TC04070

Appeal number: TC/2013/03666

VAT – taxpayer issued invoices to client which were unpaid – taxpayer eventually issuing legal proceedings against client – taxpayer de-registered - out of court settlement reached for lesser amount than amount of invoices – taxpayer issuing credit note for balance – HMRC refusing to repay balance of VAT – appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

BARLIN ASSOCIATES LTD **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE BARBARA MOSEDALE

Sitting in public at Bedford Square, London on 16 September 2014

Ms V Sloane, Counsel, for the Appellant

Mr P Rowe, HMRC officer, for the Respondents

DECISION

1. The appellant appeals against HMRC's refusal to repay it output tax shown on a credit note.

Facts

2. The facts were not in dispute. I find as follows.

3. Barlin, although it has now ceased trading, was at the relevant times in business as a trade mark attorney. Between 2005 and 2010 Barlin carried out work for Autonomy Corporation plc ("Autonomy") under a general retainer. It issued various invoices to Autonomy during that period which totalled £871,896.18, including VAT of £127,665.36.

4. Barlin accounted for the VAT (£127,665.36) on these invoices to HMRC. Autonomy did not pay the invoices. At this stage, Barlin did not make any claim to recover the VAT from HMRC on the basis that the debts were bad or otherwise.

5. But Barlin did pursue Autonomy for payment. Autonomy having refused to pay, Barlin eventually issued a claim against it in the High Court on 7 February 2011. Autonomy defended the claim, on the grounds, it said, that the work carried out by Barlin had not been properly authorised by Autonomy and/or the invoices were insufficiently particularised.

6. Barlin ceased trading towards the end of 2011 and was de-registered for VAT with effect from January 2012.

7. Its claim against Autonomy was settled out of court by the parties on 30 November 2012. Under the terms of this settlement, Autonomy agreed to pay Barlin £306,000 (£260,425.53 plus VAT of £45,574.47) in full and final settlement of the claim for £871,896.18.

8. The settlement agreement included a provision that Barlin would issue a credit note and on 12 December 2012 Barlin issued to Autonomy a credit note for the balance of the invoiced amount including VAT of £82,095.78. On 4 January 2013 Barlin wrote to HMRC asking for repayment of VAT of £82,095.78. HMRC refused repayment, and it is against that decision which Barlin appealed to this tribunal.

The law

9. What is now Art 90 of the Principle VAT Directive ("PVD") but was Art 11C(1) of the Sixth VAT Directive ("6VD") provides:

> "**Article 90**
>
> 1. In the case of cancellation, refusal or total or partial non-payment, or where the price is reduced after the supply takes place, the taxable

amount shall be reduced accordingly under conditions which shall be determined by the Member State.

2. In the case of total or partial non-payment, Member States may derogate from paragraph 1."

10. HMRC accepts that these provisions are directly effective. Mr Rowe's case is that they have been properly enacted by the UK's provisions on bad debts, s 80 Value Added Tax Act 1994 ("VATA") which permits recovery of overpaid VAT, and art 38 of the Value Added Tax Regulations 1995 ("VAT Regs") which provides as follows:

"**38 Adjustments in the course of business**

(1)….this regulation applies where –

(a) there is an increase in consideration for a supply, or

(b) there is a decrease in consideration for a supply,

which includes an amount of VAT and the increase or decrease occurs after the end of the prescribed accounting period in which the original supply took place.

(1A) …this regulation does not apply to any increase or decrease in consideration which occurs more than 3 years after the end of the prescribed accounting period in which the original supply took place.

….

(3) ….the maker of the supply shall –

(a) in the case of an increase in consideration, make a positive entry; or

(b) in the case of a decrease in consideration, make a negative entry,

for the relevant amount of VAT in the VAT payable portion of his VAT account.

(5) Every entry required by this regulation shall, except where paragraph (6) below applies, be made in that part of the VAT account which relates to the prescribed accounting period in which the increase or decrease is given effect in the business accounts of the relevant taxable person.

