For Information

Legislative Council Panel on Financial Affairs

Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012

Supplementary Information

The Administration briefed the Panel at its meeting on 5 November 2012 on the proposed legislative amendments to be contained in the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012 ("the Bill"). The Bill, which was gazetted on 28 December 2012[1], seeks to provide a comparable taxation framework for Islamic bonds ("sukuk") vis-à-vis conventional bonds, in order to facilitate the development of a sukuk market in Hong Kong.

2. In response to Members' interest in Islamic finance and some queries raised at the said meeting, this paper provides supplementary information on the following aspects –

(a) potential economic benefits and risks in relation to the development of a sukuk market and the proposed taxation framework;

(b) potential implications for conflict of laws in relation to sukuk transactions;

(c) experiences of other financial markets in their tax law reforms to facilitate sukuk issuances;

(d) operation of the proposed "reasonable commercial return" condition;

(e) investor protection;

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1 A Legislative Council brief (file ref: B9/33/2C) on the Bill was issued on 24 December 2012.

(f) training and manpower matters; and

(g) outcome of the public consultation exercise conducted by the Administration in March 2012.

Potential Economic Benefits and Risks

3. The Bill is the Administration's positive response to market views that the present tax laws may restrict the development of a sukuk market in Hong Kong and affect the competitiveness of Hong Kong vis-à-vis other financial centres in this regard. It is observed that global Islamic financial assets have expanded from US$150 billion in the mid-1990s to US$1.3 trillion in 2011. Market players have also pointed out that the demand for sukuk has been increasing in recent years, likely driven by the abundant liquidity accumulated in the Middle East and investors' preference for diversifying financial assets amidst global economic uncertainty and the European sovereign debt crisis. In particular, the first half of 2012 saw an impressive 40% year-on-year growth for global sukuk issuances. It has been estimated that, as at the end of 2012, the global volume of outstanding sukuk should have exceeded US$220 billion.

4. Since 2006, six sukuk totalling US$5.8 billion have been listed on the Stock Exchange of Hong Kong. Other sukuk have also been marketed in Hong Kong and other parts of Asia through private placements, including some Renminbi-denominated sukuk which are increasingly drawing investors' interest. These transactions have predominantly been taken place at an institutional level.

5. Given our role as a leading international financial centre and China's global financial centre, Hong Kong has the advantage of matching the needs of fund raisers and investment demand of investors among China, the Middle East and other parts of the world interested in Islamic financial products. Even though it is impossible to quantify the incremental economic benefits which the Bill may give rise to, the development of a sukuk market in Hong Kong will help diversify the

types of products and services available to our financial markets. The proposed removal of this impediment in our tax laws will likely be welcomed by the market as an initiative to enhance the competitiveness of our financial services industry and promote our asset management business.

6. All financial products involve risks. It is important for such risks to be properly disclosed to investors to enable them to make an informed choice in relation to portfolio management. It is equally important for the regulators, when authorising investment products to be offered to the public and supervising the business conduct of intermediaries, to require that the relevant risks are properly managed and that the intermediaries are fit and proper. We are also concerned about the risks that transactions may be artificially structured for purely tax avoidance motives. These issues are further addressed in paragraphs 12-16 of this information paper.

Potential Implications for Conflict of Laws

7. The Bill adopts a religion-neutral approach in drafting, and does not make specific references to Shariah terminologies. This prescriptive approach will ensure that we will not unnecessarily import Shariah principles to interpretation of Hong Kong tax laws under the legal system of Hong Kong.

8. In general, if a contractual dispute involving a cross-border implication of legal systems is brought before a Hong Kong court, the court will determine the proper forum (i.e. whether a Hong Kong court is the appropriate forum to adjudicate the dispute) and the proper law (i.e. which legal system's substantive law the court will apply to specific questions that arise in the dispute). Where the parties have agreed on the choice of forum and the choice of law governing the contract, the court will normally give effect to them. As far as sukuk issuances are concerned, most offering circulars we have come across include jurisdiction clauses (or forum clauses) and governing law clauses (or choice of law) clauses, and in many such cases the parties to cross-border Islamic financial transactions have identified English court and English

law as the relevant choices. We believe the question on whether the law of a particular system should prevail in a legal dispute will depend on the choice and circumstance of a specific case. The Bill, which essentially concerns the tax treatment of sukuk under our tax laws, does not seek to change the law governing the existing arrangements.

