# Hong Kong's game changing proposal on tax concessions for carried interest, funds and single family offices

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## In brief

The Hong Kong SAR Government (Government) prioritises consolidating Hong Kong's status as a leading asset and wealth management hub. In the 2024/25 Budget speech, the Financial Secretary announced plans to enhance preferential tax regimes for funds, single family offices and carried interest by reviewing the scope of the tax concessions, increasing the types of qualifying transactions and improving flexibility for incidental transactions. The Chief Executive also reaffirmed that the Government would consult the industry on these enhancements in his 2024 Policy Address.

The long-awaited details of the proposed changes finally came in the form of a consultation paper issued by the Financial Services and Treasury Bureau on 25 November 2024 (Consultation Paper). The Consultation Paper sets out the proposed enhancements to the unified fund exemption (UFE) regime, the family-owned investment holding vehicle (FIHV) tax concession regime and the carried interest tax concession regime. The Consultation Paper at the same time proposes introducing a tax reporting mechanism and substantial activities requirement under the UFE regime. The Consultation Paper is part of an industry consultation process designed to collect feedback on the proposed changes, which will close on 3 January 2025.

The enhancements to the three regimes are expected to further solidify Hong Kong's status as a premier international asset management hub. Notably, the proposal to extend the carried interest tax concession regime to include carried interest arising from transactions in all types of qualfiying assets, rather than limiting it to private equity transactions, will greatly enhance the regime's appeal and practicality. This extension is anticipated to have a significant positive impact, making Hong Kong a more attractive destination for fund managers to establish their presence.

This news flash summarises the proposed enhancements and our observations, with focus on the carried interest tax concession and UFE regimes. For a more detailed discussion on the proposed enhancements to the FIHV tax concession regime, please refer to a separate news flash[1].

## In detail

The Consultation Paper proposes the following enhancements to the carried interest tax concession regime, UFE regime and the FIHV tax concession regime, and seeks industry's comments on the proposals.

## Carried interest tax concession regime

### Transactions giving rise to eligible carried interest

Under the current carried interest tax concession regime, the 0% concessionary tax rate only applies to eligible carried interest arising from profits on private equity transactions that are exempt from profits tax under the UFE regime.

The Consultation Paper proposes to broaden the types of transactions that can generate eligible carried interest. Provided that other conditions are met, eligible carried interest can be from the fund’s profits arising from all classes of assets specified under Schedule 16C to the Inland Revenue Ordinance (IRO) (Schedule 16C assets) which are exempted from tax under the UFE regime (i.e. not only from private equity transactions), other non-taxable income (such as dividend income and offshore income), and other taxable income. This means that fund managers employing various strategies (including hedges, private equity, venture capital, private credit and private investments with a side pocket in secondaries), and adopting different approaches to managing the Hong Kong tax position of the fund (such as claiming exemption under the UFE regime or lodging offshore claims) may benefit from the carried interest concession under the proposal.

### Payment flow of eligible carried interest to qualifying employees

It is a well-known concern within the industry that the current concession requires the fund to allocate carried interest through a qualifying person, typically a Hong Kong entity (e.g. the Hong Kong fund manager/investment advisor). However, it is common for carried interest recipients, who are employees of the fund manager or investment advisor, to receive carried interest via an offshore special purpose vehicle, such as a special limited partner of the fund, to allow flexibility in carried interest distribution for commercial reasons. This typical carried interest structure or flow (i.e. via an offshore carry vehicle) may not meet the eligibility requirements under the existing regime, which mandates that carried interest be distributed to a qualifying person who then further distributes it as income accrued from employment to the qualifying employees.

The Consultation Paper proposes to remove the ‘paid through the qualifying person’ requirement and broaden the scope of ‘associated corporation/associated partnership of certified investment fund’ in relation to the meaning of ‘qualifying payer’. This expansion aims to include ‘closely related entities’ of the certified investment fund, regardless of their legal form, thereby providing greater flexibility of the payment flow of eligible carried interest to qualifying employees. To achieve this, the Consultation Paper proposes that an entity is considered a closely related entity of another if (i) one has control over the other, or (ii) both are under the control of the same entity/person. Views are sought on how ‘control’ should be determined (e.g. a certain percentage of beneficial interest).