(6) Any entry required to by this regulation to be made in the VAT account of an insolvent person shall be made in that part of the VAT account which relates to the prescribed accounting period in which the supply was made or received.

11. The appellant relies on this provision for its claim that it is entitled to be repaid VAT in the sum shown on the credit note (£82,095.78). It paid this sum to HMRC in respect of a supply for which it issued an invoice to Autonomy but it has now agreed with Autonomy that that sum is not due from Autonomy. The appellant considers there has been a reduction in consideration and the VAT should be repaid as VAT is meant to be exactly proportional to the value of supplies and the Directive gives it an express right to be repaid when consideration is later reduced.

12. So far as the time limit of three years in Reg 38(1A) is concerned this was repealed with effect from 1 April 2009 by the VAT (Amendment) Regulations SI

2009/586. In any event the VAT Tribunal in *GMAC* (VTD 17990 and referred to below) had held that that time limit was unlawful under the Directive and had refused to apply it; that decision, unappealed by HMRC, was no doubt the reason for the ultimate repeal of the Reg 38(1A). HMRC accepts that the three year time limit under reg 38(1A) does not apply.

Is there a reduction in consideration?

13. But HMRC do not accept that the consideration has been reduced and consider that Reg 38 as a whole is inapplicable to the appellant's position. HMRC say it is nothing more than a bad debt. Autonomy owed £871,896.18 but only paid £306,000.

14. Section 36 of VATA gives a right to recover VAT where there is a bad debt. It provides that a taxpayer can reclaim VAT paid to HMRC if and to the extent:

> "the whole or any part of the consideration for the supply has been written off in his accounts as a bad debt…" (S 36(1)(b))

15. Regulations made under section 36 provide that bad debt relief claims must be made within 4 years and six months of the date on which debt became payable: see Reg 165A(1) of the VAT Regs.

16. According to HMRC, the appellant is largely out of time to make a bad debt relief claim, although HMRC did repay some £7,000 of its claim on the grounds that the claim was made just within the 4 years and 6 months of the date of the last of the disputed invoices.

17. As a matter of law, HMRC are wrong to say that there is a bad debt. A bad debt presupposes that the would-be debtor owes money to the would-be creditor. But here Autonomy owes Barlin nothing. Although Barlin asked for £871,896.18, following the settlement, Barlin agreed to take £306,000 in full and final settlement of its claim. As a matter of law, Autonomy, having paid the £306,000, now owes Barlin nothing in respect of its claim for £871,896.18. There is no bad debt because there is no debt at all. There is no debt so there is nothing to write off.

18. I note that this was the conclusion arrived at by the Tribunal in *Cumbria CC* (below) at [77]. I agree with its conclusions and for the reasons given.

19. As there is no bad debt, the time limits for repayment in Reg 165A(1) do not apply.

20. There is no bad debt but is there a reduction in consideration?

What is the meaning of reduction in consideration?

21. HMRC relies on the 1988 VAT Tribunal decision in *Castle Associates Ltd* VTD 3497. In that case, the appellant issued an invoice. This was not paid by the recipient of the supply, originally because it was short of money. Later, the supplier decided

that the invoice over-charged the recipient (a captive company) and issued a credit note for a significant percentage of the amount of the invoice.

22. The chairman said:

> "…the supplier of the services states his charges, the recipient disputes them if he wishes, and after discussion the amount is agreed. If an invoice stating the supplier's original version of the charges has been issued in the meantime, a credit note is issued, giving credit for the difference between the charges originally stated and the agreed charges, and no doubt such a credit note would be perfectly acceptable for the purposes of the value added tax. Again if the amount has been agreed, and the invoice erroneously states a higher amount, a credit note is an appropriate method of evidencing the correction of the error. In each of these cases, the invoice misstates the transaction as it was agreed between the parties and the credit note evidence the correction of the error. But once the parties have agreed the amount of the charges for the services, and the services have been supplied, the value of the supply is ascertained. If thereafter the supplier unilaterally decides, or both parties contract, that the full amount of the agreed charges is not to be payable, in our judgement the decision or the new contract does not alter the value of the supply for the purposes of value added tax, nor does it make any difference if a credit note is issued to evidence the decision or the new contract."

