

Credit funds – understanding the revised carried interest rules

**When will credit funds be able to access the
new 34.1% carried interest rate?**

July 2025

Understanding the revised carried interest rules as they apply to credit funds

The draft legislation for the new carried interest rules that will apply from 6 April 2026 was released on 21 July 2025. This paper considers the extent to which credit funds will be able to satisfy the average holding period (AHP) condition within the new rules to access the 34.1% qualifying carried interest rate from 6 April 2026.

This paper does not consider broader aspects of the new regime, which will be considered separately. However, for credit fund managers, the key part of the new rules will be the AHP condition.

By way of reminder, under the new carried interest rules from 6 April 2026, for any fund to give rise to (reduced rate – from 47% to 34.1%) qualifying carried interest, it will need to satisfy the 40 month AHP condition.

That AHP condition exists in the current rules but, under those rules, does not apply to carried interest that is an employment-related securities (ERS). That ERS exemption has largely obscured the difficulty of applying the AHP condition to credit funds under the current regime. However, from 6 April 2026, the AHP condition will apply to all credit funds.

The current AHP rules do not operate well in relation to credit funds and it is very difficult for credit funds to have a 40 month AHP under the current rules. The reasons for this are as follows.

- The rules calculate a fund's AHP by applying a mechanical calculation at the level of the fund by assessing the AHP of the fund's "relevant investments" on a weighted average basis. Relevant investments are the investments which are made for the purposes of the fund and by reference to which the carried interest is calculated.
- While the rules seek to focus on the commercial investments of the fund (including by disregarding intermediate holding companies and structures), without application of special rules, the calculation applies on an investment-by-investment and a cash flow-by-cash flow basis, which is hugely complex. The result of the current rules is that credit funds face a huge compliance burden with credit funds often having well over 500 relevant transactions¹.
- A disposal occurs for the purposes of the current rules based on a legalistic definition, not based on whether there is a commercial disposal of the investment. Accordingly, a restructuring of an investment, unless structured within the prescriptive UK reorganisation rules, will constitute a disposal under the current rules notwithstanding that the fund has not realised any proceeds and remains exposed to the underlying assets.

- Investments which a fund makes and then syndicates are only ignored in narrow circumstances with the result that, in most cases, this activity counts towards (and so shortens) the fund's AHP.
- While the current regime contains special (T1/T2) rules that lengthen the holding period of funds with certain defined strategies by effectively back-dating investments and post-dating divestments in certain circumstances, there is no T1/T2 rule for credit funds under the current rules².
- Generally, under the current rules, there is very little assistance for credit funds with the main targeted relief a prepayment extension rule that treats certain qualifying primary loans (with detailed and hard to diligence requirements) as held for 40 months where they are prepaid earlier. There is no prepayment extension for secondary loans acquired outside of primary syndication.

We are pleased to see that the draft Finance Bill 2026 legislation seeks to address many of these issues for credit funds. In particular, the new rules:

- include a T1/T2 rule for credit funds covering multiple acquisitions of debt and equity in the same borrower group (whether the debt is acquired on a primary or secondary basis). These rules backdate subsequent debt and equity investments in a borrower group to the time of the first debt investment in that group and can also defer disposals;
- extend the 40 month prepayment extension to secondary debt acquisitions and abolish the requirement for the loan prepaid to be a "qualifying loan" (which, as noted above, was difficult to diligence); and
- introduce a commercial override to when a disposal takes place for the purposes of the rules.

¹This number of transactions does not arise due to the number of underlying groups a credit fund invests in but because investments are usually acquired (including advanced) and disposed of (including repaid) in multiple tranches and with exposure to an investee group spread across multiple debt and equity instruments issued by different companies in an investee group.

²Where one of these T1/T2 rules applies it relaxes the requirement to look at each inflow and outflow separately. These rules find a date of an investment (T1) from which a fund can treat all subsequent investments as having been made and a divestment date (T2) on which a fund can treat all earlier disposals as having been made.

A clearer path to qualifying carry for credit funds

The proposed changes will significantly extend the AHP of most long-term investing credit funds for the purposes of the new carried interest rules.

