

VAT bad debt relief

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This Practice Note outlines how a taxable person who has accounted for and paid VAT on a supply, but who is not paid the price for that supply, may claim a refund of the whole or part of the VAT that they have paid.

EU law

Under Council Directive 2006/112/EC (the VAT Directive), VAT on a supply is payable by reference to the taxable amount (or value) of the supply, which comprises everything that constitutes consideration obtained or to be obtained by the taxable person (from any person) for that supply.

References:

Council Directive 2006/112/EC, art 73

The corollary is that VAT is not payable on more than the consideration for the supply (the basis of assessment being the consideration actually received).

References:

Naturally Yours Cosmetics [1988] STC 879

In the event of cancellation, refusal or total or partial non-payment of the price for a supply, or where the price is reduced after the supply has taken place, the taxable amount of the supply is reduced accordingly.

References:

Council Directive 2006/112/EC, art 90

In the UK, refunds and downward adjustments are dealt with under the rules on credit notes.

References:

VAT Regulations 1995, SI 1995/2518, reg 38

Total or partial non-payment, ie where the whole or part of the price has become a bad debt, is dealt with by way of the VAT bad debt relief regime.

This Practice Note is primarily about the VAT bad debt regime, but to set this in context, it begins with a brief explanation of the rules on credit notes.

Credit notes

A taxable person is required to account for and pay VAT on the taxable supplies that they make. They are required to do so at the end of each prescribed accounting period, in respect of the supplies made in that period, irrespective of whether they have been paid for those supplies.

References:

VATA 1994, s 25

VAT Regulations 1995, SI 1995/2518, reg 40

The exception is where they account for VAT under the cash accounting scheme or one of the retail schemes. In those cases, they would only pay VAT on their supplies when they receive payment for them (and only on the amounts they actually receive).

References:

VATA 1994, Sch 11, para 2(7)
 VAT Regulations 1995, SI 1995/2518, Pt VIII
 VATA 1994 Sch 11, para 2(6)
 VAT Regulations 1995, SI 1995/2518, Pt IX

Occasionally, after making a supply, the taxable person may agree to the full or partial refund of, or other downward adjustment (such as a discount) to, the price for that supply. Whether this affects the amount of VAT on the supply depends on whether the refund or downward adjustment extends to the VAT element of the price.

Where the refund or downward adjustment does extend to the VAT element of the price, the taxable person would be required to:

References:

VAT Regulations 1995, SI 1995/2518, reg 38

- issue a VAT credit note to the person to whom the supply was made (where the supply was one in respect of which they were required to issue a VAT invoice), and
- adjust the amount of VAT on the supply

On the other hand, where the person to whom the supply was made is entitled to deduct all the VAT they incurred on the supply, they may agree with the taxable person not to adjust the VAT element of the price. In such a case, the taxable person would not issue a VAT credit note, and they would not be required to adjust the amount of VAT on the supply.

References:

VAT Notice 700: the VAT guide, para 18.2.1

For more information, see Practice Note: VAT overpayments and under-deductions—Price adjustments.

The remainder of this Practice Note looks at the regime that applies in a different scenario, namely, where there is no refund or downward adjustment. The price remains unchanged; it simply has not been paid (in full or at all).

Bad debt relief

A taxable person is entitled to claim bad debt relief where:

References:

VATA 1994, s 36(1)
 VAT Notice 700/18, para 2.2

- they have made a supply (whether of goods or services)
- the value of the supply is equal to or less than its open market value (which HMRC regards as the 'customary selling price' in relation to the goods or services in question)
- the taxable person has accounted for and paid VAT on the supply
- it has been at least six months since the date of the supply, and
- any part of the consideration for the supply has been written off in the taxable person's accounts as a bad debt

There are special rules on how bad debt relief operates within the VAT mini one-stop shop regime (MOSS). These are not considered further in this Practice Note. For information on the VAT MOSS, see Practice Note: VAT treatment of electronically supplied services—Special VAT registration scheme for e-services—the VAT MOSS.

Written-off and outstanding amounts

For the purposes of the VAT bad debt regime, consideration is treated as written off when it has been written off as a bad debt in the taxable person's day-to-day VAT accounts and transferred to their refunds for bad debt account (for which, see Administration below).

References:

VAT Regulations 1995, SI 1995/2518, reg 172

As mentioned above, consideration for VAT purposes is everything obtained or to be obtained by the taxable person (from any person) for a supply. This includes the VAT element, ie where the price for the supply is £100 plus VAT, both the £100 and the VAT form part of the consideration for the supply.

