Discounts and credits: tips and pitfalls for VAT

Indirect Tax



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We consider some practical issues about output tax issues, including a reference to two past tribunal cases.

Key Points

What is the issue?

It is important to be clear if output tax reductions must be adjusted by issuing a credit note to a customer; claiming bad debt relief from HMRC; or issuing another document to support the reduction. This process is important because bad debt claims are time capped, whereas price reductions are not.

What does it mean to me?

In some situations, there is no output tax to declare or reclaim, such as for refundable deposits and compensation payments made by a customer.

What can I take away?

A credit note must always give value to a customer; e.g. a bank repayment is made or the credit is offset against other unpaid invoices. If this does not happen, the supplier cannot reduce their output tax on a return.

The Utopian outcome for any business deal is to issue a sales invoice and get full payment from your customer; e.g. Betty issues an invoice for £100 plus VAT and gets paid £120. But what happens if the amount paid by Betty's customer is different from the invoiced amount, perhaps because of a prompt payment discount or – in some cases – because they refuse to pay the full amount due to faulty goods?

In this article, I will focus on the VAT challenges with the most common situations that involve giving discounts, credits and refunds.

Credit note or bad debt?

A credit note cannot be issued to write off a bad debt. They are only relevant to the correction of trading issues. This could be if a sales invoice charged the wrong price or the wrong quantity of goods or – more likely – the customer has returned some goods and wants a credit.

There is a subtle timing issue in the legislation about credit notes and bad debt situations. A business will sometimes argue that a credit note is justified, rather than a claim on the next return for bad debt relief. The reason is because a bad debt claim is time barred at four years and six months from the date of the original supply, or due payment date if later, whereas credit note reductions – often referred to as a 'decrease in consideration' – are not time barred.

The relevant legislation is at Regulation 38 of the VAT Regulations 1995. HMRC Guidance is available in the VAT Traders' Manual (VATREC) at: tinyurl.com/ysmm7jzu

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The case of *Barlin Associates*

To share one of my favourite cases – I can't believe that 11 years have passed since it was heard in the First-tier Tribunal – the key issue in the case *Barlin Associates Ltd* [2014] FTT 957 was whether a reduction in the amount owed by a customer related to a bad debt or credit note situation.

- Barlin was a trademark attorney, who made sales of £871,000, including VAT of £127,000, to Autonomy Corporation between 2005 and 2010. All of these were unpaid because Autonomy contested the fees. Legal proceedings resolved the dispute in December 2012.
- The court's verdict was that Autonomy had to pay £260,000 to Barlin, including VAT of £45,000. Barlin issued a credit note that included VAT of £82,000 in December 2012 and sought to reclaim this tax from HMRC.
- HMRC argued that the sales reduction from £871,000 to £260,000 did not represent a reduction in the value of supplies made by Barlin to Autonomy but a bad debt situation which was time barred in 2012.

The tribunal rejected HMRC's view that a bad debt situation was evident, stating: 'Autonomy owes Barlin nothing … there is no debt so there is nothing to write off.'

Non-refundable fees

In the case of *RDS Driving Services Ltd* [2017] UKFTT 660, the First-tier Tribunal considered whether the company could issue credit notes and reduce its output tax liability if students did not complete their three-stage driving instructor courses. The answer would be 'yes' if the students got a refund. That was not the case here, though, as the fees were fully paid in advance and non-refundable.

To cut to the chase, RDS accounted for output tax when it received the advance fees. However, it then claimed that if a student dropped out of the course and never started Parts 2 and 3 or Part 3, the output tax on the original payment should be reduced accordingly, even though no refund was given. The director argued that the element of the fee which was 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. Needless to say, HMRC disagreed.

The tribunal supported HMRC's view that the advance payment created a tax point for the ***right*** to carry out all three stages, and that outcome did not change if students dropped out part way through their studies.

Refundable deposits

Imagine the following situation: a business hiring out goods receives a deposit at the beginning of an agreement to cover the cost of potential damage. If the goods are returned in pristine condition, the deposit will be fully refunded.

