By email: carriedinterest@hmtreasury.gov.uk

31 January 2025

Dear HM Treasury

The tax treatment of carried interest – Consultation on qualifying conditions

The BVCA is the industry body and public policy advocate for the private equity, venture capital and private credit (together "private capital") industry in the UK. With a membership of over 600 firms, we represent the majority of UK-based private capital firms, as well as their professional advisers and investors.

Thank you for giving us the opportunity to take part in the consultation set out in "The tax treatment of carried interest – Call for evidence summary of responses and next steps". We welcome the Government's recognition that private capital channels vital investment across the UK and will play an important role in boosting economic growth. As we noted in our response of 30 August 2024 (published on our website here) to the call for evidence launched over the summer, private capital contributes to economic growth by making active investments in companies, focusing on long-term growth and operational improvement, leading to innovation, job creation and improved efficiency.

We have set out below some key points and an executive summary of our representations, followed by our answers to the four questions in chapter 4 of the consultation. We have then highlighted some of the issues raised by our members regarding the move to the new regime from April 2026. We hope that these further observations will be helpful in the context of the technical discussions described in chapter 3 of the consultation.

The changes described in the consultation raise a wide range of issues, and it is not possible to explore all of these in detail in this letter. We would welcome the opportunity to continue to work with officials in both HM Treasury and HMRC as they embark on the crucial next stage of drafting the legislation, to ensure the rules are clear, unambiguous and fit for purpose, both for the Government and for industry.

Key points

- The UK private capital industry provides vital investment for growth in the UK. 2.2m people are employed in the UK by companies backed by private capital, over 12,000 businesses are backed by UK private capital, and £20.1bn was invested in UK companies by private capital in 2023.
- It is crucial that the UK continues to be an attractive destination for investment - but global competition for this industry is fierce, and capital is mobile.
- We welcome the recognition by the Government of the **value of the private capital industry in the UK;** the desire to preserve the UK's **competitive position**

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as a global hub for investment; and the clear recognition that carried interest has unique characteristics that differ from other rewards and therefore should be taxed differently.

- We appreciate that the changes announced in the Budget were designed with the intention of striking a suitable balance between the unique characteristics of carried interest and the way it is taxed, and we welcome the Government's desire to ensure that the reformed rules work as effectively as possible. However, we are concerned that in practice a number of measures proposed in the consultation could **undermine the government's stated policy aims. We encourage the Government to consider carefully this risk and to factor in the impacts on growth and investment in the UK.**
- In our view, the combination of the move to income treatment, the extension of the income-based carried interest ("IBCI") rules to employees and the addition of the proposed new conditions **would impact UK competitiveness and reduce the UK's ability to attract international talent** to work in the UK private capital sector.
- Bringing carry into the income tax regime as a deemed trading profit could lead to **significant additional international tax issues**, including for UK-resident US persons, and those who travel frequently between different offices across Europe. Navigating double tax rules could become extremely complex and fund managers may look to focus their time outside the UK, which would be to the detriment of the wider economy. Therefore, it is **essential that the territorial rules are limited, designed carefully and that they are not onerous to comply with.**
- By setting an effective rate of around 34.1% (and potentially more in Scotland), the rules that will come into effect from April 2026 will **result in the UK having one of the highest rates of tax on carried interest** amongst key competitor jurisdictions, many of which are seeing this as an opportunity to attract talent away from the UK. This makes it all the more important that the changes that are implemented in addition to the rate increase do not make the UK less attractive as a place for managers to be based and to make investments.
- The rules that underpin the new regime already include clear requirements on holding periods for investment and risk-taking, as well as anti-avoidance provisions. The consultation asks for views on two potential additional conditions. Given the context outlined above and the requirements already embedded in the IBCI rules, **we do not think there is a case for introducing additional qualifying conditions**. We explain below why, under the IBCI framework, additional co-investment conditions or a further holding period are not needed and could in fact distort or damage investment.

- The IBCI rules also include many very detailed requirements intended to enable different types of fund structures. We welcome the Government's acknowledgement that some parts of the private capital industry (including private credit and secondaries funds) find it onerous to navigate these rules. In practice, these rules are complex and the industry has evolved since they were first introduced. Therefore, we **welcome the opportunity to provide recommendations to make the rules more workable.**
- We support the ambition for simplification and strongly recommend that the Government takes a pragmatic and flexible approach wherever possible. It is **essential that the UK remains internationally competitive** and that the rules are not so burdensome that investors are deterred from making the long-term investments in the UK that we need.
- We are pleased to participate in a detailed consultation process and **urge the Government to continue to consult industry on the development of legislation and guidance** to ensure that it is fit for purpose and does not deter investment into the UK.

Executive summary of the BVCA's representations on the proposed changes

The points we set out below aim to inform the Government's consideration and implementation of its proposals in such a way that minimises the risk of deterring investment.

The proposed new conditions

The BVCA's view is that it is not necessary for the Government to introduce either of the proposed new conditions set out in chapter 4 of the consultation and that to introduce either may have an appreciable negative impact on the UK's private capital industry. We respond below to the specific questions asked in the consultation, but in overview would make the following comments.

Aggregate minimum co-investment condition:

- There would be an unintended negative impact on smaller and emerging managers, and on venture capital managers, who may not have large amounts of capital to co-invest – with a knock-on impact on start-up businesses which would otherwise receive funding from this category of manager
- There would be significant added complexity in determining who needs to co-invest, how much is invested and what will count as a co-investment for this purpose
- A requirement for managers to invest their own money may be conceptually linked to capital gains treatment but it is not clear why this condition should apply if carried interest is to be taxed as income – this is reflected in the carried

interest tax rules of competitor jurisdictions in that countries which tax carry as income do not, so far as we are aware, also require a minimum level of co-investment

- Investors already require managers to co-invest, though the exact amount is highly dependent on the market and sector. Little would be achieved by legislating for this as a requirement beyond adding complexity and a greater need for HMRC to monitor compliance, while introducing market distortions to the natural commercial dynamics of investor negotiations
- While we are not in favour of introducing a co-investment condition, any changes in this area should not be applied at individual level, would need to be simple to comply with and should have a relatively low threshold

Minimum holding period for carried interest rights:

- This new condition would be in addition to the holding period that already exists in the IBCI rules. These two conditions measure different things so this change would impose a new and separate layer of complexity. No competitor jurisdiction has an equivalent double holding period requirement of this nature. We would urge the Government to rely on the IBCI rules as sufficient to limit qualifying carried interest treatment to the type of long-term investment for which the rules are designed.
- There is a risk of penalising strong fund performance that would otherwise result in carried interest being paid out earlier than anticipated, and of impeding the use of new types of carried interest structure that are becoming increasingly important in the industry. This risks distorting investment behaviours and creating misalignment between managers and investors which would affect the market. This is particularly the case with "deal-by-deal" carried interest structures, which are very much on the increase in the UK market and where there is greater potential for receipt of carry earlier in the life of the fund.
- Managers who are granted a potential right to received carried interest in the future would not have certainty on their tax position as, at the time of that grant, the period to payment would be unknown.

Moving carried interest from capital to income tax treatment

We understand that the decision to bring carried interest within the income tax framework was how the Government wished to deliver on its aim to reflect the economic characteristics of carried interest and the level of risk assumed by fund managers. We also understand that the new multiplier on the amount of carry subject to tax was intended as a simplification, given the blended rate that currently applies to carried interest proceeds in practice. We accept that having a single rate could achieve simplification in relation to carried interest returns for some managers, but have highlighted in this letter areas where the changes will result in significant added complexity.

One of the largest concerns raised by our members regarding the move to income tax treatment is around the considerably complex international issues. There is a strong perception that the change will result in significant uncertainty about how carried interest will be treated under double tax treaties, and an equally strong desire to avoid the need to resort to lengthy and complex treaty-based dispute resolution mechanisms. The managers most affected by this issue are also the most internationally mobile and there is therefore a real risk that if this is seen as a significant problem, these people will seek to ensure they do not come to the UK, with resulting knock-on effects for UK growth. This was recognised by the OBR in their recent paper on the costing of carried interest changes, where they state that the "main behavioural avenue for reducing liabilities is expected to be emigration."[1]

We understand, from the consultation and surrounding communications, that the Government intends the move to income treatment to be accompanied by an extension to the territorial scope of the UK tax charge on carried interest. We acknowledge that there are some scenarios in which the Government may consider it is right to extend the scope of the charge. However, we would urge the Government to have the UK's international competitiveness firmly in mind when setting the parameters of this extension.

