable item, and that exemption is for a use other than use in qualified research, the item is excluded from being an in-house research expense, even if it otherwise meets the definition of supplies in clause (ii) of this subparagraph. Exemptions or exclusions that are not based on the use of an item do not result in an exclusion from being an in-house research expense under this clause.

(I) For example:

(-a-) An item for which a taxable entity claimed the manufacturing exemption under Tax Code, §151.318 (Property Used in Manufacturing) or the sale for resale exemption under Tax Code, §151.302 (Sales for Resale) is excluded from being an in-house research expense under this clause.

(-b-) Water, sulphur, and items for which a taxable entity paid sales or use tax to another state are not subject to sales or use tax under Tax Code, §151.315 (Water), Tax Code, §151.3171 (Sulphur), and Tax Code, §151.303 (Previously Taxed Items: Use Tax Exemption or Credit), but are not excluded from being an in-house research expense under this clause.

(II) If an item is excluded from being an in-house research expense under this clause, and the taxable entity used that item in qualified research activities rather than the use for which the sales or use tax exemption was granted, the taxable entity may pay any sales or use tax, and any applicable penalty or interest, related to the purchase or use of the item. Once the applicable sales or use tax, penalty, and interest is paid, the taxable entity may include the cost of that item as an in-house research expense.

(iv) The term wages has the meaning given such term by IRC, §3401(a) (Wages). In the case of an employee within the meaning of IRC, §401(c)(1) (Self-employed individual treated as employee) the term wages includes the earned income as defined in IRC, §401(c)(2) (Earned income) of such employee. The term wages does not include any amount taken into account in determining the work opportunity credit under IRC, §51(a) (Determination of amount).

(v) If an employee performed both qualified services and nonqualified services, only wages for qualified services constitute an in-house research expense. Unless the taxable entity can demonstrate another method is more appropriate, the amount of wages that are in-house research expenses shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the report year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxable entity to the total time spent by the employee in the performance of all services for the taxable entity during the report year.

(vi) Notwithstanding clause (v) of this subparagraph, if the ratio of the total time actually spent by an employee in the performance of qualified services for the taxable entity to the total time spent by the employee in the performance of all services for the taxable entity during the report year is greater than 80%, all services performed by that employee are considered qualified services.

(B) Contract research expenses are 65% of any amount paid or incurred by the taxable entity to any person, other than an employee of the taxable entity, for qualified research. If a taxable entity satisfies the requirements of IRC §41 (b)(3)(C) (Amounts paid to certain research consortia) or IRC §41 (b)(3)(D) (Amounts paid to eligible small businesses, universities, and Federal laboratories) the percentage

of allowable contract research expenses is increased as provided by those subparagraphs.

(i) An expense is paid or incurred for qualified research only to the extent that it is paid or incurred pursuant to an agreement that:

(I) is entered into prior to the performance of the qualified research;

(II) provides that research be performed on behalf of the taxable entity; and

(III) requires the taxable entity to bear the expense even if the research is not successful.

(ii) If an expense is paid or incurred by the taxable entity pursuant to an agreement under which payment is contingent on the success of the research, then the expense is not a contract research expense because the expense is considered paid for the product or result of the research rather than the performance of the research. This clause only applies to that portion of a payment that is contingent on the success of the research.

(iii) Qualified research is performed on behalf of the taxable entity if the taxable entity has a right to the research results, even if that right is not exclusive.

(iv) If any contract research expenses are paid or incurred during one report year for qualified research that is conducted in a subsequent report year, the expenses shall be treated as paid or incurred during the report year in which the qualified research is conducted.

(v) See IRC, §41(b) for special circumstances that change the percentage that applies to contract research expenses.

(9) [~~(8)~~] Registration Number--The Texas Qualified Research Registration Number [~~number~~] issued by the comptroller to a person who submits the Texas Registration for Qualified Research and Development Sales Tax Exemption form.

(10) [~~(9)~~] Research and development activities credit (credit)--A credit against franchise tax for qualified research expenses that is allowed under Tax Code, Chapter 171, Subchapter M (Tax Credit for Certain Research and Development Activities).

~~[(10) Research and development credit--A credit against franchise tax for research and development expenses allowed under Tax Code, Chapter 171, Subchapter O, and established on a franchise tax report originally due prior to January 1, 2008.]~~

(11) Tax period--The period on which a franchise tax report is based as provided by §3.584(c) of this title (relating to Margin: Reports and Payments).

(c) Application of the Four-Part Test. Research activities must satisfy each part of the Four-Part Test, as described in paragraph (1) of this subsection, to be qualified research.

(1) Four-Part Test.

(A) Section 174 Test. Expenditures related to the research must be eligible to be treated as expenses under IRC, §174 (Research and experimental expenditures).

(i) Expenditures are eligible to be treated as expenses under IRC, §174, if the expenditures are incurred in connection with the taxable entity's trade or business and represent a research and development cost in the experimental or laboratory sense. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxable entity does not establish the capability or method for developing or improving the product or the appropriate design of the product.

(ii) For the purposes of this test, the term "product" includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxable entity in its trade or business as well as products to be held for sale, lease, or license.

(iii) Expenditures for the following are not eligible to be treated as expenses under IRC, §174:

(I) land;

(II) depreciable property;

(III) the ordinary testing or inspection of materials or products for quality control;

(IV) efficiency surveys;

(V) management studies;

(VI) consumer surveys;

(VII) advertising or promotions;

(VIII) the acquisition of another's patent, model, production, or process; or

(IX) research in connection with literary, historical, or similar projects.

