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## 22 Carried interest

- (1) In Chapter 5E of Part 13 of ITA 2007 (tax avoidance: disguised investment management fees), in section 809EZB(1) (meaning of “management fee”), for paragraph (c) substitute –
  - “(c) carried interest which is not income-based carried interest (see sections 809EZC and 809EZD for carried interest, and Chapter 5F for income-based carried interest).”
- (2) After Chapter 5E of Part 13 of ITA 2007 insert –

### “CHAPTER 5F

#### INCOME-BASED CARRIED INTEREST

##### *Income-based carried interest*

### 809FZA Overview

- (1) This Chapter determines when carried interest arising to an individual from an investment scheme is “income-based carried interest” for the purposes of Chapter 5E (and, in particular, section 809EZB(1)(c)).
- (2) Section 809FZB contains the general rule, under which the extent to which carried interest is income-based carried interest depends on the average holding period of the investment scheme.
- (3) Sections 809FZC to 809FZJ contain further provision relating to average holding periods.
- (4) Sections 809FZK and 809FZL contain an exception to the general rule for carried interest which is conditionally exempt from income tax.
- (5) Sections 809FZM and 809FZN contain a particular rule for direct lending funds.
- (6) Sections 809FZO to 809ZS contain supplementary and interpretative provision.
- (7) This Chapter does not apply in relation to carried interest arising to an individual in respect of employment-related securities as defined by section 421B(8) of ITEPA 2003.
- (8) Nothing in this Chapter affects the liability to any tax of –
  - (a) the investment scheme, or
  - (b) external investors in the investment scheme.

### 809FZB Income-based carried interest: general rule

- (1) “Income-based carried interest” is the relevant proportion of a sum of carried interest arising to an individual from an investment scheme.
- (2) The relevant proportion is determined by reference to the investment scheme’s average holding period as follows.

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<i>Average holding period</i>	<i>Relevant proportion</i>
Less than 36 months	100%
At least 36 months but less than 39 months	75%
At least 39 months but less than 45 months	50%
At least 45 months but less than 48 months	25%
48 months or more	0%

- (3) This section is subject to the following provisions of this Chapter.

*Average holding period*

**809FZC Average holding period**

- (1) The average holding period of an investment scheme is the average length of time for which relevant investments have been held for the purposes of the scheme
- (2) In this section, “relevant investments” means investments –
  - (a) which are made for the purposes of the scheme, and
  - (b) by reference to which the carried interest is calculated.
- (3) In relation to any sum of carried interest, the average holding period is calculated by reference to the time the carried interest arises.
- (4) It is calculated as follows.
 

*Step 1*

For each relevant investment, multiply the value invested at the time the investment was made by the length of time for which the investment has been held.

*Step 2*

Add together the amounts produced under *step 1* in respect of all relevant investments.

*Step 3*

Divide the amount produced under *step 2* by the total value invested in all relevant investments.
- (5) Disregard intermediate holdings or intermediate holding structures by or through which investments are made or held –
  - (a) when identifying, for the purpose of determining the average holding period of an investment scheme, what relevant investments are held for the purposes of an investment scheme, and
  - (b) for any other purpose relating to the determination of that period.
- (6) In this section, references to the length of time for which a relevant investment has been held are –

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- (a) in the case of an investment which has been disposed of before the carried interest arises, references to the time for which it was held before being disposed of, and
  - (b) in any other case, references to the time for which it has been held up to the time the carried interest arises.
- (7) For the purposes of this Chapter carried interest which is deferred carried interest in relation to a person within the meaning of section 103KG of TCGA 1992 is to be treated as arising to that person at the time it would have arisen had it not been deferred as specified in section 103KG(3)(a) or (b) of that Act.
- (8) Sections 809FZD to 809FZJ apply for the purposes of determining the average holding period of an investment scheme.

#### **809FZD Disposals**

- (1) An investment or part of an investment is disposed of where—
- (a) there is a disposal of the investment or the part of the investment for the purposes of the investment scheme which is a disposal for the purposes of TCGA 1992, or
  - (b) in any other case, there is a deemed disposal under subsection (2).
- (2) There is a deemed disposal of an investment or part of an investment under this subsection where—
- (a) under any arrangements—
    - (i) the scheme in substance closes its position on the investment or the part of the investment, or
    - (ii) the scheme ceases to be exposed to risks and rewards in the respect of the investment or the part of the investment, and
  - (b) it is reasonable to suppose that the arrangements were designed to secure that result.
- (3) In the case of a disposal of part of a holding of securities in a company which are of the same class, suppose for the purposes of determining which investments have been disposed of that the disposal affects the securities in the order in which they were acquired (that is, on a first in first out basis).
- (4) For the purposes of subsection (1)(a), disregard section 116 of TCGA 1992 (which disapplies sections 127 to 130 of that Act in relation to qualifying corporate bonds).

