pwc

Hong Kong Tax News Flash

IRD expresses views on FSIE and international tax issues at 2025 annual meeting with HKICPA

31 March 2026
Issue 5

In brief

The minutes of the 2025 annual meeting between the Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants (HKICPA or Institute) held on 30 May 2025 were recently released[1]. The meeting minutes summarise the IRD's views on various tax issues expressed during the meeting, including issues related to profits tax (covering the foreign-sourced income exemption (FSIE) regime and other matters), salaries tax, international tax and administrative matters.

This news flash highlights the IRD's views on issues related to the FSIE regime and international tax, along with our observations. For the IRD's views on other key profits tax issues, please refer to another news flash[2].

In detail

FSIE regime

EU's review on FSIE regime

The IRD reported that, since the European Union (EU) removed Hong Kong from its watchlist on tax co-operation in February 2024, Hong Kong had not been informed by the EU of any further review of the implementation of the FSIE regime in Hong Kong.

Asymmetric treatments of interest income and interest expense

(i) Offshore claim on interest income

Under the FSIE regime, offshore interest income received in Hong Kong by a covered taxpayer is deemed taxable unless the economic substance requirement (ESR) is met.

For interest income derived from lending that is not a simple loan of money (including a one-off loan financed by borrowing), the operations test applies to determine the source of the interest income.

There is a concern that satisfying the ESR may undermine the offshore nature of interest income under the operations test, as the activities counting towards the ESR may also be considered relevant operations for source-rule purposes. Therefore, the Institute sought clarification from the IRD on whether, under the operations test, offshore interest income received in Hong Kong can remain not chargeable to profits tax despite satisfying the ESR.

The IRD's clarifications are summarised below:

- The IRD reiterated that the determination of the source of profits and the assessment of whether the ESR is met were separate matters to be considered in separate contexts.

- For interest income, the operations test focused on the substantive activities that put the loan in place to generate the interest income (e.g. sourcing funds and discussing the loan terms with the borrower).

- To satisfy the ESR, a non-pure equity-holding entity should have an adequate number of qualified employees in Hong Kong and incur an adequate amount of operating expenditure in Hong Kong for carrying out the specified economic activities (SEAs), including (i) making necessary strategic decisions and (ii) managing and bearing the principal risks in respect of the assets the entity acquired, held or disposed of.

- As the SEAs were not necessarily the same as the profit-generating operations from which offshore income was derived, the determination of the source of profits was not affected by the ESR. For instance, strategic decisions made in Hong Kong (e.g. type of borrowers, short-term/long-term loan), may satisfy the ESR. Depending on the facts and circumstances of the case, the mere making of strategic decisions might not necessarily constitute profit-generating activities.

Our observations	We welcome the IRD's clarification that activities undertaken to meet the ESR do not necessarily compromise the offshore nature of interest income under the operations test. While the source of profits and the ESR are technically distinct matters, the boundary between them may not be entirely clear in practice. Professional advice should be sought where necessary, and covered taxpayers seeking certainty on their interaction may wish to apply for an advance ruling.

(ii) Deductibility of interest expense

Where a company that is not carrying on an intra-group financing business borrows from lenders outside Hong Kong that are not financial institutions to generate interest income, that interest income will be taxable if it is either (i) onshore sourced, or (ii) offshore sourced but the ESR is not met. Even if the interest income is taxable, the related interest expense will generally be non-deductible because the company cannot satisfy any of the conditions under section 16(2) of the Inland Revenue Ordinance (IRO). This asymmetry, which has become more common following the implementation of the FSIE regime, creates significant dilemmas. Against this background, the Institute asked whether the IRD

would consider reviewing the interest deduction rules or providing concessions to preserve Hong Kong's competitiveness as an international financial centre.

The IRD's responses are summarised below:

- The conditions in section 16(2) were anti-avoidance provisions and should apply to all claims for interest deductions, irrespective of whether the relevant interest expense was incurred in producing taxable onshore interest income or offshore interest income that was chargeable to tax under the FSIE regime.

- Given that Hong Kong's tax system was unique and differed from those of other jurisdictions, any consideration of adopting approaches used elsewhere would need to be accompanied by appropriate safeguards to prevent abuse.

- There were already certain exceptions to the general interest deduction rules to accommodate the needs of specific industries or business activities (e.g. interest incurred for the acquisition of (i) aircraft by a qualifying aircraft lessor and (ii) machinery or plant for research and development activities).

- Refinement to the interest deduction rules could be explored, but any amendments would require a strong policy justification, robust anti-avoidance safeguards and careful assessment of the economic impact. As a full-scale review would take time, interim targeted relaxations for certain industries or business activities might be worth exploring.

