

For information

**Bills Committee on  
Inland Revenue and Stamp Duty Legislation  
(Alternative Bond Schemes) (Amendment) Bill 2012**

**Administration's Responses to  
Written Submissions from Deputations**

The paper sets out the Administration's responses to the written submissions made by deputations upon the invitation of the Bills Committee<sup>1</sup>.

**Unanimous Support for the Legislative Proposal**

2. The Administration is encouraged by the unanimous and overwhelming support expressed by the submissions for the Bill, which seeks to facilitate and promote the development of an Islamic bond (sukuk) market in Hong Kong. They note that this development will result in a wider range of financial product offerings to the markets, and enhance the status of Hong Kong as an international financial centre and asset management centre. In particular, this may give impetus to increasing demands for Renminbi-denominated sukuk to match the financing needs of fund raisers and the investment demand of investors in China, the Middle East, South East Asia, and other parts of the world interested in Islamic financial products. Some submissions have expressed the desire for the Bill to be passed as soon as possible so as to enable market players to use our platform to arrange for sukuk issuances, thereby maintaining the competitiveness of Hong Kong as a gateway for international Islamic finance.

3. We also note that some submissions have indicated agreement to the religion-neutral approach taken by the Administration in drafting the Bill, and to the broad coverage of the types of sukuk covered by the Bill.

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<sup>1</sup> A list of respondents is set out in [Annex A](#).

## **Technical Comments**

4. We appreciate the few submissions which have set out certain technical comments. Many have noted that the Administration has already taken on board some of these suggestions as appropriate in finalising the provisions contained in the Bill after a consultation exercise launched in March 2012. We also appreciate the suggestions regarding the importance of retaining professional expertise in the Inland Revenue Department and the financial industry to deal with Islamic financial transactions. The outstanding issues mainly concern a few qualifying conditions and tax administration matters proposed in the Bill, in which case the Administration views that a reasonable balance has to be struck in relation to market development and anti-avoidance policy considerations. We have set out the Administration's responses to these issues, as well as some drafting points raised, in **Annex B**.

5. Members are invited to note the content of this paper.

**Financial Services and the Treasury Bureau**  
**April 2013**

**List of Respondents**  
**Providing Written Submissions to the Bills Committee**

The Administration is grateful to the following individuals and organisations for their written submissions to the Bills Committee.

1. Bank of China (Hong Kong) Asset Management Limited
2. Ernst & Young Tax Services Limited (“**EY**”)
3. Nasirs
4. Nova Training and Education Institute Limited
5. PricewaterhouseCoopers Ltd.(“**PwC**”)
6. Standard Chartered Bank
7. The Hong Kong Association of Banks
8. The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies
9. Hong Kong Bar Association
10. Hong Kong Investment Funds Association
11. The Law Society of Hong Kong (“**LawSoc**”)
12. The Taxation Institute of Hong Kong (“**TIHK**”)
13. Treasury Markets Association