#### **809FZE Part disposals**

- (1) Where there is a disposal of a part of an investment, the part disposed of and the part not disposed of are to be treated as two separate investments which were made at the same time.
- (2) The value of each of those two separate investments is the appropriate proportion of the value first invested in the whole investment.
- (3) The appropriate proportion is the proportion of the value of the part in question to the value of the whole investment at the time of the disposal.

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- (4) The disposal of part of an asset includes the disposal of an interest in or right over the asset (and “part disposed of” is to be construed accordingly).

#### **809FZF Derivatives**

- (1) A derivative contract entered into for the purposes of an investment scheme is an investment, subject to the following provisions of this section.
- (2) The value invested in the derivative contract is –
- (a) where the contract is an option, the cost of acquiring the option (whether from the grantor or another person),
  - (b) where the contract is a future, the price specified in the contract for the underlying subject matter, or
  - (c) where the contract is a contract for differences, the notional principal of the contract.
- (3) But where entering into a derivative contract constitutes a deemed disposal of an investment or part of an investment by virtue of section 809FZD(2)(a)(ii) –
- (a) the derivative contract is not an investment for the purposes of this Chapter, and
  - (b) the subsequent disposal of the derivative contract without a corresponding disposal of the investment or part investment is to be regarded as the making of a new investment to the extent that the scheme becomes materially exposed to risks and rewards in respect of the investment or part investment.
- (4) For the purposes of this Chapter, references to disposal, in the case of a derivative contract, include any of the following events (to the extent that the event is not otherwise a disposal under section 809FZD(1) or (2)) –
- (a) the expiry of the contract,
  - (b) the termination of the contract (whether or not in accordance with its terms),
  - (c) the disposal, substantial variation, loss or cancellation of the investment scheme’s rights under the contract, and
  - (d) in the case of a derivative contract which is an option, the exercise of the option,
- but do not include the renewal of the contract with the same counterparty on substantially the same terms.
- (5) The substantial variation of an investment scheme’s rights under a derivative contract constitutes (in addition to the disposal of the contract as originally entered into (see subsection (4)(c)) a new investment consisting of the contract as varied.

#### **809FZG Hedging: exchange gains and losses**

- (1) This section applies where –
- (a) an investment scheme has a hedging relationship between –
    - (i) a derivative contract or a liability representing a loan relationship on the one hand (“the hedging instrument”), and

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- (ii) an investment made for the purposes of the scheme (“the hedged investment”), and
    - (b) the hedging relationship relates to exchange gains or losses.
  - (2) An investment scheme has a hedging relationship between a hedging instrument and a hedged investment if or to the extent that—
    - (a) the hedged instrument and the hedged investment are designated by the scheme as a hedge, or
    - (b) in any other case, the hedging instrument is intended to act as a hedge of—
      - (i) the exposure to changes in fair value of the investment or an identified portion of the investment that is attributable to exchange gains or losses and that could affect profit or loss of the investment scheme, or
      - (ii) the exposure to variability in cash flows that is attributable to exchange gains or losses and that could affect profit or loss of the investment scheme.
  - (3) Entering into the hedging relationship is not a deemed disposal of the hedged investment under section 809FZD(2).
  - (4) The hedging instrument is not an investment for the purposes of the investment scheme to the extent that the conditions in subsection (2)(a) and (b) are met.
  - (5) But the termination of the hedging relationship is the making of an investment constituting the hedging instrument if or to the extent that the hedging instrument continues to subsist.

**809FZH Hedging: interest rates**

- (1) This section applies where an investment scheme has a hedging relationship between—
  - (a) an interest rate contract, and
  - (b) a qualifying investment held for the purposes of the fund.
- (2) An investment scheme has a hedging relationship between an interest rate contract and a qualifying investment if or to the extent that—
  - (a) the interest rate contract and the investment are designated by the scheme as a hedge, or
  - (b) in any other case, the interest rate contract is intended to act as a hedge of—
    - (i) the exposure to changes in fair value of the investment or an identified portion of the investment that is attributable to interest rates and that could affect profit or loss of the investment scheme, or
    - (ii) the exposure to variability in cash flows that is attributable to interest rates and that could affect profit or loss of the investment scheme.
- (3) Entering into the hedging relationship is not a deemed disposal of the relevant investment under section 809FZD(2).
- (4) The interest rate contract is not an investment for the purposes of the investment scheme to the extent that the conditions in subsection (2)(a) and (b) are met.

