

IRD releases further guidance on FSIE regime

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In brief

On 24 July 2025, the Inland Revenue Department (IRD) released further guidance on the foreign-sourced income exemption (FSIE) regime by expanding the list of related Frequently Asked Questions (FAQs) on its website¹. The newly added questions address whether specific items of income are considered covered income under the FSIE regime, the deductibility of expenses related to disposals and whether an in-kind dividend, in the form of shares in an overseas entity, is received in Hong Kong.

This news flash summarises the new FAQs and our observations thereon.

In detail

Share of profits from investment in overseas associate (FAQs – Question 5)

Under the equity method set out in Hong Kong Accounting Standard 28, an investment in an associate is initially recognised at cost. The carrying amount is then adjusted to recognise the investor's share of the associate's profits/losses, with a corresponding amount recognised in the investor's income statement.

A covered taxpayer's share of profits from an overseas associate, as recognised in the income statement, is not regarded as dividend under the FSIE regime. This is because such adjustments only reflect changes in the value of the investor's investment in the associate, not an actual distribution of profits. Instead, only when the associate actually distributes the profits to its investors will the distributed amount be regarded as dividend for the purposes of the FSIE regime.

Our observations: *The IRD's clarification indicates that the year of accrual for any dividend from an associate should be the year of assessment in which the dividend is declared by the associate. Accordingly, whether any of the relevant exception requirements (i.e. economic substance requirement or participation requirement) is met for such dividend should be assessed in the year when the dividend is declared, rather than the year(s) when the corresponding share of profits is recognised in the investor's income statement. As any dividend declaration will not be recognised in the income statement, covered taxpayers should ensure that mechanisms are in place to carefully track the timing of dividend declaration for accurate reporting.*

Deduction for expenses related to disposal of property (FAQs – Question 8)

Any foreign-sourced disposal gain deemed chargeable to tax under the FSIE regime is treated as not arising from the sale of capital assets even if it so arises. Generally, the taxable disposal gain is calculated as the excess of the disposal proceeds over the acquisition cost of the property and any direct expenses related to the purchase and sale of the property (e.g. legal cost and stamp duty).

For other expenses incurred in the production of the taxable disposal gain, subject to the normal deduction rules (e.g. expenses that are of a capital nature are non-deductible) and to the extent not already deducted for any year of assessment, they may be deducted as if they were incurred in the year the gain is received.

Our observations: *The IRD's clarification emphasises that the deduction of other expenses is subject to the normal deduction rules. In addition to the distinction between capital and revenue expenditure, the deduction of certain types of expenses can be subject to further conditions. For instance, the deduction of interest expenses is governed by section 16(2) of the Inland Revenue Ordinance. If the relevant conditions are not met, interest expenses incurred on money borrowed to finance the acquisition of the property will not be deductible.*

Redemption of bonds and conversion of convertible bonds into equity interest (FAQs – Question 9)

Under the FSIE regime, a 'disposal gain' means any gain or profit derived from the sale of property, while 'sale' refers to a transfer of the property (other than a transfer effected by extinguishing the property) for valuable consideration.

Redemption of bonds

Redemption of bonds refers to the repayment of the principal by the bond issuer to the bond holder upon maturity. Since the redemption of bonds does not constitute a sale, any gain derived therefrom is not regarded as a disposal gain under the FSIE regime.

However, in the case of a zero-rated bond, which was issued to the bond holder at a discount, the difference between the discounted acquisition price and the face value received by the bond holder upon redemption can be regarded as interest income to the bond holder under the FSIE regime.

Conversion of convertible bonds into equity interest

Conversion of convertible bonds into equity interest is not regarded as a sale, provided that there is no transfer of asset by the taxpayer. If the equity interest is subsequently sold, the initial purchase cost of the bond will be taken into account in ascertaining the disposal gain on the equity interest.

Receipt of foreign-sourced in-kind dividend in the form of shares in an overseas entity (FAQs – Question 13)

A covered taxpayer received shares in an overseas entity as in-kind dividend from its foreign subsidiary and then distributed those shares to its Hong Kong parent company. The investee entity is incorporated outside Hong Kong, its central management and control are exercised outside Hong Kong, and it has no operations or staff in Hong Kong. Generally, under the FSIE regime, such a foreign-sourced dividend would not be regarded as received in Hong Kong, and would not be treated as used to satisfy a debt incurred in respect of a trade or business carried on in Hong Kong.

Our observations: *The in-kind dividend distribution arrangement described above closely resembles the published Advance Ruling Case No. 75², in which it was ruled that in-kind dividend in the form of shares in an overseas entity shall not be regarded as received in Hong Kong under the FSIE regime. It is encouraging to note that the IRD is now providing further clarification on this issue. The IRD's clarification reaffirms its practice that unremitted income used for payment of dividend to shareholders, whether paid in cash or in kind, would not be regarded as received in Hong Kong. It would be helpful if the IRD could also provide additional guidance on how to determine whether covered income is regarded as 'received in Hong Kong' when received in the form of non-cash assets other than shares in an entity. For example, it is not uncommon for covered income to be received in the form of debt instruments, such as promissory notes. Clear guidance on the treatment of such non-cash assets would help covered taxpayers better understand the tax implications under the FSIE regime.*

The takeaway

We welcome the IRD's additional guidance on the FSIE regime as it provides greater clarity to taxpayers. It is expected that the IRD will continue to issue further guidance in the future, given that the FSIE regime is still in its early stages of implementation and practical uncertainties are likely to occur as taxpayers and practitioners apply the regime. We will continue to monitor the development in this area and provide updates on any significant changes as they arise.

In view of the complexities associated with the application of the FSIE regime, businesses are encouraged to seek professional advice, and where necessary, obtain advance rulings for upfront certainty. If you require our assistance, please do not hesitate to contact us.

Endnotes

1. The updated FAQs can be accessed via this link:
<https://www.ird.gov.hk/eng/faq/fsie.htm>
2. The published Advance Ruling Case No. 75 can be accessed via this link:
<https://www.ird.gov.hk/eng/ppr/advance75.htm>

Let's talk

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

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