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REPORT

PRIVATE FUNDS TAX DEVELOPMENTS

2025 REVIEW AND 2026 PLANNING CONSIDERATIONS

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PRIVATE FUNDS TAX DEVELOPMENTS: 2025 REVIEW AND 2026 PLANNING CONSIDERATIONS

2025 was characterized by significant new legislation impacting private funds that in many respects preserved the status quo of many core features relevant to private equity, ongoing judicial activity shaping enforcement and dispute resolution of tax matters implicating private funds, and an overarching sense that tax policy will continue to be a key variable in private fund structuring and returns well into the future. Particular highlights are summarized herein.

REGULATORY TAX DEVELOPMENTS

OBBBA Tax Developments

A centerpiece of 2025 tax policy was the enactment of a sweeping budget reconciliation bill commonly known as the "One Big Beautiful Bill Act" (OBBBA), signed into law by President Donald Trump on July 4, 2025.

What Didn't Happen

In the lead up to the bill's signing, many provisions were proposed that were of concern to the private funds industry—but these provisions were largely dropped from the final bill. For example:

- Carried interest taxation is unchanged by the OBBBA.
- The OBBBA did not include any new guidance regarding management fee waivers and associated deemed capital contributions.
- The OBBBA did not include any changes regarding "workarounds" to the pass-through entity tax (PTET) regimes implemented at the state level.
- The so-called "revenge tax" under proposed Section 899[1] was not enacted.
- The OBBBA did not change capital gains rates.
- The OBBBA did not change corporate tax rates.

QSBS Changes

The OBBBA made material changes to Qualified Small Business Stock (QSBS) provisions. These changes are applicable to QSBS stock issued or acquired on or after July 4, 2025. Among such changes,

- The OBBBA increases the per-person, per-issuer eligible QSBS gain exclusion amount from $10 million (not indexed for inflation) to $15 million (indexed for inflation).
- The OBBBA allows for a 50% exclusion after three years and 75% after four years, which is addition to the existing exclusion of 100% of eligible gain after a five-year holding period.
- The OBBBA expands "qualified small business" eligibility to some extent by increasing the gross asset value cap from $50 million (not indexed for inflation) to $75 million (indexed for inflation).

[1] All Section references are to sections of the Internal Revenue Code of 1986, as amended.

Private fund managers investing in private corporations (e.g., venture funds) may want to invest more heavily in QSBS-qualifying portfolio companies to avail funds and their investors of preferential treatment on gain upon the sale of the qualifying stock. These gain exclusions would also be of benefit in qualifying circumstances for carried interest partners.

Business Interest Expense Deduction

For taxable years beginning after December 31, 2024, the OBBBA permanently restores the earnings before interest, taxes, depreciation and amortization (EBITDA)-based limitation for business interest expense under Section 163(j). This change allows deductions of up to 30% of adjusted taxable income plus business interest income, which is calculated in a manner similar to EBITDA rather than earnings before interest and taxes (EBIT) and determined without regard to subpart F and global intangible low-taxed income (now referred to as Net CFC Tested Income under OBBBA) inclusions and the associated gross-ups. The Section 163(j) limitations, however, now are applied before the interest capitalization rules are applied. As a result, interest expense that is capitalized into the basis of assets is subject to the Section 163(j) limitation and included for purposes of applying the 30% cap.

These changes may benefit private funds that utilized leveraged blockers to make investments, as they allow a potential increase in interest deductibility, thus potentially improving blocker investor returns, which are typically netted by blocker tax drag.

Qualified Business Deduction

Section 199A provides, in part, a 20% deduction for qualified business income that is available to non-corporate taxpayers. Qualified business income includes income from certain qualified trades or businesses, qualified real estate investment trust (REIT) dividends, and qualified publicly traded partnership income. Qualified REIT dividends are ordinary REIT dividends other than capital gain dividends and portion of REIT dividends designated as qualified dividend income eligible for capital gains rates. This deduction, if allowed in full, equates to a maximum effective tax rate of 29.6% (37% top rate applied to income after 20% deduction). This 20% deduction was no longer available for taxable years beginning after December 31, 2025. However, the OBBBA made this deduction permanent.

Non-corporate investors in private funds that invest in portfolio companies treated as partnerships are expected to benefit from this deduction, subject to certain W-2 wage and property basis limitations. Notably, because the W-2 wage and property limitations do not apply to qualified REIT dividends, private real estate funds utilizing REIT structures continue to offer a highly efficient path for non-corporate investors to access the full 20% deduction.

CFC Downward Attribution

The OBBBA revised Section 958(b) to eliminate downward attribution for purposes of determining controlled foreign corporation (CFC) status for taxable years of foreign corporations beginning after December 31, 2025. This change reverses an expansion that was introduced by the Tax Cuts and Jobs Act (TCJA). Although Section 958(b) prohibits downward attribution for purposes of determining CFC status, newly created Section 951B addresses the types of transactions that were considered abusive in a more narrowly targeted manner. These OBBBA changes should result in fewer CFCs in private fund structures and in their portfolio company structures, as it will not be as common for foreign corporations to be classified as CFCs due solely to the US shareholder ownership of lower-tier foreign entities. This had become a common concern in foreign-parented groups of foreign affiliates that included one or more US subsidiaries, resulting in many accidental CFCs. Private fund managers are likely to have a reduced compliance burden as a result (e.g., fewer Form 5471 and Schedule K-2/K-3 obligations and related inclusions) and potentially reduce friction with investors regarding CFC classification issues and associated reporting covenant negotiations in fund documents.

Opportunity Zones

The TCJA enacted the opportunity zone program to encourage investment in certain low-income community businesses by allowing an investor to defer paying US tax on gains from the sale of stock, business assets, or any other property if such amounts were reinvested into a qualified opportunity zone (QOZ) fund. If that investment was held for a requisite period, certain future gains in the QOZ would not be taxable. Without modifications, investments in existing QOZs after December 31, 2026 would not have been eligible for new benefits, and all deferred gains from prior investments are recognized on that date.

The OBBBA permanently extends the opportunity zone program by creating a new, permanent framework for future investments, but it does not apply this retroactively to old zones. Under the new program commonly referred to as OZ 2.0 (effective for investments on or after January 1, 2027), taxpayers investing qualified gains into a QOZ fund can take a 10% basis step-up for investments held at least five years. The prior law offered a 10% basis step-up after five years and an additional 5% (totaling 15%) after seven years, but both required the holding period milestones to be reached by the fixed date of December 31, 2026. For new program investments (post-2026), deferred gains will be recognized on the fifth anniversary of the investment date.

Furthermore, the OBBBA introduced Qualified Rural Opportunity Funds (QROFs), which provide an enhanced 30% basis step-up for five-year holdings. A rural area is defined as any area other than a city or town with a population of more than 50,000 inhabitants and any urbanized area contiguous and adjacent to such a city or town.

Beginning July 1, 2026, state governors will propose a new round of QOZs for certification by the US secretary of the treasury. These new designations will be effective for 10 years starting January 1, 2027. Notably, existing TCJA-designated zones remain in effect through December 31, 2028, providing a two-year overlap with the new 2027 zones. For all OZ 2.0 investments, the permanent exclusion of appreciation after a 10-year hold is now capped at 30 years, at which point the basis is frozen at the investment's fair market value.

As a result of these changes, we expect that private fund sponsors may be interested in forming new QOZ funds. Private fund sponsors should note that the OBBBA introduced rigorous new reporting requirements. Noncompliance can lead to significant penalties, reaching $50,000 per return for large funds with over $10 million in assets.