For instance, we strongly advocate that the "tail" (the time within which someone who has left the UK may remain chargeable to tax on carried interest that relates to a former period of UK residence) should be limited in time, both as a transitional rule to exclude people who have already left the UK by a certain date, and as an ongoing overall limit to the length of time within which a tax charge may arise once someone ceases to be UK resident. It will also be crucial for non-residents to have clear, objective criteria to determine whether their UK activities will create a UK tax liability.

Extension of the IBCI rules

We note from the consultation that the removal of the employment-related security ("ERS") exemption to the IBCI rules is intended to correct an "arbitrary distinction"[2] for self-employed carry recipients. We also understand that the Government recognises that there is scope to simplify the IBCI rules.

While we are grateful for the Government's suggestion that this may be a good opportunity to modernise the IBCI rules, the removal of the ERS exemption has generated significant concern, particularly for certain categories of fund which to date

[1] Office for Budget Responsibility: Supplementary forecast information release: Costing of changes to the carried interest regime, 30 January 2025. Paragraph 1.10

[2] Paragraph 3.22 of the consultation

have relied on this exemption and which would face great difficulties complying with the IBCI rules as currently drafted. We have provided more details below on the significant challenges that this represents, and have made some suggestions as to ways in which the rules could be improved.

Payments on account

We have also drawn attention below to the practical difficulties that would arise if carried interest were to fall within the payments on account regime, given that carried interest receipts are inherently unpredictable, and many funds do not pay carry at all. We urge the Government to exclude carried interest from this regime, due to the significant additional administrative burden for taxpayers and HMRC for very limited benefit, and instead to tax carried interest only when it is received.

Our members' views

We have consulted our membership in detail about the consultation and the proposed reforms. The replies we received from our members have informed the responses in this letter, and we have included some illustrative quotes. These replies also revealed that of the members who responded to our questions[3]:

- Over 60% of respondents said the introduction of a new minimum co-investment condition would have a significant or potentially significant adverse impact on their firm.
- Over 70% said the introduction of a new holding period condition would have a significant or potentially significant adverse impact on them.
- Over 80% said that at least some of their carry recipients were in scope of the ERS regime.
- Over 65% anticipate that they will be negatively impacted by the removal of the ERS exemption if the IBCI rules are left as currently drafted.
- Approximately 70% have carry recipients who are resident outside the UK and come to the UK on short trips, and so will need to carefully consider the proposed changes to the territorial scope of the UK tax charge.

We now consider the specific questions asked in the consultation.

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

We consider that a new requirement for co-investment would create an unnecessary administrative burden and would be uncompetitive from an international perspective. While our response to the call to evidence indicated that, if introduced carefully, it would be possible to introduce a minimum co-investment condition without damaging

[3] Our survey received 45 full responses, though our membership is much larger. We have only used data from our members who responded in full.

growth and investment, this was on the basis that any such new condition would be an alternative to treating carried interest as employment income or trading profit.

There are difficulties associated with a minimum co-investment requirement, which we set out in our response to the call for evidence and which are alluded to in the consultation. Our previous comments concerning these difficulties did not envisage them being an addition to the challenges associated with trading profit treatment (most notably the complex international issues discussed below).

This "double requirement" is also not reflected in international comparisons. As our response to the call for evidence showed, a minimum co-investment is required in France and Italy where carried interest is taxed as a financial return, but not in Spain or Germany where it is taxed as employment/self-employment income.

There would, in addition, be a number of practical challenges involved in constructing a team-level co-investment requirement, including:

- How to define "co-investment" for these purposes. It would be important not to be too prescriptive on the terms of any condition and there would need to be flexibility to capture different sorts of investments made into the fund.
- How to define the "team" for these purposes. When investors evaluate the level of co-investment from the management team, they typically look at what the house as a whole contributes, which includes the GP entity as well as individuals. It would therefore make sense for any co-investment requirement to take a broad approach to what counts as a co-investment for these purposes, were this requirement to be imposed.
- Global private capital houses may award some carry to individuals from funds that are unrelated to the specific services they perform, to encourage a collaborative "one team" approach. It would be unrealistic to analyse the co-investment position for every fund within a global firm just because a small proportion of an individual's carried interest relates to the performance of all the firm's funds.
- Within a large firm, individuals move teams frequently, so tracking a "team" based solely on individuals would be administratively burdensome.
- The move to income treatment will require non-UK resident carry recipients to analyse their UK carried interest tax position and so also, potentially, whether they meet any new co-investment requirement. If the other recipients of carried interest from the same fund are not UK taxpayers, this would impose a disproportionate administrative burden and may discourage these people from working in the UK.

Therefore, while we would not be in favour of introducing a co-investment requirement, any changes in this area should not be applied at individual level, would need to be simple to comply with and should have a relatively low threshold, noting that different funds and limited partners may deploy different strategies and there are market dynamics that influence those.

A private equity firm told us:

> *"Introducing prescriptive definitional requirements into the UK tax code as to how that co-invest should be structured/financed from the team (irrespective of quantum) could create a distortive element that may unfairly penalise fund managers, particularly those without the resources to fund large co-investment programmes."*

A growth capital/mid-market firm commented:

> *"We don't consider a co-investment condition at any level is desirable as, while we appreciate the optics of managers having "skin in the game" it almost certainly adds significant uncertainty and complexity to rules with no discernible benefit."*

Question 2: Are there any further risks and/or wider considerations, beyond those identified via the call for evidence, that should inform decisions on whether the government progresses with a co-investment requirement?

We welcome the Government's recognition that it would be difficult to implement a co-investment condition on an individual-by-individual basis, and that the consultation focuses on measuring the requirement at a team level. We have previously made representations on the difficulties that an individual-by-individual test would cause for junior team members.

However, even a team level commitment will be challenging (the more so the higher the level is set) for emerging managers and new entrants to the market, given their relative lack of liquidity. There can also be regulatory questions about whether managers of certain funds are permitted to offer co-investment schemes to all staff. For instance, where UK funds are offered to UK staff, firms will generally seek to classify staff as "professionals" to allow them to invest in limited partnership funds (which are typically offered to professionals only). There is currently mixed practice around whether to use the "MIFID professional" standard for these purposes. This is a test that not all managers may be able to meet, as it relies on a net assets test in addition to expertise (in contrast to the longstanding non-MIFID test, which relies on expertise only). The issues become more complex for funds established outside the UK and/or where staff are based in multiple jurisdictions, as the regulatory treatment of different structures varies between jurisdictions.

We have also previously highlighted that even a requirement set at a low percentage would be unachievable for the largest funds, and would again draw attention to the lower percentage applied by France for funds of more than €1bn.

In both France and Italy, which impose this requirement, there are challenges associated with the application of the minimum co-investment requirement. As global fund structures become more diverse and sophisticated, there is a real risk that "legitimate" co-investment could fall outside any legislation on this point.

In addition, most fund managers are required to make co-investments of between 0.5% and 2% of total fund commitments as a commercial matter, though this practice varies significantly across sector, strategy and the size of the fund. It therefore appears very unlikely that adding what could be complex additional rules to cater for co-investment in all possible fund structures and in respect of all potential carry recipients would actually generate material additional revenue. It would simply make the rules more complicated and the UK a less attractive place for fund managers to work, which is already a concern in the context of the proposed rule changes (on carry and also on non-domiciled individuals).

In this respect, a private equity firm said:

> *"Our experience is that fund structures are becoming increasingly complex to meet the needs of international investors and wider regulatory and other reform. Therefore, attempts to create prescriptive definitions today for a co-invest condition will likely become obsolete quickly, again leading to unintended winners and losers. Increasingly complex tests in the legislation will make interpretation and compliance more challenging for fund managers (leading to higher costs where advice is required) and more difficult (and costly) for HMRC to enforce. These factors could be damaging for the UK fund management industry's competitiveness and therefore UK growth."*

We would also refer again to the representations we made in our response to the call for evidence concerning the need:

- to ensure that any changes do not constrain the ways in which carried interest and co-investment can be structured
- for any changes to be forward-looking only, and
- for purposive and flexible transitional provisions.

