VAT treatment of bad debts (excluding hire-purchase)

This document should be read in conjunction with section 39(2) of the VAT Consolidation Act 2010 (VATCA 2010) and regulations 10(2) and 27(1)(m) of the VAT Regulations, 2010.

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Introduction

Bad debt relief arises when a customer defaults in full or part on payment to a supplier where that supplier has accounted for Value-Added Tax (VAT) in respect of the supply. The conditions under which bad debt relief is allowed are set out in Section 39(2) of the VAT Consolidation Act 2010 (VATCA) and regulations 10(2) and 27(1)(m) of the VAT Regulations, 2010.

This guidance explains the VAT relief available for bad debts written off, the conditions to be satisfied and how the relief should be calculated and claimed.

1. What debts are covered by the relief

For business purposes, a debt is regarded as bad when the decision has been made that it is irrecoverable. This decision is usually arrived at when all reasonable efforts have been made, without success, to collect the debt in question and the supplier is in a position to reduce the amount of debts in his or her accounting records by the amount of the debts regarded as bad.

The expiry of the supplier's trade credit period is not, on its own, sufficient to trigger an entitlement to bad debt relief. In general, an accountable person who has accounted for VAT on a supply (other than to a connected person) may claim relief for the VAT attributable to the supply where he or she is in a position to demonstrate that:

- He or she has taken all reasonable steps to recover the bad debt.
- The bad debt is allowable as a deduction in arriving at the tax-adjusted profits for income tax or corporation tax.
- The bad debt has been written off in the financial accounts of the accountable person and the obligation to keep relevant records in relation to the debt has been fulfilled
- The person from whom the debt is due is not connected to the accountable person (see Appendix).
- The VAT bad debt relief should be calculated in accordance with the VAT analysis of the transactions outlined in paragraph 8 below, "How to calculate bad debt relief".

Bad debt relief is not available to traders who account for VAT on the moneys received basis. Furthermore, the relief is available only for bad debts actually written off and it is not available in respect of specific or general provisions for bad or doubtful debts.

2. What are 'reasonable steps'

Reasonable steps will depend on the facts and circumstances of each case and can comprise a number of actions undertaken to recover the debt. Actions taken include correspondence with the debtor, referral of the issue to a solicitor or a debt collection agency or other action undertaken which results in objective evidence that the trader is in a position to reasonably consider that the debt is bad. In such circumstances, the trader can reduce the amount of debts in his or her accounting records by the amount of the debts regarded as bad. Correspondence from a liquidator stating that there are no funds to pay non-preferential creditors would constitute such evidence and would justify the write-off of a debt.

A trader is required to retain evidence of action taken, including all correspondence, in attempting to recover the debt.

3. What does written off as a bad debt in the Financial Accounts mean

The bad debt must be written off in the day-to-day records of the business and transferred from the debtors account to a separate bad debts account. A trader is not required to wait until his or her financial year-end to write off a debt but may do so in the VAT return for the taxable period in which the debt is transferred to the bad debt account.

4. Obligations in relation to record keeping

A trader’s records of all transactions in relation to bad debts written off must include:

- the name and address of the debtor
- the nature of the goods or services to which the debt relates
- the date, or dates, on which the debt was incurred, and
- the date, or dates, on which the debt was written off
- copies of invoices issued in respect of the underlying transactions.

A trader seeking bad debt relief is required to keep copies of the relevant VAT invoices and evidence that the VAT had been accounted for. All records relating to bad debts written off must be kept for 6 years from the date of the write off.

5. Unpaid debts from connected persons

Bad debt relief is not available where a debt is due from a person connected to the supplier (see Appendix). Section 97(3)(b) of the VATCA 2010 determines the criteria for establishing whether or not a person is connected with another person.

6. Credit notes

VAT law provides that a trader, including one operating on the cash basis, is obliged to issue a VAT credit note for a reduction in consideration or the allowance of a discount after the issue of a VAT invoice. However, the question of issuing a credit note does not arise in the case of a bad debt written off.

7. How to make a claim

A claim for bad debt relief should be made in the VAT return for the period in which the debt is written off. This should be done by increasing the VAT on purchases figure in Box T2 on the VAT return form. Relief for the bad debt is allowed at the rate in operation at the date of the issue of the original VAT invoice or, in the case of a supply to an unregistered person, at the rate in force at the time of supply.

8. How to calculate bad debt relief

Where no payment has been received in respect of a supply, the relief will be in respect of the total amount of VAT accounted for on that supply.

Where a partial payment has been received in respect of a supply the relief will be based on the amount of VAT that is still outstanding in accordance with the following formula:

A x B / 100+ B

where:

A is the amount which is outstanding from the debtor in relation to the taxable supply; and

B is the percentage rate of VAT applicable to the supply.