Takeaways

In many cases, private funds were not materially negatively impacted by the OBBBA, even benefiting from the OBBBA in some cases. However, a number of provisions that would have been burdensome to the private funds industry were debated in the OBBBA bill development process before ultimately being dropped from the final bill. These or similar provisions may be proposed anew in future legislation. We will continue to monitor these developments.

Basis Shifting and Reportable Transaction Rules

In early 2025, during the final days of the Biden administration, the US Department of the Treasury (Treasury) finalized and issued regulations under TD 10028 identifying certain partnership basis-shifting transactions as reportable transactions of interest. The regulations target transactions that utilize technical aspects of partnership basis rules to achieve tax results that may not align with economic outcomes. Transactions potentially implicated include tiered partnership contributions and distributions, related-party transactions with offsetting economic positions, restructurings that generate basis without corresponding income, and certain secondary transactions involving partnership interests. Although the regulations do not automatically disallow the underlying transactions, they impose mandatory disclosure

requirements that enable the Internal Revenue Service (IRS) to identify and scrutinize transactions it views as potentially abusive. If the regulations were to remain in place, fund restructurings, secondary transactions, and internal reorganizations potentially would carry disclosure obligations even where sponsors believe the transactions are supportable on the merits.

On April 17, 2025, the government announced in Notice 2025-23, 2025-19 IRB 1428, that it would issue proposed regulations removing the final regulations (TD 10028). Treasury and the IRS stated they were removing the final reporting regulations due to criticism from taxpayers and material advisers that the rules were overly complex, unduly burdensome, and unfairly retroactive. The government also cited President Trump's February 19, 2025 executive order (EO 14219), which directed agencies to rescind regulations that are unlawful or undermine the national interest. Treasury and the IRS stated further that they are withdrawing Notice 2024-54, 2024-28 IRB 24, another Biden-era guidance in which Treasury and the IRS announced their intent to issue future proposed regulations that would have reduced or eliminated the benefits of basis-shifting transactions between related parties.

The OMB's Office of Information and Regulatory Affairs stated that it received the proposed regulations on December 4, 2025, and they are now under review.

Takeaways

While the final regulations regarding these basis-shifting rules are being retracted, there have been multiple attempts by legislators to implement similar changes. Further, the IRS did not revoke Rev. Rul. 2024-14. That ruling held that certain related party basis-shifting transactions may be challenged under the economic substance doctrine. This position is being actively litigated in Tax Court. See our discussion of *Otay Project LP v. Commissioner*[2] herein. Private funds should be aware that future changes in this area may be implemented. We will continue to monitor developments in this area.

Interim Guidance on Partnership Representative Designations

The IRS issued interim guidance in 2025 clarifying aspects of partnership representative designations, including who may serve as partnership representative and how partnership representative authority operates in practice.

While the guidance does not overhaul the existing regime, it reinforces that the partnership representative has broad statutory authority to bind the partnership in audit proceedings and that investor consent rights outside the partnership agreement generally do not constrain that authority. Further, the IRS is not bound by any limitations, restrictions or agreements placed upon the partnership representative by the partnership in the partnership agreement, any side agreements, or any other document to which the IRS is not a party.

Takeaways

For private funds, these clarifications heighten the importance of carefully drafting partnership agreements to manage partnership representative appointment and authority, coordinating partnership representative provisions with side letter commitments, and managing investor expectations regarding audit participation.

[2] Docket No. 6819-20.

SIGNIFICANT CASE LAW AFFECTING PRIVATE FUNDS

Stelliam Investment Management LP

On May 28, 2025, a US investment management partnership, *Stelliam Investment Management LP* (Stelliam), filed a petition in the Tax Court challenging an IRS notice of final partnership administrative adjustment (FPAA) for two tax years (2016 and 2017) that reallocated all of Stelliam's ordinary income to its founder, an individual, arguing the IRS erred by finding that Stelliam was not in substance a partnership for US federal income tax purposes.[3] Per the petition, the founder formed Stelliam as a Delaware limited partnership in 2006 with one general partner (Stelliam GP LLC) and two limited partners—the founder and his wife. The couple made capital contributions of $1 million and $1,000 respectively, in exchange for their respective limited partnership interests in Stelliam.

In 2007, the founder gifted his Stelliam limited partner interests to three family trusts: (1) a grantor trust for the benefit of the founder's three children (Trust 1), (2) a grantor trust for the benefit of the founder's siblings (Trust 2), and (3) a grantor trust for the benefit of the founder's nieces and nephews (Trust 3; collectively, the Trusts). For the applicable tax years at issue, the founder's wife was the trustee of Trust 1; another individual was the trustee of Trust 2 and Trust 3. The petition provides that limited partner interests were gifted to the Trusts before Stelliam began commercial operations and were properly reported on US federal gift tax returns. The founder gifted additional limited partner interests to his wife in 2015, increasing her Stelliam ownership percentage.

The FPAA concludes that Stelliam is wholly owned by the founder, was not in substance a partnership for U.S. federal income tax purposes and that all of Stelliam's ordinary income must be attributed to the founder for the tax years at issue. According to the petition, the IRS reached its conclusion by applying partnership anti-abuse principles under Treasury Regulations Section 1.701-2.

Takeaways

For private fund sponsors, *Stelliam* is particularly relevant to management company and general partner entity structuring, fee-sharing arrangements, and expense allocations among related entities. The case illustrates the IRS's continued reliance on substance-over-form analysis when evaluating whether purported tax partnership arrangements reflect genuine economic relationships.

The IRS and courts are increasingly willing to collapse formal structures where operational realities suggest that partnership form is being used primarily to achieve tax advantages. We will continue to monitor developments in this case.

Otay Project LP v. Commissioner

The Tax Court is in process of reviewing the validity of an $867 million basis adjustment that was claimed in a partnership with related partners in the active case *Otay Project LP v. Commissioner.*[4] The IRS contends that the partnership, which was owned by two brothers, used sham negative inside basis to eliminate gain from the partnership's liquidation and in doing so exploited the Section 743(b) basis adjustment rules. The IRS asserts that the basis adjustments accordingly are disallowed under the economic substance doctrine and/or the general partnership anti-abuse rule in Treasury Regulation Section 1.701-2. The taxpayer in *Otay* argued that the basis adjustment was a consequence of a complex

[3] *Stelliam Investment Management LP, Stelliam GP LLC, Tax Matters Partners v. IRS*, Docket No. 7843-25.

[4] Dkt. No. 6819-20.

plan to unwind the partnership, which was required after the brothers had a falling out and had to separate their interests in the partnership's assets.

A trial for the case was held in October 2024, which was followed by a post-trial briefing in April 2025. We are now awaiting an opinion from the court.

Takeaways

As in *Stelliam*, it appears that the IRS is willing to apply anti-abuse regulations as well as common law principles such as the substance-over-form doctrine and step transaction doctrine to partnerships in a broad manner. Private funds often use partnership structures and are encouraged to consider potential application of these anti-abuse measures in even their ordinary course transactions. Of particular note, funds may wish to review continuation fund transactions, in-kind distributions to fund partners of fund property (e.g., distributions from a "splitter" partnership in which a blocker is invested and flow-through partners invest directly, or routine in-kind distributions), as well as tiered partnership distributions and contributions.

Limited Partner Exemption from Self-Employment Tax Update

In our 2024 private funds year in review, we discussed the Tax Court's decision in *Soroban Capital Partners LP v. Commissioner*,[5] regarding exemptions from the Self-Employed Contribution Act (SECA) tax on allocations to certain limited partners. In *Soroban*, the Tax Court analyzed the limited partner exception under Section 1402(a)(13) and adopted a "functional analysis" framework that focuses on the partner's role and level of participation. Section 1402(a)(13) generally excludes a limited partner's distributive share of partnership income from net earnings from self-employment, except for guaranteed payments for services. The statute provides that "there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c)."