In this context, a venture capital firm said:

> *"Where countries have structured carried interest taxation to require minimum levels of GP commit, this raises barriers to entry for emerging managers and reduces the diversity of the industry because the ability to launch new funds is restricted to individuals with significant personal wealth or wealthy personal networks."*

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

In our view, the Government does not need to introduce this new condition as a protection against carried interest being used as a form of disguised annual or short-term bonus, as this protection already exists in the IBCI rules. These rules operate effectively to distinguish the "unique characteristics" of non-IBCI carried interest which "set it apart from other types of reward" (adopting the terminology of the consultation).

We consider that adding a universal, individual minimum holding period rule to the already complex IBCI rules would do little to protect Government revenue (for the reasons discussed below) but much to add uncertainty to the eventual tax treatment of carried interest when it is received, introduce unnecessary differences in the tax treatment of carried interest in ostensibly similar circumstances, and introduce potential tax motivated misalignment between fund managers (as the carried interest recipients) and their investors. All of this would detract from the basic attractiveness of the carried interest regime as one reason why fund managers are based in and operate from the UK rather than another country. We are concerned that this additional rule would undermine the Government's stated objective of introducing an improved carried interest tax regime which is "simpler, fairer and more stable".

Existing IBCI holding period

As is well understood, the IBCI regime already includes a requirement for carried interest to be paid from a fund that has an average holding period for its investments of 40 months (or 36-40 months on a tapering basis). This ensures that carried interest tax treatment only applies to returns from activities involving holding investments for the medium to long term.

Carried interest awards fit in with this timescale as they are intended (by fund investors as well as fund managers) to align the interests of the carried interest holders and the fund investors to generate capital returns over the expected life of the fund. Carried interest is not used by fund managers as a way of delivering short term rewards to their staff. Private capital managers normally receive a salary (if they are employees) or drawings (if they are LLP members), and often bonuses, all of which are taxed as income in the normal way. This is distinct from any right they may have to share in any future carried interest payments.

Team dynamics

There are circumstances in which carried interest will be allocated after the fund is already established. Examples of this would be when individuals join a fund manager, when individuals are promoted, and when individuals leave and their carried interest is reallocated. However, we think that it would lead to unnecessary complexity and uncertainty of future tax treatment to add an additional individual minimum holding period for these limited circumstances. It would, in our view, make the carried interest tax regime disproportionately unattractive in an attempt to protect against the use of carried interest as a form of disguised bonus, when that issue does not exist in practice in the industry.

Using the example of leavers, the rules will, as stated, include provision that the consideration for the sale of carried interest is treated as carried interest. Currently, the IBCI rules apply what is effectively a forward-looking test to whether that receipt would be taxed as IBCI or not, with a degree of practical certainty when the carried interest is granted. If an individual minimum holding period rule were added to the IBCI rules, then this would either mean that leavers might be adversely taxed (leading to an artificial incentive to remain with the fund in which they had carry) or would require the introduction of a bespoke derogation from the IBCI treatment, so adding additional complexity to the rules for little revenue generating purpose.

Penalising strong performance

We feel it is also important to recognise that strong early performance naturally shortens a fund's average hold period, creating a risk that new or extended holding-period requirements could unfairly penalise such success. All else being equal, a fund with stronger performance from assets acquired earlier in its lifecycle will typically have a higher IRR and pay out carried interest sooner. This outcome is clearly better for investors and is encouraged by the market, yet it results in a shorter hold period.

The current IBCI rules mitigate this to some degree by incorporating a forward-looking average. However, it is difficult to see how a comparable level of protection could be applied at the individual level without introducing significant complexity — particularly if two separate holding-period conditions are envisaged. If managers are discouraged from pursuing early, high-value opportunities or must navigate overly complex rules, they may favour jurisdictions that are more conducive to timely and proportionate rewards for strong performance.

In some instances where a fund is holding an asset in a separately managed account, a manager may have to dispose of an asset earlier than anticipated because the single investor requires liquidity or divestment. In such cases, which are outside of the fund manager's control, it seems inequitable to penalise potential carryholders.

Deal-by-deal carry structures

Funds that are structured on a "deal-by-deal" basis would also find it hard to meet a time-based condition such as is contemplated in the consultation. As we explained in our response to the call for evidence, most UK and European funds are structured on a "whole fund" basis, but US-style deal-by-deal models are becoming increasingly important. We would contend that it is in the interests of a strong UK private capital industry for a firm's choice between different carried interest models to be based on commercial, rather than tax, considerations.

Deal-by-deal arrangements typically have a similar overall economic outcome to a European-style "whole fund" model, as although they may deliver carry returns earlier, this is subject to clawback provisions which require managers to pay back amounts where the fund as a whole does not meet the requisite level of returns for investors. It is also often the case, particularly in a venture capital context, that any early carry payments may end up as a tiny fraction of the overall carried interest paid by a fund, but the proposed condition has the potential to taint the tax treatment of all that fund's carried interest.

We note that the IBCI rules already cater for deal-by-deal carry models and any holding period requirement at the participant level would need to recognise these arrangements.

A related point is that an increasing number of funds are set up as single-asset vehicles, either by managers who raise funding with a different mix of investors for each investment or in single asset continuation vehicles. These funds would typically pay out carry earlier than a fund that holds multiple investments, but any concern about not applying carried interest treatment to short-term investments is already adequately addressed by the IBCI rules and so, we would suggest, any additional holding period requirement is unnecessary.

International comparison

As a matter of international comparison, jurisdictions which impose a minimum holding period at an individual level (e.g. France and Spain) do not also have an equivalent of the IBCI rules. There is no jurisdiction which operates this double requirement. This would render the UK uncompetitive and out of step with rival jurisdictions.

If a separate requirement to monitor the period of time between carry being awarded and carry arising to carry holders is to be introduced alongside the extension of the IBCI rules, this will require extensive tracking of information. In the context of a large, multi-strategy manager with a highly mobile workforce, these changes will be particularly onerous, especially when compared to carried interest regimes in other jurisdictions. It would create a clear disincentive for fund managers to base themselves in or to work in the UK.

Design complexity

Additional points that would need to be addressed in designing any minimum holding period include:

- Identifying when the period begins and ends. Many firms do not award all available carried interest at the inception of a fund but make further awards of carry to individuals over the fund's life, based on those individuals' performance. Existing carry-holders may therefore be awarded carry at different times. We would urge the Government to avoid a rule that requires incremental awards of carry to be tracked for each carry-holder individually (potentially resulting in a blended calculation with some carried interest qualifying and some not). We would instead suggest that any such period should be measured at a fund level, as is the case with the equivalent rule in the French carried interest tax regime.

- Equitable treatment for clawbacks, which are particularly prevalent in deal-by-deal structures, whereby carry that has already been paid out can be required to be repaid if overall fund performance does not meet certain pre-agreed metrics. To avoid the need to recalculate the holding period in this situation (with the result that the manager may not achieve tax finality regarding their carried interest payments for many years after initial receipt), we would suggest that in these circumstances the holding period should continue to run until the entitlement to carry becomes absolute.

It follows from all of the above that it is not, in our view, necessary or helpful to introduce the additional complexity and uncertainty of an individual minimum holding period. Many of our members representing a wide range of firms consider that this would have an adverse effect on them. If the Government is, nonetheless, minded to introduce a minimum holding period, we would be keen to discuss this with you further with a view to helping to design the rule in a way that is flexible, workable and minimises additional burdens as well as any potential damage to the UK's international competitiveness.

