For information
on 3 May 2010

Legislative Council Panel on Financial Affairs

Islamic Finance - Proposed Amendments to the Inland Revenue Ordinance (Cap. 112) and Stamp Duty Ordinance (Cap. 117)

Purpose

This paper sets out the framework and schedule of the legislative proposal to amend the Inland Revenue Ordinance (Cap.112) ("IRO") and Stamp Duty Ordinance (Cap.117) ("SDO") with a view to leveling the playing field for common types of Islamic bonds ("Sukuk") vis-à-vis conventional bonds in terms of tax liabilities.

Background

2. To put it in the most general and succinct way, Islamic financial services and instruments are those that comply with the requirements, restrictions and prohibitions imposed by the Shariah[1] which is a religious concept. Islamic financial industry has grown into a global business of an estimated US$1 trillion in recent years, and is accepted by both Muslims and non-Muslims. Notwithstanding the global financial turmoil and the Dubai World crisis, market remains generally optimistic about the long-term prospect of the development of Islamic finance.

3. Development of Islamic finance in Hong Kong can help diversify our financial platform and enhance our competitiveness as an international financial centre. Against this backdrop and given the market-led nature of the initiative, our guiding policy principle is to level the playing field for the Islamic financial industry when compared with the conventional financial

[1] Relevant examples include *Riba* (prohibition on receipt and payment of interest) and *Haram* (prohibition on dealing in banned activities e.g. alcohol and pork).

industry. We do not intend to provide any advantages or incentives to the former over and above those available to the latter.

4. Having regard to market need and views, our policy is to promote the development of a local Sukuk market as the first step of promoting the development of Islamic finance in Hong Kong. This has been enshrined in the Chief Executive ("CE")'s Policy Addresses and the Financial Secretary ("FS")'s Budgets since 2007-08. Looking forward, we remain open as to whether and, if so, how the development of other Islamic financial products in Hong Kong can be further promoted.

Framework of the Legislative Proposal

Scope – Profits Tax, Property Tax and Stamp Duty

5. According to in-house studies as well as feedback from market players, the major impediment to the development of a Sukuk market in Hong Kong is our tax regime. This is because the structuring of Sukuk often involves transfer of underlying assets and setting up of special purpose vehicles, such that the launch and transactions of Sukuk in Hong Kong may attract additional tax implications when compared with conventional bonds and hence putting Sukuk in a disadvantaged position from the commercial viability point of view.

6. We therefore need to amend the IRO and SDO to level the playing field for Sukuk vis-à-vis their conventional counterparts as far as profits tax, property tax and stamp duty liabilities are concerned.

Approach – Prescriptive

7. We propose to adopt a prescriptive approach in line with that adopted in the United Kingdom ("UK")[2]. We intend to set out the qualifying criteria/features concerning the relevant types of Sukuk in both the IRO and SDO. Unless otherwise specified, financial arrangements falling under the requisite qualifying criteria/features will be granted with the relevant tax neutrality treatments.

[2] The UK, similar to Hong Kong, is a common law jurisdiction.

8. Given the fast pace of financial innovation and market development nowadays, it is virtually impossible to cover all types of Sukuk in the IRO and SDO. Having regard to overseas practice, in-house studies and market need, we intend to cover four types of Sukuk, viz. *Ijarah* (leasing), *Mudarabah* (profit-sharing), *Murabahah* (cost-plus) and *Musharakah* (joint venture) in the current legislative exercise since they are relatively common in the market. To the extent possible, both the asset-based and asset-backed types of the aforesaid Sukuk, which are in the nature of debt securities, will be covered.

9. As in the case of the UK, we do not intend to make specific reference to the Shariah in the IRO and SDO. Prescriptive legislative provisions, without the mentioning of the Shariah, would provide more certainty to market players, and avoid possible queries about discrimination (religious or otherwise) as well as disputes on the interpretation of the Shariah.

Major Features of the Proposed Legislative Amendments

10. In gist, we intend to amend the IRO and SDO in the current legislative exercise to set out, inter alia, the following –

(a) qualifying criteria/features for the relevant types of Sukuk as mentioned above, viz. *Ijarah*, *Mudarabah*, *Murabahah* and *Musharakah;*

(b) circumstances under which the tax neutrality treatments will be disapplied or revoked, as well as the relevant limitation period;

(c) authority to waive or amend in future by order or regulation (a) above to accommodate new types of Islamic financial products and fast-evolving market conditions;

(d) tax treatments for the originator, Sukuk issuer and Sukuk holders under different types of Sukuk arrangements, including deeming the specified capital sums and payments as borrowings and interest payments respectively (applicable to the IRO only);

(e) expansion of the scope of the qualifying debt instrument regime under which profits tax concession to varying degrees is available to cover the relevant types of Sukuk (applicable to the IRO only);

(f) stamp duty exemption in the case of substitution of Sukuk asset (applicable to the SDO only); and

(g) mandatory adjudication of relevant instruments by the Collector of Stamp Revenue appointed under the SDO with no adjudication fee payable (applicable to the SDO only).

11. We have been engaging industry bodies and market players to formulate the above legislative amendments. We shall continue to gauge market views to fine-tune the amendments.

Interim Arrangements

12. Pending implementation of the aforesaid legislative amendments to the IRO and SDO to level the playing field for Sukuk vis-à-vis conventional bonds, market players can make use of the administrative mechanisms available under section 87 of the IRO[3] as well as section 52 of the SDO[4] to apply for profits tax, property tax and stamp duty exemption for Sukuk issuance and transactions. Applications made under these two provisions are considered on a case-by-case basis.

13. We issued a package of reference materials, including a flowchart, to the industry in November 2009 to facilitate their application for tax exemption in relation to Sukuk under the aforesaid administrative mechanisms. The industry in general considers that the materials are of high reference value.

14. Notwithstanding the administrative efforts, we consider the current legislative exercise necessary as the proposed legislative amendments will provide more certainty and clarity to market players, which would be

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[3] Under section 87 of the IRO, the CE in Council may by order exempt any person, office or institution from payment of the whole or any portion of any tax chargeable under the IRO on a case-by-case basis.

[4] Under section 52 of the SDO, the CE can remit or refund wholly or in part the stamp duty paid or payable in respect of any instruments chargeable with stamp duty on a case-by-case basis. The CE has delegated the relevant approving authority to, inter alia, the Secretary for Financial Services and the Treasury.

conducive to the development of a Sukuk market in Hong Kong.

Legislative Timetable

15. In the light of the complexity and technicality involved in drawing up the legislative amendments and other competing priorities because of the intervening global financial turmoil, preparation of the proposed legislative amendments has taken longer than expected. Having regard to the current progress, we aim to introduce the relevant amendment bill into the Legislative Council within 2010. In the process, we shall continue to gauge the views of market players on the draft legislative amendments with a view to ensuring that they would address relevant market views and meet evolving market needs.

Financial Services Branch
Financial Services and the Treasury Bureau
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