23. I do not find that this case supports HMRC's position because I do not accept that it was correctly decided. The chairman gave no authority for the view which I have recited above. It is in direct conflict with the clear provisions of the 6VD which was in force at the time, and which provided, as Art 90 of the PVD now provides, as recited at §9 above, that VAT is reduced "where the price is reduced after the supply takes place". Yet the chairman above said that the VAT was not reduced where the parties agreed to a reduction in the price after the supply. That is clearly wrong.

24. (I note in passing that HMRC's reliance on the case was also misplaced as the situation in this case appears to be the one envisaged by the chairman at the start of the above quoted paragraph of the supplier issuing an invoice before the price was agreed, in which he appeared to accept that a later agreement for a lower amount than asked would lead to a VAT repayment.)

25. Only a year later, I find that a correct application of the law was made by a different VAT Tribunal chairman in the case of *Cobojo Ltd* VTD 4055 (1989). In that case the supplier issued an invoice which the recipient did not pay. In 1979 the supplier issued legal proceedings against the recipient, who still refused to pay, stating that the supplier had provided the services without being properly authorised (an echo of Autonomy's defence in this case). An extraordinary eight years later the legal action was dismissed for want of prosecution by the supplier, so it was unable to reclaim any money from the recipient. The supplier issued a credit note against the entire amount of the invoice and sought to reclaim the VAT on the credit note from HMRC.

26. As with this case, HMRC's position was that there was no adjustment of consideration, but merely a bad debt. The Tribunal allowed the appeal, rejecting HMRC's case that there was a bad debt and saying:

> "The tribunal determines that [the credit note] was a bona fide document intended to correct the genuine mistaken belief that the services were properly supplied whereas the supply was challenged and, without the issue coming before the Court, the claim of the appellant failed."

27. The effect of the failed legal proceedings was that the recipient did not owe anything to the claimant: there was no debt, and therefore no bad debt. On the other hand, it seems to me that it would be correct to describe the position as one of "cancellation" in the sense meant in Art 90. The credit note cancelled the invoice because the would-be supplier had had to accept that it did not make the supply for which it had issued the invoice.

28. Much more recently, there is the VAT Tribunal decision in *Cumbria CC* [2011] UKFTT 621 (TCC). Cumbria CC ("CCC") entered into a contract with DEFRA. It invoiced DEFRA over £4 million for services rendered, but DEFRA refused to pay contending the charges were in excess of what was agreed. CCC issued proceedings against DEFRA in the High Court and, as in this case, the matter was settled before it reached a hearing. The terms of the agreement was that DEFRA would pay CCC £200,000 including VAT in full and final settlement of CCC's claim. DEFRA paid this.

29. CCC attempted to reclaim the excess VAT with a bad debt claim which was refused by HMRC; it then issued a credit note, the VAT on which HMRC also refused to pay. The Tribunal agreed with HMRC that CCC could not make a bad debt relief as there was no outstanding debt between CCC and DEFRA (see [77]). It allowed the appellant's appeal on the basis of Reg 38:

> "[81] Further, the Settlement was reached, and the High Court action settled, on the plainest possible terms. DEFRA was to pay CC the sum of £200,000. That sum was to be paid in full and final settlement of the latter's claim against the former. No further sum was to be paid to cover any VAT liability; no sum was to be paid by way of interest, and each party was to bear its own costs. In our judgment, in those circumstances not only was the litigation settled, the consideration for CCC's supplies was reduced. The conditions contained in reg 38 were satisfied. CCC is therefore entitled to recover the VAT it overpaid on the sums invoices to DEFRA….
>
> [83] ….In our judgment, reg 38 is the means whereby any claim settled similarly to that of CCC is to be adjusted as a reduction in consideration…"

Conclusions

30. Art 90 refers to "the case of cancellation, refusal or total or partial non-payment, or where the price is reduced after the supply takes place". It does not perhaps deal

expressly with the position of a supplier who issues what it considers to be a correct invoice, but the recipient disputes it and considers that only a lower sum or perhaps nothing is owing, and the parties later agree that nothing or only part of the sum is actually owing. On a literal interpretation, perhaps, "the price is reduced" does not really cover this sort of situation because it seems the recipient of the supply did not agree to the invoiced price. But Article 90 must be considered in its context. It applies to non-payment as well as where payment is consensually reduced; its intent is to reflect Article 1 of the PVD that:

> "the principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services….."

