The Personal Tax Planning Review

UNDOING A TAXABLE SUPPLY: VAT AND CREDIT NOTES

Stephen Brandon[1]

There are no general provisions in either the national legislation or the Sixth Directive expressly covering the issue of credit notes[2]. While CEC Notice 700, paragraphs 60/62, provide "guidance", there is no explanation of the conceptual basis on which the right to issue a credit note depends, nor does such guidance encompass all the situations where that right does in fact exist.

The purpose of this article is to look at one situation where the authorities, all at Tribunal level, conflict. My concern is with the case where a tax invoice has been issued in respect of an intended supply but, for whatever reason, the intended supply does not take place, either in whole or in part, so that all or part of the consideration is unpaid. While there are references to a number of conflicting decisions each having effect, in the standard works (see, e.g., *Butterworths Indirect Tax Service*, paragraph A 14.18) it is suggested that the cases which disallow the taxpayer from "cancelling" a tax invoice in respect of a non-existent supply are both out of line and wrong.

The statutory basis governing the issue of a credit note is in fact Value Added Tax Act 1994 ("VATA") section 1(1), that is, so far as relevant for this article, the provision that VAT is only chargeable on the supply of goods or services in the United Kingdom. *Prima facie*, if the supply does not take place, VAT is not due. The second provision (and it is *its* existence which usually causes the problem) is VATA section 6, which governs the timing of a supply. By subsection (4), it is provided that if, before a supply is made, a tax invoice is issued:

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2 General Regulations 1985 (SI 1985/886), Regulation 14, lays down the form of a credit note but only applies where there is a change in the law, by the alteration of the rate of tax, or of the descriptions of exempt or zero-rated supplies.

> "... the supply shall ... be treated as taking place at the time the invoice is issued."

Thus, if a tax invoice is issued, even if no supply takes place, tax must be paid. If this is to be avoided, or tax paid reclaimed (by the adjustment of the taxable person's account), the decisions at Tribunal level require that a valid credit note must be issued.

Does the Sixth Directive set out a general right to issue a credit note? In substance, it would seem so. Article 11.C.1 provides that:

> "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 States."

There is a right of derogation, but only in relation to total or partial non-payment. The UK has, of course, enacted provisions in relation to non-payment, covering bad debts, but, aside from Regulation 14, there is no other general provision. It is suggested that, insofar as the Tribunals have not already conferred the right to give a genuine credit and adjust an account accordingly, this provision has direct effect, and that the UK cannot rely on its own failure to enact "conditions".[3]

One important question that arises is whether the credit may only be given by virtue of a mutual agreement between supplier and customer, or whether the supplier can act unilaterally. The Commissioners have in the past been wary of unilateral acts, since the customer may have obtained an input tax credit and may not adjust *his* account, perhaps being unaware of the credit where payment has never been made. Looking again at the Sixth Directive, is the reference to "cancellation" meant to cover both situations? I believe it must be. The provision as a whole does not just point to bilateral agreement, for example, by use of the word "refusal". Furthermore, if one examines the French original of Article 11.C.1, this provides that:

> "En cas d'annulation, de résiliation, de résolution, de non-paiement total ou partiel ..."

It is suggested that the draftsman, by use of "... d'annulation, de résiliation, de résolution ...", has covered both unilateral and bilateral terms. Aside from the terms of Article 11.C.1, however, it is suggested that it is a fundamental principle

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[3] The imperative "shall" indicates a right to a reduction. Also, if the Member States are free to ignore this provision, why provide for the limited right of derogation? The right to impose conditions protects the Member States against abuse.

of VAT law that if no taxable supply takes place, the taxable person should be able to adjust his account so that no tax is due in respect of it.

I believe the law was correctly argued[4] and applied in the *Securicor Granley* case[5] (itself applying the *British United Shoe* case)[6]. Thus a credit note, to be valid, must be "... issued *bona fide* to correct a genuine mistake or overcharge, or to give a proper credit." If the credit note is issued because the supply has not been made, that must be a "proper credit". Further, it cannot matter that the recipient of the credit note does not agree or even receive the credit note. The taxable person is not merely seeking "bad debt relief" in a roundabout way: if no supply has taken place, tax should not be chargeable. It is only because of the provisions of section 6(4) that tax may have to be accounted for in the first place, but once it is clear that the supply has not and will not take place, a taxpayer is entitled to alter his account accordingly. The credit note, the Tribunals have decided, is an appropriate mechanism for doing this.[7]

There is authority to the contrary. In *Mannesmann Demag Hamilton*[8] the chairman held that, where goods were sold under a "reservation of title" clause, a recapture by the taxable person, following a failure to pay, did not give him the right to issue a credit note. The reasoning was that what is now VATA section 6(4) provided that the taxable supply was to be treated as taking place when the credit note was issued, and thus tax remained payable. With respect, this cannot be correct. Section 6(4) is merely a timing provision, as is clear from subsection (1), in referring to determination of "when" a supply is made. Nor can *Hamilton* be justified on the basis that goods have been supplied, since all that was supplied was mere possession. The consideration due was most certainly *not* directly attributable to such short-term possession (as required by the principle in the *Apple & Pear*[9] case). What if there is no reservation of title clause? In that case there *is* a taxable supply, but if the goods are recovered (even if because of a lack of payment) and a credit note issued, it is suggested that the credit note would also be effective since there has, without doubt, been the "cancellation" of the supply and the taxpayer should be able to issue a credit note in respect of that cancellation.

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4 By Philip Lawton QC and this author.

5 [1990] VATTR 9.

6 [1977] VATTR 187.

7 It may be questioned, however, whether it is in fact necessary to issue a credit note at all where, for example, the customer has disappeared.

8 [1983] VATTR 156.

9 [1988] STC 221.

Lastly, it was held in *George Hamshaw (Golf Services)*[10] that, where a club subscription was paid in advance and the club ceased trading during the year, a credit note (issued to cover payment for the period in respect of which services could not be provided) was ineffective. The chairman referred to what is now section 6(4). Again, this cannot be correct. If the taxable person is unable to provide taxable services, he is entitled to issue a credit note. Conceptually, it can make no difference that payment has also been made for some supplies which took place. The fact that the customer may, in the liquidation, be unable to recover the full amount of the repayment, is neither here nor there. There is nothing in VATA to deem consideration to have been paid in respect of those services which never took place. In such a case, unless there is an exceptional (and valid) term in the contract which deems the consideration to have been paid for something less than the whole supply agreed upon, a credit note would, in my view, wholly remove any VAT liability in respect of services not performed.

[10] (1979) VATTR 51.