For discussion
on 5 November 2012

Legislative Council Panel on Financial Affairs

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

Purpose

The Administration is formulating the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill ("the Bill"), which seeks to provide a comparable taxation framework for Islamic bonds ("sukuk[1]") vis-à-vis conventional bonds, in order to facilitate the development of a sukuk market in Hong Kong. This paper briefs Members on the proposed legislative amendments.

Islamic Finance Development

2. It has been the Administration's policy objective to develop a conducive platform to enable the development of Islamic finance[2] in Hong Kong. This will help diversify the types of products and services available to our financial markets, and consolidate Hong Kong's status as an international financial centre and asset management centre.

3. Islamic finance is amongst the fastest growing segments in the international financial system, with a presence in both Muslim and non-Muslim communities. Globally speaking, Islamic finance assets

[1] "Sukuk" is a generic term used to encompass a broad range of financial instruments designed to conform with the principles of Islamic law ("Shariah"). The Shariah prohibition on interest means that the creation of a purely debt based saleable security is not possible. Sukuk are often structured in a way so as to generate the same economic effects as conventional bonds, but in a Shariah-compliant manner. This is achieved through the use of assets and various contractual techniques to conform with Shariah principles. Sukuk issuers will use sukuk proceeds to acquire assets with a view to generating income or gains to fund coupon payments to sukuk holders. At the end of the sukuk term, issuers will dispose of any remaining assets and redeem the sukuk certificates.

[2] The term "Islamic finance" encompasses any type of financial activity that is undertaken in accordance with Shariah.

have expanded from US$150 billion in the mid-1990s to US$1.3 trillion in 2011. The number of Islamic financial institutions has increased to over 600 in more than 75 economies. Market capitalisation of Dow Jones Islamic Market World Index reached US$14.5 trillion in September 2012.

4. Sukuk are one of the most prominent instruments used in Islamic finance, and have been typically issued by some corporates or sovereigns in order to raise funds in the domestic or international capital markets. As at end of 2011, the global volume of outstanding sukuk topped US$178 billion, as the year witnessed record high new sukuk issuances of US$85 billion. The first half of 2012 saw an impressive year-on-year growth for global sukuk issuances by 40%. Market expects that, by the end of this year, the global volume of outstanding sukuk will exceed US$220 billion.

5. Hong Kong has developed a highly liquid capital market with a large presence of international financial intermediaries, a well-established market infrastructure, a sound legal system, a transparent regulatory framework, and a low and simple tax regime. 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. Hence, we are well placed to promote a sukuk market in Hong Kong as a first step in developing Islamic finance[3].

6. Major jurisdictions, such as Malaysia, the United Kingdom ("UK"), Singapore, Japan and France, have amended their tax laws to catch up with the innovations of this rapidly expanding market. Since sukuk have more complex product structures than their conventional bond counterparts (that is to say, sukuk are usually structured with special purpose vehicles and multiple asset transfers), they may attract additional profits or property tax exposures, or stamp duty charges under our tax laws. We observe that tax reforms in most other jurisdictions aim to provide the necessary clarity in tax laws to facilitate issuance of sukuk and to level the playing field between comparable instruments in terms of tax treatment.

[3] For example, the investment holding arm of a sovereign has issued a US$358 million exchangeable sukuk in March 2012 and listed it on the Stock Exchange of Hong Kong. That issue was well received by investors, recording an over-subscription rate of about three times. In addition, a Malaysian bank has launched its Islamic banking window in Hong Kong in 2008 to serve its client base.

The Bill

7. In the case of Hong Kong, the Administration aims to introduce amendments to the Inland Revenue Ordinance (Cap. 112) ("IRO") and Stamp Duty Ordinance (Cap. 117) ("SDO") to provide a comparable tax framework that caters for the issuance of sukuk, thereby removing an impediment perceived by the market to developing a sukuk market in Hong Kong.

8. The Bill will not confer special tax favours on the Islamic finance sector. We are simply ensuring that financial instruments of similar economic substance are afforded similar tax treatments. In addition, the Bill will not make specific references to Shariah terminologies, and will adopt a religion-neutral approach in drafting. We will use the term "alternative bond scheme" ("ABS"), instead of "sukuk", to denote the specified arrangements to which the proposed tax treatment should apply[4].

