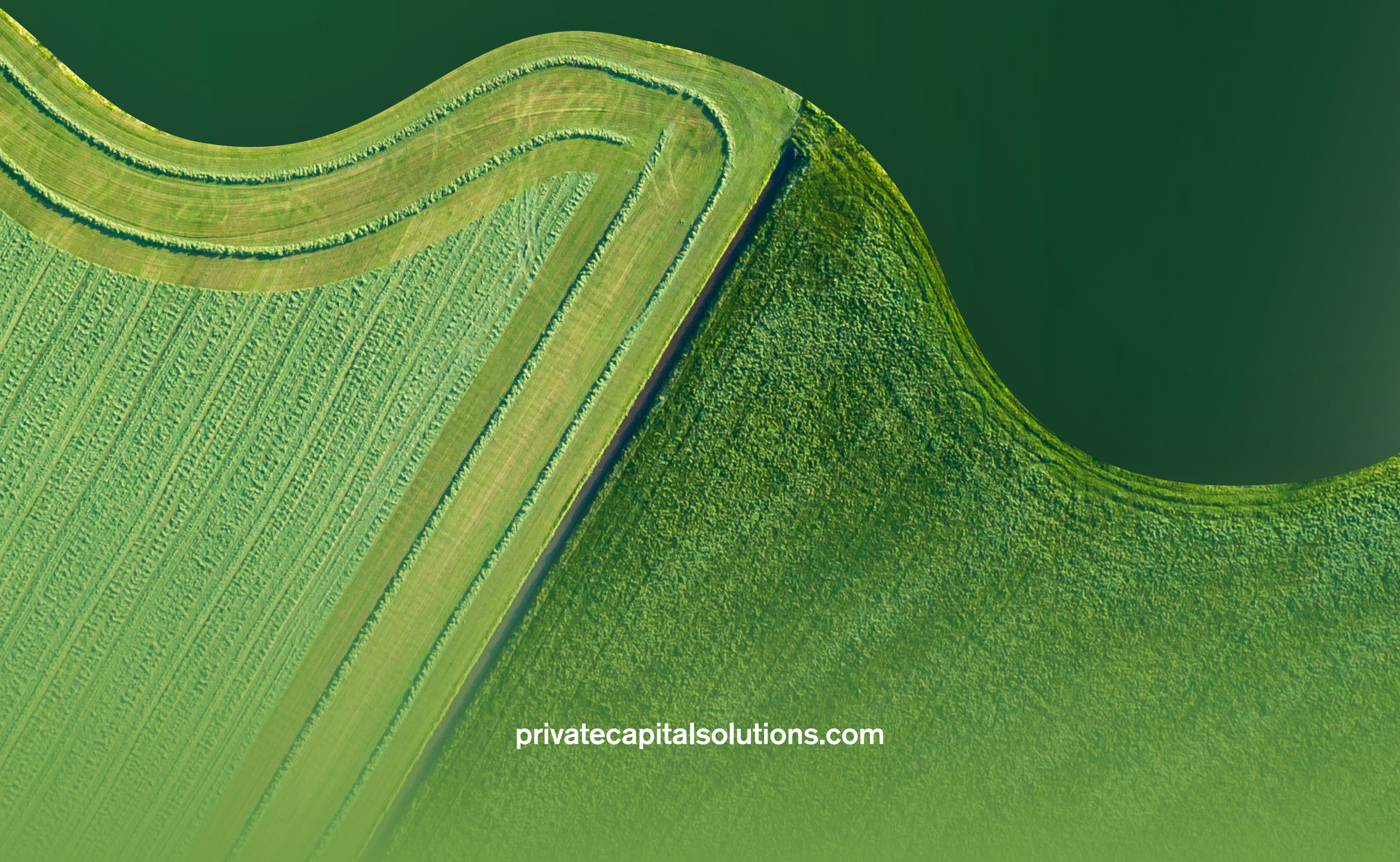
MACFARLANES

Carried interest tax reform

Latest developments and next steps

June 2025



privatecapitalsolutions.com

Carried interest tax reform

Latest developments and next steps

Introduction

On 5 June 2025 the Government published its latest policy paper on reforming carried interest taxation and in it:

- confirmed, in response to the consultation that concluded in January 2025, that the reformed carried interest regime will not be subject to new qualifying conditions (beyond the extension of the Income-Based Carried Interest (IBCI) rules to all carried interest);
- provided an update on how the Government's thinking on the territorial aspects of the reformed regime has developed since the Autumn Budget 2024, including announcing several new statutory rules that will limit the circumstances in which the UK taxes non-residents in respect of carried interest; and
- provided some detail on where changes will be made to the average holding period aspects of the IBCI rules to assist certain strategies, particularly credit funds and secondary funds.

In this paper we examine these new developments.

Qualifying conditions

At the Autumn Budget 2024 the Government announced that the carried interest tax regime would be reformed so that, from 6 April 2026, carried interest receipts will be exclusively taxed within the income tax and National Insurance Contributions (NICs) regime as receipts of a deemed trade carried on by the relevant executive. Importantly however, qualifying carried interest receipts will be subject to a multiplier of 72.5%, so that additional rate taxpayers will pay an overall 34.1% effective rate of income tax and NICs. Qualifying carry will be amounts that satisfy the current definition of carried interest and which do not fall foul of the IBCI rules that, from 6 April 2026, will need to be navigated in respect of all carried interest (with the proposed removal of the Employment Related Security exception).

The Autumn Budget announcement explained that the Government was considering whether new conditions (in addition to IBCI) should be introduced to restrict the circumstances in which carried interest would benefit from the multiplier. Between the Budget and January 2025, the Government undertook a consultation which examined the case for introducing either a minimum co-investment condition or a requirement that an individual has held their carried interest for a minimum period.

Stakeholder responses to that consultation generally argued that new conditions were not needed to ensure the carried interest regime is appropriately targeted.

In the latest announcement, the Government has confirmed that it believes the carried interest regime will be appropriately targeted based on the current conditions, and that new conditions will not therefore be introduced.

Territoriality

As explained above, from 6 April 2026, carried interest receipts will be taxed as receipts of a deemed trade. One of the consequences of that change is that, without more, carried interest proceeds arising to non-UK tax resident individuals would have been subject to UK carry tax to the extent those proceeds were attributable to duties carried on in the UK. That position is, of course, subject to the terms of any applicable double tax treaty (DTT) – although, as explained below, the way that DTTs should be applied in this context is not clear-cut.

Following the announcement at the Autumn Budget 2024 there were some important open questions about how these territorial aspects would operate in practice and their effects both for non-resident individuals who perform workdays in the UK and those who have ceased to be UK resident.

Enacting the Budget proposals without further provision would have given rise to a material additional compliance burden for both taxpayers and HMRC and increased the risk of double taxation in certain situations (with a consequential chilling effect on migration and work travel to the UK).

In its latest announcement the Government has set out how it intends the territorial aspects of the new regime to work, with the aim of ensuring that the UK remains attractive to internationally mobile investment management executives, while securing that carried interest proceeds with a strong UK nexus remain within the ambit of UK tax.

Proposals in summary

The Government intends to introduce the following statutory limits on the UK's taxing rights in relation to carried interest arising to non-resident individuals:

- any UK duties performed prior to Autumn Budget Day 2024 (30 October 2024) will be treated as if they were non-UK services. This means that the extra territorial tail will not apply by reference to UK duties performed by an executive before 30 October 2024;
- any UK duties performed in a tax year for which an individual is not UK resident will be treated as if they were non-UK services, provided the executive spends fewer than 60 workdays in the UK during the relevant tax year. This means that limited business travel to the UK by non-residents after 30 October 2024 will not trigger the tail; and
- any UK duties performed in any tax year will also be treated as if they were non-UK services if three full tax years (in addition to the current tax year) have passed during which time the individual was neither UK tax resident nor met the 60 UK workday threshold. This means that the tail will only last three years for an individual leaving the UK provided they limit their workdays in the UK post non-residence to below the 60 workday threshold.

