

## **WHAT TO DO IF YOU ARE NOT PAID**

Contractors need to consider the effects and practicalities if their client/agent fails to pay for services that have been provided and invoiced through your Personal Service Company.

Even more so in this current economic gloom there is the risk of client companies or agencies going out of business without warning, and without paying their debts, including you. We all hope this will never happen, but in the event that you find yourself in this unfortunate position, being forearmed with the correct information about tax, vat and other implications can make the whole experience a little easier to cope with.

### Bad Debt Relief for tax purposes

Under current HMRC CT rules, a deduction for a bad or doubtful debt can be made against the profits in the year in which the debt becomes bad or doubtful. It can only be treated as such if

- a) The customer is subject to a winding up order (receivership, bankruptcy, liquidation etc) and the official receiver has notified you in writing that the outstanding debt will not be paid. (If a part payment is offered, the balance of the outstanding debt will become the bad debt), or
- b) You have made considerable efforts, and can evidence as such, to obtain payment from the customer, such as legal representation, court summons etc.

Once the bad or doubtful debt has been established, a deduction, by way of a write off, can be made in the company accounts. This should be done in the period in which the decision to write off is taken. Any subsequent debt recovery must be included in the accounting period in which it is received. The bad debt is shown as an expense in the profit and loss account, but the original sale value will also be included in sales income, in the year in which the services were supplied. If the bad debt relates to an earlier accounting period, tax will have already been accounted for on that sale. If the subsequent bad debt occurs in a later accounting period, the write off will offset the original sale, albeit in a different year. If both sale and write off occur in the same accounting period, the effect will be a “non event” – a sale that never happened.

It is advisable to notify Garbetts as soon as you suspect a bad debt is likely, and then confirm the position at the end of the accounting year. Before we include the write off in the company accounts we will want confirmation from you that one of the two conditions above has been met. HMRC may wish to enquire into the circumstances of a bad debt write off, especially if it is sizeable, so it is better to be forearmed.

### Bad Debt Relief for VAT purposes

If you sell something to a customer but the customer never pays you, you can reclaim the VAT you charged and paid to HMRC. HMRC calls this 'bad debt relief'.

If however you are using the VAT “cash accounting” scheme (the vast majority of our PSC clients operate on cash accounting), and are applying normal vat (not flat rate) there should be no VAT bad debt relief to consider, as you won't actually be out of pocket in terms of VAT (but see later section for users of the flat rate scheme).

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VAT registered businesses using the invoice basis of VAT accounting will want to secure a refund of any VAT they have paid across to HMRC on invoices which end up being bad debts. Recovering the VAT is straightforward – Firstly, the debt must be more than six months old and less than four years and six months old to qualify for VAT bad debt relief. If you are entitled to claim bad debt relief, you add the amount of VAT you are reclaiming to the amount of VAT you are reclaiming on your purchases (input tax) and put the total figure in Box 4 of your VAT Return. To work out how much bad debt relief you can claim on a VAT inclusive balance, you need to apply the appropriate VAT fraction to the unpaid amount.

Businesses using the Flat Rate Scheme for VAT are subject to special rules under the bad debt relief scheme. Under FRS, if you use the cash accounting VAT method, you may be eligible for bad debt relief if:

- you have not been paid by your customer and it has been at least six months since you made the supplies
- you have not accounted for and paid tax on the supply
- you have written off the debt in your accounts.

If you meet all these conditions, your claim will be for the difference between the VAT you charged your customer and the amount you would have declared to HMRC had you been paid. This is because your flat rate VAT takes account of input tax that you would otherwise, under normal VAT, have been entitled to recover. If the unpaid invoice was originally £1,000 + VAT £200, the total bad debt would be £1,200. If your FRS % rate was 14%, the FRS VAT would be £1,200 x 14% = £168, so the claim would be £200 less £168 = £32. This is the amount you can claim back from HMRC, and should be included in box 4 of the next VAT return. If you are using the Garbetts PSC accounts template you might find this a little tricky to show on the sheet, so ask us to do the manual adjustment for you once you have worked out the amount of relief you are entitled to claim.

### Legal procedures/steps towards recovery

Depending on the size of the debt, and the situation your customer is in, you may want to engage the services of a solicitor who specialises in debt recovery. You could take this on yourself - a County Court Summons is relatively easy to prepare and serve, but there are pitfalls, and even if your claim is successful in the County Court, recovery of the debt under a judgement is still left for you to deal with, so a court judgement does not guarantee payment.

If you intend to pursue the outstanding debt through legal proceedings, it is probably going to be worthwhile engaging a professional to do this for you. Keep a record of correspondence relating to the unpaid debt – statements, reminders, solicitor's letters etc. These will need to be produced if HMRC wishes to review the circumstances of your bad debt claim in the event that your efforts to recover payment are unsuccessful.

Before you embark on any costly legal proceedings, try to ascertain the current trading position of the defaulting customer, are they subject to insolvency/bankruptcy proceedings for example? If so, it will probably be pointless pursuing any unpaid debts, as the company's assets will be frozen. In due

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course, you should be contacted by the insolvency practitioner assigned to handle the case, once they have determined who the creditors are. In most cases there will be insufficient funds to pay out to anyone except the preferred creditors (Banks, HMRC, unpaid staff wages), so the chances are you will be a long way down in the pecking order. However, written confirmation from the insolvency firm is sufficient for bad debt write off purposes.

What if the unrecovered debt puts your own business in financial trouble?

This can be a real headache for an owner managed business. Even though you have uncollected debts, there are still the usual day to day bills to pay, including taxes. During the period when you have been building up a sizeable total of unpaid sales invoices, you may have been forced to use company tax savings to fund your own salary and dividend withdrawals, with the intention of plugging the hole once the payments came in. The result: insufficient funds to pay the company's tax and vat debts.

The first rule is don't bury your head in the sand, and don't put action off until it becomes an even bigger problem. If you cannot see an appropriate way out of the company's financial situation, and wish to get your company back to a solvent position, it may be useful to speak to an Insolvency Practitioner. Don't be alarmed by the title, they are not simply in the business of winding companies up, they also have a role in assisting businesses to find a way back from the brink. Insolvency Practitioners can advise and assist you in discussions with HMRC over unpaid taxes, and offer ideas to help you get your company back on its feet.

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