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UK Issues Draft Legislation Relating to Taxation of Carried Interest

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This week, the UK published draft legislation relating to the taxation of carried interest.

The draft legislation is 48 pages long, combining new drafting and amendments to existing legislation, that go beyond just carried interest. It is dense and will take time to process. Luckily, HM Treasury has allowed for an eight-week period of consultation, so there is time to unpack what has been presented and submit a considered response.

In the meantime, we've outlined the proposed legislative framework below. We will provide further details over the coming weeks.

Confirmation of rate and trading status

As previewed in the UK's October budget last year, carried interest is moving into the income tax regime. The new drafting will sit in the Income Tax (Trading and Other Income) Act 2005; the prior carry provisions contained in the Taxation of Chargeable Gains Act 1992 are being replaced.

"Qualifying profits" (carried interest where the fund's investments satisfy the average holding period test — the income-based carried interest, or IBCI, rules in the current system), will be trading income, with 72.5% of qualifying profits subject to income tax with the remainder being untaxed. The trade will be treated as taking place in the year that the carry is received, which simplifies the admin around paying tax.

As expected, and in line with HM Treasury's paper on carry reform from last month, the conditions to be "qualifying" ***do not*** include either: (a) a minimum holding period for the individual between award and receipt of their carry; or (b) a minimum co-investment requirement.

Given the move into the income tax regime, a deduction is specifically allowed for any money paid as consideration for a carry entitlement (we note that non-cash consideration is currently not deductible). In addition, a claim must be made to HMRC where the value of the carry entitlement has been taxed as employment income.

Confirmation of extra-territorial scope and relaxations

As a result of being treated as trading income, the UK will seek to exercise extra-territorial taxing rights on non-UK residents. The apportionment of taxing rights to the UK will be based on the proportion of an individual's "applicable workdays" that are "UK workdays."

An applicable workday is any day on which investment management services are performed and a UK workday is a day in which more than three hours of investment management services, with a newly expanded meaning, are undertaken in the UK. There are some sensible provisions around travelling to and from the UK via air, sea or under-sea tunnels, meaning that you're not in the UK until you leave your train, plane or ship (and have left the UK as soon as you board) even if you're in UK air, water or land.

As announced previously, the legislation contains three limitations to the UK's extra-territorial tax rights, which simplifies things for people leaving, coming to or visiting the UK. The catch is that they apply only in respect of qualifying carry, so non-qualifying (IBCI) carry remains subject to extensive UK taxing rights, requiring reliance on double tax treaties for exemption for short-term visitors.

In brief, for qualifying carry paid to an individual who is non-UK resident at the time the carry is received:

1. UK workdays pre-30 October 2024 are ignored;
2. any year with under 60 UK workdays is ignored; and
3. any UK workday is ignored once a person has been non-UK resident for three complete tax years, meaning that for qualifying carry, these rules apply only to current and certain former UK residents.

In interpreting these limitations, for a person who is non-resident and has over 60 UK workdays there will be an apportionment of carry based on the proportion of “applicable workdays” that are UK workdays.

Additionally, because the three limitations described above apply only in respect of qualifying carry, individuals holding carry that is potentially non-qualifying will need to give careful consideration to the time they spend in the UK, and its consequences. This is particularly complicated given that a fund may produce a combination of qualifying and non-qualifying carry.

Unhelpfully, there are some rather draconian provisions that seek to impose the new trading income tax on those who have become temporarily non-UK resident in or prior to the current tax year (2025-2026). This effectively subjects carried interest that was realised prior to April 2026 under the current capital gains tax regime to the new trading income regime. We anticipate that with these changes fewer executives will choose to return.

Crediting and double tax

The proposed legislation contains crediting provisions to avoid double taxation. These provisions are very limited, requiring the individual to make a claim to HMRC, and applying only where another person pays UK tax in relation to the carried interest, or income tax is paid by the carry recipient “in respect of the individual's entitlement to carried interest.” This income tax charge is drafted by reference to a general earnings charge under Section 62 of the Income Tax (Earnings and Pensions) Act 2003 or under the employment-related securities (ERS) regime. There are some clear gaps in these provisions, potentially as a reaction to the very broadly drafted crediting provisions in the current carry rules that simply refer to “tax.” We expect there will be extensive representations made on these provisions.

Average holding period (formerly IBCI)

The removal of the ERS exemption means that more people will be caught by the average holding period regime. In recognition of the expanded scope the government has made certain amendments to the rules, particularly adjusting the approach to:

- credit funds;
- fund of funds; and
- unwanted short-term investments.

Credit funds

As promised, the IBCI legislation relating to the treatment of credit funds has been amended. In the main, the changes are helpful in more closely aligning the activities of credit funds with the aims and principles of the IBCI legislation; His Majesty's Revenue and Customs has taken on board a number of the suggestions made during the consultation process. These measures apply to credit funds as defined. A credit fund is broadly one that has 50% of total value invested in debt investments and more than 50% of total value in debt investments held for 40 months or more.