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- (5) But the termination of the hedging relationship is the making of an investment constituting the interest rate contract if or to the extent that the interest rate contract continues to subsist.
  - (6) In this section “qualifying investment” means –
    - (a) money placed at interest,
    - (b) securities (excluding shares issued by companies), and
    - (c) alternative finance arrangements.

#### **809FZI Significant interest in a company: further investment**

- (1) Where an investment scheme has a relevant interest in a trading company or the holding company of a trading group, any further investment for the purposes of the scheme in that company is to be regarded as having been made at the time the relevant interest was acquired.
- (2) In this section “relevant interest” means –
  - (a) in the case of a controlling equity stake fund, a 25% interest, and
  - (b) in any other case, a controlling interest.
- (3) In this Chapter, “controlling equity stake fund” means an investment scheme in relation to which the condition in subsection (4) is met.
- (4) The condition is that it is reasonable to suppose that, when investments cease to be held for the purposes of the scheme, more than 50% of the total value invested for the purposes of the scheme will have been invested in investments which –
  - (a) are controlling interests in trading companies or trading groups, and
  - (b) have been held for more than four years.

#### **809FZJ Significant interest in a company: disposals of investments**

- (1) Where an investment scheme has a relevant interest in a trading company or the holding company of a trading group, any disposal for the purposes of the scheme of an investment in the company is to be regarded as not being made until the a relevant disposal is made.
- (2) In this section “relevant interest” means –
  - (a) in the case of a controlling equity stake fund, a 25% interest, and
  - (b) in any other case, a 40% interest.
- (3) In this section “relevant disposal”, in relation to a company, means a disposal which (apart from subsection (1)) has the effect that the scheme ceases to have a relevant interest in the company.

#### *Conditionally exempt carried interest*

#### **809FZK Conditionally exempt carried interest**

- (1) Carried interest which –
  - (a) arises to an individual from an investment scheme, and
  - (b) is conditionally exempt from income tax,is to be treated as if it were not income-based carried interest to any extent.

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- (2) Carried interest is conditionally exempt from income tax if Conditions A to D are met.
  - (3) Condition A is that the carried interest arises to the individual in the period of four years beginning with the day on which investments first start to be made for the purposes of the scheme.
  - (4) Condition B is that the carried interest would, apart from this section, be income-based carried interest to any extent.
  - (5) Condition C is that it is reasonable to suppose that, were the carried interest to arise to the individual at the relevant time (but by reference to the same relevant investments), it would not be income-based carried interest to any extent.
  - (6) The “relevant time” referred to in subsection (5) is whichever is the earliest of—
    - (a) the time when it is reasonable to suppose that the investment scheme will be wound up;
    - (b) the end of the period of four years beginning with the time when it is reasonable to suppose that investments will cease to be made for the purposes of the scheme;
    - (c) the end of the period of four years beginning with the day on which the sum of carried interest arose to the individual;
    - (d) the end of the period of four years beginning with the end of the period by reference to which the amount of the carried interest was determined.
  - (7) Subsection (5) does not affect what would otherwise be the time at which an investment is disposed of for the purposes of this Chapter.
  - (8) Condition D is that the individual makes a claim under this section for the carried interest to be conditionally exempt from income tax.

#### **809FZL Carried interest which ceases to be conditionally exempt**

- (1) Carried interest which is conditionally exempt from income tax ceases to be conditionally exempt from income tax at whichever is the earliest of—
  - (a) the time when the investment scheme is wound up;
  - (b) the end of the period of four years beginning with the time investments cease to be made for the purposes of the scheme;
  - (c) the end of the period of four years beginning with the day on which the sum of carried interest arises to the individual;
  - (d) the end of the period of four years beginning with the end of the period by reference to which the amount of the carried interest is determined;
  - (e) the time at which Condition C in section 809FZK(5) ceases to be met.
- (2) Carried interest which ceases to be conditionally exempt from income tax is to be treated as having been income-based carried interest at the time it arose to the individual if or to the extent that, had it arisen to the individual at the time it ceased to be conditionally exempt (but in relation to the same relevant investments) it would have been income-based carried interest.

