



GREAT FUND INSIGHTS

UK carried interest reform – *Practical insights for funds and fund managers*

Speed read

From April 2026, all UK carried interest will be taxed as trading income rather than under the current capital gains tax regime, and therefore subject to income tax and national insurance contributions (NICs). “Qualifying” carry (broadly, carry from funds meeting minimum average holding period (AHP) requirements) will benefit from an effective top rate of 34.1%. Non-qualifying carry will be taxed at full income tax and Class 4 NICs rates (an effective rate of up to 47%).

Looking beyond the increase in the tax rate, which had historically been 28% under the capital gains regime, in this article we provide some insight into what opportunities and practical implications the regime change may have for funds and fund managers:

- **Simplification opportunity:** The shift to a single income tax regime removes the need to analyse whether underlying returns are capital or income in nature. Fund managers may see this as an opportunity to simplify historically complex carry structures that were required to achieve capital treatment. However, the AHP rules themselves remain an area of complexity requiring close attention.
- **Potential misalignment of interests:** The lower tax rate depends on meeting minimum holding periods, potentially giving rise to a paradoxical incentive for fund managers to hold investments longer than is optimal for the fund and its investors, where an attractive early exit opportunity arises.
- **Credit funds stand to benefit:** Targeted amendments to the AHP rules, together with the removal of the capital or income source payment distinction, should make it easier for credit funds to qualify, including removal of restrictions on direct lending funds, better treatment of debt drawdowns and early prepayments, and more flexible rules for unwanted short-term investments.
- **Non-UK residents face new compliance burdens:** The territorial scope provisions mean that non-UK resident carry holders may need to track UK workdays carefully and assess whether funds meet AHP requirements before travelling to the UK. A 60 UK workday threshold provides some relief, but only for carry that is expected to be qualifying at the time of the first UK workday.



Overview

Carried interest is a share of the fund's profits that is paid to investment managers as a form of performance-related return, typically arising as a percentage of the returns available for distribution once the ordinary investors have received returns above an agreed hurdle.

Since the origins of the private equity industry in the UK in the 1980s and 1990s, the structuring of carried interest was focused on seeking to ensure that the returns fell to be treated as capital gains in the hands of the individual carry participants, as this gave rise to lower tax rates. For many years, the applicable tax rate had been 28%, increasing to 32% in 2025.

Under the outgoing regime, all carry-related payments received by UK residents (including payments of an income nature) are subject to a minimum level of capital gains tax at this rate. However, where a carried interest payment is made up of a mixture of underlying income and capital components, each component of the return is to be dealt with separately. Any income component will retain its income character (and will be subject to tax at a top rate of 45% in England and Wales).

In addition, even where the underlying source of the payment is capital in nature, there are certain tax regimes that can result in carried interest being taxed as income, including the income-based carried interest (IBCI) rules and the disguised investment management fees (DIMF) rules.

However, significant changes to the tax treatment of carried interest in the UK are expected to come into effect imminently. The UK Government first announced these changes in its Autumn Budget on October 31, 2024, and draft legislation for the broader changes previously announced was published on July 21, 2025. If this legislation is introduced, then, from April 2026, all carried interest payments will be treated as trading profits and subject to UK income tax and Class 4 National Insurance Contributions (NICs). "Qualifying" carried interest will be adjusted by applying a 72.5% multiplier on the applicable rate of income tax, which would result in an effective top rate of tax of 34.1%.

Given that the more favourable rate of income tax will only be available for "qualifying" carry, ensuring that funds meet the conditions for carry to be treated as "qualifying" is already a key focus for new funds.

Carried interest will be "qualifying" where it satisfies the average holding period (AHP) requirements. Broadly speaking, the AHP requirements are intended to ensure that "qualifying" carried interest treatment is limited to long-term rewards by requiring a minimum average holding period for the fund's assets. If the fund's relevant investments are held for at least 40 months based on the weighted average investment holding period calculation, then 100% of the carried interest from that fund should be treated as qualifying. If relevant investments are held on average for less than 36 months, then none should be treated as qualifying. If they are held on average for between 36 and 40 months, then a proportion would be treated as qualifying.

