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ARTICLE

Legislating for a New UK Carried Interest Tax Regime

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HM Revenue & Customs (HMRC) published the long-awaited draft legislation for the new UK carried interest tax regime in July and it is due to come into effect from April 6, 2026. Previously taxed as a capital gain, carried interest will be treated as trading income and subject to income tax and Class 4 National Insurance contributions (NIC) for any carried interest arising from that date.

The draft legislation was introduced following a significant period of consultation between HMRC, HM Treasury and industry, and marks the start of an eight-week technical consultation, running until mid-September. The purpose of this consultation is to resolve any drafting inconsistencies or other necessary amendments for the legislation to work as intended.

Who will be affected?

Individuals who receive carried interest, where either the individual is a UK tax resident at the time of receipt, or the carried interest relates to investment management services performed in the UK by a non-UK resident where the individual meets certain conditions will be subject to the new regime. There will be no grandfathering under the changes for carried interest awarded prior to April 6, 2026, so from that date, capital gains treatment will simply no longer be available.

Main features

In line with the existing regime, the new regime will apply where an individual performs investment management services directly or indirectly in respect of an investment scheme under widely defined arrangements and a sum of carried interest arises to the individual under those arrangements. The draft legislation provides that the individual is treated as carrying on a trade, and carried interest (less any permitted deductions) is treated as the profits of that trade.

The principal division of carried interest taxation into two tax regimes will also be retained. Carried interest that does not satisfy a 40-month investment portfolio holding requirement — previously income-based carried interest and now to be termed "non-qualifying carried interest" — remains

subject to full income tax and NIC. Carried interest that does meet the 40 months portfolio holding period and other applicable conditions will be classified as "qualifying carried interest" subject to a special rate of income tax and NIC.

The new legislation will provide that qualifying carried interest (subject to limited permitted deductions) is treated as trading profits for tax purposes, but qualifying carried interest (less permitted deductions) is subject to a multiplier of 72.5%, whereas non-qualifying carried interest is not. Under the current highest income tax rate of 45% and NIC of 2%, the 72.5% multiplier would result in an effective 34.1% combined tax and NIC rate for qualifying carried interest (less permitted deductions).

Detailed provisions for determining the average holding period of an investment scheme and specific provisions relating to the time of acquisition of various types of investment, which are similar to the provisions in the current income-based carried interest rules in the disguised investment management fee legislation, are also included. The main change is that credit funds will be generally treated in the same way as other funds.

The definition of carried interest remains based on characteristics (very broadly, considering the priority waterfalls of payment for investors and circumstances under which carried interest holders are permitted to participate). The scope of "investment schemes" will however be expanded to include alternative investment funds (AIFs). The definition was previously limited to investment funds defined as collective investment schemes — which applied to most investment schemes but had a specific exclusion for closed-ended corporate funds. A driving factor behind the expansion to include AIFs is the availability of the lower carried interest tax rate for such corporate arrangements. The corporate inclusion is not necessarily positive for all arrangements.

A further change is the introduction of the asset-level average holding period for employment-related securities from April 6, 2026; employment-related securities are excluded from current income-based carried interest rules but will now be included within the Non-Qualifying Carried Interest rules.

Exclusive regime and double taxation

Generally, carried interest will only be chargeable to income tax under the new regime and not any other provisions. If, however, a tax charge arises in respect of carried interest under section 62 (earnings) or Part 7 (employment income in respect of share-related incentives) of the Income Tax (Earnings and Pensions) Act 2003, that income tax charge will still stand, but the individual may make a claim for the carried interest charge to be adjusted to prevent double taxation. The relief given is "just and reasonable", rather than pound for pound. The new regime does not, therefore, deliver an "exclusive regime" as was originally proposed.

Double tax relief will be similarly available where UK tax has separately been charged on another person in relation to the same carried interest. However, there is no express double tax relief in respect of non-UK tax, though this relief may be available, depending on the terms of an applicable double tax treaty.

As carried interest (less permitted deductions) will be taxed as trading profits, the relevant treaty article from a UK perspective is likely to be the business profits article, but that may not align with the other jurisdiction's treatment of carried interest. Therefore, the ability to claim double tax treaty relief remains uncertain.

There is also scope for individuals to elect to treat their carried interest as arising at an earlier time than it would otherwise do. This election can allow individuals who are taxable on carried interest in the UK and another jurisdiction to align the timing of their tax charges to facilitate double tax treaty claims.

While retaining a significant number of principal features of the current legislation, the new legislation also sets out the circumstances in which carried interest is deemed to arise to an individual where it arises to another person — which are equivalent to the current rules under the disguised investment management fee regime. In addition, numerous anti-avoidance provisions will still apply where arrangements are entered into to fall within certain provisions of the regime.

Concessions

The draft legislation reflects the government concessions made in the June policy update on the carried interest tax reform, which were the subject of prolonged discussion between HM Treasury and industry and ultimately accepted as too difficult to introduce. Specifically:

- There will be no minimum co-investment requirement or minimum carried interest holding period condition.
- The geographical scope of the new regime has been reduced, so that UK investment management services performed by a non-resident individual in a tax year do not give rise to UK tax where such services do not exceed 60 UK working days (broadly defined as three hours of work performed in the United Kingdom on a given day).
- UK resident individuals leaving the United Kingdom will not be subject to UK tax on their carried interest payment if three full tax years (in addition to the current tax year) have passed, during which the individual was neither UK tax resident nor met the above 60 UK workday threshold.

Favourable reception

Although there are likely to be some technical changes following the consultation period, the draft legislation does appear to be clearly set out and clarifies certain areas that are currently uncertain. The government's June climbdown on aspects, such as abandoning the requirement for managers to pay for their carried interest award and foregoing a minimum carried interest holding period at manager level, removed some of the key sticking points.

The new regime may be seen as simpler for taxpayers to apply as carried interest will be solely within the income tax regime rather than split between capital gains tax and income tax as it is today and so may be not unfavourably received by investment managers (assuming, pragmatically, the tax rate for carried interest would have been set at the same level, regardless of whether it was technically subject to income tax or capital gains tax).

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