



VAT on Deposits & Early Termination Payments – A Reminder

What has changed?

Starting from April 1, 2022, a significant change affects properties chosen for tax purposes. The HMRC now considers most compensatory payments and early termination fees in land contracts as part of VAT taxable supplies. This means VAT will be charged on these payments, based on the rate used for the transaction involved

This policy change was confirmed in February 2022 – see HMRC Brief 2 (2022) “VAT early termination fees and compensation payments”^[1].

The change follows previous guidance briefs confirming that HMRC would, going forward, consider most early termination fees, compensation payments and retained payments & deposits as falling within the scope of VAT – see respectively HMRC Brief 12 (2020)^[2] and Brief 13 (2018)^[3].

HMRC’s previous position

Previously, the view taken by HMRC was that such early termination fees, compensatory payments and deposits (etc.) were, broadly speaking, payments to ‘compensate’ the recipient (as opposed to payments for ‘supplies’ of goods & services) and were accordingly outside the scope of VAT.

However, this is no longer the position adopted by HMRC.

How does this affect commercial property transactions?

Where a property is opted to tax, one must consider the VAT position of payments made or to be made under our related land contracts and leases. For instance:

Deposits paid on exchange of contracts:

Where a deposit is paid on exchange, this may be regarded by HMRC as a “payment on account for a taxable supply” – i.e. the prospective sale/transfer of the property being the taxable supply *on account* of which the deposit is paid.

If the deposit is paid to the seller’s solicitor as *stakeholder* but is later released to/forfeited by the seller, HMRC takes view that a charge to VAT is triggered – presumably on release/forfeiture, and notwithstanding a question as to whether a ‘supply’ has in fact been made. The seller will be required to account to HMRC for VAT on the released/forfeited deposit^[4]. Subject to the contract terms, the seller may be entitled to demand that the buyer pay the relevant VAT, in addition to the principal deposit released/forfeited.

If the deposit is paid to a solicitor as the seller’s *agent*, the liability for VAT is incurred at the point of payment.

Option sums:

Where an option sum is paid as consideration for the option, then, as with a deposit paid to the seller’s solicitor as agent, a charge to VAT is triggered at the point of payment. The recipient landowner must account to HMRC for VAT at the appropriate rate.

If the option agreement requires that VAT be paid in addition to principal sums passing under the agreement, then the buyer/developer will be liable to the landowner for VAT in addition to the principal option sum.

Lease break options and break fees/penalties:

In line with the above, the revised position from HMRC is that a fee or penalty paid for the early termination of a lease will now incur a charge to VAT. This is the case regardless of whether or not the break option and the relevant fee/penalty are included in the lease on grant.

Consideration remains equally appropriate for the VAT treatment of payments made pursuant to other common contractual arrangements, for instance, exclusivity agreements and promotion agreements.

What contractual steps should be taken?

When acting for sellers who have opted to tax, thought should be given to whether a VAT top-up element is required on the exchange of contracts, in addition to the principal stakeholder deposit sum. If the deposit is later forfeited, the stakeholder is then able to release to the seller the principal deposit together with the VAT element due to HMRC (thereby mitigating the risk of the buyer’s failure to pay the VAT element). The buyer may also wish to require that a corresponding VAT invoice is prepared and held pursuant to a solicitor’s undertaking for simultaneous handover should the deposit be forfeited.

Leases should be reviewed to confirm whether, where a break fee or penalty is payable on exercising a break

option, the corresponding VAT is also reserved for payment and, crucially, to consider *when* the VAT must be paid. Break options can operate both ways, to be exercisable by the landlord or the tenant. Though perhaps less common in practice, a break fee payable by the landlord may be subject to the same VAT considerations as a fee payable by the tenant.

In both instances, ideally, the issue should be considered when agreeing on the relevant heads of terms.

[\[1\]](#)

[\[2\]](#)

[\[3\]](#)

[\[4\]](#) Land & Property Liaison Group (VAT) meeting – 17th May 2019

For further advice on commercial property transactions, please contact our [Real Estate](#) team.