

# ADOPTED RULES

Adopted rules include new rules, amendments to existing rules, and repeals of existing rules. A rule adopted by a state agency takes effect 20 days after the date on which it is filed with the Secretary of State unless a later date is required by statute or specified in the rule (Government Code, §2001.036). If a rule is adopted without change to the text of the proposed rule, then the *Texas Register* does not republish the rule text here. If a rule is adopted with change to the text of the proposed rule, then the final rule text is included here. The final rule text will appear in the Texas Administrative Code on the effective date.

## TITLE 1. ADMINISTRATION

### PART 15. TEXAS HEALTH AND HUMAN SERVICES COMMISSION

#### CHAPTER 355. REIMBURSEMENT RATES SUBCHAPTER C. REIMBURSEMENT METHODOLOGY FOR NURSING FACILITIES

##### 1 TAC §§355.307, §355.316

The Texas Health and Human Services Commission (HHSC) adopts an amendment to §355.307, concerning Reimbursement Setting Methodology, and new §355.316, concerning Reimbursement Methodology for Pediatric Care Facilities. Section 355.307 and §355.316 are adopted without changes to the proposed text as published in the August 6, 2021, issue of the *Texas Register* (46 TexReg 4765). The rules will not be republished.

##### BACKGROUND AND JUSTIFICATION

The amendment and new section are necessary to comply with the 2022-23 General Appropriations Act, Senate Bill (S.B.) 1, 87th Legislature, Regular Session, 2021 (Article II, HHSC, Rider 40). This legislation requires HHSC to revise the reimbursement methodology for pediatric long-term care facilities to mirror that of Medicare reimbursement.

The amendment removes language related to the pediatric nursing facility rate methodology currently in §355.307(c)(1) - (c)(4) and moves it to new §355.316. The creation of new §355.316 improves clarity as it separates the pediatric care facility reimbursement methodology from the reimbursement methodology used for nursing facilities in general. The language in new §355.316 is updated to meet the requirements of the new reimbursement methodology.

The reimbursement methodology revision will lead to reimbursement rates that are calculated at higher levels than under the current methodology, leading to higher quality and greater access to care for medically fragile children in Texas.

##### COMMENTS

The 21-day comment period ended on August 27, 2021.

During this period, HHSC did not receive any comments regarding the proposed rules.

##### STATUTORY AUTHORITY

The amendment and new section are adopted 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 Gov-

ernment 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 agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

Filed with the Office of the Secretary of State on September 29, 2021.

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Karen Ray

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Texas Health and Human Services Commission

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## TITLE 4. AGRICULTURE

### PART 2. TEXAS ANIMAL HEALTH COMMISSION

#### CHAPTER 33. FEES

##### 4 TAC §§33.1 - 33.4

The Texas Animal Health Commission (commission) in a duly noticed meeting on September 21, 2021, adopted amendments to Chapter 33, titled "Fees", of Title 4, Texas Administrative Code. The amendments are adopted without changes to the proposed text as published in the August 6, 2021, issue of the *Texas Register* (46 TexReg 4770). The rules will not be republished.

##### JUSTIFICATION FOR RULE ACTION

The amendments to Chapter 33 continue fee collection from Certificates of Veterinary Inspection to further commission services, activities, and programs protecting and promoting Texas animal agriculture. Additionally, the adoption of the rules improve readability and increase awareness of the electronic Certificate of Veterinary Inspection option as well as the third-party Certificates of Veterinary Inspection approved by the commission.

##### HOW THE RULES WILL FUNCTION

The adopted rules update terms and recognize modern technologies for obtaining Certificates of Veterinary Inspection.

Grammatical and editorial changes for improved readability are adopted in each section. Section 33.1, concerning Definitions, deletes "livestock market" as it is not used elsewhere in Chapter 33. Section 33.2, concerning Certificate of Veterinary Inspection, updates the rule by deleting the effect of certificates issues prior to 2005 and adding the option for electronic Certificates of Veterinary Inspections. Changes to §33.3 are non-substantive to improve readability. The new section, "Enforcement and Penalties", is adopted as §33.4 to clarify applicable penalties and violations.

#### SUMMARY OF COMMENTS RECEIVED AND COMMISSION RESPONSE

The 30-day comment period ended September 5, 2021. The commission did not receive any public comments during that time.

#### STATUTORY AUTHORITY

The Texas Animal Health Commission is vested by statute, §161.041(a), titled "Disease Control", to protect all livestock, exotic livestock, domestic fowl, and exotic fowl from disease. The commission is authorized, through §161.041(b), to act to eradicate or control any disease or agent of transmission for any disease that affects livestock, exotic livestock, domestic fowl, or exotic fowl.

Pursuant to §161.046, titled "Rules", the commission may adopt rules as necessary for the administration and enforcement of this chapter.

Pursuant to §161.112, titled "Rules", the commission shall adopt rules relating to the movement of livestock, exotic livestock, and exotic fowl from livestock markets and shall require tests, immunization, and dipping of those livestock as necessary to protect against the spread of communicable diseases.

Pursuant to §161.060, titled "Authority to Set and Collect Fees", the commission by rule may charge a fee for an inspection made by the commission.

Pursuant to §161.0601, titled "Certificates of Veterinary Inspection", the commission by rule may provide for the issuance, including electronically, of a Certificate of Veterinary Inspection by a veterinarian to a person transporting livestock, exotic livestock, domestic fowl, or exotic fowl. The commission by rule shall set and charge a fee for each Certificate of Veterinary Inspection provided to a veterinarian.

Pursuant to §161.148, titled "Administrative Penalty", the commission may impose an administrative penalty on a person who violates Chapter 161 or a rule or order adopted under Chapter 161. The penalty for a violation may be in an amount not to exceed \$5,000, effective September 1, 2021.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

Filed with the Office of the Secretary of State on October 1, 2021.

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Mary Luedeker

General Counsel

Texas Animal Health Commission

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For further information, please call: (512) 719-0724

## CHAPTER 45. REPORTABLE AND ACTIONABLE DISEASES

### 4 TAC §§45.1 - 45.4

The Texas Animal Health Commission in a duly noticed meeting on September 21, 2021, adopted amendments and new rules to Chapter 45, titled "Reportable and Actionable Diseases", in Title 4 of the Texas Administrative Code. Sections 45.1, 45.3 and 45.4 are adopted without changes, and those sections will not be republished. The commission is adopting §45.2 with changes, and this section will be republished. The amendments are adopted with changes to §45.2 as published in the *Texas Register* on August 6, 2021, (46 TexReg 4789). In consultation with the Department of State Health Services, the commission will add §45.2(c) to the chapter requiring "Diseases and agents of disease transmission in animals that are reportable to both the Texas Animal Health Commission and the Department of State Health Services in accordance with 25 TAC §97.3(b) may be reported to either agency, which will be forwarded to the other agency."

#### JUSTIFICATION FOR RULE ACTION

During the 87th Texas Legislative Session, Senate Bill 705 removed the statutorily prescribed list of diseases from which the commission is tasked with protecting all livestock, exotic livestock, domestic fowl, and exotic fowl as recommended by the Sunset Advisory Commission's review process. Instead of those statutorily prescribed disease lists, Senate Bill 705 amended Texas Agriculture Code §161.041, which now requires the commission adopt and periodically update rules listing the diseases that require control and eradication. The amended §161.041 also requires the commission to adopt and periodically update rules listing the diseases that the commission determines require reporting pursuant to Texas Agriculture Code §161.101. As such, the commission adopts the new title of Chapter 45 to "Reportable and Actionable Diseases" to accurately reflect which diseases are reportable to and actionable by the commission.

The rules will allow the commission to continue detecting and responding to diseases and agents of disease transmission that affect domestic and exotic livestock and fowl. The continued reporting requirements ensure the commission is timely notified to control the disease. In following the Sunset Advisory Commission's decision to prescribe the disease list by rule, the commission has more flexibility to prevent, manage, and eradicate reportable animal diseases. The adopted disease list also improves readability and reduces confusion by consolidating the number of disease lists and using more consistent and common disease names.

The purpose of the addition to §45.2(c) is to avoid repetitive efforts on the part of those required to report, and the content aligns with 25 TAC §97.5(b)(2). If an animal disease or agent of disease transmission is reportable to both the commission and the Department of State Health Services it may be reported to either agency and that agency will share the information with the other.

#### HOW THE RULES WILL FUNCTION

Section 45.1, concerning Definitions, amends definitions to align with §161.041 and §161.101 of the Texas Agriculture Code. Section 45.2, concerning Duty to Report, adds agents of disease transmission, updates terminology, and reorganizes which diseases must be reported to the commission pursuant to Texas

Agriculture Code §161.101. The scope of information a veterinarian must report to the commission is clarified, and one consolidated list of reportable and actionable diseases is adopted to reduce confusion and improve understanding. Section 45.4, concerning Enforcement and Penalties, is adopted to describe the scope of violations and respective penalties as prescribed by Chapter 161 of the Texas Agriculture Code.

#### SUMMARY OF COMMENTS RECEIVED AND COMMISSION RESPONSE

The 30-day comment period ended on September 5, 2021. The commission did not receive any public comments.

#### STATUTORY AUTHORITY

The amendments and additions are proposed under the following statutory authority in Chapter 161 of the Texas Agriculture Code.

The commission is vested by §161.041(a) to protect all livestock, exotic livestock, domestic fowl, and exotic fowl from diseases the commission determines require control or eradication. The commission is authorized pursuant to §161.041(b) to act to eradicate or control any disease or agent of disease transmission for any disease that affects livestock, exotic livestock, domestic fowl, or exotic fowl, regardless of whether the disease is communicable, even if the agent of transmission is an animal species not subject to the jurisdiction of the commission. The commission may adopt rules necessary to carry out those purposes. The commission shall adopt and periodically update rules listing the diseases that require control or eradication by the commission.

Pursuant to §161.046, titled "Rules", the commission may adopt rules as necessary for the administration and enforcement of Chapter 161, Texas Agriculture Code.

Pursuant to §161.101, titled "Duty to Report", a veterinarian, a veterinary diagnostic laboratory, or a person having care, custody, or control of an animal shall report to the commission the existence of diseases listed in rules adopted by the commission among livestock, exotic livestock, bison, domestic fowl, or exotic fowl. The commission shall adopt and periodically update rules listing the diseases that the commission determines require reporting under this section. Pursuant to Senate Bill 705 enacted by the 87th Texas Legislature, the disease list is removed and the commission is required to adopt the disease list by rule.

Pursuant to §161.145, titled "Veterinarian Failure to Report Diseased Animals", a veterinarian commits an offense if they willfully fail or refuse to comply with a provision of Subchapter F of Chapter 161 or with a rule adopted under Subchapter F.

Pursuant to §161.148, titled "Administrative Penalty", the commission may impose an administrative penalty on a person who violates Chapter 161 or a rule or order adopted under Chapter 161. The penalty for a violation may be in an amount not to exceed \$5,000, effective September 1, 2021.