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- (3) All such assessments and adjustments of assessments are to be made as are necessary to give effect to subsection (2).
  - (4) Any amount paid by way of capital gains tax in respect of carried interest which is conditionally exempt from income tax is to be treated as if it had been paid in respect of any income tax liability arising under subsection (2).

*Direct lending funds*

**809FZM Direct lending funds**

- (1) Carried interest arising from an investment scheme which is a direct lending fund is income-based carried interest in its entirety.
- (2) For the purposes of this Chapter, a direct lending fund is an investment scheme in relation to which it is reasonable to suppose that, when investments cease to be made for the purposes of the scheme, a majority of the investments made for the purposes of the scheme (calculated by reference to value invested) will have been direct loans made by the scheme.
- (3) For the purposes of this Chapter, an investment scheme makes a direct loan if for the purposes of the scheme money is advanced at interest to a company where—
  - (a) the company is not connected with the investment scheme,
  - (b) the money is advanced under a genuine commercial loan agreement negotiated at arm's length,
  - (c) repayments are fixed and determinable,
  - (d) maturity is fixed, and
  - (e) the scheme has the positive intention and ability to hold the loan to maturity.
- (4) For the purposes of this Chapter the acquisition of a direct loan is to be regarded as a direct loan if it is made within the period of 120 days beginning with the day on which the money is first advanced.

**809FZN Direct lending funds: exception**

- (1) Section 809FZM does not apply to carried interest arising from a direct lending fund if—
  - (a) it is reasonable to suppose that, when the investments cease to be made for the purposes of the fund, the relevant term of at least 75% of the direct loans made by the fund (calculated by reference to value advanced) will have been at least four years,
  - (b) the fund is a limited partnership, and
  - (c) the carried interest is a sum falling within section 809EZF(2) or (3).
- (2) Section 809FZB applies to carried interest to which, by virtue of subsection (1), section 809FZM does not apply.
- (3) In this section “relevant term” means the period which—
  - (a) begins with the time when the money is advanced, and
  - (b) ends with the time by which, under the terms of the loan, at least 75% of the principal due under the loan must be repaid.



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- (4) For the purposes of this Chapter, where –
- (a) a direct loan made by an investment scheme has a relevant term of at least four years,
  - (b) the loan is repaid by the borrower to any extent before the end of four years from the time the loan is made,
  - (c) the borrower is not connected with the investment scheme, and
  - (d) it is reasonable to suppose that the borrower’s decision to repay was not affected by considerations relating to the application of section 809FZM,
- the loan is to be treated as held for four years.

*Supplementary*

**809FZO Anti-avoidance**

- (1) For the purposes in subsection (2), no regard is to be had to any arrangements the main purpose of which, or one of the main purposes of which, is to reduce the proportion of carried interest which is income-based carried interest.
- (2) Those purposes are –
- (a) determining the average holding period, or
  - (b) determining whether an investment scheme is a controlling equity stake fund.
- (3) In determining to what extent carried interest is income-based carried interest, no regard is to be had to any arrangements the main purpose, or one of the main purposes, of which is to secure that section 809EZA(1) does not apply in relation to some or all of the carried interest.

**809FZP Treasury regulations**

- (1) The Treasury may by regulations make provision relating to the calculation of the average holding period in some or all cases.
- (2) That provision includes in particular –
- (a) provision for a method of calculating that period which is different from that in section 809FZC;
  - (b) provision as to what is and is not to be regarded as an investment;
  - (c) provision as to when an investment is to be regarded as made or disposed of;
  - (d) anti-avoidance provision.
- (3) Regulations under this section may –
- (a) amend this Chapter;
  - (b) make different provision for different purposes;
  - (c) contain incidental, supplemental, consequential and transitional provision and savings.

**809FZQ “Reasonable to suppose”**

- (1) For the purposes of this Chapter, in determining what it is reasonable to suppose in relation to an investment scheme, regard is to be had to all the circumstances.

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- (2) Those circumstances include in particular any prospectus or other document which –
- (a) is made available to external investors in the investment scheme, and
  - (b) on which external investors may reasonably be supposed to have relied or been able to rely.

