

ALERTS

UK Taxation of Carried Interest – Request for Input

January 14, 2025

In our Autumn Budget Statement 2024 webinar on 5th November^[1], we discussed the government's proposals for a revised regime for the taxation of carried interest in the UK, to be introduced with effect from April 2026. HM Treasury is now undertaking a technical consultation on the proposed regime, which focuses on how the line should be drawn between carried interest, which is income-based carried interest ("IBCI"), and 'qualifying' carried interest, which is non-IBCI.^[2]

Currently, the distinction between IBCI and non-IBCI is based on a test that looks at the weighted average holding period of the assets in the fund (the 36/40 month test). **The government intends that this average asset holding period test should remain in place.**^[3] However, the consultation asks for views on whether there is a case for further conditions, which would need to be satisfied in order for carried interest to be non-IBCI. The two conditions proposed^[4] are:

1. A minimum co-investment requirement; and
2. A minimum time period between a carried interest award and the receipt of carried interest.

Schulte intends to submit a written response to the government's consultation. In order that the views, insights and experience of our clients are accurately and fully represented, we invite you to share any contributions you may wish to make as we formulate our formal response. This can be on an anonymous or attributed basis. You can send your views by email, or if you prefer, please do not hesitate to call us. The

closing date by which responses to the consultation must be submitted is 31 January 2025 and accordingly we would ask for your input by no later than 5pm GMT on 28 January 2025. We have set out below further details of the proposed conditions and the questions raised in the consultation.

The aggregate minimum co-investment condition

The proposal is that ‘qualifying’ non-IBCI treatment will only be available where the fund management team makes a minimum level of co-investment in the fund, so that fund managers are exposed to a material amount of risk in connection with the funds which they manage. Other jurisdictions typically apply a similar test by requiring the management team to co-invest a percentage of the total investor commitments. The government is not proposing an individual-by-individual co-investment requirement, recognizing that this would be difficult to implement in a way which is proportionate and fair, and would adversely impact those individual fund managers less able to raise the upfront capital to meet a minimum co-investment condition – in particular, more junior fund managers or new entrants to the market.

The consultation also recognises that there are a number of practical challenges with implementing a minimum co-investment requirement (even on a team basis), such as the definitional challenge of identifying the “fund” in complex structures that might involve a range of different feeder, parallel and aggregator vehicles, and the difficulty of selecting an appropriate level for a universal minimum co-investment condition where an appropriate and feasible level of co-investment is likely to differ across different investment strategies. It is perhaps reasonable to say that a team minimum co-investment condition is currently not the government’s favoured option.

Nevertheless, the questions on which the consultation welcomes representations are as follows (and we have glossed some of these with our own amplifications of the government’s questions):

1. How to define the “fund” for the purposes of any new condition? -

Given the difficulties where there are complex fund structures as described above;

2. The minimum level(s) of [team] co-investment that should be required? – For example, should this be 1% of total investor

commitments? Or 5%? Is there already a market requirement for “skin

in the game” which requires a minimum level of co-investment from the management team? What level of such market-obligated co-investment is typical?

3. What types of co-investment arrangements should count for the purpose of meeting the condition?

4. The time period during which the condition must be satisfied? – Is this for the life of the fund?

5. Is there a need for transitional arrangements for existing funds?

The government also welcomes representations on any further risks or wider considerations that should be highlighted in this context.

Minimum holding period for carried interest rights

The government’s proposal is that there should be a minimum period between the grant of carried interest rights to an individual and the actual receipt of carried interest by that individual. This would be in addition to the average fund asset holding period which currently identifies IBCI and ‘qualifying’ non-IBCI (the 36/40 month test) which will remain in place. In contrast to any team-level minimum co-investment condition, a carried interest minimum holding period requirement would be assessed at the level of the individual fund manager.

The consultation identifies that the fact that fund managers must generally wait a considerable period of time before receiving carried interest is one of the factors that gives carried interest its unique economic characteristics (and justifies it being more favourably taxed than other forms of performance related remuneration, such as employee bonuses). Accordingly, the government is seeking views on the merits and design of a minimum holding period condition. The specific questions on which views are sought (again, along with the gloss of our amplifications) are:

1. How might the length of any new time-based condition best be designed to reflect the nature of carried interest rewards? – Is there already a period between grant and receipt that is required for management teams? Seven years is often cited as an average period – is this true for you, or could it be less? Are you aware that the typical

period is more or less depending on the investment strategy followed for the fund?

Separately, are there difficulties involved in applying a minimum time-based condition to certain individuals such as new joiners? Or individual managers who pick-up carried interest from leavers who have forfeited their carried interest (and so might not hold this newly-acquired carried interest for the required minimum period)?

- 1. 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 [minimum holding period] condition of this kind?** – *The government's current view is that transitional rules for existing funds are not needed. But if you are aware of existing specific fact patterns to consider as part of any final determination, which would mean that transitional rules would be needed to ensure a fair result, we should make the government aware of them.*

Your contributions

The consultation closes on 31 January 2025, so we would need to hear from you by 28 January 2025 in order to include your contributions in our response and make sure that all important views are represented. Please do not feel the need to respond on all aspects of the consultation – your views on the particular aspects that are most relevant and important to you in the actual context of your management business are very welcome. We look forward to hearing from you.

Authored by *Nick Fagge* (+44 (0) 20 7081 8009) and *Dan Roman* (+44 (0) 20 7081 8033).

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] The recording of the webinar is still available here.

[2] Broadly, with effect from April 2026, all carried interest (IBCI and 'qualifying' non-IBCI) will be taxed as trading profits and so be subject to 45% income tax and 2% Class 4 NICs, but 'qualifying' carried interest that is non-IBCI will attract a 72.5% multiplier, reducing the overall effective

rate of income tax and NICs on such 'qualifying' non-IBCI carried interest to 34.075%.

[3] The government has also announced that the current "ERS exclusion", under which carried interest that arises in respect of an employment-related security is automatically not IBCI, will be removed. Consequently, all carried interest will in the future need to meet the 36/40 month test in order to be regarded as 'qualifying' non-IBCI.

[4] The consultation document indicates that the government may adopt both, or either one, of the two proposed conditions.

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Fagge**
Partner
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Roman**
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