The commission certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the commission's legal authority.

#### §45.2. Duty to Report.

(a) A veterinarian, a veterinary diagnostic laboratory, or a person having care, custody, or control of an animal shall report the existence of the following diseases and agents of disease transmission among livestock, exotic livestock, domestic fowl, or exotic fowl to the commission within 24 hours after diagnosis, unless otherwise required, if the disease or agent of disease transmission is:

- (1) recognized by the United States Department of Agriculture as a foreign animal disease or a reportable animal disease;
- (2) the subject of a cooperative eradication program with the United States Department of Agriculture;
- (3) reportable to the World Organisation for Animal Health (OIE);
- (4) the subject of a state emergency, as declared by the Governor; or
- (5) a disease or agent of disease transmission designated by the Texas Animal Health Commission in §45.3(c) of this chapter.

(b) In addition to reporting the existence of a disease under subsection (a) of this section, the veterinarian shall also report to the commission information, to the extent applicable, relating to:

- (1) the species and number of animals affected and exposed on the premises;
- (2) any clinical diagnosis or postmortem findings;
- (3) any death losses;
- (4) location of animals; and
- (5) animal(s) owner's and caretaker's name, address, and telephone number; and
- (6) name and telephone number of the veterinarian or other person in attendance.

(c) Diseases and agents of disease transmission in animals that are reportable to both the Texas Animal Health Commission and the Department of State Health Services in accordance with 25 TAC §97.3(b) may be reported to either agency, which will be forwarded to the other agency.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

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Texas Animal Health Commission

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For further information, please call: (512) 719-0724



## CHAPTER 46. EXPORT-IMPORT FACILITIES

### 4 TAC §§46.1 - 46.6

The Texas Animal Health Commission (commission) in a duly noticed meeting on September 21, 2021, adopted new Chapter 46, titled "Export-Import Facilities", in Title 4 of the Texas Administrative Code, comprising §46.1, concerning Definitions; §46.2, concerning Duty to Report; §46.3, concerning Recordkeeping Requirements; §46.4, concerning Movement Restrictions; §46.5, concerning Right of Entry; and §46.6, concerning Enforcement and Penalties. Sections 46.1 - 46.3, 46.5, and 46.6 are adopted without changes to the proposed text as published in the August 6, 2021, issue of the *Texas Register* (46 TexReg 4794) and will not be republished. Section 46.4 is adopted with structural edits for clarity and is republished in this issue of the *Texas Register*.

## JUSTIFICATION FOR RULE ACTION

The 87th Texas Legislature enacted House Bill 1958, relating to the regulation of livestock export-import processing facilities. House Bill 1958 created Section 161.0445 of the Texas Agriculture Code, which requires an owner or person in charge of an export-import facility to notify the commission not later than 24 hours after an animal received or held at the export-import facility is refused export out of this state or entry into another country. Sections 161.0445(c) and 161.0445(d) of the Texas Agriculture Code authorize the commission to require reporting and record-keeping requirements and provisions governing the movement, inspection, testing, or treatment of animals.

The adoption of these rules will allow the commission to improve disease surveillance and control of high-risk animals at export-import facilities to better protect Texas animal agriculture. In the event a high-risk animal is refused export out of this state or into another country, the commission may respond quickly to mitigate such disease risks.

## HOW THE RULES WILL FUNCTION

Section 46.1, concerning Definitions, defines relevant terms to aid understanding of the chapter. Section 46.2, concerning Duty to Report, requires the owner or person in charge of the export-import facility to report to the commission certain information concerning an animal refused from international trade within 24 hours of refusal. Section 46.3, concerning Recordkeeping Requirements, identifies the required information an export-import facility must record, maintain, and provide to the commission if an animal(s) is refused export out of this state or into another country. Section 46.4, concerning Movement Restrictions, restricts the movement of refused animals and animals in their shipment unless a commission representative permits movement on a VS Form 1-27. Section 46.5, concerning Right of Entry, clarifies the commission's ability to enter a public or private export-import facility to examine records, inspect animals, or perform a duty pursuant to Chapter 161 of the Texas Agriculture Code. Section 46.6, concerning Enforcement and Penalties, describes the scope of violations and penalties as prescribed by Chapter 161 of the Texas Agriculture Code.

## SUMMARY OF COMMENTS RECEIVED AND COMMISSION RESPONSE

The 30-day comment period ended on September 5, 2021. The commission received two comments. One comment was received by an individual who did not indicate support or opposition of the rule, the other by the Texas Southwestern Cattle Raisers Association who supports the rule adoption. To the extent the commission could determine, summaries of the comments relating to the rules and the commission's response follows.

**Comment:** The individual commenter did not indicate support or opposition to the proposed rule; the commenter stated that Chapter 46 does not require animals to have access to water, food or shelter when they are detained at any Texas export-import facilities. The commenter suggested adding those requirements as the commission will provide a hotline for reporting.

**Response:** The comment is outside the scope of the proposed chapter. Instead, the commission is authorized to act to eradicate or control any disease or agent of disease transmission that affects livestock, exotic livestock, domestic fowl, or exotic fowl. As such, the commission is not modifying the content of the rules in response to this comment.

**Comment:** The Texas Southwestern Cattle Raisers Association stated their support for the adoption of Chapter 46 based on the increased protection the rules provide against diseases and pests that threaten cattle health and could impact beef supply by allowing the commission to receive notification when animals are rejected for export due to inadequate records, disease, or pest concerns.

**Response:** The commission respectfully agrees and is not modifying Chapter 46 in response to this comment.

## STATUTORY AUTHORITY

The Texas Animal Health Commission is vested by statute, §161.041(a), titled "Disease Control", to protect all livestock, exotic livestock, domestic fowl, and exotic fowl from disease. The commission is authorized, through §161.041(b), to act to eradicate or control any disease or agent of transmission for any disease that affects livestock, exotic livestock, domestic fowl, or exotic fowl.

Pursuant to §161.0445, titled "Regulation of Export-Import Processing Facilities", the commission may, for disease or pest control purposes, adopt rules necessary to implement, administer, and enforce this section. The rules may include reporting and recordkeeping requirements and provisions governing the movement, inspection, testing, or treatment of animals.

Pursuant to §161.046, titled "Rules", the commission may adopt rules as necessary for the administration and enforcement of this chapter.

Pursuant to §161.047, titled "Entry Power", a commissioner or veterinarian or inspector employed by the commission may enter public or private property for the exercise of an authority or performance of a duty under Chapter 161.

Pursuant to §161.054, titled "Regulation of Movement of Animals; Exception", as a control measure, the commission by rule may regulate the movement of animals. The commission may restrict the intrastate movement of animals even though the movement of the animals is unrestricted in interstate or international commerce. The commission may require testing, vaccination, or another epidemiologically sound procedure before or after animals are moved. The commission is authorized, through §161.054(b), to prohibit or regulate the movement of animals into a quarantined herd, premises, or area. The Executive Director of the commission is authorized, through §161.054(d), to modify a restriction on animal movement, and may consider economic hardship.

Pursuant to §161.148, titled "Administrative Penalty", the commission may impose an administrative penalty on a person who violates Chapter 161 or a rule or order adopted under Chapter 161. The penalty for a violation may be in an amount not to exceed \$5,000, effective September 1, 2021.

### §46.4. *Movement Restrictions.*

Unless permitted for movement on a VS Form 1-27 by a commission representative, the owner or caretaker of an animal refused export out of this state or entry into another country shall not move the animal or animals in its shipment from the export-import facility if:

- (1) the animal is refused for a disease or pest concern; or
- (2) the animal or an animal in the shipment does not meet the commission's applicable testing, entry, inspection, permit, identification, movement, or change of ownership requirements.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

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For further information, please call: (512) 719-0724



## CHAPTER 53. MARKET REGULATION

### 4 TAC §§53.1, 53.3 - 53.6

The Texas Animal Health Commission (commission) in a duly noticed meeting on September 21, 2021, adopted amendments to §53.1, Facilities; §53.3, Quarantine; §53.4, Market Identification; and §53.5 Market Recordkeeping. The commission further adopted new §53.6, Enforcement and Penalties. These amendments and new section are adopted without changes to the proposed text as published in the August 6, 2021, issue of the *Texas Register* (46 TexReg 4797), and will not be republished.

#### JUSTIFICATION FOR RULE ACTION

The purpose of the rule adoption is to continue disease surveillance, control, enhanced marketability, and quality assurance. The adopted rules also improve readability and compliance by clarifying and removing inconsistencies in existing regulations.

#### HOW THE RULES WILL FUNCTION

Section 53.1, concerning Facilities, clarifies that certain requirements are not limited to brucellosis testing and provides grammatical and editorial changes for accuracy. Section 53.2, concerning Release of Animals, is not changed. Section 53.3, concerning Quarantine, provides editorial amendments for improved readability. Section 53.4, concerning Market Identification, removes a cross-reference to a brucellosis program requirement that no longer exists; if the market elects to voluntarily test, the addition to this rule retains the market's responsibility to supply cattle eartag and backtag identification to the veterinarian prior to relevant testing. Section 53.5, concerning Market Recordkeeping, clarifies and corrects the records a market must maintain according to existing commission rules and federal regulations. The section is reorganized to improve compliance and readability; no existing content is deleted. Section 53.6, concerning Enforcement and Penalties, describes the scope of violations and respective penalties as prescribed by Chapter 161 of the Texas Agriculture Code.

#### SUMMARY OF COMMENTS RECEIVED AND COMMISSION RESPONSE

The 30-day comment period ended on September 5, 2021. The commission received one comment from an individual who opposed §§53.1, 53.3 and 53.6. Of the comment received and to the extent the commission could determine, a summary of that comment and the commission's response is below.

Comment: The commenter requested the TAHC be permitted to place livestock, domestic fowl, or exotic fowl exposed to or infected with certain diseases in a sanctuary rather than slaugh-

tering those animals and ensure that the producer or livestock market, not the non-profit sanctuary, bears the cost of remediation.

The commenter also requested the TAHC not make special exceptions for businesses to sell diseased cattle, which includes carcinoma, through a livestock market if visual examination of the livestock is made by a TAHC agent or by the USDA - Food Safety and Inspection Service (FSIS).

The commenter also requested the TAHC require dealers to track downed cows and pigs so the state is able to track and record downed animals per livestock market considering each livestock market must provide a workspace for TAHC representatives.

Response: The comment is outside of the scope of the amended rule. As such, the commission is not amending Chapter 53 because of the comment, but will take suggestions under advisement for future rulemaking where applicable.

#### STATUTORY AUTHORITY

The Texas Animal Health Commission is vested by statute, §161.041(a), titled "Disease Control", to protect all livestock, exotic livestock, domestic fowl, and exotic fowl from disease. The commission is authorized, through §161.041(b), to act to eradicate or control any disease or agent of transmission for any disease that affects livestock, exotic livestock, domestic fowl, or exotic fowl.

