

# Hong Kong Tax Alert

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## **Government proposes to allow tax deductions for (i) capital expenditures on purchasing intellectual property (IP) from associates and (ii) upfront license fees for the right to use IP**

*The above two proposals are contained in an industry consultation paper issued by the Government in January 2026 and engagement sessions with stakeholders were subsequently held in March 2026.*

*During the engagement sessions, the representatives from the Inland Revenue Department (IRD) explained in more details the rationale for the key tax provisions of the proposals, including the justification for the retention of section 16EC(4)(b) in the Inland Revenue Ordinance (IRO) based on the principle of tax symmetry.*

*A legislative bill for the above proposals is expected to be introduced within 2026. Clients who have any questions on the above can contact their tax executive.*

## Capital expenditure on acquiring IP from associates

### Conditions for tax deduction

As an anti-avoidance measure, the current section 16EC(2) of the IRO denies tax deduction for capital expenditure incurred on IP purchased wholly or partly from an associate. To encourage multinational corporations to centralize the management of their IP in Hong Kong and facilitate domestic intra-group transfer of IP for better exploitation and commercialization, the Government proposes to suitably relax section 16EC(2).

Under the proposal, tax deduction for capital expenditure incurred on the purchase of IP from an associate will be allowed subject to the following terms and conditions:

Qualifying IP	<ul style="list-style-type: none"><li>Patent right and right to know-how under section 16E; and</li><li>Copyrights, registered designs, registered trademarks, protected layout-design (topography) rights, protected plant variety rights and performer's economic rights under section 16EA (i.e. the scope remains the same as that of the eight types of IP now specified in sections 16E and 16EA of the IRO).</li></ul>
Anti-avoidance provisions	<ul style="list-style-type: none"><li>In addition to the existing general anti-avoidance provisions in section 61A of the IRO, a new main purpose test will be introduced to disallow tax deduction for the acquisition cost of IP from associates if the main purpose or one of the main purposes of the acquisition is obtain a tax benefit<sup>1</sup>.</li><li>The other existing specific anti-avoidance provisions under section 16EC(4) of the IRO remain applicable. Notably, under the proposal, section 16EC(4)(b) will be retained to deny tax deduction where the IP is wholly or principally used outside Hong Kong by a person other than the taxpayer under a licensing arrangement.</li></ul>
Transfer pricing requirement	<ul style="list-style-type: none"><li>Domestic intra-group transfers of IP will be carved out from the domestic transaction exemption provided under section 50AAJ of the IRO such that such transfers will be subject to the transfer pricing (TP) rules in Hong Kong.</li><li>The TP documentation requirement in Hong Kong will also apply to such transfers unless exempted by virtue of the total amount of the relevant transactions being lower than the threshold.</li></ul>
Independent valuation requirement	<ul style="list-style-type: none"><li>A third-party independent valuation report is required where acquisition cost exceeds HK\$3 million in related-party transactions.</li><li>Taxpayers are required to provide an independent valuation report to substantiate the deduction claim upon request.</li></ul>

### Taxation of sales proceeds, including any capital gains, of Hong Kong IP transferors

In addition, as a safeguard against taxpayers obtaining excessive tax deduction under the proposal by transferring an IP that has appreciated in value between two Hong Kong group companies, the full amount of the sales proceeds, including any capital gains, received by the transferor, less the amount of the costs of the IP that has not yet been allowed for deduction, will be treated as a trading receipt chargeable to profits tax in the hands of the transferor.

## Upfront licence fees for the right to use IP in a licensing arrangement

### Conditions for tax deduction

To further encourage the development and commercialization of IP, the Government proposes to allow tax deduction for upfront license fees incurred for the right to use IP in a licensing arrangement, irrespective of whether they are capital or revenue in nature, provided they are incurred for generating profits chargeable to tax in Hong Kong.

<sup>1</sup> A tax benefit refers to an avoidance, postponement or reduction of a liability to pay tax chargeable under the Inland Revenue Ordinance.