New T1/T2 rule for credit funds

- There will be a new T1/T2 rule for credit funds.
- A credit fund is defined as a fund where, at the time it starts to invest, it is reasonable to suppose that (i) more than 50% of the total value invested by the fund will be invested in debt investments, and (ii) more than 50% of the total value invested by the fund will be invested in investments which are held for 40 months or more (assuming the application of the new T1/T2 rule below).
- Access to the new T1/T2 rules requires a credit fund to make a "significant debt investment" which is, put simply, a debt investment of at least £1m.
- T1 is the time the significant debt investment is made and all subsequent debt and equity investments in the same borrower group as that in which the significant debt investment is made (all of those investments being "associated investments") are backdated to T1.
- T2 is the time of the disposal whereby the credit fund has, by disposing of associated investments, disposed of at least 50% of the greatest amount invested at any one time in associated investments³. The disposal of any associated investments by the fund before T2 is treated as taking place on T2.
- T1 is also assisted by a new rule that provides that a debt investment is made by a fund where there is an unconditional obligation to advance a loan if that is before the loan is actually advanced.

Other changes assisting credit funds

- There is a substantive change to avoid the legalistic definition of a disposal causing debt and "debt for equity" restructurings in respect of a borrower group to artificially shorten the fund's AHP. A credit fund does not dispose of a debt investment (i) in the event that a loan is extended on substantially the same terms, or (ii) as a result of a transaction undertaken for commercial purposes where before and after the transaction the credit fund is exposed to substantially the same risks and rewards in respect of the debtor group.
- There is a new prepayment extension pursuant to which a fund is treated as holding a debt investment for 40 months where (i) a debt investment is repaid by a borrower before the end of 40 months from the time the fund made its investment in the debt, and (ii) when the debt was acquired by the fund it had at least 40 months to run and the fund had a positive intention and ability to hold the debt until its repayment date. That repayment extension is not linked to the (complex) definition of a qualifying loan, the concept of which has been abolished.
- Transfers of debt between associated investment schemes are also now ignored with the date of acquisition of the acquiring fund being the original acquisition date of the transferring fund. Schemes are associated if an investor in one of those schemes would reasonably regard that investment as an investment in the arrangements as a whole rather than exclusively in any particular scheme. This should assist transfers between entities of the same fund (for example currency sleeves) but likely not to a parallel fund of one which is not stapled to the main fund. However, provided a syndication/transfer does not trigger T2, the narrowness of this rule and the other (existing) syndication rule should be less of a concern as the debt sold will be treated as continued to be held by the transferring fund until T2.
- One negative is there have not been any changes to assist NAV-based carry paid by evergreen credit funds which will likely be non-qualifying carried interest. In particular, the conditional exemption rules will continue to only apply for the first four years of a fund where the carry is calculated on a NAV basis. The particular issues presented by evergreen funds are set out in the Appendix.

³Or, less likely to be relevant, the credit fund's investment in associated investments is worth less than the greater of £1m or 5% of the total value invested in associated investments immediately before the disposal.

Our concluding thoughts

We are pleased with the proposed AHP rule changes as they apply to credit funds and reflect most of the changes we had sought.

A T1/T2 applying to all debt and equity in a borrower group whether acquired on a primary or secondary basis will make a huge difference.

More generally, we are pleased that the rules accept that primary lending activity should not be favoured over secondary debt activity, a point further demonstrated by the prepayment extension rule being extended to apply to secondary debt acquisitions prepaid early. The removal of the qualifying loan requirement to access the prepayment extension is also very welcome from an administration perspective as it was near impossible for credit funds to efficiently diligence those requirements.

The relaxation of the definition of a disposal for credit funds is also an important change, ensuring transactions whereby a credit fund restructures its investment do not artificially shorten its holding period.

There are of course comments to make on the draft legislation in the consultation period, but the takeaway is that these changes are a huge help to credit fund managers and will both materially reduce their compliance burden in applying the rules and materially increase the chances of their funds reaching the 40 month AHP requirement.

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The new rules are a meaningful step forward - simplifying the regime, aligning more closely with credit fund structures and, crucially, offering a clearer path to the 34.1% qualifying carried interest rate.

Damien Crossley, Partner

Appendix

Evergreen funds

How are evergreen funds structured?

Possible evergreen credit fund models include:

- NAV-based open-ended structures (where investors can invest and redeem on an ongoing basis at NAV);
- hybrid vehicles (where investors can invest at NAV but exit by electing to put their investment into “run off” whereby they receive their share of existing investments as they are realised); and
- vintage structures (which closely follow closed-ended fund concepts but seek to “roll” investors directly from each vintage to the next without requiring a fresh commitment).