Pursuant to §161.0415, titled "Disposal of Diseased or Exposed Livestock or Fowl", the commission may require by order the slaughter of livestock, domestic fowl, or exotic fowl exposed to or infected with certain diseases.

Pursuant to §161.0417, titled "Authorized Personnel for Disease Control", the commission must authorize a person, including a veterinarian, to engage in an activity that is part of a state or federal disease control or eradication program for animals.

Pursuant to §161.046, titled "Rules", the commission may adopt rules as necessary for the administration and enforcement of this chapter.

Pursuant to §161.049, titled "Dealer Records", a commission may require a livestock, exotic livestock, domestic fowl, or exotic fowl dealer to maintain records of all livestock, exotic livestock, domestic fowl, or exotic fowl bought and sold by the dealer. The commission may inspect and copy the records of a livestock, exotic livestock, domestic fowl, or exotic fowl dealer that relate to the buying and selling of those animals. The commission by rule shall adopt the form and content of the records maintained by a dealer. A dealer is a person engaged in the business of buying or selling animals in commerce on the person's own account; as an employee or agent of the vendor, the purchaser, or both; or on a commission basis. That does not include a person who buys or sells animals as part of the person's bona fide breeding, feeding, dairy, or stocker operations but does include livestock markets and commission merchants.

Pursuant to §161.054, titled "Regulation of Movement of Animals; Exception", the commission, by rule, may regulate the movement of animals. The commission may restrict the intrastate movement of animals even though the movement of the animals is unrestricted in interstate or international commerce. The commission may require testing, vaccination, or another epidemiologically sound procedure before or after animals are moved. The commission is authorized, through §161.054(b), to

prohibit or regulate the movement of animals into a quarantined herd, premises, or area. The Executive Director of the commission is authorized, through §161.054(d), to modify a restriction on animal movement, and may consider economic hardship.

Pursuant to §161.056(a), titled "Animal Identification Program", the commission, to provide for disease control and enhance the ability to trace disease-infected animals or animals that have been exposed to disease, may develop and implement an animal identification program that is no more stringent than a federal animal disease traceability or other federal animal identification program.

Pursuant to §161.065, titled "Movement from Quarantined Area; Movement of Quarantined Animals", a person in violation of a quarantine may not move livestock, domestic animals, or domestic fowl in this state from any quarantined place in or outside this state; move quarantined livestock, domestic animals, or domestic fowl from the place in which they are quarantined; or move commodities or animals designated as disease carriers or potential disease carriers in this state from a quarantined place in or outside this state. The commission may provide for a written certificate or written permit authorizing the movement of commodities or animals from quarantined places or the movement of quarantined commodities or animals. If the commission finds animals that have been moved in violation of a quarantine established under this chapter, the commission shall quarantine the animals until they have been properly treated, vaccinated, tested, or disposed of in accordance with the rules of the commission.

Pursuant to §161.113, titled "Testing or Treatment of Livestock", the commission may establish rules regarding the tests, vaccination, and treatment of animals at livestock markets. Section 161.113(c) provides that the commission may require the owner or operator of the livestock market to furnish adequate chutes or holding pens or have access to other essential testing and dipping facilities within the immediate vicinity of the livestock market. Pursuant to Senate Bill 705, effective September 1, 2021, the commission may require the owner or operator of the livestock market to furnish adequate equipment or facilities or have access to essential equipment or facilities within the immediate vicinity of the livestock market.

Pursuant to §161.114, titled "Inspection of Livestock", an authorized inspector of the TAHC may examine livestock consigned to and delivered on the premises of a livestock market before the livestock are offered for sale. The inspector may require an animal be tested or vaccinated if necessary, which must occur before the animal is removed from the livestock market.

Pursuant to §161.115, titled "Entry Power", an agent of the commission is entitled to enter any livestock market to exercise authority or performance of a duty under Subchapter G of Chapter 161.

Pursuant to §161.116(b), titled "Sale or Delivery of Diseased Cattle", a person may not sell diseased cattle, which includes carcinoma, unless the cattle are sold through a livestock market where visual examination of livestock is made by an agent of the commission or by the USDA. Under §161.116(c), a person may not release diseased cattle from a livestock market unless the cattle are consigned directly to a federally approved terminal market or to a slaughtering establishment maintaining federal, state, or state-approved veterinary postmortem inspection; and accompanied by a certificate or permit issued by a TAHC or

USDA representative naming the terminal market or slaughtering establishment.

Pursuant to §161.146, titled "Compliance with Livestock Market Regulation", an owner or operator of a livestock market must furnish adequate facilities, permit an agent of the commission to enter the market, exercise an authority, or perform a duty under Subchapter G of Chapter 161, Texas Agriculture Code.

Pursuant to §161.147, titled "Failure to Maintain Dealer Records", a person commits an offense if the person fails to maintain or permit the inspection of a record required under Section 161.049 of Chapter 161.

Pursuant to §161.148, titled "Administrative Penalty", the commission may impose an administrative penalty on a person who violates Chapter 161 or a rule or order adopted under Chapter 161. The penalty for a violation may be in an amount not to exceed \$5,000, effective September 1, 2021.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

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Mary Luedeker

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For further information, please call: (512) 719-0724



## CHAPTER 55. SWINE

### 4 TAC §§55.1 - 55.5, 55.7, 55.9, 55.10

The Texas Animal Health Commission (commission) in a duly noticed meeting on September 21, 2021, adopted amendments to Chapter 55, §§55.1 - 55.5, 55.7, 55.9, and 55.10, in Title 4 of the Texas Administrative Code. These amendments are adopted without changes to the proposed text as published in the August 6, 2021, issue of the *Texas Register* (46 TexReg 4800). The rules will not be republished.

#### JUSTIFICATION FOR RULE ACTION

The adoption of these rules improves readability and clarifies existing swine regulations. The rules meet the requirements of Senate Bill 705 and Senate Bill 1997 amendments enacted by the 87th Texas Legislature and federal rules and standards.

#### HOW THE RULES WILL FUNCTION

In all adopted sections, editorial and grammatical changes are made. Section 55.1, concerning Testing Breeding Swine Prior to Sale or Change of Ownership, clarifies and updates several definitions as well as adds "TAHC Authorized Veterinarian" and clarifies that tested animals shall be officially identified. Section 55.2, concerning Restricted Use of Modified Live Virus Classical Swine Fever Vaccine, corrects the rule with regard to the use of the vaccine as well as changes the disease name pursuant to the Senate Bill 1997 enacted by the 87th Legislature. Section 55.3, concerning Feeding of Garbage Requirements and Garbage Feeding Facility Permit amends the title to better describe the section. The section is reorganized for improved readability. Section 55.4, concerning Livestock Markets Han-

dling Swine, updates and corrects multiple rules. Section 55.5, concerning Pseudorabies, amends several rules to align with federal regulations and federal standards. The commission did not amend §55.6 or §55.8. Clarifications are adopted in §55.7, concerning Slaughter Plant Requirements, including the amendment regarding the state diagnostic laboratory in response to Senate Bill 705 enacted by the 87th Legislature. Section 55.9, concerning Feral Swine Requirements, Facility Approval and Authorization, amends the section title to better describe the feral swine programs and provides clarifications throughout the section. Section 55.10, concerning Enforcement and Penalties, describes the scope of penalties pursuant to Chapter 161 of the Texas Agriculture Code.

#### SUMMARY OF COMMENTS RECEIVED AND COMMISSION RESPONSE

The 30-day comment period ended on September 5, 2021. The commission received one comment from an individual who opposed §§55.3, 55.4, and 55.7. Of the comment received and to the extent the commission could determine, the summary of the comment and the commission's response is below.

**Comment:** The commenter requested the TAHC restrict the feeding of garbage to pigs to continue disease reduction. The commenter also requested the TAHC not allow livestock markets and dealers in Texas to sell downed pigs; instead, humanely euthanize them for continued disease reduction. Additionally, the commenter stated that the TAHC should authorize only a licensed veterinarian to euthanize downed animals as opposed to hanging, shooting, or burying downed pigs alive. The commenter also asked the TAHC to not change "kill" to "slaughter" in 4 TAC §55.7.

**Response:** The suggested changes to §55.3 and §55.4 are beyond the scope of the amended rules. The commission disagrees with the suggestion to retain "kill" in §55.7 because the definition of "slaughter" is narrower and consistent with the slaughter plant practices. The commission values the specificity and applicability the amended term "slaughter" provides in §55.7. As such, the commission is not modifying any content in response to the comment.

#### STATUTORY AUTHORITY

These rules are adopted pursuant to the following statutory authority found in Chapters 161 and 165 of the Texas Agriculture Code. The Texas Animal Health Commission is vested by statute, §161.041(a), titled "Disease Control", to protect all livestock, exotic livestock, domestic fowl, and exotic fowl from disease. The commission is authorized, through §161.041(b), to act to eradicate or control any disease or agent of transmission for any disease that affects livestock, exotic livestock, domestic fowl, or exotic fowl.

Pursuant to §161.0412, titled "Regulation and Registration of Feral Swine Holding Facilities", the commission may require the registration of feral swine holding facilities for disease control purposes. The commission may also require a person to register with the commission if the person confines feral swine in a holding facility for slaughter, sale, exhibition, hunting, or any other purpose specified by commission rule to prevent the spread of diseases.

Pursuant to §161.0417, titled "Authorized Personnel for Disease Control", a person, including a veterinarian, must be authorized by the commission to engage in an activity that is part of a state or federal disease control or eradication program for animals.

Pursuant to §161.042, titled "Sale and Distribution of Veterinary Biologics", the commission may control the sale and distribution of all veterinary biologics except rabies vaccine.

Pursuant to §161.046, titled "Rules", the commission may adopt rules as necessary for the administration and enforcement of this chapter.

Pursuant to §161.047, titled "Entry Power", the commissioner or a veterinarian or inspector employed by the commission may enter public or private property for the exercise of an authority or performance of a duty under Chapter 161.

Pursuant to §161.048, titled "Inspection of Shipment of Animals or Animal Products", an agent of the commission is entitled to stop and inspect a shipment of animals or animal products being transported in the State of Texas to determine if the shipment is in compliance with the laws and rules administered by the commission affecting the shipment, determine if the shipment originated from a quarantined area or herd, or determine if the shipment presents a danger to the public health or livestock industry through a communicable or noncommunicable disease.

Pursuant to §161.054, titled "Regulation of Movement of Animals; Exception", the commission by rule may regulate the movement of animals, including feral swine, as a control measure. The commission may restrict the intrastate movement of animals, including feral swine, even though the movement of the animals is unrestricted in interstate or international commerce. The commission may require testing, vaccination, or another epidemiologically sound procedure before or after animals are moved. The commission by rule may prohibit or regulate the movement of animals, including feral swine, into a quarantined herd, premise, or area. In connection with the regulation of the movement of feral swine, the commission by rule may require disease testing before movement of feral swine from one location to another, and establish the conditions under which feral swine may be transported.