Coverage

9. Sukuk are innovative financing instruments, and can have a wide range of underlying structures. The Bill will specify the following types of arrangements to cover five most common types of sukuk product structures in the global market, and will prescribe their major features and characteristics –

(a) <u>lease arrangement</u> ("Ijarah"): a bond-issuer[5] to enter into a lease in respect of an acquired asset with an originator to generate investment return[6];

(b) <u>profits sharing arrangement</u> ("Musharakah" and "Mudarabah"): a bond-issuer to enter into a business undertaking with an

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[4] The same law drafting approach was taken in the UK. The term "alternative finance investment bond" is used in the relevant UK legislation.

[5] In a typical sukuk structure, an originator is the party which is in need of funding and therefore sets up a special purpose vehicle for the purpose of issuing sukuk certificates to obtain proceeds from sukuk holders. The special purpose vehicle, sukuk certificates and sukuk holders are known as "bond-issuer", "alternative bonds" and "bond-holders" respectively in the context of the Bill. And in this regard, an ABS comprises a "bond arrangement" (under which a bond-issuer issues alternative bonds to bond-holders to raise funds) and an "investment arrangement" (under which the bond-issuer uses bond proceeds to enter into some specified business arrangement with an originator with a view to generating income or gains to fund coupon payments to bond-holders).

[6] These investment returns will be used to fund coupon payments to bond holders.

originator to carry on business activities to generate investment return;

(c) purchase and sale arrangement ("Murabahah"): a bond-issuer to sell an asset to an originator with a markup to generate investment return; and

(d) agency arrangement ("Wakalah"): a bond-issuer to appoint an originator as its agent to manage an acquired asset to generate investment return.

10. The graphical illustrations of the product structures of these ABS are shown at **Annex**. We understand from market practitioners that around 95% of global sukuk issuances in 2011 and the first half of 2012 were based on these sukuk product structures. The market has also pointed out to us that the tax laws should allow for flexibility to accommodate other types of ABS as new sukuk product structures become popular, in order not to hinder market development. To address these market concerns, we propose to include a clause in the Bill to empower the Financial Secretary to expand the coverage of eligible ABS to respond to evolving market developments, by way of subsidiary legislation[7] in future.

Qualifying Conditions

11. We need to ensure that -

(a) a prospective ABS is economically equivalent to a typical conventional bond structure, hence its eligibility for the proposed tax treatment under Hong Kong tax laws;

(b) reasonable safeguards are put in place to minimise tax avoidance; and

(c) the proposed taxation framework would encourage the sukuk benefitted thereunder would have a nexus with Hong Kong, hence directly promoting our financial market development.

12. Therefore, we propose to prescribe in the Bill a set of qualifying conditions for a prospective ABS –

[7] This will be subject to negative vetting of the Legislative Council.

(a) <u>“limit on return” condition</u>: Both the maximum total amount of the bond return that may be payable to the bond-holders under the terms of the scheme 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;

(b) <u>“ABS as financial liability” condition</u>: The bond arrangement and the investment arrangement must be treated as a financial liability of the bond-issuer and the originator respectively in accordance with either the Hong Kong Financial Reporting Standards or International Financial Reporting Standards;

(c) <u>“maximum term length” condition</u>: The term of the ABS must not be longer than 15 years[8];

(d) <u>“arrangements performed according to tenor” condition</u>: The ABS is performed according to the features and characteristics as prescribed in the Bill;

(e) <u>“bond-issuer as a conduit” condition</u>: Under the terms of the scheme, the maximum total amount of the investment return that may be receivable by the bond-issuer must not exceed the maximum total amount of the bond return payable to bond-holders. And the total amount of the investment return actually received by the bond-issuer must not exceed the total amount of the bond return actually paid to bond-holders; and

(f) <u>“connected with Hong Kong” condition</u>: The alternative bonds must be listed on a stock exchange in Hong Kong, or issued bona fide and in the course of carrying on business in Hong Kong, or marketed in Hong Kong, or lodged with and cleared by the Central Moneymarkets Unit operated by the Monetary Authority.

Proposed Tax Treatment

13. The Bill will provide for certainty of the tax position of two

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[8] 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. To address future demand and evolving market needs, the Bill will propose a clause to enable the Financial Secretary to amend the term length limit by way of subsidiary legislation (subject to negative vetting by the Legislative Council) in future.

aspects of a typical ABS, namely (a) the “alternative bonds” issued by bond-issuer to bond-holders, and (b) the “investment arrangement” between an originator and the bond-issuer. The underlying principle is to treat a prospective ABS that meets the qualifying conditions as a conventional bond arrangement for the purposes of the IRO and SDO, and to apply the comparable tax treatments accordingly subject to the necessary modifications to relevant provisions of the IRO and SDO.