To simplify the application of this approach, the Government has also introduced an objective method for attributing carried interest proceeds to UK duties. This is considered further below.

International aspects of the new regime

As noted above, from 6 April 2026, the new carried interest regime will bring all carried interest receipts within the income tax framework so that they are subject to income tax and Class 4 NICs as the profits of a deemed trade, regardless of the nature of the underlying proceeds.

The deemed trade will be treated as carried on in the UK to the extent that the investment management services by virtue of which the carried interest arose (the "relevant investment management services") were performed in the UK - i.e., the same apportionment rule that currently applies for Foreign Income and Gains (FIG) purposes (and previously for the remittance basis) under s.103KC TCGA 1992.

That will have two main effects:

- first, non-UK residents will be subject to income tax on carried interest proceeds to the extent it relates to relevant investment management services that were performed in the UK. That domestic charge will be subject to any applicable DTT and will now also be subject to the new statutory guardrails referred to above; and
- second, UK residents who benefit from the proposed new FIG regime for a tax year should be exempt from tax in respect of carried interest arising to them during that tax year, to the extent those proceeds relate to relevant investment management services performed outside of the UK. The FIG regime will be available for the first four years of UK tax residence.

Statutory limitations on domestic charge

Without more, the new charge to tax on carried interest receipts arising to non-residents would have had no minimum threshold so that any relevant investment management services performed in the UK would have triggered a UK tax exposure in relation to carried interest proceeds relating to those services, subject to the terms of any applicable DTT.

The statutory "guardrails" that the Government has proposed aim to limit this scope without constraining the UK's ability to tax returns that have a strong nexus with the UK.

We have considered how the proposed rules will apply in the three main situations that we consider will be relevant in practice, namely:

- **mobile executives,** who are not UK tax resident but who perform workdays in the UK;
- **leavers**, who cease UK tax residence or otherwise cease to have a relevant UK tax nexus but continue to receive distributions from carried interest referable to duties performed in the UK; and
- **new arrivals** who become UK tax resident but continue to receive distributions from carried interest awarded pre-migration.

As set out below, the question of which DTT article should apply in each case is not clear-cut. The Government takes the view that the deeming of carried interest to be proceeds of a trade in the UK's domestic legislation will mean that the business profits article of an applicable DTT will apply. Put simply, that would mean that the UK will have taxing rights in respect of carry proceeds referable to UK duties to the extent those duties give rise to a UK permanent establishment for the executive. What level of presence and activity would give rise to a UK permanent establishment for an executive for DTT purposes is not certain although clearly the greater the presence of the executive in the UK and the more concentrated that presence is on a particular location, the more likely it is that a permanent establishment will be created. The extent to which an applicable DTT will preserve the UK's taxing rights in respect of a non-resident is an untested point in this context and it is a point on which others may take a different view. Further, whatever the correct approach from a UK domestic perspective may be, it is possible that in practice the other country that is party to the relevant DTT may take a different view. In this paper we have proceeded based on the Government's analysis (which certainly has merit), to better illustrate how HMRC should see the new regime applying.

Mobile executives

As explained above, under the proposal announced at the Autumn Budget 2024, non-UK tax resident individuals performing workdays in the UK could have been taxed under domestic UK law if they received carried interest that was to any extent attributable to those UK duties, with no threshold, subject to DTT relief.

The Government has sought to mitigate this situation by introducing a minimum workday nexus threshold of 60 days, so that non-UK tax resident executives will only be taxable in the UK in respect of carried interest proceeds attributable to investment management services performed in the UK during a tax year for which the 60 workday nexus threshold is met. Such proceeds may arise in a later tax year to that in which the relevant services were performed; however, the nexus threshold will apply in relation to the year(s) in which the services were performed, not the year in which proceeds arise.