(B) Discovering Technological Information Test. The research must be undertaken for the purpose of discovering information that is technological in nature.

(i) Research is undertaken for the purpose of discovering technological information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxable entity does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.

(ii) In order to satisfy the requirement that the research is technological in nature, the process of experimentation used to discover information must fundamentally rely on principles of the physical or biological sciences, engineering, or computer science. A taxable entity may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement.

(iii) A determination that research is undertaken for the purpose of discovering information that is technological in nature does not require that the taxable entity:

(I) seek to obtain information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxable entity is performing the research; or

(II) succeed in developing a new or improved business component.

(C) Business Component Test. The application of the technological information for which the research is undertaken must be intended to be useful in the development of a new or improved business component of the taxable entity, which may include any product, process, computer software, technique, formula, or invention that is to

be held for sale, lease, or license, or used by the taxable entity in a trade or business of the taxable entity.

(i) If a taxable entity provides a service to a customer, the service provided to that customer is not a business component because a service is not a product, process, computer software, technique, formula, or invention. However, a product, process, computer software, technique, formula, or invention used by a taxable entity to provide services to its customers may be a business component.

(ii) A design is not a business component because a design is not a product, process, computer software, technique, formula, or invention. While uncertainty as to the appropriate design of a business component is a qualifying uncertainty for the Section 174 Test and the Discovering Technological information test, the design itself is not a business component. For example, the design of a structure is not a business component, although the structure itself may be a business component. Similarly, a blueprint or other plan used to construct a structure that embodies a design is not a business component.

(D) Process of Experimentation Test. Substantially all of the research activities must constitute elements of a process of experimentation for a qualified purpose. A process of experimentation is undertaken for a qualified purpose if it relates to a new or improved function, performance, reliability, or quality of a business component. Any research relating to style, taste, cosmetic, or seasonal design factors does not satisfy the Process of Experimentation Test.

(i) A process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxable entity's research activities.

(ii) A process of experimentation must:

(I) be an evaluative process and generally should be capable of evaluating more than one alternative; and

(II) fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and involve:

(-a-) the identification of uncertainty concerning the development or improvement of a business component;

(-b-) the identification of one or more alternatives intended to eliminate that uncertainty; and

(-c-) the identification and the conduct of a process of evaluating the alternatives through, for example, modeling, simulation, or a systematic trial and error methodology.

(iii) A taxable entity may undertake a process of experimentation if there is no uncertainty concerning the taxable entity's capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxable entity's research activities. Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.

(iv) The substantially all requirement of this subparagraph is satisfied only if 80% or more of a taxable entity's research activities, measured on a cost or other consistently applied reasonable basis constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability, or quality. The substantially all requirement is satisfied even if the remainder of a taxable entity's research activities with respect to the business component do not constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability, or quality.

(v) Non-experimental methods, such as simple trial and error, brainstorming, or reverse engineering, are not considered a process of experimentation.

(vi) Factors considered in determining whether a trial and error methodology is experimental systematic trial and error or non-experimental simple trial and error include, but are not limited to:

(I) whether the person conducting the trial and error methodology stops testing alternatives once a single acceptable result is found or continues to find multiple acceptable results for comparison;

(II) whether all the results of the trial and error methodology are recorded for evaluation;

(III) whether there is a written procedure for conducting the trial and error methodology; and

(IV) whether there is a written procedure for evaluating the results of the trial and error methodology.

(vii) Examples.

(I) Example 1. A taxable entity is engaged in the business of developing and manufacturing widgets. The taxable entity wants to change the color of its blue widget to green. The taxable entity obtains several different shades of green paint from various suppliers. The taxable entity paints several sample widgets, and surveys its customers to determine which shade of green its customers prefer. The taxable entity's activities to change the color of its blue widget to green do not satisfy the Process of Experimentation Test because its activities are not undertaken for a qualified purpose. All of the taxable entity's research activities are related to style, taste, cosmetic, or seasonal design factors.

(II) Example 2. The taxable entity in Example 1 chooses one of the green paints. The taxable entity obtains samples of the green paint from a supplier and determines that it must modify its painting process to accommodate the green paint because the green paint has different characteristics from other paints it has used. The taxable entity obtains detailed data on the green paint from its paint supplier. The taxable entity also consults with the manufacturer of its paint spraying machines. The manufacturer informs the taxable entity that it must acquire new nozzles that operate with the green paint it wants to use because the current nozzles do not work with the green paint. The taxable entity tests the new nozzles, using the green paint, to ensure that they work as specified by the manufacturer of the paint spraying machines. The taxable entity's activities to modify its painting process are not qualified research. The taxable entity did not conduct a process of evaluating alternatives in order to eliminate uncertainty regarding the modification of its painting process. Rather, the manufacturer of the paint machines eliminated the taxable entity's uncertainty regarding the modification of its painting process. The taxable entity's activities to test the nozzles to determine if the nozzles work as specified by the manufacturer of the paint spraying machines are in the nature of routine or ordinary testing or inspection for quality control.