A private equity firm said this about the proposed new minimum holding period:

> *"We believe this additional criteria is unnecessary, particularly when combined with a co-investment requirement and the current 40 month hold period concept. Given the duration which funds last, it is unrealistic to expect there to be no changes in allocation over the life of a fund (either to deal with leavers, promotions, new recruits etc) acknowledging that for those within the ERS legislation, valuation considerations will apply when granting the interest in any event. Time should run for these purposes from the first date of grant of any award rather than re-starting the clock for any incremental award."*

A global private equity firm and private credit investor told us:

> *"The best thing UK could do for competitiveness is to ensure the regime is not unduly complicated or restrictive. In this respect, we don't think an additional holding period at individual level is required given there is already fund level holding requirements via IBCI (and this is not dissimilar to US and German regimes)."*

A venture capital firm said:

> *"The VC sector is cyclical, and some vintages (eg 2021-22) will have much longer time elapsed between carried interest award and realisation; while in other vintages, the natural time frame will be much shorter. Any minimum hold period rules will need to take into account good vintages and bad vintages."*

A growth capital/mid-market firm commented:

> *"Introducing an individual-level minimum holding period poses significant risks of market distortion, which should be a primary policy concern. Such distortions include discouraging early wins by penalising rapid value creation, creating misalignment within teams by imposing disparate holding requirements, deterring spinouts and innovative fund structures, and hindering promotions and lateral hires by adding financial barriers to career advancement. These outcomes could undermine the dynamic and competitive nature of the UK private capital market, deterring both existing and potential talent, and stifling the entrepreneurial spirit that drives investment success."*

Question 4: Do you foresee any unintended adverse consequences for fund managers in existing funds from a government decision not to introduce transitional arrangements on the introduction of a condition of this kind?

In our response to the call for evidence, we addressed the unintended adverse consequences arising for fund managers following the introduction of a minimum co-investment condition, and the need for transitional provisions. Therefore in this letter we have focussed on the proposed minimum holding period condition.

Introducing a time-based condition will clearly benefit fund managers who have historically issued carried interest as early as possible in a fund's life. If such a condition were introduced without any transitional provisions, it would favour fund managers who had granted carried interest early. This would result in fund managers obtaining different tax treatment on the receipt of carried interest from funds that are ostensibly the same in terms of investment type and holding period, but where carried interest was granted earlier in one than in the other. We note that the holding period is not a condition that can be retro-fixed and is also not within the fund manager's control to manage going forward, as investments need to be realised in accordance with the commercially agreed terms of the fund.

The lack of parity of treatment between equivalent taxpayers and the inability to "cure" any failing in the historic holding period, especially where carried interest is otherwise "good", are, in our view, strong reasons to include some form of transitional provisions if a holding period condition is introduced.

Effective transitional arrangements would uphold investor confidence in the UK and minimise the risk of disruptive restructurings and relocations. Transitional provisions that respect the carried interest arrangements originally agreed between fund managers and their investors would maintain continuity, protect existing commitments, and maintain the stability of the UK as an asset management hub.

Broader observations on the new regime

As mentioned above, we have taken the opportunity provided by this consultation to highlight the following issues, all of which we hope to discuss with you in further detail as the draft legislation is developed.

International issues raised by the change from capital to income

We have significant concerns about the international issues that are created by bringing carried interest into the income tax regime as a deemed trading profit. The risk is that these will make the UK unattractive to the fund industry. The primary concern is the risk of double taxation and specifically that:

- UK residents may not obtain double tax relief for foreign taxes deducted at source on fund returns (e.g. withholding tax or non-resident capital gains taxes levied at fund level); and
- Non-UK residents may not be able to credit UK tax on their UK duties against tax in their country of residence.

This is likely to change these people's behaviour, because they may reduce or limit their time in the UK or not come here at all. We also note that non-residents will include both individuals who have left the UK in the past, and those who have never been UK tax resident.

For those that have left the UK in the past, we understand there may be concerns that some individuals might be awarded carried interest while working in the UK and then become non-resident, and so not pay their fair share of UK taxes. We recognise this concern when no or very little tax is paid in the other country, but many individuals will need to move to another country for business reasons and it will be a significant barrier to relocation if the individual then has double taxation in their new country due to their historic UK duties.

We therefore consider it extremely important that international matters are accorded suitable attention and careful discussion. Large numbers of our members have informed us that they have serious concerns in this area.

We recognise that the Government has already taken the decision to tax carried interest as a trading profit, but nonetheless consider it is right for us to point out that the international complexities we highlight in this letter would not arise if carry were to continue to be taxed as an investment return, as is the case under the current rules.

We would note that the reforms are without international precedent. The comparison with Germany is often cited, but this is misleading as the regime in Germany has a number of attributes that would not apply in the UK, including the specific German rules about trading and non-trading funds. We have included an example below which provides more information on the issues arising in Germany. Therefore, the future regime does not have an international comparison which could otherwise be used for exploring these points.

We appreciate the Government's focus on ensuring that the UK remains an attractive destination for the international asset management industry, most recently evidenced in the Mansion House speech of 14 November 2024. This will, we hope, include ensuring that the carried interest reforms are attractive to asset managers themselves, who are a highly mobile group of individuals. We welcome the Government's recognition of the need to ensure that talented professionals do not face unwelcome restrictions or complexities in the UK in relation to their financial incentives, and in particular when considering how the same incentives would be treated by other jurisdictions.

Impacts

We are concerned that, if these international issues are not addressed, the resulting complexities (particularly any uncertainty about the tax implications of standard business travel to the UK) could result in private capital firms choosing not to use the UK for their management team and possibly even for their investments and holding company structures, undoing previous successes such as the QAHC regime.

These disadvantages might well outweigh the potential additional tax revenue which the Government may seek to raise from taxing non-UK resident carried interest recipients on that part of their carried interest determined to be attributable to work done in the UK, after taking into account applicable double tax treaty protections. While it might be argued that many of these potential international issues are already present under the DIMF rules, most executives do not fall within DIMF. Carried interest has a much broader scope.

If issues as to creditability for double taxation are not adequately addressed, we are concerned that managers may stop coming to the UK. For instance, US nationals may face the prospect of UK tax on their carry of 34.1%, plus US federal tax of 20% or 37% (depending on whether the US regards this as a short or long term capital gain), plus US "net investment income tax" (NIIT) of 3.8%, plus, if they are living in the US at the relevant time, US state taxes of, for instance, 11% in New York or 13% in California. Similar concerns apply to nationals of other countries, for instance German nationals may face 34.1% UK tax plus 28.5% German tax. Our members based in global firms tell us that even today, when the reforms are still at the stage of consultation, the prospect of double taxation at these levels is making it difficult for them to persuade people in their own organisations to come to work in the UK.

A global private equity firm told us:

> *"Our funds invest all over the world and many countries seek to levy withholding taxes or non-resident capital gains tax on fund investment returns. This is an area of increasing scrutiny and litigation by international tax authorities and so it is important that the UK tax reform on carried interest*

allows double tax relief for taxes suffered at source on fund investment returns. In our view, the "deemed trading" treatment of carried interest is a significant barrier to achieving this with certainty as it will require Double Tax Treaty analysis on a case-by-case basis on every source of foreign income and gains suffering local taxes."

Regarding the potential impact on non-UK residents, a venture capital firm said:

> *"We view this as very negative for the industry. It is important to our business to be able to attract the best global talent to support our portfolio of start ups. These individuals tend to be globally mobile technical experts. As a result we may lose access to this talent."*

A private equity firm commented:

> *"The largest commercial impact is expected to be decreased interest from fund executives in travelling to and from the UK. This will be potentially damaging to the competitiveness of the UK's fund management industry unless uncertainty is resolved. Non-UK employees with alternative options will not want to be caught in the UK tax net on their carried interest (potentially for multiple years after their final UK workday) and so would be more reluctant to spend time in the UK. In contrast, UK employees are aware that they are already within the UK tax net, and that their carried interest is expected to be subject to UK tax even after they cease to be UK tax resident. In both scenarios the compliance burden of making double tax relief claims (and the risk of double tax if application of the treaty is unclear) are expected to be a deterrent to travel."*

Another global private equity firm and private credit investor told us:

> *"This has been the most talked about point of the proposed changes to carried interest. For any previous non-doms that have been tracking their UK / Non-UK work days there is some acceptance of how this might work but for many others who will now be caught they will not have this information easily accessible as will not have had to previously keep track. As noted above, it makes the UK significantly less attractive for anyone looking to do a short term assignment in the UK and is likely to be a significant impediment on us being able to attract the international talent which was previously easily accessible. There is also concern for the several individuals that have previously spent time in the UK but have been non-UK resident for some time as these individuals are now being clawed back into the UK tax net and will have limited knowledge or ability to comply with these new rules and we expect this retroactive taxation may also cause commercial tensions."*

A further venture capital firm pointed out:

> *"Not all of the value accrued to the carry pool was generated whilst the carry holder was a UK resident so doesn't seem right for the UK to bring 100% of the final carry amount into scope. Equally, it would be hard to discern the value accrued to the pool at the point of the carry holder becoming non-UK resident but that is potentially what should be done so as to only scope in the gains made whilst tax resident in the UK."*

We would welcome further discussions on the technical and practical aspects of these international issues, and also specifically on the many UK-resident US persons within the fund industry who, as you are aware, face specific tax challenges. This will be extremely important to our members.