31. The intention is to charge VAT on the price of the services; so Art 90 must be read as including a situation where the supplier unilaterally issues an invoice and then agrees the price in a lower amount. Reg 38 is the UK's enactment of that part of Art 90 which refers to cancellation or subsequent reduction in price and must similarly be read as including a situation where the supplier unilaterally issues an invoice but then agrees that the actual price is lower than that shown on the original invoice. Such a situation is envisaged by Art 90 when it refers to 'the price is reduced after the supply takes place' and this situation is envisaged by what Reg 38 refers to as a 'decrease in consideration for a supply'. And that is effectively the conclusions of the Tribunal decisions in *Cobojo Ltd* and *Cumbria CC*. I consider they are right.

32. The effect is that Barlin was entitled to issue a credit note for the balance of the invoices issued years earlier which it had agreed with Autonomy were an overcharge because there was a reduction in the price of the supply after the supply took place.

Time limits

33. Mr Rowe's last justification for HMRC's refusal to repay the input tax to the appellant was that the appellant's claim was made out of time. He maintains that where the appellant has de-registered before the adjustment in consideration has taken place, the time limit for giving effect to the adjustment runs from the date of the original supply.

34. There is no legislative authority for HMRC's view (although it is a view which they have published). As I have mentioned there is no time limit between the original supply and the adjustment in the consideration for it as reg 38(1A) was repealed. Nevertheless, reg 38 does require the adjustment to be entered in the VAT books of the trader in the VAT accounting period in which it is made (Reg 38(5)). For an insolvent person, the entry must be made in the books for the prescribed accounting period in which the supply was originally made: Reg 38(6).

35. The meaning of Reg 38(6) is not entirely clear. As it is inevitable that the prescribed accounting period in which the supply took place will be historic by the time of the adjustment, Reg 38(6) implies that a retrospective adjustment can be made. The repeal of Reg 38(1A) suggests that there is no temporal limit on making such an adjustment.

36. HMRC do not agree with this. A claim for a historic VAT period is necessarily made late. So the claim must come under s 80 VATA. This imports an overall time limit. Any retrospective alteration to the VAT accounting period in which the invoice was issued, undertaken on the basis of Reg 38(6) and with the benefit of hindsight, and on the grounds that the taxpayer has "brought into account as output tax an amount that was not output tax due" in that accounting period, is subject to s 80(4) and the four year time limit.

37. Reg 38(6) does not apply to the appellant in this case as it is not insolvent. But it cannot rely on Reg 38(5) as it is no longer registered. So Mr Rowe considers that, as it has no current VAT accounting period, the adjustment must be made in the VAT accounting period in which the invoices were issued, on the basis of a s 80 claim that Barlin "brought into account as output tax an amount that was not output tax due" (with the benefit of hindsight). So Mr Rowe considers the appellant faces the same time limit problem as an insolvent person under Reg 38(6).

38. I cannot agree.

39. In so far as the effect of Reg 38(6) is that, at the date the consideration is adjusted (ie the date of the credit note), the taxpayer is too late under s 80 to adjust its books for the prescribed accounting period in which the invoice was issued, its effect is to make it impossible for the taxpayer to reclaim the overpaid VAT to which it is entitled under Art 90 PVD.

40. While Mr Rowe was at the hearing reluctant to accept this, that is the effect of the construction for which he argues. There is no adjustment in consideration until the credit note is issued. If the credit note is issued more than 4 years after the original invoice, on HMRC's view a taxpayer which is insolvent or unregistered as at the date the credit note is issued is unable to claim the refund. Yet under Art 90 PVD it has a directly effective right to do so.

