VAT focus

GMAC: getting bad debt relief right

Speed read

In a dispute lasting more than ten years, the Court of Appeal has ruled, in *HMRC v GMAC (UK) Plc*, that the UK's pre-1997 VAT bad debt relief rules did not comply with EU law. The old UK rules included two conditions for bad debt relief: the property had to have passed ('the property condition'); and the debtor must be formally insolvent ('the insolvency condition'). The court considered the property condition neither appropriate nor necessary under EU law. The court also objected to the insolvency condition on the grounds that the inherent need for legal proceedings, which could not be justified in the case of small debts, had the effect of excluding entire classes of bad debt claims from relief. GMAC's claims were not time-barred by applicable EU law principles; however, claims in relation to supplies made before 27 July 1990 were time-barred under domestic law.

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Article 11C(1) of the Sixth Directive provides as follows:

'In the case of cancellation, refusal or total or partial non-payment [of price], or where the price is reduced after [a] supply takes place, the taxable amount [by reference to which VAT on the supply is calculated] shall be reduced accordingly under conditions which shall be determined by the member states. However, in the case of total or partial non-payment, member states may derogate from this rule.'

Article 11C(1) is now article 90 of the VAT Directive and provides for VAT bad debt relief, an area that is simple – but only in concept. In application, it has never been straightforward (at least not in the UK).

The concept is simply this: A taxable person makes a taxable supply to a customer. He leaves the price outstanding as a debt. He accounts to HMRC for, and pays, VAT on the supply. However, his customer does not pay him – the debt becomes a bad debt. The taxable person claims a refund from HMRC of the VAT he paid on the supply.

The question is what conditions need to be satisfied in order for relief to be available. This depends on when the supply was made and which regime was in play.

VAT bad debt relief was introduced in the UK in 1978. The original regime (the old scheme) applied to supplies made between 1 October 1978 and 26 July 1990 (inclusive). It was replaced by a different regime (the new scheme) in 1990, which applied to supplies made on or after 1 April 1989. (A taxable person could avail of either the old scheme or the new scheme in relation to supplies made between 1 April 1989 and 26 July 1990 (inclusive) but not both.) Further changes were made (via FA 1997) in relation to supplies made after 19 March 1997, and even further changes were introduced with effect from 1 January 2003.

The old scheme included the following conditions (set out in FA 1978 s 12(2)):

'A person shall not be entitled to a refund … unless –
(a) he has proved in the insolvency and the amount for which he has proved is the outstanding amount of the consideration less the amount of his claim; …
(c) in the case of a supply of goods, the property has passed to the person to whom they were supplied.'

The requirement to prove in the insolvency of the recipient of the supply was removed in 1986. The requirement for the recipient to be insolvent at all was removed in 1990 (when the new scheme was introduced). The requirement for property to pass was removed in 1997 (pursuant to FA 1997).

Enter GMAC

GMAC sells cars to retail customers on hire-purchase terms. Payment is made periodically by the customer by way of instalments (typically, over 36 months or less). Title to the car is retained by GMAC until the final payment is made. The sale is treated as a supply of goods (see VATA 1994 Sch 4 para 1), and VAT on the supply is payable in full at the outset of the transaction.

Where the customer defaults, GMAC would repossess the car and sell it at auction. Proceeds realised at the auction would be applied towards reducing the balance still owing from the customer. In such cases, GMAC would likely incur a bad debt.

For supplies made by GMAC between 1978 and 1997, the terms of the applicable regime(s) were such that VAT bad debt relief was not available:

- firstly, because property in the car would not have passed where the customer defaults (because under hire-purchase agreements property does not pass until the final payment is made), the requirement in relation to property passing would not be satisfied; and
- secondly, because GMAC was circumspect in seeking court orders for money judgments, and it was not its policy to institute bankruptcy or winding-up proceedings, the requirement in relation to insolvency might not be satisfied (for example, where the costs associated with the proceedings were not commercially justified).

(The same was, of course, also true of any taxpayer in a similar position to GMAC in relation to supplies made by it between 1978 and 1997; for example, other businesses operating in the hire-purchase space or those selling goods with retention of title clauses.)

GMAC considered that both the requirement in relation to property passing (the property condition) and the requirement in relation to insolvency (the insolvency condition) were incompatible with EU law and should be dis-applied on that basis. It therefore sought, in 2006, to claim relief in respect of the bad debts it had incurred on supplies made by it between 1978 and 1997.

HMRC disagreed, and also argued that GMAC's claims were time-barred.

After more than ten years, the dispute finally made its way to the Court of Appeal on 28 and 29 June 2016, and four months later (on 25 October), the court delivered its judgment (*HMRC v GMAC (UK) Plc* [2016] EWCA Civ 1015, reported *in Tax Journal*, 4 November 2016).

Compatibility

As mentioned above, article 11C(1) of the Sixth Directive obliges member states to reduce the taxable amount of a supply in certain circumstances. It also confers a discretion on member states to derogate from such obligation in cases of total or partial non-payment of consideration. Member states are not, therefore, obliged, and can choose not, to give relief for bad debts.