In *Soroban*, the Tax Court concluded that the exception does not apply to a partner who is "limited in name only," but instead applies only to a partner who is functioning as a limited partner. The court adopted a functional analysis test that looks to the partner's level of activity and participation in the business, rather than to the partner's legal status under state law. That decision significantly altered how SECA exposure was evaluated and introduced a fact-intensive inquiry focused on conduct and operations.

Throughout 2025, the private funds and asset management industry closely watched the appellate activity surrounding this issue. Following the Tax Court's decision in *Soroban*, appellate activity quickly developed around the limited partner exception. *Sirius Solutions LLLP* was the first case to be appealed, with oral argument before the US Court of Appeals for the Fifth Circuit in February 2025.[6] *Soroban* itself was later appealed to the US Court of Appeals for the Second Circuit[7], and *Denham Capital Management LP* was appealed to the First Circuit[8]. Together, these cases set the stage for the first appellate consideration of whether the Tax Court's functional analysis framework would be sustained.

[5] 161 T.C. No. 12.

[6] *Sirius Solutions L.L.L.P. v. Commissioner*, No. 24-60240 (5th Cir.)

[7] *Soroban Capital Partners LP v. Commissioner*, No. 25-2079 (2nd Cir.)

[8] *Denham Capital Management LP v. Commissioner*, No. 25-1349 (1st Cir.)

Although the Fifth Circuit's opinion in *Sirius* was issued in January 2026,[9] just outside the calendar year, it represents a development of such importance that it bears noting here. In *Sirius*, the Fifth Circuit vacated the Tax Court's decision[10] and rejected the functional analysis framework. The court held that for purposes of Section 1402(a)(13), a "limited partner" is defined by state-law limited liability status, not by the level of participation in the partnership's business or by a fact-intensive inquiry into a partner's activities. The court emphasized that the statutory text, contemporaneous dictionary definitions, and more than four decades of consistent administrative practice all point to limited liability, as opposed to passivity, as the defining characteristic of limited partner status.

The Fifth Circuit's decision marks the first time an appellate court has directly rejected the Tax Court's functional approach. While binding only in the Fifth Circuit and issued by a divided 2–1 panel, *Sirius* materially reshapes the legal debate by providing a credible appellate counterweight to the IRS's and the Tax Court's activity-based framework. It strengthens arguments grounded in statutory text, legal structure, and historical tax administration, and it underscores the importance of administrability and predictability in applying the SECA rules.

In addition to *Soroban*, *Denham*, and *Sirius*, a growing number of businesses organized as state-law limited partnerships have filed Tax Court petitions challenging the IRS's position under Section 1402(a)(13), including *Atalaya Capital Management LP* (Dkt. No. 3253-25), *Moon Capital Management LP* (Dkt. No. 1929-25), *MKP Capital Management LP* (Dkt. No. 126-25), *Riverstone Equity Partners LP* (Dkt. No. 17512-24), and *Point72 Asset Management LP* (Dkt. No. 12752-23). This expanding docket highlights the significance of the issue for the private funds and asset management industry.

Takeaways

Although *Sirius* was decided in early 2026, it represents the most meaningful appellate development to date in a debate that dominated 2025. The issue remains unresolved nationally, with appeals pending in the First and Second Circuits and the possibility of divergent approaches among the courts. Final resolution will depend on how those courts rule, how the IRS responds, and whether Congress ultimately chooses to weigh in.

In the meantime, sponsors and fund managers should continue to approach SECA exposure thoughtfully. While *Sirius* strengthens arguments grounded in entity structure, state-law limited liability, and historical administrative practice, uncertainty remains outside the Fifth Circuit. Conservative structuring, careful governance practices, and clear disclosure continue to be prudent, particularly where partners play active roles in management or operations.

Please see our LawFlash Fifth Circuit Rejects 'Passive Investor' Test for Limited Partner Exception to Self-Employment Tax for further discussion.

YA Global Update

In our 2024 private funds year in review, we discussed the Tax Court's 2023 and 2024 opinions regarding the facts of YA Global Investments, LP, a Cayman Islands fund (YA Global), and its private fund activities. YA Global provided funding to portfolio companies through convertible debentures, standby equity

[9] *Sirius Solutions L.L.L.P. v. Commissioner,* No. 24-60240, 2026 WL 196555 (5th Cir. Jan. 16, 2026).

[10] Under a stipulation of settled issues filed December 19, 2023, Sirius and the IRS agreed that the Tax Court's November 2023 opinion in *Soroban Capital Partners LP v. Commissioner*, 161 T.C. No. 12 (2023), is precedential and applicable to the parties' dispute.

distribution agreements (SEDAs), and other securities. Under a SEDA, YA Global committed to purchasing up to a specified dollar value of a portfolio company's stock over a fixed period, typically two years. Although the portfolio companies were public, they were relatively illiquid, microcap companies that would have been unable to procure funds from conventional sources, such as commercial banks.

The Tax Court held that YA Global was engaged in a US trade or business for the taxable years at issue by attributing the activities of YA Global's US manager to the fund. Although the parties had primarily argued about whether the fund's transactions rendered it a lender or an underwriter, rather than an investor or trader, the court did not make any determinations in that regard. Instead, the court held that YA Global's manager, on YA Global's behalf, provided services to portfolio companies in exchange for fees when it sourced and negotiated transactions, conducted due diligence, and structured and managed the transactions. This view of the role of the fund's manager—as a service provider to portfolio companies—is unusual and out of step with industry norms.

As a result of its determination that YA Global had a US trade or business, the Tax Court held that the fund was liable for withholding taxes under Section 1446 for its income allocable to foreign partners, including the Cayman feeder fund. Additionally, the Tax Court determined that YA Global was required to recognize gain under the "mark-to market" rule of Section 475(a)(2) for each of its taxable years as a result of the Tax Court's holding that YA Global was a "dealer in securities" for purposes of Section 475(c)(1)(A). The Tax Court also held that YA Global did not have reasonable cause for its return positions, explaining that the fund's 2015 malpractice suit against its accountants and tax preparers indicated that the fund believed "at some point" that those advisors were negligent. More detail is provided in our prior thought leadership.

YA Global is challenging the Tax Court's decision in the US Court of Appeals for the Third Circuit. Its opening brief was filed on September 18, 2025, and the government's answering brief was filed on January 12, 2006.[11]

In its brief, YA Global argues that the Tax Court has no basis for its determination that the fund manager provided services to portfolio companies on the fund's behalf and that the court misapplied the legal standards under Section 864(b)(2). YA Global also argues that the Tax Court incorrectly determined the meaning of "customers" in Section 475 based on its misreading of the statute and the relevant regulations. In addition, YA Global challenges the Tax Court's view that the fund's 2015 malpractice case is relevant to its reliance on advisors in 2006, 2007, 2008, and 2009.

Takeaways

Private funds and their advisors should continue to carefully scrutinize their structures and the details of their operations to ensure they do not inadvertently subject their non-US and tax-exempt investors to US income taxes. In particular, funds and managers should review their fee arrangements to avoid the pitfalls highlighted in YA Global. In addition, funds that engage in private lending or other structured finance arrangements should keep a close eye on how their investments may be taxed pending resolution of the Third Circuit's decision. We will continue to monitor developments in this case.

[11] YA Global Investments LP v. Commissioner; No. 25-1766.

IRS AND TREASURY DEPARTMENT DEVELOPMENTS

Priority Guidance List

The IRS and Treasury Department released their Priority Guidance Plan for the 2025–2026 fiscal year, which identifies the guidance projects that will receive priority attention and resources from July 1, 2025 through June 30, 2026. The plan provides a roadmap of Treasury's near-term regulatory agenda and highlights the areas where new, revised, or withdrawn guidance is most likely.

