ICAEW
REPRESENTATION 11/25

THE TAX TREATMENT OF CARRIED INTEREST: CONSULTATION ON QUALIFYING CONDITIONS (FROM 6 APRIL 2026))

Issued 30 January 2025

ICAEW welcomes the opportunity to comment on the tax treatment of carried interest: consultation on qualifying conditions from 6 April 2026 published by HM Treasury on 30 October 2024, a copy of which is available from this link.

ICAEW considers that there is no need for a minimum co-investment requirement for tax purposes. This is because, for most funds, investors already require the fund managers to co-invest.

For the minimum holding period option, the income-based carried interest rules already tax carried interest as income where the fund's average holding period of its investments is less than 40 months. A minimum holding period for individual fund managers would add an additional layer of complexity and would have an impact on their job mobility.

ICAEW considers that grandfathering provisions are required for existing carried interest entitlements because the level of co-investment and carried interest entitlements are governed by the partnership deed agreed at a fund's inception and cannot be changed.

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This response of 30 January 2025 has been prepared by the ICAEW Tax Faculty with input from the ICAEW Corporate Finance Faculty.

Internationally recognised as a source of expertise, the ICAEW Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business. ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark the tax system and changes to it, are summarised in Appendix 1.

The Corporate Finance Faculty is ICAEW's centre of professional expertise in corporate finance. It contributes to policy development and responds to consultations by international organisations, governments, regulators and other professional bodies. It provides a wide range of services, information, guidance, events and media to its members, including its highly regarded magazine Corporate Financier and its popular series of best-practice guidelines. The faculty's international network includes member organisations and individuals from major professional services groups, specialist advisory firms, companies, banks and alternative lenders, private equity, venture capital, law firms, brokers, consultants, policy-makers and academic experts. More than 40 per cent of the faculty's membership are from beyond ICAEW. ICAEW has supported, and the faculty and its members have been key contributors to, *Private Equity Demystified: An explanatory guide* by John Gilligan and Mike Wright, since it was first published in 2007. The commentary and in-depth explanations are supported by findings of peer-reviewed academic studies and the book has featured on reading lists of leading universities and business schools. The latest edition explains how fund performance is measured and how contracts between institutional investors and private equity firms are structured. We would be happy to send a copy of the book to the carried interest team(s) at HM Treasury and HMRC.

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KEY POINTS

1. ICAEW acknowledges the government's aims of a fair taxation system for carried interest, while recognising the UK's strength as an asset management hub. ICAEW agrees that there should be conditions that permit carried interest receipts to be classed as 'qualifying carried interest' in order to benefit from the 72.5% multiplier. Those conditions should be based on the unique long-term and risky nature of private equity (PE) investments and returns.

Minimum co-investment

2. ICAEW considers that it is unnecessary to have a minimum co-investment requirement for carried interest to be treated as 'qualifying carried interest' from 6 April 2026. In most structures, external investors (the limited partners (LPs)) already require investment managers (as the general partner (GP)) to co-invest in the funds they manage. Investors want fund managers to have 'skin in the game' (ie, to have a vested interest in the performance of the fund). The level of co-investment, which we understand is typically between 1% and 3%, is the subject of hard-fought commercial negotiations. It therefore seems unnecessary to have corresponding conditions for tax purposes that might artificially distort the nature of those negotiations. Moreover, while the larger, well-established funds may be able to meet the conditions, other funds (eg, emerging, venture, growth and regional) may not, thus resulting in an unlevel playing field.
3. Furthermore, any test that considers co-investment by individual fund managers would be: a) impractical to track in some structures; b) prejudicial to those from less well-off socio-economic backgrounds who do not have large financial resources to commit long-term, thus limiting diversity among PE workers; and c) more risky for those at earlier stages of their career and without personal wealth.

Minimum holding period

4. In terms of a minimum holding period, funds with European-style 'whole fund' carried interest entitlements do not expect to receive carried interest for some years and recognise that any earlier receipts would be unusual, although not impossible if the underlying investments were performing well or exited more quickly than expected. We are aware of ICAEW members in private equity who, by year eight, had not received carried interest. In comparison, in US-style deal-by-deal funds, the carry entitlements arise much earlier. The income-based carried interest (IBCI) rules already consider the average period that a fund holds its investments and, if that is less than 36 months, the carried interest is wholly taxable as income tax, with pro-rating between income tax and capital gains tax (CGT) for periods of less than 40 months. ICAEW considers it important that fund managers can dispose of their investments at the right time for both the investee business and the investors, and that tax considerations over and above the IBCI rules should not delay deals from being done at a time agreed between those parties.
5. Any conditions that are introduced, particularly relating to a minimum holding period, should consider those who join or leave PE funds part way through the fund's life. For example, the test should take into account the fund's lifespan, rather than just the length of service of the individual.

