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Client briefing

In *HFFX*, the Supreme Court rejects HMRC's argument based on the allocation of partnership profits between the corporate and individual members of an LLP but determines that the deferred LLP remuneration received by the individual members was taxable as miscellaneous income. HMRC's surprise consultation on modernising the distributions framework could significantly reshape how companies structure share buybacks, demergers and capital returns involving individual or trustee shareholders. In *Barclays Services Corporation*, the Upper Tribunal upholds the FTT's decision that a US company providing support services to the UK business through a UK branch could not be part of a VAT group because it did not have sufficient resources to constitute a fixed establishment in the UK at the time of the application to join the VAT group. HMRC's guidance on the VAT exemption for 'the management of credit by the person granting it' appears to be more generous than EU law.

HFFX: the limits of 'profit-sharing arrangements' and the breadth of miscellaneous income

In *HMRC v HFFX LLP* [2026] UKSC 17, the Supreme Court had to determine the tax treatment of profits made by a limited liability partnership, allocated to a corporate member of that partnership (GSAM) and then reallocated to individual members as 'Special Capital' under an incentivisation and deferral arrangement referred to as the 'Capital Allocation Plan'. The allocation process, in brief, was that HFFX's Managing Member would write to GSAM with recommendations (which could be amended in certain circumstances) as to how the Special Capital should be reallocated to the individual members (the 'indicative allocations'). GSAM had discretion to vary the actual allocation of Special Capital. If the arrangements worked as intended, GSAM would be taxed at corporation tax rates on the amounts allocated to it and the subsequent reallocation of Special Capital would not be taxable for the individual members.

HMRC sought to tax the individual members in three alternative ways. First, HMRC argued that on a purposive construction of ITTOIA 2005, s 850 (partnership profit allocation), the profit shares allocated to GSAM are to be regarded as the individual members' profit shares and taxable on their receipt. This argument had failed before the lower courts and the Supreme Court also held that s 850 did not apply here. Second, HMRC argued successfully that ITTOIA 2005, s 687 (miscellaneous income) applied in relation to the Special Capital sums received by the individual members. Third, HMRC argued that ITA 2007, Chapter 4 of Part 13 (sales of occupation income) applied. In light of the conclusion that s 687 applied, however, the Supreme Court decided it was not necessary or appropriate (given the absence of assistance of Court of Appeal decisions on this point) to determine this third argument. We will have to wait for a case in which the sale of occupation income point is determinative of whether income tax should be paid to get the view of the Court of Appeal or Supreme Court on this issue.

Section 850 ITTOIA: profit-sharing arrangements

The Supreme Court had to determine whether the profit shares allocated to GSAM should be properly regarded as the individual members' profit shares when subsequently reallocated to them. The Supreme Court concluded the purpose of s 850 is to impose taxation on the 'look-through' basis in accordance with the contractual rights of the partners applicable in the relevant period. Section 850 provides certainty as to who has responsibility for payment of tax in relation to partnership profits based on the partnership's 'profit-sharing arrangements' during that period. The Supreme Court concluded this means the arrangements have to include a contractual right to receive the profit, to be treated as his or her income under s 850 in that period.

HMRC's argument that the Court should apply s 850 in a way which reflected what HMRC argued was the 'commercial reality' of the case (being that a member would receive the indicative allocation unless it was decided not to pay it) was described as 'untethered from the language used by Parliament to impose the tax charge'. Section 850 is to be applied in accordance with 'the ordinary and natural meaning of the words used in it and the determinate legal concepts to which those words refer'. On this basis, the profit shares allocated to GSAM were not to be regarded as individual members' profit shares.

Section 687 ITTOIA: miscellaneous income

HMRC were successful, however, on their alternative argument that s 687 applied in relation to the deferred remuneration sums received by the individual members. Section 687 imposes income tax on income from any source not otherwise charged to income tax. By the time of the Supreme Court hearing, HFFX and the individual members had conceded that the deferred remuneration payments were 'income' but argued that there was no 'source' within the meaning of s 687.

The Supreme Court took the natural meaning of the word 'source' and concluded that an activity may qualify as a source. The Supreme Court agreed with the reasoning of the Court of Appeal that, on the facts, the decision-making process of the Managing Member and GSAM in implementing the Capital Allocation Plan (subject to the implied duty for GSAM to exercise its discretion rationally and for the purposes for which it was conferred in accordance with *Braganza v BP Shipping Ltd* [2015] UKSC 17) was the source of the deferred income received by the individual members. The Supreme Court also rejected the argument that there could be a source only if the recipient had a legal right to the receipt and concluded: 'A source of income may exist so long as there is some relevant and sufficient factor connecting the income and the recipient, as there is in this case.'

Distributions framework consultation

HMRC's consultation on modernising the taxation of distributions and repayments of capital from companies, published on 23 June as part of Tax Update 2026, was quite a surprise and could fundamentally change how share buybacks, demergers and returns of capital are structured.