The 2025–2026 plan includes several projects related to implementation of the OBBBA, signaling continued focus on translating the statute into workable regulatory and administrative rules. For private funds, this suggests that additional technical guidance affecting partnership and investment structures may be forthcoming.

The plan also places notable emphasis on deregulation and burden reduction initiatives. Of particular relevance to the private funds industry are projects addressing the centralized partnership audit regime established by the Bipartisan Budget Act of 2015 (BBA regime). Given the operational and economic complexity the BBA regime has created for funds and investors, its inclusion on the Priority Guidance Plan is a meaningful signal that Treasury and the IRS are considering adjustments to improve administrability and reduce unnecessary burden.

Takeaways

The Priority Guidance Plan does not describe the substance or scope of any specific project, but inclusion on the list signals that guidance activity in these areas is likely in the near term.

For private funds, this creates a meaningful opportunity to engage. In particular, the projects involving the BBA partnership audit regime provide a timely opening to advocate for clarifications and reforms that reduce administrative burden and better reflect how fund structures operate in practice.

Thoughtful industry input through comment letters and other engagement efforts can influence how these projects are shaped and implemented. Morgan Lewis stands ready to assist with developing strategy, drafting comments, and supporting advocacy efforts.

IRS Leadership

IRS leadership remains in a period of structural transition. Frank Bisignano, who currently serves as chief executive officer (CEO) of the IRS, is expected to guide the agency through the upcoming filing season and into 2026. The creation of the CEO role in October 2025 marked a significant shift in IRS governance, separating day-to-day operational management from the traditional commissioner model. The CEO reports to Treasury Secretary Scott Bessent, who is serving as acting commissioner, and Mr. Bisignano concurrently serves as commissioner of the US Social Security Administration.

At the same time, the Office of Chief Counsel remains in flux. The absence of a Senate-confirmed chief counsel has practical implications for the pace and direction of guidance projects, regulatory approvals, and litigation positions. Chief counsel historically plays a central role in shaping technical tax policy, reviewing major guidance, and coordinating enforcement strategy. An absence of permanent leadership in that office adds another layer of uncertainty to the IRS's regulatory and administrative posture.

Together, the shift to a CEO-led model and the lack of settled leadership in the chief counsel's office reflect a broader reconfiguration of IRS governance at a moment when the agency is managing complex statutory implementation and increased scrutiny of its regulatory authority.

Takeaways

While it remains unclear whether a new commissioner or chief counsel will be nominated and confirmed in the near term, private funds should not expect a material slowdown in enforcement or compliance activity. Operational continuity is likely to be preserved, even amid leadership transition.

That said, leadership uncertainty can affect the timing, prioritization, and tone of guidance, particularly in technically complex or policy-sensitive areas. For private funds, this environment reinforces the importance of close monitoring of IRS developments and early engagement when guidance projects move forward, as institutional direction may evolve as permanent leadership is established.

CROSS-BORDER TAX DEVELOPMENTS

US Trade or Business and Sourcing

In LTR 202536015, the IRS reviewed whether a foreign vehicle's foreign-source interest income from loans originated by a related party should be treated as income effectively connected with a US trade or business (ECI). Normally, foreign-source interest would not be expected to be ECI, but it may be if it is generated by the active conduct of a US trade or business. The facts of the ruling are unique, but the ruling is helpful to understand the IRS's analysis on loan origination activities in the cross-border tax context.

The ruling addressed whether the ownership by a foreign corporation (FC) of participations in underlying loans originated by a not-for-profit international organization (Originator) and an FC's issuance of securities collateralized by the participations to allow private investors to invest indirectly in the loans generated ECI to an FC. An FC's foreign-source income from the participations would be ECI only if (1) the Originator's activities in the United States in originating and modifying the loans would be treated as performed on behalf of an FC, (2) those activities would constitute the active conduct of a banking, financing, or similar business, and (3) the Originator's US office would be attributed to an FC.[12] The ruling concluded that an FC's foreign-source income and gain from participations would not be treated as ECI.

The ruling focused on the nature of the activities conducted, where decision-making occurred, and whether the activities rose above passive investment. Specifically, the ruling analyzed several factors, including the following:

- The Originator does not have customers for purposes of Section 864 and the Treasury Regulations thereunder as it is a not-for-profit international organization whose pricing and terms of the loans reflect its unique mission and not an attempt to make profit
- The Originator retains decision rights with respect to the loans, including whether to modify a loan against the interests of an FC or its investors
- The Originator and FC are legally and economically independent of one another
- The Originator deals with borrowers as a principal for its own account

The ruling does not address whether the FC is engaged in a US trade or business.

Separately, the IRS reviewed a factual situation involving a master fund that is a foreign hedge fund treated as a partnership for federal income tax purposes. ILM 202548005 analyzed whether a foreign taxpayer is engaged in a US trade or business for purposes of Section 882(a) because of its securities

[12] *See* 864(c)(4), 865(e)(2), 882(a)(1); Treasury Regulations Sections 1.864-5, -6, and -7.

sale-and-repurchase transactions (repo transactions), and if not, whether the taxpayer received US sourced fixed and determinable annual or periodic income subject to tax and withholding under Section 871(a) or 881(a).

Repo transactions function as either a secured loan and/or a securities lending transaction. In such repo transactions in this ruling, one counterparty (the "cash lender" and "securities borrower") purchased securities from the fund (the "cash borrower" and "securities lender") subject to an agreement for the fund (i.e., the cash borrower/securities lender) to repurchase the securities in the future. The fund also engaged in reverse repo transactions (i.e., repo transactions from the perspective of the cash lender/securities borrower) to borrower collateral for short trades.

The IRS concluded that the fund's repo transactions do not constitute a US trade or business for purposes of Section 882(a) as such transactions generally fall within an exemption from such status for trading under Section 864(b)(2)(A)(ii) (the Trading Safe Harbor). Similarly, any reverse repo transaction that may fall outside the Trading Safe Harbor are merely investment activities insufficient to result in a US trade or business for purposes of Section 882(a). The IRS emphasized that the fund was a non-dealer that generally engaged in exempt trading under the Trading Safe Harbor. Additionally, the IRS concluded that the fund's reverse repo transactions may also fall within the Trading Safe Harbor, but to the extent the fund's reverse repo activity falls outside the Trading Safe Harbor, the reverse repo activities were more akin to passive investment than active business operations.

The IRS further concluded that the fund's associated securities lending fees paid by US counterparties were fixed and determinable annual or periodic income. However, the fund was not liable for withholding tax on the fees because they were treated as foreign-source pursuant to Notice 2025-63 (released on October 23, 2025).

Takeaways

These rulings are not precedential but they appear to validate the importance of shielding origination and borrowing activities from foreign feeders or other foreign affiliates in private credit funds that wish to avoid generating ECI for their foreign affiliates and investors and they further appear to allow continued reliance on the Trading Safe Harbor when available.

Funds earning borrowing fees may wish to review whether they had previously reported borrowing fees as US source income and could revert that decision via amendment and refund if appropriate in light of this guidance.

ECI determinations and sourcing determinations in the private credit context remain highly fact-specific, and similar economic activities may yield different outcomes depending on execution and oversight. We are happy to assist in analyzing and reviewing these matters.

Foreign Investment in Real Property Act and Qualified Investment Entity Developments

An interest in a domestically controlled real estate investment trust (DC REIT) is not a US real property interest (USRPI), and therefore a foreign person's gain on the sale or disposition of a DC REIT interest is not subject to US federal income tax or withholding under the Foreign Investment in Real Property Tax Act rules. Historically, real estate funds would form US blocker corporations to aggregate foreign investment, relying on a rule that treated the domestic corporation as a US person regardless of its ultimate foreign ownership, thereby helping the REIT meet the "domestically controlled" threshold.

