**Draft Rules to Implement House Bill 22-1118**

The Colorado Department of Revenue, Division of Taxation, convened a workgroup February 28, 2023, to discuss the promulgation of a new sales tax rule to implement [House Bill 22-1118](https://leg.colorado.gov/bills/hb22-1118). Among other things, the bill requires any purchaser who submits a sales or use tax refund claim to provide with their claim any pertinent data, information, and documentation the Executive Director of the Department may prescribe by rule. The Department has drafted rules to implement House Bill 22-1118, taking into consideration comments provided by stakeholders at the workgroup and written comments received by the Department. A brief discussion of how the draft rules address certain issues is provided below.

***Sellers’ Account Numbers***

Currently, the Department requires purchasers to provide with their refund claim the federal employer identification number (FEIN) or Colorado account number (CAN) for the seller of each sales transaction included in the refund claim. Stakeholders indicated that purchasers may have difficulty obtaining the FEIN or CAN from the seller because the seller has gone out of business, is not responsive, or is not willing to provide it to the purchaser. However, a sales tax refund can only be allowed if the sales tax was paid to a licensed seller and the Department needs the seller’s FEIN or CAN to verify licensure.

The draft rule attempts to balance the Department’s duty and obligation to verify licensure with the challenges that purchasers may face in obtaining the FEIN or CAN for a particular seller included in the refund claim. With respect to each transaction included in the refund claim, draft Rule 39-26-703–2(3)(a)(ii) and (3)(b) require the refund applicant to make a good faith effort to obtain the FEIN or CAN for the seller and provide it with the claim, but also allows an exception if the applicant is unable to obtain the CAN or FEIN for the seller, despite the applicant’s good faith effort. In such case, the applicant must include with their refund claim information that allows the Department to identify the seller’s CAN or FEIN.

***Local Sales Taxes***

Currently, the Department requires purchasers to provide with their refund claim a separate accounting of each state-administered local sales tax, such as city, county, and special district sales tax, included in the claim. At the workgroup, stakeholders indicated that this generally did not present a challenge for businesses claiming sales tax refunds but acknowledged that it may be difficult for private individuals claiming sales tax refunds. Because the Department administers sales tax for many local jurisdictions, it must ensure that refunds are made from the sales taxes paid to the applicable local jurisdiction.

The draft rule attempts to balance the Department’s fiduciary responsibilities to local jurisdictions with consideration for the challenges a private individual may encounter in determining the amount of each local sales tax included in their purchases and refund claims. With respect to each transaction included in the refund claim, draft Rule 39-26-703–2(3)(a)(vi) and (3)(c) require the refund applicant to separately state the amount of state, city, county, and special district sales tax paid but also allows an exception for refund claims made by private individuals.

***Required Documentation***

Currently, the Department requires refund applicants to submit invoices and proof of payment with their refund claims. For refund claims including fewer than 100 total invoices, the claimant must provide copies of all invoices and proof of payments included in the claim. For claims including 100 or more total invoices, the claimant must provide invoices and proof of payment for at least 25% of the invoices included in the claim.

At the workgroup, stakeholders acknowledged the need to provide documentation, such as invoices and proof of payment, but explained that proof of payment can be more challenging to provide because businesses today make payment through various electronic means that do not result in traditional documentary evidence, such as a canceled check. Stakeholders also questioned whether a purchaser should need to provide proof of payment for all of the purchases made from the same seller.

Draft Rule 39-26-703–2(5) substantially reduces proof of payment requirements for claims including more than 400 payments and establishes a limit with respect to sales transactions included in the refund claim that were from the same seller, occurred during the same month, and qualified for the same exemption type. The draft rule also identifies documentation to provide proof of payment, depending on whether payment was made by check, electronically, or through a payment processing service. Additionally, draft Rule 39-26-703–2(4) reduces the documentation requirements for claims including more than 5,000 total invoices and substantially reduces the documentation requirements for claims including more than 10,000 total invoices.

**Proof of Payment**

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| --- | --- |
| *Total payments included in the claim* | *Submission requirement* |
| 100 or fewer | Proof of payment for all payments included in the claim |
| More than 100 | Proof of payment for 100 payments plus 0.2% of the total payments included in the claim in excess of 100 payments |

**Invoices**

|  |  |
| --- | --- |
| *Invoices included in the claim* | *Submission requirement* |
| 100 or fewer | All invoices included in the claim |
| More than 100, but fewer than 5,000 | 100 invoices plus 25% of the total invoices included in the claim in excess of 100 invoices |
| More than 5,000, but fewer than 10,000 | 1,325 invoices plus 20% of the total invoices included in the claim in excess of 5,000 invoices |
| More than 10,000 | 2,325 invoices plus 2.5% of the total invoices included in the claim in excess of 10,000 invoices |

***Penalty Assessment***

At the workgroup, stakeholders requested additional guidance regarding the penalty imposed for incomplete claims. Draft Rule 39-26-703–2(8) provides clarification regarding the penalty. A refund claim is incomplete if it does not include both a completed Department form DR 0137B, Claim for Refund of Tax Paid to Vendors, and substantially all of the required pertinent data, information, and documentation. If a refund claim appears to be incomplete, the Department will notify the refund applicant, who must within 60 days either provide the missing data, information, and documentation, demonstrate why the claim is not incomplete, or withdraw the claim. If the refund applicant does not either provide the missing data, information, demonstrate the completeness of the claim, or withdraw the claim within the time provided, the penalty will be assessed.

***Protective Claims***

House Bill 22-1118 enacted a provision in section 39-26-703(5)(d), C.R.S., regarding protective claims. The term “protective claim” did not previously appear in Colorado sales and use tax statutes and regulations. Draft Rule 39-26-703–1 and draft Rule 39-26-703–2(7) provide both general guidance relating to protective claims and specific information about requirements relating to protective claims based on federal guidance and case law and existing Department guidance for protective claims for state income tax.

The concept of “protective claims” arises from case law regarding federal income tax. The IRS provides a general explanation of protective claims in [IRS Chief Counsel Advice 201136021](https://www.irs.gov/pub/irs-wd/1136021.pdf):

"The concept of a 'protective claim' is not used in the Code or regulations, but is established by case law... A protective claim is a present claim contingent upon a future event; it is a statement that upon the happening of the contingency the claim will be prosecuted... In general, a protective claim is based on an expected change in the tax law, other legislation, regulations, or case law... [A] valid protective claim contains a present claim that the Service may immediately allow or disallow once the contingency is resolved."

In [Service Center Advice Memorandum 199941039](https://www.irs.gov/pub/irs-sca/9941039.pdf), the IRS further explains that “[a] claim should not be viewed as a valid protective claim … merely because the taxpayer labels it as such.” Furthermore, the designation of a refund claim as a protective claim does not dictate the handling of the claim by the taxing authority. “The Service has discretion in deciding how to process protective claims,” the IRS notes. “In general, it is in the interests of the Service and taxpayers to delay action on protective claims until the pending litigation or other contingency is resolved.”

Draft Rule 39-26-703–1 and draft Rule 39-26-703–2(7) reflect the principles established in case law regarding protective claims and are consistent with guidance issued by the IRS and the Department for protective claims for income tax refunds. The draft rules provide guidance regarding protective claims for Colorado sales and use tax refunds, consistent with section 39-26-703(5)(d), C.R.S.