The consultation proposes wide-ranging reform of the tax rules for shareholders within the charge to income tax. Although not intended to affect corporate shareholders directly, the proposals will need to be taken into account by companies structuring transactions with those shareholders.

HMRC's concern is that the distributions code has remained largely unchanged since the introduction of corporation tax in 1965. The consultation says the rules generally operate well, but that the commercial and legal environment has moved on. A common theme is the desire to ensure that 'economically similar' payments to shareholders are taxed consistently – for which read, taxed as income.

The proposals could have significant consequences in a number of areas:

- **Reductions of capital**: If enacted, the proposals will prevent the insertion of a holding company (NewCo) above a company making a distribution (OldCo) to increase 'good capital' and reduce the tax on a reduction of capital. Instead of allowing the capital amount to be uplifted by inserting NewCo, share buybacks and other returns of capital would reflect a 'frozen' amount of capital, based on the amount subscribed for the original investment and matching the CGT deferment of the original base cost. This is intended to produce the same outcome as if the OldCo shares had been sold back without inserting NewCo. However, HMRC do not intend the proposals to affect shareholders restructuring for legitimate business purposes.

- **Demergers**: The removal of the capital reduction route would increase reliance on statutory demergers. HMRC therefore want to clarify and relax some statutory demerger conditions, but the quid pro quo would be removal of the right to an automatic tribunal appeal where statutory demerger clearance is refused.

- **Distributions from non-UK companies**: Different rules currently apply depending on whether a distribution is from a UK or non-UK resident company. For UK companies, there is a broad statutory definition of distributions, underpinned by detailed rules to ensure that extractions of value from continuing companies are charged to income tax. For non-UK companies, however, the income tax charge is much narrower, applying only to 'dividends which are not of a capital nature'. Determining whether dividends are 'of a capital nature' has created uncertainty for taxpayers and disputes with HMRC.

  The Government is exploring aligning the treatment of distributions from non-UK resident companies with that of UK resident companies. Even then, the rules would still need to distinguish between a 'dividend' and 'any other distribution', currently determined by the characteristics of the non-UK entity by reference to UK law, which can itself create uncertainty and disputes. The Government is therefore also exploring a deeming provision to clarify when a payment is a dividend or other distribution if certain factors are present.

- **Transactions with close companies**: Various proposals would bring the distributions code and loans to participators rules into alignment to ensure extractions of value in favour of shareholders are charged clearly under one set of rules.

- **Purchase of own shares**: The relief for purchases from departing shareholders of close companies, which depends on the subjective 'trade benefit test', could be replaced with more mechanical requirements.

- **Transactions in securities (TiS)**: HMRC say that the TiS rules reflect an 'outdated approach' to anti-avoidance and can be 'difficult to apply'. They are considering a clearer, more principles-based regime, operating as a backstop where more specific legislation does not apply.

The consultation runs until 14 September 2026. Given the complexity of the current rules and the wide-ranging nature of the proposed changes, it is to be hoped that the reforms will not be rushed and that proper consideration is given to making the legislation workable.

Barclays VAT grouping case: fixed establishment and protection of the revenue

The question before the Upper Tribunal (UT) in *Barclays Services Corporation and another v HMRC* [2026] UKUT 211 (TCC) was whether the First-tier Tribunal (FTT) had erred in law in making its decision that HMRC were entitled to reject the application by BESL, acting as representative member of the Barclays VAT group, for BSC, a company incorporated in the US with a branch in the UK, to join the VAT group. BSC makes supplies of services to the Barclays Corporate Group, including to BESL and other members of the VAT group. The UK branch was established to manage the delivery of BSC's services to non-US recipients and the delivery of services to BSC from non-US service providers.

The UK VAT grouping rules have implemented Article 11 of the Principal VAT Directive on a 'whole establishment' approach, rather than, as is common in EU countries, an 'establishment only' approach. This means that, where a foreign company is eligible to join a UK VAT group registration and does so, all of that company's activities are then subsumed within the UK VAT group registration, rather than solely the activities of that company's UK branch. In order for a foreign company to join a UK VAT group it must have a 'fixed establishment' in the UK (VATA 1994 s 43A). Even if it has a fixed establishment in the UK, HMRC are entitled to refuse an application for a company to join a VAT group in certain circumstances where it is necessary for the protection of the revenue (VATA 1994, s 43B(5)(c)).