41. Mr Rowe put the case that before the credit note was issued, and within the Reg 165 time limits, Barlin could have made a claim for bad debt relief, implying that it was not therefore impossible for Barlin to have reclaimed the VAT at stake in time. I do not accept this. There was clearly no bad debt after the date of settlement: but there was no bad debt before the date of settlement either. While at this point there was still a debt outstanding, and the client had not paid it, it was neither a bad debt nor written off in Barlin's accounts. It was not a bad debt and it was not written off because Barlin was actively pursuing payment: a debt is only 'bad' and able to be written off when the creditor has formed the view that it is a valid debt but one which will not be paid. Barlin, on the contrary, pursued payment of it. So I do not accept Mr Rowe's point. Bad debt relief was never available to Barlin.

42. Mr Rowe also suggested that a deregistered taxpayer has no rights under Art 90. I do not accept that that is right as a matter of law. There is nothing on the face of Art 90 which limits the right of repayment to persons who have remained VAT registered. Not only that, there is no reason in logic for such a distinction. As mentioned above, the intention of the PVD (and the 6VD before it) is that the VAT charged should be

exactly proportional to the price: there is no reason why a person should not be able to recover VAT overpaid on a supply on which the price is reduced subsequent to de-registration. If he were unable to do so, the tax authority would have received more VAT than the price of the transaction entitled them to. Barlin was entitled to repayment under art 90 when the credit note was issued notwithstanding the fact that it had at that point de-registered for VAT.

43. Under UK law, Barlin's only hope for the repayment to which it was entitled under Art 90 was to rely on Reg 38. HMRC's case is that it is out of time to do so. In this context the appellant relied on *GMAC* (VTD 17990) where the VAT Tribunal said:

> "[64] …It is common ground ….that Art 11C(1) has direct effect and that a Member State canot take away the right conferred by that provision by measures which the Member State takes to establish the conditions under which the right is to be enjoyed. Moreover, the derogation which Member States are permitted to make under Art 11C(1) … must be objectively justifiable; the same must be applicable to the conditions which the Member States are required to determine….the conditions imposed by Member States are concerned with procedure and evidence. They are not permitted to go further than necessary; and any conditions imposed must be justified…they may be imposed to check that the reduction is not fictitious.
>
> [65] Here the 'condition' imposed by rule 38(1A) is concerned neither with the procedures for making the claim nor with the evidence required to support it….It is a blanket limitation which as the effect of ousting the taxable person's basic right to be taxed on the consideration received by him and no more. As such, the three year limitation on making the claim by reference to the time when the original supply is made is incompatible with Art 11 generally and GMAC's rights under Art 11C(1) in particular. Rule 38(1A) has rendered ineffective GMAC's right to relief. On that basis we think that GMAC is entitled to rely on its Community law rights; and to the extent that the Commissioner's decision seeks to deny GMAC those rights, the decision is wrong. Our conclusion on the three year limitation issue is therefore in favour of GMAC."

44. I agree with what the Tribunal said in *GMAC* (and I note that HMRC did too in that it subsequently albeit belatedly repealed Reg 38(1A)). In any case where Reg 38(6) applies or the s 80(4) time limit applies because the taxpayer has deregistered, and the credit note is issued outside the s 80 time limit of four years, UK legislation makes it impossible for the taxpayer to exercise its directly effective Art 90 right to repayment, because the taxpayer is 'out of time' before the claim is eligible to be made. To that extent, s 38(6), and s 80(4) in so far as it applies to insolvent or deregistered taxpayers relying on Reg 38, is unlawful. I will disregard the time limit as I am required to do by the European Communities Act 1972 in order to apply European law.

45. There is therefore no time limit in respect of which the taxpayer must make its Reg 38 claim for repayment under s 80. But in the event Barlin made its claim very

promptly following the issue of the credit note. HMRC ought to have repaid Barlin when it made its claim in January 2012.

46. The appeal is allowed.

47. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

BARBARA MOSEDALE
TRIBUNAL JUDGE

RELEASE DATE: 15 October 2015