Pursuant to §161.055, titled "Slaughter Plant Collection", the commission may require slaughter plants to collect and submit blood samples and other diagnostic specimens for testing for disease. The commission by rule shall determine the method of collecting, submitting, and testing of blood samples and other diagnostic specimens.

Pursuant to §161.114, titled "Inspection of Livestock", an authorized inspector may examine livestock consigned to and delivered on the premises of a livestock market before the livestock are offered for sale. If the inspector considers it necessary, the inspector may have an animal tested or vaccinated. Any testing or vaccination must occur before the animal is removed from the livestock market.

Pursuant to §161.115, titled "Entry Power", an agent of the commission is entitled to enter any livestock market for the exercise of authority or performance of a duty under Subchapter G, Chapter 161.

Pursuant to §161.1375, titled "Movement of Feral Swine", a person commits an offense if the person recklessly moves feral swine in a manner that does not comply with commission rules or as the owner or person in charge of a holding facility in which feral swine is held, permits another to remove feral swine from the holding facility in a manner that does not comply with commission rules.

Pursuant to §161.148, titled "Administrative Penalty", the commission may impose an administrative penalty on a person who

violates Chapter 161 or a rule or order adopted under Chapter 161. The penalty for a violation may be in an amount not to exceed \$5,000, effective September 1, 2021.

Pursuant to §161.150, titled "Failure to Register Feral Swine Holding Facilities; Holding of Feral Swine", a person commits an offense if the person recklessly maintains a feral swine holding facility that is not registered under §161.0412 of the Texas Agriculture Code or as the owner or person in charge of a holding facility that is not registered under §161.0412 holds or permits another to hold feral swine in the holding facility.

Pursuant to §165.022, titled "Method of Disease Eradication", the commission shall adopt rules following notice and public hearing for the enforcement of cooperative programs for disease eradication, including rules providing for the manner, method, and system of eradicating swine diseases. Pursuant to Senate Bill 1997 enacted by the 87th Texas Legislature, effective September 1, 2021, the commission may by a two-thirds vote adopt rules that are more stringent than the federal minimum standards for cooperative programs.

Pursuant to §165.026, titled "Feeding Garbage to Swine", a person may not feed restricted garbage to swine or provide restricted garbage to any person for the purpose of feeding swine, except that a facility operated by the Texas Department of Criminal Justice may feed restricted garbage to swine if the garbage is properly treated in accordance with applicable federal requirements. A person may feed unrestricted garbage to swine only if the person first registers with and secures a permit from the commission. The commission may adopt rules for registration under this section, including rules providing for registration issuance, revocation, and renewal, disease tests, inspections, bookkeeping, and appropriate handling and treatment of unrestricted garbage. Registration with the commission shall be made on forms prescribed by the commission, and the commission shall furnish those forms on request.

Pursuant to §165.027, titled "Entry Power", a representative of the commission, including a member of the commission, is entitled to enter the premises of any person for the purpose of inspecting swine or the heating or cooking equipment required by Subchapter B, Chapter 165, or for the purpose of performing another duty under Subchapter B, Chapter 165. A person may not refuse to permit an inspection authorized by Subchapter B, Chapter 165.

Pursuant to §165.041, titled "General Penalty", a person commits an offense if the person violates a provision of Subchapter B, Chapter 165 or a rule adopted under that subchapter. An offense under this section is a Class C misdemeanor unless it is shown on the trial of the offense that the defendant has been previously convicted under this section, in which event the offense is a Class B misdemeanor. A person commits a separate offense for each day of violation.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

Filed with the Office of the Secretary of State on October 1, 2021.

TRD-202103880

Mary Luedeker  
General Counsel  
Texas Animal Health Commission  
Effective date: October 21, 2021  
Proposal publication date: August 6, 2021  
For further information, please call: (512) 719-0724

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## CHAPTER 59. GENERAL PRACTICES AND PROCEDURES

### 4 TAC §59.5

The Texas Animal Health Commission (commission) in a duly noticed meeting on September 21, 2021, adopted amendments to §59.5, concerning Public Information Act Requests, in Chapter 59, titled "General Practices and Procedures", in Title 4 of the Texas Administrative Code. This amendment is adopted without changes to the proposed text as published in the August 6, 2021, issue of the *Texas Register* (46 TexReg 4812), and will not be republished.

#### JUSTIFICATION FOR RULE ACTION

The commission adopted this section of Chapter 59 for greater transparency because the rule provides the public with several clear and accessible methods from which to choose to make a public information request. The rule also promotes consistency in the commission's application of the Texas Public Information Act.

#### HOW THE RULE WILL FUNCTION

The adopted rule clarifies language on submitting public information requests and makes terminology more consistent. An amendment specifies that public information requests may be sent to one of the methods indicated on the agency's website rather than by mail to the attention of the General Counsel to help ensure that any requests are promptly forwarded to the commission's Public Information Coordinator. Another amendment relating to charges for public records removes an outdated reference and examples of records that may be furnished without charge and incorporates by reference the Office of the Attorney General's (OAG) cost rules. Finally, the amendment regarding inspections of records clarifies when a member of the public may physically inspect records and allows for the denial of access under certain circumstances.

#### SUMMARY OF COMMENTS RECEIVED AND COMMISSION RESPONSE

The 30-day comment period ended on September 5, 2021. During that time, no public comments were received.

#### STATUTORY AUTHORITY

Section 59.5 of Title 4, Texas Administrative Code is adopted pursuant to the following authorities:

Texas Agriculture Code §161.046, titled "Rules", which authorizes the commission to adopt rules as necessary for the administration and enforcement of this chapter.

Texas Government Code §552.234, titled "Method of Making Written Request for Public Information", which authorizes the commission to approve one or more methods of delivery of requests for public information in addition to those required by statute and to designate one electronic mail address for receiving requests for public information.

Texas Government Code §552.261, titled "Charge for Providing Copies of Public Information", which authorizes the commission to charge for providing a copy of public information in an amount that reasonably includes all costs related to reproducing the public information, including costs of materials, labor and overhead.

The commission certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the commission's legal authority.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

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Mary Luedeker

General Counsel

Texas Animal Health Commission

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For further information, please call: (512) 719-0724



## TITLE 28. INSURANCE

### PART 6. OFFICE OF INJURED EMPLOYEE COUNSEL

#### CHAPTER 276. GENERAL ADMINISTRATION SUBCHAPTER A. GENERAL PROVISIONS

##### 28 TAC §§276.3 - 276.5

INTRODUCTION. The Office of Injured Employee Counsel (OIEC) adopts amendments to existing rules at 28 Texas Administrative Code (TAC), Chapter 276, Subchapter A, §§276.3 - 276.5. The adopted amendments update rules to ensure efficient agency operations; maintain consistency with statute; and simplify publication requirements. The amendments are adopted without changes to the proposed amendments published in the September 3, 2021, issue of the *Texas Register* (46 TexReg 5537). OIEC adopts amendments to §§276.3, 276.4, and 276.5.

REASONED JUSTIFICATION. OIEC identified a number of rules that required updates during the agency's rule review under Texas Government Code §2001.039, which requires a state agency to review each of its rules every four years. The agency identified rules that are outdated, inconsistent with statutory language, or fail to clarify the language and purpose of statutes.

The adopted amendment to §273.3, Rulemaking Petition, clarifies rules may be petitioned by an "interested person." This language is consistent with the language in Government Code §2001.021, Subchapter B.

The adopted amendment to §276.4, Sick Leave Pool, removes references to the "Deputy Public Counsel" and adds language reflecting the Public Counsel's discretion to designate a sick leave pool administrator under Government Code §661.002. This change is part of a general effort to remove functional job titles from agency rules.

The adopted amendment to §276.5, Employer's Notice of Ombudsman Program and First Responder Liaison to Employees,

updates publication requirements under Labor Code §404.153 to eliminate language designating publication locations and font sizes. This change is part of a general effort to remove complexity from agency rules.

SUMMARY OF COMMENTS. OIEC did not receive any comments on the proposed amendments.

STATUTORY AUTHORITY. The Public Counsel adopts the amendments to §§276.3 - 276.5 as authorized under Labor Code §404.006 to adopt rules as necessary to implement Chapter 404 of the Labor Code.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

Filed with the Office of the Secretary of State on October 4, 2021.

TRD-202103913

Gina McCauley

General Counsel

Office of Injured Employee Counsel

Effective date: October 24, 2021

Proposal publication date: September 3, 2021

For further information, please call: (512) 804-4194



### SUBCHAPTER B. OMBUDSMAN PROGRAM

#### 28 TAC §276.10

INTRODUCTION. The Office of Injured Employee Counsel (OIEC) adopts amendments to 28 Texas Administrative Code (TAC), Chapter 276, Subchapter B, §276.10. The proposed amendments update the rule to ensure efficient agency operations; maintain consistency with statute; and eliminate a license requirement.

The amendments are adopted without changes to the proposed text as published in the September 3, 2021, issue of the *Texas Register* (46 TexReg 5538). The rule will not be republished.

REASONED JUSTIFICATION. OIEC identified a number of rules that required updates during the agency's rule review under Texas Government Code §2001.039, which requires a state agency to review each of its rules every four years. The agency identified rules that are outdated, inconsistent with statutory language, or fail to clarify the language and purpose of statutes.

The proposed amendments to §276.10, Ombudsmen Training and Continuing Education Program, remove §276.10(c)(2)(A) and §276.10(a)(1) regarding obtaining and maintaining a valid workers' compensation adjuster license and the associated continuing education requirement. The change follows state-wide efforts to reduce burdensome licensing requirements. These deletions will also require amending §276.10(a)(2), to remove references to continuing education for obtaining and retaining the adjusters' license. The proposed amendment to §276.10(c)(1)(B) will remove functional job titles.

SUMMARY OF COMMENTS. OIEC did not receive any comments on the proposed amendments.

STATUTORY AUTHORITY. The Public Counsel adopts the amendments to 28 TAC §276.10 as authorized under Labor Code §404.006 to adopt rules as necessary to implement Chapter 404 of the Labor Code.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

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TRD-202103914

Gina McCauley

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Office of Injured Employee Counsel

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For further information, please call: (512) 804-4194

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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 adopts amendments to §3.340, concerning qualified research, with changes to the proposed text as published in the April 16, 2021, issue of the *Texas Register* (46 TexReg 2555). The rule will be republished.

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 received comments regarding the proposed amendments from: Shannon Rusing of Texas Oil & Gas Association (TXOGA); Dale Craymer of Texas Taxpayers and Research Association (TTARA); Patrick Reynolds of Council on State Taxation (COST); Shane Frank of alliantgroup, LP (alliantgroup); Michael Thompson of Ryan; Kreig Mitchell of Kreig Mitchell LLC; Ronnie Berry of Celanese Corporation (Celanese); and Jennifer Woodard of Associated General Contractors of Texas (AGC of Texas).