A vintage model paying carry will typically be “realisation model” carry with each vintage having a normal fund waterfall. However, in non-vintage style evergreen funds (aka “true evergreens”), which pay a carry, the carried interest will generally be calculated based on the increase in NAV over a reference period. That carried interest is rarely paid on a purely annual basis (so not like a hedge fund). Instead, there is normally a ramp up period before any carried interest is calculated (for example, the first three years of the fund) and then the carried interest accrued in a year might be paid out over more than one year (to protect investors from a subsequent downturn).

If a true evergreen fund issues true carried interest (i.e. a proprietary interest in the fund, as opposed to a performance fee), it is by its nature a perpetual interest. A perpetual right to carried interest is not naturally in a form that can be awarded to executives as, absent someone leaving and being subject to forfeiture, the award would be for life. Therefore, if “perpetual at source” carried interest is awarded to executives, the carry needs to be divided into vintages (for the purposes of awarding entitlements to carry only) at a feeder partnership level, with the carried interest awarded to the team then being entitled to carried interest from the fund paid over, say, the next five years. When that period is over, a new interest would be created at the feeder level (“carried interest series 2”) carrying an entitlement to carry distributions from the underlying fund over the next five years and that series 2 carried interest would then be issued to executives in the then desired proportions.

Tax treatment of carried interest in evergreen funds

We now analyse the tax treatment of true carried interest in true evergreen funds under the existing and revised carried interest rules.

Under the existing rules, if carried interest is awarded to an employee it would be an ERS and, subject to any acquisition tax liability, future distributions would be taxed as carried interest at 32% save to the extent the entitlement is satisfied by an allocation of income. In an evergreen credit fund context with ongoing carry payments, there is likely to be a higher proportion of interest income comprised in a carry distribution than where carry is paid on a realisation model basis (where the carry would largely be satisfied by repayments of principal at the end of the life of the fund). The AHP rules would not be a concern for employees under the current rules due to the ERS exception from the AHP rules.

For a self-employed recipient under the current rules (and for all recipients from 6 April 2026), it would be necessary to consider the AHP rules. Under those rules, at each time carried interest was paid by the fund, it would be necessary to identify the relevant investments (i.e. the investment by reference to which the carried interest is calculated) and work out their AHP on the assumption that the fund had disposed of all of the relevant investments it held at the end of the reference period.

Assuming the carried interest was calculated by reference to the increase in the NAV of a fund during the calendar year 2026, the relevant investments would be those investments held on 1 January 2026 and acquired during 2026. Any investments still held by the fund on 31 December 2026 would be deemed disposed of at that time. This would mean (ignoring the conditionally exempt carried interest rules) a fund could not reach a 40 month AHP in the first 40 months of the fund.

Even beyond that time it would be difficult to hit a 40 month AHP for relevant investments given the extent to which capital will likely be reinvested. If, in the above example, on 31 December 2025, a loan of 100 (which was made on 31 December 2021) were repaid (for 100) and reinvested on that same date (31 December 2025) into a new loan of 100 that was still held on 31 December 2026, the AHP of that 100 of capital will have reduced from four years for the 2025 calculation to one year for the 2026 calculation.

In an evergreen credit fund context therefore, given the likely extent of reinvestment it would seem always to be necessary to rely on the conditionally exempt carried interest rules for the AHP condition to be ratified. This can be contrasted, for example, with an evergreen infrastructure fund where the investments are held for the long term with the result that, after a while and with no reinvestment, the fund would have a 40 month AHP.

The conditionally exempt carried interest rules allow the AHP to be satisfied in retrospect and do so by effectively disapplying the deemed disposal rule and allowing investments to continue to be held to reach the required AHP. However, under the current rules, for funds which pay carry otherwise than on the realisation model basis (including true evergreen funds) conditional exemption is only available for the first four years of the fund's life.

On that basis, assuming carry was first paid by an evergreen credit fund only after the end of year three of the fund's life, there would only be one carry distribution that could be assisted by conditional exemption.

On that basis, allowing evergreen credit funds to access the new qualifying carry rate would require the conditional exemption rules to be extended for funds paying carry otherwise than on a realisation basis. To cater fully for evergreen funds, the ability to apply conditional exemption would need to be indefinite.

The draft legislation published on 21 July 2025 does not propose an extension of the four year period for the conditioned exemption to be available for NAV-based carry funds.



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