However, on April 24, 2024, Treasury and the IRS issued final regulations (detailed in our prior year in review) that affected planning techniques. Specifically, the 2024 final regulations modified the

determination of whether a qualified investment entity (QIE) is domestically controlled. Under the 2024 final regulations, if more than 50% (by value) of a non-publicly traded US corporation was held by foreign persons, in determining whether a QIE is domestically controlled, a "look-through rule" would be applied such that a REIT with foreign owners holding shares of the REIT through domestic corporations may no longer qualify as DC REITs. The final regulations included a 10-year transition rule. Existing REITs (as of April 24, 2024) can generally continue to use the old "no look-through" rule until April 24, 2034, provided they do not significantly change their ownership or acquire a certain amount of new assets. On October 20, 2025, Treasury and the IRS issued proposed regulations that would modify the 2024 final regulations. Under this new guidance, all domestic C corporations (excluding other REITs or RICs) are treated as non-look-through persons. This means a domestic C corporation shareholder is counted as a domestic person for the DC REIT test, regardless of its ultimate foreign ownership.

Taxpayers may immediately rely on the proposed regulations for transactions occurring before the date the proposed regulations are finalized. If finalized as proposed, the rules would be effective for transactions occurring on or after April 25, 2024, effectively nullifying the 2024 look-through rule from its inception and reverting the law to its pre-2024 state.

Takeaways

The 2025 proposed regulations may remove foreign investor barriers to investment in US real estate. Private fund managers should review existing fund structures that could not rely on DC REIT status to assess the impact that the 2025 proposed regulations have on those structures. We are available to assist in these matters.

Foreign Governments

On December 15, 2025, Treasury and the IRS issued final regulations[13] that adopt (and finalize), with some modifications, proposed regulations issued in November 2011[14] and December 2022,[15] as well as certain proposed and temporary regulations issued in June 1988[16] regarding a foreign government's qualification for the US income tax exemption under Section 892. Treasury and the IRS concurrently issued proposed regulations that would provide guidance for determining the circumstances in which acquisitions of loans (and other debt) are investments or commercial activities for purposes of Section 892.[17] Below sets forth a general overview of Section 892 and the 2025 final and proposed regulations.

Section 892

On December 15, 2025, Treasury and the IRS published final regulations (the Final Regulations) and proposed regulations (the Proposed Regulations) under Section 892. The below outlines a number of key observations in the context of private funds.

[13] TD 10042.

[14] 76 FR 68119.

[15] 87 FR 80108; 87 FR 80097.

[16] 53 FR 24100 (1988 proposed regulations) with a cross-reference to temporary regulations under Section 892 TD 8211, 53 FR 24060 (1988 temporary regulations).

[17] 90 FR 57928.

Background

Under Section 892, income of a foreign government received from investments in the US in (1) stocks, bonds, or other domestic securities owned by such foreign government, (2) financial instruments held in the execution of governmental financial or monetary policy, or (3) interest on deposits in banks in the US of moneys belonging to such foreign government, is not included in gross income and is exempt from US federal income tax. The Section 892 exemption does not apply to any income that (1) is derived from the conduct of any "commercial activity" (whether within or outside the US), (2) is received by a "controlled commercial entity" or received (directly or indirectly) from a "controlled commercial entity," or (3) is derived from the disposition of any interest in a "controlled commercial entity."

The Final Regulations and Proposed Regulations provide guidance as to the meaning of "commercial activity" and "controlled commercial entity." The Final Regulations are in many ways consistent with prior proposed regulations; however, as outlined in more detail below, the Final Regulations expand and modify certain rules. The Proposed Regulations introduce new standards regarding situations in which lending activities and certain acquisitions of debt may be treated as "commercial activities." The IRS has requested comments regarding these standards, which market participants may view as unduly narrow or restrictive.

Final Regulations

- ***Defining Commercial Activities:*** The Final Regulations make clear that the concept of "commercial activities" is broader than the concept of conducting a "trade or business" under the principles of Section 864 and authorities construing that provision, and that the broader scope is not simply a result of the fact that "commercial activities" are tested on a global basis. In this regard, in the preamble to the Final Regulations, Treasury considered but specifically declined to adopt comments on the 2011 proposed regulations that would have provided an exemption from commercial activities for (1) certain lending activities (see the discussion of lending activities, below), (2) the receipt of fees, when incidental to providing capital for an investment, or (3) transitory ownership of a tax transparent entity. The preamble states that, to the extent the commercial activities of a fund sponsor are attributable to a foreign governmental investor by reason of partnership attribution or on the basis of agency, the foreign governmental investor will be considered to be engaged in the conduct the commercial activities. The practical impact of the modifications made in the Final Regulations along with the commentary in the preamble and the new standards articulated in the Proposed Regulations in the investment fund context is not entirely clear at this time. For example, it has long been the practice of foreign governmental investors to waive the receipt of excess fee offset amounts in order to minimize risks associated with management fee reductions for certain transaction fees (i.e., the risk that the activities resulting in such transaction fees may be attributed to the foreign governmental investor). Following the issuance of the Final Regulations, investors may question whether the mere waiver is adequate. Foreign governmental investors may look to the rules in the Final Regulations related to qualified partnership interests for a back stop in the event that the waiver of receiving excess fee offsets is not viewed as an adequate mitigant against potential commercial activities attribution.
- ***Qualified Partnership Interest Exception:*** The commercial activities of an entity treated as a partnership for US federal income tax purposes are generally attributed to its partners. The 2011 proposed regulations under Section 892 contained the so-called "limited partner exception," which provided that a limited partner would not be treated as engaged in commercial activities solely by reason of holding a limited partnership interest in a partnership. A partner would be considered a "limited partner" for these

purposes if it did not have rights to participate in the management and conduct of the partnership's business. Foreign governmental investors have traditionally been wary of solely relying on the limited partnership exception for purposes of avoiding commercial activities attribution. The 2011 proposed regulations left open a number of questions on how the limited partner exception should be applied and, by its terms, whether the application of the limited partner exception was entirely a facts-and-circumstances inquiry. The Final Regulations generally adopt the limited partner exception with certain helpful modifications. Under the Final Regulations, the limited partner exception has been renamed the "qualified partnership interest exception." Similar to the limited partner exception, a holder of a "qualified partnership interest" in a partnership that engages in commercial activity will not, by reason of holding such partnership interest, be treated as engaged in commercial activity. In general, a holder of a qualified partnership interest must (1) have no personal liability for claims against the partnership, (2) not have the right to enter into contracts on behalf of the partnership, (3) have no right to participate in management of the partnership's business, and (4) not control the partnership (i.e., have effective control and/or own 50% or more of the partnership). The Final Regulations also specify that rights designed merely to protect and monitor capital investment are not management rights that can undermine a holder's qualified partnership interest status. The Final Regulations notably also provide a safe harbor for minority holders. Specifically, the safe harbor applies for holders that (1) have no personal liability for claims against the partnership, (2) do not have the right to enter into contracts on behalf of the partnership, (3) do not have the right to participate in management of the partnership's business, and (4) hold directly or indirectly 5% or less of either the partnership's capital or profits interests. The Final Regulations also provide rules for how the qualified partnership interest exception will apply in tiered partnership structures.