Ronnie Berry of Celanese and Jennifer Woodard of AGC of Texas requested a public hearing on the proposed amendments. The comptroller held the public hearing on Monday, June 28, 2021, at 9:00 a.m. in Room 170 of the Stephen F. Austin Building, Austin, Texas 78701. Benjamin Barmore of alliantgroup, Michael Thompson of Ryan, Alyssa Honnette of RSM, Dale Craymer of TTARA, Carolyn Labatt of Great South Texas Corporation (GSTC), and John Ferris of RealPage, Inc. (RealPage) testified at the hearing.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, and Shane Frank of alliantgroup each requested that the comptroller provide additional affirmative examples where a taxpayer qualified for the credit. These requests were for general examples, examples related to the Oil and Gas industry, and examples related to software development. The comptroller declines to provide additional examples in the rule because the current examples are sufficient.

Shane Frank and Benjamin Barmore of alliantgroup and Michael Thompson of Ryan commented that the proposed rule would eliminate entire industries from having any qualified research activities. The comptroller declines to modify the rule based on these comments. This is not the intent of the rule and there is no language in the rule that prevents a taxpayer from being engaged in qualified research based on the industry of the taxpayer.

The comptroller adds a new subsection (a)(1) to define the term "business component." The comptroller bases this term on Internal Revenue Code (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) 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](http://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](http://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](http://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 paragraph (c)(6), the second 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 ref-

erence. The proposed regulations referenced in those Internal Revenue Bulletins were not part of the Treasury Regulations in effect on December 31, 2011. 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.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Michael Thompson of Ryan, Ronnie Berry of Celanese, Jennifer Woodard of AGC of Texas, Carolyn Labatt of GSTC, and John Ferris of RealPage suggested that the Treasury Regulations that taxpayers had the option to apply to the 2011 federal income tax year, such as Treasury Regulation, §1.41-4(c)(6) and Treasury Regulation, §1.174-2, should be included in the definition of "Internal Revenue Code." For the reasons described above, the comptroller declines this suggestion.

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.

Shane Frank of alliantgroup and Michael Thompson of Ryan commented that the redefinition of qualified research is unnecessary, will cause confusion for taxpayers, and does not conform to IRC, §41. The comptroller declines to modify the rule based on these comments. The amendments to this definition are intended to provide additional guidance to taxpayers regarding how the definition of qualified research was incorporated into Texas law. The new definition is not intended to, and does not, conflict with the IRC that was incorporated into Texas law. Any part of the rule that does not have a direct basis in federal law was included to address ambiguities that were not addressed in IRC, §41 or any applicable Treasury Regulations.

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 de-

preciation. 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.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, Ronnie Berry of Celanese, and Jennifer Woodard of AGC of Texas, Alyssa Honnette of RSM, Carolyn Labatt of GSTC, and John Ferris of RealPage commented that the clear and convincing evidence standard is unnecessarily burdensome and suggested that the comptroller should apply the same burden of proof that is required for the federal income tax R&D credit. The comptroller declines this suggestion. The clear and convincing evidence standard is generally applicable to all sales tax exemptions and nothing in Tax Code, §151.3182 incorporates the federal burden of proof.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, Michael Thompson of Ryan, Ronnie Berry of Celanese, Jennifer Woodard of AGC of Texas, Alyssa Honnette of RSM, Carolyn Labatt of GSTC, and John Ferris of RealPage commented that the requirement to provide contemporaneous documentation is unnecessarily burdensome and suggested that the comptroller should require the same types of documentation that is required for the federal income tax R&D credit. The comptroller declines this suggestion. The requirement for contemporaneous documentation is generally applicable to all sales tax exemptions and nothing in Tax Code, §151.3182 incorporates the federal documentation requirements.

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.

Michael Thompson of Ryan and Kreig Mitchell of Kreig Mitchell LLC suggested that services should be allowed to be business components and that subsection (c)(1)(C)(i) should be removed. The comptroller declines this suggestion. The term "business component" is defined by IRC, §41(d)(2)(B) as "any product, process, computer software, technique, formula, or invention which is to be--(i)held for sale, lease, or license, or (ii)used by the taxpayer in a trade or business of the taxpayer." Services do not fit within this definition. Concerns regarding taxpayers that provide services are addressed by this subsection by providing that a taxpayer may have qualified research activities for

research related to business components that are used to provide services.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, Michael Thompson of Ryan, Kreig Mitchell of Kreig Mitchell LLC, Ronnie Berry of Celanese, and Jennifer Woodard of AGC of Texas suggested that designs should be allowed to be business components and that subsection (c)(1)(C)(ii) should be removed. The comptroller declines this suggestion. The term "business component" is defined by IRC, §41(d)(2)(B) as "any product, process, computer software, technique, formula, or invention which is to be--(i)held for sale, lease, or license, or (ii)used by the taxpayer in a trade or business of the taxpayer." The commenters suggested that a "design" can be produced and is included in the term "product." The surplusage canon of statutory construction requires that statutory provisions not be read in a way that would render any word redundant. An interpretation of the term "product" that is broad enough to include the term "design" would also include the terms "process," "computer software," "technique," "formula," and "invention." Such an interpretation would render all those terms redundant. The commenters also suggested that excluding a design from being a business component is inconsistent with the applicable federal law because Treasury Regulation, §1.41-4 provided that uncertainty as to the appropriate design of a business component can be a qualifying uncertainty for the Section 174 Test, the Discovering Technological Information Test, and the Process of Experimentation Test. In the phrase "appropriate design of a business component" the word design does not refer to the business component itself, it is describing a quality of the business component.

Shane Frank of alliantgroup, Michael Thompson of Ryan, Ronnie Berry of Celanese, Jennifer Woodard of AGC of Texas, and Mike Williams of RSM suggested eliminating subsection (c)(1)(D)(vi). The comptroller declines the suggestion to eliminate this subsection but does modify it to address these concerns. The guidance in this subsection is a non-exhaustive list of factors that the comptroller considers when determining if a trial and error experimental method is qualifying systematic trial and error or non-qualifying simple trial and error. These factors do not affect the evaluation of a process of experimentation that does not consist of trial and error. This subsection also does not require a systematic trial and error process to satisfy all the enumerated factors.

Shane Frank of alliantgroup, Michael Thompson of Ryan, and Jennifer Woodard of AGC of Texas suggested reconsidering, eliminating, or modifying subsection (c)(1)(D)(vii)(V), Example 5 (related to the Process of Experimentation Test). The comptroller declines this suggestion. This example is intended to address common issues encountered in administering the R&D exemption.

Shane Frank of alliantgroup, Michael Thompson of Ryan, and Jennifer Woodard of AGC of Texas suggested reconsidering, eliminating, or modifying subsection (c)(1)(D)(vii)(VI), Example 6 (related to the Process of Experimentation Test). The comptroller declines the suggestion to eliminate this example because this example is intended to address common issues encountered in administering the R&D exemption. Jennifer Woodard of AGC of Texas commented that one sentence of this example could be read such that computer-aided simulation would not qualify as a process of experimentation. That was not the intent of this example because such activities are expressly allowed by the

applicable Treasury Regulations. The example has been modified to address this concern.

Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, and Michael Thompson of Ryan suggested reconsidering, eliminating, or modifying subsection (c)(1)(D)(vii)(VII), Example 7 (related to the Process of Experimentation Test). The comptroller declines this suggestion. This example is intended to address common issues encountered in administering the R&D exemption. This example is also consistent with Treasury Regulation, §1.41-4(a)(8), Example 2, which provides that testing to determine if something works as specified by the manufacturer is an activity in the nature of routine or ordinary testing or inspection for quality control and is not qualified research.

Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, and Michael Thompson of Ryan suggested reconsidering, eliminating, or modifying subsection (c)(1)(D)(vii)(VIII), Example 8 (related to the Process of Experimentation Test). The comptroller declines the suggestion to eliminate this example because this example is intended to address common issues encountered in administering the R&D exemption. Dale Craymer of TTARA and Patrick Reynolds of COST suggested that this example may stand for the proposition that the Process of Experimentation Test requires evaluating multiple alternatives. That was not the intent of this example because such a requirement is not required by the IRC. The example has been modified to address this concern.

Michael Thompson of Ryan suggested eliminating or modifying subsection (c)(1)(D)(vii)(IX), Example 9 (related to the Process of Experimentation Test). The comptroller declines the suggestion to eliminate this example because this example is intended to address common issues encountered in administering the R&D exemption. Mr. Thompson suggested that this example may stand for the proposition that the information discovered by a process of experimentation must be completely new to the world. That was not the intent of this example because such a requirement is not required by the IRC. The example has been modified to address this concern.

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.

Shane Frank of alliantgroup, Michael Thompson of Ryan, and Mike Williams and Alyssa Honnette of RSM suggested modifying or eliminating subsection (c)(4). The comptroller declines this suggestion. This subsection does not preclude any type of computer software from qualifying for the R&D exemption. It pro-

vides guidance regarding types of computer software development activities that are likely to qualify or unlikely to qualify, but also explicitly states that any computer software development activities that meet the requirements of the Four-Part Test qualify for the R&D exemption.

Michael Thompson of Ryan commented that subsection (c) conflicts with state law because it is not solely based on the IRC and Treasury Regulations. The comptroller declines to modify the rule in response to this comment. The applicable federal statutes and regulations are incorporated by reference into Tax Code, §151.3182, making them a part of that section. The comptroller has rulemaking authority under Tax Code, §111.002 (Comptroller's Rules; Compliance; Forfeiture) to adopt rules for the enforcement of Tax Code, §151.3182. There is no part of subsection (c) that conflicts with the applicable federal statutes or regulations, anything in subsection (c) that is not based on those statutes and regulations is intended to resolve ambiguities in them to allow the comptroller to enforce Tax Code, §151.3182.

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.

Shane Frank of alliantgroup suggested eliminating the list of activities that are deemed to be after commercial production, found in subsection (d)(1)(B). The comptroller declines this suggestion. This list is based primarily on Treasury Regulation, §1.41-4(c)(2)(ii)(A-F). The only item that is not found in Treasury Regulation, §1.41-4(c)(2)(ii)(A-F) is the inclusion of any activities that involve the use of an item for which the taxpayer claimed the manufacturing exemption under Tax Code, §151.318. 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. If a taxpayer is engaged in manufacturing, processing, or fabricating tangible personal property for ultimate sale, that tangible personal property 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.

Shane Frank of alliantgroup suggested that the examples found in subsection (d)(1)(E) are flawed. Mr. Frank provided one specific example of such a flaw: "For instance, Example 1 assumes that a newly designed belt that has never been used in an actual manufacturing process will work perfectly immediately upon integration in the taxpayer's production process. This rarely occurs." The comptroller declines to modify the rule based on this comment. The only specific issue identified relates to Example 1, an example directly based on Treasury Regulation, §1.41-4(c)(10) Example 1, which is incorporated by reference into Texas law.