(III) Example 3. A taxable entity is engaged in the business of manufacturing food products and currently manufactures a large-shred version of a product. The taxable entity seeks to modify its current production line to permit it to manufacture both a large-shred version and a fine-shred version of one of its food products. A smaller, thinner shredding blade capable of producing a fine-shred version of the food product is not commercially available. Thus, the

taxable entity must develop a new shredding blade that can be fitted onto its current production line. The taxable entity is uncertain concerning the design of the new shredding blade because the material used in its existing blade breaks when machined into smaller, thinner blades. The taxable entity engages in a systematic trial and error process of analyzing various blade designs and materials to determine whether the new shredding blade must be constructed of a different material from that of its existing shredding blade and, if so, what material will best meet its functional requirements. The taxable entity's activities to modify its current production line by developing the new shredding blade satisfy the Process of Experimentation Test. Substantially all of the taxable entity's activities constitute elements of a process of experimentation because it evaluated alternatives to achieve a result where the method of achieving that result, and the appropriate design of that result, were uncertain as of the beginning of the taxable entity's research activities. The taxable entity identified uncertainties related to the development of a business component, and identified alternatives intended to eliminate these uncertainties. Furthermore, the taxable entity's process of evaluating identified alternatives was technological in nature and was undertaken to eliminate the uncertainties.

(IV) Example 4. A taxable entity is in the business of designing, developing and manufacturing automobiles. In response to government-mandated fuel economy requirements, the taxable entity seeks to update its current model vehicle and undertakes to improve aerodynamics by lowering the hood of its current model vehicle. The taxable entity determines, however, that lowering the hood changes the air flow under the hood, which changes the rate at which air enters the engine through the air intake system, which reduces the functionality of the cooling system. The taxable entity's engineers are uncertain how to design a lower hood to obtain the increased fuel economy, while maintaining the necessary air flow under the hood. The taxable entity designs, models, simulates, tests, refines, and re-tests several alternative designs for the hood and associated proposed modifications to both the air intake system and cooling system. This process enables the taxable entity to eliminate the uncertainties related to the integrated design of the hood, air intake system, and cooling system. Such activities constitute 85% of its total activities to update its current model vehicle. The taxable entity then engages in additional activities that do not involve a process of evaluating alternatives in order to eliminate uncertainties. The additional activities constitute only 15% of the taxable entity's total activities to update its current model vehicle. In this case substantially all of the taxable entity's activities constitute elements of a process of experimentation because it evaluated alternatives to achieve a result where the method of achieving that result, and the appropriate design of that result, were uncertain as of the beginning of its research activities. The taxable entity identified uncertainties related to the improvement of a business component and identified alternatives intended to eliminate these uncertainties. Furthermore, the taxable entity's process of evaluating the identified alternatives was technological in nature and was undertaken to eliminate the uncertainties. Because 85% of the taxable entity's activities to update its current model vehicle constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability, or quality, all of its activities satisfy the Process of Experimentation Test.

(V) Example 5. A taxable entity is in the business of providing building and construction services, including the construction of warehouses, strip malls, office buildings, and other commercial structures. The taxable entity is engaged to construct a structure in a part of Texas where foundation problems are common. The taxable entity's engineers were uncertain how to design the structure to ensure stability of the structure's foundation because the taxable entity had never designed a structure in a similar location. The taxable entity's engineers used their professional experience and various building codes to determine how to design the foundation based on the conditions at the construction site. The engineers chose to use piles in the foundation. The taxable entity constructed a test pile on site to confirm whether this would work in the conditions present on the construction site. This test pile would become part of the foundation of the structure regardless of whether the engineers had to redesign the additional piles required for the foundation. The taxable entity's activities in using professional experience and business codes to design the foundation did not meet the Process of Experimentation Test because the activities did not resolve technological uncertainties through an experimental process. Constructing the test pile also did not meet the Process of Experimentation Test because it was not an evaluative process.

(VI) Example 6. A taxable entity is in the business of providing building and construction services, including the construction of warehouses, strip malls, office buildings, and other commercial structures. For one of its projects to construct an office building, the taxable entity was uncertain how to design the layout of the electrical systems. The taxable entity's employees held on-site meetings to discuss different options, such as running the wire under the floor or through the ceiling, but did not actually experiment by installing wire in different locations. The taxable entity did use computer-aided simulation and modeling to produce the final electrical system layout, but, in this case, such use was not an experimental process. The taxable entity's activities did not satisfy the Process of Experimentation Test because it did not conduct an experimental process of evaluating alternatives to eliminate a technological uncertainty.

(VII) Example 7. A taxable entity is an oil and gas operator that recently acquired rights to drill in an area in which it had not previously operated. The taxable entity decided to use horizontal drilling in this area, but it had never drilled a horizontal well and was uncertain how to successfully execute the horizontal drilling. At the time the taxable entity began horizontal drilling, the technology to drill horizontal wells was established. The taxable entity selected technology from existing commercially available options to use in its horizontal drilling program. The taxable entity's activities did not satisfy the Process of Experimentation Test because evaluating commercially available options does not constitute a process of experimentation.

(VIII) Example 8. A taxable entity is an oil and gas operator that recently acquired rights to drill in an area in which it had not previously operated. The taxable entity decided to use horizontal drilling in this area. The taxable entity had drilled a horizontal well before in a different formation and at different depths. However, it had never drilled a horizontal well in this formation or at the required depths and was uncertain how to successfully execute the horizontal drilling. The taxable entity utilized its existing technology to perform its horizontal drilling operations in this area and the existing technology was successful. The taxable entity's activities did not satisfy the Process of Experimentation Test because the taxable entity did not evaluate any alternative drilling methods.

(IX) Example 9. A taxable entity sought to discover novel cancer immunotherapies. The taxable entity was uncertain as to the appropriate design of the proteins to be used as a drug candidate. The taxable entity identified several alternative protein constructs and used a process to test them. The taxable entity's process involved testing the constructs using in vitro functional assays and binding assays, and either modifying the designs or discarding them and repeating the previous steps. The taxable entity took the resulting products from the in vitro testing and tested the drug candidate in living organisms. This process evaluated the various alternatives identified by the taxable entity. The taxable entity's activities satisfied the Process of Experimentation Test.