For those familiar with the previous regime for carried interest, in effect, this is where it is not "IBCI" (i.e., income-based carried interest). Although the draft legislation now uses different terminology, many of the underlying principles for the average holding period calculation are similar to the current IBCI rules, but there are some crucial differences. The IBCI rules do not currently apply to employment-related securities, so carry holders that received their carry in connection with their employment do not need to consider them. Typically, this meant that the IBCI only needed to be considered by individuals who owned or were partners in the investment management firm.

Under the new regime, the AHP rules will apply to all carry, meaning that rules which were not previously relevant to most UK carry holders will now determine whether they benefit from the lower rate.

As with the previous IBCI regime, there are specific rules for conditionally qualifying carried interest where fund managers receive early distributions of carried interest and the fund's AHP is reasonably expected to be 100% qualifying carried interest, so that if the conditions are met then the early distribution can be taxed at the lower rate.

Insight

OPPORTUNITIES TO SIMPLIFY CARRY STRUCTURES?

While many carry holders will no doubt be disappointed with the trend of increasing tax rates on carried interest, fund managers may be looking at the new rules as an opportunity to simplify what can often be quite complex and bespoke carry arrangements. The fact that all carried interest will be taxed as trading income is arguably a more principle-based approach, removing the need to draw what can sometimes be quite nuanced distinctions between carry with an underlying source that is capital versus income in nature.

Instead of focusing on the nature of the underlying source of the payments, interested parties will be focused on ensuring that investment strategies are expected to meet minimum AHP requirements, which will now be relevant to all carry (and not just those not structured as employee-related securities). While the AHP rules remain an area of complexity, with some different rules applying depending on the type of fund involved, they are arguably more precise than the case-law-based assessment of whether a particular return is income or capital.

The UK isn't the only jurisdiction moving towards a more principle-based approach to taxation of carried interest either. Belgium has introduced a specific regime for carried interest which provides for carry to be taxed at a specific rate (25%) regardless of whether the payment is distributed by way of capital or income.

There is a further interesting dynamic worth mentioning. While minimum AHP requirements may be a more precise way of assessing whether carry ought to benefit from the lower rate of taxation (i.e., in recognition of the fact that it is part of an investment activity, without having to look at the capital vs income nature of underlying payments), it does have the potential to create a misalignment of interests. Consider a scenario where an unsolicited and lucrative offer is made to purchase a particular investment—fund managers would have a tax incentive to hold on to the investment to ensure minimum AHP requirements are met, in circumstances where it may be in the interests of the wider fund and its investors to sell it.

GOOD NEWS FOR CREDIT FUNDS

In general, the new regime is also good news for credit funds, which have typically struggled to structure the return on their carry as capital rather than income given that a large proportion of the returns from credit funds is often in the form of interest and fees, which is almost inevitably treated as income. In addition, the government intends to introduce targeted amendments to the AHP requirements as compared to the previous IBCI regime, making it easier for credit funds to meet the conditions where they are, in substance, carrying out long-term investment activities within the spirit of the regime. Some of the most notable changes affecting credit funds include:

- Removing the restriction against direct lending funds (which was previously only permitted if it fell within a narrow exemption).
- Prescribing when a debt or equity investment is to be treated as made in circumstances where it relates to an existing significant debt investment (and, in effect, allowing the holding period to be extended so that drawdowns etc. are treated as made when the significant debt investment was made), and when it is to be treated as disposed of.
- Disregarding unexpected early prepayments of debt in certain circumstances so that it can still be treated as held for 40 months.
- Changes to the rules for unwanted short-term investments (e.g., where a portion of a loan is intended to be syndicated), so that there is no requirement that the investment be disposed of within 12 months (although that must still be the intention), and removing the requirement that the investment comprise less than 25% of capital invested.

More broadly, the draft rules specifically disregard transfers between associated investment schemes (so that an investment is treated as held for the whole period in which it was held by the associated funds), and make it easier to ignore distortions otherwise caused by unwanted short-term investments.