Michael Thompson of Ryan suggested eliminating or modifying subsection (d)(1)(E)(iii), Example 3 (related to the Research After Commercial Production Exclusion). The comptroller declines the suggestion to eliminate this example because this example is intended to address common issues encountered in administering the R&D exemption. Mr. Thompson suggested that this example uses the term "design" in a way that conflicts with subsection (c)(1)(C)(ii) of this section and that the example does not distinguish research related to the development of a process to

manufacture an item from the research related to the item itself. The example has been modified to use the term "design" consistently with subsection (c)(1)(C)(ii) of this section and to apply the example to the manufacturing process as well.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, and Michael Thompson of Ryan suggested eliminating or modifying subsection (d)(2)(F), Example 6 (related to the adaptation of an existing business component exclusion). The comptroller declines to eliminate this example, however, the comptroller does agree to modify the example to clarify that the research is not being excluded because the research was meant for a particular customer.

Shane Frank of alliantgroup suggested eliminating subsection (d)(2)(F)(1-3), Examples 1 through 3 (related to the adaptation of an existing business component exclusion). The comptroller declines this suggestion. These three examples are directly based on Treasury Regulation, §1.41-4(c)(10) Examples 3 through 5, which are incorporated by reference into Texas law. Mr. Frank suggested that these examples are "... especially problematic since the Treasury Department and IRS have previously instructed that the research after commercial production, adaptation, and duplication exclusions do not cover research activities that otherwise satisfy the requirements for qualified research." This statement is based on a statement in the supplementary information found in Treasury Decision 9104, 2004-1 C.B. 406, which was the treasury decision that adopted Treasury Regulation, §1.41-4. This supplementary information is not part of the text of Treasury Regulation, §1.41-4 and is not incorporated by reference into Texas law. The comptroller declines to interpret the research after commercial production, adaptation, and duplication exclusions such that they do not apply if the research activities otherwise satisfy the requirements for qualified research. The surplusage canon of statutory construction requires that statutory provisions not be read in a way that would render any word redundant. Such an interpretation would render all three of these exclusions redundant.

Michael Thompson of Ryan suggested that the comptroller should restate, verbatim, the guidance provided by the IRS in Treasury Decision 9786 (2016), which adopted Treasury Regulations regarding the Internal Use Software Exclusion. The comptroller declines this suggestion. IRC, §41(d)(4)(E) gives the IRS the authority to adopt regulations to create exceptions to the Internal Use Software Exclusion that are not found in the IRC. The comptroller does not have a similar grant of statutory authority to create exceptions to the Internal Use Software Exclusion.

At the public hearing, Dale Craymer of TTARA requested clarification of the comptroller's position with respect to the funded research exclusion. Subsection (d)(7), relating to the funded research exclusion, is based on the IRC applicable to the 2011 federal income tax year. This includes IRC, §41(d)(4)(H), Treasury Regulation, §1.41-4(c)(9), and Treasury Regulation, §1.41-4A(d). The comptroller intends subsection (d)(7) to be consistent with the text of those statutes and federal regulations. While federal court cases interpreting those statutes with respect to the federal income tax R&D credit are not binding authority for the Texas sales tax R&D exemption, they are persuasive authority and will be considered by the comptroller on a case-by-case basis.

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.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Ronnie Berry of Celanese, Jennifer Woodard of AGC of Texas, Alyssa Honnette of RSM, and Carolyn Labatt of GSTC suggested that the amendments be applied prospectively. The comptroller disagrees that the additions or revisions in the adopted rule are retroactive changes in law. The additions or revisions are expositions of existing comptroller policy regarding Tax Code, §151.3182 (Certain Property Used in Research and Development Activities; Reporting of Estimates and Evaluation), a statute that was adopted by the Legislature in 2013, rather than changes. At the same time, these same commenters encouraged the comptroller's office to recognize Treasury Regulations that were adopted after the effective date of IRC, §41 as clarifications that should be applied retroactively to the 2011 federal income tax year, even when the IRS does not require that those regulations apply to the 2011 federal income tax year. As discussed in more detail above, with the exception of regulations that are not required to be applied to the 2011 federal income tax year, the comptroller does recognize Treasury Regulations that were adopted as clarifications. The comptroller does not view the amendments to this section any differently than the amendments to the Treasury Regulations that are applicable to the 2011 federal income tax year.

The comptroller amends relettered subsection (i) to explain that the provisions of this section, including the additions and revisions in the adopted rule, apply to the sale, storage, or use of tangible personal property occurring on or after January 1, 2014.

The amendments are adopted under Tax Code, §111.002, 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) 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).

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

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

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

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

(10) 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, §167 (Depreciation) or §168 (Accelerated cost recovery system); and

(C) is sold, leased, rented to, stored, or used by a taxpayer 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 may not claim the exemption if that taxpayer 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 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, for-

mula, 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) The following are factors that may be considered in determining whether a trial and error methodology is experi-

mental systematic trial and error or non-experimental simple trial and error. Evidence provided to determine the type of trial and error is not limited to these factors, nor is evidence of each factor required. These factors only apply to determining whether a process of experimentation is systematic trial and error. Systematic trial and error is not the only qualifying process of experimentation. These factors are:

(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 used computer-aided simulation and modeling to produce the final electrical system layout. While in some cases computer-aided simulation and modeling may be an experimental process, in this case, it was not an experimental process because the taxpayer did not use the computer-aided simulation and modeling to evaluate different alternatives in a scientific manner. 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 merely used its existing technology and did not perform any experimentation to evaluate alternative any drilling methods.

(IX) Example 9. A taxpayer sought to discover 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 busi-

ness 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 and manufacturing processes 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 develops various integrated circuit devices and associated manufacturing processes. The taxable entity 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 product and manufacturing process to produce the product 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 product or manufacturing process 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 product and associated manufacturing process 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 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 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 avail-

able. 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, and did not involve creating a new or improved business component.

(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) Texas Qualified Research and Development Exemption Registration. In order to claim an exemption under this section, a taxpayer must first register with the comptroller and obtain a registration number.

(1) Registration procedure. To obtain a registration number, a taxpayer 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 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 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 may request that a registration number be given retroactive effect.

(A) A taxpayer may request that a registration number have retroactive effect by following the procedures 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 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 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) 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) Divergent use. When a registrant uses an item purchased under a valid Texas Qualified Research Sales 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) 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) Effective dates.

(1) The provisions of this section apply to the sale, storage, or use of tangible personal property occurring on or after January 1, 2014.

(2) 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 adoption and found it to be a valid exercise of the agency's legal authority.

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Comptroller of Public Accounts

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For further information, please call: (512) 475-2220



## SUBCHAPTER V. FRANCHISE TAX

### 34 TAC §3.599

The Comptroller of Public Accounts adopts amendments to §3.599, concerning margin: research and development activities credit, with changes to the proposed text as published in the April 16, 2021, issue of the *Texas Register* (46 TexReg 2565). 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 received comments regarding the proposed amendments from: Shannon Rusing of Texas Oil & Gas Association (TXOGA); Dale Craymer of Texas Taxpayers and Research Association (TTARA); Patrick Reynolds of Council on State Taxation (COST); Shane Frank of alliantgroup, LP (alliantgroup); Michael Thompson of Ryan; Kreig Mitchell of Kreig Mitchell LLC; Ronnie Berry of Celanese Corporation (Celanese); Jennifer Woodard of Associated General Contractors of Texas (AGC of Texas); and Mike Williams of RSM US LLP (RSM).

Ronnie Berry of Celanese and Jennifer Woodard of AGC of Texas requested a public hearing on the proposed amendments. The comptroller held the public hearing on Monday, June 28, 2021, at 9:00 a.m. in Room 170 of the Stephen F. Austin Building, Austin, Texas 78701. Benjamin Barmore of alliantgroup, Michael Thompson of Ryan, Alyssa Honnette of RSM, Dale Craymer of TTARA, Carolyn Labatt of Great South Texas Corporation (GSTC), and John Ferris of RealPage, Inc. (RealPage) testified at the hearing.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Ronnie Berry of Celanese, Jennifer Woodard of AGC of Texas, Alyssa Honnette of RSM, and Carolyn Labatt of GSTC suggested that the amendments be applied prospectively. The comptroller disagrees that the additions or revisions in the adopted rule are retroactive changes in law. The additions or revisions are expositions of existing Comptroller policy regarding Tax Code, Chapter 171, Subchapter M (Tax Credit for Certain Research and Development Activities), a statute that was adopted by the Legislature in 2013, rather than changes. At the same time, these same commenters encouraged the Comptroller's office to recognize Treasury Regulations that were adopted after the effective date of Internal Revenue Code (IRC), §41 as clarifications that should be applied retroactively to the 2011 federal income tax year, even when the IRS does not require that those regulations apply to the 2011 federal income tax year. As discussed in more detail below, with the exception of regulations that are not required to be applied to the 2011 federal income tax year, the comptroller does recognize Treasury Regulations that were adopted as clarifications. The comptroller does not view the amendments to this section any differently than the amendments to the Treasury Regulations that are applicable to the 2011 federal income tax year.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, and Shane Frank of alliantgroup each requested that the comptroller provide additional affirmative examples where a taxable entity qualified for the credit. These requests were for general examples, examples related to the Oil and Gas industry, and examples related to software development. The comptroller declines to provide additional examples in the rule because the current examples are sufficient.

Shane Frank and Benjamin Barmore of alliantgroup and Michael Thompson of Ryan commented that the proposed rule would eliminate entire industries from having any qualified research activities. The comptroller declines to modify the rule based on these comments. This is not the intent of the rule and there is no language in the rule that prevents a taxable entity from being engaged in qualified research based on the industry of the taxable entity.

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 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](http://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](http://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](http://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 second 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 not part of the Treasury Regulations in effect on December 31, 2011. 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.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Michael Thompson of Ryan, Ronnie Berry of Celanese, Jennifer Woodard of AGC of Texas, Carolyn Labatt of GSTC, and John Ferris of RealPage suggested that the Treasury Regulations that taxable entities had the option to apply to the 2011 federal income tax year, such as Treasury Regulation, §1.41-4(c)(6) and Treasury Regulation, §1.174-2, should be in-

cluded in the definition of "Internal Revenue Code." For the reasons described above, the comptroller declines this suggestion.

The comptroller amends the definition of "qualified research" in renumbered paragraph (7) to explain that qualified research must satisfy the Four-Part Test.