(2) Application of the Four-Part Test to business components. The Four-Part Test is applied separately to each business component of the taxable entity. Any plant process, machinery, or technique for commercial production of a business component is treated as a separate business component from the business component being produced.

(3) Shrink-back rule. The Four-Part Test is first applied at the level of the discrete business component used by the taxable entity in a trade or business of the taxable entity. If the requirements of the Four-Part Test are not met at that level, then they are applied at the next most significant subset of elements of the business component. This shrinking back of the product continues until either a subset of elements of the product that satisfies the requirements of the Four-Part Test is reached, or the most basic element of the product is reached, and such element fails to satisfy any part of the Four-Part Test.

(4) Software development as qualified research. In determining if software development activities constitute qualified research, the comptroller will consider the facts and circumstances of each activity.

(A) Application of Four-Part Test to software development activities.

(i) A taxable entity must prove that a software development activity is qualified research and meets all the requirements of the Four-Part Test under paragraph (1) of this subsection, even if the activity is likely to qualify as described in subparagraph (B) of this paragraph.

(ii) A taxable entity may prove that a software development activity described as unlikely to qualify in subparagraph (C) of this paragraph, is qualified research by providing evidence that the activity meets all the requirements of the Four-Part Test under paragraph (1) of this subsection.

(B) Software development activities likely to qualify. Types of activities likely to qualify include, but are not limited to:

(i) developing the initial release of an application software product that includes new constructs, such as new architectures, new algorithms, or new database management techniques;

(ii) developing system software, such as operating systems and compilers;

(iii) developing specialized technologies, such as image processing, artificial intelligence, or speech recognition; and

(iv) developing software as part of a hardware product where the software interacts directly with that hardware in order to make the hardware/software package function as a unit.

(C) Software development activities unlikely to qualify. Types of activities unlikely to qualify include, but are not limited to:

(i) maintaining existing software applications or products;

(ii) configuring purchased software applications;

(iii) reverse engineering of existing applications;

(iv) performing studies, or similar activities, to select vendor products;

(v) detecting flaws and bugs directed toward the verification and validation that the software was programmed as intended and works correctly;

(vi) modifying an existing software business component to make use of new or existing standards or devices, or to be compliant with another vendor's product or platform;

(vii) developing a business component that is substantially similar in technology, functionality, and features to the capabilities already in existence at other companies;

(viii) upgrading to newer versions of hardware or software or installing vendor-fix releases;

(ix) re-hosting or porting an application to a new hardware such as from mainframe to PC, or software platform, such as Windows to UNIX, or rewriting an existing application in a new language, such as rewriting a COBOL mainframe application in C++;

(x) writing hardware device drivers to support new hardware, such as disks, scanners, printers, or modems;

(xi) performing data quality, data cleansing, and data consistency activities, such as designing and implementing software to validate data fields, clean data fields, or make the data fields consistent across databases and applications;

(xii) bundling existing individual software products into product suites, such as combining existing word processor, spreadsheet, and slide presentation software applications into a single suite;

(xiii) expanding product lines by purchasing other products;

(xiv) developing interfaces between different software applications;

(xv) developing vendor product extensions;

(xvi) designing graphic user interfaces;

(xvii) developing functional enhancements to existing software applications/products;

(xviii) developing software as an embedded application, such as in cell phones, automobiles, and airplanes;

(xix) developing software utility programs, such as debuggers, backup systems, performance analyzers, and data recovery;

(xx) changing from a product based on one technology to a product based on a different or newer technology; and

(xxi) adapting and commercializing technology developed by a consortium or open software group.

(d) Excluded research activities. Qualified research does not include the activities described in this subsection.

(1) Research after commercial production. Any research conducted after the beginning of commercial production of the business component.

(A) Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use or meets the basic functional and economic requirements of the taxable entity for the component's sale or use.

(B) The following activities are deemed to occur after the beginning of commercial production of a business component:

(i) preproduction planning for a finished business component;

(ii) tooling-up for production;

(iii) trial production runs;

(iv) troubleshooting involving detecting faults in production equipment or processes;

(v) accumulating data relating to production processes;

(vi) debugging flaws in a business component; and

(vii) any activities that involve the use of an item for which the taxable entity claimed the manufacturing exemption under Tax Code, §151.318.

(C) In cases involving development of both a product and a manufacturing or other commercial production process for the product, the research after commercial production exclusion applies separately for the activities relating to the development of the product and the activities relating to the development of the process. For example, even after a product meets the taxable entity's basic functional and economic requirements, activities relating to the development of the manufacturing process may still constitute qualified research, provided that the development of the process itself separately satisfies the requirements of this section, and the activities are conducted before the process meets the taxable entity's basic functional and economic requirements or is ready for commercial use.

(D) Clinical testing of a pharmaceutical product prior to its commercial production in the United States is not treated as occurring after the beginning of commercial production even if the product is commercially available in other countries. Additional clinical testing of a pharmaceutical product after a product has been approved for a specific therapeutic use by the Food and Drug Administration and is ready for commercial production and sale is not treated as occurring after the beginning of commercial production if such clinical testing is undertaken to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms for the product. A functional use, characteristic, indication, combination, dosage, or delivery form shall be considered new only if such functional use, characteristic, indication, combination, dosage, or delivery form must be approved by the Food and Drug Administration.

(E) Examples.

