CHAPTER 14

BAD DEBT RELIEF

14.1   Introduction

Consider the situation with two traders, Trader A and Trader B.

Trader A sells goods to Trader B. Trader A raises an invoice for the goods at £1,000 plus VAT. Trader B pays the invoice promptly so £1,175 is paid to Trader A.

On the VAT Return of Trader A, there is output VAT of £175, and this will be paid to HMRC. On Trader B's VAT Return there is input tax of £175 and this will be reclaimed from HMRC on Trader B's VAT Return. Thus the output and input position is circular. No one has yet borne the output VAT and this is quite right because it is only the final consumer that bears the VAT. The final consumer has not yet been introduced into the chain.

<div align="right">VATA 1994, s. 36
SI 1995/2518
Reg 165-172</div>

14.2   The problem

Problems arise where Trader B fails to settle the invoice promptly.

Using the same example, goods are sold from Trader A to Trader B, and Trader A raises an invoice for £1,000 plus VAT. Trader B is a late payer, so no cash goes across from Trader B to Trader A. Assuming that both traders are under invoice accounting using the "tax point" rules, Trader A will still have an obligation to pay £175 of output tax to HMRC.

Trader B accounts for VAT on an invoice basis, so he is entitled to reclaim the £175 from HMRC by way of input tax. This is regardless of whether or not he has paid the VAT.

So at the moment, there is inequity. HMRC are in the same position as before because they receive money from Trader A and have paid it out to Trader B.

Trader A is not happy. He has accounted for output tax of £175 without receiving anything from Trader B. Trader B however, is extremely happy. HMRC have given him £175 and he has not paid Trader A.

Assume 6 months have passed from the due date of the invoice. At this point Trader A is entitled to claim "bad debt relief". Trader A can claim back £175 from HMRC as part of the input tax on his VAT return, but this cannot be made until 6 months have passed since the original due date. HMRC are now out of pocket, as they have paid back £175 to Trader A.

<div align="right">VATA 1994, s. 36(1)</div>

In order for HMRC to balance their books, there is a requirement for Trader B to repay the original input tax to HMRC once 6 months has passed. When (and if) Trader B does eventually pay Trader A, he will account for the output tax, and Trader B can then claim back the input tax again.

14.3   Conditions

The first condition is that Trader A must have **supplied goods or services and must have accounted for and paid the output VAT on the supply.**

The whole or part of the **consideration has been written off** in Trader A's accounts as a bad debt. This is simply an entry in the bad debts account within Trader A's books.

Six months must have elapsed since the later of the date of supply and the due date of the invoice. Consequently it is very important to show terms of payment on invoices.

The **claim must be made within 4 years and 6 months** from the later of the date of the supply and when it was due for payment.

14.4   Records & notification

Before submitting a bad debt relief claim, the claimant must hold VAT invoices and other such records showing that VAT has been accounted for and paid on the supply, and that the consideration has been written off in his accounts as a bad debt.

Trader A need not notify Trader B that they have claimed bad debt relief. However Trader B is **obliged** to repay the £175 on any debt that is over 6 months overdue.

14.5   Part Payments

Traders often pay sums on account - they have an account running with a particular supplier whereby amounts paid are deducted from invoices that are outstanding.

Unless the purchaser identifies the payment as relating to a particular invoice, the general rule is that cash received is allocated to the older invoices first.

This can be important when the trader raises invoices which have different VAT liabilities. For example, invoices could be for a mixture of zero-rated, standard-rates or exempt items.

Supplies made on the same day are aggregated and treated as one, and any payments are rateably apportioned between those two invoices.

Illustration 1

Assume for the purposes of this illustration that the VAT rate is 17.5% throughout

Invoices	Net	VAT	Gross
	£	£	£
4.1.11	600	105	705
10.1.11	1,000	-	1,000
15.2.11	400	70	470
19.3.11	800	140	940
20.4.11	2,000	350	2,350

The due date is within 7 days of the invoice date.

Cash was paid on 1 March 2011 of £2,000, without any specific invoice allocation.

As the payment was not invoice specific, we allocate the cash to the older invoices first. Consequently £705 clears the invoice on 4 January 2011, £1,000 clears the invoice on 10 January 2011 and the balance of £295 goes against the invoice dated 15 February 2011.