A ‘qualifying employee’ generally refers to an individual employed by a ‘qualifying person’ or its associated corporation/partnership conducting business in Hong Kong. The Consultation Paper suggests expanding the scope of ‘associate’ to include a ‘closely related entity’, aligning with the revised definition of ‘qualifying payer’. This would enable individuals employed by any entity within the same group, regardless of legal form, to qualify as ‘qualifying employees’.

### Hurdle rate

The regime currently requires a hurdle rate in a carried interest arrangement, and it is unclear whether the hurdle rate can be zero. As a matter of practice, the terms of each fund, including the hurdle rate, are commercial agreements between the investors and the general partner/fund manager, depending on the unique characteristics of each fund and the credentials of the investment team. It is not commercially practical to benchmark the hurdle rate of one investment fund against others engaging in the same or similar strategies. In fact, it is not uncommon that there is no hurdle rate (or the hurdle rate is zero) under a carried interest arrangement.

The Consultation Paper proposes to remove the hurdle rate requirement in the definition of ‘eligible carried interest’. This is a welcoming change that can accommodate the commercial realities of how funds operate.

### Certification requirement for funds

Under the current regime, tax concession only applies to carried interest paid out from a ‘certified investment fund’, which is certified by the Hong Kong Monetary Authority (HKMA) as compliant with the criteria for certification published by the HKMA. As part of the certification requirement, the fund or its investment manager is required to submit an auditor's report to assist the HKMA in determining whether a fund has invested in a private company. However, being an HKMA-certified fund does not automatically qualify the carried interest distributed by such a fund for tax concession. The Inland Revenue Department (IRD) would still need to assess whether other conditions are met before granting the concession.

The Consultation Paper proposes to remove the HKMA certification requirement (including the requirement to prepare an auditor’s report) to simplify the practical application of the concession.

***Our observation:*** *The Government's proposed enhancements to the carried interest tax concession regime address several long-standing issues since the introduction of the tax concession regime, such as the carried interest payment flow. These should be welcomed by the industry, as they now accommodate typical carried interest arrangements commonly adopted by funds. The removal of the HKMA certification requirement also simplifies the process of obtaining the tax concession and reduces compliance costs.*

*Most importantly, the proposed expansion to cover different types of income and profits – not only those arising from transactions in private companies exempt under the UFE regime but also other Schedule 16C assets (e.g. listed shares and private credit) – is a significant improvement over the existing regime. This broadens the scope of the tax concession regime to encompass almost all types of fund managers investing in Schedule 16C assets, which derive UFE tax-exempt, offshore sourced, and/or taxable income. This is a game-changing move to attract fund managers to establish and operate in Hong Kong.*

## UFE regime

### Definition of 'fund'

Currently, the definition of 'fund' specifically includes sovereign wealth funds. However, pension funds are not currently included in the definition, and depending on their specific structure and arrangement, they may not fall within the meaning of 'fund'. For example, overseas pension funds that set up wholly owned subsidiaries to act as their own fund managers may not qualify as a 'fund', and therefore would not be eligible for tax exemption under the UFE regime.

The Consultation Paper proposes to include pension funds within the meaning of 'fund', with the proposed scope defined as 'an arrangement that is established and operated in a jurisdiction exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and regulated as such by that jurisdiction or one of its political subdivisions or local authorities'. The proposed scope is closely modelled on the definition in the Global Anti-Base Erosion Model Rules under Pillar Two.

In addition to pension funds, the Consultation Paper proposes to include endowment funds[2] within the 'fund' definition.