Example 1

Bad debt relief for a supply, other than a supply under hire purchase:

Sale Price of the Goods: €24,600 (€20,000@23% = €4,600)
(**B**) VAT rate: 23%
VAT amount accounted for on the supply: €4,600
Amount received from debtor: €14,520
(**A**) Amount outstanding from debtor: €10,080

The VAT adjustment for bad debt relief is €1,884, calculated as follows:

(€10,080 x 23) / (100 + 23) = €1,884

9. What if a customer pays everything but the VAT

If a customer pays the VAT-exclusive amount charged for goods or services but refuses to pay the VAT charged, the relief should be calculated by entering the total unpaid amount at 'A' in the formula in the preceding paragraph.

10. Accounting for VAT on the recovery of a bad debt that has been written off

If after claiming bad debt relief, an accountable person receives payment of any part of the debt he or she must make an adjustment to the bad debt relief already claimed. The adjustment should be made by reducing the VAT on purchases figure in Box T2 on the VAT return form for the period in which the payment is received. The amount of the adjustment should be calculated by using the formula in paragraph 8 where 'A' is the total amount received from the debtor.

11. Property transactions

Bad debt relief is not allowable in the case of leases of ten years or more, which were created prior to 1 July 2008.

12. Bad debts determined after a transfer of business

Where, as part of the transfer of a business in accordance with Sections 20(2)(c) or 26 of the VATCA 2010, the transferor of the business transfers debts that, subsequent to the transfer, are determined to be bad debts, there is no entitlement to bad debt relief. However, bad debt relief subject to the normal conditions is available in respect of any debts retained by the transferor that are not included in the transfer.

13. Insured debts

An entitlement to receive compensation payment under a policy of insurance against bad debts does not affect entitlement to bad debt relief. This is not affected by any condition of an insurance policy that may assign the right to recover the debt to the insurer.

14. Third party payments, payments in kind and mutual debts

Bad debt relief cannot be claimed to the extent that any payment is received by any third party in respect of a debt owed by a customer, e.g. payment by a guarantor or payment by a director of a debt owed by a company.

Payments in kind, e.g. goods or services bartered in exchange are also considered to be payments for supplies, valued at their open market prices.

If a supplier owes an amount of money to a purchaser, which can be set off against the amount owing to the supplier, the consideration to be written off as a bad debt must be reduced by the amount owed by the supplier.

15. Factored and invoice-discounted debts

Where a debt is assigned by one person to another without recourse, whether as part of a factoring or invoice-discounting arrangement or otherwise, the originator ceases to have an entitlement to any bad debt relief in relation to that debt. In a factoring or invoice-discounting arrangement, with recourse, the originator may be entitled to bad debt relief where all the other conditions in this guidance are satisfied. Please refer to VAT information on debt factoring and invoice discounting.

16. Reservation of title

The sale of goods under an agreement for the reservation of title until the goods are paid for does not affect entitlement to bad debt relief.

17. Hire purchase

Special rules apply to determine the amount of the relief in the case of hire purchase or credit sale. Please refer to VAT information on hire purchase transactions.

Appendix

(a) any question of whether a person is connected with another person shall be determined in accordance with the following:

I. a person is connected with an individual if that person is the individual's spouse, or is a relative, or the spouse of a relative, of the individual or of the individual's spouse

II. a person is connected with any person with whom he or she is in partnership, and with the spouse or a relative of any individual with whom he or she is in partnership

III. subject to clauses (IV) and (V) of subparagraph (V), a person is connected with another person if he or she has control over that other person, or if the other person has control over the first-mentioned person, or if both persons are controlled by another person or persons

IV. a body of persons is connected with another person if that person, or persons connected with him or her, have control of that body of persons, or the person and persons connected with him or her together have control of it

V. a body of persons is connected with another body of persons -

- if the same person has control of both or a person has control of one and persons connected with that person or that person and persons connected with that person have control of the other
- if a group of 2 or more persons has control of each body of persons and the groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person with whom he or she is connected
- if both bodies of persons act in pursuit of a common purpose
- if any person or any group of persons or groups of persons having a reasonable commonality of identity have or had the means or power, either directly or indirectly, to determine the activities carried on or to be carried on by both bodies of persons, or
- if both bodies of persons are under the control of any person or group of persons or groups of persons having a reasonable commonality of identity,

VI. a person in the capacity as trustee of a settlement is connected with –

- any person who in relation to the settlement is a settlor, or
- any person who is a beneficiary under the settlement.

(b) "**control**", in the case of a body corporate or in the case of a partnership, has the meaning assigned to it by section 4(2) of the VATCA 2010;
"**relative**" means a brother, sister, ancestor or lineal descendant.