**Administration’s Detailed Responses to Written Submissions to Deputations**

<b>Relevant Provision in the Bill</b>	<b>Observations from Relevant Deputations</b>	<b>Administration’s Responses</b>
<p>Sections 2(3)(f), 3(2), 6(2)(a)(ii)(B), 10(3) and 10(9)(b)(i) of Schedule 17A to the Inland Revenue Ordinance (“IRO”)</p>	<p>Provisions may be added to allow a bond-issuer to hold a reserve to deal with contingencies or indemnity contracts (Takaful / insurance) to regulate the investment return. Consideration may be given to replacing the term “<i>insurance</i>” with “<i>contract of indemnity</i>” [Nasirs]</p>	<p>The relevant clauses do not prohibit a bond-issuer from holding a reserve to deal with contingencies or taking out an insurance. Items “D” and “E” in the formula used for calculating investment return paid under a specified investment arrangement in section 10(3) of Schedule 17A already covers the scenario to allow a bond-issuer and an originator to hold a reserve to regulate the investment return. Section 10(9)(b)(i) of the same Schedule refers to insurance money and contemplates the possibility of a bond-issuer arranging an insurance in relation to the underlying assets of an investment arrangement. Section 10(9)(b)(i) is broadly drafted in that it refers to “<i>other compensation of any description....in respect of the destruction or loss</i>”. Therefore, “contract of indemnity” is covered. The Commissioner of Inland Revenue (“CIR”) may further clarify these matters in a Departmental Interpretation and Practice Note (“DIPN”).</p>
<p>Sections 3(3)(b) 3(4), 10(3) of Schedule 17A to IRO</p>	<p>Consideration may be given to adding the words “<i>exchanged or replaced</i>” to cover a change of the specified asset. [Nasirs]</p>	<p>The meaning of the words “<i>disposed of</i>” and “<i>acquired</i>” in section 3(3) of Schedule 17A is wide enough to cover a situation when an asset is “<i>exchanged or replaced</i>”. Sections 6(2) and 9(5) of the same Schedule further elaborate on this situation, in relation to a lease arrangement and an agency arrangement respectively. The same applies to section 10(3).</p>

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Section 4 of Schedule 17A to IRO	Please clarify the term " <i>material time</i> ". <i>[Nasirs; LawSoc]</i>	The term " <i>material time</i> " can refer to any time during the specified term.  Suppose a scheme is of a term of 10 years. At the end of year 3, a question arises as to whether the scheme is, at that time, a specified alternative bond scheme. Then the material time refers to the end of year 3; and the scheme is a specified alternative bond scheme at that time if –  (a) the terms of the scheme are those as described of an alternative bond scheme in section 2 of Schedule 17A, and have always been so during those 3 years; and  (b) the terms of the investment arrangement in the scheme are those as described of a specified investment arrangement in sections 6 to 9 of Schedule 17A and have always been those as so described of the same specified investment arrangement during those 3 years.
Section 6(2)(a)(ii)(B) of Schedule 17A to IRO	The word " <i>and</i> " should be replaced by " <i>or</i> ". <i>[LawSoc]</i>	Agreed. We will prepare a committee stage amendment ("CSA") to this effect.
Section 12 of Schedule 17A to IRO	The retroactive disqualification of a qualified bond arrangement or a qualified investment arrangement may have unintended consequences beyond	It would be difficult to determine what "unavoidable commercial circumstances" will render it suddenly impossible for a scheme to comply with the qualifying conditions prescribed in the Bill. The Administration is concerned about a possibility under which an alternative bond scheme may be deliberately structured to meet the qualifying conditions in the earlier part of the

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	<p>detering tax avoidance as arrangements that are disqualified due to unavoidable commercial circumstances will be treated in the same manner as tax avoidance arrangements and penalised.</p> <p><i>[EY]</i></p>	<p>term to take the tax relief, while distributing coupon payments that is blatantly above reasonable commercial return or linked to profits in the later part of the term. In this case, the arrangement concerned will essentially be an "equity-like" sukuk arrangement, which is not economically equivalent to debt arrangements. The Bill seeks to give comparable tax treatment for debt-like sukuk arrangements, as it applies to conventional debt arrangements, in view of their economical equivalence. As a matter of principle, the disqualification rules set out in section 12(3) and (4) are reasonable on anti-avoidance grounds.</p>
<p>Section 13 of Schedule 17A to IRO Section 47D(1)(a) of SDO</p>	<p>Greater flexibility should be offered to allow bond-holders to benefit from better returns without breaching the "reasonable commercial return" condition in section 13. It is also questionable whether sukuk arrangements may make fluctuating coupon payments over the scheduled payment dates, and why the returns generated in the whole term and each payment period should be considered. The section does not specify any objective means to test whether this condition is</p>	<p>The general principle under IRO has been that an arrangement will be treated as a debt arrangement if it is a debt arrangement in both form and substance. To facilitate the development of a sukuk market in Hong Kong, the Bill allows an arrangement to be treated as a debt arrangement as long as it is such an arrangement in substance. In line with this basic premise of the Bill, the "reasonable commercial return" condition prescribed in section 13 of Schedule 17A to the IRO requires an arrangement to yield no more than reasonable commercial return compared to a loan of money. Without an arrangement meeting the "reasonable commercial return" condition, the basic premise for treating it as a debt arrangement is not established.</p> <p>The condition does not seek to disallow bond-holders to benefit from better investment returns or to restrict the return of a sukuk product in the market. Nor is it intended to arbitrarily set for the market what a reasonable commercial return should be. It only impacts on whether the "sukuk" may be treated as if it were a debt arrangement. The fact that a sukuk does not comply with the</p>