14. As regards the “alternative bonds”, the Bill will provide that bond proceeds paid by bond-holders to the bond-issuer are to be regarded as money borrowed by the bond-issuer from the bond-holders, and the coupon payments payable by the bond-issuer to the bond-holders are to be regarded as interest payable on such money borrowed. Consequently, the relevant tax implications are as follows –

(a) the tax concession and exemption for qualifying debt instruments under sections 14A and 26A of the IRO will apply accordingly to eligible alternative bonds;

(b) coupon payments payable to the bond-holders on the alternative bonds will be accorded the same treatment, for deductions, under section 16(2)(f) of the IRO that apply to interest payable on conventional bonds;

(c) the list of specified transactions in Schedule 16 to the IRO will be expanded to cover the alternative bonds for the purposes of exempting certain profits of non-residents from tax under section 20AC of the IRO;

(d) the alternative bonds are not to be regarded as a mutual fund, unit trust or similar investment schemes for the purposes of section 26A of the IRO;

(e) the alternative bonds will be treated as certificates of deposit for the purposes of section 15(1)(j), (k) and (l) of the IRO, and any disposal gains before maturity and the premium / discount element received on maturity will be treated as trading receipts for profits tax purposes unless they can fall within the qualifying debt instrument scheme to which section 14A will apply; and

(f) transfer of an alternative bond will not be subject to stamp duty charges on Hong Kong stocks in most cases under the SDO, as it will be regarded as "loan capital" as defined in section 2 of the SDO.

15. As regards the "investment arrangement" between an originator and a bond-issuer (in relation to the underlying assets of the ABS), the acquisition cost of the assets is to be regarded as the money borrowed by the originator from the bond-issuer. The investment return is to be regarded as interest payable on the money borrowed by the originator from the bond-issuer. Consequently, the relevant tax implications are as follows –

(a) certain asset transactions[9] (i.e. acquisition, leasing and disposal) between the originator and the bond-issuer, or between the originator and the business undertaking (entered into between the originator and the bond-issuer), are to be disregarded for the purposes of profits tax and stamp duty under the IRO and SDO[10] respectively. In these cases, the originator is to be regarded as the owner of any asset acquired, and hence any income, expenditure (including depreciation allowances), profits, gains or losses arising from or attributable to the asset will belong to the originator for tax purposes; and

(b) any investment return (e.g. rentals paid by the originator to the bond-issuer) is not to be regarded as a consideration payable in respect of the right of use of land and / or buildings for the purposes of property tax under section 5B of the IRO.

Assessment and Other Procedural Matters

16. The Bill will provide for relevant assessment and procedural matters to address tax avoidance concerns. We will modify the existing sections 51C and 51D of the IRO, and add new provisions to the SDO, to

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9 These transactions will normally not exist but for the purposes of establishing an ABS, and thus attracting additional tax exposures which are otherwise irrelevant to a conventional bond structure. The Bill will propose a clause to empower the Financial Secretary to specify relevant transactions to be likewise disregarded by way of subsidiary legislation (subject to negative vetting by the Legislative Council) to provide tax relief for eligible ABS and cater for market developments.

10 This essentially means that stamp duty under heads 1(1), 1(1AA), 1(1A), 1(1B), 1(2), 2(1), 2(3), and 2(4) in the First Schedule to, and under section 29D(2)(a) of the SDO is not chargeable on instruments executed in relation to transactions of Hong Kong immovable property or Hong Kong stock between the originator and the bond-issuer, or between the originator and the business undertaking.

allow a reasonable record-keeping period[11] imposed on any originator or bond-issuer of the ABS eligible to the tax relief. They will be obliged to inform the Commissioner of Inland Revenue and the Collector of Stamp Revenue of any disqualifying event, which may lead to the withdrawal of the relief granted in its entirety under the IRO and SDO[12]. A security will be required in respect of the payment of stamp duty charge to reduce the risk of irrecoverable duty in the event of any withdrawal of stamp duty relief.