Furthermore, UK services performed before 30 October 2024 are treated as non-UK services and therefore do not contribute to a UK territorial tail. An executive who became non-UK tax resident on or before 5 April 2024 will not therefore have a UK carry tax tail (even before considering DTT relief) provided they stay non-resident and keep their UK workdays below 60 from 6 April 2024. This helps to address a concern that the new extra-territorial scope of UK carry taxation has an element of retroactivity in its effect.

While not stated, we would expect that the proposed nexus threshold will be modelled on the conditions for a “work tie” in the UK statutory residence test (SRT) for individuals. Those rules will determine when an individual is “working”, and what counts as a UK workday. If that approach is adopted, we believe it would be appropriate to deviate from the SRT rules in some respects, for example so that the definition of “work” specifies that only time spent in the course of a trade involving the performance of investment management services is treated as “working” for the purposes of assessing whether the minimum threshold is met (thereby excluding time spent in the UK on unrelated work, for example as a charitable trustee).

Leavers

While an individual is UK tax resident, they will be taxable under domestic law on all carried interest proceeds they receive, subject to the potential application of the FIG regime and credit for overseas tax. Once such an individual has ceased UK residence then, under the new regime as announced at the Autumn Budget 2024, they would have been taxable under UK domestic law on carried interest proceeds attributable to services performed in the UK in the same way as mobile executives. It should be noted that, once an individual becomes non-resident, under the new regime the UK would not tax carried interest proceeds attributable to non-UK duties performed while they were UK resident.

As with mobile executives, the Government intends to circumscribe its taxing rights to situations where it considers carried interest proceeds have the strongest UK nexus. That involves two new rules:

- first, if a non-resident individual is subject to tail exposure, as noted above, duties performed by that individual in the UK prior to 30 October 2024 will be treated as duties performed outside the UK in determining their UK tax exposure; and
- second, the liability “tail” under the new regime can be limited to three years. Under this new rule, an individual who is not resident in the UK and does not meet the 60 workday threshold for a tax year will not be exposed to UK tax in respect of carried interest *arising to them in that tax year* if the individual was also not UK tax resident and did not meet the 60 workday threshold for any of the previous three tax years.

As such, an individual who ceased to be UK tax resident on 5 April 2025 will have a UK tax exposure in respect of carried interest proceeds attributable to their UK duties undertaken between 30 October 2024 and 5 April 2025 but that exposure will be their only exposure and will lapse on 5 April 2028 (even if the relevant carry is not fully realised by that date) provided the individual stays non-resident and does not hit the 60 workday threshold while non-resident.

Summary in respect of mobile workers and leavers

The overall effect of the announced measures is that, under the new regime, carried interest proceeds attributable to relevant investment management services performed in the UK will not be included in a non-resident individual’s UK taxable base to the extent those services are either (i) undertaken before 30 October 2024; or (ii) undertaken during a tax year in which the individual is not UK resident and does not meet the 60 UK workday nexus threshold.

That position is then subject to an overriding rule that an individual will not be subject to UK tax in respect of carried interest proceeds arising to them in a given tax year provided that they are neither UK tax resident nor meet the 60 workday threshold during that tax year or any of the previous three tax years.

To take another example, consider an executive who is UK resident now and who ceases to be UK tax resident on 5 April 2030 (and who then stays non-UK resident and keeps their UK workdays below 60). Their UK tax exposure in respect of carried interest proceeds received by them after they become non-resident will be limited to the extent those proceeds are attributable (on a time apportioned basis, as explained below) to UK duties performed in the period from 30 October 2024 until 5 April 2030 but that exposure will lapse on 5 April 2033.

In our view these changes should deliver the Government appropriate taxing rights, while helping to reduce the compliance burden for taxpayers and HMRC and avoid discouraging people from migrating to and working in the UK. A time-limited tail will also practically minimise the risk of double taxation for leavers as the individual may benefit from an inpatriate regime in their new country of residence for that three-year period (and in any event with such an obvious nexus to the UK for the tax being claimed by the UK, one might expect credit for the UK tax to be more available in practice).

