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Kirkland Alert

UK Improves Draft Legislation Relating to Taxation of Carried Interest

04 December 2025

As part of the post-budget Finance (No. 2) Bill, updated draft carried interest tax legislation was published on 4 December 2025.

The updated draft legislation builds on the draft that was published for consultation in July 2025 and has taken on board many of the comments made by us, and others, during the consultation period. We've annotated an abridged version of our original *Alert* from July below to highlight where the improvements have happened and show where there are still difficulties. Our original *Alert* remains in *italics*.

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.

"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.

> **Update:** The updated draft legislation confirms that carry can (but does not have to) arise from multiple funds under the same arrangements. This follows on from prior confirmation from HMRC that each set of arrangements will constitute a separate trade, which becomes relevant when filing tax returns and claiming treaty reliefs.

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).

> **Update:** Deductions are now permitted for consideration in money or money's worth.

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 on 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.

> **Update:** The concepts of UK and non-UK workdays remain unchanged in the updated draft.

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 treated as non-UK workdays;*
2. *any days in a year with under 60 UK workdays are treated as non-UK workdays; and*
3. *any UK workday is treated as a non-UK workday 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.

> **Update:** It has been confirmed that these limitations still apply only in respect of qualifying carry. However, in acceptance of some of the comments made during the consultation, some changes have been made in the new draft.
>
> 1. **Non-qualifying carry:** It was recognized that where there is uncertainty over whether or not carry may be qualifying, this may deter non-UK residents from making business trips to the UK (with the above rules on UK workdays in mind). New drafting confirms that where, on the first UK workday in a relevant period, it is reasonable to make the assumption that profits would be qualifying, a day that would otherwise be treated as a UK workday will instead: (i) be treated as a non-UK workday; but (ii) remain an applicable workday, in applying the rules described above.
> 2. **Unilateral relief:** A new provision has been included to enable unilateral relief to be claimed under the UK's domestic tax rules, in a circumstance where non-UK tax (corresponding to capital gains tax) is suffered on an amount that is also taxed in the UK under the new carried interest regime. It remains to be seen how this provision will apply in a situation where there is a double tax treaty between the UK and the relevant non-UK jurisdiction, but both jurisdictions nevertheless claim taxing rights over an amount. See the box below for a summary of how unilateral relief typically works.
> 3. **Permanent establishment:** One issue raised in the consultation process was the difficulty of determining when an individual undertaking investment management services could be regarded as having a permanent establishment in the UK (for the purposes of applying a double tax treaty). This is not addressed in the new draft rules, but HMRC is currently consulting on guidance. This is a key concept because the UK's claim to extra-territorial taxing rights is based on carried interest being business income, which, under double tax treaties, is taxable by the country in which the taxpayer has a permanent establishment.

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.

> **Update:** These provisions remain in the updated draft.

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.

> **Update:** The provisions on double taxation have been updated in the new draft, taking on board the responses made during the consultation process.
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> The new carried interest charge is generally intended to have primacy over other UK tax charges. However, where carried interest would fall to be taxed as UK trading profits under general principles, a new provision means that an individual can now elect to apply that general charge (instead of the new carried interest charge), which they may choose to do if, for example, it was beneficial to them to do so because it would enable them to obtain deductions.
>
> Similarly, where a sum of carried interest is taxed as employment income — either as general earnings or under the ERS rules — it will now fall outside the new carried interest rules without the need for a claim to be made.
>
> In addition, changes have been made to the original anti-double taxation provisions. The intention behind these is helpful, but it is unclear that (as a technical matter) they would prevent all potential instances of double taxation.

> This is because the provisions turn on the idea that an individual has been subject to tax under one of the main (rather than subsidiary) charging provisions of the regime. It still appears possible, for example, that if an individual dies holding an entitlement to carried interest, there could be an inheritance tax charge by reference to that entitlement, followed by an income tax charge (under a subsidiary provision of the regime) when the carry is actually paid. Given the intention behind the amendments, it is to be hoped that this anomaly is adjusted as the Bill makes its way through Parliament.

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; HMRC 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.

> **Update:** The definition of debt investments has been expanded to include arrangements that are deemed to be 'loan relationships' for corporation tax purposes — for example, arrangements that produce returns that are economically equivalent to interest, alternative finance arrangements, certain repo arrangements and manufactured interest relationships.
>
> These are positive changes and will enable more funds that think of themselves as credit funds to now satisfy the definition of a credit fund under this legislation.

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.

> **Update:** These provisions have been amended to apply to all loans irrespective of their initial term, with the debt being treated as held for its full initial term (capped at 40 months). For this relaxation to apply it is necessary for the fund to have both the ability and the intention to hold the debt in accordance with its initial terms.
>
> This is a welcome relaxation, which enables more debt investments to fall within the average holding period (AHP) 'stretch' provisions without impacting the commercial activities of the fund. For example, a loan with a 36-month term, repaid after 12 months will still be treated as being held for 36 months for the purposes of the AHP calculation.

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.

> **Update:** The draft legislation has clarified when T1 starts. The previous draft referred to the time at which there was an unconditional obligation to advance money. What constitutes an unconditional obligation has now been defined as excluding obligations that are contingent only by reference to: (i) condition(s) that are outside the control of the fund, or its connected persons; and (ii) condition(s) that it is reasonable to assume a prudent investor would have obtained on making an investment at arm's length of the same size and nature as the debt investment.
>
> The exclusion of these conditions is a positive move that will allow funds to operate these rules with more certainty in practice.