- In the context of commingled private funds, the safe harbor provided in the Final Regulations is a welcome development. The safe harbor indicates that minority investments in private funds by foreign governmental investors where the investor may be granted some limited protection and/or rights, including, for example, a right to sit on an advisory board, does not preclude access to the qualified partnership interest exception. Moreover, in light of the clarifications noted above related to the breadth of commercial activities, minority investors and sponsors may start actively relying on the qualified partnership interest exception where the fund may engage in certain customary practices that could create some commercial activity concerns (e.g., typical market management fee offset arrangements). Notwithstanding the helpful guidance, because the safe harbor continues to rely on a facts-and-circumstances analysis, sponsors will need to consider potential withholding agent risk, and foreign governmental investors will need to consider whether any rights granted under fund documents are extensive enough to deprive them of the protection of the qualified partnership interest exception.
- ***United States Real Property Holding Corporations:*** Historically, foreign governmental investors have had to monitor real estate holdings to avoid United States Real Property Holding Corporations (USRPHC) status for foreign governmental controlled entities. This is because of a per se rule, which provided that a controlled entity that would be a USRPHC if it were a US domestic corporation would be treated as engaged in commercial activities and, therefore, a controlled commercial entity. In 2022, Treasury released proposed regulations providing that the general per se rule would not apply to (1) foreign governmental investors that were also qualified foreign pension funds under Section 897, and (2) corporations that were deemed to be a USRPHC under the general rule solely as a result of minority ownership interests in other corporations. The Final

Regulations limit the USRPHC per se rule to domestic corporations and provide that a foreign corporation cannot be a deemed USRPHC and thus a controlled commercial entity for that reason. The Final Regulations maintain the minority interest exception adopted in the 2022 proposed regulations so that foreign governmental investors who formed holding structures in reliance on those regulations do not need to unwind structures. Overall, the Final Regulations are a welcome change for foreign governmental investors (and private fund sponsors) who no longer need to monitor USRPHC investments for controlled commercial entity concerns.

- ***Applicability:*** The Final Regulations are applicable to tax years beginning on or after December 15, 2025.

Proposed Regulations

- ***Commercial Activities and "Debt Acquisitions":*** As noted above, Treasury has stated that the scope of "commercial activities" is something broader than conducting a "trade or business" under the principles of Section 864 and authorities construing that provision. The Proposed Regulations highlight this notion in the context of "debt acquisitions." Under the Proposed Regulations, any "debt acquisition," including at original issuance, is treated as a commercial activity, unless it meets one of two safe harbors or is characterized as an "investment" under a facts-and-circumstances test. The safe harbors cover (1) the acquisition of debt in a registered offering with underwriters unrelated to the acquirer and (2) the acquisition of debt traded on an established securities market from a seller that is not the issuer and is not related to or under joint management with the acquirer (unless the debt qualified as an investment in the hands of the related seller). In applying the facts-and-circumstances test (which may be particularly relevant in the private credit or private equity context), the Proposed Regulations indicate that the following factors should be considered:
    - Whether the acquirer solicited borrowers and/or held itself out as willing to make loans or acquire debt at original issuance
    - Whether the acquirer materially participated in negotiating and structuring debt terms
    - Whether the acquirer is entitled to receive compensation not treated as interest (including original issue discount) for US federal income tax purposes
    - The form of debt and the issuance process (e.g., whether the debt is a bank loan or a private placement)
    - The percentage of debt acquired relative to the percentage acquired by other buyers
    - The percentage of equity in the debt issuer held by the acquirer and the value of that equity relative to the amount of debt acquired
    - For distressed debt and debt workouts where there may be a debt-for-debt exchange, whether there was a reasonable expectation at the time of the original debt purchase that the original debt would default

In the context of private funds, a number of considerations and questions may arise. First, there may be questions related to shareholder loans that have long been used to partially capitalize corporate blockers. Sponsors and investors alike will want to take the view that shareholder loans to blockers should be treated as "investments." However, in light of the aforementioned factors, the parameters for any shareholder loan, such as the debt/equity ratio, will need to be carefully evaluated. Second, the Proposed Regulations indicate that Section 892 benefits would not be available on US sourced interest from certain

debt acquisitions treated as commercial activities. Thus, foreign governmental investors may need to consider relying on the portfolio interest exemption or treaty benefits. Further, in situations where a particular investment in debt could be treated as a commercial activity, investors will need to consider whether the qualified partnership interest exception may be available for purposes of avoiding broader commercial activities attribution or, alternatively, whether the foreign governmental investor should consider using an investment vehicle that does not rely on Section 892.

The Proposed Regulations related to debt acquisitions include a number of examples that illustrate the application of the "debt acquisition" principles:

- A single loan may result in commercial activity if the foreign governmental investor or its representative held itself out as a lender, structured, and negotiated the loan and the foreign governmental investor did not otherwise own any equity in the issuer. This example reflects the Treasury and IRS view that limiting lending transactions to a certain number of loans per year does not preclude treating the limited lending activity as a commercial activity.
- A foreign government's loan to an 80% owned entity was not a commercial activity where the value of the loan was equal to 50% of the value of the foreign government's equity interest in the entity. This example indicates that, in certain circumstances, shareholder loans may not be considered commercial activities. However, the debt-to-equity ratio was lower than often seen in a leveraged blocker context.
- In the case of distressed debt that is modified and thus deemed exchanged for "new" debt, the loan is not viewed as an "investment" if the investor is a member of the creditors' committee negotiating the terms of a modified loan. Conversely, where an unrelated creditors' committee negotiates the workout, the investor may be viewed as acquiring the "new" loan in the deemed exchange as an investment.

Effective Control

Section 892 defines a controlled commercial entity to include not only an entity in which a foreign governmental investor holds (directly or indirectly) more than a 50% interest, but also an entity in which the foreign governmental investor holds any interest that gives it "effective control" over such entity.

Under the Proposed Regulations, the prior concept of "effective practical control" is renamed "effective control," which tracks the statutory language. The Proposed Regulations clarify that a foreign governmental investor has "effective control" over an entity if the interests it holds give it control over the operational, managerial, board-level, or investor-level decisions of such entity. When testing "effective control," equity interests, debt interests, voting power, contractual rights, significant business relationships, regulatory authority, and other relationships that confer decision-making authority to the foreign governmental investor will be considered. Additionally, all interests directly or indirectly owned by an integral part or controlled entity of a foreign government would be considered together, regardless of whether the integral parts or controlled entities are functionally independent.

Consistent with the forgoing, where a foreign governmental investor is, or the foreign governmental investor controls, a managing party or managing member of an entity, the foreign governmental investor will be viewed as having effective control. Alternatively, a foreign governmental investor may not be viewed as having effective control where its rights are limited to consultation rights.

The Proposed Regulations provide a number of informative examples related to effective control. In light of the Proposed Regulations, investors and sponsors may need to more carefully consider the scope of investor rights, where such rights confer authority to an investor that may ultimately affect the management and economics of an entity.

- ***Comment Period**:* In the preamble to the Proposed Regulations, the Treasury has invited comments. The comment period for the Proposed Regulations ends Friday, February 13, 2026.
- ***Applicability:*** The Proposed Regulations will generally apply to tax years after their finalization and do not contain a transition or grandfathering rule for existing investments.

The forgoing summary highlights key aspects of the Final Regulations and the Proposed Regulations but does not represent a comprehensive analysis of the Final Regulations and the Proposed Regulations.

Reverse Hybrid Issues

In IRS generic legal advice memorandum AM 2025-002 (GLAM), the IRS confirmed that if a US treaty contains a fiscal transparency provision similar to the 2016 US model treaty, treaty benefits (including reduced branch profits tax rates) may be claimed by a foreign reverse hybrid entity based on the residence and qualification of its owners.