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	<p>met. It should also permit adjustments for, say, the rate of inflation. The condition should either be removed or clarified through a DIPN. It will be helpful for CIR to provide an advance ruling on whether a scheme has complied with the condition.</p> <p><i>[Nasirs; LawSoc; EY; TIHK; PwC]</i></p>	<p>condition only means the sukuk cannot be regarded as a debt arrangement for tax purposes. The test should not have any impact on the attractiveness of sukuk if their economic substances are essentially similar to those of conventional debt arrangements, and will not disqualify a sukuk arrangement merely because it is paying floating coupon payments.</p> <p>This condition is necessary as the Islamic concept of “sukuk” covers a variety of instruments. In terms of returns to investors, some sukuk are debt-like, some linked to equity profits. This Bill aims to apply a comparable tax treatment to debt-like sukuk, as it applies to conventional debt arrangement, due to their equivalence in terms of economic substances. CIR therefore needs to have regard to the quantum of the return to investors, in relation to each payment period and the whole term of the instrument, in order for him to be satisfied that the bond return of an alternative bond scheme will not exceed an amount that would be a reasonable commercial return on money borrowed of an amount equal to the bond proceeds.</p> <p>To offer the market more clarity, CIR is prepared to elaborate on the operation of the condition in a DIPN. CIR is minded to exclude sukuk where</p> <ul style="list-style-type: none"> <li>(i) the fixed rate or margin is blatantly above what would be reasonable for a commercial debt security on similar terms and carrying similar risks; and</li> <li>(ii) the proposed or actual periodic distributions are linked to profits, as these kinds of patterns of bond returns suggest that the instrument in</li> </ul>

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		<p>question is an equity sukuk (hence not being a debt arrangement in the context of the IRO).</p> <p>The prevailing market conditions (including interest rate and inflation), the credit rating of the issuer concerned, and the terms of the product all form part of the overall consideration. Taxpayers may seek an advance ruling under section 88A of the IRO if in doubt.</p> <p>A similar “reasonable commercial return” condition is used in the definition of “loan capital” under section 2(1) of Stamp Duty Ordinance (“SDO”, Cap. 117) for the Collector of Stamp Revenue (“CSR”) to determine whether an investment product is a loan capital exempt from stamp duty liability. The definition has been in operation since 1981.</p>
<p>Section 15(c) of Schedule 17A to IRO Section 47D(1)(c) of SDO</p>	<p>The words “<i>wholly or partly</i>” may be added before “<i>are marketed in Hong Kong</i>”. <i>[LawSoc; Nasirs]</i></p>	<p>The policy intent is that the “Hong Kong connection” condition will be sufficiently satisfied, if only part of alternative bonds issued under a specified alternative bond scheme are marketed in Hong Kong. This is in line with IRD’s current interpretation of the reference to “marketed in Hong Kong” in the existing section 16(2)(f)(ii) of IRO.</p>
<p>Section 16 of Schedule 17A to IRO</p>	<p>The Administration has positively taken on board a previous suggestion to relax the</p>	<p>90% of the global sukuk issuances in the past decade were of a term of 15 years or less. In fact, over half of such issuances are of a short term of 5 years or less. The proposed provision has struck a reasonable balance between the</p>