The proposed terms and conditions for the tax deduction are as follows:

Qualifying licences	<ul style="list-style-type: none"> <li>▪ Exclusive licence, sole licence and non-exclusive licence</li> </ul>
Qualifying IP	<ul style="list-style-type: none"> <li>▪ The same eight types of IP under sections 16E and 16EA stated above</li> </ul>
Deduction period	<ul style="list-style-type: none"> <li>▪ To be spread evenly over the licensing term</li> <li>▪ Special rules apply where the licensing terms are subsequently amended</li> </ul>
Claw-back arrangement	<ul style="list-style-type: none"> <li>▪ Proceeds from the termination or assignment of IP licensing rights in excess of the unallowed amount will be treated as a taxable trading receipt</li> </ul>
Anti-avoidance provisions	<p>Where the circumstances so warranted, the Commissioner is empowered to:</p> <ul style="list-style-type: none"> <li>▪ determine the arm's length price of which a tax deduction is claimed;</li> <li>▪ request the licensee to submit a valuation report to substantiate the deduction claim; and</li> <li>▪ allocate the consideration when a licence to use IP is acquired, assigned or terminated together with any other dealings</li> </ul>

### *Taxation of upfront licensing fees of Hong Kong licensors regardless of their nature*

In addition, to ensure tax symmetry, where a licensee has claimed upfront licence fees for tax deduction under the proposal, such fees received by or accrue to a Hong Kong licensor will be deemed as a trading receipt chargeable to tax in Hong Kong.

### **Commentary**

We welcome the Government's above proposals which will further promote Hong Kong as a regional IP trading hub and create the demand for IP-related professional services such as marketing, legal, and valuation etc.

### *Proposed taxation of any capital gains derived by Hong Kong IP transferors*

Understandably, the Government is concerned that where an IP has appreciated in value, a group may internally transfer the IP at its full market value so as to obtain tax deduction at an amount higher than the acquisition costs of the IP to the group.

This proposed measure however may not facilitate commercial mergers and acquisitions, where a taxpayer has acquired the shares of a target that owns an IP that has appreciated in value. In such a case, the taxpayer would likely have effectively paid the full appreciated value of the IP through the share deal.

Where immediately after the acquisition, the transfer of the IP from the target to other group companies for the purpose of integrating the IP of the group for better commercial exploitation, the proposed measure would then tax the capital gains of the target. This is so notwithstanding that the group has effectively incurred full cost for the acquisition of the IP based on the market value of the IP.

If the potential abuse concerned cannot be adequately addressed by the anti-avoidance provisions stated above, instead of taxing any capital gains of the group transferor, the Government may consider restricting the tax deduction granted to the group transferee to the actual relevant costs (including those involved in a share deal) incurred by the group for the IP.

### *Controversial issues on the retention of section 16EC(4)(b)*

Section 16EC(4)(b) of the IRO denies tax deduction for the acquisition cost of an IP where the IP is wholly or principally used outside Hong Kong by a person other than the taxpayer under a licensing arrangement. The retention of the section in its current form appears controversial.

This would particularly be the case given that section 16EC(4)(b) would also apply to deny the tax deduction where the right to use an IP outside Hong Kong is granted royalty-free by a Hong Kong taxpayer to their overseas contract manufacturer for manufacturing goods the sale of which will generate profits of the Hong Kong taxpayer chargeable to tax in Hong Kong.

The relevant rules for determining the source of royalty income as stated in paragraph 9 of the Departmental Interpretation and Practice Notes (DIPN) No. 22 (Revised) issued in August 2020 are that:

**"If a person has purchased the proprietary interest of an intellectual property outside Hong Kong and licenses it to another person outside Hong Kong for use outside Hong Kong, the royalty income so derived will generally be regarded as non-Hong Kong sourced income and hence will not be subject to profits tax."**

As compared to the previously stated source rules for royalty income, the above quoted source rules seem to also focus on the place of purchase and grant of the licence of an IP, in addition to the place of use of the IP.

Thus, **where an IP is purchased or licensed in or from Hong Kong**, the location where the IP is used may not conclusively determine the source of royalty income derived from the IP. In other words, in such a case, royalty income for granting the right to use the IP outside Hong Kong under a licensing arrangement could still be regarded as onshore sourced and chargeable to tax in Hong Kong under section 14 of the IRO.

Even if the royalty income is offshore sourced and not chargeable to tax under section 14, it will nonetheless be chargeable to tax under section 15I of the IRO under the foreign-sourced income exemption (FSIE) regime. Under the FSIE regime, such royalty income will be chargeable to tax in Hong Kong when it is “received in Hong Kong” by an entity of a multinational enterprise group, unless qualifying research and development (R&D) expenditure under the nexus requirement is incurred.