Tax Law Reforms in other Jurisdictions

9. Malaysia, the United Kingdom, Singapore, Japan and France are among those jurisdictions which have amended their tax laws to provide the necessary clarity to facilitate issuance of sukuk, to level the playing field between comparable instruments in terms of tax treatment, or to provide other types of tax reliefs or incentives. The coverage of the tax treatment in each jurisdiction may vary - some of these jurisdictions cover only specified types of sukuk, while some others like Malaysia (with an established market for Islamic finance) cover a range of other Shariah-compliant financial transactions in addition to sukuk.

10. Notwithstanding that the taxation frameworks in different legal systems vary and that a direct comparison may not be appropriate, a common approach is to compare a sukuk arrangement to a conventional bond arrangement for taxation purposes.

11. The Administration has considered relevant overseas developments and market demands, vis-à-vis the existing frameworks in the Inland Revenue Ordinance and Stamp Duty Ordinance, in formulating the Bill.

Operation of the "Reasonable Commercial Return" Condition[2]

12. As in all tax law proposals, we need to ensure that reasonable safeguards are put in place to minimise tax avoidance. As far as the Bill is concerned, one of the proposed qualifying conditions is

[2] We have used the term "limit on return" condition when we introduced the legislative proposal to the Panel on Financial Affairs on 5 November 2012 (see LC Paper No. CB(1)91/12-13(02)). In order to better reflect our policy intent, we have renamed the condition as the "reasonable commercial return" condition.

the “reasonable commercial return” condition. In essence, to satisfy this condition, both the maximum total amount of bond return that may be payable to bond-holders under the terms of a sukuk product, and the total amount actually paid to them, must not exceed an amount that would be a reasonable commercial return on money borrowed of the amount of the bond proceeds.

13. The proposed “reasonable commercial return” condition does not mean 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. The purpose of this test (which will have regard to the return usually payable to holders of typical conventional bonds) is to exclude sukuk, for the purposes of the proposed tax treatment, where the return is blatantly above what would be a reasonable commercial return for a debt security on similar terms and carrying similar risks, or where the return is linked to equity-like returns or profits. The test should not have an impact on the attractiveness of sukuk if their economic substances are essentially similar to conventional bonds.

14. This condition will have to be complied with to the satisfaction of the Commissioner of Inland Revenue / Collector of Stamp Revenue not only at issuance but also during the entire term of an eligible sukuk product, in order for that product to be accorded the tax treatment as proposed in the Bill. The condition will apply to individual sukuk issuance separately even though there can be several series of sukuk issuances under a master issuance programme.

Investor Protection

15. Mainstream sukuk, including those covered in the Bill, is likely to fall within the definition of “securities” in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (“SFO”, Cap. 571). The same disclosure requirements, as well as licensing and conduct regulations for intermediaries, apply in relation to sukuk products, as long as they are “securities”. In such cases, it would be necessary to seek authorization by the Securities and Futures Commission under the SFO on the issuance of any advertisement, invitation or document, which is or

contains an invitation to the public to enter into or offer to enter into an agreement to acquire the relevant sukuk products, unless an exemption applies. If the sukuk is in the form of shares or debentures, the Companies Ordinance ("CO", Cap. 32) also sets out the content and registration requirements for any prospectus, notice, circular, advertisement or other document which offers or invites offers to subscribe for or purchase any shares in or debentures (including bonds) of a company in Hong Kong or a company incorporated outside of Hong Kong. These statutory requirements are implemented so that product issuers are required to make adequate disclosure and thus afford a measure of protection to investors.