Attribution of carried interest proceeds to UK duties

There are a number of ways in which one could attribute carried interest proceeds to relevant investment management services performed in the UK. To reduce uncertainty and facilitate compliance for both taxpayers and HMRC, the Government intends to legislate the basis upon which the apportionment should be done.

The proposed statutory basis is to apportion carried interest proceeds between UK and non-UK duties across a period pro rata to the individual's relevant UK and non-UK workdays for that period. Details on how that rule will operate have not been provided although we would expect that when a sum of carried interest arises to a non-resident you would first allocate that carried interest across previous years during which the relevant investment management services were performed on a straight-line basis and, within relevant years to which a UK tax tail applies, allocate between UK and non-UK workdays on a pro rata basis.

We wait to see whether this statutory attribution rule will also be applied for the purposes of apportioning between UK and non-UK duties:

- DIMF income arising to non-UK resident individuals; and
- carried interest proceeds arising to UK resident individuals that may be relieved under the equivalent (in the new carried interest regime) of s.103KC TCGA 1992 and the FIG regime.

New arrivals

For individuals who become UK tax resident while holding carried interest awarded pre-arrival, the starting point under the new carried interest regime is that the full amount of any carried interest proceeds received by the UK resident will be taxed in the UK subject to relief under the FIG regime. There is nothing in the 5 June 2025 announcement to improve the position for new arrivals while UK resident. As under the current regime, those amounts may also be taxed in the country of departure, either because that country:

- regards the carried interest as income sourced in that country - for example, carried interest distributions are treated as employment income in Spain, which may seek to tax those distributions to the extent they are referable to services historically performed in that country;
- imposes an exit tax at the time of departure on the unrealised value of the carried interest entitlements, as we understand may be the case for departing French and Dutch executives; or
- imposes tax charges on citizens or former residents, as is the case in the US.

We note, however, that for many years the UK's non-domiciliary tax regime was instrumental in reducing both the risk of double taxation and the need for individuals to claim credit relief in these situations. As carried interest is a long-term asset, it is likely that new arrivals to the UK will continue to receive proceeds from carried interest awarded pre-arrival after they cease to be able to benefit from the new four-year FIG regime and they will need to rely on double tax relief to avoid double tax in those situations.

Income-Based Carried Interest (IBCI)

Under the current carried interest tax regime, carried interest that is IBCI is automatically taxed as trading income and may not access the capital gains tax (CGT) rate for carried interest. Carried interest is IBCI if the fund in respect of which it is paid has an "average holding period" (AHP) for its investments of less than 40 months. Essentially the IBCI rules aim to target the carried interest tax regime at funds that are investing for the long-term.

The IBCI AHP calculation is complex although to date that difficulty has been obscured for many funds by the employment-related securities (ERS) exemption, which provides that the IBCI rules do not apply to carried interest that is an ERS. However, at the Autumn Budget 2024 the Government announced that the exemption will be removed with effect from 6 April 2026, when the new carried interest regime is introduced.

The Government recognised some of the difficulties and, in the consultation response document published at the Autumn Budget 2024, committed to making "targeted amendments to the IBCI rules to ensure they work appropriately for private credit funds".

The latest announcement has some further detail on the proposed changes to the IBCI rules, and reassuringly those changes are presented in a way that suggests other refinement might also be considered.

In seeking to mitigate the impact of the IBCI rules the Government has announced the following changes:

- the removal of the deemed IBCI status of certain direct lending funds due to their structure or terms, meaning that all credit funds will be able to escape IBCI by reference to their AHP;
- a new "T1/T2" rule[1] for all types of credit fund, which will deem debt investments to be made and disposed of at a specific time. Assuming this is implemented in respect of all debt in a borrower group (acquired on either the primary or secondary market) our modelling shows that this will significantly aid credit funds with respect to their AHPs;
- changes to the T1/T2 rules as they apply to secondary funds and fund of funds to make them easier to access and simpler to apply;
- a more generous provision disregarding a wider range of commercial scenarios in which a fund might dispose of an asset very shortly after acquiring it, including in relation to loan syndications and bundles of assets acquired by secondary funds; and
- unspecified changes in relation to tax distributions which we hope will ensure tax distributions can access the qualifying rate and that their existence does not pollute other carried interest in a fund.