Helpfully, the legislation specifically provides that for credit funds where debt investments initially have a repayment date of 40 months and are intended to be held until that date but happen to be repaid within 40 months due to factors not influenced by tax considerations, the debt investments are nevertheless treated as being held for 40 months for the purposes of the holding period test.

Under the old rules, it was difficult for credit funds to give rise to anything other than IBCI (non-qualifying profits under this new regime). Under the proposed rules, credit funds are no longer deemed to be “bad” unless exceptions apply. Instead, the approach to credit funds mimics those for other strategies in that a fund satisfying the conditions to be a credit fund will have its investment period stretched via “T1/T2” provisions. T1 in this case being the time that the holding period is calculated from and T2 being the time that the holding period ends.

Where a credit fund has a significant debt investment (a debt investment of at least £1 million or at least 5% of the total amounts raised from external investors in the fund), any associated debt or equity investment (i.e., an investment in the same group) is treated as being made when the original significant debt investment was made and disposals of associated investments are not considered as being made until a relevant disposal occurs. A relevant disposal occurs when at least 50% of the greatest amount invested in associated investments is disposed of or where the investment value falls below £1 million or 5% of the total value invested in associated investments.

The legislation also contains specific provision to facilitate the restructuring of debts in commercial contexts. The new provisions essentially apply a qualitative approach, whereby restructuring events are not treated as disposals of a debt investment, where they comprise either: (a) transactions extending a loan on substantially the same terms; or (b) transactions undertaken for commercial purposes where the fund before and after the transaction remains exposed to substantially the same risks and rewards.

Furthermore, assets acquired in such transactions are treated as part of the original debt investment for the calculation of holding period tests.

The combination of the T1/T2 provisions and the specific rules for restructuring transactions are welcome (especially compared with the existing rules) and will assist credit funds in certain scenarios to ensure their holding periods are not foreshortened when they retain economic exposure to an asset following a restructuring. However, the restructuring provision still contains some significant questions of interpretation.

For example, in relation to the extension of a loan, it is unclear what the requirement to be ”on substantially the same terms” means in the context of changes to interest rates or changes to the borrowing covenants. How is substantial due to be measured (is it by reference to the concept of a substantial modification as is used in accounting terms)? And in relation to a struggling group, if a creditor exchanges a significant secured creditor position for unsecured subordinated debt or equity based on the commercial deal with the creditors as a whole it is unclear if the creditor would be regarded as being exposed to the same risks and rewards before and after the exchange.

In complex restructurings, creditors are often offered a range of different instruments and positions in the capital stack. How do the rules apply in this context where a creditor accepts more upside (e.g., in an equity instrument) in exchange for releasing debt which may contain more downside protection (which may have higher ranking and security)? It may be that the T1/T2 rules would assist in these types of scenarios, but further elaboration or guidance relating to the meaning of these provisions would be welcome.

Fund of funds

The prior provisions relating to secondary and fund of funds were overly prescriptive and difficult to operate. The new proposed provisions combine the approach taken to secondary and fund of funds, which makes sense given that the strategies often overlap.

Extensive representations were made to the UK government regarding the commercial operation of fund of funds and secondary funds. Some of these representations have been taken into account but in our view, there is more work to do.

Unwanted short-term investments

The unwanted short-term investment provisions in the existing IBCI rules are intended to prevent investments that were not intended to be part of the long-term investment portfolio of the fund from unduly reducing the average holding period calculation. The existing rules are restrictive when it comes to the type of debt investments which can benefit. The time period in which an unwanted investment has to be disposed of is six months for securities and three months for debt, which has generally been considered to be too short to be of real benefit. The new rules remove the qualifications for debt investments, and increase the time period to 12 months for all asset classes.

Tax distributions

Tax distributions or tax advances (i.e., distributions made by funds in advance of carried interest distributions to enable fund managers to manage tax liabilities) have raised some concerns in the past, in particular around whether they would be treated as IBCI, or if they would qualify as carried interest at all. While the new rules helpfully make clear that tax distributions (as defined) are to be treated as carried interest, the definition may not cover all instances in which tax distributions are paid (e.g., some sponsors pay tax distributions to all team members, even if only a subset of team members (e.g., US taxpayers) have a tax liability that triggers the payment).

Other points to note

As alluded to above, the proposed legislation in addition to making the above fundamental changes also imports a slew of tweaks to the existing regime, both for carried interest and management fees more broadly, and these are changes that we are working through. To highlight the key areas:

- expanding the definition of both investment management services and investment scheme (the latter being likely to have more impact);
- provision for continuation vehicles;
- provision for the treatment of tax distributions (which on a first assessment appears to be fairly UK centric); and
- changes to the definition of co-investment returns.

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Suggested Reading

- 24 July 2025 Press Release Kirkland Advises Nordic Paper on Long Term Financing Agreement
- 22 July 2025 Press Release Kirkland Advises Luminate Capital on Strategic Growth Investment in Facilities Management Express
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