However, the Consultation Paper does not propose to include a single investor fund (i.e. a 'fund-of-one'), which is commonly used for various commercial and practical reasons by investors, as a 'fund' that can enjoy tax exemption under the UFE regime.

### Business undertaking for commercial or industrial purposes

A business undertaking for general commercial or industrial purposes is not a fund and thus does not qualify for exemption under the UFE regime. While the Departmental Interpretation and Practice Notes No. 61 clarifies that a fund engaging in transactions in Schedule 16C assets will not be regarded as a business undertaking for general commercial or industrial purposes, the Consultation Paper proposes amending the relevant provisions in the IRO to codify this understanding in order to provide additional clarity.

### Expanding the scope of Schedule 16C assets as qualifying investments

Schedule 16C to the IRO specifies the classes of assets that qualify for profits tax exemption/concession under the UFE regime and FIHV tax concession regime. Introduced in 2019, Schedule 16C has not been updated since its inception.

*Loans and private credit investments*

During turbulent times, investors continue to favour credit funds and special situations-focused funds, which have grown significantly in recent years to capitalise on global market opportunities. However, the current UFE regime does not provide profits tax exemption for private credit funds, as 'loans' are not included in Schedule 16C. Consequently, profits from loan transactions do not qualify for profits tax exemption under the current UFE regime, and interest income derived from loans is not considered incidental income.

The Consultation Paper proposes including loans and private credit investments as Schedule 16C assets. This change would make transactions in loans and private credit investments, as well as interest income from holding these assets, eligible for profits tax exemption under the UFE regime (see the discussion on incidental income below regarding interest income.)

*Virtual assets*

Cryptocurrencies and digital assets are an emerging asset class for alternative investment managers, as well as for family offices and high-net worth investors. Keeping abreast of the scope of financial products and investments which are of interest to the investment sector is important in fostering Hong Kong as an international asset and wealth management hub.

The Consultation Paper proposes that the scope of virtual asset is to have the same meaning as that under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615), with the modification that a digital representation of value issued by a central bank, government or their authorised entities would still be included as a virtual asset. This definition encompasses commonly traded cryptoassets such as exchange tokens (e.g. Bitcoin and Ethereum), certain utility tokens and stablecoins.

However, similar to the approach adopted in the United Kingdom in defining designated cryptoassets qualifying for the Investment Manager Exemption, the proposed definition specifically excludes cryptographically secured digital representations that provide holders with an interest in any underlying assets other than the Schedule 16C assets, in order to protect Hong Kong's tax base and prevent the use of virtual assets to circumvent existing limitations on Schedule 16C assets.

*Interests in non-corporate private entities*

Currently, the UFE regime provides tax exemption for transactions in securities of private companies, excluding non-corporate private entities such as interests in partnerships. The Consultation Paper proposes expanding the coverage of Schedule 16C assets to include interests in non-corporate private entities and seeks comments on the types of such entities (e.g. partnerships) that should be covered.

*Other proposed qualifying investments*

Other proposed extensions to the scope of Schedule 16C assets are (i) immovable property situated outside Hong Kong; (ii) emission derivatives/allowance[3] and carbon credits[4]; and (iii) insurance-linked securities (proposed to have the same meaning given by section 129A of the Insurance Ordinance (Cap. 41), i.e. securities issued through insurance securitisation.

**Definition of private company**

Currently, a 'private company' is defined to mean a company (whether incorporated in or outside Hong Kong) that is not allowed to issue any invitations to the public to subscribe for any shares or debentures of the company.

To determine if a company can issue public invitations for share or debenture subscription, all circumstances are examined. For companies incorporated in Hong Kong, the Companies Ordinance applies to assess if it is a private company. For companies incorporated outside Hong Kong, overseas legislation applies. If a company is allowed to issue such invitations to the public by taking additional steps or seeking approval without a substantial change to its nature, the company is treated as not prohibited from issuing shares or debentures to the public, and consequently is not a private company.