The Government has also suggested there will be other technical changes. We have been making representations for other technical and substantive changes to be made to assist credit and secondary funds and will continue those discussions with HM Treasury during the next phase of consultation. We will update affected managers separately and in more detail on the IBCI position.

Mechanics of implementation

Bringing carried interest into the income tax charging framework is on the face of it a straightforward aim, however there are some hidden complexities.

For example, the way that the current DIMF and IBCI rules are designed does not take account of some of the "asset-like" features of carried interest. Those rules do not include the concept of a "base cost" that reduces the amount of a carried interest distribution in respect of which an individual is taxable, or detailed provision for sales and purchases of carried interest, and appropriate charging rules will therefore need to be drafted.

Another area that warrants careful consideration is how to ensure the new regime operates (as the Government intends) as an exclusive charge, with other schedular income tax or CGT charges disapplied in relation to the underlying income and gains out of which carried interest is paid.

The Government has confirmed that carried interest will be subject to the Income Tax Self Assessment (ITSA) payment on account regime such that income tax and Class 4 NICs paid on carried interest in one tax year will feed in to the default estimate of a taxpayer's payments on account for the next tax year. However, it should be noted that the ITSA rules give taxpayers considerable flexibility to reduce their payments on account if they believe their taxable income will reduce from one year to the next.

The Government has indicated that it will publish draft legislation for technical consultation with stakeholders, and we expect this will be as part of an "L-Day" package in July 2025. That should be helpful in allowing firms and practitioners to stress-test the draft legislation and provide feedback to HM Treasury and HMRC so that the legislation can be refined ahead of the expected Autumn Finance Bill.

Note: [1]There are already special rules for various other investment strategies that lengthen the holding period of an investment scheme by effectively back-dating investments and post-dating divestments in certain circumstances. Where one of these special rules applies it relaxes the requirement to look at each inflow and outflow separately; instead a fund can apply a "T1/T2" approach, treating all of its investments as made at the time when it acquired its first interest and all its disposals as not being made until it ceases to have a "relevant interest".

Contacts

Damien Crossley
Partner
DD +44 (0)20 7849 2728
damien.crossley@macfarlanes.com

James McCredie
Partner
DD +44 (0)20 7849 2129
james.mccredie@macfarlanes.com

Sophie Donnithorne-Tait
Partner
DD +44 (0)20 7849 2670
sophie.donnithorne-tait@macfarlanes.com

Joe Robinson
Partner
DD +44 (0)20 7791 4211
joe.robinson@macfarlanes.com

Alicia Osei
Partner
DD +44 (0)20 7849 2773
alicia.osei@macfarlanes.com

Rhiannon Kinghall Were
Head of Tax Policy
DD +44 (0)20 7791 4131
rhiannon.kinghallwere@macfarlanes.com

Bezhan Salehy
Tax Policy Specialist
DD +44 (0)20 7849 2290
bezhan.salehy@macfarlanes.com

George Apps
Senior Associate
DD +44 (0)20 7849 2623
george.apps@macfarlanes.com

Joe Maughan
Senior Associate
DD +44 (0)20 7791 4122
joe.maughan@macfarlanes.com

Lawrence Parkin
Senior Associate
DD +44 (0)20 7849 2916
lawrence.parkin@macfarlanes.com

Macfarlanes LLP

20 Cursitor Street London EC4A 1LT

T +44 (0)20 7831 9222 | F +44 (0)20 7831 9607 | DX 138 Chancery Lane | macfarlanes.com