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	<p>“maximum term length condition” to cover sukuk products of a term length of 15 years or less. This notwithstanding, two respondents suggest the removal of this condition.</p> <p><i>[PwC; EY]</i></p>	<p>needs to facilitate market development and to address tax avoidance concerns. To cater for future market development, section 16(2) of the Schedule provides that the Financial Secretary may, by notice published in the Gazette, amend the period specified in subsection (1).</p>
<p>Section 20(2)(b) of Schedule 17A to IRO</p>	<p>The use of the term “<i>interest</i>” in this section is necessary for the purpose of the Ordinance and the tax relief given. However, this term is avoided in the sukuk market. A clarification in the DIPN may be desirable.</p> <p><i>[Nasirs]</i></p>	<p>Section 20 of Schedule 17A is important to apply the tax treatment for conventional bonds under the IRO to a qualified bond arrangement in a specified alternative bond scheme. The “<i>additional payments payable by the bond-issuer to the bond-holders under the qualified bond arrangement</i>” are therefore regarded as “<i>interest payable on the money borrowed by the bond issuer from the bond-holders</i>”. This deeming provision is necessary to apply the interest provisions in the IRO (e.g. sections 15(1)(f), (g) or (i), 16(1)(a) and (2)) to such additional payments, so that they are taxed or deducted as interest in profits tax determination. The relevant provisions do not seek to relate to the Islamic financial principle regarding the prohibition of “<i>interest</i>”. CIR will consider clarifying this in the DIPN.</p>
<p>Section 24 of Schedule 17A to IRO</p>	<p>The Administration has positively taken on board a previous suggestion to shorten</p>	<p>The Administration has already further relaxed the relevant requirements without unduly restricting the power of CIR / CSR to pursue necessary assessment work and tackle tax avoidance. For the purposes of the IRO,</p>

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Section 47J of the SDO	<p>the record-keeping period. However, these record-keeping requirements should be further shortened, so that a sukuk issuance would not be disadvantaged vis-à-vis that for conventional bonds.</p> <p><i>[EY; PwC]</i></p>	<p>section 24 of Schedule 17A to the IRO requires relevant documents to be kept until the expiry of three years after the end of the term of the scheme or the expiry of seven years after the relevant transaction, whichever is the later. For the purposes of the SDO, section 47J requires relevant documents to be kept until the expiry of one year after the end of the scheme term. A reasonable balance has been struck in relation to tax compliance and anti-avoidance considerations.</p> <p>We understand from market players that, due to the unique structures of sukuk, relevant transaction documents will usually be kept at least during the entire term of the instrument. The proposed requirement should represent minimum compliance efforts on the part of an issuer in order for it to be eligible for the proposed tax relief or treatment. The streamlined record-keeping requirements will enable CIR / CSR to assess whether certain qualifying conditions (for example, “reasonable commercial return” and “bond-issuer as conduit” conditions) are met and to re-assess the arrangements upon withdrawal of the special tax treatment or relief. Business records kept in electronic forms will also be acceptable.</p> <p>There are precedents that Hong Kong tax law will require specific record-keeping requirements for certain transactions in view of the anti-tax avoidance considerations and unique nature of the transactions in question. For example, section 35(3) of the SDO requires the prescribed register, statement, and other records and documents to be preserved during the life of a unit trust scheme and for a period of not less than 1 year thereafter.</p>