Timing

No part of any consideration can be written off for the purposes of the VAT bad debt regime until at least six months have passed since the date when the amount first became due and payable. Where, for example, the taxable person issues a VAT invoice dated 1 January allowing 60 days for payment, and the invoice remains unpaid, the debt can only be written off in early September: ie six months after the due date (and not six months after the date of the invoice).

Calculating the written-off amount

Where the consideration is not wholly in money, the non-monetary part of the consideration is expressed as an amount in money equal to such part of:

References:

VATA 1994, s 36(3A)

- the value of the supply, and
- the VAT on the supply

as is attributable to the non-monetary part of the consideration.

For example, where X sells equipment situated in the UK to Y for £1,000 plus VAT, and the whole of the consideration is to be discharged by Y via the transfer in due course to X of a commodity situated outside the EU (the value of which both parties agree to be £1,200), the non-monetary consideration (ie the non-EU commodity) will be expressed in X's VAT accounts as £1,000 (as to the value of its supply to Y) and £200 (as to the VAT on the supply).

The amount to be written off is reduced by:

References:

VAT Regulations 1995, SI 1995/2518, reg 172

- any amount owed by the taxable person to the recipient of the supply that can be set off against the debt owed by the recipient to the taxable person, and
- the value of any enforceable security held by the taxable person against the recipient

The amount treated as written off for the purposes of bad debt relief is referred to in this Practice Note as the 'written-off amount'.

The outstanding amount

Relief is given by way of a refund of VAT computed by reference to the 'outstanding amount'.

*References:**VATA 1994, s 36(2)*

The outstanding amount, in relation to any supply, is calculated by reference to the written-off amount, and is equal to:

*References:**VATA 1994, s 36(3)*

- the written-off amount, where no part of the written-off amount has been received at the time of the claim, and
- where any part of the written-off amount has been received by that time, the amount by which the amount so received is exceeded by the written-off amount (ie written-off amount less received amount(s))

For the purposes of calculating the outstanding amount, the written-off amount is treated as received where it is received by:

*References:**VATA 1994, s 36(3)*

- the taxable person, or
- any person to whom any right to receive any part of the consideration that has been written off has been assigned

Example

By way of example:

- X makes a supply to Y for £100 plus VAT on 31 January
- the applicable terms are that the £120 will be paid within two calendar months
- no payment is made or received by 31 March
- as of 31 March, X owes Y £20 by way of an enforceable debt
- X writes £100 (ie £120 - £20) off as a bad debt in its VAT accounts on 30 September
- the written off amount is £100
- before X can make a claim for bad debt relief, it receives £30 from Y
- the outstanding amount is £70 (£100 - £30)

Allocation

Where the taxable person has made more than one supply to the same person (the purchaser), the question arises when they receive payment from the purchaser as to how that payment should be allocated between those supplies.

Where the purchaser specifies, at the time of payment, the supply to which the payment should be allocated, and the payment discharges the consideration for that supply in full, the payment would be applied to that supply.

*References:**VAT Regulations 1995, SI 1995/2518, reg 170*

In any other case, the payment would be allocated first to the earliest-dated supply, and then, to the extent that the consideration for that supply does not exhaust the payment, to the next-dated supply and so on. Al-

location is, therefore, based on the chronological order of the supplies (and not, for example, by reference to whether they are taxable or exempt etc). Where more than one supply was made on the same day, the same-dated supplies would be aggregated, and any part of the payment that is allocated to that particular day would be pro-rated between the same-dated supplies.

References:

VAT Regulations 1995, SI 1995/2518, reg 170

By way of example:

- two standard rated supplies and one exempt supply are made on 1 January—supply A for £100 plus VAT, supply B for £200 plus VAT and supply C for £300
- two standard rated supplies are made on 3 January—supply D for £500 plus VAT and supply E for £500 plus VAT
- no payment is made or received for any of the supplies by 29 December—if a claim were to be made on 29 December, the outstanding amount would be £1,860, but no such claim is actually made
- £440 is received on 30 December
- under the allocation rules, supply A, supply B and supply C are aggregated and treated as if they were a single supply made on 1 January
- similarly, supply D and supply E are aggregated and treated as if they were a single supply made on 3 January
- the £440 is allocated to 1 January in its entirety—2/11 (£80) is allocated to supply A, 4/11 (£160) is allocated to supply B and 5/11 (£200) is allocated to supply C
- the outstanding amount in relation to supply A is £40
- the outstanding amount in relation to supply B is £80
- the outstanding amount in relation to supply C is £100
- £800 is received on 31 December
- £220 of the £800 is allocated to 1 January, and the remainder is allocated to 3 January— $\frac{1}{2}$ (£290) to supply D and $\frac{1}{2}$ (£290) to supply E

Special rules apply to allocate payments between the supply of goods and the supply of credit under hire-purchase, conditional sale and credit sale agreements.