*Interpretation*

**809FZR Controlling, 40% and 25% interests**

- (1) For the purposes of this Chapter, an investment scheme has a “controlling interest” in a company if share capital of the company is held for the purposes of the scheme which –
- (a) amounts to at least 50% of the ordinary share capital of the company, and
  - (b) carries an entitlement to at least 50% of –
    - (i) voting rights in the company,
    - (ii) profits available for distribution to shareholders, and
    - (iii) assets of the company available for distribution to shareholders in a winding-up.
- (2) For the purposes of this Chapter, an investment scheme has a “40% interest” or “25% interest” in a company if share capital of the company is held for the purposes of the scheme which –
- (a) amounts to at least 40% or 25% respectively of the ordinary share capital of the company, and
  - (b) carries an entitlement to at least 40% or 25% respectively of –
    - (i) voting rights in the company,
    - (ii) profits available for distribution to shareholders, and
    - (iii) assets of the company available for distribution to shareholders in a winding-up.
- (3) For the purposes of this section any share capital held by a company controlled by an investment scheme is to be regarded as held for the purposes of the investment scheme.

**809FZS General interpretation of Chapter 5F**

- (1) In this Chapter –
- “25% interest” and “40% interest” have the meanings given in section 809FZR;
  - “alternative finance arrangements” has the same meaning as in Part 6 of CTA 2009 (see section 501(2) of that Act);
  - “arrangements” has the same meaning as in Chapter 5E (see section 809EZE);
  - “carried interest” has the same meaning as it in section 809EZB (see sections 809EZC and 809EZD);
  - “contract for differences” has the same meaning as in Part 7 of CTA 2009;
  - “controlling equity stake fund” has the meaning given in section 809FZI;
  - “controlling interest” has the meaning given in section 809FZR;

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“derivative contract” has the same meaning as in Part 7 of CTA 2009 (but see below);

“designated” has the same meaning as for accounting purposes;

“direct lending fund” and “direct loan” have the meanings given in section 809FZM;

“exchange gain or loss” has the same meaning as in section 475 of CTA 2009;

“external investor” has the same meaning as in Chapter 5E (see section 809EZE);

“future” has the same meaning as in Part 7 of CTA 2009;

“interest rate contract” means –

- (a) a derivative contract whose underlying subject-matter is, or includes, interest rates, or
- (b) a swap contract in which payments fall to be made by reference to a rate of interest;

“investment” does not include –

- (a) cash awaiting investment, or
- (b) cash representing the proceeds of the disposal of an investment, where the cash is to be distributed as soon as reasonably practicable to investors in the scheme;

“investment scheme” has the same meaning as in Chapter 5E (see section 809EZA(6));

“limited partnership” means –

- (a) a limited partnership registered under the Limited Partnerships Act 1907,
- (b) a limited liability partnership formed under the Limited Liability Partnerships Act 2000 or the Limited Liability Partnerships (Northern Ireland) Act 2002, or
- (c) a firm or entity of a similar character to any of those mentioned in paragraph (a) or (b) formed under the law of a country or territory outside the United Kingdom;

“loan relationship” has the same meaning as in section 302 of CTA 2009 (but see below);

“option” has the same meaning as in Part 7 of CTA 2009, disregarding section 580(2) of that Act;

“sum” has the same meaning as in Chapter 5D (see section 809EZB(3));

“trading company” and “trading group” have the meanings given by paragraphs 20 and 21 of Schedule 7AC to TCGA 1992;

“underlying subject matter” has the same meaning as in Part 7 of CTA 2009.

- (2) For the purposes of the definition of “derivative contract”, read Part 7 of CTA 2009 as if –
  - (a) references to a company were references to an investment scheme, and
  - (b) references to a contract of a company were references to a contract for the purposes of an investment scheme.
- (3) For the purposes of the definition of “loan relationship”, read Part 5 of CTA 2009 as if –

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- (a) references to a company were references to an investment scheme, and
    - (b) references to a loan relationship of a company were references to a loan relationship for the purposes of an investment scheme.”
  - (3) In section 809EZA of ITA 2007 (disguised investment management fees: charge to income tax), in subsection (3) –
    - (a) in paragraph (a), for “performs” substitute “at any time performs or is to perform”;
    - (b) omit paragraph (b);
    - (c) in paragraph (c), for “the scheme” substitute “an investment scheme”.
  - (4) In section 2 of ITA 2007 (overview), in subsection (1), after paragraph (hb) insert –
    - “(hc) income-based carried interest (Chapter 5F),”.
  - (5) The amendments made by this section have effect in relation to sums of carried interest arising on or after on or after 6 April 2016 (whenever the arrangements under which the sums arise were made).