There are no output tax issues here because the deposit does not relate to a taxable supply of goods or services. And even if the customer forfeits their deposit – because of a damage issue – there is still no output tax to declare; the payment is compensation to the business owner for the time and cost needed to repair the goods, so the deposit is outside the scope of VAT.

Customer refunds: a change in the law

VAT enthusiasts will recall an important change to the legislation that took effect on 1 September 2019, the intention being to prevent a business from issuing a credit note to a customer but not giving any 'real world' value to the customer for that credit; i.e. the credit is neither repaid to the customer's bank account nor immediately offset against other unpaid invoices for the same customer (see HMRC Supply and Consideration Manual VATSC06635).

To share an example, imagine that Builder Bob has agreed to build an extension at the home of a wealthy customer for £200,000 plus VAT and is paid £240,000 in advance by the customer before a brick is laid. The job goes wrong – Builder Bob becomes Bodgit Bob – and Bob agrees a credit of £60,000 plus VAT to appease a very annoyed customer. However, Bob cannot afford to immediately repay £72,000 because of cash flow problems, so agrees to pay £1,000 plus VAT each month for the next five years.

In this situation, Bob can only reduce the output tax on his VAT returns when he pays each refund; the credit note is irrelevant. He should issue a credit note to the customer within 14 days of each refund being made and not in one lump sum. If the customer is registered for VAT, they will reduce their input tax claim in the period that includes the repayment dates (see HMRC Notice 700 para 18.2.6).

Prompt payment discount

A prompt payment discount incentivises customers to pay their dues by a certain date, such as a 10% price reduction if payment is made within 30 days:

- VAT must be paid to HMRC according to the amount paid by the customer in cases where prompt payment discount is offered by a supplier. The original sales invoice must therefore charge VAT on the full value of the supply in case the discount offer is not taken.
- A major concern when the legislation was revised in 2015 was that a business would need to issue many credit notes to customers taking advantage of discounts. Revenue and Customs Brief 49 (2014) issued on 22 December 2014 confirmed that this is not necessary as long as suppliers give clear instructions on their sales invoice that customers must reduce their input tax if they claim the discount. Suppliers will reduce their output tax.

See ***Teapot sales: prompt payment discount.***

Teapot sales: prompt payment discount

Betty sells ceramic teapots to Sally for £5,000 plus VAT, offering a 10% prompt payment discount if Sally pays within 30 days. Betty's original invoice must charge £1,000 VAT; i.e. 20% of the full selling price. She will reduce her output tax by £100 if Sally takes advantage of the discount. As long as Betty makes it clear on her invoice that Sally must reduce her input tax if the discount is taken, then Betty will not need to issue a credit note.

Note: The wording to be used on Betty's invoice is not specified in law. HMRC gives a suggested wording: '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.' (See HMRC Notice 700 para 18.2.2.)

Conclusion

A business must consider many issues when the original VAT charged on an invoice is reduced: bad debts, discounts, pricing errors, issues with faulty or retuned goods or a poor quality service. To summarise some important issues, see ***Credit notes and discounts: five practical tips***.

Credit notes and discounts: five practical tips

1. A credit note issued to a customer does not need to adjust the original VAT charged on the invoice if both parties agree. This outcome will only be relevant if the customer can fully claim input tax on their expenses. The document raised must clearly state: ‘This is not a credit note for VAT.’ (See HMRC Notice 700 para 18.2.3.)
2. If a credit note is raised without adjusting the original VAT charged on the invoice, both parties must adjust the inputs and outputs figures in Boxes 6 and 7 of their VAT returns; i.e. to reflect the reduced price of the original supply.
3. A credit note only has legal status when it is issued to a customer; the customer will need the document to support their input tax reduction if they are registered for VAT.
4. It is sensible to review HMRC’s published guidance about the contents of ‘valid credit notes’. For example, they must include the number and date of the original sales invoice(s), giving a clear link between the original supply and subsequent price reduction. (See HMRC Notice 700, para 18.2.3.)
5. A business must never raise a credit note in a bad debt situation. A supply of goods or services has still taken place and a bad debt outcome does not change that outcome.

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