

New VAT rules on prepayments

(B1129 – 10.41 minutes)

The issue

There has always been uncertainty in the VAT world about whether a business must still account for output tax on an advance payment for goods or services, where the customer does not get a refund if he does not receive what he has paid for:

- An advance payment for goods or services creates a tax point – so output tax is due at the time the payment is received if it relates to a taxable supply of goods or services.
- If the customer cancels the order, so does not receive any goods or services from the seller, and the order/contract says he is not entitled to a refund, is the business entitled to reduce the output tax it declared when the payment was made i.e. on the basis that the payment then becomes outside the scope of UK VAT?

Business Brief 13(2018)

The above Brief was issued by HMRC on 13 December 2018 and applies from 1 March 2019. In effect, HMRC has cleared the muddy waters on this issue by confirming the following change in its interpretation of the law:

“When a full or part payment is made on account for a taxable supply, a chargeable event occurs and VAT becomes due on the amount paid. If the supply does not take place, the VAT must not be reduced, unless the payment is refunded.”

CJEU case law

The policy change was announced in the 2018 Budget so is not unexpected. And HMRC’s justification for making the change without the need to amend the law is because it is applying the conclusions of two CJEU cases.

1. Air France-KLM (C-250/14) – about air tickets purchased and not used by the buyer
2. Firin ODD (C-107/13) – about input tax on supplies where payment has been made but no taxable transaction has been carried out.

In the Air France-KLM case, the dispute related to VAT of 5.5% that applies to flights within French territory and whether output tax was payable on cancelled bookings. In ruling for the tax authorities, the court confirmed that the relevant issue was “the passenger’s right to benefit from the performance of the transport service regardless of whether the passenger exercises that right.”

Dealing with VAT on advance payments

Here is a suggested three-stage process:

Stage 1 – Does the deposit relate to a taxable supply of goods or services? – an easy example is a tenant who will rent the commercial premises from a landlord who has opted to tax the building in question. Contrast this with a deposit paid to rent a flat, where the rental income is exempt from VAT, so there will obviously be no output tax issue on any deposit paid in advance.

Stage 2 – Is the deposit non-refundable? if the answer at stage 1 is ‘yes’, then the next challenge is to confirm if the deposit paid by the customer is refundable or non-refundable. And this is where care is needed because output tax is only relevant to non-refundable deposits.

Example

Joe trades as an ice-cream manufacturer and is going to rent premises from Sue, who has opted to tax the property so will charge VAT on the rent to Joe. This is not a problem for Joe because he is VAT registered and can claim input tax. The rental agreement states that Joe must pay a deposit of three months rent plus VAT at the beginning of the agreement, which will be refunded to him when he leaves the premises if he leaves them in the same condition as he found them.

In this situation, no output tax is due on the deposit because the intention is for it to be refunded to the customer (Joe). It does not reflect an advance payment for goods or services. The reference to VAT is not output tax, it is way of calculating the final amount of the deposit paid by Joe e.g. 3 months x £2,000 per month + 20% = value of deposit.

Stage 3 – What is the tax point? – with two ‘yes’ answers to the first two stages, the final challenge is to decide the tax point for VAT purposes i.e. when the deposit or advance payment is included on a VAT return. It will almost certainly be the date that the deposit is paid by the customer. However, it is important to check that this has not been preceded by an advance sales invoice being raised, which would create an earlier tax point, unless the business is on the cash accounting scheme.

Practical example of new policy

Imagine a customer books a hotel for March 2019 and pays a non-refundable deposit in January 2019 – say £60. The latter date creates a tax point so 1/6 of the payment is declared as output tax on the VAT return that includes January. If he cancels the booking with the hotel before 1 March 2019, the Brief confirms that the hotel can retain the full £60 deposit and reduce its output tax if this has always been its past policy. But if its policy has always been to still pay the output tax, then HMRC says it cannot change its policy (or claim a windfall on past cancellations and no-shows) because it has applied the law correctly.

If the customer cancels the booking on or after 1 March 2019, or just doesn’t show up, the new interpretation will apply to the sacrificed deposit i.e. no reduction in output tax is allowed.

End to confusion?

A few years ago, a case about advance annual gym memberships received by Esporta Ltd [2014]EWCA Civ 155 was heard in three different courts, the issue being whether output tax could be adjusted if a member cancelled his subscription before the end of the year. The VAT at stake was £1.3m and the court ruled in favour of HMRC, confirming that the company had supplied the right of entry to the gym, even though the member did not fully utilise the facility.

The positive outcome with the new rules is that debates and arguments about the VAT status of forfeited advance payments and deposits should be confined to history. If the supplier keeps the money in the event of a cancellation of goods or services, and it is linked to a VATable supply, then output tax cannot be reduced. Is this a rare and welcome victory for tax simplification?

Contributed by Neil Warren