The existing definition and interpretation may cause ambiguity regarding whether certain types of overseas companies are considered private companies. The Consultation Paper proposes simplifying the definition of a private company to mean a company whose shares or debentures are not traded on any stock exchange[5]. This proposed revision applies to both the UFE regime and the FIHV tax concession regime.

**Income eligible for tax exemption**

The IRD has long considered bond interest income as incidental income, subject to the 5% threshold, which has posed issues for bond funds deriving interest income as their primary source of revenue. The Consultation Paper proposes expanding tax-exempt income to include all income from qualifying transactions (which can cover interest income from bonds, marketable debt securities, loans and private credit investments), removing the 5% threshold and introducing an exclusion list. The Consultation Paper suggests that income derived from private companies engaged in property trading or property development of immovable properties in Hong Kong may be examples of income that will be excluded. These changes apply to both the UFE regime and FIHV tax concession regime.

To provide clarity, we recommend that the Government provide guidance on the types of income eligible for tax exemption, especially for newly added Schedule 16C assets, such as staking income from virtual assets.

**Definition of special purpose entities**

Currently, a special purpose entity (SPE) is defined as an entity that is wholly or partially owned by a fund and is established solely for the purpose of holding (whether directly or indirectly) and administering only Schedule 16C assets and/or investee private companies.

The Consultation Paper proposes to expand the permissible activities of SPEs to cover the acquisition, holding, administering and disposal of investee private companies and/or another SPE, as well as activities incidental to those activities. This proposed expansion in permissible activities would equally apply to SPEs under the FIHV tax concession regime.

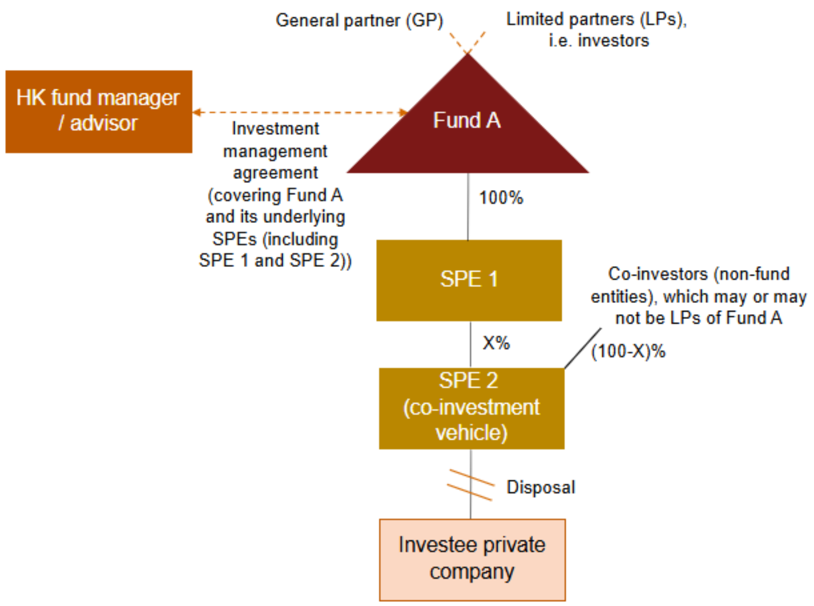
We welcome the proposed expansion of permissible activities for SPEs. However, to align with the current definition, the expanded scope of permissible activities should also apply in relation to other Schedule 16C assets, and not only to investee private companies and other SPEs.

**Application of UFE regime to co-investment vehicle**

A special purpose vehicle meeting the definition of SPE is exempt from profits tax under the UFE regime on its assessable profits to the extent that corresponds to the percentage of shares or interests that a tax-exempt fund holds in the SPE.

