VAT - Dealing with
refunds / bad debts / non-refundable fees / cancellation charges / prompt payments

SUMMARY

Your business may sometimes give refunds or raise credit notes, e.g. if goods are returned by customers or an invoice contains a pricing error. How is this different to bad debt relief, and why is it important to make a distinction?

A credit situation involves a whole or part reduction in the invoice amount - a bad debt is where the customer doesn't pay. Bad debt relief claims are subject to time limits, so impress upon your client the difference between the two. If HMRC reclassifies a credit as a bad debt, it might be too late to claim relief.

BACKGROUND

It is important to be clear about the difference between a "credit" situation and a "bad debt" outcome. In the latter case, you expect your customer to pay their dues but for some reason, some or all of the payment is not made. This means that any output tax you account for on a VAT return can be claimed back on a future return as long as two conditions are met:

- the sales invoice for the original sale is at least six months overdue for payment; and
- the invoice has been written off in the accounts of the supplier, i.e. a credit to debtors and a bad debt expense entry is made in the profit and loss account.

Pro advice. Be clear with your clients that the key date is when the invoice is six months after the due payment date, and not six months from the date of the sales invoice. So, if an invoice is raised on 31 March 2017 on 60-day payment terms, the earliest possible date for a bad debt claim for VAT purposes is the VAT return that includes 30 November 2017.

If a business uses the cash accounting scheme, then bad debt relief is automatic. Note that you do not issue a credit note in bad debt situations.

CREDIT NOTES

A credit note is used to wholly or partially offset the amount of a sales invoice. This can include VAT, but will not in all situations.

Example. John is a clothes wholesaler and sold five dresses to retailer Samantha for £100 + VAT each, i.e. a total invoice of £500 + VAT. One of the dresses is the wrong colour and is returned for a refund, and another is slightly damaged so John agrees to give a 50% discount for this item. John will raise a credit note to Samantha for £150 + VAT.

If John and Samantha are both VAT registered, the credit note can be raised without any VAT, i.e. with no adjustment to the VAT originally paid.

Pro advice. In such cases, the document raised must clearly state: "This is not a credit note for VAT".

If both parties agree, the credit can instead be adjusted by the customer issuing a debit note per VAT Notice 700, para 18.2 (see **Follow up**).

Pro advice. In situations where a credit note is raised without adjusting the original VAT charged on the invoice, both parties must still adjust the value of their inputs and outputs in Boxes 6 and 7 of the VAT return, i.e. to reflect the reduced price of the original supply.

One of the key reasons that it is imperative to distinguish between a credit adjustment and a bad debt is that bad debt claims are time barred at four years and six months from the date of the original supply, whereas credit adjustments have no time limit.

HMRC will look closely at any large transaction that results in output tax being reduced. If it has been wrongly classed as a credit adjustment instead of a bad debt, there would be no relief if the time limit has passed.

NON-REFUNDABLE FEES

What is the situation where a non-refundable fee is charged in advance of a supply, and ultimately the supply never occurs? This was considered in the First-tier Tribunal (FTT) in RDS Driving Services v HMRC [2017] TC06087 (see **Follow up**). The VAT position of non-refundable fees relevant to students who did not complete their driving instructor courses was considered.

The company offered trainee driving instructors the chance to pay an advance fee (non-refundable) to cover the cost of all three parts of their driving course. The fee was discounted compared to a separate payment for each of Parts 1, 2 and 3.

NO SUPPLY?

RDS accounted for output tax when it received the advance fee but then claimed that if the student dropped out of the course and never started Parts 2 or 3, the output tax on the original payment should be reduced accordingly, even though no refund was given to the student.

It argued that the element of the fee relevant to the uncompleted parts of the course did not relate to a supply of goods or services and was therefore outside the scope of VAT.

The FTT supported HMRC's view that the advance payment created a tax point for the right to carry out all three parts of the course, and that outcome did not change if the student dropped out part way through their studies, stating *"I find that as each part of the course is integral to the course as a whole, and the trainee has prepaid for the whole course, it would be artificial to split the supply"* .

Pro advice. This case highlights an important VAT principle, namely that "the right" to benefit from goods or services is a supply in its own right. The fact that the students did not complete their courses in some cases was irrelevant and did not affect the VAT position. The VAT liability is based on the known facts at the time of supply, i.e. the full payment is standard-rated and there will be no scope to reduce output tax if the membership is cancelled.

CANCELLATION CHARGES

This is different from circumstances where a security deposit is subject to forfeiture. Imagine the following situation: a business hiring out bikes always receives an extra payment from customers before the hiring takes place to cover the cost of any potential damage.

If the bike is returned in good condition, the customer is fully refunded their deposit. In this situation, there is no output tax issue because the initial deposit does not relate to a taxable supply of goods or services.

Even if the customer forfeits their deposit, there is no output tax to pay because the payment is effectively compensation to the business owner for the time and cost they will incur repairing the bike, i.e. the deposit retention is outside the scope of VAT.

PROMPT PAYMENTS

Your clients may offer customers a discount for early payment of an invoice, e.g. a 5% reduction in exchange for payment within 30 days. The rules regarding the VAT treatment changed with effect from 1 April 2015.

Now, VAT must be paid to HMRC according to the amount paid by the customer in cases where a prompt payment discount is offered by a supplier. The previous rules allowed VAT to be charged on the discounted amount, irrespective of whether the customer took advantage of the discount.

A major concern when these rules were introduced was that a business could need to issue a lot of credit notes to customers taking advantage of the discounts. But Revenue and Customs Brief 49 (2014) (see **Follow up**) confirms that this is not necessary - as long as a supplier gives a clear instruction on their sales invoice that a customer must reduce their input tax if they take advantage of the discount. The supplier can then reduce their output tax as well, without the extra administration.

Example. Joan sells goods to Sue for £2,000 plus VAT, offering a 10% prompt payment discount if Sue pays within 30 days. Joan's original invoice will charge £400 VAT, i.e. 20% of the full selling price. She will reduce her output tax by £40 if Sue takes advantage of the discount. As long as Joan makes it clear on her original invoice that Sue must reduce her input tax if the discount is taken, then Joan will not need to issue a credit note.

Pro advice. The wording to be included by your clients on their sales invoices where a prompt payment discount is offered is not specified in law. But HMRC suggests the following: "A discount of X% of the full price applies if payment is made within Y days of the invoice date. No credit note will be issued. Following payment you must ensure you have only recovered the VAT actually paid."

FOLLOW UP:

- VAT Guide: https://www.gov.uk/government/publications/vat-notice-700-the-vat-guide/vat-notice-700-the-vat-guide
- Tribunal: http://www.bailii.org/uk/cases/UKFTT/TC/2017/TC06087.html
- HMRC Brief 49: https://www.gov.uk/government/publications/revenue-and-customs-brief-49-2014-vat-prompt-payment-discounts