Examples of common problem scenarios

We have previously shared with you examples of scenarios where international issues would give rise to problems and uncertainties under the new regime. We have summarised some of these examples below.

Example 1

A UK-resident individual works at a global private equity firm in the UK and receives £100 of carried interest from a US fund. £30 of US tax has been deducted from this payment because the US views the investment return at fund level as being ECI (i.e. US source income effectively connected with a US trade or business).

It is unclear whether the individual will be able to claim double tax relief for the US tax suffered at source on their UK personal tax return, and if not, whether there is anything else that can be done under the US/UK double tax treaty to eliminate double taxation. If obtaining relief involves something other than making a claim in a tax return, there is a concern that this would be costly, time-consuming and uncertain as to outcome.

Example 2

A French-resident individual works at a global private equity firm, spending four days a week working in France and one day a week working in the UK. They are exempt from UK payroll taxes under the short term business visitors rules and are generally eligible for benefits under the France/UK double tax treaty. They receive £100 of carried interest in 2027-28.

In this scenario, the individual will be concerned to know whether they have a UK tax liability or are covered by the treaty. If there is a UK tax liability, they will need to know whether this will be referable to their UK duties performed in 2027-28, or over a longer period, and potentially a period that began before April 2026 when the new rules come into effect. They will also need to know how to ascertain whether they have created a UK permanent establishment, and whether the carried interest would be regarded as attributable to their UK duties.

The individual would also be reliant on the French tax authorities allowing double tax relief for any UK tax liability, otherwise the effective tax rate on their UK duties would be over 70%.

<u>Example 3</u>

A UK-resident individual works at a global private equity firm. In 2026, they perform significant work on a European investment while based in the UK. They leave the UK in 2027 before receiving any carried interest. In 2028, they receive £100 of carried interest from the fund which aggregates returns from multiple deals, including the one on which they worked.

For the rules to be both fair and workable, it needs to be clear that any resulting UK tax arises in 2028, when the carried interest is received, and not 2026, when the services were performed. The individual will also need to know how to determine how much of the carried interest should be regarded as attributable to their UK duties. This could be calculated on the basis of time spent, although this would have an associated compliance burden and may not reflect how much each deal contributed to the carry payout.

Non-resident individuals – non-treaty jurisdictions

The focus of discussions during the consultation period has been on treaty jurisdictions and the meaning of a permanent establishment. The permanent establishment requirement for individuals derives from the operation of a typical treaty and the fact that the terms "business" and "enterprise" are generally defined so as to include individual activity; and a permanent establishment is generally required for a jurisdiction to have the right to tax an "enterprise" of the other jurisdiction. Thus, under a typical treaty, non-resident individuals carrying on a UK trade should only be subject to tax on the profits of a permanent establishment.

However, outside treaty protection, s6(2) ITTOIA 2005 provides that a non-resident is subject to UK tax on profits from a trade to the extent that the trade is carried on in the UK. There is no reference to the need for a permanent establishment; this concept arises in relation to corporation tax under s5 CTA 2009, but it is not present in s6.

Although the UK has a wide treaty network, there may well be jurisdictions which do not have a full treaty with the UK in which carried interest holders are resident. These individuals may need to consider their position to the extent they perform any services at all in the UK, however minor, and will be concerned to know whether they should expect to file a UK tax for extremely limited UK activity. This goes to the point alluded to below in relation to what will constitute the performance of the relevant services, but it is important that executives in non-treaty jurisdictions are considered. If there is insufficient clarity then, given the wording of the law in s6 ITTOIA 2005, the reality is that such individuals are likely to be advised that they must simply avoid any business travel at all to the UK, with adverse consequences for the UK fund industry.

Non-resident individuals – treaty application to a deemed trade

It will be extremely important to understand the Government's position on the application of treaty relief, how this is supported by case law in this area and the impact on wider considerations. We set out below some points to illustrate the areas on which clarity will be needed.

We note that there is, in reality, no individual trade being carried on by the executives concerned. Hence, a key question is the extent to which the Government considers that a trade deemed to exist for domestic law purposes can also be deemed to exist for treaty purposes, which would have the effect of extending the UK's taxing rights. We should be happy to discuss this when it has been fully considered by reference to the relevant case law.

If the Government's view is that this deeming rule can be read into treaties so that, generally, the UK will claim taxing rights in the event of a permanent establishment of the deemed trade, it cannot be assumed that treaty jurisdictions would readily accept a position which has the effect of reducing their taxing rights.

To give an analogy, suppose that the UK and jurisdiction X had entered into a double tax treaty with a "typical" capital gains tax article under which UK residents would be subject to tax on X-source gains only if they were, broadly, sourced from real estate located in X; otherwise, the UK would generally expect taxing rights on X-source gains arising to its residents. If X were subsequently to pass a law deeming all capital gains to be derived from real estate located there, it would not be expected that HMRC would simply accept reduced taxing rights under the treaty by virtue of a domestic deeming rule which does not reflect the reality assumed by the treaty. By extension, one would expect the UK's treaty partner jurisdictions to take a similar approach, if the UK takes the view that a deeming rule can be read into the treaty.

If other jurisdictions, as might be anticipated, take a different interpretation which preserves their expected taxing rights, it will be important to understand how the Government expects any resulting issues to be addressed. We would caution that, if it becomes necessary to rely on treaty-based mutual agreement procedures ("MAP"), this would make the UK much less attractive to the investment fund industry. The MAP process is regarded as time consuming and expensive, with disputes often taking years to resolve.

Example: carried interest from German non-trading funds

Germany taxes its residents on carried interest from non-trading[4] funds as deemed self-employment income at an effective tax rate of 28.5%. There has been a recent case in Germany where it was found that this carried interest should not fall into the "business profits" article of the US/Germany DTT and should instead be in the "capital gains" or "other income" articles. The case did not proceed further than this or consider double tax relief as it was only concerned with establishing the allocation of taxing rights, and it concluded that these belonged to Germany.

We consider that the arguments in this case carry over from the US to the UK/Germany DTT and that the precedent would lead to a difference in interpretation of the DTT if the UK were to look to the "business profits" article. In this situation, OECD guidance on the model DTT[5] Article 23 at paragraph 32.5 indicates that the country of residence (in this case Germany) would not need to give double tax relief and instead resolution would need to be sought via MAP.

The clarity of this German example is rare because there is at least some established precedent under this recent case (although no such precedent exists for German trading funds) and it highlights that there can still be material double tax issues even when the residence country taxes the carried interest as deemed self-employment income (i.e. in the same way proposed for the 2026 UK tax reform).

We also note this German tax case concerns matters that occurred in 2011 and was decided in 2024. Engaging in MAP in another country where there is no such domestic precedent represents a very long period of significant potential uncertainty for UK taxpayers over their double tax relief positions. This risk alone could significantly deter such individuals from spending time in the UK.

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[4] The 'non-trading' criteria in the German tax code is very different to the UK concepts of IBCI or the badges of trade. It is instead based on a 2003 circular issued by the German tax authorities. Before 2004, carried interest from non-trading funds was taxed as underlying returns at a time when Germany did not tax capital gains at all. In 2004, the law was changed to deemed self-employment income at a special tax rate as a compromise and it remains in place today.

[5] This OECD guidance is available at the following link and paragraph 32.5 is on page 1050 of the PDF: *https://www.oecd.org/en/publications/model-tax-convention-on-income-and-on-capital-2017-full-version_g2g972ee-en.html*

Another issue that would arise, if the Government's view is that the deeming rule can be read into treaties, is the question of how a permanent establishment of the deemed trade would be created. There would need to be clarity on when the Government is likely to consider a permanent establishment to have come into existence, how the nature of various activities will be treated, especially in a global deal context, and what evidence individuals will be required to produce of the nature of their activities. We would again emphasise that, if the Government places a significant or unclear evidentiary burden on executives to prove that "normal" business travel does not result in a UK tax liability, this is likely to dissuade funds from activity in the UK.

