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UK carried interest consultation update: DLA Piper’s insights

As part of the UK government’s ongoing consultation process to reform the tax treatment of carried interest, the government published its updated response and policy proposal on 5 June 2025: link here.

DLA Piper is among a select group of advisors and stakeholders that have engaged in additional discussions with HMRC and HM Treasury regarding the proposed changes. We have also submitted written responses to the prior consultation questions.

This article summarises the key takeaways from the June consultation document, and our view on what these changes mean for fund managers.

Key summary

Starting in April 2026, a revised tax regime for carried interest will be introduced. Fund managers will need to consider three key changes:

- **Increased tax rate for carried interest**: in April 2025, the capital gains tax rate on carried interest increased by 4%, from 28% to 32%. From April 2026, a new ring-fenced income tax regime for carried interest will be introduced. Under this regime, all ‘qualifying carried interest’ will be treated as trading profits and subject to a ‘flat tax rate’ of (up to) 34.075%, including national insurance contributions (**NICs**) irrespective of the nature of the return.
- **Expansion of the Income Based Carried Interest (IBCI) test**: the employment related securities exclusion is to be abolished, and funds will now be required to hold their assets for at least 40 months, using the weighted average investment-holding period, in order for the carry to be subject to the flat tax rate of 34.075%. If this condition is not met, the carry can be taxed partially or entirely at the ordinary tax rate on trading profits, of up to 47%.
- **Territorial scope of the revised regime**: carry holders who spend time working in the UK may be subject to UK taxation on their carry even after leaving the UK, on the basis that the carry is treated as profits of a UK trade. This raises concerns of double taxation.

Next steps

The publication of the June 2025 response and policy proposal marks the latest step in reform of UK carried interest. In our recent discussions with HMRC and HM Treasury, they confirmed that draft legislation is anticipated to be published in mid to late July. This will form part of the next stage of the consultation process that will conclude in mid to late September. The final legislation will be included in the Finance Act 2026. Additionally, HMRC has indicated that HMRC Guidance on the new carry regime will be published on or around 6 April 2026.

Proposals that are to be dropped

Following recommendations from key stakeholders, including DLA Piper (see link), the government confirmed that the following two proposals will now be **dropped**:

- **Minimum co-investment condition:** initially proposed by the UK Chancellor, Rachel Reeves, last year, this condition was intended to be a part of the new regime. However, the consultation document acknowledged that introducing a minimum co-investment condition would make the UK regime "*less competitive*" compared to other jurisdictions, and would lead to "*unintended and/or distortive outcomes*".
- **Minimum holding period for carried interest rights:** the consultation document accepted that the IBCI test at fund level is sufficient and with respect to a second minimum holding period at carry level, "*the complexity associated with a minimum time period requirement would not be proportionate*".

The above aligns with comments made by DLA Piper in its submissions to HMRC.

Expansion of the IBCI rules

Under current rules, to benefit from the lower carry tax rates the carry must not be considered IBCI, an anti-avoidance test. Carry that falls within the IBCI test is subject to tax at the (highest) rate of 47%, including Class 4 NICs as trading income. Broadly, to ensure that the carry is not IBCI, the fund must hold its assets for at least 40 months, using the weighted average investment-holding period. While a proportion of the carry will fall outside the IBCI test if assets are held between 36 and 40 months, there are also special rules for each asset class and additional restrictions that apply to credit funds.

Until now, there has been an exemption from the IBCI test for carry holders who are employees of the Sponsor, with their carry rights considered as employment related securities (**ERS**). This has been known as the 'ERS exclusion'. Pursuant to the amended carry rules, the ERS exclusion is to be abolished without any grandfathering provisions.

This change will compel many, if not most, fund managers to consider the application of the IBCI rules from April 2026. With carried interest now being taxed as income, the IBCI test will be renamed the Asset-Level Average Holding Period (**AHP**) condition. However, for simplicity and continuity, we will continue to refer to the IBCI test in this article, as it has been historically known.