Shane Frank of *alliantgroup* and Michael Thompson of *Ryan* commented that the redefinition of qualified research is unnecessary, will cause confusion for taxpayers, and does not conform to IRC, §41. The comptroller declines to modify the rule based on these comments. The amendments to this definition are intended to provide additional guidance to taxable entities regarding how the definition of qualified research was incorporated into Texas law. The new definition is not intended to, and does not, conflict with the IRC that was incorporated into Texas law. Any part of the rule that does not have a direct basis in federal law was included to address ambiguities that are not addressed in IRC, §41 or any applicable Treasury Regulations.

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 two 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 customer, 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.

Dale Craymer of *TTARA*, Patrick Reynolds of *COST*, and Michael Thompson of *Ryan* commented that subsection (b)(8)(A)(iii) should be eliminated because purchasing items using a sales tax exemption should not result in those items being excluded from being supplies. The comptroller declines this suggestion. As described above, supplies only qualify for the franchise tax R&D credit if they are used in qualified research. Some sales tax exemptions are allowed for activities that cannot be qualified research.

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.

Michael Thompson of Ryan and Kreig Mitchell of Kreig Mitchell LLC suggested that services should be allowed to be business components and that subsection (c)(1)(C)(i) should be removed. The comptroller declines this suggestion. The term "business component" is defined by IRC, §41(d)(2)(B) as "any product, process, computer software, technique, formula, or invention which is to be" (i) held for sale, lease, or license, or (ii) used by the taxpayer in a trade or business of the taxpayer." Services do not fit within this definition. Concerns regarding taxable entities that provide services are addressed by this subsection by providing that a taxable entity may have qualified research activities for research related to business components that are used to provide services.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, Michael Thompson of Ryan, Kreig Mitchell of Kreig Mitchell LLC, Ronnie Berry of Celanese, and Jennifer Woodard of AGC of Texas suggested that designs should be allowed to be business components and that subsection (c)(1)(C)(ii) should be removed. The comptroller declines this suggestion. The term "business component" is defined by IRC, §41(d)(2)(B) as "any product, process, computer software, technique, formula, or invention which is to be" (i) held for sale, lease, or license, or (ii) used by the taxpayer in a trade or business of the taxpayer." The commenters suggested that a "design" can be produced and is included in the term "product." The surplusage canon of statutory construction requires that statutory provisions not be read in a way that would render any word redundant. An interpretation of the term "product" that is broad enough to include the term "design" would also include the terms "process," "computer software," "technique," "formula," and "invention." Such an interpretation would render all those terms redundant. The commenters also suggested that excluding a design from being a business component is inconsistent with the applicable federal law because Treasury Regulation, §1.41-4 provided that uncertainty as to the appropriate design of a business component can be a qualifying uncertainty for the Section 174 Test, the Discovering Technological Information Test, and the Process of Experimentation Test. In the phrase "appropriate design of a business component" the word design does not refer to the business component itself, it is describing a quality of the business component.

Shane Frank of alliantgroup, Michael Thompson of Ryan, Ronnie Berry of Celanese, Jennifer Woodard of AGC of Texas, and Mike Williams of RSM suggested eliminating subsection (c)(1)(D)(vi). The comptroller declines the suggestion to eliminate this subsection but does modify it to address these concerns. The guidance in this subsection is a non-exhaustive list of factors that the comptroller considers when determining if a trial and error experimental method is qualifying systematic trial and error or non-qualifying simple trial and error. These factors do not affect the evaluation of a process of experimentation that does not consist of trial and error. This subsection also does not require a systematic trial and error process to satisfy all the enumerated factors.

Shane Frank of alliantgroup, Michael Thompson of Ryan, and Jennifer Woodard of AGC of Texas suggested reconsidering, eliminating, or modifying subsection (c)(1)(D)(vii)(V), Example 5 (related to the Process of Experimentation Test). The comptroller declines this suggestion. This example is intended to address common issues encountered in administering the R&D credit.

Shane Frank of alliantgroup, Michael Thompson of Ryan, and Jennifer Woodard of AGC of Texas suggested reconsidering, eliminating, or modifying subsection (c)(1)(D)(vii)(VI), Example 6 (related to the Process of Experimentation Test). The comptroller declines the suggestion to eliminate this example because this example is intended to address common issues encountered in administering the R&D credit. Jennifer Woodard of AGC of Texas commented that one sentence of this example could be read such that computer-aided simulation would not qualify as a process of experimentation. That was not the intent of this example because such activities are expressly allowed by the applicable Treasury Regulations. The example has been modified to address this concern.

Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, Michael Thompson of Ryan, and Mike Williams of RSM suggested reconsidering, eliminating, or modifying subsection (c)(1)(D)(vii)(VII), Example 7 (related to the Process of Experimentation Test). The comptroller declines this suggestion. This example is intended to address common issues encountered in administering the R&D credit. This example is also consistent with Treasury Regulation, §1.41-4(a)(8) Example 2, which provides that testing to determine if something works as specified by the manufacturer is an activity in the nature of routine or ordinary testing or inspection for quality control and is not qualified research.

Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, and Michael Thompson of Ryan suggested reconsidering, eliminating, or modifying subsection (c)(1)(D)(vii)(VIII), Example 8 (related to the Process of Experimentation Test). The comptroller declines the suggestion to eliminate this example because this example is intended to address common issues encountered in administering the R&D credit. Dale Craymer of TTARA and Patrick Reynolds of COST suggested that this example may stand for the proposition that the Process of Experimentation Test requires evaluating multiple alternatives. That was not the intent of this example because such a requirement is not required by the IRC. The example has been modified to address this concern.

Michael Thompson of Ryan suggested eliminating or modifying subsection (c)(1)(D)(vii)(IX), Example 9 (related to the Process of Experimentation Test). The comptroller declines the suggestion to eliminate this example because this example is intended to address common issues encountered in administering the

R&D credit. Mr. Thompson suggested that this example may stand for the proposition that the information discovered by a process of experimentation must be completely new to the world. That was not the intent of this example because such a requirement is not required by the IRC. The example has been modified to address this concern.

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.

Shane Frank of alliantgroup, Michael Thompson of Ryan, and Mike Williams and Alyssa Honnette of RSM suggested modifying or eliminating subsection (c)(4). The comptroller declines this suggestion. This subsection does not preclude any type of computer software from qualifying for the R&D credit. It provides guidance regarding types of computer software development activities that are likely to qualify or unlikely to qualify, but also explicitly states that any computer software development activities that meet the requirements of the Four-Part Test qualify for the R&D credit.

Michael Thompson of Ryan commented that subsection (c) conflicts with state law because it is not solely based on the IRC and Treasury Regulations. The comptroller declines to modify the rule in response to this comment. The applicable federal statutes and regulations are incorporated by reference into Tax Code, Chapter 171, Subchapter M, making them part of that Subchapter. The comptroller has rulemaking authority under Tax Code, §171.662 (Rules) and §111.002 (Comptroller's Rules; Compliance; Forfeiture) to adopt rules for the enforcement of Tax Code, Chapter 171, Subchapter M. There is no part of subsection (c) that conflicts with the applicable federal statutes or regulations, anything in subsection (c) that is not based on those statutes and regulations is intended to resolve ambiguities in them to allow the comptroller to enforce Tax Code, Chapter 171, Subchapter M.

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.

Shane Frank of alliantgroup suggested eliminating the list of activities that are deemed to be after commercial production, found in subsection (d)(1)(B). The comptroller declines this suggestion. This list is based primarily on Treasury Regulation, §1.41-

4(c)(2)(ii)(A-F). The only item that is not found in Treasury Regulation, §1.41-4(c)(2)(ii)(A-F) is the inclusion of any activities that involve the use of an item for which the taxable entity claimed the manufacturing exemption under Tax Code, §151.318. 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. If a taxable entity is engaged in manufacturing, processing, or fabricating tangible personal property for ultimate sale, that tangible personal property 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.

Shane Frank of alliantgroup suggested that the examples found in subsection (d)(1)(E) are flawed. Mr. Frank provided one specific example of such a flaw: "For instance, Example 1 assumes that a newly designed belt that has never been used in an actual manufacturing process will work perfectly immediately upon integration in the taxpayer's production process. This rarely occurs." The comptroller declines to modify the rule based on this comment. The only specific issue identified relates to Example 1, an example directly based on Treasury Regulation, §1.41-4(c)(10) Example 1, which is incorporated by reference into Texas law.

Michael Thompson of Ryan suggested eliminating or modifying subsection (d)(1)(E)(iii), Example 3 (related to the Research After Commercial Production Exclusion). The comptroller declines the suggestion to eliminate this example because this example is intended to address common issues encountered in administering the R&D credit. Mr. Thompson suggested that this example uses the term "design" in a way that conflicts with subsection (c)(1)(C)(ii) of this section and that the example does not distinguish research related to the development of a process to manufacture an item from the research related to the item itself. The example has been modified to use the term "design" consistently with subsection (c)(1)(C)(ii) of this section and to apply the example to the manufacturing process as well.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, and Michael Thompson of Ryan suggested eliminating or modifying subsection (d)(2)(F), Example 6 (related to the adaptation of an existing business component exclusion). The comptroller declines to eliminate this example, however, the comptroller does agree to modify the example to clarify that the research is not being excluded because the research was meant for a particular customer.

Shane Frank of alliantgroup suggested eliminating subsection (d)(2)(F)(1) - (3), Examples 1 through 3 (related to the adaptation of an existing business component exclusion). The comptroller declines this suggestion. These three examples are directly based on Treasury Regulation, §1.41-4(c)(10) Examples 3 through 5, which are incorporated by reference into Texas law. Mr. Frank suggested that "these examples are especially problematic since the Treasury Department and IRS have previously instructed that the research after commercial production, adaptation, and duplication exclusions do not cover research activities that otherwise satisfy the requirements for qualified research." This statement is based on a statement in the supplementary information found in Treasury Decision 9104, 2004-1 C.B. 406, which was the treasury decision that adopted Treasury Regulation, §1.41-4. This supplementary information is not part of the text of Treasury Regulation, §1.41-4 and is not incorporated by reference into Texas law. The comptroller declines to interpret the research after commercial production, adapta-

tion, and duplication exclusions such that they do not apply if the research activities otherwise satisfy the requirements for qualified research. The surplusage canon of statutory construction requires that statutory provisions not be read in a way that would render any word redundant. Such an interpretation would render all three of these exclusions redundant.

Michael Thompson of Ryan suggested that the comptroller should restate, verbatim, the guidance provided by the IRS in Treasury Decision 9786 (2016), which adopted Treasury Regulations regarding the Internal Use Software Exclusion. Mike Williams of RSM similarly suggested the comptroller adopt the High Threshold of Innovation Test found in those Treasury Regulations. The comptroller declines these suggestions. IRC, §41(d)(4)(E) gives the IRS the authority to adopt regulations to create exceptions to the Internal Use Software Exclusion that are not found in the IRC. The comptroller does not have a similar grant of statutory authority to create exceptions to the Internal Use Software Exclusion.