Additionally, while we understand that the target of the international elements of the proposed changes are executives who, broadly, leave the UK to become non-resident before their carry arises, treaties do not distinguish between different categories of non-residents in that way. Executives who have lived in the UK and then leave it and become non-resident under the provisions of the relevant treaty are no less non-resident for treaty purposes than those who have never been UK resident. It will not be possible to treat them differently under a treaty.

Withholding and source issues

A related issue is that if the UK regards any carry arising to non-UK residents as trading profit, it becomes unclear how relief will apply under other treaty articles.

For example, if carry arises to a French resident and is treated as being subject to UK tax as a deemed trading profit and within the business profits article of a treaty, a question arises as to the correct treatment of any UK withholding tax on e.g. interest amounts giving rise to the carry, for which the French executive would normally be able to claim relief under the UK/French double tax treaty. It is unclear whether the UK would provide treaty relief on the "interest" arising to the French executive, while simultaneously treating these amounts as the profit of a UK trade. Equally, if France does not respect the "business profits" treatment, it would not give credit for the UK tax and the executive would be subject to UK and French tax on the relevant amounts, possibly pending MAP procedures which, as indicated above, are unworkable.

The complexity is exacerbated if other jurisdictions are involved: for example if, in the previous example of the French executive, some of the carry which is potentially within scope of UK tax derives from Spanish source interest (or another jurisdiction requiring relief from withholding, potentially via treaty), there could be further issues. If the UK seek to apply the business profits article then the French executive may seek relief under that article. However, they might also seek relief under the Spanish (or other) treaty on the basis of receiving interest income from an investment. There could well be considerable resultant confusion in France as to the nature of the executive's activity and it would be extremely unlikely for the French tax authorities to accord relief under both treaties because the individual cannot readily claim that the same activity is both trading and investing. While these are not solely "UK issues", the UK's policy change would be the cause of the resultant problems rendering the UK a more complicated and unattractive jurisdiction with which to be involved.

UK-resident US persons

Specific issues arise in relation to UK-resident US persons. These people are not in a conventional treaty position because the US taxes its citizens on their worldwide income regardless of whether they are US resident. This means that the UK/US treaty contains some unique provisions to address these issues and, relatedly, some unique challenges.

As an example of the issues that will need to be considered, there are timing differences that can make it hard to match US and UK tax charges on carried interest for the purposes of double tax relief. To assist with this problem, a US person may make an election under s103KFA TCGA 1992, but the Government will need to ensure that they are not unintentionally disadvantaged by any aspect of the new rules. For instance, if the Government were to proceed with the introduction of a new minimum holding period, the earlier date on which carry is deemed to arise under a 103KFA election should not be taken as the relevant date when determining the length of the holding period.

We would be keen to have a separate discussion with you on these issues.

Transitional provisions

The international issues discussed above also raise important questions regarding the need for transitional provisions, which among other points should recognise that those who are potentially coming within the UK tax charge for the first time are unlikely to have sufficient historic records of their UK activities to allow them to make an accurate self-assessment for prior periods. We have not attempted to address transitional issues here, but would welcome the opportunity to discuss this with you as a part of a wider conversation about the international repercussions of the move to income treatment.

Further discussions

We appreciate that we have not, at this stage, offered specific solutions to these international issues - this is challenging in the absence of an understanding of the Government's technical position. We consider it important that there is continued close engagement on these issues. For instance, we would be keen to explore whether the extension to the UK's territorial scope could be better focussed on "problematic" circumstances, while not dissuading funds from operating in the UK.

We would also strongly advocate that the "tail" (the time within which someone who has left the UK may remain chargeable to tax on carried interest that relates to a former period of UK residence) should be limited in time, both as a transitional rule to exclude people who have already left the UK by a certain date, and as an ongoing overall limit to the length of time within which a tax charge may arise once someone ceases to be UK resident.

It will also be crucial for non-residents to have clear, objective criteria to determine whether their UK activities will create a UK tax liability. It may be worth exploring a rule, similar to the approach adopted in the rules on short-term business visitors, applying a minimum number of days per year which a non-UK resident would need to spend in the UK before they would have to consider whether they have triggered a UK tax liability.

We would welcome the opportunity to have further discussions with you about how the international issues we have raised could be addressed.

Application of IBCI regime to employees

The consultation explains that the exclusion (in s809FZU ITA 2007) from the IBCI rules for carried interest that arises in respect of employment-related securities (ERS) is to be removed, as the Government does not believe that distinguishing between employees and self-employed LLP members in this way is justified.

The current IBCI rules are complex and are already viewed as onerous to engage with, particularly by many international fund management groups. With the removal of the ERS carve-out, a far wider range of fund managers will now need to grapple with the monitoring and compliance burden of applying the rules. This will be particularly challenging in relation to carried interest deriving from funds that were established before the new rules come into effect. This could be alleviated by retaining the ERS exemption for carried interest that has been granted to employees before that date.

Interaction between the ERS regime and the new carried interest regime

The consultation is unclear as to how the charging provisions in the ERS code will interact with the new flat tax rate regime for carried interest. Para 3.23 says:

> "The removal of the ERS exclusion from the IBCI rules will not impact the application of the ERS rules to awards of carried interest to employees, where the rules will continue to operate as currently."

We understand that it is the Government's intention that the ERS rules will apply on the award of carried interest (so, in the context of a typical private equity fund limited partnership structure, when the individual executive acquires their interest in the carried interest partnership). However, it is unclear to us whether it is also intended for it to be possible for later employment tax charges to arise under the ERS regime. It is also unclear why there should be a tax charge on grant of carried interest, or the ERS rules should apply to carried interest at all, when the future receipts from it will be taxed as trading income.

We consider that the trading income charge should be the sole charge on the receipt of and returns from carried interest. This would have the benefit of simplifying the regime and be in accordance with the Government's flat tax rate policy. It would also prevent any distinction between the tax treatment of employee and self-employed carry holders.

We note that the consultation states at 3.12 that the new tax charge on trading profits will be an "exclusive charge"; this would not be the case if the ERS regime continues to apply.

IBCI and specific fund types

We welcome the Government's intention to make targeted amendments to the IBCI rules to ensure that they operate effectively.

The consultation recognises that it can be difficult to apply the IBCI rules to credit funds, but there is a much wider range of funds and structures that are currently not well catered for in this regard, where fund managers have effectively been relying on the ERS exclusion to date (because it is difficult to fit these funds within the simplified average holding period requirements and application of the rules without the simplified method is so complicated). We also note below that for some strategies, such as continuation funds, the IBCI rules may be triggered despite the true economic holding period being significantly longer than the 40-month minimum envisaged by the rules.

The current legislation takes a prescriptive approach, which means that it is not well adapted to the rapidly changing and flexible commercial environment of the private capital industry. A simpler and purposive approach which is based less heavily on the details of individual investment events would have much to recommend it, but we note that the consultation envisages the new laws working within the existing legislative framework. We have therefore addressed some specific issues in this regard below.

In this context, a global private equity firm told us:

> *"The IBCI rules are reasonably well tested for traditional VC and PE funds but there is wider concern over IBCI status for all other funds (e.g. debt, real estate, infrastructure, secondaries, fund of funds, continuation, retail PE, evergreen, multi-strategy ...). There are a large spectrum of strategies in the market which evolve over time (e.g. retail PE funds didn't exist when the IBCI rules were introduced in 2016). Which strategies need special IBCI rules/consideration and how will HMT/HMRC keep the conditions up to date as and when strategies continue to evolve (noting there is still no published HMRC guidance from the existing 2016 IBCI regime)?"*

Credit funds

The key problematic area for credit funds is that the IBCI regime distinguishes between loan origination and other credit strategies. The former are likely to be subject to the special rules for "direct lending funds" under which carried interest deriving from them is automatically IBCI unless it falls within a narrowly drafted exception. That exception, broadly, only applies to limited partnership funds with carried interest structured in accordance with the "MoU model" and for which at least 75% of their book is "qualifying loans". This is clearly problematic for corporate funds and for funds with non-MoU model carry (e.g. carry based on the net asset value of the fund's assets).