References:

VAT Regulations 1995, SI 1995/2518, reg 170A

VAT-only invoices

As mentioned above, the outstanding amount in relation to a supply is determined by reference to the written-off amount, which in turn is determined by reference to the consideration for the supply, which is everything obtained or to be obtained by the taxable person (from any person) for the supply. This includes the VAT element, ie where the price for the supply is £100 plus VAT, both the £100 and the VAT form part of the consideration for the supply.

This means that where a taxable person:

- makes a supply for £100, thinking it is exempt
- then realises, after receiving the £100, that VAT (at 20%) was in fact payable, and
- issues a VAT-only invoice to the recipient of the supply

if that invoice is not paid, the bad debt is £20. A successful claim for VAT bad debt relief would result in a refund of an amount equal to VAT (at 20%) computed by reference to £20, ie $\frac{1}{6}$ of £20 = £3.33.

The taxable person may consider the entire amount stated in the VAT-only invoice to be VAT, and expect a refund of the whole amount, but the reality is that they have already received $\frac{5}{6}$ of the total consideration for

the supply, which includes 5/6 of the VAT on the supply. Only 1/6 of the VAT, therefore, is a bad debt, and only 1/6 can be the subject of a bad debt relief claim.

References:

Simpson & Marwick v HMRC [2013] STC 2275

Administration

A taxable person must hold the following documents before they make a claim for bad debt relief:

References:

VAT Regulations 1995, SI 1995/2518, reg 167

- a copy of the VAT invoice issued in respect of the supply on which the bad debt has arisen (or, where the issue of a VAT invoice was not required in respect of the supply, documents that show the time, nature and recipient of, and consideration for, the supply)
- documents that show that they have accounted for and paid VAT on the supply, and
- documents that show that the consideration for the supply has been written off in their accounts as a bad debt

A claim is made by including the amount of the refund sought in the 'input tax' box (box 4) of the VAT return.

References:

VAT Regulations 1995, SI 1995/2518, reg 166

The claim must be made within four years and six months after the later of:

References:

VAT Regulations 1995, SI 1995/2518, reg 165A

- the date on which the written-off consideration became due and payable to (or to the order of) the taxable person, and
- the date of the supply

The claimant taxable person must keep a 'refunds for bad debts' account as part of their VAT records.

References:

VAT Regulations 1995, SI 1995/2518, reg 168

This account must record the following information in respect of each claim:

References:

VAT Regulations 1995, SI 1995/2518, reg 168

- in relation to each supply that was the subject of the claim:
 - the amount of VAT on the supply
 - the prescribed accounting period in which the VAT was accounted for and paid to HMRC
 - the date and number of any VAT invoice issued in respect of the supply (or, where the issue of a VAT invoice was not required, the time, nature and recipient of the supply), and
 - any payment received for the supply
- the outstanding amount to which the claim relates
- the amount of the claim, and
- the prescribed accounting period in which the claim is made

Subsequent payment

Where, after obtaining bad debt relief (ie a refund), the taxable person receives payment for the relevant supply, or the consideration for the supply is subsequently reduced, they must pay the refund (or the appropriate portion) back to HMRC.

References:

VAT Regulations 1995, SI 1995/2518, reg 171

The amount to be repaid must be included in the 'output tax' box (box 1) of the VAT return for the prescribed accounting period in which the subsequent payment is received.

References:

VAT Regulations 1995, SI 1995/2518, reg 171

Input tax

A person who receives a taxable supply who is entitled to deduct any of the input tax on that supply loses that entitlement to the extent that the consideration for the supply remains unpaid six months after:

References:

VATA 1994, s 26A

- the date of the supply, or
- the due date for the unpaid (or unpaid part of the) consideration

whichever is the later.

If they have already deducted the input tax, they would be required to repay the amount (or the appropriate portion) back to HMRC.

References:

VAT Regulations 1995, SI 1995/2518, reg 172H

If, after repaying the amount to HMRC, the person then pays the whole or part of the unpaid consideration for the supply, they would become entitled to deduct the input tax (or the appropriate portion) again.

References:

VAT Regulations 1995, SI 1995/2518, reg 172I