As noted in the GLAM, there is little guidance directly addressing the interaction of US income tax treaties and domestic law as applicable to a foreign entity that is taxable as a corporation for US tax purposes but is fiscally transparent under the law of an owner's jurisdiction (a "reverse foreign hybrid") that earns business profits. Due to their classification as taxable entities for US tax purposes, reverse foreign hybrid entities are subject to tax on income effectively connected with ECI as well as branch profits tax (BPT). Tax treaties may serve to reduce or eliminate taxes on ECI and/or BPT, assuming the taxpayer at issue qualifies for treaty benefits. There has been some uncertainty regarding whether a foreign reverse hybrid entity that is not a resident under the terms of an applicable treaty could nevertheless claim BPT treaty benefits if its owners qualified.

Takeaways

Many private fund structures have cross border structures that include foreign reverse hybrid entities, such as a non-US blocker formed for investment by non-US investors or US tax-exempt investors. The GLAM provides welcome analysis that a foreign reverse hybrid entity, such as a non-US blocker, may claim treaty benefits for BPT based on the residence and qualification under an appliable tax treaty of its owners. The GLAM, however, is not binding precedent. Nevertheless, it offers some assurance on how the IRS views these issues.

DEVELOPMENTS IN AI TAX PRACTICE

Generative artificial intelligence is increasingly being deployed by private fund managers, as well as by the law firms and accounting firms servicing such clients, to augment tax and legal services, particularly in areas such as tax research, document review, drafting, data extraction, and compliance workflows.

Law firms, including our firm, are adopting generative AI to assist with legal research, contract and memorandum drafting, due diligence, and issue spotting, driven both by internal productivity objectives and increasing client expectations that firms responsibly leverage AI to deliver higher-value, cost-effective services.

At the same time, the use of generative AI in the tax and legal context presents material risks that firms are actively working to manage. These risks include inaccurate or fabricated outputs, embedded bias, over-reliance on AI-generated analysis, and confidentiality and privilege concerns when client data is used in AI systems. Law firms are emphasizing robust governance frameworks, human-in-the-loop

review, strict data controls, and clear internal policies governing permissible AI use to ensure that professional judgment remains paramount and that ethical and regulatory obligations are met.

Takeaways

In the private fund context, including legal and accounting advisors thereto, the prevailing approach views generative AI not as a substitute for technical expertise, but as a tool that—when carefully governed—can enhance accuracy, efficiency, and strategic insight while preserving client trust and professional responsibility. We will continue to monitor developments in this area.

STATE AND LOCAL TAX DEVELOPMENTS

State and local tax developments center on heightened partner-level tax exposure, evolving workaround regimes, and expanding nexus and sourcing rules. Changes to the federal state and local tax (SALT) deduction cap and increased scrutiny of pass-through entity tax (PTET) structures are influencing state planning, particularly for investment management businesses. States continue to adjust income tax rates, add capital gains surcharges, and refine conformity to federal law, increasing the importance of partner domicile, gain timing, and entity structuring.

- In California, the elective pass-through entity tax (PTET) has been extended through 2030, and new regulations require service and intangible revenue (including asset management receipts) to be sourced based on where the benefit of the service is received, which could affect apportionment and state income tax liability for fund managers and portfolio service providers.
- Massachusetts adopted a $500,000 sales threshold for corporate nexus, meaning remote sales and intangible delivery can trigger corporate excise tax even without physical presence, and the state also moved to single sales factor apportionment for corporations.
- Illinois is eliminating its 200-transaction sales tax nexus test and imposing economic nexus based solely on $100,000 of sales, in addition to sourcing changes for service and retail occupation taxes; Illinois also changed the sourcing of capital gains and losses from pass-through entity interest sales, allocating them based on apportionment factors rather than taxpayer residence.
- Other states like Arkansas and Kansas are adopting market-based sourcing for services and intangible property, consistent with broader multistate sourcing trends.

Several states have broadened indirect tax bases that can impact funds, portfolio companies, and service providers.

- Maryland imposed a 3% sales and use tax on data and IT services and has adopted higher personal income tax brackets with a 2% capital gains surcharge for high-income taxpayers, elevating state tax on investment gains.
- Washington expanded its sales tax to include various professional, digital, and IT services, such as advertising and custom software, and is modifying its business and occupation tax structure with new surcharges, affecting entities with significant receipts.

Takeaways

Collectively, these developments underscore the importance of evaluating nexus, apportionment, and service tax exposure across states where funds and portfolio activities generate revenue. These changes increase compliance complexity for private funds with multistate footprints, portfolio companies operating remotely, or revenue tied to services and intangibles. Overall, SALT planning for private funds requires

closer coordination between fund-level structuring, partner tax considerations, and multistate compliance strategies.

UK TAX DEVELOPMENTS

Carried Interest Reform

From April 6, 2026, there is a fundamental overhaul of the tax treatment of carried interest, shifting from (generally) tax as a capital gain to income tax treatment. The rules are not yet final, but have undergone government consultations and updates, so they can be expected to be close to the final rules. The remainder of this summary assumes the rules are adopted as currently drafted. Under these new rules, carried interest will be deemed to be trading profits, meaning carried interest holders must report these amounts as income through self-assessment. Returns will be subject to both income tax and class 4 national insurance contributions. Prior to these changes, carried interest was often taxed as a capital gain, at a rate of 28% up to April 6, 2025 and 32% after that. The way carried interest is defined has been updated, partly to prevent avoidance of the rules, and is now broadly defined to capture all profit-related returns that relate to alternative investment funds or collective investment schemes (including those earned through feeder and parallel vehicles), regardless of whether the return is capital or income (such as dividends) in nature.

Because carried interest will be classified as trading profits, the obligation to pay income tax will fall within the payments on account system, requiring individuals to pay tax installments based on estimated carried interest throughout the year. This will be a major change particularly for carried interest holders who are employees, who generally would not historically have had to make payments on account. For all carried interest holders, it is likely to present compliance challenges, due to the unpredictable and lumpy nature of carried interest returns. There is no grandfathering for older funds, so any carried interest arising after the commencement date will fall under this new regime regardless of when the fund was established.

To maintain the United Kingdom's competitiveness, the government is introducing a 72.5% multiplier for qualifying carried interest. This means that instead of paying the full relevant marginal rate of income tax (at rates up to 45%) on the carried interest, only 72.5% of the profit is subject to tax. For taxpayers subject to tax at the highest rate of income tax, the effective tax burden is approximately 34.1% (compared to the rate of 32% on capital gains received as carried interest that has been in force since April 6, 2025, which was a transitional change made last year).

The returns will be qualifying carried interest provided the fund must meet specific criteria regarding its average holding period (AHP) of investments, which is a similar test to the existing income-based carried interest rules. Carried interest from a fund with an AHP of at least 40 months will fully qualify, and a sliding scale applies for investments held between 36 and 40 months. Any carried interest from investments held for less than 36 months will be taxed in full as trading income at the higher income tax rates (up to 45%), plus national insurance contributions. There are special rules to make the AHP easier to apply to certain types of funds, such as funds of funds and debt or credit funds.

For employees who receive carried interest, there is additional complexity; as is currently the case, carried interest will be classified as an employment-related security (ERS). If the employee does not pay the full market value upon acquisition (e.g., where carried interest is granted mid-way through the fund's life, or after investments have already been made), there will be a tax charge upon acquisition. Employees and their employers should continue to execute Section 431 elections when carried interest is granted, to protect against future employment income charges on the growth of the asset. When taxable returns from the carried interest arise, employees will report it as trading profits via self-assessment and

will need expressly to make a claim with HM Revenue & Customs for relief for any tax previously paid under the ERS rules.

The new legislation also brings additional complexity for managers with international carried interest holders. Non-residents who perform investment management–related services while physically in the UK are now expressly within the scope of these rules. A safe harbor exists for those who spend fewer than 60 days a year in the UK, subject to certain conditions, but those exceeding this limit will generally be taxed on a portion of their carry. This shift may create complications regarding foreign tax credits, particularly for US taxpayers who may experience timing differences and find it harder to offset UK trading income taxes against US capital gains liabilities.

