



Hong Kong enhances tax deduction proposals for intellectual property

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In brief

Following a two-month consultation earlier this year¹, the HKSAR Government (Government) has recently set out in a paper submitted to the Legislative Council (LegCo) Panel on Commerce, Industry, Innovation and Technology its refined proposals to expand the profits tax deduction for capital expenditure on intellectual property (IP), after considering the views received during the consultation². The original consultation paper covered two broad areas of the deduction rules: (1) allowing deductions for covered IP acquired from associates; and (2) allowing deductions for upfront licence fees for the right to use covered IP.

The refined proposals enhance certain aspects of the original proposals and, most notably, introduce a new proposal allowing deductions for the relevant purchase cost of covered IP used by a licensee outside Hong Kong, where the related licensing income is taxable under the foreign-sourced income exemption (FSIE) regime.

We are pleased that the Government has adopted several of our recommendations, including:

- the newly introduced proposal regarding tax deductions for covered IP under a licence where the related IP income is taxable under the FSIE regime;
- excluding from profits tax the capital gains portion of the transferor's sale proceeds in a domestic intra-group IP transfer;
- reconsidering the HK\$3 million threshold for the third-party independent valuation requirement; and
- allowing taxpayers, subject to certain conditions, to rely on an independent valuation report covering multiple assets (including the covered IP) to satisfy the valuation requirement, rather than requiring a standalone IP valuation report.

This news flash summarises the changes to the proposals and sets out our observations.

In detail

Refined proposals on expanding IP tax deductions

After considering the views received from stakeholders during the consultation, the Government has incorporated several suggestions and made corresponding enhancements to the proposals.

Proposal 1: Allowing deductions for IP acquired from associates

The following table summarises the original proposals contained in the consultation paper and the refined proposals set out in the LegCo paper.

Key aspects	Original proposals	Refined proposals
(i) IP acquired from Hong Kong associates		
Amount of deduction available to the purchaser	Acquisition cost incurred by the purchaser	Lower of – (a) the sum of (i) deduction allowable to the seller for the purchase of the IP ³ , and (ii) the qualified research and development (R&D) expenditure incurred by the seller for the R&D activities carried out on such IP ⁴ ; and (b) the acquisition cost incurred by the purchaser
Amount of taxable income for the seller	Full amount of sale proceeds received, less any unallowed IP deductions	Sale proceeds received, capped at the deductions previously allowed
Third-party independent valuation report	Required if the acquisition cost of the IP is HK\$3 million or more	Not required
Transfer pricing rules and documentation requirements	Domestic transaction exemption does not apply	Domestic transaction exemption applies
(ii) IP acquired from non-Hong Kong associates		
Amount of deduction available to the purchaser	Acquisition cost incurred by the purchaser	No change
Third-party independent valuation report:		
<ul style="list-style-type: none"> Threshold 	Acquisition cost of the IP is HK\$3 million or more	To be set out in a future guidance note
<ul style="list-style-type: none"> Whether a valuation report covering multiple assets is acceptable 	Not addressed	Yes, provided that the valuation report includes a separate valuation for each of the IPs for which deduction is claimed

Apart from the changes outlined above, the refined proposals do not otherwise alter the following aspects of the original proposals:

- The safeguard measure based on a main purpose test will be retained, such that deductions will be denied if the main purpose, or one of the main purposes, of the acquisition is to obtain a tax benefit, having regard to all relevant facts and circumstances.
- The scope of covered IP remains unchanged and will continue to cover the same eight types of IP currently covered under the existing IP deduction regime⁵.

Our observations

We welcome the significant refinements to the original proposals regarding IP acquired from Hong Kong associates. Limiting the taxable proceeds of the transferor to the deductions previously allowed would preserve Hong Kong's long-standing principle of not taxing capital gains. The removal of the originally proposed transfer pricing and documentation requirements, as well as the requirement for a third-party independent valuation report for each individual IP asset, would further enhance the regime's practicality.

Regarding the requirement to prepare a third-party independent valuation report where the value of IP acquired from non-Hong Kong associates exceeds the threshold, we appreciate the Government's confirmation that it is not necessary to prepare a standalone IP valuation report for each covered IP to satisfy this requirement. However, we hope that the Government will reconsider our recommendation that taxpayers be allowed to perform the valuation on a portfolio (instead of individual) basis when several interlinked IP assets are transferred together in a single transaction.

Proposal 2: Allowing deductions for upfront licence fees

The Government proposes allowing tax deductions for upfront licence fees incurred for the right to use IP under a licensing arrangement, whether capital or revenue in nature, provided the fees are incurred in the production of assessable profits. The original and refined proposals are largely identical, as summarised below:

- **Three forms of covered licences:** The deduction will apply to (i) exclusive licences, (ii) sole licences, and (iii) non-exclusive licences.
- **Eight types of covered IP:** The deduction will be limited to the eight types of IP currently covered under the existing IP deduction regime⁵.
- **Franchise rights involving the licensing of covered IP:** Deduction will be available for the portion of franchise fees attributable to the licensing of covered IP, provided that the taxpayer can identify the covered IP. Details will be set out in a future guidance note to be issued by the Inland Revenue Department.
- **Deduction period:** Rather than being fully deductible upfront, the licence fee will be deductible in equal instalments over the licence term, in line with the accounting amortisation treatment. If the licensing arrangement changes, the remaining deduction will be spread over the remaining licence term. Where deductions already claimed exceed the revised licence fee, the excess will be clawed back.