Amounts outstanding:

Invoices	Net	VAT	Gross	Cash paid	Outstanding
	£	£	£	£	£
4.1.11	600	105	705	705	-
10.1.11	1,000	-	1,000	1,000	-
15.2.11	400	70	470	295	175
19.3.11	800	140	940	-	940
20.4.11	2,000	350	2,350	-	2,350

Once the cash received has been allocated, the trader can prepare the VAT return to 30 September 2011.

At 30 September 2011 there are invoices which have been outstanding for over 6 months. The invoice dated 15 February 2011 would have had a due date of 22 February 2011. Consequently, that is over 6 months old and bad debt relief is available in the quarter to 30 September 2011.

7/47ths of the outstanding amount gives a bad debt claim of £26.06.

The invoice dated 19 March 2011 has a due date of 26 March 2011. Again this is more than 6 months old, so a full bad debt claim can be made. This is £940 x 7/47 which is £140.

The total bad debt claim is £166.06, and that will be treated as input tax in the return to 30 September 2011.

The invoice dated 20 April 2011 will not be 6 months old until 27 October 2011, therefore the business will have to wait until the following quarter to claim bad debt relief in respect of that invoice.

14.6 Meaning of "paid" from 1st April 2009

HMRC Revenue & Customs Brief 18|09 redefines what constitutes payment for bad debt relief purposes from the 1st of April 2009. They accept that payment of output tax is made to the extent it is covered by deductible input tax.

Illustration 2

For example, if a return shows output tax of £200,000 and input tax of £110,000, £90,000 is the tax due for the period. This amount is not paid to HMRC due to trading difficulties.

Output tax	£200,000
Input tax	(£110,000)

Net tax	£90,000

At a later date it becomes clear that bad debts have been incurred in the period that includes £120,000 of VAT.

Under the new rules, bad debt relief of £30,000 can be claimed in respect of this sum even though the net tax due on the return was not paid. This is because the input tax of £110,000 is deemed to be part payment of the output tax due on the return.

Output tax	£80,000 (on supplies that were paid)
Input tax	(£110,000)

Net tax	(£30,000)

Bad debt relief can be claimed on the excess of input tax over output tax on non bad debt relief supplies, i.e. £110,000 input tax less £80,000 output tax.

Example 1

Thud Ltd raised the following invoices on Lex Ltd:

Invoices	Net	VAT	Gross
	£	£	£
15.3.11	1,000	-	1,000
20.4.11	200	35	235
24.4.11	600	105	705
29.5.11	2,000	350	2,350
29.5.11	500	-	500
16.6.11	800	140	940

All invoices are due for settlement immediately.

Lex Ltd paid £235 on 15.5.11 and stated that the payment was in respect of the invoice raised on 20.4.11.

Lex Ltd paid a further £3,000 on 31.8.11

Calculate the bad debt relief claim to be made on the return to 30 November 2011. [Assume a VAT rate of 17.5% throughout]

Answer 1

Invoices	Net £	VAT £	Gross £	Cash paid £	Outstanding £
15.3.11	1,000	-	1,000	1,000	-
20.4.11	200	35	235	235	-
24.4.11	600	105	705	705	-
29.5.11	2,000	350	2,350	} 1,295	See below
29.5.11	500	-	500		See below
16.6.11	800	140	940	-	940

The cash paid on 15 May 2011 was specifically allocated against the invoice dated 20 April 2011.

The second payment on 31 August 2011 is allocated against older invoices first. £1,000 goes against the invoice dated 15 March 2011. £705 goes against the invoice dated 24 April 2011, and £1,295 goes against the invoices dated 29 May 2011. Those invoices have been raised on the same day so they are effectively treated as one invoice.

The bad debt claim is therefore on the taxable amount outstanding on the invoices dated 29 May 2011.   To calculate what proportion of the £2,350 is still outstanding, apportion the cash allocation of £1,295 to these two invoices.

$$£[2,350 - (1,295 \times \frac{2350}{2350 + 500}) = £1,282.19$$

The bad debt relief claim on the return to 30 November 2011 will be;

$$£1,282.19 \times 7/47 = \underline{\textbf{£190.96}}.$$

The invoice raised 16.6.11 is not 6 months old so does not qualify for bad debt relief.