Issues may arise where an SPE acts as a co-investment vehicle. This is illustrated in the example below: SPE 2 is a co-investment vehicle which is X% held by Fund A (a tax-exempt fund) via SPE 1, and its remaining interests are held by co-investors that are non-fund entities. As the co-investors are not tax-exempt funds under the UFE regime, the part of the assessable profits of SPE 2 corresponding to the percentage of interests held by the co-investors are not tax-exempt in the hands of SPE 2, even though SPE 2 is managed by the fund manager of Fund A. Such partial exemption at the SPE 2 level gives rise to many practical and commercial challenges in allocating the relevant tax costs to the respective shareholders of SPE 2.

<u>Example – Typical co-investment structure</u>




The Consultation Paper proposes introducing a 'de minimis rule' such that if a tax-exempt fund has 95% or more of the beneficial interest (whether direct or indirect) in the SPE, the SPE's profits from transactions in qualifying transactions will be fully exempt.

While the proposal is a step in the right direction, the 95% de minimis threshold is unlikely to facilitate most co-investment scenarios, as co-investors typically hold more than 5% of the interests in the SPE. We recommend lowering the de minimis threshold to better accommodate these co-investor arrangements. To address potential concerns of abuse, the Government could consider implementing anti-abuse provisions to safeguard against such risks.

**Tests applicable to transactions in private companies**

Under the current UFE regime, profits from transactions in securities of a private company (not holding more than 10% of its assets in immovable property, excluding infrastructure, in Hong Kong) would not be eligible for tax exemption where:

- The securities in the private company being sold have been held by the fund or SPE for less than two years (i.e. holding period test);
- The fund or SPE has control over the private company (i.e. control test); and
- The aggregate value of the private company's short-term assets exceeds 50% of the value of the company's total assets (i.e. short-term asset test).

The Consultation Paper proposes to remove the control test and short-term asset test, but not the holding period test, in assessing whether tax exemption is available for profits from transactions in a private company under both the UFE regime and the FIHV tax concession regime.

Separately, subject to views on the proposed inclusion of interests in non-corporate private entities as Schedule 16C assets, the Consultation Paper proposes that the same set of tests will equally apply to the non-corporate private entities concerned.

The removal of the control test and short-term asset test, while retaining the holding period test, will narrow rather than expand the scope of the exemption. For example, if a fund holds a minority interest in a private company for less than two years before disposal, the gain would not qualify for exemption under the proposed revised rule. Therefore, we recommend that no changes be made to the existing tests applicable to transactions in private companies.

Acknowledging that the carve-out for 'infrastructure' may not cover some 'new infrastructure' such as data infrastructure and logistics centres, the Consultation Paper further proposes adjusting the definition of 'infrastructure' so that suitable types of infrastructure assets may be carved out from the application of the immovable property test.

**Deeming provisions**

Currently, the deeming provisions will apply to any Hong Kong resident person if the resident person, who alone or jointly with any of the person's associates, has a 30% or more of beneficial interest in a tax-exempt fund / an SPE (or any percentage if the fund is an associate of the resident person).

The Consultation Paper proposes to relax the application of the deeming provisions such that they would not apply to:

(i) resident natural persons;
(ii) resident holding entities (i.e. entities that are not business undertakings for general commercial or industrial purposes, do not carry on any trade or business, have a certain percentage of direct or indirect beneficial interest owned by resident individuals, and are interposed between the resident individuals and the fund);
(iii) resident funds exempted under the UFE regime;
(iv) resident persons who would have been exempted from tax in respect of income or profits derived from Schedule 16C assets if the assets had been held, or the transactions in those assets had been undertaken, directly by the person in the same manner as that of the fund. An example is life insurance corporations whose assessable profits are deemed to be 5% of the premiums from life insurance business in Hong Kong of the corporation during the basis period for that year.

To prevent the abusive use of the profits tax exemption by converting taxable transactions in loans and private credit investments by financial institutions, insurance companies and money lenders into tax-exempt transactions through structuring via a fund, the deeming provisions are proposed to be expanded. This expansion would deem Hong Kong resident investors who are financial institutions, insurance companies and money lenders, either alone or jointly with associates, holding 10% or more beneficial interest in a tax-exempt fund (or any percentage if the fund is an associate) as subject to the deeming provisions, in relation to income derived by the fund from loans or private credit investments.

