Proskauer

Taxing Carried Interest in the UK: The New Regime Announced in the Labour Government's Autumn Budget 2024

Tax Talks on **November 12, 2024**

On Wednesday 30 October 2024, the UK government announced changes to the UK taxation of carried interest as part of the 2024 Autumn Budget. Changes were expected following statements made by the Labour Party in the run up to their July 2024 general election win, including in their manifesto, and HM Treasury's (HMT) subsequent call for evidence on the tax treatment of carried interest published on 29 July 2024.

The framework for the changes has now been announced and in this article we summarise the proposed new regime and provide initial thoughts on some of the implications for private investment fund managers with activities in the UK. No draft legislation has been published for the new regime, and the details of the new regime are subject to further consultation with HMT and HM Revenue & Customs (HMRC) (see below for further details), so not all the details are known at this stage and this article is based on what we know so far.

Outline of the changes and timeline

There will be no change to the UK taxation of carried interest proceeds received (or to use the legislative term "arising") between now and 5 April 2025.

The 2025/26 tax year (from 6 April 2025 to 5 April 2026) will be a transition year, with a rate increase from 28% to 32% for carried interest capital gains, but otherwise no change to the current UK rules for taxation of carried interest.

The more significant changes to the UK taxation of carried interest are set to be effective from 6 April 2026 and generally to affect all carried interest proceeds received on or after 6 April 2026. The remainder of this article describes this proposed new regime for UK carried interest taxation from 6 April 2026.

In basic terms, what changes to carried interest taxation are proposed from April 2026?

Carried interest proceeds will be taxed as trading income of the individual receiving the carried interest. Income tax and self-employed (Class 4) national insurance will apply.

(The carried interest proceeds will also be taxed as trading income of the individual where the individual is deemed to receive the carried interest, which could include proceeds received by a partnership of which they are a partner or received by their personal holding structure. In this article we therefore refer to the individual receiving or being deemed to receive carried interest.)

The default rule will be that carried interest will be subject to tax at the recipient's marginal rate of income tax and Class 4 national insurance (currently 45% and 2% respectively for additional rate taxpayers). In other words, the default tax rate for carried interest proceeds from April 2026 will be 47% for additional rate taxpayers.

However, a special rate will apply to carried interest which is "qualifying carried interest". This is stated to be 72.5% of the prevailing rates. Based on current rates, this special rate will be 34.075% for additional rate taxpayers, i.e. 47% multiplied by 72.5%. In the remainder of this article, references to rates will be to the rates applicable to additional rate taxpayers.

In order to be "qualifying carried interest" to which this 72.5% multiplier applies:

- the carried interest must fall within the existing definition of carried interest within the "disguised investment management fee" (DIMF) rules (which at a very high level means that it must fall within the existing "safe harbour" definition or be a profit related return of which there is a significant risk of non-payment); and
- the carried interest must not be treated as "income based carried interest" (IBCI) – IBCI is an existing feature of the UK carried interest legislation and broadly means carried interest from a fund which has an average holding period (weighted by value invested) of less than 40 months.

In addition, the consultation process will consider whether further conditions will have to be satisfied for carried interest to be "qualifying carried interest". The conditions being explored are:

- a minimum GP commitment requirement, applied on a team basis rather than an individual basis, may need to be satisfied (depending on the outcome of the further consultation); and
- there may also be a requirement for a "lock up" (again depending on the outcome of the further consultation), i.e. contractual arrangements which prevent the carried interest holder from accessing their carried interest until an (as yet unspecified) minimum holding period has been satisfied.

In short, to access the new 34.075% rate for carried interest, the carried interest must be from a fund which has an average holding period of more than 40 months and may also need to satisfy a minimum GP commitment and/or "lock up" test.

Does this mean that the 40 month average holding period rules which previously applied only to LLP members will apply to all carried interest holders from April 2026?