In *Goldsmith* (Case C-330/95), the CJEU ruled that: 'The power to derogate, which is strictly limited to [cases of total or partial non-payment of consideration], is based on the notion that in certain circumstances and because of the legal situation prevailing in the member state concerned, non-payment of consideration may be difficult to establish or may only be temporary. It follows that the exercise of that power must be justified if the measures taken by the member states for its implementation are not to undermine the objective of fiscal harmonisation pursued by the Sixth Directive.'

The issue in *GMAC* was whether the property condition and the insolvency condition were justified within the terms of the above dicta.

The Court of Appeal did not think so.

It considered the property condition neither 'appropriate [*nor*] necessary', and said that: 'The justification suggested in *Goldsmiths* … difficult to establish or temporary – cannot apply. It is no more difficult to establish that a hire purchase agreement has given rise to a bad debt than it is in the case of any other debt', and held the property condition to be contrary to EU law.

As for the insolvency condition, it identified the main objections to this as follows: '… the condition in the old scheme requires legal proceedings to have been taken to obtain the bankruptcy of an individual debtor or the winding up of a company. Such proceedings would simply not be justified in the case of small debts, and would not be available at all for debts owed by individuals below the bankruptcy limit. The result is that entire classes of bad debt claims are excluded from relief, when there is no reason to suppose that they are not genuine bad debts … the evidence was that in 90–95% of repossessions by GMAC there was no bankruptcy or insolvency … In very large part the insolvency condition could not be satisfied as a matter of business practice. Plainly in the case of smaller traders, or large traders whose business depends on small debts, the obstacles would be yet greater. Such wholesale inroads into the right to relief, which is intimately connected to the right to be taxed on the consideration actually obtained, cannot sensibly be justified on the basis that it is the unintended consequence of the adoption of a convenient bright line test'.

The court held the insolvency condition to be contrary to EU law as well.

Limitation

HMRC argued that GMAC's claims were time-barred by applicable EU law principles. It considered that where a taxable person asserted EU law rights (as GMAC was doing), he could not merely take the benefit of the rights, he had to take the burden as well, and the burden in the case of GMAC was to act within a reasonable period of time. This was the so-called EU reasonable time principle (see, for example, *Allen* (Case T-433/10P)). GMAC brought its claims in 2006, in relation to debts that had become due by 1994 (at the latest), so (HMRC argued) by 2006, GMAC had become barred from asserting any EU law rights it might have had because whatever might be considered a 'reasonable' time, it would not be as long as the 12 years between 1994 and 2006.

The Court of Appeal did not agree.

It held that while GMAC was indeed asserting its EU law rights, it was doing so through the mechanism of domestic UK legislation, and such legislation was 'to be read as being silent as to any time limit, and as therefore not imposing any'.

HMRC also argued that GMAC's claims were time-barred by domestic UK legislation – namely, FA 1997 s 39(5), which provides that, after 19 March 1997, claims could no longer be made under the old scheme (in relation to supplies made between 1 October 1978 and 26 July 1990 (inclusive)).

The issue here was whether, like the property condition and the insolvency condition, s 39(5) should also be disapplied on grounds of being incompatible with EU law. This depended on whether it was necessary for GMAC to be given notice of the abolition of the old scheme and, if so, whether adequate notice had been given. Notice of the abolition was in fact given in the form of a Budget news release and a Budget Notice, both issued on 26 November 1996 (and, of course, the Finance Bill itself which eventually became FA 1997). If such notice were held not to be adequate (which was what the Upper Tribunal found in [2012] UKUT 278), the abolition would be in breach of applicable EU law principles such as the principle of effectiveness (which requires that the provision in question does not make it virtually impossible or excessively difficult for the taxpayer to exercise his EU law rights) or the principle of legitimate expectations.

> The issues considered in *GMAC* remain relevant to taxpayers who have been contesting the legitimacy of the property condition and the insolvency condition for years

The Court of Appeal held that s 39(5) did not fall foul of any such principles. It considered that GMAC had more than adequate time to exercise its EU law rights – as mentioned above, there was a long 'crossover period' during which both the old scheme and the new scheme were available in relation to certain supplies, which meant that supplies that fell only within the old scheme were of 'considerable antiquity' by the time s 39(5) was enacted. In the circumstances, the court considered the four-month notice period (starting with the Budget news release and Budget Notice issued following the pre-Budget statement in 1996) to be adequate notice, and held that s 39(5) did not render the exercise by GMAC of its EU law rights excessively difficult or virtually impossible.

Although a significant portion of *GMAC* is a tour of the history of VAT bad debt relief in the UK, the issues considered remain relevant to taxpayers who (like GMAC) have been contesting the legitimacy of the property condition and the insolvency condition for years. The question now is whether (and, if so, the extent to which) their claims are affected by the Court of Appeal's judgment on FA 1997 s 39(5). ■

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▶ Cases: *HMRC v GMAC (UK)* (2.11.16)