At the public hearing, Dale Craymer of TTARA requested clarification of the comptroller's position with respect to the funded research exclusion. Subsection (d)(7), relating to the funded research exclusion, is based on the IRC applicable to the 2011 federal income tax year. This includes IRC, §41(d)(4)(H), Treasury Regulation, §1.41-4(c)(9), and Treasury Regulation, §1.41-4A(d). The comptroller intends subsection (d)(7) to be consistent with the text of those statutes and federal regulations. While federal court cases interpreting those statutes with respect to the federal income tax R&D credit are not binding authority for the Texas franchise tax R&D credit, they are persuasive authority and will be considered by the comptroller on a case-by-case basis.

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.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank and Benjamin Barmore of alliantgroup, Ronnie Berry of Celanese, Jennifer Woodard of AGC of Texas, Alyssa Honnette of RSM, Carolyn Labatt of GSTC, and John Ferris of RealPage commented that the clear and convincing evidence standard is unnecessarily burdensome and suggested that the comptroller should apply the same burden of proof that is required for the federal income tax R&D credit. The comptroller declines this suggestion. The clear and convincing evidence standard is generally applicable to all franchise tax credits and nothing in Tax Code, Chapter 171, Subchapter M incorporates the federal burden of proof.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, Patrick Reynolds of COST, Shane Frank of alliantgroup, Michael

Thompson of Ryan, Ronnie Berry of Celanese, Jennifer Woodard of AGC of Texas, Alyssa Honnette of RSM, Carolyn Labatt of GSTC, and John Ferris of RealPage commented that the requirement to provide contemporaneous documentation is unnecessarily burdensome and suggested that the comptroller should require the same types of documentation that is required for the federal income tax R&D credit. The comptroller declines this suggestion. The requirement for contemporaneous documentation is generally applicable to all franchise tax credits and nothing in Tax Code, Chapter 171, Subchapter M incorporates the federal documentation requirements.

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.

Shannon Rusing of TXOGA, Dale Craymer of TTARA, and Patrick Reynolds of COST suggested that the instructions for how combined groups should calculate their credit in proposed subsection (i) were not supported by the statute because the statute provides that the combined group is the taxable entity for the purposes of this credit. Shannon Rusing of TXOGA also suggested that the separate application of the higher education rate to different members of the combined group was similarly not supported by statute. At the public hearing held on this section, the comptroller requested comments on this issue. After careful consideration of this issue, the discussion at the public hearing, and all the comments received, the comptroller has modified subsection (i) as described below.

The comptroller restructures relettered subsection (i) into four paragraphs. The first sentence of the current subsection is now new paragraph (1). The second sentence of the current subsection is now in new paragraph (2). New paragraph (2) also explains that the total qualified research expenses of each member of the combined group shall be added together to determine the total credit claimed on the combined report. New paragraph (3) explains that a change in membership of the combined group results in a new taxable entity and the resulting combined group is not entitled to the carryforward of the credit because it is no longer the same taxable entity as the taxable entity that established the credit carryforward. New paragraph (3) also provides a list of six situations that will not be considered a change in the membership of the combined group. New paragraph (4) explains that the higher education rate described in relettered subsections (g)(3) - (4) applies to the combined group as a whole.

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.

The amendments are adopted under Tax Code, §111.002, 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.

§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 (1) 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.

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

(8) Qualified research expense--This term has the meaning given in IRC, §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) Registration Number--The Texas Qualified Research Registration Number issued by the comptroller to a person who submits the Texas Registration for Qualified Research and Development Sales Tax Exemption form.

(10) 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).

(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, com-

puter 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) The following are factors that may be considered in determining whether a trial and error methodology is experimental systematic trial and error or non-experimental simple trial and error. Evidence provided to determine the type of trial and error is not limited to these factors, nor is evidence of each factor required. These factors only apply to determining whether a process of experimentation is systematic trial and error. Systematic trial and error is not the only qualifying process of experimentation. These factors are:

(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 con-

cerning 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 used computer-aided simulation and modeling to produce the final electrical system layout. While in some cases computer-aided simulation and modeling may be an experimental process, in this case, it was not an experimental process because the taxable entity did not use the computer-aided simulation and modeling to evaluate different alternatives in a scientific manner. 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 merely used its existing technology and did not perform any experimentation to evaluate any alternative drilling methods.

(IX) Example 9. A taxable entity sought to discover 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 en-

ty. 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 and manufacturing processes 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 develops various integrated circuit devices and associated manufacturing processes. The taxable entity 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 product and manufacturing process to produce the product 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 product or manufacturing process 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 product and associated manufacturing process 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 extensive, 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, and did not involve creating a new or improved business component.

(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 experimen-

tation 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) Eligibility for credit.

(1) A taxable entity is eligible to claim a 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) 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 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.

(g) Amount of credit.

(1) Qualified research expenses in Texas. Subject to subsection (h) 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 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) 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 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) 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) 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) 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.

(2) The combined group is the taxable entity for purposes of this section. The total qualified research expenses of each member of the combined group shall be added together to determine the total credit claimed on the combined report.

(3) If there is a change in membership of the combined group, the resulting combined group is a new taxable entity and the resulting combined group is not entitled to the carryforward of the credit under subsection (l) of this section because it is no longer the same taxable entity as the taxable entity that established the credit carryforward. For the purposes of this section, there is no change in membership of the combined group if:

(A) the common owner or owners of the members of the combined group changes without any change in the members of the combined group;

(B) the common owner or owners change without any change in the members of the combined group other than the addition of a newly-formed entity that is the new common owner;

(C) the combined group undergoes a corporate reorganization that does not result in any member entities leaving the combined group;

(D) two or more members of the combined group merge;

(E) one or more members of the combined group forms a new entity that is a member of the combined group; or

(F) one or more members of the combined group is terminated, dissolved, or otherwise loses its status as a legal entity.

(4) A combined group 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 subsection (g)(3) and (4) of this section, even if not all of the members of the combined group have qualified research expenses that are related to higher education contracts.

(j) 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) Limitation. The total credit claimed under this section for a report, including the amount of any carryforward credit under subsection (l) of this section, may not exceed 50% of the amount of franchise tax due for the report before any other applicable tax credits.

(l) Carryforward.

(1) If a taxable entity is eligible for a credit that exceeds the limitation under subsection (k) of this section, the taxable entity may carry the unused credit forward for not more than 20 consecutive reports.

(2) Research and development 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.

(4) For application of the carryforward to combined groups, see subsection (i)(3) of this section.

(m) 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) Application for credit.

(1) 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 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) 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 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 adoption and found it to be a valid exercise of the agency's legal authority.

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For further information, please call: (512) 475-2220



## TITLE 37. PUBLIC SAFETY AND CORRECTIONS

### PART 15. TEXAS FORENSIC SCIENCE COMMISSION

#### CHAPTER 651. DNA, CODIS, FORENSIC ANALYSIS, AND CRIME LABORATORIES

##### SUBCHAPTER A. ACCREDITATION

###### 37 TAC §651.7

The Texas Forensic Science Commission ("Commission") adopts an amendment to 37 Texas Administrative Code §651.7 without changes to the text as published in the August 27, 2021, issue of the *Texas Register* (46 TexReg 5370) correcting the description of the scope of activities that are considered under the forensic discipline crime scene investigation. The current rule incorrectly limits the scope of activities covered under the exemption to activities "not integral to an expert examination

or test." Crime Scene Investigation activities can include initial screening examinations or tests that should be covered by the exemption. The adopted change removes the limitation for clarification and to facilitate efficient laboratory operations. The amendment is necessary to reflect adoptions made by the Commission at its July 16, 2021, quarterly meeting. The adoption is made in accordance with the Commission's accreditation authority under Code of Criminal Procedure, Article 38.01 §4-d, and the Commission's rulemaking authority under Article 38.01 §3-a.

Summary of Comments. No comments were received regarding the amendments to this section.

Statutory Authority. The amendment is proposed under Code of Criminal Procedure, Article 38.01 §3-a, which directs the Commission to adopt rules necessary to implement Article 38.01, and §4-d(b) and (c), which authorizes the Commission to adopt rules providing, modifying, or removing accreditation exemptions.

Cross reference to statute. The proposal affects 37 Texas Administrative Code §651.7.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

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## SUBCHAPTER C. FORENSIC ANALYST LICENSING PROGRAM

### 37 TAC §651.207

The Texas Forensic Science Commission ("Commission") adopts an amendment to 37 Texas Administrative Code §651.207 without changes to the proposed text as published in the August 27, 2021, issue of the *Texas Register* (46 TexReg 5371), expanding the list of forensic practitioners eligible for the General Forensic Analyst Licensing Exam to include crime laboratory administration and management personnel, crime scene investigators and employees who perform latent print processing. The rule will not be republished. Currently, crime laboratory managers, crime scene investigators and employees performing only latent print processing are not eligible for the General Forensic Analyst Licensing Exam. The change permits crime laboratory managers, crime scene investigators and employees who only perform latent print processing, working in accredited forensic laboratories, to voluntarily take the exam if they wish. The amendment is necessary to reflect adoptions made by the Commission at its July 16, 2021 quarterly meeting. The adoption is made in accordance with the Commission's forensic analyst licensing authority under Code of Criminal Procedure, Article 38.01 §§ 3-a and 4-(a).

Summary of Comments. No comments were received regarding the amendments to this section.

Statutory Authority. The amendment is adopted under Tex. Code Crim. Proc. art 38.01 §§ 3-a and 4-(a).

Cross reference to statute. The adoption affects 37 Texas Administrative Code 651.207.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

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### 37 TAC §651.209

The Texas Forensic Science Commission ("Commission") adopts an amendment to 37 Texas Administrative Code §651.209, concerning Forensic Analyst and Forensic Technician License Expiration and Reinstatement without changes to the text as published in the August 27, 2021, issue of the *Texas Register* (46 Tex Reg 5375). The amendment sets forth a process for forensic analyst license expiration and subsequent reinstatement under certain circumstances. Currently, the Commission does not have a license expiration policy to incentivize timely renewals. The rule changes establish a timeline for license expiration and explain the notice licensees will receive before license expiration. The amendments are necessary to

reflect adoptions made by the Commission at its July 16, 2021 quarterly meeting. The adoption is made in accordance with the Commission's forensic analyst licensing authority under Code of Criminal Procedure, Article 38.01 §4-a, which directs the Commission to adopt rules to establish the qualifications for a forensic analyst license and the Commission's rulemaking authority under Code of Criminal Procedure, Article 38.01 §3-a, which directs the Commission to adopt rules necessary to implement Code of Criminal Procedure Article 38.01.

Summary of Comments. No comments were received regarding the amendments to this section.

Statutory Authority. The amendment is adopted under Code of Criminal Procedure, Article 38.01 §3-a, which directs the Commission to adopt rules necessary to implement Article 38.01, and Article 38.01 §4-a(d), which directs the Commission to adopt rules to establish the qualifications for a forensic analyst license.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

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