(i) Example 1. A taxable entity is a tire manufacturer and develops a new material to use in its tires. The taxable entity conducts research to determine the changes that will be necessary for it to modify its existing manufacturing processes to manufacture the new tire. The taxable entity determines that the new tire material retains heat for a longer period of time than the materials it currently uses for tires, and, as a result, the new tire material adheres to the manufacturing equipment during tread cooling. The taxable entity evaluates several alternatives for processing the treads at cooler temperatures to address this problem, including a new type of belt for its manufacturing equipment to be used in tread cooling. Such a belt is not commercially available. Because the taxable entity is uncertain of the belt design, it develops and conducts sophisticated engineering tests on several alternative designs for a new type of belt to be used in tread cooling until it successfully achieves a design that meets its requirements. The taxable entity then manufactures a set of belts for its production equipment, installs the belts, and tests the belts to make sure they were manufactured correctly. The taxable entity's research with respect to the design of the new belts to be used in its manufacturing of the new tire may be qualified research under the Four-Part Test. However, the taxable entity's expenses to implement the new belts, including the costs to manufacture, install, and test the belts were incurred after the belts met the taxable entity's functional and economic requirements and are excluded as research after commercial production.

(ii) Example 2. For several years, a taxable entity has manufactured and sold a particular kind of widget. The taxable entity initiates a new research project to develop a new or improved widget. The taxable entity's activities to develop a new or improved widget are not excluded from the definition of qualified research under this paragraph. The taxable entity's activities relating to the development of a new or improved widget constitute a new research project to develop a new business component and are not considered activities conducted after the beginning of commercial production.

(iii) Example 3. For the purposes of this example, assume that the taxable entity's development of its products satisfies the Four-Part Test described by subsection (c) of this section and is not otherwise excluded under this subsection. A taxable entity is a manufacturer of integrated circuits for use in specific applications. The taxable entity designs various integrated circuit devices and assembles various product configurations for testing. After an internal process of testing, the taxable entity delivers a sample quantity of the integrated circuit to a potential customer for further testing. At the time when the samples are delivered to the taxable entity's potential customer, the potential customer has not agreed to purchase any integrated circuits from the taxable entity. This process of testing by both the taxable entity and its potential customer continues until an acceptable design is achieved. At that point, the taxable entity and the potential customer enter into an agreement for the delivery of an order of the integrated circuits. In some cases, no acceptable design is achieved, and no agreement is reached with the potential customer. Research activities occurring prior to an agreement are not considered activities conducted after the beginning of commercial production because the integrated circuits were not yet ready for commercial use. Any research that occurs after an agreement is reached are excluded as activities conducted after the beginning of commercial production because the integrated circuits were ready for commercial use once the design was accepted by the potential customer.

(2) Adaptation of existing business components. Activities relating to adapting an existing business component to a particular customer's requirement or need. This exclusion does not apply merely because a business component is intended for a specific customer. For example:

(A) Example 1. A taxable entity is a computer software development firm and owns a general ledger accounting software core program that it markets and licenses to customers. The taxable entity incurs expenditures in adapting the core software program to the requirements of one of its customers. Because the taxable entity's activities represent activities to adapt an existing software program to a particular customer's requirement or need, its activities are excluded from the definition of qualified research under this paragraph.

(B) Example 2. Assume that the customer from Example 1 pays the taxable entity to adapt the core software program to the customer's requirements. Because the taxable entity's activities are excluded from the definition of qualified research, the customer's payments to the taxable entity are not for qualified research and are not considered to be contract research expenses.

(C) Example 3. Assume that the customer from Example 1 uses its own employees to adapt the core software program to its requirements. Because the customer's employees' activities to adapt the core software program to its requirements are excluded from the definition of qualified research, the wages the customer paid to its employees do not constitute in-house research expenses.

(D) Example 4. A taxable entity manufactures and sells rail cars. Because rail cars have numerous specifications related to performance, reliability and quality, rail car designs are subject to exten-

sive, complex testing in the scientific or laboratory sense. A customer orders passenger rail cars from the taxable entity. The customer's rail car requirements differ from those of the taxable entity's other existing customers only in that the customer wants fewer seats in its passenger cars and a higher quality seating material and carpet that are commercially available. The taxable entity manufactures rail cars meeting the customer's requirements. The rail car sold to the customer was not a new business component, but merely an adaptation of an existing business component that did not require a process of experimentation. Thus, the taxable entity's activities to manufacture rail cars for the customer are excluded from the definition of qualified research because the taxable entity's activities represent activities to adapt an existing business component to a particular customer's requirement or need.

(E) Example 5. A taxable entity is a manufacturer and undertakes to create a manufacturing process for a new valve design. The taxable entity determines that it requires a specialized type of robotic equipment to use in the manufacturing process for its new valves. Such robotic equipment is not commercially available. Therefore, the taxable entity purchases existing robotic equipment for the purpose of modifying it to meet its needs. The taxable entity's engineers identify uncertainty that is technological in nature concerning how to modify the existing robotic equipment to meet its needs. The taxable entity's engineers develop several alternative designs, conduct experiments using modeling and simulation in modifying the robotic equipment, and conduct extensive scientific and laboratory testing of design alternatives. As a result of this process, the taxable entity's engineers develop a design for the robotic equipment that meets its needs. The taxable entity constructs and installs the modified robotic equipment on its manufacturing process. The taxable entity's research activities to determine how to modify the robotic equipment it purchased for its manufacturing process are not considered an adaptation of an existing business component.

