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Reforming the Taxation of Carried Interest

October 2024

The UK Chancellor has announced that with effect from 6 April 2025 the minimum tax rate on carried interest will increase to 32% and that from 6 April 2026 the taxation of carried interest will be further reformed. This follows the Call for Evidence on the tax treatment of carried interest, for which HM Treasury has published a summary of responses and outlined the next steps. This document restates the government commitment to ensuring that the tax regime appropriately reflects the economic characteristics of the reward but also recognises the complexity of the legislation in this area. The reform is due to take effect from April 2026 in order to allow for a period of technical consultation with expert stakeholders. During the period of consultation there is the ability to request a meeting with HM Treasury and submit written representations up until 31 January 2025.

Call for evidence – Summary of responses

This confirms that most respondents to the Call for Evidence emphasised the need to protect the UK asset management sector's competitive position and avoid a system that is overly prescriptive. Where respondents did make policy proposals, these included:

- Mandatory minimum co-investment requirements across the fund management team;
- Changes to the Income Based Carried Interest ("IBCI") rules to encourage long-term investment;
- A minimum holding period before carried interest can be paid out;
- A flat rate, rather than a blended rate, as can currently be the case where carried interest consists of income and dividends; and
- A more favourable regime for venture capital and emerging private equity funds, to support scale up businesses.

In addition to this respondents specifically cautioned against:

- Blanket treatment as employment income given its practical challenges;
- A system which looked at minimum co-investment requirements on an individual-by-individual basis;
- New rules which fundamentally change the features of the existing regime; and
- Making significant changes without appropriate transitional provisions.

Respondents also noted that the changes to other UK tax rules, such as the taxation of non-UK domiciled individuals could also impact the UK's competitive position and therefore any changes should not be looked at in isolation.

Government response and next steps

Having considered the evidence the government continues to believe there is a compelling case for reform and intends to introduce a revised tax regime, which aims to ensure carry is taxed in line with its economic characteristics, puts the regime on a stable footing for the long-term and safeguards the UK's status as an asset management hub. The proposed regime will retain well understood concepts from the existing legislative regime but will sit wholly within the Income Tax framework.

Overview of proposed regime

- The basic rule will be that all carried interest is treated as trading profits and subject to income tax and Class 4 National Insurance Contributions (NICs).
- Carried interest will be 'qualifying' carried interest where it is not IBCI, with amounts potentially eligible for the multiplier being computed under the existing principles of the carried interest provisions.
- Where an individual receives qualifying carried interest, the amount brought into charge will be multiplied by 72.5%. The net amount, after applying the 72.5% multiplier, will be the amount brought into charge as trading profits and taxed at the individual's applicable marginal rate of Income Tax plus Class 4 NICs.
- For additional rate taxpayers this will result in an effective tax rate of 34.08%.
- The tax charge under the existing regime will be an exclusive charge, removing the complications caused by the carried interest rules sitting alongside general principles.
- The exclusion for employment related securities from the IBCI rules will also be removed.

The government will also work with industry to make targeted amendments to the IBCI rules to ensure they operate effectively, especially in the context of private credit funds.

1 Territorial scope

It is proposed that the approach in this area will mirror the approach taken in the disguised investment management fee ("DIMF") rules currently, such that non-UK residents will only be subject to income tax on carried interest to the extent that it relates to services performed in the UK (subject to the terms of any applicable double tax agreement).

2 Interaction with 4-year FIG regime

From April 2025, the remittance basis of taxation will be replaced by a new 4-year foreign income and gains (FIG) regime.

Qualifying carried interest which relates to non-UK services should benefit from relief under the FIG regime. Whereas non-qualifying carried interest subject to the IBCI rules will continue to be subject to the same provisions as currently, with only IBCI relating to 'pre-arrival services' able to benefit from relief under the FIG regime.

3 Transitional provisions

The government's view is that while the reforms represent a major legislative change, they do not impose new conditions or requirements which could not reasonably have been foreseen when existing funds were established and therefore do not consider that any transitional provisions will be required. Notwithstanding this, the government has asked for specific fact patterns that should be considered before any final determination is made on this point.

4 Consultation on Qualifying Conditions

As part of the consultation the government will consider the need for further qualifying criteria to ensure access to qualifying carried interest treatment is appropriately limited, specifically asking for views on:

Question 1:

Recognising the challenges in this area, how might any team-level co-investment requirement be most successfully constructed?

Question 2:

Are there any further risks and/or wider considerations, beyond those identified via the call for evidence, that should inform decisions on whether the government progresses with a co-investment requirement?

Question 3:

How might the length of any new time-based condition best be designed to reflect the nature of carried interest rewards?

Question 4:

Do you foresee any unintended adverse consequences for fund managers in existing funds from a government decision not to introduce transitional arrangements on the introduction of a condition of this kind?

If you would like to discuss the implications of the proposals in further detail, please contact:

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