However, for a purchased IP, generally no further R&D expenditure would need to be incurred. This is because any R&D expenditure on further developing the purchased IP may only be attributable to any new IP so developed.

While taxpayers may, in some cases, structure any offshore royalty income as not being “received in Hong Kong” (e.g., by distributing the same as dividends to their shareholders and therefore not rendering the income chargeable to tax under the FSIE regime), this does not seem to justify the retention of section 16EC(4)(b) in its current form. The reality is that commercial constraints may prevent some taxpayers from adopting such arrangements.

Thus, applying section 16EC(4)(b) to deny tax deduction for the acquisition cost of an IP where the income derived from the use of the IP is chargeable to tax in Hong Kong under sections 14 or 15I of the IRO would be against the tax symmetry principle.

### *Possible ways to deal with the issue of tax symmetry*

In the case of a Hong Kong taxpayer authorizing their overseas contract manufacturer to use their IP to produce goods on their behalf, the IRD may explore whether such use of the IP could be regarded as solely that of the Hong Kong taxpayer rather than the contract manufacturer, i.e., the contract manufacturer is the agent of the Hong Kong taxpayer in such use of the IP. If so, such arrangements would not be caught by of the existing terms of section 16EC(4)(b).

In any case, reference may also be made of the of the case *ATG v Comptroller of Income Tax [2011] SGIBR 2* decided by the Income Tax Board of Review of Singapore. Based on the facts of the case, it was held that the plant and machinery provided by the Singapore taxpayer to its overseas contract manufacturer were for the production of chargeable profits of the Singapore taxpayer, albeit the contract manufacturer would also benefit from the arrangements. Thus, the Singapore taxpayer was entitled to claim tax depreciation allowances in respect of such use of the plant and machinery.

Applying a similar approach to the situation where a Hong Kong taxpayer authorizes their overseas contract manufacturer to use their IP for the production of goods, such use of the IP may also be regarded as for the production of the chargeable trading profits of the Hong Kong taxpayer.

Furthermore, even if there are implicit royalties to be charged by the Hong Kong taxpayer to the contract manufacturer, the IRD may also explore whether any such royalty income could be regarded as Hong Kong sourced, given that the authorization is typically granted from Hong Kong in the course of the trading operation of the Hong Kong taxpayer conducted in Hong Kong.

### *Introducing the “main purpose” test not warranted*

The policy objective of allowing tax deduction for the acquisition cost of IP from an associate is to encourage bringing in IP to Hong Kong and facilitate centralization of IP for better exploitation.

As such, the proposed introduction of the “main purpose” test, a bar which is generally considered lower than that for invoking the general anti-avoidance provisions in section 61A of the IRO under the “sole or dominant purpose” test, does not also seem to be warranted.

### *Expanding or clarifying the scope of IP for tax deduction of upfront licensing fees*

Upfront licensing fees received by a non-Hong Kong licensor in respect of the use of IP rights covered by sections 15(1)(a), 15(1)(b) and 15(1)(ba) of the IRO will normally be subject to withholding tax in Hong Kong. The types of IP rights covered by these sections appear to be slightly broader than the eight types of IP under the proposal.

For example, upfront franchise fees paid to a non-Hong Kong franchisor that cover the right to use a trademark in Hong Kong and for the franchisor to impart knowledge on the franchisee in connection with the use of the trademark and the business operational model will normally suffer withholding tax in Hong Kong.

However, while the part of the franchise fees relating to the use of the trademark may qualify for the proposed deduction, that part relating to the impartation of knowledge, apparently not constituting “know how” as defined in section 16E(4) of the IRO, may not. The consultation paper has not indicated whether an apportionment of such fees for the proposed tax deduction would be allowable.

As such, we suggest the Government may (i) consider allowing tax deduction for the payment of an upfront licensing fee so long as it will be subject to withholding tax in Hong Kong if such fee **accrues to or is received** by a non-Hong Kong licensor; or (ii) specifically allow apportioning an upfront licensing fee for tax deduction based on the valuation of the IP involved, where the fee paid covers both qualifying and non-qualifying IP.

### *Taxing upfront licensing fees of Hong Kong licensors on the “accrual” basis only*

In addition, the Government may also consider taxing the upfront licensing fees of Hong Kong licensors on the “accrual” basis only rather than on the “accrues to or received” basis as proposed.