**Tax reporting and substantial activities requirement**

The UFE regime has always been a self-assessment system, and pre-approval from the IRD is not required to enjoy the tax concession. Additionally, overseas domiciled funds meeting the eligibility conditions of the UFE regime are not required to file annual profits tax returns with the IRD.

The increasing focus of the Organisation for Economic Co-operation and Development on preferential tax regimes, along with the emphasis on substantial activities requirements and ongoing monitoring by the relevant tax authorities, are key elements in designing a preferential tax regime. To ensure that Hong Kong complies with international taxation standards, the Consultation Paper proposes a new tax reporting mechanism. Going forward, funds and SPEs intending to take advantage of the profits tax exemption under the UFE regime will need to file profits tax returns with the IRD annually.

The Consultation Paper indicates that the proposed tax reporting mechanism is intended to be simple, requesting only essential information. The IRD will continue to consult with the industry on the specific data points needed for tax reporting, based on feedback from the consultation.

Additionally, the Consultation Paper proposes introducing a substantial activities requirement, mandating at least two qualified employees and an annual operating expenditure of at least HK$2 million, subject to the 'adequacy' test. As with other existing preferential tax regimes, outsourcing of the investment services to third parties or associates is allowed, provided that the services are carried out by an outsourced entity in Hong Kong and the fund exercises adequate monitoring and control over the relevant activities. In determining whether a fund satisfies the substantial activities requirement, the IRD will thoroughly examine all the facts and circumstances relating to the fund, including the activities performed by the fund manager in Hong Kong.

***Our observation:*** *We welcome the Government's proposed enhancements to the UFE regime and FIHV tax concession regime, particularly the expansion of the scope of Schedule 16C assets to include loans, private credit investments, virtual assets and interests in non-corporate private entities. This aligns with the evolving investment landscape relevant to current economic conditions. Additionally, the inclusion of all income derived from qualifying investments and removal of the 5% incidental income threshold address the long-standing issue of bond interest income being treated as incidental income subject to the 5% threshold requirement. Allowing pension funds and endowment funds to qualify as 'funds' under the UFE regime is a strategic move to attract different classes of key investors to establish and operate in Hong Kong. The carve-out of resident natural persons, UFE-exempt funds, resident holding entities satisfying certain conditions and resident persons who would have been exempt from tax in respect of income or profits derived from Schedule 16C assets under specific provisions of the IRO from the deeming provisions is also a positive development.*

*However, the introduction of the new tax reporting requirement for filing profits tax returns with the IRD may be perceived as an added administrative burden for investment funds managed in Hong Kong. While tax reporting requirement is not entirely new in our neighbouring jurisdictions, we understand that the section 13D fund tax incentive scheme in Singapore remains as self-administered. Therefore, we support that tax reporting, if required, should be as simple as possible to minimise the information required to be reported. Furthermore, we recommend providing more guidance on how funds, particularly offshore funds, can comply with the tax filing requirement.*

*Besides, the proposed substantial activities requirement should be applied on a consolidated basis for the fund and all SPEs held, directly or indirectly, by the fund, rather than on each fund and SPE individually.*

*Given the unavoidable need for ongoing monitoring of tax incentive regimes in the current international tax environment, we hope that the IRD will adopt a pragmatic approach when implementing the new tax reporting mechanism and the substantial activities requirement.*

## The takeaway

We are pleased that the Government has taken industry feedback into account in the Consultation Paper to further enhance the carried interest tax concession regime, the UFE regime and the FIHV tax concession regime. We also look forward to the effective implementation of these enhancement measures.

Hong Kong is one of the largest asset and wealth management hubs in Asia, given its leading position as an international financial centre, a strong community of investors and professional service providers, and its proximity to Chinese mainland and other Asian jurisdictions. The enhanced preferential tax regimes will further strengthen Hong Kong's position and provide a conducive environment for the asset and wealth management industry. Nonetheless, in view of the rapid changes in market demand and financial market development, the Government should conduct regular and timely reviews of the enhanced regimes to ensure they remain attractive, effective, and well-utilised.