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.*

> **Update:** The definition of 'disposal' has been simplified and is now triggered when the base amount held in associated investments is less than 50% of the greatest base amount ever held in such associated investments. The base amount is the value invested for the purposes of the scheme. The test is, therefore, flipped from looking at the amounts disposed of, to the amounts retained. The fallback position that looked to absolute value has been removed, which is helpful to funds making smaller loans.

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.

> **Update:** These provisions have been updated fairly extensively, with a view to working in a wider range of commercial restructurings. In particular, there are now specific exclusions for releases of debt under s.322 of the Corporation Tax Act 2009 (CTA 2009) and modifications or replacement of loan relationships where s.323A(2) of CTA 2009 applies, meaning that restructurings taking advantage of debt-for-equity swaps and the corporate rescue exemption will not trigger a disposal for AHP purposes.
>
> We also welcome the introduction of a broader principles-based concept that looks to whether the fund has substantially the same economic exposure before and after the transaction (which is, naturally, undertaken for commercial purposes). We understand that HMRC will be providing examples of what it considers to be "substantially the same" and "economic exposure".

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.

> **Update:** See above.

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.

> **Update:** Although this provision has remained unchanged, the addition of the general principles restructuring provision ameliorates the impact.

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.

> **Update:** See above.

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.

> **Update:** There have been further positive updates to the fund of funds provisions. In particular, the type of investment that a fund needs to expect to hold to qualify for fund of funds treatment has been expanded to include direct co-investments (investments made alongside and on substantially the same terms as another fund). Further, the conditions surrounding the funds that can be invested into have been relaxed. These changes should enable more funds to qualify for this treatment.
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> In addition, the time at which an investment is treated as being made is when an unconditional commitment is made, and distributions from the underlying funds will be treated as partial disposals and therefore disregarded for AHP purposes, unless those partial disposals trigger the more general disposal thresholds.

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.

> **Update:** The new draft contains some adjustments in relation to the unwanted short-term investment provisions. The drafting has been expanded to cover parts of investments, as well as single investments, with the proviso that the “unwanted” element is not more than half of the total value of the investment(s) made by the fund as part of the relevant transaction. Another welcome change is that as long as (at acquisition of the investment(s)) the manager intends to dispose of the unwanted element within 12 months, the disposal does not actually have to occur within that 12-month period.

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).*

> **Update:** These provisions have been updated to reflect standard tax distributions clauses and now apply to tax (anywhere in the world) payable, or expected to be payable, by reference to "any individual's entitlement to carried interest under the arrangements".

Evergreen Funds

There is increasing investor and manager demand for evergreen-style funds that provide a source of more long-standing capital for a particular strategy or allow an investor's capital to be recycled over a longer term than the standard fixed term of a typical private capital fund. These evergreen funds typically calculate their carried interest based on the net asset value of their investments. Under the prior draft rules, such carry benefited from conditionally qualifying carried interest treatment only for the first 4 years of the fund's life; this has now been amended to 10 years, which is a positive move, although some would argue in the context of an evergreen fund (which will by its nature run for many more than 10 years), still not enough.

Unilateral Relief

- The UK's domestic unilateral relief provisions allow UK taxpayers to claim credits (in their UK tax computations) for certain tax paid in a non-UK territory.
- Unilateral relief is intended to act as a fallback where an individual could be subject to double tax, but treaty relief is unavailable (either because a treaty does not exist, or the treaty does not cover the relevant tax (such as US state taxes)).
- So far as capital gains are concerned, where tax: (i) is paid in a non-UK territory; (ii) is calculated by reference to any capital gain accruing in that territory and (iii) corresponds to UK tax, credit for that tax is allowed against UK capital gains tax.
- The new draft rules specifically modify this provision for carried interest, so that tax which satisfies (i)-(iii) above can be allowed as a credit against a UK income tax charge arising under the new carried interest regime.
- By way of practical example:

- UK resident carry recipient (Individual X) performs investment management services in respect of Fund A.
- Fund A invests in real estate rich companies and disposes of a real estate rich asset in Country Z. Country Z imposes non-resident capital gains tax on the gain arising.
- There is no treaty between the UK and Country Z.
- Fund A is in carry and Individual X is to receive 100 of carry from this disposal. Country Z taxes this amount as a gain at 20%.
- Under the new carry rules, Individual X is treated for UK tax purposes as receiving profits of a trade equal to 100. Assuming all are qualifying profits, UK income tax of 34.075 is due.
- Even though the foreign tax of 20 is taxed on a "gain", rather than income, a unilateral credit is available in the UK to reduce the UK income tax payable to 14.075.

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Related Services

Practices

- Tax

Suggested Reading

- 02 December 2025 Kirkland Alert Treasury and IRS Issue Final Regulations on Excise Tax on Share Repurchases by Publicly Traded Corporations
- 24 July 2025 Kirkland Alert UK Issues Draft Legislation Relating to Taxation of Carried Interest
- 23 October 2025 Kirkland Alert Treasury and IRS Issue New Taxpayer-Favorable Proposed Regulations on Domestically Controlled REITs