Other considerations

6. ICAEW considers that transitional provisions should be introduced. PE funds cannot make additional co-investments in funds that may have closed to new investors, say, 10 years ago, in order to meet any new co-investment test. One possibility is to have a grandfathering provision where the minimum co-investment could be set at x% for existing funds and set at a higher percentage for new funds.
7. Those working in PE may also be non-UK domiciled and will also be affected by the abolition of the remittance basis of taxation and the proposed £1m cap from April 2026 on business property relief (BPR) for inheritance tax (IHT). PE and venture capital funds make a valuable contribution to the UK economy by investing in businesses they can grow, both in terms of profitability and job creation. ICAEW urges the government to ensure that any changes are

not detrimental to the UK's economic competitiveness and its attractiveness as a place to live and work and invest in the PE sector. We understand that these changes, along with the uncertainty over what their tax treatment will be, has already led to people leaving the UK and overseas workers postponing their arrival in the UK. A key principle of a good tax system is that taxpayers need certainty – see tenet two in Appendix 1.

BACKGROUND TO CARRIED INTEREST AND THE TAXATION THEREOF

8. PE, venture and growth capital funds have a positive impact on the UK economy, job creation and productivity – they take businesses where the existing shareholders might be running the business on a 'care and maintenance basis' ahead of their retirement and fund the next tier of management to grow it. Smaller funds make deals that larger funds won't and are often the first institutional investors into multi-generational family businesses and into businesses that require support to scale up. In its green paper, *Invest 2035: The UK's Modern Industrial Strategy*, the government recognised the need to target support at scale-up industries and address the challenges faced by businesses that need finance to scale up
9. Funds are usually structured as limited partnerships, with the fund manager acting and investing as the GP and the external investors becoming the LPs.
10. There is no guarantee that carried interest will be paid, as not all funds make sufficient profits to pay carried interest. This is because other payments must be made first and in a set order (sometimes known as a 'waterfall'), as stated in the limited partnership agreement, such as:
    - the management fee (around 2% of the funds that the external investors have committed to provide) which is paid to the GP;
    - the repayment of loans used to acquire investments;
    - the 'preferred return' (or 'hurdle rate') to external investors (the LPs) of say 8% to 10% of the amounts they have loaned;
    - the 'catch up' phase in some agreements, which is where the carried interest holders receive 100% of distributions until they have received 25% of the investor's preferred return.
11. Only then is the remaining 'super-profit' (or carried interest) shared between the external investors, who typically get an 80% share, with the other 20% going to the PE firm and its employees or partners. In its 2024 submission to HMRC, the industry body, the British Private Equity & Venture Capital Association (the BVCA), noted only around 50% of private capital funds achieve sufficient returns to pay caried interest.
12. The current tax treatment of carried interest is based on a Memorandum of Understanding between the then Inland Revenue and the BVCA. This is supplemented by several other measures:
    - The 2015 carried interest CGT rules aimed to create a CGT liability on the full amount of carried interest receivable, essentially by limiting the recipient's CGT base cost under the rules for partnerships to the amount they paid for their carried interest entitlement. The disguised investment management fee rules (DIMF) rules were also introduced to tax fees for investment management services that are not linked to the performance of the fund as income rather than capital receipts.
    - The 2016 IBCI rules ensure that shorter term receipts of carried interest (receivable up to 40 months) are liable to income tax, as if they were DIMF, rather than to CGT. The 2015 and 2016 rules were designed in consultation with the PE industry.
    - The employment-related securities rules.
    - The offshore funds rules.