Yes. Under the current IBCI rules (which treat carried interest receipts from funds which have an average holding period of less than 40 months as trading income, with tapering for funds with an average holding period between 36-40 months) individuals who are granted carried interest as employees are generally exempt from the application of the rules. This has meant it has been thought of as a regime which only applies to LLP members (or other non-employee carry recipients). However, this exclusion for those who are granted carried interest as employees is to be abolished from April 2026.

How certain is it that the changes proposed from April 2026 will be implemented?

The proposals are subject to consultation between now and April 2026, with the first consultation closing on 31 January 2025. It is to be welcomed that there is a relatively long period of consultation, rather than a rush to implement the changes.

However, given the background to these changes and the tone of the consultation document, in our view this consultation should be thought of as a consultation on the technical detail of the new rules and the finer points of how the rules will be applied, rather than a consultation on whether or not the proposed new regime will be imposed or a consultation on the broader policy aspects of the new regime.

It is worth noting three important exceptions to this.

First, the minimum GP commitment requirement is not yet a confirmed feature of the new regime. Rather the government say they are exploring it, which leaves open the possibility that this requirement may not be included in the final legislation.

Second, the same is true of the requirement for a “lock up”.

Third, there is a specific statement in the government’s paper recognising that the IBCI rules can be difficult to apply to private credit funds and committing to work with expert stakeholders to consider amendments to address this, with the proviso that qualifying carried interest treatment should still be limited to funds engaged in long-term investment activity. In light of this, it is expected that we may see changes to how the IBCI rules apply to credit funds and as such the commentary on the application of the IBCI rules below does not cover the position of credit funds.

More generally, we would like to hope that in the consultation on the technical detail, there will be scope for finessing the IBCI rules as currently implemented, insofar as they can have undue or unintended effects on certain other types of funds (some of which are mentioned below). But it remains to be seen how open the government will be to this.

What are the challenges with the applying the IBCI average holding period rules?

A detailed examination of the IBCI rules is beyond the scope of this article. However, what sounds like a simple test – whether a fund has an average holding period, weighted by value invested, of less than 40 months – raises a number of technical questions and can be complex to apply in practice. Some fund managers will have been grappling with these complexities since 2016 because they have LLP members who have been subject to these rules; others will be faced with these complexities for the first time from April 2026.

The complexities take various forms and differ from fund strategy to fund strategy.

For buyout, growth and venture strategies, many of these complexities amount to technical niggles, particularly around the rules which allow follow-ons to be backdated and staged exits to be postdated in certain cases. There can also be practical difficulties with the way that the conditional exemption rules only allow a single re-test (the conditional exemption rules allow a taxpayer to treat carried interest as not being IBCI where it is paid out early from a fund at a time when the fund's average is still below 40 months but where it is expected that the average will be greater than 40 months later in the life of the fund). It is likely that for most equity funds these points will not prove insurmountable, but some small revisions to the drafting of the rules could take away some of the uncertainties and seemingly unintended consequences. Failing that, guidance from HMRC on their view of the application of the rules, which has not yet been published, would be helpful.

For funds of funds and secondaries funds, the technical challenges can be more pronounced. There are provisions in the legislation designed to alleviate some of the complexities for these funds, but they do not necessarily sit well with how these funds operate in practice and the specific facts of how a particular secondaries fund or a fund of fund manages its investments can result in different outcomes. As mentioned, a detailed exploration of these points is outside the scope of this article, but those managing secondaries funds and funds of funds who have not had to deal with these rules until now could usefully start assessing how these rules will affect their UK teams.

How do these changes affect non-UK residents who spend, or have during the life of the relevant fund spent, some of their time working in the UK?

One of the areas where there is currently most complexity and uncertainty is how the proposed post-April 2026 regime will affect non-UK resident individuals. In part, this is due to the wide range of different circumstances in which non-residents may find themselves and in part due to uncertainty about how the tests for territoriality will be interpreted and how they will interact with any relevant double tax treaties.