(F) Example 6. A taxable entity is an oil and gas operator and has been engaged in horizontal drilling for the past ten years. Recently, the taxable entity was hired by a customer to drill in a formation. The drilling objectives included targeting an interval within that formation for horizontal drilling. The taxable entity was uncertain about the successful execution of the horizontal drilling because it had not previously drilled a horizontal well in that formation. The taxable entity was also uncertain about the economic results from the targeted interval. The taxable entity drilled several horizontal wells before its customer was satisfied with the economic results. The taxable entity modified its existing horizontal drilling program based on these results. The taxable entity's activities to identify a horizontal drilling process are excluded from the definition of qualified research because the activities consisted of adapting an existing business component (its existing horizontal drilling process) to meet a particular customer's need.

(G) Example 7. For the purposes of this example, assume that the taxable entity's development of its products satisfies the Four-Part Test described by subsection (c) of this section and is not otherwise excluded under this subsection. A taxable entity is a manufacturer of rigid plastic containers. The taxable entity contracts with major food and beverage manufacturers to provide suitable bottle and packaging designs. The products designed by the taxable entity may be for repeat customers and the sizes and types of bottle may be similar to previous products. The development of each new product, and the production process necessary to produce the products at sufficient production volume, starts from new concept drawings developed by engineers. The taxable entity uses a qualifying process of experimentation to evaluate alternative concepts for the product and production processes. The taxable entity's activities related to both the product and the production process are not excluded from the definition of qualified research as an adaptation of an existing business component.

(3) Duplication of existing business component. Any research related to the reproduction of an existing business component, in whole or in part, from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component. This exclusion does not apply merely because the taxable entity examines an existing business component in the course of developing its own business component.

(4) Surveys, studies, etc. Any efficiency survey; activity relating to management function or technique; market research, testing or development (including advertising or promotions); routine data collection; or routine or ordinary testing or inspection for quality control.

(5) Computer software. Any research activities with respect to internal use software.

(A) For the purposes of this paragraph, internal use software is computer software developed by, or for the benefit of, the taxable entity primarily for internal use by the taxable entity. A taxable entity uses software internally if the software was developed for use in the operation of the business. Computer software that is developed to be commercially sold, leased, licensed, or otherwise marketed for separately stated consideration to unrelated third parties is not internal use software.

(B) Software developed by a taxable entity primarily for internal use by an entity that is part of an affiliated group to which the taxable entity also belongs shall be considered internal use software for purposes of this paragraph.

(C) This exclusion does not apply to software used in:

(i) an activity that constitutes qualified research, or

(ii) a production process that meets the requirements of the Four-Part Test.

(D) The determination as to whether software is internal use software depends on the facts and circumstances existing at the beginning of the development of the software.

(6) Social sciences, etc. Any research in the social sciences, arts, or humanities.

(7) Funded research. Any research funded by any grant, contract, or otherwise by another person or governmental entity.

(A) Research is considered funded if:

(i) the taxable entity performing the research for another person retains no substantial rights to the results of the research; or

(ii) the payments to the researcher are not contingent upon the success of the research.

(B) For the purposes of determining whether a taxable entity retains substantial rights to the results of the research:

(i) Incidental benefits to the researcher from the performance of the research do not constitute substantial rights. For example, increased experience in a field of research is not considered substantial rights.

(ii) A taxable entity does not retain substantial rights in the research it performs if the taxable entity must pay for the right to use the results of the research.

(C) If a taxable entity performing research does not retain substantial rights to the results of the research, the research is considered funded regardless of whether the payments to the researcher are

contingent upon the success of the research. In this case, all research activities are considered funded even if the researcher has expenses that exceed the amount received by the researcher for the research.

(D) If a taxable entity performing research does retain substantial rights to the results of the research and the research is considered funded under subparagraph (A)(ii) of this paragraph, the research is only funded to the extent of the payments and fair market value of any property that the taxable entity becomes entitled to by performing the research. If the expenses related to the research exceed the amount the researcher is entitled to receive, the research is not considered funded with respect to the excess expenses. For example, a taxable entity performs research for another person. Based on the contract, the research activities are considered funded under subparagraph (A)(ii) of this paragraph because payments to the researcher are not contingent on the success of the research. The taxable entity retains substantial rights to the results of the research. The taxable entity is entitled to $100,000 under the contract but spent $120,000 on the research activities. In this case, the research is considered funded with respect to $100,000 and is not considered funded with respect to $20,000.

(E) A taxable entity performing research for another person must identify any other person paying for the research activities and any person with substantial rights to the results of the research.

(F) All agreements, not only research contracts, entered into between the taxable entity performing the research and the party funding the research shall be considered in determining the extent to which the research is funded.

(G) The provisions of this paragraph shall be applied separately to each research project undertaken by the taxable entity.

(e) [~~(c)~~] Eligibility for credit.

(1) A taxable entity is eligible to claim a [~~research and development activities~~] credit for the periods in which the taxable entity is engaged in qualified research and incurs qualified research expenses. The credit may be claimed on a franchise tax report for qualified research expenses incurred during the period on which the report is based.

(2) A taxable entity has the burden of establishing its entitlement to, and the value of, the credit by clear and convincing evidence, including proof that the research activities meet the definition of qualified research, the amount of any qualified research expenses, and applying the shrink-back rule described in subsection (c)(3) of this section.

(A) All qualified research expenses must be paid or incurred in connection with research activities that are qualified research.

(B) All qualified research expenses must be supported by contemporaneous business records.

(i) Contemporaneous business records for wages are records that were created and maintained during the period in which the taxable entity paid the employee to engage in qualified services. This includes, but is not limited to, payroll records, employee job descriptions, performance evaluations, calendars, and appointment books.

(ii) Contemporaneous business records for supplies are records that were created and maintained during the period in which the supplies were purchased. This includes, but is not limited to, inventory records, invoices, purchase orders, and contracts.