- **Claw-back on termination or assignment of licences:** If all or part of the licensed rights are terminated or assigned, any proceeds exceeding the unallowed deduction will be taxable, but only up to the amount of deduction previously allowed, consistent with existing recoupment rules.
- **Anti-avoidance provisions:** To prevent abuse, the Commissioner of Inland Revenue will be empowered to (i) determine the arm's length price for which a deduction is claimed and require the licensee to submit a valuation report to substantiate the claim, and (ii) allocate the consideration where a licence to use IP is acquired, assigned or terminated together with other dealings.
- **Deeming provision for licensing income:** For clarity, any sums received by or accrued to a Hong Kong licensor in relation to the right to use IP will be deemed trading receipts chargeable to profits tax.

Our observations

It seems that the rationale for the proposed deeming provision has changed. The consultation paper originally stated that the provision was intended to maintain tax symmetry. By contrast, the refined proposals explain it as a measure intended to provide clarity, on the basis that sums received by or accrued to a person carrying on a business in Hong Kong for granting the use of, or the right to use, IP under a licensing arrangement are generally already chargeable under the general charging provision. The Government therefore appears to regard the deeming provision as confirming the existing tax treatment, rather than expanding the scope of charge. While this is understandable, the increased reliance on deeming provisions risks undermining fundamental taxing principles by bypassing established tests for the determination of the taxability of profits.

Proposal 3: Allowing deductions for IP used by a licensee outside Hong Kong

Tax deductions for the purchase cost of covered IP, regardless of whether the IP is acquired from associates, are subject to anti-avoidance provisions. These include the blanket denial of a deduction for the purchase cost of covered IP used by a licensee outside Hong Kong under section 16EC(4)(b) of the Inland Revenue Ordinance (IRO). In its original proposal, the Government did not propose any changes to section 16EC(4)(b) on the ground that it was necessary to uphold the tax symmetry principle.

However, many stakeholders have pointed out that, following the introduction of the FSIE regime, offshore royalty income from licensing acquired IP is deemed taxable when received in Hong Kong by a covered taxpayer, while the purchase cost of the IP concerned would not be deductible as such IP is used by a licensee outside Hong Kong under section 16EC(4)(b), thereby creating an inequitable tax outcome.

To address these concerns, the Government introduces a new proposal to allow tax deductions for the relevant purchase cost of IP used by a licensee outside Hong Kong, where the relevant royalty income is taxable under the FSIE regime, regardless of whether the licensee is an associate. The deduction will be allowed on a proportionate basis by reference to the capital expenditure incurred for the purchase of the IP concerned.

Our observations

While we have long advocated for the complete removal of section 16EC(4)(b) since it could give rise to undesirable tax consequences beyond the FSIE context, we warmly welcome the Government's new proposal to carve out covered IP acquired to generate royalty income taxable under the FSIE regime from the blanket denial under section 16EC(4)(b), as it resolves the most critical inequity. As the amount of royalty income taxable under the FSIE regime is determined by reference to the nexus ratio,

we understand that the amount of tax deduction will be adjusted proportionately to reflect the amount of royalty income that is taxable, and that further guidance will be provided to illustrate how the deductible amount is determined.

Legislative timeline

The Government plans to introduce a legislative bill to implement the refined proposals, which will be tabled before the LegCo in 2026. It is intended that the relevant amendments will apply to enterprises that have purchased IP or acquired rights to use IP on or after 1 April 2026.

The takeaway

We are pleased that the Government has incorporated several stakeholder recommendations, including those submitted by us, into the proposal, making the IP deduction rules more practical and user-friendly. Building on this progress, we will continue to advocate for the adoption of our other recommendations, as discussed above, to help ensure that the regime is more attractive and internationally competitive.

We also welcome the Financial Secretary's indication in this year's Budget that the Government will review and enhance the tax arrangements for R&D expenditure, another issue we have long championed. In particular, we have highlighted the significant challenge faced by Hong Kong taxpayers who are currently unable to claim deductions for outsourced R&D payments to their associates in the Chinese Mainland, a common and commercially necessary arrangement. We hope this review will lead to a relaxation of the deduction criteria, which would complement the current proposal to enhance the IP deduction rules and further strengthen Hong Kong's position as an international innovation and technology hub.

If you would like to understand how the refined proposals may affect your IP holding structure and arrangements, please do not hesitate to contact us.

Endnotes

1. Our news flash on the consultation can be accessed via this link:
<https://www.pwchk.com/en/hk-tax-news/2026q1/hongkongtax-news-feb2026-2.pdf>
2. The LegCo paper outlining the refined proposals can be accessed via this link:
<https://www.legco.gov.hk/yr2026/english/panels/ci/papers/ci20260519cb2-628-2-e.pdf>
3. The deduction allowable to the seller in relation to the purchase of IP refers to the notional deduction amount allowable to the seller. This appears to be intended to cover cases where the seller could not claim a tax deduction for the purchase cost, whether under the existing IP deduction rules or because of other restrictions.
4. Qualified R&D expenditure means any expenditure incurred in relation to the R&D activities for which deduction is allowable under section 16B of the IRO.
5. The eight types of covered IP are:
 - (1) patent rights
 - (2) rights to know-how
 - (3) copyrights
 - (4) registered trade marks
 - (5) registered designs
 - (6) performer's economic rights
 - (7) protected layout design (topography) rights
 - (8) protected plant variety rights

Let's talk

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

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Hong Kong Tax News Flash

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