Territorial issue

The effect of the *Danske Bank* case (Case C-812/19). is to impose a territorial limitation on Article 11. There is no such territorial limitation in VATA 1994, s 43A, however, and indeed the UK has made a feature of having a relatively competitive VAT grouping regime partly because of its whole establishment approach. Nevertheless, HMRC asked for a construction of s 43A to conform with Article 11 so as to impose a territorial limitation so that only the activities of the UK branch could be grouped and not the whole entity. The FTT had held that such a conforming construction was not possible because it would result in a fundamentally different regime. The UT did not consider this a valid reason for not applying a conforming construction but instead held that a conforming construction was not possible here as imposing a territorial restriction would go against the 'grain or underlying thrust' of the legislation.

Fixed establishment issue

The UT, like the FTT before it, left the precise meaning of the terms 'established' and 'fixed establishment' to be determined in a subsequent case, proceeding, as did the FTT, on the basis that the taxpayers' test of what establishment means in s 43A is correct, rather than HMRC's narrower test. If the UT had not concluded that the FTT had not erred in law in reaching its decision on the taxpayers' test it would then have gone on to consider whether that was the correct test in law.

According to the taxpayers' test, for the UK branch to be a fixed establishment on 1 December 2017 (the date of the application, which the parties agreed was the relevant date that the eligibility requirements for grouping fell to be assessed) it required, on that date, sufficient human and technical resources in the UK to make a meaningful commercial contribution to BSC. This required the UK branch to have comparable control to an owner over the relevant human and technical resources.

The UT considered that the FTT had taken a pragmatic approach in applying the test put forward by the taxpayers on the basis that if they failed to prove a fixed establishment applying that test, they would also have failed the more stringent test proposed by HMRC. The taxpayers appealed to the UT on a number of grounds but the UT concluded the FTT had not erred in law in reaching its conclusion on the fixed establishment issue that on 1 December 2017 the UK branch did not have comparable control over the human and technical resources.

Protection of the revenue issue

It was not necessary to decide this issue in light of the conclusion there was no fixed establishment but, had it been necessary, the UT said it would have reached a contrary conclusion to the FTT and found in favour of HMRC. In the UT's (obiter) view, HMRC could reasonably have decided to refuse the grouping application under the protection of the revenue provision. The UT's reasons for this were that the anticipated VAT savings were considerable compared to the resources of the branch, and the timing of the VAT grouping application was found to be driven by the opportunity to generate an additional significant tax benefit.

VAT on securitisations: restrictive view of credit management exemption

The recent General Court case of *Veronsaajien oikeudenvalvontayksikkö v A Oy* (Case T-184/25) is causing some consternation for European securitisations. The case effectively says that if someone originates a loan, assigns it to someone else (e.g. a securitisation SPV), but continues doing everything in relation to the loan for a fee, that fee is not VAT exempt as the management of credit by the person granting it. If servicing fees charged by the originator to an SPV have to be charged subject to VAT, this will be a hard cost for the typical securitisation SPV which makes only exempt supplies and cannot recover such VAT.

In this case the originator/servicer did not maintain the original contract and the General Court emphasised in its reasoning the significance of the disappearance of the original lender-borrower relationship. It is unclear from the case, however, whether the same principles would apply if only the receivables are beneficially assigned rather than there being a full transfer of the contractual relationship.

Although this case is obviously not binding on the UK post-Brexit, HMRC's published position in their VAT Finance Manual VATFIN3240 potentially conflicts with the decision in two respects. First, where receivables are beneficially (but not legally) assigned by the originator, HMRC guidance is clear that the exemption will apply to the supply of management of credit services by the originator. Second, HMRC's guidance envisages that the exemption is wider than EU law suggests and that it can apply beyond the original borrower-lender relationship. According to the guidance: 'A third party can be appointed as the servicer. In circumstances where the legal title to the debts has been transferred from the originator to that third party along with the risk/burden of the loans/receivables, e.g. by novation, the liability of the servicer fee will also be exempt as management of credit by the person granting the credit.'

In this novation scenario, the third party effectively steps into the shoes of the originator and takes the place of the original lender and so it makes sense that any services it provides to the SPV should be exempt as the management of credit by the person granting it – but whether this would also be the case under EU law remains to be seen.

What to look out for:

- The OECD consultation on revisions to update and modernise OECD Transfer Pricing Guidance Chapter VII (intra-group services) closes 22 July. This will be followed by a meeting to discuss the outcomes of the public consultation in November 2026.

- The technical consultation on the International Controlled Transactions Schedule (ICTS) closes 31 July. The ICTS reporting requirement is expected to apply for accounting periods beginning on or after 1 January 2027. The consultation includes a revised draft template aimed at reducing business burdens, including targeted changes for financial services.

- The consultation on reforms to the taxation of UK resident individual members of reverse hybrid entities (such as LLCs) closes 31 July.

- There is plenty in the consultation on modernising the taxation of distributions and repayments of capital from companies to keep everyone busy over the summer and beyond! HMRC have emphasised that the 12-week consultation period is just the start of the process and that getting the fundamental reforms right (reflecting feedback from stakeholders) is more important than rushing them through.

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