(iii) Contemporaneous business records for contract research expenses are records that were created and maintained during the period in which the contract research expenses were paid or incurred. This includes, but is not limited to, contracts and invoices.

(3) An Internal Revenue Service audit determination of eligibility for the federal research and development credit under IRC, §41 (Credit for increasing research activities), whether that determination is that the taxable entity qualifies or does not qualify for the federal research and development credit, is not binding on the comptroller's determination of eligibility for the credit.

(f) [~~(d)~~] Ineligibility for credit.

(1) A taxable entity is not eligible to claim a credit on a franchise tax report for qualified research expenses incurred during the period on which the report is based if the taxable entity, or a member of the taxable entity's combined group[~~, if the taxable entity is a combined group~~], received an exemption from sales and use tax under Tax Code, §151.3182 (Certain Property Used in Research and Development Activities; Reporting of Estimates and Evaluation) during that period.

(2) A taxable entity that is not eligible to claim a credit under this subsection may carry forward an unused credit under subsection (l) of this section. [~~entity's ineligibility under this subsection does not affect the taxable entity's eligibility to claim a carryforward of unused credit under subsection (j) of this section.~~]

(g) [~~(e)~~] Amount of credit.

(1) Qualified research expenses in Texas. Subject to subsection (h) [~~(f)~~] of this section, and except as provided by paragraphs (2), (3), and (4) of this subsection, the credit allowed for any report equals 5.0% of the difference between:

(A) all [~~the~~] qualified research expenses incurred during the period on which the report is based; and

(B) 50% of the average amount of all qualified research expenses incurred during the three tax periods preceding the period on which the report is based.

(2) Entities without qualified research expenses in each of the three preceding tax periods. Except as provided by paragraph (4) of this subsection, if the taxable entity has no qualified research expenses in one or more of the three tax periods preceding the period on which the report is based, the credit for the period on which the report is based equals 2.5% of the qualified research expenses incurred during that period.

(3) Qualified research expenses under a higher education contract. Subject to subsection (h) [~~(f)~~] of this section, and except as provided by paragraph (4) of this subsection, if the taxable entity contracts with one or more public or private institutions of higher education for the performance of qualified research and the taxable entity incurs qualified research expenses in Texas [~~this state~~] under the contract during the period on which the report is based, then the credit for the report equals 6.25% of the difference between:

(A) all qualified research expenses incurred during the period on which the report is based; and

(B) 50% of the average amount of all qualified research expenses incurred during the three tax periods preceding the period on which the report is based.

(4) Entities with qualified research expenses under higher education contracts but without qualified research expenses in each of the three preceding tax periods. If the taxable entity incurs qualified research expenses in Texas under a contract with one or more public or private institutions of higher education for the performance of qualified research during the period on which the report is based, but the taxable entity has no qualified research expenses in one or more of the three tax periods preceding the period on which the report is based, then the

credit for the period on which the report is based equals 3.125% of all qualified research expenses incurred during that period.

(5) Same method of computing qualified research expenses required. Notwithstanding whether the statute of limitations for claiming a credit under this section has expired for any tax period used in determining the average amount of qualified research expenses under paragraph (1)(B) or (3)(B) of this subsection, the determination of which research expenses are qualified research expenses for purposes of computing that average must be made in the same manner as that determination is made for purposes of paragraph (1)(A) or (3)(A) of this subsection. The comptroller may verify the qualified research expenses used to compute the prior year average, even if the statute of limitations for the prior year has expired. This verification will not result in an adjustment to tax, penalty, or interest for any report year for which the statute of limitations is closed.

(6) A taxable entity with any qualified research expenses under higher education contracts in a tax period may include all of its qualified research expenses in the calculations under paragraphs (3) and (4) of this subsection, even if not all of the qualified research expenses are related to higher education contracts. For taxable entities in a combined group, see subsection (i) of this section.

(h) [~~(f)~~] Attribution of expenses following transfer of controlling interest.

(1) If a taxable entity acquires a controlling interest in another taxable entity, or in a separate unit of another taxable entity, during a tax period with respect to which the acquiring taxable entity claims a credit under this section, then the amount of the acquiring taxable entity's qualified research expenses equals the sum of:

(A) the amount of qualified research expenses incurred by the acquiring taxable entity during the period on which the report is based; and

(B) subject to paragraph (4) of this subsection, the amount of qualified research expenses incurred by the acquired taxable entity or unit during the portion of the period on which the report is based that precedes the date of the acquisition.

(2) A taxable entity that sells or otherwise transfers to another taxable entity a controlling interest in another taxable entity, or in a separate unit of a taxable entity, during a period on which a report is based may not claim a credit under this section for qualified research expenses incurred by the transferred taxable entity or unit during the period if:

(A) the taxable entity that makes the sale or transfer is ineligible for the credit under subsection (f) [~~(d)~~] of this section; or

(B) the acquiring taxable entity claims a credit under this section for the corresponding period.

(3) If during any of the three tax periods following the period in which a sale or other transfer described by paragraph (2) of this subsection occurs, the taxable entity that sold or otherwise transferred the controlling interest reimburses the acquiring taxable entity for research activities conducted on behalf of the taxable entity that made the sale or other transfer, the amount of the reimbursement is:

(A) included as qualified research expenses incurred by the taxable entity that made the sale or other transfer for the tax period during which the reimbursement was paid, subject to paragraph (5) of this subsection; and

(B) excluded from the qualified research expenses incurred by the acquiring taxable entity for the tax period during which the reimbursement was paid.