More generally, the IBCI rules do not contain provisions to cater for certain features of credit funds that can reduce average holding periods. For example, it is common for credit funds to originate loans and shortly thereafter to transfer tranches of them to other lenders. This process of syndication will reduce average holding periods but is not specifically allowed for by the regime. Similarly, the regime's limited "loan to own" provisions do not cater for most common security enforcement or borrower restructuring scenarios e.g. debt for equity swaps. The IBCI rules do specifically allow for early repayment by borrowers not to impact adversely on the holding period calculation, but this provision (s809FZR ITA 2007) essentially only applies to loans originated by the fund.

If credit funds are no longer able to rely on the ERS exclusion, it will be crucial that the IBCI regime is reformed so that it can be straightforwardly and fairly applied to the full range of strategies pursued by those funds which, in broad terms, are investing in loans in various forms rather than carrying out a traditional securities investment activity.

A growth firm making buyout and private credit investments said:

> *"Credit strategies and open-ended funds could be negatively impacted by the proposed changes. Unless the IBCI rules are significantly reformed credit funds will find it difficult to access the multiplier."*

Continuation funds

The IBCI regime can also pose problems for other fund strategies. In the years since the introduction of the IBCI regime, there has been significant growth in the use of "continuation funds" (sometimes called "continuation vehicles"). These support long-term investment strategies by enabling certain investors to exit, or sell down a stake in, an existing fund, while allowing other existing investors to retain an interest in the underlying assets and providing an opportunity for new investors. The structures used vary, but typically, all or some of the assets of an original fund are transferred to a new fund that is managed by the same management team, existing investors are given an opportunity to cash out (in whole or in part) or reinvest in the new fund and new investors are brought into the new fund.

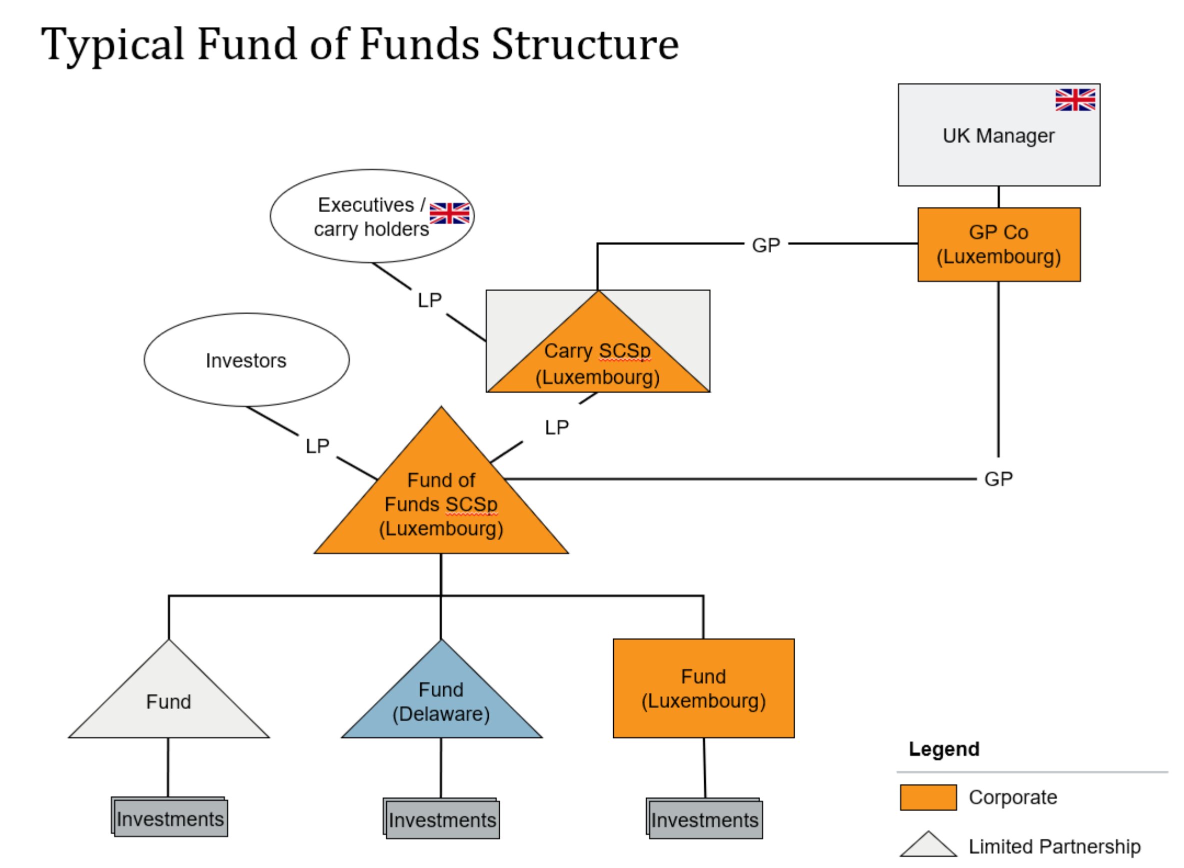
A sophisticated secondary market is important for closed-ended investment funds (such as limited partnership funds extensively used by many alternative asset classes, including private equity and venture capital). This is because it encourages initial investors, by giving them comfort that liquidity is likely to be available during the lifetime of the fund, and, in the case of continuation funds in particular, by facilitating further investment in assets that would benefit from more time and capital before leaving fund ownership.

However, the current IBCI rules can be problematic for continuation fund arrangements. This is because there are no provisions that allow the ownership periods of assets by the original fund and the continuation fund to be aggregated and treated as a single period of ownership. For example, if an original fund holds its assets for a weighted average period of 35 months before transferring them to a continuation fund managed by the same executives, DIMF charges may be triggered both at the time of the transfer and when the assets are realised, despite the total holding period being 70 months, with any initial DIMF charge potentially being unfunded (if the executives are not receiving cash proceeds or are required to reinvest their proceeds in the continuation fund, as will commonly be the case).

With a significantly increased cohort of individuals coming within the IBCI rules from 6 April 2026, we recommend that specific provisions are introduced to facilitate the use of continuation funds, for instance by recognising that they are a single, continuous investment for those carried interest holders who simply continue their interest in the continuation fund by rolling it over or “resetting” it.

Funds of funds and secondary funds

Funds of funds and secondary funds both make investments into other funds (many of which may operate outside the UK market entirely) as shown in the highly simplified[6] chart below.



Amounts invested into the underlying investments are dictated by the GP of the underlying fund, which will "draw down" amounts from investors on a regular basis to fund running costs as well as to make investments.

Specific, simplified rules as regards the computation of an average holding period for assets are critically important to these funds, as they will very rarely have the right to require underlying fund managers to produce the information needed to ascertain a holding period computed under UK tax law principles as regards the assets held by the underlying funds. This problem is compounded because in a real structure, there may be

[6] As stated, vehicles shown in this chart are by way of a simplified example. The vehicles shown may be located in other jurisdictions. Further, there are often many more vehicles which may be located in other non-UK jurisdictions beyond Luxembourg or Delaware.

many hundreds of underlying portfolio companies/assets, across multiple jurisdictions, and over which the fund of funds, or secondaries fund, can have no control.

Funds of funds and secondaries are an increasingly significant section of the private capital market, enabling investors, such as pension funds, to access a wider range of funds than would otherwise be practical, and also facilitating long-term investments by providing a mechanism for different investors to exit at different times.

The IBCI legislation already makes special provision for funds of funds and secondaries, thereby recognising the importance of these strategies, but, critically, the ERS exemption has meant that these rules are little used in practice. The removal of the exemption means that many participants in this sector of the industry will need to engage with the IBCI rules for the first time, and we envisage that this will be highly problematic for a number of reasons, including the difficulty with meeting the relevant definitions of a fund of funds or a secondaries fund, and the rules being widely perceived to be overly detailed and prescriptive. These difficulties are exacerbated by the fact that funds of funds and secondaries have separate definitions, when in reality many funds may have multiple strategies and invest in multiple asset classes.

We would encourage the Government to build more flexibility into the rules, so that they are fit for the market as it exists today, and can accommodate the ways in which it may evolve in the future.

