

Hong Kong (SAR) Tax Alert

July 2025 | Issue 5



The IRD's further guidance on the foreign-sourced income exemption regime



Summary

The Hong Kong Inland Revenue Department (IRD) recently provided further guidance on the foreign-sourced income exemption (FSIE) regime by publishing four new frequently asked questions (FAQs) on its designated FSIE webpage. In this tax alert, we summarise the key points covered in the new FAQs and share our observations.

The new FAQs on the FSIE regime

On 24 July 2025, the IRD posted four new FAQs¹ onto its webpage on the FSIE regime. The newly added FAQs are all grouped under "Covered Income" and marked as **NEW** on the webpage. We summarise in the table below the key points covered in the new FAQs.

New FAQs	The IRD's views / guidance
5	<p>When an investment in an overseas associate is accounted for using the equity method, the share of profits from the associate recognised in the income statement is not regarded as dividends under the FSIE regime. Instead, the actual profits subsequently distributed by the associate will be regarded as dividends.</p> <p><i>KPMG observations:</i></p> <p><i>An investor's accounting entries in respect of profits of an associate under the equity method are as follows:</i></p> <p><i>Share of profits from the associate:</i></p> <p>Dr. Investment in associate (B/S) Cr. Share of profits from associate (P/L)</p> <p><i>Profits distribution from the associate:</i></p> <p>Dr. Cash (B/S) Cr. Investment in associate (B/S)</p> <p><i>Given the above accounting entries and the IRD's clarification, MNE entities in Hong Kong with investment in an overseas associate would need to look beyond the income statement to keep track of any foreign-sourced dividends derived (in form of profits distribution from the associate) during a year of assessment (YOA).</i></p>

¹ The IRD's FAQs on the FSIE regime can be accessed via this link: <https://www.ird.gov.hk/eng/faq/fsie.htm>

New FAQs The IRD's views / guidance

- 8** Expenses incurred in producing taxable foreign-sourced gains from disposal of capital assets under the FSIE regime are deductible, provided that they are not themselves capital in nature.

*KPMG observations: The IRD's clarification is in line with our interpretation of section 15Q of the Inland Revenue Ordinance, which stipulates that an outgoing or expense incurred in producing specified foreign-sourced income that is chargeable under the FSIE regime may be deducted **in accordance with, and without limiting, Division 4** (which contains section 17(1)(c) on non-deductibility of expenses that are capital in nature).*

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- Redemption of bonds upon maturity does **not** constitute a sale and a gain on redemption (if any) is **not** regarded as a "disposal gain" under the FSIE regime.
 - However, for a zero-rated bond issued at a discount, the difference between the face value of the bond received upon redemption and the discounted purchase price **could be regarded as interest** under the FSIE regime.
 - Conversion of convertible bonds into equity interest is **not** regarded as a sale under the FSIE regime, provided that no transfer of asset by the taxpayer is involved. For any subsequent sale of the equity interest, the equity disposal gain will be computed based on the **original acquisition cost of the convertible bonds**.

KPMG observations:

In the case of a zero-rated bond (or other bonds issued at a discount), if the difference between the face value and discounted purchase price of the bond is regarded as foreign-sourced interest income, further clarification from the IRD on the following issues would be welcomed:

- *whether such interest income would be regarded as "received in Hong Kong" if the whole or a portion of the redemption proceeds are received in Hong Kong, and*
- *which year is the year of accrual for such interest income given that the economic substance requirement under the FSIE regime needs to be met in the year of accrual.*

For an MNE entity in Hong Kong that has elected for taxation of financial instruments on a fair value basis, the tax treatment would follow the accounting treatment and it appears that the foreign-sourced interest income would be regarded as accrued when the notional interest income is recognised in the income statement according to HKFRS 9. However, it is less clear whether the IRD would regard the year of redemption as the year of accrual for an MNE entity that has not elected for fair value basis of assessment and therefore the notional interest income recognised in the income statement is disregarded for tax purposes.

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- Foreign-sourced in-kind dividends (in form of shares of an overseas incorporated investee entity) distributed by a foreign subsidiary to an MNE entity in Hong Kong would generally **not** be regarded as received in Hong Kong if:
 - the investee entity has no business operation, establishment or staff in Hong Kong; **and**
 - the central management and control of the investee entity is exercised outside Hong Kong.
 - If the in-kind dividends received by an MNE entity in Hong Kong are subsequently distributed to its parent entity in Hong Kong, such dividends would **not** be treated as used to satisfy a debt incurred in respect of a trade or business in Hong Kong.

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- 13** *KPMG observations: In addition to this FAQ, the IRD has published Advance Ruling Case No.75² in which it ruled that in-kind dividends received by a Hong Kong company in form of shares of a foreign subsidiary which does not have any establishments, operations or assets in Hong Kong are not "received in Hong Kong". Based on the published ruling and the FAQ, it seems that the place where the share register is kept is not considered by the IRD as one of the crucial factors. In cases that are less clear-out than those outlined in the published ruling and the FAQ (e.g. a foreign-incorporated investee entity having a registered branch or minimal operations in Hong Kong but with the central management and control exercised outside Hong Kong), taxpayers would need to give the matter further consideration.*

KPMG observations

We welcome the IRD's further clarification on its interpretation and administration of the FSIE regime. However, as pointed out above, uncertainty on the tax treatment under the FSIE regime may still exist for more complex business arrangements or issues.

Business groups in Hong Kong deriving specified foreign-source income should take note of the IRD's latest guidance, consider the implications of such guidance in light of their own facts and circumstances, and determine whether actions are required to ensure tax compliance and optimise the overall tax outcome.

If you have any questions or need any assistance regarding the FSIE regime in Hong Kong, please feel free to [contact us](#) or your usual KPMG tax advisor.

² For more details of the case, please refer to our previously issued [Hong Kong \(SAR\) tax alert – Issue 15, November 2024](#).

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