TERRITORIAL SCOPE

It is the UK Government's position that carried interest is, in substance, a reward for the provision of investment management services and that such services performed in the UK should be taxed in the UK. Non-UK tax residents may therefore be subject to UK income tax on carried interest if they perform investment management services in relation to any fund and on any day they spend more than three hours performing those services in the UK (a "UK workday"). This is subject to the terms of any applicable double taxation agreement.

UK workdays can be ignored if, broadly speaking, an individual has fewer than 60 such UK workdays in a particular tax year. The first draft of the legislation envisaged this provision only applying in relation to "qualifying" carried interest. However, the UK Government subsequently acknowledged that this would create uncertainty for non-resident fund managers who would not, at the time of a particular visit to the UK, know whether carried interest will ultimately be qualifying. Accordingly, this threshold should now apply by reference to carried interest where it was reasonable to assume, when the first UK workday took place, that the carried interest would have been qualifying ("anticipated qualifying profits").

This approach falls short of where many had hoped the legislation would land. Even under the revised drafting, a non-UK resident individual who spends less than 60 workdays in the UK may still be subject to UK income tax on their carried interest on funds that do not and are not at the time expected to satisfy the weighted average holding period requirements, subject to the terms of an applicable double tax agreement.

Funds and non-UK managers should be aware of the practical implications of these provisions in their short-term business travel arrangements. The key practical takeaways are:

- It may be necessary to monitor and assess whether non-UK funds with non-UK carry holders meet the UK's minimum AHP requirements before such non-UK carry holders travel to the UK.
- Even where such funds are reasonably expected to meet the UK's minimum AHP requirements, non-UK resident carry holders and their employers will need to implement robust workday tracking policies and measures to ensure that the 60 UK workday thresholds are not exceeded (or, at least, that non-UK managers are aware of the potential UK tax and compliance burdens that may arise if they are).
- When tracking UK workdays, funds and non-UK managers should be aware that a day can be a UK workday for a particular tax year even if the non-UK manager has not yet been granted their carried interest —this is because the "relevant period" for a particular tax year can begin before carry is even granted (since it runs from when external investors are first admitted or when the individual starts performing investment management services, which may be before the carry is awarded), and potentially looking back to workdays since October 30, 2024 for qualifying carry purposes.

There is also an important reset mechanism: UK workdays can be ignored if an individual subsequently has three consecutive non-UK tax years (i.e., years where the individual is non-UK resident and does not breach the 60 UK workday threshold). This is an important easement for managers who relocate permanently or who have accidentally exceeded the 60 UK workday threshold early on in the life of the fund.





HMRC has expressed its view that, in determining taxing rights under an applicable double tax agreement, carried interest will fall within the scope of the business profits article. In cases where another jurisdiction treats carried interest as an investment return under its domestic law and, as a result, applies the capital gains article, the jurisdiction of residence of the non-UK carried interest recipient should provide relief from double taxation (in line with the Commentary to the OECD Model Tax Convention).

Under the majority of the UK's double tax agreements, deemed trading profits (whether qualifying or non-qualifying carried interest) must be attributable to an individual's UK permanent establishment for the UK to have taxing rights.

Whether a permanent establishment exists is a question of fact. The fact that the firm for which an individual works has its own fixed place of business is not determinative, but if the firm has UK offices to which the individual has access, this is capable of constituting a place of business at the disposal of the individual's enterprise. This will be an important point in practice, and further guidance from HMRC on this is expected.

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NEXT STEPS

The new carried interest regime represents a fundamental shift in the UK taxation of carried interest, moving from a capital gains-based approach to a trading income framework. While the effective top rate of 34.1% for qualifying carried interest remains competitive, fund managers and their advisers will need to carefully navigate the AHP requirements to ensure they benefit from the lower rate. The rules create new compliance burdens, particularly for non-UK residents who must now carefully monitor UK workdays and assess AHP requirements before undertaking activities in the UK. However, the regime also offers opportunities for simplification by removing the need to analyse whether underlying returns are capital or income in nature, and credit funds in particular should benefit from the targeted amendments to the AHP rules.



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