Funds of funds and secondary funds: suggested improvements to the IBCI rules

The current rules provide that a fund of funds meeting certain conditions is not required to look through intermediate holding structures, but can treat its investments as being its holdings in the funds that it invests in directly. This is particularly important for all funds of funds to be able to rely on, and needs to be a robust and future proof test. The treatment of the fund interest as the "investment" by a fund of funds or secondaries fund is also consistent with reality and should, we would submit, be the default treatment.

We note that at present this override provision only applies to investments in underlying funds which are "collective investment schemes". In addition, in order to qualify as a "fund of funds" under these rules, "substantially all" of the fund's investments by value must be in "collective investment schemes", of which the fund holds less than 50% by value.

The use of the "collective investment scheme" definition to define the types of investment that can qualify is problematic, and increasingly so, as we see a rapidly increasing use of corporate fund vehicles in the market, for example in response to ATAD II reverse hybrid legislation applicable to partnerships being introduced in Luxembourg. Fund vehicles which are bodies corporate are generally regarded as being outside the collective investment scheme definition, making it now very hard for many funds of funds to clearly meet this test as regards their prospective investments.

In addition, the qualifying investment rules contain provisions broadly designed to prevent funds of funds from investing in funds managed by the same fund management group. We understand these to have been an anti-avoidance measure, rather than there being a specific objection to this as a matter of principle, and as such (given the more general anti-avoidance provisions already contained in the legislation) we think these could reasonably be removed.

In reality many funds in the market use external AIFMs to manage their funds and it seem to us very likely that entirely unrelated funds could be viewed as "managed" by the same manager under the existing rules, making it very hard to comply with and manage risk in this area. This is also anticipated to be problematic where, for example, management firms consolidate, so that there may be cross-investment in funds, or where a continuation vehicle (which has been set up to enable existing investors to have liquidity) acquires interests in other existing funds managed by the same fund management group.

A further problematic aspect of the "qualifying investment" definition is the concentration threshold whereby the fund of funds and any connected funds must hold no more than 30% by value in any underlying scheme. This is entirely out of the control of the fund of fund investor, and will change over time as the underlying funds continue to raise investments, if other investors default on their investment, and/or if there are mergers between fund management groups. It also presents challenges for parallel, "sidecar" or AIV structures, and does not account for "GP led" or continuation vehicles where ownership often exceeds these thresholds. All of these structures are becoming increasingly common in a market that has changed greatly since the IBCI rules were developed.

The requirement that the investment should be on "the same terms" as other investors in the underlying fund is similarly challenging; each investor will typically negotiate a "side letter" with a range of terms specific to their investment. Published HMRC guidance in this area, that has been so long awaited, could help to clarify these issues and offer some leeway on the interpretation of these areas.

The rules determining the start and end date of the holding periods for these funds operate by reference to "investments" of at least £1m or at least 5% of the amounts raised by the underlying fund being made or exited. We are unclear as to the rationale for these limits and thresholds and would welcome the Government revisiting them, to ascertain whether they are still necessary and, if so, whether they could be made less restrictive. If these restrictions are retained, guidance would be welcomed as to whether they apply to amounts committed to an underlying fund, or amounts drawn down. In addition, at present, interests held across multiple underlying fund vehicles within the same fund structure seem unable to be aggregated when applying these thresholds. This contrasts with other thresholds in the IBCI rules, where interests of "associated investment schemes" can be aggregated; a similar rule in this context would be helpful.

Very similar issues to the above also apply in the context of secondary funds, as the legislative test to qualify in this category shares many of the features of the fund of funds definition. In addition, as explained in the continuation fund section above, for funds which do not fall within the specific category, the rules do not cater well for this type of situation where a fund is buying into mature assets on the secondary market.

Multi-strategy funds

In practice, a private equity fund of funds may combine a primary investing strategy (i.e. one which makes traditional fund of fund investments by committing to invest in newly raised funds) with a secondary investing strategy (i.e. purchasing existing fund interests from investors wishing to exit their positions) and possibly also making direct minority co-investments (i.e. providing extra capital to invest directly into a deal that may be too large for the main fund to purchase alone). It is possible that multi-strategy funds may (co-incidentally) be able to meet the tests for one or more of the existing categories of fund (e.g. as a fund of funds) but this is far from certain, and as a policy matter there seems no obvious reason to disadvantage multi-strategy funds by requiring a proportion of the full amount of capital raised for a fund to be invested into a single strategy.

The same issue is also potentially relevant to fund managers who use compartmentalised corporate fund vehicles (such as those seen in Luxembourg and Ireland) where a new fund may be formed by creating a new compartment of an existing corporate fund vehicle.

The current qualifying tests applicable to different fund types generally require a significant proportion of the capital raised by the "fund" to be invested in a single strategy in order to qualify under the tests. We would welcome a relaxation of the rules in this area to allow multi-strategy funds to meet more than one test and still qualify, potentially under different categories for the different strategies.

Transitional issues

We would like to highlight the need for transitional arrangements in relation to the removal of the ERS exemption from IBCI. As set out above, in many strategies the process of calculating the average holding period is administratively very difficult and in some places impossible (for example, for a fund of funds not satisfying the conditions for fund of funds treatment that is not able to get information regarding underlying investments). For these arrangements, removing the ERS exception with no amelioration for existing arrangements will mean that many fund managers will be treated as receiving non-qualifying carried interest in situations where, although the conditions are satisfied, it is not possible for this to be proved.

Further, for funds to qualify for the special calculation treatments provided for in the IBCI rules, it is typically necessary to signpost a fund's investment intentions in the PPM (private placement memorandum), or other documentation made available to investors (s809FZY ITA 2007). A fund that has been relying on the ERS exemption may not have this documentation in place, even though, based on the investment strategy and operation of the fund, the conditions would otherwise be satisfied.

Payments on account

A practical matter that will need to be addressed under the new rules is the potential application to carried interest of the payments on account (PoA) regime. Carried interest receipts are inherently unpredictable, do not follow regular annual patterns and are often not received at all, posing significant challenges for carry holders to estimate their future receipts accurately for PoA purposes. If carry were to fall within the PoA rules, inaccurate estimates could result in significant cash flow challenges, or exposure to late payment interest.

There would also be an additional administrative burden for carry recipients of continually having to consider whether reductions to PoA amounts should be made or not (with very little clarity on whether such a reduction will ultimately be correct). This would place increased pressure on internal finance teams to generate accurate carry forecasts, which is particularly challenging due to the unpredictable timing and quantum of carried interest distributions. This would impose a significant burden on internal resources, and on HMRC to monitor compliance.

For these reasons we would urge the Government to exclude carried interest from the PoA regime, and instead to tax carried interest only when it is received.

Impact of change from capital to income on domestic venture capital

Finally, we wanted to draw attention to a practical matter regarding dry tax charges which has caused some concern amongst carryholders in the venture capital industry as a result of the proposed change in the taxation of carry from capital to income. It is common for some venture capital funds to distribute their carry in specie to their carryholders as stock in companies from which the venture capital fund is exiting, typically in an IPO. At such point, carryholders receiving the stock will suffer a dry tax charge unless the distribution also includes cash, which is not typically the case.

If the carryholder is not able to then sell this stock at a gain, they would, under the current framework, at least be able to offset the dry tax charge against the capital loss on the stock, or carry the loss forward to offset against future carried interest gains.

Under the new regime (with carry taxed as trading income), such deductions are evidently not possible. This risks making it less attractive to invest in venture capital funds, at a time when the UK needs more of this investment in order to drive growth. We note that in the US, carry in the form of public stock is not taxed until the shares are sold. This may be an approach the UK could consider adopting, but even then there would be transitional issues as many carry holders in the venture capital sector are holding shares today that will trigger significant losses, which they will be unable to offset against future carry once it is reclassified as income.

Thank you again for the opportunity to respond to this consultation. As this submission makes clear, there are many areas of detail where additional work is required. We welcome the consistent engagement by officials as you have worked with the industry to ensure you have a full understanding of the potential impact of the changes and how that would affect the UK's competitiveness.

The prospect of careful consideration of the industry's response to the consultation, and further detailed engagement to make the changes effective for both the Government and the industry, is welcome and essential if the significant remaining issues are to be resolved.

Yours sincerely,

Michael Moore
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