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Section 24 of Schedule 17A to IRO	Please clarify if records kept in electronic form are acceptable. <i>[Nasirs]</i>	Yes. CIR / CSR accepts that documents can be kept in an electronic form following the implementation of the Electronic Transactions Ordinance (Cap. 553). To this end, CIR has issued an information note entitled "Admissibility of Business Records kept in Electronic Form for Tax Purposes" in July 2009 ( <a href="http://www.ird.gov.hk/eng/pdf/pam60e.pdf">http://www.ird.gov.hk/eng/pdf/pam60e.pdf</a> ).
Section 26 of Schedule 17A to IRO Section 4(5A) of the SDO	It is not necessary to extend the time limits for raising additional profits tax assessments or recovering stamp duty in cases of a disqualification beyond the normal statutory time limits. If anti-avoidance is the issue, the extended time limits may apply only to unlisted sukuk. <i>[EY; PwC]</i>	<p>As the long title of the Bill suggests, the proposed amendments to the IRO are to "<i>bring particular types of arrangements that are economically equivalent to debt arrangements under tax rules comparable to those applying to debt arrangements</i>". It is important for CIR to ascertain the economic substance (instead of just the legal form) of the series of transactions underpinning a sukuk deal to determine the tax treatment and liability. Thus, sections 60 and 79 of the IRO have to be modified to suitably lengthen the usual time period within which CIR may raise additional assessment or refund tax paid in excess upon retrospective revocation of the special tax treatment. This is particularly relevant to a longer-term sukuk involving a disqualifying event referred to in section 12(5) of Schedule 17A to the IRO.</p> <p>The same applies to the recovery of stamp duty if the current limitation period of 6 years from the expiration of the time for stamping under section 4(5) of the SDO is not extended. Without the extended limitation periods in the proposed section 4(5A), an obvious loophole will be created for tax avoidance, especially when a bond-issuer and an originator will likely to be related parties for asset transfers.</p>

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		<p>The extended limitation period does not only seek to enable CIR to make an additional assessment or CSR to recover the stamp duty chargeable. It applies also to refunding tax paid in excess to taxpayers. Where the sukuk transactions are determined to be ineligible for the proposed special tax treatment, there will be cases where coupon payments taxed previously in a profits tax assessment as "interest incomes" are treated as non-taxable distributions, and tax paid in excess can then be refunded to sukuk holders.</p> <p>Discriminatory treatments for listed and unlisted sukuk are not recommended, as whether an instrument is listed on a stock exchange or otherwise should not alter the economic substance of the underlying transactions.</p>
Existing sections 61 and 61A of the IRO	Existing general anti-avoidance rules in sections 61 and 61A of IRO should provide sufficient powers for CIR to prevent tax avoidance. There is no need for targeted anti-avoidance rules. <i>[EY]</i>	<p>The SDO has no anti-avoidance provisions. Reasonable safeguards are therefore needed to minimise tax avoidance.</p> <p>Most of the qualifying conditions (sections 13 to 19 of Schedule 17A of the IRO) are not merely for anti-avoidance. Sections 13 and 18 reflect the characteristics of interest payments and conduit interest payments under conventional debt securities respectively. Sections 14 and 19 reflect the accounting treatments for conventional debt securities and conventional conduit debt securities respectively. They are used to distinguish debt-like sukuk from equity sukuk, thus ensuring that the alleged specified alternative bond scheme is economically equivalent to a typical conventional bond structure. Section 15 is</p>

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		<p>added to encourage sukuk to have a connection with Hong Kong hence promoting Hong Kong's financial market development. The qualifying conditions will apply to the SDO by virtue of the proposed section 47C and 47D of the SDO.</p>
<p>Section 47F(3) of SDO</p>	<p>The proposed security arrangement may be further relaxed or removed. Please clarify whether the security can be achieved by registering a first charge over the assets in question.</p> <p><i>[LawSoc; EY]</i></p>	<p>The proposed security arrangement is necessary to protect the revenue in case a previously granted tax relief is withdrawn due to any disqualification.</p> <p>CSR is prepared to accept a security which may include a registered first legal charge on the leasehold property, a pledge of quoted shares or a bank guarantee. The operation will be elaborated in a Practice Note issued by CSR. These options will provide flexibility to originators or bond-issuers in complying with this requirement, and minimise their costs.</p>