What Didn't Change

A number of proposals initially put forward were not adopted. In particular, there are no new requirements for individuals to contribute their own capital or to hold their personal interest for a minimum period for their carried interest to qualify.

Managers who grant carried interest to employees will still have to report the grants under the normal employment-related security rules, and will need to determine whether employees have paid full value for the carried interest (and/or require the making of Section 431 elections within 14 days of the grant).

The disguised investment management fee and mixed member partnership rules will continue to apply to prevent artificial arrangements that are either aimed at accessing the reduced rates for qualifying carried interest, or aim to shield the individuals from personal tax in respect of carried interest.

Takeaways

The jurisdiction of the fund itself remains neutral; the tax treatment is determined by the way the carry is determined, the activities of the individuals and the holding period of the assets, rather than where the fund is legally domiciled. Managers will need to record the holding periods carefully to provide accurate information on the AHP to the carried interest holders.

Carried interest holders will have to prepare for the cash flow impact of paying income tax in installments.

Care will need to be taken when paying tax distributions to carried interest holders who are subject to tax in the UK, because they may not themselves qualify for the reduced rate of tax unless carefully managed.

While carried interest under these rules will not be subject to UK payroll reporting (Pay As You Earn, or PAYE), managers will need to prepare for providing information to carried interest holders to enable them to meet their compliance requirements (in particular the need to pay tax in installments over the course of the tax year). Employees are likely to require additional assistance from their employers to comply with their obligations.

Managers of debt or credit funds will want to track what are known as "T1/T2" rules that allow for backdating of investment dates in certain cases to help meet the 40-month AHP.

Carried interest holders who are not resident in the UK but spend workdays in the UK will need to track the time spent working in the UK and abroad to determine whether they satisfy the safe harbor, and, if not, to quantify the portion of their carried interest that will be taxable in the UK.

Reserved Investor Fund: A New UK Fund Vehicle

The Reserved Investor Fund (RIF) is a new UK unauthorized contractual scheme designed for professional and institutional investors. It has been available since March 2025 and offers a lower-cost, more flexible alternative to existing UK fund structuring options, particularly for closed-ended or hybrid funds.

The RIF was introduced to enhance the UK's existing funds regime and make the UK more competitive as a fund domicile. The aim is to provide an onshore alternative to offshore structures (such as Jersey or Guernsey property unit trusts) and to attract investment into UK real estate, infrastructure, private equity and private debt.

Unlike UK authorized contractual schemes (ACSs), which must be open-ended and approved by the UK Financial Conduct Authority (FCA), RIFs operate under a lighter regulatory regime and do not require registration with Companies House or FCA approval.

Broadly, a RIF is transparent for income purposes and is not subject to tax on gains. This means income is taxed at the investor level and not at the fund level, and neither the RIF nor its investors are subject to tax on capital gains when the RIF sells its assets. UK investors, and certain non-UK investors if the RIF is rich in UK real estate, are subject to tax on any capital gains when they dispose of their interest in the RIF. There is no UK stamp duty, stamp duty reserve tax, or stamp duty land tax (SDLT) on transfers of units in a RIF. If the RIF acquires real estate, SDLT is payable by the RIF (but not its investors).

There are various requirements to benefit from the RIF regime, including that a fund must meet at least one of the following three restrictions: (1) it must be UK property rich (broadly, it derives more than 75% of its gross asset value from UK land); (2) it has no UK property assets; or (3) all its investors are exempt from UK tax on capital gains.

Takeaways

The RIF fills a gap in the UK market by offering a cost-effective and flexible fund structure for professional and institutional investors. It is expected to appeal to commercial real estate fund managers seeking a fully onshore UK option, as well as managers launching commingled funds with other investment strategies.

PILLAR TWO: OECD GLOBAL ANTI-BASE EROSION RULES AND US SAFE HARBOR

Pillar Two is a key part of the Organisation for Economic Co-operation and Development (OECD) Project addressing the tax challenges arising from the digitalization of the economy.

The rules require large multinational enterprise (MNE) groups with an annual consolidated revenue exceeding €750 million ($887 million) to pay a minimum effective tax rate of 15% on all their profits, on a country-by-country basis. If profits in a jurisdiction are taxed below 15%, a top-up tax applies. These rules are now in force in the UK, most EU countries and other major jurisdictions worldwide.

While the rules are primarily aimed at large trading groups, they can in principle affect any kind of MNE group that meets the €750 million threshold, including private capital houses, their funds, holding structures and underlying portfolio companies. The scope of the rules relies heavily on how the parent of the group in question prepares its consolidated accounts. An important question in a private funds context is, therefore, which parts of the management and fund structure (or both) are required to prepare consolidated accounts, and which entities are included in those consolidated accounts.

There are exclusions from the Pillar Two rules for "excluded entities," which include certain investment funds, real estate investment vehicles, pension funds, and government entities. Most widely held private equity funds (but not single-investor funds or unregulated funds) should qualify as "excluded entities," which means they do not themselves have tax and compliance obligations under Pillar Two. However, this is not a complete exclusion, as their revenues still count toward the €750 million threshold that determines whether Pillar Two applies to the broader group. A fund could also be pulled into scope if an investor within the scope of Pillar Two has a 50% or more interest in the fund and accounts for it using the equity method of accounting.

For a fund, the ideal outcome would typically be that it neither consolidates its investments nor is consolidated by its investors and is, therefore, not in scope of Pillar Two.

Recent Development: Side-by-Side Safe Harbor

Effective January 1, 2026, the OECD introduced a side-by-side (SbS) safe harbor for groups headquartered in recognized jurisdictions. The US is currently the only jurisdiction approved for the SbS safe harbor, but the OECD has indicated that additional jurisdictions may qualify in the future. This safe harbor recognizes the US tax regime as meeting Pillar Two standards and relieves eligible US-parented MNEs from top-up taxes under Pillar Two.

This relief is not absolute. Jurisdictions around the world can still impose their own "qualified domestic minimum top-up taxes," which are unaffected by the SbS safe harbor. Moreover, groups in scope of Pillar Two must still comply with its administrative requirements (including filing information returns), even if no top-up tax is due.

The package announced on January 1 also includes other safe harbors, aimed at simplifying the Pillar Two regime.

Takeaways

Pillar Two establishes a global floor of 15% tax for large MNE groups, reshaping cross-border tax planning and reporting for these groups. Private funds can expect heightened diligence and more extensive compliance obligations across their structures in the years ahead.

Fund sponsors should bear Pillar Two in mind as the house and fund investments grow and consolidated revenues approach the €750 million threshold. The Pillar Two rules may be particularly pertinent if an MNE group includes, or plans to acquire, entities established in low-tax jurisdictions. Sponsors would also want to continue to monitor how investors treat their fund investments for accounting purposes, especially in situations such as funds-of-one and separately managed accounts, and instances where an investor would have to consolidate the fund.

Investors are increasingly sensitive to Pillar Two risks. Market practice on addressing these risks contractually is still evolving, but we are routinely seeing fund documents include representations and covenants addressing Pillar Two issues and subscription documents including detailed questions for investors on consolidation.

For MNE groups headquartered in the United States, the introduction of the SbS safe harbor offers considerable relief. While it does not remove their Pillar Two compliance and reporting obligations, it significantly reduces the likelihood of top-up taxes arising on cross-border operations and investments. Such businesses will be interested in how, and when, the SbS safe harbor is enacted in the jurisdictions in which the group operates (which may take a year or even two).

CONCLUSION

2025 marked a year of sustained pressure on private fund tax structures through litigation, guidance, and enforcement. Sponsors that proactively adapt to these developments will be better positioned to manage risk and respond to investor expectations in 2026.

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