Other proposed changes to the IBCI rules include:

- **Credit funds**: currently, the rules for credit funds treat carried interest arising from a direct lending fund as automatically failing the IBCI condition unless the fund makes 'qualifying loans' which satisfy a number of conditions, including direct loans with a term of at least four years. Under the new proposals, credit funds will be closely aligned with other asset classes and will have a shorter 40-month holding period for debt assets, with amended T1/T2 rules to account for loan term extensions, early repayments, restructurings, and an expansion of the 'loan to own' provisions. HMRC has verbally confirmed that the definition of a 'credit fund' will also be expanded and will draw on existing provisions in the UK tax code, including the loan relationships rules, to define the meaning of debt investments for tax purposes.
- **Fund of funds and secondary funds**: the current rules will be amalgamated into a single set of provisions that better reflect commercial practice. The mechanics of the T1/T2 rules will be streamlined to ensure they are more straightforward to apply, and HMRC has verbally confirmed that they will look to simplify the definition of a 'qualifying investment' for this asset class.
- **Expanding the scope of the unwanted short term investment exclusion**: this will capture a broader range of commercial scenarios, including in relation to loan syndications and bundle of assets acquired by secondary funds.
- **Addressing various other technical issues**: these include the application of the scheme director condition for venture capital and significant equity stake funds and the treatment of tax distributions to carry holders. Additionally, HMRC has verbally confirmed their intention to amend the definition of a significant interest in land as it applies in a non-UK context.

While the above changes are welcome, particularly as they apply to credit funds, they amount to tweaking the IBCI test rather than a comprehensive overhaul. Subject to the aforementioned changes, the existing key provisions of the test will largely remain in place.

Territorial scope

In line with the October 2024 consultation document, the government has confirmed that, starting from April 2026, carried interest will be treated as profits of a deemed trade carried out in the UK. This applies to the extent that the relevant investment management services are performed in the UK.

Consequently, non-UK residents will be subject to UK 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.

Under the current tax rules (assuming the Disguised Investment Management Fee (DIMF) rules do not apply), a UK carry holder who ceases to be UK tax resident is generally not subject to UK tax on carry subsequently earned. However, under the new rules, since carry earned is considered profits of a UK trade, a portion of the carry would be subject to UK tax even after the individual has ceased to be UK resident at the time carry distributions are subsequently received.

The June consultation document explains that the government's proposal is based on an important policy shift: "*In particular, the government is not willing to maintain a position in which a fund manager can spend many years working in the UK, only to become non-resident shortly prior to receiving carried interest and thereby not be subject to UK tax on the reward*."

As discussed in a previous DLA Piper article (link), this means that non-UK residents could become subject to UK taxation and may need to rely on the UK's network of double taxation (**DTT**) agreements to avoid being taxed in two jurisdictions on the same carry. In practice, the risk is that the relevant DTT would not provide protection. The UK would treat carried interest as profits of a trade (and would have taxing rights under the Business Article), whereas most overseas countries would treat carried interest on gains as capital gains (and would have taxing rights under the Capital Gains Article).

This concern is acknowledged in the June consultation document: "*The government recognises, however, that there may be uncertainties relating to other jurisdictions' approach to the application of DTAs, in particular in cases where carried interest is treated as an investment return under another jurisdiction's domestic law. Although there are established mechanisms to resolve international tax disputes, the government acknowledges that the potential need to rely on such processes creates uncertainty, which in turn risks discouraging fund managers from choosing to work in the UK*."

In practice, a DTT will likely provide some relief by requiring the individual to have a UK permanent establishment (**PE**) before being subject to UK tax on carried interest. However, the risk of double taxation remains a real concern.

In recognition of this "uncertainty", the government plans to introduce three statutory limitations on the territorial scope of the revised regime. Importantly, these limitations will only apply to 'qualifying carried interest', i.e. carried interest that benefits from the c.34% tax rate. Carry that is classified as IBCI will not benefit from these statutory limitations.