BACKGROUND TO THE CURRENT CONSULTATION

13. On 29 July 2024, the Chancellor of the Exchequer announced that action would be taken in respect of the 'carried interest loophole'. A call for evidence was published and feedback was requested on the following three areas:
    - **Question 1: How can the tax treatment of carried interest most appropriately reflect its economic characteristics?** The government notes that there are a range of circumstances in which carried interest is received, and that the characteristics of the reward will not be the same in all cases.
    - **Question 2: What are the different structures and market practices with respect to carried interest?** The government is particularly interested to understand how these differences should be taken into account as part of its reforms.
    - Question 3: Are there lessons that can be learned from approaches taken in other countries? While many other countries have specific regimes for the taxation of carried interest, their detail and conditions for access vary.
14. ICAEW responded to the call for evidence on 30 August 2024 (ICAEW REP 064/24) and our submission provided further background on the taxation of PE funds.
15. At the Autumn Budget on 30 October 2024, the Chancellor announced that:
    1. the existing rates of CGT on carried interest of 18% (where the gain falls within the basic rate tax band) and 28% (for higher rate taxpayers) would be increased to a single rate of 32% from 6 April 2025.
    2. From 6 April 2026, carried interest will be brought wholly within the income tax regime. It will be taxable as profits from a trade, liable to income tax and class 4 national insurance contributions (NIC). To reflect the 'unique characteristics', only 72.5% of carried interest that is classed as 'qualifying carried interest' will be taxable in this way.
    3. The IBCI rules would be amended to include employment-related securities.
16. On 30 October 2024, HM Treasury also published a summary of the responses to the call for evidence (chapter 2), outlined the proposed changes listed above (chapter 3) and launched the consultation on the criteria for carried interest to be 'qualifying carried interest' (chapter 4). The consultation on 'qualifying carried interest' is focused on whether there should be a minimum co-investment requirement and/or a minimum period between carried interest being awarded to the fund manager and its receipt.

ANSWERS TO SPECIFIC QUESTIONS

THE MINIMUM CO-INVESTMENT

Question 1: Recognising the challenges in this area, how might any team-level co-investment requirement be most successfully constructed?

17. ICAEW does not support a co-investment requirement at the individual level. To do so could deny opportunities for advancement to those from less wealthy backgrounds and to those at early stages of their careers.
18. In some structures, for example those with a 'house fund' where the management team's resources are pooled, ICAEW has been advised that it would be almost impossible to track how one individual's contribution has been used at any given point.
19. In most structures, a level of co-investment by the investment fund managers (the GP) is already required by external investors (the LPs), so that the managers have a vested interest in the fund's performance (skin in the game). The level of co-investment is the subject of hard-fought commercial negotiations, so ICAEW questions whether there is any need for a separate minimum co-investment requirement for tax purposes. Carried interest is not necessarily based on the level of co-investment.

20. ICAEW considers that any legislation relating to co-investment should:
    - take into account the size of the fund, as the amounts that a fund's management team can personally or collectively contribute does not scale up when a fund gets larger. We note that smaller funds are not necessarily run by smaller teams;
    - define what a 'team' is;
    - capture all the different points that the funds from the management team come into the structure (eg, house funds, subsidiary of a corporate fund);
    - factor in the investment manager's co-investment in underlying assets (eg, they may acquire a share in the trading premises used by the target business);
    - recognise that many VC funds do not have a co-investment requirement, so a universal co-investment requirement could damage smaller or early-stage funds;
    - be clear on the date that any co-investment needs to be made by to count. For example, is it based on the date of the capital commitment, or the date the funds are called upon (eg, ahead of an investment in a target business)?
    - consider if any exemptions should be made for new PE, venture and growth capital funds, particularly for the first fund they launch. It may take new firms several years to get FCA approvals, etc, in place before they can start raising funds. During that time, the personal resources of the fund's management team will have been depleted and the LPs recognise that they may not be able to meet a large minimum co-invest requirement. Funds with a broader agenda, including social impact and diversity within the organisation would also be disproportionately affected.

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?

21. It would be difficult for any new regulations to encompass the number of different structures that exist to satisfy different investor's requirements (eg, individual, local government, pension funds, corporate). There is also the geographical reach of the fund, the fund's regional, UK-wide or multinational focus and the types of carry (bonus carries, shadow/phantom carries) that have developed over time.
22. The feedback that ICAEW received from the firms who assisted with this response is that those who are most able to meet a minimum co-invest condition are likely already satisfying it and are the ones who don't need preferential tax treatment.
23. Funds may have been established up 10 to 12 years ago and the investment managers made their co-investments based on market demands and tax legislation at that time. PE firms can't make additional co-investments retrospectively in existing funds. A lack of transitional rules seems unfair.
24. One possibility for a grandfathering provision would be to have a minimum co-invest, of say x%, for funds who have already closed to new investors, and a minimum, say y%, for new funds going forwards.

THE MINIMUM HOLDING PERIOD

Question 3: How might the length of any new time-based condition best be designed to reflect the nature of carried interest rewards?