(4) An acquiring taxable entity may not include on a report the amount of qualified research expenses otherwise authorized by paragraph (1)(B) of this subsection if the taxable entity that made the sale or other transfer described by paragraph (2) of this subsection received an exemption under Tax Code, §151.3182 during the portion of the period on which the acquiring taxable entity's report is based that precedes the date of the acquisition.

(5) A taxable entity that makes a sale or other transfer described by paragraph (2) of this subsection may not include on a report the amount of reimbursement otherwise authorized by paragraph (3)(A) of this subsection if the reimbursement is for research activities that occurred during a tax period in which the entity that makes a sale or other transfer received an exemption under Tax Code, §151.3182.

(i) [~~(g)~~] Combined reporting.

(1) A credit under this section for qualified research expenses incurred by a member of a combined group must be claimed on the combined report for the group required by Tax Code, §171.1014[~~(Combined Reporting; Affiliated Group Engaged in Unitary Business)~~].

(2) Each member of a combined group determines its credit under this section as if it were an individual taxable entity. The total credits of each member of the combined group shall be added together to determine the total credit claimed on the combined report.

(3) Each member of a combined group is entitled to that portion of the carryforward of the credit under subsection (l) of this section in proportion to the amount of the credit created by each member's qualified research. Each member of a combined group remains entitled to its portion of the carryforward even if the member changes combined groups for any reason.

(4) The higher education rate described by subsection (g)(3) and (4) of this section applies to each member of a combined group separately and not to the combined group as a whole.

(5) The combined group is the taxable entity for purposes of claiming the credit. Eligibility for and the amount of the credit is determined by each member as if it were an individual taxable entity [~~this section~~].

(j) [~~(h)~~] Tiered partnership reporting.

(1) An upper tier entity and a lower tier entity may claim a credit under this section for qualified research expenses; however, an upper tier entity and a lower tier entity cannot claim a credit under this section for the same qualified research expense.

(2) An upper tier entity that includes the total revenue of a lower tier entity for purposes of computing its taxable margin as authorized by Tax Code, §171.1015 (Reporting for Certain Partnerships in Tiered Partnership Arrangement) may claim the credit under this section for qualified research expenses incurred by the lower tier entity to the extent of the upper tier entity's ownership interest in the lower tier entity.

(k) [~~(i)~~] Limitation. The total credit claimed under this section for a report, including the amount of any carryforward credit under subsection (l) [~~(j)~~] of this section, may not exceed 50% of the amount of franchise tax due for the report before any other applicable tax credits.

(l) [~~(j)~~] Carryforward.

(1) If a taxable entity is eligible for a credit that exceeds the limitation under subsection (k) [~~(i)~~] of this section, the taxable entity may carry the unused credit forward for not more than 20 consecutive reports.

(2) Research and development credits [~~Credits~~], including credit carryforwards, are considered to be used in the following order:

(A) a credit carryforward of unused research and development credits accrued under Tax Code, Chapter 171, Subchapter O (Tax Credit for Certain Research and Development Activities), before its repeal on January 1, 2008, and claimed as authorized by §3.593 of this title (relating to Margin: Franchise Tax Credits);

(B) a credit carryforward under this section; and

(C) a current year credit.

(3) If a taxable entity claims a carryforward on a report within the statute of limitations, the comptroller may verify that the credit that established the carryforward was based on qualified research activities, even if the statute of limitations for the year in which the credit was created has expired. This verification will not result in an adjustment to tax, penalty, or interest for any report year for which the statute of limitations has expired. The verification may result in an adjustment to the carryforward for all periods within the unexpired statute of limitations and for all future periods in which the taxable entity may claim the carryforward.

(m) [~~(k)~~] Assignment prohibited. A taxable entity may not convey, assign, or transfer the credit allowed under this section to another entity unless all of the assets of the taxable entity are conveyed, assigned, or transferred in the same transaction.

(n) [~~(l)~~] Application for credit.

(1) [~~A taxable entity must apply for a credit under this section.~~]A taxable entity applies for the credit by claiming the credit on or with the franchise tax report for the period for which the credit is claimed. A [~~To apply for a credit, a~~] taxable entity must also complete Form 05-178, Texas Franchise Tax Research and Development Activities Credits Schedule, its electronic equivalent, or any form promulgated by the comptroller that succeeds such form.

(2) The comptroller may require a taxable entity that claims a credit under this section to provide all data and information required for the comptroller to evaluate the credit and to comply with Tax Code, §151.3182(c).

(o) [~~(m)~~] Amending reports.

(1) If a report was originally due and filed after the effective date of this section and a credit allowed under this section was not claimed, a taxable entity may file an amended report within the statute of limitation to claim a credit, if the taxable entity or a member of its combined group does not have an active Registration Number for that period. See §3.584 of this title for information about filing an amended report.

(2) If a taxable entity or member of the combined group has or had a Registration Number for a period for which it intends to claim a credit allowed under this section, the taxable entity or member of the combined group must submit a written request to cancel the registration before claiming a credit. The written request must contain [~~with~~]the following information:

(A) the tax period(s) covered by the report for which it intends to claim a credit allowed under this section; and

(B) a statement whether any tax-exempt purchases were made. If tax-exempt purchases were made, include an original or amended sales and use tax report with tax due, penalty, and interest for the sales tax periods that cover the tax-exempt purchases.

(3) If a report was filed claiming a credit allowed under this section and the taxable entity later decides to claim a sales and use tax exemption under Tax Code §151.3182, the taxable entity must:

(A) file an amended franchise tax report that does not claim the credit under this section and pay any tax, penalty, and interest due;

(B) apply for a Registration Number; and

(C) file a request for a sales and use tax refund for taxes paid on purchases under Tax Code, §151.3182.

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

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