The three statutory limitations that apply to 'qualifying carried interest' are as follows:

- services performed in the UK prior to 30 October 2024 will be treated as if they were non-UK services.
- if an individual is (i) not UK resident, and (ii) spends fewer than 60 workdays in the UK during the relevant tax year, any UK services performed in that tax year will be treated as non-UK services; and
- any UK services performed in a tax year will be treated as non-UK services provided three full tax years (in addition to the current tax year) have passed without the individual being UK resident or spending 60 or more workdays in the UK.

As such, an individual will only come into scope of being subject to tax on carry, to the extent that:

- services were performed in the UK in a tax year (after 30 October 2024) in which the individual was UK tax resident or met the UK 60 workday threshold in that tax year;
- UK services were performed within the previous three tax years; and
- where there is a relevant DTT between the UK and another jurisdiction, the UK services are attributable to a UK PE of the relevant individual.

Where an individual does fall within the scope of UK taxation, a time-based apportionment system will be used to determine the amount of carry that is subject to UK tax.

Miscellaneous

The June consultation document confirms that the government does not plan to exempt carried interest recipients from the payments on account rules. This means that taxpayers who have declared carried interest on a self-assessment tax return may need to pay tax in advance for the following year.

Payments on account are calculated by reference to a person's total income tax (and Class 4 NICs) liability for the previous tax year. Under the revised regime, income tax (and Class 4 NICs) paid in the previous year on carried interest will be relevant to the calculation of any payments on account due. While the consultation acknowledges that carried interest receipts can be "irregular and unpredictable" in nature, it notes that the same is true of other forms of trading profit. There is also a mechanism under the payments on account rules for taxpayers to claim a reduction or cancellation of payments on account to avoid overpayments of tax.

The government has also clarified that ERS charges, taxed at a higher rate, will take priority over the new carried interest tax regime. This is particularly relevant in cases where employees have not signed a s.431 joint election when a carry right was granted, resulting in an ERS charge when the carry is distributed.

Conclusion

The government's decision to drop both the minimum co-investment condition and the minimum holding period for carried interest rights is welcome news, reflecting industry concerns. Additionally, the UK government has acknowledged the potential for double taxation related to the territorial nexus of the new regime and has sought to limit its applicability with three statutory limitations. Amendments to the IBCI rules, particularly concerning credit funds, will also address some of the more unfair aspects of the test.

However, significant changes are on the horizon. Fund managers need to start preparing by collecting information on their new and existing funds to ensure compliance with the IBCI rules. Implementing this new reporting regime will require both time and financial resources. For smaller fund managers, where the compliance hurdle is higher and the amount of anticipated carry is less certain, the additional effort may not be worth it.

They may instead opt for alternative structures, such as employment bonus schemes or synthetic carry plans (although employer NICs at 15% may make these alternatives less attractive). On the other hand, mid-market and larger fund managers are likely to view the compliance burden as another reporting challenge, but one that is ultimately worth the time burden and cost (especially if costs can be borne by the investors as a fund cost).

Regarding the new territorial nexus, taxing fund managers for a portion of their carry once they leave the UK, represents a major policy shift. Given the increasing strain on government budgets, it is perhaps understandable that the government seeks to ensure that carry holders do not avoid paying tax by leaving the UK prior to receiving their carry. However, questions may arise as to why equivalent protections are not in place for individuals selling investment properties or businesses (there is no exit tax for individuals).

Moreover, taxing fund managers even after they have left the UK may prompt those who were considering leaving the UK to expedite their departure. Additionally, this policy could deter fund managers based in other jurisdictions, such as the US or other European countries, from spending time in the UK office, as they would not want to be subject to UK tax on carry once they return to their home jurisdiction. This risk could lead to a decline in London's pre-eminence compared to other European financial hubs like Paris and Frankfurt.

Overall, while the government's responsiveness to industry concerns is commendable, the impending changes will necessitate careful planning and adaptation by fund managers to navigate the new landscape.

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