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Insights

AUTUMN BUDGET 2024 – CARRIED INTEREST: A NEW REGIME INCOMING

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SUMMARY

Yesterday, the Government announced that the CGT rates for carried interest arising on or after 6 April 2025 will increase to 32%, in line with the 4% increase to the higher rate of CGT which took effect immediately. That is just an interim measure however, and, from April 2026, a new regime will be introduced which will bring all carried interest within the scope of income tax. Importantly, the new regime will provide a lower effective tax rate of 32.625% for additional rate taxpayers (plus NICs) for certain "qualifying" carried interest.

Details of the new regime were published by the Government, including a consultation, closing on 31 January 2025, requesting views on how to define what conditions should be introduced to access the lower effective tax rate.

The shape of the new regime is not yet fully settled, and fund managers will need to monitor closely and, indeed, consider whether they want to respond to the consultation. That said, it appears that, broadly speaking, the design of the new regime will more closely align the UK's carried interest rules with regimes in some other European countries.

In her speech, the Chancellor's statement on carried interest was relatively brief – an increase in the capital gains tax rates to 32% from April 2025 and, from 2026, further reforms "to ensure that the specific rules for carried interest are simpler, fairer and better targeted".

While we waited for the speech to end and the relevant budget documents to be published, the instant reaction was that a CGT rate hike for carried interest was expected, and an increase of 4% was not as high as some commentators had predicted. It also aligned with the 4% increase in CGT for higher and additional rate taxpayers from 20% to 24%, although that rate change took effect from yesterday!

But what of the further reforms? That position became clearer once the Government published its "Summary of Responses and Next Steps" to their Call for Evidence in July 2024 on "The Tax

Treatment of Carried Interest".

Therein, the Government announced that, from April 2026, it will introduce a revised regime which will treat all returns meeting the statutory definition of carried interest that arise to an individual as the profits of a trade that the individual carries on in the UK. The profits of this trade will be subject to income tax at rates of up to 45% and Class 4 National Insurance Contributions (NICs) – and the returns will therefore be outside the scope of CGT. However, for "qualifying" carried interest, the profits subject to tax will be adjusted by applying a 72.5% multiplier, which will result in an effective tax rate of 32.625% for additional rate taxpayers (plus Class 4 NICs).

By way of reminder, carried interest, also referred to as "carry", is a form of performance-related "reward" that individuals managing an investment fund can receive from the profits of their fund, subject to that fund generating a prescribed preferred return for its investors (and, for statutory purposes, it is key that there is a significant risk that a certain amount of that reward would not arise to the individual). Certain carried interest returns are subject to CGT (for now at least), partly due to these unique characteristics (including the fact it is not a guaranteed form of profit due to its dependency on the performance of the fund's underlying investments, and is not an immediate return for fund managers given the general length of time in which investment profits are distributed).

It is, broadly speaking, those characteristics which will likely form the basis of when the lower effective income tax rate (i.e. the 72.5% multiplier) will be available for "qualifying" carried interest under a new regime. However, it is not yet clear what conditions will need to be met for this purpose – accordingly, as part of their Summary document referenced above, the Government launched a consultation for views on what those conditions should be. They specifically focused on two areas (both of which are features of carry regimes in some other European jurisdictions):

- Whether a minimum co-investment requirement should be introduced (and noting the concern that an investment requirement imposed at the level of individual fund managers could act as an obstacle to the market for more junior managers and new entrants who may struggle to raise the appropriate capital, this may be tested by reference to the entire population of carry-holders instead of looking to whether each individual investment professional has contributed a minimum level of capital).

- Whether there should be a minimum holding period for carried interest rights (being the time between the award of the right to receive carried interest and carried interest arising to the fund manager. This is a point worth being aware of for existing fund managers as the Government indicated that transitional rules will not be introduced in respect of this condition (although have asked for views as to whether this would cause any unintended adverse consequences)).

Accordingly, there appears to be scope for interested stakeholders to influence the shape of these conditions in the new regime. The consultation will run until 31 January 2025.

Elsewhere, of particular interest in the Summary document:

- The Income-based Carried Interest (**IBCI**) rules will be retained – indeed, it is these rules which will be amended to reflect the above referenced conditions to constitute "qualifying" carried interest. In other words, carried interest will be qualifying when it is not IBCI.

- The IBCI rules will also be amended to remove the exclusion for employment-related securities, and thus will equally apply to employee and self-employed fund managers (which, the Government considers, removes arbitrary distinctions based on structuring). Depending on the details of the new regime, this will mean that employees will need to consider the IBCI rules going forward, including the average holding period of the relevant fund's investments and whether it exceeds 40 months (a current requirement for full capital treatment to apply for self-employed managers). That said, the Government noted that this change may have a disproportionate effect on private credit funds, which often need to rely on the exclusion for employment-related securities to prevent the application of IBCI rules. The Government has said that it will work with stakeholders to consider targeted amendments to the rules to address this.

- On the topic of employment-related securities, the Government confirmed that that the removal of the exclusion from the IBCI rules will not impact the application of the employment-related securities generally to employee fund managers. It will therefore be important to see how the new regime – which focuses on payments of carried interest – caters for the income tax charge that can arise on the initial award of carried interest rights. Although carried interest rights awarded to employees on the establishment of a fund are unlikely to attract an income tax charge in practice (because HMRC generally accepts that such a right has no material value), any subsequent award or reallocation of carried interest once the fund's investments have increased in value will generally be charged to income tax if awarded to an employee for no consideration. The potential for double taxation therefore will need to be addressed and is likely to be raised during the consultation on the new regime.

- The Government has confirmed that co-investment returns will not be caught by the new regime. Any exclusion for co-investment returns would presumably be similar to existing exclusions in the chargeable gains carried interest rules and the Disguised Investment Management Fees (**DIMF**) rules that can apply to an arm's length return that arises to a manager from a collective investment scheme. These exclusions are relatively narrow, however, as the return must (i) arise on the same kind of investment as investments in the scheme made by external investors, (ii) be reasonably comparable to the returns to external investors and (iii) be governed by reasonably comparable terms as those applicable to external investors. The implications of this position will need to be considered when structuring co-investment arrangements and existing arrangements may need to be reviewed to confirm whether returns will benefit from the exclusion.

- The new regime will sit alongside the existing DIMF rules which will be retained. It is the definition of carried interest under these rules (section 809EZC and 809EZD ITA 2007) which will be used for the new regime.

For now therefore, no change to the taxation of carried interest until the rate increases to 32% in April next year (2025), but lots to consider in the meantime (and certain non-domiciled managers will also be mindful of the replacement of the "non-dom" regime with a new residence-based regime). The proposed carried interest changes do not appear to raise any money for the Exchequer until 2027-28 (indeed, it is forecast to lose £5 million in 2026-27!).

Otherwise, the next key date is 31 January 2025, being the deadline to submit any representations to the consultation. Whether the new regime results in a "simpler, fairer and better targeted" set of rules is still to be determined!

* With thanks to Miriam Walters-Manneh for her assistance in writing this blog.

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Kyle O'Sullivan

London

kyle.osullivan@bclplaw.com
+44 (0) 20 3400 4291