Public Consultation

17. The Administration conducted a two-month public consultation on the draft provisions to be included in the Bill in March 2012. Altogether 15 responses were received from a broad range of interested stakeholders. A large majority of respondents welcomed the legislative proposals, with a view to enhancing Hong Kong's competitiveness in financial services and enabling Hong Kong to perform as a gateway for international Islamic finance. We have taken on board many useful suggestions and comments, after balancing relevant perspectives (in terms of market development, evolving market needs, and anti-avoidance policy considerations), in contemplating the draft provisions in respect of coverage, qualifying conditions, other procedural matters and obligations, as explained in the preceding paragraphs. We have issued a Consultation Conclusion to address these suggestions and comments on 29 October 2012[13].

Way forward

18. The Administration is finalising the Bill with a view to introducing it to the Legislative Council in early 2013.

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[11] For the purposes of the IRO, the Bill will seek to require relevant documents to be kept for a period extended to "3 years after the end of the ABS term" or "7 years after the relevant transaction", whichever is longer. For the purposes of the SDO, the Bill will require relevant documents to be kept until the expiry of a period of 1 year after the end of the ABS term.

[12] In this regard, sections 60 and 79 of the IRO will be modified to suitably lengthen the usual time period within which the Commissioner of Inland Revenue may raise additional assessment or refund tax paid in excess.

[13] The Consultation Conclusion has been uploaded to the homepage of the Financial Services and the Treasury Bureau (http://www.fstb.gov.hk/fsb).

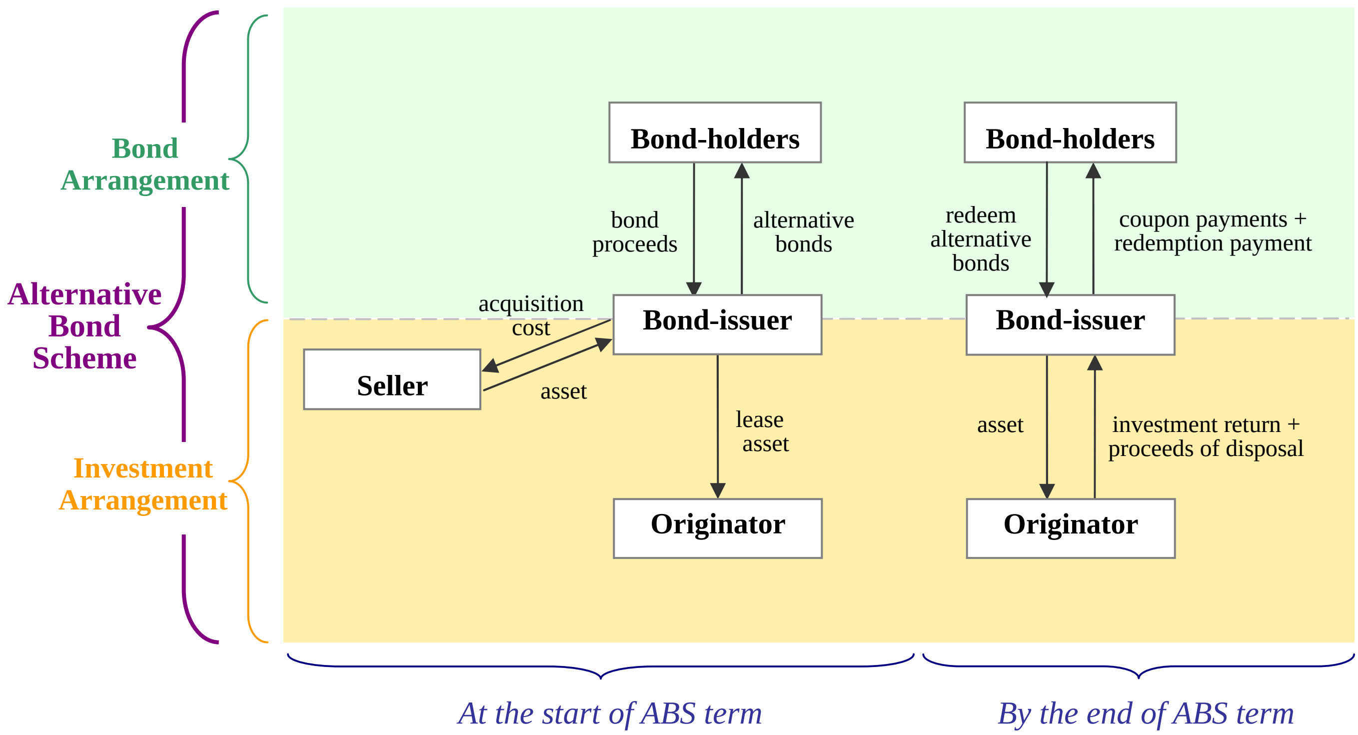
19. Members are invited to note the legislative proposal outlined in this paper.