25. The mid-tier UK based PE funds with European 'whole fund' carry that we spoke to advised that it was unusual for them to become entitled to any carry within five years. Indeed, some ICAEW members reported that they had not received carried interest by year eight. Shorter holding periods are more of an issue for funds with 'US-style' deal-by-deal carry entitlements.
26. The UK already has the IBCI rules, which are complicated, that charge the full amount of carried interest to income tax where the average holding period of the fund's investments is less than 36 months, with a tapered charge to income tax where that period is at least 36

months but less than 40 months. A conditional exemption (s809FZS, ITA 2007) can be claimed for carried interest that arises in the four years from when a fund starts to invest, because the average holding period is only known when the fund ends. ICAEW considers that expanding this legislation would add even more complexity and contradicts the stated aim of simplicity at para 3.6 of this consultation document.

27. When recruiting, smaller funds need to be able to offer competitive packages to attract talent, otherwise they lose out to the bigger funds.

28. Institutions can control their exit activity, so they can block an exit until they have met any minimum holding period. Fund managers need to be able to make the best commercial decisions for their funds and for the underlying businesses they have invested in (ie, when is the right time to sell/float) and their decisions should not be unduly influenced by tax-related concerns (that might delay a sale). PE firms and investors often reinvest the profits from one fund into their new fund. If exits were delayed any reinvestments into other businesses via the new fund would also be delayed, thus depriving those businesses of the funding they need to grow.

29. How would those who join a fund part-way through (say two years in) be dealt with if there is, say, a five-year minimum holding period? Could the test be based on fund's life, rather than the individual's length of service? As it stands, those individuals would still be outside the IBCI 36- and 40-month rules because those are based on the average period that the fund holds its investments.

30. If a minimum holding period is introduced in addition to the IBCI rules, we understand that the UK would be the only country to have two time-based measures for carried interest. This would put the UK at a competitive disadvantage globally.

31. For whole fund/EU-style carries, would all of an individual's carry receipts be 'non-qualifying carried interest' if there was a small or unanticipated carry entitlement before the end of the minimum holding period? Would it be pro-rated for later sums?

32. Overall, if the government considers that at least one of the proposed tests is necessary, ICAEW's preference would be for a minimum holding period. A lot of structures used by the private equity funds, especially ones with overseas/multi-national focus, may find it difficult to fit into a simple co-invest definition.

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?

33. When the proposed changes to the taxation of carried interest are viewed in conjunction with the changes to the taxation of non-UK domiciled individuals, particularly the complexity of the four-year income and gains regime, PE funds are concerned about how they will incentivise staff to come to the UK. Anecdotally, we understand that there are workers who have already deferred coming to the UK until there is certainty on what these rules will be. We are concerned that the lack of transitional provisions will also accelerate departures from the UK.

34. In addition, the loss of BPR for IHT will make the UK less attractive for overseas investors. People who have no connection to the UK and no equivalent to IHT in their home jurisdiction will find themselves liable to UK tax because their shareholdings or partnership interests are treated as UK situs assets.

35. ICAEW considers that there should be provisions for those joining or leaving funds, and for those coming to or leaving the UK (ie, equivalent of split year treatment).

OTHER UNINTENDED CONSEQUENCES

36. Fund managers may charge higher management fees (say 2.5% to 3% compared to the current norm of around 2%) to retain the same after-tax income. Higher fees would mean that there are less funds to invest in growing businesses and consequently lower profits available to the external investors (the LPs) – including pension funds and local authorities.

The 2023 Mansion House reforms challenged pension funds to invest more in UK unlisted equities and the potential for higher management fees may deter this.

37. ICAEW has concerns that the potential proposed changes could result in more junior team members not being able to participate in carried interest arrangements, while senior team members would hold more carried interest in future funds and benefit from the multiplier.

OTHER ISSUES

38. Currently, carried interest is taxed according to the nature of the relevant amount coming up from the underlying fund/ its assets. To the extent that interest income flows up, it is taxed as interest income; under the proposed regime all amounts will be taxed as deemed trading income liable to income tax and class 4 NIC. ICAEW welcomes the simplification of the rules, meaning there will no longer be the need to undertake onerous work to trace the source of carried interest (ie, interest, dividends, rental income, capital gain, etc), although this will still be required to calculate taxable returns on co-investment.
39. ICAEW notes that it is not the government’s intention to disadvantage credit funds. There are other types of funds that are not currently covered by the IBCI rules, such as retail funds or multi-strategy funds. Does the government intend to bring these into the IBCI rules and, if so, on what terms?

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see https://goo.gl/x6UjJ5).