## Endnotes

1. Our news flash on the proposed enhancements to the FIHV tax concession regime can be accessed via this link: https://www.pwchk.com/en/hk-tax-news/2024q4/hongkongtax-news-nov2024-20.pdf

2. Proposed scope of 'endowment fund': An arrangement that is established and funded by a charitable entity for the purpose of (i) carrying out financial activities; and (ii) holding and managing a pool of assets, for the benefit of such charitable entity. In this regard, 'charitable entity' means a charitable institution or trust of a public character that is exempt from tax under section 88 of the IRO.

3. Proposed scope of 'emission derivatives': Derivatives that the payoffs of which are wholly linked to the payoffs or performance of the underlying emission allowances, of which the holding is recorded in a registry of a regionally or internationally recognised emission trading system (e.g. the UK Emissions Trading Registry, and the Union Registry under the European Union Emissions Trading System).

4. Proposed scope of 'carbon credits': Carbon credits that are traded on the Core Climate set up by the Hong Kong Exchanges and Clearing Limited.

5. The Consultation Paper proposes that the relevant time for determining whether a company of which the shares or debentures are held by the fund or SPE is a private company is the time when income eligible for the profits tax exemption is derived by the fund or SPE. Additionally, despite that the company's shares or debentures are traded on a stock exchange at the time when an income eligible for the profits tax exemption is derived by the fund or SPE, the company is still to be regarded as a private company if: (i) the income concerned is a gain from disposal of shares or debentures held by the fund or SPE in the company; and (ii) the Commissioner of Inland Revenue is satisfied that the main purpose, or one of the main purposes, of the public offering of the company's shares or debentures is to enable the fund or SPE to dispose of the company's shares or debentures.

## Let's talk

For a deeper discussion of how this impacts your business, please contact:

**PwC South China (incl. Hong Kong SAR) Tax Leader**

Jeremy Ngai
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

**PwC's Financial Services Tax Team based in Hong Kong**

John Chan[1]
Partner
+852 2289 1805
john.dp.chan@hk.pwc.com

Vanessa Chan
Partner
+852 2289 1804
vanessa.ps.chan@hk.pwc.com

Eric Gong
Partner
+852 2289 5626
eric.t.gong@hk.pwc.com

Rex Ho[2]
Partner
+852 2289 3026
rex.ho@hk.pwc.com

David Kan[3]
Partner
+852 2289 3502
david.kh.kan@hk.pwc.com

Sandy Lau
Partner
+852 2289 3526
sandy.wh.lau@hk.pwc.com

Jacqueline Yan
Partner
+852 2289 3530
jacqueline.yan@hk.pwc.com

Clarence Leung
Partner (Asset Finance and Leasing)
+852 2289 3599
clarence.kf.leung@hk.pwc.com

Peter Brewin[4]
Partner (Transfer Pricing)
+852 2289 3650
p.brewin@hk.pwc.com

Ali Tse
Partner (Transfer Pricing)
+852 2289 3508
ali.mh.tse@hk.pwc.com

Alex Xiang
Partner (Transfer Pricing)
+852 2289 5817
alex.xiang@cn.pwc.com

(1) Asia Pacific Insurance Tax Leader
(2) Asia Pacific Financial Services Tax Leader, Chinese mainland and Hong Kong SAR Financial Services Tax Leader, Hong Kong Asset & Wealth Management Tax Leader
(3) Hong Kong Real Estate Tax Leader
(4) Hong Kong Digital Assets Leader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For more information, please contact:

| | |
|---|---|
| Long Ma | Charles Chan |
| +86 (10) 6533 3103 | +852 2289 3651 |
| long.ma@cn.pwc.com | charles.c.chan@hk.pwc.com |

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