Our observations	The restrictive deduction conditions in section 16(2) may increasingly result in interest expenses incurred in producing assessable profits being non-deductible. Consequently, taxpayers' lending activities are effectively subject to profits tax on a gross rather than net basis, creating an undue financial burden. This risks undermining Hong Kong's competitiveness as an international financial centre. We hope that the Government's current review of the tax concession for corporate treasury centres (CTCs) will address these concerns and at least lead to enhancements in the interest deduction framework applicable to CTCs, as we advocate, thereby safeguarding Hong Kong's competitiveness.

Filing of profits tax return in respect of non-resident persons (BIR 54)

For a covered taxpayer engaged in the sublicensing of a trade mark for use outside Hong Kong, where both the licensing and sublicensing contracts were effected outside of Hong Kong, the relevant royalty income should be offshore sourced. As a trade mark is not qualifying intellectual property (IP), that income will be deemed taxable under the FSIE regime when it is received in Hong Kong

The IRD confirmed that, where such royalty income is received in Hong Kong and deemed taxable in a later year (i.e. year of receipt), rather than the year in which it is recognised in the accounts (i.e. year of accrual), the corresponding royalty expense paid to the non-resident licensor, which would otherwise be non-deductible, becomes deductible in the year of receipt. Accordingly, the non-resident licensor is chargeable to profits tax on the royalty payment made by the taxpayer under section 15(1)(ba) of the IRO in the year of receipt, and the taxpayer is required to file BIR 54 and comply with the withholding obligation under section 20B of the IRO.

To ease the taxpayer's compliance burden and subject to the taxpayer's agreement, the IRD indicated that it could explore an administrative arrangement under which the royalty income would be assessed in the year of accrual regardless of whether it is received in Hong Kong. In this case, the relevant filing and withholding obligations could be met in the year of accrual.

Our observations	We appreciate the IRD's willingness to consider an administrative measure to ease taxpayer's compliance burden. This issue is relevant not only to trade marks, but also to other types of IP, because even where the IP is qualifying IP, a covered taxpayer will generally be unable to meet the nexus requirement under a licensing and sublicensing arrangement. If such a measure is introduced, taxpayers should assess whether the foreign-sourced royalty income is likely to be received in Hong Kong, having regard to the intended use of the unremitted amount. Bringing that income into charge in the year of accrual before it is received in Hong Kong may be disadvantageous if the amount is ultimately not received in Hong Kong. Subject to commercial considerations, the parties may also agree that the Hong Kong taxpayer will bear the withholding tax, with corresponding adjustments to other terms of the royalty agreement.

Hong Kong certificate of resident status (HK CoR)

HK CoR for non-treaty purposes

With the introduction of a general definition of 'tax resident in Hong Kong' under the IRO, the Institute asked whether the IRD would consider issuing a HK CoR for non-treaty purposes, specifically for the purposes of the GloBE rules under Pillar Two and the economic substance legislation in no- or only nominal-tax jurisdictions (ES law). The IRD responded as follows:

- The introduction of a general definition of 'tax resident in Hong Kong' under the IRO and the issuance of HK CoRs were separate matters. The IRD would issue HK CoRs only where clearly necessary for implementing Comprehensive Double Taxation Agreements/Arrangements (CDTAs) or the IRO.

- The IRD's explanations in Agenda Item A4(a) of the 2020 annual meeting with the Institute regarding the issue of HK CoRs for ES law or other non-treaty purposes remained relevant[3]. In essence, the IRD would not issue HK CoRs for such purposes.

- The IRD was not aware of any requirement under the GloBE rules that the tax residence of a constituent entity had to be proved by means of a CoR. The IRD would continue to monitor practices in other jurisdictions and consider whether issuing HK CoRs for GloBE purposes would be necessary.

Bulk applications for HK CoR for purposes of State Tax Administration Circular 2018 No. 9 (PN 9)

For the purposes of the CDTA between the Chinese Mainland and Hong Kong SAR, a HK CoR issued for a calendar year generally proves the applicant's Hong Kong resident status for that calendar year and the two succeeding calendar years.

If a HK CoR application relates to tax benefits under PN 9, the relevant applicants should submit their applications to the IRD as a bulk application. However, the IRD does not accept bulk applications involving companies that already hold a valid CoR for the relevant year. Such companies may apply separately for a new HK CoR only after the existing one expires.

The IRD explained that those companies could use their existing HK CoRs for PN 9 purposes and that issuing multiple HK CoRs to the same company within the three-year validity period could cause confusion and prompt enquiries from the State Taxation Administration. Nonetheless, Hong Kong resident entities specifically requested by the Chinese Mainland tax authority to submit a HK CoR within

the three-year validity period might elaborate on the reasons and circumstances in their applications. Each case would then be assessed based on its individual facts.