16. In view of this, the current regime of the SFO and CO, in terms of authorisation of product and disclosure documents, conduct regulation of intermediaries, and other investor protection provisions, apply to mainstream sukuk, as they apply to other bond products. We will need to examine the product structures and the way it is marketed to exactly determine the application of the relevant legislation to any particular case. While global sukuk transactions are generally carried out at an institutional level, investors will be informed of the risks of sukuk products through the current conduct regulation of intermediaries selling securities products. The Administration intends to invite the newly-established Investor Education Centre to raise the awareness of the public regarding the nature and risks of sukuk and other issues to note when investing in this type of products.

Training and Manpower Matters

17. The Administration and relevant regulators have been working with relevant parties to promote market awareness and knowledge of Islamic finance. For example, the Hong Kong Monetary Authority ("HKMA") has been in close collaboration with international organisations (such as the Islamic Financial Services Board and the International Centre for Education in Islamic Finance) and local industry bodies (such as the Treasury Markets Association) to provide training to market practitioners on this front. Over the past few years, the HKMA has organised seminars covering a wide range of topics such as Islamic

capital markets, Islamic equity funds and indices, Islamic banking, and tax and accounting treatment of Islamic finance transactions. Response from the market has so far been positive.

18. In the process of formulating the Bill, the Administration and relevant regulators have maintained a continuous dialogue with relevant parties in major Islamic financial markets in order to better understand the latest global developments. For example, in September 2012, representatives of the Financial Services and the Treasury Bureau and the HKMA participated in the Global Islamic Financial Forum held in Malaysia and exchanged views with other regulators and market participants on the latest market sentiments and developments (such as tax law reforms like the one being pursued in Hong Kong).

19. We believe that these ongoing interactions will be useful in building interest in Islamic finance activities in Hong Kong. We will continue to work with the market and interested parties to this end.

Outcome of the Public Consultation Exercise in March 2012

20. The Administration launched a two-month public consultation on the proposed legislative amendments in March 2012. Altogether 15 responses were received from a broad range of interested stakeholders (including accounting firms, law firms, banks, financial institutions and professional bodies), some of which may be directly or indirectly involved in the field of Islamic finance. A list of the respondents is set out in **Annex**. The Consultation Conclusions have been published on the website of the Financial Services and the Treasury Bureau (www.fstb.gov.hk/fsb).

21. In gist, a large majority of the respondents welcomed the legislative objectives and proposals as outlined in the consultation paper, with a view to enhancing Hong Kong's competitiveness in financial services and enabling Hong Kong to be a gateway for international Islamic finance. Some respondents have invited the Administration to consider including the "wakalah" structure (an agency arrangement which is becoming increasingly popular in recent years) in the scope of the Bill.

Some have expressed views on the operation and intent of the qualifying conditions (for example, the “reasonable commercial return” condition as referred to in paragraphs 12-14), record-keeping and other procedural matters.

22. The market is in general in favour of the Administration taking a reasonable approach in providing tax relief for genuine sukuk products, in order to remove an impediment perceived by the market to sukuk issuances in Hong Kong. The Administration has taken on board many useful suggestions and comments, after balancing relevant perspectives (in terms of market development, evolving market needs, and anti-tax avoidance policy considerations), in finalising the provisions as contained in the Bill. We have responded to the detailed comments in the Consultation Conclusions.

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

Financial Services and the Treasury Bureau
January 2013

<u>Annex</u>

List of Respondents
in the Public Consultation Exercise in March 2012

- CIMB Islamic Bank Berhad
- Citibank, N.A., Hong Kong Branch
- Clifford Chance
- Ernst and Young Tax Services Limited
- HSBC
- KPMG Tax Limited
- Labuan IBFC
- The Hong Kong Association of Banks
- The Hong Kong Institute of Certified Public Accountants
- The Law Society of Hong Kong
- The Taxation Institute of Hong Kong
- The Treasury Markets Association
- Standard Chartered Bank
- PricewaterhouseCoopers Ltd.
- Mr. Wong Yuen-shan