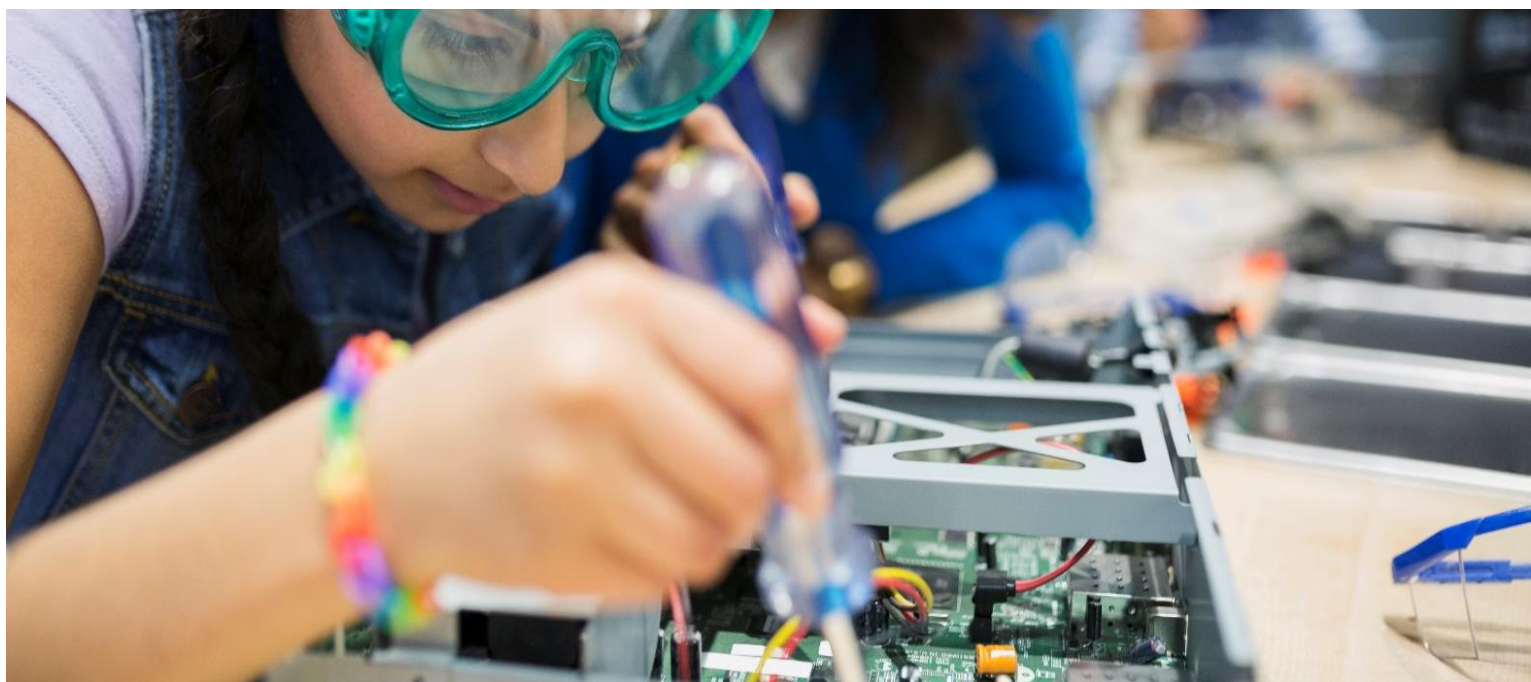
The latter basis of taxation would tax the upfront licensing fees of a Hong Kong licensor in full in the year when the fees are received, even though a substantial part of the fees may only be recognised in the accounts of the Hong Kong licensor in subsequent years on the “accrual” basis.

### *Low HK\$3 million threshold for a valuation report for an IP*

The requirement for obtaining an independent valuation report where the capital expenditure incurred for the acquisition of an IP exceeds HK\$3 million appears to be on the low side. This seems to be the case regardless of whether the threshold is on a per IP basis or on a transaction basis in which more than one IP may be involved.

To be in line with the corresponding threshold in Singapore of S\$10 million, we propose the Government may consider increasing the threshold to HK\$60 million on a per transaction basis.

A legislative bill for the above proposals is expected to be introduced within 2026. Clients who have any questions on the above can contact their tax executive.



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