Financial Services and the Treasury Bureau
29 October 2012

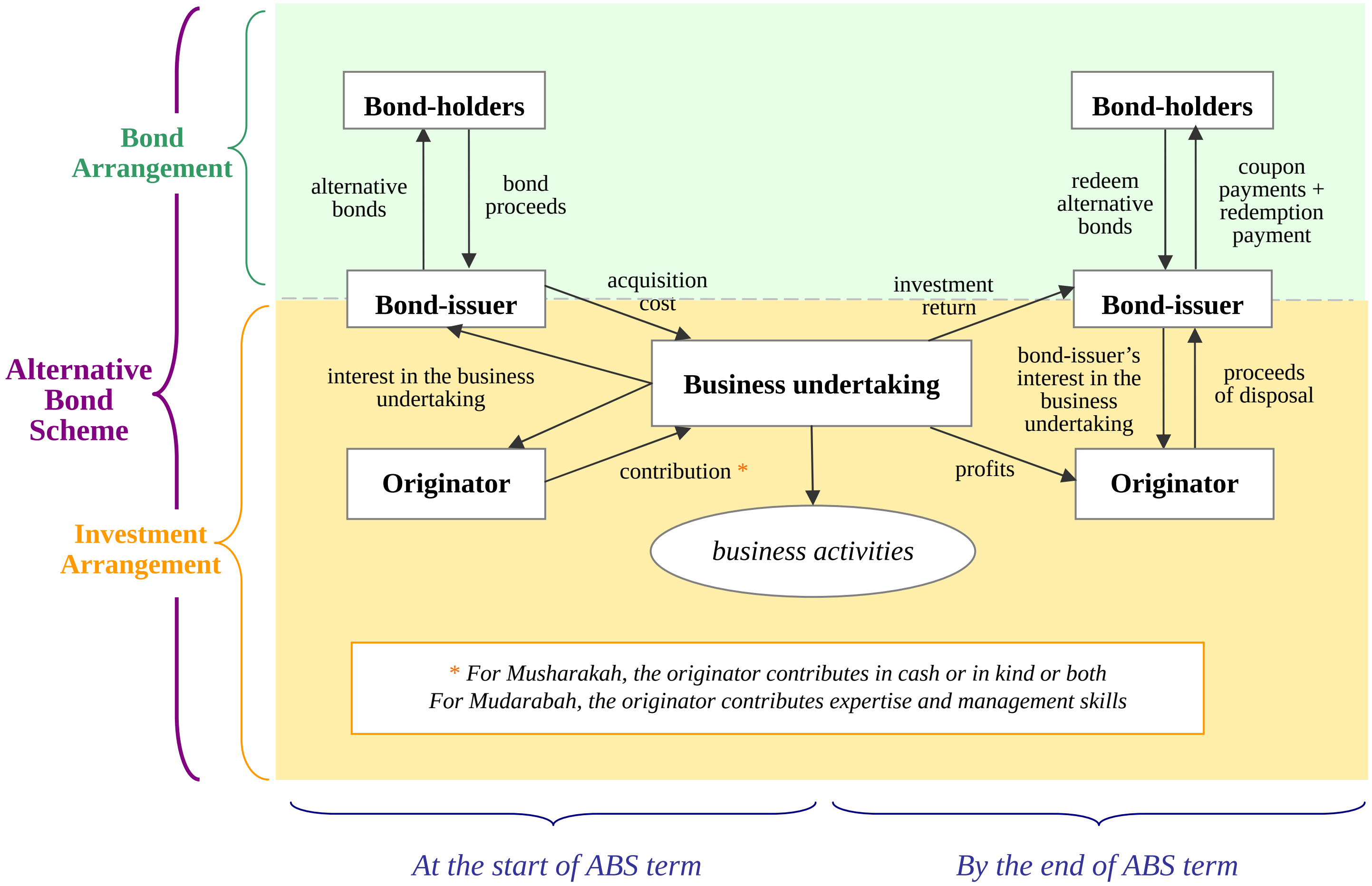
Annex

Common Product Structures of Sukuk

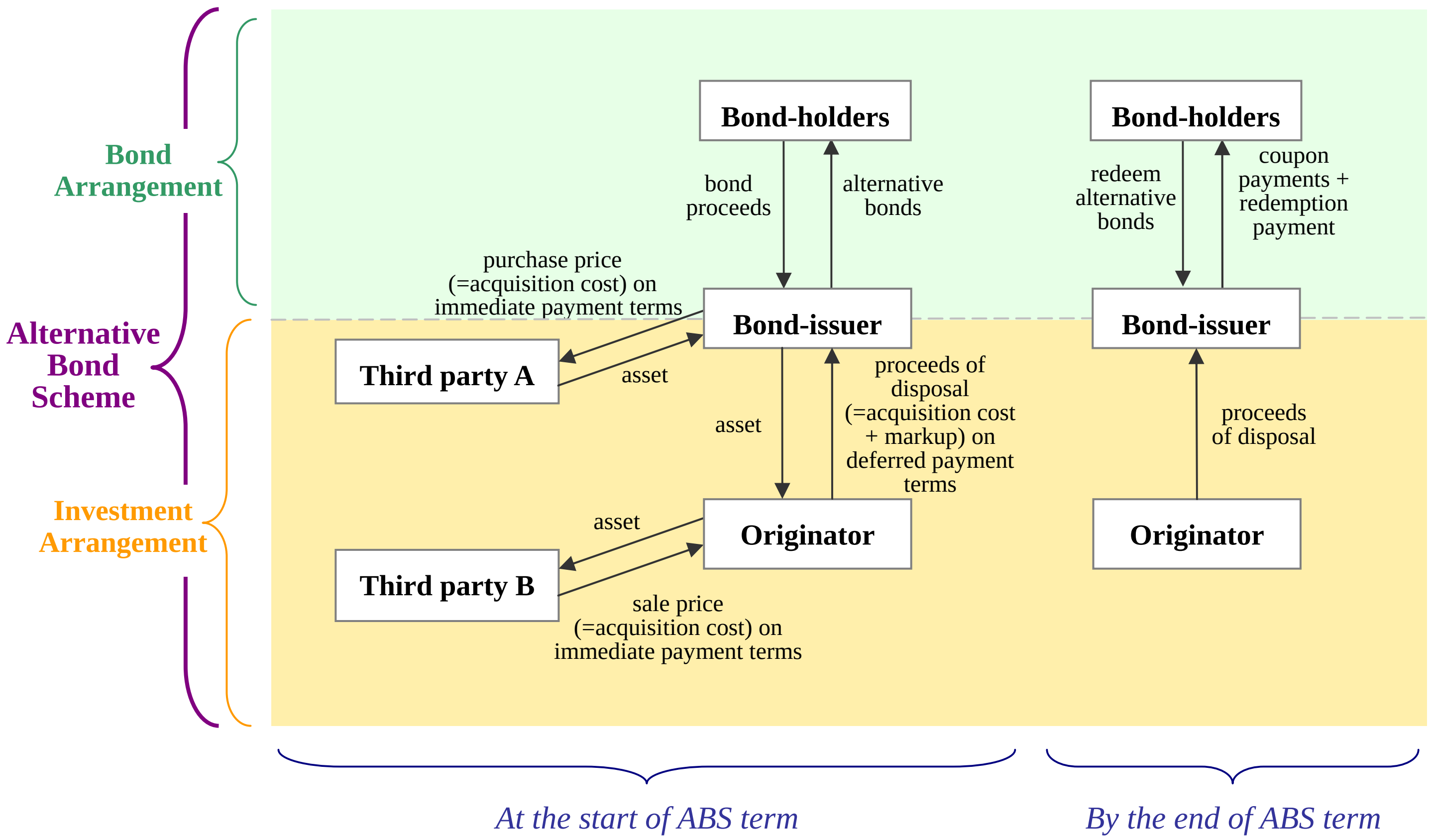
1. Diagram illustrating the key features of ABS structured on the basis of lease arrangement ("Ijarah")



2. Diagram illustrating the key features of ABS structured on the basis of profits sharing arrangement (“Musharakah” and “Mudarabah”)



3. Diagram illustrating the key features of ABS structured on the basis of purchase and sale arrangement ("Murabahah")



4. Diagram illustrating the key features of ABS structured on the basis of agency arrangement ("Wakalah")