HK CoR for disposal gains

The IRD noted that a HK CoR would generally be issued when the income in respect of which tax benefit was to be claimed under the CDTA had arisen. However, recognising that some taxpayers might have a genuine need to apply for a HK CoR before the subject income arose, the IRD was prepared to consider such application if the taxpayer could show that it was reasonably certain that the subject income would arise in the year for which a HK CoR was applied. To facilitate the processing of the application, the applicant should provide documents showing (i) the stage that the transactions or activities giving rise to the subject income and (ii) the level of certainty that the subject income would arise in the relevant year. For disposal gains, examples of such documents included the agreement for sale and purchase and memorandum of understanding. A mere assertion that the gains were expected without documentary evidence would not be accepted.

Country-by-country (CbC) filing obligation in demerger case

Where a Hong Kong entity and its subsidiaries, as part of a CbC reportable group (Group A), are sold and form an independent Group B in Year 1 (with the Hong Kong entity being the new ultimate parent entity (UPE)), the IRD's views on Group B's CbC reporting obligations are as follows:

- In its *Guidance on the Implementation of Country-by-Country Reporting*[4], the OECD provided two approaches to determining whether Group B was subject to CbC reporting requirement for Year 1:
    - Approach 1: Since Group B did not exist legally as an independent group in Year 0, it was not required to file a CbC report for Year 1.
    - Approach 2: The sub-group of entities (which became Group B upon sale) already existed from an economic point of view before the sale (i.e. as part of Group A), and should file a CbC report for Year 1 if the consolidated revenue for the sub-group of entities for Year 0 reached the relevant threshold.
- Whether Group B was required to file a CbC report for Year 1 depended on the approach adopted by the UPE jurisdiction. Since Hong Kong adopted Approach 2, Group B (with a Hong Kong UPE) was required to comply with the CbC reporting requirements in Hong Kong if its consolidated revenue for Year 0 was at least HK$6.8 billion. On the other hand, if Group B was a foreign group whose UPE was in a jurisdiction that adopted Approach 1, the Hong Kong constituent entity was not required to file a CbC report in Hong Kong for Year 1.
- If Group B (with a Hong Kong UPE) had adopted Approach 1 in filing prior years' CbC returns, it needed to notify the IRD and comply with the CbC reporting requirements in Hong Kong under Approach 2.
- The OECD also noted that for merger, acquisition or demerger cases, the thresholds for CbC reporting and the GloBE rules were tested differently, and that it was reviewing the CbC reporting threshold accordingly.

The takeaway

The annual meeting provides a valuable opportunity for practitioners and the IRD to exchange views. The IRD's clarifications shed light on several important areas, offering practical guidance that will help taxpayers and practitioners address practical issues more effectively. Please contact us if you have any questions on the matters discussed.

Endnotes

1. The meeting minutes can be accessed via this link: https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/036_Mar-2026.pdf

2. The news flash can be accessed via this link: https://www.pwchk.com/en/hk-tax-news/2026q2/hongkongtax-news-apr2026-4.pdf

3. The minutes of the 2020 annual meeting between the IRD and the HKICPA can be accessed via this link: https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/031_Oct-2020.pdf

4. The guidance can be accessed via this link: https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/cbcr/guidance-on-the-implementation-of-country-by-country-reporting-beps-action-13.pdf

Let's talk

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

PwC's Corporate Tax Leaders based in Hong Kong

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

Rex Ho
+852 2289 3026
rex.ho@hk.pwc.com

Cecilia Lee
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Jenny Tsao
+852 2289 3617
jenny.np.tsao@hk.pwc.com

Agnes Wong
+852 2289 3816
agnes.hy.wong@hk.pwc.com

Kenneth Wong
+852 2289 3822
kenneth.wong@hk.pwc.com

In the context of this News Flash, China, Chinese Mainland or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macau Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PwC's client service team or your other tax advisers. The materials contained in this publication were assembled on 31 March 2026 were based on the law enforceable and information available at that time.

This News Flash is issued by PwC's National Tax Policy Services in Chinese Mainland and Hong Kong, which comprises a team of experienced professionals dedicated to monitoring, studying and analysing the existing and evolving policies in taxation and other business regulations in Chinese Mainland, Hong Kong, Macau, Singapore and Taiwan. They support PwC's partners and staff in their provision of quality professional services to businesses and maintain thought-leadership by sharing knowledge with the relevant tax and other regulatory authorities, academies, business communities, professionals and other interested parties.

For more information, please contact:

Long Ma
+86 (10) 6533 3103
long.ma@cn.pwc.com

Charles Chan
+852 2289 3651
charles.c.chan@hk.pwc.com

Please visit PwC's websites at http://www.pwccn.com (China Home) or http://www.pwchk.com (Hong Kong Home) for practical insights and professional solutions to current and emerging business issues.