Carried interest proceeds, whether qualifying carried interest or not qualifying carried interest, will be deemed for UK tax purposes to be trading income, as the profits of a deemed trade carried on by the individual. Based on the government's proposal, the starting point is that this deemed trading income should be taxable in the UK "to the extent that the investment management services by virtue of which the carried interest arose were performed in the UK". The government state that this is subject to the terms of any applicable double tax treaty.

In light of this statement, the current working assumption is that – despite there being some important technical questions about how treaties work in the context of deemed trading income – the government in principle accept that the UK does not have taxing rights over this deemed trading income if there is a suitable double tax treaty with a typical business profits article with the jurisdiction where the individual is tax resident and the conditions for that treaty and that article applying are met. In short, this could mean that an individual resident in a jurisdiction with which the UK has a full double tax treaty may be outside the scope of the UK carried interest tax charge provided they, as an individual, do not have a UK permanent establishment.

However, even if the above is correct, it is unlikely to help all non-resident individuals, because some may still be within the scope of the charge in certain circumstances, for example if (i) they are not resident in a jurisdiction with a suitable double tax treaty, (ii) they are resident in such a treaty jurisdiction but they have a UK permanent establishment (which could include an interest in a UK LLP or take the form of a fixed place of business, for example), or (iii) they are resident in such a treaty jurisdiction and they do not have a UK permanent establishment, but they previously had such a UK permanent establishment at some point during the life of the fund from which the caried interest derives. These are issues which have existed for a small number of non-UK resident individuals who have received or been deemed to receive IBCI or DIMF incomesince those rules were introduced in 2015/2016, but from April 2026 they will affect a significantly larger number of people.

Those seeking to understand how these rules can affect them may be non-UK tax resident individuals who regularly spend some time working in the UK and who hold (or whose personal holding structures hold) carried interest. They may be non-UK tax resident individuals who are frequently present in the UK for business, but not regularly working in the UK. They may be individuals who have been UK tax resident, have left the UK and ceased to be UK tax resident and no longer spend time working in the UK, but who had spent time working in the UK earlier in the life of the fund from which the caried interest derives.

Each such individual situation will need to be analysed on its specific facts because the facts that can go to whether they have a UK permanent establishment may be different, the prior links with the UK may be different, and the position as regards treaty relief may be different. All these points can affect the outcome. What is more, as the consultation on these new rules progresses, it may become clearer how the UK government is thinking about the technical questions on the application of double tax treaties in the context of deemed trading income.

What should a private investment fund manager with individuals who work in the UK do in preparation for April 2026?

Fund management houses who have not previously had to apply the 40 month average holding period rules to their funds in relation to UK carried interest should start analysing their funds from that perspective, paying particular attention to how the special rules for certain types of funds may help. Assessing how the conditional exemption rules might apply to them based on the expected cadence of carried interest payments may also be helpful.

Fund management houses with non-UK resident individuals who are carried interest holders who spend some of their working time in the UK should consider seeking advice on the specific facts of those individuals' situations in order to understand the potential effect of the April 2026 changes on them. These individuals are likely to want to seek their own personal tax advice on their position too.

Fund management houses with carried interest holders who are UK resident individuals who are also US taxpayers may wish to consider, or encourage these carried interest holders together with their personal advisers to consider, the interaction of these proposed new UK rules with US tax rules, particularly in the context of double tax relief.

UK tax resident carried interest holders who have previously made use of the UK's regime for non-domiciliaries are also likely to be affected by the significant reforms to that regime to be introduced from April 2025 (in essence, its abolishment and replacement with a new tax regime for foreign income and gains based on residence, the details of which are beyond the scope of this article). Such individuals will need to keep a close eye with their personal advisers on the interaction between those reforms and the 2026 changes to carried interest taxation.

All private investment fund management houses should keep apprised of developments as these proposals move through the consultation stage, as this is not the end of the story.

View Original

Related Professionals

- **Catherine Sear**
  Partner
- **Frazer Money**
  Partner